Outlook 2016: Asia ex Japan Equities

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For the year ahead, our preferred areas for investment are companies with strong cash flows and, in this low earnings growth environment, low cost producers that also have a flexible cost base.

Looking back on 2015, Asian stockmarkets have had a challenging year as slowing global and emerging market growth, particularly in China, have weighed on investor sentiment. However, in retrospect, the beginning of 2015 bore striking similarities to the previous year when brokers were also recommending clients buy into China. In 2015, the advice came at the start of a clearly unsustainable run-up in Chinese A-share markets. We look with interest to see what recommendations will be for 2016.

In our view, the key is to ignore the market noise in Asia. Our warnings of a bubble driven by margin lending were vindicated when stock prices duly collapsed in the middle of the year. This further reinforced our view that investing in the region requires seeking out quality companies that provide consistent shareholders returns and which trade at reasonable valuations.

Asia continues to offer significant structural advantages in terms of growth potential over the longer term, but there are short-term headwinds that need to be factored into investment decision making. Asian companies are faced with three key global trends which will impact the landscape: demographics, deflation and disruption.

Disruption in Asia

The Volkswagen (VW) diesel emissions scandal that was uncovered in September may at first glance look like an issue that only impacts European car manufacturers, but we believe this is part of a wider global trend where watershed moments for industries can be the ringing of dire warnings for certain companies. It is also a prime example of an event where “disruptors” can benefit from the downfall of industry incumbents. In the case of autos, the VW scandal has the potential to accelerate the long-term shift of the “old” car industry, dominated by petrol and diesel, to one where electric vehicles and hybrids dominate.

In a world where technological change is moving increasingly fast, this shift is just as applicable in Asia as it is in Europe. Long-term winners could include Taiwanese and Hong Kong technology companies (as electric cars are electronic products) while losers may end up being the current original equipment manufacturers (OEMs) that provide autos with parts, and oil companies.

If our predictions end up being correct, then OEMs and oil companies could turn out to be value traps – much like Asian department stores and supermarkets that have seen their market shares, and profits, eroded by online competitors. The point is that anticipating this disruption will be key to long-term returns and no industry in the region will be immune from it.

Surely Asian markets are cheap?

The main question we keep getting asked by clients is “are Asian markets cheap?”. Our response remains “not as cheap as you probably think”. This has been treated with some incredulity given the disappointing performance of Asian markets this year and indeed for the last five years, where returns on the main MSCI All Country Asia Pacific ex Japan index have effectively been zero in US dollar terms. When a lot of the banks and commodity stocks, of questionable value, are removed from indices, the resulting price multiples are in line with long-term averages (see charts below). Furthermore, many of the quality consumer and domestic names that we are really keen on are still expensive.

Chart 1: Stockmarkets look cheap on paper

Source: DataStream, MSCI, CLSA, as at 16 October 2015

Chart 2: But unfortunately not that cheap when questionable banks and commodity stocks are removed

Source: DataStream, MSCI, CLSA, as at 16 October 2015

The problem remains that a combination of overinvestment, excessive leverage, weak end demand and major technological disruption has, and is still, causing significant headwinds for Asian corporate earnings. This has caused a major compression in return on equity (ROE) in the region.

To get a sustained recovery in Asian stockmarkets we are going to need better earnings and returns on invested capital. For this we are going to have to see a return of inflation and economic growth, and some creative destruction of excess capacity.

Where are the opportunities?

We continue to be relatively cautious on the Asian equity outlook as we head into 2016. We can still find enough ideas to remain close to fully invested, however, clients should be reasonable about likely returns given rerating potential is low. Our caution stems from our view that deflationary forces and the sluggish global economy are headwinds for Asian stockmarkets. Deflation is also not good if you have excessive amounts of debt – significant leverage has been added since the Global Financial Crisis, particularly in the corporate sector in Greater China. We do not see Asian stockmarkets enjoying a deflationary boom as sluggish investment and consumption mean return on invested capital (ROIC) is likely to remain under pressure. Asian stockmarket returns have been disappointing as too many companies focus on growth rather than ROIC.

We can find quality investment opportunities in the region but it is difficult and involves ignoring large parts of the market index or “beta”. Our preferred areas for investment are companies with strong cashflows and, in this low earnings growth environment, low cost producers that also have a flexible cost base. We continue to like companies that are able to tap into the growing trend of

urbanisation and the rise of the middle class.

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