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POINT**

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Asia ex-Japan Equities **FIVE KEY THEMES FOR ASIA EQUITIES IN 2018**



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KEY POINTS

- The outlook for Asia in 2018 appears positive, supported by ongoing global growth and improving demand. We have identified five key themes that we believe will be particularly influential for Asia ex-Japan equities over the coming year.
- Chinese market reform is likely to be a key influence in 2018, as President Xi Jinping looks to push through his ambitious reform agenda. Meanwhile, the worry for investors is the potential impact that this might have on near-term growth.
- The Asian consumer remains a major investment theme. Populations continue to grow, wealth is increasing, and household leverage is also rising, particularly in China, all of which is resulting in significant changes in patterns of consumption.
- The rapid advancement in new technologies is another pivotal theme in Asia, in 2018 and for many years to come. Innovation in areas such as automation, augmented reality, and artificial intelligence means that these areas now represent the new frontier in technology advancement.
- The potential impact of rising U.S. interest rates is also significant for Asia in 2018. Historically, a tightening U.S. monetary policy environment has been problematic for Asian economies. However, the landscape today is very different, with Asia less beholden to U.S. rate decisions. Should U.S. rates move too quickly, however, Asian economies could come under pressure.
- Finally, while somewhat overshadowed by China's reform ambitions, India's government also appears committed to pushing through important market improvements. While execution has been an issue in the recent past, this is set to be another influential theme in Asia in 2018.

The Asia ex-Japan region has been a major beneficiary of the ongoing global economic growth story. This was duly reflected on the equity markets in 2017, with Asia ex-Japan equities outperforming all other major global equities markets. We see a continuation of this improving demand environment, underpinning our optimistic

outlook for the Asia region in 2018. In this article, we have identified five key themes that we believe will be particularly influential for Asia ex-Japan equities over the coming year.

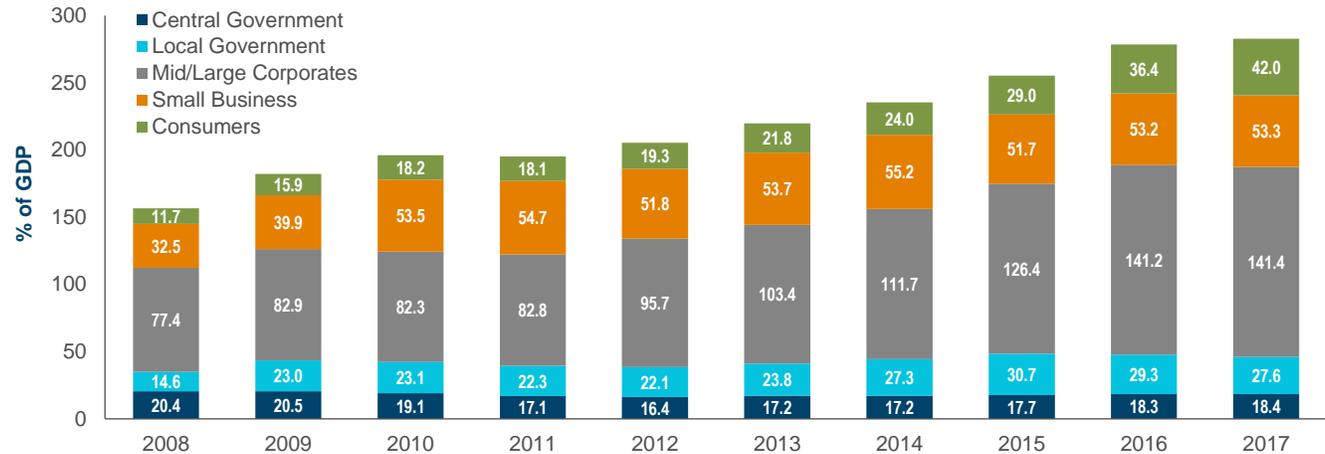
1. CHINESE MARKET REFORMS

With President Xi Jinping emerging from the recent Communist Party of China conference with his power notably enhanced, the way now seems clear for him to press ahead with his ambitious reform agenda. Principal objectives in this regard include reducing China’s high level of corporate debt as well as delivering much-needed supply-side reform.

Indeed, efforts aimed at deleveraging China’s corporate sector have been underway for some time, and while there remains plenty to do, progress is being made. For example, where China’s state-owned enterprises (SOEs) are concerned, actions including shutting down inefficient producers, encouraging mergers and acquisitions, and even allowing some companies to fail rather than being constantly propped up with more debt are having an effect, at least in preventing any further deterioration in the debt burden (Figure 1). Meanwhile, China’s superior economic growth rate means that the existing debt can be more easily serviced going forward.

Figure 1: China Debt-to-GDP Breakdown, % of GDP

As of December 31, 2017



Source: Morgan Stanley.

In terms of supply-side reform, once again progress is being made as the government looks to remove excess capacity in the form of inefficient and unprofitable SOEs. Over the past two years, reductions in excess capacity in the coal and steel industries, for example, have been achieved at a faster-than-anticipated rate. More broadly, the focus on supply-side reform, and particularly on corporate deleveraging, reflects a shift toward a more market-driven environment in China. This, in turn, is creating better risk/reward opportunities for investors.

Indeed, the improved discipline being shown by Chinese companies has created a new opportunity set for investors, and we have increased our exposure to Chinese stocks, particularly more cyclical names and companies with industry-leading positions. One such example is our holding in a Chinese pharmaceutical business. The company is a leader in the area of Chinese traditional medicine with a highly recognized brand. It is also a direct beneficiary of SOE reform, rallying strongly during 2017 after a large stake in the business was sold to private enterprise.

The Chinese government has made it clear that pushing through potentially painful reform measures is a key priority. Accordingly, this could have negative implications for the economy in the near term (though growth will likely still be healthy!). It was interesting to note that, in a break from recent tradition, President Xi failed to set an

annual growth target at the recent Communist Party conference. This seems to support the view that he is more concerned about securing China's long-term economic health and stability than he is about hitting any short-term growth targets/expectations. Indeed, if President Xi can push through many of these painful reforms now, this should be positive for China's longer-term economic prosperity and market value.

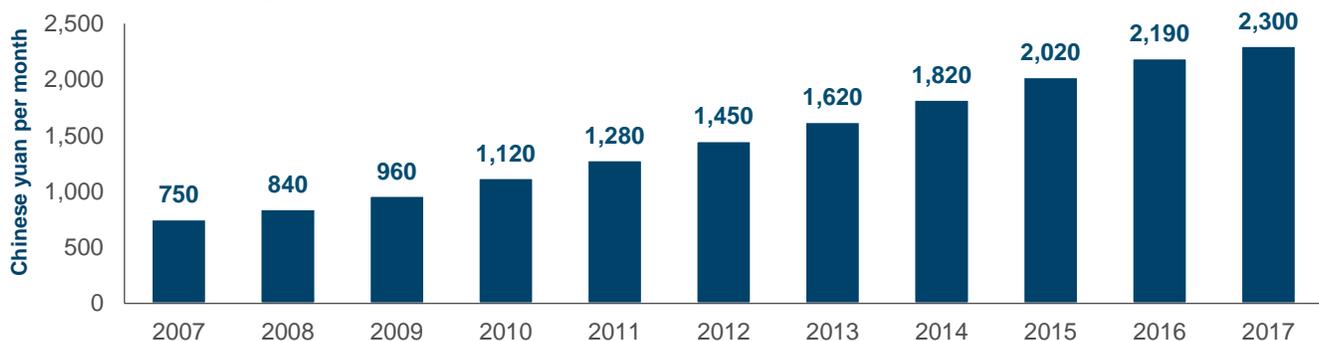
2. THE ONGOING INFLUENCE OF THE ASIAN CONSUMER

Unsurprisingly, the Asian consumer remains a major investment theme. Populations continue to grow, with almost half the world's population situated in China and India alone. Wealth is increasing while household leverage also continues to rise, particularly in China. Not only is this leading to broader penetration across a wider range of goods and services, it is also changing consumption patterns.

For example, in the past China's household sector has been characterized by relatively low levels of debt. However, this is changing, and the increase in the level of household debt over the past decade is a major shift, with significant knock-on implications for consumption. What's more, despite the increase over the past decade, household debt is still at a relatively low level in China. With this in mind, we believe that the Chinese consumer, in particular, has the potential to drive the next phase of growth in Asia for years to come. Certainly, the growth in income evident in China appears to underpin this upbeat outlook. For the past two decades China has managed to push through substantial minimum wage increases every year, in the region of 7% to 8%, broadly across the country (Figure 2). Indeed, China's growth in median income rate is one of the highest in the Asia region, if not the world, and this continues to act as a consumer stimulus for the economy.

Figure 2: Growth in China's Minimum Wage is a Government Priority

China minimum monthly wages, as of December 2017



Source: Tradingeconomics.com.

The consumer theme is central throughout our Asia equity portfolios. China is now the largest online retail market globally, yet we believe that there is still a long runway to growth. The adoption of online shopping, and the rise of electronic commerce companies such as Tencent and Alibaba, means that Chinese consumers are increasingly turning to the Internet to purchase an ever-growing array of goods and services.

3. TECHNOLOGICAL INNOVATION AND ADVANCEMENT

The rapid advancement and growth in new technologies is another pivotal theme in Asia, one that we believe is set to run for many years. Where once the focus of technology consumers and investors was dominated by traditional computers, tablets, and mobile phones, innovation in areas such as automation, augmented reality, and artificial intelligence means that these areas now represent the new frontier in advanced technology.

Within our Asia portfolios, we look to capture this innovation in various ways. The Internet of things, for example, is a central investment theme, as we aim to capture the rapid growth in network connectivity, including electronics, software, sensors, actuators, and other upstream components that are integral to the ever-increasing connectivity of our physical devices, appliances, cars, and more.

Elsewhere, we look to identify interesting businesses that we believe, by virtue of their unique or innovative technologies, offer a long runway for growth. One example is our investment in a Taiwan-listed manufacturer of high-precision camera lenses and 3D sensors. The company is a major supplier, providing lenses and facial recognition technology that unlock the latest model iPhones.

Another way that we look to capture the rapid growth in areas like artificial intelligence, augmented reality, automation, robotics, and electric vehicles is to play these themes through our exposure to semiconductors. All technologies, from computers and mobile phones through to the new wave of technological innovations, such as electric vehicles and robotics, require microchips in order to function. As such, we hold a large position in a Taiwanese chip producer. We believe the company's leading technology gives it a competitive edge in this growth industry and, as innovation and advancement continue at pace, demand for microchips is only set to increase.

Continuing global growth, improving business conditions, reform measures, and consensus expectations for improved corporate earnings all suggest an upbeat outlook for Asia ex-Japan in 2018.

4. U.S. MONETARY POLICY

Another central theme for Asia in 2018 is the potential impact of rising U.S. interest rates. Historically, a tightening U.S. monetary policy environment has been negative for Asian economies. Rising U.S. interest rates means higher yields on U.S. assets, prompting capital that is invested elsewhere to be repatriated back to the U.S., causing the U.S. dollar to strengthen. In the past, this reversal in international capital flows has tended to result in an abrupt drying-up of external funding in Asian economies, particularly for smaller Southeast Asian nations, and a sharp depreciation of local currencies.

However, the landscape in Asia is very different today. Driven by falling inflation, real interest rates in Asia are at relatively high levels compared with the U.S., meaning Asia does not need to follow in the footsteps of the U.S. Current account deficits of many Asian countries are also in surplus and currencies are broadly stable, providing a solid buffer against increases in U.S. interest rates. As such, unlike in the past, Asian central banks will not necessarily be forced to respond with rate hikes of their own, potentially choking off growth.

If the U.S. rate cycle rises too steeply, however, or at a quicker pace than the market is expecting, then Asian economies will come under pressure. However, our base-case scenario is for a more measured and gradual "normalization" of U.S. interest rates. In this kind of environment, we see Asian economies and markets being minimally impacted.

While we are mindful of certain domestic financial sectors in Asia given their sensitivity to rising U.S. interest rates, at a more general level, we have recently built our exposure to Asian banks, focusing on high-quality franchises. One example we like is not only a leading industry player, but is also a front-runner in terms of incorporating automation and digitalization throughout its business. This is another theme that we look for in prospective investments: namely, companies that are prepared to spend on technology, as this ultimately drives operational and cost efficiencies.

5. INDIA—THE "OTHER" ASIAN MARKET UNDERGOING REFORM

While China's reform agenda might have captured more of investors' attention, it is not the only Asian country to be actively pushing through significant market reforms. India's Prime Minister Narendra Modi has already delivered on a number of his core objectives, including a demonetization scheme designed to reduce corruption and the introduction of comprehensive, single goods and services tax, replacing the complex multiple indirect tax structure that existed previously. The government has also enacted a USD \$32 billion recapitalization of India's

large, state-controlled banks, many of which remain plagued by bad corporate loans. While this was not the major financial system overhaul that some deemed necessary, it was certainly a step in the right direction. The reforms have not always been delivered in the clearest and most constructive manner, leading to confusion and prompting market volatility. However, in our view, there is little doubt that the government is committed to delivering necessary reforms in order to secure India's long-term economic health.

We currently maintain an underweight position in India. With equity valuations that appear demanding in many sectors, we have been content to allocate selectively to the market. While our long-term positive outlook on the market remains intact, we are waiting for signs of revival in the capital expenditure cycle before we make a further allocation to the market.

Continuing global growth, improving business conditions, reform measures, and consensus expectations for improved corporate earnings all suggest an upbeat outlook for Asia ex-Japan in 2018. That said, there are headwinds to contend with, not least being a potential near-term softening in Chinese growth and the risk of U.S. monetary policy tightening at a faster-than-expected rate. However, despite equity valuations in Asia rerating higher over the past year, they remain at a reasonable discount relative to most other major global equity markets. Growth potential plus low relative valuations equal good reason to be optimistic in 2018.

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