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Timely intelligence and analysis for our clients.

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Asia ex Japan Equities

CONVICTION-BASED INVESTING AMID A TOUGHER ASIA ENVIRONMENT

KEY POINTS

- Despite the rally in Asia ex Japan equities over the past two years, valuations remain undemanding, both relative to their own history and compared with global equity indices.
- Certainly, the Asia ex Japan region continues to offer exciting opportunities, in our view, with the ongoing strength of the Chinese consumer being a principal theme. Certain sectors have also clearly lagged the broader market rally in recent years, with a number of good-quality companies now looking appealing on a valuation basis.
- That said, the near-term environment is not without challenges. Earnings pressure, tightening liquidity, rising interest rates, and higher oil prices are all headwinds to contend with in 2018.
- Accordingly, this is an environment suited to research-driven, conviction-based investing. We continue to follow the same, simple approach—identifying quality, cash-generative businesses that are run by capable people and holding these companies so that they can continue to compound growth over time.

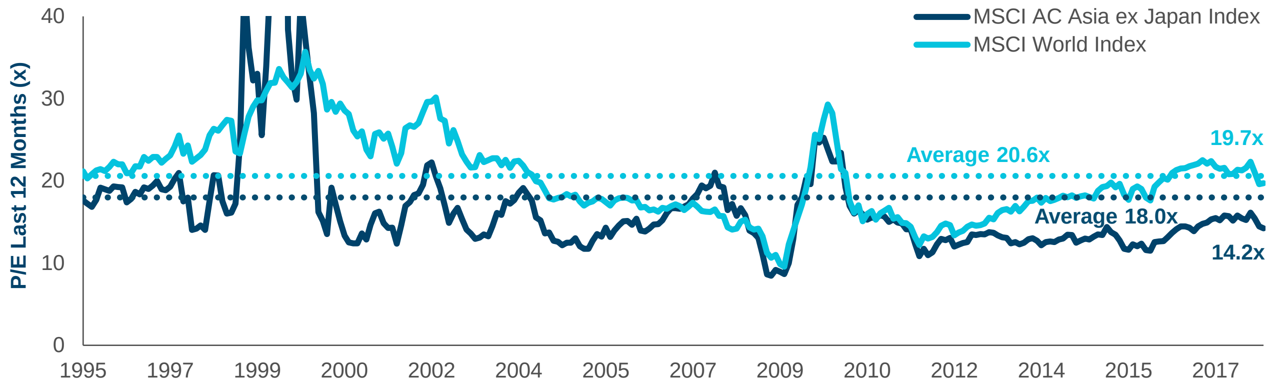
Despite the rally in Asia ex Japan equities over the past two years, valuations remain undemanding, both relative to their own history and compared with global equity indices (Figure 1). Indeed, Asia ex Japan equities experienced a trough in 2015 to early 2016, and we are still only at a relatively early stage in the market cycle. That said, the near-term environment appears more challenging than in recent years, calling for an active, conviction-based investment approach.

A MORE CHALLENGING NEAR-TERM ENVIRONMENT

In our view, there are two primary challenges for Asia ex Japan markets in 2018. The first is the prospect of corporate earnings coming under increased pressure. In 2017, Asian companies delivered better-than-expected earnings results, with technology stocks playing a particularly prominent role. This led to an increase in positive earnings revisions, which ultimately drove markets higher. However, so far this year, Asia ex

Figure 1: **Valuations Are Undemanding**

As of April 30, 2018



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Japan earnings revisions have generally been flat. This has been particularly noticeable among many of the large tech-sector names that led the market rally last year. Importantly, companies in the region continue to deliver earnings growth, just not to the extent that we saw in 2017. Accordingly, while companies generally continue to display healthy fundamentals, we think there is a risk of earnings disappointment during the latter half of 2018—not necessarily by a wide margin, but this could still be an issue for investors after what was such a strong year in 2017.

The second primary challenge is that China's deleveraging process continues apace, and we are already seeing some indications that various liquidity measures are tightening in China. Given the country's importance to the broader Asia ex Japan region, any tightening in the flow of money from China makes for a more difficult overall environment. That said, the average household income in China is growing by around 10% per year,[1] as the government continues to hike minimum wages and employers struggle to find enough skilled labor. Given this substantial annual uplift, the strength of the consumer in China is a principal theme within our portfolios.

Meanwhile, there are other headwinds that the region must contend with in 2018—namely rising interest rates and the increasing price of oil. With regard to interest rates, the U.S. has started along the monetary tightening path, and this will have repercussions in Asia. It is, perhaps, among the more developed Asian markets, particularly in Hong Kong (HK), where the impact will be most immediately felt. Given that the HK dollar is pegged to its U.S. counterpart, local rates have already started to rise as Hong Kong effectively imports U.S. monetary policy. Meanwhile, particularly for many of the southeast Asian countries, when U.S. rates have risen in the past, these economies have generally been forced to follow suit and not always willingly. However, with inflation expectations low at present, we are still relatively comfortable that these economies are not under any immediate pressure to raise rates. Our base-case expectation is for a measured increase in U.S. rates while Asian economies are fundamentally stronger than in the past and better able to withstand a gradual rate hike by the U.S. In many instances, their interest rate levels are higher than in the U.S., and they have seen healthy improvements in current accounts.

The other important factor for the Asia ex Japan region is the price of oil, which, for many, has been surprisingly strong in 2018. In recent years, the low level of oil prices has been a principal reason for why inflation has not been a problem in Asia. With oil prices rising once more, given that almost all countries in the region are oil importers, this could lead to inflationary pressure, which, in turn, could put further upward pressure on interest rates.

[1]Trading Economics, as of March 31, 2018.

Certainly, the Asia ex Japan backdrop in 2018 looks more challenging than it did in 2017. The good news, however, is that the market rally seen over the past two years has been largely concentrated in a select group of "new economy" stocks in areas like technology, health care, and consumer services. Accordingly, certain sectors have lagged the broader market rally, and there are a number of good-quality companies that now look appealing on a valuation basis. As such, we continue to focus on those businesses with durable growth drivers and that are highly cash generative.

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TAPPING INTO THE CHINA A-SHARES OPPORTUNITY

We are particularly excited about the opportunities in China's A-share market, which is still dominated by retail investors and vastly underpenetrated by foreign investors compared with more developed Asian markets. Foreign ownership in China A-shares remains at around 2% levels versus markets like Taiwan and South Korea, which have about 40% foreign ownership. T. Rowe Price has invested in China A-shares for the past decade, and we have recently added more analysts to research companies in this promising market. On June 1, 2018, more than 200 Chinese stocks were added to key MSCI indices for the first time. While we do not see this as a particular game changer for investing in the region, what it does mean is that a lot of foreign investors, who have previously taken a very narrow view of the A-shares market, will now have to start looking at these companies more closely.

Over the last five years, most global investors investing in China have simply piled into the growth-oriented names, particularly in the technology- and internet-related areas. However, interest is starting to broaden beyond the tech sector alone. With this in mind, for some time we have been looking to identify and invest in those companies that we think foreign investors will be drawn to. We feel that we have an advantage in this respect, given our long and comprehensive knowledge of many of these A-share companies. Additionally, also, as a foreign investor, we have a good understanding of the type of companies that other foreign investors might be interested in. As mentioned, healthy annual minimum wage increases in China means consumer demand is very strong. More and more Chinese households, for example, are buying simple products that are very prominent in the western world, such as cars and insurance. Meanwhile, "product premiumization" is also a big theme, as Chinese consumers are increasingly demanding higher-quality products.

THE TARIFFS ISSUE—UNCERTAIN BUT PERHAPS NOT AS SEVERE AS FIRST ANTICIPATED

Of course, the tariffs issue is one that has caused considerable uncertainty and concern for investors in recent months. It is worth noting that this is not so much of an issue for our Asia ex Japan portfolios, which tend to be more closely aligned with domestic economic demand. However, we also have exposure to a number of large multinational companies within our portfolios, and these could be negatively impacted in the event of an escalation of sanctions between the U.S. and China. For now, however, it seems any such escalation has been put on hold, with both the U.S. and China agreeing on a framework for discussions and China promising to "substantially increase purchases of U.S. goods and services." While it is not our base-case expectation, if we were to potentially see an escalation and a full-blown trade war were to develop, this would certainly be a negative for the region.

Our outlook for Asia ex Japan is broadly positive in the coming months. Valuations in the region are undemanding, corporate fundamentals are solid, and we anticipate further earnings growth in 2018, albeit at a slower pace than last year. Companies in the region are also generating greater cash flow as a result of management teams showing greater capital spending discipline. However, the near-term headwinds in the region have also clearly increased. Accordingly, this is an environment to back one’s conviction in the opportunities that arise from detailed, fundamental research. From a portfolio perspective, we continue to follow the same, simple approach—identifying quality, cash-generative businesses that are run by capable people and holding these companies so that they can continue to compound growth over time.

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