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PRICE POINT

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Timely intelligence and analysis for our clients.

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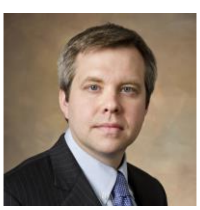

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Asia Equities

DESPITE GEOPOLITICAL RISKS, ASIA LEADING GLOBAL MARKETS

KEY POINTS

- Asian markets have rebounded this year despite geopolitical risks, buoyed by more stable economies, relatively attractive stock valuations, and improving earnings and cash flows.
- Along with rising tensions with North Korea, the policy outlook for China, which could dampen growth, poses key risks for the region.
- While volatility may increase, T. Rowe Price's managers remain optimistic for the intermediate and longer term as improving fundamentals in the region are expected to continue.

UNEXPECTED REBOUND

Following President Trump's election last November, emerging markets in Asia faced an ominous outlook.

The region already was burdened by years of disappointing earnings growth and revived fears of a collapse in China's economy and currency. Now its markets were confronted with potentially protectionist U.S. trade policies, a strengthening dollar that sunk many Asian currencies to multiyear lows, and the U.S. Federal Reserve's commitment to raising interest rates—developments that could impede Asian economic growth and capital investment.

After a sell-off toward the end of 2016, however, emerging Asian markets unexpectedly rebounded.

Through September of this year, the MSCI All Country Asia ex Japan Index rose 31% (in U.S. dollars), reaching the highest level in almost two years. Such major markets as China, India, Taiwan, and South Korea gained more than 20%—though the recovery has been tempered by the recent rise in tensions with North Korea.

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—ANH LU, PORTFOLIO MANAGER

These markets have generally been buoyed by several developments: more stable economies in the region, especially China’s; low global interest rates; a more gradual approach by the Fed than expected; relatively attractive stock valuations; a recently weakening dollar; and government reforms in several countries that are gaining traction. Also, a damaging protectionist U.S. trade policy seems less likely.

Most of all, our managers say improving earnings and cash flows—along with a pickup in global trade that has helped exporters—have been key catalysts for the revival. Indeed, improving fundamentals are outweighing significant geopolitical risks.

PROFITS

“You’re seeing profit margins stabilizing or improving and topline revenues continuing to grow,” says Eric Moffett, manager of the Asia Opportunities Equity Strategy. “Many Asian companies initiated massive investment programs in the 2000s, but the money was poorly invested.”

“Today, companies have finally adjusted to the slower growth environment we’ve seen in Asia since 2011,” he adds. “Companies in the region, and particularly in China, have found capex [capital expenditure] discipline. Free cash flow in the region is absolutely booming, leaving more cash to deleverage, to pay down debt, or to share with shareholders via dividends or buying back shares.

“This is partly why investors, particularly foreign investors, have gone from being extremely bearish on the region to becoming more optimistic and why the markets have done well.”

Anh Lu, manager of the Asia ex-Japan Equity Strategy, also notes that even with the recent gains, “valuations in Asia as a whole relative to the rest of the world are still more attractive. And real interest rates in Asia, while not high, are not as low as most other markets, so that provides a little cushion. Economic growth has slowed from what it was historically, but it’s still better than in other parts of the world.”

Of course, the heightened tensions over North Korea’s nuclear missile threat have recently cast a dark shadow over these positive developments. So far, as of the end of September, markets more or less have taken that threat in stride after a modest setback in August—though volatility has risen.

CHINA STABILIZING

A significant factor in the emerging Asia rebound: Fears of a collapse in China’s economy and currency have receded over the past year as both have stabilized with more government stimulus.

“Domestic demand in the mainland has stayed resilient, and many sectors and companies are expanding strongly,” Mr. Moffett says. “Sentiment in the country both by investors and companies has improved remarkably.”

Chris Kushlis, a fixed income sovereign analyst for Asia, says “the risks of a Chinese crisis have notably subsided, and the economy has improved on the back of significant policy support. Foreign exchange reserves are once again slowly rising as efforts to stem capital outflows have been largely successful.

“As long as China’s central bank can ensure ongoing liquidity and is not constrained by significant capital outflows, then the risk of a financial crisis in China is modest, in our view.”

Ms. Lu adds, “China has a very deep market now, so even if macro conditions moderate, there are enough good companies to invest in that we can always find potential moneymaking ideas in China.”

Moreover, the opportunity set for U.S. investors has expanded with China’s volatile domestic A-share market, dominated by individual Chinese investors, recently opening to foreign investment. MSCI will add A-shares to its main emerging market index next summer.

“Some of the bigger blue chip companies in that market are actually very high quality,” Mr. Moffett says. “Interestingly, they are not that expensive because local retail investors find the companies that just slowly grind and grow every year boring. We think some can be great companies over the long term.”

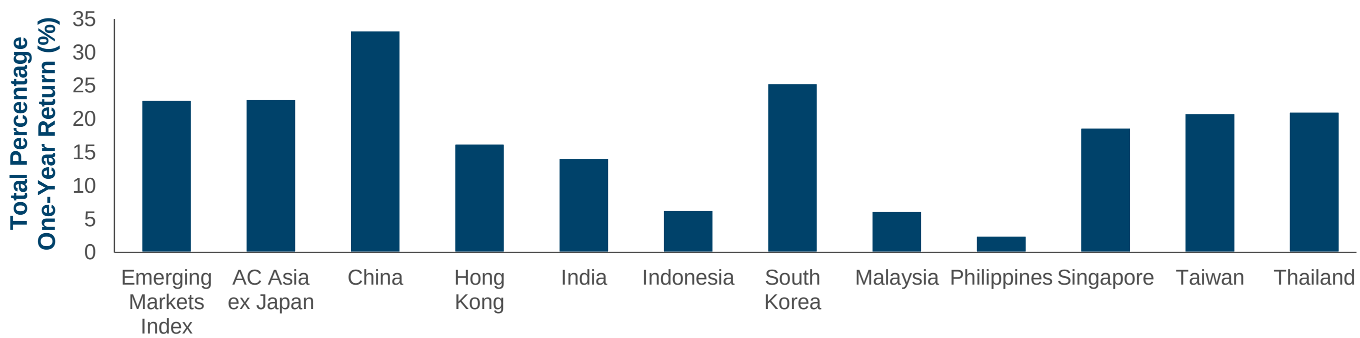
At the same time, investors remain concerned about China’s dependence on government spending to sustain growth and its rising debt, which has pushed its debt-to-gross domestic product ratio to record levels recently.

Mr. Kushlis says that, while growth of leverage in the corporate sector has slowed, he remains concerned about those risks and “off balance sheet” borrowings by local governments.

Longer term, Mr. Kushlis worries that “China’s failure to deal more decisively with its financial and leverage risks and its continued reliance on infrastructure stimulus are eroding growth potential. We expect China to continue to maintain a high level of debt, muddling through over the coming years, with growth slowly declining over an extended period.”

Figure 1: **Most Asia Ex-Japan Equity Markets Have Provided Strong Returns Over the Past Year**

Percentage Gains From Sept. 30, 2016, Through Sept. 30, 2017



Past performance cannot guarantee future results.

MSCI indexes used: Emerging Markets, AC Asia ex Japan, China, Hong Kong, India, Indonesia, South Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand.

INDIA REFORMING

India’s market surge this year has been driven by strong corporate earnings and optimism about structural reform. The Indian economy seems to have weathered the government’s unexpected demonetization measure last November in which large-denomination bank notes were withdrawn and replaced to ensure the integrity of the country’s monetary system.

The most recent elections in India and progress on the long-overdue nationwide goods and services tax (GST) legislation also boosted confidence that Prime Minister Narendra Modi will advance his reform agenda, which focuses on corruption, housing, ease of doing business, improving governance of banks, and containing inflation.

"In India, all the stars are aligned now," Mr. Moffett says. "You have a strong leader pushing through really big reforms in the economy, most recently the GST; low commodity prices, a boon for a country that's an importer of oil and other resources; very favorable demographics; and an economy that in many ways is uncorrelated with the rest of Asia."

Ms. Lu agrees that India's "government is moving in the right direction, but progress has been slow. What we need to see in India is for the capex cycle to pick up. Most of it is supported by government spending. We're not really seeing private capital being put to work."

> "Long term, we're just very struck by how strong the potential is for the region to grow, and it's not over-owned by investors. So there is a lot of opportunity for Asia ahead."
>
> —ERIC MOFFETT, PORTFOLIO MANAGER

While the outlook for India overall remains positive, stock valuations have become more challenging. "It's hard to say that we can find value easily," Ms. Lu says, "but we believe the companies we hold will continue to deliver expected earnings."

SOUTH KOREA RESILIENT

So far, South Korea's stock market and economic recovery, boosted by improving earnings and exports, has remained on track despite the escalating North Korean threat, along with the country's domestic political turmoil.

That turmoil has included the impeachment of President Park Geun-hye, the indictment of the heir to one of the country's largest conglomerates, and a standoff with China—its largest trading partner—over the deployment of a U.S.-built anti-missile defense system.

T. Rowe Price managers say the North Korean military threat is difficult to handicap, but some are generally taking a more cautious stance toward South Korean equities and bonds.

However, they are encouraged by new President Moon Jae-in's focus on and the progress made in South Korean corporate governance.

"A lot of the biggest companies that historically have not done a good job of allocating capital and sharing cash with shareholders are becoming much more shareholder friendly," Mr. Moffett says. "Over recent years, many of the largest conglomerates have seen a generational change in leadership."

That progress could continue, Ms. Lu says, because there is still a lot of excess cash on corporate balance sheets. Moreover, as Mr. Moffett notes, "by some measures, South Korea is the cheapest market in the world today."

RISKS

Aside from the continuing concerns about North Korea, the firm's managers agree that the policy outlook for China poses a major risk for the region and beyond.

Chinese President Xi Jinping is expected to solidify his power at the party congress this fall and possibly pursue tougher reforms to reduce leverage in the economy and overcapacity.

“This is a chance for China to really address its structural problems,” Ms. Lu says. “Global investors will be watching to see in what direction policy veers. That’s the biggest risk and opportunity over the next year.”

Mr. Moffett says early signs suggest that the reform pace is not going to slow and could quicken next year, dampening growth.

Longer term, Mr. Kushlis believes a faster-than-expected downturn, an unintended credit crunch resulting from a crackdown on financial risk, and a revival in capital outflows remain key risks for China and the broader region.

Other risks in Asia include: a still-possible move toward protectionism in U.S. trade policy, a faster-than-expected pace of Fed tightening, the overall pace and scale of global growth, a sharp reacceleration of the Chinese economy, any retrenchment on reform efforts, and an unexpected strengthening of the dollar.

Although volatility is expected to increase in the coming months, our managers remain optimistic for the region in the intermediate and longer term, citing the upturn in earnings and return on capital, relatively attractive valuations, improving corporate governance and government reforms, economies that are handily outpacing the developed world, and favorable demographics.

Also, China no longer is considered to be on the precipice of a financial crisis, though more structural reforms are needed for a successful transition to lower, but higher-quality, growth.

“Long term, we’re just very struck by how strong the potential is for the region to grow,” Mr. Moffett says, “and it’s not over-owned by investors. So there is a lot of opportunity for Asia ahead.”

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