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JUNE 2018
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A BROADLY FAVOURABLE OUTLOOK

Our outlook for Asia ex Japan is broadly positive for the coming months. Valuations in the region are undemanding, corporate fundamentals are solid and we anticipate further earnings growth in 2018, although at a slower pace than last year. Many Asian companies are showing greater capital spending discipline, and thus generating good cash flow. 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.

NEAR-TERM HEADWINDS

In 2017, Asian companies, particularly tech stocks, delivered better than expected earnings. Yet in 2018, Asia ex Japan earnings revisions have generally flatlined, particularly many of the large tech companies that led the market last year. Companies in the region continue to grow their earnings, just not at the same speed as in 2017. While company fundamentals remain sound, we think earnings could disappoint later in 2018. While the disappointments might not be huge, it could still spook some investors. China's ongoing deleverage drive could also weigh on markets in 2018. 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.

In addition, the US has started to tighten, and this will affect Asia, particularly Hong Kong which pegs the HK dollar to its US counterpart. However, we expect a measured increase in US rates, while Asian economies are fundamentally stronger than in the past and so better able to withstand gradual US rate hikes. Many Asian countries have higher interest rates than in the US and their current accounts have improved. The surprise jump in oil prices could also be a factor, given that almost all the countries in the region are oil importers. This could lead to inflationary pressure which could put further upward pressure on interest rates.

TARRIFS, BUT NOT AS BAD AS FEARED

Tarrifs have caused considerable concern for investors recently, but our Asia ex Japan portfolios tend to be more aligned with/leveraged into domestic economic demand. However, we do hold a number of large multinational companies which could suffer in the event of an escalation between the US and China.

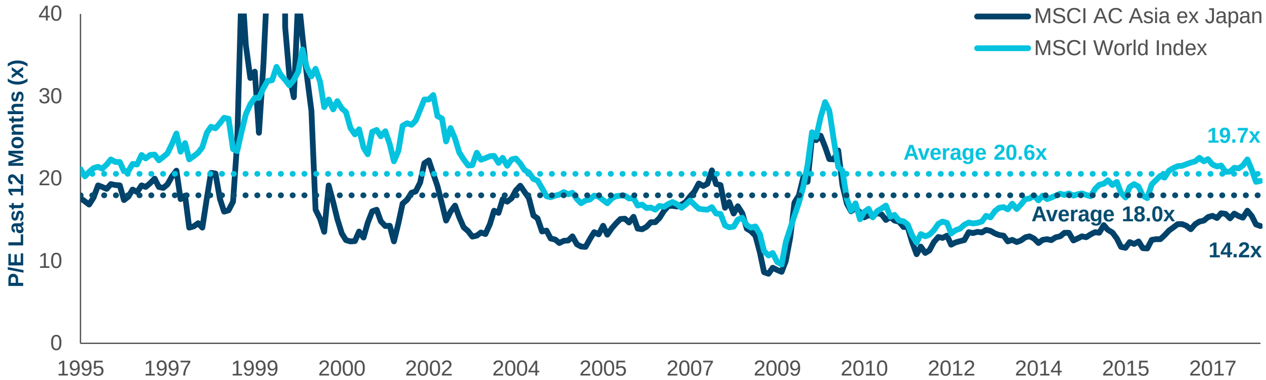
It seems the trade war has been "put on hold" for the moment, with both the US and China agreeing on a framework for discussions and China promising to "substantially increase purchases of US goods and services". It's not our base case, but if a full-blown trade war were to develop, then this would certainly be a negative for the region.

THERE IS GOOD NEWS!

Despite the two-year rally in Asia ex Japan equities, valuations remain undemanding, both relative to history and the wider market (Figure 1). Indeed, we believe we are still only at a relatively early stage in the market cycle following the dip in 2015/2016.

Figure 1: **Valuations Undemanding**

As at April 30, 2018



Source: FactSet.

A select group of "new economy" stocks in tech, healthcare and consumer services has driven the market rally to date. Some sectors have lagged the broader rally, generating a number of good quality companies that now look attractively valued.

Yum China, for example, which owns and operates the KFC and Pizza Hut chains on the mainland, provides a good example. Yum China has generated significant amounts of cash—much of which it has returned to shareholders—and operates a high-quality, Asian-focused consumer business with western-style corporate governance. The company has been a mainstay in the strategy since its 2014 inception, and we regard it as a core holding.

TAPPING INTO CHINA A-SHARES

We are particularly excited about the opportunities in China's A-shares market.

On 1st June 2018, more than 200 Chinese stocks (A-shares) were added to key MSCI indices for the first time. While this may not be an immediate game chanber, a lot of foreign investors will now have to start looking at these companies more closely. Foreign ownership in China A-shares remains at around 2% levels, versus about 40% for markets like Taiwan/Korea. For some time we have been looking to identify and invest in those companies that we think foreign investors will want to buy. We feel that we have an advantage given we have a long and comprehensive knowledge of many of these A-share companies going back a decade. As a foreign investor ourselves, we have a good understanding of the type of companies that other foreign investors might be interested in.

Key Risks—Transactions in securities denominated in foreign currencies are subject to fluctuations in exchange rates which may affect the value of an investment. Returns can be more volatile than other, more developed, markets due to changes in market, political and economic conditions.

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