



# Asia, Looking to 2015 and Beyond

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by Robert Horrocks, PhD

Over the next decade, I expect Asia's economies to continue to raise living standards and to narrow the income gap between its own citizens and those in the U.S. or Europe.

**Why do I think this?** Asia continues to have a high savings rate. A country cannot invest or grow over the long term without a pool of savings, and it can be risky to rely on external funding to finance domestic growth. Asia currently has enough savings to support its own development. It also has a track record of increasing productivity through improving education. The region has championed the individuals' desire to make money. It has successfully opened its markets to the world in order to learn about new products and methods of industrial organization. Finally, it has a decent track record of government policy reform to support growth and markets. None of this has been perfect; and indeed, although rates of change have been fast, Asia is still a relatively poor part of the world. Over the long term, all of this just means that there is plenty of blue sky ahead.

**But what about the next year?** Much will rest in the hands of central bankers and still more will depend on Asia's reform progress. For those who think it is too easy to focus on the future and too dangerous to dismiss the near term, I will be watching the following during 2015 to see how Asia's growth is progressing.

**First, Japan is home to the world's best central banker, Haruhiko Kuroda:** How often has that sentence been written in the history of central banks? Mr. Kuroda has paid attention to the monetary policy scholars regarding zero percent interest

rates. He knows he has to be aggressive—and indeed credibly aggressive—in monetary policy. He seems willing to confront the conventional wisdom that bankers must be conservative, die-hard inflation fighters. Prime Minister Shinzo Abe appears to support him on this issue.

I expect Mr. Kuroda will continue to push inflation expectations up to 2% and to keep them there. Remember, a weaker yen is the symptom of the policy, not the policy itself. This inflation policy also creates incentives for firms to whittle down cash balances and raise prices. Not all companies will do it but we will look for those that have the willingness and the ability to take heed. Yes, in a weak yen environment, even domestically focused companies can be attractive holdings because a reflationary environment can offset the currency weakness, particularly among companies that use higher operating leverage.

**How does this compare to the rest of the world?** With all the talk of tapering, in effect, monetary policy has been tightening in the U.S. since May 2013. The Standard & Poor's 500 (S&P 500) seems unconcerned, as it continues to rise on somewhat expensive valuations, considering the fact that corporate margins are already high. Most people expect the U.S. economy to strengthen—and there is probably better than a 50–50 percent chance that it will. But there must have been some impact from the tighter policy and I do not think investors are paying much attention to the risks of a slowdown. The recent fall in the price of oil is surely a warning that all is not well with global growth.

In *Europe*, I am most concerned, because inflation is already below that in Japan and the political will to do anything about it seems weak. Central bankers have been frozen at times (Recall Sweden's culpability in maintaining bizarrely tight monetary policy in the face of even meager signs of growth). So, I have lost confidence that there will be a policy action in Europe as decisive as that in Japan. Thus, I believe Japan remains a better prospect for demand growth than Europe in the short run.

*China* is better-placed going into 2015, in terms of market valuations than it is in terms of economic momentum. But these things can quickly change. Whereas much of the talk about China focuses on internal issues, I still think that a lot of the slowdown in headline growth is simply due to the hangover from the economic problems of the U.S. and Europe. To that effect, as Matthews Asia Investment Strategist Andy Rothman has continually stressed in his *Sinology* letter and other client communications, it is not that I believe China is in any meaningful sense "export-driven." It is, in fact, an economy that is in the process of rotating more toward services. However, stronger exports, and a rising current account surplus, create an easier background in which to try to bring down the credit-to-GDP ratio, which is something the Chinese appear intent on doing.

Of course, China is not exactly the darling of the markets at the moment. It is quite hard to have a nuanced conversation about China with the U.S. hedge fund community without being accused of naivety.

This suggests to me that, in terms of the stock market at least, China may be the short-term beneficiary of U.S. growth. Unlike investors in the U.S. equity markets, China investors are likely to benefit even more from that growth because market valuations have not been imbued with any lofty expectations. Conversely, a weakening global growth outlook would add extra pressure to China. This is because China is unlikely to enact further sustained or significant stimulus measures. China will likely persevere with its anti-corruption drive, regardless of the economic environment. Still, given market valuations that are about 10x earnings and a 3% yield, along with the potential to continue to outpace global GDP growth by 3–4 percentage points over the next decade, one cannot be too disheartened.

Finally, China continues to push ahead with financial sector liberalization, which is at least improving the environment for small and medium enterprises while introducing, at the margin, a better assessment of risk practices in lending.

This brings me to *India*: Here, we have some optimism in the markets and valuations have been pushed up to reasonably high levels. If a decade from now we are able to look back on today, and say that Prime Minister Narendra Modi's reforms freed up agriculture, revived the property market, spurred infrastructure investment and liberalized the labor market, we would conclude that stocks today are inexpensive. But India is not straightforward. Attempted reforms are typically met with resistance and it will not likely be smooth sailing. The market has moved up partly because India is slowly emerging from a credit squeeze but also because of sentiment. Momentum has been based on hope for reform, rather than on reality. As we enter the new year, the government will have to continue to convince people with its rhetoric that it can deliver on actual reforms. While I cannot forecast this, I acknowledge the risk that the market could be vulnerable to disappointment.

The possibility that India will achieve Chinese-like growth rates is beguiling and seems possible. That would lift hundreds of millions out of poverty and into more middle-class lifestyles, and would be an enormous opportunity for the kind of companies we favor. But our hope for the future always needs to be tempered by reality. Investment opportunities in companies often depend on the price we pay for them. But it does bring to the fore, the need to have a long-term time horizon when investing in India. There will be plenty of opportunities to become emotional in 2015. I suppose keeping a level head will be important.

Across *Southeast Asia*, the challenges for 2015 will likely be more similar to India than to North Asia. Here, countries are by-and-large in the early stages of industrial development. During 2015, I will look for continued investment from the North into the South. As wages rise in the North, labor-intensive businesses will move their operations to the Association of Southeast Asian Nations (ASEAN) and to frontier economies. We expect to see this in top-down government-provided data, but also will be looking for these trends in the approximately 3,000 company meetings I expect

our investment team to have next year. This increases the links between countries in Asia and can only be positive for intraregional cooperation. It is always interesting to see who is visiting whom. Given the high degree of alignment that policy-makers seem to have with their reformist agendas, I will be looking to see how the relationships between Modi, Abe, and President Xi Jinping develop; and what kind of diplomatic outreach is made to ASEAN. Will the U.S. be supportive or, as it has too often seemed to me in the past, play the role of spoiler in order to block China's attempt to increase its influence? What seems to be a secular trend, though, is the increasing foreign direct investment that is coming into the region. ASEAN governments will likely look to encourage this with legal and structural reforms, in order to increase trust in their markets and compete for/retain this capital.

Clearly *Indonesia* is a potential point of stress in ASEAN. It is a market that is vulnerable to tighter U.S. monetary policy and it has done less than India to minimize its current account and inflationary issues. Joko Widodo, Indonesia's new president did not achieve the sweeping victory that reformists hoped he would. Monitoring his progress on reform will be a key issue for this economy. *Thailand* has its own political issues but the situation there, in contrast to Indonesia, is actually more stable than at first glance. During 2015, I suspect political concerns will take a back seat to the unfolding credit cycle, with the possibility that Thailand may see a continued rebound in sentiment if the banks can remain healthy.

The U.S. dollar will likely also play a big role in the markets. A strong dollar is historically a headwind for Asia. While I see no fundamental backing for the idea of a secularly strong dollar against the region's currencies, momentum alone—based on sentiment around a recovering economy—could push the dollar higher. To date, the dollar is moving noticeably against the euro, more so than it is against currencies in Asia. I have noted that I believe stronger growth brings benefits to Asia, too. We do not fear a repeat of 1997 because we

believe the region is far better-placed: living within its means, not overheated, with reasonable asset prices and much less U.S. dollar debt exposure. Nevertheless, just keep an eye on countries with current account deficits—Indonesia, the Subcontinent and Australasia. They may be able to deal with economic pressure from a strong dollar by devaluing their currencies somewhat but that can cause U.S. dollar returns to suffer in the short term.

*All in all, I think we will go into 2015 optimistic about the future.* We will continue to invest in the part of the world that is most focused on reforms. It is the part of the world that, according to the International Monetary Fund, will account for two-thirds of the world's middle class in 2050 and we position our portfolios accordingly. That puts us a little at odds with the conventional wisdom; at least as it is expressed in the markets, which tends to have a shorter-term investment horizon and a clear preference for high yield bonds and U.S. equities. But we do have a valuation argument on our side. I will not say that Asia is trading at bargain levels. It is not. It appears that valuations are low—but a significant portion of that is accounted for by depressed valuations in state-run banks (predominantly in China) and heavily-cyclical or indebted businesses.

Focusing on portfolios in which businesses have a high return on invested capital, brings valuations closer to the level of the S&P 500. However, current analyst estimates project much faster underlying earnings growth for such Asian businesses. I believe portfolios focused on dividend-paying equities can far exceed rates of growth in the S&P 500—at price-to-earnings discounts of over 20%. So, I look at the potential headwinds in 2015 through the lens of long-term growth and some valuation cushion. Finally, short-term earnings growth will likely be supported by improving margins and returns on equity. That makes me modestly optimistic—and my long-term view is more optimistic still.

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