MARKET INSIGHTS

INVESTORS RUSH INTO EMERGING ASIA AND ASIA HIGH DIVIDEND STOCKS

APRIL 2017

Emerging Asian equities have stormed into 2017 (Figure 1), having lagged other emerging markets throughout 2016 despite some attractive valuations. As confidence in Asian growth has returned, investors have shrugged off not only the uncertainties swirling around Mr. Trump and his proposed border adjustment tax but also fears of a potential trade war with China and (now receding) concerns of a stronger US dollar.

Emerging market equities (apart from Europe which is “resting”) have generally outperformed so far in 2017 as investors continue to find their risk to reward profiles attractive; “yes”, the risk may be higher, but investors are clearly reasoning that still attractive valuations and the resulting higher potential returns more than compensate for that additional risk.

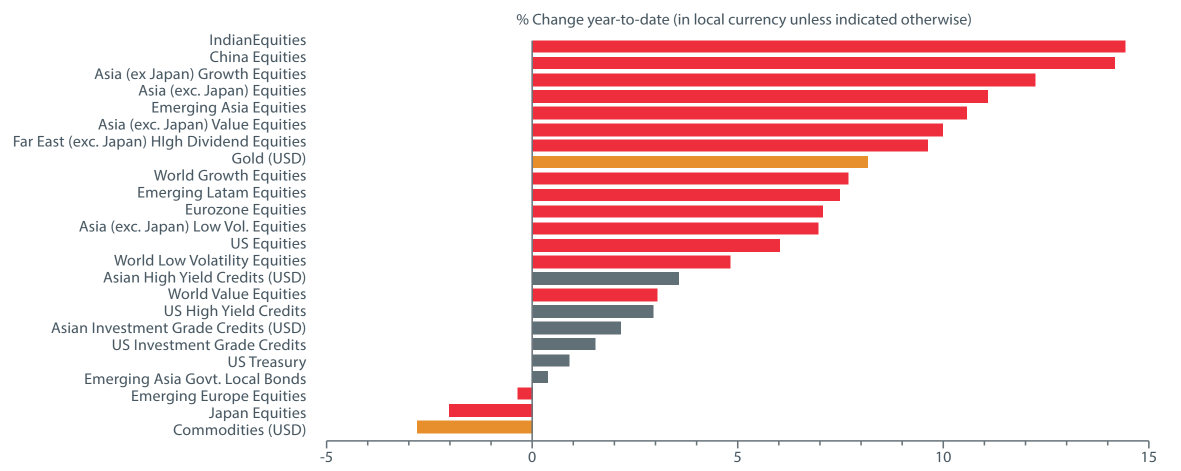
Significantly, high dividend stocks in Asia Pacific (excluding Japan) have also rebounded suggesting investors see good ongoing dividend yields despite the forecast rises in US interest rates.

The same dynamics are evident in the bond market albeit to a lesser extent: investors seem to be reasoning that the return on riskier, higher yielding bonds is sufficient to justify that additional risk. They too have rallied, but with less conviction than equities.

In short, the rush to risk (i.e. towards Asian and emerging market equities and higher yielding bonds), that began in 2016 has continued into 2017.

The question is, “What happens next?”

Fig 1: Asia (including high dividend stocks) storms into 2017



Source: MSCI, Barclays Capital , JP Morgan and Commodities Research Bureau from Datastream, as of 7 April, 2017.

All indices are in local currency terms. Note that past performance is not an indicator of either present or future performance.

FOR HOW LONG CAN THE “RUSH TO RISK” BE SUSTAINED?

Here the picture is mixed; the global news flow is generally encouraging and the drivers behind investors’ reawakened interest in Asia seem intact. Many opportunities remain, notwithstanding the shenanigans surrounding Mr. Trump’s presidency.

But several critical constraints are either intensifying or emerging, particularly in relation to sovereign bonds and US equities. Both are showing signs of “valuation fatigue”, (which may not necessarily be synonymous with sell-offs given the high levels of liquidity still circulating). In addition, many equity markets, while still attractively or fairly valued, are not as cheap as they were three months ago.

The bottom line is that apart from in the US, equities per se seem to have momentum left. Indeed, they could well trend higher structurally if the dynamics of the bond/equity interplay are any guide.

BOND’S 30 YEAR RALLY ENDS. WILL EQUITIES TAKE UP THE BATON?

It is easy to make the case that the long term rally in sovereign bonds is over; yields are at record lows and inflation will likely firm, albeit moderately. Indeed, many sovereign yields are already below the rate of inflation, which implies these bond prices will fall at some point (unless deflation becomes the norm, which is not forecast[1]).

The basic message is that those investors who bought bonds, both for income and capital growth over the past thirty plus years, are finding their comfortable world has been turned upside down.

Against this backdrop, it is easy to argue that equities are girding themselves for a long term rally not least because of the wide valuation “yield gap” that exists between (fairly valued equities) and (expensive) bonds, especially sovereign bonds. (Figure 2)

The basic message is that the yield “gap” (resulting from bonds’ extended rallies) between bond’s (very low) redemption yield and equities’ (in-line-with-average) earnings yield will come under increasing pressure to narrow owing to either (a) sovereign bond sell-offs (i.e. the redemption yield rises), or (b) equity rallies (i.e. the earnings yield falls).

A major sell-off in global sovereign bonds, while possible, seems less likely given that inflation will

Fig 2: Rising equities (rather than falling bonds), will likely close the bond/equity yield “gap”

Source: Barclays Capital and Thomson Reuters from Datastream, 7 April, 2017.

1 Consensus Economics Ltd, 13 March, 2017.

likely remain subdued[1] and global liquidity is high. More likely is that equities will trend higher especially as profit growth forecasts are rising; in other words, the structural case for overweighting equities is strengthening.

Viewed from within this prism, the powerful long term interplay between bonds and equities clearly dwarfs the short term impact of any rise in US interest rates even if the Fed is more aggressive than advertised (as many fear). Higher risk bonds still offer attractive yields, but for investors seeking both yield and growth, the pendulum is swinging firmly in equities' direction.

EMERGING MARKET EQUITIES OFFER ATTRACTIVE YIELDS. SOVEREIGN BONDS LOOK UNATTRACTIVE

Where do the real potential returns lie? The picture is unambiguously clear; attractive potential returns abound in equities with emerging market equities leading the pack (Figure 3). Respectable real returns can be found in bonds but only if one takes on more risk.

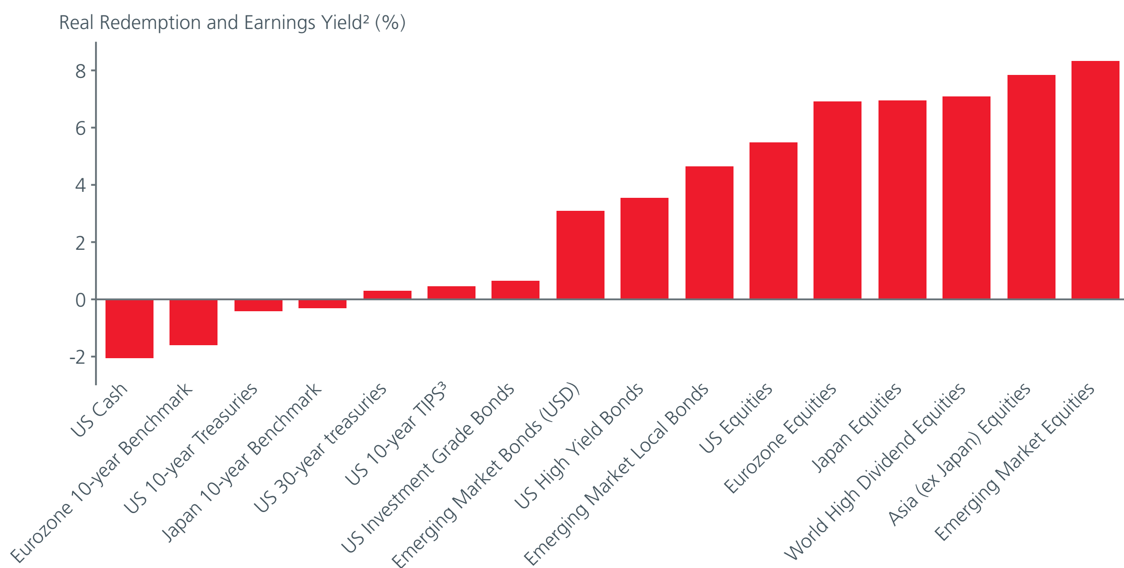
This picture is pretty much the same as that towards the end of 2016 despite 2017's rallies. It is also a further affirmation that Asian and emerging market equities still have more momentum.

That high dividend equity earning yields remain attractive also reaffirms that these stocks could do well even as the interest rate cycle turns.

The proviso, of course, is whether these assets hold value. If each asset class is expensive, or the attractive valuation is based on forecast profits that prove too optimistic, any rally would likely have a short shelf life.

It is time to dig a little deeper.

Fig 3: Asia and emerging market equities offer the highest real return opportunities



Source: Citibank Sovereign Bond indices, Barclays Capital Bond indices, JP Morgan Emerging Market Bond indices , MSCI, Standard and Poors, Tokyo Stock Exchange and EuroSTOXX, from Datastream as at 7 April, 2017.

1 Consensus Economics Ltd, 13 March, 2017. 2 Real redemption yield for bonds, earnings yield for equities. The equities earnings yield is based on the consensus prospective price earnings multiple as measured by IBES.
3 Treasury Inflation Protected Securities.

BOND "WINNERS" AND "LOSERS"

Although expensive, "safer" bonds (i.e. sovereigns and shorter dated bonds) still hold some appeal owing to their low risk and hence "safer" yields. But (a big "But"), should inflation be higher than forecast, the risk of a sharp capital sell-off exists. In contrast, there are still potential (albeit limited) capital gains to be made in higher yielding bonds especially Asian dollar high yields.

Even here, valuation limitations are coming into sharp focus. US high yield bonds, for example, look to be entering the final stages of their extended rally.

While the yield gap with the comparable benchmark US Treasury is around 250 basis points above the record low, the gap has historically narrowed further only under exceptional circumstances (Figure 4). There is room for these high yields to rally further, but the main reason for buying them is increasingly their yield.

The potential for capital gains is probably higher in both Asian US dollar high yields and in Asian emerging market bonds, but as with US high yields, their attraction increasingly lies in their "carry".

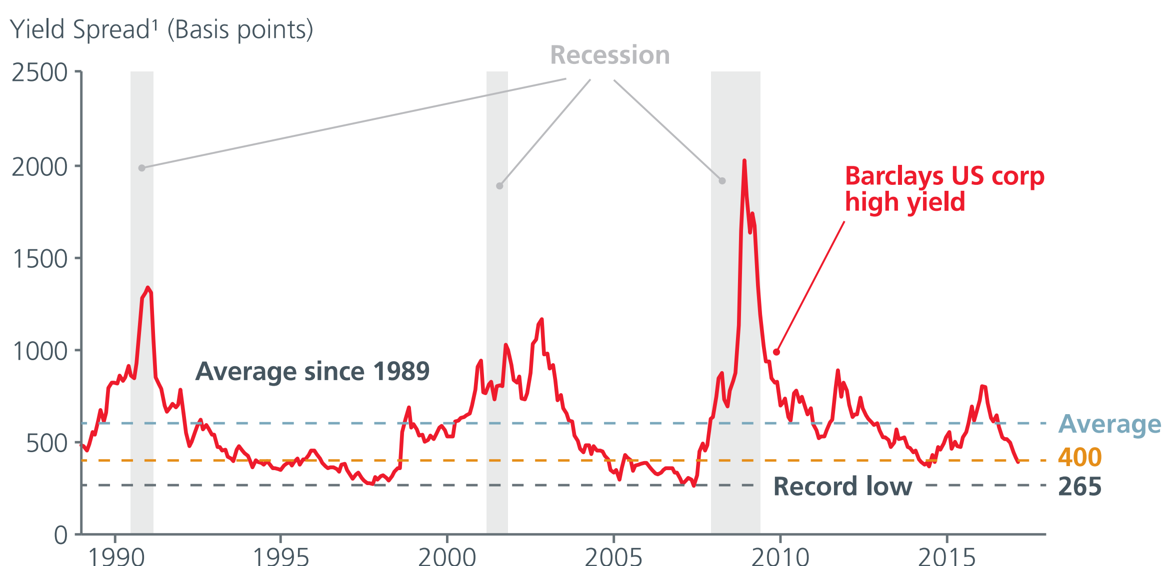
This general bond picture could change radically should inflation accelerate beyond current expectations. As already indicated, inflation is forecast to moderate in 2018 after a 2017 uptick; while a sustained bond sell-off seems unlikely at this stage, the situation requires monitoring.

EQUITY VALUATIONS ARE SUPPORTED BY STRONG PROFIT UPGRADES

In direct contrast, the fundamental case for equities is strengthening. Notably, there has been a strong rebound in confidence as the profit forecasts have risen on the back of generally better economic news.

The result has been accelerating profit growth forecast upgrades particularly in the emerging markets and Asia per se (Figure 5).

Fig 4: Good news could trigger another leg in the US high yield bond rally, but the upside is increasingly limited



Source: Barclays Capital and Thomson Reuters from Datastream, 7 April, 2017.

1 The yield spread is the difference between the redemption yield on the Barclays US High Yield index less that on a benchmark US Treasury of similar duration.

This upgrade momentum could possibly stall in the coming months; not only has 2016's rise in commodity prices (which can have a significant impact on emerging markets) reversed but also the low base effect is working its way through.

Offsetting this downward pressure, however, are China's rising factory door prices; this rise is feeding investor confidence that China's growth is strengthening. If so, the downside to commodity prices seems limited.

Overall, global growth is forecast to be around 2.8% this year firming to 3% in 2018. With attractive valuations still to be found in most equity markets, it is difficult to argue that the rallies are over. There will, no doubt, be the inevitable consolidation as markets "rest" and their paths will, no doubt, reflect developments in the US, where equities do look expensive.

US EQUITIES LOOK EXPENSIVE. FAIR TO GOOD VALUE EXISTS IN ASIA

While the equity rally into 2017 has raised valuations, few markets have discounted the better news flow to the extent than has occurred in the US.

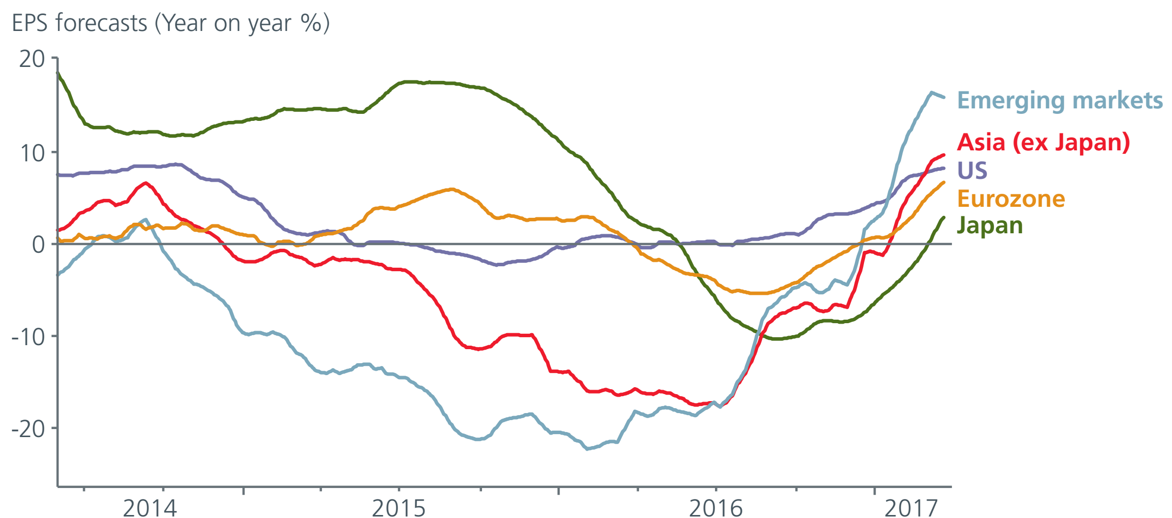
The "Trump effect" on US growth, for example, seems excessively discounted with a peak rise of around 14% in US equities since last November (far outstripping the 2½% rise in forecast earnings (resulting in the US prospective price earnings multiple rising from an already rich 16¼X to 18X at its March 2017 peak[1]).

The bulls correctly cite firming wage bills and rising house prices as evidence of recovery. The bias in job creation numbers (to those over 55) suggests, however, that the recovery may not be as robust as high equity valuations indicate, despite rising confidence.

This recovery profile suggests bond investors cannot be dismissed in assuming that any rate hikes will be lower than Fed guidance (a stance diametrically opposed to equity investors who fret that the rise in rates could be more aggressive than advertised).

Rising US rates could be cited as a signal that the best has been seen in US equities but (a)[2] rates can rise significantly before they chop off an equity rally, (b) three 2017 rates hikes have been broadly broadcast (as has the longer term goal of 3% by 2019), and (c) the Fed Funds futures suggest investors have

Fig 5: Profit forecasts (especially in emerging markets) bounce back after 2016's "hit"



Source: IBES consensus EPS forecasts from Datastream, 7 April, 2017.

1 IBES based on S&P Composite as of 7 April 2017. 2 Between mid-2004 and mid 2006, for example, the Fed Funds target rate rose from 1.00% to 5.25%. Over this period, the Standard and Poor's 500 Composite index rose some 27%.

already discounted 2017's three proposed rate hikes, (although the short term bond market is less aggressive in this discounting).

Nevertheless, it is easy to conclude that the best has been seen in US equities. While high valuations provide little support, a sustained fall would likely be moderated by the still high level of liquidity.

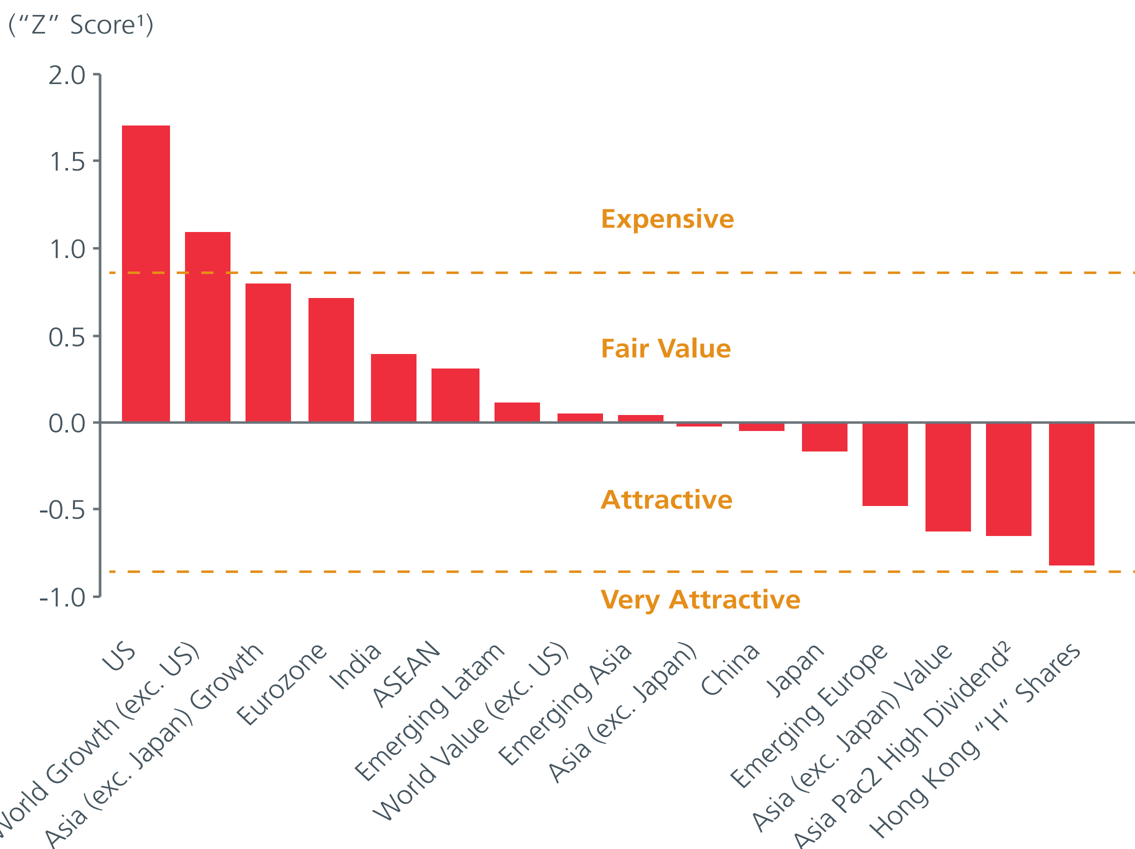
Under these conditions, the valuation case for Asian and emerging equities remains compelling, albeit not as compelling as three months ago (with a few exceptions such as China). As Figure 6 illustrates, most Asian markets lie on the cheap side of fair value.

And, unlike the US, the better news emerging elsewhere seems to have been only partially discounted. China's factory prices, for example, have risen some 14% since early 2016 whereas the profit forecasts only began rising in early 2017.

In short, 2016's China growth cynicism had a far greater impact on the profit forecasts than did the hard evidence of rising factory gate prices. This situation is now correcting.

The bottom line is that the momentum behind the Asian and emerging market rallies remains intact given still attractive valuations. As confidence in the growth and profit forecasts grows, Asia's deep value is being snapped up, quickly!

Fig 6: Attractive value abounds in Asia – it is being snapped up quickly



Source: Thomson Reuters Datastream, as at 7 April 2017.

1 The "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend over a 10-year period. The two outer dotted lines represent the limits within which around 70% of all world values lie. 2 Based on historical data. NB: The "Z" score is calculated on a 12 year basis except for Thailand (9 years), Asia Low Volatility (4 years), Taiwan (11 years) and Asian REITS (10 years) owing to a lack of data in these markets. The chart is for illustrative purposes only; measured on a consistent basis, Asian Low volatility stocks would be much cheaper relatively.

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