

Matthews Asia Perspective

Q&A: Market Volatility Opens Opportunities in Asia



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What was behind the recent market volatility in the U.S.?

There were technical reasons behind the recent stock market fall in the U.S. Some volatility trades were unwound and we heard a lot in the media that the severe market swings were a purely technical thing and we do not have to worry about it. There is an element of truth in that but investors should also just be a bit cautious about the U.S. cycle. It does look quite late in the cycle and the U.S. market is not cheap. Bond yields are going up, which is causing a spike in market volatility. If bond yields continue to rise, then the market may see more selling pressure unless corporate earnings can accelerate.

What would it take for U.S. earnings to pick up?

It requires either a more inflationary environment in the U.S., so companies can raise prices, or wages need to be depressed or to not rise by much. Both of these are unlikely. If inflation were to pick up, I think the Federal Reserve is likely to raise interest rates even faster. As for wages, it is difficult to see how wages remain depressed with the unemployment rate so low and also by the fact that the U.S. corporations have been squeezing wages for quite some time.

How does the spike in U.S. market volatility affect Asia?

Investors should not expect Asia to be immune to any weakness in the U.S. stock market, but Asia looks a lot earlier in the cycle to me. By that I mean, Asia has been allowing wages to rise over the past five or six years so you can go through a prolonged period of policymakers favoring corporate profits. Many countries in Asia, including Japan and Thailand, need inflation. China can have higher rates of inflation, so inflationary pressures are not that much of a concern in Asia.

Valuations in Asia appear much more reasonable than they are in the U.S. So whereas any sort of further weakness in the U.S. market is obviously going to be felt in Asia, the region has a lot of things going for it in terms of the better earnings cycle, a greater ability to withstand inflation and cheaper valuations. It's difficult for me to say how much of the fall in the U.S. was short-term technical and how much is because the economic cycle seems to be a little bit long in the tooth. It's far easier for me to say from a relative point of view I think Asia is actually quite well placed to withstand any weakness in the U.S. market.

Is the long-term outlook for growth in Asia still positive?

Yes, Asia overall has high saving rates, strong manufacturing bases and an openness to ideas and trade. All of these things combined lead to faster productivity growth, faster wage growth and improved living standards. Europe and the U.S., meanwhile, continue to look inward. All of the things that made Asia grow quickly—openness to new ideas, openness to the rest of the world—are not happening in Europe and the U.S. The two parts of the world are in different growth modes.

What is the corporate earnings outlook for Asia?

Despite fast economic growth in Asia, we really haven't seen growth in corporate profits. Nominal GDP growth in Asia has been very strong ever since around 2011. Profits really went nowhere. It's only over the past year or so that they've ticked up.

A key determinant of how fast profits can grow is what is happening to wages, and in Asia, policymakers have been raising minimum wages. It started in China. They've done it across Southeast Asia. And as soon as you raise minimum wages everybody in the

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economy wants a wage increase. This means corporate profits have been squeezed because you have not had the topline inflation that allows companies to increase profits.

How can you have such strong economic growth and yet corporate profits go nowhere?

The answer is that over the past five or six years, policy-makers in Asia have been far more concerned with looking after the worker, looking after the common man, than they have been looking after corporations and supporting profit growth. And they do this for social stability reasons. So the political chaos in Europe and the political polarization in the United States are born of a sharp divide between the wealthy and the poor. You're not seeing that in Asia because Asian policymakers put social stability over stock markets. In the U.S. and Europe, policymakers have put stock markets over social stability.

Do you think equity markets will be more volatile this year?

I expect more volatility in the stock market than we have seen in the past. In terms of just price moves in the U.S. market over the past year, it's probably been a period of the lowest volatility this century and probably the last century as well. It's hard to imagine that would

continue. Volatility can be an opportunity because given where the earnings cycle is, given where the valuations are, you're likely to see value emerge much more quickly in Asia than you will in other parts of the world. So the question is not about whether there will be volatility or not. The question is: Where is the best place to take advantage of that increase in volatility? My guess is that Asia is probably where you are likely to see more opportunity to put your money to work.

What sectors in Asia are attractive to you?

We continue to favor domestic demand companies in Asia. If you are seeing weakness in the U.S. and in the U.S. economic cycle, you want to be in those domestic demand companies. Part of that is because over the past few years we've seen an emergence of local brands in Asia. They've always been there but they have always seen a lot of competitive pressure from the foreign multinational brands. Over the past couple of years or so, foreign brands have been losing market share to local brands. So the value is in the domestic-demand companies. It is in the small- and the mid-cap stocks, focusing on those companies that have good, long-term earnings prospects and meanwhile trying to avoid some of the overheated, hot sectors of the moment.

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