# Perspectives Q&A:
## Can Asia's Stock Rally Continue?

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***Do you see Asia's equity rally continuing into 2018, and why?***

We believe the rally will continue. Earnings have been subdued in Asia for a number of years. We suspect a main reason has been a focus by governments on minimum-wage increases. On average, these have been well ahead of economic growth rates. Corporate margins have been squeezed as a result. These policies have reversed, however, meaning that corporate profits ought to be able to grow sustainably at faster rates over the medium term. Asia's companies also have faced relatively tight monetary conditions and a strong U.S. dollar. These have improved recently—the dollar no longer seems to be on a strengthening trend and Japan and China (along with Indonesia) have started to loosen monetary policy. We suspect other economies in the region can follow their lead. There is even plenty of room for fiscal stimulus across Asia, too.

***Is there a point at which Asia's equity valuations are just too high? When would investors consider diversifying from heavy allocations in Asian equities to bonds?***

Valuations can always become too high. We would argue a couple of points, however, that make current valuations for the market in general seem less aggressive than at first glance. First, earnings have been depressed for six years across most of Asia. That means that the market, although it may be discounting another year of strong profit growth, is not yet discounting multiple years, in our view. Therefore, price-to earnings (P/E) ratios may be less extreme than they appear. Other measures, such as price-to-book ratios, suggest that Asia is much more reasonably valued.

Second, a lot of the extreme valuations have been in growth stocks—in particular, mega-cap growth companies, including software giants and industrial automation, and some health care companies. During years when earnings growth across the region has been subdued, these companies have attracted a high premium for their growth. If profit growth broadens out, that premium may fall. We believe the rest of the market, in particular many small- and mid-cap companies, seems fairly priced.

Diversifying into bonds faces a real challenge at the moment because yields are low and spreads are low almost everywhere around the world. One area where spreads look a little more reasonable is in high-yield corporate bonds in Asia. As for a significant asset allocation switch, we don't think that will happen unless central banks make a big monetary mistake by tightening too much.

As we listen to clients from around the world, we hear that few are overweight Asia. Very few are confident that the rally will continue. Some are looking to "buy on the dip" but most are skeptical. That gives us a little comfort, as we think a lot of the overexuberance in asset markets is in places like cryptocurrency, not necessarily in broad equity markets.

***If U.S. interest rates go up two or three times next year as expected (meaning a total increase of 50 to 75 basis points), what effect would that have on P/E ratios in the United States? In Asia?***

We think price-to-earnings (P/E) ratios would fall. We also think that growth in the United States would slow significantly, so the economic impact on the United States would likely be far more severe than on domestic demand-driven Asian companies. The yield spread between two-year and 10-year Treasuries is as low now as it was in late 2007. It is only 65 basis points. Three rate increases by the Federal Reserve would threaten to "eat up" that entire spread. That is the prediction the market seems to be making but in our view it is an aggressive prediction. The Fed risks doing too much.

**Figure 1. Two-Year to 10-Year Yield Spread in U.S. Bond Market**

Source: Economic Research Division, Federal Reserve Bank of St. Louis; data as of 11/24/17

### *What would be the impact of U.S. tax reforms, if implemented, on equity valuations in the United States? In Asia?*

The likely impact of U.S. tax reforms, if implemented as the Republican Party envisages, would largely be on the U.S. dollar. A higher U.S. government deficit would likely raise real interest rates and attract foreign investors to buy U.S. Treasuries. That demand would probably push the dollar higher. In addition, corporate tax breaks, to the extent they would increase investment, likely would also increase the trade deficit. This would be achieved through a rising dollar. The investment impact of tax cuts may not be as strong as Republicans expect, but the overall effect of the plan would be a stronger dollar and that probably would put downward pressure on Asia's P/E ratios.

### *Will Asian investors be comfortable with P/E ratios higher than they are now?*

If Asia's corporations continue to grow profits strongly, we do not think P/E ratios are overly high. Other measures, such as price-to-book ratios, are actually very low. It is not unusual at the beginning of an upturn in markets for P/E ratios to seem quite high, particularly if earnings have been depressed. Over time, however, even if there is strong earnings growth, investors would expect valuation levels to return to historic averages. Those averages can be misleading in Asia, however, because the overall composition of markets has changed quite a bit over the past 10 or 20 years. In a global context, too, we think Asia's valuations, particularly cyclically adjusted valuations, and even P/E ratios look reasonable.

**Disclosure and Notes**

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