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Matthews Asia

Matthews Asia Perspective:
The Key Challenges for Asia

The biggest economy in the region, China, is undoubtedly slowing, generating many negative headlines, casting negative aspersions on the outlook for the country and creating more anxiety among the investment community with regards to Asia.

For Sharat Shroff, Lead Manager of the Matthews Pacific Tiger Fund, dealing with negative news in Asian economies is nothing new. Indeed he says many of the issues the region faces this year are a continuation of those the Fund has been navigating in both 2014 and 2015.

"I do not tend to give 12 month outlooks, says Shroff. "But if you are looking for themes there are three key ones; excessive leverage, the possibility of a slowdown in growth and the pace of structural reforms. These are the ones that have been causing the most concern and are likely to continue to do so this year."

Addressing each of these factors in turn, Shroff says that China has long been the poster child of the high levels of debt in the Asia region. However while debt has been increasing over the past two decades in Asia, he argues, economic activity has also been growing at a rapid rate.

"While there are exceptions such as Malaysia and Thailand which we do worry about, beyond these there was a process of deleveraging in the region, especially since the Asian financial crisis in 1997," he says.

"In the last 5–10 years this has reversed and countries have been taking on more debt, but the question you have to ask is whether this is financial deepening or financial distress? Per capita, across Asia, incomes have been steadily rising and at this point in time it does not feel like we are staring financial Armageddon in the face."

In terms of the slowing growth in economies across the region, Shroff says the fact that for the last three-to-four years Asian companies have not been reporting strong performance numbers is disappointing when compared to its own history. This he says has largely been driven by erosion in corporate profitability.

"For about the last five years whereas in the US the returns on equity (ROE) have been expanding, in Asia they have been shrinking," he says. "While there are signs this profitability is starting to stabilize, certainly in the non-commodity and non-industrial space, what is more important is to put the Asian growth story into a global context. Globally I anticipate the trend line growth of economies to be lower, so even if Asian growth does fall it will likely still be better than what other global economies report."

The final factor to consider when looking at the prospects for Asia is the success of the structural reforms that have been taking place. Shroff says these reforms are key to stimulating growth, but admits that the pace of them has been uneven.

"There is clearly an opportunity for countries to improve productivity levels, but as yet we have not seen real forceful reforms that will get them on this path," he says. "However a focus on the big initiatives masks the smaller reforms that have already been implemented. There is progress."

Shroff says that even if volatility does continue throughout the region this year, his job is to ignore the noise and focus on the individual stock opportunities, of which he notes there are plenty.

For example in a tough year for the MSCI AC Asia ex Japan index, Shroff says the healthcare sector ended 2015 in positive territory, while from a country perspective Vietnam, despite its depreciating currency, finished 2015 on a positive note.

"The reality is that a large part of the index is made up of financials, energy and oil & gas companies, whereas healthcare only represents 2–3%," he says. "As such its strong performance is like hearing a tree falling in the woods because it simply not as visible when the much larger sectors are underperforming and are dominating the headlines."

So how does Shroff distance himself and the Fund away from all the negativity? The first thing he says that is important is maintaining a focus on three-to-five years out and not getting sucked into what is happening this or next quarter.

"You also have to stay focused on simply getting the companies and businesses you invest in right," he says. "There is no way for me to get a clear grasp of what the central banks around the world are thinking and what policymakers are trying to do. Our strength is more in talking to the underlying companies and figuring out what their business plans are and expressing these views in the portfolio."

Shroff adopts a bottom up stock picking approach, and seeks companies that have sustainable competitive advantages. Within the portfolio there are a certain number of biases, with the focus on consumer and service oriented companies and sectors (such as healthcare), which aim to capture the growth of domestic demand in the region.

"These businesses have done much better than the whole industrial landscape," says Shroff. "It also means that at any given point in time, a large part of the portfolio's value derives from within Asia itself."

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