Matthews Asia

Matthews Asia Perpective

Why Invest in Asia in an Age of Confrontation?

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Investors are allocating their money as if the short-term trend is now the long-term reality.

I've been grappling with the recent political changes in the U.S. and wondering whether they demand a radical rethink of investment strategy. I have come to the conclusion that the answer is no. The current climate feels like one of confrontation—and why invest in Asia in this age of confrontation? It's easy to get sucked into the political climate and forget the fundamental facts of economic growth. So, although political parties in Europe, the U.K. and the U.S. seem particularly polarized—with nationalism, anti-immigration, protectionism and mercantilism still dominant themes in attracting votes—there are some things that these trends can't change, such as Asia's savings, productivity and growth.

Late last year, my colleague Andy Rothman and I addressed some of these issues as they affect Asia, and particularly China, during a U.S. roadshow as well as via webcast. I expect that much of the coming weeks and months may involve communicating our views on long-term investing in Asia in the face of sensational headlines and, at times, bleak sentiment, driven by changes of course in U.S. policy.

But beyond what we may personally feel about politics, what are the effects on economies as some of the world's largest economies turn inwards? How should we think about this? There are obviously lots of currents and sub-currents we could discuss and plenty of opportunity for volatility in the coming weeks and months. But I want to focus on three aspects. Hopefully, these will bring to light the opportunities inherent in Asian investing in the face of any market sell-downs.

First, we really must stop thinking of Asia as being driven by exports, or by the economy of the U.S. Asia is far too large to truly be driven by anything other than its internal dynamics. Exports are not insignificant, but they are a secondary concern. I believe that growth depends on the desire and ability of people to work hard, learn and better their standards of living. This desire remains unchecked in Asia. Opportunities, too, regardless of any trade issues, remain plentiful in the domestic economies. Over the long term, thrift, productivity and reform—those are the things that count. Second, the actual confrontation that we see (challenges that Asia's labor force may face from U.S. political populism) may actually work in favor of investors in Asia. Let's look at the long-term internal drivers of Asian economic growth and then the reasons behind recent disappointing earnings performance in Asian corporates. Then maybe we can discern a brighter future ahead. We may see stronger overall growth in the Asian region for one thing and a distribution of that growth that may be more favorable to corporates than it has been in the immediate past. Third, confrontation also means less correlation, and the attractiveness of international assets rises.

CORRELATIONS

Let's take the last point first. Even in the rhetoric of confrontation, the international investor can see a silver lining. For, where we can find growth at low correlations to our home investments, we should be especially excited. The shift in correlations has been palpable in recent weeks, compared to 10-year averages. So, even as the changes in tone and policy

Figure 1. 10-Year Correlation (12/31/05–1/12/17)

	NKY	SHSZ300	HSI	KOSPI	TWSE	AS51	PCOMP	SENSEX	KSE	SET	DSEX	FBMKLCI	MSETOP	JCI	VNINDE	SPX	SX5E
NKY	1.00																
SHSZ300	0.20	1.00															
HSI	0.66	0.38	1.00														
KOSPI	0.65	0.24	0.72	1.00													
TWSE	0.58	0.27	0.67	0.72	1.00												
AS51	0.68	0.20	0.70	0.65	0.62	1.00											
PCOMP	0.50	0.22	0.58	0.53	0.56	0.55	1.00										
SENSEX	0.54	0.17	0.67	0.60	0.57	0.56	0.48	1.00									
KSE	0.15	0.11	0.19	0.18	0.21	0.18	0.15	0.14	1.00								
SET	0.49	0.15	0.56	0.53	0.51	0.53	0.53	0.51	0.20	1.00							
DSEX	-0.04	0.00	-0.10	-0.17	-0.14	-0.03	-0.14	-0.01	0.12	-0.12	1.00						
FBMKLCI	0.46	0.27	0.61	0.56	0.54	0.53	0.57	0.53	0.18	0.51	-0.13	1.00					
MSETOP	0.00	0.08	-0.01	0.01	0.04	0.01	-0.01	-0.05	-0.02	-0.01	0.01	-0.04	1.00				
JCI	0.48	0.23	0.59	0.56	0.56	0.55	0.62	0.55	0.12	0.58	-0.08	0.63	0.01	1.00			
VNINDE	0.27	0.14	0.30	0.21	0.20	0.30	0.27	0.24	0.12	0.26	0.07	0.23	0.05	0.23	1.00		
SPX	0.64	0.11	0.61	0.59	0.54	0.69	0.45	0.54	0.13	0.47	-0.05	0.38	0.00	0.43	0.27	1.00	
SX5E	0.67	0.12	0.62	0.61	0.53	0.69	0.44	0.58	0.14	0.47	-0.10	0.43	0.00	0.44	0.25	0.83	1.00

Figure 2. 3-Month Correlation (10/1/16–1/12/17)

	NKY	SHSZ300	HSI	KOSPI	TWSE	AS51	PCOMP	SENSEX	KSE	SET	DSEX	FBMKLCI	MSETOP	JCI	VNINDE	SPX	SX5E
NKY	1.00																
SHSZ300	0.32	1.00															
HSI	0.42	0.48	1.00														
KOSPI	0.60	0.17	0.63	1.00													
TWSE	0.65	0.21	0.68	0.68	1.00												
AS51	0.70	0.38	0.54	0.57	0.53	1.00											
PCOMP	0.28	0.22	0.54	0.31	0.52	0.31	1.00										
SENSEX	0.26	0.17	0.68	0.62	0.59	0.31	0.51	1.00									
KSE	0.13	-0.04	0.21	0.10	0.12	0.25	-0.04	0.08	1.00								
SET	0.12	0.05	0.47	0.25	0.21	0.13	0.31	0.37	0.15	1.00							
DSEX	0.06	0.08	0.40	0.25	0.18	0.18	0.29	0.21	0.25	0.22	1.00						
FBMKLCI	0.25	0.13	0.59	0.41	0.59	0.27	0.59	0.53	0.02	0.24	0.21	1.00					
MSETOP	-0.13	-0.41	-0.26	-0.09	-0.16	-0.16	-0.01	-0.15	0.07	-0.11	0.12	-0.26	1.00				
JCI	0.12	-0.08	0.41	0.33	0.48	0.12	0.53	0.57	0.13	0.40	0.09	0.60	-0.18	1.00			
VNINDE	0.31	0.14	0.30	0.26	0.26	0.38	0.28	0.19	0.10	0.26	0.24	0.19	-0.04	0.14	1.00		
SPX	0.07	0.10	0.12	0.20	0.07	0.14	-0.01	0.09	-0.02	0.13	0.03	0.13	0.02	-0.03	0.00	1.00	
SX5E	0.09	0.03	0.19	0.29	0.17	0.09	0.14	0.33	-0.04	0.30	-0.01	0.14	0.02	0.08	-0.04	0.66	1.00

NIKKEI 225 CSI 300 Index (NKY); Hang Seng Index (SHSZ300); KOSPI Index (KOSPI); Taiwan TAIEX Index (TWSE); S&P/ASX 200 Index (AS51); PSEi - PHILIPPINE SE Index (PCOMP); S&P BSE SENSEX Index (SENSEX); KARACHI All Share Index (KSE); Stock Exchange of Thailand Index (SET); DSE Broad Index (DSEX); FTSE Bursa Malaysia KLCI (FBMKLCI); MSE Top 20 Index (MSETOP); Jakarta Composite Index (JCI); Vietnam HCM Stock Exchange Dec (VNINDE); S&P 500 Index (SPX); Euro Stoxx 50 Pr (SX5E). It is not possible to invest directly in an index.

Source: Bloomberg

are potentially affecting the global economy, they are surely already impacting the way that markets move. For Asia is now showing little or no correlation with the U.S. Is this the way that international markets will evolve—with the U.S., Europe and Asia each increasingly dancing to their own tune? That may be expecting too much too quickly. But it is something to monitor.

The markets clearly seem to be de-linking Asia and the U.S. to an extent. And that is not too far removed from the rhetoric of recently elected President Donald Trump: "Our companies can't compete with them now because our currency is too strong. And it's killing us."

Agree or not with the analytical framework behind these words, this is a strong sentiment that seems pervasive in the new U.S. administration. To those that focus just on the past five years, it seems a bizarre thing to say—U.S. company results have outperformed Asia over that time period. But is that the true trend or just a short-term blip? To put things in context, let us look at the long term.

Figure 3. Aggregate Earnings Per Share Growth, from December 31, 2001

Not surprisingly, Asia ex Japan equities have outperformed U.S. equities in U.S. dollar terms over 10 and 15 years but underperformed the U.S. over 1 and 5 years

	Asia ex Japan	U.S.	Japan	Europe
15 Years EPS CAGR	9.6%	7.4%	8.6%	3.3%
10 Years EPS CAGR	4.3%	1.8%	2.2%	-3.3%
5 Years EPS CAGR	-1.2%	1.5%	3.7%	-7.9%
1 Year EPS CAGR	-9.2%	-4.6%	2.1%	-1.1%

Source: FactSet Aggregate Index; 31 Dec. 2001 to 31 Dec. 2016

IS THE SHORT-TERM TREND THE LONG-TERM REALITY?

The story is the same when we look at dividends per share—superior long-term growth; inferior short-term growth. However, today investors are paying more attention to the short term than the long term: backward-looking price-to-earnings ratios in the U.S. are at about 24X versus 18.7X for Asia ex Japan as of mid-February, according to FactSet Market Aggregates. I look at backward-looking ratios because that shows how people are forecasting growth compared to where we know we are now. In other words, investors are allocating their money as if the short-term trend is now the long-term reality. Let me put this another way, for emphasis, when you account for the fact that a company's value is largely created in the long term, investors believe earnings and dividends in the U.S. will outgrow Asia over the long run and this will translate into better returns for the U.S. over the long term. Is this a likely outcome?

I say no. I believe it is quite unlikely.

My argument runs from economic growth to profit growth and from returns on capital to valuation. First, let's consider GDP growth. In Figure 4, you can see that even Asia's wealthier nations (Singapore, Japan, Hong Kong and South Korea) tend to have a high savings rate. India and Indonesia, often thought of as savings constrained due to their current account deficits, also currently save about 32% of GDP.

Figure 4. Savings Matter

Asia's high savings rates help grow their economies faster. Savings means investment => Growth

Savings as a % of GDP	
Developing Asia	41.5%
China	46%
Singapore	46%
Japan	25%
Hong Kong	25%
South Korea	36%
India	32%
Indonesia	32.5%
E.U.	21.7%
G-7 countries	20.1%
U.S.	18.7%
Brazil	16.4%

Source: economywatch.com; June 30, 2016

Asia can still invest productively to grow its capital stock and seek efficiencies from reform and innovation. Indeed, Chinese President Xi Jinping set the tone with his comments at Davos: "We should develop a dynamic, innovation-driven growth model."

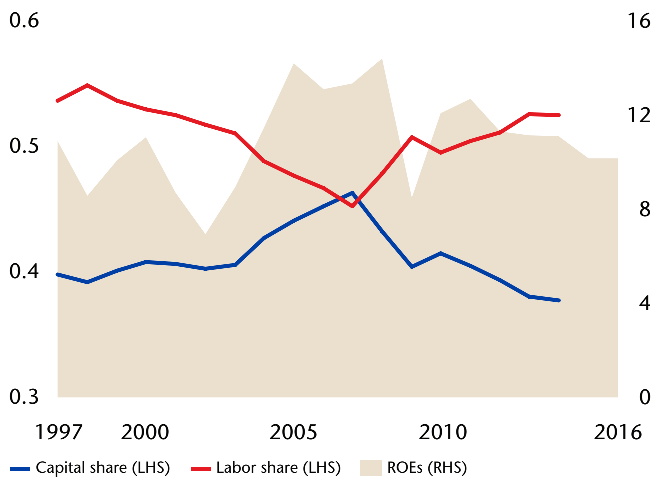
Second, let's look at GDP growth's relationship to profit growth. It should not be surprising that the share of profits in GDP is relatively stable over longer periods of time. Yes, it fluctuates, but there are natural boundaries as to how far it can go. Thus, over the long term, faster nominal GDP growth should result in faster profit growth. In Asia, it depends how you measure it, but

Asia ex Japan's nominal GDP (using the same year-end weights as the FactSet Aggregate Market index) grew at about 8.2% compound annual growth rate between December 2001 and December 2016, according to IMF figures. That seems reasonable, for the unadjusted IMF regional groupings performed in the same ballpark (Asia and Pacific 8.2%; East Asia 7.7%; South Asia 10.7%; Southeast Asia 9.7%). Profit growth in the FactSet Aggregate Index, in terms of earnings per share, was 9.6%. But in any year-to-year comparison, the correlation was only 0.75. And whereas it is true that accelerating nominal U.S. dollar GDP growth is usually associated with positive profit growth, the mere fact of strong growth in any one year does not guarantee strong profit growth in that same year.

The key learning from this is that you are not going to get much useful information from looking at year-to-year nominal GDP growth, but if you are willing to look out over a longer time period, it is indeed a useful guide as to future profit growth. And here, according to our methodology and IMF forecasts, we should expect nominal U.S. dollar GDP growth of 7.5% to 10% over the next three to five years. That range—plus or minus 5% on the lower bound for the sake of factoring in risk (so 2.5% to 12.5%)—would seem to set a sensible range for four-year profit growth in Asia's listed companies, given IMF forecasts. I think the midpoint, 7.5% is achievable. Now that looks really quite decent compared to the U.S., where nominal GDP growth can be reasonably expected to muster 3% to 4% and where the outlook for corporate profits is likely to be below that rate. Why? Because corporate profits over the last decade have been at levels of GDP not seen since the 1950s—there just isn't that much more juice to squeeze out of that particular lemon. We are often told this is a global phenomenon. Well, no, not exactly. We do see it in many countries but *not*, for example, in many Asian countries where the picture is markedly different. According to the Asia Productivity Organisation (APO), labor's share of income in China has risen from 47% to 55% from 1970–2014; for Asia as a whole, it is a similar story.

This seems right. It tallies up with listed-company level data. As wages have continued to rise, particularly in light of recently rising minimum wages, without offsetting productivity gains of the same magnitude, corporate profits have been squeezed. Returns on equity in listed companies have been declining since 2007 to 2008, when the labor share of income in China troughed. I think it likely that this trend will either reverse or at the very least be less severe in coming years, allowing more of that GDP growth to accrue to capitalists than otherwise would have been the case. I am confident, therefore, that earnings per share growth in Asia will likely be much closer to nominal GDP growth than it is has been in recent years. And is a more protectionist U.S.A. likely to reverse this? I doubt it. For if the U.S. is to abandon its strong dollar policy—as evidenced by the president's comments—and is determined to compete with Asian labor costs by using devaluation, then surely wouldn't the Asian capitalist benefit from cheaper labor costs at home? Margins may at least stabilize, if not rise, and capital's share of income will likely rise at least in line with GDP growth.

Figure 5. Labor and Capital Shares of Income in Asia



Sources: Asia Productivity Organisation, as of 12/31/2014; FactSet Research Systems (ROEs of Asia ex Japan)

In my view, future profit growth will likely be superior in Asia.

What about returns on capital? Well, here we have to accept that Asia, on average has been worse-performing than the U.S. Asia ex Japan's weighted average return on capital is 9.2%, and average 5-year return on invested capital is higher at 10.6%, as of late February 2017. For the U.S., the numbers are 11.3% and about 12%. Now that is not much lower, but it is less than the U.S. If we look just at the S&P 500 Index, the numbers are 13.1%—a full 3 percentage points advantage, which is not insignificant. But there is also a role for stock picking here, after all, if we get to be selective with the U.S. universe, let's be selective with the Asia ex Japan universe. Let's just use the total of Matthews Asia's holdings on behalf of clients as a universe. If we look at the weighted average return on capital of Matthews Asia holdings, it is 13.9%. The five-year average return on invested capital for Matthews Asia holdings is 15.8%. This compares with 11.3% and 12.1% for the U.S. FactSet Aggregates and 12.3% and 13.1% for companies that comprise the S&P 500 Index. So, within this fast-growing region, one can buy companies with good returns on capital—as good as, if not better, than the average U.S. company. That is the role of stock selection.

And in the current environment, we are able to pick such companies without overpaying. After all, I have said, one might expect therefore that one would have to pay a premium for these businesses over the average U.S. business. But, no—using EV/EBIT (to address capital structure differences) the Matthews Asia average stock is comparable to the average U.S. stock (14.6X for both at the median; 16.2X vs 18.2X at the weighted average; and 11.9X vs 14.0X at the weighted harmonic average) as of late February. If that comparison seems too broad, then let's look at the companies that comprise the S&P 500 Index (we are then comparing a similar number of stocks, 14.6X vs. 14.6X; 16.2X vs 16.4X and 11.9X vs. 13.8X).

So, when we look at returns on capital and valuation, Asia still looks compelling, at least in terms of the typical Matthews Asia holding.

CONTINUED FOCUS ON THE DOMESTIC

For sure, Federal Reserve policy and the dollar do play a key role in global monetary policy. But it is becoming increasingly narrow-minded to think of the U.S. as the center of the world. One might make the argument that a more protectionist U.S. is already thinking about retreating from that role anyway. And maybe China will step into the fray. But just on plain data: the IMF reckons that the U.S. will have added about US$3 trillion to GDP in the five years to end 2016; China alone will have added US$3.9 trillion. Emerging and developing Asia together added US$4.7 trillion. Although the U.S. was the second-largest contributor to growth in terms of single countries, in third place was India and in fourth place South Korea. Other Asian countries proliferate in the leading growers—from Vietnam to Bangladesh. If the world is to split into trading blocs: the Americas, Europe, and Asia; it is likely that Asia will be the most vibrant of the three.

So we continue to focus on the domestic companies—even in the light of a rising share of capital income at the expense of labor's share in Asia, wages will still be growing strongly. Demand will still be growing quickly: a weak U.S. dollar policy would mean that will likely be the case even more so in US$ terms for domestic businesses. As investors in Asian companies, this is an enticing prospect. Growth will likely be more favorably skewed towards the capitalist in Asia than it has been in the immediate past so the investor will share more of the growth of the region's consumer. And it is still in the consumer-facing businesses that we find the most commercially structured industries, best-managed companies, and higher return-on-capital businesses.

SHORT-TERM DECISION-MAKING IN THE LONG-TERM CONTEXT

Despite this potential for growth and for improved returns to capital, the short-term worries still remain—tariffs, trade wars, the short-term impact of policies that might further strengthen the dollar. One can reasonably expect volatility to increase—statistical measures of volatility in the U.S. are extremely low as I write. Policy moves are uncertain. And while I am confident that the growth in Asia will assert itself on profits and investment returns over time, I cannot say with any confidence that the next few months will be a smooth ride. But until I see the fundamentals driving domestic growth in Asia change significantly, the new age of confrontation, of low or negative market correlations, of a U.S. determined to compete with Asian labor, that new age seems to offer plenty of long-term opportunities. For the long-term fundamentals of growth persist in Asia, even as short-term markets moves might be clouded by sensationalism and hype.

Enterprise value to Earnings Before Interest and Tax (EV/EBIT) is a measurement to whether a share in a company is cheap or expensive, relative to competing firms or the wider market.

Price-to-Earnings Ratio (P/E Ratio) is a valuation ratio of a company's current share price compared to its per-share earnings.

Return on Equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested, and is calculated as net income divided by shareholder's equity.

Return on Invested Capital (ROIC) is a calculation used to assess a company's efficiency at allocating the capital under its control to profitable investments. The return on invested capital measure gives a sense of how well a company is using its money to generate returns.

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