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ASEAN Equities: Expect gradual progress

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Key takeaway: Global concerns are masking domestic resilience in ASEAN. Sustained economic growth, positive structural themes and attractive current valuations present long-term opportunities.

Differentiated performance within ASEAN entering Q4 2018
Asian equity markets have been weak since the end of Q1 2018 and the ASEAN region has not been spared. The MSCI AC ASEAN index is now down over 4% year to date in SGD terms and 7% in USD terms. But not all markets are equal as seen in the chart below, Indonesia and the Philippines have been particularly hard hit.

CHART 1: Performance has been differentiated within ASEAN equities (Year to Date, 31 July 2017)

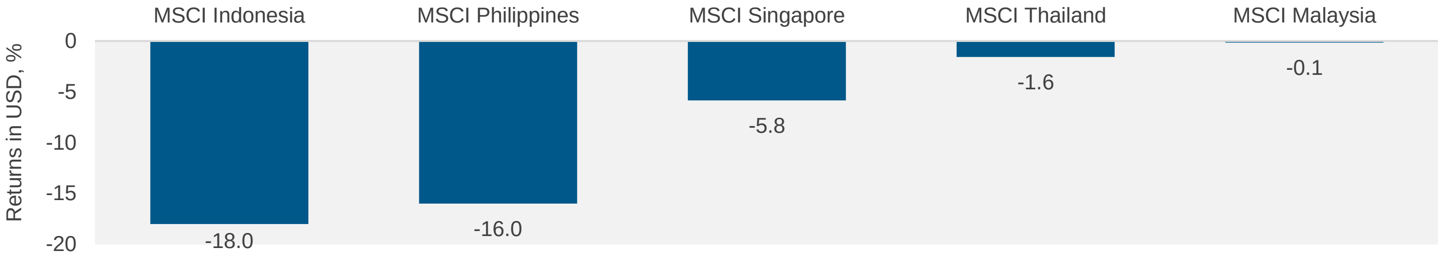

Chart 1 Sources: Legg Mason, Bloomberg as at 31 July 2018

Overarching reasons for the weakness
As we see it, there are two main drivers to this sell off. The first is the change in the global liquidity environment as Quantitative Easing (QE) ends and interest rates rise. Whilst the world was awash with liquidity and extremely low rates, capital sought out higher returns and flowed aggressively to Emerging Markets such as Indonesia and the Philippines.

As this reverses and capital begins to flow in the other direction, pressure is being felt on exchange rates. For example, the Indonesian Rupiah is 5% weaker against the Singapore Dollar year to date, which itself is 3% weaker against the US dollar. The result is not only lower returns due to exchange rate moves, but also a more challenging growth environment as policy reacts to the new reality of tighter liquidity. Investors are discounting a lower growth environment as well as concerns on where capital may flow if the world becomes more risk adverse.

The second driver is diminishing corporate earnings expectations. 2017 was the first time in many years when analysts had substantially underestimated the growth in earnings. Valuations in the region have been above average for some time now, but with a big upgrade to earnings growth expectations, markets were able to progress without a further re-rating. However, that expected growth doesn't look set to continue as reflected in the weaker equity markets.

Corporate earnings to grow above 2017's level
We are about half way through the Q2 2018 reporting season and its quite clear that earnings expectations are being reset. In the last month almost twice as many companies have seen downward earnings revisions compared to those seeing upward adjustments.

Nevertheless, we are still likely to see a higher level of earnings in 2018. To give some context, Indonesia is forecasted to have earnings grow at 11% in 2018, whereas the market was forecasting 13.6% at the beginning of the year. Filipino corporates have seen the biggest cut to earnings growth down to 6.1%. The one exception is Singapore; where earnings growth in 2018 at 14.9% is considerably higher than 6 months ago, although even the forecasts for Singapore-based companies peaked a few months ago.

For the bottom-up investor, these figures suggest the environment for corporates is still reasonable and growth is possible, but things are tougher. There are also significant differences between sectors. Take the energy and commodity companies for example; who are growing earnings rapidly on the back of higher oil prices. Singapore banks also look to benefit from the interest rate cycle so long as bad debts remained subdued. On the other hand, consumer companies in the Philippines and Indonesia are finding managing costs and margins much tougher than expected hampered by rising inflation and weak domestic currencies.

Higher rates and exchange rate volatility will obviously bring to mind the problems of overseas debt funded corporates in Asia back in the Asian Financial Crisis. However, our observation is that far fewer companies today face this difficulty. As rates rise and credit becomes harder to obtain it will be cash generative companies with strong balance sheets, who can invest from their earnings who have the most strategic flexibility and those are exactly these companies we prefer in such an environment.

Expect gradual progress without significant disruption

Despite recent unease, we are still expecting gradual progress without significant disruption. Such an environment when accompanied by a steeper yield curve should prove positive for the banks in the region, in particular the Singapore Banks, who have struggled with extreme low domestic rates and therefore living with low margins for a number of years. The worst of the credit cycle appears to have finished and we do not see any worsening, in addition loan growth is slowly picking up along with margins. Until their recent outperformance, they were trading at historically low valuations and continue to appear attractive to us.

The consumer facing sectors are always of interest in a region driven by urbanization, expanding incomes and growing populations. Whilst we are conscious of the macro instability, it is important not to lose sight of the structural drivers. Hence, the recent fear is presenting valuation opportunities in a number of consumer segments. At the moment consumer staples, such as supermarkets look particularly interesting given they benefit from a number of enduring trends, yet by their very nature, tend to be less cyclical.

Long term positive on Indonesia and Philippines

There is no shortage of interesting and diversified investment opportunities across ASEAN. In general, the less developed markets present the most interesting long-term opportunities, in particular Indonesia and the Philippines. This stems from faster growing economies, the opportunity for positive reforms to enhance growth and stability and underpenetrated consumer markets. However, the last few years has seen valuation levels in these markets higher than historically reflecting most of the opportunity but not all the associated risks. We may not quite be there yet, but this situation means that valuations are trading below long term averages for the first time in some years. Given the interest rate cycle, we may not yet have seen the bottom, but opportunities will be presented.

CHART 2: Forward Price to earnings for Indonesia and Philippines are below their long term average

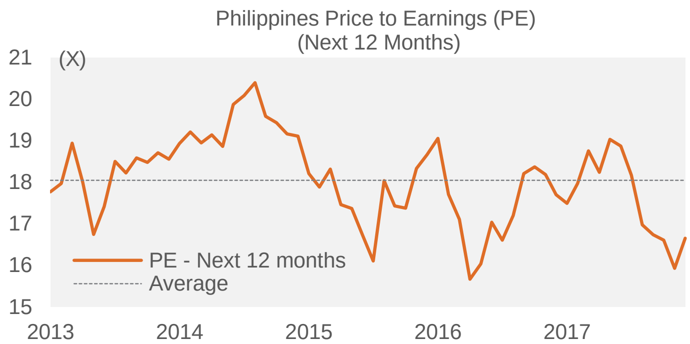

Chart 2 Sources: Martin Currie and FactSet as at 20 July 2018. All data is in USD.

For the more immediate future we are positive on Singapore. Not only does it offer relative safety in this tricky macro environment, but earnings are superior within the reginal context and valuations are below long term averages. In addition, our preference for Singapore banks, we see opportunities in the engineering and consumer sectors.

Prudent authorities

Conscious of past episodes of volatility, including the taper tantrum of 2013, authorities are keen to maintain stable exchange rates and low inflationary expectations amid capital outflow. However, to do this involves higher interest rates and contractionary fiscal policy even at a point in time where the local economies could do with a boost. Indeed, both the Indonesian and Philippine central banks have now raised rates by 1% so far. Recently, Indonesia also announced policies to reduce imports to shore up the current account deficit. In the Philippines inflation has picked up and the current account has moved into deficit, hence we see a bigger move in rates than previously anticipated. These moves are prudent from a long term macro-stability point of view, but they will crimp growth and earnings in the short term, weighing on stocks over the coming year.

Economic growth, structural themes, attractive valuations

To conclude, it is important during market sell offs and periods of volatility to remember the long-term reasons to invest. ASEAN offers some of the best growth dynamics within Asia, coupled with structural themes such as infrastructure, consumer growth and trade. The valuation multiples over the last few years have reflected this, but the current sell off may present an opportunity to invest in good long term growth companies at lower valuations.

Source: Legg Mason, Martin Currie as at 21 August 2018. All data as at 31 July 2018 unless otherwise stated. ASEAN refers to Thailand, Indonesia, Philippines, Singapore and Malaysia. PLEASE REFER TO THE IMPORTANT INFORMATION ON THE FINAL PAGE. FOR PUBLIC USE IN SINGAPORE, HONG KONG AND TAIWAN AND DISTRIBUTORS' USE IN MACAU ONLY.

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