MARKET INSIGHT

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2016 Asia Outlook

The year-end holiday season is a time of reflection: a chance to look back at what has transpired over the previous year and look ahead to the next 12 months.In time honoured tradition, let's look into our crystal ball to see what 2016 has in store for selected Asian nations.

China Economy Stabilising

We start with the biggest elephant in the room – China, where we continue to expect a stabilisation of the economy. The latest November PMI figures were mixed but indicated that a rebalancing of the economy away from manufacturing (November official manufacturing PMI came in at 49.6) and towards services and consumption (non-manufacturing PMI improved to 53.6). We fully expect this trend to continue. In addition, we expect further cuts to interest rates and the bank reserve requirement ratio as inflation remains largely under control. These measures together with a pick-up in infrastructure spending and a recovery in the property sector should allow the country to hit its revised 6.5% growth target. A stable China is crucial as it has a direct bearing on the rest of Asia.

Furthermore, the announcement that the International Monetary Fund will include the Chinese Yuan into the Special Drawing Rights (SDR) basket of reserve currencies is a significant development. Not only is it an acknowledgment that China has formally arrived as an economic superpower, but it also points towards further liberalisation of China's financial sector. In this regard, expect the Shenzhen-Hong Kong Stock Connect to be launched in the first half of 2016, as well as additional measures to develop the onshore bond market.

Cyclical Recovery in India

In what could be an important development, the other giant in Asia – India is showing signs that a cyclical recovery in its economy could continue into 2016, where GDP growth is expected to exceed 7.5% (Q3 GDP was up 7.4% yoy). India generally disappointed in 2015as far too much was expected of Prime Minister Modi. Things however are looking up as projects which were previously held up by bureaucratic gridlock are slowly being revived, while domestic consumption is improving with higher urban discretionary spending (the seventh pay commission should help spur spending as incomes rise). The plunge in commodity prices have also kept inflationary pressures in check which has allowed the Reserve Bank of India to implement accommodative monetary policies.

While questions remain over India's current account deficitand the high level of non-performing loans in the banking sector, these issues have generally been under control and will ease should the anticipated growth in the economy materialise.

Vietnam a Rising Star, the Philippines Still Strong

South-East Asian economies have generally been under pressure in 2015. The Philippines has been the lone bright spot, and Vietnam now appears set to join. The Philippines has been one of the fastest growing economies in Asia over the last few years as the no-nonsense style leadership of President Aquino has spurred domestic investments, spurring a boom in the local property market and a rise in domestic consumption. There are concerns however that the economy could slow in 2016 with growth falling below 6%. In addition, there is political risk as the country enters an election year with questions over the identity of the new President and whether he or she can continue the good work of the Aquino administration.

The Vietnamese economy is on the cusp of a strong rebound in 2016 and is seen as one of the key beneficiaries of the recently signed Trans Pacific Partnership Agreement (TPP). Vietnam has a deep pool of highly skilled low cost workers and has attracted labour intensive industries to set up operations on its shores. Indeed, one of the biggest exports out of Vietnam these days are Samsung smartphones, a sign of how manufacturing is booming in the country. The TPP will likely further accelerate this development. In addition, the Vietnamese government is

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also committed to opening up sectors that were previously closed to foreign participation – for instance, foreigners are now permitted to purchase property, while there is talk that caps on foreign ownership in the domestic stock market will be eased.

Rest of South East Asia Faces Challenges

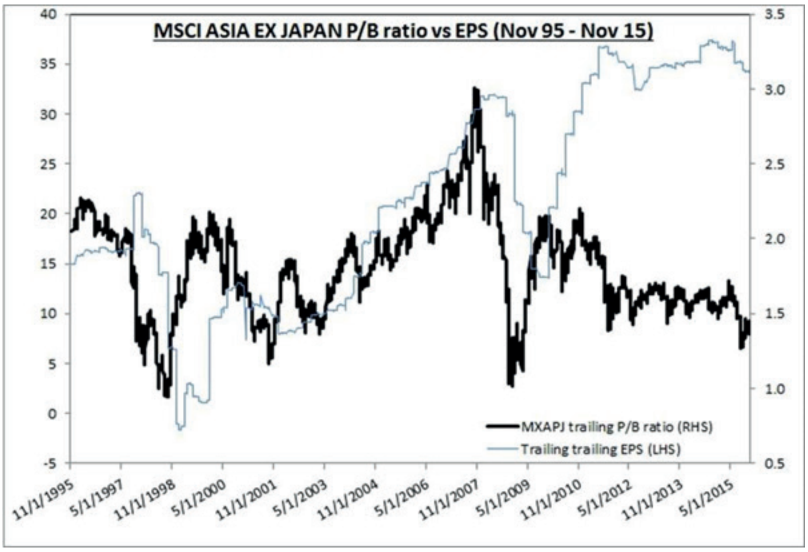
Problems however persist in Thailand, Indonesia, Malaysia and Singapore where the outlook remains challenging. Malaysia has suffered with the plunge in oil prices and the 1MDB debacle which has questioned the legitimacy of Prime Minister Najip Razak's leadership. Akin to the problems plaguing India, Indonesia also disappointed this year as President Joko Widodo failed to turn the economy around and Indonesian markets suffered from capital flight. Thailand is also faced with a host of problems from terrorist bombings which affected tourism, to a lack of action by the military leadership to help the domestic economy, to slowing consumer spending as Thai consumers grapple with being one of the most indebted in Asia. Meanwhile, Singapore has been seen growth moderate significantly to just over 2% as the country struggles to shift away from population-led growth to productivity-led growth.

Despite these issues, there are some signs that things could turn around for these troubled nations in 2016. Indonesia for instance is starting to show some signs of improvement in consumption and capital expenditure, which could lead to a potential recovery in corporate earnings.

Asian Markets Still Attractively Valued

Asian equity markets have had a rollercoaster year. A strong start saw the MSCI ex-Japan index peak in April before suffering a steep correction till September, before staging a bounce in October. Still, as at end-November the index is still down -12% and likely to post another year of negative returns.

Valuations however remain quite compelling. The graph below shows that the trailing price-to-book ratio for the MSCI Asia ex-Japan index is close to the levels last seen after the bursting of the tech bubble in 2001 and not far from the trough levels during the Asian and the Great Financial Crisis ('GFC'). Interestingly, the close correlation between earnings and the price-to-book ratio has broken down since the GFC. This is due to steadily falling ROEs for Asian companies since 2010, a likely result of widespread de-leveraging of corporate balance sheets and pressure on net margins as earnings expectations have been consistently lowered. 2016 however could be the year where Asian corporate ROEs start to rise again, thereby leading to a re-rating for Asian stocks. Indeed, Asian equity markets tend to correct ahead of the start of the Fed's tightening rate cycle, but then generally bounce back after the first rate hike. If history repeats itself, a Fed rate hike in December will help set up Asian equities for a good 2016.



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