MARKET INSIGHT

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Market analysis

View from Asia

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Hazy conditions in Asia to clear in Q4

We usually enjoy a nice view from our office here in Singapore. These days however, the iconic Marina Bay Sands is shrouded by a thick layer of haze, while the nearby island of Sentosa is completely blocked from view. The poor visibility is due to the annual fires started in Indonesia's agricultural regions of Sumatra and Kalimantan to clear forest land. The poor air quality has led to the closure of schools in Singapore and Malaysia and is estimated to cost the region close to $14 billion.

The outlook for Asia and emerging markets has been similarly uncertain with an estimated $40 billion having fled the region in Q3 according to the Institute of International Finance, the worst capital outflow since the financial crisis of 2008. Bloomberg also reports that over $5 billion left Indonesian, Thai and Philippines equities in the same period as investor confidence in the region plummeted following concerns over China – both on the state of its economy, and worries over stock and currency market volatility. Uncertainty over the impending Fed rate hike is also contributing to the jitters with the taper tantrum of 2013 fresh in investors' minds. The results have been ugly for Asian markets which suffered a 17.4% correction in Q3, one of the worst quarters since the 2008 financial crisis, led by a sharp selloff in Chinese equities.

The recent weak economic data released from China has only reinforced these fears. Indeed, it is likely that China's Q3 GDP growth will fall short of the official target of 7%. While partly, weaker numbers aredue to falling external demand as global growth tails off, domestic issues are arguably the main reason for the poorer figures. The first is that President Xi Jinping's strong anti-corruption drive, while beneficial over the long-term, has led to a short-term collapse in domestic spending (catering / gifting) and more importantly, caused government paralysis as officials are reluctant to make decisions for fear of future prosecution. It is notable that China's local fixed asset investments have more than halved since the start of the anti-corruption drive.

Secondly, the structural rebalancing away from export-driven growth to one that is more dependent on domestic consumption has contributed to the slowing growth. While a lot of attention has been drawn to China's deteriorating export and manufacturing numbers, the fact that China continues to grow its services industry has flown under the radar. This can be seen by the divergence between China's manufacturing and services PMIs – the manufacturing sector continues to contract (September manufacturing PMI at 49.8, below 50 indicating contraction), while the non-manufacturing sector continues to expand (September non-manufacturing PMI stayed strong at 53.4). This structural shift is a necessary step in the development of China's economy and should see domestic consumption contributing a larger proportion to GDP growth in the future.

Improvement in China's Q4 Economic Numbers

We maintain our view that the Chinese government will be able to engineer a soft landing for the economy. The slew of economic stabilisation measures unleashed by the authorities includes looser monetary policy – through cuts to the interest rate and reserve requirement ratio, infrastructure spending plans and initiatives to support the property sector. All these policies however will take time to take effect. As such, we expect China's economic numbers to start showing improvement from Q4 onwards.

Furthermore, China's key housing market is still in good shape. The housing sector is arguably more important than the local equity market, with 66% of household assets tied up in property as opposed to less than 10% in equities. As such, it is encouraging that average home prices appreciated for the fourth straight month in August, while new home sales increased 16%, paring down inventory levels. The series of interest rate cuts and loosening of mortgage rules has helped reduce the debt burden on homeowners and thus support demand for housing.

Market Sentiment Weak

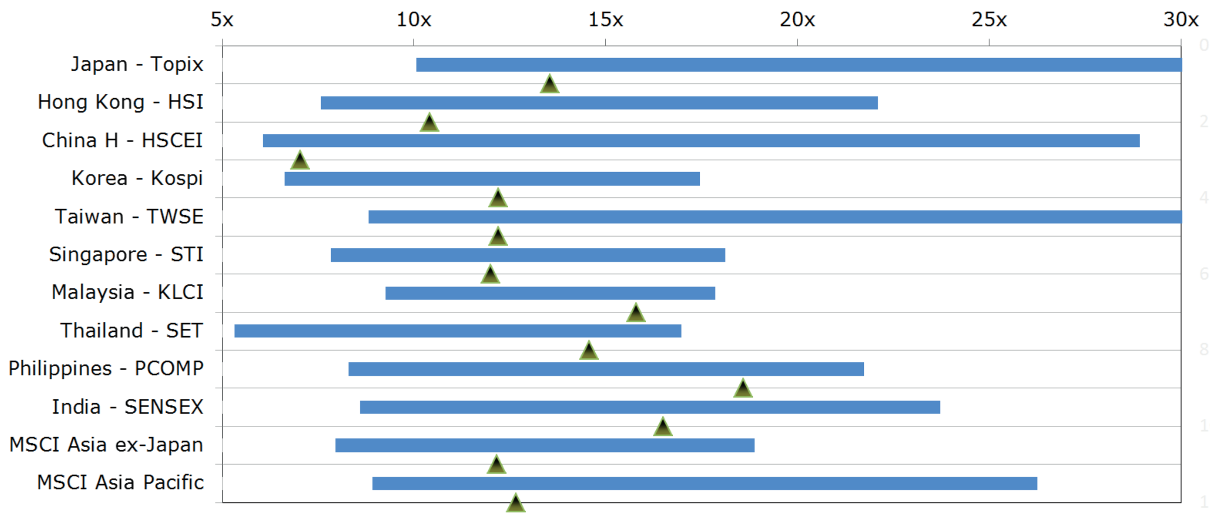
While the Chinese economy appears well supported, the same cannot be said for investor sentiment. Market sentiment currently for Chinese equities is very depressed. Retail investors appear to have lost confidence in the local A-shares market. Margin trading has dropped from its peak of CNY2.5 trillion in June to the current level of CNY1 trillion, suggesting that much of the animal spirits have dissipated. Most investors feel betrayed by the government for first talking up the stock market, then failing to step in with the appropriate action to support the market when the bubble burst. It will likely take some time before retail investors are willing to dip their toes back into A-shares. China H-shares have also suffered from poor investor sentiment as international investors reduced their emerging market and Asian equity positions.

As a result of the selloff, valuations for Chinese stocks are now at very attractive levels. The chart illustrates that China H-shares are trading at the low end of its 10-year historical PE range, suggesting that most of the bad news is already priced in. With investors' heavily underweight China, it may not take very much good news for H-shares to stage a recovery.

Another potential catalyst for a recovery in Chinese equities includes the upcoming 5th Plenary Session where there will be a reshuffling of government officials (ahead of potential changes to the powerful Politburo Standing Committee in 2017) and preparing the 13th Five Year Plan. Indications that President Xi Jinping has managed to strengthen his political position would lead to a renewed mandate for economic reforms. This could also cause a shift in the anti-corruption initiative and "un-paralyse" government decision-making. The impact of these shifts could result in a pickup in fixed asset investments and push along the SOE reform agenda. China's State Council recently unveiled a blueprint to reformSOEs and while the timeline is unclear, it will lead to more efficient use of capital, better productivity and enhanced returns to shareholders.

Some experts say that the hazy conditions plaguing Southeast Asian countries could last till November due to the drier El Nino effect this year. Clearer skies however are expected once the monsoon rains arrive. By then the outlook for Asian markets should also be less hazy as stronger news flow coming out from China starts to trickle in.

Asian Markets Current PE vs 10yr range (2005 - 2015)



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