Asia: Looking Through the Policy Volatility

The new decade starts with optimism. Inevitably the outlook for the year will be shaped by the evolution of Sino-US trade talks and the effect it has on sentiment. But the rebound in money supply growth in developed countries is a plus point. A return to quantitative easing in the US and European will end the need for Asian policymakers to consider raising interest rates or tighten fiscal policy.

Inflation-adjusted interest rates in Asia are already positive outside of Australia and the US dollar-linked markets of Hong Kong and Singapore. Yields in Asia are higher than developed nations and equities are cheaper, making both an option for a balanced portfolio.

Chart 1: MSCI Asia Forecast PE v MSCI Developed Markets

Source: Bloomberg

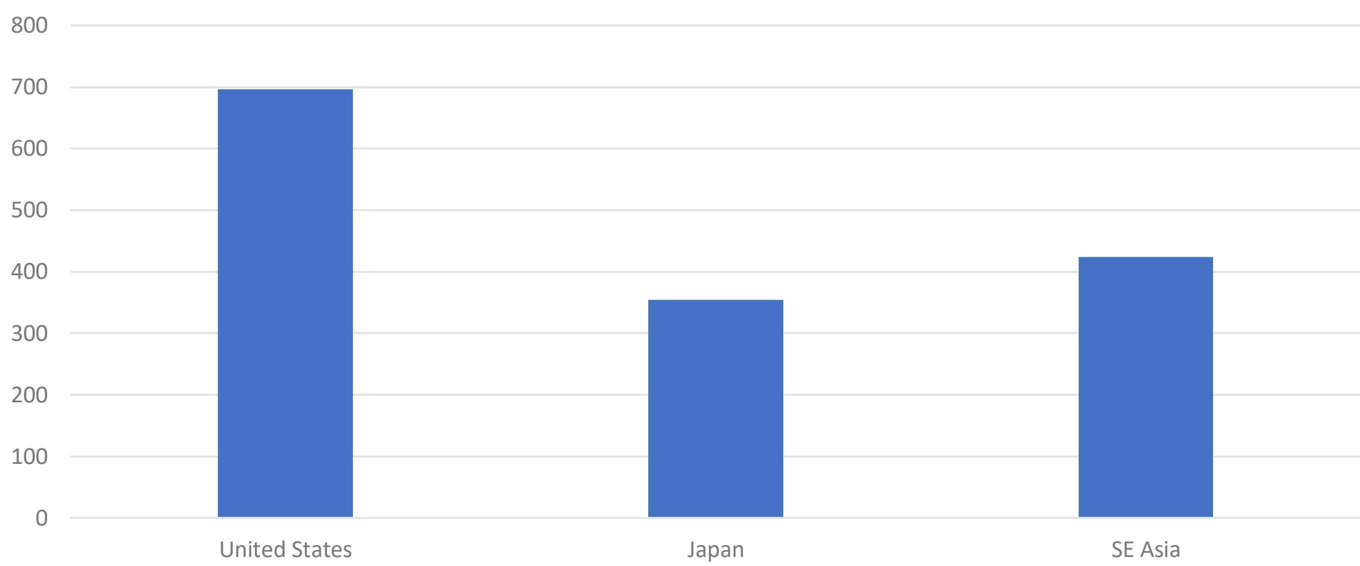
US-China: Tensions to Stay

Washington and Beijing have engaged in a trade spat for most of President Trump's term in office. Most professional observers are looking for some concessions in the early months of 2020. We expect some, such as allowing greater US agricultural exports, but little else. Trade tensions will inevitably continue to shock Asian financial markets periodically.

The key considerations for investors are 1) does President Trump's business style make a deal or an easing of tensions likely? 2) does China have any incentive to offer olive branches or even concessions? 3) what are the knock-on effects in Asia for trade and financial flows?

In the first case, 2019 was a year in which President Trump largely delivered on threats but stalled on agreements. Trade barriers went up as expected but talks to begin normalising relations invariably fell through each time. By the end of 2019, it had become clear that re-negotiating US-Sino trade relations was only one of President Trump's objectives and major moves forward were only likely when all adversaries, including European allies, started to give ground.

Chart 2: Exports to 1) US, 2) Japan and 3) Southeast Asia



Source: Bloomberg

In short, President Trump is pushing for a full package of concessions from the international community, thus making 'the deal' with China less likely in the near term. The trade war with China has not produced the onshoring of jobs to industrial sectors and states of the US, which are essential to President Trump's re-election hopes. Trump's incentives to settle are not high.

If the US won't blink, what about Beijing? President Xi doesn't face any major leadership challenges in 2020. Could there be a unilateral move? We believe that social events in Hong Kong, Taiwan's impending elections, the fact that mainland growth hasn't slumped in 2019 as tariffs bite and the re-orientation of China's trade towards Southeast Asia has given Beijing a need and room to wait.

In short, with neither side needing to move, there is little chance of an early resolution.

Knock ons: Semis & Southeast Asia

But this isn't necessarily a market negative. This is not a materially different state of affairs to last year.

South Korea and Taiwan benefit from having US political backing and a large, dependent customer base in China. They are well placed to gain better trading terms from China. Exporters and manufacturers in these two nations should be shielded from downside risk. That said, gains for semiconductor manufacturers are likely to be muted given US national security concerns and dependence of Taiwanese / South Korean manufacturers on American component suppliers.

Also, Southeast Asia is gaining from being co-opted into a Chinese-centric trading block and China's re-orientation of its supply chain. This transition has intensified as tariffs have increased. Vietnam, in particular, has picked up market share from diminished US exporting activity.

Japan: The High Jump

An additional beneficiary is Japan. Inward tourism has rocketed in the last ten years. Just over 6 million people visited Japan in 2009. Little changed until 2011. Since then the number of visitors has broken the 30 million mark with the majority coming from China, Taiwan and South Korea.

The Tokyo Olympics will be held in July and August 2020. Tourism, hotels, consumerism and demand for Yen will likely remain strong throughout the year.

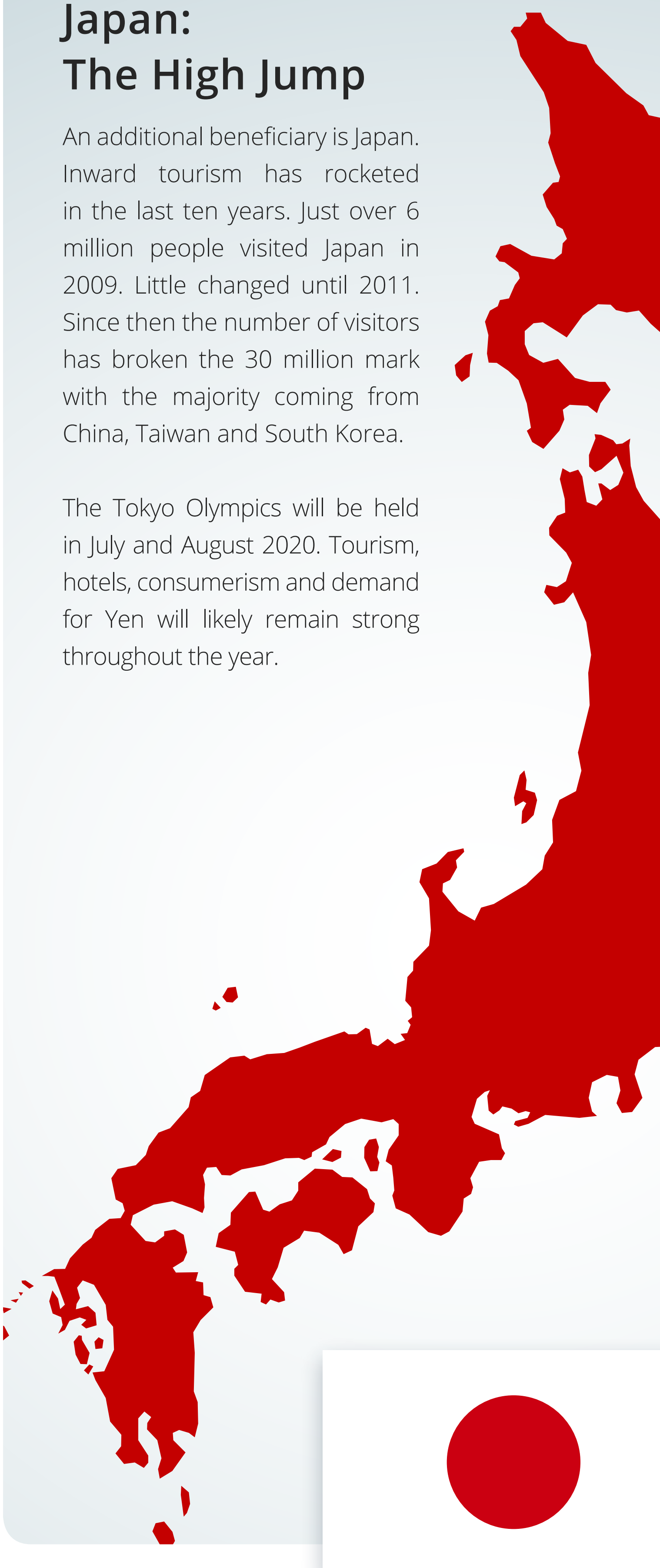
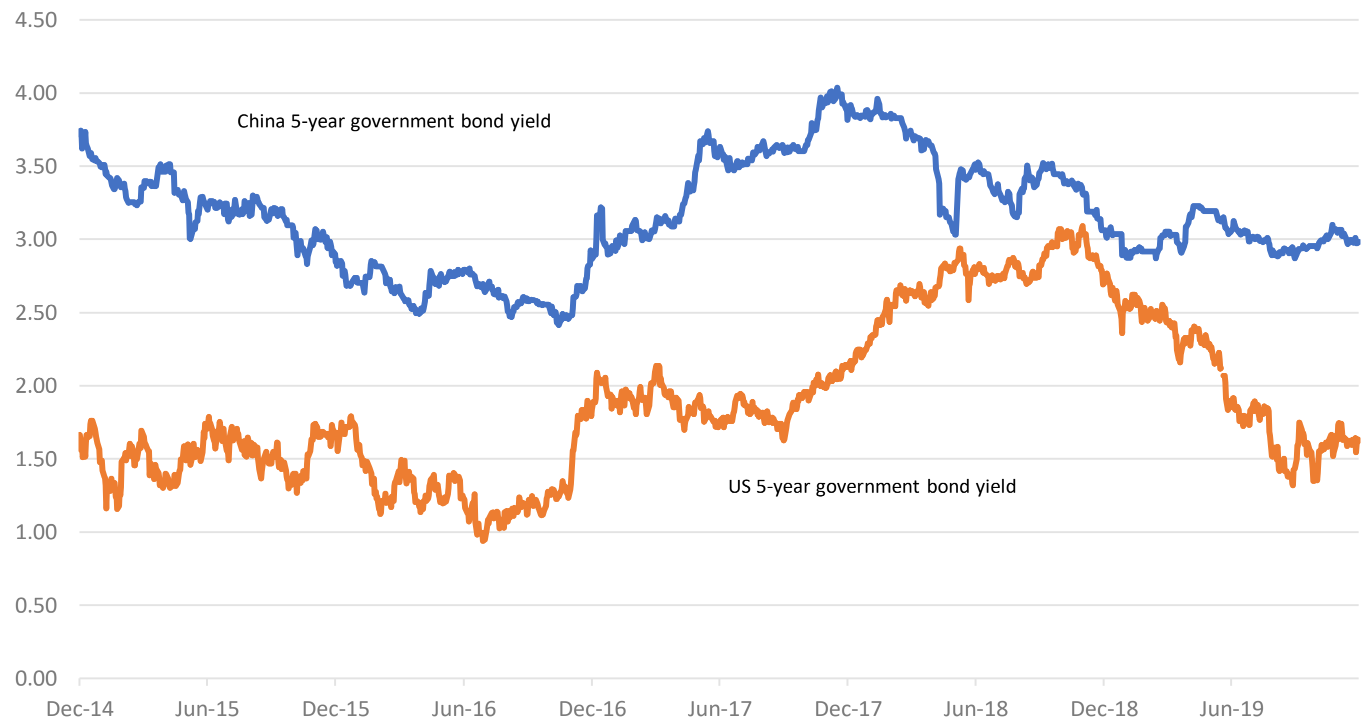


Chart 3: Chinese 5-year CNY bonds v US 5-year government bond yield



Source: Bloomberg

Asian bonds: Yield Gap

From an investment perspective, Sino-US trade tensions are less critical to potential returns than regional growth and capital flows from low interest yielding developed markets. While consensus forecasts expect China's headline growth rate to fall from 6.1% in 2019 to 5.9% in 2020 and then 5.7% in 2021, growth in the rest of Asia is expected to bottom out in the next six months. Growth should return to near trend levels by 2021, providing there is no recession in the US (not our central forecast).

As growth recovers, we could see the same sustained flows into Asia as 2013-15. Policy loosening by the US Federal Reserve and the European Central Bank is once again suppressing long-term interest rates in developed markets and improving spread returns for Asian currencies and bonds. Asian bond yields remain attractive relative to the US and Europe. Asian High Yield bonds carry an average yield of 7%. Asian 5-year government bonds yield 1-3% points more than in developed markets.

Asian equity markets are cheaper than developed markets, trading at a price-to-earnings multiple of 14x 2020 earnings for Asia ex-Japan index versus 16.4x for developed markets. The latter is priced at close to its 10-year high. Asian equities now represent a better risk-reward proposition than their developed market counterparts.

Asian FX: US Dollar Peak?

Once again, the year's outlook is heavily dependent on the direction of the US dollar. After substantial gains in 2018, the greenback has not moved a long way again against Asian currencies over the last 12 months. If US monetary policy remains loose as the Federal Reserve appears to be signalling, then another year of currency, reasonable stability is likely. That again is a positive for Asian bonds and equities as growth stabilises and currency risk diminishes.

By Mark McFarland

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