# What's Your 2014 Market View?

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## by Robert Horrocks

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It's that time of year: the sun has weakened and the days are shorter; the U.S. is now in the grips of a polar vortex; children have penned their complaint letter to Santa's delivery elves; and around the globe, ruddy-cheeked members of asset allocation committees are in a state of high excitement about what 2014 holds in store. Now it is time for the prognosticators to gaze into the near future.

During this season, perhaps the most famous of all North American prognosticators makes his appearance on February 2nd—Punxsutawney Phil. The famous groundhog has made over 100 predictions since 1887 for either an "early spring" or a "long winter" on Groundhog Day. Unfortunately for Phil, in what is essentially a flip-of-the-coin type decision, his accuracy is about 39%.[i] I am tempted to say that the same would essentially be true for stock market prognosticators, properly measured. But their (our) views are so hedged and balanced and nuanced that any outcome is justified. Phil is at least admirable in his clarity.

But as Phil's track record shows, clarity can be overrated. And I certainly do not intend to provide such a clear prediction with but a 50/50 chance of being right or, worse still, if right, no real hope of knowing why I was right. For, as far as my calculations can make out, using each year-end over the past two decades as a starting point, the correlation between 12-month price returns in Asia ex Japan and 12-month earnings-per-share growth or book-value-per-share growth is marginally negative and essentially zero.

The Big Chill

But at least we can say something about the current environment for investing in Asia and how it might change. Asia's markets have started 2014 suffering their own kind of chill. We enter 2014 with credit cycles in Asia at a more advanced stage than in the U.S. and Europe. That means the short-term news flow in Asia this year is more likely to be concerned with bank balance sheets, rising bad loans, and more constrained access to funding for companies. This is currently being matched by restrictive credit policy by some central banks. China, for example, has been trying to moderate credit growth and prevent real estate bubbles. India has been tightening credit to try to improve its current account balance, dramatically slowing industrial production to a crawl, and Indonesia is embarking on a similar course. Even Thailand, where the current account is roughly in balance, seems to have a credit cycle that is somewhat long in the tooth. Seeing this, many asset allocators have decided to switch into countries in North Asia—China (China/ Hong Kong), Japan and Korea. Each has a current account surplus and therefore is thought of as financially secure. This seems logical and smart. There is an issue with this switch, though. Firstly, although it is undeniable that it is in general a switch from more expensive valuations to cheaper ones, and that is—all else being equal—a good thing; it is also, necessarily, a switch from countries with limited capital to those with abundant capital. And that is a double-edged sword because at the company level, capital is often wisely used if scarce but frittered away when plentiful.

U.S. monetary policy seems likely to occupy center stage for a while yet as people fret about interest rates. But 2013 was actually a very interesting year for monetary policy theory in that it seemed to show that monetary policy can be effective even when interest rates have no further room to be lowered. This effectiveness seems strong enough even to offset fiscal tightening, which is estimated to have placed a "fiscal drag" that may have reduced U.S. GDP growth by about 1.5%, according to some economists. The IMF suggested that the change in the cyclically adjusted deficit in the U.S. was a contraction of about 2.4% of 2013 GDP—so at least this much should have been subtracted from GDP due to the efforts to cut spending and raise taxes. The fact that it didn't, seems strongly suggestive of either a spontaneous recovery of demand or the power of monetary policy without interest rate changes. And in the final months of the year, the U.S. Federal Reserve successfully communicated a tapering and the market rallied on the news. How could this be? Well, the Fed succeeded in convincing the market that it would maintain monetary stimulus so long as there was spare capacity in the economy but indicated that its decision to start a moderate tapering of monetary stimulus was because it believed demand was indeed on the rise.

So, I suppose, if you twist my arm for a forecast, I would say that the likelihood is that nominal GDP in the

U.S. may grow at a faster rate this year than last—and maybe even sustain that higher rate of growth through 2015. Europe too, may be warmed by the U.S.'s economic glow.

What Does this Mean for Asia?

I believe faster growth in the world would be a relatively benign environment for Asia’s stock markets. However, there are some caveats to this, particularly for us at Matthews Asia. Let us start with the good news: first, stronger nominal GDP would help exports. And although Asia’s economies are not “export-driven” in my view, having strong external demand for their products certainly helps growth in the economy as a whole—possibly adding a percentage point or more to growth rates. So, that would be a positive boost to GDP and would help countries like India and Indonesia whose current account deficits have recently concerned investors. Second, stronger U.S. nominal GDP growth does seem to feed through into stronger dividend growth in Asia. But (and here comes the equivocation), I would like to stress something I have previously written in several shareholder communications: It is not at all certain that rallies driven by sharper growth in external economies will boost our portfolios to the same extent as Asia's markets. To the extent that it benefits exporters and companies with high operating leverage, or more cyclical businesses, it is not consistent with the bias of our strategies, which are positioned toward sustainable long-run growth. We saw how some of these potential trends might influence different investment styles. The latter part of the year was very difficult for yield-based strategies and although this was mitigated somewhat by continued outperformance of high return on capital businesses, this is by no means guaranteed to be the case if growth picks up and starts to flatter some of the weaker balance sheets. In general though, looking beyond the near term, historically higher-than-average dividend yields of 2.5% and lower-than-average price-to-earnings ratios have delivered better-than-average returns over a five-year period. This bodes well for long-term returns in the absolute sense and relative to the U.S. where the valuation discount Asia enjoys is as great as it was in 2005.

China will undoubtedly remain a major discussion point this year. And given its influence on the regional and increasingly global economy, we should perhaps make a specific reference to it. We began 2013 mired in depression about China and emerging markets in general and ended in a swift burst of euphoria about China’s reformist rhetoric. Neither struck me as being particularly realistic stances to China. I expect that after the depression and the euphoria, something closer to realism will emerge and that people will realize several things:

1) Chinese banks are risky investments from the equity holder’s point of view and likely to be congenital capital raisers.

2) But being nationally owned and controlled does give the entire system in China a certain amount of stability.

3) China does have a credit problem—largely a question of the pace of credit growth rather than the level.

4) However, China’s leaders are not stuck in a cul-de-sac. They have plenty of avenues for reform to keep productivity growing.

5) Finally, there have been discussions of the various “traps.” These include demographic, low-wage labor and income traps, which will become a little more nuanced as people understand these are less “traps,” and should be likened more to bends in the road (or in some cases may not even exist at all).

Comfort Zone

Rather than trying to guess the trajectory of markets over the next 12 months, I would rather extend my horizon over a slightly longer term. Even then, I would be less concerned about exact predictions. Rather, since emotion, and more particularly “comfort” is important in making decisions, I shall say what makes me more comfortable in the future of Asia and what makes me less comfortable. In doing so, I am on somewhat safer statistical grounds, as I will show. But I claim no more than that. First, let us turn to growth.

I think of growth in Asia the same way I think of my kids’ growth. Both in terms of physical growth and maturity, I like to think they progress in leaps and bounds, however erratically this may be. The point is that all you can do is lay the groundwork for growth—proper nutrition, decent schooling and an unimpeachable example of open curiosity and ethical behavior. When that is done, the rest ought to follow.

So, how has Asia been doing as it grows up? We happen to know a bit about this. It has been the world’s only region with countries that have consistently closed the gap with the developed world in U.S. dollar standards of living over the last 30 years. This has been done through fast rates of productivity growth; these rates of growth depend on: growing labor forces (a little), growing capital stock (a lot) and better technology or creativity (also a lot). And there is plenty of evidence that Asia has increasingly embraced free markets in recent decades; educated its population; saved a lot and invested those savings in capital goods, and become open to trade in goods, services and ideas. All of these developments have propelled Asia’s rates of productivity growth generally in excess of the rest of the world and particularly in the area of innovation or change in technology. This is what people will often disparagingly refer to as “copying.” (But, when I see someone doing something better than what I am doing, I copy them—am I wrong?) At the same time, Asia seems a far more stable place politically compared to the Asia of a decade or two ago. Authoritarian governments have either been relaxing control or giving way completely to democratic institutions. So, the parental scorecard for Asia reads quite well—and we believe that has to give one a great deal of comfort that the region may well continue to generate above average rates of growth in the future.

Robert Horrocks, PhD

Chief Investment Officer and Portfolio Manager

Matthews Asia

[i]StormFax Weather Almanac,http://www.stormfax.com/ghogday.htm



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