2017 Third Quarter Review

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by Team
of Matthews Asia

Twenty years ago on July 2 1997, Thailand devalued its currency, the baht. Thus began the final denouement of years of overinvesting in Asia that came to be called the Asian Financial Crisis.

One after another, markets and economies toppled like dominoes. I remember being in Hong Kong during the crisis as hedge funds tried to attack the Hong Kong dollar peg; stock prices dove in a frenzy. I saw professional South Korean investors reduced to tears, ashen faced, as they watched what they feared was the unravelling not just of their stock markets but of their country. Foreigners bid US$1 for indebted Korean companies. “On the tombstone of every bankrupt company in Asia, you’ll see the names of Korean Banks,” remarked one stock broker, alluding to the region-wide loans these banks had made.

It hadn’t started as such a panic. The first analysis that greeted the baht devaluation included the idea that Thailand was managing its currency to smooth out volatility as they tried to reflate the economy. The baht fell 10% to 20% on that first day and it was just starting. “Just wait until the market opens,” one person told me after the devaluation: “It is going to soar.” Within two years, it had lost 80% of its value.

In truth Thailand needed deflation not inflation. It had persistently been spending more than it saved. Economies elsewhere in Asia also needed to deflate. But devaluing currencies couldn’t do the job—it just increased the burden of U.S. dollar debt, on which their companies had binged, sent these businesses into bankruptcy and thereby further crippled the economy. Indonesia’s total GDP eventually fell by nearly 60% in U.S. dollar terms; Thailand and South Korea’s dropped by nearly 40%. Stock markets fell by considerably more than that. The memory of this event has persisted even longer; it still casts a shadow over the region, even as Asia’s markets rally.

Asia's markets have gotten off to a strong start this year, and yet the most common refrain I hear is one of fear. Is it too late? Have they overheated again?

But 2017 is not 1997.

We are nowhere near having overheated economies. Singapore, Taiwan and South Korea indeed are running very large current account surpluses (meaning their domestic savings are greater than their spending.) Thailand, whose current account was in deficit as recently as 2013, now runs one at 11% of GDP. Nor is inflation a problem—core inflation in the 12 major markets of the region averages less than 2%. In India and Indonesia (which until recently had inflation problems), rates have been lowered to a moderate 4.1% and 3.3%, respectively. Asian currencies, which had weakened in 2014 and 2015 as economies wrung out some excesses, have now stabilized and (like the South Korean won and the Taiwan dollar) even strengthened against the U.S. dollar. U.S. dollar external debt is simply not an issue as it was 20 years ago. This time, the currencies did their job. These are all signs of stability; indeed, one can reasonably argue that what Asia really needs is a burst of stimulus.

Corporate earnings are finally on the move, too. Year-to-date, earnings per share in Asia ex Japan have risen by 7%[1]. This is a dramatic acceleration in growth and it has helped the markets move higher and outperform both the U.S. and Europe. But, as I have pointed out before, Asia’s corporate profits have been in the doldrums for a few years now. We must consider the recent improvement in profits in the context of many years of zero growth. When we do, the recent performance is less surprising. Today, earnings per share in Asia ex Japan are still 4% lower than they were nearly six years ago. So, what we are seeing is accelerating profit growth over just a few months—after no growth in U.S. dollar terms for six years— even though sales per share have risen by 10% in U.S. dollars over that time, despite currency weakness.
Can this acceleration in earnings be sustained?

Likely yes, I believe, especially if several factors continue: First, is moderate GDP growth. This is the basic fuel for sales and profit growth. The IMF expects the Asia Pacific region to grow by 6.4% a year in U.S. dollar terms between 2016 and 2022. Growth should be even faster in Southeast Asia at 8% per annum. Second, is the fact that this growth should be supported by fiscal and monetary loosening. Asia has plenty of room to stimulate its economies, with its high savings ratios and low core inflation. Third, is the fact that corporate margins appear to be improving. We are not seeing the same wage hikes in Asia that characterized the years between 2010 and 2015 in particular, as minimum wages were hiked above the rate of productivity growth.

Asia’s earnings are looking better, but they are still lower than they were six years ago. I am hopeful the better growth in earnings can be sustained. This should help to sustain increasing investor confidence from abroad. Headline valuations are high on measures like price-to-earnings, but they don’t look that high when you take into account that earnings are depressed. There have been some false dawns over the last couple of years, with expectations of earnings growth slipping away. But I am more confident now that the recent earnings strength can be sustained. Of course, markets don’t go up in a straight line and the recent low volatility will not be sustained. However, if current economic conditions persist, I would be inclined to treat such volatility as an opportunity—not something to fear.

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[1] All EPS data come from Factset FR0000A3 Asia ex Japan Index, as of June 16 2017.