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Nikko Asset Management

FROM THE ASIAN EQUITY DESK

Market Outlook 2018

Summary

- The MSCI AC Asia ex Japan (AxJ) Index returned 38.0% in USD terms year-to-date, on the back of a broad-based economic recovery. The Index outperformed the MSCI World Index, which rose 20.8% in USD terms in the same period.

- A robust global economy and monetary policy tightening could benefit export-orientated economies in Asia. Coupled with a recovery of consumption within the region, we continue to believe that Asian equities provide better earnings growth prospects at a more attractive valuation relative to developed markets.

- We maintain favourable of Chinese stocks, in particular those within the new economy sectors. We are also structurally positive on India given the government's commitment to reform and fiscal stimulus. Meanwhile, we remain selective within the Technology sectors in Korea and Taiwan and maintain our underweight to ASEAN.

Asian Equity

Market Review

- Asia ex-Japan still offers attractive relative valuations

2017 saw the first broad-based economic and market recovery since 2009. Investor sentiment remained largely optimistic despite rising political uncertainties, supported by positive economic data and stronger earnings growth. Year-to-date (YTD), the MSCI World Index rose 20.8% in USD terms. Within Asia, the MSCI AC Asia ex Japan (AxJ) Index outperformed the broader world index with a 38.0% YTD return.

As we draw to a close on 2017, Asian Equities valuations have re-rated back towards long term averages at 15x forward price-to-earnings and 1.7x forward price-to-book. Despite Asia's outperformance, MSCI World still trades at 18x forward price-to-earnings and 2.3x forward price-to-book even while offering lower growth. As such, we continue to advocate that Asian equities provide better earnings growth prospects at a more attractive valuation relative to developed markets equities, despite some pockets of excessive optimism.

Market Outlook

- Favourable on China's new economy sectors & Hong Kong banks

In China, post the 19th Communist Party Congress, fiscal policy and property growth impulses should likely moderate and reform intensity may rise as the refreshed leadership focuses on rebalancing and improving the quality of growth. The shift in emphasis to quality growth, in particular, augurs well for consumption and innovation, which are areas that we are weighted towards. We maintain our preference for the new economy sectors - Internet, Consumer and Healthcare as we continue to find a number of innovative companies with good long term prospects within these segments.

In Hong Kong, we remain optimistic that the momentum of better loan growth and the prospect of higher interest rates would continue to drive returns for Hong Kong banks.

- Remain structurally positive on India given reform implementation and fiscal stimulus

We retain our structurally positive outlook on India, given the government's commitment to reform, allied with a potential expansion in fiscal budget in the run up to key state elections and ultimately the national election in 2019. In addition, we expect India's economic growth to rebound in 2018 as the adverse impact from demonetisation and GST wanes and the PSU bank recapitalisation boosts corporate capex. We maintain an overweight position in Indian equities, focusing on some unloved areas of the market as well as long term sustainable franchises that stand to benefit from India's move towards more organised market structures.

- Focus more on niche areas within Korea & Taiwan's Technology sectors

Korea and Taiwan have been key beneficiaries of a resurgence of their respective Technology sectors. There is now a greater need to be more selective in this segment. After the strong earnings growth in the memory semis this year, there is a risk that DRAM or NAND prices could roll over in 2018 as new capacity comes on.

Even though China and South Korea seem to have made significant progress in normalising relations, the latest missile launch from North Korea this month suggests that geopolitical risk continues to loom. Taiwan's Technology sector has benefited from strong positive sentiment following robust

demand for Apple's new iPhone X, but the pace of upgrades has slowed and valuations are no longer as attractive. Hence, we focus on stocks exposed to niche areas of the value chain, namely electric vehicles and display solutions.

- Remain underweight on ASEAN, with relative preferences for Singapore & Indonesia

We maintain our underweight stance in ASEAN. Economic growth has been slow to improve across the majority of ASEAN markets owing to a lower weighting of Technology in their respective export markets. Subdued agricultural prices and political uncertainties have in turn suppressed consumption, which is a key driver of economic growth across the region.

Singapore and Indonesia remain relative preferences, and we continue to eschew equities in Malaysia. In Thailand, we see early signs of consumption recovery following the cremation of the King after a year of mourning, but elections due next year have the potential to create further uncertainty and delay spending across both corporates and households.

Looking Ahead

Further upside in 2018 possible for the region

Going forward, a robust global economy and well telegraphed withdrawal of monetary stimulus in advanced economies provides a good back-drop for export-orientated Asian economies. As Central Banks tighten their belts, we can expect investor focus to shift to regions and sectors that offer better sustainable growth as opposed to cyclical sectors riding the early stages of reflation.

Consumption trends in Asia have been strong across North Asia and India, while are recovering in parts of ASEAN. We also find key sub-sectors where Asia is emerging as a global leader and note that innovation and R&D spend continues to ramp up. We still find Asian equities attractive on a long term view given valuation support, notwithstanding pockets of excessive optimism. Provided domestic inflationary environments remain under control and geopolitical flash points do not flare up, we see another good year for Asian equities ahead.

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