Economics & Strategy

DBS Focus

3Q Equity Strategy — Position defensively

Strategy / Equities

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- *A volatile summer as US-China trade dispute intensifies. Asia markets could have downside of about 16% if further tariffs are imposed*
- *Not time to bargain hunt yet until valuations are more palatable*
- *We think that this time round, compared to last year, the correction should be shallower and over a shorter period than last year*
- *We like markets which are domestic demand oriented, have the flexibility for policy stimulus and where valuations are attractive enough to cushion the downside. China/Hong Kong, Singapore, Indonesia and Philippines are our favoured markets*

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Refer to important disclosures at the end of this report.

3Q strategy — Position defensively

Asia markets are likely to face a volatile summer as the US-China trade dispute intensifies. The world awaits with for 17 June, when a decision will be made on the fate of USD300bn worth of Chinese exports. If these goods are hit with tariffs, there will be implications on global growth, cause an abrupt halt to the late cycle, and also exert downside pressure on the RMB and Asian currencies. **We believe the correction in May is just the beginning of a risk-off move, and if further tariffs are imposed, further de-rating can be expected.**

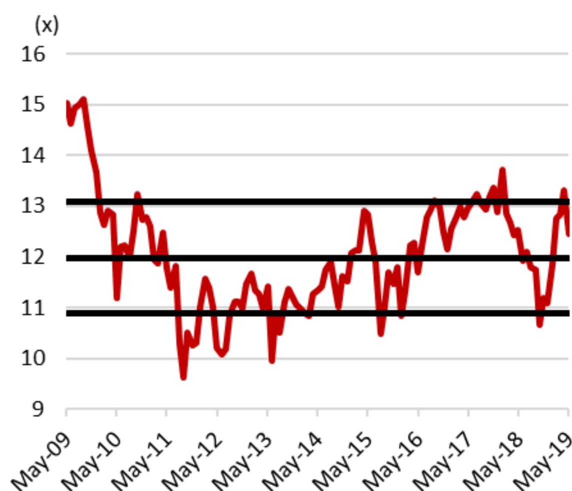
To recall, Asia markets were in a corrective mode for slightly more than six months during the trade war spats last year. **Based on what happened in 2018 and valuations touching recent lows, Asia markets could have downside of about 16% from here.**

Correction so far should be considered healthy

Asia ex-Japan PE valuations, at end-April, had returned to near +1SD above historical average compared to -1SD at the beginning of the year, leaving very little room for valuation re-rating. A correction, if any, should be considered healthy as it resets Asia markets to more attractive levels. Current valuations are still above average, and hence it is still not a good time to bargain hunt, in our view.

However, we think this time round, compared to last year, the correction should be shallower and over a shorter period than last year. Compared to last year when the Fed was hiking rates multiple times, expectations were high in terms of growth, and government policies were more of tightening rather than stimulating, especially in China. In contrast, the current environment is more supportive of growth.

Asia ex-Japan — 12-month forward PE valuations



Source: Thomson Reuters, DBS

Asia ex-Japan — 12-month forward earnings growth forecast near historical low

Source: Thomson Reuters, DBS

Low base in terms of economic activities

Investors should find comfort in an environment where economic activities have touched a low base now, compared to last year before the trade war threats surfaced. A secular downtrend is already ongoing, and we may already be very near the bottom. First-quarter GDP growth in most Asia economies, especially the export-oriented ones, have touched a low point. At the same time, because of the downturn, business expectations for manufacturing activities, which were the strongest early last year, had since collapsed to a low point by the end of the year. It has picked up slightly recently but not to exuberant levels.

Meanwhile, we think the trade war could give rise to opportunities for ASEAN countries to capture some of the trade diversion and manufacturing diversification from China.

Likewise for earnings growth, there are little expectations on it.

More resilient domestic demand-oriented stocks in ASEAN and China

Current earnings growth of 4.4% for Asia ex-Japan region has potential downside risk in the face of a global growth slowdown scenario and volatility in macro variables such as oil prices, currencies and interest rates. Stocks in highly cyclical and export-oriented markets such as Taiwan and Korea may continue to see earnings downgrades. However, we think corporate earnings in ASEAN, India, and China should be relatively more resilient as these markets are populated with stocks driven by domestic demand and are less exposed to the export cycle.

Asia ex-Japan markets: Exposure by economic sector

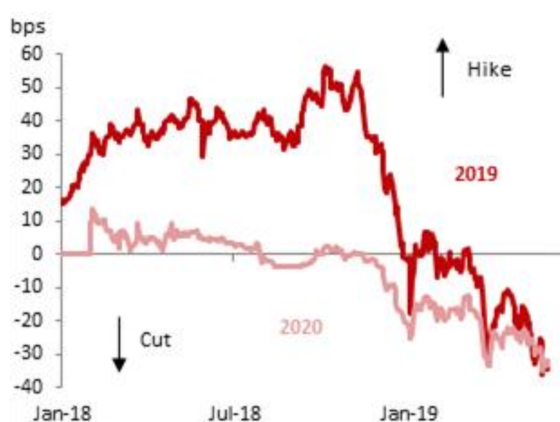
	Defensive sectors	Cyclical exposure	Global Price exposure	Interest rate exposure
Hong Kong	12%	19%	12%	57%
Singapore	18%	37%	2%	43%
Thailand	28%	24%	20%	27%
Indonesia	34%	14%	14%	38%
India	18%	29%	21%	33%
Taiwan	9%	59%	15%	17%
Korea	18%	59%	11%	12%
China	16%	25%	13%	46%
Malaysia	43%	12%	13%	33%
Philippines	35%	16%	6%	44%

Source: Thomson Reuters, DBS

A hawkish vs dovish Fed

We believe we are at the top of the interest rate cycle in the near term with possible rate cuts should the downturn worsen. The liquidity environment in Asia should be better compared to last year when the Fed was still hiking interest rates and on "auto-pilot" mode, versus "neutral" and data-watching approaches currently. Asia bonds and currencies should see less pressure from outflows and central banks should have the flexibility to cut rates if the global environment worsens. In the case of Indonesia, DBS fixed income strategist thinks that Indonesia government bonds are the most undervalued, and the last time Indonesia displayed this level of relative undervaluation was during the height of the emerging market selloff in 3Q18. We believe value investors will return to bargain hunt in the region and stabilise flows.

Market Fed hike / cut pricing since 2018



Source: Bloomberg, DBS

Stimulus measures to cushion growth slowdown

We see the potential of more stimulus measures among Asian countries to safeguard against potential downside macro risks. During the mini Emerging Markets currency crisis last year, Asian governments and central banks had managed the crisis well with sound and credible policies, thus leading to a recovery in their currencies. With elections overhang being removed for many of the Asian countries with no major surprises, domestic demand-oriented policies can now be followed through. Moreover, a more dovish Fed and lower inflation have opened doors for rate cuts in many of these economies.

Opportunities in Asian markets

We believe the volatility will still be high in the second half of the year. We don't think there will be a collapse in Asia equities, and while pausing for a trade resolution which may or may not come, **investors should stay defensive in their positioning**. At this point, the **downside risks are higher than the upside as valuations are not supportive**. If a trade deal comes through, hence removing a lot of uncertainties, it is still not too late to reposition for beta, in our view.

We like markets which are domestic demand oriented, have the flexibility for policy stimulus and where valuations are attractive enough to cushion the downside. China/Hong Kong, Singapore, Indonesia and Philippines are our favoured markets.

Any policy or supportive responses from China in view of the challenging trade and currency conditions may lend some support to the China and Hong Kong markets. Investors should focus on sectors which are not directly impacted by the trade war, such as **rail, infrastructure and cement sectors which are typically supported by government policies**. We also like domestic-driven sectors such as education, property management, Hong Kong property, Hong Kong REITs, and internet.

Recall that the correction in China last year wasn't just about the trade war but also due to regulatory reform and deleveraging which had hurt many sectors and impacted credit availability. With **deleveraging partially taking a back seat** and **regulatory reform already in the price for many of the sectors**, and coupled with **supportive government measures**, we should not see a similar downward shift in sentiment like last year. As the country deals with US threats, we think there are many retaliation options, compared to last year as its domestic stimulus policies, which it has geared up, have proven to provide resilience and stability to the economy.

China 'A' shares' low correlation with global markets, due to its proportionately high pool of domestic investors, including the "National team", should also make it a fairly defensive market. Moreover, Chinese stocks will gain additional weightings in the next six months in international benchmarks, and we expect inflows to come through. Other than efforts made to stimulate the economy and stabilise growth, structural changes such as new growth transformation initiatives in Greater Bay Area, science and technology innovations, and capital market reforms should bring about more opportunities.

The Singapore market is unlikely to be spared from volatility and portends downside risks in the coming weeks. However, we think there is **enough valuation cushion to support the Singapore market**, even if US tariffs rise, provided US-China trade talks continue to take place. **Singapore REITs is still our favoured sector** as it stands to benefit from lower bond yields, which can be expected in this environment.

In Indonesia, we have to monitor the RMB for downside risks as the weak sentiment in the currency market could drive outflows in Indonesia bonds and equities, spiraling into a vicious downward cycle. **We remain positive on Indonesia as we believe its equity market should rebound** once the dust settles, **led by confidence placed in Bank Indonesia (BI)** and a rebound in the rupiah. As in last year, we see BI navigating the economy through the dark clouds. **To us, JCI at below 6000, USD/IDR at above 15,000, and 10-year bond yields at above 8.5%, if all come about, will be a strong buy for the market, as evidenced in past strong market rebounds.**

The Philippines held its general elections and a strong mandate was given to President Duterte's allies. This should ensure **policy continuity post the next presidential elections for another good six years**. During President Duterte's tenure, the country has gained rating upgrades, which is now at BBB+, and saw bitter but needed tax reforms hurting market sentiment in the past two years. **We believe with prudent macro policies going forward, growth should be sustainable in the next few years.** Pro-growth policies on infrastructure spending can be expected to continue. Inflation is still benign and that should boost sentiment and outlook for rate cuts. The central bank is cognisant on liquidity risks in the system and has started to ease the reserve requirement ratio (RRR), which is the highest in the region. We believe there is further room for RRR cuts. We stay Overweight on the Philippines.

Thailand has been one of the worst performers this year, dragged by domestic political developments, but should prove to be more resilient. There are, however, a few concerns as growth could disappoint as its economy is very export oriented while the government looks to push domestic demand growth, which may be delayed given the political situation. **We stay Neutral on Thailand and recommend investors to accumulate stocks with solid fundamentals, reasonable valuations and decent yields**.

Malaysia is still an Underweight to us. We believe there is still a lot of uncertainty to its growth prospects given that the economy also depends heavily on exports. Investors can seek defensiveness in some of the sectors which have high dividend yields, like the REITs and the Construction sector which is a prime beneficiary of pump-priming activities.

In India, we expect domestic policies to support rural consumption post-election. Policy flexibility may see rate cuts and increase fiscal spending as the government and central bank have been very disciplined on the twin deficits' sore points. Meanwhile 2018 earnings growth was a low base and consensus is expecting the earnings to rebound strongly this year. We are keeping the market at Neutral.

We believe that **Taiwan and Korea**, **both** being very cyclical and tech-oriented markets, **have the highest downside risks as the trade war arising from the China-US tensions** has spread from trade to tech. We stay underweight on both markets.

Having said that, **both economies have the room to expand fiscal policy, given their strong government balance sheets.** The Korean government has unveiled a KRW6.7tr supplementary budget in April to shore up the economy, and Bank of Korea can still cut rates if needed. **Taiwan's presidential and parliamentary elections are not far away** (January 2020) and hence, substantial government policy changes could be delayed to next year, but **domestic sentiments could be quite positive**.

Asia market 3Q recommendations

Overweight	Neutral	Underweight
China / Hong Kong	India	Taiwan
Singapore	Thailand	Malaysia
Indonesia		Korea
Philippines		

Source: DBS. Notes: Overweight — To hold more weight than the benchmark weight; Neutral — To hold the same as the benchmark weight; Underweight — To hold less weight than the benchmark weight

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