UNION BANCAIRE PRIVÉE

ASIA MACRO STRATEGY

2020 Outlook: Key Focuses in the Year of the Rat

Report | 13 December 2019

For Professional Investors only in Hong Kong and Accredited Investors (in respect of accounts opted-in to be treated as Accredited Investors) and Institutional Investors only in Singapore

Growth Prospects: Cyclical Rebound against Subdued Backdrop

After a global slowdown in 2019, UBP expects world growth to stabilise on a moderate trend in 2020 (up 2.4% vs. 2.3% in 2019). We expect an industrial cyclical rebound on low inventory provided that United States (US) and China sign a phase one trade agreement.

Political and geopolitical risks will remain, but recession risks have abated in US and Germany. Trade wars have been a drag on global growth. Beyond a possible phase one trade deal, further Sino-US trade negotiations on remaining tough issues could be as bumpy and even more prolonged. Also, a trade deal signed between US and China does not necessarily prevent an escalating confrontation on non-tariff issues.

Global Economic Forecasts

GDP Growth (%)	2018 2018 Actual	2019F UBP Forecast	2020F UBP Forecast
China	6.6	6.1	5.7
Hong Kong	3.0	-1.9	-0.5
Indonesia	5.2	5.0	5.2
India	7.4	5.3	6.1
Korea	2.7	1.8	1.9
Malaysia	4.7	4.3	4.1
Philippines	6.2	5.3	5.4
Singapore	3.1	0.2	1.3
Taiwan	2.6	2.0	1.8
Thailand	4.1	2.5	2.8
Asia Total	**6.0**	**5.2**	**5.1**
Asia ex. China	**4.8**	**3.3**	**3.8**
World	**3.0**	**2.3**	**2.4**
Developed countries	**2.2**	**1.5**	**1.4**
Emerging countries	**4.6**	**3.8**	**4.2**

Source: UBP forecasts, Bloomberg historical data

The Asian outlook remains subdued but may improve if tariff rollback occurs as part of a partial trade agreement. Asia's (ex. Japan) gross domestic product (GDP) is expected to grow 5.1% in 2020. Excluding China, GDP for the rest of the region is expected to expand by 3.8%.

China's growth will slow to 5.7% on Beijing's continued measured and targeted policy easing. India's expansion will pick up from this year's trough to 6.1%, while the export-led economies such as South Korea, Taiwan, and Singapore should improve modestly from current subdued trends.

Hong Kong's economic recession will extend into the next few quarters and will end 2020 with a mild annual contraction.

Inflation risk remains distant and we expect Asia's CPI inflation to average 2.1% in 2020, down from 2.6% this year. Beyond the surge in food prices – most noticeably in China and India but should eventually normalize - core inflation rates should stay benign across the region given the modest growth profile. A weaker USD and continued stable oil prices will also help control imported inflation in Asia.

Policy Outlook: Fiscal and Continued Monetary Easing Important

Accommodative monetary policy will remain in place for a long time, with further central banks' balance sheet expansion. But with low and negative interest rates limiting the power of monetary policy, additional support from fiscal policy will be a key market focus in the coming years.

Japan has already kick-started a modest fiscal package to offset its value-added tax (VAT) drag and should have room for modest supplementary budget as monetary easing runs to its limit. Europe may expand fiscal measures in 2020 under the new economic leadership but the US is expected to follow only after next year's presidential election.

We anticipate the US dollar (USD) will depreciate modestly in 2020 on slower US growth and inflation dynamics as well as further Federal Reserve's (Fed's) rate easing and balance sheet expansion. Unless global growth nosedives, the USD's safe haven status that supported its appreciation in 2019 is unlikely to maintain. A more stable USD/CNY profile will also help prevent the greenback strength. USD weakness will provide an important backdrop for more stability in EM and Asian currencies and selective strength in high-carry currencies such as the Indonesian rupiah (IDR).

Most Asian countries should have sufficient fiscal flexibility especially China, Hong Kong, South Korea and Singapore. India's bold corporate tax cuts in late 2019 should curb its ability to pump-prime further while Indonesia will focus on long-term infrastructure investment. Hong Kong's huge fiscal reserves will be useful to buttress the economy during these rainy days under which lingering political tensions have caused an abrupt economic contraction.

Overall, Asia's fiscal policy will be modestly expansionary but unlikely to see serious slippage as fiscal discipline remains key to the region's policy mindset.

Measured monetary easing is anticipated to extend in China to avoid major re-leveraging risk, while further policy rate cuts are expected in South Korea, Indonesia, Philippines and Malaysia.

We expect India's central bank to look beyond transitory inflation factors due to higher food prices and continue interest rate reduction in 2020 in light of its fiscal constraint.

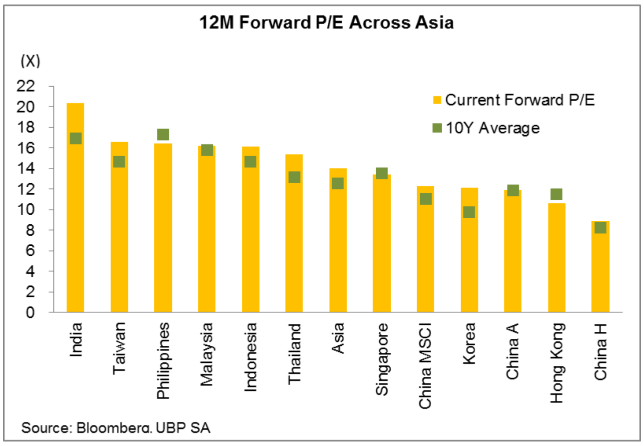
Asia Equities: Selective Opportunities

In our global asset allocation, we advise an overweight on emerging market equities on more global policy accommodation. A weaker USD expected in 2020 means currency overlay strategy should add returns on selective non-US equity markets.

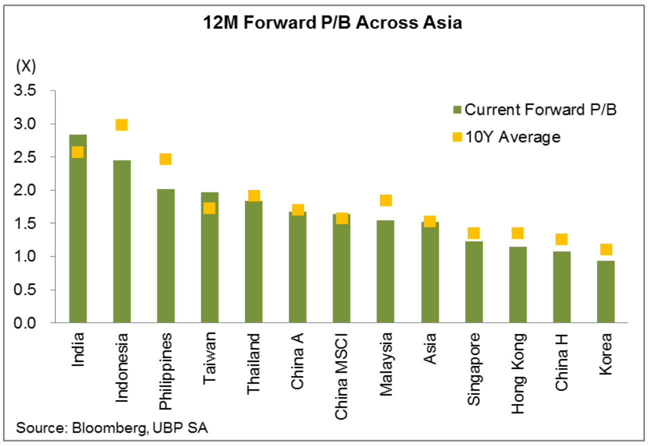
Current valuation of MSCI Asia (ex. Japan) is not cheap after the index rallied 12% from January's low. Consensus earnings forecast downgrades have continued, currently stand at about 2% for 2019 and an optimistic 14% to 15% for 2020.

Top-down we expect -1% to -3% for 2019. Next year earnings are likely to trim to 5% to 8% given our global and regional growth scenario. Currently, the market is most sanguine on Korea and India EPS growth but least on Singapore, Malaysia and the Philippines.

MSCI Asia (ex. Japan) 12-month forward price/earnings (P/E) multiples is trading at 14.5x vs.10-year average of 12.5x. Forward price/book (P/B) ratio is trading at 10-year average of 1.5x. We expect no major re-rating in 2020 unless a decisively better trade deal outcome causes de-risking and firmer cyclical earnings recovery.



Within Asia, however, we continue to favour China and Hong Kong on valuation measures, as well as modest multiples expansion on a partial trade deal. Reduced political tensions and protest violence should also underpin Hong Kong's valuations.



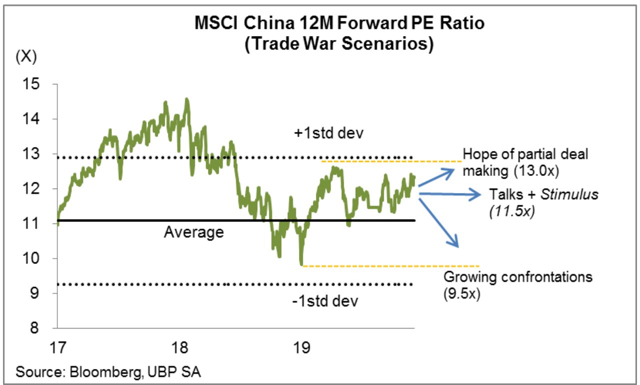
Despite its disappointing GDP growth and expansive valuation, we still favour India for the potential lift in earnings from bold corporate tax cuts. We also like Singapore and the Philippines on their attractive discount and Indonesia on its relative steadiness.

In Hong Kong, Hang Seng Index (HSI) at 25,500 to 26,000 level looks a defensive level with forward P/E multiples at around 10.2x to 10.5x. Upside potential to 11.7x multiples as assumed in our phase one trade scenario will put HSI level to around 27,500 to 28,500 (up 5-8% from current level). A stronger cyclical earnings recovery on significant tariff rollback or more constructive subsequent trade negotiations will push upside potential to 10-15%.

Equally important, the city's protest violence should reduce as the anti-government camps return to 'within-the-constitution' fight against Carrie Lam administrative after their landslide victory in November's district council elections.

Current earnings downgrades are centred on the slump in local consumption and tourist arrivals. However, they should continue to be cushioned by the growing dominance of Chinese firms in HSI with their stable revenue bases outside of the Hong Kong economy.

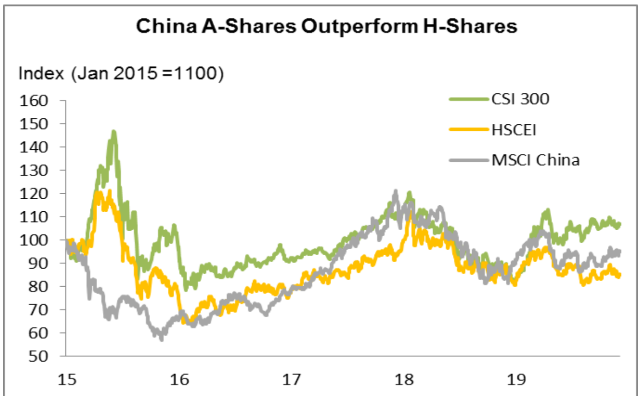
In addition, we see a slim chance of President Trump sabotaging Hong Kong's status quo by imminently exercising the new human right law on the city as long as trade talks continue to progress. As such, a re-rating of HSI on Hong Kong losing its special trading status and global financial centre's role looks more a tail than main risk in the coming year.



Source: Bloomberg, UBP SA

In China, valuations have steadily improved on the bumpy but still progressive trade negotiations. We still expect modest upside multiples re-rating of MSCI China on a mini-trade deal and continued policy accommodation, with forward P/E trading to 12.5x to 13.0x from current 12.3x. Beyond that, valuations will look stretched unless trade compromise deepens with tariffs decisively peaked out and rolled back significantly.

We continue to prefer onshore A-shares market (i.e. new economy and domestic consumption, services and technology plays) over offshore H-shares (i.e. old economy dominated by banks, energy and telecoms). The trade war has prompted Beijing to quicken its reform and development on domestic sectors and to unleash their growth potential to counteract the economy's vulnerability to global trade. Also, a reversal of its high reliance on the US capital market has forced China to open up its domestic financial and asset markets which will create more investable opportunities for global investors.

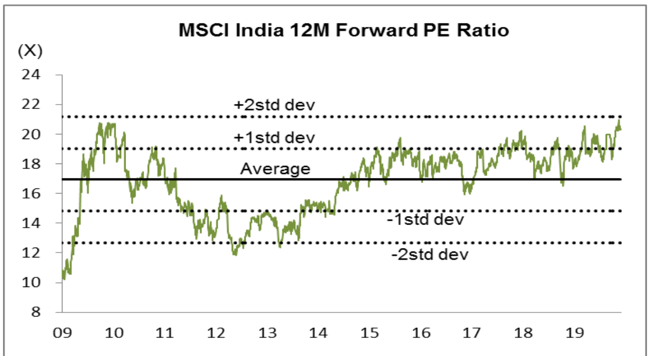


Source: Bloomberg, UBP SA

We advise an active strategy to focus on onshore A-shares with preference for long-term structural opportunities in healthcare, education, insurance and online entertainment and technology. Short term, cyclically low valuations in real estate, industrials and materials should be supported by re-rating potentials.

By contrast, for better risk management especially against any unexpected risk arises from trade talks or domestic economic transformations (e.g. banking reform), select long-short hedge fund strategies are our preference for useful asymmetric exposure to Chinese equities.

In India, MSCI India is currently trading at 20.4x forward P/E, two standard deviations above its 10-year mean. Indian equities have always been expansive – built on the 'Modi premium' of reform actions and promises.

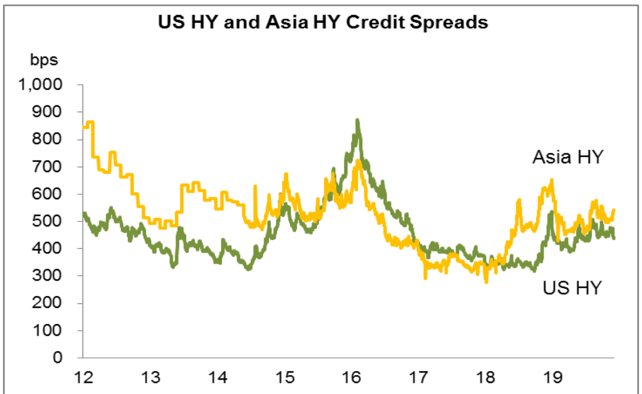


Source: Bloomberg, UBP SA

We expect India's central bank will capitulate with further rate easing in 2020 as headline inflation retreats while the fiscal stance will stay modestly expansionary as the tax cuts run through. Recent bold corporate tax cuts should boost corporate earnings growth by 6-8% points cumulatively in FY2019 and FY2020, supporting current high market valuations. Forward P/B ratio is expected to trade up again to 3.0x to 3.2x from current 2.8x.

Asia Fixed Income: Buy on Dips

Globally, we advise an overweight in both high yield and emerging market debts. Further global monetary easing plus increased budgetary policy supports should favour an overall short-duration strategy. Given tightness in US high yield spread, we see opportunities in emerging markets and Asia high-yield markets but beware of idiosyncratic risks.



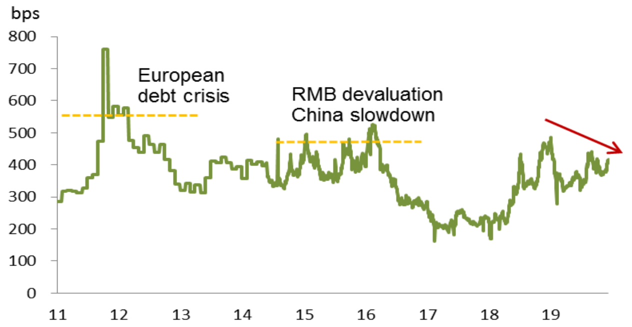
Source: Bloomberg Barclays Asia x Japan USD Credits, UBP SA

In Asia, flight to quality has kept USD investment grade (IG) credits spread steady at around 120-130 basis points (bps) throughout 2019. Asia USD high yield (HY) credits, after reaching a tight of only 275bps in average spread during early 2019, has been riding on a bumpy path with spread averaging 540bps currently.

We see this as attractive entry level relative to Asia IG and US HY. Relative spread between Asia HY and Asia IG has widened back to close to post-European crisis peaks in late 2018 (470bps) before narrowing back slowly to current 410bps.

In absolute terms, we target Asia HY spread to tighten back to the five-year mean of about 480bps in 2020 (from current 540bps). Relative spread to Asia IG is expected to narrow to about 360bps (from current 410bps).

Asia USD HY vs. IG Spread Differential



Source: Bloomberg Barclays Asia x Japan USD Credits, UBP SA

Asia's USD credit supply in 2020 should be easily absorbed, with projection of net issuance of around USD80 billion – halved the peak of USD150 billion in 2017. China will continue to control offshore issues while India's NBFCs (non-bank financial companies), faced with tighter domestic credit condition, may come more to the USD market but still expected to remain small.

In China, Beijing has tightened regulations on offshore USD issues this year – only allowing issue for firms' refinancing needs - which should lead to improved supply condition ahead. 2020 is the 'maturity wall' of China USD credits (because of significant issuance in 2017 mostly with 3-year maturity) but tightening supply in 2018-19 will make the maturity picture healthier post-2020.

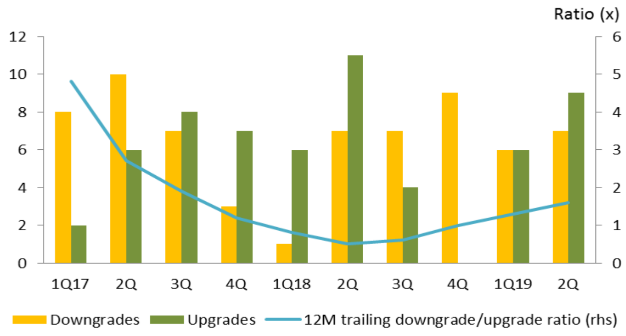
China HY credit spreads has widened by some 200bps during second quarter of 2019 (2Q19) and 3Q19 partly because of over-reaction to housing market tightening. Now that housing prices have decisively softened, policy tightening will only taper off as overheating concerns ease in the coming year.

Latest defaults and debt restructuring news in China (Tewoo's USD credit and onshore RMB China credits) have affected sentiment but the policy backdrop remains favourable.

Despite idiosyncratic repayment risk, this is certainly not the tipping point of China's credit default and market dislocation will correct back as seen in previous similar episodes. Indeed, Asia's credit profile has continued to improve with more upgrades than downgrades despite the regional economic slowdown and a protracted trade war.

Indonesia and India credits will stay expansive as their spreads continue to trade through China's even with 2-3 notches lower rating in general. However, a strong trade deal may reduce the diversification need into these two markets that has helped tightened their respective spreads over the past year. Our sector picks are selective industrials and land developers in Indonesia, and renewable energy and financials in India.

Asia Credits - Downgrades vs. Upgrades



Source: Moody's

Finally, the peak out of USD strength will favour local-currency bonds in 2020 compared to 2019. Continued across-Asia monetary accommodation combined with measured fiscal expansion should ensure lowering of government bond yields in most Asian countries. We favour high real yielding markets in Indonesia and India, and also expect a more stable CNY, continued monetary easing and global bond index inclusion to accelerate foreign inflows into China's onshore government and policy banks' debts.

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Disclaimer

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