Market Bulletin

June 13, 2019

Domestic demand: Silver lining amid the cloudy Asian trade outlook

In brief

- Latest weakness in Asian trade was mainly dragged by China-bound exports and the decline has been broader and deeper than expected.
- This underperformance will have negative implications for Asian earnings outlook in the near term, given the close relationship between Asia's export trend and its corporate earnings performance.
- That said, domestic demand and continued structural growth in Asia should provide some buffer against market volatility and provide income that contributes to total return.
- Our newly constructed 'domestic' vs. 'export-oriented' indices prove that domestically-geared companies have delivered more consistent earnings growth and, subsequently, return to investors. This calls for an active approach in investing in Asian equities, especially considering the challenging times in global trade.

Trade has always been a key element in Asia's economic growth, driving corporate earnings and market performance. However, headwinds arising from the recent surge in protectionism and an increasingly uncertain global trade environment have undermined the region's trade activities. The latest weakness in Asian trade was mainly dragged by China-bound exports and the decline was broad-based, spanning across all export categories while affecting both intra-regional and extra-regional trade. This underperformance will likely have negative implications for Asian earnings outlook in the near term.

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TRADE FALLOUT BETWEEN U.S. AND CHINA RIPPLED THROUGH GLOBAL SUPPLY CHAINS

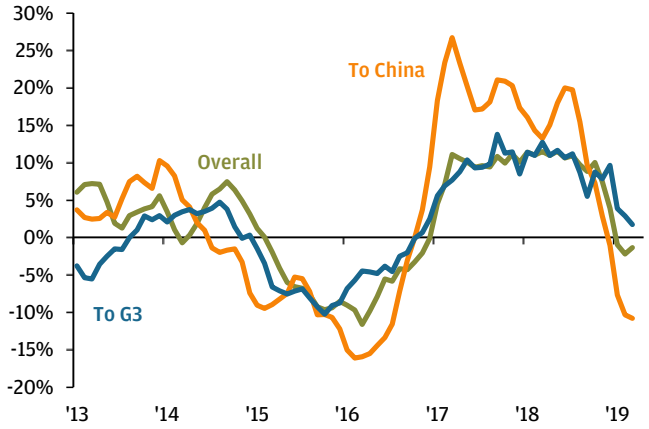
Since late 2018, Emerging Asia[1] (EM Asia) exports growth plunged sharply, entering negative territory (**Exhibit 1**). The decline is largely attributed to plummeting exports to China beginning from mid-2018, where it fell from +20.0% in June 2018 to -10.8% in March 2019. Meanwhile, exports to the G3[2] also fell, but at a more moderate pace.

[1]Emerging Asia includes China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
[2]G3 economies are Japan, European Union and U.S.

EM Asia exports growth falls into negative territory

EXHIBIT 1: EM ASIA OVERALL EXPORTS AND KEY DESTINATIONS

YEAR-OVER-YEAR CHANGE, 3MMA



Source: CEIC, J.P. Morgan Asset Management. Data are as of May 31, 2019.

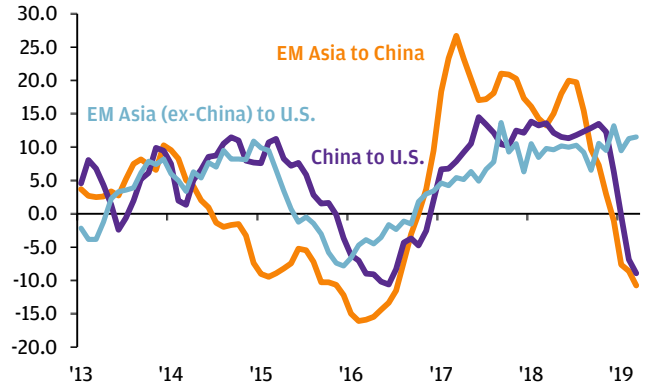
Recalling the situation in mid-2018, U.S. and Chinese authorities had begun their several bouts of tariffs and this unsurprisingly, hurt bilateral trade between the two countries. Given that global supply chains are highly diverse and integrated, collateral damage arising from a trade dispute between the two largest economies of the world is unavoidable. Asia, in particular, is one of the hardest hit given that majority of embedded components within Chinese exports to the U.S. are produced by other Asian countries such as Korea and Taiwan.

As illustrated by **Exhibit 2**, the latest stress in regional export chain was focused mainly in EM Asia exports to China and China's exports to U.S. Interestingly, growth in EM Asia (ex-China) exports directly to the U.S. (blue line), held up relatively well in the range of high positive single digit to double digits. This relative resilience of EM Asia (ex-China) exports to U.S. suggests potential acceleration and ongoing broadening in the migration of supply chains away from China to other neighboring countries within Asia.

EM Asia (ex-China) exports directly to the U.S. remain stable

EXHIBIT 2: EXPORTS GROWTH BETWEEN EM ASIA, CHINA AND U.S.

YEAR-OVER-YEAR CHANGE, 3MMA



Source: CEIC, J.P. Morgan Asset Management. Data are as of May 31, 2019.

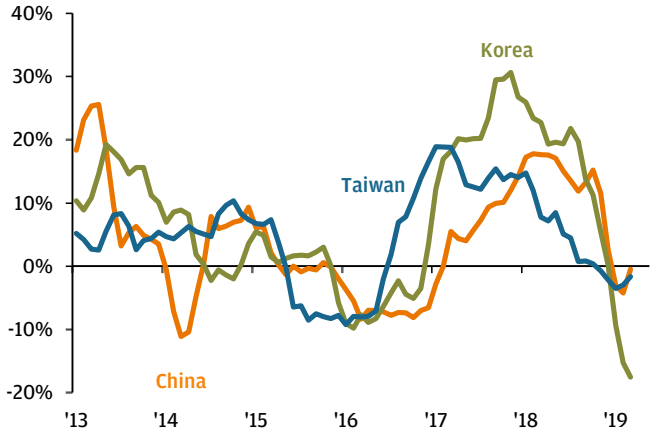
The global tech cycle slowdown is not helping

Besides the ongoing U.S.-China trade dispute, weakening global demand and the downswing in the global technology industry have also driven the exports downturn. In particular, the electronics sector was hit by the dual blow of heightened policy risk and sluggish end-consumer demand for key products. Looking at **Exhibit 3**, electronics exports from China, Korea and Taiwan, the major Asian tech exporters, have been falling precipitously. The contraction of electronics exports narrowed in China and Taiwan in the last few months but this will unlikely improve further after the U.S. recently stepped up pressure on China within the technology space.

Electronics sector was hit by both policy risk and weak demand

EXHIBIT 3: ELECTRONIC EXPORTS FROM CHINA, KOREA AND TAIWAN

YEAR-OVER-YEAR CHANGE, 3MMA



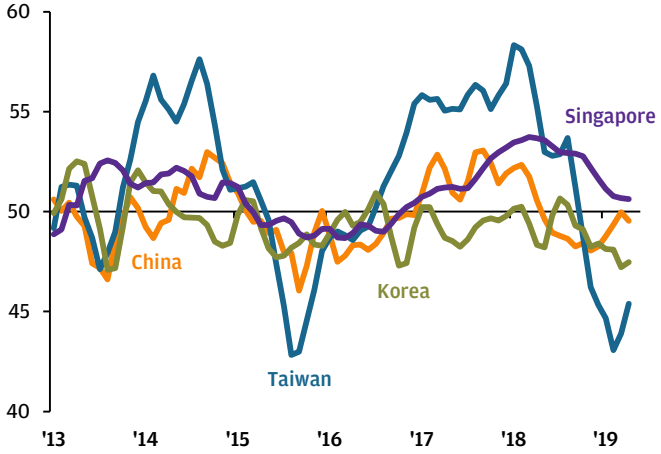
Source: CEIC, J.P. Morgan Asset Management. Data are as of May 31, 2019.

Looking ahead, with the recent re-escalation of trade frictions, the Asian trade outlook will continue to face challenges. The tariffs currently implemented and possible future ones will continue to dampen exports demand as producers' margins shrink from rising costs and consumers face higher prices if these incremental costs are passed on to them. Latest readings on the new orders component of the manufacturing purchasing managers' index (PMI) for Asian countries suggest that firms are increasingly cautious in the face of elevated uncertainties (**Exhibit 4**). Global capital expenditure, an important driver of trade, will likely soften further as the businesses delay spending and investment plans. A lack of new investments means that future growth potential will likely take a hit and the impact of lower growth will be reflected in weaker corporate earnings.

Manufacturers around the region remain hesitant about the outlook

EXHIBIT 4: MANUFACTURING PURCHASING MANAGERS' INDEX–NEW EXPORT ORDERS

INDEX

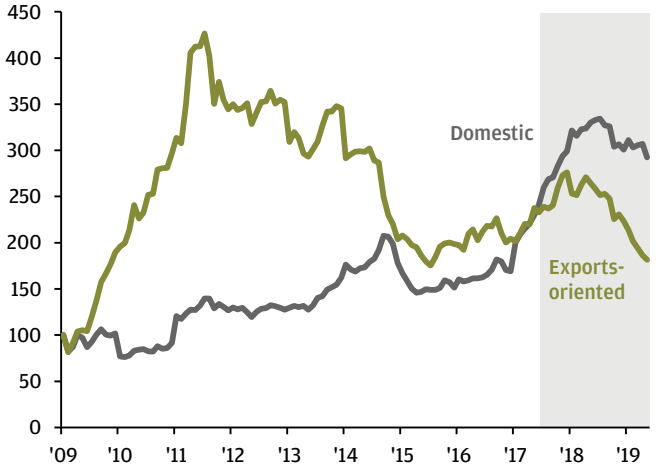


Source: CEIC J.P. Morgan Asset Management. Data are as of May 31, 2019.

Domestic companies show greater resilience

EXHIBIT 5: MSCI AC ASIA PACIFIC EX-JAPAN INDEX–EPS, DOMESTIC VS. EXPORTS-ORIENTED COMPANIES

EARNINGS PER SHARE



Source: Factset, MSCI, J.P. Morgan Asset Management. Data are as of May 31, 2019. See Appendix for more information on the methodology of creating the two indices.

Domestic-driven companies show silver lining

While we do not expect the export picture to brighten anytime soon, we can identify some silver linings in the cloudy outlook.

First, the structural growth story for many Asian economies remains intact, especially as the drivers of Asia's economic growth and corporate earnings have gradually been changing over the years—moving away from exports and toward the region's own consumers. Lifestyle and consumption upgrades, change in dietary habits from rising wealth, ongoing infrastructure development as well as urbanization continue to underpin the Asian macroeconomic and equities outlook.

As **Exhibit 5** illustrates, the 'Domestic' index has been able to consistently deliver and continue to improve over the years and has been outperforming the 'exports-oriented' index since end-2017. Meanwhile, following the global financial crisis in 2008, the 'exports-oriented' index recovered significantly in 2009-2011 but has been generally trending downward since then. Admittedly, both indices have moderated since the start of trade tensions in mid-2018 as cautious sentiment has dampened the overall earnings outlook. However, the 'Domestic' index fared better at weathering the "storm" as it remains relatively insulated from the ongoing downturn in the trade and technology cycle.

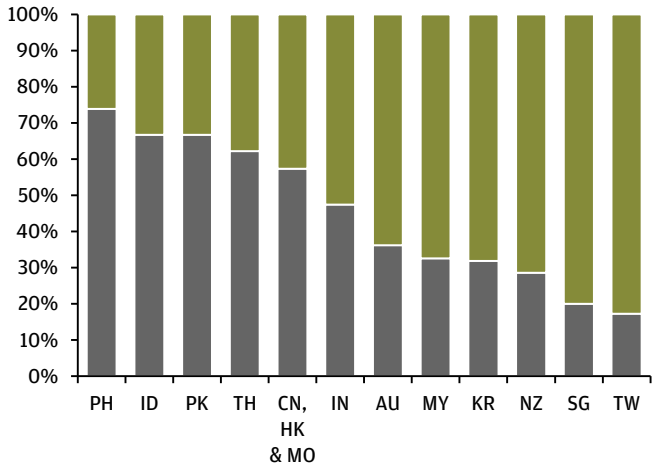
Investment implication

In the current environment, domestically-driven Asian economies will likely outperform exporters (as seen in the shaded area in **Exhibit 5**). As a result, investors are advised to take a more active approach in sector, company and country selection. ASEAN, particularly Philippines, Indonesia and Thailand, with significant exposure to domestic demand (**Exhibit 6**) and as the biggest beneficiary from the supply chain shift out of China, should continue to offer a better alternative within the EM Asia universe.

ASEAN companies generally have a greater domestic focus

EXHIBIT 6: REVENUE EXPOSURE, DOMESTIC VS FOREIGN

REVENUE EXPOSURE



Source: Factset, MSCI, J.P. Morgan Asset Management. PH = Philippines; ID = Indonesia; PK = Pakistan; TH = Thailand; CN, HK & MO = China, Hong Kong & Macau; IN = India; AU = Australia; MY = Malaysia; KR = South Korea; NZ = New Zealand; SG = Singapore; TW = Taiwan. Data are as of May 31, 2019.

On monetary policy, continuous support from central banks and governments suggest liquidity will remain ample, supporting growth. The continuous dovish pivot by the U.S. Federal Reserve and the potential extended pause should give more flexibility to Asian central banks who can now focus more on domestic concerns as the primary driver of monetary policy, especially as inflation remains subdued. Asian investors can take comfort that there is policy ammunition at home to help navigate the trade slowdown.

Appendix

To examine if domestically-geared companies are truly more resilient in the current trade environment, we decomposed the Asian equity market index into 2 broad definitions based on its revenue exposure: domestic demand and export-oriented (companies which operations have greater foreign exposure). To do this, we took the universe of stocks within the MSCI AC Asia Pacific ex Japan index and split them into two buckets. The first bucket, the "Domestic" bucket, includes companies which revenues are at least 95% exposed to the countries in which they are headquartered. The second bucket, the "Exports-oriented" bucket, contains the rest, companies which revenues are less than 95% exposed to the countries in which they are headquartered.

Over the time period we examined (January 2009 – Present), monthly adjustments are made to the bucket to reflect changes in a company's operations over time. Subsequently, earnings-per-share (EPS) for each bucket is calculated by summing the market-value weighted EPS for each company on a monthly basis over the examined period. Both the 'Domestic' and 'Exports-oriented' EPS series are then indexed to 100 on 31 January 2009, allowing us to compare the earnings trend of both buckets in **Exhibit 5**.

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