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Asian Perspectives

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- Market sentiment has weakened despite a still strong backdrop for earnings and economic growth.
- Financial conditions are tightening, and a strengthening US dollar is contributing as it tightens the screws on dollar borrowers globally.
- Asian countries are less vulnerable to the greenback's appreciation because Asia's reliance on dollar financing is lower than in other parts of the world.
- Lower valuations in Asia are increasing the appeal of equity and fixed income assets. We especially like cyclical stocks and high yield credits.

Macro backdrop

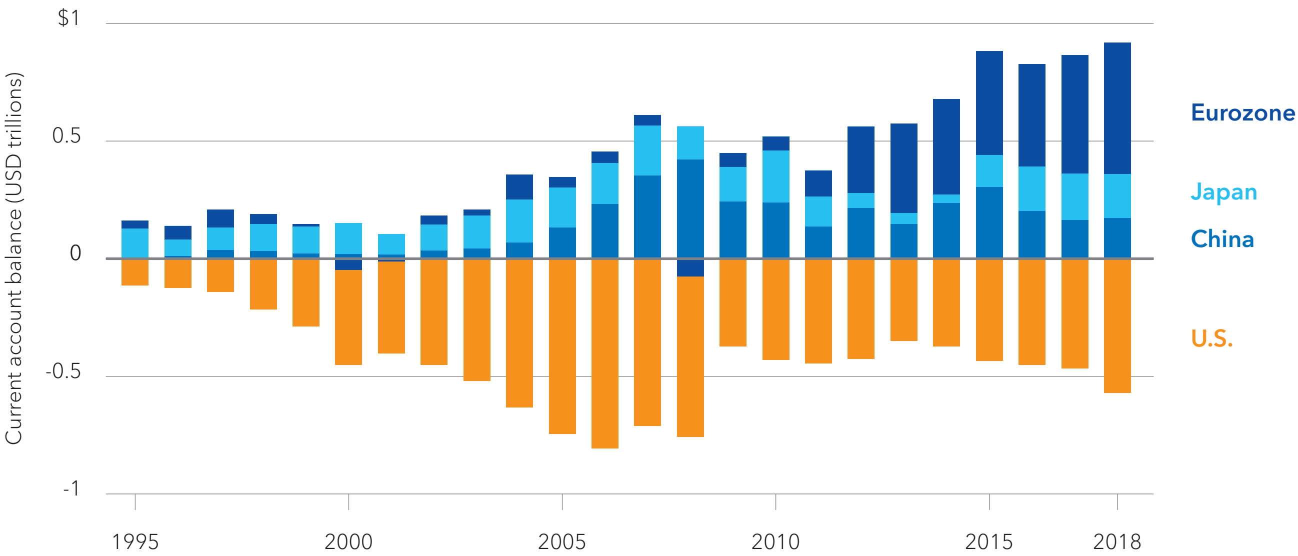
In 2018, policy and macroeconomic uncertainties have replaced last year's optimistic views of a synchronized global recovery as the main drivers of markets. Fiscal stimulus and a tax overhaul have supercharged U.S. growth, leading to rising interest rates and a strengthening dollar. These are causing headwinds for other countries – especially in Latin America – while US protectionist policies are also causing much pain in markets.

Falling business confidence leads to delayed corporate spending and investment, and tariffs trigger retaliation pushing up costs and depressing demand. Appetite for risk has fallen despite a solid backdrop for earnings and economic growth. The shift in business and investor sentiment is the clearest casualty, but our base case is that the global economy will make it through the uncertainties albeit with episodic bouts of market volatility.

We believe the US-China economic tensions go beyond the bilateral trade gap; the rivalry centers on China's technology development plan and its competitive and national security implications for the US. Restrictions on Chinese investments in the US and transfers of technology to China are likely to persist. But the issue is broader than China. See the *persistent US trade gaps* chart. Further trade actions globally could derail the economic expansion.

Persistent US trade gaps

Current account balance for major economies, 1995-2018



Source: BlackRock Investment Institute, with data from OECD, June 2018. Note: The bars show the annual current account balance for each economy. 2018 numbers based on OECD forecasts.

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Equities

- The fundamentals for Asian equities remain solid, underpinned by strong economic and corporate earnings growth. Trade frictions, however, have made the economic outlook less clear and investor sentiment has suffered as a result.
- China's deleveraging pace has slowed due to rising risks to global growth related to trade tensions. We believe Chinese leaders will avoid massive stimulus on infrastructure and property investment while remaining committed to their reform agenda. We see confidence returning to markets once the US-China tension ebbs and economic growth stabilizes in China.
- We are positioned for reflation – overweight financials, materials and industrials. This hasn't worked lately due to the uncertain outlook and investors' wait and see attitude.

Love the unloved

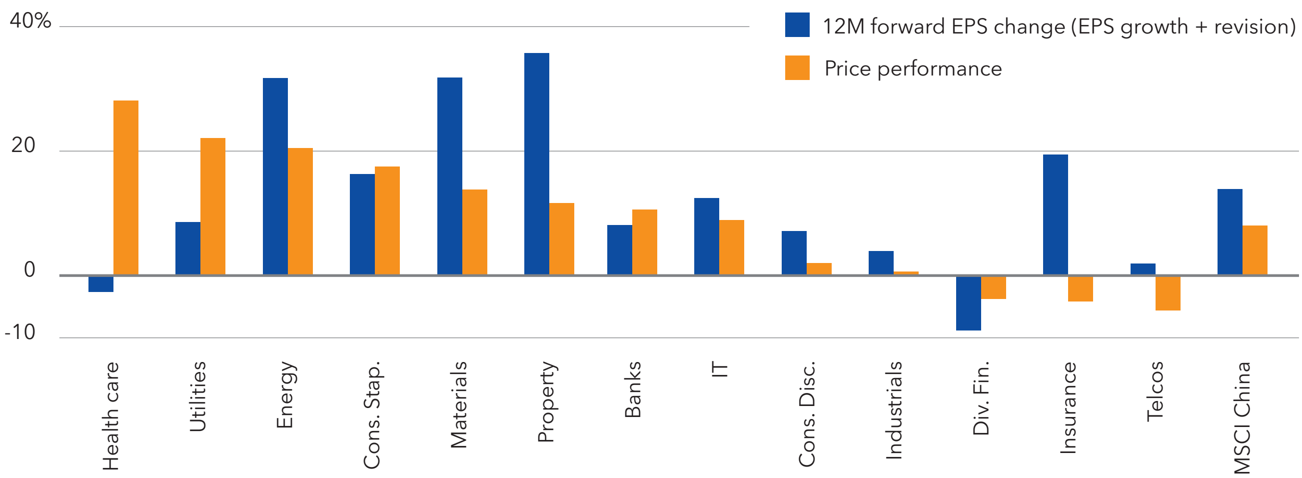
As China's economy is anticipated to slow, the knee-jerk response of many investors is to ditch cyclical sectors, such as real estate, materials and energy. Not surprisingly, these sectors have seen massive deratings in 2018, with price-to-earnings ratios declining sharply from the start of this year. The *derating of macro sensitive sectors in China* chart shows the relationship between a robust earnings picture (blue bars moving higher) and lackluster-to-negative price performance (orange bars) leading to massive deratings.

Our expectation of resilient domestic investment supports our contrarian view to favor Chinese cyclical sectors. We see little evidence of weakness in construction activity and material demand at the sector and corporate levels. In May 2018, China produced 9% more steel, 10% more electricity, and sold 17% more heavy trucks and 71% more excavators than one year ago[1]. Our research also suggests that balance sheets for real estate developers and local governments are generally strong and can sustain investment in H2 2018. The concern over their financing difficulty amid financial deleveraging seems overdone. In fact, the decline in risk appetite of financial institutions is in favor of landowners which have tangible real assets as credit collaterals.

[1] Source: National Bureau of Statistics, Wind as at June 2018

Derating of macro-sensitive sectors in China

Sector breakdown of MSCI China Index, Dec. 2017 – Jun. 2018



Source: FactSet, I/B/E/S, MSCI

Asian equities in brief

Why now

- **Earnings** – Expanding fuelled by an export recovery. Also, the end to the 6-7 year strike on capex should benefit Asia's industrial sector as more companies upgrade their plant and equipment.
- **Valuations** – Attractive vs. other asset classes, and also in certain cyclical areas such as the energy and the materials sectors.
- **Positioning** – Investors remain underweight to the region relative to the MSCI AC World Index.

Most overweight in

- **India** – Diverse stock-picking opportunities and rising rural incomes.
- **Indonesia** – Reasonable valuations look attractive against a healthy balance sheet, falling inflation, high interest rates and progress in structural reforms. Prefer financials and infrastructure plays.
- **Financials/Industrials/Energy** – Earnings leverage and positive risk/reward.

Cautious on

- **Technology sector** – Expensive valuations
- **Hong Kong and Singapore** – Highly sensitive to US interest rates
- **Taiwan** – Dominated by large-cap tech companies that are richly priced.

Main risks

- **Trade frictions** – The clearest threat to the near-term growth outlook.
- **Rising US interest rates and stronger dollar** – Higher US interest rates make high-yielding EM and Asian assets relatively less attractive. A stronger greenback raises the cost for EM borrowers to service their dollar debt.

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Fixed income

- Policy and geopolitical uncertainty, as well as rising oil prices, have increased near-term risks for Asian credit. Yet the long-term case remains solid based on a global savings glut and income needs of an ageing population.
- We see value emerging in Asian credit, with yields back to five-year highs. We believe the cheaper valuations for Asian credit are primarily due to a supply glut in recent quarters and not deteriorating fundamentals.
- We have seen a deterioration in US-China trade negotiations, and trade frictions are increasing outside Asia. We remain optimistic about a negotiated solution. This would remove much of the uncertainty that has led investors and business leaders to pause.

Mind the Asian yields

Asian credit yields are close to a five-year high, over which period the asset class has delivered one of the highest risk-adjusted returns across global asset classes. Income has contributed the bulk of the return affording low volatility relative to other asset classes. The market is now pricing in three rate hikes in the US over the next year, and current yields provide a good buffer in the event of a repricing of Fed expectations. After a nine-month adjustment in yields and recent sell-off in risk assets, we believe value is emerging in Asian credit – especially relative to peers in the US and Europe.

In July, we saw a reprieve in Asian high yield and the broader credit spectrum. Key drivers were the bias toward easing by Chinese policymakers, oil prices receding, better inflows and expectations that the trade tensions will lessen. The trade situation, however, remains in flux and it is hard to predict in the short term.

Our case for Asian credit remains unchanged – a high-quality market with an improving credit trajectory that offers an attractive spread over developed markets adjusted for duration and volatility.

A reason for our optimism is the significant improvement in sovereign and corporate fundamentals relative to five years ago. We particularly like high yield, where we have been adding risk selectively in China and Indonesia. Another reason for optimism is our belief that the trajectory of global rates from here will support credit. The main risks are an unwieldy China slowdown and an escalation of a trade war, neither of which are our base case.

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Indeed, the cheaper valuations seen recently in Asian credit reflect weaker technicals (supply and demand) and not deteriorating fundamentals. See table *How fundamentals have improved in Asian credit*.

How fundamentals have improved in Asian credit

	Leverage has come down due to higher earnings		Liquidity profiles have improved
	Net Debt / EBITDA*	**EBITDA Margin***	**Cash / Short Term Debt***
Dec 2013	2.0 X	14.0%	85%
Dec 2017	1.8 X ▼	18.1% ▲	110% ▲
Why this matters	This is a leverage ratio that shows how many years it would take for a company to pay back its debt if net debt and EBITDA are held constant. It serves as an indication of a firm's ability to handle its debt burden.	This is an assessment of a firm's operating profitability as a percentage of its total revenue. It allows investors to compare companies of different sizes because it breaks down operating profit as a percentage of revenue.	This ratio calculates a company's ability to pay current liabilities using only cash and cash equivalents. If the company is forced to pay all current liabilities immediately, this metric shows the company's ability to do so without having to sell or liquidate other assets. It looks at the risk of a company having financial difficulties.
	Lower = Better	**Higher = Better**	**Higher = Better**

Source: BlackRock, June 2018; * data based on the J.P. Morgan Asia Credit Index (JACI)

Asian credit in brief

Why now

- **Valuations** – After a nine-month adjustment in yields, we believe value is emerging.
- **Global rates, strong fundamentals** – We believe the trajectory of global rates will support credit, and fundamentals in Asia (both sovereign and corporate) remain supportive of the asset class. The cheaper valuations recently seen in Asian credit reflect weaker technicals and not deteriorating fundamentals.

Most overweight in

- **High yield** – We like Indonesian high yield issuers with USD linked revenue or partially hedged USD liabilities. We also like Chinese real estate, where we have seen improvements in gross margins, interest coverage and revenue growth.

Cautious on

- **India** – India has been a long-standing overweight, but higher oil prices, an uncertain political climate and stress in the banking system led us to temporarily reduce our positions. Reforms in recent years should manifest themselves positively in the medium term, and the central bank's firm focus on inflation adds to its credibility.

Main risks

- **Policy, geopolitical and inflation uncertainty** – We now have a slightly more cautious near-term view on Asian credit and expect continued asset price volatility. This underscores security selection as a key driver for performance.
- **Oil prices** – Rising oil prices affect the region, raising the potential for fiscal slippage, current account widening and higher inflation. We see limited upside for oil prices from current levels.

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