MIRAE ASSET
Building on principles

Asia: Cutting Through the Noise Series

Issue IV – Asian Equities: Different This Time? September 2017

Key Takeaways:

- Since 2011, developed market (DM) equities have outperformed emerging market (EM) equities, driven by stronger earnings growth and macroeconomic fundamentals.
- However, with DMs burdened by high valuations and monetary tightening, we could see the end of Asian underperformance over the next five years.
- EM outperformance during a period of US tightening would run counter to historical patterns, but we believe that Asia is especially positioned to benefit from key structural shifts.
- In Asia, passive funds will be hard-pressed to match their DM performance, as proven active funds are better equipped to capitalize on the region's numerous market inefficiencies.

"We propose that there are opportunities for active funds to outperform in Asia due to the region's intrinsic market inefficiencies."

Narrowing the Gap

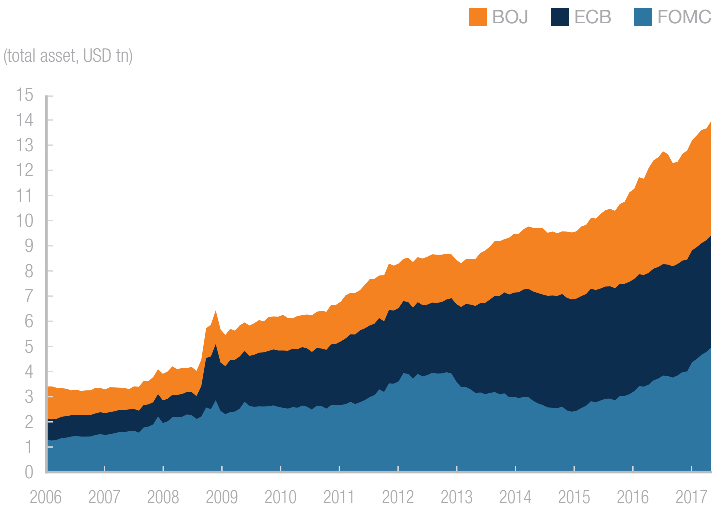
For almost a decade Asian stocks have lagged far behind their DM counterparts. However, key indicators and structural shifts suggest that conditions are ripe for a narrowing of the discount.

Following the global financial crisis, DM equities have enjoyed a steady premium over their EM counterparts on the back of stronger earnings growth and lower risk perception facilitated by various structural factors, including macroeconomic stability, policy transparency, relatively efficient banking systems, and advanced infrastructure.

However, with the Federal Reserve (Fed) preparing to unwind its balance sheet and the European Central Bank (ECB) also likely to switch to tightening, the era of easy money is coming to an end for DMs. In effect, after a decade of monetary stimulus, the next few years will be uncharted territory for global markets—and we believe that Asian equities will start to close the gap with DM equities. Questions over the ability of DM governments, namely the Trump administration, to engineer fiscal stimulus to counter tightening will lead to a rise in policy uncertainty unlike anything investors have seen since 2011, when the most recent period of EM underperformance began.

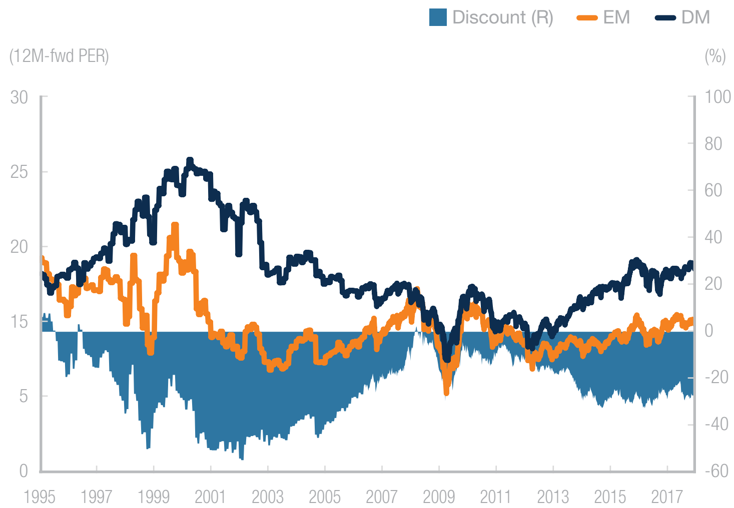
QE Creates Misallocation of Capital

Source: Bloomberg (2017)



The EM Discount is Stabilizing

Source: Datastream (2017)



It's Different This Time?

Calling for relative outperformance by Asian stocks during a US tightening cycle may seem counterintuitive in light of the following long-standing factors: 1) global rate synchronization, with the Fed serving as the world's monetary policy leader; 2) the high foreign debt levels of EMs; and 3) Asia's heavy reliance on DM-bound exports. However, we believe that the influence of these factors is on the decline, which could cause Asian equities to behave differently than during previous periods of US tightening.

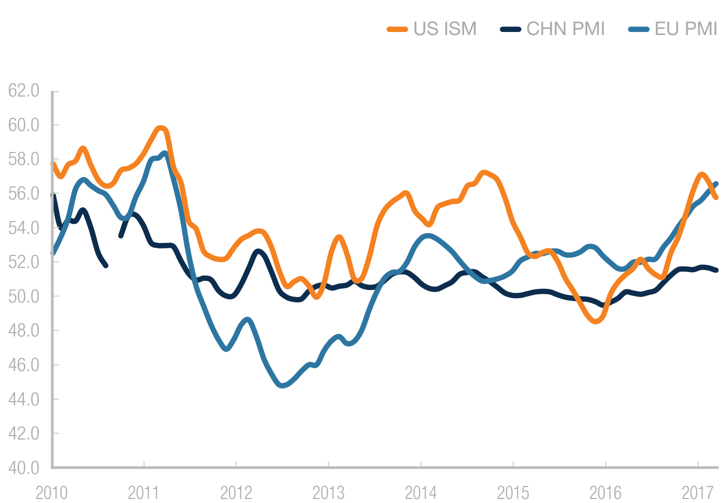
In terms of monetary policy, Asia is set to show clear divergence from the US, with the region still enjoying room for further easing. Indeed, aside from the Bank of Japan (BOJ), Asian central banks have not yet implemented zero interest-rate policy (ZIRP) or quantitative easing (QE) measures, which means that they have bullets that Europe and Japan do not enjoy.

In addition, Asia's exposure to foreign debt is being carefully managed after a multitude of painful experiences and clear warning signs from financial markets regarding the inevitable end of QE. In particular, currency swaps, such as those outlined in the Chiang Mai Initiative (CMI), are being implemented to buffer against potential exogenous shocks (e.g., sudden rate increases and policy shifts) that could lead to the emergence of contagion risk. And Asian countries are instituting safeguards to make their historically vulnerable and highly cyclical banking systems much more robust.

Finally, it should be noted that Asia's dependence on US-bound exports has been steadily declining amid the rise of China and other countries in the region as major importers. While Korea and Taiwan have long been considered strong proxies for global growth due to their extensive export offerings and heavy exposure to outbound trade, it is notable that the KOSPI's and TAIEX's historically strong correlations with the US ISM index have somewhat decoupled.

China Avoids A Hard Landing

Source: Bloomberg (2017)

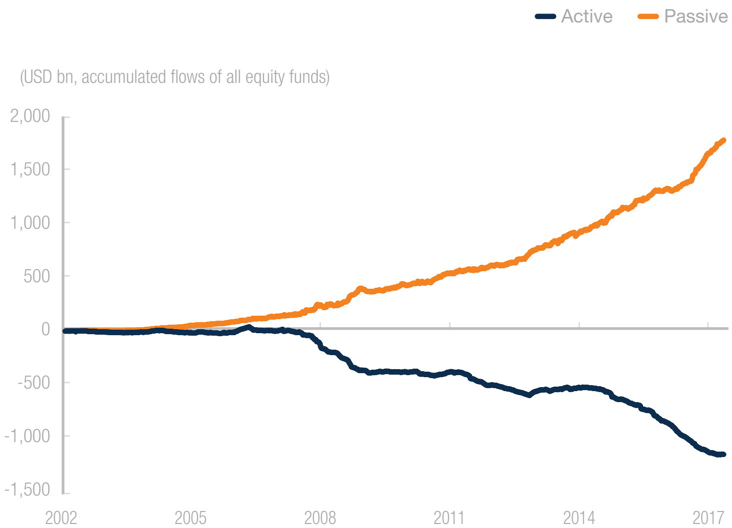


Active vs. Passive in Asia

Over the past few years, the leakage of fund flows stemming from the rising penetration of exchange-traded funds (ETFs) has served as a major impediment to Asian equities. Our analysis shows that the rise of ETFs is coming at the expense of closet index funds and fundamental fund managers lacking investment discipline and clear philosophies.

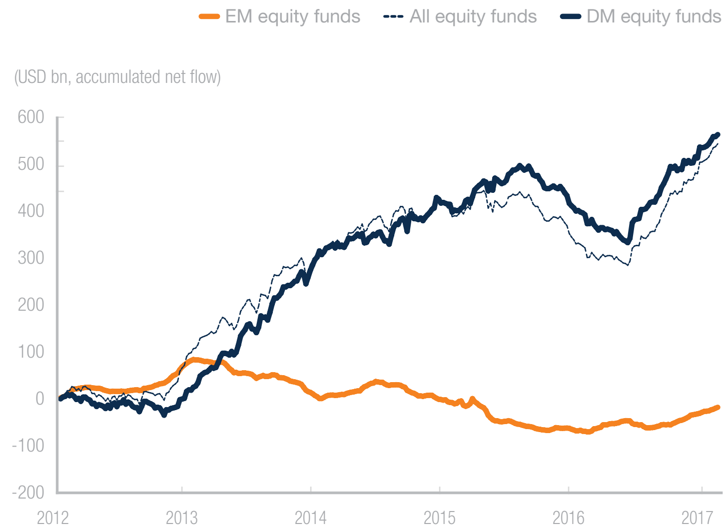
From Active to Passive

Source: EPFR (2017)



Global Equity Fund Flows

Source: EPFR (2017)



Even for truly active funds, it is undeniable that the rules of the game are changing rapidly amid the proliferation of super computer-powered algorithms and 24-hour data consumption. But for all of the amazing technological advances made in recent years, machines and software are still likely a long way from being able to accurately parse information quality and replicate the foresight that comes with years of experience. Specifically, with information delivery and market structures remaining relatively inefficient in Asia, it remains difficult for purely computer-based models to accurately price in management variables, corporate strategy, governance issues, policy/regulatory risks, earnings quality, and macro sensitivity.

The rise of ETFs is coming at the expense of closet index funds and fundamental fund managers lacking investment discipline and clear philosophies.

Experience and Skill Count

With this in mind, we propose that there are opportunities for active funds to outperform in Asia due to the region's intrinsic market inefficiencies. In our view, information processing/delivery issues, inter-country regulatory differences, and current liquidity conditions suggest that active management is more suitable for Asia than passive exposure. The data on Asian companies that gets fed into quant programs are not likely yet timely or accurate enough to generate consistent alpha, and even smart-beta ETFs geared toward capturing qualitative factors are likely to fall short of experienced, skillful fund managers.

Emerging Market Fund Flows

Source: EPFR (2017)

Asia ex-Japan Fund Flows

Source: EPFR (2017)

Over the next few years, tightening by the world's biggest central banks could provide significant headwinds. While history tells us such macro uncertainty bodes ill for EM equities, we argue that Asia stands apart from other EMs due to its structural improvement in debt management, enhanced macro fundamentals, and policy room. Against this backdrop, we argue that history is not destiny and that active funds are better positioned to help investors seize on opportunities in the region.

> *"Information processing/delivery issues, inter-country regulatory differences, and current liquidity conditions suggest that active management is more suitable for Asia than passive exposure."*

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