Topic Paper
March 2018

Asian Equities: Finding Value in Unexpected Places

PERSPECTIVE FROM THE TEMPLETON GLOBAL EQUITY GROUP

EXECUTIVE SUMMARY

- Asian markets today are attractively valued relative to US markets, and are poised to benefit from several likely tailwinds in the US and global economy.
- We are finding value in unexpected places across telecommunications and utilities companies, that will experience higher consumer demand from the growing middle class.
- Japan and Korea offer compelling value investment opportunities in our view, with selective value also available in the Chinese market.

Peter Wilmshurst, CFA
EVP, Templeton Global Equity Group
Portfolio Manager, Templeton Global Growth Fund (ASX:TGG)

Many Asian economies appear more resilient today than they did during the Asian Financial Crisis two decades ago, with better current account balances and less exposure to foreign-denominated debt. Many of these markets also appear attractively valued relative to the United States, with bourses in Hong Kong, China, Korea and Taiwan trading at 12-13x this year's earnings compared to 17-18x in the US. In general, Asian markets today appear modestly valued and highly levered to the improvement in the global growth cycle, which could accelerate further following US tax reform and fiscal stimulus. A weaker dollar as the US budget deficit widens, and the subsequent rise in commodity prices, also suits these markets well.

As ever, our approach to regional investment opportunities begins from the bottom up, employing fundamental security analysis within a value-oriented, long-term framework.

Our long-term horizon and insistence on discounted valuations tends to create contrarian portfolios. While our investments rarely ever hinge on explicit macro forecasts, we do analyse top-down developments in the regions and sectors we cover, and reflect those findings in our analysis of companies.

In this paper, we share some of the fruits of our analysis, offering views on the risks and opportunities facing Asian equities, both top-down and bottom-up. Overall we continue to find compelling opportunities in the region, though not necessarily in the places one might expect. While Asia will not be immune from developments outside its borders, fundamental conditions within the region have improved significantly since the Asian and Global Financial Crises, and valuations remain undemanding, particularly relative to the later-cycle US market.

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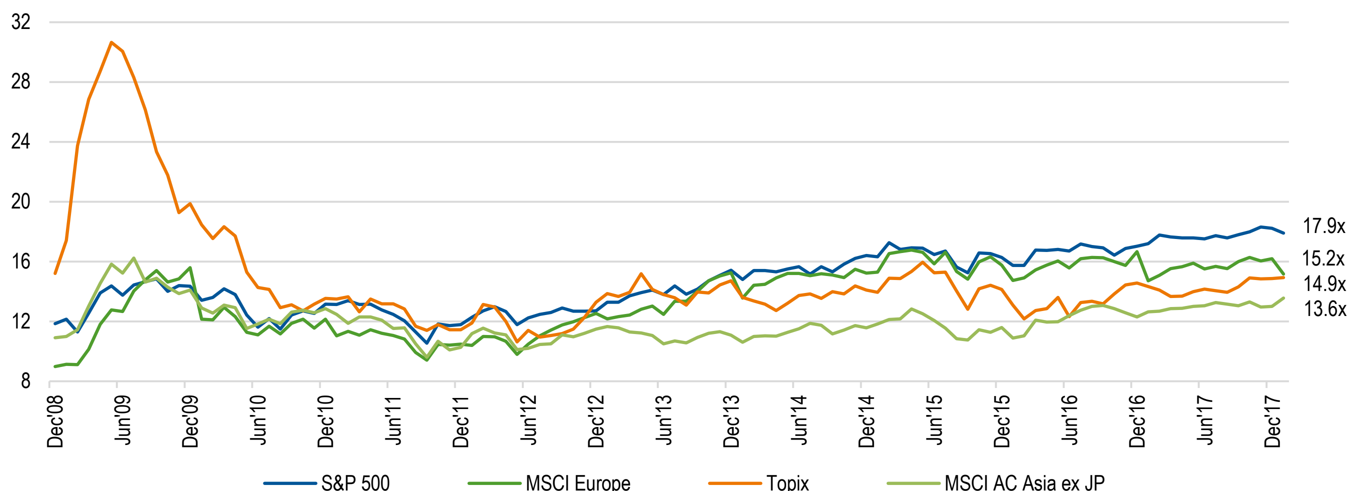
Asian Equities Are Modestly Valued Compared to Other Regions

Price to 12-Month Forward Earnings

As of 31 January 2018



Source: Bloomberg, FactSet.

When the US Sneezes, Asia Still Catches a Cold

Beginning with the risks, the US remains in many ways the tail that wags the dog in Asia, with fluctuations in Fed policy rates and the value of the US dollar having wide-ranging effects on a region where many countries still peg policy to Washington. The implications here are both cyclical and structural. On the cyclical front, an inflationary overheating and disorderly rise in interest rates in the US could prompt aggressive Fed policy tightening, prematurely curtailing Asian expansionary conditions. Alternatively, a deflationary bust and recessionary conditions in the US could severely curb risk appetite in the high-beta Asian region.

In the meantime, a continuation of the status quo—a "Goldilocks" scenario of globally synchronised growth, accommodative policy and modest inflation—suits the Asia region just fine. While we have no special insight into how long this cycle will last, the fact that US policymakers are determined to perpetuate it should not be overlooked. Indeed, the core thrust of US economic policy—stemming from both President Trump and the Federal Reserve Board—should have favourable knock-on effects for Asian equities. The Fed wants to see a gradual and orderly normalisation of policy, which would likely support the earlier-cycle, undervalued markets in Europe and Asia, rather than a US economy and stock market already operating close to full utilisation and with profit margins near peak. Trump wants to bolster growth with fiscal stimulus, which would likely benefit Asian markets also—at least in the near-term—given their sensitivity to the US dollar and the global economic cycle.

The elephant in the room is US protectionism, though we think concerns here may be overstated. President Trump may have campaigned on a plank of economic nationalism, but he hasn't made much progress in implementing protectionist policies via legislation or trade negotiation. This doesn't mean there isn't more in the pipeline; the US administration is pursuing tariffs on steel and aluminum imports and investigations into China's intellectual property practices could lead to tariffs and investment measures. Earlier tariffs levied on solar panels and home appliances highlight Trump's comfort with mercantilist measures. However, the most significant protectionist action that President Trump has taken thus far vis-a-vis Asian economies is his decision to withdraw from the Trans-Pacific Trade Partnership. While the US may still rejoin the treaty—some reports suggest withdrawal is a negotiating tactic—even if they don't, we wouldn't necessarily view it as negative for Asian stocks. For China at least (with whom the US has the largest bilateral trade deficit), Trump's withdrawal creates a regional vacuum that Chinese interests look well-positioned to fill given the impetus of Xi Jinping's ambitious "One Belt One Road" regional infrastructure initiative. As for the 11 remaining countries from the original pact, they are still forging ahead with a free trade zone that will account for roughly $10 trillion in annual economic output, even without the US.

Turning to the structural implications of US policy on Asian markets, these largely involve US currency and its balance of payments. Supply and demand dynamics in the US government's funding market are changing. Washington will likely increase debt issuance to fund its deficit at a time when the Fed and ECB are winding down bond purchases and savings rates in the western world are near all-time lows. Western savers and central banks have been key sources of demand for US debt, but their reduced appetite going forward could result in Asian savers and governments stepping in to soak up the extra liquidity. Any potential flow of funds from east to west in such a scenario would likely strengthen the dollar and

create significant headwinds for emerging market equities. Alternatively, all that money printing and deficit spending could finally erode confidence in the US Treasury, helping hasten the shift away from dollar hegemony and spurring a flow of funds from west to east in search of higher and more stable real rates of interest. While it's important to understand the dynamics at play, the uncertainty of timing and wide array of potentialities surrounding the impact of US policy on Asia makes investing in these themes something of a fool's errand, in our view. Instead, we attempt to circumvent this uncertainty by focusing on individual companies with undervalued long-term growth and cash flow potential that are likely to benefit from structural shifts specific to the region.

Sector Opportunities in Asia – Finding Value in Unexpected Places

Where we are currently finding opportunities may be surprising. From a sector standpoint, Asian bourses tend to have high concentrations in financials, technology and commodities. While these sectors offer their share of bottom-up opportunities, their popularity often obscures opportunities elsewhere in the region. To some extent, the technology sector depends on western consumer demand (think smartphones, PCs, laptops), while commodity demand is primarily a function of centrally-planned Chinese fixed asset investment. By comparison, we believe some of the best structural growth opportunities in Asia are effectively plays on the long-term wealth accumulation and demand potential of Asian consumers. We're not necessarily talking about the makers of electronic gadgets or luxury goods—they cater to a global audience and command premium valuations—but instead, the owners and operators of critical infrastructure required to facilitate the rise of a new middle class.

The telecommunications and utilities sectors are two such examples. They're less exciting and lower profile than some other sectors, but also home to companies that trade at significantly cheaper valuations and form the indispensable buildings blocks of a modern society by providing things like high-speed mobile data and efficient, on-demand heating fuel. From the telecommunications sector, we are currently finding bargains in companies like China Mobile and China Telecom, two of that country's "Big Three" telecoms providers. Sir John Templeton said that "to find a bargain, you have to look where people are pessimistic." Pessimism abounds in China's telecommunications industry as investors worry about unlimited data pricing competition and the high capex forecasts associated with the buildout of the nation's 5G network. Yet, data pricing in the industry has so far been rational, and the high levels of investment are both required to create scalability and at least partially offset by the fact that Chinese telcos do not have to pay for access to spectrum. While the market continues to focus on the perceived negatives, we see companies trading at undemanding valuations that are growing earnings and dividends and investing to gain scale and share in a secular growth market.

Select Asian utilities also offer lowly-valued exposure to Asian growth trends. Hong Kong-listed gas infrastructure company, Kunlun Energy, is one such example. After transitioning from a poorly run, state-owned energy company to a better managed gas distribution utility, the firm looks well-positioned to stabilise earnings and capitalise on an uplift to both margins and volumes as gas demand grows in the future. Trading at less than 10x this year's expected earnings, Kunlun is another example of how we are finding attractively valued exposure to Asia's secular growth themes in unexpected places.

Regional Opportunities in Asia – Korea, Japan and China

In terms of where we are finding the best value geographically, both Korea and Japan (and to a lesser extent, China) have offered up compelling opportunities recently. Japan is one of the few markets in the world that is both under-owned and trading at a discount to its historical valuation levels. Investors just can't seem to overcome the stigma of low growth, expensive valuations, excessive leverage and poor returns long associated with Japanese equities. Yet, these legacy characteristics have all, to varying degrees, improved. Japanese GDP is growing at an above-trend pace, Nikkei earnings per share recently reached their highest level since 1991, and non-financial sector net debt-to-EBITDA recently fell to the lowest level in three decades. Furthermore, the 5% return on assets achieved by corporate Japan is more than double its 10-year average and closing the gap with global peers. Even corporate governance is showing signs of improvement as Prime Minister Shinzo Abe progresses with his "third arrow" of structural reforms. The measures, aimed at the corporate sector and including new codes of governance and stewardship, are addressing some of Japan's more opaque and uncompetitive business practices and helping shift the balance of power from stakeholders to shareholders. As fundamentals have improved, valuations have actually become more attractive, with Japanese equities now trading on par with developed world peers on cyclically adjusted earnings multiples for the first time in twenty years. Structural headwinds attributable to aging demographics and high government debt persist, but by and large Japan is heading in the right direction, and we continue to find selective bargains in the market.

Like Japan, Korea's recovery has been fundamentally driven, with corporate earnings rising and the won appreciating on the back of strong export growth, which has bolstered the current account surplus and foreign reserves. Yet, as with Japan, valuations have yet to follow suit. Despite rising 45% in USD terms in 2017 alone, the MSCI Korea Index actually trades at a lower forward P/E than it did at the beginning of the year. Some policies introduced under left-leaning President Moon, including increases to minimum wages and higher corporate tax rates, have rattled investors and may be partially responsible for the de-rating.

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Nevertheless, the Moon Administration has also progressed with shareholder-friendly efforts to reform the large chaebol conglomerates, already resulting in higher payout ratios and improving return prospects. With a solid economic and corporate profit cycle taking hold and the Bank of Korea now beginning to hike rates for the first time in six years, we continue to see significant upside potential for select companies in this lowly-valued market.

China's systemic importance also gives it the potential to disrupt regional equity markets if the government fails to cool financial speculation and transition to a more sustainable economic model without materially slowing growth. Consider the challenges. China's debt burden appears Himalayan for an economy at its stage of development; the extent of mal-investment and unrealised loan losses, particularly among state-owned enterprises (SOEs), is likely vast; credit bubbles in financial assets and property markets remain inflated; and the country continues to defy the "Impossible Trinity" by simultaneously managing its exchange rate, running an independent monetary policy and maintaining (mostly) open capital flows.

While the excesses and imbalances will eventually need to be addressed—perhaps through a significant re-pricing of risk—we also shouldn't underestimate the ability of China's central planners to promote stability in the meantime. Overall, the country still offers an interesting combination of high growth and cheap valuations for some companies, though we have largely steered clear of expensive sectors and state-controlled sectors plagued by excessive leverage and capacity. We believe the best opportunities in China exist among lowly-valued H-Shares in the service-oriented sectors likely to capture an increasing share of China's future economic growth.

Finally, any escalation of conflict on the Korean peninsula or in the South China Sea would obviously be a negative for regional risk appetite, though this is difficult to forecast. The best way we can handicap the North Korean situation is by recognising that the primary objective of the country's leadership is to retain power. Since any use of a nuclear weapon would almost certainly lead to forcible regime change in North Korea, we believe the most likely outcome is a continued cold war stalemate scenario with periodic flare-ups and détentes.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Value securities may not increase in price as anticipated or may decline further in value. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments; investments in emerging markets involve heightened risks related to the same factors.

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