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MARKET INSIGHTS

COULD OIL FUEL ASIAN RALLIES?

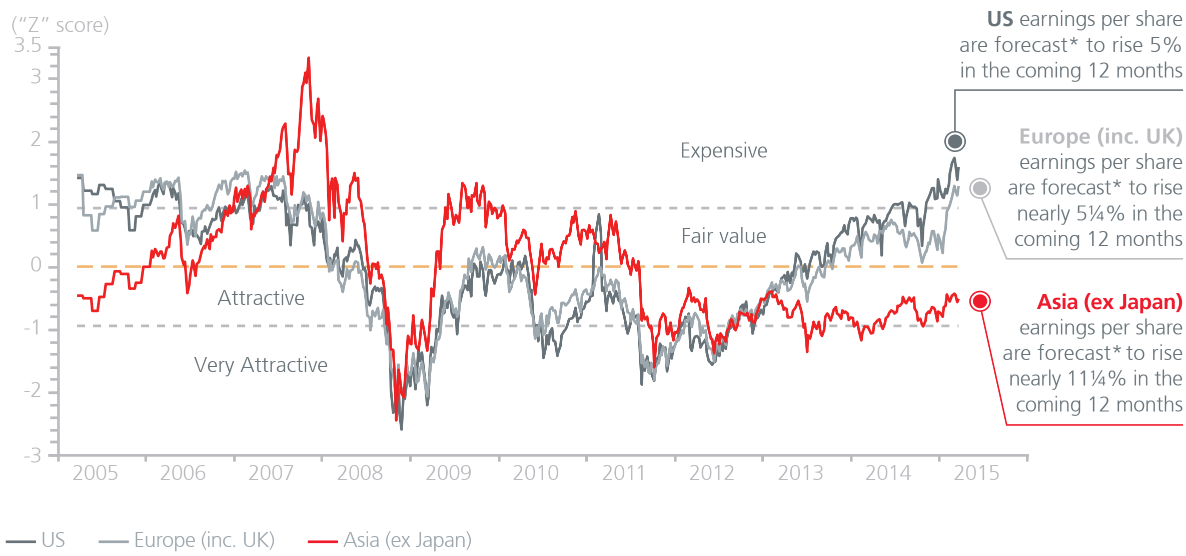
MARCH 2015

Low Asian equity valuations could get a healthy boost triggered by low oil prices, especially as those factors holding valuations down seem to be running out of steam.

Asian equities have had some solid rallies in recent years[1]. Valuations[2], however, have only trended modestly higher (if at all); most rallies rose roughly in line with earnings growth. As a result, the price earnings multiple expansion clearly evident in the US has been only partially reflected in Asia (apart from the Philippines and Thailand).

The result is the wide valuation gap evident in Fig.1. This will close one day, but how and when?

Fig.1. Asia (ex Japan) looks "Attractive". US is "Priced for perfection". Europe discounts a "Yet to be seen" recovery.



Source: Eastspring Investments (Singapore) Ltd, MSCI and IBES from Datastream, 25 March 2015. Note that the "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all values lie. The middle dotted line indicates the 10-year average. *The consensus forecast from IBES as at 25 March 2015.

[1]Since its rally began in October, 2011, the US equity market has risen 85% as of late March 2015. Both Japan and the Philippines have risen more (in local currency terms). In fact, Indonesia, Hong Kong, Thailand and China have all risen more than 50% (in local currency terms). [2]As measured by the "Z" score, a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple (based on the IBES 12-months forward consensus earnings per share forecast) from its long-term trend.

One major constraint holding Asian valuations down could be that despite some solid corporate sales growth, Asian companies have been less successful than their US counterparts, in converting this sales growth into earnings growth.

Since 2012, for example, US corporate sales have risen 7¼%[3]. In contrast, earnings per share rose 16¾%. But this impressive achievement has its Achilles' heel; that strong profit growth was mostly driven by massive cost cutting and surging share-buy backs. This game cannot continue forever; a recent lack of earnings growth suggests that it is ending – unless US sales accelerate. They are not, and new orders are falling.

The Asian experience is diametrically opposed. Whereas sales rose 20½%, earnings per share only rose 5¾% (largely as rising Asian debt siphoned profits into servicing that debt). But this broad figure is also misleading as 2014 declines in both Korean and Thai profits mask solid growth elsewhere (especially in Taiwan).

The situation seems to be this. In the US, high valuations suggest the good corporate news has been discounted in large measure. Moreover, the drivers of that good news seem to be slowing (and possibly reversing).

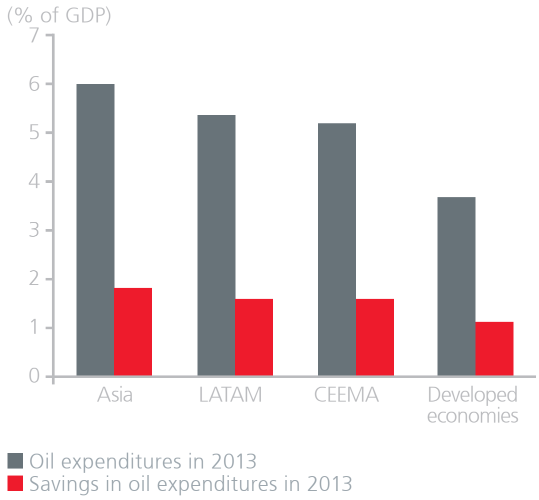
In Asia, low valuations suggest that assorted concerns have also been discounted. Moreover, poor specific economy performances are distorting the aggregate data, creating a more-than-justified negative picture. (The Philippines' strong performance, for example, suggests that investors are willing to look beyond the immediate picture).

While Asia's concerns seem adequately identified and discounted, its positives are not! And this is where lower oil prices could come into play.

OIL'S IMPACT ON ASIA

Not only are lower oil prices putting cash back into Asian pockets but also Asia is the globe's biggest beneficiary of lower oil prices, as Fig.2 illustrates.

Fig.2. Asia, a big oil consumer, is a big beneficiary



Source: Goldman Sachs as at 6 January 2015 from Statistical Review of World Energy, CEIC, Haver*. Asia includes: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan, Thailand. LATAM includes: Argentina, Brazil, Chile, Mexico. CEEMEA includes: Czech Republic, Hungary, Poland, Russia, Turkey. Developed includes: Australia, France, Germany, Japan, New Zealand, United Kingdom, United States.

One reason why investors may be reticent to take the low-oil-price bait is because they doubt whether oil prices will remain at current low levels. If these were to jump back towards $100 per barrel (pb), any Asian valuation rally based on lower oil prices would quickly reverse.

So, what is the outlook for oil prices? This is where it gets tricky.

The International Energy Agency forecasts that 2014's oil surplus will continue into 2015 as long as Saudi Arabia continues to produce crude at its 2014 rate[4]. This implies that oil prices will remain low for most of 2015. It is 2016 and onwards that is the issue.

Our simple analysis suggests that there is a natural lower limit to which oil prices can fall on a sustained basis – and that is around $60-61pb; this is the point at which many US and Canadian shale producers start to cut production as profits come under pressure[5].

[3]IBES data as at 25 March 2015. [4]International Energy Agency, 16 January 2015 Report and Eastspring Investments (Singapore). [5]Scotiabank Equity Research and Scotiabank Economics as reported in Vox, as at 15 February 2015.

But strong pressures exist for OPEC to increase prices. While no one knows exactly OPEC's (presumably very low) cost of production, we do know that OPEC members are running large budget deficits, which need to be financed. Hitherto, these deficits were funded by high oil price revenue. By some estimates, Saudi Arabia needs oil to be priced at around $90bp to finance its deficit[6].

For working purposes, it thus seems reasonable to assume that the price of oil will settle somewhere between $60bp and $90bp with a bias towards the lower limit.

If so, Asia remains a major beneficiary[7]. Fig.3 illustrates how much Asian growth reacts to lower oil prices while Fig.4 illustrates its impact on inflation.

The first immediate message one receives is that lower inflation will likely encourage on-going easing Asian monetary policies – that is good for both bonds and equities.

Such a scenario would, we expect, lead to an upgrading of Asia's profit forecasts. But coming into 2015, the opposite has occurred; there have been profit downgrades not just in Asia (Japan and Taiwan are notable exceptions), but across-the-board globally.

This downgrading could reflect rising concerns surrounding a potential 2015 US rate hike (albeit modest) and an associated fear of the potential impact of an Asian capital flight on growth. The slowing Chinese economy seems to be magnifying these fears (although a 2015 forecast growth rate of 6½% - 7% in the globe's second largest economy cannot be regarded as "bad").

Despite these more recent concerns, low (mostly) Asian valuations strongly suggest they have been discounted. Asian equity valuations (Fig.5) lie within the "Attractive" to "Fair Value" ranges with the notable exception of the Philippines and Thailand.

That both markets have continued to rally despite being two of the world's most expensive, could possibly reflect not only their sound fundamentals but also that both rank among Asia's top beneficiaries of cheap oil. In other words, investors may already be looking beyond today's expensive valuations towards the additional profits growth that lower oil prices could engender.

Fig.3. Impact of different oil prices (in USD) on Asian 2014 growth

	90.0	80.0	70.0	60.0	50.0
China	0.1	0.2	0.3	0.4	0.5
Hong Kong	0.1	0.1	0.2	0.3	0.3
India	0.1	0.2	0.3	0.4	0.5
Indonesia	0.1	0.1	0.2	0.3	0.4
Japan	0.1	0.2	0.3	0.4	0.6
Korea	0.1	0.2	0.3	0.4	0.5
Malaysia	-0.1	-0.2	-0.3	-0.4	-0.5
Philippines	0.2	0.4	0.7	1.0	1.3
Singapore	0.1	0.3	0.5	0.7	0.9
Taiwan	0.1	0.2	0.3	0.4	0.5
Thailand	0.2	0.4	0.7	0.9	0.2

Source: UBS and CEIC as at January 2015.

Fig.4. Impact of different oil prices (in USD) on Asian 2014 inflation

	90.0	80.0	70.0	60.0	50.0
China	-0.2	-0.5	-0.8	-1.1	-1.4
Hong Kong	-0.1	-0.2	-0.3	-0.4	-0.5
India	-0.3	-0.8	-1.3	-1.8	-2.3
Indonesia	-0.1	-0.3	-0.5	-0.7	-0.9
Japan	-0.2	-0.4	-0.6	-0.7	-0.9
Korea	-0.2	-0.4	-0.6	-0.8	-1.0
Malaysia	-0.2	-0.4	-0.7	-1.0	-1.3
Philippines	-0.3	-0.7	-1.2	-1.6	-2.1
Singapore	-0.2	-0.5	-0.8	-1.1	-1.4
Taiwan	-0.2	-0.3	-0.5	-0.7	-0.8
Thailand	-0.3	-0.8	-1.3	-1.8	-2.3

Source: UBS and CEIC as at January 2015.

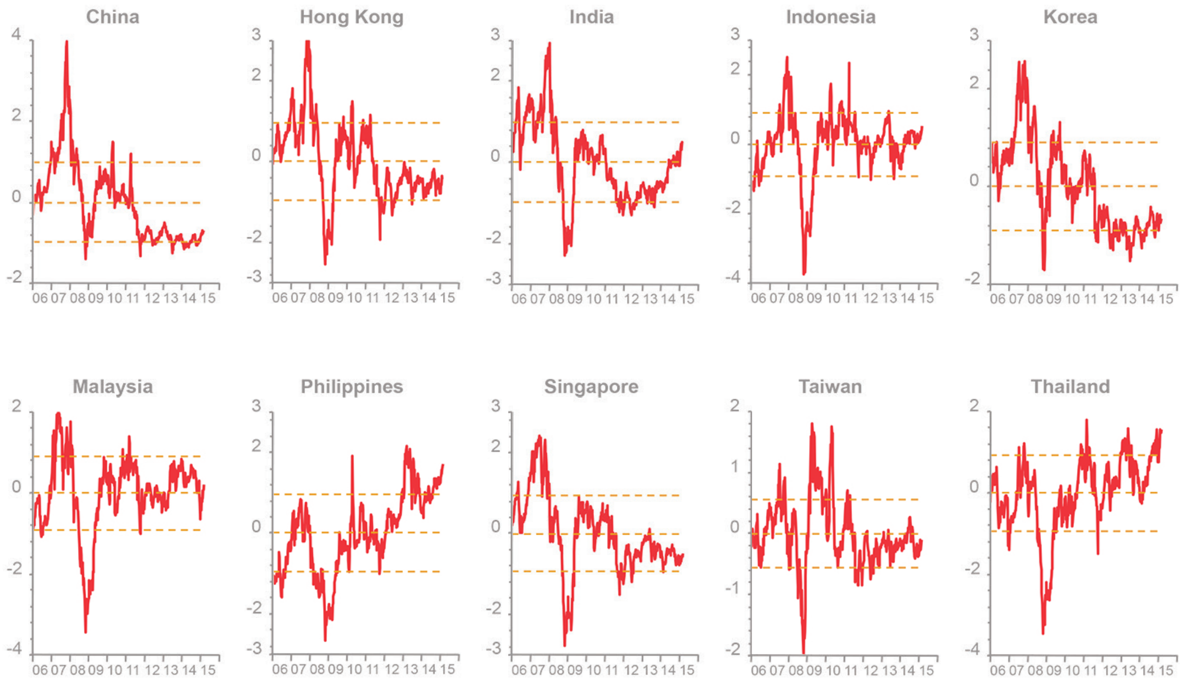
[6]Ali Aissaoui, Apicorp Economic Commentary, August - September 2012 as quoted by Matthew Hulbert, European Energy Review in a paper to Chatham House, October 2012. [7]According to UBS Economics Research as at January 2015.

Both could well be precursors of developments within the rest of Asia as attention focuses on the benefits of lower oil prices rather than well-analysed concerns that have been well discounted. The question is, "When?"

The tide could be changing. As the US and European valuation gaps with Asia widen, as the beneficial impact of the stronger USD on Asia's exports are felt, and as the benefits of lower oil prices on Asian growth and interest rates become more apparent, the grounds will have been laid for an Asian rebound.

2015 could well be the year in which the tide turns in Asia's favour. And low oil prices could well be the lubrication needed.

Fig.5. Valuation of Asian markets



Source: Eastspring Investments, MSCI and IBES from Datastream, 10 March 2015. Note that the "Z" valuation is a composite measure giving equal weighting to the variation of the historical price to book ratio from its long-term trend and the variation of the prospective price earnings multiple from its long-term trend. The two outer dotted lines represent the limits within which around 70% of all values lie. The middle dotted line indicates the 10-year average.

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