Diversify on a Dime

Using ETFs to Manage Your Asian Equities Portfolio

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Asian equities, like their global counterparts, had a grueling start to the year. The MSCI AXJ (Asia ex-Japan) index, which reflects the performance of Asian equities, was down dramatically by 11% at one point in January before bouncing back to end the March quarter 1.5% higher.

The uncertainties that have existed since December 2015 have led to big swings in the equity market. Adding to worries of a hard landing in China was the sharp plunge in oil prices to a low of US$26 per barrel in February, geopolitical tensions, the prospects of Britain's exit from the EU ('Brexit'), and the impact of negative interest rates in Europe and Japan.

Against this backdrop, investors should continue to adopt strategies that minimise risk and seek income sources. In this regard, exchange-traded funds (ETFs) offer an efficient means to diversify portfolios. ETFs also allow investors to navigate safely through choppy markets, a slow global growth environment, low and stable interest rates, and improving credit spreads. Moreover, because ETFs also provide investors with a range of choices for exposure to different asset classes, the use of ETF strategies has been gaining appeal.

They are a good way to begin participating in the equities markets of Asia, especially when liquidity and access to markets may be challenging at times.

While the markets have calmed down after the wobbly 2016 start and Asian equities have shown some recovery momentum since March, the question remains whether these gains can be sustained for the rest of the year?

China: The Wild Card

China is making a delicate and tricky transition from an economy driven largely by exports and investment in fixed assets such as property to one that's supported by domestic consumption. But the transformation may take years and cause volatility in Asian markets.

China holds the key to how the rest of the region performs. Collectively, the Chinese and Hong Kong markets account for 40% of the MSCI AXJ Index. Our Hong Kong and China Equities Strategist believes that while the year has gotten off to a choppy start, the performance this year should be better than 2015's; the markets' valuations are low, and most investors are already averse to Chinese and Hong Kong equities so sentiment is unlikely to get any poorer. At the very least, this ensures that downside will be limited in 2016. In the near term, improved sentiment towards A-shares will have a knock-on positive impact on Hong Kong's market. Over the longer term, the gains will need to be sustained by growing confidence in China's ability to steer its economy through a raft of supply-side reforms, while avoiding a hard landing.

Despite the potential for a liquidity-driven rebound in the A-share market, sentiment remains fragile because of the delicate macro-economic transition currently underway in China. This will result in heightened volatility for China, Hong Kong, and the rest of Asia.

We will be watching the following:

Headline GDP momentum. Investors will want to see that the "new normal" GDP growth of 6.5% can be sustained amid intensifying downside risks, global economic and political uncertainties, and the lack of any near-term impetus from medium- to longer-term economic restructuring plans.

Direction of the CNY is an unknown. The Chinese yuan's fluctuation is exacerbated by speculation, making normal investing more challenging that it already is. It is also not clear that the Chinese government will not pursue competitive devaluation if the economy slows down. Additionally, the policy direction and market impact before and after China's Special Drawing Rights (SDR) inclusion remain unclear. Recent rounds of yuan devaluation are already hurting some China-related companies' earnings forecasts.

Equity-market regulations. Markets tend to overreact and overshoot in its boom-and-bust cycles while they speculate on when regulations (such as those imposed on margin lending and shorts) will be implemented or lifted. Hence, investors have been perturbed by the recent flip-flop in regulations. For instance, The Shanghai-Shenzhen 'circuit breaker' was implemented for two days before being suspended The dangling of unproven market-support measures has left investors wondering about how the market is going to be regulated.

Banking sector's non-performing loans. Banks have an outsized representation in the Chinese market. Investors remain wary of rising non-performing loans in Chinese banks, notwithstanding the already low valuations.

India: Underweight

- Investors gave the thumbs-up to India's budget, reinforcing Prime Minister Narendra Modi's commitment to fiscal discipline and fueling hopes of more rate cuts by the Reserve Bank of India. The Sensex Index rebounded from the quarter's lows but still ended March 3% lower.

- Worries over the Indian markets stem from high valuations and overly optimistic expectations of earnings growth and reforms.

- Its twin deficits will always be a source of vulnerability unless a broad-based consolidated strategy can be implemented to bring about higher-quality growth to warrant the deficits.

- India's economy is unlikely to expand like it used to, as growth momentum is slowing and the recovery hasn't been broad-based.

- Private investments have been weak and are unlikely to pick up anytime soon, now that banks are facing asset-quality concerns and reforms have stalled.

Overweight on Emerging Southeast Asia; Neutral on Indonesia

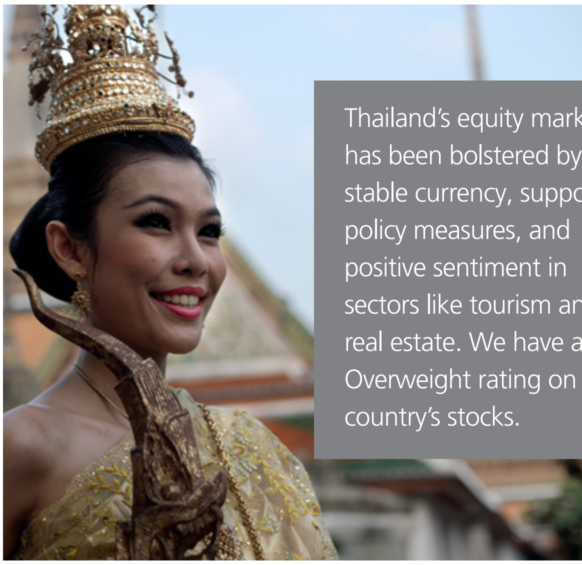
The best-performing markets in the March quarter were the emerging Southeast Asian markets of Thailand, Indonesia, and the Philippines.

- They were bolstered by a stable outlook for their respective currencies, and the recovery in oil prices from the year's lows.

- Earnings upgrades and inflows are gathering pace as their currencies strengthen.

- There are also tentative signs that domestic sentiment has bottomed out in these economies; government stimulus measures are on track to lift domestic demand offsetting weakness in external demand.

- Central banks in these countries generally exhibit flexibility in monetary policy, with a tolerance for weaker currencies and a focus on ensuring prudence in their budget deficits. This helps shore up investor confidence.



Thailand's equity market has been bolstered by a stable currency, supportive policy measures, and positive sentiment in sectors like tourism and real estate. We have an Overweight rating on the country's stocks.

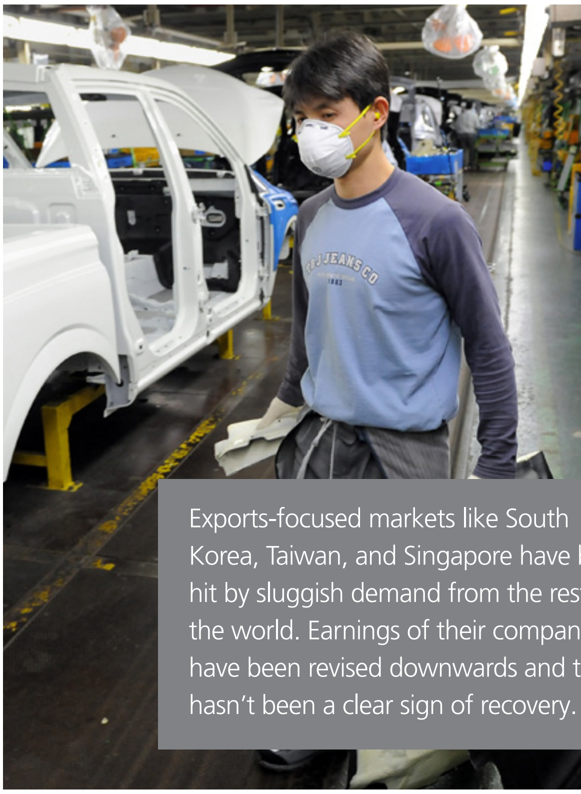
Exports-Oriented Markets: Less Preferred

- In contrast to Asia's emerging economies, Singapore, Taiwan, and South Korea have been hit by a flurry of growth downgrades as their exports plunge. There hasn't been any clear sign of recovery in the June quarter.

- Based on latest advanced GDP estimates, Singapore's real GDP growth was flat in the March quarter. This contrasts sharply with a robust 6.2% expansion in the previous quarter.

- Taiwan had registered negative year-on-year growth for the past two quarters, and is likely to have a third quarter of decline when March quarter GDP growth is released.

- Stimulus policies may be implemented only after May when the new government takes office. The impact of these measures will only be felt much later.
- Business sentiment continues be poor in the face of a deteriorating global growth outlook and financial market turmoil.
- In South Korea, the stimulus effects of the previous round of monetary and fiscal easing have started to fade in the domestic sector.
- After the ruling party lost its majority in the legislative elections in April, there were hopes that the government could frontload some of the stimulus spending to boost short-term growth.



Exports-focused markets like South Korea, Taiwan, and Singapore have been hit by sluggish demand from the rest of the world. Earnings of their companies have been revised downwards and there hasn't been a clear sign of recovery.

What to Do in a Slow-Growth, High-Volatility Environment?

The slow-growth global environment has resulted in heightened volatility and greater dispersion. Against this backdrop, the use of ETF strategies has been gaining appeal. ETFs offer an efficient means to achieve portfolio diversification, allowing investors to navigate safely through choppy markets, a slow-low global growth environment, low and stable interest rates, and improving credit spreads.

Because ETFs are traded like stocks even as they derive their values from an underlying index, investors in ETFs enjoy the benefits of diversification more than those who invest in shares of single companies.

They also enjoy greater flexibility that goes with investing in entire markets or regions. The diversification feature of ETFs will strongly appeal in an environment where visibility is low, and conviction about individual company earnings are lacking. Global ETFs also provide investors a range of choices for exposure to different asset classes.

For ETF investors, hedging portfolio risks amid market volatility and finding alternative income sources through dividends remain key themes. Investors should continue to adopt strategies that minimize risk and seek income sources.

Because ETFs represent a basket of stocks, they typically trade at much higher volumes than individual stocks. High trading volumes mean high liquidity, enabling investors to get in and out of investment positions with minimum risk and expenses. ETFs help to limit single stock risk while minimizing transaction costs, and hence enhancing overall returns.

ETFs are a good way to begin participating in the equities markets of Asia, especially when liquidity and access to markets may be challenging at times, and investor education is limited.

Summary of market recommendations

Overweight	Neutral	Underweight
Malaysia	Singapore	Taiwan
Thailand	Indonesia	India
	Hong Kong	Philippines
	China	
	Korea	