Think

Asia Pacific in 2019: watch for risks and opportunities

January 2019

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INTRODUCTION

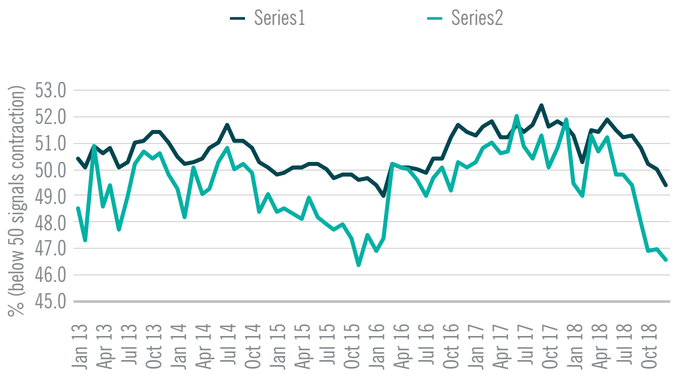
After 10 years of relatively unabated economic strength, the region looks to be stuttering. However the softer economic environment does not come as a surprise; mid last year we flagged a potentially slower growth trajectory for the Asia Pacific region in the latter half of 2018. Among the reasons we cited trade tensions exacerbating weakness in China's economic slowdown, tighter financing conditions from rising global interest rates, and the related pass-through into weaker domestic demand. However, it is the depth and breadth of the potential slowdown that should currently worry global institutional investors. To be sure, regional growth has slowed in the past few months, but the outlook remains cloudy at best if recent equity market performance is any guide.

In the coming months, potential external headwinds will continue to blow the way of the region. A no-deal Brexit remains a real possibility, which could fracture growth in the world's ninth largest economy. A full-blown trade war between the United States and China should not be discounted, even as negotiations are continuing. North Korea has faded from the screen but tensions in the Korean peninsula could reignite at anytime. A Democrat-controlled House of Representatives also spells a more difficult political and economic road in the United States. Not to mention, a (or any) black swan event could fracture and lead to a downward spiral in world growth. Monetary policy is unlikely to provide as much support as it did during the global financial crisis a decade ago, as global interest rates remain at sub-optimal levels. Against this backdrop, how should investors position themselves?

TALE OF TWO HALVES (AGAIN)

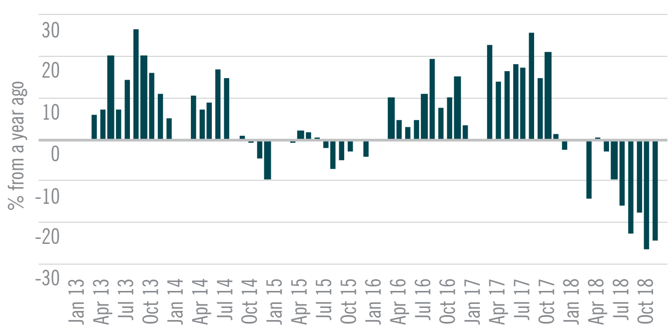
The ongoing slowdown in economic sentiment and conditions will likely persist through the first half of this year. Risks are particularly front-loaded in the near-term, especially on the clarity of trade prospects between the United States and China. In China, the slowdown that started in May last year will continue through the coming months, as trade tensions continue to bite into the manufacturing and export sectors. The manufacturing PMI fell to 49.4% in December 2018, contracting for the first time since July 2016. More crucially, the PMI new export orders fell to 46.6% for the seventh month, suggesting that industrial weakness is likely to persist. Profitability in turn has contracted seven straight months through to December last year, as demand weakness and uncertainty eat into revenue and sales. While the sharply slower 4.6% year-on-year rise in November exports (from 14.4% and 15.0% in September and October) bears concern, the weakness in imports (3.1% in November from 20.9% in October) suggests that domestic conditions are starting to soften too.

Fig.1: China: purchasing managers index



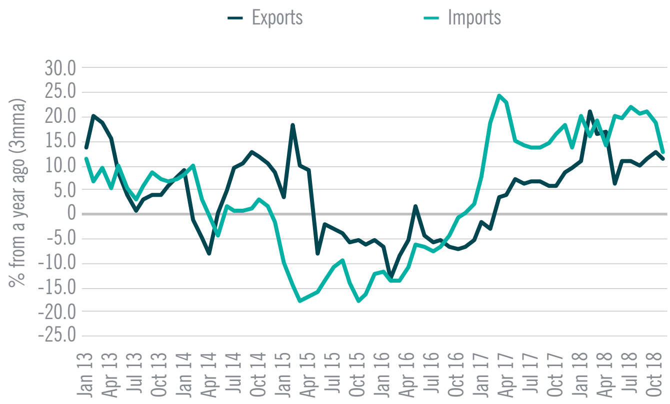
Source: CEIC

Fig.2: China: industrial profit



Source: CEIC

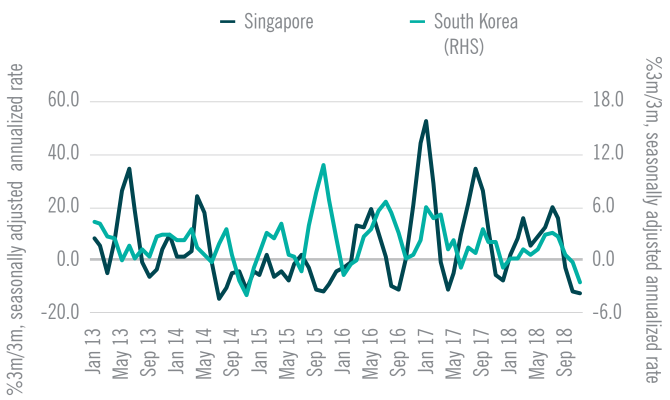
Fig.3: China trade



Source: CEIC

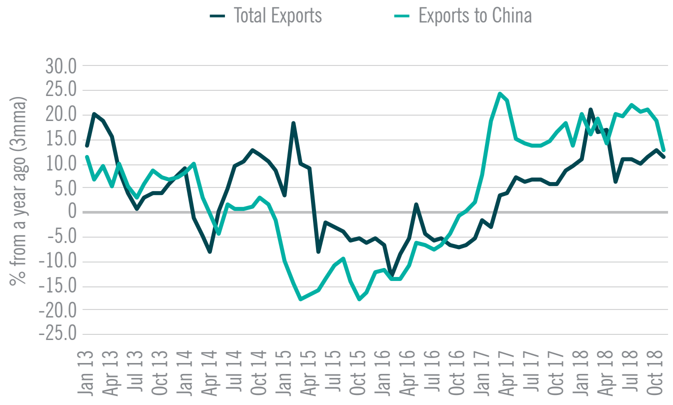
China's slowing economy – growth weakened to 6.5% in Q3 last year, the slowest pace in a decade – in turn is starting to have a more meaningful knock-on effect across Asia, through trade exposure even before the true extent of the trade war has begun to bite. Latest manufacturing data from Singapore and South Korea – good barometers of global and regional trade – suggests a deepening slowdown in output, in turn reflecting unease over trade prospects. Tellingly, South Korea's exports to China slowed sharply in the last two months of 2018, with semiconductor sales hit particularly hard as a result of the trade tariffs. The Singapore economy also expanded by a slower-than-expected 2.2% (a year ago basis) in the final quarter of last year, with official expectations for growth at 1.5%-3.5% in 2019.

Fig.4: Singapore, South Korea: industrial production



Source: CEIC

Fig.5: South Korea: Exports



Source: CEIC

On balance, regional growth is likely to slow in 2019 for the second year in a row. According to Oxford Economics, Asia Pacific is projected to expand by 4.3% this year, from 4.5% in 2018. The good news is that real activity is likely to stabilise, and then pick up momentum in the second half. Following an uneven first half, businesses and consumers are expected to reset their expectations, providing in turn a floor for growth to recover. Policy stimulus to jump-start growth is expected to show results in the latter part of the year. China for instance is expected to ease credit conditions through more reserve requirement cuts, while allowing reforms to continue.

In Australia, while previously a rate increase is expected this year, monetary policy tightening is now pushed back to mid-2020, allowing households and businesses to weather a weaker external growth climate. Many economies running fiscal surpluses also have the capacity to stabilize growth conditions. Not withstanding that domestic demand conditions also remain healthy, with the jobless rate at near decade lows across many regional economies. Robust corporate and household balance sheets built up over the years can help unleash demand to support growth. Unlike during the Asian financial crisis, regional economies are also in a much better position to weather external downturns (see THINK Asia Pacific: Asia Pacific cities in Tomorrow's World dated 21 March 2018).

BEWARE OF RISKS BUT MORE IMPORTANTLY, WATCH OUT FOR OPPORTUNITIES

It is during these more uncertain periods that a bigger picture lens should shine on Asia Pacific. The structural trends driving an ongoing power shift from West to East is undeniable. Asia Pacific economies and markets will become increasingly prominent, alongside greater importance within a global portfolio. With an eye to the future, investors should take the opportunity during the current slowdown to actively participate in the long-term growth of regional markets. After all, while robust economic and financial conditions are the main reasons for sequential cap rate compression over the years, tight competition for assets from foreign and domestic investors has also played a part in driving down yields. This trend will persist, as structural growth will continue to draw capital into the region. Interest rates may be rising but on a structural downtrend, which will keep a lid on cap rates. Add secular megatrends into the picture and this is not the time to take a foot off the engine – watch for any window of opportunity in the coming months.

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