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Tailwinds: Asian Equities after the Coronavirus

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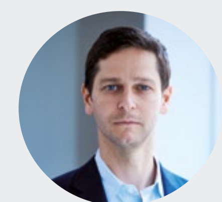

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As the global economy recovers, we foresee three factors driving returns in emerging-market Asian equities, two from alpha and one from beta: increased stock dispersion, higher levels of earnings surprises and potentially a weaker, more supportive US dollar.

Introduction

2020 has been an exceptionally tough year by the standards of any investor. Corporate earnings have taken a significant hit as the world economy has headed into recession. However, we are seeing the signs of a recovery and as the data improves, it is likely that corporate earnings will start to follow. In such an environment, active management can come into its own.

Furthermore, idiosyncrasies in specific equity markets offer some hope. In our view, Asian equities may benefit from three tailwinds: two for alpha and one for beta. The level of single-stock dispersion in emerging Asian equity markets is relatively high and the level of earnings revisions is likely to increase given the impact of the coronacrisis, in our view. Both increase the opportunity set for active managers to generate alpha, giving them a broader canvas to apply their deeper awareness of the stock-specific factors that dictate earnings. From a beta perspective, Asian economies may be further supported if the US dollar does weaken.

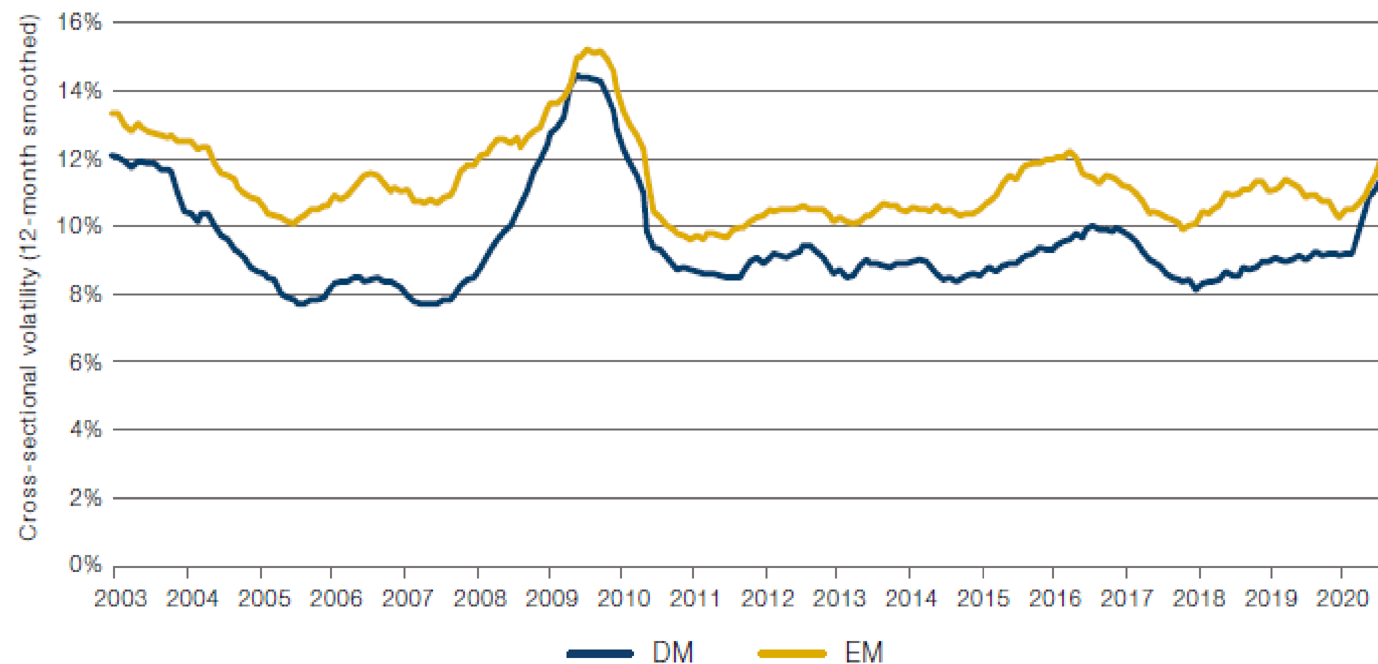
Cross-Sectional Dispersion

> " Emerging market equities – of which emerging Asia is the overwhelming majority – have consistently shown higher levels of dispersion than their developed counterparts. "

A key driver of returns to alpha in Asian equity markets is cross-sectional single-stock dispersion – or the distribution of returns of all the securities over a given timeframe. The higher the dispersion, the lower the correlation among the stocks. Conversely, when stock dispersion is low, stocks exhibit a tendency to trend together. A high level of stock dispersion creates an opportunity set for active managers, allowing them to more easily capture the fundamental drivers of equity performance, and isolate alpha through stock picking.

Emerging market ('EM') equities – of which emerging Asia is the overwhelming majority – have consistently shown higher levels of dispersion than their developed counterparts (Figure 1). Indeed, whilst the roughly 2% higher level of dispersion enjoyed by EM over developed markets ('DM') tends to dissipate during times of market stress – such as during the Global Financial Crisis ('GFC') and the coronacrisis – this market stress naturally creates higher levels of total dispersion for both geographies, enhancing the opportunities available to active managers.

Figure 1: Cross-Sectional Single Stock Dispersion – EM Versus DM



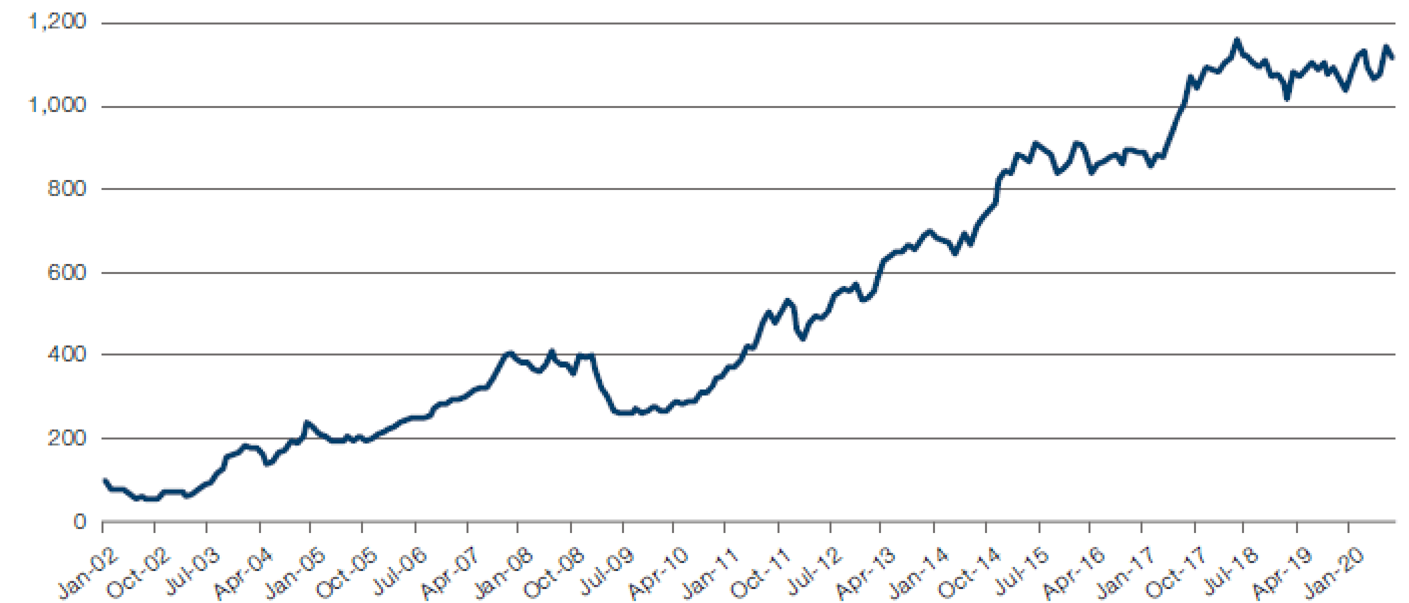
Source: Man GLG; as of August 2020.

Earnings Revisions: The Joy of Surprises

> "The correlation of returns from earnings revisions to factors is quite unstable and time varying. This instability presents another source of potential alpha."

The second persistent source of alpha in Asian equities is the exceptional returns from earnings' revision strategies. Based on almost 19 years of data for MSCI Asia ex Japan, a simple strategy of buying the best decile of 3-month change in 12-month forward EPS and selling short the bottom decile yields an annualised return of almost 15% (Figure 2). In some respects, the persistence of these returns is the other side of the dispersion coin: Asian markets are less efficient than major developed markets, securities research coverage is less deep and company management is less practiced in polishing earnings guidance. All of these factors tend towards a greater degree of surprise in earnings. So, a manager that can accurately understand where the consensus is wrong has great scope to extract alpha.

Figure 2: Asia ex Japan Inter-Decile Spreads, 3-Month EPS Revisions

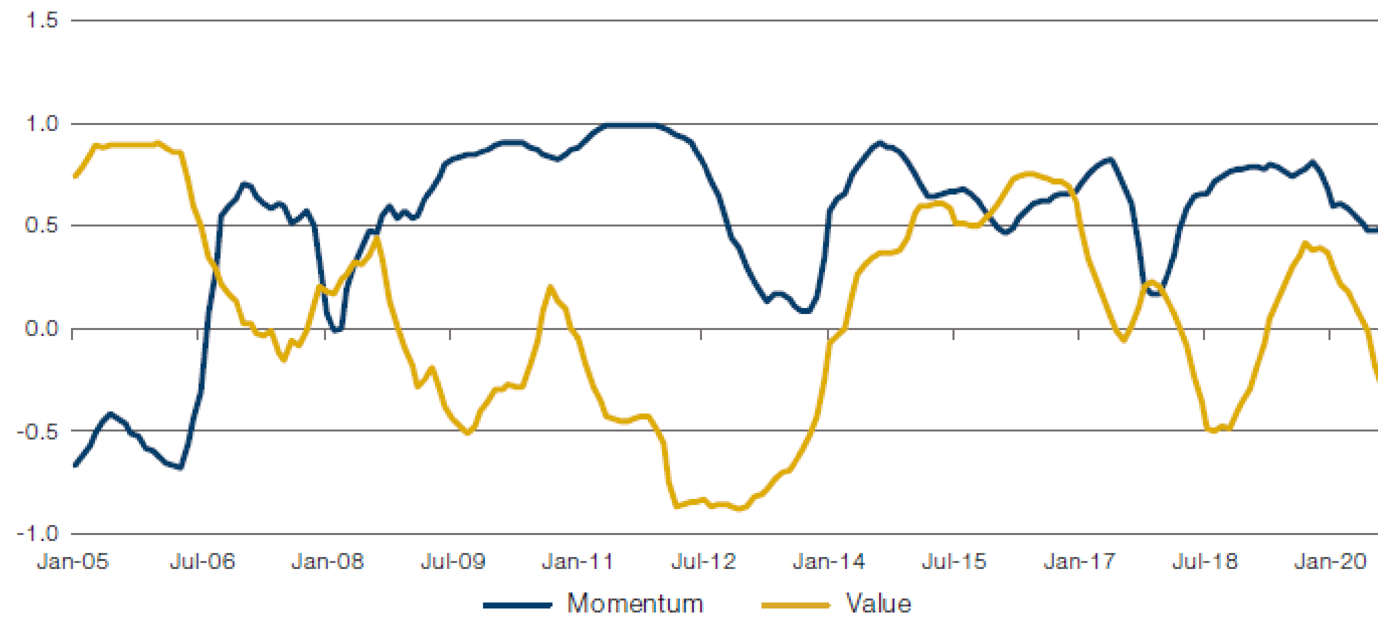


Source: Man Group, MSCI, Bloomberg; as of 31 August 2020.

It is also the case that the correlation of returns from earnings revisions to factors is quite unstable and time varying. This instability presents another source of potential alpha. Figure 3 shows the 2-year rolling correlation of the 12-month returns from the long/short earnings revision strategy shown above, to Fama-French Momentum and Value ('winners minus losers' and 'high minus low', respectively, in Fama-French terminology). While the correlation to Momentum is mostly positive over time, it collapses to almost zero periodically, driven by moments of risk aversion, and changing leadership in fundamental factor regimes. This can be understood through the highly variable correlation to value (as illustrated by the orange line in Figure 3): as factor leadership changed in Asia in 2013/14 from Quality-led to Value-led, momentum in earnings revisions collapsed before recovering. For a discretionary manager with a well-developed factor toolkit, understanding and pre-empting these changes in factor regimes, and understanding where leadership in earnings revisions will show up next, can be a highly rewarding strategy.

At Man GLG, we are heavily engaged in building out this toolkit, which will be discussed in forthcoming articles.

Figure 3: Two-Year Rolling Correlation of Value and Momentum Factor Returns in Asia ex Japan to Returns From Earnings Revisions



Source: Man Group, Kenneth R. French Data Library, Bloomberg, MSCI; as of 31 August 2020.

Can the Dollar Weaken?

Indeed, the relative strength of the US dollar is the beta factor in dictating the returns to Asian EM.

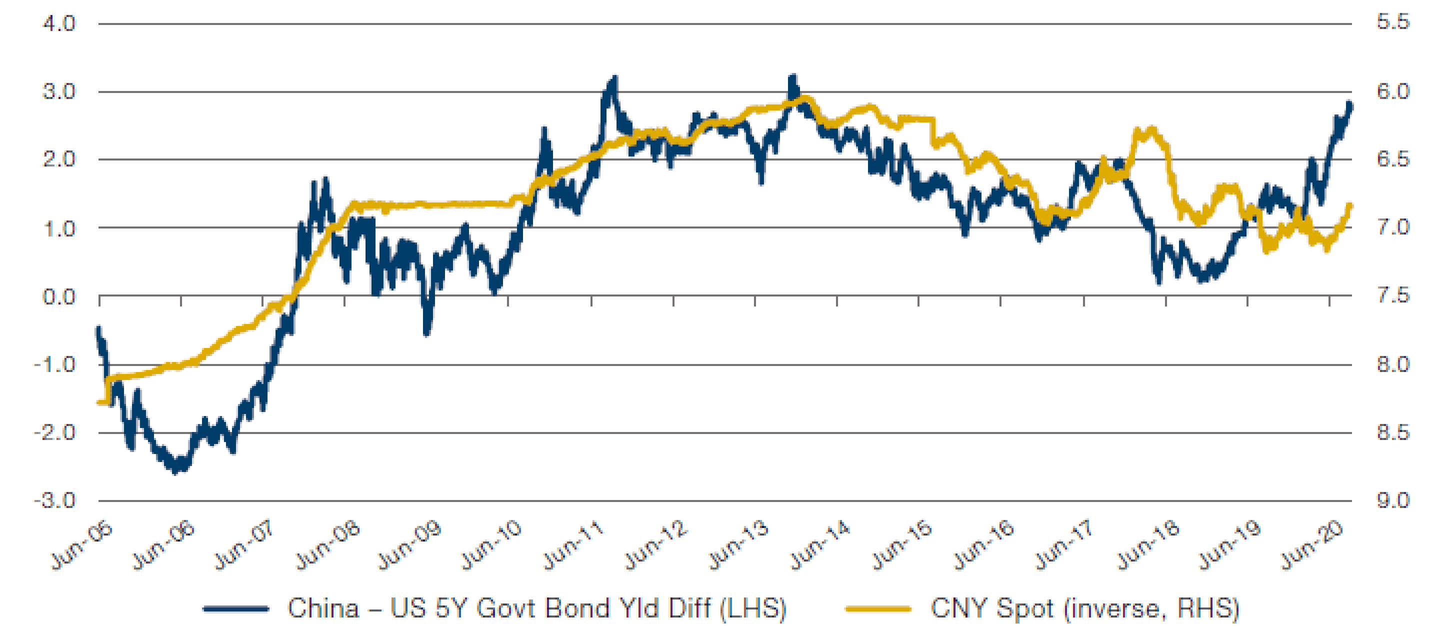
We would stress here that predicting the path of currencies is not our aim here. We believe that the cross-sectional dispersion and earnings revisions provide ample opportunities to generate alpha in Asian equities. However, there have been some key macro developments in 2020 that suggest the case for dollar weakness has developed. And should the dollar weaken (and we outline below why it may), this may provide another tailwind to Asian equities.

> **" There have been some key macro developments in 2020 that suggest the case for dollar weakness has developed. And should the dollar weaken, this may provide another tailwind to Asian equities. "**

The first factor is the Federal Reserve's decision to cut US interest rates to almost zero. This has removed the interest rate differential between the dollar and the majority of DM currencies. It is our experience that the US dollar weakness is broad-based: the median Asian currency during a period of dollar weakness behaves much like the euro or the Swedish krona.

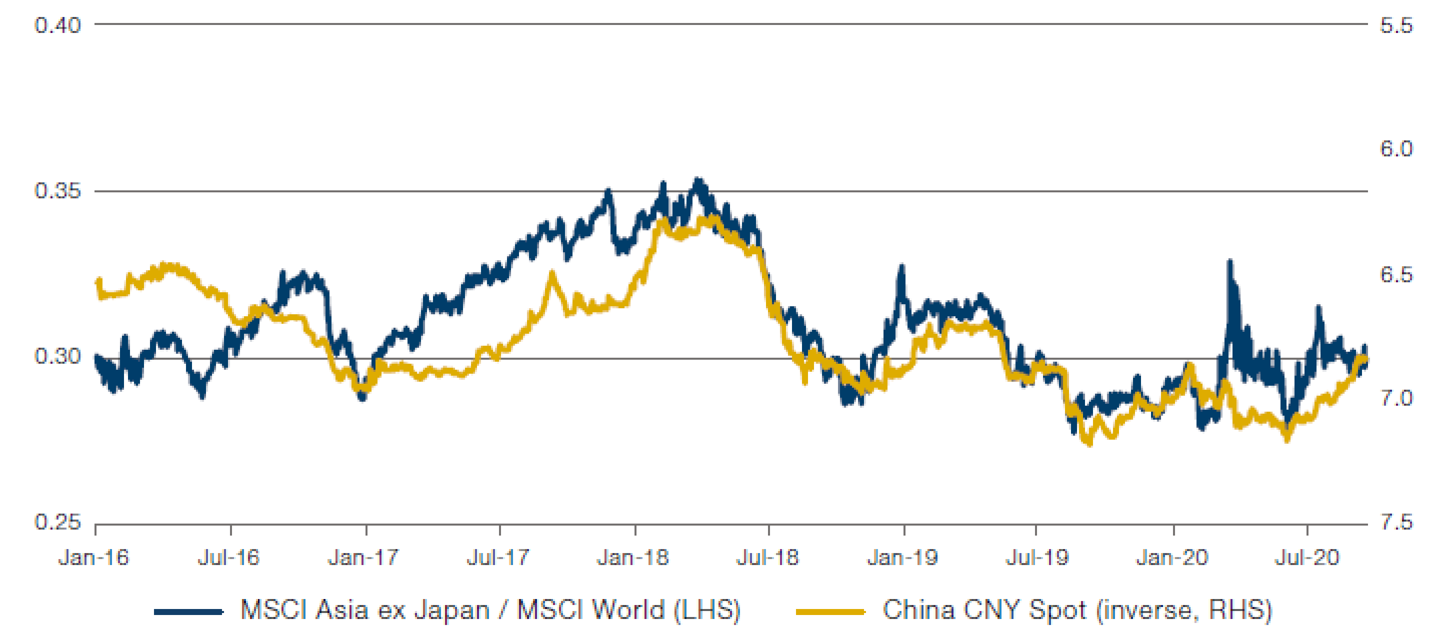
Similarly, the interest rate differential between China and the US have historically been a significant determinant of the level of the Chinese yuan. Figure 4 shows the correlation between the spot level of Chinese yuan and the spread between the yields of 5-year Chinese and US government bonds: as the spread increases – as is the case currently – the yuan tends to strengthen appreciably. This acts as a tailwind for Asian equities, with positive implications for equity returns in relative terms (Figure 5).

Figure 4: CNY Spot Versus Generic 5-Year Chinese-US Government Bond Spread



Source: Bloomberg; as of 10 September 2020.

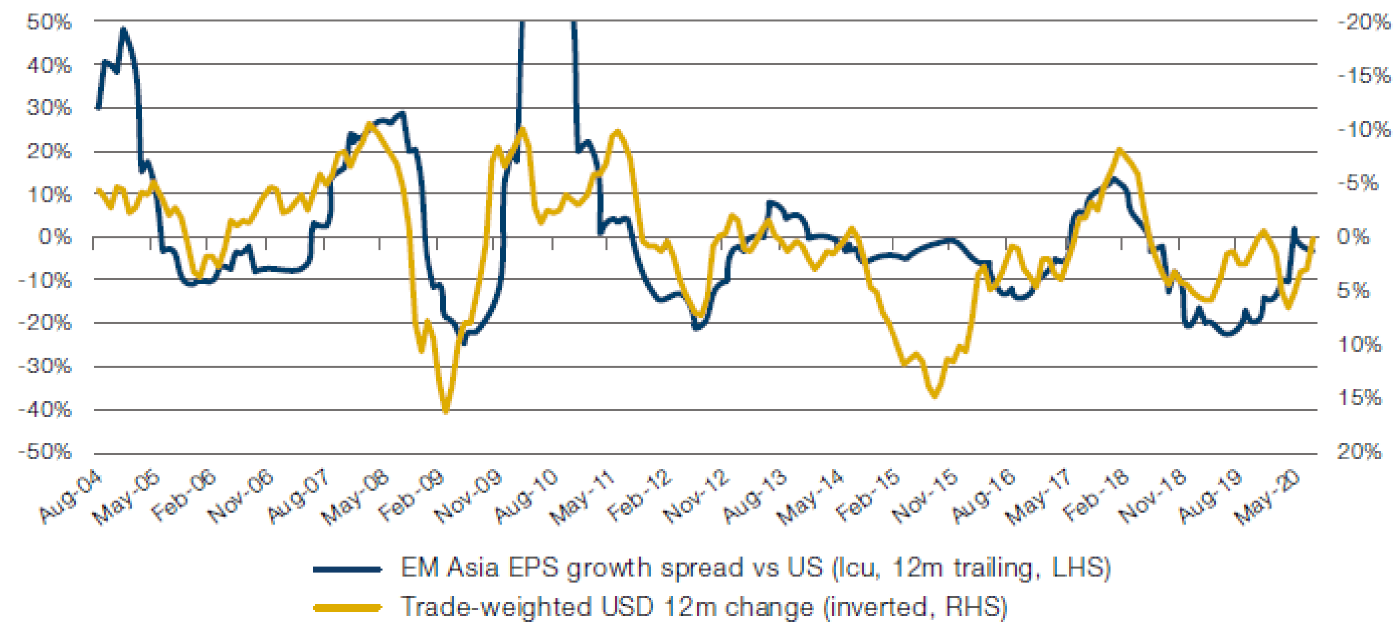
Figure 5: CNY Spot Versus MSCI Asia ex-Japan/MSCI World



Source: Bloomberg; as of 10 September 2020.

Perhaps most significant, given our belief in the centrality of earnings revisions, is that there is a meaningful historical relationship between the trade-weighted US dollar, and the spread of EM Asian EPS over the US. Crucially, this relationship is in local currency terms, meaning that the benefits of US dollar weakness are far more than a translation effect – weakness of the dollar drives operational gains for Asian companies (due to the region's export orientation, and inherent cyclicality), and vice versa.

Figure 6: Trade Weighted USD Versus the Spread Between EM Asia and US EPS



Source: Man GLG; as of 30 September 2020.

Conclusion

The coronavirus pandemic has already forced the global economy into a recession, but as the recovery begins, investors in emerging Asian equity markets can be reassured by the likelihood that opportunities for alpha generation may expand: emerging market stock dispersion has consistently been higher than developed markets and tends to increase during recessions. Additionally, earnings surprises may likely increase due to similar factors. Finally, Asian economies may be further supported if the US dollar does weaken.

" The coronavirus pandemic has already forced the global economy into a recession, but as the recovery begins, investors in emerging Asian equity markets can be reassured by the likelihood that opportunities for alpha generation may expand. "