

APAC Equity Strategy

After the cyclical run, what next?

Equity Strategy

Asia Pacific

Inventory depletion is now leading to an export volume improvement

Since [early March](#) we've been recommending Tech and cyclicals in general over defensives to 'play' the inventory cycle. Our view was that with inventory adjustment quite advanced, a gradual pick-up in production and exports would help cyclical stocks. Six months on, this macro trend appears to be playing out with inventories generally lower, PMI export orders recovering and all three of Korea, Taiwanese and Japanese exports now showing positive volume growth.

But the valuation gap in favour of cyclicals is gradually closing

In March and [again in May](#) when we reiterated the cyclicals call, there was a wide valuation gap in favour of cyclicals relative to defensives. However this valuation gap is now closing (see Chart below). We see less upside for cyclicals now relative to defensives even though the improving PMI order and export trend might persist. Some areas still look good, such as Chemicals, but pockets are looking more fully valued and in smartphone semis, Bill Lu and Nick Gaudois [highlight some inventory risk](#) now exists.

Less upside in Tech now, but relatively speaking we still prefer north Asia

Despite recommending a more balanced cyclical/defensive tilt than earlier, we are still overweight Korea, Taiwan and Japan. This has to be viewed in the context of our expectation of gradual Fed tightening and with it weaker Asian currencies and slightly higher bond yields. We see this hurting south Asia *relatively* more than north Asia.

Trying to find balance in cyclical and defensive stocks

Our MSCI Asia ex Japan index target is 525 for year-end, 3% lower than current levels. Liquidity may keep stocks elevated [as we've highlighted](#), but If markets do correct later this year as rates rise, we don't want to be in high beta cyclicals. Likewise, if a correction is sparked by higher rate fears, yield-sensitive defensives are not likely to be much help. We screen for cyclicals with good earnings momentum, relatively attractive valuations, and betas that are not too high, and defensives with low beta to rising yields, and attractive earnings/valuations (see page 3). Among them: TSMC, Pegatron (both Key Calls), Samsung Electronics, Siam Cement, and the defensives: WH Group, China Mobile, GAIL, China Med Systems. The bottom line, most of the relative money has been made in the cyclicals. While there is still a case for some cyclical tilt, we'd recommend a bit more balance in portfolios.

Niall MacLeod

Strategist

niall.macleod@ubs.com

+852-2971 6186

Matthew Gilman

Strategist

matthew.gilman@ubs.com

+852-2971 8173

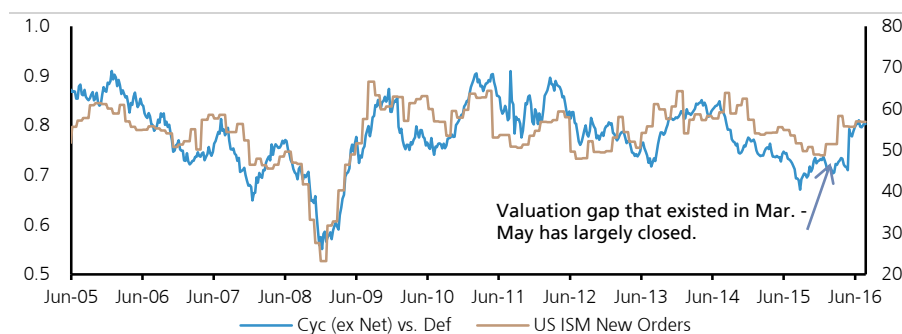
Yuka Murata

Strategist

yuka.murata@ubs.com

+852-3712-4951

Figure 1: Non-commodity Cyclicals versus Defensives and US ISM new orders



Source: Datastream, UBS

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Incoming data, directionally supports our thesis

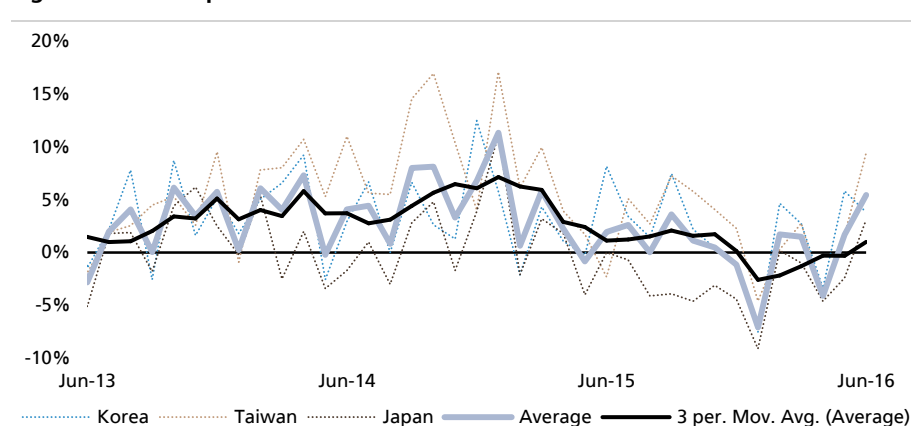
Figure 2: Changes to Macro data since last May-end (greener, the better)

Change in Macro indicator vs May	US	China	Korea	Taiwan	Japan
GDP inventory change	Decrease	NA	Decrease	NA	Decrease
ISM inventory survey	51 - flat				
PMI - stocks of finished goods*	49-better	50-worse	49-worse	50-worse	49-worse
PMI new orders	57-better	51-better	50-worse	51-better	48-better
PMI new export orders	53-better	50-better	51-better	52-better	45-worse
Export volumes	NA	NA	Increase	Increase	Increase

Source: Datastream, CEIC, Bloomberg

Data shows an overall directional improvement at the macro level since May when we last visited this thesis.

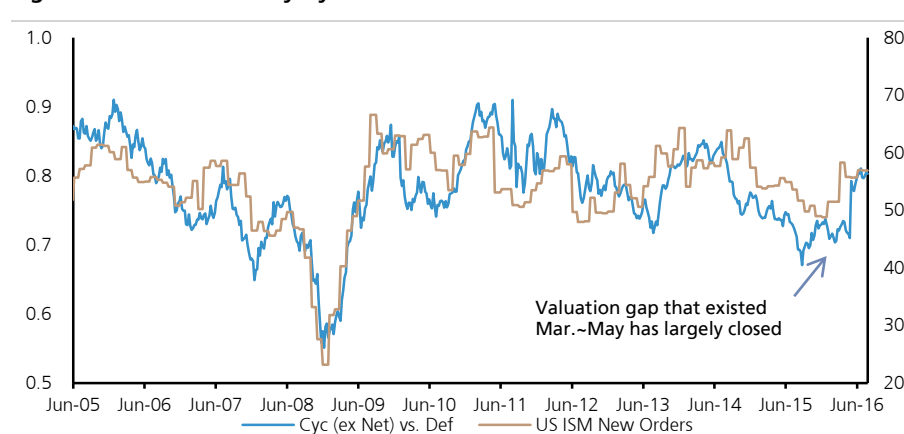
Figure 3: Total export volume



Source: Bloomberg

In Asia, the three month moving average of export volume as well as all spot data is now positive for the first time this year. Duncan has characterised this as getting less bad ([see his note](#)).

Figure 4: Non-commodity Cyclical versus Defensives and US ISM new orders



Source: Datastream, UBS

However, this seems to be largely priced in following the recent outperformance of cyclicals. The valuation gap is no longer as big as it was in May.

In the past, cyclicals have been more expensive than defensives, but the point is that the big valuation gap has already closed.

Stocks to get the best of both worlds

Figure 5: UBS AxJ Buy rated cyclicals with lower beta, attractive valuation, positive /flat to positive earnings momentum (EM).

Industry	Name		M.Cap U\$		Price	Upside	β	P/E 16	P/E 17	EM
Autos	Hyundai Mobis	KR	22,094	Buy	253500	18%	0.7	7.2	7.0	1%
Autos	Kia Motors	KR	15,400	Buy	42900	37%	0.5	5.6	5.5	0%
Cons Svs.	Genting	MY	7,605	Buy	8.21	41%	1.1	16.0	14.1	0%
Energy	PTT Public Co.	TH	28,596	Buy	346	10%	1.2	11.4	10.1	9%
Energy	Formosa Petrochem	TW	28,529	Buy	94.9	19%	0.9	23.1	23.2	10%
Materials	Siam Cement	TH	17,917	Buy	516	11%	0.7	12.6	12.6	6%
Materials	Formosa Plastics	TW	15,870	Buy	79	15%	1.0	15.1	13.7	3%
Semis	Samsung Elec.	KR	216,160	Buy	1639000	10%	1.1	11.1	10.0	17%
Semis	TSMC	TW	144,843	Buy	177	13%	1.0	14.5	13.2	5%
Software	NCsoft	KR	5,046	Buy	269000	14%	0.7	21.2	16.3	8%
Tech H/W	LG Display	KR	9,868	Buy	30800	17%	0.6	18.7	9.5	76%
Tech H/W	Delta Electronics	TW	14,017	Buy	171	14%	1.0	22.6	19.7	4%
Tech H/W	Pegatron	TW	6,440	Buy	78.4	14%	1.0	7.9	7.8	6%
Tech H/W	Advantech Co.	TW	5,144	Buy	258	3%	1.0	26.7	23.5	3%
Transport	Hyundai Glovis	KR	6,178	Buy	184000	30%	0.6	12.5	12.0	0%

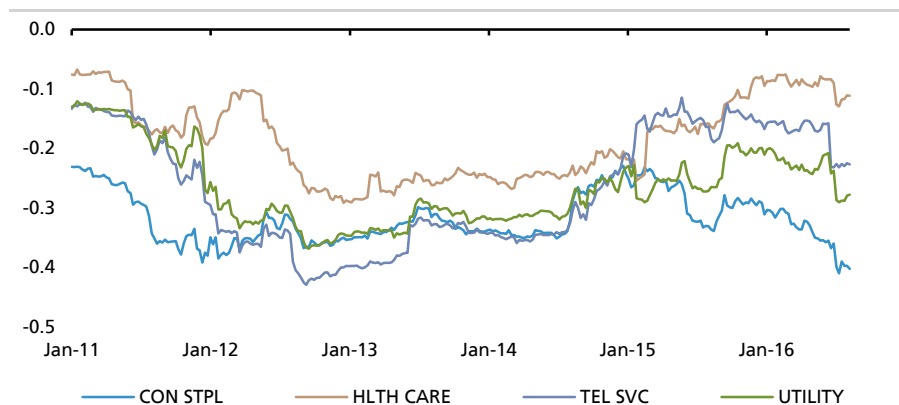
Source: Datastream, UBS

We continue to like cyclicals, as we expect a Fed rate hike within the year, which would be less favorable to the currently well-owned defensives.

However, given the downside we expect to the market before year-end, we recommend stocks with typically lower beta.

For a list of Japanese stocks, please see [page 11](#).

Figure 6: Defensives - 3Y rolling avg correlation to US 10YR treasury yields



Source: Bloomberg

Our concern now with owning defensives is their negative correlation to rising bond yields.

Especially year to date, correlation has become more deeply negative for all defensives except Health Care. If bond yields rise, we see challenges for some defensives.

Figure 7: UBS Buy rated defensives with positive correlation to bond yields, attractive valuation, and good earnings momentum

Industry	Name		M.Cap U\$		Price	Upside	Cor *	P/E 16	P/E 17	EM
Cons Stap	WH Group	HK	11,506	Buy	6	33%	-0.02	12.3	10.7	5%
Cons Stap	Puregold Price Club	PH	2,711	Buy	45.1	9%	-0.08	22.1	19.4	2%
HealthCare	CSPC Pharma Grp.	CN	5,374	Buy	7.64	8%	-0.05	22.0	17.8	6%
HealthCare	China Med. Sys. Hdgs.	CN	4,170	Buy	13.02	10%	0.05	20.9	16.8	5%
Teleco	China Mobile	CN	252,960	Buy	96.5	24%	-0.07	15.5	14.5	0%
Teleco	China Comm. Svs	CN	3,698	Buy	4.19	31%	0.10	9.4	8.7	2%
Teleco	LG Uplus	KR	4,334	Buy	11650	13%	-0.08	10.7	10.8	4%
Utilities	China Longyuan Power	CN	6,976	Buy	6.77	26%	0.03	11.5	8.6	5%
Utilities	GAIL (India) Ltd.	IN	6,873	Buy	373.2	21%	0.03	13.4	10.0	7%
Utilities	Tenaga Nasional	MY	20,762	Buy	14.74	15%	-0.09	11.2	10.6	2%

Source: Datastream, UBS

Given less upside to cyclicals compared to 3 months prior, look for more balance through defensives. To address the negative correlation defensives have against short term rates, we select defensives with positive correlation to yields, with good earnings momentum and attractive valuations.

For a list of Japanese stocks, please see [page 12](#).

Changes since we last visited inventory numbers

Figure 8: Changes to Macro data since last May-end (greener, the better)

Change in Macro indicator vs May	US	China	Korea	Taiwan	Japan
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PMI new orders	54-better	51-better	50-worse	51-better	48-better
PMI new export orders	53-better	50-better	51-better	52-better	45-worse
Export volumes	NA	NA	Increase	Increase	Increase

Source: Datastream, CEIC, Bloomberg

In May, we recommended Tech and cyclical, given what we believed was [the early stages inventory digestion](#) and gradually improving new orders. Evidence coming in suggests this economic thesis is playing out.

Figure 9: Changes to Micro data and sector valuations since last May-end

	Changes since May	Inventory	May P/B Upside	Today P/B upside	Change to P/B upside (% pts)
Auto	China	Up	25.9%	6.9%	-19.0
	Korea	Flat	37.4%	44.2%	6.8
Chemical	China	Up	244.0%	262.8%	18.8
	Korea	Down	-45.9%	-29.1%	16.8
	Japan	Down	36.1%	37.8%	1.7
Steel	China	Down	-6.0%	-19.5%	-13.5
	Korea	Down	-2.2%	-9.6%	-7.4
	Japan	Up	36.1%	48.9%	12.8
Hardware	Korea	Down	25.0%	1.7%	-23.3
	Japan	Down	47.0%	50.4%	3.4
	Taiwan	Down	15.2%	2.3%	-12.9
Semi.	Korea	Flat	145.4%	49.0%	-96.4
	Japan	Down	53.1%	45.1%	-8.0
	Taiwan	Flat	12.3%	0.5%	-11.8

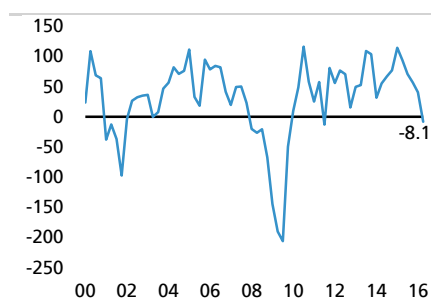
Source: Datastream, CEIC, Bloomberg, UBS

Data at the Micro level is more mixed. Our P/B-ROE model for industries shows that post the recent Tech sector rally, upside has diminished compared to May. However, Chemicals in China and Japan have increased P/B upside compared to May, with lower inventory.

The Macro data: continued adjustment in areas

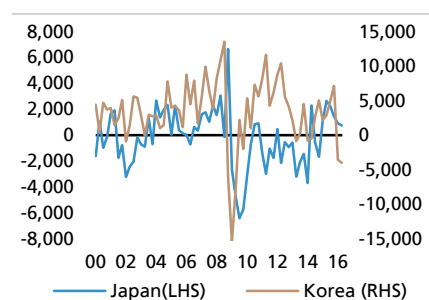
GDP data

Figure 10: US Real GDP change in private inventories (US\$ bn)



Source: Census Bureau

Figure 11: Japan, Korea GDP private inventory change (lcl fx, bn)

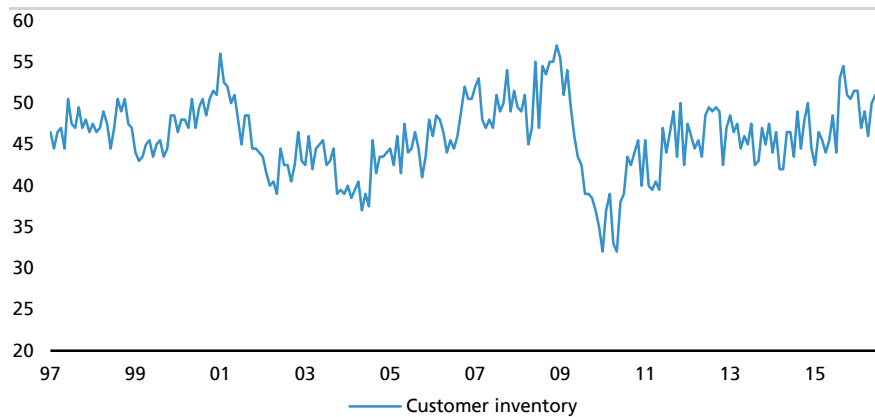


Source: Bloomberg

In the US, inventories have subtracted from GDP growth in Q2. We view this as a positive for Asian equities. In Asia, Japan and Korea have also seen change in private inventory drag, with Korea seeing contraction for two consecutive quarters. While none of this is good for growth, it does set up a better environment if inventory digestion leads to higher production ahead.

Inventory surveys

Figure 12: US ISM Manufacturing Survey – customer inventory

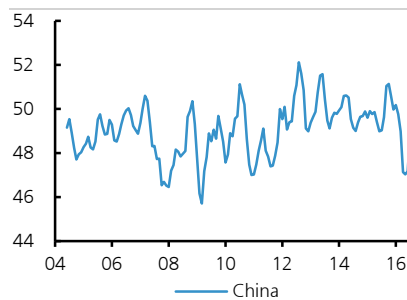


Source: Bloomberg

ISM survey data shows perceived customer inventory levels peaked last September.

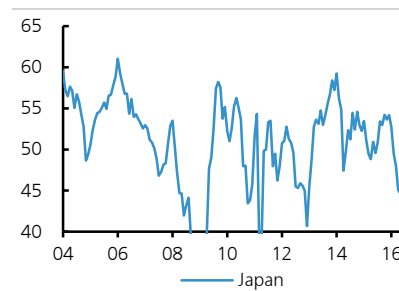
We were highlighting that the series was back below 50 in March. More recently the time series has bounced up a little, which is less positive for the idea that businesses think their customer's inventory is too low.

Figure 13: CN PMI inventory (3MMA)



Source: Haver

Figure 14: JP PMI inventory (3MMA)



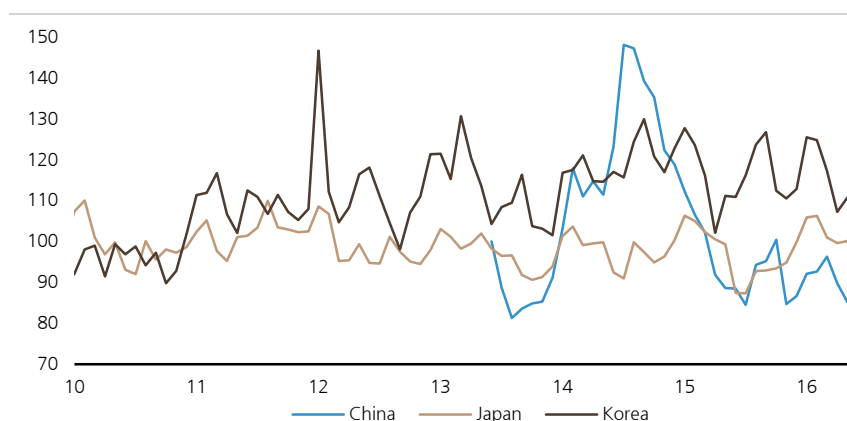
Source: Haver

PMI's stocks of finished good is where the data is less supportive of our thesis. Especially in China and Japan, levels seem to be creeping higher more recently from low levels.

The Micro data: most sectors see inventory falling

Chemicals

Figure 15: Chemicals inventory levels



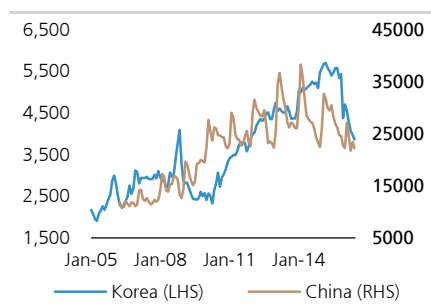
Source: JPCA, KOSIS, Datastream

Inventory in Japan and Korea for polymers are falling. Especially for low density polyethylene (LDPE) and polypropylene (PP) in Japan, inventory levels are 1std dev. below averages. For Korea, the same is true for high density polyethylene (HDPE).

In China, methanol inventory is quite high while for MEG levels are flat.

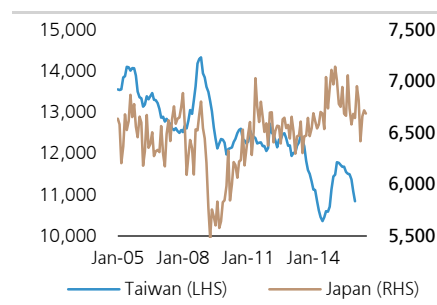
Steel

Figure 16: KR, CN steel inventory (kt)



Source: KOSA (data up to 6/2016), Mysteel (data up to 6/2016)

Figure 17: TW, JP steel inventory (kt)

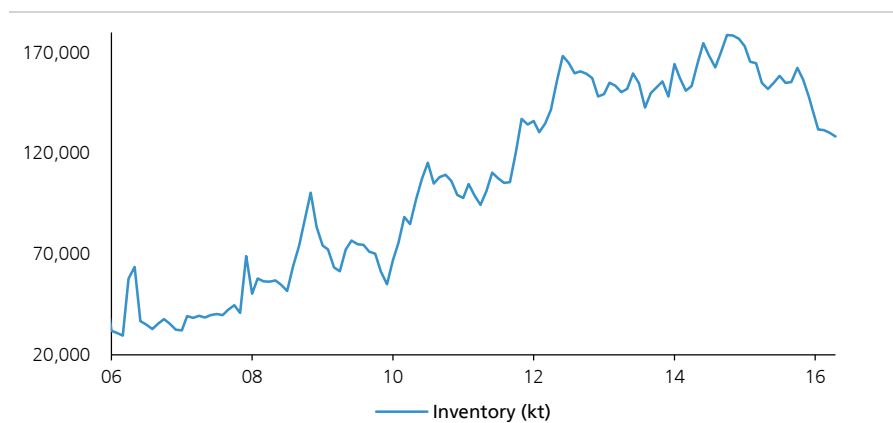


Source: TS&IA (data up to 12/2015), JI&SF (data up to 6/2016)

While steel lends itself to a lesser degree to our thesis given other structural sector specific issues, we see inventory levels falling. However problems with overcapacity is likely to prevent it from an imminent recovery in production.

Coal

Figure 18: China coal inventory – (mines + ports + power plants)

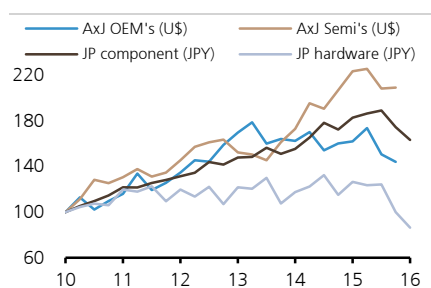


Source: China Mining Association

Similarly for coal, the sector has structural problems. However, we note the sharp decline in inventory as a positive.

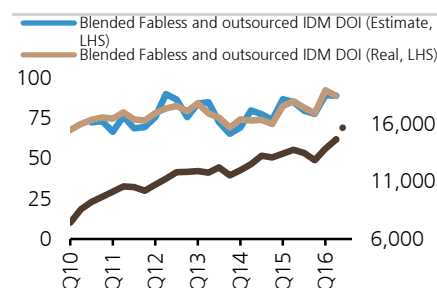
Tech

Figure 19: Inventory nominal value where 6/2010 = 100



Source: Company data, Bloomberg, UBS Asia Tech Team (as of June-end)

Figure 20: Semiconductor inventory dollar and inventory days (Q316 est)

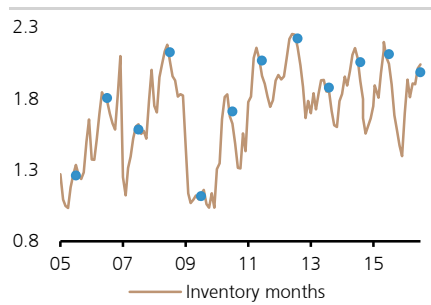


Source: Company data, UBS estimates *DOI = days of inventory

For Japan tech, the reduction in inventory is on average 20%. Within AxJ Tech, inventory level has also fallen, albeit still high. AxJ Semi has seen the least inventory decline. In fact, using customer and foundries growth differences, Bill Lu creates Q316 inventory forecasts. Using this, inventory appears to be building up, making Bill more cautious on the sector, especially Mediatek.

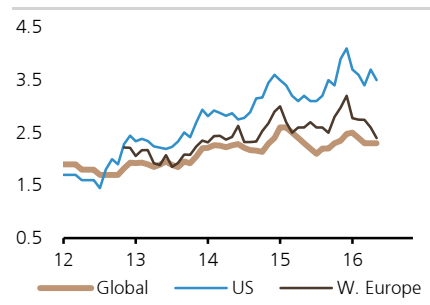
Autos

Figure 21: China dealership



Source: China Auto Association, UBS

Figure 22: Hyundai Motor inv. months

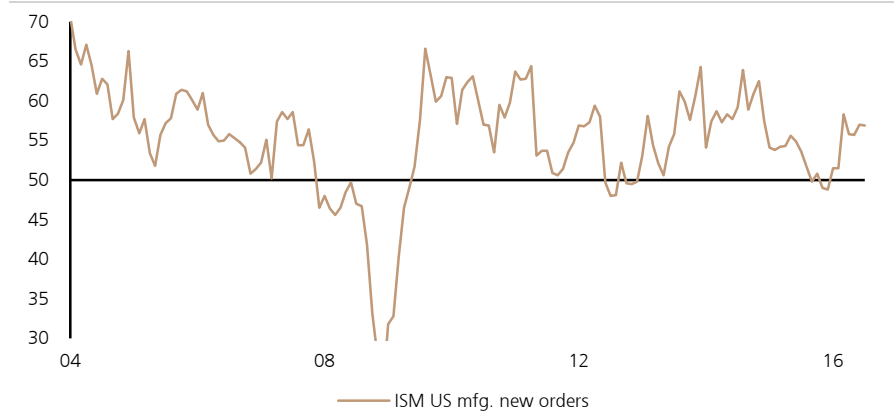


Source: Company data, UBS

Most auto inventory data is expressed relative to sales (which we don't like – more on this later). Inventory for autos remains at high levels but directionally, is falling. For Hyundai Motor, the only company to publish inventory data, inventory months remains flat globally.

Production data: noticeable pick-up

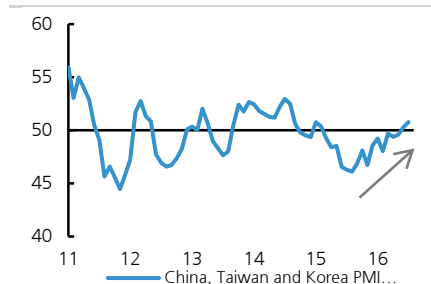
Figure 23: US ISM survey manufacturing new orders



Source: Bloomberg

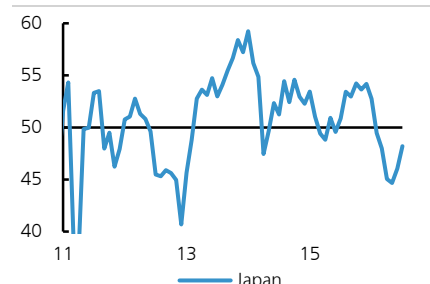
Leading indicators such as new orders are starting to stabilize in the US, consistently in expansionary territory.

Figure 24: PMI new orders average



Source: Haver

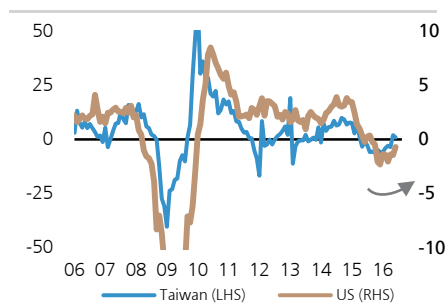
Figure 25: Japan PMI new order



Source: Haver

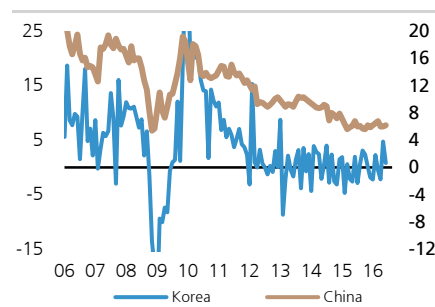
In Asia ex Japan, new orders is in expansionary territory for the first time in 2 years last month. In Japan, while new orders is still in negative territory, there has been a strong up-tick last month.

Figure 26: Taiwan, US I/P



Source: Bloomberg

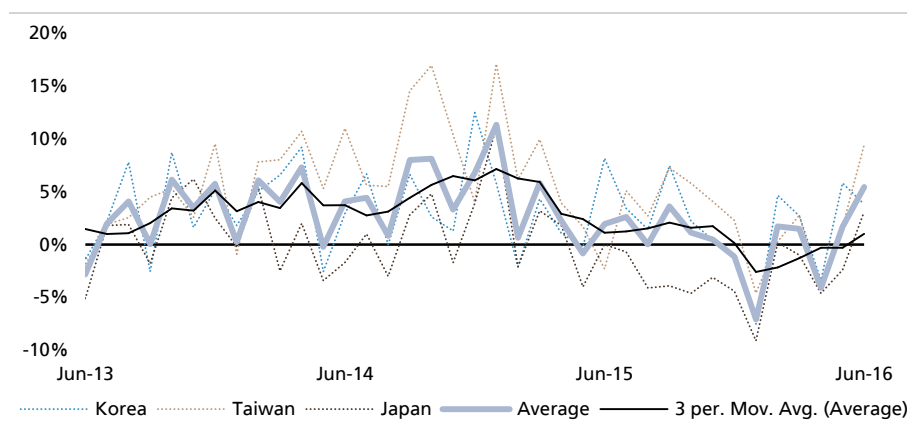
Figure 27: Korea, China



Source: Bloomberg

This has led to nascent industrial production recovery in some countries. We have yet to see it take hold in Korea

Figure 28: Total export volume



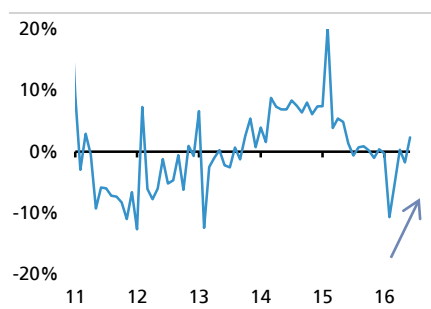
Source: Bloomberg

And in export volumes for North Asia are starting to turn positive.

Duncan has characterised this as getting less bad ([see his note](#)).

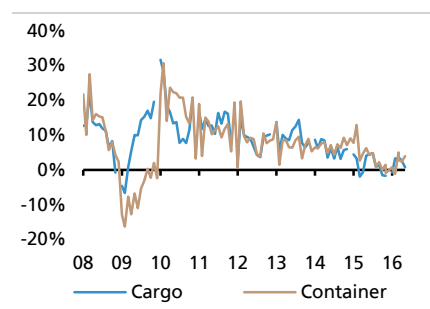
We note that the three month moving average of export volume as well as all spot data is now positive.

Figure 29: Asia air freight volume Y/Y



Source: Association of Asia Pacific Airlines

Figure 30: China throughput at ports

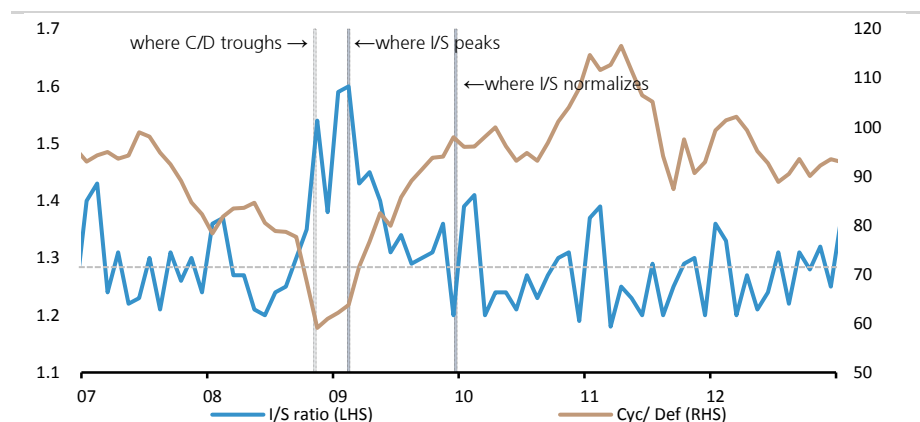


Source: CEIC

This is complemented by transport data such as freight volumes in Asia picking up and to a lesser extent throughput in China.

Why we don't like the Inventory/Sales ratio

Figure 31: Using I/S ratio's trough to call inflexion points

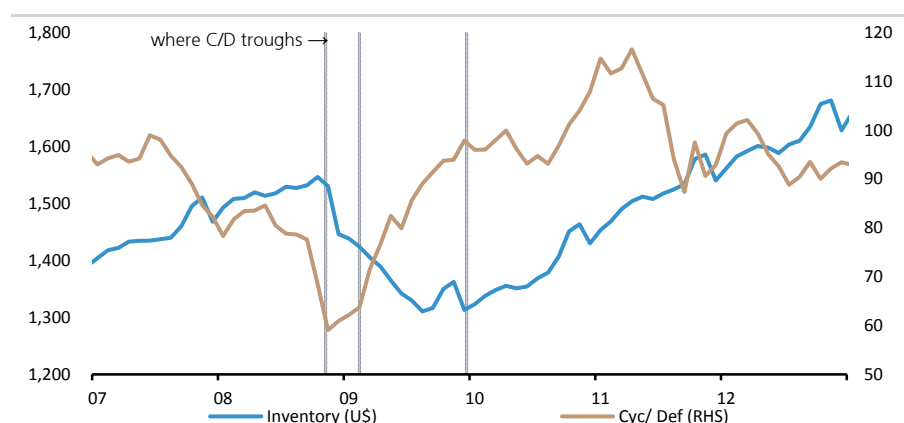


Source: Census Bureau, Datastream, UBS

The pushback to our analysis is that Inventory/Sales ratios are high. They were early in the year. However in our view they can give very confusing signals.

Much like we highlighted in our note of [February 2009](#) [recommending a tilt to cyclical](#), inventory destocking at one company causes their suppliers' sales to fall. Looking at a ratio of inventory to sales therefore can be misleading as both the nominator and denominator are cross-infected by destocking itself.

Figure 32: Using absolute inventory value to call inflexion points



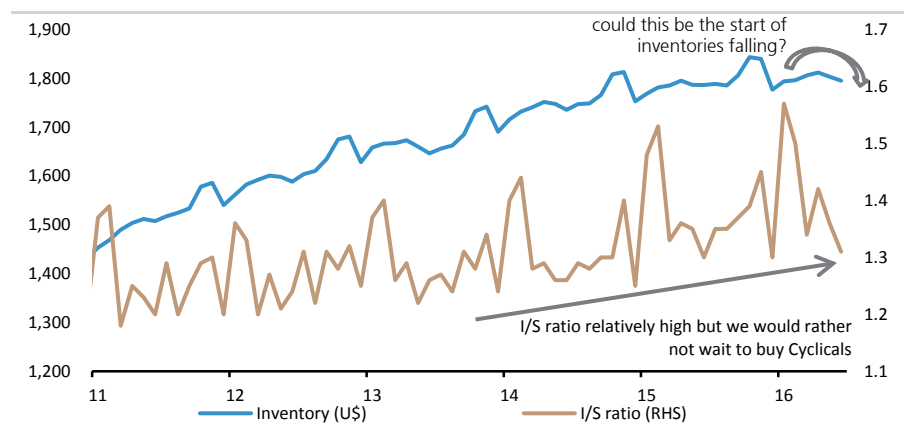
Source: Census Bureau, Datastream, UBS

From a performance perspective, waiting for the I/S ratio to come down to more 'normal' levels is too late (Figure 31). The best time in 2009 to have bought cyclicals (in relative terms) was when destocking *began* (Figure 32). NOT when the inventory/sales ratio had normalized (in late 09).

Highlighting that inventory/sales ratios were high was a consistently bad indicator throughout the cyclical run of 2009. Instead, we think focusing on inventory falling and new orders gradually improving is a better signal to be positive.

If the I/S ratio does drop further later this year, we would not view this as a signal to turn incrementally more positive on cyclicals.

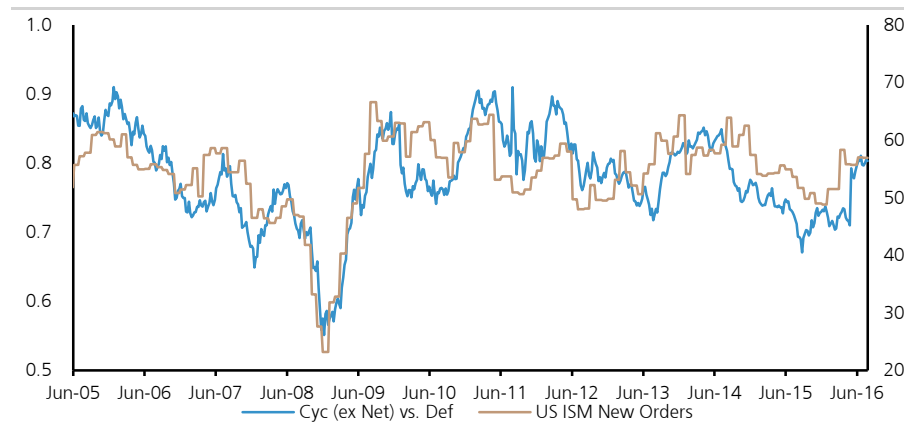
Figure 33: I/S ratio and absolute inventory levels today



Source: Census Bureau

This is becoming more and more priced in but wait

Figure 34: Non-commodity Cyclical versus Defensives and US ISM new orders



Source: Datastream, UBS

Comparing cyclical and defensives (adjusting for the low bond yield environment which has pushed up the valuation of defensives) shows that the valuation gap between cyclical and defensives has closed since earlier this year.

Some cyclicals, noticeably Tech, have already moved up already, closing the valuation gap.

Figure 35: Latest P/B valuation and implied ROE versus consensus 12M fwd ROE

Chemicals	Latest P/B	Implied ROE	12M fwd ROE
China	1.67	8.3%	16.5%
Korea	1.18	11.5%	10.0%
Japan	1.28	6.1%	9.1%
Taiwan	1.54	8.6%	10.4%
Steel	Latest P/B	Implied ROE	12M fwd ROE
China	0.94	4.7%	2.0%
Korea	0.51	3.1%	1.7%
Japan	0.65	-0.9%	3.9%
Taiwan	1.18	1.8%	0.9%
Automobiles	Latest P/B	Implied ROE	12M fwd ROE
China	1.58	14.7%	15.2%
Korea	0.56	5.8%	10.1%
Japan	1.25	7.4%	12.2%
Elec. Comp.	Latest P/B	Implied ROE	12M fwd ROE
Korea	0.87	1.3%	1.5%
Japan	1.44	5.1%	9.3%
Taiwan	1.48	5.7%	11.1%
Elec. Semi.	Latest P/B	Implied ROE	12M fwd ROE
Korea	1.13	11.1%	16.2%
Japan	1.43	1.6%	8.4%
Taiwan	2.72	17.3%	17.5%

Source: Datastream, UBS

We model the logarithmic P/B and ROE relationship over bond yields to back out what current valuations imply about expected ROE.

Where implied ROE is lower than forward ROE, there is a discount where the market is not pricing in an ROE recovery. This is the case in pockets of Chemicals, Automobiles and Tech.

Valuation appears to be fair in Korean Chem, Chinese Autos and Taiwan Semiconductors. On the latter, we re-flag Bill's research on [Mediatek's inventory buildup](#).

Steel across the region, appears fully valued.

Cyclicals with low beta. Yield resilient defensives.

Figure 36: UBS AxJ Buy rated cyclicals with lower beta, attractive valuation (rel. history), and positive/flat EM

Industry	Name		M.Cap U\$		Price	Upside	β	P/E 16	P/E 17	EM
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Energy	PTT Public Co.	TH	28,596	Buy	346	10%	1.2	11.4	10.1	9%
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Materials	Formosa Plastics	TW	15,870	Buy	79	15%	1.0	15.1	13.7	3%
Semis	Samsung Elec.	KR	216,160	Buy	1639000	10%	1.1	11.1	10.0	17%
Semis	TSMC	TW	144,843	Buy	177	13%	1.0	14.5	13.2	5%
Software	NCsoft	KR	5,046	Buy	269000	14%	0.7	21.2	16.3	8%
Tech H/W	LG Display	KR	9,868	Buy	30800	17%	0.6	18.7	9.5	76%
Tech H/W	Delta Electronics	TW	14,017	Buy	171	14%	1.0	22.6	19.7	4%
Tech H/W	Pegatron	TW	6,440	Buy	78.4	14%	1.0	7.9	7.8	6%
Tech H/W	Advantech Co.	TW	5,144	Buy	258	3%	1.0	26.7	23.5	3%
Transport	Hyundai Glovis	KR	6,178	Buy	184000	30%	0.6	12.5	12.0	0%

Source: Datastream, UBS

We continue to recommend cyclicals. However, we note that the upside is limited compared to where we were earlier in the year. Given the modest market downside we forecast before year-end, we select cyclical stocks with typically lower beta.

Figure 37: UBS Japan Buy rated cyclicals with low beta, attractive valuation (rel. history), and good EM

Group	Name		M.Cap U\$		Price (lcl)	Upside	β	P/E 16	P/E 17	EM
Autos	Nissan Motor	JP	41,033	Buy	982.5	26.2%	1.1	7.1	6.4	2%
Autos	Aisin Seiki	JP	13,541	Buy	4800	6.3%	1.1	14.2	12.5	-4%
Cap Gd	Nidec	JP	27,117	Buy	9174	9.0%	1.0	28.9	24.4	0%
Cap Gds	Makita	JP	10,226	Buy	7560	1.9%	1.0	22.7	20.3	-5%
Cap Gds	Daifuku	JP	2,135	Buy	1761	36.3%	1.1	13.3	12.6	0%
Materials	Shin-Etsu Chemical	JP	30,387	Buy	7158	10.4%	0.9	19.8	18.4	8%
Materials	Nissan Chemical	JP	4,611	Buy	3015	26.0%	1.0	19.1	17.9	-1%
Tech H/W	Keyence	JP	43,425	Buy	71860	8.5%	1.0	30.0	25.9	4%
Transport	Hitachi Transport	JP	2,146	Buy	1930	8.8%	0.7	12.5	11.0	7%

Source: Datastream, UBS

The same screen for Japan, but instead of positive earnings momentum, we screen for stocks with earnings momentum better than the market (-5%) to account for currency induced weakness.

Figure 38: UBS AxJ Buy rated defensives with low correlation to bond yields, attractive (rel. history) valuation, and positive earnings momentum

Industry	Name		M.Cap U\$		Price	Upside	Cor *	P/E 16	P/E 17	EM
Cons Stap	WH Group	HK	11,506	Buy	6	33%	-0.02	12.3	10.7	5%
Cons Stap	Puregold Price Club	PH	2,711	Buy	45.1	9%	-0.08	22.1	19.4	2%
HealthCare	CSPC Pharma Grp.	CN	5,374	Buy	7.64	8%	-0.05	22.0	17.8	6%
HealthCare	China Med. Sys. Hdgs.	CN	4,170	Buy	13.02	10%	0.05	20.9	16.8	5%
Teleco	China Mobile	CN	252,960	Buy	96.5	24%	-0.07	15.5	14.5	0%
Teleco	China Comm. Svs	CN	3,698	Buy	4.19	31%	0.10	9.4	8.7	2%
Teleco	LG Uplus	KR	4,334	Buy	11650	13%	-0.08	10.7	10.8	4%
Utilities	China Longyuan Power	CN	6,976	Buy	6.77	26%	0.03	11.5	8.6	5%
Utilities	GAIL (India) Ltd.	IN	6,873	Buy	373.2	21%	0.03	13.4	10.0	7%
Utilities	Tenaga Nasional	MY	20,762	Buy	14.74	15%	-0.09	11.2	10.6	2%

Source: Datastream, UBS

We recognize that some defensives have been a yield play as of late. As we expect yields to rise slightly alongside a Fed rate hike, we select defensives that are resilient to rising rates.

Cor* indicates correlation to 10Y US treasury yields, where positive to low negative correlation implies relative resilience of share price to rising rates

Figure 39: UBS Japan Buy rated defensives with low correlation to bond yields, attractive valuation (rel. history), and positive earnings momentum

Industry	Name		M.Cap U\$		Price	Upside	Cor *	P/E 16	P/E 17	EM
Cons Stap.	Japan Tobacco	JP	69,063	Buy	3923	35%	-0.04	17.2	17.0	1%
Cons Stap.	Eisai	JP	17,403	Buy	5957	51%	0.10	44.3	41.2	12%
HealthCare	Chugai Pharmaceutical	JP	18,159	Buy	3370	28%	-0.07	32.9	25.4	7%

Source: Datastream, UBS

We include the same defensives screen for Japan.

While they appear expensive in absolute terms, relative to its history valuations are not as high.

The bottom line, we think the evidence points to ongoing inventory de-stocking and think that a gradual production improvement still looks probable in the balance of this year.

In relative terms therefore, we continue to prefer cyclical to defensives, and recommend north Asian markets over more US Dollar and rate sensitive south Asia. We would note that this is a relative call. Our index target remains 4% below current MSCI Asia ex Japan levels.

Figure 40: Summary of our country views

UBS STRATEGY VIEW		KEY DEBATES	RISKS TO OUR VIEW
OVERWEIGHT			
Japan (vs. APAC)	A gradually improving global cyclical backdrop, tighter US policy, an equity market that is already factoring in current spot FX rates, and estimates that have dropped but are now beating forecasts, all suggest Japan should do better in H2. Further evidence of better corporate governance ('Kakusei') should also be supportive.	<ul style="list-style-type: none"> Does the Fed tighten or the BoJ ease further? Will corp governance lead to ROE improvement? Will the reflation story take hold? 	<ul style="list-style-type: none"> BoJ decides not to ease further / stronger JPY. Earnings disappoint. Corporate governance reform disappoints. Negative rates impact on bank earnings
Taiwan	Expect Taiwan to benefit from a cyclical pick-up, especially in the US where we expect inventory digestions to support growth in H2. In a relative context, valuations are reasonable and recent PMIs have shown improving new export orders.	<ul style="list-style-type: none"> What could drive tech earnings? What's the outlook for China end-demand? 	<ul style="list-style-type: none"> Fed rate hike implications for Taiwan policy Success of iPhone product launches Global/US recovery fails to materialise
Korea	Korea benefits from an improving export-cyclical growth backdrop. Attractive valuations and recently earnings momentum has turned positive.	<ul style="list-style-type: none"> Will shareholder returns significantly improve? Can the earnings picture improve other than for short-term cyclical reasons? 	<ul style="list-style-type: none"> Corporate governance reforms impress / disappoint Global/US recovery fails to materialise Domestic consumption falters.
NEUTRAL			
India	Structurally bullish given that we are deep into balance sheet repair and expect lower capex to lift utilisation ratios and returns on capital. Reforms continue to progress too. We had expected inflation targeting to support lower inflation, lower rates and a better current account, supporting future growth. However RBI Governor Rajan's resignation raises uncertainty around the inflation and monetary policy outlook and therefore we think India may struggle to outperform until this clears.	<ul style="list-style-type: none"> When will economic & earnings growth turn around? Is reform (lower rates) still on track? 	<ul style="list-style-type: none"> Inflation and implications for rate cuts Backtracking on the reform agenda Economic and earnings growth Oil price rebound Well owned
Thailand	Thailand is relatively expensive. Nevertheless, on a relative earnings basis it looks good, while we see further scope for interest rate cuts. This feeds back into valuations – lower yields are propping up valuations as the domestic liquidity surplus increasingly finds its way into local equities.	<ul style="list-style-type: none"> When does infrastructure investment come through and do they deliver on it? When will we get more clarity on constitutional arrangements? 	<ul style="list-style-type: none"> Political risk. Infrastructure spending and growth delivers.
Indonesia	Expensive valuations following strong inflows in H1 2016. Reform progress, slowing credit growth and improved current account balance are helpful, but much of this improvement is already in the price. Risk that this could de-stabilise if BI cuts rates further too soon. Potential Fed rate hikes in coming months may also pressure the IDR and Indonesian equities.	<ul style="list-style-type: none"> Is the earnings improvement sustainable? Are rate cuts compatible with currency and current account improvement? 	<ul style="list-style-type: none"> Current account improvement / deterioration Fed rate hikes and higher US rates Commodity prices (CPO and coal) Reform disappointment (e.g. tax amnesty)
Singapore	Valuations very cheap and already reflect the macro/Fed hike concerns. The macro outlook remains a headwind given sensitivity to US rate hikes given rapid expansion of debt in the past decade. Corporate margins are likely to be squeezed and asset quality still deteriorating, but much is already in the price.	<ul style="list-style-type: none"> How does ongoing commodity weakness play out? How will an expensive exchange rate and interest rate adjustment affect asset prices? 	<ul style="list-style-type: none"> Valuation rebound risk from very low levels. Fed policy. NPL cycle. Oil price. Regional weakness.
China	Faster credit growth is likely to coincide with better growth data. But this is coming at the expense of longer-term stability. Our analysis suggests this may lead to further absolute upside for MSCI China, but not necessarily on a relative basis, and we would be more positive on the outlook for the US, than China.	<ul style="list-style-type: none"> Will FX concerns recede? Reforms: when will they become visible? Banking sector balance sheet health? 	<ul style="list-style-type: none"> FX fears return if US\$ strengthens. A more pronounced growth slowdown. Commodity / inflation rebound may impede central bank's capacity to ease.
UNDERWEIGHT			
Hong Kong	Sensitive to US rate hike via currency peg, especially after rapid rise in private sector debt/GDP. Exposed to China slowdown and RMB devaluation impact on retail sales, asset prices, and slowing mainland tourist numbers.	<ul style="list-style-type: none"> If US rates rise, how much could asset prices adjust? Impact of RMB devaluation? How much impact from a China visitor slowdown? 	<ul style="list-style-type: none"> RMB devaluation and China growth Fed rate hike Property related measures (policy) Visitor growth slowdown
Malaysia	Weak earnings on the back of lower oil and domestic slowdown. FX reflects some of these risks, but equities are not obviously cheap given the fall in near-term earnings.	<ul style="list-style-type: none"> Has the oil slump come to an end? Where does the currency go from here? Does political noise recede? 	<ul style="list-style-type: none"> Oil price rebounds. Politics. Current account improvement. Rebound in the currency.
Philippines	Premium valuations already reflect the strong growth backdrop and current account surplus. High valuations at risk from Fed tightening which has been a negative.	<ul style="list-style-type: none"> The impact on rates and FX from the Fed? 	<ul style="list-style-type: none"> Inflation and its impact on policy.
Australia (vs. APAC)	Valuations relatively expensive vs history and doubts over the sustainability of the commodity rebound and earnings improvement. Ex resources earnings growth remains positive but constrained, with the renewed strength in the A\$ posing potential earnings headwinds if sustained. With a large part of the market acting as a quasi-yield or income trade, a rising bond yield backdrop a challenge.	<ul style="list-style-type: none"> Have commodity priced bottomed? Further AUD weakness or RBA cut? Will property prices turn down? How much more capital do the banks need to raise? 	<ul style="list-style-type: none"> US bond yields given rate sensitivity of Australian equities. Commodity price rebound. Significantly lower AUD / rate cut.

Source: UBS

Valuations and performance

Figure 41: Country valuations and performance

MSCI	% of index	Performance US\$ (%)				P/E (x)			P/Book (x)			EPS growth (%)			DY (%)	ROE (%)
		1m	3m	YTD	2015	2015	2016E	2017E	2015	2016E	2017E	2015	2016E	2017E	2016E	2016E
China	31.2	5.5	12.6	3.0	-10.0	12.9	12.8	11.2	1.46	1.44	1.32	-3.4	0.6	14.4	2.3	11.3
Hong Kong	12.1	0.6	10.0	5.4	-3.3	16.7	16.2	15.5	1.23	1.15	1.10	-13.5	3.0	4.5	3.2	7.1
Indonesia	3.2	4.0	20.0	24.6	-21.0	19.9	18.6	16.2	3.34	2.98	2.68	-8.2	7.2	14.5	2.1	16.0
India	9.6	0.1	8.5	4.9	-7.4	21.8	19.2	16.2	3.22	2.85	2.60	3.5	12.9	18.2	1.5	14.8
Korea	17.5	5.1	14.3	13.3	-7.9	11.7	10.9	10.0	1.05	1.00	0.92	16.4	7.3	8.4	1.8	9.2
Malaysia	3.3	2.0	5.3	7.2	-22.4	16.5	16.9	15.7	1.74	1.66	1.58	-1.4	-2.5	8.1	2.9	9.8
Philippines	1.7	-1.4	5.4	14.0	-8.1	21.9	20.4	18.6	2.89	2.65	2.41	5.8	7.6	9.3	1.6	13.0
Singapore	4.6	-1.5	5.2	3.1	-20.8	12.3	13.1	12.5	1.11	1.10	1.06	-4.4	-5.9	4.3	4.0	8.4
Thailand	2.7	4.5	15.0	30.2	-25.5	17.9	16.2	14.4	2.18	2.00	1.85	-1.4	10.7	12.4	2.8	12.3
Taiwan	14.0	2.9	13.9	15.7	-14.4	13.9	14.6	13.2	1.77	1.68	1.58	-0.1	-4.9	11.1	3.9	11.5
Asia ex Jp		3.3	11.8	8.6	-11.3	14.0	13.7	12.3	1.47	1.41	1.31	0.3	2.2	11.1	2.6	10.3
Japan*	40.1	4.4	7.3	0.7	7.8	15.3	14.0	12.8	1.19	1.12	1.05	-2.8	9.2	9.7	2.3	8.0
Australia*	12.5	2.3	8.9	8.4	-14.1	17.9	17.0	15.7	1.80	1.84	1.76	-14.6	4.9	8.1	4.4	10.8
APAC		3.6	9.6	5.3	-4.3	14.7	14.3	12.9	1.36	1.31	1.23	-2.2	3.3	10.4	2.7	9.2
USA		0.2	4.1	6.2	-0.8	19.2	19.0	16.8	2.89	2.80	2.62	0.2	1.0	13.2	2.1	14.7
Europe		2.9	-0.4	-2.7	-5.3	16.1	16.4	14.5	1.69	1.69	1.63	-5.6	-1.6	13.1	3.6	10.3
Emerging		3.3	12.3	13.1	-17.0	14.3	13.3	11.7	1.50	1.46	1.34	-7.3	7.3	13.3	2.6	11.0
World		1.6	4.4	4.8	-4.3	17.3	17.1	15.1	2.04	1.99	1.88	-3.3	1.4	12.9	2.6	11.6

Source: IBES, MSCI, Thomson Datastream, UBS. Note: * Japan and Australia data for March and June year-ends

Figure 42: ASIA EX JAPAN sector valuations and performance

	% of index	Performance US\$ (%)				P/E (x)			P/Book (x)			EPS growth (%)			DY (%)	ROE (%)
		1m	3m	YTD	2015	2015	2016	2017	2015	2016	2017	2015	2016	2017	2016	2016
Energy	4.0	-1.2	6.7	12.1	-21.4	15.6	16.7	12.1	1.02	0.95	0.91	-30.6	-6.8	38.6	2.6	5.7
Materials	4.3	3.1	12.3	16.1	-11.9	19.8	14.1	12.7	1.20	1.11	1.05	-0.3	40.0	11.4	2.8	7.8
Industrials	8.2	3.2	8.7	0.5	-10.5	13.5	14.4	12.6	1.18	1.15	1.08	14.5	-6.4	14.8	2.4	8.0
Cons Disc	9.3	2.7	9.0	3.6	-16.4	15.2	14.1	12.4	1.66	1.56	1.45	-11.0	7.7	13.5	2.1	11.0
Cons Staples	5.2	-0.9	2.8	7.6	-3.1	26.2	23.3	20.5	3.26	3.11	2.87	11.4	12.6	13.6	1.9	13.4
Health Care	2.5	0.2	7.1	-0.6	6.2	31.7	27.9	22.4	3.98	3.92	3.39	20.1	13.7	21.1	0.8	14.0
Financials	29.4	3.1	12.6	4.1	-12.7	10.0	10.1	9.5	1.05	0.99	0.93	2.7	-0.5	5.5	3.4	9.9
Tech	27.0	6.7	17.7	18.4	-8.2	18.2	17.0	14.6	2.47	2.29	2.06	-6.4	6.9	16.2	1.9	13.5
Telecoms	6.2	-0.4	9.1	11.0	-11.5	17.3	17.5	15.9	1.52	1.99	1.88	1.7	-1.0	9.8	3.4	11.4
Utilities	3.9	1.7	6.9	7.6	-11.5	9.8	11.0	10.8	1.41	1.31	1.22	51.4	-11.4	2.3	3.3	11.9
Asia ex Jp		3.3	11.8	8.6	-11.3	14.0	13.7	12.3	1.47	1.41	1.31	0.3	2.2	11.1	2.6	10.3

Source: IBES, MSCI, Thomson Datastream, UBS

Figure 43: JAPAN sector valuations and performance

MSCI Japan	% of index	Performance JPY (%)				P/E (x)			P/Book (x)			EPS growth (%)			DY (%)	ROE (%)
		1m	3m	YTD	2015	Mar 16	Mar 17	Mar 18	Mar 16	Mar 17	Mar 18	Mar 16	Mar 17	Mar 18	Mar 17	Mar 17
Energy	0.8	-2.1	-8.5	-23.1	-3.7	-8.5	11.0	9.2	0.59	0.58	0.55	0.0	0.0	18.8	3.4	5.3
Materials	5.9	4.6	2.4	-12.7	-2.6	15.7	14.5	12.2	1.00	0.97	0.92	-17.0	8.6	18.6	2.0	6.7
Industrials	19.9	-2.6	-2.0	-11.7	2.2	25.1	14.1	13.1	1.28	1.22	1.14	-37.0	77.2	8.3	2.1	8.6
Cons Disc	21.2	1.5	1.9	-17.7	4.9	11.9	13.4	11.6	1.24	1.18	1.10	9.2	-11.6	16.3	2.5	8.8
Cons Staples	8.0	-5.0	-6.6	-12.8	26.4	26.1	22.3	20.2	2.36	2.18	2.06	6.7	17.0	10.5	1.9	9.8
Health Care	8.0	-8.4	-8.9	-15.9	33.0	24.9	24.4	22.8	2.20	2.12	2.03	66.6	1.9	7.3	2.1	8.7
Financials	17.3	0.8	-4.4	-24.2	7.6	9.8	9.8	9.7	0.70	0.66	0.63	-1.5	-0.5	1.6	3.2	6.7
Tech	10.4	-1.4	1.1	-14.2	4.2	17.1	17.9	15.6	1.40	1.35	1.28	-7.6	-4.5	15.3	2.1	7.5
Telecoms	6.5	4.1	-1.0	3.1	14.8	16.0	13.3	12.1	2.13	1.76	1.60	2.8	20.3	10.0	2.0	13.2
Utilities	2.0	-8.4	-9.1	-27.5	10.5	7.5	11.5	11.5	0.77	0.69	0.65	51.7	-35.2	0.3	2.1	6.0
Japan		-1.1	-2.2	-15.9	8.1	15.3	14.0	12.8	1.19	1.12	1.05	-2.8	9.2	9.7	2.3	8.0

Source: IBES, MSCI, Thomson Datastream, UBS

Figure 44: AUSTRALIA sector valuations and performance

MSCI Australia	% of index	Performance AUD (%)				P/E (x)			P/Book (x)			EPS growth (%)			DY (%)	ROE (%)
		1m	3m	YTD	2015	Jun 16	Jun 17	Jun 18	Jun 16	Jun 17	Jun 18	Jun 16	Jun 17	Jun 18	Jun 17	Jun 17
Energy	4.9	1.7	5.1	5.8	-33.3	20.3	25.4	16.2	1.15	1.17	1.13	-49.1	-20.3	57.0	2.4	4.6
Materials	14.5	5.9	11.0	24.4	-22.1	29.6	23.2	20.1	1.27	1.64	1.57	-56.5	27.4	15.7	2.4	7.0
Industrials	6.0	-4.3	-0.9	9.8	18.2	32.7	27.6	25.2	3.83	4.11	3.83	-1.0	18.7	9.4	3.8	14.9
Cons Disc	3.0	4.1	13.6	13.4	23.5	25.5	23.1	21.1	3.39	3.28	3.17	9.9	10.4	9.3	3.2	14.2
Cons Staples	7.7	4.3	7.6	6.2	-6.1	21.7	19.9	18.5	2.59	2.50	2.42	-18.1	9.2	7.2	4.1	12.6
Health Care	6.9	-5.3	0.3	11.4	17.2	27.3	27.9	23.6	7.64	7.01	6.22	12.2	-2.0	18.2	1.9	25.2
Financials	51.2	-0.3	0.6	-3.4	-0.6	13.9	13.6	13.1	1.62	1.56	1.50	-2.1	2.5	3.7	5.6	11.5
Tech	0.4	8.3	-6.4	-14.6	-1.5	13.9	13.8	12.7	3.81	3.46	3.20	-7.7	0.8	8.1	3.4	25.2
Telecoms	2.7	-8.0	-7.2	-1.2	-2.4	18.8	16.6	15.4	3.34	3.39	3.25	-2.3	13.0	8.0	4.9	20.4
Utilities	2.7	-4.4	5.8	9.1	23.2	25.9	23.5	21.6	1.94	1.91	1.92	7.7	10.0	9.2	4.9	8.1
Australia		0.2	2.8	3.6	-3.3	17.9	17.0	15.7	1.80	1.84	1.76	-14.6	4.9	8.1	4.4	10.8

Source: IBES, MSCI, Thomson Datastream, UBS

Valuation Method and Risk Statement

Although there are many uncertainties with equity investing, generally economic and policy surprises pose the most consistent and continuous risks. Economic growth can be volatile, leading to earnings uncertainty. Inflation volatility can likewise lead to interest rate uncertainty. The direction and level of policy rates has a substantial impact upon equity valuations.

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UBS Investment Research: Global Equity Rating Definitions

12-Month Rating	Definition	Coverage ¹	IB Services ²
Buy	FSR is > 6% above the MRA.	47%	32%
Neutral	FSR is between -6% and 6% of the MRA.	38%	25%
Sell	FSR is > 6% below the MRA.	15%	21%
Short-Term Rating	Definition	Coverage ³	IB Services ⁴
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	<1%	<1%

Source: UBS. Rating allocations are as of 30 June 2016.

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

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Company Name	Reuters 12-month rating	Short-term rating	Price	Price date
Advantech Co.	2395.TW	Buy	N/A	NT\$258.00 25 Aug 2016
Aisin Seiki	7259.T	Buy	N/A	¥4,800 25 Aug 2016
China Communications Services	0552.HK	Buy	N/A	HK\$4.19 25 Aug 2016
China Longyuan Power^{2, 4}	0916.HK	Buy	N/A	HK\$6.77 25 Aug 2016
China Medical System Holdings	0867.HK	Buy	N/A	HK\$13.02 25 Aug 2016
China Mobile (HK) Ltd^{4, 16a, 16b}	0941.HK	Buy	N/A	HK\$96.50 25 Aug 2016
Chugai Pharmaceutical	4519.T	Buy	N/A	¥3,370 25 Aug 2016
CSPC Pharmaceutical Group	1093.HK	Buy	N/A	HK\$7.64 25 Aug 2016
Daifuku	6383.T	Buy	N/A	¥1,761 25 Aug 2016
Delta Electronics	2308.TW	Buy	N/A	NT\$171.00 25 Aug 2016
Eisai	4523.T	Buy	N/A	¥5,957 25 Aug 2016
Formosa Petrochemical Corporation^{2, 4}	6505.TW	Buy	N/A	NT\$94.90 25 Aug 2016
Formosa Plastics	1301.TW	Buy	N/A	NT\$79.00 25 Aug 2016
GAIL (India) Ltd.	GAIL.BO	Buy	N/A	Rs373.20 25 Aug 2016
Genting	GENT.KL	Buy	N/A	RM8.21 25 Aug 2016
Hitachi Transport System	9086.T	Buy	N/A	¥1,930 25 Aug 2016
Hyundai Glovis	086280.KS	Buy	N/A	Won184,000 25 Aug 2016
Hyundai Mobis	012330.KS	Buy	N/A	Won253,500 25 Aug 2016
Japan Tobacco⁷	2914.T	Buy	N/A	¥3,923 25 Aug 2016
Keyence	6861.T	Buy	N/A	¥71,860 25 Aug 2016
Kia Motors	000270.KS	Buy	N/A	Won42,900 25 Aug 2016
LG Display^{7, 16b}	034220.KS	Buy	N/A	Won30,800 25 Aug 2016
LG Uplus	032640.KS	Buy	N/A	Won11,650 25 Aug 2016
Makita	6586.T	Buy	N/A	¥7,560 25 Aug 2016
MediaTek Inc.	2454.TW	Neutral	N/A	NT\$244.00 25 Aug 2016
NCsoft	036570.KS	Buy	N/A	Won269,000 25 Aug 2016
Nidec	6594.T	Buy	N/A	¥9,174 25 Aug 2016
Nissan Chemical	4021.T	Buy	N/A	¥3,015 25 Aug 2016
Nissan Motor	7201.T	Buy	N/A	¥982.5 25 Aug 2016
Pegatron	4938.TW	Buy	N/A	NT\$78.40 25 Aug 2016
PTT Public Company Ltd.	PTT.BK	Buy	N/A	Bt346.00 25 Aug 2016
Puregold Price Club	PGOLD.PS	Buy	N/A	P45.10 25 Aug 2016
Samsung Electronics	005930.KS	Buy	N/A	Won1,639,000 25 Aug 2016
Shin-Etsu Chemical	4063.T	Buy	N/A	¥7,158 25 Aug 2016
Siam Cement⁷	SCC.BK	Buy	N/A	Bt516.00 25 Aug 2016
Taiwan Semiconductor Manufacturing^{16b}	2330.TW	Buy	N/A	NT\$177.00 25 Aug 2016
Tenaga Nasional⁴	TENA.KL	Buy	N/A	RM14.74 25 Aug 2016
WH Group	0288.HK	Buy	N/A	HK\$6.00 25 Aug 2016

Source: UBS. All prices as of local market close.

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