



Still Constructive Toward Asia Ex-Japan

North Asia may be first to enter the post-coronavirus era.

August 2020

KEY INSIGHTS

- We remain positive on the long-term prospects for Asia ex-Japan, though short-term visibility is low on account of the coronavirus, global recession, and the contraction in world trade.
- The economic outlook for north Asia has improved, while coronavirus concerns still loom large for India and parts of Southeast Asia, where progress is lagging.
- A resumption of trend growth in Chinese domestic demand should help to underpin the regional Asian economy in 2021, though weak global export demand remains a significant potential headwind.



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North Asia First to Bring the Coronavirus Under Control

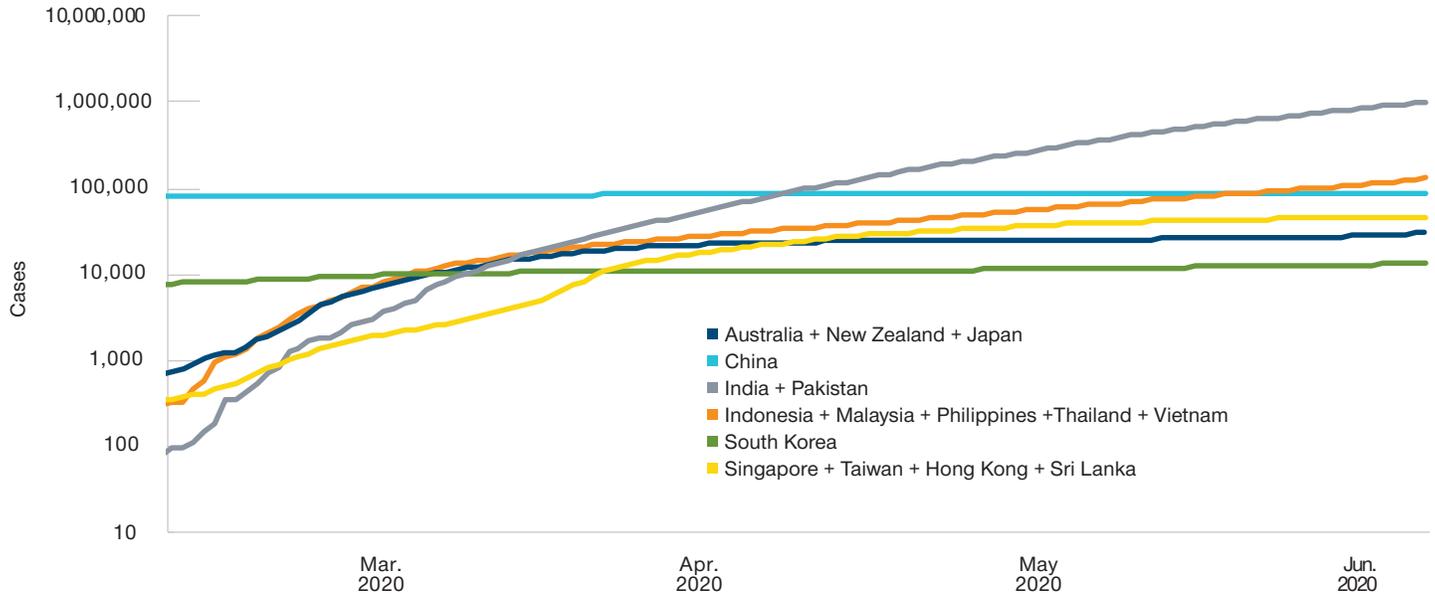
In north Asia (Greater China, Korea, and Japan), public health authorities have succeeded in bringing the coronavirus under control. The chances of a major second wave appear low, although it cannot be ruled out. A cluster of new cases in Beijing in June brought the potential for a second wave into sharper focus. Public health experts believe a second wave can be controlled more easily than the first, given China's extensive experience in fighting the coronavirus. Asian governments are well aware of the risks of a renewed outbreak and remain on high alert. Responding to a small cluster of new infections in May, Wuhan tested all 10 million residents for coronavirus within 10 days, a remarkable feat. Only a small number of new cases were identified, all of which

were asymptomatic and thought unlikely to be infectious.

North Asia is the first region to move into the post-coronavirus era, as restrictions have been removed or relaxed. The sharp decline in new cases means consumers and businesspeople can see light at the end of the tunnel, while this is also where markets have bottomed in previous pandemics. In contrast, the coronavirus is still spreading rapidly in India, despite the country having imposed one of the strictest national lockdowns. Ratings agency Fitch recently cut India's outlook to negative, citing the acceleration in new infections as the lockdown was eased. In ASEAN (the Association of Southeast Asian Nations), the COVID-19 curve is less steep, but it has yet to flatten. Among ASEAN countries, Indonesia is lagging with new cases around 1,000 per day and a low testing capacity. Vietnam in

North Asia Has Successfully Flattened the COVID-19 Curve

(Fig. 1) Total confirmed cases to date, grouped by country



As of July 9, 2020.

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contrast has managed its coronavirus outbreak well, with an early reopening of the economy.

China’s Strong Policy Response to Support Recovery

Fiscal policy, rather than monetary policy, is the key to Beijing’s efforts to reboot the Chinese economy after the lockdown. There was also a monetary response to the crisis, reflected in faster growth in bank lending and total social financing, a broad measure of credit. But new annual targets for bank lending and credit announced in June imply slower growth in the second half of the year, a sign that China remains cautious about fully opening the credit taps. Fiscal stimulus in 2020 on a broad definition is about 5.5% of gross domestic product (GDP).¹ This is a lot smaller than China’s fiscal response to the global financial crisis in 2008. That was over 12% of GDP but, in

retrospect, brought many problems in its wake. China’s fiscal stimulus in 2020 also looks small when compared with the measures announced by the U.S. and a number of other countries. However, China’s lockdown was relatively shorter, causing less economic damage and less need for extreme policy support. Many of the big fiscal packages announced by other countries included loan guarantees and interest rate subsidies, which inflate the headline figure but have only a limited impact on demand. China’s fiscal response to the coronavirus is focused more on traditional infrastructure spending, which has a higher domestic demand content. Fiscal stimulus of 5.5% of GDP is actually quite punchy, and the impact is already starting to show in China’s monthly economic data.

We believe fiscal and monetary easing can contribute to a more broad-based upturn for China in 2021, in turn

¹ The IMF defines the broader measure of China’s fiscal deficit to include a number of large off-budget programs, such as special purpose government bonds to finance infrastructure, and Local Government Financial Vehicle net bond issuance.

potentially providing support to other Asian economies. That said, economic recovery in Asia will also depend on global demand, and this has not begun to come back yet. Asian exporters are important employers, so the recovery will depend on the workforce being able to maintain their jobs. The global demand shock to Asia from the coronavirus remains a key risk that is only just beginning to play out.

Asia Ex-Japan Becoming More Closely Integrated With China

Resumption of trend growth in Chinese domestic demand is expected to be the primary growth driver for the region in 2021. Over a longer time frame, we see the Asian economy becoming more, not less, closely integrated with China. There is evidence of a regional factor driving Asian economic growth associated with the rise of China and its impact on neighboring economies. In the early stages, China's export growth was mainly driven by outward processing, i.e., the assembly of inputs from Asia and elsewhere for re-export to final markets in the U.S. and Europe. As China moved up the value-added chain, the domestic value-added share of exports has increased. It rose from 73% in 2005 to 83% in 2016 according to OECD estimates, a level higher than in Germany, France, or South Korea. As a result, more of the global manufacturing supply chain today resides in China than before. Other

Asian countries have still benefited from the growth in China's domestic market and from Chinese tourism while supplying a smaller share of China's demand for intermediate goods than in the past.

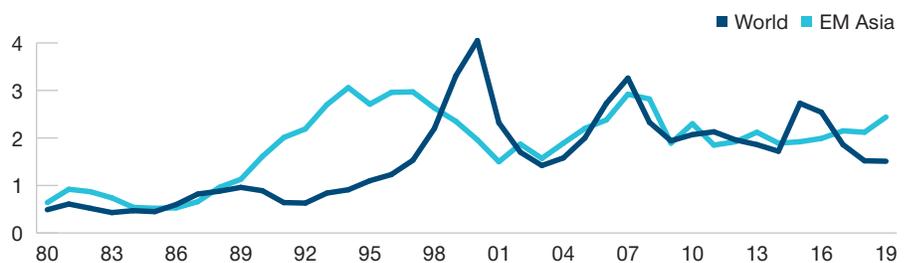
Global Supply Chains Unlikely to Exit China Quickly

The retreat from globalization and shift away from dependence on global supply chains became a hot topic after the disruption caused by the coronavirus. Some see supply chains migrating from China in order to diversify risk or to be closer to end markets in the U.S. and Europe. Over the medium to longer term there is likely to be some migration, as multinational companies appear to be recognizing the merits of greater diversification. But in the short term, changes to global supply chains may be rather limited, as in many cases, there are large sunk costs.

For more complex, higher value-added goods, few countries can match China's scale and sophisticated production and logistic networks. Moving supply chains for these products from China is likely to result in significantly higher short-term costs and a potential loss of competitiveness. Moreover, by quickly resuming operations after the coronavirus lockdown, China has demonstrated the quality and strength of their supply chain ecosystem. Labor-intensive, low value-added manufacturing production is another story. This will continue to migrate

Globalization Fears May Be Overdone With Respect to Asia

(Fig. 2) FDI (Foreign direct investment) as a share of GDP (%)



As of May 29, 2020.
Source: HSBC Global Research.

“On a trailing price-to-book value basis, Asia ex-Japan is currently trading around one standard deviation below its 10-year average.”

from China to lower-cost locations, as it has done for the past decade. Much of this production is likely to stay in Asia, however, migrating to Vietnam, Malaysia, Indonesia, and increasingly India. The net loss of manufacturing production capacity to the region due to supply chains leaving China may be quite small.

Asia Ex-Japan Earnings and Valuations

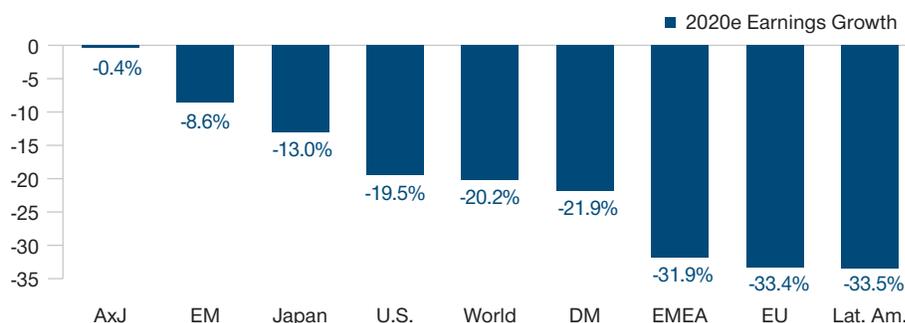
Analysts have been quick to cut their earnings estimates in response to the coronavirus, though there is probably further to go. From January to May, consensus earnings growth estimates for MSCI Asia ex-Japan in 2020 was cut by 23%. In momentum terms, the one-month rolling earnings upgrade ratio² hit a trough in April and has been slowly improving since, led by China, Taiwan, and Korea. By country, China, Taiwan, and India are forecast to achieve low, single-digit earnings growth in 2020, with Hong Kong and ASEAN markets posting potential declines ranging from 16% to 25%. The 20% increase projected for Korea is an exception.

It reflects a depressed base in 2019 due to the global slump in semiconductors followed by a cyclical rebound this year.

As earnings per share (EPS) for 2020 are trough earnings, depressed by the predations of the coronavirus pandemic, trailing price-to-earnings valuations may be a better metric for the purpose of valuation comparisons. On this basis, the region is not far from its 10-year mean, and overall valuations appear reasonable. On a trailing price-to-book value basis, Asia ex-Japan as measured by the MSCI Asia ex Japan Index is currently trading around one standard deviation³ below its 10-year average. China—a market less impacted by the coronavirus—stands on a moderate premium to history. In contrast, some markets in Southeast Asia (MSCI EM ASEAN Index) appeared cheap, trading in late April at 25% to 35% below their 10-year average. It is there that we have been able to find some good investment opportunities as, from a bottom-up perspective, good quality companies were sold off indiscriminately during the coronavirus panic.

Asian Earnings May Suffer Less From COVID-19

(Fig. 3) Consensus earnings (EPS) growth estimates by region—2020



As of June 30, 2020.

Sources: FTSE Russell/FactSet and HSBC (see Additional Disclosures).

AxJ = FTSE All-World Asia Pacific x JP AU NZ, EM = FTSE All-World Emerging, Japan = FTSE Japan, U.S. = FTSE U.S., World = FTSE All-World, DM = FTSE All-World Developed, EMEA = FTSE All-World EMEA, EU = FTSE All-World Europe, LatAm = FTSE All-World Emerging Latin America.

Actual results may differ materially from estimates.

² The earnings upgrade ratio equals the number of analyst earnings estimate upgrades divided by the total number of analyst earnings estimate changes calculated as a one-month rolling average.

³ The standard deviation is a measure of the amount of variation or dispersion of a set of values around the mean of the series. A low standard deviation indicates the values tend to be close to the mean while a high standard deviation indicates the values are spread out over a wider range.

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Investment Themes in Asia Ex-Japan

We are not making any changes to our strategic approach to investing in Asian equities because of the coronavirus. We will continue to follow our rigorous method of seeking high-quality, cash-generative businesses run by strong management teams and holding them for the longer term to try to take advantage of their growth compounding potential. Our focus on companies with the potential for sustainable earnings growth naturally biases the fund toward companies with strong balance sheets. We believe our emphasis on balance sheet strength helped us to weather some of the stress in the first quarter sell-off.

The dislocation to Asian markets in February and March provided a rare opportunity to add positions in companies with good long-term prospects that had become heavily oversold during the market panic, trading at what we regarded as distressed valuations. There was a brief window at the height of the coronavirus fears when we could buy quality Asian companies at what we regarded as bargain basement prices. As always, new positions were driven by bottom-up stock fundamentals rather than by any strong top-down views. Chinese equities were quicker to recover than other Asian markets. This enabled us to employ some of our strong China performers where valuations appeared full after the rebound as a funding source for opportunities in other markets.

We believe many of the best opportunities were in Southeast Asia and, more recently, Hong Kong. The really sharp market corrections in these markets came later than in China. In all, we acquired 14 new holdings in the first quarter, which for us is an extraordinarily large number given our buy-and-hold investment style. Many of the new names

were quality stocks that had been on our radar screen for a long time but whose valuations had been unattractive until the coronavirus panic caused investors to sell them down indiscriminately. We also took the opportunity to add to positions in oversold quality names in Hong Kong, one of the region's worst-performing markets that has been hit by U.S.-China tensions and fear of renewed street protests as well as the coronavirus. An indication that the Hong Kong market had become oversold lies in the fact that a number of major listed companies have recently been buying back their shares.

As a result of the above changes, the fund is currently overweight the Philippines and Hong Kong. China switched from an overweight to a moderate underweight in terms of direct country exposure, though if one includes our Hong Kong exposure and some regional stocks with strong China exposure, such as a large wine company listed in Australia, then it is perhaps more accurate to say the fund is neutral Greater China.

Conclusion

We remain constructive on the long-term outlook for Asia ex-Japan equities, although we believe that global recovery from the disruption created by the coronavirus pandemic may turn out to be a gradual process. The recent market correction allowed us to build positions in a number of high-quality names that previously traded at much higher valuations. We continue to identify companies that we believe are well positioned to manage their way through the crisis and emerge in good shape once recovery takes hold. We think there is value to be recognized in many good businesses in Asia as global economic activity should gradually normalize over the next six to 12 months.



WHAT WE'RE WATCHING NEXT

We will look for signs that India and Southeast Asia are following Northeast Asia in bringing their coronavirus outbreaks under control. We will continue to search for high-quality Asian companies that can be acquired at undemanding valuations, run by strong management teams with the ability to generate durable earnings growth.

Additional Disclosure

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