Looking ahead: A deep dive into Asia

Following on from our 2021 Mid-year outlook report, our investment teams provide a deeper dive into Asia, offering their insights on the macro backdrop as well as the opportunities in the region over the next six months and beyond.

MACRO

How has Asia's vaccination roll-out impacted the outlook for the region?

At the start of 2021, Emerging Asia (EM Asia) in general appeared to be managing the COVID-19 outbreak better than the rest of world. Six months on however, EM Asia appears to be lagging in the vaccination rollout, which has in turn delayed the economic reopening in the region. On a brighter note, there appears to be some recent improvement, as more EM Asia countries secure vaccine supplies and vaccination programmes are being implemented in earnest. The two largest economies, China and India, are currently vaccinating their populations at an unprecedented pace. The majority of the populations in these two countries could be vaccinated by end of 2021 or early 2022.

The vaccination roll-out is particularly important for Asean as domestic demand accounts for a significant share of GDP. For example, domestic consumption makes up 68% and 73% of GDP for Vietnam and Philippines respectively. Economic activity in these countries can only pick up when vaccination rates rise and domestic consumption returns on the back of higher consumer confidence.

Chinese economic recovery appears to be losing momentum. Should investors be concerned?

The recovery in China's services sector has lagged the manufacturing sector as the government has imposed COVID-19 restrictions in selected cities when necessary. At the same time, Chinese household incomes have not been boosted to the same extent as in many of the developed countries, since Chinese policymakers have directed more of their stimulus towards infrastructure spending and corporate tax cuts, rather than direct transfers to households.

That said, China's PMI readings are still in expansionary territory. Investors would need to exercise care when comparing China's PMI indicators against the developed markets' as the Chinese economy did not contract as sharply in 2020 and was already recovering in the second quarter, when the downturn in many developed economies was still accelerating.

EQUITY MARKETS

The Chinese equity markets have underperformed developed and other Asian markets year to date. Does this present opportunities for investors?

The Chinese equity markets' underperformance must be taken in context against their earlier gains. In USD terms, the MSCI China Index returned 55% in 2019 and 2020, while the CSI-300 Index rallied 91%. The MSCI China Index is trading at 16x 12-month forward price to earnings[1]. Valuations look reasonable with earnings expected to grow 23% in 2021 and 15% in 2022. The same can be said for the CSI-300 Index which is trading at 15.3x 12-month forward price to earnings. Meanwhile earnings are expected to grow 23% and 13% in 2021 and 2022 respectively.

Regulatory headwinds have weighed on Chinese technology stocks in 2021, and valuations of selected stocks are looking increasing compelling, especially for investors with a longer-term horizon. Although the future direction of these headwinds are hard to predict, we believe that technology should be a core exposure in investors' portfolios as technological innovation and independence are key pillars in the Chinese government's growth agenda, and there is increasing support for domestic technological R&D. Meanwhile, with China being the largest Electric Vehicle (EV) market in the world, we are also seeing significant innovation from domestic companies within the EV supply chain.

Within China, we also like the Chinese property management and logistics companies as they continue to enjoy increasing demand for their services. In contrast to real estate developers, property management is an asset light business, and one that can earn stable streams of recurring income. Meanwhile, with the continuing rise in e-commerce in China, warehouse logistics have become increasingly important. The recent successful listing of nine new Chinese infrastructure real estate investment trusts (C-REITs) also presents interesting opportunities for investors while giving real estate companies access to more cost-effective capital.

What are the prospects for the Asean markets given their underperformance year to date?

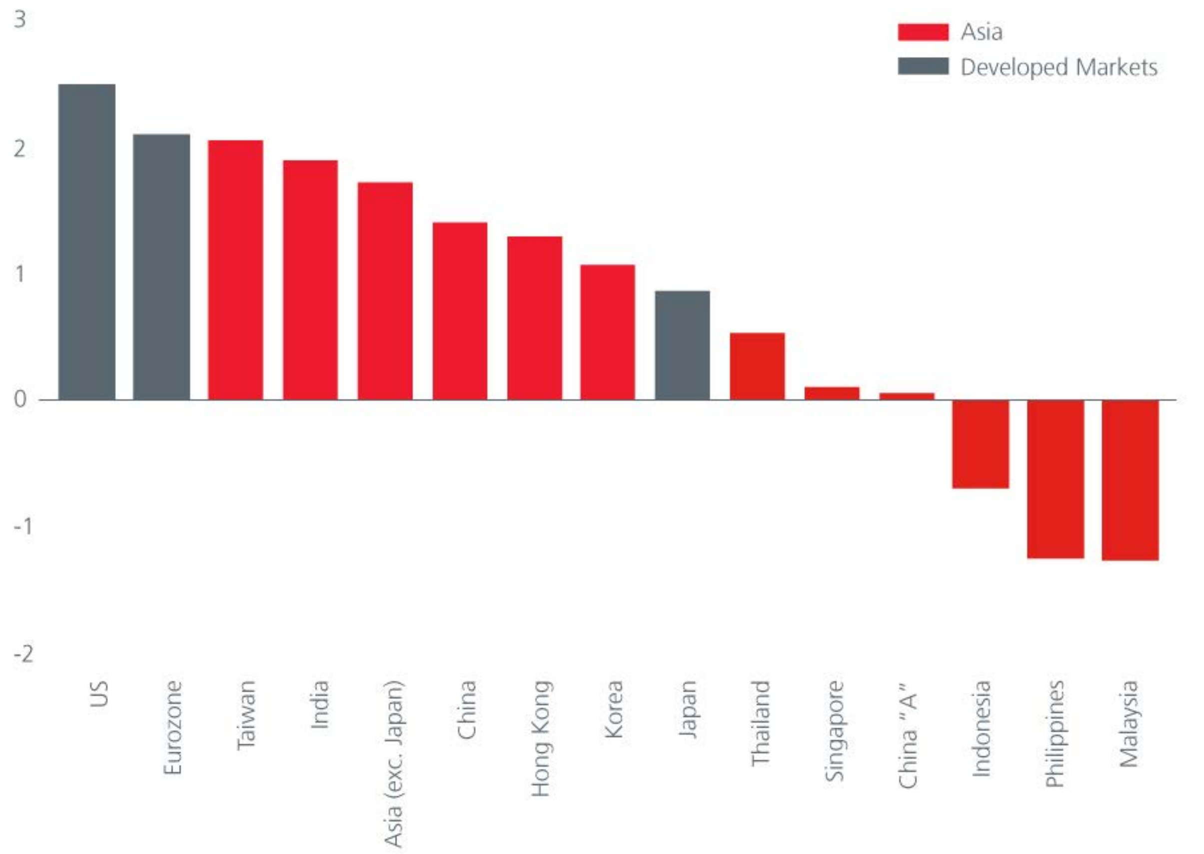
A delayed economic re-opening, poor handling of the COVID-19 outbreak and low vaccination rates have weighed on most Asean markets. Investors may have anticipated these markets to rally given expectations that commodity exporters would benefit from high commodity prices. As mentioned earlier, an accelerated vaccination roll-out is needed to lift domestic consumption in Asean, which can in turn increase economic activity and earnings. From a price-to-earnings perspective, Asean's valuations may look expensive since earnings are depressed. However, valuations look compelling should earnings normalise. From a price-to-book perspective, the Philippines market is trading at more than one standard deviation below its 10-year average. The Indonesian and Malaysian markets are also trading below their 10-year price-to-book averages, while the Singapore and Thai markets are trading in line with their historical averages. Fig. 1. If the political backdrop is stable, a potential rebound in consumer spending and attractive valuations underpin the long-term attractiveness of the Asean markets.

The Indian equity market has been resilient to date, despite news headlines focusing on the COVID-19 development in the country. Why is this so and what are the key drivers for the market going forward?

Despite COVID-19 developments, earnings have been in line for the Indian equity market. In 4QFY2021, 38% of MSCI India companies beat earnings expectations while another 38% of companies met expectations. This is largely because the Indian equity market has diverse sizable sectors that derive revenues from both within and outside of India. With regard to the COVID-19 vaccination roll out, 4.1%[2] of the Indian population is currently fully vaccinated, with 12% of the population

Source: [1]As of 26 June 2021. [2]Our World in Data. 30 June 2021. Fully vaccinated as in having two doses.

Fig 1: Price-to-book – Z-scores



Source: Refinitiv Datastream and MSCI for all except China"A", 17 June 2021. Z scores calculated based on 12-year rolling price to book.

having received at least one dose of the COVID-19 vaccination. The vaccine roll out is expected to accelerate following the Modi government's recent decision that everyone in India age 18 and up would be eligible for free COVID-19 shots. As vaccination rates pick up, economic activity and earnings will be further supported.

The Japanese equity market continues to trade at a relative discount to global peers. Is this a buying opportunity or a value trap?

Japanese equities have performed positively, though the market has generally lagged global peers year-to-date. Recent volatility in the domestic market may have been reflecting some concerns around the fourth coronavirus wave hitting Japan, ahead of the Olympics which is scheduled to start in July. Investors' general perception is that Japan is characterized by aging demographics as well as a low growth, low inflation and low interest rate environment. However, we believe this perception ignores the longer-term structural changes that underpin the improved fundamental health of corporate Japan. Gradual but steady corporate restructuring over the last decade has led to strong balance sheet health, which has consequently put Japan on a stronger footing to weather the major exogenous shock. This has helped Japanese corporates stay surprisingly resilient despite the pandemic.

On the macro front, the broader domestic economy has also shown surprising resilience. For example, we have observed a trend improvement in industrial production notwithstanding some short term volatility. Meanwhile the labour market has remained tight, with the unemployment rate at a relatively modest 2.8%.

While we have observed some near-term rotation in the market, the valuation dispersion between growth and value stocks remains very stretched. This provides a conducive environment for patient, fundamentally driven stock pickers like us. We believe that our disciplined process anchored around valuations, in addition to a patient time frame, is key not only to delivering outsized returns in the current environment but is also that which makes our strategy durable across time and cycles.

BOND MARKETS

Governments globally have taken on large amounts of debt to fund their stimulus programmes. Should we worry about elevated debt levels among Asian governments and corporates?

Compared to the developed markets, Asian governments have been more moderate in their fiscal stimulus programmes and have taken on less debt. China is a good example. In fact, its three-red line policy to rein in leverage in the property sector appears counter cyclical and China's shadow financing market has shrunk. The Chinese government is expected to continue its deleveraging efforts. Although this may create some volatility in the markets, it is unlikely to destabilise the Chinese financial system.

The 2021 default rate in Asia is expected to be only marginally above its historical average, a testament to Asia's leverage discipline. Fig.2. Despite the noisy headlines, defaults in the Chinese bond market in 2021 have kept to 2020's pace. That said, we note that the seven bond defaults we have witnessed in China year to date included larger companies that have significant market share in their sectors. This bears monitoring. We also note that in the Asian High Yield space, it is increasingly important for companies to communicate consistently and regularly with investors, to avoid becoming targets of speculative news and rumours which may hurt their bond prices.

As investors focus on when the Federal Reserve will start reducing its bond purchases, do Asian bond markets face the risk of another taper tantrum?

We expect the risk of a taper tantrum to be lower going forward. For one, any policy normalisation from the Federal Reserve is likely to be much better telegraphed compared to 2013. The pace of normalisation will also be much more gradual. At the same time, most bond funds appear better prepared with higher cash levels going into 2021. This suggests that institutional investors may look to take advantage of any taper-induced sell-off to increase their bond exposures, which would in turn temper the bond market's decline.

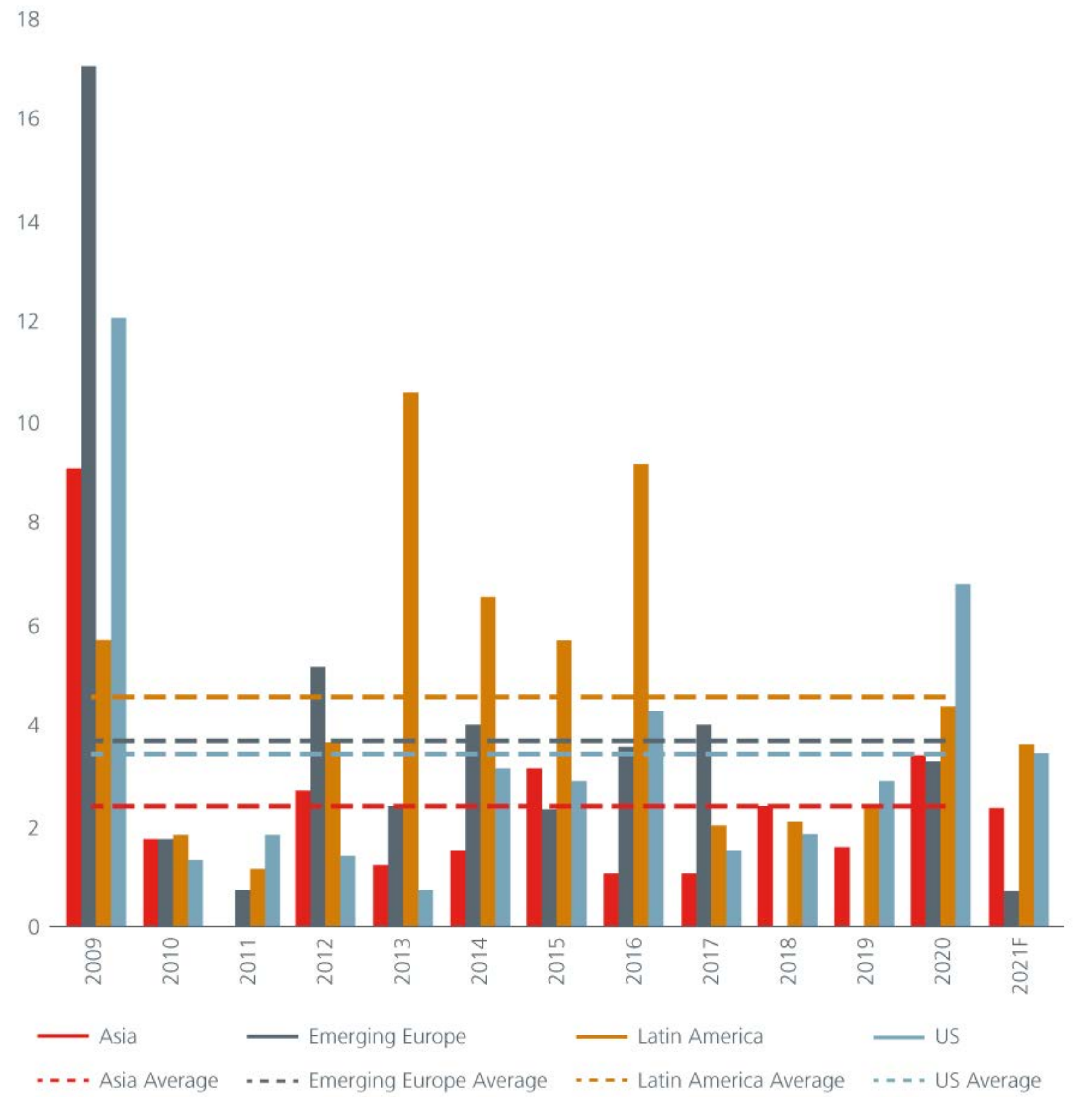
Asian High Yields and Asian corporate bonds have durations of around 3 and 5 years respectively, much lower than their US counterparts. This makes Asian bonds less vulnerable to rising bond yields. The higher income provided by Asian bonds also present investors with a greater buffer against rising yields, as seen from the positive returns which Asian High Yields were still able to generate in the first quarter of 2021. Asian sustainable bonds are also likely to be more resilient to rising US yields given strong investor demand and limited supply.

The Chinese government bond market is gradually being added to global bond indices and has enjoyed strong inflows in 2021. Why should investors consider Chinese bonds?

The Chinese government bond market is becoming too large for investors to ignore. The market has become more accessible and more internationalised. It is less correlated to other developed and Asian government bond markets, hence offering investors greater diversification. It also offers higher yields relative to other developed and many other Asian bond markets. In addition, investors can benefit from potential RMB appreciation.

We would like to thank Dean Cashman, Goh Rong Ren, John Tsai, Leong Wai Mei, Michelle Qi and Pearly Yap for their insights and inputs into this article.

Fig 2: Asia's default rates expected to remain manageable in 2021



Source: JP Morgan, January 2021 based on par value of defaulted bonds and excluding 100% quasi-sovereigns. Note: Average default rates are calculated from 2009 -2019.

Disclaimer

This document is produced by Eastspring Investments (Singapore) Limited and issued in:

Singapore and Australia (for wholesale clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore, is exempt from the requirement to hold an Australian financial services licence and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Australian laws.

Hong Kong by Eastspring Investments (Hong Kong) Limited and has not been reviewed by the Securities and Futures Commission of Hong Kong.

Indonesia by PT Eastspring Investments Indonesia, an investment manager that is licensed, registered and supervised by the Indonesia Financial Services Authority (OJK).

Malaysia by Eastspring Investments Berhad (531241-U).

This document is produced by Eastspring Investments (Singapore) Limited and issued in Thailand by TMB Asset Management Co., Ltd. Investment contains certain risks; investors are advised to carefully study the related information before investing. The past performance of any the fund is not indicative of future performance.

United States of America (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is registered with the U.S Securities and Exchange Commission as a registered investment adviser.

European Economic Area (for professional clients only) and Switzerland (for qualified investors only) by Eastspring Investments (Luxembourg) S.A., 26, Boulevard Royal, 2449 Luxembourg, Grand-Duchy of Luxembourg, registered with the Registre de Commerce et des Sociétés (Luxembourg), Register No B 173737.

United Kingdom (for professional clients only) by Eastspring Investments (Luxembourg) S.A. - UK Branch, 10 Lower Thames Street, London EC3R 6AF.

Chile (for institutional clients only) by Eastspring Investments (Singapore) Limited (UEN: 199407631H), which is incorporated in Singapore and is licensed and regulated by the Monetary Authority of Singapore under Singapore laws which differ from Chilean laws.

The afore-mentioned entities are hereinafter collectively referred to as **Eastspring Investments**.

The views and opinions contained herein are those of the author on this page, and may not necessarily represent views expressed or reflected in other Eastspring Investments' communications. This document is solely for information purposes and does not have any regard to the specific investment objective, financial situation and/or particular needs of any specific persons who may receive this document. This document is not intended as an offer, a solicitation of offer or a recommendation, to deal in shares of securities or any financial instruments. It may not be published, circulated, reproduced or distributed without the prior written consent of Eastspring Investments. Reliance upon information in this posting is at the sole discretion of the reader. Please consult your own professional adviser before investing.

Investment involves risk. Past performance and the predictions, projections, or forecasts on the economy, securities markets or the economic trends of the markets are not necessarily indicative of the future or likely performance of Eastspring Investments or any of the funds managed by Eastspring Investments.

Information herein is believed to be reliable at time of publication. Data from third party sources may have been used in the preparation of this material and Eastspring Investments has not independently verified, validated or audited such data. Where lawfully permitted, Eastspring Investments does not warrant its completeness or accuracy and is not responsible for error of facts or opinion nor shall be liable for damages arising out of any person's reliance upon this information. Any opinion or estimate contained in this document may subject to change without notice.

Eastspring Investments (excluding JV companies) companies are ultimately wholly-owned/indirect subsidiaries/associate of Prudential plc of the United Kingdom. Eastspring Investments companies (including JV's) and Prudential plc are not affiliated in any manner with Prudential Financial, Inc., a company whose principal place of business is in the United States of America or with the Prudential Assurance Company, a subsidiary of M&G plc (a company incorporated in the United Kingdom).

eastspring investments

A member of Prudential plc (UK)