eastspring investments

A member of Prudential plc (UK)

Focus on ASEAN's longer-term potential

Bryan Yeong, Portfolio Manager, Eastspring Investments, Singapore

ASEAN markets have not been spared the dreadful effects of the pandemic, with structural factors and reliance on global trade adding to their burden. However, if we look beneath the dreary headlines, it becomes apparent the COVID-19 cloud is obscuring the bloc's longer-term potential.

Most ASEAN countries – except for Indonesia and the Philippines – have seen significant success in containing the virus' spread[1]. The economy, however, is a different story. Second-quarter GDP numbers, measured on a year-on-year basis, are displaying double-digit yearly declines across the board. The worst performer is Malaysia, with a 17.1% drop[2], but its neighbours are not too far behind. Singapore's GDP fell by 13.2%, Thailand's by 12.2%, and the Philippines by 16.5%[345].

That said, there are outliers – namely Indonesia and Vietnam. Indonesia saw its second-quarter GDP dip by only 5.32%, while Vietnam held on to a sliver of growth with a positive 0.36% showing[67]. Still, the overall picture painted by the top-line economic data looks gloomy. The Asian Development Bank (ADB) has progressively downgraded its full-year 2020 GDP forecast for the region and now expects a 3.8% overall contraction[8].

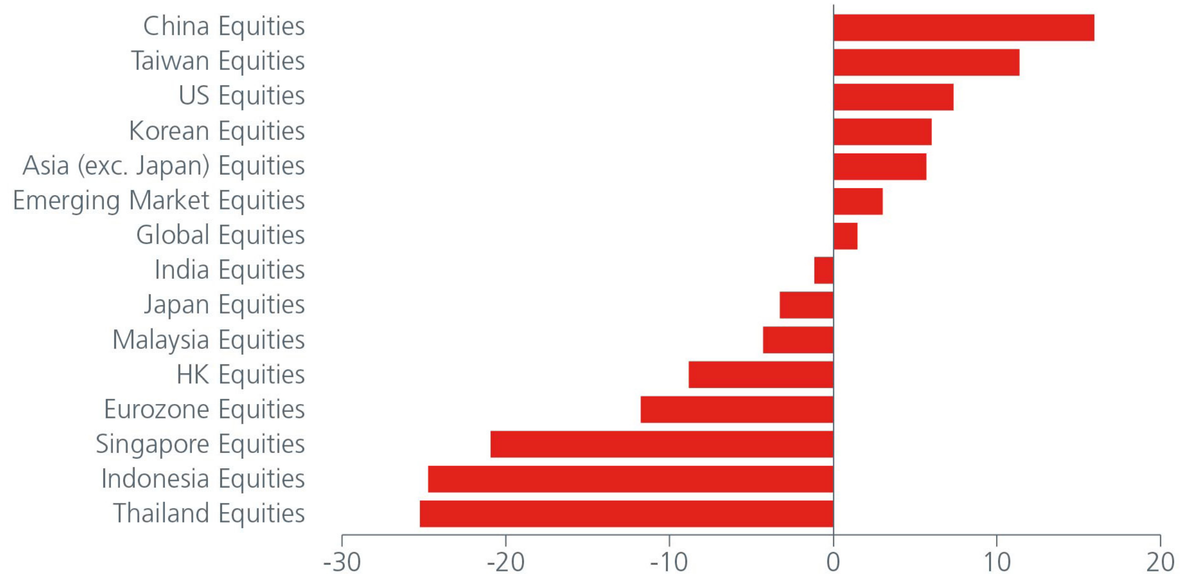
Fig 1: GDP growth rate, % per year

	2018	2019	2020F	2021F
Brunei	0.1	3.9	1.4	3.0
Cambodia	7.5	7.1	-4.0	5.9
Indonesia	5.2	5.0	-1.0	5.3
Laos	6.2	5.0	-2.5	4.5
Malaysia	4.8	4.3	-5.0	6.5
Myanmar	6.4	6.8	1.8	6.0
Philippines	6.3	6.0	-7.3	6.5
Singapore	3.4	0.7	-6.2	4.5
Thailand	4.2	2.4	-8.0	4.5
Vietnam	7.1	7.0	1.8	6.3
South East Asia	5.1	4.4	-3.8	5.5

Source: Asian Development Bank as at 30 Sep 2020

Source: [1]https://www.worldometers.info/coronavirus/#countries. [2]https://asia.nikkei.com/Economy/Malaysia-GDP-plunges-record-17.1-in-Q2-under-pandemic-pressure. [3]https://www.reuters.com/article/thailand-economy-gdp/thai-q2-gdp-shrinks-12-2-y-y-weakest-in-22-years-idUSB7N2DZ008. [4]https://www.cnbc.com/2020/08/11/singapore-releases-second-quarter-2020-gdp-economic-data.html. [5]https://www.thestar.com.my/aseanplus/aseanplus-news/2020/08/06/philippines-gdp-shrank-165-in-q2-enters-technical-recession. [6]https://www.thejakartapost.com/news/2020/08/05/indonesias-gdp-contracts-deeper-than-expected-at-5-32-in-q2.html. [7]https://asia.nikkei.com/Economy/Vietnam-Q2-GDP-growth-slows-to-0.36-due-to-pandemic. [8]https://www.adb.org/sites/default/files/publication/635666/ado2020-update.pdf

Fig. 2: Year-to-date returns of global equities in local currency terms



Source: Refinitiv Datastream as at 30 Sep 2020

This trend has also been reflected in the stock markets. Asian equities have partially recovered from March lows, mirroring the global trend. But the extent of the revival in South East Asia has trailed that of other markets such as the China, Taiwan and Korea.

WHY HAS ASEAN BEEN SO BADLY HIT?

Trying to pinpoint any single issue as the primary reason why the pandemic has so negatively impacted ASEAN isn't so straightforward. Here are several factors that could have contributed.

- **Less effective pandemic response -** ASEAN's pandemic containment measures pales in comparison to its North Asian neighbours.
- **Strong tourism dependence -** Countries like Thailand, Philippines, Cambodia, and Singapore all rely heavily on the now crippled tourism industry[9].
- **A lack of tech exposure -** The tech industry has been the year's most robust performing sector. But outside of Singapore, ASEAN generally has little exposure to this sector.
- **High exposure to financials -** The region has high exposure to the financial sector which has been hit hard given the exposure to the economy and credit cycle
- **Lower liquidity -** The year has seen highly liquid, high-growth large-caps outperform, a segment that is also generally lacking in the ASEAN market.

All these point toward a grim economic outlook for the ASEAN markets – at least in the near term. The question is whether such short-term headwinds will translate to a dim medium or even long-term outlook.

We think not. We already see signs of bottoming out, with the ADB progressively increasing its 2021 GDP forecast for Asia – even as it decreased its GDP forecast for this year. Indeed, it now expects the region to post a 5.5% GDP growth for 2021.

Source: [9]https://knoema.com/atlas/topics/Tourism/Travel-and-Tourism-Total-Contribution-to-GDP/Contribution-of-travel-and-tourism-to-GDP-percent-of-GDP

ASEAN IN PRIME POSITION TO BE THE "PLUS ONE"

The pandemic has forced companies worldwide to recognise the importance of building resilient supply chains to decrease concentration risks. In short, move away from relying on the commercially efficient "just in time" global supply chains toward "just in case" localised supply chains. It thus entails diversifying away from China and adopting the "China Plus One" strategy.

To be sure, China's ability to resume production quickly post COVID-19 and other inherent advantages like a large domestic market, well-developed infrastructure and a supply-chain ecosystem mean that existing production facilities are unlikely to relocate out of China in a hurry. However, there is likely a bigger inclination to put incremental capacity expansion outside of China given the ongoing US-China tensions. Location, favourable demographics, and continually improving manufacturing capabilities, suggest that the ASEAN bloc is in a prime position to be that "plus one".

Ratings agency Moody's has noted that trade diversification is "likely to favour ASEAN economies over time"[10]. Meanwhile, global consulting firm McKinsey has described South-East Asia as a "leading alternative" to China for labour-intensive manufacturing and lists it as a critical lever for speeding up the economic recovery, in addition to laying the foundation for future growth[11].

Two other significant catalysts also support the region's potential: greater integration and faster digitalisation.

GREATER REGIONAL INTEGRATION TO BOOST GROWTH

Policy makers in ASEAN are cognizant that it is even more important now to advance regional integration, remain committed to an open and rules-based regional economic environment, as well as build a more resilient and integrated ASEAN supply chain. In fact, the multi-country group is stepping up cooperation efforts, making it an outlier that could stand to reap even greater benefits from the diversification of global trade flows.

One example is the ASEAN-Wide Self Certification (AWSC) scheme[12]. This scheme – recently implemented on 20 September 2020 – allows member states to self-declare the origin of their exports instead of going through a lengthy bureaucratic process. It is expected to further decrease friction in local trade, which will help strengthen the integrity and resiliency of supply chains. On a more global level, trade agreements such as the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and Regional Comprehensive Economic Partnership (RCEP) are also on the menu.

Such free trade agreements are an explicit form of driving greater economic participation and growth. But there is a more subtle impetus that can also boost growth in the region – digitalisation.

FASTER DIGITALISATION TO DRIVE CROSS-BORDER TRADE

Before the pandemic struck, ASEAN had significant "digital gaps", with the OECD noting that Internet usage among its members was over 30 percentage points lower compared to the OECD average[13]. Asian governments have hastened actions to close the digital divide. For example, Singapore recently signed "digital economy pacts" with Australia, Chile, South Korea, and New Zealand, which will enable digitalisation of trade processes and facilitate more significant cross-border trade. China is already planning to invest over US$3.5 billion to build a China-ASEAN Digital Trade Centre to promote greater digital economic cooperation.

Source: [10]https://www.moodys.com/research/Moodys-Global-supply-chain-shifts-will-have-mixed-credit-implications--PBC_1242716. [11]https://www.mckinsey.com/featured-insights/asia-pacific/reimagining-emerging-asean-in-the-wake-of-covid-19. [12]https://www.customs.gov.sg/businesses/certificates-of-origin/awsc. [13] https://www.oecd.org/going-digital/southeast-asia-connecting-SMEs.pdf

The pandemic has swiftly pushed ASEAN's digitalisation strategy from the "nice to have" to the "must have" category, and businesses – particularly small and medium sized enterprises (SMEs) – have had to scramble to keep up. But it is not without its risks. McKinsey's research has found that the top 10% of companies capture 60% to 95% of a sector's digital revenues[14]. And with ASEAN SMEs comprising over 88% of all enterprises, responsible for over half of total employment, and contributing more than 30% of GDP, a growing digital divide for SMEs would be detrimental for the bloc's economic recovery[15].

However, should the divide begin to narrow, it could also translate to additional revenues – and thus GDP. A study by Google, Temasek, and Bain & Company put the size of ASEAN's Internet economy at US$100 billion in 2019 and predicts it to triple by 2025[16].

STRUCTURAL FACTORS WEIGH ON ASEAN ECONOMIES

With the global outlook remaining cloudy, we believe local factors (i.e. debt, demographics and reforms) will play a more important role in differentiating the medium-term structural growth outlook for the respective ASEAN economies.

For instance, Indonesia's and Philippines' virus containment measures have not been as effective but lower exposure to global recession, relatively high structural growth, and the policy easing suggests these countries can recover sooner. Their lower debt to GDP ratio and favourable demographics also suggests lesser headwinds from deleveraging and deglobalisation.

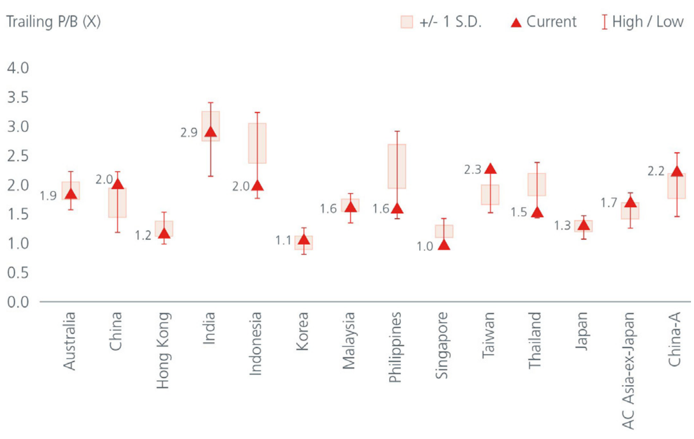
Despite an ageing populace and an export-oriented economy, Singapore's good track record of rolling out growth-boosting initiatives, and the current focus on accelerating digital transformation and raising productivity will likely counter demographic headwinds. And Vietnam is one of the leading beneficiaries of the "China Plus One" strategy. Meanwhile, Malaysia and Thailand are currently grappling with political uncertainty, which may hinder progress on needed reform measures. Further, Thailand's heavy reliance on tourism revenue will weigh on Thailand's recovery path.

In view of the bloc's uneven recovery outlook, ground-level insights and determining commiserate market valuations are crucial to uncover and exploit the opportunities.

KNOWING WHERE TO LOOK MATTERS

To be sure, corporate earnings and economies will continue to see the effects of the pandemic in the short to medium-term. However, the long-term fundamentals of the region remain intact and hence the the price-to-book valuation measure may more useful at this point; on this basis, most ASEAN markets are trading below their 5-year historical average. This suggests opportunities for the discerning investor.

Fig. 3: Price-to-book ratio versus the 5-year historical range



Source: Refinitiv Datastream and Eastspring Investments as at 30 Sep 2020

Source: [14]https://www.mckinsey.com/business-functions/organization/our-insights/unlocking-success-in-digital-transformations. [15]https://asean.org/asean-economic-community/sectoral-bodies-under-the-purview-of-aem/micro-small-and-medium-enterprises/overview/. [16]https://www.blog.google/documents/47/SEA_Internet_Economy_Report_2019.pdf eastspring investments

A member of Prudential plc (UK)

For instance, Singapore's valuations remain attractive compared to regional peers. While its open economy remains vulnerable to external factors, we believe the country remains a strong hub for intra-Asia growth and enjoys a safe haven status backed by a favourable fiscal position, large reserves and a stable currency. Within our Singapore equity portfolios, we are overweight in Consumer Staples.

In the Philippines, we are focussed on attractively valued mid-caps and off-benchmark opportunities amidst the rich valuation of large-caps. We are constructive on the long-term outlook in view of the country's favourable demographics and healthy macro fundamentals, plus the fact the country has room for both fiscal stimulus and monetary easing.

Disruption from the pandemic is expected to last several quarters and impact near-term earnings, but is unlikely to derail Indonesia's long-term structural growth. With low public debt ratio and benign inflation, the country has room for both fiscal stimulus and monetary easing. We are overweight Real Estate stocks.

Over in Malaysia, certain sectors of the markets that benefited from the coronavirus pandemic, such as glovemakers, have seen valuations rising to a premium relative to history. Nonetheless we expect private consumption to be resilient due to stable labour market and commodity prices and as such are overweight the Consumer Discretionary sector.

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).