The future looks bright for Asia's equity markets

Asian markets poised to outperform with the region set to play an even bigger part in the global economy

2 November 2022

By the Asian Equity Team

Introduction

Global markets, including many Asian stock markets, have faced many bumps in 2022. While there have been some notable standouts such as India and Indonesia, the region's overall performance has been poor. At the turn of 2021, some investors had hoped for a rosier year ahead. But such a view has so far proved to be rather optimistic, with the MSCI All Country World Index remaining volatile and down over 20% year-to-date. For global markets, the outlook heading into the remainder of 2022 is likely to be driven by developments including central banks' policy decisions and geopolitical issues like the Russia-Ukraine war. However, beyond the gloomy outlook, we believe that long-term opportunities exist for investors in the region. Asia continues to offer opportunities in terms of attractive companies, and in our view the region will remain the world's growth engine over the long term.

Asian consumption to power the world

Asia is in prime position to assume the role of the world's consumption growth engine, as Asian consumers are expected to account for half of global consumption growth over the near future. Despite claims from Elon Musk regarding an imminent "population collapse", the world's population is still climbing. According to the United Nations, the world's population is projected to surpass eight billion in November of 2022 and grow to around 8.5 billion in 2030[1], and Asia stands to benefit the most from this trend. Beyond sheer numbers, growing affluence is another decisive element, as level of economic growth and profits matter for markets. Asia's major economies now have well-developed capital markets, and their economic policy making decisions have been on par with, and in some cases, arguably stronger than those of their developed economy peers. Potential growth rates are also much higher than in more developed markets. Hence, the rise in private wealth in Asia and the resulting changing consumption patterns remain another area of focus.

The fact is the world is aging, and the baby boomers are exiting the global workforce. The world has benefitted from lower inflation levels as production shifted to low-cost manufacturing in Asia, and now, the impact of global labour/workers shortages are more pronounced for businesses around the world. ASEAN's and India's workers are in a good position to contribute to, as well as benefit from, producing the goods that the world needs. A significant part of Asia's population is comparatively younger than other parts of the world—and it is the youth who are more adaptable to and welcome speedy changes. A large population of younger individuals also represents a more attractive balance between working age populations and retired workers. Successful companies capitalise on such

[1] United Nations. *2022 Revision of World Population Prospects*. 2022.

changes and use these trends to improve their performance. Furthermore, growing populations also mean a larger market demand for products and services.

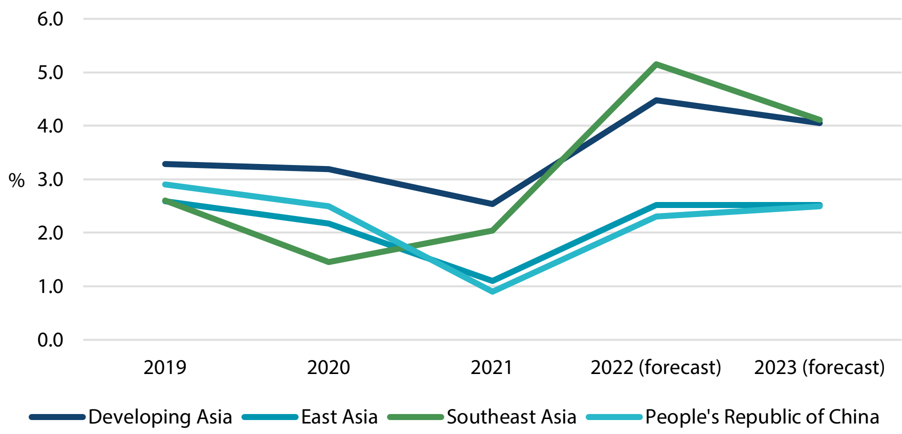
Stay the course with Asian equities

China is arguably already one of the driving forces for global growth. The Chinese market is driven by different factors and requires other methods of analysis, but it has the advantage of lower correlation with other markets. However, it is interesting to observe that despite the extraordinary growth in the Chinese economy over the last decade, the Indian and the Taiwanese share markets have outperformed China, and China is in fact lagging slightly behind the Asia-ex-Japan Index. The key ingredients for successes in India and Taiwan are exceptionally well-managed companies (such as India's Reliance and HDFC Bank, Taiwan's Taiwan Semiconductor Manufacturing Company) that adapt well to changes and use capital efficiently, enabling them to become world-leaders in their respective fields.

We also like other sweet spots and key drivers to Asia's future growth, such as:

- The global move to net zero which needs equipment made in Asia. Many countries are well-positioned to take advantage of potential net zero transition opportunities because they are rich in natural, human and technological capital. Such capital includes renewable-power potential, forestry potential and mineral reserves.
- Inflation has reared its ugly head globally, sending markets into a tailspin and leaving a serious imprint on economies across the world. Many parts of Asia are also feeling the strain though we believe that the inflation spike in Asia should be transitory, so there are lesser risks towards tightening measures compared to the Western economies. The Asian Development Bank has lifted its inflation forecasts from 3.7% to 4.5% for 2022 and from 3.1% to 4.0% for 2023 due to higher energy and food prices[2]. Despite such upward revisions, inflationary pressures in developing Asia are expected to remain less severe than their global peers. At the bottom line, the inflation narrative in advanced economies—including the US and the Eurozone— does not quite fit Asia. While not all forms of inflationary pressure can be avoided, the severity of supply-chain bottlenecks and surge in food prices do vary across regions.

Chart 1: Inflation rates across Asia



Source: Asian Development Bank Data Library, 2022.

- Asia's regulatory and business landscape continues to advance in terms of environmental, social and governance (ESG) adoption. This is crucial as ESG disclosure in Asia remains uneven across the region. Such uptake and improvements in ESG standards should result in higher-quality ESG data across Asia in the next few years, which allows investors to better assess the risks and opportunities that are present across Asia's equity markets.
- The continued digitisation of the world, and technological developments such as the metaverse. Asia unsurprisingly produces the hardware, but it also leads research and developments (R&D) in the digital frontier. For instance, South Korea has been pouring money into the metaverse and has plans to nurture professionals

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[2] Asian Development Bank. *Asian Development Outlook Update (ADOU) 2022*. September 2022.

and companies to specialise in metaverse technology. We can also expect investments in innovation and R&D to play a significant role in the net zero transition, and many Asian countries such as China, Japan, Singapore and South Korea are well-placed in this respect as they spend a significant proportion on R&D as a percentage of their GDP.

Appetite for China hinges on its policies

Investors have rightfully expressed "deep" concerns over China's economic slowdown, softening exports, technological regulatory crackdown and rapidly souring relations with the West. However, the Chinese top brass is looking to reflate economic growth as the 20th National Congress of the Chinese Communist Party wrapped up on 22 October. The work report outlined President Xi Jinping's common prosperity initiative, along with his vision of green development and greater self-reliance in science and technology. Chinese policymakers over the past months have started to attempt arresting its property slump, along with deploying an expansive fiscal policy. Due to China's relatively moderate level of inflation, the central bank can be more supportive by easing monetary conditions further.

The supportive policy backdrop should have helped the Chinese economy withstand downward pressure. However, the positive impact has so far been outweighed by the heavy toll stemming from the country's zero-COVID policy. It has become evident that the economic and social costs from sticking to its guns when it comes to the zero-tolerance approach has hit the Chinese economy, hurting consumption and investment.

We should still recognise that China remains the second largest economy in the world. Companies recognise the importance of this fact, whether they are iron ore miners like BHP and Rio Tinto, or technology companies like Apple, or even F&B companies like Starbucks or Yum! Brands. Investors are also in reality indirectly exposed to China, as a number of companies in developed market portfolios have a large exposure to the country.

Secondly, there is more than one China market. There is a difference between US-listed Chinese stocks compared to H-shares (referring to companies incorporated in mainland China that are traded on the Hong Kong Stock Exchange), which is again dissimilar to A-shares (domestic shares that are denominated in renminbi and traded in the Shanghai and Shenzhen stock exchanges). Many of the US-listed companies are operating under the variable interest entity structure, where more regulatory risk exists. To assess the risk adequately, investors should not expect such Chinese regulation to be the same as US regulation.

Ultimately, the Chinese government wants to ensure a competitive and well-functioning capital market and shift its reliance to equity markets instead of bank debt. The overall direction of Chinese government policies and the industries that they have deemed as the cornerstones of the policy direction are clear. Therefore, we believe that investors with the right research on the ground in China and with a methodical process that tries to understand Chinese policy developments stand to benefit from investing in Chinese A- and H-shares.

Asia's pain before the gain

To put it simply—there are risks in all markets. Unfortunately, few assets these days are entirely free of risks. Russia's invasion of Ukraine was a risk that in hindsight almost all investors ignored. Political risks exist everywhere; Donald Trump could become the US president again and implement drastic policy changes. Hence, we believe that anticipating change, understanding change and acting on that are vital for finding success in Asia, and convert what some see as challenges into opportunities.

Recent Asian market weakness has also been exacerbated by the continuous rise of the US dollar against other foreign currencies, tightening financial conditions globally. As the world's reserve currency, the dollar appeals to investors as a refuge during periods of global economic uncertainty. This is compounded by the fact that policy decisions made in the US often reverberate widely. Consequently, every lurch upwards by the dollar is helping to feed inflation in other regions. While Europe is bearing the brunt and inching closer to recession, Asia is impacted as well.

Asia has historically been an exporter of goods to the West, and it has reacted negatively to a tightening cycle by the US Federal Reserve. However, this time around, Asia's future is much more about its own consumption narrative and the global move towards net zero, so it should be less impacted by a slowdown in the US. The interest rate connection also seems much weaker. Asian inflation pressures are rising, but generally less than in the US and other Western countries. Hence, we should see relatively lesser policy tightening in Asia, and in fact, China is easing monetary policy to shore up its economic growth. On a relative basis, Asian markets look set to outperform as the region becomes an even more important part of the global economy.

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