2023 Asian equity outlook

Seeing strengths in Asia amid broader uncertainties

By the Asian Equity Team
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It was the best of times, it was the worst of times…

“Whatever it is, it’s better in the wind”[1]. That’s why riding a motorcycle is different from driving a car. Still not convinced?! “On a cycle the frame is gone. You’re completely in contact with it all. You’re in the scene, not just watching it anymore, and the sense of presence is overwhelming”. Robert Pirsig puts its perfectly in his book *Zen and the Art of Motorcycle Maintenance*.

Having taken a fair share of beating at the bourses this year, a diversion was needed, which came in the form of Pirsig’s book. The book discusses the romantic (i.e. what things are) and classical (i.e. what things mean) views, and proposes an approach to bridge the dichotomy. While reading the book, I started to draw parallels with investing. Ironic, since the primary reason for picking up the book was as a diversion from investing! Investors, like the author, seek to combine the “what is” and the “what it means” to identify the “best” opportunities (“excellence” or aretḗ in Greek is how the author puts it). Because this eventual goal is broadly true for all investors regardless of investment process, horizon, or strategy, the book has many a useful lesson. Of the many quote-worthy lines in the book, included here a few that are particularly relevant to investing—mental fortitude, process integrity[2], and building teams; they are all self-explanatory.

> “Is it hard? Not if you have the right attitudes. It’s having the right attitudes that’s hard”.
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> “The real purpose of the scientific method is to make sure nature hasn’t misled you into thinking you know something you actually don’t know”.
>
> “The place to improve the world is first in one’s own heart and head and hands, and then work outward from there”.
>
> “…every teacher tends to grade up students who resemble him the most”.
>
> “We always condemn most in others, he thought, that which we fear most in ourselves”.

Lest you feel short-changed by a handful of pithy quotes from a book you might never read, outlined forthwith is our read of Asian equity markets in 2023.

Geopolitical fault lines are so deeply drawn now that any hope of a full reconciliation between the US and China appears to be in the realm of fantasy. Consequently, national agendas which were already beginning to surface in the early days of the COVID pandemic are gaining prominence. Energy security has taken centre stage even as the world relies on global energy supply chains. The climate agenda is certainly not to be pooh-poohed at; here too, functioning global supply chains will be critical. There is ongoing debate as to the stickiness of inflation, and the economic pain the world needs to reckon with before signs of a recovery become visible. Asset markets appear preoccupied with guessing what the Federal Reserve is itself guessing—when will inflation ebb enough to hold/ease interest rates?

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[1] A quote by Ralph Waldo Emerson
[2] For details on Nikko Asset Management Asia’ investment process, please refer to the article "Harvesting Growth, Harnessing Change".

It is easy to be overwhelmed by the permutations of possible outcomes. But things don't appear so dire in Asia. Inflation, which is effectively a value transfer from net consumers to net producers, may continue to benefit India and pockets of ASEAN due to favourable demographics and rising productivity. Indeed, inflation has slowed in Asia since 1990 owing to a combination of monetary and fiscal factors. Cheap and reliable energy is crucial for economic growth in the long run. China's economic miracle was a coal miracle as was Europe's; recently, the US has benefited from a shale revolution. India and China can buy cheap energy from Russia, moral hazard aside, and most Asian economies have relatively young energy infrastructure that is increasingly going "green". Accelerated infrastructure building is expected to raise productive capacity, and if funded by fiscal deficits and foreign capital seeking higher returns than is available in developed markets, it may keep inflation in control.

1984 no more?

The 20th National Party Congress affirmed Chinese President Xi Jinping's preeminent position in China's Communist Party and granted him a third presidential term. His grip on power remains firm, dispelling any illusions of collective party leadership and perhaps disappointing some quarters.

Although *1984*, George Orwell's seminal dystopian novel, tends to remind readers of Stalinist Russia and more recently, China, Orwell himself explained that the novel was not an attack on any particular government but a satire of totalitarian tendencies in society and was a warning against complacency. Indeed, Trumpian behaviours remain fresh in our memories. It is worth noting that development and reforms continue to dominate the Chinese narrative—after all, the ruling party's political legitimacy is reliant on economic development and improving the lives of its citizens. This is underscored by the recent easing of COVID restrictions in response to unprecedented popular discontent.

While's China labour productivity has increased by 16% annually over the last 10 years, wage levels in China today are 20 times higher than they were in 1992, making automated assembly lines more compelling than in the past. A robot is virtually at cost parity with a human worker in China now. Thus, President Xi is focused on "high quality development" and the need to bolster capability and innovation, especially in areas critical to China's national interests. For example, China aims to digitize 70% of manufacturing companies above a designated size.

We prefer areas that are broadly aligned with these strategic imperatives—energy security, greater self-sufficiency, improving cost of living and domestic consumption.

Divergent, or convergent?

President Xi also reiterated the desire for a "complete reunification of the Chinese nation"—a euphemism for China's desire to take Taiwan back under its fold. If Russia's invasion of Ukraine has taught us anything, it is to never completely discount such a possibility. Nonetheless, this is not our base case for the foreseeable future, where our concern is the demand headwinds affecting consumer technology, a mainstay of Taiwanese exports. This latter concern also extends to South Korea. The easing of Chinese COVID-related restrictions ought to benefit both countries—albeit offset to an extent by a slowdown in US demand.

With technology becoming an ever-greater part of our lives, semiconductor technology, and its supply chain, will remain important. Both Taiwan and South Korea will remain critical in this regard.

We find idiosyncratic opportunities in integrated circuit design, healthcare, and energy infrastructure in these markets.

A Suitable Boy

Vikram Seth's magnum opus, *A Suitable Boy*, is a tale of a complex society experiencing change—not just generational change, but societal and cultural change—with nuanced themes and subtext. While the 1400-page novel is set in India in the 1950s, it could just as easily apply to contemporary India.

The world's 5th largest economy is likely to enjoy political stability akin to the 1950s; Prime Minister Narendra Modi is expected to win a third term just as Xi Jinping recently did, but for one small difference—India is the world's largest democracy! This bodes well for policy continuity. Being the only large economy that has diplomatic relations with the US, countries in the Middle East and Russia, also offers geopolitical cache, particularly as a potential US ally to counter China's influence in Asia.

India has surpassed every nation, including China and the US, in digital financial transactions. This is extraordinary for a country which was heavily cash-reliant until just six years ago. Nearly a quarter of India's energy is now green, with renewable energy tariffs competitive vs. fossil fuel derived energy. And Asia's richest men, Gautam Adani and Mukesh Ambani, have committed billions of dollars to develop green energy and the attendant supply chain. The recently introduced PLI (Production Linked Incentive) Scheme has seen active take-up and is attracting genuine investment into the country as part of global China+1 supply chain reconfigurations. The financial savings rate, even at a historical high of 16% in FY21, is well below the global averages and hints at its still immense potential on account of its favourable demographics.

We have a favourable view of banks and consumption.

Unfinished Nation(s)?

The soap opera that is Malaysian politics, and its slightly more insipid version that is playing out in Thailand, leave us wanting. Should things improve on this front, there are pockets in the technology and electric vehicle supply chain in these countries that could emerge as attractive. Singapore's political stability is certainly a welcome change compared to the developments at its northern neighbours, but the majority of its equity market's fortunes are reliant on economic developments around the region.

As such, Indonesia and, to a lesser extent, the Philippines appear in the limelight.

It is worth noting that manufacturing doesn't exist in a vacuum; there is an entire supply chain tied to it. Reconfiguring an entire supply chain is therefore more than just building manufacturing capacity in a new location—it takes time! But once accomplished, it has a much larger impact on the economy that originally estimated. Indonesia is critical to the world electrifying transport owing to its nickel deposits. By focusing on a long-term vision, Indonesia has seen a 19-fold ramp-up in nickel exports in the past decade and has attracted battery making onshore; these projects have pulled in more than USD 25 billion in investments. Only 20% of the workforce in Indonesia is formally employed; the formalisation of its large workforce should improve economic productivity even as foreign capital seeks opportunities here.

The Philippines boasts a large, young, English-speaking population that is enjoying steadily improving access to financial services through digital means. By steadily increasing its reliance on locally developed "green" energy, the reliance on energy imports will likely decline from the current 2–3% of GDP.

Renewable energy businesses, and electric vehicle materials and the related supply chains are areas we are most enthused by in the ASEAN region.

The last word...

Recently, I was pointed to an article titled "Even God would get fired as an active investor", by author and portfolio manager Wesley Gray, PhD in 2016. Gray showed that even assuming perfect foresight, with a medium-term investment horizon (five years, which sounds reasonable), a portfolio would have experienced substantial drawdowns during the holding period. Invariably, this is when investors want to withdraw capital from their managers, or managers tend to sell to protect themselves from more pain. This highlights that in order to actually realise the returns <u>that you know for sure thanks to perfect foresight</u>, it would require mental discipline, and conviction in the investment thesis (underline is mine). On this point, Pirsig offers good insight:

> "Peace of mind…is the whole thing…The ultimate test is always your own serenity. If you don't have this when you start and maintain it while you're working, you're likely to build your own personal problems right into the machine itself…the selection from among many choices, the art of the work is just as dependent upon your own mind and spirit as it is upon the material of the machine. That's why you need the peace of mind".

Season's greetings, best wishes for 2023, and happy investing!

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