

Asia-Pacific (ex-Japan) equities marginally fell year-to-date (as of 24 September) amid substantial dispersion among markets¹. The recent resurgence of COVID-19 cases, coupled with rising inflation across the globe and volatility in China, has raised questions about the pace of the economic recovery and the trajectory of regional equity markets. In this investment note, our Asian Equities investment team outlines the key factors that will drive equities for the remainder of 2021. Although the divergence in regional performance is expected to continue, we believe the broad Asian equity universe offers attractive opportunities for active managers to find diversification and reasonably-valued companies.

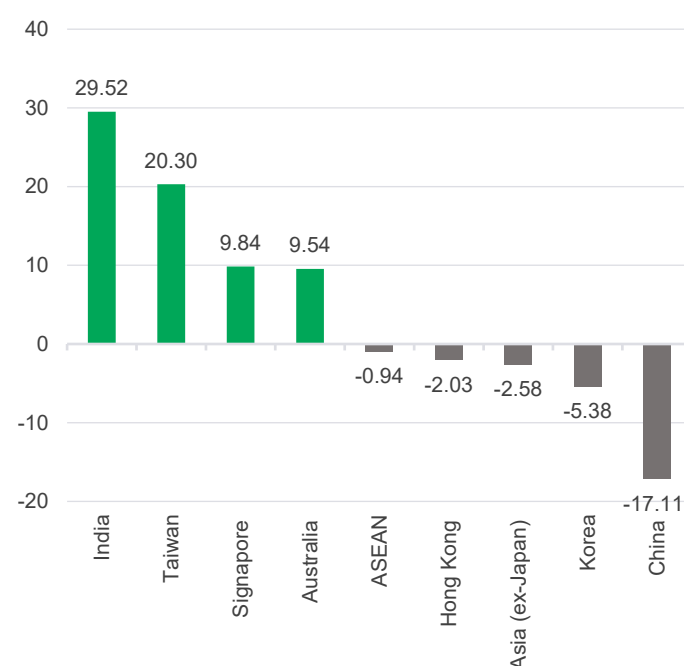
Asia-Pacific (ex-Japan) equities: Strategic opportunities amid a diverging landscape

Throughout the COVID-19 pandemic, both last year and into 2021, we foresaw a divergence in the performance of Asian equity markets. In 2020, those East Asian markets with superior virus containment measures and relatively higher inoculation rates led the region, while ASEAN countries lagged due to concentrated urban populations, limited access to vaccines, and less developed healthcare infrastructure.

Looking at regional performance year-to-date (24 September 2021), this dynamic has experienced some changes (see Chart 1). Some North Asian markets, such as Taiwan, have continued to perform, while others have fallen along with the worst-performing market, China. India has emerged as the best performing regional market, rebounding after experiencing a second wave of COVID-19 earlier in the year. Meanwhile, ASEAN markets have posted marginally negative performance.

Chart 1: Asian equity market performance, 2021 (YTD)²

MSCI Index Performance % (US dollar)



Rest of 2021: Growth divergence expected to continue

After a sharp recovery from the pandemic-driven collapse in economic activity so far in 2021, we expect growth, both globally and across Asia-Pacific, to moderate throughout the rest of 2021. The resurgence of COVID-19 cases, particularly in India,

¹ MSCI Asia-Pacific fell 2.58% through 24 September 2021) but there was significant divergence between the best-performing market (India) and worst-performing one (China).

² Bloomberg, as of 24 September 2021.

has deferred the highly anticipated economic recovery to the latter part of the year. Even then, the hope of any significant recovery throughout the remainder of the year depends greatly on inoculation rates and each country's ability to contain the spread of new variants.

On the policy front, the US Federal Reserve (the Fed) adopted a more hawkish tone at its June policy meeting³ and might begin the long process of tapering its monthly asset-purchase programme. This is likely to be one of the most closely watched events moving forward. Other major central banks have also indicated shifts towards a tightening bias⁴.

Our current macro assessment: monetary policy and inflation

In our view, most market participants are not yet ready for tighter monetary policy globally. This is evidenced by companies with negative free cash flow trading at the highest price-to-book (P/B) values, relative to the market, in the past 20 years. The market may be pricing in excessive optimism on these companies, with growth fuelled by external capital rather than organically generated cash flows. However, this may be challenged into a sell-off as bond yields rise.

Inflation may also challenge some companies. Rising raw material prices, freight costs, and the reduced supply of electronic components and semiconductor chips in the first half of 2021 is expected to place pressure on the corporate profits of certain downstream industries. However, we think the impact of cost-push inflation will ease when supply chains across different regions resume to more normal levels.

China: Opportunities amid increased volatility and a shifting regulatory landscape

In China, regulatory and policy risks have recently escalated. While the extensive rollout of new rules and regulations creates short-term pain and may impede the near-term growth of some listed companies, we

believe the long-term benefits of stable and orderly development in the affected sectors far outweigh the short-term risks to earnings.

Looking ahead, China's economic agenda will centre around the development of advanced technology, the real economy, industrialisation and decarbonisation. These are areas where we anticipate policy tailwinds.

For example, we are positive on China's **renewable energy sector** – especially companies in the power-grid network and solar-energy supply chain – where we see strong structural growth potential, driven by the government's goal to reach carbon neutrality by 2060.

The readiness of 5G infrastructure is expected to unleash the potential of segments such as industrial automation, autonomous driving, smart cities, and artificial intelligence. Such development is expected to drive demand for cybersecurity software and services. This area remains underappreciated, in our view.

We also see opportunities in regions outside of China, i.e., Europe, the US, and other emerging markets. This includes companies exposed to the recovery in consumption and investments.

Tech in Taiwan and Korea

While investors may be concerned about short-term weakness in the tech cycle, we believe the long-term growth outlook for the sector in Taiwan and Korea remains promising. We expect another round of tech-product upgrades to occur in 2022, as tech bellwethers introduce new chips and software that must be supported by new product specifications. Furthermore, the deployment of 5G-related applications remains at a nascent stage of growth, and we believe that momentum will gather pace in 2022.

³ [Transcript of Chair Powell's Press Conference -- June 16, 2021 \(federalreserve.gov\)](#).

⁴ People's Bank of China, European Central Bank, Bank of England, and Reserve Bank of Australia.

India: A slower rebound favours financials, materials, IT names

India suffered a setback after COVID-19 cases spiked during the second wave. But as this appears to be easing and state governments have indicated they will take a more measured approach when easing restrictions, suggesting that a more gradual economic recovery lies ahead. We expect a downward revision in the full-year 2022 earnings estimate before seeing improvements in 2023. Given rising material and commodity prices across the globe, we think that Indian-branded consumer-goods companies face margin pressure.

That said, we see favourable risk-reward characteristics in the following sectors:

1. **Financials:** Most large banks are well capitalised, and we expect credit costs will be under control. Furthermore, the banks are more likely to benefit from formalisation and the cyclical recovery following the second COVID wave.
2. **Materials:** We are optimistic about the domestic building materials sector, as we believe companies here could pass on cost increases at a faster rate than pure consumer companies.
3. **IT services:** With US corporate earnings showing strength, IT remains cyclically well positioned. We are more positive on larger-cap names, as they are better positioned to manage salary inflation and attrition during the upturn. IT also gives protection against policy tail risk if the rupee depreciates due to changes in global monetary policy.
4. **Structural growth opportunities over the longer term:** We are constructive on macro themes, such as import-substitution plays that benefit from the “Made in India” policy and the “China+1” supply-chain diversification trend⁵.

Opportunities are present across the materials and healthcare sectors.

ASEAN: Opportunities amid a challenging economic landscape

The recovery in most Southeast Asian countries now looks more subdued following the resurgence of COVID-19 cases. The spread of the more infectious Delta strain amid a relatively slower vaccination rollout has taken its toll on the region's economy. We now expect a downward revision to growth outlooks for this year. That said, we believe that companies in the following sectors will outperform:

1. **Healthcare:** During the initial stage of the outbreak, hospitals suffered from low patient flows and the cancellation of elective surgeries. Over time, these hospitals managed to pivot and have subsequently benefited from assisting the government in performing COVID tests and treating patients. Income derived from these services has helped sustain earnings growth. Post-COVID, these facilities should benefit from the normalisation of operations and a resumption in healthcare tourism.
2. **Exporters:** Manufacturers in Southeast Asia should continue to do well due to solid demand from re-opening in the US and Europe. Some companies have benefited from the shift in orders from China to Southeast Asia. While restricted operations and component shortages may cause some disruption, we believe the impact will be short-lived. The exporters also tend to benefit from a stronger US dollar in the event of tapering-related anxiety.
3. **Digitisation of the ASEAN economies:** As highlighted the [2021 outlook](#), Southeast Asian countries, particularly Indonesia, are experiencing robust growth in their digital economies. Data centres in Indonesia are

⁵ Multi-national companies based in China to look for another supply chain centre in Asia to diversify supply chains.

rapidly expanding as digitisation gathers pace across the financial, e-commerce, and ride-hailing sectors. Demand for logistics and warehousing services has grown strongly in the region, and we see high levels of investment in these areas. We anticipate the public listings of key sector leaders in the second half of 2021, particularly in Malaysia and Indonesia, will set the benchmark for the future listing of more “new economy” businesses in Southeast Asia.

Conclusion

The divergence of Asian equities’ performance thus far in 2021 is poised to continue. North Asian economies and Singapore with higher vaccination rates and better containment measures should have a longer runway for growth. In contrast, the recovery for many ASEAN markets has been delayed and may not occur until the end of 2021 or early 2022. This divergence offers a unique opportunity for active managers to choose quality companies throughout the region.

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