2022 Asian Equity Outlook: Well positioned to navigate tightening

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Summary

- We believe that Asian economies are well positioned to navigate monetary tightening in the US. Government finances are healthier, as are corporate balance sheets. Most Asian economies are digitising faster than their western peers, while consumption is set to receive a meaningful boost from economic reopening.
- In China we prefer domestically focused quality companies in areas with a more favourable policy backdrop, such as the environment, industrial upgrade and innovative healthcare. In India, areas such as healthcare, the new economy, private sector banks and real estate appear attractive.
- Within South Korea and Taiwan, we see opportunities in integrated circuit design, software, clean technology, content creation and industrial automation.
- As for the ASEAN region, we favour Indonesia and the Philippines, and believe that the ongoing reconfiguration of supply chains will continue to benefit Indonesia and Vietnam.

"When your mother asks, 'Do you want a piece of advice?' it is a mere formality. It doesn't matter if you answer yes or no. You're going to get it anyway.", said American humourist Erma Bombeck.

This piece is a bit like that.

Following a collective failure to predict the events of 2020, and modestly better success in anticipating some of the events in 2021, here is the latest instalment of our annual outlook. In 2021, I tried to read books from different genres in the hope that dabbling at the intersection of subjects would lead to epiphanies and insights that will make for a better investor. For instance, I learnt that it is apparently legal to be naked in Spain—anywhere, anytime. I also learnt that all mammals have seven cervical vertebrae i.e. bones in the neck (yes—you, the giraffe and the dolphin!). Also, that you are more likely to get a computer virus from visiting religious internet sites than adult sites. However, the crystal ball appears no less opaque; but I've elicited a few laughs and more than a few raised eyebrows at social gatherings.

I also learnt that a mega yacht exchanged hands for USD 650,000—which seems ridiculously cheap considering it has four storeys, two helipads, several lounges, a dance floor and a jacuzzi. So, what's the catch, you ask? The *Metaflower*, as the yacht is called, was sold by investor and developer Republic Realm in the most expensive NFT (non-fungible token) deal in the Sandbox metaverse, a virtual world built on the Ethereum blockchain. In plain-speak, it's not real!

It is hard enough to identify, understand and assess drivers of businesses and valuations IRL (an acronym for "in real life"—in case you too are a tech dinosaur), let alone attempting this in the virtual realm. But that's what the metaverse will force us to do in the coming years. It suffices, for the purposes here, to note that the metaverse is a digital universe, in every sense. For example, is a mall located on the digital equivalent of the Champs-Élysées as "valuable" as another equally large one located on the digital equivalent of Park Avenue? IRL, they're subject to different tax regimes, different interest rate environments, different cultures and different demand patterns. In the virtual world, they're more similar than they're different because the "weather" can be designed, and it will be equally easy to own/rent a "space" on virtual Champs-Élysées as it will on a virtual Park Avenue. And what really is "demand" in the early days of the metaverse? Will it be a case of "build it and they will come" or will it be a case of supply meeting existing demand?

As if that wasn't enough of a curve ball, the average half-life of a public company is about a decade (as noted by Michael Mauboussin[1] a few years ago), implying that the investable universe is continually in flux. The eight largest stocks in the S&P 500 Index at the time of writing are also the eight largest stocks in the Nasdaq Index—all tech giants. The same is true in China, where seven of the 10 largest stocks in the MSCI country benchmark started off as tech businesses. This is as much a reflection of their dominance, as it is of the world's general shift "online". And all these companies are meaningfully different today than they were a decade ago. Morphing into "platforms", which resulted in stronger competitive moats, has now invited regulatory scrutiny, because governments are wising up to the fact that monopsony (the platform is the only buyer for all companies further up the supply chain) is just as bad as monopoly. And this is as true in the West as it is in the East.

Thus, the primary challenge facing investors—distinguishing between a company's fundamentals and the expectations implied by its market price—is growing increasingly difficult. Nonetheless, we are duty-bound to prognosticate, and prognosticate we shall.

We believe that Asian economies are well positioned to navigate monetary tightening in the US. Government finances are healthier, as are corporate balance sheets, allowing countries to calibrate their response to ground reality. Most Asian economies are digitising faster than their western peers, either because they have no choice, and/or because they have no legacy infrastructure investments to encumber them. Digitisation is deflationary; it also boosts productivity. Consumption is set to receive a meaningful boost from economic reopening even as a demand rebound in the West is supportive of Asian goods exports. As things stand, real rates are expected to remain at low levels in the US compared to those in Asia through 2022, pointing towards stable foreign exchange rates—historically another headwind for USD returns in "risky" Asian equities. Markets in the region are attractively valued compared to developed peers relative to the growth they offer. Foreign ownership is also at decade lows.

Citizen Kane?

Recently, US Commerce Secretary Gina Raimondo stated that the US wanted to slow down China's rate of innovation by working "with…European allies to deny China the most advanced technology so that they cannot catch up in critical areas like semiconductors". Also, China imports more than two thirds of its energy needs via oil and natural gas imports. To reduce external dependency, the Chinese government has decided to develop the requisite intellectual property and energy resources domestically. However, this requires investment and time, translating to slower, albeit better quality, growth in the coming years. To make that more palatable for the population, while ensuring a third term as president, Premier Xi Jinping has put forth an agenda of "common prosperity"; that it is a phrase that was used by Mao Zedong in the 1950s, and Deng Xiaoping in the 1980s, is telling.

Citizen Kane, hailed as one of the greatest pieces of cinema to come from Hollywood, is at once a metaphor for isolationism (evidently, a successful one!), and an example of the nexus of media and politics with one influencing the other. Both, or perhaps neither, may apply to today's China.

[1] "Thirty Years: Reflections on the Ten Attributes of Great Investors", Michael J. Mauboussin, August 4, 2016

The move by China to tackle the three big mountains ("三座大山")—property, healthcare and education—has forced a fundamental rethink of the risk premium implicit in investing in Chinese equities. The handling of the Evergrande default is seen to have revealed the state's reluctance to condone profligacy, at the corporate level as well as by the banking sector, while instituting measures to reassure investors that reliance on excessive leverage will be penalised. Thus, we prefer domestically focused quality companies in areas with a more favourable policy backdrop, such as the environment, industrial upgrade and innovative healthcare.

That investing in the Hong Kong equity market no longer warrants a section unto itself, with the territory's market reduced to a footnote in the China section, is reflective of the realpolitik.

The Best Exotic Marigold Hotel

A comedy-drama with an ensemble cast, the *Best Exotic Marigold Hotel* is a tale of a group of retirees lured by promotions for the recently reconstructed Marigold Hotel in India and are surprised when they arrive to find the establishment in disarray. The characters come to terms with the past, deal with change and eventually come out happy.

Quintessentially, this is the story of investing in Indian equities—there's the lure of a better times to come ('this time will be different"), there's the realisation of ground reality (the "Hindu" rate of growth), there's change (of governments, of economic conditions, of central bankers), and there's eventually a happy outcome notwithstanding the bumpy route (~13.5% annualised USD returns over the past two decades).

This time perhaps is different after all. The ingredients for change are present in the reforms the government continues to push through. The production-linked incentive scheme introduced in November 2020 has some teeth, and gaining momentum. Earlier this year, the government also raised foreign investment limits in the insurance industry; announced plans to create an asset reconstruction company to manage bad debts of Indian state-owned banks; and revealed a new disinvestment policy that would focus on privatising state-owned enterprises in non-strategic sectors. The scrapping of retrospective taxation laws was also a step in the right direction. Should the walk follow the talk, the economy is well positioned for the next decade even if traction on these reforms isn't smooth. Thus, areas such as healthcare, the new economy, private sector banks and real estate appear attractive.

Run Lola Run[2]

As COVID-19 has run longer than many had anticipated, it has transformed what is "normal" for work, social interaction and recreation—with digital means replacing physical means to an unprecedented (I realise this word is overused—apologies!) extent. This in turn means that technology has never been a greater part of our lives, and if early murmurings about the metaverse are anything to go by, it will be the very fabric of our lives, literally and figuratively.

That semiconductor technology, and the attendant supply chain, will be essential to making this possible is a given. The networking, computation, virtual platforms, content and hardware that this entails translates to enduring growth, and hitherto unimagined areas of application. Both Taiwan and South Korea will remain critical therein. Absent an insider in the Communist Party's Politburo, talk of China taking military action against Taiwan, the US response given President Joe Biden's reaching out to Taiwan, and the resulting fallout, are entirely in the realm of speculation—possibilities with low probabilities. Time is therefore better spent identifying companies in this ecosystem that will be invaluable regardless; we find such opportunities in integrated circuit design, software, clean technology, content creation and industrial automation.

Wag the Dog[3]

Thailand, thanks to continual political histrionics and its poor handling of COVID-19, offers lacklustre prospects, in our view. Malaysia fares no better, for more or less same reasons.

[2] A thriller about a woman who needs to come up with a large sum of money in 20 minutes to save her boyfriend
[3] A comedy about a spin doctor's bid to divert public attention

Singapore's zero-tolerance policy vis-a-vis COVID-19 has become a case of the perfect being the enemy of the good, in our view. However, the progressive opening of the economy, albeit slowly, is a sign that there is growing acknowledgement of the economic imperative.

When Joko Widodo was first elected president of Indonesia some seven years ago, there was hope that he would usher in a new era of growth for the country. The embers of that hope had nearly fizzled out by the time the Omnibus laws were passed in 2020. Fortunately, the rise of the digital economy, no thanks to the government, has captured investor attention, as it has in the Philippines. For this reason, and notwithstanding political ennui, Indonesia and the Philippines offer attractive investment opportunities, relatively speaking. The ongoing reconfiguration of supply chains will continue to benefit Indonesia and Vietnam, in our view.

The last word…

As yet another year goes by, and various events force a re-evaluation of our outlook, it is worth remembering American writer Dale Carnegie's words, "today is the tomorrow you worried about yesterday".

Season's greetings, best wishes for 2022, and happy investing!

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