



IT'S TIME TO LOOK EAST

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RODERICK SNELL

As scholars from Joseph Schumpeter to Christopher Freeman have observed, economic and social crises frequently result in rapid innovation and new secular trends being born. As investors, we believe Asia ex Japan could be one of the major beneficiaries of the current global crisis. It is time to look east.

Why so?

Asia ex Japan was the first region to enter the coronavirus (Covid-19) crisis and is the first to exit, with around 80 per cent of the countries represented in our strategy (by weight) open for business and getting back to work. The region has also seen, so far, the most effective response to the epidemic. In Taiwan and Vietnam, for example, coronavirus deaths per one million of population stand at 0.3 and 0 respectively. That compares to roughly 450 in the UK and 230 in the US.

More importantly, Asian countries are generally returning to normality in reasonable financial strength. The modest financial stimulus and monetary response observed across the region stands in stark contrast to the many trillions of dollars desperately being deployed by western economies as their interest rate structures collapse. For much of the developed world, such profligacy will be a major financial burden for years to come, leading to slower growth and potentially weaker currencies. The majority of Asia ex Japan looks attractively placed in comparison. With 'more government' fast becoming the norm in the west, will capital seek higher, safer returns elsewhere?



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At a company level, one of the most important changes is likely to be an acceleration of research and development and innovation across the region – need being the mother of invention. As the global economy’s supply chains shift and localise, Asian companies will have to adapt to local demand and to new ways of doing business. With most of our strategy invested in companies involved in technology and innovation, we feel we are already reasonably well placed for such an outcome. Several of our holdings have already benefitted, be it from a sudden shift in adoption of the online economy across South East Asia, to increasing use of cloud infrastructure in China.

Country-wise we continue to think about China’s place in the world, supply chain risks (with Vietnam a possible beneficiary), and potential vulnerabilities in India. Most countries will be benefitting from the additional boost of collapsing energy prices.

We still see good earnings growth from the majority of our holdings and valuations are at a significant discount to slower-growing developed markets. For investors, we see the sun rising favourably in the east.

OUTLOOK – ASIA EX JAPAN COMING OUT IN GOOD SHAPE

We view the world potentially splitting between countries that have been well-managed in this pandemic – predominantly in Asia, and those that have not – mostly in the developed west. The consequences over the coming decade may be profound.

In Asia, where the crisis has generally been far better controlled than in other regions, with lower case and mortality rates, many countries are already getting back to work. Several, including South Korea and Taiwan, never had to fully shut down like those in the west. In China, major cities such as Shanghai have around 80 per cent or more of their businesses open, national domestic flight numbers are nearly back to pre-crisis levels, and leading indicators such as automotive and property sales are growing year-on-year (both by around four per cent in April). More importantly, these countries have done so with limited monetary and financial stimulus.

The situation in the developed world could hardly be more different. Covid-19 outbreaks have been more severe, lockdowns continue, and countries have embarked on stimulus programmes with amounts many times those seen in the Global Financial Crisis. In several ways this is the reverse of the 2008 financial crash, when China bailed out the global economy with its unorthodox debt-fuelled stimulus. The coronavirus crisis of 2020 is being defined by various members of the G7 casting aside financial orthodoxy and instead embracing radical ideas such as the direct subsidy of lost personal incomes. A shift to Modern Monetary Theory in Europe, and maybe even in the US, no longer seems like an outlandish possibility.

The world is now awash with trillions of dollars of stimulus seeking an economic return, and we ask ourselves where does this capital flow to? Where are returns most attractive? The increasingly debt-laden economies of the west, where near-zero or even negative interest rates look set to persist for many more years. Or the faster structural growth of Asia ex Japan, combined with limited balance sheet expansion and reasonable yields and interest rates. We believe there is a reasonable chance it is the latter. If correct, such an inflection point would be extremely supportive for Asian assets over the coming decade.

WHAT HAVE WE BEEN DOING?

Given our long-term time horizon, it would be unusual for us to make any sudden, dramatic changes to our holdings. We believe our strong growth bias, focused on the region's positive demographics, the rising middle class and adoption of technology, remains attractive. Nevertheless, economic crises frequently herald the beginnings of new secular trends and innovation and we have been thinking hard about how this may impact our strategy.

Perhaps the most important change we have seen through the crisis is an acceleration in the adoption of technology, improving economies of scale and strengthening the competitive moats around some leading technology firms. We believe this key trend will persist and given our strategy's substantial technology exposure, it is one that should significantly benefit our clients.

China has arguably led the way, with several of the country's internet companies seeing significant increases in user numbers and engagement under lockdown. One of our newer holdings, Meituan Dianping, the online food delivery business, experienced a 400 per cent increase in grocery deliveries and employed more than 330,000 new delivery drivers. JD.com had to hire 20,000 new logistics employees to help with increasing ecommerce orders, while DingTalk, owned by Alibaba and considered the world's largest collaboration service designed for companies, experienced downloads increasing fifteen-fold.

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Perhaps more interestingly we have seen an acceleration of innovation across the traditionally less technology-savvy parts of the region. Just as SARS was a turning point in the birth of ecommerce in China in 2003, helping to establish companies such as Alibaba and JD.com, we believe Covid-19 could be doing the same for ecommerce across large parts of the ASEAN region.

One of our largest holdings SEA Ltd, an ASEAN ecommerce and gaming business, has seen a surge of new companies joining its online market place (+35 per cent last quarter), and many new buyers joining the site for the first time. ASEAN governments are also becoming more supportive of the online economy, quickly realising it is a far more effective medium for collecting tax receipts compared with offline cash transactions.

We see a permanently higher shift in the adoption of the online economy across South East Asia.

This surge of technology use across Asia ex Japan is certainly a positive, however the potential impact of the virus on the development of competitive dynamics is arguably even more important. Surging demand initiated by Covid-19, has dramatically shortened the time required for companies to scale up and achieve dominance. The winners will establish themselves over the next couple of years rather than decades. This reduced timeframe will curtail the number of competitors entering the market, and profits will accrue to an increasingly small number of existing players. An enduring feature of this crisis is likely to be the strong getting stronger. For companies such as SEA this is a major positive.

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Some modest changes have been made to our holdings, mainly taking advantage of extreme price moves in the market. For example, we purchased LONGi Green Energy, China's largest and highly profitable solar cell maker. We believe the company's scale will give it a substantial competitive edge, in what should be one of China's most interesting growth stories: renewable energies. We also increased our exposure to some quality cyclical companies that were trading on distressed multiples, for example Nexteer, the auto component maker, which is well placed for an era of autonomous driving.

Funding has come in part from India, where we have some concerns. The country was already experiencing a lacklustre economy before the coronavirus struck, in part due to the long-term failure to sort out issues in the banking sector, exacerbated by recent problems in the non-banking financial sector (triggered by the collapse of the country's leading infrastructure finance company, IL&FS). We have also been disappointed by the Indian Government's failure to address some of the pressing structural issues inhibiting economic growth, especially the country's restrictive labour and land laws. As a consequence, India did not enter the current crisis in good shape, but perhaps more worryingly the lack of proactive policy making has left us questioning whether the current Modi Government cares more about the social agenda (e.g. promoting Hindu nationalism) or the economic one.

China on the other hand, our largest country position, has been deleveraging and rebalancing its economy away from investment and towards consumption for several years. The growth we see in the country today is the highest quality we have seen for many years, driven by the private sector. There will inevitably be concerns over the country stemming from this crisis, from her relationship with the US, including potential Covid-19 retaliation, and the future of globalisation with firms seeking more diverse supply chains.

These are important areas for us to consider. However, most of our Chinese holdings, which are private companies focused on the domestic consumer, should be less affected by these issues, given the strong secular growth drivers of rising domestic consumption and technology adoption.

Although increasing tensions with the west and a desire to diversify supply chains are likely long-term headwinds for Chinese export growth, this trend will create many specific winners and losers. We believe Vietnam (the largest overweight country in our strategy) will be one of the biggest beneficiaries. The country has already been the major winner from the relocation of manufacturing away from China, and any acceleration of this trend will fuel Vietnam's exports further.

CONCLUSION

The current global crisis is likely to create new secular trends and spur innovation. We believe Asia ex Japan could be one of the major beneficiaries. The region is coming out of this crisis first, in significantly better financial shape than western economies, with superior long-term growth prospects and more attractive valuations. The year 2020 may well be an inflection point where Asia ex Japan becomes a favoured asset class over the coming decade. We believe our strategy of growth companies focused on technology and innovation is extremely well placed in such an environment. Investors should turn their attention to the east.

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