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Structural Trends Supporting Asian Equities

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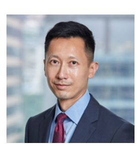

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There are a number of supportive structural trends shaping the opportunity in Asian equities, many of which—perhaps counterintuitively—have been amplified by the pandemic and U.S.-China trade tensions.

"Across other emerging Asian markets like ASEAN and India, the new digital economy is still fairly nascent and immature, thereby providing many opportunities for investors to capture the long-term growth that results from the rise of technological ubiquity and the digital economy."

Asian markets have performed well amid the worst global economic backdrop since the Great Depression. Indeed, 2020 has shaped up to be a year of many paradoxes—the year has brought with it a severe economic contraction as governments shut down activities, yet we have seen new highs in select stock markets, largely due to governments' aggressive fiscal and monetary policies. In terms of market performance, there are also sharply contrasting developments—between the technology and non-technology sectors, the Asian economies that have been successful in containing the virus and those that are still plagued by the pandemic, and the beneficiaries of the work-from-home environment and its victims.

Reflecting these characteristics, the North Asian markets have outperformed the ASEAN region this year given their greater tech exposure and success in containing COVID. Growth stocks—which typically include beneficiaries of the pandemic like tech, health care and new consumption companies—also outperformed value stocks like banks and tourism, which have been more challenged by the pandemic.

Markets were able to bounce off the lows in March much faster than expected—especially in the context of the extent of the contraction and the number of job losses—thanks to timely and aggressive actions by central banks and governments. At the same time, COVID has helped accelerate a number of structural trends, leading to a significant re-rating of large cap companies in the tech space.

While the pandemic remains troublesome with second and third waves now flaring up in Europe and the U.S., we expect the global economy to continue its path to recovery in 2021. In addition to this, we are likely closer to finding an effective vaccine that can help unlock economies still struggling with containment.

With earnings bottoming out this year and the recovery broadening from economies beyond China and North Asia to ASEAN and India, especially once a vaccine becomes available, we are constructive on the outlook for Asian equities as a whole—a view that is underpinned by the following four secular themes.

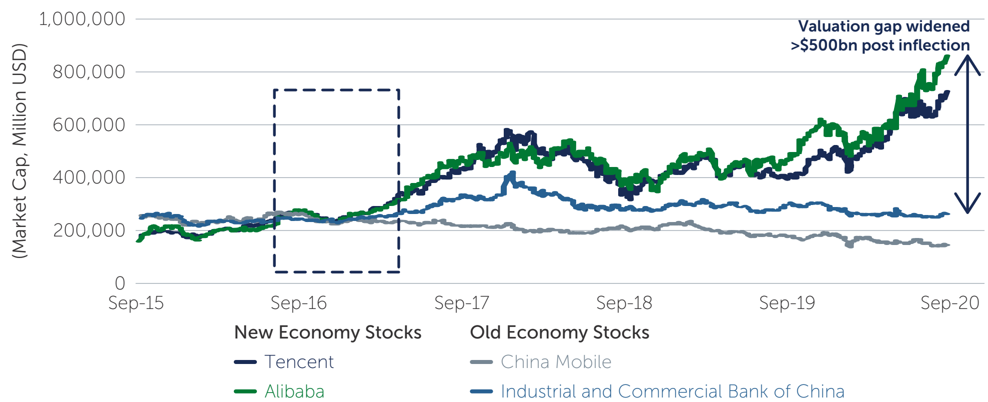
Digitalization of the Economy

Across the world, the COVID pandemic has accelerated the inevitable pervasiveness of technology in our lives and the ascendency of the digital economy. Within technology, Asia leads and lags in different areas. For example, e-commerce and financial tech are further penetrated in China than the rest of the world—and even leading developed markets—in terms of adoption. But in other areas like IT spending and cloud infrastructure, China still lags the U.S. despite massive amounts of data generation. Across other emerging Asian markets like ASEAN and India, the new digital economy is still fairly nascent and immature, thereby providing many opportunities for investors to capture the long-term growth that results from the rise of technological ubiquity and the digital economy. The key is selecting the emerging leaders in ASEAN and India.

Notwithstanding the relative immaturity of the new economy in Asia, the composition of the region's equity markets is gradually reflecting this dynamic. While the old economy giants, such as China Mobile and Industrial and Commercial Bank of China, were the largest companies in China over five years ago, new economy giants Tencent and Alibaba have leapfrogged them in value and continue to create significantly more value for shareholders **(FIGURE 1)**. The ASEAN region appears to be undergoing a similar change currently, with ASEAN's leading e-commerce platform and game developer, SEA Limited, taking over old economy titans Development Bank of Singapore and Singapore Telecommunications **(FIGURE 2)**.

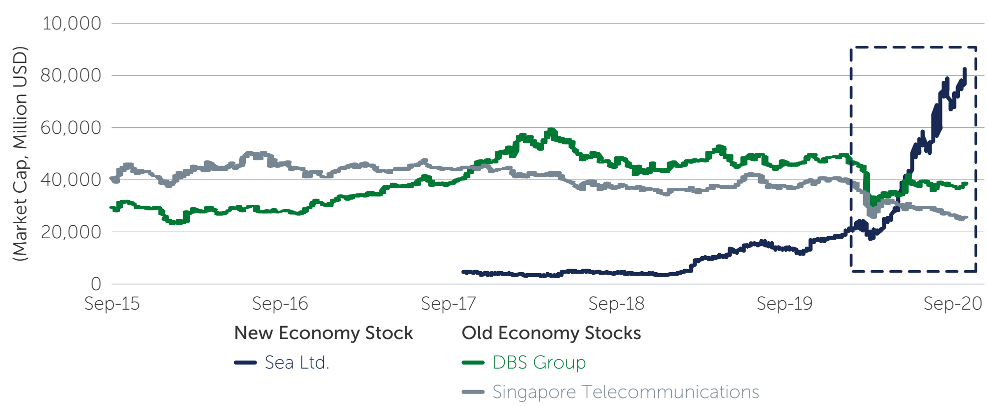
The rise of the digital economy presents an exciting secular growth opportunity for investors. There are multiple ways to gain exposure along the different value chains—ranging from content owners like Tencent and platforms like Alibaba, to infrastructure enablers like Taiwan Semiconductor Manufacturing Company and Samsung.

FIGURE 1: China—New Economy vs. Old Economy



SOURCE: Bloomberg. As of October 2020.

FIGURE 2: ASEAN—New Economy vs. Old Economy

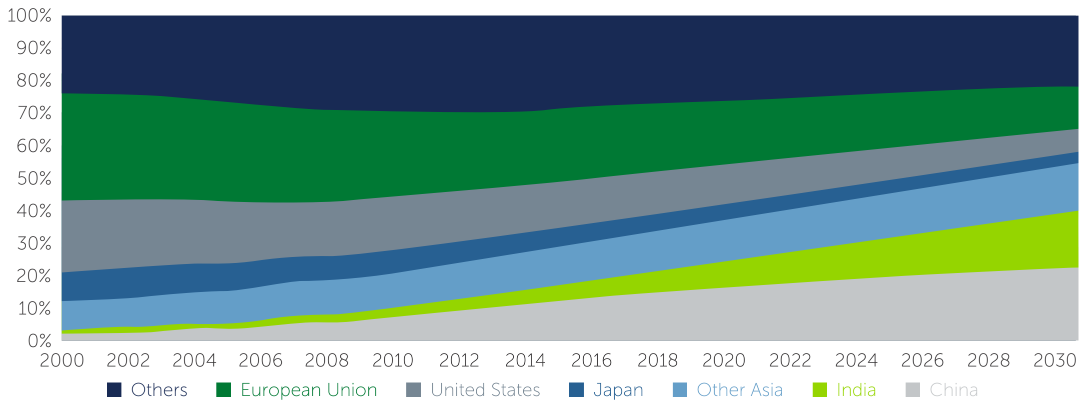


SOURCE: Bloomberg. As of October 2020.

Demographics: An Influential Asian Middle Class

One of the greatest secular attractions of investing in Asia is its powerful demographic story. In the next 10 years, Asia is expected to have the largest middle class population in the world and become the largest middle class market in value, led by both China and India **(FIGURE 3)**. Knowing who this key Asian middle class is, and what they want to buy, is key for companies' growth prospects—and for uncovering the companies best positioned to benefit from this structural trajectory.

FIGURE 3: Global Distribution of the Middle Class to 2030



SOURCES: Homi Kharas; the Brookings Institution; CLSA. As of September 2018.

Arguably, the most influential Asian middle class today is the Chinese millennials, who account for roughly 25% of the population[1]—although we expect Indian millennials to become increasingly significant over the next decade. As this generation of Chinese millennials has aged into its prime consumption years, the effects on the market have been significant. For one, millennials' spending on luxury brands equated to roughly RMB 415 billion in 2018, far outpacing that of older generations.[2] Compared to Gen Xers, millennial consumption of luxury goods, from handbags to clothing to luggage, is expected to increase notably in the future, by as much as 50%.[3]

In terms of distribution channels, having an online/e-commerce presence is crucial—as unsurprisingly, Chinese millennials are very comfortable with e-commerce. Given millennials' extensive social media usage, leveraging this channel as a source of product feedback can help companies come up with more marketable products faster. One example of a company using e-commerce to drive sales growth and improvements in margins is Li Ning, a Chinese sporting goods company. Li Ning is also benefiting from the trend of Chinese millennials preferring local brands as they become more confident and appreciative of their own culture and identity—something that should also benefit local brands more broadly.

De-Globalization & Supply Chain Diversification

De-globalization is another structural trend shaping the investment opportunity in Asia. Over the last decade, many large multinational corporations have looked to diversify their manufacturing supply chains beyond China, driven primarily by the country's rising labor costs compared to other regions. More recently, the trade tensions between the U.S. and China, and the resulting tariffs, have amplified the efforts of companies to relocate. COVID, too, has accelerated this trend in many ways, exposing supply chain vulnerabilities and underscoring the importance of diversification beyond one country.

1. Sources: UN World Population Prospects; Barings. As of August 2019.
2. Source: McKinsey & Co. As of April 2019.
3. Source: CRR. As of June 2018.

In many cases, countries in ASEAN and India have been the beneficiaries, with their large and competitive labor force, and potentially strong consumer base, looking increasingly attractive. Perhaps unsurprisingly, countries in the region have enacted policies to support the competitiveness of the market, ranging from corporate tax cuts to flexible labor policies. There is even some external support from countries like Japan, where the government has introduced subsidies to help Japanese businesses diversify their supply chains outside of China. While supply relocation and reconfiguration can take years, we believe countries like Vietnam, Malaysia and Thailand—where electronics and other manufacturing capabilities have been improving—will continue to benefit as this trend evolves.

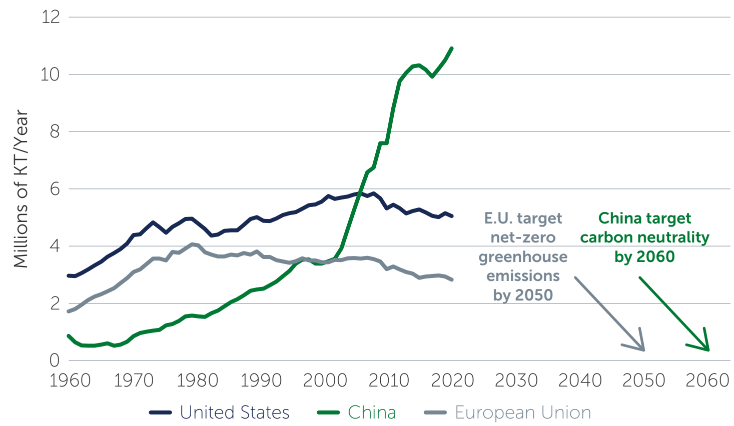
The wheels of de-globalization are in motion and, in our view, unlikely to reverse course. In this environment, diversification is required of businesses, not only from a cost standpoint but also to improve resilience. We believe ASEAN and India will be some of the biggest beneficiaries of this theme. Even though these markets are struggling in the near term, they appear to be very well-positioned for further growth once the pandemic begins to recede. Further, as China increasingly looks to localize and internalize key technologies in order to limit its reliance on external manufacturers, companies in these regions that can step in and fill the gap should see strong growth prospects and re-rating opportunities.

Sustainability

Last but not least, the rising importance of sustainability will likely have a positive impact on both demand outlook and valuation for companies aligned with this trend—or conversely, negative implications for those that do not adapt to this tidal change. From the pandemic to the massive wildfires in Australia and California, 2020 has given way to a number of factors likely to hasten the urgency of sustainable practices. Indeed, policy makers in the E.U. and China have set timelines to achieve carbon neutrality, fast-tracking the implementation of sustainable policies, which will likely have a favorable impact on the demand for renewables like solar. For example, in China, solar is expected to achieve grid parity this year—which essentially provides a constructive economic case for companies to go green. Overall, we believe Asian companies are well placed to ride this secular theme given that a number of businesses are leading suppliers within the renewables value chain.

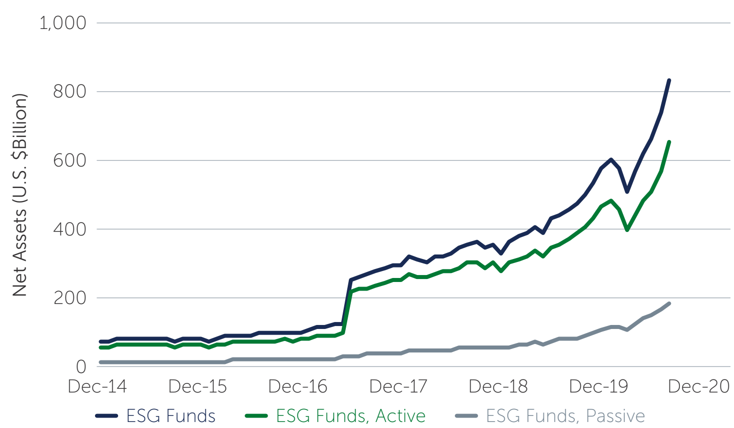
The increasing pervasiveness of sustainability is not limited to corporates, but is also increasingly impacting individual lifestyle and hygiene practices. For example, lockdowns and fears of contagion due to close physical contact have led commuters to choose modes of transport such as biking over cramped subways, where practical. In fact, governments around the world have announced policies to provide greater support for bike commuters—from additional cycle lanes in New York and Paris to subsidies for bikes in Italy and the U.K.

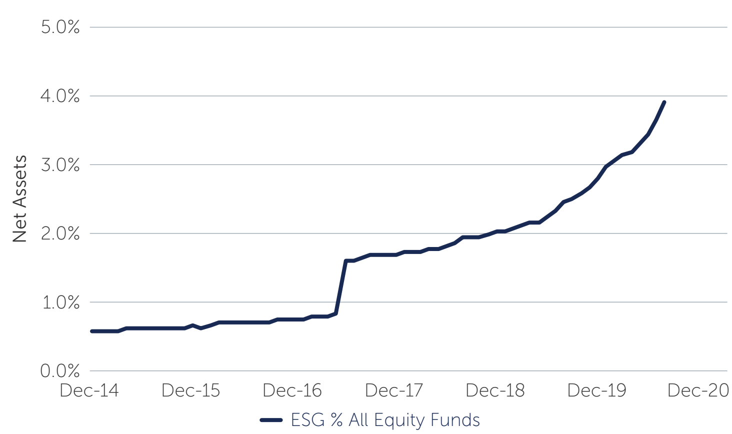
FIGURE 4: The E.U. and China: Ambitious C02 Emissions Targets



SOURCES: World Bank; European Commission; Haver Analytics; Goldman Sachs Global Investment Research. As of October 2020. Data from the World Bank is extended forward using data from the European Commission. CO2 emissions are from burning fossil fuels and manufacturing cement. Note: E.U. and U.S. targets are in terms of greenhouse gas emissions where CO2 is a major component but not exhaustive. Targets are not net.

FIGURE 5: Resilient AUM Growth Trend for ESG Funds





SOURCES: EPFR; Citi Global Research. As of October 2020.

Increasing scrutiny from institutional shareholders could also add pressure on corporates to focus more on environmental, social and governance (ESG) related issues. Indeed, at Barings, we have increased engagements with companies this year. We have also fully integrated a dynamic and proprietary ESG evaluation approach into our investment process, and through active engagement, we seek to promote positive change in firms' ESG practices.

Capitalizing on an Inefficient Market

Asian equities are an inefficient asset class and remain a fertile ground for active, bottom-up investors with a robust and proven investment philosophy and process to generate alpha. As we look across the markets today, we continue to find many companies whose medium-term (5-year) earnings outlook is not fully captured in current share prices.

In the near term, markets are likely to remain volatile. However, due largely to the supportive secular trends unfolding across the region, we see good long-term potential in Asian equities—and believe that times of stress and volatility can result in opportunities to purchase well-positioned companies at attractive prices.

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