Manulife Investment Management

2019 mid-year outlook — Asian equities

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Asian equities proved to be resilient in the first half of 2019, despite the negative impact of escalating Sino-US trade tensions. At the mid-year point, all regional markets have weathered the volatility and remain in positive territory[1].

While the headline numbers are noteworthy, we believe the underlying catalysts of reform and change in the region are equally worthy of investors' attention. In North Asia, disruptions in the form of economic rivalry between China and the US should push tech firms to prioritise research and innovation as supply chains change. This reconfiguration of production can spill over to Southeast Asia, where developing countries such as Vietnam should benefit from an upgrade in manufacturing capacity. Recent election results in India and Indonesia should also boost policy continuity and human capital development to propel economic growth.

Beyond the numbers

Asian equities weather volatility in the first-half

Asian equities held up strongly in the first half of 2019, despite the negative impact of escalating Sino-US trade tensions. As the two countries continued talks through the first four months of 2019, markets were positive about the prospects of a deal. This optimism, combined with the Federal Reserve's increasingly dovish stance, boosted liquidity and investor sentiment in the region. By mid-April, Asian equities had posted a roughly 16%[2] gain.

In May, however, this market consensus gradually disintegrated. A tweet by US President Donald Trump in mid-May threatening new tariffs, followed by an increase in tariffs on Chinese imports and subsequent Chinese retaliation, erased some of the advances. Although this rupture in expectations drove markets lower, Asian equities still held onto respectable gains[3] for the first half of the year. China and Hong Kong, the most affected markets, remained strongly in positive territory, while markets such as Indonesia and India were boosted by positive election results[4].

A deepening strength

The resilience of Asian markets amidst persistent macro volatility is significant. Granted, some things have changed since trade tensions escalated in 2018; most notably, the Fed's dovish stance, including its June statement that opened the door for potential rate cuts, has effectively put a floor in the market. Capital inflows to Asian markets were also net positive for most of the first half[5].

However, we also believe regional markets are potentially reflecting something deeper that will drive changes in the second half of 2019 and beyond: a renewed emphasis on research and development (R&D) and innovation among tech firms in NE Asia, and a rapidly evolving manufacturing, business, and human capital landscape in SE Asia.

Risks and opportunities for Asian tech

As we have regularly noted in our base case for the Sino-US trade war, even if the US and China ultimately reach a trade agreement in 2019, investors should realise that the tensions underlying the current dispute are structural and long-term in

[1] Bloomberg, as of 21 June 2019, MSCI country indices, total returns in US dollars.
[2] Bloomberg. MSCI Asia (ex-Japan) year-to date gain was 16% as of 17 April 2019. It is not possible to invest directly in an index.
[3] Bloomberg. MSCI Asia (ex-Japan) was up 10.68% year-to-date as of 21 June 2019. It is not possible to invest directly in an index.
[4] Bloomberg, as of 21 June 2019.
[5] Source: JP Morgan, June 2019.

nature. This point is evident from the US's two-pronged approach to the dispute to engage in negotiations to resolve trade issues, while on the other it has cut off Chinese technology companies from US suppliers.

Although it's still too early to gauge the full implications of these moves, we believe it represents a potential long-term opportunity for Chinese and Asian technology firms. Indeed, although the growth prospects of some Chinese tech companies will inevitably be hurt in the short term, advanced technology suppliers in Korea and Taiwan may be key beneficiaries, as they are able to supply both US and Chinese firms over the short-term. For example, semiconductor foundries and small design houses in Taiwan can benefit as China readjusts its supply chains.

Over the long term, regional technology firms are clear that even if trade sanctions are removed, a bifurcation in technology development and standards between the US and China may redefine global supply chains in the future. As a result, we believe R&D and innovation will continue to be top issues in Asia tech companies' boardrooms to prepare for such a scenario.

Asian Elections: Focus on labour and business reforms

We also believe Asian equities should benefit from election results in South and Southeast Asia. Indeed, incumbent victories in India and Indonesia removed investment uncertainty and laid the foundations for policy continuity. We see potential beneficiaries in the region from shifting supply chains; Vietnam has emerged as one potential beneficiary from persistent trade tensions.

- **Indonesia:** President Joko Widodo's electoral victory in April, followed by Standard and Poor's subsequent sovereign credit-rating upgrade in late May, recognised the fruits of his first-term economic reform agenda. That agenda will likely evolve in his second-term from an emphasis on investment in infrastructure to a broader set of goals, including supporting income growth among the poor/middle class, improving access to basic education, and promoting greater flexibility in the labour market [6]. Progress in labour-market reforms has notably lagged so far, and the country's real economic growth performance has suffered as a result [7]. Accelerating those reforms should help boost Indonesia's long-term potential growth prospects. Based on Jokowi's new mandate, we are currently constructive on sectors in consumption, contractors and financials in Indonesian equities.

- **India:** Prime Minister Narendra Modi party's margin of victory in Indian elections surprised on the upside, which should give him greater flexibility in implementing difficult reforms. Domestic reforms carried out over the last few years have resulted in a more formal economy, with better public infrastructure and a healthier state of private sector banks. Despite some near-term slowdown, this backdrop provides a solid foundation for medium to long-term growth, which we believe will gradually improve in the second half of 2019. Turning to market sectors and we remain constructive on large private banks, as they are gaining market share with both deposits and loans. Furthermore, we also see a continuing improvement in asset quality. Elsewhere, we are also constructive on industrials which are benefiting from robust public spending on power, roads and housing.

- **Vietnam:** Although our current exposure in Vietnam is small, we are actively looking for opportunities in the country for several reasons. First, the government's macroeconomic management has notably improved from previous years. Growth has stabilised, and the central bank has kept inflation under control, translating to a more stable currency. Second,

[6] Widodo spoke of expanding education and health benefits during his campaign, two of middle-class and lower-class household' largest expenses. A meaningful boost in government support in these areas would thus increase income levels among households.

[7] In his first term Indonesia grew by 5.1% annually; the IMF said ambitious economic reforms could enable Indonesia to grow at 6.5% by 2022. Demographic trends are expected to increase Indonesia's annual real GDP growth by close to 1 percentage point during 2020−50. Source: IMF, "Realizing Indonesia's Economic Potential", 2018; The Economist, 31 May 2019.

> Vietnam is a primary beneficiary of shifting supply chains in Asia at the expense of China. Many multinational regional electronics producers have set up production in Vietnam, with more looking to do so as the threat of a long-term technology schism heightens. Some businesses have also increased trade with Vietnam by building up supply chains in the country for textiles. In fact, Vietnam was one of the fastest-growing sources of American imports from Asia in the last quarter and could potentially overtake the UK as a supplier to the US if it keeps up that pace[8].

On the last point, as discussed by my colleague Kai Kong Chay in his "Mid-Year Outlook: Greater China Equities", Sino-US trade tensions have reinforced the rebalancing of supply chains, creating opportunities for regional players in both NE Asia (Taiwan) and SE Asia (Vietnam, Bangladesh, and to fill the supply gap. China is the anchor of supply chains and trading blocs throughout the region, and now that businesses have the incentive to diversify manufacturing away from the country, its Asian neighbours stand to benefit. Increasingly, regional business should also employ a "one plus one" (China and an ASEAN country) approach to rebalancing their supply chains, which can open up new opportunities across the region.

From Tariffs and Tech to Talent

Our overall view of Asian equities is positive, acknowledging that volatility may be part of the near-term landscape. ASEAN countries should benefit economically from China's policy tools as the trade tensions unfold: whether it's managing the trajectory of currency, continued loosening in the form of reserve ratio requirements or lending-rate cuts, or developing local brands. While nimble small-to-medium enterprises in the ASEAN bloc stand to benefit from the changing dynamics of trade beyond the region, internally, Asia should continue to strengthen through deepening reforms, political stability and more vibrant domestic economies.

And this speaks to the larger point: The Asian market is evolving and creating new economic opportunities even amid persistent trade tensions. Indeed, if market observers believed 2018 was the year of "tariffs", and 2019 is the year of "technology", then 2020 may be the year of "talent". Although we live in a world dominated by numbers- from the rate of tariffs applied on goods to the latest GDP print- investors should also look beyond the data to understand how these disruptions are forcing countries to focus on human capital-building and seeding long-term reforms that will ultimately create a more dynamic and innovative region.

[8] Imports from the Southeast Asian economy jumped 40.2% in the first three months of 2019 from a year earlier, while orders from South Korea rose 18.4%, latest U.S. Census Bureau data shows.

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