The Changing Faces of Asia

Asia is undergoing a period of transformation. The growth at all costs model is a thing of the past, with quality of growth now much more important. Many of the key economies in Asia, such as China, Japan, India and Indonesia are all undergoing structural changes with varying degrees of success. Now could be a good time to reallocate funds back to Asia. As the different faces of Asia keep changing, this article aims to help investors rethink and review the market fundamentals.

A ROTATION BACK TO ASIA

After the US and then Europe have had their time in the sun, now could be the time for Asia to drive the global bull market forward. A rotation back into Asian equities is clearly indicated by net fund inflows, which have driven the outperformance of Asian markets over their developed western counterparts in the last three months.

Most Asian stock markets publish information about the level of foreign buying. This data shows that foreigners have been net buyers of all Asian markets pretty consistently over the last five months. This picture is supported by the mutual fund flow data, which shows that investors have been strong buyers of Asian mutual funds over the last few months.

In certain respects this is natural as investors compare the valuation of Asia to the US and European markets. Having gone through a period of rethinking and reviewing, many investors are starting to believe that now could be a good entry point. And on a relative basis, after a strong period of performance in western developed markets, Asian market valuations have started to show more appeal to global investors.

Beyond valuations, the recent strong performance in Asia is also supported by improved fundamentals and structural reforms endorsed by strong governments. These positive changes in turn underpin investor sentiment which looks set to remain buoyant in the coming months.

Looking into major markets across the region, it is not hard to identify that Japan and China are undergoing structural reforms intended to change the growth patterns of the world’s second and third largest economies; while the newly elected political leaders in India and Indonesia have caused an uptick in sentiment. Narendra Modi in India and Joko Widodo or “Jokowi” in Indonesia are both seen as pragmatic leaders who are expected to reduce corruption, cut through red tape, build infrastructure, and lead world’s second and fourth biggest countries by population back onto faster growth tracks.

CHINA – ADAPTING TO THE “NEW NORMAL”

There has been a visible improvement in the performance of China equities in the last few months which has been an instrumental part of the Asian market revival. This improvement relates to two main drivers – smaller scale and targeted stimulus and reform of state-owned enterprise (SOE), which should help the country adapt to a “new normal” of a slower but more sustainable pace of growth.

Mini Stimulus

The government has put in place modestly loose and stimulative conditions to help stabilise economic growth, instead of large scale stimulus which would spur short-term growth at the expense of longer-term reform efforts and risk increasing debt levels and bad loans.

In a recent speech at the World Economic Forum, Premier Li Keqiang said the government would maintain its focus on structural adjustments and dealing with long-term issues such as employment rather than paying too much attention to short-term issues.
fluctuations in some economic indicators.\(^2\)

This year, the People’s Bank of China (PBoC), along with targeted Required Reserve Ratio (RRR) cuts, has also used tools such as re-lending, re-discounting, Standing Lending Facility (SLF) and Pledged Supplementary Lending (PSL) to provide financing for targeted industries or projects such as agriculture and affordable housing.

Meanwhile, some cities have relaxed home purchase restrictions, and banks have eased mortgage requirements.

For example, in the second quarter, the PBoC provided a three-year RMB1 trillion PSL to China Development Bank for projects relating to slum clearance – a form of targeted stimulus that will boost base money, at a lower rate of 4.5% than the benchmark rate of similar tenor which is 6.15%\(^3\). More recently, the central bank provided another three-month RMB500 billion (USD81 billion) SLF for the country’s Big Five banks to channel funds to public housing, private businesses and other areas important to the economy.

The impact of the liquidity injection is expected to be similar to a RRR cut of 50 basis points on China’s entire banking system\(^4\).

Compared to one-time rate cuts, the PBoC has more flexibility in terms of allocating liquidity by rolling out these targeted mini stimulus programmes, and is able to alleviate short-term liquidity tensions without causing a possible large scale overflow of liquidity.

### China’s (selected) mini stimulus programmes in 2014

<table>
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<tr>
<th>Date</th>
<th>Description</th>
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<tbody>
<tr>
<td>Apr</td>
<td>200bp RRR cut for qualified rural commercial banks and 50bp RRR cut for rural cooperative banks</td>
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<tr>
<td>May</td>
<td>The PBoC called for greater support for mortgage loans, especially for the first home buyers</td>
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<tr>
<td>Jun</td>
<td>50bp RRR cut for qualified banks leading to agricultural or small and micro-sized companies</td>
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<tr>
<td>(2Q)</td>
<td>RMB 1 trillion PSL to China Development Bank for social housing projects</td>
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<tr>
<td>Aug</td>
<td>State Council issued ten detailed guidelines to lower the funding costs for the real economy</td>
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<tr>
<td>Sep</td>
<td>The PBoC provided a total of RMB 500 billion of SLF to the Big Five banks</td>
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Source: FIL Limited, PBoC, CBRC, State Council, FT, September 2014

#### SOE Reform

The bottom-line impact of SOE reform is arguably the area where the most progress has been made since the reform programme was announced by the third Plenum last November. The reform programme is aimed at shifting economic power away from SOEs and towards the private sector.

Since the global financial crisis in 2008, while the dominance and monopolies of state companies have increased in key sectors, their efficiency has been decreasing but debt ratios have climbed. The return on equity (ROE) of state companies has steadily fallen since 2008, and the government’s stimulus packages have caused leverage ratios of state companies to rise significantly, as they tend to have better access to bank financing than private companies. From 1996 to 2013, the ROE among state companies has been inversely correlated with the percentage of state-owned equity.

This indicates that a higher level of private equity participation is likely to improve the efficiency of state companies. Developing mixed ownership is a market-based methodology to enhance efficiency and profitability by inviting private-sector capital. The reform is not only positive for SOEs’ earnings outlook, but also meaningful in terms of supporting China’s GDP growth especially at a time of economic slowdown.

Although SOE reform is a long term and on-going process, the share prices of those SOEs being reformed have improved and this is likely to continue for the rest of the year. Examples include China Mobile, one of the best stock market performers at the time of writing, where the bottom line should be helped by reduced handset subsidies; Petrochina, where increased capital expenditure discipline could improve cash flow; and China National Building Materials, where increased private sector equity ownership could improve a weak balance sheet.
Correlation between ROEs of listed SOEs and shares of state-owned equity

Correlation = - 81%

Source: FIL Limited, Goldman Sachs, Wind, June 2014

Shanghai – Hong Kong Stock Connect

Global investors will soon be able to monetize China’s still promising growth in a more direct and efficient manner through the Shanghai-Hong Kong Stock Connect scheme to be launched in mid-October. Investors will be able to trade RMB10.5 billion of Hong Kong-listed stocks through the Shanghai exchange (Southbound), and RMB 13 billion of mainland shares through Hong Kong (Northbound) on a daily basis.

Seen as a significant step in the opening up of China’s capital markets, the scheme is expected to integrate the China A and Hong Kong markets to create a single ‘China’ market which would rank as the second largest equity market by market cap (USD6.7 trillion) and the third largest in terms of cash trading (USD35.7 billion per day), and adds 855 companies with more than USD 1 billion of market capitalisation to the investable universe for global investors. Referring to the experience of other Asian markets such as Korea and Taiwan, Goldman Sachs expects China A shares to be included in global benchmarks in the near future.

JAPAN – CORPORATES IN FOCUS

The policies of Shinzo Abe have garnered much attention since they were laid out in early 2013. Initial enthusiasm over Abenomics has given way to scepticism, which was exacerbated by a fall in quarterly GDP post the increase in consumption tax in April 2014. The focus of attention is now very much on the all-important third arrow of growth-oriented structural reform. While the trajectory and the target of the first arrow (monetary easing) and the second arrow (fiscal stimulus) was easy to see, it may not be realistic to expect the immediate impact of the third arrow, which has wider and more long-lived aims.

A more relevant focus area is the corporate sector, where a range of policy actions could bring about improved ROE at Japanese companies and reignite sustained interest in Japanese equities. By transforming the corporate sector, the government can go a long way to transforming Japan and leading the broader economy to a sustainable growth path. Higher corporate profitability can support higher wages, increased investments and improved shareholder returns, which should help underpin pension fund performance and increased tax revenues.

“This news is positive and highlighted further integration between the HK and China markets. Once implemented, it is likely we’ll see liquidity improve and the valuation gap between A and H shares will be arbitrated. Additionally, the news is supportive for overall sentiment.”

John Ford, Chief Investment Officer, Asia Pacific Equities
Robust Corporate Earnings

Despite weak recent economic data such as headline GDP and industrial production numbers, the Japanese stock market performed well in the second quarter and foreign investors became net buyers again.\(^6\)

Investors’ focus has been shifting from macroeconomic policies to individual company’s fundamentals and earnings growth potential. Corporate earnings have been robust - Topix earnings were up 2% QoQ and 3% YoY during the second quarter.\(^7\)

It is clear that it is earnings that drive share prices, not GDP. CLSA research shows that the disconnect between GDP and profits is not a new phenomenon in Japan, as changes in GDP over the last 20 years only explain 2% of the variation in profits over the same time period.

Nominal GDP and nominal pre-tax profits (JPY trillion)

“A combination of improving fundamentals and attractive valuations is clearly good news for investors and this – coupled with the fact that the Japanese market is under-researched for its size – is creating significant opportunities for bottom-up stockpickers.”

Nicholas Price, Portfolio Manager of FF Japan Aggressive Fund

Corporate Governance and Capital Efficiency

One of the key domestic growth drivers of Japanese equities is corporate governance and capital efficiency. Despite a track record for product innovation, Japanese companies have generally displayed a relatively poor record on profitability and shareholder value creation. In a bid to solve the paradox, the government has put Japanese companies at the front and centre of its structural reform efforts.

The Ito Review\(^8\) reveals that Japanese companies showed similar levels of leverage and asset turnover relative to the US and Europe but significantly poorer returns on sales and ROEs. In fact, most Japanese companies’ ROEs are below the average cost of capital of 6-7%. On the other hand, deflation since the 1990s has led companies to hoard cash on their balance sheets.

A key goal of Abenomics is to activate this cash, either for efficient reinvestment in the business or for improving shareholder returns. The new Stewardship and Corporate Governance codes are designed to reshape Japanese corporate behaviour.

Published in February 2014, the Stewardship Code is aimed to improve communication between companies’ shareholders and management. After publicly accepting the Code, institutions should disclose their intentions to vote their shares, publish their voting records, and engage in dialogue with companies on issues that could impact long-term shareholder value, or to explain why they do not. Having long been silent, institutional investors signing up to the Code are now expected to play their part in cajoling companies onto more sustainable growth paths that create shareholder value in the long term.
The data from Japan's Financial Services Agency (FSA) shows that, as of 10th June 2014, 127 institutional investors had adopted the Code, who collectively hold around JPY88 trillion (USD860 billion) in Japanese shares or about 19% of the equity market.6

The Corporate Governance Code, due to be published by the Tokyo Stock Exchange and FSA in time for the 2015 season of general shareholders’ meetings, is designed to elevate the broad governance culture among Japan companies. In 2013, less than 20% of TOPIX companies had external directors, compared to 85% in the US and 70% in Europe. The introduction of the Code is expected to positively redefine Japanese company board structures, and, in turn, to support a firmer focus on shareholder value creation.

In addition, the Japan Government Pension Investment Fund (GPIF), the world’s largest pension fund with JPY128.6 trillion (USD1.26 trillion) assets under management, has championed the use of the new JPX-Nikkei 400 index, a select group of companies with high ROEs and good governance. The GPIF’s requirement for some of its passive equity managers to track the JPX-Nikkei 400, rather than the Topix, has already begun to create a new hierarchy in the market. It now looks clear that the management of Japanese companies will no longer be able to ignore low ROEs, since they risk disinvestment and voting opposition from pension funds adopting new ROE-aware benchmarks.

Taken together, these reform measures represent a potentially powerful set of catalysts for shifting Japanese corporate behaviour away from stakeholder-centric to shareholder-centric. A combination of top-line growth, improving profitability, and improving capital efficiency in the Japanese corporate sector would create a more favourable market environment for stock pickers and rekindles lasting interest in Japanese equities among global investors.

INDIA AND INDONESIA – HOPE ON NEW LEADERS

Both India and Indonesia have elected new leaders – Narendra Modi and Jokowi - who bring a breath of political fresh air. Neither leader is from the established political elite families that have ruled those countries for decades, and both are widely expected to improve the business operating environment, at first glance at least, through actions such as reducing corruption, cutting through red tape, building infrastructure, and improving government efficiency.

India – Improved Fundamentals

India has seen a pick-up in growth following a couple of years of disappointment. Barely a year ago, Indian equities were suffering primarily due to the lack of policy initiatives and weak governance, but they have rebounded sharply this year. Foreign investors have been net buyers in India this year. As of 27th Aug, flows have risen sharply to USD 30 billion, up 360% YoY, including USD 13 billion into equities. The strong performance is not only attributable to upbeat sentiment brought by the election result, but also meaningful improvement in the fundamentals of the Indian economy.

In the March-June quarter this year, India’s real GDP expanded at an annual rate of 5.7% — the fastest rate in more than two years. Consumer-price inflation has come down to around 8% from a double-digit level one year earlier. The country’s fiscal deficit for the April to July period was reduced to 2.5% of GDP from 3.0% in the same period last year. Having touched a record low of INR69 to the dollar last August, the rupee has also recovered to the INR60 level.

For the first time in 30 years, the election has led to the formation of a single party majority government and it seems that India’s policy paralysis might finally be coming to an end. The new pro-business government has raised hopes that policy initiatives will be stepped up to help the economy get back to its higher long-term growth trajectory.

The government’s structural reform agenda is aimed at removing supply-side bottlenecks to growth, reducing the fiscal deficit, incentivising infrastructure investment, private investments to restart a new capex cycle, equity infusion in banks, tax incentives to increase disposable incomes and capital markets reforms are all steps in the right direction.”

Sandeep Kothari, FF India Focus Fund’s Portfolio Advisor
focusing on labour-intensive manufacturing, and improving governance.

The Union Budget presented by the new government on 10th July primarily aims to bring the fiscal deficit down to 3% and revive GDP growth to 7%-8% in three years from the current pace of 4%.

The Budget intends to push infrastructure investment, including setting up seven new industrial cities, 15,000 km of gas pipelines, 16 new ports (while upgrading existing ports), starting urban railways in cities with populations over two million, and building 8,000 km of new highways. Banks will be allowed to give long-term loans for these infrastructure projects without restrictions on their reserve/liquidity requirements. The government also encourages private sector participation in infrastructure projects.

A key challenge for the new government is to re-start the investment cycle by providing a more conducive environment for businesses to operate in. In the Union Budget, the government encouraged foreign direct investment (FDI) by raising foreign shareholder caps in the insurance and defence sectors from 26% to 49%. The foreign ownership limit for the e-commerce sector has been raised to 100%. It also encouraged companies to revive their capex plans by providing an investment allowance of 15% for a period of three years to manufacturing companies willing to invest more than INR250 million in plants and machinery.

In August, the government continued to deliver its budget targets, launching Pradhan Mantri Jan Dhan Yojna, a mega financial inclusion plan under which bank accounts and RuPay debit cards with inbuilt insurance cover of INR100,000 will be provided to people with no access to formal banking facilities. The scheme seeks to provide two accounts to each of the 75 million identified households by August 2018, and would cover both rural and urban bank accounts linked to a RuPay debit card. The plan would not only enhance India's financial structure and boost the banking sector, but also provide large-scale employment and alleviate poverty by bringing the poor into the economic mainstream.

Indonesia – Expectations on Jokowi

Thanks to the favourable election result, Indonesia is the best performing market among the five ASEAN countries this year. Foreign net buying has been strong, having amounted to USD4.8 billion at the end of August. With the positive sentiment fully priced in, the market will be evaluating Jokowi's actions and plans on future policies when he takes office on 20th October.

One key catalyst for the market over the next 12 months is cutting the huge fuel subsidy which is blamed for many of the country’s problems, including high current account deficits (CAD) and slowing growth. The successful execution of fuel subsidy cuts would also reflect Jokowi’s commitment to reforms, and hence improve Indonesia’s outlook for the coming decade.

In the past ten years, the Indonesia government has underspent its capital spending (mostly for infrastructure) but overspent its subsidy budget, except in 2009 when oil prices fell sharply. The phenomenon shows that the government’s spending ability is being held hostage by the oil price movement. Currently, fuel prices are more than 50% subsidised, a level which is no longer sustainable.

The Revised State Budget of 2015 allocated IDR291.1 trillion (USD$24.7 billion) to fuel subsidies, equivalent to 14.4% of total planned government spending in 2015. This shows the incumbent government has little interest in improving the country’s fiscal situation and creates further expectations on Jokowi to cut fuel subsidies quickly.

Cutting the fuel subsidy would give more fiscal room to the government to spend on infrastructure and rejuvenate the economy in the medium term. Luhut Pandjaitan, adviser to Jokowi notes that the government has to spend at least 5-6% of GDP on infrastructure (vs. 2.5% of GDP as per 2014 Budget) to ensure GDP growth over 6%, and prioritise the spending on seaports, railway double-tracking, power plants,
electricity transmission, gas pipelines, agricultural irrigation and research facilities. Infrastructure and other related sectors such as construction and banking would benefit from the reform in energy and reallocation of public spending.

Indonesia’s fuel subsidy is at unsustainably high level (IDR trillion)

“Hopefully, the new president will be able to tackle some of the longer-term issues facing the country like improving infrastructure, reducing reliance on subsidies and driving more business investments so that Indonesia can turn into a current account surplus country without having to rely so heavily on commodity prices.”

Gillian Kwek, the portfolio manager of FF ASEAN Fund

CONCLUSION

Already the most fast developing continent, the exciting new element of economic reforms adds a fresh new dimension to the appeal of investing in Asia. With valuations being attractive, now could be a good entry point for investors to increase their allocations to the region in order to participate in the continent’s long-term structural growth story.
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