

7. What are the long-term prospects for Chinese growth and investment?

Although the economic reopening after years of lockdown will generate a powerful near-term boost, longer-term prospects over the next decade will be less attractive than those experienced during the previous decade. The IMF sees economic growth over the next decade averaging c. 4.5% vs. over 7% in the decade prior to the pandemic. This growth deceleration will be caused by declining demographics (the total population is expected to shrink, compounded by rising dependency ratios due to the lagged effects of the 'One-Child' policy), less scope for debt-fueled investment given high debt levels, and a constant backdrop of geopolitical tensions with the US over Taiwan and potentially other regions. In light of the above backdrop, we are targeting a structural 'at weight' exposure to Chinese equities, but will tactically vary exposure levels in both directions over time depending on the specific opportunity sets available and valuation levels.

After being the first economy to reopen following the initial wave of Covid-19, the Chinese economy rebounded strongly in 2020 and the first half of 2021, generating GDP growth of 8.1% in 2021. On the back of this economic strength, Chinese policymakers chose to take action on their long-stated goals of addressing social and systemic risks caused by the rapidly expanded consumer internet sector and the build-up of debt levels across the economy (with a specific focus on property developers). 2021 and 2022 were marked by crackdowns on technology companies, curbs on borrowing by the country's property firms, compounded with a refusal to ease very restrictive Zero Covid policies. While some policies seemed well-intentioned and rational over the longer term, the implementation was both swift and heavy-handed, compounded by a poor communication of policy change domestically and internationally. As a result, investors demanded a much higher risk premium for holding Chinese assets whose volatility rose sharply. For example, the MSCI China equities index fell -24% in 2021 and fell a further -43% to a nadir in October 2022, before rebounding by 41% on the easing of Covid restrictions to end the year down -20%.

China is no stranger to implementing radical reforms. In the 1980s Deng Xiaoping privatised many industries and eliminated price controls, protectionist policies and regulations to restart growth following years of stagnation under Mao. These moves transformed the economy, paving the way for China's entry into the World Trade Organisation in 2001, introducing the global market to the vast and cheap Chinese labour force. What followed was four decades of uninterrupted growth of the Chinese economy, increasing GDP per capita from less than \$200 to \$12,500 per person (c.11% p.a. equivalent). This rapid growth story paved over cracks within the economy and the broader ideological legitimacy of the Communist Party which the actions taken in 2021 were designed to address. The inability to execute these successfully, led to a sharper-than-expected deceleration and market volatility.

A re-pivot to focusing on economic growth, including a full reopening from “Zero Covid” and supportive fiscal and monetary policy, means growth for 2023 should be strong.

However, after the October 2022 Party Congress, there seems to have been another policy ‘*volte face*’. The restrictions that had been hampering the Chinese economy since mid-2021 appear to be easing at a very rapid pace. At the December 2022 Central Economic Work Conference – the annual economic-policy agenda setting meeting for the Communist Party of China (“CPC”) – the top priority for 2023 was economic growth. This contrasts sharply with the Party Congress narrative a few months earlier, where the rhetoric was focused on security, socialism, and defence.

This policy shift, and greater clarity over the future regulatory environment, have led to expectations for economic activity to reaccelerate in 2023. Rising consumption and normalising services spending should boost employment, while declining risk aversion should lower the household savings rate. Deutsche Bank forecast over 6% GDP growth in 2023 and 2024, while others have similarly upgraded their forecasts, supported by an expected boom in reopening spending. The main reasons are:

China has fully reopened from “Zero Covid” lockdowns

Then: Focused on sticking to a “zero covid” policy throughout most of 2022 due to a large number of unvaccinated elderly and a vaccine that was low efficacy against new variants.

Now: The abrupt end of essentially all Covid restrictions, triggered in part by public unrest in Shanghai, was one of the biggest surprises in Chinese policy. Most forecasters expected a slow reopening starting around March/ April 2023, at the end of the regular flu season, to minimise the impact on the health system.

The Chinese property Sector is now being offered support

Then: Property developers were one of the earliest targets of regulation. The “three red lines” policy aimed to insulate the risk built-up from excessive levels of leverage at property developers from the broader economy, by putting red line limits on debt-to-cash, debt-to-assets and debt-to-equity ratios, beyond which additional borrowing would be limited.

Now: Only c.6% of property developers complied with all three red lines at the start of 2021.³² The stress put on working capital due to fewer pre-sales during covid lockdowns, triggered a mass liquidity crisis and a series of defaults on the debt of property developers. In 2023 we have seen a move from “3 red lines” to a “16-point recovery plan”. The government, in response to the growing unrest over unfinished apartment buildings and the potential for a complete collapse of the whole industry, removed many of the debt restrictions, while urging banks to lend more to developers and making it easier for developers to borrow.

Technology reforms are “basically complete”

Then: The growth of the consumer internet sector over the past decade created two great challenges for the Communist Party. First, the cultural control these platforms exerted were huge, promoting behaviour deemed undesirable by the Party and challenging their control (e.g., media addiction). Second, it created vast wealth for founders, which in turn provided them with broader power and influence as well as highlighting inequality within society.

Now: Fast forward to 2023, China has moved to create “golden shares” in the influential tech companies, such as Alibaba and Tencent, where by the Government owns a 1% interest in the company but this provides them with a Board seat or special voting rights on certain key business decisions. Guo Shuqing, the Communist Party secretary at the People’s Bank of China, said the so-called rectification campaign of 14 large tech platforms was “basically complete.”

Despite positive sentiment at the start of 2023, longer-term we view the era of extraordinary China growth to be nearing an end.

Putting the Chinese economy back on the right long-term track will require more than just the reversal of recent policies, due to ongoing structural problems or “the four D’s” – Demographics, Debt, Decoupling, and Demand.

³² S&P Global

Demographics: The Chinese population has shrunk for the first time since the “Great Leap Forward” famine, placing a firm headwind to economic growth in the country’s path

Ageing economies are nothing new. The developed world is rapidly ageing. However, China is facing an increasing risk of “getting old before it gets rich” – the so-called ‘middle-income trap’. 2022 marked the first year that the official Chinese population shrank in sixty years. The number of births dropped to <10m in 2022, the fewest since 1790. Even if China succeeds in preventing its fertility rate from declining and increasing it to 1.1, its population is forecast to drop to 1.08 billion by 2050 and to 440 million by 2100, approximately the same size as the US. All being equal, the country’s share of the world’s population, which declined from 37% in 1820 to 22% in 1950-80, will fall to 11% in 2050 and 4% by 2100.

China’s efforts to boost its fertility rate face three major challenges:

1. The One-Child policy dramatically increased the cost of raising children as the working-age population has to carry a larger share of the burden of supporting their parents.
2. China’s household disposable income is equivalent to only 44% of its GDP, compared to 72% in the United States and 65% in the United Kingdom.
3. The Chinese housing market was valued at four times the country’s GDP in 2020, whereas the US real-estate market is valued at 1.6 times GDP making new household formation costly.

It is unlikely that policymakers would burst the property bubble to the extent required to allow young people the chance to step on the property ladder as it would stymie growth and potentially create financial systemic risks. This leaves the option of Japan-style policies to encourage childbirth e.g., reducing the cost of schooling through the banning of for-profit after school education. However, in Japan, these policies were costly, with only a temporary boost. The slow march of demographics seems to be one that China will not be able to reverse.

Debt: The room for continued use of debt to drive China’s economic growth is limited by already high debt levels and fear of systemic risks.

Economic stimulus remains supportive, which should support 2023 growth. However, this is coming from a low base. Overall, policy looks balanced and does not yet point to large-scale stimulus. Gavekal sees a rapid rebound of service-sector loan demand, stronger policy support and a sales recovery in the property sector leading to a substantial increase in developer financing and mortgage issuance. Total credit growth will probably peak at around 11% this year, which, after accounting for a likely modest increase in government debt, means private credit growth should climb to about 10.5%, a level similar to 2020. However, conservative monetary policymakers have noted the risk of inflation and will probably tighten if the economy starts to heat up rapidly.

Beyond this year, the outlook remains challenging. Debt becomes a challenge when levels grow faster than the economy – either because borrowing costs and/or levels have risen, or because borrowing is being used to finance projects which are less multiplicative to economic output. Years of reliance on debt-fueled investment-led growth has reduced the efficiency of capital investment. Viktor Shvets³³ highlights that the Chinese economy now needs \$8-10 of investment for every dollar of GDP that it generates.

China’s debt as a % of GDP hit a new high in June 2022, with local authorities borrowing heavily to underpin an economy weighed down by Covid-19. This increases the chance that debt could cause a systemic risk to the economy, under certain scenarios. Hence, Chinese officials are likely to gradually start dialing back infrastructure investment when the property market recovery reaches a more stable footing. Other factors could also speed up the withdrawal of supportive policy. As witnessed in developed countries, a rise in demand for service sector employment combined with a reduction in labour availability due to high levels of illness from Covid could see currently low levels of inflation begin to climb through upwards pressure on wages and inflation.

Decoupling: The Chinese economy under Xi Jinping is placing greater emphasis on security and independence, as competition with the United States continues to cause global frictions and risks of further decoupling

China's GDP was 13% the size of the US in 2001, 77% in 2021 and is expected to surpass the US by 2030. Under Hu Jintao, Xi Jinping's predecessor, China did not have a particularly clear policy on international relations, leaving it open to interpretation and making the relationship between China and the US easier. Xi Jinping, however, felt that the relationship between China and the US did not reflect the current economic standing of both countries, and he adopted a more assertive and less accommodative approach to relations. In the dialectical view of the Chinese leadership, the United States is an implacable enemy out to stifle China's rise to be the largest economy in the world. With that in mind, being self-sufficient or at least having a sphere of influence outside of those controlled by the US is critical. This is what has been driving the increased focus on security, socialism, and defence.

For the Biden administration, its stated desire to work with Beijing to address shared interests in combating climate change and "managing strategic risks" in the bilateral relationship was balanced against a long list of concerns from ongoing trade disputes, human rights abuses in Xinjiang, Tibet and Hong Kong, and Chinese ambitions for Taiwan.

The US CHIPS Act aims to create more onshore semiconductor manufacturing capability in with the stated goal of reinforcing national economic security strategy. In China many view this as confirmation that the US is actively looking to slow down China's broader growth. Regardless of the motives, it is being called the most serious challenge to Chinese growth for 44 years.

The Chinese do not have the scientific ability to recreate the technology and it is not something they can fix in the near term by spending a lot of money. The reason the US was able to successfully handicap the high-tech industries in China, is that China heavily depends on Western intellectual contribution.

The war in Ukraine has also highlighted the continued risk of threats from Chinese claims over Taiwan. Investors in Russia experienced the impact of holding investments in a country that faced swift sanctions. Conversely, it also highlighted to China the risks of a poorly executed invasion. Many experts believe that the risk of a war over Taiwan in the near term is low – due to the reliance China and the US have on each other economically. However, in the medium to longer term, the risks appear greater. President Xi has stated numerous times that Taiwan is considered part of China and will be reintegrated at some point. One of the biggest risks on the horizon is the potential election of a pro-independence candidate in the 2024 Taiwan elections. General Mike Minihan, head of US Air Mobility Command, predicted that US and China will go to war in 2025, with the Taiwan presidential elections giving Xi his reason to do so. However, President Xi and the Chinese Communist Party are far too aware that an outright invasion of Taiwan would also be a daunting strategic task. Such a war could last years and would require significant preparation. A strategic surprise would be a casualty of the sheer scale of the preparations needed, including:

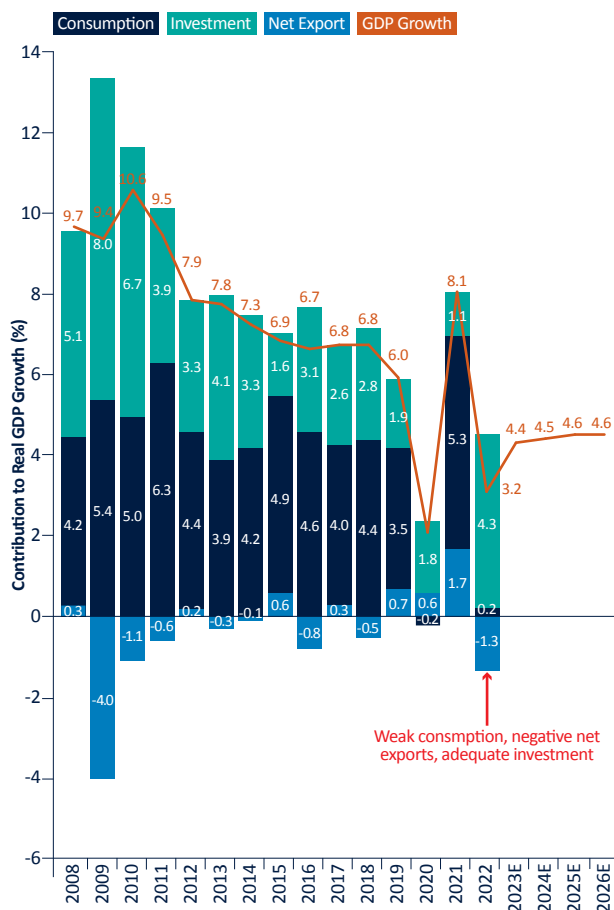
- **Build-up of munitions**
(no strong evidence so far)
- **Build-up of enlisted personnel**
(no strong evidence so far)
- **Financial insulation against sanctions**
(some evidence but also tied with the benefits of reducing economic reliance rather than purely to remove the risk of sanctions)

Demand: For years China has hoped that a boom in domestic consumption will become a source of sustainable economic growth, reducing dependence on volatile foreign demand and replacing the natural decline in exports and capital formation. Without further economic liberalisation and an increase in social safety nets the savings rate in China will likely remain high, hindering consumption from becoming a stronger driver.

Last year, outgoing Premier Li Keqiang stated “the greatest potential of the Chinese economy lies in the consumption by the 1.4B people”. In 2022, as economic conditions worsened, consumption accounted for about a third of the 3% annual GDP growth rate. In comparison, consumption accounted for two-thirds of China’s 8.1% annual GDP growth rate in 2021.

Exhibit 41

With the outlook for other drivers of growth souring, it is not clear that domestic consumption in China can pick up the slack

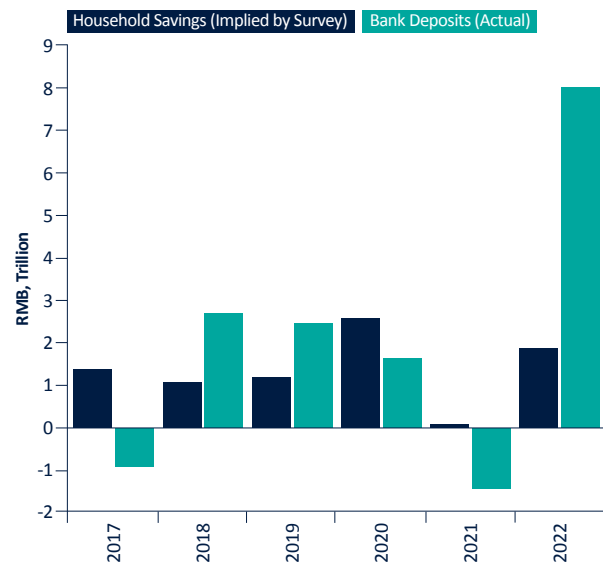


Source: BCA, National Bureau of Statistics China

It is hoped that abandonment of zero-COVID policies will unleash a flood of Chinese spending. If reopening does increase confidence, some studies suggest that large pandemic savings will support spending (c.\$3.9T in bank deposits according to People’s Bank of China). However, this huge build-up of bank deposits is largely down to wealthy households changing their asset allocation out of riskier assets and delaying property purchases, rather than excess savings. It stands to reason that excess deposits are mainly in the hand of wealthy households with a low propensity to consume (particularly domestically within China following re-opening), and will likely flow back into financial assets.

Exhibit 42

Households did save in 2022, but a large part of the increased deposits was not surplus saving, rather wealthy households moving out of risky assets (shown is the change in annual flow of total household savings (from a survey) and new bank deposits)



Source: Gavekal

Longer-term, continued uncertainty on outlook combined with the lack of social safety nets in China – something highlighted clearly during the pandemic – make it unlikely that the savings rate will decline to anywhere near the level that will help create strong internal consumption-driven growth.

Investment Implications: In light of the above backdrop, we are targeting a structural ‘at weight’ exposure to Chinese equities, but will tactically vary exposure levels in both directions over time depending on the specific opportunity sets available and valuation levels.

8. What is the outlook for investing in Emerging Markets ex-China?

At present, a combination of tactical tailwinds, structural headwinds and execution options lead us to maintain a market weight exposure to EM. In the medium term, we expect to see strategic opportunities (particularly in India), including private allocations, as we develop our network within the space.

At a very high level, any peak in developed market monetary tightening would likely remove an important support for the US Dollar. US dollar strength typically acts as a headwind for emerging market equities (EM), Exhibit 43.

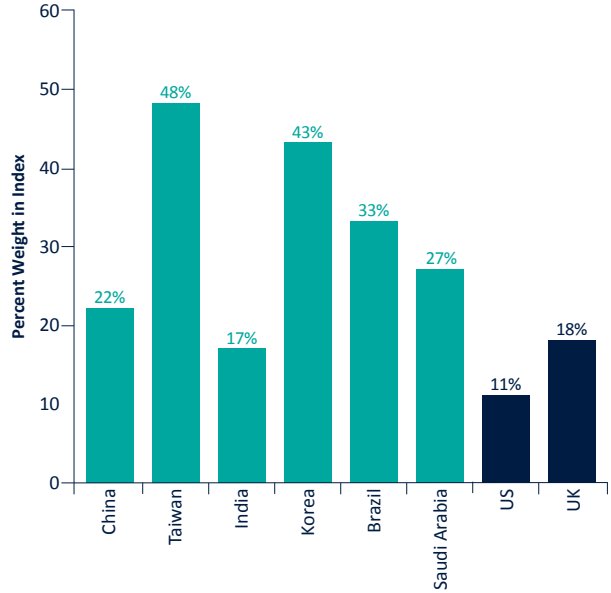
Exhibit 43
EM equities tend to outperform in weakening US Dollar environments

Scenario (Data 2000 - present)	Average EM outperformance v DM (YoY %)
US Dollar Index YoY >10%	-10%
US Dollar Index YoY >5%	-3%
US Dollar Index YoY <-5%	12%
US Dollar Index YoY <-10%	16%

Source: Bloomberg

However, given the paradigm shifts outlined earlier, past history may be less representative of future performance. China, the main driver of EM equity performance, faces clear structural issues (which are discussed further in our China section). China’s reopening post-Covid should benefit broader EM through regional trade, tourism, and commodity demand but targeted passive investment options are somewhat constrained. Accessing specific countries via ETFs is inhibited by either a proliferation of poor governance or high levels of stock concentration and idiosyncratic risk (Exhibit 44), be it in semiconductors in Taiwan and Korea, or basic materials and energy in Brazil. In those regions where corporate governance is a concern and local relationships are a significant asset, we will only be comfortable investing in conjunction with specialist managers with deep regional knowledge. Outside of China, the only large EM market that we currently deem to be sufficiently diversified alongside of having a wealth of active management opportunities is India. As we discuss in further detail below, we believe there are many attractive features of the Indian market, but it is not clear that these are best accessed through public markets given valuations at present.

Exhibit 44
% weight of top 2 stocks in index



Source: Bloomberg

This leads us to conclude that maintaining market weight exposure to EM via broad passive instruments is the most appropriate stance as we reduce our China overweight. We continue to explore and build upon the menu of active managers we have available in EM as well as assessing the potential for future private allocations to India and

other countries in Southeast Asia. Private allocations could facilitate more direct access to companies that are exposed to the strong underlying growth trends in the region.

India: What is the long-term outlook for investment?

The Indian economy has a structural growth advantage over others in EM, thanks to demographics, government initiatives and trends in international supply chains. Private allocations may offer the best access to this growth, but questionable corporate governance standards mean it is essential to find investment partners with deep local knowledge and strong due diligence credentials.

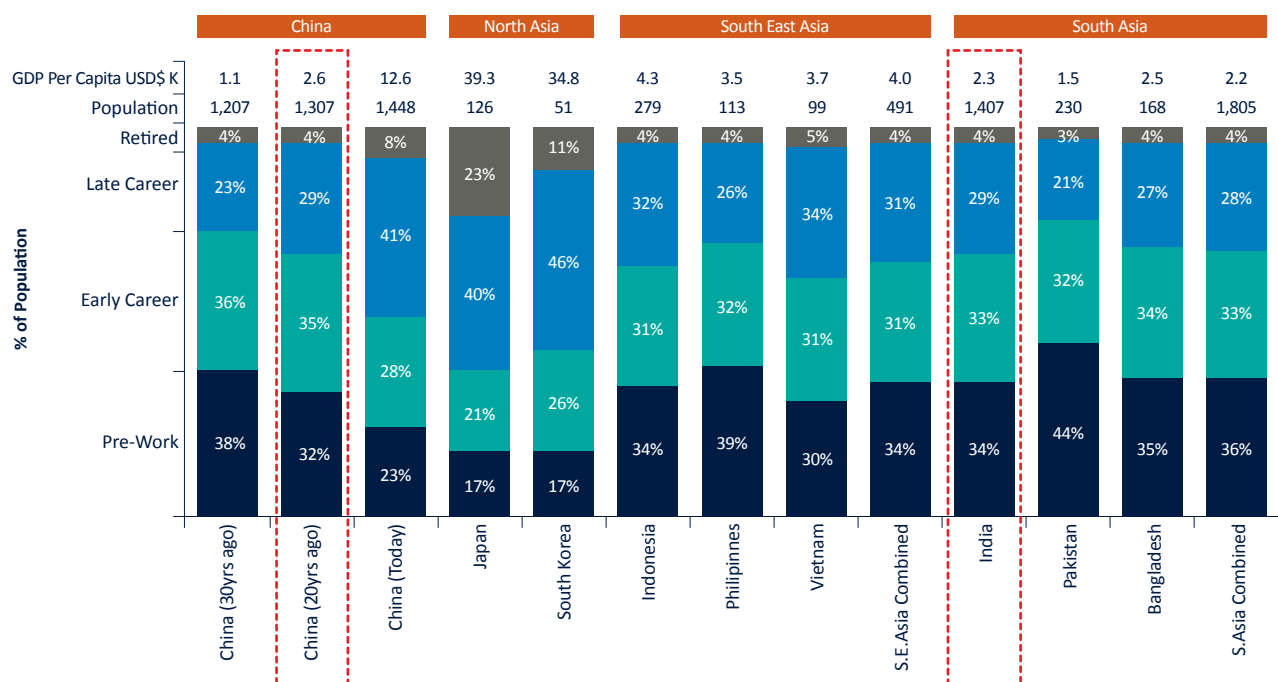
Experts estimate that the impact of demographics, government policies and investment will mean that real GDP growth in India will average +6.5% over the coming decade compared to just c. +4% in China.³⁴ Morgan Stanley estimate that India will be the 3rd largest economy in the world by 2027 with its GDP forecast to double over the next 10yrs. This

superior growth is primarily based on demographics and government policies designed to entice capital investment into the economy. India's population is young and not expected to peak until 2064 with a median age of just 27yrs. The population in China, by contrast, has already begun to contract with a median age close to 40 years.³⁵ India's population mix and GDP per capita closely resemble the demographic mix observed in China 20 years ago (Exhibit 45). Income levels are also growing at a rapid rate and the proportion of the population classified as middle class has risen from 14% a decade ago to 31% at present. It is expected to rise to 63% by 2047.³⁶ This would represent a significant change in the industrial mix of the Indian economy and its consumption patterns. In order to facilitate this transition, a major logistics upgrade is required akin to what occurred in China over the course of the last two decades.

The government believe that a programme centred on attracting capital via tax cuts, incentives for manufacturing and infrastructure development will drive a revival in the corporate CAPEX cycle. They expect this will be aided by the trend in international supply chain diversification away from China. The government is allocating 20% of its fiscal budget towards capital investment in 2023, the highest amount in over a decade.³⁷ This is a strategy which has been enabled by reform of the tax system in

34 Morgan Stanley
 35 UN Population Division
 36 UN Population Division
 37 Bloomberg

Exhibit 45
India's demographics closely resemble those of China 20yrs ago



Source: World Bank

recent years with tax revenues that have jumped +34% in the last year and nearly tripled in the last 10yrs.³⁸ Spending on physical infrastructure has risen to 8T Rupees from just 1T Rupees 9 years previously and the government has successfully rolled out a huge digital infrastructure system known as “India stack” which includes a payments system and a digital identification system.³⁹ On initial inspection, the programme seems to be working. Tata, India’s 5th largest listed corporate, intends to invest \$18B annually out to 2027, a figure which would make it India’s largest investor.⁴⁰ The three largest areas of investment will be directed towards energy transition, technology (particularly semiconductor packaging) and digital consumption. International companies are also investing. The Economist reports that Apple exported more than \$2.5B worth of iPhones from India in 2022 nearly twice the previous year’s figure. Foxconn, Apple's largest supplier, has been attracted by the ample supply of labour (at a 50% lower cost than China) and the significant tax incentives offered by the Modi administration. A key question is whether this investment cycle will be different to the last cycle which lasted from 2003-2011. That cycle was driven almost entirely by debt financing and ended in a protracted deleveraging process for Indian financials which are a key driver of performance in listed equity markets. The opportunity set outside of listed equity markets has increased significantly in recent years. Bain Capital reported that both the number and average size of venture capital deals in India have doubled in the last two years leaving the market four times as large as it was in 2020.⁴¹

While a growing private opportunity set looks attractive, there should be a high hurdle for assessing opportunities given the significant issues with corporate governance. Investment in India is not without its structural challenges. There is a history of poor governance practices that have left investors exposed even in the very recent past. Byju, once India’s most valuable start-up, is now in the process of cutting its headcount after being accused of inappropriate accounting practices in recent months,⁴² a charge they deny. The Economist has reported that several other high-profile start-ups also stand accused of fraud or at the very least overly aggressive accounting

assumptions. These issues also extend to listed equities. In late January 2023 Hindenburg Research, an infamous activist short seller, released a report in which they alleged that Adani Group, the third largest conglomerate in India, had engaged in stock manipulation and accountancy fraud.⁴³ Adani have denied the allegations calling the report “malicious”, “selective” and “baseless”. The World Economic Competitiveness Forum cited corruption as the single most problematic factor for doing business in India. Outside of this, there are complex societal and business issues to be addressed. The female labour force participation rate stands at just 9% (vs. 46% in the US). With the Modi government religious tensions are never far from the surface either and Muslim participation in the labour force is just 7% despite representing over 14% of the overall population. Experts highlight that these are factors that will limit potential growth relative to current expectations if they are not properly addressed. All of this leads us to conclude that while India presents strong opportunities for outperformance over the long term it is essential to find investment partners with deep local knowledge and strong due diligence credentials.

Can India continue to outperform in the near term? The outperformance of listed Indian equities is unlikely to continue in the near term given the headwinds from valuations and China reopening. The IMF is forecasting an annualised growth rate of c. +6.4% over the next two years in India, comparing favourably to +4.1% for broader emerging economies and +1.3% for developed economies. Analysts are pricing in EPS growth at +15% in 2023 and +14% in 2024 compared to just +3% and +12% for the broader MSCI Asia ex Japan Index. Despite this backdrop most experts believe that listed Indian equities are unlikely to experience a third consecutive year of outperformance versus broader EM equities. First, domestic growth is expected to slow marginally as a result of a fading reopening growth boost (6.1% vs 6.8%). Second, the reopening of China is expected to disproportionately benefit north Asian economies on a relative basis and has the potential to impact India in a negative manner via higher energy costs. Interest rates will also likely have to rise further to contend with persistent core inflation.

38 Bloomberg

39 Bloomberg

40 The Economist

41 Bain Capital

42 The Economist

43 <https://www.ft.com/content/aa626668-5b7f-4697-9ef0-ba9b2bfff5155>

Perhaps the most pertinent factor for many investors is valuation. The MSCI India currently trades on 22x 2023 earnings, 30% above its long-term historical average and an 80% premium to the rest of the EM space. This would suggest that the superior earnings growth is well established in current market pricing. The PEG ratio for Indian equities is 1.4x compared to just 0.4x for Korea and 0.7x for China. The MSCI India has annualised returns of +10.6% in USD terms over the last three years compared to just -1% for the broader MSCI EM Index.⁴⁴ This has meant that the weight of Indian equities within the EM index has risen from 8% to 16% since October 2020 whereas the weight of Chinese equities has fallen from 43% to just 28% over the same period. While valuation and performance are not good timing indicators, they do suggest some mean reversion is an elevated probability in the near term.

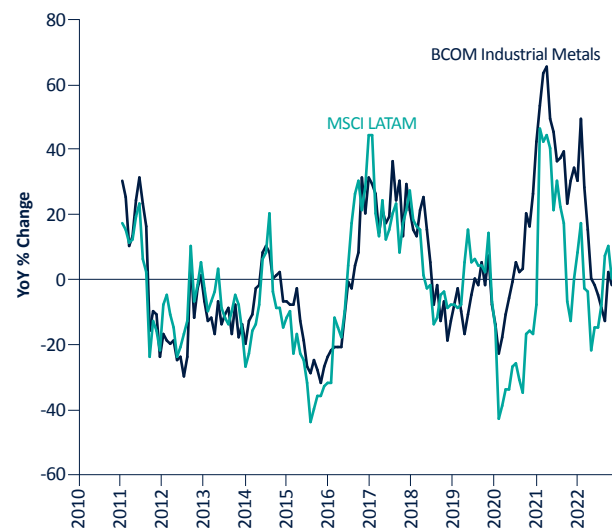
LATAM:⁴⁶ Will slowing globalisation provide a structural benefit?

Near/friend-shoring is expected to marginally benefit LATAM equities but institutionalised protectionism and a lack of domestic investment are structural impediments to meaningful outperformance. LATAM is expected to benefit from the trend towards near/friend-shoring which should lead to significant FDI inflows as capital repositions away from China. Structural tightness in commodity markets should also provide a benefit given the importance of metals/mining and resource extraction to these economies with Mexico exposed to the oil and gas sector and the larger south American economies exposed to the green metals/battery materials sectors. For context, 72% of total exports from LATAM are linked to commodities compared to just 25% in Asia.⁴⁷ Exhibit 46 illustrates that industrial metal returns tend to be the key return driver for LATAM equities.

The Economist notes that the corporate landscape in LATAM is dominated by established family-run conglomerates and a mass of small unproductive firms. Roughly half of the region's labour force works in the informal economy. Almost all of the growth in the region has been driven by population growth with productivity remaining stagnant at best, Exhibit 47. Productivity per employee is roughly one quarter of what it is in the US and experts suggest that the root cause of this is protectionism.⁴⁸ While trade

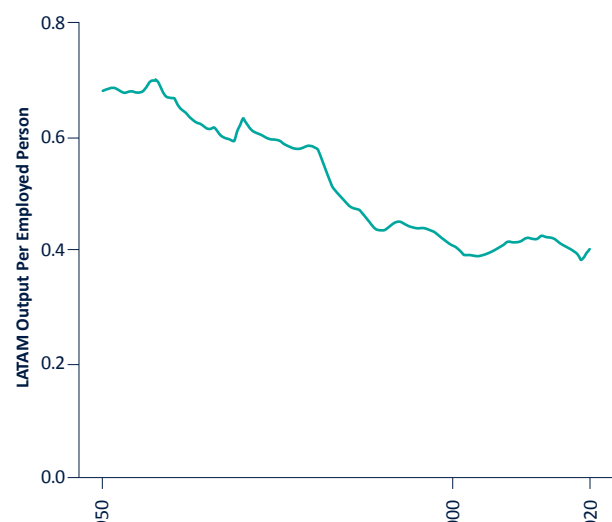
tariffs were slashed during the 1990s there is a raft of non-tariff barriers and regulation that protect established firms and unions. William Maloney of the World Bank notes that "the protection of incumbent firms means they get away with poor management, a lack of innovation and a lack of investment". Brazil, for example, the largest LATAM economy, ranks 124 out of 190 in the World Bank's Ease of Doing Business rankings. Each of these factors have contributed to an overdependence on commodity exports as the lack of investment and geographical constraints mean that high/mid-tier manufacturing has limited scope for growth.

Exhibit 46
LATAM equities tend to be highly correlated to the performance of base metals



Source: Bloomberg

Exhibit 47
Productivity has been stagnant at best in LATAM



Source: The Economist

⁴⁴ Morgan Stanley

⁴⁵ As at mid-February 2023

⁴⁶ IMF definition of Latin America and the Caribbean

⁴⁷ America's Quarterly

⁴⁸ The Economist

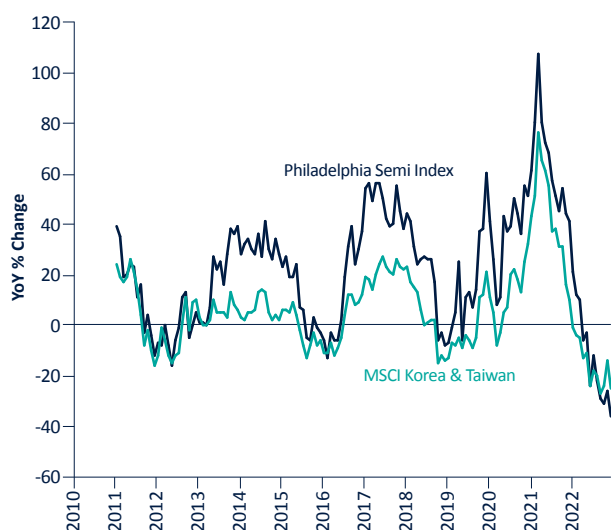
Are valuations attractive in LATAM? The MSCI LATAM Index trades on a forward P/E of 7.4x versus a long-term average of 14.4x meaning it trades -1.5 standard deviations below the historical average. This, however, is heavily influenced by a sharp rise in earnings expectations for 2023 (+36% versus Jan 2022) that are explicitly linked to the rise in energy and base metal prices. Price to book value may provide a more stable estimate of valuation and currently suggests that valuations are slightly below their long-term historical average.⁴⁹

Korea & Taiwan: What is the long-term case for an allocation?

Both Korea and Taiwan stand to benefit from the structural growth trend in semiconductor usage. However, an allocation to a broader-based semiconductor vehicle could be preferable given the idiosyncratic risk in these countries' indices and the geopolitical risk associated with Taiwan in particular. From a structural perspective the economies of Korea and Taiwan are intrinsically linked to the semiconductor sector, Exhibit 48, with the sector representing roughly 40% of both indices. Semiconductors are expected to be an area of structural growth for the global economy as a result of the green energy transition (EVs, smart grids) and digitalisation trends (cloud, 5G, AI, data centres).

Exhibit 48

Korea/Taiwan equities tend to be highly correlated to the performance of semiconductors



Source: Bloomberg

There are however some key risks associated with an investment in these regions. First, the semiconductor cycle is currently in a slowdown phase. PCs and smartphones account for roughly 50% of chips sold globally (this is expected to drop to less than 35% by 2030) and data from Gartner research suggests that smartphone sales fell by -6% in 2022 and sales of PCs fell by -10%. New research suggests that key industrial customers for chip firms had inventories that were +40% above average as of late August 2022 with the spot cost of memory chips having dropped by -40% on a year-on-year basis.⁵⁰ The consensus among analysts is that inventory destocking may be completed by the end of H1 2023.⁵¹ An end to rate hikes and a reopening of China would also assist in improving the outlook for the semiconductor cycle. Second, there is a high degree of idiosyncratic risk associated with an investment in Korea and Taiwan, with the two largest stocks accounting for >40% of each index, Exhibit 44. Finally, in Taiwan, there is geopolitical risk associated with the risk of China invading. All of this would suggest that if the structural growth story is attached to the semiconductor sector, as opposed to the specific regions, then investors may be better served with an allocation to the global semiconductor sector particularly if Korea and Taiwan introduce idiosyncratic and geopolitical risks.

Are valuations attractive in Korea/Taiwan? Korea/Taiwan offer attractive valuations, stand to benefit from China reopening and a potential bottom in the semiconductor cycle but stock specific risk makes any targeted allocation very challenging. Korea and Taiwan exhibit some of the lowest valuations in emerging markets both relative to their own histories and to other countries in EM. This is despite the fact that both indices have seen the largest negative revisions to 2023 EPS expectations over the course of the last year -40% and -18% respectively while the average revision for Brazil, India, Malaysia, South Africa and Saudi Arabia was just -3%. However, as discussed above, the key consideration for investment in the region remains the timing of the semiconductor cycle as well as the concentration of idiosyncratic risk within the index, both of which combine to make any potential allocation quite challenging.

⁴⁹ As at mid-February 2023

⁵⁰ The Economist

⁵¹ Bernstein

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