Finding Growth in Asia

February 19, 2016

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As investors, we tend to look for themes to guide medium- to long-term asset allocations. So far this year has been riddled with volatility, resulting from the uncertainty surrounding several factors, including the inception of the U.S. Federal Reserve interest rate hiking cycle, the basket linkage and subsequent devaluation of the Chinese currency, an ongoing commodity supply glut and a diverse set of global central bank monetary policies. So where can an investor find a reasonable investable theme? One thematic idea that I find fairly convincing is that Asia stands out in a world of low economic growth—especially emerging Asia. This year, India should surpass China as Asia's fastest-growing large economy, expected to rise more than 7% in 2016. But India and China are not the only Asian growth stories. The International Monetary Fund (IMF) expects Vietnam, Indonesia, Malaysia, Bangladesh, Myanmar and the Philippines to all grow above 5% on average during the next five years.

Sustainable Growth is Possible in Asia

Sustainable GDP growth can come from various sources. In Asia, high domestic savings serve as a stable foundation of investment not susceptible to the ebb and flows from foreigners to drive growth. Other structural factors include the continued population migration into more productive urban centers, growing working age demographics in much of the region and a rapidly expanding middle class. To reinforce the importance of the ballooning middle class you must first realize the sheer size of the changes taking place—some even call it a "mega-trend." The Asian Development Bank estimates that in 1990 Asia's middle class population totaled 565 million, or about 21% of the region's overall population. As of 2008, the middle class expanded to 1.9 billion people and the estimate for 2030 grows even higher to 2.6 billion people or 4.5 times its middle class population size in 1990. This structural change in the wealth of Asia should have significant ramifications on the growth of global consumption.

Changes to the Investment Landscape

Back in the 1990s and early 2000s, countries and companies got rich exporting to Asia. The developed economies in Europe and North America flooded raw materials and finished goods into China and other fast-growing Asian economies that depended on imported goods to build roads, bridges, power plants, office buildings, apartment complexes and other infrastructure-related projects to satisfy the needs of growing urban populations. Fixed asset investment in China boomed from 2000 through 2010, averaging over 23% growth per annum, and export and cyclically driven economies enjoyed a massive tailwind as commodity prices more than doubled on the back of real-time demand and speculation that demand would continue. Fast-forward five years to 2015 and reality hits. After more than a decade of production capacity expansion, China and select other fast-growing economies now produce a much larger portion of what they consume. Chinese imports, which once grew at over 16% each year, now register annual increases of less than 5%. This is a paradigm shift that will have medium-term implications on investment opportunities within the region. No longer can you assume that the export powerhouses of the past, that reaped profits from the Asian consumer growth story, can repeat this performance going forward. The fact is that China is now taking market share from the same companies that once supplied it with necessary imports. This is happening across sectors—manufacturing, industrial and consumer-related alike.

How to Access the Asian Consumption Story

Traditionally, an investor could tap Asia's growth by buying large developed market, multinational stocks that exported goods into the region's rapidly growing economies. Auto and heavy equipment manufacturers, food and beverage producers and raw materials suppliers were able to exploit the Asian growth engine. But today, getting access to Asian growth and the boom in consumption is not so straight forward. Weaker Asian currencies have made imported goods more expensive and simultaneously local manufacturers and producers have been able to capture significant market share from foreigners. In addition, many Asian economies—China, South Korea and India in particular—are rapidly moving toward more consumer-led and services-led growth models. In a nutshell, grabbing a slice of the Asian consumption pie has become much more competitive. To further complicate matters, passive vehicles like exchange-traded funds (ETFs) that aim to track the major Asian benchmarks fall well short of providing significant access to Asia's consumers.

Passive or Active?

In the past, if an investor wanted to add growth to their portfolio outside of developed markets, they may have bought an emerging market equity ETF or benchmark-aware mutual fund. Ten years ago, those vehicles provided access to cyclical drivers of growth, including commodities, energy, materials and industrials plus financials, while having a larger representation of Latin America and Europe than they do today. From 2001 to 2007, cyclical exposure made sense as China was vacuuming up raw materials, and commodity exporters and heavy equipment suppliers were happy to provide them. The "old" emerging economy was thriving.

But today, a different approach is necessary. After four years of commodity weakness, being exposed to cyclical ups and downs has proven fruitless. The emerging and Asian economies are still growing (faster than their developed market counterparts) but the "old" economy stocks—which the benchmarks and ETFs are typically overweight—are suffering, while the "new" consumption-based stocks are generally more sheltered from cyclical volatility. The MSCI Emerging Markets Index holds over 70% in Asia today, but more importantly, it holds only about 21% in the consumer-related and health care sectors combined. The most popular regional Asian benchmark, the MSCI AC Asia ex Japan Index, is no better with only about 17% combined in consumer and health care stocks as of the end of 2015. No doubt, there are going to be winners and losers in the current economic environment. Finding those companies that occupy strong competitive positions, are cash generative and have low levels of debt—at reasonable valuations is always a challenge. Active managers who find those companies while mitigating cyclical volatility can truly add value.

Conclusion

We would argue that growth is indeed very difficult to find these days, but Asia is a good place to look. Within Asia, the consumption theme is one of the most investable we can find. Performance in 2015 highlights the defensive nature of consumption as consumer staples and health care were the best-performing sectors whereas energy, materials and industrials were among the worst within the MSCI All Country Asia ex Japan Index. Interestingly, the three-year and five-year sector returns show a similar result where consumer staples and health care outperformed more cyclical sectors—illustrating the theme's potential robust nature. Regardless of the outperformance in recent years, we believe consumption-related stocks can leverage the unprecedented growth of the global middle class for years to come while helping to mitigate the reality that China and other large emerging markets are importing less and producing more for themselves. We see the traditional benchmarks and ETFs as backward-looking, and as a result, view finding growth within companies that are able to harness increased domestic demand as a reasonable way forward.

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