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S E R I E S

REPORT

Asian Investment Dynamics

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Asia's Investment Dynamics

A recent US-China Series Virtual forum on *Investment Dynamics for Asia* in 2021 featured my good friend:

Eric Robertsen — Head of Global Research, Chief Strategist at Standard Chartered Bank

I have decided to publish this paper as my Sunday report for one primary reason. My conversation with Eric hit all the right notes with the correct focus on the here and now and a dispassionate discussion of the longer-term opportunity sets for the region. Eric and I certainly do not agree on all points, especially on the outlook for the dollar, but I always come away from my conversations with Eric reassessing all of my assumptions.

The one point I want to emphasize is the resiliency of the export sector. This has been a theme US-China Series has explored at length, especially given our conversation in January with Dr. Debbie Elms of the Asian Trade Center. Intra-Asian trade is one of those themes that never gets the credit it deserves as a driver of sustainable growth for the region. While trade within Asia helped spark the recovery in the months post the COVID trough, CPTPP and RCEP will reinforce these trends for decades to come.

Eric and I discuss whether tight credit spreads are justified over the long haul, and while local currency bonds have struggled this year after a remarkable 2020, it will be the structural gains such as these regional trade agreements that will justify a lower funding cost for governments and corporates across the region in the years ahead.

Despite an improving structural picture, the Federal Reserve remains the driver of global beta for Asia and the balance of the emerging world. A loose Fed that remains unconvinced about inflation risk will continue to buoy global assets. However, investors are increasingly concerned about the idea of a premature tightening with Asia and particularly China, being the source of angst.

China has been draining liquidity, and we have evidence that activity is peaking. Regulations over Ant Group and the establishment of a bank holding company will temper their consumer credit activities as the fintech behemoth is forced to provide more capital against each liability. These risks now appear to be spreading to Tencent, showing that Fintech regulation is so much more than a knee-jerk reaction to a speech by Jack Ma. Technology regulation will be a continued drag on Chinese technology multiples and has the potential to lead to further Chinese equity underperformance.

Fintech regulation is a defacto tightening in itself. Politicians from Taiwan and South Korea are discussing asset bubbles. What is very clear is that Asian authorities are taking the asset excesses of unprecedented global liquidity much more seriously than developed market peers.

I have several observations:

- 1) Asian policy has been much tighter than the US and EU. So, from a relative policy standpoint, we are already living the aforementioned reality.
- 2) The Federal Reserve drives global risk assets and beta. The Fed is a rising tide that lifts all boats, and global assets will be supportive provided the Fed stays the course.
- 3) Policy tightening is relative. While China, South Korea, and Taiwan may tinker with policy, Asia doesn't have an inflation problem, and while some liquidity could be drained, a full-blown tightening cycle is a long way away. This tightening cycle would be most unlikely unless the Fed hinted it was moving in the same direction.

Policy divergence is rare—about as rare as long-term underperformance of US assets. Tighter Asian policy is a net drag on Asian assets, but a continuation of loose USD liquidity will swamp this and ensure continued asset strength across the globe.

I have worked on the notion that MSCI world will rally 20% in 2021, but the divergence of performance between markets will be negligible. Slightly tighter Asian monetary policy isn't a signal to sell emerging market exposures, but it should prompt you to re-think your strategy that it is time to dump US equities for the balance of the globe. Dumping assets comes when the Fed talks about tightening, not when Asia discusses it.

The long-term framework for Asia and China remains remarkably constructive. However, the skeptics will push back and say that this potential has been omnipresent yet continues to disappoint. US equity outperformance of the regions is the clearest evidence that Asia has underwhelmed. Patience is required for Asian investors, and while the grass may be occasionally greener In the United States, the long-term outlook for Asia and its assets has never been more rosy.

Asia's Economic Momentum

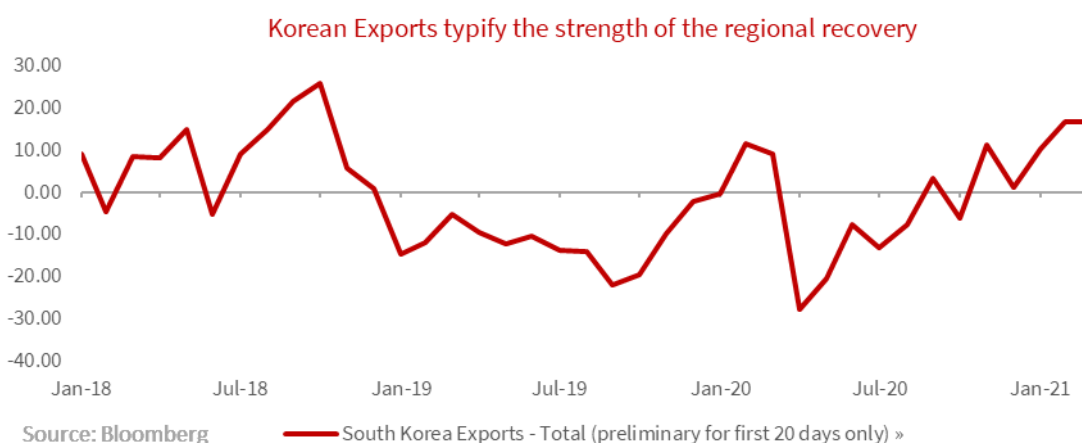
Eric Robertsen: Most would agree that the post-pandemic growth recovery this year will come in large part from Asia. Yet misperceptions exist, where some believe that growth will be driven solely by China; other commentaries suggest that the surge in exports is unsustainable. We believe those are incorrect: several factors all point in the direction of a more sustainable and more diverse recovery for Asia, where a sustained recovery could turn the recent tide of Asian asset underperformance.

Assuming that trade agreements play a role in nurturing growth, discuss the sustainability of the export sector and where growth dynamics are constructive and sustainable outside of China.

Eric Robertsen: There were several trends observed last year:

- Asian exports were recovering extremely quickly by Q3. In particular, in September, exports out of emerging markets —specifically Asia — had already recovered in volume terms to their pre-pandemic levels.
- Over the last couple of years, trade between emerging market countries became an increasingly larger share of the global pie than trade between EM and Developed Market trading partners.
- This idea of trade channels within regions continued its momentum throughout the COVID-19 crisis.

Some suggest that the demand for medical equipment will subside as COVID starts to ease up, but it is clear that demand for technology — an equally strong contributor to this trend — will not abate. In fact, we may be at the beginning of a recovery cycle lasting up to four years for products such as memory chips and semiconductors.



This demand is underestimated and will remain despite the temporary, technology-heavy demands worldwide in light of COVID.

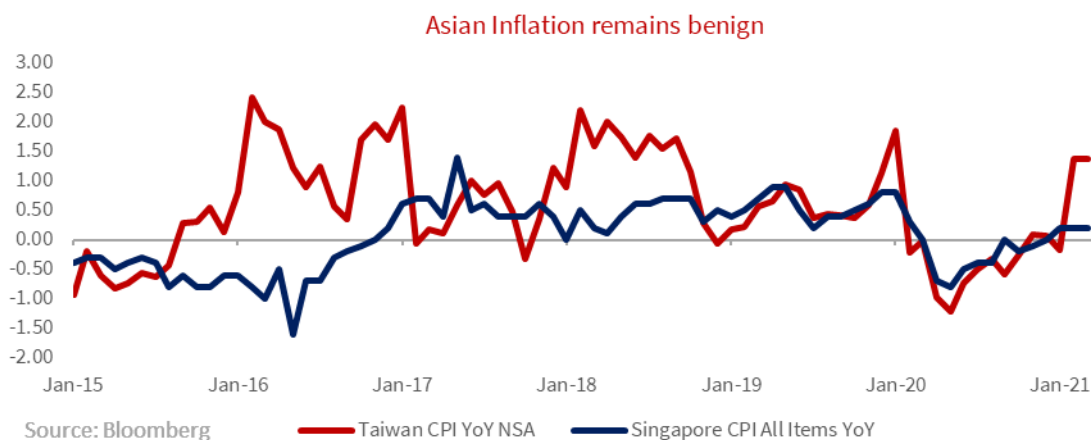
The global chip shortage is seeing the early stages of a three to four-year recovery cycle. If it is happening in chips, could it happen across other tech sectors?

Eric Robertsen: this is different from the inventory cycle for Asian memory chips in 2018. Whereas once Korea could not keep up with demand, supply has stabilized, and I believe it is quite a sustainable cycle. Across Asia, critical economies such as Malaysia, Singapore, Indonesia, and Taiwan will be meaningful contributors to regional growth because of their leverage on global trade, which will persist for the next few years and broaden in scope.

Concerns over Asset Bubbles in Asia

Asia started this recovery cycle several quarters ahead of the West. Given the global recovery in the next few months, there are two possibilities for the region: one is a much more elongated cycle for Asia, the other is a potentially damaging tightening cycle. Discuss this prospect, particularly within the context that Asian central banks are more alarmed by asset bubbles than their Western counterparts?

Eric Robertsen: This year has seen low levels of inflation around the world but especially in large parts of Asia, with expectations that those equity and asset markets that are geared towards global trade and growth would perform well.



Some key points:

- A tension in emerging markets exists where positive views on fixed income in these markets are weighed by concerns over debt.
- Currency markets are seen as a preferable place to hide than the local currency fixed income market; the former was getting the tailwind of a weakening dollar, as well as the tailwind of a return of capital flows into Asian equity markets. Last year they had \$80 billion of outflows in all of the equity markets, excluding China.
- The debt side is cause for concern. The front end of yield curves, generally speaking, had seen the full extent of the rate-cutting cycle, and those that may see further cuts were already fully priced in.

- The back end of the yield curve is potentially vulnerable to the idea of expanding fiscal stimulus, budget deficits, and debt issuance, which would run the risk of leading to the yield curve steepening.

Even with attractive valuations and continued accommodation from central banks, we were left with a bias towards stronger Asian currencies, followed by equity, as opposed to fixed income.

With Korea as an example, discuss the contrast between capital inflows from trade and currency weakness being driven by equity flows. Does a tightening of policy in Asia relative to the United States naturally lead to stronger currencies, or is that a sign of potential risk asset underperformance in the region?

Eric Robertsen: Korea benefited from a surprise upside in terms of its trade recovery. Equity flows started returning by the middle of the third quarter last year, and risk asset markets rebounded strongly. The short-term anxiety, i.e., KRW weakness, has caught the market off-guard in the first months of the year.

As foreign investors began exiting Korea, some of the country's domestic investors — whether retail or pension funds — started to deploy some capital overseas. We believe those flows are starting to reverse back into Korea. It is the case that the combination of given factors in fiscal and monetary policy are more critical considerations in the medium term.

Few of the major central banks in Asia will be tightening monetary policy any time soon since they can keep policy loose and, therefore, growth supportive thanks to small amounts of capital outflows. The delicate balance is further made possible with inflation and low-interest rates.

China is slightly different as it withdraws excess liquidity to ease credit growth while stimulating the economy through fiscal measures if needed. It is a perfect combination for a currency, and the RMB has been relatively resilient on that front.

Will the strength of Asian currencies be a function of improving Asian fundamentals or deteriorating fiscal or balance outlook in the United States? Is this an issue of improving risk tolerance in Asia or seeing the risk premium in the US start to rise?

Eric Robertsen: We strongly believe that the US' growth differential with the rest of the world will start to narrow. The US will start to catch up to some of the 'first in, first out' economies of Asia thanks to fiscal stimulus. At the risk of exaggeration, the composition of fiscal stimulus in the US can be described as growth supportive but currency destructive. But as most of the fiscal stimulus that is expected over the next month will be income supportive, the consumption of basic goods from Asia and trade deficit will worsen.

I would argue that US economic growth in the second and third quarters this year will be spectacular — but not dollar positive.

Infrastructure Spending in the US

Spending thus far has done little to improve long-term productivity prospects in the United States. Is an infrastructure spending program the solution?

Eric Robertsen: The composition of the current fiscal package, as current estimates go, includes \$350 billion of support for state and local governments, a pure fiscal transfer that does not increase the productive capacity of the economy in terms of the fiscal multiplier.

A significant portion will go directly into consumers' pockets as a pure check or unemployment benefits. With up to half of the package directed towards these two sources, Congress may be less inclined to pass a subsequent bill focused on infrastructure spending. From a medium-term economic and fiscal multiplier point-of-view, the chronology of the fiscal stimulus packages is in the wrong order.

Infrastructure spending would have been the top priority had COVID-19 not hit the world. Looking at the disconnect between commodities and markets, there's a stronger argument that even the lack of inflation is an argument for the reflation narrative.

Eric Robertsen: We advocate the reflation narrative and a procyclical view on emerging markets. Our views on commodities have been constructive since September last year, and it is our belief that the regional recovery story in Asia is sustainable in the medium-term. These all support the reflation narrative. While a spike in inflation over the course of a couple of quarters is possible for a variety of reasons, I think in the medium term, we're still in a disinflationary environment.

Given infrastructure spending priorities, could Treasury Secretary Yellen issue 50-year treasury notes as a solution?

Eric Robertsen: This would have been the preferred solution six months ago. At the time, the supply-demand imbalance in treasuries was skewed towards excess demand even though supply was high. At this moment, there are enough participants in the market trying to sell fixed income in reaction to the news flow and implying a continual concern about long-dated supply.

The Asian central banks and issuance offices are facing this exact challenge right now, and as a result, are announcing more fiscal stimulus and issuing more debt as curves steepen.

Emerging markets have not had the benefit of zero interest rates. As the cost of servicing debt is high, an increase in debt is riskier. In these circumstances, the possible issuance of 50-year bonds would not be very popular, forcing central banks to find other ways to manage debt.

While debt monetization will take place in some form for most major economies, it is an incremental step towards a worrying direction. If the Federal Reserve and other entities start issuing 30, 40, or 50-year debt that is bought by central banks, the delicate balancing act may be challenged, even as some emerging economies are in a better state compared to 2013: the current account deficits which prevailed eight years ago are much smaller today. And, foreign

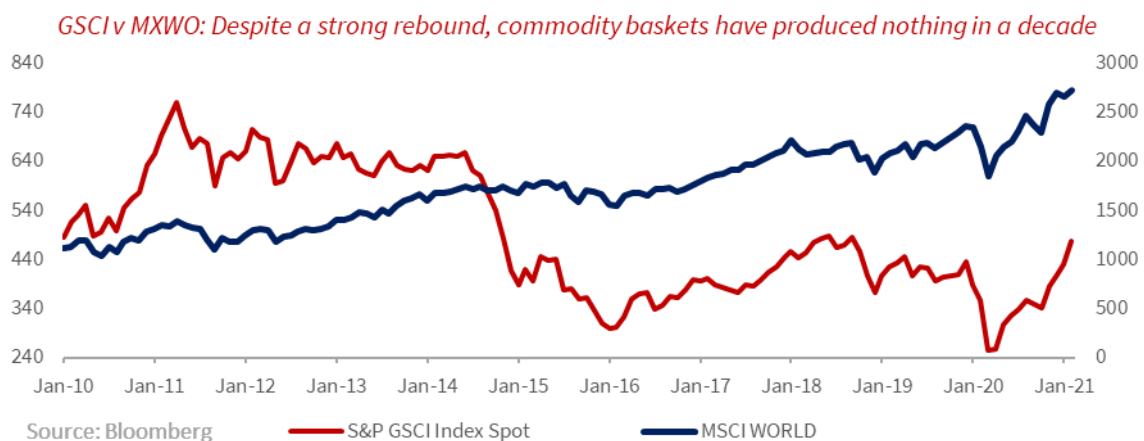
investor positioning in these markets was much higher in 2013 compared to now. Even as these markets are steepening, they are less vulnerable today compared to a decade ago.

Inflation Concerns and Tapering

The inflation narrative is taking hold, as signs such as equity sector rotation point to this. What are some observations in the commodity complex, its sustainability, and the arguments for and against the commodity super-cycle?

Eric Robertsen: As governments around the world increase infrastructure spending to support their economies, the case is pretty straightforward for commodities such as metals and energy — envision the energy demand, for instance, over the next few quarters when travel resumes. The contrarian to the bullish outlook on commodities would argue that the markets are effectively bringing forward all of their assumptions and expectations about future demand.

Rising prices may mean that the short-term peak in the commodity cycle — consolidation followed by increases — is relatively close, but I believe prices are sustainable. Over the past two decades, the gap between commodities versus the S&P historically wide. While not as related to the output gap, it's a similar kind of significant delta.



In other words, the increase in commodity prices is insufficient to be the sole driver of the narrowing of the output gap and sustained inflation.

Supply deficits are driving prices higher, but it may be difficult to extrapolate that productivity will have a sustainable impact on growth. Are we in a near-term, high-growth environment for no other reason than we are coming off a very low base?

Eric Robertsen: The output gap is undoubtedly relevant for a number of markets around the world, including the United States. My stance on the deflation view comes from current conditions in Asia, where economies such as Taiwan, Thailand, Korea, Singapore will all have inflation rates between 0 and 1 percent this year.

This output gap was in place in many places even before COVID-19. Global growth in early 2020 was not positive enough to remove some of the excess slack that we know exists in the economy. Then, the global economy was hit by a bomb, and the US is millions of jobs short compared to a year ago. It will take more than six months of good growth to sort of correct that output gap.

As the Fed responds to — and not preempt — growth, when will talks of tapering begin?

Eric Robertsen: The Fed could begin to comfortably talk about an actual tapering plan in Q4 of this year, and if all goes accordingly, tapering could begin in the first quarter of 2022. The argument would extend to the year afterward, where if growth continues in 2022 in the US and the global economy, the Fed could think about thinking about raising rates perhaps in the first two quarters of 2023.

The core PCE price index would need to reach and sustain itself at a two percent threshold. In the past decade, there have been several instances where that two percent level has come close to being reached, yet which have been rejected quite quickly. In other words, the Fed will need to believe that growth as above trend is sustainable and that the improvement in inflation is also sustainable. The latest commentaries show they are very skeptical about it.

US Core PCE: Sustained period above 2% are rare. Doesn't this imply zero for much much longer



Since they announced their average inflation targeting, the Fed has admitted that it tapered and tightened too quickly in the aftermath of the great financial crisis. They did it preemptively at the time, but now they're going to be reactive.

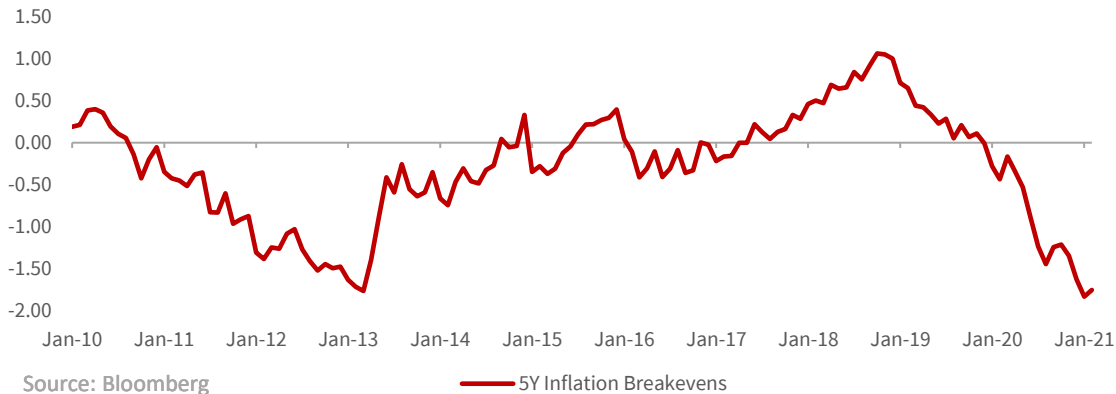
The bear flattening becomes the real problem for markets as a sign of when the tapering conversation could begin. Could the ten-year be used as the proxy, and is there a level of the ten-year that would spur the Fed into action?

Eric Robertsen: A nominal yield could approach close to one and three-quarters percent before the Fed would feel the need to take any action beyond verbally reassuring the market, and the decomposition of yields matters almost as much as the nominal yield level. Some key points:

- If nominal yields increase by 30 basis points, it's all inflation break evens, and real yields are minus 80 basis points in the ten-year and minus 190 basis points in the five-year. If

real yields are stable and term premia stay relatively contained, a further curve steepening is made possible, led by break evens.

US Inflation Breakevens - a further curve steepening is made possible, led by break evens.



- From a monetary policy point of view, the average inflation targeting regime is trying to achieve slightly higher nominals, very low real yields, and higher inflation expectations. While Treasury yields will not go much higher, the risks are skewed towards further steepening.
- The Fed's reaction will depend on how this happens: the use of reactionary yield curve control over the next few months may be a tough sell. A brand-new strategy would be difficult for the markets, even if the Fed acknowledges the strength of the market and the need to lean into the bond market for various reasons.
- The Fed would be more likely to pursue an Operation Twist-type initiative, taking advantage of current conditions in the existing market and potential for supply. The drawdown of TGA leaves a massive amount of liquidity in the front end, which the Fed could reduce and shift it out to the back end.

Is there a sweet spot for the Fed where they can taper without a tantrum?

Eric Robertsen: A taper would be possible if there are buffers and protective measures on top of it.

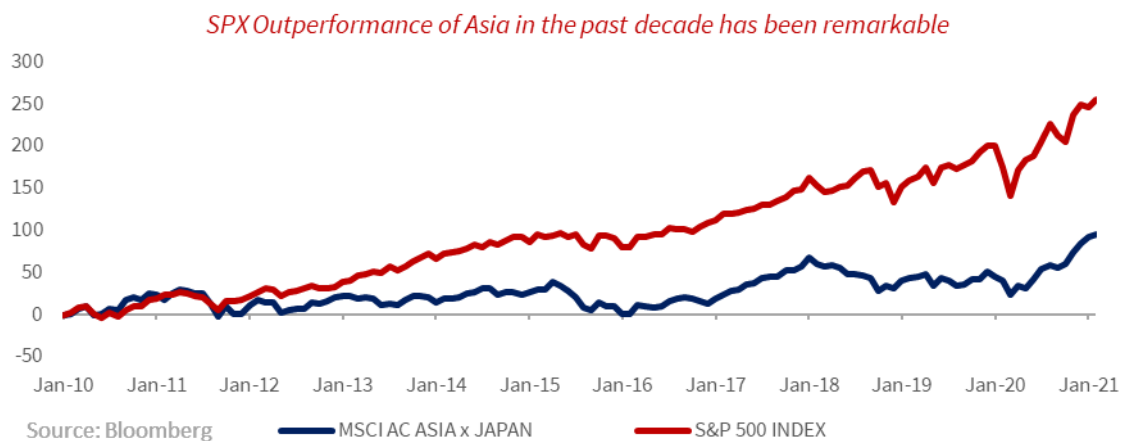
The US may see decent growth this year where Core PCE price index is stable at two and a quarter. When some of the euphoria around higher yields and steepening curves have cooled off, and perhaps ten-year treasuries are sitting only at one and a half at the end of the year, the Fed could look to reduce to pre-COVID levels.

This would require a very precise set of economic conditions on the growth and inflation sides, as well as active tightening from other central banks around the world.

Asian Assets' Performance

Asia's underrepresentation in global portfolios versus its economic dominance is a significant disconnect. What is the impact on Asian asset markets, and how can this macro disconnect be alleviated?

Eric Robertsen: In the decade between 2010 and 2020, the S&P effectively outperformed MSCI EM by 100 percent or nearly 10 percentage points per year excluding dividends. A dollar-denominated investor during this period could maintain an effective portfolio adjusted for volatility by being long on US equities, US treasuries, and US credit, all without taking on currency and sovereign risk outside the US.



Now, the interest rate differential between the US and developed markets has effectively collapsed. The growth differential has changed dramatically. US asset markets no longer seem to offer the same value compared to several years ago. In contrast, now the MSCI EM trades at up to a 26 percent valuation discount to the S&P, and commodity and commodity-linked markets trade at very aggressive discounts as well. Asset managers are noticing the growth potential of this market and its underrepresentation in many client portfolios.

Will Asia's central banks be viewed as credible for foreign investors? China is an excellent leading indicator. Over a trillion RMB's worth of inflows entered their bond market last year at a time when bond yields were rising in the Chinese Government Bond market: this is a strong sign of the perceived credibility of onshore assets for foreign investors. This same credibility could extend across markets in Asia, signaling a potential avalanche of capital to flow into the region.

How do Asian investors think about offshore capital allocation? Are developing brands at relatively cheaper valuations likely to encourage capital to stay home?

Eric Robertsen: The average investor in Asia may take on a slightly different view. Global brands may be concentrated in the US, but they have valuation premiums that factor in growth that are assumed to be continually sustainable.

While most Asian economies may not have the concentration of global brands, many of these countries have emerging brands that are highly relevant for their countries and the region at large. These regional names may be unproven on a global scale, but the trade-off increases complexity and optionality from a pure equity point of view. And from conversations with investors, diverse and homegrown expertise is quite valuable. One of Asia's advantages consists of higher penetration rates of smartphone use and online applications compared to other parts of the world. Businesses that leverage these advantages will be sort after.

What is the multi-year view that investors should have on India versus China? How should global allocators think about the trade-off between those two countries?

Eric Robertsen: As India and China are on different growth trajectories, their exposure to and dependence upon global trade are very different, as are their strengths and vulnerabilities. India's economic growth trajectory over the next few years will rival that of China's.

Yet India's ability to procure energy at a reasonable price remains one vulnerability, especially if oil prices were to rise. Moreover, the volatility of onshore inflation is a concern for both onshore and offshore investors. Despite the avalanche of foreign capital going into India's equity markets, the accessibility of the onshore bond market is still quite limited.

I would expect both China and India to be engines of growth for the region, despite being at different stages of that maturity cycle, a sign of the diversity of the region.

Discuss if excess credit is a concern and if macro fundamentals across the world — particularly in Asia — are constructive enough to justify tight credit spreads.

Eric Robertsen: For investors looking at 30-year hard currency bonds at above 3 percent compared to 30-year treasuries at above 2 percent, some may choose to lessen the risks by opting for the latter. If the dollar recovers in the next six months, investors would much prefer dollar-denominated treasuries over dollar-denominated sovereign credit.

One could be long currency and equity in emerging markets but also being long treasuries as a portfolio hedge because much of the good news is built into financial market prices at the moment. A short dollar view, as well as a pro cyclical view on other parts of the world, would be consistent.

All this sounds remarkably constructive for Asian equity. Credit may not tighten as much, but it is a positive for strong Asian equity markets in the next 12 to 24 months.

Eric Robertsen: I think that's right, even if there may be bumps in the road and reflation as its setbacks and bouts of volatility. But the net direction of travel is for strong emerging markets' asset performance.

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