Schroder Asian Shares Fund

Market Summary

Stock markets were mixed in January, with developed market shares advancing in general while emerging markets saw negative returns. There were signals from major central banks that interest rate cuts may not be forthcoming as soon as had been hoped.

Asian equities fell alongside EM markets as investors scaled back their expectations for swift interest rates cuts and amid ongoing concerns about weaker economic growth in China. China, Hong Kong, and South Korea were the weakest index markets in the month, while India and the Philippines achieved modest gains.

The sell-off in China came amid investor concern that the world's second-largest economy could face a long period of slow economic growth, with factory output contracting for the fourth consecutive month in January. The crisis in China's property market, once the engine of economic growth, also continues to weaken investor sentiment towards the county's stock market.

Share prices in Thailand and Singapore were also significantly lower in the month, while declines recorded in Taiwan, Malaysia and Indonesia were more modest. In contrast, India achieved a modest gain in the month with the country's stock market continuing to attract strong inflows from overseas investors as well as domestic participants, reflecting its growing strategic status as an alternative to China.

Performance Review

Asian equities started the year with a negative return for January. Risk appetite weakened as investors scaled back expectations for swift interest rates cut given the still-improving US economy. Against such backdrop, the fund registered a negative return, and performed in-line against the benchmark during the period. At the regional level, stock selection across Indonesia and Taiwan, coupled with underweight across China and Korea, were amongst the positive contributors to relative performance. However, this was offset by negative overweight in Hong Kong given lingering concerns around the growth outlook for China.

Our exposure to India via SISF Indian Equity was a top contributors to performance during the period, as the broader Indian equity market continued to outperform the region. At the individual stock level, Indonesia's Bank Mandiri outperformed amid continuing positive loan growth across the board, especially in the corporate segment, while asset quality continued to improve. China's oil producer, CNOOC, was another notable contributor, supported by its surprised increase in volume guidance, with potential for capex cuts and increased payout ratios. Elsewhere in China, share price for household electronics manufacturer, Midea Group, saw robust performance on the back of double-digit growth in its air conditioning and export businesses, while softer material costs, consistent efficiency improvement and RMB appreciation are also expected to boost margin. In Taiwan, leading semiconductor foundry, TSMC ended the month higher on the back of solid growth outlook for 2024 while robust AI demand is expected to drive continuous margin expansion from advanced chips in the coming year.

Conversely, concerns around macro weakness of China, coupled with a lack of sufficient policy responses and geopolitical tension remained a key headwind and continued to impair investor sentiment, weighing on some of our holdings especially the consumption-related names such as AIA and Budweiser Brewing. Our healthcare names including Hutchmed China and Wuxi Biologics all saw disappointing performance as a result of a proposed bill in the US to potentially limit the use of Chinese biotech companies on US taxpayer dollars. While concerns around potential US regulatory restrictions over Chinese biotech and CMO companies are not new to the market, this has caused sharp share price corrections in sector towards the end of the month. Meanwhile, HK-listed luggage maker, Samsonite, declined as the company normalizes guidance on its post-Covid sales growth for 2024, which was still above the pre-Covid peak levels. Elsewhere, Korea's Samsung Electronics fell as investors remained concerned about the global demand outlook for electronics, while the pace of offering High Bandwidth Memory products as an alternative to Hynix remains uncertain in the near term. Korea's battery maker LG Chem also saw share price correction on investors' worries over slowing EV demand, while low chemicals margin and metal prices also remained key headwinds for near term earnings.

Outlook/positioning

Risk appetite in global equity markets continues to ebb and flow with changes in US financial conditions – i.e., moves in bond yields, the US dollar and expectations for the Fed funds rate over the coming quarters. After a strong end for asset markets in 2023, January saw a retracement in the Asian and Emerging markets as investors discounted a likely delay for the first US interest-rate cut – from March to slightly later in 2024. This in turn pushed up bond yields and the dollar, tightening monetary conditions at the margin and triggering profit-taking. Geopolitical risks also increased on the back of disruptions to sea-borne trade through the Middle East, bolstering oil prices and reigniting some concerns over cost-push inflation. Despite these modest adjustments to expectations, markets continue to price in a benign soft landing for the US economy, in which growth slows in 2024, but there is no recession and inflation eases towards the Federal Reserve's (Fed) target. This should allow the commencement of multiple rate cuts later this year. This 'goldilocks' scenario – growth not too hot, or too cold – is clearly the best possible outcome for Asian markets as well. Outside of Hong Kong and China, the regional equity markets were broadly stable through the first month of the year. Within Asia, country level performance extended the patterns seen through much of 2023, with the China markets continuing to struggle, while India, Korea and Taiwan exhibited much stronger momentum.

Disappointing Chinese macroeconomic data and the lacklustre policy response in recent months are undermining confidence, not only in the near-term cyclical outlook, but also in longer-term growth forecasts. Geopolitical tensions between China and the US remain a serious overhang, and in the face of these worries and the weak growth outlook, international investors have continued to reduce positions in Chinese equities. This has triggered a sharp fall in onshore and offshore indices in the first few weeks of 2024.

After the initial optimism over the rebound in economic growth following China's abandonment of Covid controls in late 2022, sentiment steadily deteriorated over the past year. The market view has swung towards a new consensus that the cyclical recovery is disappointing and the scope for stimulus is limited. Although we have seen a rapid normalisation in travel patterns and most other aspects of day-to-day life, it appears that consumer and business confidence are still fragile after two years of intermittent lockdowns and disruptions. A weak labour market, pressure on household incomes and falling property prices have all heightened concerns and depressed consumption. Although luxury spending has been more robust – as seen in the healthy results this year from leading European brands – 'down trading' is apparently common in the mass market, where the majority of consumers remain more cautious. Perhaps most importantly for the Chinese economy, the property market and the broader construction industry continue to deteriorate. Sales volumes have collapsed and prices are under pressure as buyers step back from the market and deflationary expectations set in. Developers are reluctant to start new construction projects, or are unable to, given their severe cash constraints. Many of the largest private players are facing solvency issues that are further undermining confidence in the pre-sale market as project completions are delayed in many cities. Given the huge scale of the construction industry, and all the related activities across China, this weakness remains a major headwind for broader economic growth. Property is also the largest store of household savings, so falling prices are likely dampening consumer confidence. Manufacturing industries, meanwhile, are experiencing a slowdown, reflected in much weaker recent Chinese export data, which is acting as a drag on private investment spending and job creation across the economy.

Given these very visible headwinds for growth, the debate among investors in recent months has moved away from China's cyclical upside potential towards a refocus on longer-term structural issues. These include a shrinking working age population, the large debt overhang at the local government level, property market difficulties and elevated geopolitical risks; all are contributing to a more deflationary environment. Investors are impatient for renewed policy stimulus from the Chinese authorities to underpin demand, and a shortage of concrete policy measures in recent months has contributed to the market weakness. We have seen reductions in interest rates and an easing of downpayment requirements for mortgages. Additionally, the government has approved an extra borrowing quota of ¥1 trillion to finance infrastructure investment. However, these measures are still deemed too small, given the scale of the problems. The drip feed of modest policy easing appears to have done little to shift broader consumer confidence and buyer sentiment towards the property market. We continue to expect further targeted stimulus measures in the coming months to provide an element of downside protection for the economy. However, there is little evidence currently that the authorities are considering much more aggressive fiscal measures to kick-start consumption and investment.

Despite the weaker headline macroeconomic data and property market troubles, the operating performance from the Hong Kong and Chinese equities we own has been much less worrying, as reflected in recent earnings results. The strongest operating performance has been in the travel and leisure-related sectors – hotels, gaming, restaurants, luggage and beverage companies. Here, the rebound in activity and earnings in China has broadly met, or in some cases, exceeded initial expectations this year. E-commerce and online advertising sales have also seen a modest rebound, helping the key large-cap online players to deliver strong bottom-line growth, aided by greater cost discipline and, in some cases, aggressive share buybacks. There are also signs of gradual improvement in areas such as life insurance sales and high-end retail property rentals. All of this points to a broader economy, outside the property development industry, that is sluggish and patchy, but not in a downward freefall. Unfortunately, in most cases, stock prices for these companies have remained under pressure, despite the healthier earnings. Where earnings disappoint, the market is extrapolating weakness. Where they have surprised positively, the market does not trust that they will be sustained. As a result, we have seen a dramatic de-rating of most segments of the Hong Kong and China markets as investor outflows exaggerate share-price moves.

We share many investors' concerns about the structural headwinds China faces. However, given the extremes of negative sentiment, there is still room for the authorities to surprise positively with better-coordinated policy support going forward. In addition, better-managed businesses with stronger franchises can still deliver growth, even against a softer economic backdrop. After the recent sell-off, share prices in many sectors in Hong Kong and China are not far off levels seen in the depths of the Covid restrictions, when the earnings outlook was far more uncertain for most companies. Given this mismatch in share-price performance against operating fundamentals, and the current very low expectations for the Hong Kong and China markets, we continue to see attractive opportunities in selective areas on a bottom-up basis.

Korean and Taiwanese equities performed very well in the last year, owing to gains in the key large-cap semiconductor stocks that dominate their indices. There was also significant retail buying momentum in narrower market themes, such as AI-enablers and battery-supply chains. While end-market demand has remained soft for many electronics products, and inventories are still quite elevated in some parts of the supply chain, investors have started to position for an improvement in the coming quarters. Encouragingly, recent comments from companies in the industry point to a stabilisation in the Chinese smartphone market and optimism about a modest rebound in personal computer demand through 2024. As inventories normalise, a more regular ordering pattern and improved pricing backdrop should allow for renewed top-line growth. We continue to think that the underlying structural drivers for semiconductors will remain very strong in the coming years. The recent excitement over new AI applications such as ChatGPT is another example of the significant potential new demand for high-end processors and memory chips. The former are almost exclusively manufactured by TSMC in Taiwan, including most Nvidia chips, while the latter are mainly produced by Korean manufacturers, such as Samsung and Hynix. We have some concerns that the recent excitement over the revenue potential of AI and battery components companies may be excessive for some of the retail favourite stocks that have performed very strongly in the last few months. Nevertheless, valuations for large-cap industry leaders within the sector remain attractive and we still have significant exposure to our preferred stocks in anticipation of the cyclical recovery over the medium term.

Indian equities have also performed much better than their Chinese counterparts. Sentiment towards the Indian economy and its longer-term potential remains very positive at a time when China's fortunes are increasingly being questioned by investors. A healthy domestic growth outlook, geopolitical tailwinds, scope to increase market share in global manufacturing at the expense of China and steady domestic fund inflows into local equity markets are all factors in the market's favour. Valuations remain elevated in many sectors, so this positive outlook is well-discounted today – especially for small- and mid-cap stocks that have been the focus of domestic buying and where expansion in valuation multiples is most marked. However, we continue to see strong longer-term fundamentals in areas such as private sector banks, healthcare and select consumer-related stocks, which remain core positions in regional portfolios.

Aggregate valuations for regional equities are back below longer-term average levels. As usual, there remains a significant spread in multiples between those stocks and sectors in favour today, and the apparently 'deep value' on offer in less popular areas. Markets such as India and Taiwan that performed strongly last year are trading at marked premiums to their own historical averages. At the same time, the Hong Kong and China indices are sitting close to all-time low multiples. Gains in Asian equities generally require a more stable global macroeconomic backdrop, a less hawkish Fed, reduced volatility in US-China relations and a more positive Chinese cyclical outlook. These factors are important to attract flows back into the market from foreign investors. Visibility remains limited on many of these fronts – most importantly the China policy backdrop in 2024. Nevertheless, we remain hopeful of a continued gradual recovery in activity in key stocks and sectors in China, and a rebound in technology sector fundamentals through 2024. This could underpin our preferred Asian equities over the medium term. In the meantime, we remain very selective in our exposure, given the continued uneven nature of the recovery in the region, and disciplined about valuations.

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