Schroders

Schroder Asian Shares Fund

Market Summary

Asian equities recorded a negative performance in April, with sharp declines in China, Taiwan and Thailand offsetting share price gains in Indonesia and India.

China was the weakest index market in April, despite economic growth expanding at a faster rate than expected in the first quarter. Ongoing tensions with the US and other Western nations over Taiwan also weakened investor sentiment towards the country. Share prices in Taiwan ended the month in negative territory as demand for semiconductors, one of Taiwan's main exports, declines due to weaker growth in other parts of the world.

Indonesia was the best-performing index market in April as the country accelerates its efforts to become a major player in the global electric vehicle (EV) supply chain by tapping its nickel reserves, a key raw material used for making EV batteries. Indian equity prices also achieved robust gains in April, driven by gains in real estate and information technology stocks.

Performance Review

Asian equities struggled and edged lower in April as renewed concerns over US-China tensions raised risk aversion in the market. Market has turned more defensive, with energy, telco and pharma outperforming while internet and technology lagged. Against such backdrop, the fund registered a negative return and underperformed the benchmark for the month. At the regional level, our overweight exposure and positive stock selection in Hong Kong was a key contributor. This was however more than offset by our selection in Taiwan. From a sector perspective, our underweight exposure in communication and selection across real estate and consumer discretionary added to relative returns, while exposure to industrials and technology have dragged on returns.

As investors shifted focus to defensives, our real estate and financial holdings across the region advanced and were among the key contributors to performance. In India, HDFC Bank saw share price advance given solid earnings outlook driven by healthy loan growth and improving net interest margin as credit cost continued to normalise. China / Hong Kong insurers also added value as China Pacific Insurance and AIA traded higher as new business continued to improve, with activities picking up across Hong Kong and other key Chinese cities. Commercial landlord Swire Properties also rose on the back of its solid FY22 results and an improving outlook for rental demand following the HK-China border reopening. In other sectors, China's Sinopec and CNOOC were also among the key contributors as they also benefited from a general rotation into defensive / yield names during the month.

On the negative side, our technology names in Taiwan and Hong Kong, including TSMC, MediaTek, and ASMPT were among the key detractors from perfoormance as inventory correction in the sector appeared to be taking longer than initially anticipated and may extend into 2H23 as end demand remained weak. Share price weakness was also seen in new energy / EV related names such as China's solar PV supplier, Longi Green Energy, and electric valve maker Zhejiang Sanhua, as investors became concerned about the oversupply situation in China and implication on product pricing. Last but not least, investors' profit taking in Chinese internet / ecommerce names such as Alibaba, Baozun and JD.com has weighed on share price performance as investors remained concerned over a soft domestic consumption recovery while the competitive intensity in the industry remains elevated.

Outlook/positioning

April was another relatively quiet month for Asian equity markets, with regional indices closing slightly lower. China and Taiwan were the weakest markets, with most other countries registering small positive gains. After extreme volatility in US bond markets in March, exaggerated by the onset of a liquidity crisis among some US regional banks and troubles at Credit Suisse, the macroeconomic backdrop was calmer during April. US bond yields traded sidewise in a much tighter range, with little change in the broader US dollar indices. Concerns about the banking sector have eased somewhat as several of the weakest players have been taken over by stronger banks, and the authorities have put in place new liquidity facilities to support short-term funding needs. Meanwhile, inflation data remains stubbornly high in the US as tight labour markets and continued robust consumer spending keep service sector prices rising faster than desired by the US Federal Reserve (Fed). A further rate hike is therefore expected in May and the tone of commentary from Fed members remains fairly hawkish. There is a desire to slow economic growth in order that core inflation can return closer to the Fed's 2% target. It is still very unclear what shape the economic slowdown – in terms of inflation and economic growth – will take in the coming quarters. There is heated debate over the likelihood of a 'soft' versus 'hard' landing for the US economy. This in turn remains a major overhang for equity markets, with downside risk to earnings forecasts expected should a recession become evident over the medium term. In addition to the uncertainties over the US inflation/growth/rates outlook, Asian markets have struggled to make much progress in the last two months. This is due to continued question marks over: (a) the strength of the Chinese recovery following its re-opening; and (b) the timing of any recovery in demand for the technology sector.

In China and Hong Kong, business and consumer activity continue to normalise after the ending of Covid controls and two years of on-off disruptions to mobility. The strongest rebound has been visible (in common with patterns seen in other areas of the world) in travel and leisure spending, with stocks in the hotel, gaming, beverage and restaurant sectors benefiting. However, after very strong performance for many consumer discretionary stocks from the November lows of last year through to the Chinese New Year, share prices have recently consolidated. Recent earnings data in these sectors have generally been very strong, but investors remain concerned about the durability of this rebound. Outside these more visible areas of 'revenge spending,' the recovery in the broader economy is patchier and many companies remain conservative in their forward guidance. This is causing some disappointment following the earlier re-opening rally in the market. The caution is probably not a surprise given that employment and incomes have been under severe pressure in many areas in the last few years. In addition, consumer confidence has been hit by the weakness in the residential property market, which is the key source of wealth for most households. It is still very early days in the post-Covid cycle, and it will take time to rebuild confidence amongst consumers and smaller businesses. However we remain optimistic that consumption – and hence corporate profitability – can continue to improve going forward as business gradually picks up. Markets today are reluctant to anticipate this potential upside and have now moved into the 'show me' phase, waiting for concrete earnings revisions before stocks can move higher.

The performance of offshore-listed Chinese stocks also remains heavily influenced by geopolitical factors, given the dominance of international investors in the shareholder base of these companies. Increased tensions between the US and China over the latter's tacit support for Russia during the Ukraine conflict is not helping sentiment, given the risks of further US sanctions against strategic Chinese industries. Chinese internet stocks were under pressure again during April and have now retraced around half of their gains from the November lows last year. This is in stark contrast to the strength seen recently in several of the larger-cap US technology and internet stocks. There are signs that advertising spending and e-commerce volumes have started to pick up gradually since March. However, investors remain sceptical about the scope for further upside in this cycle, given continued intense competitive pressures and greater regulatory scrutiny.

Korean and Taiwanese equities have performed well since the start of the year, owing to gains in the key large-cap semiconductor stocks that dominate their indices. Although end-market demand has remained soft for several quarters, and inventories are very elevated across the supply chain, investors have started to position for an improvement in demand expected in the second half of this year. Recent cuts in capital expenditure by memory producers support the view that we are now hitting the trough of the cycle. Nevertheless, guidance from many technology companies points to continued softness in the second and third quarters, pushing the timing of any recovery out by a quarter or more. This caution has in turn taken some of the wind out of the recovery trade in the technology sector. Here again, it feels like investors are taking more of a wait-and-see approach before chasing share prices higher. Inevitably, there remains considerable uncertainty about the precise timing of this cyclical rebound, but we continue to think that the underlying structural drivers of semiconductor demand will remain very strong in coming years. The recent excitement over new AI (artificial intelligence) applications such as ChatGPT is another example of significant potential new demand for high-end processors and memory (the former are almost exclusively manufactured by TSMC in Taiwan, while the latter is produced by Korean manufacturers such as Samsung and Hynix). Valuations for 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.

After lagging North Asia's strong rebound from November to January, Indian equities have proved more defensive than their Chinese counterparts during the recent market pull-back. In part, India's earlier underperformance (up to the end of January) was a mean reversion after much stronger returns in the prior 18 months. As international investors rotated back into China and other North Asian markets since November, they took profits in India, where valuations had become relatively stretched. More recently, however, India has benefited – relative to China in particular – from an absence of geopolitical headwinds and steady domestic fund inflows into the local equity market. Valuations remain elevated in many sectors and cracks have started to appear in the demand outlook for the important software industry. 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.

Markets have fallen by 5-10% from their January highs, and aggregate valuations for regional equities are back to slightly below longer-term average levels. There are, as ever, plenty of risks to the outlook on the economic and political fronts. As the last few months have reminded us, gains in Asian equities require a more stable global macroeconomic backdrop and greater confidence in US-China relations. Nevertheless, we remain hopeful that there is scope for a more durable recovery in China activity and a rebound in technology sector fundamentals later this year that can underpin Asian equities over the medium term. The collapse in Asian markets in the third quarter of 2022 felt like capitulation, with many international investors 'giving up' on the region after a barrage of adverse headlines on many fronts surrounding China. We are still only six months past this inflection point, and it feels as though there should be scope for further rehabilitation if investors start to discount a more positive medium-term earnings outlook as stronger numbers start to come through. In the meantime, we remain very selective in our exposure, given the likely uneven nature of the recovery in the region, and disciplined about valuations. We will look to take profits in stocks where we feel the cyclical recovery is fully priced in.