LOMBARD ODIER
INVESTMENT MANAGERS

2020 Outlook

Asian Equities year ahead

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February 2020

2019 was an uncomfortable year for equity investors who were beset by various concerns ranging from a US recession to further escalation of the China US trade dispute. Despite the concerns, equity markets climbed the wall of worry to post respectable returns in 2019. Equity markets' good performance was supported by the intervention by the US Federal Reserve with a series of interest rate cuts and a finalization of the Phase One trade deal that removed the key uncertainty of further escalation between the world's two largest economies.

2020 looks to repeat the 2019 experience in terms of the variety of concerns. Investors' confidence was tested in early January when Middle East tensions sharply escalated. Investors are now confronted by the viral outbreak in Wuhan, China. It is normal to fear a pandemic outbreak and the market sell-off reflects investors trying to price in the impact of the outbreak. While the impact of the Novel Coronavirus (2019-nCoV) outbreak will be unknown for a while, the history of such previous viral outbreaks suggest the economic and financial markets impact are short and temporary. We also take some comfort that the Chinese authorities' response has improved remarkably from the obfuscation and secrecy exhibited during the SARS outbreak and, more concretely, China has made containing and resolving the outbreak its top priority and has mobilized its considerable resources to this end.

The macro conditions are conducive for Asian equities, with Asian policy makers having policy flexibility to support economic growth if needed. The region's policy makers have managed its fiscal and monetary policies relatively well over the last two years, to guard against sharp economic slowdown while allowing their currencies to act as shock absorbers. With inflation remaining subdued, policy makers have room to be accommodative in 2020.

We were overweight in Financials over the past two years given our differentiated view on the sector's earnings growth. This overweight was reduced over the course of 2019 as the investment thesis played out and the tailwind for earnings eased. In 2020, we still see opportunities in the sector with reasonable earnings coupled with undemanding valuation. One trend that will persist is the dispersion in returns within the sector, with the stronger players getting stronger at the expense of weaker peers.

Information Technology was the best performing sector in 2019 as investors looked through the weakness of 2019's earnings in anticipation of a better 2020. In semiconductors and memory chips, we see some optimism for recovery as 5G telecommunication deployment may help soften overall smartphone market weakness in 2020 but we remain cautious on the overall smartphone supply chain given the lack of new applications that would demand 5G speeds. We continue to view the internet and eCommerce space favorably given the structural growth in this space.

Consumer Discretionary was the second best performing sector in Asia in 2019, significantly outperforming Consumer Staples. We expect to see this trend continue in 2020 with well-positioned Chinese discretionary names benefiting from the multi-year trend of premiumization. Within Staples we have a preference for companies with proven execution capabilities and exposed to trading up opportunities.

We hope you enjoy the report, and thank you for reading it.

Asia Equities team (as at 6 February 2020).

OUTLOOK FOR 2020

2019 at a glance – a year of shocks and resilient equity markets

Contrary to most investors' expectations, 2019 turned out to be a good year in terms of performance despite investors' fears and anxiety over the course of the year. Equities climbed the wall of worries in 2019 and the good performance was aided by the US rate cuts and trade truce between China and the US. All major regional equities recorded positive performance. Asian Ex Japan equities were up 18.2% (USD terms) compared to +27.7% for MSCI World. Over the last three years, Asia Ex Japan equities returns were on par with MSCI World, as shown in Figure 1.

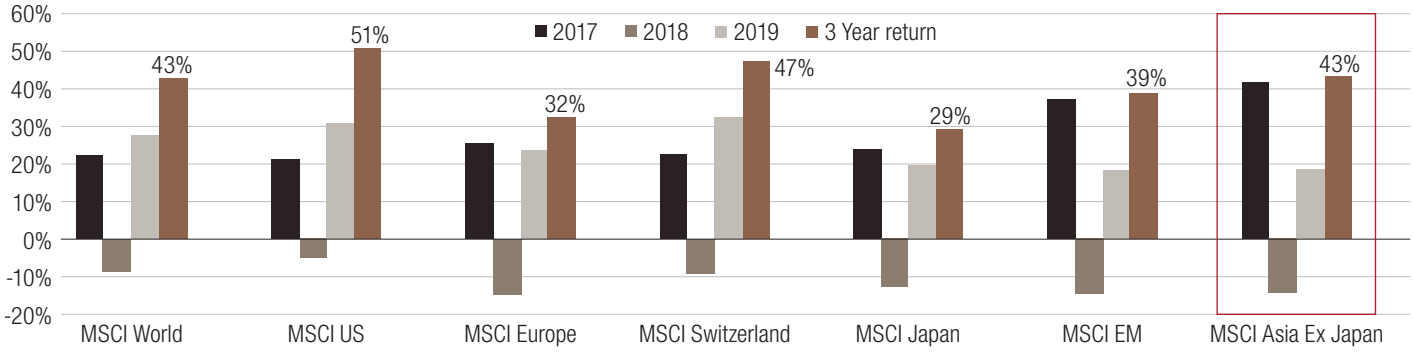
Macro backdrop for 2020 – continued policy flexibility if needed

The year started with a series of events that challenged investors' risk appetite. On 3 January, global equities were shaken by a sharp escalation in the Middle East conflict leading to sharp pull backs and a spike in oil prices. This bout of risk aversion quickly reversed and equity markets continued to perform as the "Phase One" trade deal between China and the US removed the most significant source of uncertainty regarding global growth. Investors' confidence was further dented towards the end of January, this time by a potential pandemic originating in China (more on this later). We currently see this as a temporary setback as macroeconomic conditions have improved, with recent indicators turning positive, and past experiences suggest there is a limited long term impact on equity performance from viral outbreaks.

In 2019, Asian policy makers adjusted their policies to be more supportive as global interest rates eased. With the Federal Reserve on pause for the rest of 2020 in view of moderating growth and the US political calendar, Asian policy makers have room to be accommodative.

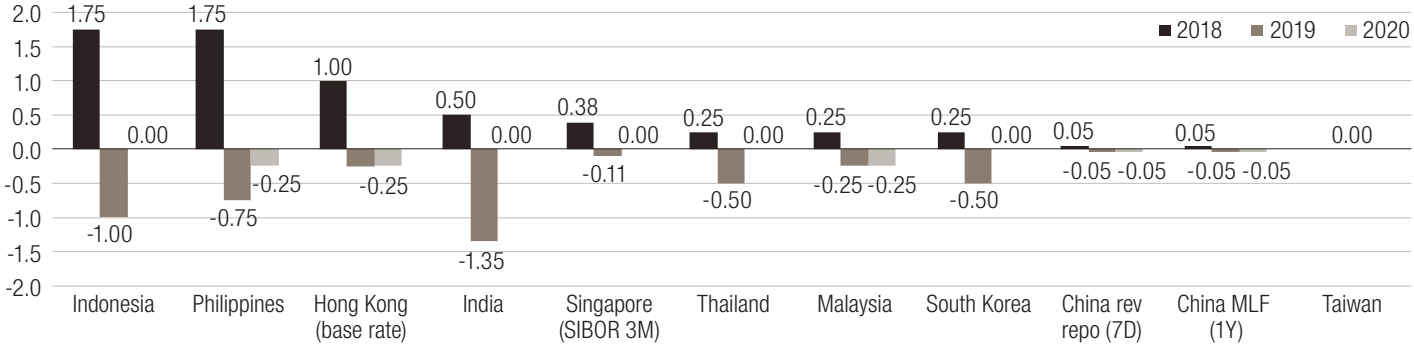
In particular, for the weaker currency economies like Indonesia and India, the benign inflation outlook give the policy makers there room to ease further if needed. In China, the recent spike in inflation is temporary, reflecting the pork shortage in the country. We do not expect the People's Bank of China (PBoC) to tighten on this food-related inflation.

Figure 1 – Yearly market performance by key regions (3 years, USD)



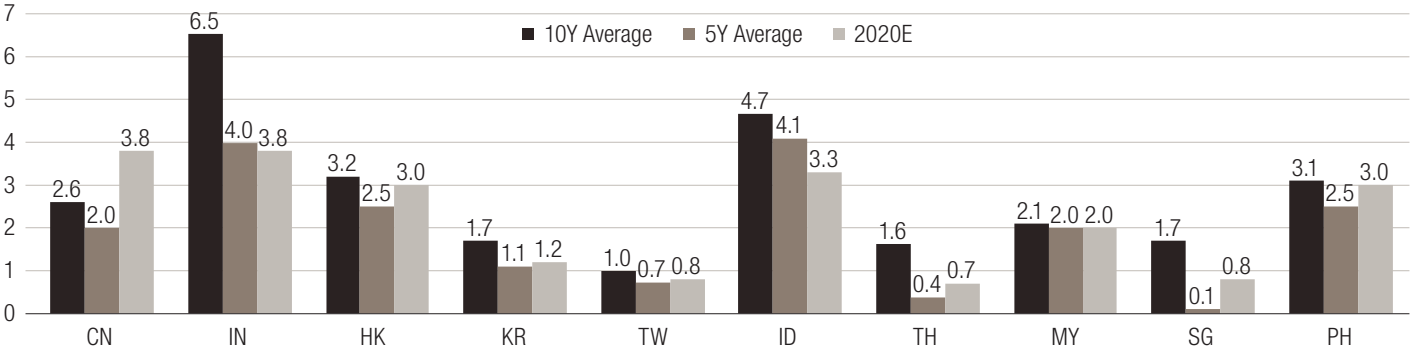
Source: Bloomberg.

Figure 2 – Asia policy rate changes (percentage)



Source: Bloomberg, 2020 are LO Asia estimates.

Figure 3 – Historical and current Asia consumer inflation (percentage)



Source: Bloomberg, IMF World Economic Outlook Database, Morgan Stanley Research.

China US Trade Conflict – Phase One concluded and a truce, for now

After giving investors many anxiety attacks over the last two years, China and the US have concluded a "Phase One" trade deal to halt further escalating rounds of retaliatory trade tariffs against each other. In our 2019 note, we indicated that the risk of "the worst case scenario of a full scale trade war is less likely now" as both sides were incentivized to reach an agreement. We also did not believe a "blue-sky scenario (rewind to pre 2017)" was likely. The contours of the Phase One deal look similar to what we expected.

The key parts of the Phase One deal signed on 15 January are:

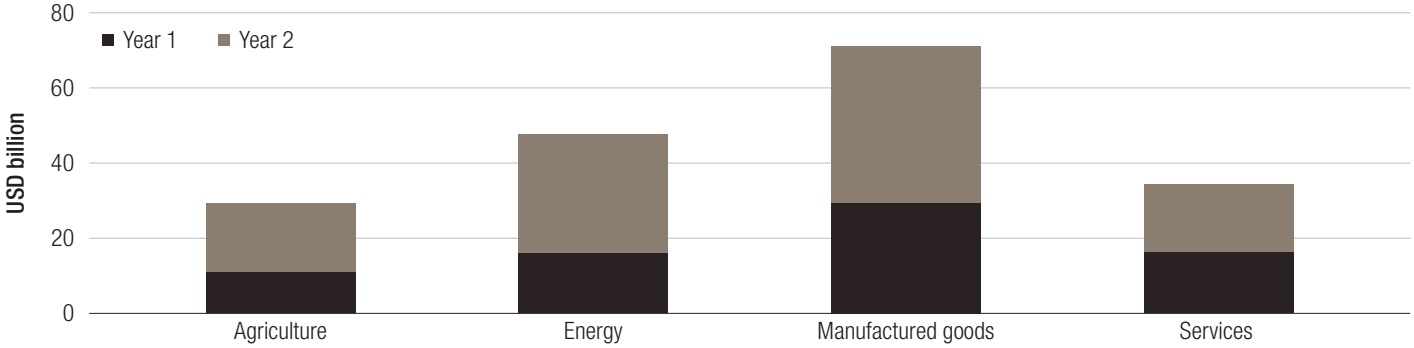
1. China agrees to purchase an additional USD 200 billion of US goods and services over two years to reduce the trade deficits between the two economies.
2. In exchange, the US agreed to reduce tariffs on USD 120 billion in Chinese goods from 15% to 7.5% but the bulk of US tariffs on China remain in place until Phase 2 is agreed. There will be no linear escalation as long as the deal is in place.
3. Issues of IP and forced tech transfers remain exposed to different interpretations by both sides.
4. There is no grace period for the deal (minimum period before any objection can be raised) and the resolution mechanism is bi-lateral.

We are not particularly optimistic about a Phase Two deal for the remainder of 2020 given the US political calendar and the deep structural issues between both sides which remain unresolved, but the Phase One deal delivered what the markets needed – an *end to further escalation* between the two largest economies.

An important sidenote to the truce in trade tension is that China's growth did not fall apart in 2019 (as we expected). China mobilized monetary and fiscal policy support in response to the slowdown and effectively cushioned the slowdown in the economy resulting from the trade conflict. We believe part of the reason for the moderate stimulus in 2019 was the increased resilience in the Chinese economy as the economic structure becomes more service and domestic consumption driven, from the export driven model of the past. With the Phase One deal concluded, we expect China policy responses will be become more measured and data dependent in 2020.

Figure 4 – Beijing USD 200 billion buying Spree

China has commmitted to increase purchases from US over two years



Source: US, Whitehouse.

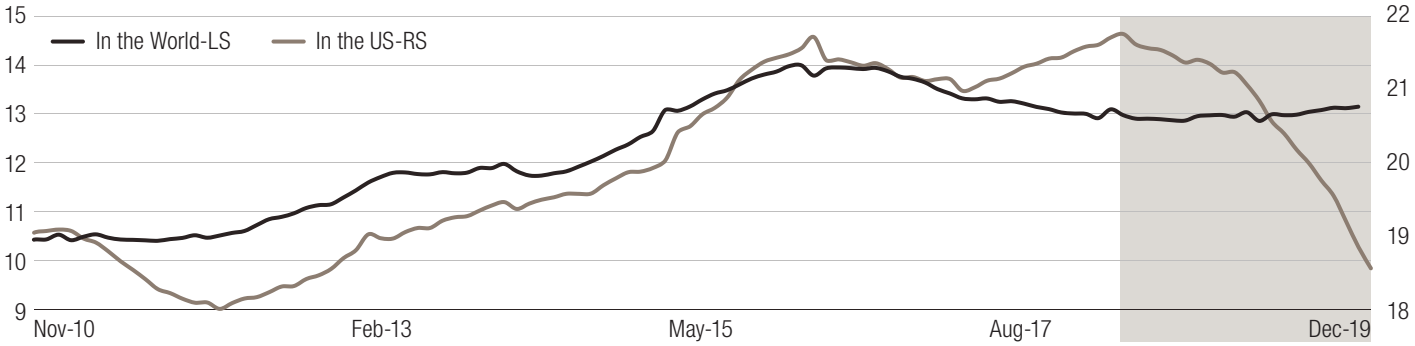
Note: Additional US exports to China on top of 2017 baseline.

One datapoint that was quite counter-intitutive when tracking China's economy over the past year was China's global export market share, as illustrated by Figure 5. While we expected China's export share to the US to *fall*, it was very surprising to see China's share of global exports *increasing* over the same period. This data point is quite puzzling and surprising, and we suspect that some of China's exports have been re-routed to the rest of world (and onwards to the US) and that Chinese companies have been reasonably successful in diversifying their end markets away from the US.

Over the longer term, there will be a shift of investments if the trade tensions between the two largest economies continue. However, corporates' desire to diversify their manufacturing base is running up against the reality of China's entrenched "hardware" and "software" advantages as the world's factory. China's key appeal as a manufacturing hub has ceased to be about labor cost for sometime now, with other Asian economies offering lower wages. Increasingly, China's key advantage is about the logistic advantages it has built up over the past decades.

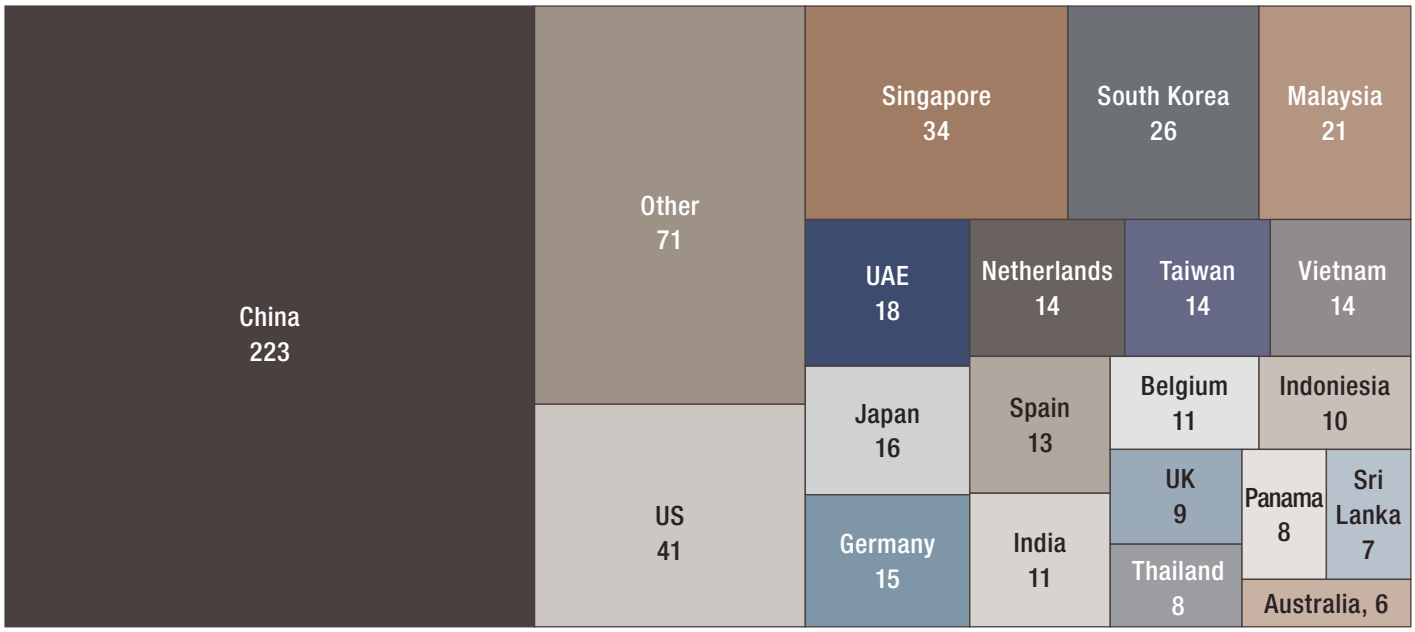
Take for example shipping. China's annual container throughput is the largest in the world. It is 4 times bigger than the US and about 16 times larger than Vietnam. A significant part of this immense logistical edge is that China is also a massive consumption market leading to two-way shipping traffic which other economies are unable to match. While international corporates may want to diversify their manufacturing capabilities going forward, the process is going to take considerably longer and be a lot more painstaking than we previously thought.

Figure 5 – China export share (%), 12MMA



Source: Haver, Morgan Stanley Research.

Annual container throughput (million teus)



Source: Bloomberg Media.

2019-nCoV pandemic scare – be aware, be prepared and do not panic

On 8 December 2019, the Chinese government identified the death of 1 patient and 41 others hospitalized with unknown etiology in Wuhan, Hubei province, China, a city of 11 million residents. The evidence so far indicates that the initial outbreak is associated with exposures to Huanan Seafood Wholesale Market in Wuhan which was subsequently closed on 1 January 2020. It has been confirmed that this viral outbreak is a novel coronavirus.[1] This new virus is currently designated as 2019-nCoV and since the initial detection, the number of infected cases have increased significantly and has spread across the world and the resulting fear of a global pandemic has led to equity sell offs in Asia and globally.[2]

This is a developing issue as we are in the initial stages of infection and the number of infected are likely to increase, and perhaps *significantly* from here. At this point, it is clear that 2019-nCoV has mutated (like SARS) and is capable of human to human transmission. The infection rate appears to be higher than SARS but fortunately, the mortality rate also appears to be lower. The table below compares the current infection and mortality rates with prior significant viral outbreaks.

While there is room for improvement, the Chinese response to 2019-nCoV has improved remarkably from the obfuscation and secrecy during SARS. The Chinese health authorities notified WHO (World Health Organization) on 31 December 2019 once it confirmed that it was a new coronavirus. The authorities also quickly shut down the seafood market once it confirmed it was the source of the outbreak.

Within a month of the first detection, Chinese health authorities posted the full genome of the 2019-nCoV in GenBank, the NIH genetic sequence database, and in the Global Initiative on Sharing All Influenza Data (GISAID) portal. This action has facilitated detection of this virus globally and is acknowledged by other health authorities like the US CDC (Centers for Disease Control and Prevention) and the WHO.

The quick shutdown of the original source of the virus and the transparency of the data sharing with international health organizations stands in marked contrast with the experience of SARS. During SARS, the Chinese government did not report the abnormal new infection to the WHO until 4 months after the first case was reported. The genetic sequences of SARS were also not completed until March 2003, 5 months after the first cases were recognized in November 2002.

The Chinese political leadership has made tackling the 2019-nCoV a top national priority with President Xi making his first public remark on the outbreak on 20 January where he spoke of "the need for timely release of information." Premier Li Keqiang is heading a group on the prevention and control of the novel coronavirus outbreak. China quickly implemented forceful measures including the largest quarantine in modern human history on 23 January 2020. First with Wuhan and further expanding to the entire Hubei province. As at 26 January, about 41 million people are under quarantine. While the authorities have faced criticism about this unprecedented quarantine, in view of the infection rate of this virus, quarantine is probably the most effective measure it could take to contain the spread of the virus.

		SARS	MIDDLE EAST RESPIRATORY SYNDROME (MERS)	AVIAN INFLUENZA (H7N9)	2019-nCoV
	Period	**Late 2002 to mid 2003**	**2013 to 2015 (ongoing)**	**2013 to 2017**	**Dec 2019 (ongoing)**
China, including Hong Kong	Confirmed cases	7,082	1	1,564	27,863
	Fatalities	646	0	615	563
	Mortality rate	9%	0%	39%	2%
Wuhan, China	Confirmed cases				10,117
	Fatalities				414
	Mortality rate				4%
Outside China	Confirmed cases	1,355	2,493	3	202
	Fatalities	167	858	0	1
	Mortality rate	12%	34%	0%	0%
Global	Confirmed cases	8,437	2,494	1,567	28,065
	Fatalities	813	858	615	564
	Mortality rate	10%	34%	39%	2%

Source: WHO, National Health Commission, Center for Infectious Disease Research & Policy, updated as at 6 February 2020.

[1] Coronaviruses are a large family of viruses that are common in many different species of animals, including camels, cattle, cats, and bats. Rarely, animal coronaviruses can infect people and then spread between people such as with MERS and SARS.

https://www.cdc.gov/coronavirus/2019-ncov/summary.html

https://www.who.int/emergencies/diseases/novel-coronavirus-2019

[2] Some statistics on the US regular flu season and the associated mortality rates.

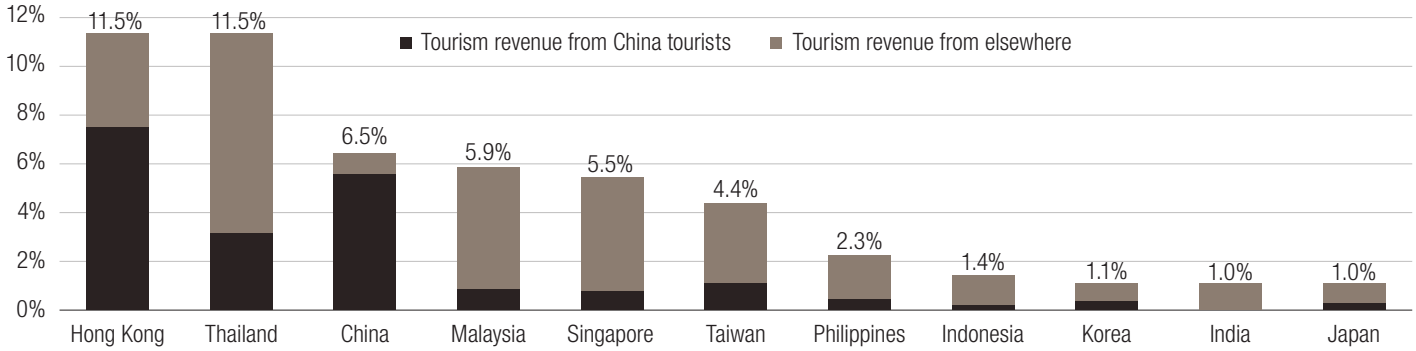
https://www.cdc.gov/flu/about/burden/2017-2018.htm#table1

This outbreak will put a dampener on economic activities, with tourism most severely impacted, and spill over to impact the restart of manufacturing activity as the official and unofficial quarantine delay the normal resumption of economic activity post the Chinese New Year period in China. At this point it is difficult to put a numerical number to the impact of this new viral outbreak. Using the SARS event as a reference, it was estimated that SARS costed the world economy USD 40 billion[3] during its outbreak.

One important difference this time is the importance of Chinese tourism to Asia's regional economies. If the viral outbreak continues to spread, many Asian economies will likely suffer a more severe dip in tourism revenue. In particular, Thailand, Malaysia and Singapore are most exposed to Chinese tourism revenue in the region.

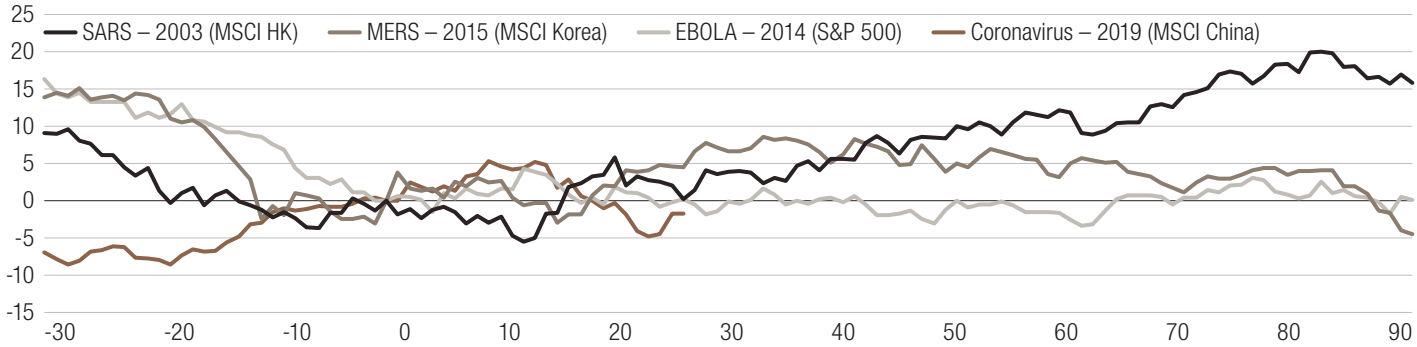
Looking at past equity markets performance during public health scares, such scares do not lead to permanent damage to equity markets as the following table will illustrate:

Figure 6 – Tourism revenue (% of GDP, 2018)



Source: CEIC, Morgan Stanley Research. China tourist receipt for Hong Kong, Malaysia, Singapore and Thailand are actual data. Data for other countries economies are estimated from China tourist arrival % share of total. Data as at 2017 for Indonesia. For the China bar stack, tourism revenure from China tourists refer to domestic tourism and tourism revenue from elsewhere refer to foreign tourism revenue.

Figure 7 – Equity index total returns before and after key public health scares



Source: Bloomberg, Lombard Odier Asia.

It is also clear that the currency markets reflect this temporary impact as well looking at the SARS event in 2002 to 2003.

SARS STAGES	PERIOD	CNY	TWD	KRW	JPY	SGD	THB	AUD	INR	IDR
	16 November 2002 – 2 January 2003	0%	-0.65%	1.43%	0.34%	1.06%	0.62%	0.10%	0.35%	1.16%
Escalation	2 January 2003 – 12 March 2003	0%	0.18%	-4.28%	2.25%	-0.19%	1.01%	5.08%	0.74%	0.30%
	12 March 2003 – 10 April 2003	0%	-0.13%	1.13%	-1.95%	-1.59%	-0.28%	2.00%	0.55%	0.45%
Stabilization	10 April 2003 – 13 May 2003	0%	0.14%	2.46%	2.41%	2.21%	1.12%	6.43%	0.50%	4.67%
De-escalation	13 May 2003 – 31 July 2003	0%	0.88%	1.63%	-3.23%	-1.41%	0.90%	0.12%	2.16%	-0.83%

Source: Bloomberg, Morgan Stanley Research; *Note: Negative means local currency depreciated versus USD.

[3] https://www.ncbi.nlm.nih.gov/books/NBK92473/

Fundamentals still matter – Asia's valulations are compelling

On fundamental measures, Asian equities look very attractive especially relative to global equities, as shown in Figure 8. MSCI Asia Ex Japan is trading at 1.66 times price to book (PB, its historical average) and is very attractive at this level compared to MSCI World's current 2.62 times PB (above its historical average of 2.4 times PB).

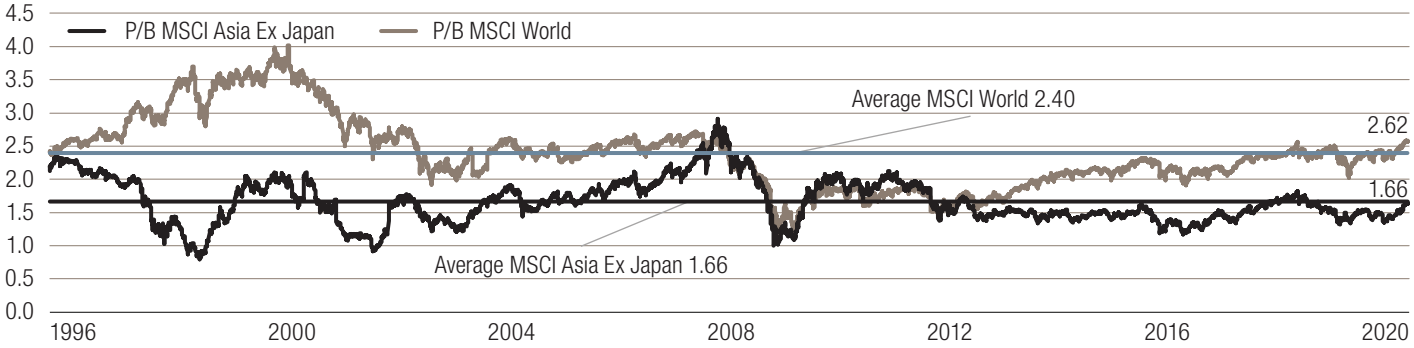
Foreign investor flows into Asia has also recovered from the recent low of -0.6% in January 2019 (12 month rolling basis). We have seen a return of foreign investor flow to reach positive territory but it is still well below recent highs (Figure 9).

ASIAN FINANCIALS IN 2020 – TAILWIND WEAKENING BUT NO HEADWINDS YET

Financials as a sector (10.6% return USD) lagged the overall Asia Ex Japan equity index in 2019. This was offset by strong stock selections which enabled our Financials sector bets to outperform and add value to the portfolio. Our overweight in Financials since early 2018 has been contrarian and has paid off. Our conviction then was driven by our differentiated view that the earnings environment was better than market consensus, with stronger topline growth and significant improvements to provisioning requirements. Throughout the last two years, as our investment thesis played out, we have reduced our overweight in Financials. In 2020, we believe the stock price dispersion amongst the strong and weak players will continue and we will be more selective in Financials.

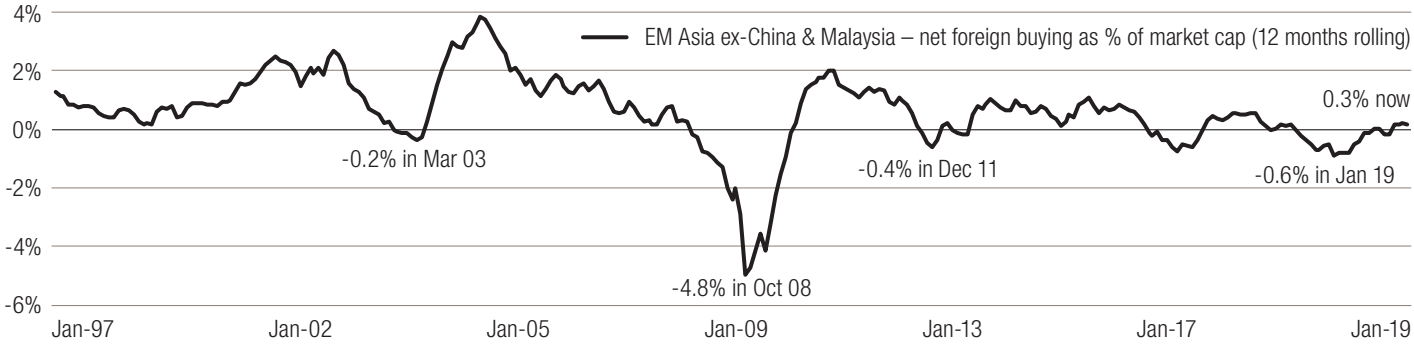
The operating environment will continue to support moderate top line growth as macroeconomic conditions continue to be resilient for Asian economies. This is also supportive for asset quality as we do not see a resurgence of non performing loans (NPLs) in the region. That said, it would be difficult to see provisioning levels drop significantly from current levels. This combination of moderate top line growth and normalizing provisioning levels will support slower but still positive earnings growth for Asian financials.

Figure 8 – Price to Book for MSCI Asia Ex Japan and MSCI World



Source: Bloomberg.

Figure 9 – Net foreign buying as percentage of market capitalisation (12m rolling)



Source: Stock exchanges of India, Indonesia, Korea, Taiwan, Thailand, Philippines, Credit Suisse.

Strong return dispersion to continue

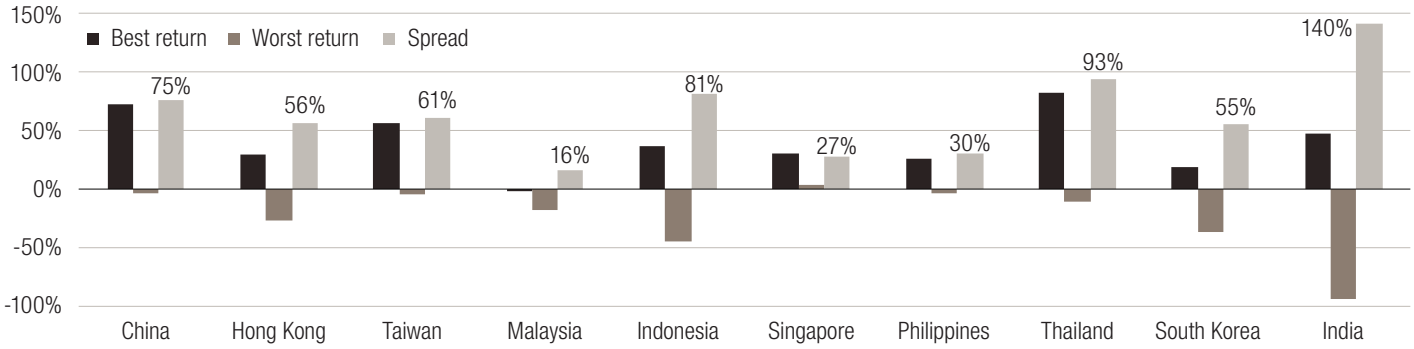
While the average return for the Financials sector was lackluster in 2019, there was significant dispersion within the sector across the countries. Figure 10 illustrates the best and worst 2019 returns (in USD) for the financials stocks we monitor in Asia. Of particular interest is the significant spread between the best and worst performers within countries. This strong return dispersion plays to our strengths in stock selection versus sector allocation and, given the moderating operating environment, this trend will continue in 2020, in our view.

Fundamental trends

In Hong Kong and Singapore, we have likely seen the peak of their NIM (net interest margin) improvement in 2019 as banks in these two countries have benefited from the uptick in interbank rates in 2019. This is unlikely to continue in 2020 and in fact may retrace as Hong Kong and Singapore interbank rates follow the US rate cuts (Figures 11 and 12).

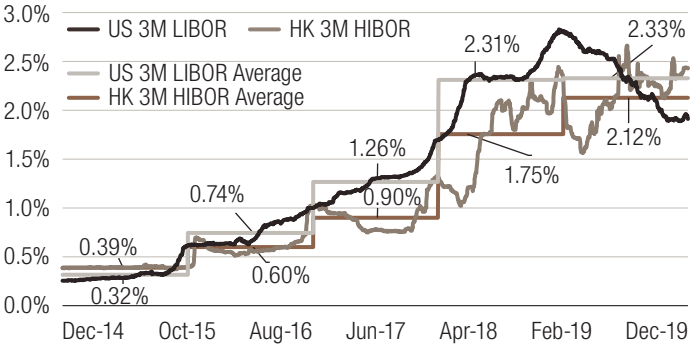
NIMs outlook generally for the region is softer in 2020 as interest rates have inched down. With liquidity returning, loan demand is coming off recent highs, and the relative pricing power of the Asian banks are weaker. The softer NIM outlook is offset by stable loan growth in the region. We see loan growth moderating in the larger Asian economies and accelerating in Association of Southeast Asian Nations (ASEAN) in 2020. The resulting top line picture is one that is softening but still showing positive momentum.

Figure 10 – Return spreads across countries for financials in 2019



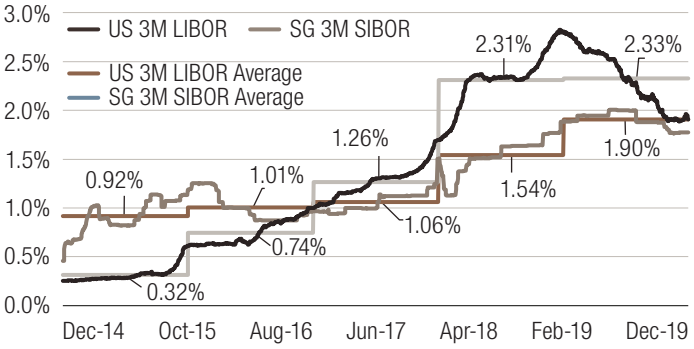
Source: Bloomberg.

Figure 11 – US and Hong Kong 3M interbank rates



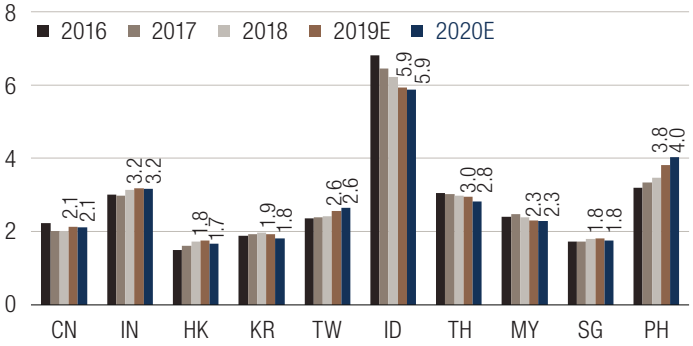
Source: Bloomberg.

Figure 12 – US and Singapore 3M interbank rates



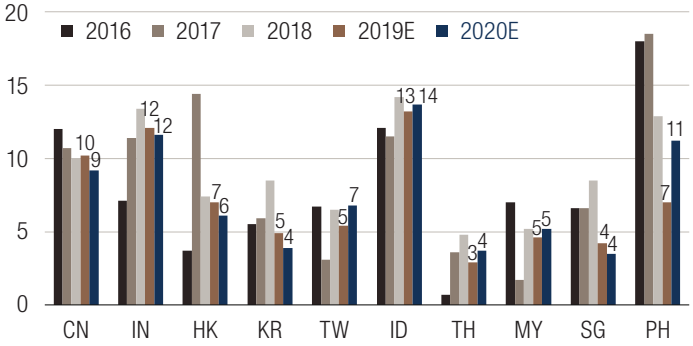
Source: Bloomberg.

Figure 13 – Asian banks' net interest margin (in percentage)



Source: Company data, Morgan Stanley Research.

Figure 14 – Asian banks' loan growth (in percentage)



Source: Company data, Morgan Stanley Research.

No signs of asset quality deterioration

One of the key pillars behind our conviction in Financials has been benign asset quality conditions post the mini credit cycle of 2015-2017. This thesis has played out as Asian banks have digested non performing loans (NPLs) without capital damage (outside of India) and, in most countries, merely dampened earnings. NPL ratios continue to improve and are stabilizing at low levels despite the uncertainties in 2019. The outlook continues to be quite good for 2020. The low NPL ratios will anchor provisions and would not impact Asian banks earnings significantly.

Asian banks' NPL ratio (in percentage)

Gross NPL ratio (%)

(%)	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019E	2020E
China							16.0	11.2	3.5	3.0	2.5	2.5	1.6	1.2	1.0	1.0	1.0	1.2	1.7	1.7	1.6	1.5	1.5	1.5
India – Govt				12.4	11.4	9.7	8.2	5.9	3.7	2.9	2.6	2.2	2.5	2.5	3.3	3.9	4.3	4.7	8.9	9.3	13.0	10.2	9.0	8.0
India – Pvt				4.6	9.3	7.5	3.9	2.5	1.5	1.8	2.4	2.9	2.7	2.2	1.9	1.7	1.7	1.9	2.6	4.1	4.7	3.9	3.9	3.5
India	11.7	14.0	12.6	11.8	9.6	9.0	7.2	5.0	3.1	2.5	2.5	2.4	2.6	2.5	2.9	3.3	3.6	3.8	6.7	7.4	9.8	7.7	7.0	6.1
Korea	5.9	7.3	13.4	8.0	0.7	0.6	0.5	0.4	1.3	0.9	0.8	1.3	1.3	1.7	1.3	1.4	1.5	1.3	1.1	0.9	0.8	0.7	0.7	0.7
Taiwan	3.7	4.4	5.1	4.6	5.7	2.0	2.5	2.1	1.6	1.6	1.4	1.3	1.1	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.3
Indonesia	2.4	66.7	49.7	16.0	10.7	6.5	5.8	4.0	10.9	7.7	4.8	3.2	3.0	2.5	2.1	1.8	1.7	1.8	2.1	2.6	2.4	2.1	2.1	2.0
Thailand	16.5	47.9	50.4	25.8	19.1	19.6	15.8	13.7	10.7	8.8	8.2	6.4	6.0	4.7	3.7	3.1	2.9	2.8	3.3	3.6	3.9	3.9	3.9	3.6
Malaysia	3.2	8.3	10.3	9.3	12.4	11.6	10.7	8.7	7.0	6.1	4.6	3.4	3.5	3.8	2.9	2.1	1.8	1.7	1.8	2.0	2.0	1.9	1.9	1.9
Singapore	3.6	10.7	12.9	9.1	8.3	7.9	6.8	5.1	3.8	2.8	1.5	1.7	2.4	1.6	1.2	1.2	1.0	0.9	1.1	1.4	1.6	1.5	1.6	1.7
Hong Kong	1.0	4.3	9.0	6.9	6.8	5.3	4.0	1.8	1.0	0.6	0.5	0.7	0.6	0.3	0.2	0.3	0.3	0.4	0.4	n.a.	n.a.	n.a.	n.a.	n.a.
Australia	1.0	0.9	0.8	0.7	0.7	0.6	0.4	0.3	0.4	0.5	0.6	1.1	1.7	1.9	1.7	1.5	1.2	0.9	0.8	0.9	0.8	0.8	0.9	1.0
Philippines				12.0	11.3	11.9	10.3	7.4	8.9	7.0	5.6	4.6	4.1	3.6	2.8	2.4	1.6	1.3	1.2	1.2	1.1	1.3	1.3	1.3
Pakistan									6.2	7.3	7.5	7.9	10.4	11.5	12.4	12.4	10.8	9.9	8.6	7.5	7.6	7.1	7.5	7.6
Japan																		0.0	0.0	0.0	0.0	0.0	0.0	0.0
Vietnam																2.3	2.8	2.5	1.8	1.7	1.7	1.8	1.9	2.0

Source: Company reports, Credit Suisse estimates.

Loan loss provisions across Asian countries have peaked and are stabilizing at low levels. We see the potential for some banks to opportunistically build provision coverage (India and China) to manage earnings but provision charges will remain at low levels relative to history and the peak in 2016-2017. This will continue to support bottom line earnings for most Asian banks.

With softening revenue growth, and no further tailwinds from sharply lower provisions, Asian banks generally will see their earning per share (EPS) growth rate moderate in 2020 (Figure 15). We will be more selective in the sector and lean towards reducing our positions in the sector.

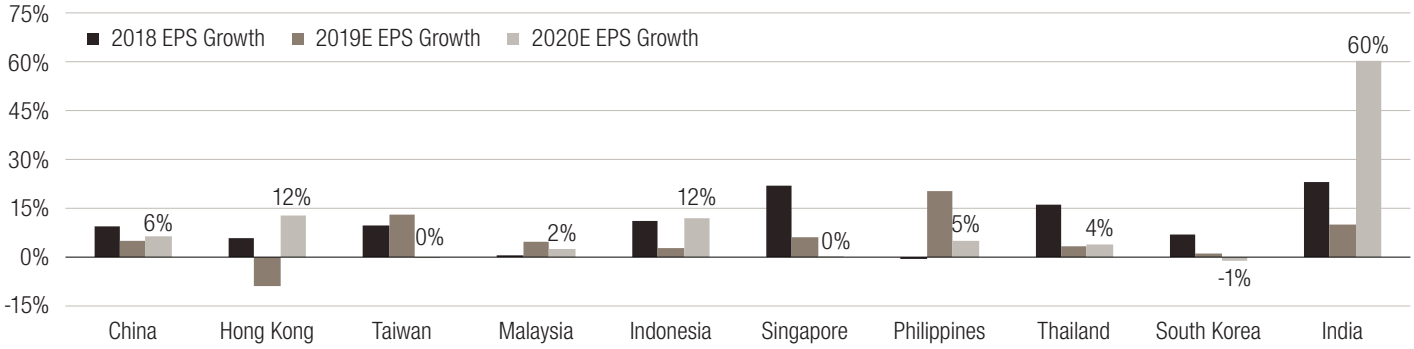
Asian banks' loan loss provisions (in basis points)

P&L provisioning (bp of loan)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019E	2020E
China			206	76	205	102	133	80	62	67	84	138	56	52	59	53	52	73	99	100	103	118	111	110
India – Govt							272	197	149	106	85	75	84	119	139	127	141	150	269	245	433	319	201	132
India – Pvt							125	49	87	134	150	167	184	104	71	71	74	79	139	195	207	201	164	119
India	245	228	178	197	187	181	240	160	131	115	106	103	112	115	120	111	122	129	226	227	349	273	186	127
Korea	105	380	561	383	264	114	231	156	66	51	52	107	113	120	66	75	66	56	52	43	37	35	35	37
Taiwan	59	67	129	128	157	316	203	110	150	232	88	84	69	17	16	13	30	18	7	21	23	19	20	24
Indonesia				-198	711	235	170	120	157	216	167	223	233	145	54	47	66	84	137	201	141	117	113	112
Thailand	250	494	731	286	100	122	90	77	40	132	160	86	74	57	74	76	90	83	138	139	165	133	128	113
Malaysia	201	359	238	151	194	142	99	103	106	92	70	71	70	44	27	18	23	22	38	50	38	26	30	29
Singapore	138	224	150	23	69	83	63	19	19	15	30	69	98	44	34	24	26	26	27	38	38	17	22	21
Hong Kong	50	150	288	142	125	64	46	-32	-27	-17	1	27	19	3	8	9	11	17	21	n.a.	n.a.	n.a.	n.a.	n.a.
Australia	29	33	27	29	35	30	26	22	18	17	28	60	70	39	30	31	22	16	17	19	15	13	14	16
Philippines				180	115	138	120	116	143	176	165	94	148	132	77	69	95	52	31	47	43	40	49	48
Pakistan									138	103	194	148	229	155	139	97	7	19	59	20	-9	35	43	52
Japan																		6	-6	7	0	-1	0	0
Vietnam																146	163	143	187	206	270	247	254	252

Source: Company reports, Credit Suisse estimates.

Figure 15 – Average EPS growth for Asian banks (2018-2020E)



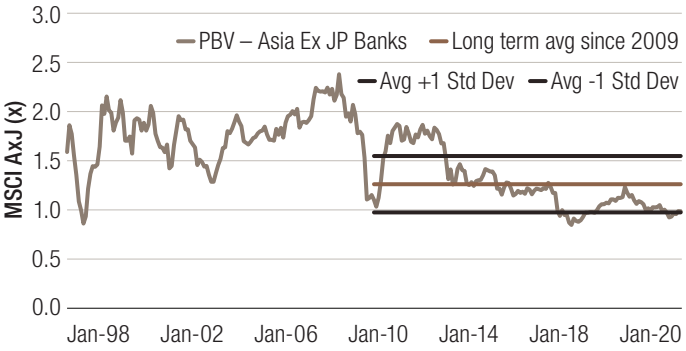
Source: Bloomberg, Lombard Odier Asia Equity Estimates.

We still favour some companies that are well placed to continue to expand market share and grow their earnings above industry peers. In particular, we see significant EPS upside for the well-capitalized private banks and non bank financial companies (NBFCs) in India as they take market share in the coming 18-24 months as their competitors (state owned banks and poorly capitalized private peers) struggle to deal with their asset quality and rebuild their capital. While we are typically wary when banks grow much faster than their industry, this is a unique situation where the industry is going through a shake up and will likely consolidate to the benefit of the strong players.

Valuation is supportive

Valuation is still supportive for Asian banks and one of the reasons why we still find attractive investments in the sector. Asia Ex Japan banks trades at under 1x PB which is one standard deviation below its 10 year average of 1.25x PB (Figure 16).

Figure 16 – MSCI Asia ex-Japan banks price to book value



Source: Morgan Stanley Research.

ASIA TECH OUTLOOK 2020

A strong start to 2020

Tech stocks have entered 2020 at elevated levels in anticipation of a better 2020. We started from a low base in early 2019, with earnings downgrades for most of the first-half of last year before some stabilization by mid-2019 or 3Q19 and then recovered strongly in 4Q19.

Although the market ended at a higher note, the semiconductor industry actually declined by 12% in 2019 while global smartphone shipments declined an estimated 2-3% last year. However, share prices did not respond much to those earnings downgrades. The MSCI Asia ex-Japan IT Index reached the lowest point in first week of 2019 and rallied strongly towards the end of 2019. It rose 42% in 2019 to a record level (total return incl. dividends) versus 18% for the broader MSCI Asia ex-Japan Index.

The market seems to have looked through the weakness of 2019 a year ago and come to the conclusion that 2020 would be a better year. The share prices of some mega-cap names in Asia Tech such as TSMC[4] and Samsung Electronics[4] exited 2019 at near-record levels although both companies experienced a down year in 2019. The share price of both companies hit their bottom in the first week of 2019.

In 2020, we expect a recovery in sub-sectors such as semiconductors and memory chips. 5G deployment in smartphones may stop further decline in the overall smartphone market. Although the Coronavirus outbreak in China and around the world may have some impact on the recovery, we expect this would only delay the process by about 2-3 months. In the Internet space, the secular growth trend should continue. Online payment may become a key theme for growth for the 2 internet giants, as Alibaba's Ant Financials[4] considers listing in Hong Kong, and Tencent's[4] WeChat Pay gradually becomes the next driver for the company's longer term growth, after having invested in this area for more than 5 years.

Risk on US-China tech war unlikely to go away

Although China and the US have reached phase one of a trade agreement, we believe that the dispute in the tech space will continue for years to come. China will continue to find alternative sources for its components outside of the US to reduce risks. In the long term, we may see a bipolar world in the tech space with China creating its own supply chain versus the US. In fact, it has already happened in the internet space. Tencent and Alibaba have already created their own ecosystems in China whereas Google[4] and Amazon[4] both have close to negligible access to the Chinese market.

As we move into the new decade, we expect the Chinese government to use subsidies to push for its hardware and software independence and Chinese companies will continue to shift the supply chain away from US companies. This also offers opportunities for other Asian suppliers from Japan, Korea and Taiwan to replace US suppliers in some of the more advanced semiconductor and components.

[4] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document. The case studies provided in this document are for illustrative purposes only and do not purport to be recommendation of an investment.

A recovery in the semiconductor industry

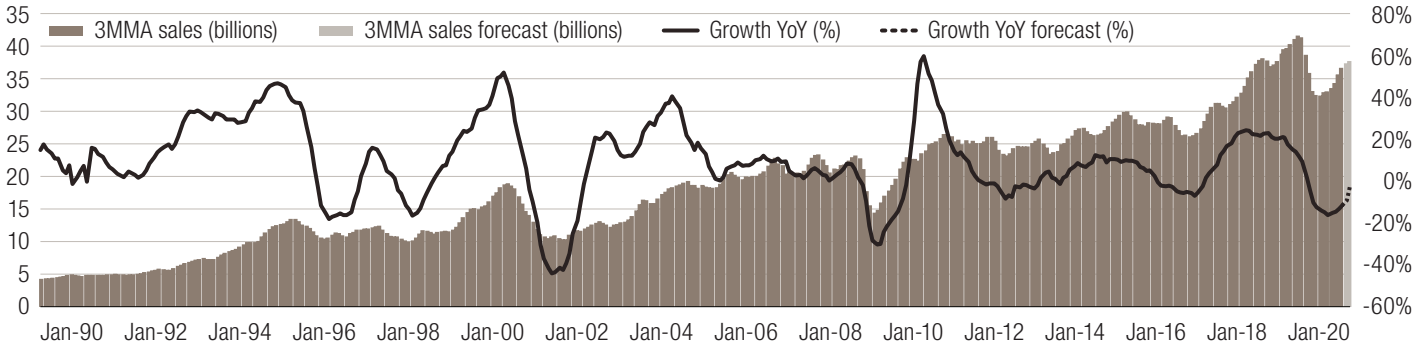
The semiconductor industry has been growing at a compound annual growth rate (CAGR) of mid-single-digit (%) over the past two decades but it declined 12% in 2019, mostly driven by sharp decline in DRAM and NAND flash memory prices. Excluding memory chips, the industry was still down by less than 2% in 2019. We have seen the semiconductor industry's year-on-year growth rate rebound slightly at the end of 2019. We believe 2020 will likely be a recovery year for the industry, as 5G smartphones and mobile network services will likely drive plenty of new phone launches this year and a rebound on memory prices that started in 2H19 should drive the industry higher, from a low base in 2019. The Coronavirus outbreak may affect the recovery in 1Q20, but we still expect the market to pick up again in 2Q20.

5G deployment to revive the smartphone industry

The smartphone market has not grown for 2 years already. Although we saw a small number of 5G phone launches in 2019, most countries still have not offered 5G data services and 5G shipments in 2019 was less than 1% of the overall smartphone market.

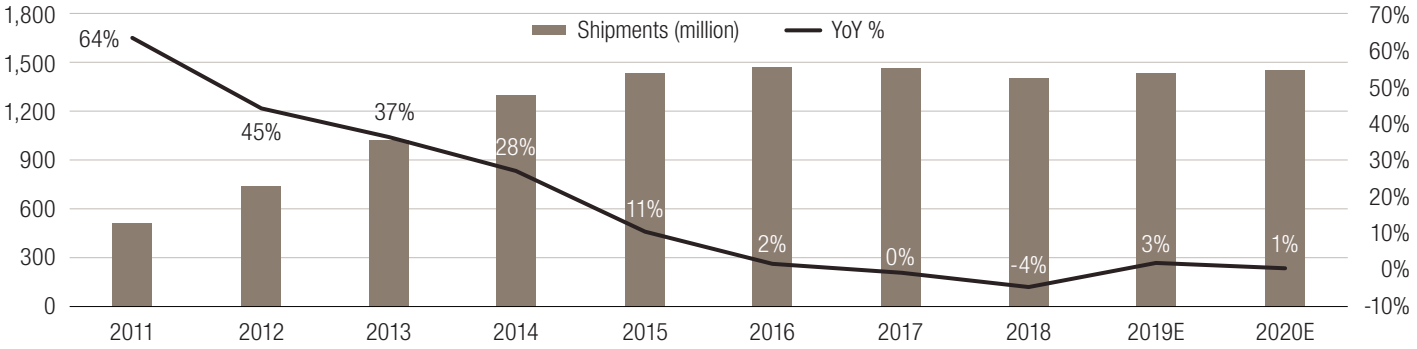
With more 5G smartphone launches and 5G mobile services available from mobile carriers, 2020 will be the first full year of 5G deployment. This should help drive a recovery in this market. We expect around 10% penetration rate (on a sell-through basis) of 5G phones in the overall smartphone market in 2020, which implies around 150 million units. This is lower than the market expectations

Figure 17 – Global semiconductor sales and 3-month moving average (3MMA) YoY growth



Source: Citi Research, WSTS.

Figure 18 – Global smartphone shipments forecast



Source: IDC, LOIM estimates.

of mid-teens % (or 220 million – 250 million units). The main reasons for this shortfall are:

1. The backbone of the current 5G network is still based on 4G in most countries. The speed of the 5G network today is only several times faster than 4G, but not the 10x-20x that was widely reported in the media. Normal consumers may not notice the difference when they watch a video or use most of the apps today.
2. 5G mobile plans will be more expensive than 4G. Together with the higher prices of 5G phones, the total cost of ownership for 5G is still meaningfully higher than 4G.

Therefore, we believe the market could be hot in the second and third quarters of 2020 (1Q likely hit by the virus outbreak) because of many new phone launches. The market may turn more cautious some time in 2H20 when consumers realize that they don't see much of a difference when using the current apps on their phones. Before we see new applications that can fully utilize the high speed of 5G, the replacement cycle of smartphones will likely be similar to the previous 2-3 years. We believe that equipment makers are safer bets because they do not need to worry about the sell-through of the new products. Device makers have to buy equipment to build the capacities to prepare for all the new product launches. Specification upgrades in smartphones is getting tougher going forward because all upgrades come with a cost. The cost of materials for a 5G phone is at least USD 40-50 higher than its 4G predecessor. Any further upgrades on other features will make it more difficult to sell the phone because of a higher price.

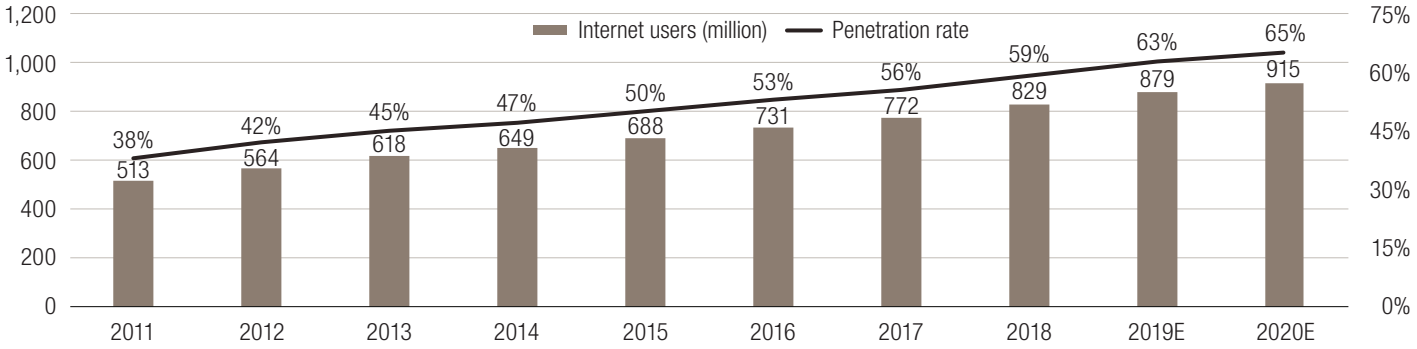
China Internet/eCommerce continue to outperform

Tencent's[4] WeChat platform still accounts for most of the time spend (~40%) by internet users in China. Although this is expected to come down by roughly a couple of points per year, since the internet penetration rate in China is still low (63% in 2019) compared to nearly 90% in the US, there is still room to grow in the next 3-5 years. It also gives the company plenty of room to monetize from its huge user base.

In 2020, advertising and payments are likely to be the drivers of Tencent, in our opinion. The company is increasing advertisement loading on the WeChat platform (from 3 ads per day to 4). The company is also testing short videos on the platform to increase the user time spent, thus creating more opportunities for advertising revenue. On WeChat Pay, it is increasing the take rate in the F&B segment this year. At the same time, we also expect the company to reduce its cash burn on Tencent Video, which should help its profitability this year.

On the eCommerce front, China's online GMV (gross merchandized value) is expected to grow another 18% in 2020 after >20% growth in 2019. This is still more than twice the total retail sales growth rate of 8% in 2019. Although the online growth rate has decelerated over the years, it is still expected to grow at a double-digit rate for years to come. This will certainly benefit online shopping giants such as Alibaba.[4] Although the company has been faced with more competition over the past 2 years (especially in low-tier cities with Pinduoduo[4]), we do believe Pinduoduo's business model is hard to sustain once it reduces the cash burn with fewer or no subsidies.

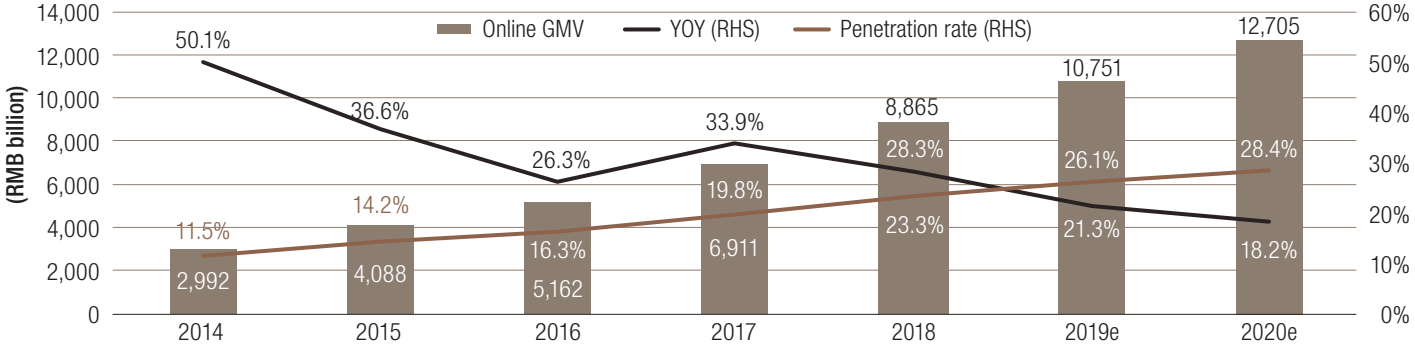
Figure 19 – China internet user and penetration rate



Source: CNNIC, Morgan Stanley estimates.

[4] Any reference to a specific company or security does not constitute a recommendation to buy, sell, hold or directly invest in the company or securities. It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities discussed in this document. The case studies provided in this document are for illustrative purposes only and do not purport to be recommendation of an investment.

Figure 20 – China online GMV (2014-2020E)



Source: iResearch, NBS, Morgan Stanley Research estimates.

ASIA CONSUMER/HEALTHCARE

We expect Asian Consumer Staples and Consumer Discretionary sectors to show a contrasted performance again in 2020, as was the case in 2019, when these sectors were up +35% and +7% respectively, versus +18% for the Asian benchmark.

The Consumer Discretionary segment's key drivers are Chinese names active in online retail, sporting goods, electrical appliances, education, and consumer services, as consumers continue their multi-year quest for higher-end, value-added, life-enhancing goods and services. We see less potential upside in the automotive sub-segment as China operators face high costs to transition towards electric vehicle (EV) targets, while EV subsidies will fade; Indian auto and two-wheeler stocks have been weak for several quarters but the macro and regulatory backdrop at this point is not supportive of a strong bounce in 2020.

In Asian Consumer Staples, we see attractive stock-specific stories (turnaround situations, trading up happening even within staple goods in China), as well as reliable operators with proven multi-year ability to execute well. We see limited upside, however, in most staples names in Korea, Thailand and Singapore, given the soft domestic economy. Interestingly in 2019, sharp share price increases occurred in Chinese liquor and beer stocks, but were unable to offset weak performance in the more "developed" Asian staples as these stocks are largely A-shares and carry little weight in the benchmark.

We focus below on the Chinese and Indian markets, which account for 84% and 11%, respectively, of our overall Consumer/Healthcare exposure within the fund.

China

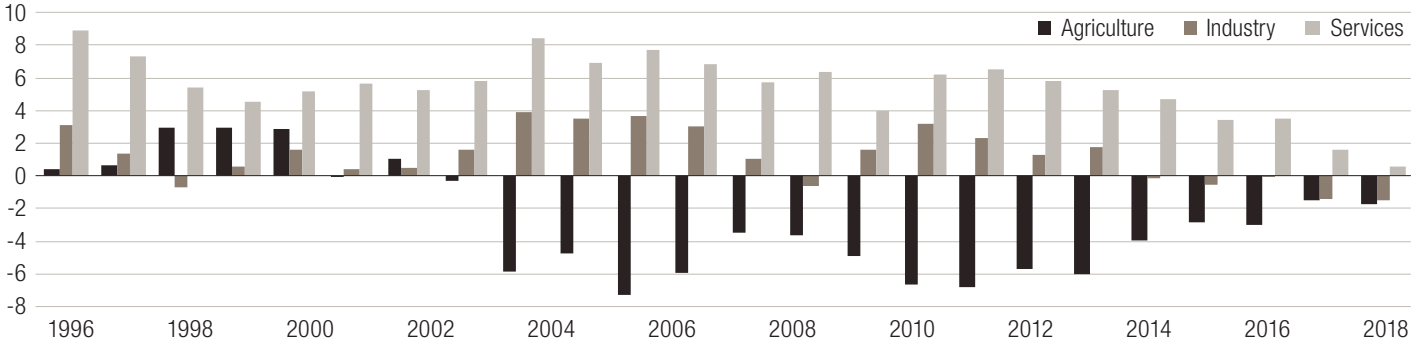
Consumption should continue to be well-supported in China in 2020. As a key component of the country's GDP growth (78% of GDP growth in 2018 was driven by consumption) and as a key driver of social equality and peace, dynamic consumer demand is clearly desirable for authorities. In 2019, several measures clearly avoided Chinese consumption being affected by weakness in the manufacturing sector. In April, the main VAT rate was cut from 16% to 13%. This was partly absorbed by companies but also encouraged spending. Employment was supported by a cut to companies' basic social security contribution rate, from 20% to 16% in May, as well as government-encouraged lending to SMEs through state banks.

Additionally, in December, the State Council (China's cabinet) pledged to relax the country's household registration system (hukou) with steps which would virtually eliminate it in most of China, as targeted cities (with fewer than 3 million residents) account for 90% of the country's 300 prefecture-level cities. This will encourage urbanization and give migrants access to numerous services which the previous system barred them from. We believe this will help to compound growth coming from lower-tier cities, which has been a clear feature in China consumer companies' development and focus in 2019, in fields as diverse as online retailing, after-school tutoring, sporting goods, staples consumption like dairy, beer and noodles etc.

Beyond the above measures, which will continue to impact 2020, we anticipate the regulatory environment should be fairly quiet. Reforms in healthcare and EV are ongoing, but we do not expect a situation of numerous and radical reforms, given that a large number of sectors were already targeted in 2018 or early 2019 (online lending, shadow banking, electric vehicles, education, healthcare, online gaming, e-commerce, duty-free spending and others).

Broad support for consumer spending should also continue to be driven by salary inflation, which for much of the last decade has been in the high single/low double digit range, depending on industries. One factor underpinning this is the decline in the working population. The chart below shows that the only sector providing net jobs now is Services, but also that China's working population has been in net decline since 2018. The latter phenomenon will arguably create various issues for government in the long term, but in the short term it will certainly trigger salary tightness and spending incentive for the working population (Figure 21).

Figure 21 – China: Change in workforce by sector (million people)

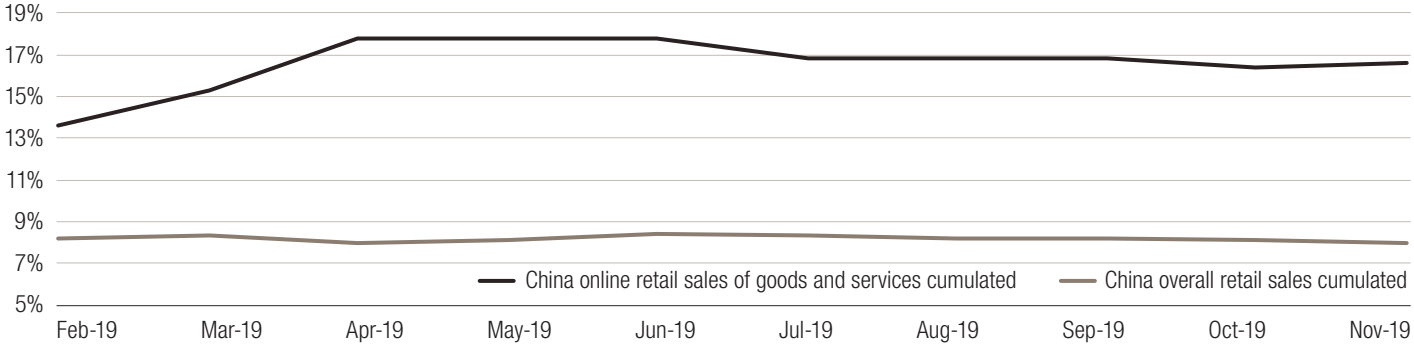


Source: World Bank.

Recent data supports our positive outlook: consumer retail sales have been stable (Figure 22) and robust with companies reporting a tough but rational competitive landscape in most categories. The Services PMI indicator was at 53.5/52.5 in November and December 2019 (and averaged 52.5 in 2019).

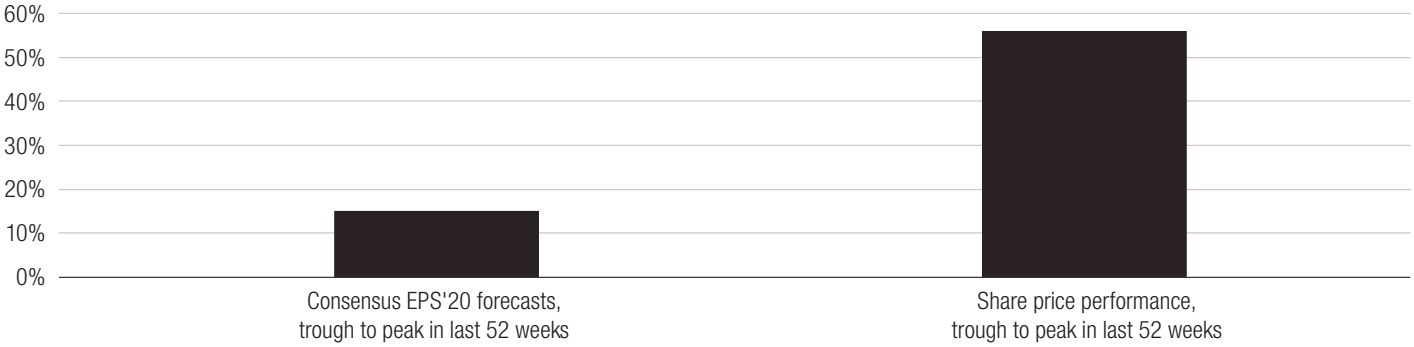
Looking at 2020, our preferences go to Chinese names with remaining margin turnaround potential (from the restructuring of distribution and/or repositioning of brand name), and to companies with a long runway of double-digit sales growth in areas like online retail, online travel, sports, electronic appliances, last-mile services, restaurants, education etc. That said, we are mindful of valuations, and look for companies with EPS growth prospects in which we have strong conviction. Indeed, much of the 2019 share price performance in Chinese consumer stocks was due to multiple expansion, as shown in Figure 23.

Figure 22 – China retail sales growth very stable in 2019



Source: Bloomberg.

Figure 23 – China consumer sector 2019 enjoyed clear expansion of valuation multiples



Source: Bloomberg as at 16 January 2020; average of 23 stocks representing China's main consumer staple and discretionary sub-segments.

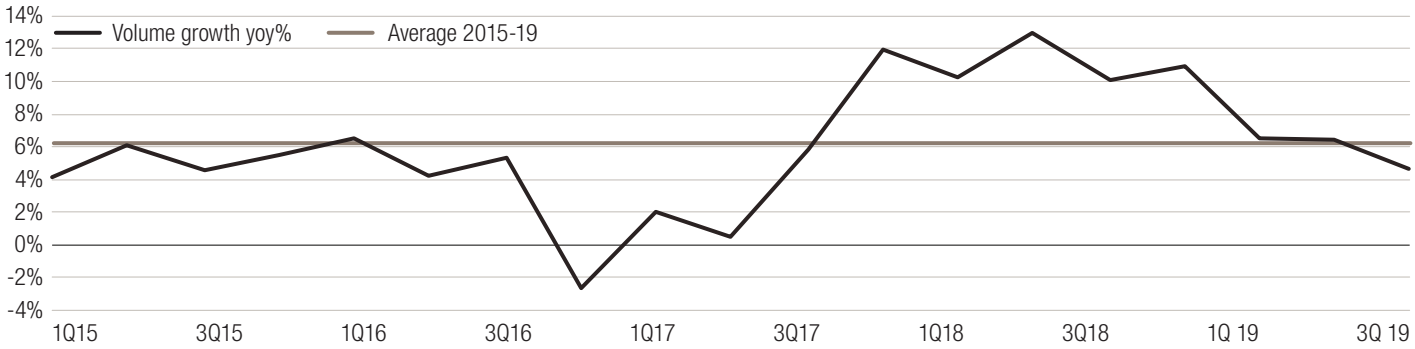
India

The overall Indian market was weak in the context of Asia in 2019, up 6.5% versus the MSCI Asia ex-Japan which was up over 18%. Indian Consumer Staples and Consumer Discretionary stocks were even weaker, declining by 3% and 10%, respectively. In the aftermath of the non-bank financial institutions' (NBFCs) meltdown in September 2018, and of resulting financing issues, India's GDP growth slowed from 5.8% in Q1 to 5.0% in Q2 and 4.5% in Q3. Central government spending was capped by weak tax revenues. Consumer companies' volume growth was slower, but still quite resilient as shown below (with the exception of autos and two-wheelers, which faced sector-specific issues). This resilience was supported by an above-average monsoon and subsidies of 900 billion INR (USD 12.8 billion) reaching 140 million farmers.

The outlook for 2020 has only marginally improved so far. At a country level, last year's significant rate cuts and liquidity focus by the Reserve Bank of India (RBI) should help, as should the corporate tax rate reduction from 35% to 25%. We are seeing a few green shoots: Goods and Services Tax (GST) collection has been improving recently, industrial production grew 1.8% in November in contrast to the 4.2% contraction in September-October. However, we have yet to see the transmission of this into the real economy. Private capex is sluggish, several consumer companies recently reported no improvement in weak rural demand, inflation has spiked (on temporary factors), and a c. 30% hike in mobile telecommunication tariffs clouds the consumer demand recovery. The Union Budget released on 1st February 2020 included only mild measures in favour of consumption.

Within India Consumer/Healthcare, our preference goes to companies with high brand recognition, a proven track-record even in a weak macro cycle, and multi-year market penetration potential. Although valuation levels are not cheap, these types of companies tend to deliver results very consistently. We include Healthcare in our views, as healthcare is largely a discretionary (out-of-pocket) expense for the overwhelming majority.

Figure 24 – Chart: India top consumer companies' volume growth below the 5-year average (ex-autos and two-wheelers)



Source: Companies, LOIM calculations, calendar quarters shown.