2021 Pan-Asian Investment Outlook

LONGLEAD CAPITAL PARTNERS

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THE EIGHT KEY DRIVERS UNDERPINNING PAN-ASIAN EQUITY MARKET PERFORMANCE IN 2021

Global investors have found in 2020 that they can't ignore Pan-Asia. The region contains some of the world's top performing equity markets this year, the fastest-growing economies and industries and many of the most innovative companies.

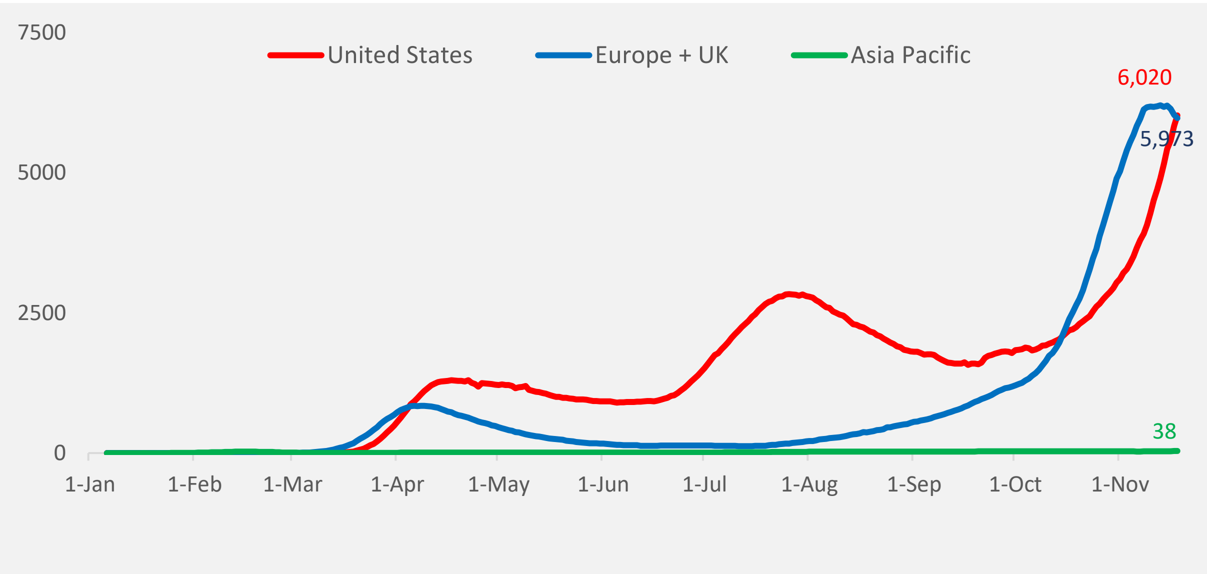
*In the **2021 Pan-Asian Investment Outlook**, Dr Andrew West, Managing Director and co-founder of Longlead Capital Partners, a specialist Pan-Asian equity long/short manager, outlines the eight key drivers which will continue to shape the performance of Pan-Asian markets in 2021.*

1. Europe and US face uphill battle against COVID-19 as Asia Pacific company earnings rebound

The COVID-19 pandemic has shown a material divergence in how Pan-Asia and the US and Europe have responded to and weathered the crisis.

Figure 1 below starkly demonstrates the impact of the very different approaches taken across the world – while new case numbers (scaled per one million population) in the Asia Pacific region have been so low they barely register on the chart, in the US and Europe, new cases measured on the same basis are over 150x higher and are increasing at an exponential rate.

Figure 1: COVID-19 incidence by region.
(14 day rolling New Cases per 1m population)



Source: Our World in Data (COVID Cases); Wikipedia (population statistics)

Despite the divergent experience in the health impact of the pandemic, when we look at earnings estimates for companies across the region, it is notable that market analysts initially reduced their earnings forecasts by the same amount irrespective of region (25% -30% in aggregate for key indices across the US, Europe and Asia Pacific). Earnings expectations bottomed across global markets in May and have since subsequently risen, supporting the broader global market rebound that has been underway. As we look to 2021, it is key to understand how the pandemic will affect company earnings and the clear conclusion is that a continued Pan-Asian earnings rebound is more certain than in other regions.

Recent vaccine announcements have been greeted with enthusiasm and hope for the global economy in 2021. However, the reality is that widespread availability of such vaccines is unlikely to be achieved until mid-2021 at the earliest, and even then, adoption rates are uncertain. It remains likely that a material portion of the world's population will remain unvaccinated by even the end of 2021, and COVID-19 may remain endemic over that period in certain regions such as North America and Europe where the spread has been relatively uncontrolled.

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We are now witnessing the reimposition of lockdowns and social and business restrictions in these regions that may stall their nascent earnings recovery. Indeed, in November, earnings expectations in Europe have once again stalled as their latest lockdowns take effect. The market implications of this is clear – for so long the pandemic continues, predictable earnings growth can only be assured by controlling the virus, and this is where the Asia Pacific region stands out.

Pan-Asia stands apart from other regions in its successful strategy of widespread mask usage, testing, social distancing and contact tracing which is controlling new COVID-19 case numbers. Consequently, the region's economies and companies are rebounding strongly. Notably, the rise in earnings estimates across Asia Pacific has accelerated since September and this is expected to continue into the new year, powering Pan-Asian equities to outperform global counterparts.

We see Asia's effective response to the pandemic to result in strong domestic and intra region demand. This will be the key driver of company earnings and equity markets in the first half of 2021, with a reacceleration of global trade benefitting Asia later in the year.

2. Biden win to restore sentiment towards Pan-Asian equity markets in 2021

The impact of the US-China trade war on not just China but the entire Pan-Asian region is perhaps best seen in the relative performance of equity markets over the last couple of years. With US President Donald Trump ratcheting up tariffs against China from the start of 2018, the MSCI Asia Pacific Index underperformed the S&P 500 index over the subsequent two years by approximately 30%. Over this period, global investor appetite for emerging markets and Asian equities dropped materially due to the drag on potential portfolio performance.

The relevance of the win by President-elect Biden and the Democratic Party in the 2020 US election should therefore not be underestimated for Pan-Asian equities. Current Democratic Party policy statements appear to place less emphasis on unilateral actions against China (e.g. tariff escalation) and more on US domestic policy, particularly given the need to support the US economy out of recession.

Once President-elect Biden takes power, we see this leading to a period of greater predictability with respect to US-China geopolitics, compared to the era of broad-based tariff imposition that markets became accustomed to under President Trump. Contentious issues such as intellectual property protection for US companies will likely remain sources of tension between the countries. However, the impact of such negotiations is likely to be far less material for listed Pan-Asian companies.

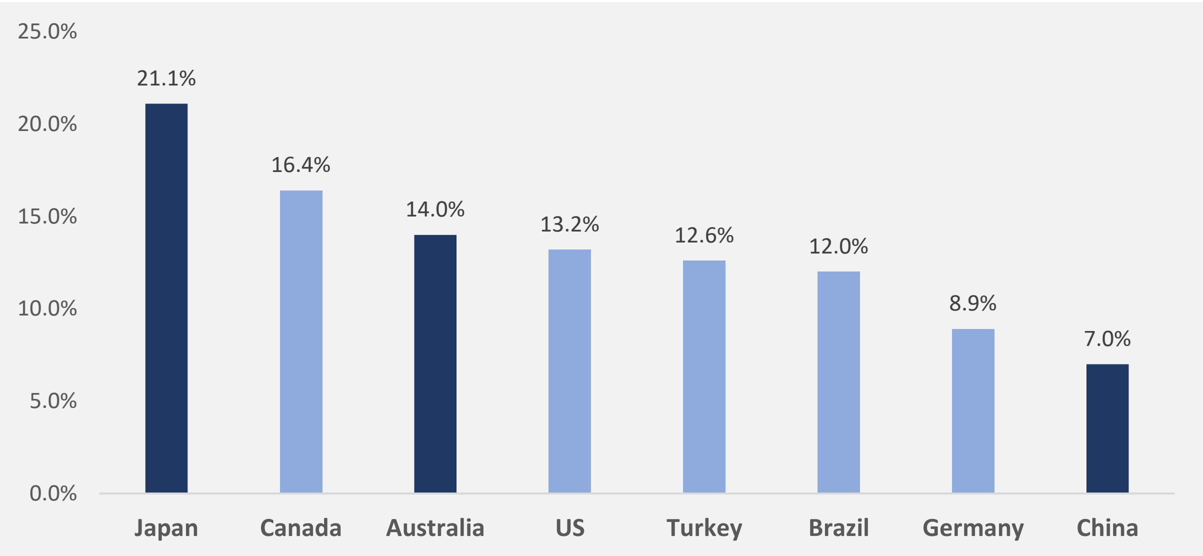
Since the US election result there are already signs that sentiment is improving towards Pan-Asian equities, with tariff risks taking on a lower level of importance for the region and recent performance suggestive of an ongoing catch up underway. We await the decision of a Biden administration with respect to existing tariffs, particularly if, as currently appears to be the case, China meets its commitments for agricultural purchases and seeks renewed negotiations with the US. It remains a possibility that trade becomes a tailwind for Pan-Asian equities in 2021 and not the headwind of the past few years.

3. Government stimulus programs in the Pan-Asian region will drive above trend growth in 2021, underpinning markets

Pan-Asian region economies have been among the largest recipients of government fiscal stimulus measures since COVID-19 began, despite their success in managing the pandemic. The peak impact of these measures will be felt in the region in 2021 as programs ramp, underpinning markets.

Figure 2 compares the largest stimulus programs around the world, with three of the top eight countries being in the Asia Pacific region. Japan leads the world as potentially the world's most fiscally stimulated economy based on announced programs at 21% of GDP, with Australia at 14% of GDP, and China 7% of GDP.

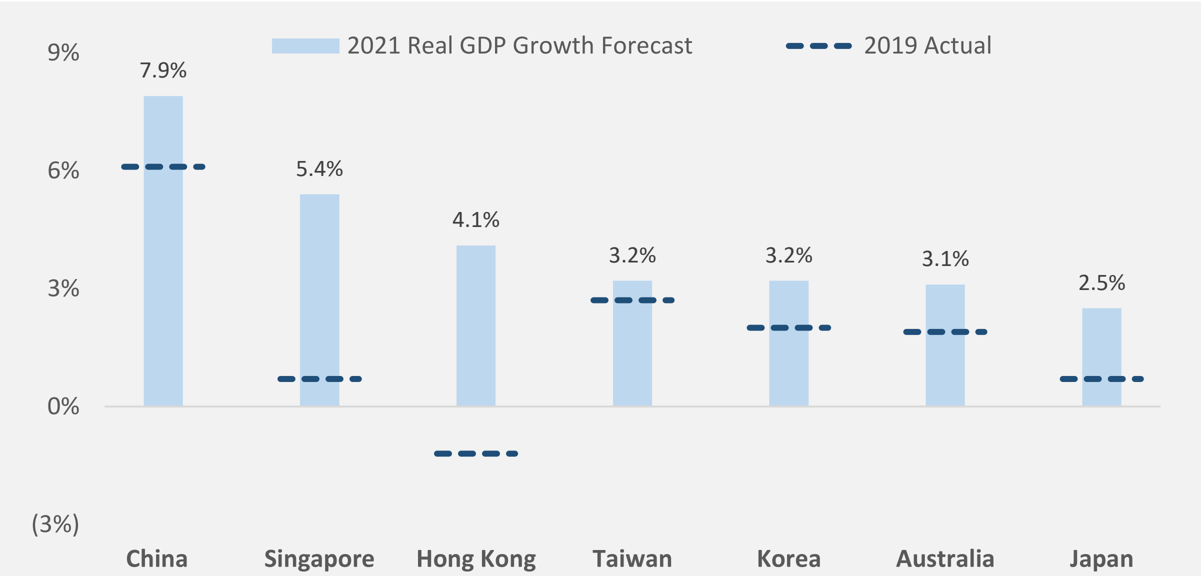
Figure 2: Value of COVID-19 fiscal stimulus packages announced by governments
(percentage of GDP)



Source: Statista

The relevance of these stimulus programs is in the impact they will have on forecast economic growth in 2021. Stronger economies and faster growth will once again likely support a strong rebound in Pan-Asian company earnings and stock prices. Figure 3 shows current economic growth forecasts across the seven key markets in which Longlead primarily invests. In each case, the average forecast economic growth rate for 2021 exceeds that achieved by the same economy in 2019 before the pandemic. Economies such as Singapore, Hong Kong and China all stand out for the implied economic reacceleration being predicted by the market. The last time the region experienced such an economic reacceleration was in 2016/2017 which precipitated an equity bull market.

Figure 3: Economists forecasting above trend GDP growth in 2021 in the Pan-Asian region. GDP growth forecasts compared with 2019 actuals (pre-pandemic)



Source: Bloomberg Professional, Bloomberg October survey of global economic forecasters

4. Value on offer in Pan-Asia while scarce elsewhere

While many global markets have rallied back from their March lows, company earnings in most countries may take till 2022 or later to rebound to pre-pandemic levels based on analyst forecasts. This raises the key question: what upside remains for company valuations?

With record low global interest rates pushing up equity valuations, and earnings near cyclical lows due to the pandemic, price to earnings ratios of major market indices such as the S&P500 are being stretched from both ends and almost uniformly suggest that global equities are expensive versus history. This is not necessarily true, and we need to recognise that price to earnings ratios can be quite inaccurate at the bottom of the cycle.

At these times investors are better served analysing cyclically adjusted earnings multiples or equity risk premiums, but such methods can be difficult to analyse accurately without long term databases to work from. One simple tool that can be useful at time of cyclically depressed, but rebounding earnings, is **price to sales multiples**. This ratio compares a company's market capitalisation to its revenues which are less affected by the cycle. When we amalgamate all the companies in an index and look at the price to sales ratio of the different markets, the stability of the revenue line can provide a useful benchmark to compare how cheap or expensive a market is versus its longer term history.

Figure 4 compares current price to sales multiples for the US (S&P 500 index) against the key indices for major Pan-Asian markets. With global interest rates near zero, it would not be unexpected to see all markets near their 10-year peak, but that is not the case in Pan-Asia. It is quite apparent that US equities appear as expensive as they have ever been in the last 10 years, while equities in markets such as Australia, Hong Kong and Singapore are still at or below their average valuations over the same period on this metric.

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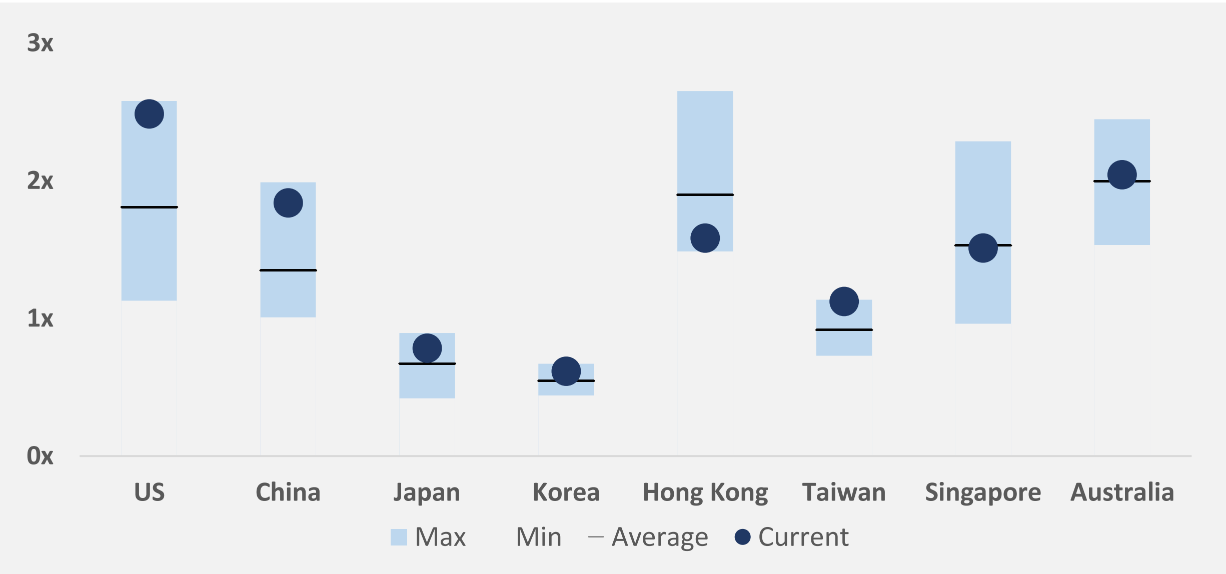
With Pan-Asian economies set to rebound strongly in 2021, and valuations in the region at reasonable levels, the landscape again supports a conclusion of regional outperformance.

As we flag below in the risks for 2021, economic reacceleration does bring with it the likelihood that long term interest rates may also increase in 2021. Other markets that sit at the expensive end of their historical ranges due to record low interest rates are vulnerable in 2021 to rising volatility if bond rates spike. At Longlead, we find greater attraction hunting for opportunities in markets that are historically cheap but still offer earnings acceleration, which is the picture presented in Pan-Asia.

Figure 4: Price to sales multiples for major markets – Current multiple vs 10 year historical range



Source: Bloomberg data; analysis by Longlead

5. IPO opportunities in Asia on the rise with performance nearly double the next best region

It used to be that large Asian companies looked to list in the US market to achieve higher valuations, but this is no longer the case.

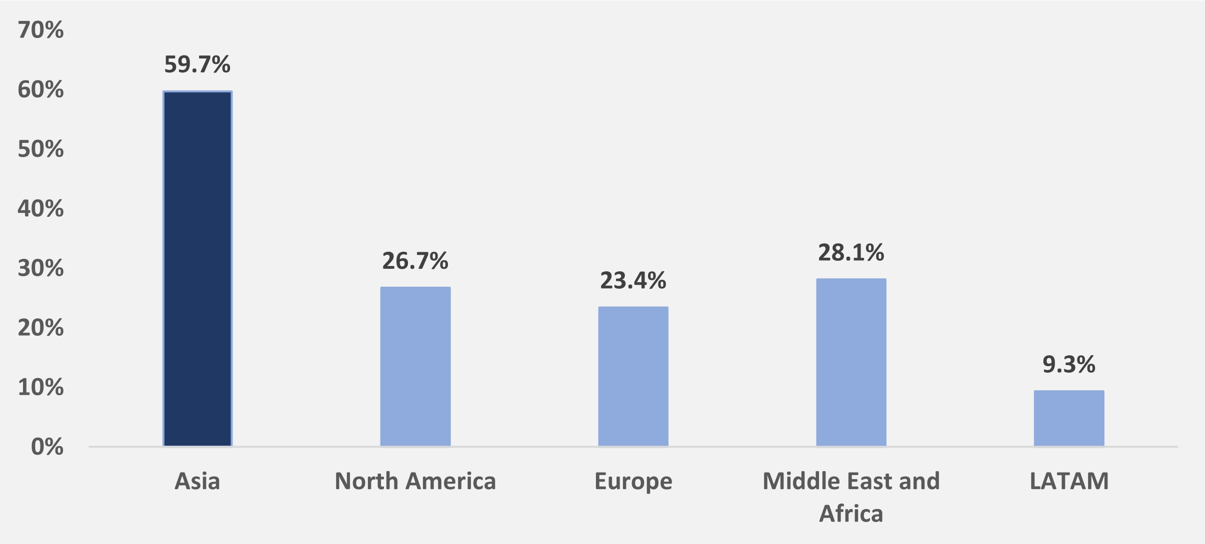
In June, the Shanghai stock exchange issued new regulations designed to assist the homecoming of US-listed Chinese companies to China's STAR market. Hong Kong has also launched a new Chinese technology index designed to attract listings of Chinese firms to its market. The success of such initiatives is seeing a growing pipeline of previously US-listed Chinese companies, many of whom have been largely inaccessible to Chinese investors, launching secondary IPOs in Hong Kong or mainland China exchanges. A company such as Alibaba is a well known example of these "homecoming" offerings. Given healthy Asia investor appetite, most of these offerings have performed well.

Analysis from Refinitiv reports that China mainland exchanges' share of global equity fund raising has been increasing rapidly and reached a record of over 25% of all IPOs and secondary raisings in 2020 so far. This pipeline of opportunities continues to build into 2021.

While the pipeline of raisings remains strong, the performance of these deals also warrants attention. Figure 5 demonstrates that in 2020 so far, the weighted average performance of all IPOs across Asia has been more than double the next best region at 59.7%. Drilling into this performance shows mainland China and Korean IPOs leading the way. Healthy IPO markets are often a sign of healthy equity markets in general. The statistics in Figure 5 offer another window into the attractive returns on offer in Asia.

Figure 5: 2020 YTD Regional Performance of IPOs

(Deal date to 19 November 2020)



Source: Bloomberg Professional

6. Global investors still fundamentally underweight Asian equities

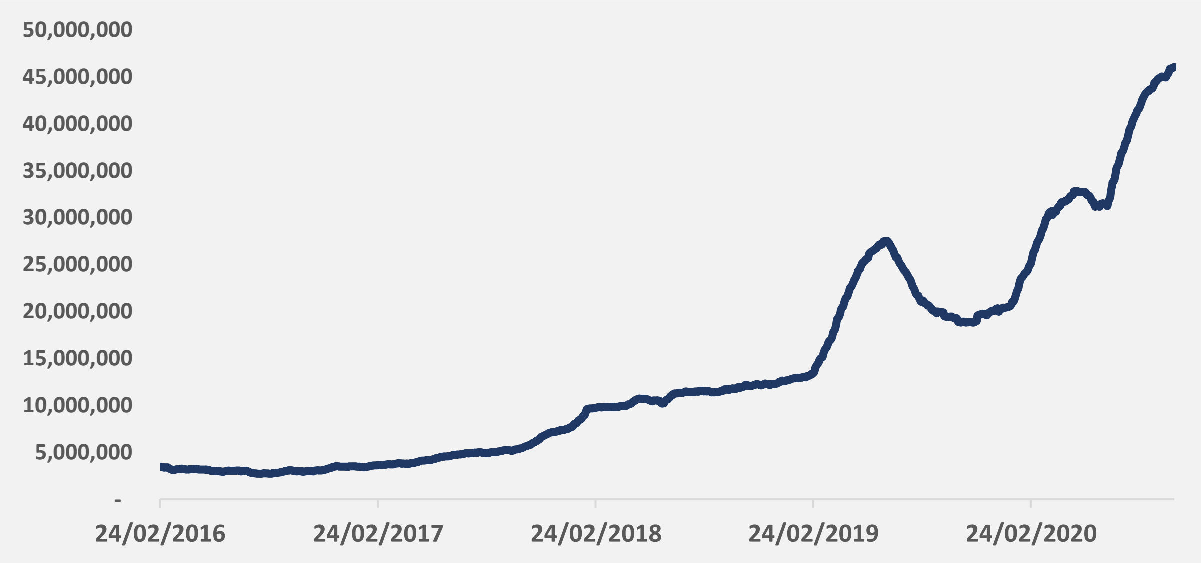
Investors have been steadily increasing their exposure to Asian equities and this "structural bid" is likely to continue through 2021, providing additional support for Pan-Asian markets. As noted previously, the US-China trade war impacted global investor sentiment towards the region's equity markets but this risk has started to recede with an associated catch up in equity market performance evident in 2020.

Global investors are however still fundamentally underweight Asia, and China in particular, with increasing allocations to the region's markets to provide incremental equities demand. As an example, China's share of global GDP is approximately 16% and its share of global GDP *growth* is substantially higher than this. Yet China equities share of the MSCI World All Countries benchmark index has a long way to go to get anywhere near these levels given the current low base of only 5.2% as at September

2020. In Australia, we estimate from Superannuation Fund disclosures that individual investors have on average only 6-8% of their equity exposure in Asian equities despite the region representing nearly one third of global market capitalisation.

Many investors are not waiting for the benchmarks to lift their China country weightings given the opportunities on offer. One way of observing this is in the total value of Northbound trading through the Shanghai-Hong Kong Stock Connect shown in Figure 6. The daily value of this trading has accelerated markedly in 2020 reinforcing this view of investor intentions which remain a powerful driver of medium term stock returns.

Figure 6: Total daily value of trading through the Northbound Shanghai-Hong Kong Stock Connect program. *(1,000 CNY, 90 day moving average)*



Source: Bloomberg data; Longlead analysis

7. Asian supply chains uniquely placed to benefit from increased spending in future technologies.

While a post pandemic economic rebound is already underway in Pan-Asia, a key question for investors is how to identify the companies and industries with the largest opportunities in 2021.

In this regard, Longlead has examined whether the historically unprecedented magnitude of many government fiscal programs quantified in Figure 2 will disproportionately benefit some industries over others, resulting in super-charged growth in those areas in the year ahead.

In aggregate, the identified fiscal programs represent trillions of dollars in spending that will peak in 2021 and flow into Pan-Asia's supply chains. What is notably different in this cycle however is that this spending is increasingly being directed towards decarbonisation initiatives in addition to technology focused, nation building projects that can improve sustainability and support productivity and economic growth. These investment drivers have been identified for some time, however 2021 appears to represent a key inflection point.

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The sectors that will benefit most from the trillions of dollars in new government spending include renewable energy, electric mobility, and 5G telecommunications; with Pan-Asian companies that dominate these industries being the key winners.

Renewable Energy

Long term, structural demand growth for renewable energy on the back of government decarbonisation initiatives will accelerate from 2021 as governments have re-prioritised this area.

Both China and Japan have recently committed to dates for carbon neutrality paving the way for investment in renewable energy projects to accelerate. China's estimated investment to achieve carbon neutrality is US$15 trillion over the next three to four decades which represents an enormous opportunity for companies involved in the solar, wind, hydro, hydrogen and electric mobility industries.

Consolidation has appeared in the renewable energy sector in recent years, which is improving the competitive landscape and economics for Pan-Asian suppliers. For example, according to the Global Wind Energy Council, the top 3 wind turbine manufacturers, Xinjiang Goldwind Science and Technology, Vestas Wind Systems and Siemens now account for almost 50% of this rapidly growing market. Less well known suppliers into this industry are for the most part Pan-Asian companies. For example, the world's largest supplier of glass fibre for wind turbine blades is the mainland Chinese company, China Jushi. The solar industry, that is dominated by Chinese companies has also consolidated materially in the last two years. Sectors like wind and solar, whose economics have been marginal in the past are improving and offering new opportunities.

Electric mobility

The global electric vehicle (EV) penetration rate is expected to rapidly accelerate in 2021 as government initiatives and automotive company EV model launches ramp simultaneously. This will benefit Pan-Asian companies given their central role in the auto supply chain.

"The global electric vehicle penetration rate is expected to rapidly accelerate in 2021 as government initiatives and automotive company EV model launches ramp simultaneously with companies in Pan-Asia best placed to benefit"

The transition to EV mobility is happening ahead of prior expectations as costs come down and decarbonisation is re-prioritised. The UK, for example, has announced its intention to ban the sale of internal combustion engine (ICE) vehicles by 2030. Volvo has indicated it plans to stop selling traditional ICE vehicles by 2025 - only four years away - and other auto OEMs are expected to follow suit.

China remains the largest market for EVs, accounting for approximately 50% of global EV share. China still sold 1.21

million units of EVs in 2019, almost 4 times larger than what was sold in the US, despite cutting the subsidies on electric cars. This local demand has positioned Chinese and other Pan-Asian auto parts companies as critical suppliers of EVs and components globally which puts them in box seat to benefit from the rapid transition.

The EV adoption trend also has a widespread impact across multiple supply chains encompassing companies in Hong Kong, Japan, Korea and Taiwan. Asian companies such as LG Chem (Korea), CATL (China), Samsung SDI (Korea) and Panasonic (Japan) supply most of the world's lithium ion batteries for electric vehicles. Companies in Taiwan are central to the production of advanced driver assistance technologies, high voltage charging equipment, and even printed circuit boards designed for the rugged requirements of automotive use. These companies are experiencing rapid growth that is best summarised by UBS' recent estimate that EV battery demand will grow *ten-fold* by 2025.

5G telecommunications

Countries including China, Japan and Korea, have announced new initiatives in 2020 to accelerate the rollout and adoption of 5G telecommunications networks, as they see it as a key enabler of productivity and an industry that has large scale investment opportunities that will support an economic rebound. This accelerated rollout will benefit mobile handsets, antennas, Internet of Things (IoT) devices, servers, data centres and even telecommunications construction and consultancies, with many of the leaders across all these segments in Pan-Asia.

5G is now moving mainstream globally enabled by handset launches from Samsung, Apple, Xioami, Huawei, Oppo and others, as well as broader 5G network construction. On the back of a new handset upgrade cycle, we expect an inflection point for 5G telecommunications in 2021 with Asia being the main supply chain for the key components including cameras, antennas, modems, memory, printed circuit boards and accessories.

5G connectivity is an exciting area for Longlead to hunt for ideas as we see disruption to various business models. It is not only about consumer mobile telecommunications, but also the industrial internet of things (IoT) including smart home devices. The extensive reach of 5G is now creating an ecosystem for new IoT players in the Pan-Asia region, extending past technology companies to even plastic injection moulding and packaging materials.

Within 5G itself, different segments and countries are moving at a different pace and this creates the opportunity to hunt for winners and losers by connecting the dots. For example, Apple's 5G iPhone requires a higher end camera, longer battery life, greater processing power, more memory and capacitors - all of which are sourced from a global supply chain. Within the infrastructure side, with Huawei and ZTE being on the US blacklist, specific suppliers have lost business that are aligned to these companies, while at the same time creating opportunities for others to take share. In some cases, Longlead's investment team see challenges for 5G infrastructure owners to effectively monetise their investments, with the need to delay them further based on higher capex needs.

At its core, the disruption created by the 5G acceleration in 2021 creates a fertile hunting ground for both long and short investment opportunities with Pan-Asia at the core of this industry.

8. Potential risks worth considering for 2021: global interest rates and a value rotation

The seven key drivers outlined above point to a positive outlook for Pan-Asian market outperformance in 2021. However, investors still need to consider how macroeconomic movements might shift the base case scenario.

Falling global interest rates have been a positive tailwind for equities over the last 3 years but with real rates in negative territory in many countries, further falls appear less likely. Indeed, in a reflationary period where an effective vaccine enables global economies to synchronously re-accelerate, it is possible to see episodes of inflation appear and an associated spike in long term bond yields.

This is counter to the consensus view in the market that interest rates will remain low for the next three years. Such episodes can have two impacts that are worth considering:

1) Market sell-offs: A rapid move upwards in long term bond yields would likely see equities sell off sharply at that time given low rates have been a primary driver of higher valuations. This remains a risk to watch for in 2021 and describes a scenario of a choppy market recovery. Despite a generally positive outlook for equities, a solid foundation in portfolio hedging remains important and market sell-offs may well create further opportunities as seen after the March 2020 market bottom.
2) Value rotations: The pandemic saw two related impacts on relative sector performance. Social restrictions and the “work from home” dynamic saw e-commerce and information technology demand spike. Global interest rates also fell to historic lows which most benefits the valuation of high growth stocks. The combination of these factors drove a 60% cumulative outperformance of growth stocks over value stocks at the peak of the crisis, based on analysis by Longlead’s team. A reversal of these trends could see this unwind which we refer to as a value rotation. Signs of this have already appeared in late 2020 on news of the vaccine. We expect further episodes of value rotation to appear at points in 2021 and this risk can be managed through a focus on underlying risk exposures and a sharp focus on intrinsic valuation over the price momentum of stocks.

Conclusion

2021 is likely to be the year that the global economy rebounds from COVID-19 and this should be positive for equities. However greater success with suppression of the pandemic, geo-political de-escalation, faster economic growth and more attractive valuations all lead to our conclusion that Pan-Asian markets can outperform. Many investors remain underweight Pan-Asian equities but with recent performance attracting increasing allocations to the region’s markets, this is rapidly changing and will add another driver of Pan-Asian equity performance in 2021.

Longlead Capital Partners is a specialist Pan-Asian long-short equity manager that focuses on identifying investment opportunities inside the rapidly changing business environments that are unique to Asia and was founded in 2014 by Tim Campbell & Andrew West. Longlead operates investment strategies that target absolute returns with low correlation to equity markets using fundamental bottom up stock selection. The team which is situation in Singapore and Australia utilises an "on the ground" research model that leverages insights obtained from a broad universe of companies right across the region.

Dr Andrew West is a Managing Director and co-founder of Longlead based in Longlead's Sydney office. Andrew has two decades of experience in investment and financial analysis across hedge funds, private equity, and academic research and holds a 1st class honours degree in Commerce and a PhD in Economics (Finance) from the University of Sydney.