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DEVELOPED ASIA-PACIFIC

Growth Dynamics in Asia-Pacific – Crucial Differences in the Region

Why look at Developed Asia-Pacific?

For investors interested in Asian equities, there are multiple options depending upon the level of risk they are willing to assume. MSCI Asia allocation can be seen as a blended growth portfolio. Given the shifting dynamics in the region – with the maturing of China and emergence of the Association of South East Asian Nations (ASEAN) and India as burgeoning industrial centers – investors may decide to split their Asia allocation between Emerging and Developed countries. Alternatively, they may allocate to an MSCI Developed Pacific ex Japan (Asia-Pac), based on the growth characteristics of the sub-region e.g. Australia, New Zealand (NZ), Hong Kong (HK) and Singapore.

Over the past ten years, the MSCI Developed Pacific ex Japan index has returned an annual average of 4.2%[1]. Key characteristics of this growth have been a relatively high income component exemplified by a five-year average dividend yield of around 4%[2] (Chart 1). Also, the degree of diversification within this Index has increased (from 27% to 42%) since 2012 – a reflection of the proliferation and variation in the sources of return for Asia-Pac economies as the region's growth pattern evolves. Related to this diversification, risk within this index has also declined from 23% to 15.5% over the same period.

Nikko Asset Management's Asian equity team defines these characteristics as "quality growth" compared to the more dynamic, capital appreciation oriented growth of Emerging Asia. Australia is by far the largest component of the index (58.8%[3]) , so it is critical to understand how changing regional growth dynamics are affecting returns in its economy.

As Asia has become further integrated within global supply chains, different markets have been incorporated into those supply chains in varying fashions. China has been a key driver of Asia-Pacific growth, with its demand for inputs for export-led industrialization.

Though there are differences amongst the Asia-Pac countries, these nations also share certain similarities — a UK common law based corporate governance structure and strong local consumption, led by construction and high net migration.

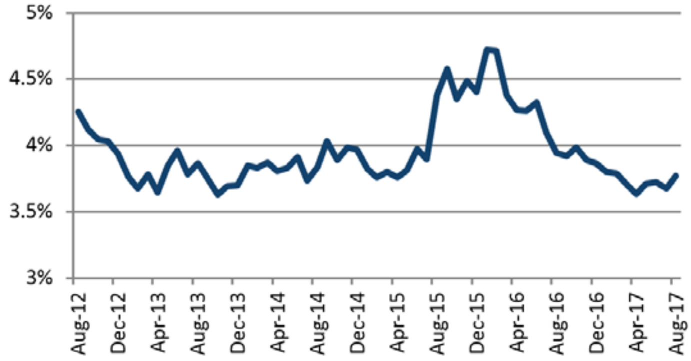
These countries also stand to benefit in the future, as China's growth shifts from external-driven, industrial production to more domestic-driven services consumption. Service sectors in Asia-Pac economies, which make up most of the index (i.e. Financials 40.2%), are likely beneficiaries.

For countries such as Australia and NZ, which have long been sources of "rocks and crops" exports for the region, this shift poses challenges; however, there are also benefits. Services such as tourism, healthcare and education are advantageously positioned, as the Chinese middle class expands.

Similarly for HK and Singapore, services such as finance, trade and transport are also seen as strong growth opportunities. Singapore, in particular, is focused on the "digital economy" and technology oriented services e.g. Fintech.

An aspect of China's evolution is the shift of manufacturing to other Emerging Asian countries – particularly in ASEAN – including Indonesia, Thailand, Philippines and Malaysia, as well as "frontier" states, like Myanmar, Cambodia, Laos and Brunei. Thus, as global corporate chains adopt a China+1 approach to diversifying supply, these countries should provide Developed Asia-Pac exporters with new sources of demand for traditional inputs, which should help offset the decline of such exports (especially commodities) to China.

Chart 1: MSCI Pacific ex Japan – Dividend Yield 5Y Trend

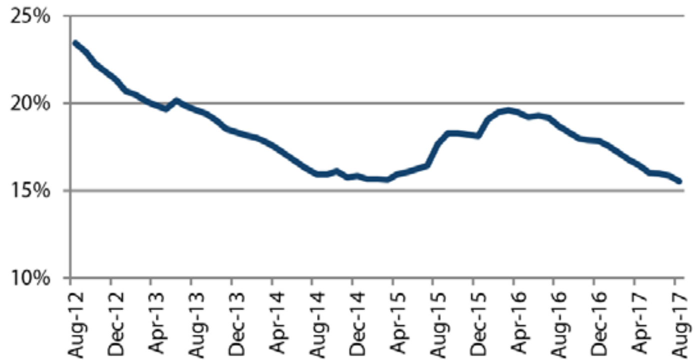


Source: MSCI Barra September 2017

Chart 2: MSCI Pacific ex Japan – Diversification 5Y Trend

Source: MSCI Barra September 2017

Chart 3: MSCI Pacific ex Japan – Total Risk 5Y Trend



Source: MSCI Barra September 2017

Meanwhile, MSCI Emerging Asia Index's 5Y return has surged faster than the stated 4.2% for Asia-Pac, and is up 30.05% YTD as of 31 July versus Asia-Pac's 18.43% — although on a 10-year annual basis these indices have similar returns[4]. Notably, the income component of Emerging Asia is now lower — with its dividend yield actually declining from 2.5% to 2.0% in the past five years.

What is the regional growth dynamic?

Australia & NZ have been beneficiaries of Chinese demand for mining and agriculture, HK financial services are integrated with China, and Singapore is becoming a gateway to ASEAN

Australia

Australia represents over half of the MSCI Pacific ex Japan Index; consequently, its currency has been a major contributor to the total return of the index. Understanding the country's growth dynamics, as well as its import/export role within the region, is crucial when assessing potential market returns. The country's current "long boom" is the lengthiest stretch of uninterrupted growth in modern history, running from 1992 to present[5]. This growth has been fueled by its heavy dependency on China's demand for minerals; unsurprisingly, China has been Australia's largest export market since 2009, and it dwarfs other nations, accounting for 34% of export income with Asia total accounting for 80%[6].

Chart 4: Australian GDP Annual Growth Rate

Source: TradeEconomics 2017

Although the mining sector continues to dominate Australia's exports (accounting for 75% of Australian economic output), since 2014 the service sectors (e.g. education, finance, healthcare and inbound tourism) have gained an increasing percentage share of exports. This diversification of exports is expected to continue as the Chinese economy rebalances and evolves over time.

It should be noted that the sustainability of Australia's long economic boom has also depended upon domestic household consumption and in particular, construction. Also notable is that migration has helped drive population growth of 1.7% — higher than developed economies in other regions (US and Europe).

Hong Kong

Hong Kong is the second largest component (29%) of the Asia-Pac group, and essentially part of the "Greater China" economic zone. It has long been the gateway for China's trade. In 2015, "financial services" was a significant component of GDP representing 17.6%[7]. The contribution of services is very likely to increase because manufacturing has predominately shifted to mainland China or ASEAN countries.

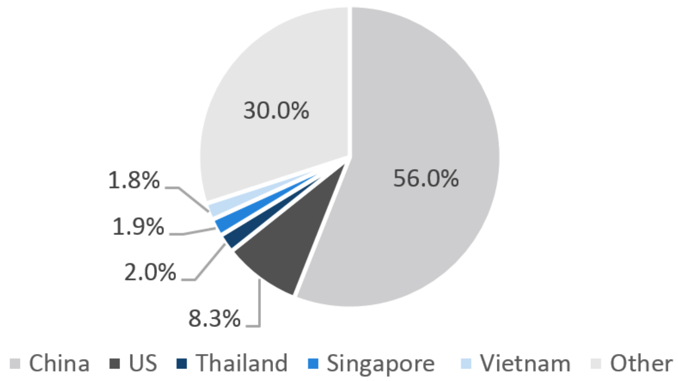
With the expansion of services demand in China, Hong Kong is well-positioned as a beneficiary in this area. Its integration through StockConnect and other market initiatives are likely to be key drivers in areas such as asset management and securities transaction services. Banking services alone have increased 95% from 2006 to 2015[8].

As with Australia, China's transition is going to be a significant determinant in Hong Kong's growth dynamic. Already highly integrated as a service center for China, as the nature of China's demand for services shifts, Hong Kong is well positioned to adapt to those changes.

Chart 5: HK Forecast Growth in Services GDP

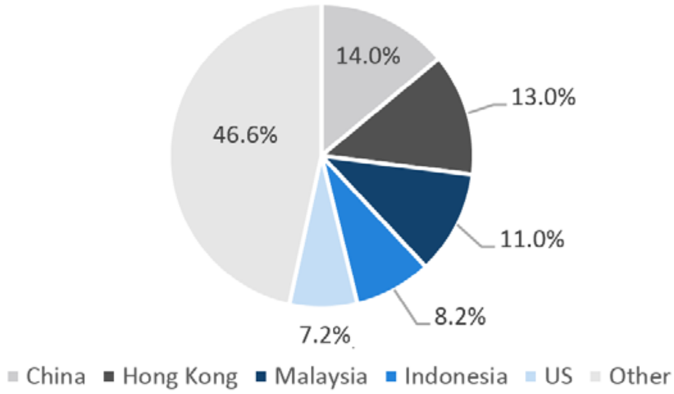
Source: TradeEconomics 2017

Chart 6: HK Exports 2016 – Gateway to China



Source: TradeEconomics 2017

Chart 8: Singapore Exports 2016 – Gateway to ASEAN



Source: TradeEconomics 2017

Singapore

Singapore is 11% of Asia-Pac and its largest trading partner is also China, followed by HK — it too has a key role as a services hub for ASEAN.

Manufacturing is far more important for Singapore (at around 20% contribution to GDP in 2016[9]) than it is for Hong Kong. In particular, strong demand from China (and globally) for semiconductors and related components have helped boost these sectors in recent quarters.

Services, principally transport and finance (7.7% and 13.1% of GDP respectively[10]), though showing slower growth in 1H 2017, have also started to accelerate again this year. IT & Communications (in particular Information services) are seen as key growth segments as Asian IT spending increases[11].

With ASEAN economies expanding their industrial capacity, they are increasingly competitive in basic manufacturing sectors that historically China has dominated. Singapore's role as a gateway to these markets also positions it well to take advantage of this change.

Chart 7: Singapore GDP Growth Rate

Source: TradeEconomics 2017

New Zealand

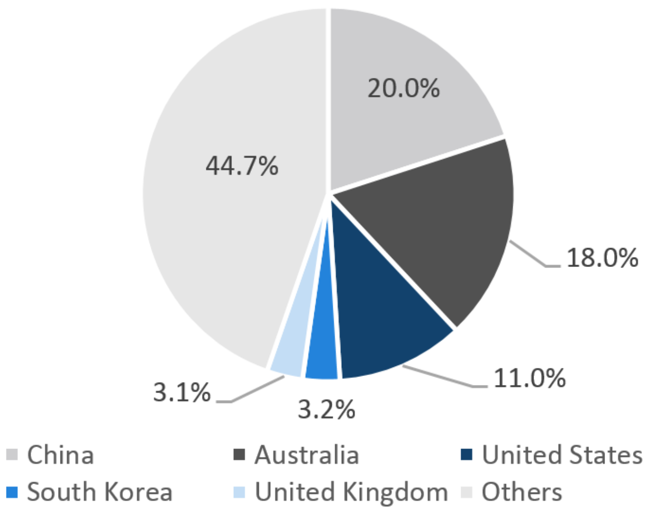
While New Zealand is a relatively small component of the Asia-Pac index (1.42%), it has seen a steady, decade-long economic expansion.

It has benefited greatly from exports to China (20% of exports), though this has been primarily in agriculture (especially dairy), rather than mining. Asia overall accounted for 50% of exports.

Its reliance on commodity export growth has likewise been cushioned by domestic consumption — particularly by construction — which has remained strong even after the rebuilding that occurred following major earthquakes in 2016. Net migration has also helped New Zealand, as it has Australia.

With the transition in China's economy, New Zealand is similarly adapting by growing services such as tourism, education and healthcare. It is also looking at ways to tap into value-added opportunities in traditional agricultural exports, as Asian consumer tastes for more expensive products develop.

Chart 9: Breakdown of New Zealand Exports by Region



Source: TradeEconomics 2017

Key Themes in Changing Asia-Pac Growth

Five key growth themes for Investors to consider

The following are secular trends that Nikko Asset Management's Asian equity team sees as driving long-term returns in the Asia-Pac region;

1) Increasing Tourism

Australia and Singapore are well-poised to benefit from the growth in outbound China tourism. Hong Kong had seen a slowdown in inbound tourist numbers, but these appear to be recovering in 2017. Indeed, overall, Chinese spending on tourism is expected to reach $421 billion in 2021.

Chart 10: Growth in Chinese outbound tourism

Source: CLSA

2) Healthcare Gains from Demographics

Australia has very well managed healthcare companies. Other Asia-Pac countries also have a positive structural story in medical infrastructure, including hospitals and medical equipment. We would likewise see the Insurance Industry as a beneficiary of this trend.

3) Australian & New Zealand Agriculture

There is expanding global demand for agricultural products, as middle class incomes increase and consumer spending on food and beverages expands. While there has been much volatility in this sector — particularly in dairy, relating to Chinese policy changes impacting imports this year — there is a long-term growth story in value-added products.

In addition, two key cyclical themes that are affecting returns in the short to medium term are:

4) Commodity Prices Rebound

While China's economy is in transition, and its demand for commodities is slowing, other sources of demand are growing. The ASEAN region's GDP is projected to grow by 5% in 2017, and India's growth also offers another source of demand in the region. This appears to have further upside, as commodity producers — particularly Australian mining companies — have been under pressure to pay out earnings, rather than expand production. So, supply is likely to remain relatively tight relative to demand.

5) Hong Kong Banking

Hong Kong banks have suffered from declining US interest rates, which has impacted their net interest margins and profitability. As the Fed has raised interest rates in 2017 (albeit slowly), Hong Kong financials in particular have benefitted from this trend, with equity prices recovering strongly in 1H 2017. Given the extent of the increase, we see this cyclical trend slowing down in 2H 2017.

Conclusions

Developed Asia offers a quality growth exposure – income oriented and focused on value added services and products

For investors who want to take advantage of the high growth rates in Asia, but are concerned about risks to external sources of demand (such as more protectionist trade policies), the quality growth characteristics of Asia-Pac markets are relatively more attractive than Emerging Asia. The higher income component to Asia-Pac earnings and relatively larger sources of domestic growth have helped buffer Asia-Pac growth — as evidenced by Australia's adapting to the 2014 downturn in commodities demand.

That is not to say that Asia-Pac is "decoupled" from global supply chains that are driven by US and European import demand. However, their focus on China and the way in which China is evolving — with increasing demand for services rather than just raw materials and components — provides Asia-Pac with an opportunity to diversify and increase value-added goods and services.

China's reductions in basic manufacturing capacity and coal production are also impacting other parts of Asia. For ASEAN countries, this is enabling rapid expansion of industrial capacity, and the rise of these Emerging Asian markets also flows through to Asia-Pac. Singapore in particular stands to benefit from this.

Ultimately, the style of growth that an investor seeks will determine which market they want to invest in. Emerging Asia offers some of the most dynamic growth in the world, but Developed Asia-Pac offers more mature economies, established governance structures, and upside in value added sectors driven by regional growth dynamics.

1. On a gross annualized basis
2. Based on MSCI Barra Data September 2017
3. MSCI Pacific ex Japan Factsheet July 2017
4. MSCI Emerging Asia growth annualized on a 10 year basis is 3.61% actually lower than Asia-Pac at 4.22%
5. Economist "How Australia broke the Economic Record" 6 Sept 2017
6. Trade Economics Sept 2017
7. As of 2015 according to Statista Sept 2017
8. HK SAR Census and Statistics Dept "Statistical Digest of the Services Sector 2017" Business Times
9. Singapore's Services Growth Picks Up Pace" 11 August 2017
10. Dept. of Statistics Singapore, Share of GDP by Industry 2016, Sept 2017
11. Singapore Business "Winners and Losers in Singapore Services" 28 March 2017

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