Matthews Asia

Transcript: Navigating the Asia ex Japan Market Webcast

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ANDREW PATERSON: Hello, everyone, and welcome to our latest on-demand webinar today, which focuses on the outlook for Asia ex Japan equity markets and the Matthews Asia ex Japan Dividend Fund. My name's Andrew Patterson. I'm responsible for distributing Matthews Asia Funds and Strategies throughout the UK and EMEA region. I'm joined today by Yu Zhang, portfolio manager of the Matthews Asia ex Japan Dividend Funds.

Yu, I think we're both mindful that like many other global equity markets, investors in Asia have experienced quite a challenging 2022 so far. Year to date as at the end of July, the MSCI Asia ex Japan benchmark is down some 17% in US dollar terms. So our objective today is threefold. Firstly, we'd like to share our thoughts with you on what has driven market weakness. We'll touch on inflation trends in Asia and related investment implications, the continuation of China's strict zero COVID policy and what this means for Chinese economic growth, and the prospects for the Chinese consumer looking forward. And staying with China, we'll also look at the real estate sector weakness, the evolving regulatory landscape and geopolitical issues surrounding Taiwan.

But despite these issues that we've just mentioned, Yu and the team see several reasons for optimism as we look ahead, so we'll provide some opinion here. Tying this all together, we'll conclude with a higher-level introduction to the Matthews Asia ex Japan Dividend Fund, which is a strategy that we continue to see interest in from investors. Yu will describe how he and the team manage the portfolio and how it is currently positioned to hopefully capture the growth opportunities as we see them, as we look ahead.

So with that, Yu, you've worked on the Asia ex Japan Dividend Fund since its inception in 2015, but for the benefit of some listeners who may be interacting with you for the first time, please can you give a brief introduction to your background at Matthews Asia?

YU ZHANG: Thanks, Andrew. Hi, everyone. My name is Yu Zhang. I've been working with Matthews since 2007. I'm the lead manager on Asia ex Japan Dividend strategy and also I'm one of the co-lead managers on the Asia Dividend strategy, which includes Japan, and I also help my colleague to co-manage Matthews' China Dividend strategy.

ANDREW PATERSON: Thank you. That's useful background. Just moving on to the first part of the discussion today, we want to home in on inflation and interest rate trends in the Asia ex Japan region. And our listeners will only be acutely aware of the rising inflationary pressures in the US, the UK and Europe, which is prompted central banks to kickstart a relatively aggressive rate hiking cycle. This in turn has had severe knock-on impacts for equity markets, particularly from a style perspective with the growth style struggling relative to value by quite some margin. Yu, can you just provide insight to the inflationary picture within Asia ex Japan? What has this meant for interest rates in the region and subsequent equity market performance?

YU ZHANG: Inflation is indeed trending up in many parts of Asia, and we have seen this year, most of the Asian central banks have been quite proactive, raising interest rates, trying not to "fall behind the curve". Having said that, the biggest market in Asia, China, the inflation picture is quite different. CPI increase in China at the moment is very modest, probably due to very weak demand, and the Chinese economy has been under pressure since the second half of last year. And that is why we think the central bank in China, PBOC, is easing on the margin even though it is not a very aggressive quantitative easing, relatively a more modest sort of easing policy, and this compared to the rest of the economies globally has created a very clear policy divergence.

In terms of equity performance by style, we have seen a similar divergence between value and growth for Asia during the first six months of 2022. Using MSCI Asia ex Japan Value Index versus Growth Index, value has been outperforming by a clear margin. More recently however, with some of the early signs of potential inflation being picking up, some of the growth stocks have made a comeback and are starting to close a little bit of the underperformance versus the value stocks.

ANDREW PATERSON: Thank you. You mentioned there that demand within China has been weak, which has resulted in a relatively benign inflation environment there, so this in turn must be somewhat related to China's continuation of a strict zero COVID policy and the lockdowns associated with that.
So this must be acting as a drag on economic growth, consumer sentiment, equity market performance. How do you see the zero COVID policy evolving? I suppose importantly, are there any signs that things could be relaxed in the coming quarters?

YU ZHANG: Yes. Very clearly, China's zero COVID policy has been the major impediment behind the very weak economic recovery we have seen this year in China, despite supportive monetary and fiscal policy responses from the government. Well, I'm still of the view that as the economic pressure continues to build up in China, it is a matter of when not if that China will ease on the margin for its zero COVID policy and eventually find a final exit out of the zero COVID. But in the near term, given the Chinese Communist party will hold its 20th Congress Party in the middle of October in Beijing, the COVID policy actually is being further tightened up leading up to the Congress Party Meeting.

The impact on the domestic economy and the stock market has been clearly quite negative. Zero COVID really suppresses domestic consumption in China. Households or consumers are either unable or unwilling to spend, and given the weak economic outlook, people tend to save more. Together with the weakness in the property market at the moment, the Chinese economy overall is operating well below its capacity. And even for the government, the beginning of the year 5.5% GDP growth at this moment is no longer regarded as a must achieve target. Responding to such head winds, Chinese equities after a short period of outperformance towards the end of second quarter, in the third quarter so far, they again started to lag in terms of equity returns.

Looking ahead, once the Party Congress gets out the way, I think it is still possible that Beijing could relax its zero COVID policy and emphasize economic growth, and there are a few signs of a potential easing. Just as of today, China confirmed the first overseas trip by President Xi Jinping since the onset of COVID, and also, we have seen a steady increase of international long-haul flights coming into the country and foreign visitors are also getting a little bit easing in terms of visa application.

So all these, together with the pandemic control measures, a few Chinese companies are raising their efforts to come up with indigenous mRNA vaccines as we speak. So all these things could help China to gradually find its way out of zero COVID. I think in terms of forward-looking equity market reaction, it really depends whether the government will move its restrictive COVID policy into a more pragmatic approach, sort of balancing COVID prevention with supporting economic growth. That will have, I think, a meaningful impact on how the Chinese equity market will perform for the rest of the year. Having said all that, I don't think a full-scale reopening for China is a high-probability event. That's something we probably have to wait for until the first half of next year.

ANDREW PATERSON: Thank you. So there's certainly some indication there that a more pragmatic approach to COVID is potentially coming out of China in the future, but out with that there's several other topics that continue to hit the headlines when it comes to China. We read reports of real estate market weakness. Of course, there's the evolving regulatory backdrop creating uncertainty for investors, particularly in the tech space. And then in addition, there's the continuation of China, US, Taiwan geopolitical tension. So can you just take each of those points in turn and share some of your opinions there please?

YU ZHANG: Sure. I think regarding the real estate downturn, there are a few things happening at the same time. As the media has reported, we have seen a wave of Chinese home buyers stopped serving their mortgage payment. I think that there is a little bit of a distinction that our audience needs to keep in mind if we compare this mortgage situation with what happened during last global financial crisis related to the subprime lending in the U.S. market. In the case of the Chinese mortgage boycott, I call it boycott, it is mostly due to that certain term private real estate developers are under tremendous financial distress. And they are unable to fund the construction work and finish the product delivered to the home buyers. And that's why, to protect their own interest, some of these home buyers actually are stopping paying mortgage payments. And we have to keep in mind that this is not another sort of run of subprime lending that is unfolding in China.

It is not about people's financial ability to make mortgage payments. These people, they have the financial resources to continue serving the mortgage but they are unwilling to make the payment because they are not getting the final products from the developers. So it's a pretty important distinction from the U.S. prime lending. And also in China. The overall financial system I would say has enough buffer building in place. Whether you look at the reserves made by different commercial banks, whether the potential funding support from the government will ring-fence some of these troubled real estate companies, financial distress within their individual company or within the sector and not lead to a potential spillover into a more systemic risk to the overall financial system in China. And I think, as we are speaking, both the central government as well as local governments are trying to coordinate more comprehensive solutions trying to ensure consumers' interest in terms of receiving the finished apartments first.

And then, at the same time, they are also trying to offer some financial backing or supports to higher quality top tier private developers. It's not a full-scale bail out per se, but rather as we have seen more recently, some of the higher quality private developers are getting a government sort of guarantee and allowing them to issue domestic bond to renew some of the financial resources they need to carry over the project. So, these are some of the things I think that are unfortunately another clear head wind for the near-term growth outlook for Chinese economy. But at the same time, I don't think it is as worrisome causing a potential full scale systemic risk to the entire system.

Moving on to the Chinese internet sector, I think regulatory tightening domestically has probably passed its peak level. At this moment the government is more worrying about the employment situation and these large internet platform companies usually employ a huge army of workers. So, the government is turning more supportive towards their business to ensure social stability so to speak.

The other thing that has been an overhang on these internet companies from a stock market standpoint is the uncertainty regarding Chinese internet, Chinese ADR companies potentially delisting from the U.S. stock market. And on this issue we have seen some recent positive developments. The two countries, China and the U.S. have announced a preliminary agreement which allow PBAOC to conduct all the inspection in Hong Kong and potentially solve this longstanding dispute. Whether it will completely remove the ADR delisting problem, that remains to be seen, but however the recent announcement of the agreement has been a move in the right direction.

We have seen in many cases Chinese ADR companies trading at a very distressed valuation level. And if you look at these company's ability to continue generating huge amount of free cash flow, and many of these companies' balance sheet are sitting with a huge pile of net cash, we actually think, from an investment standpoint, total value is really emerging for these usually perceived growth stocks like Chinese internet companies, internet stocks, and increasingly, even from an income angle. Some of these Chinese internet companies are starting to use shareholder return tools including paying dividends or conducting much bigger scale share buybacks, essentially, to support the value of the stock, and as well sending an interesting signal to the equity market.

Moving on to Taiwan. From an equity investing perspective, the near-term risk of a military conflict as we have seen in the Russia-Ukraine situation, is likely a low probability event. And I think that that's why, overall, the equity market has mostly shrugged off this tension for now. However, over the medium term, this tension probably will lead to a further decoupling for economic activities between China and the U.S. And we have seen that a technology decoupling has been underway already for a couple years.

As far as implication for investments, I think from China's perspective, technology, energy and food independence will all become very important area that could yield pretty interesting investment angles. And from the U.S. perspective, I'm looking at this more from an overall supply chain de-risking or supply chain diversification away from China, which, in the Asian context, probably will be potentially interesting signals for some of the smaller emerging economies in Southeast Asia for countries like Vietnam, Indonesia, and India on the other hand as well.

ANDREW PATERSON: If we just continue on that train of thought; you mentioned three countries there; Vietnam, Indonesia, India, these are countries, unlike

China, that are gradually returning to the new normal post-COVID and I know you've actually embarked on your first research trip to some of these countries for quite some time. How would you assess the broader economic recovery across Asia?

YU ZHANG: I visited some of these countries, including Thailand and Vietnam in late May, early June. And my major take-away from that trip was that many of these economies are indeed moving down the path of reopening, and people's mentality is no longer so scared of COVID, rather, people are learning to "live" with the virus. Given the overall infection rate and vaccination rollout, people generally feel much safer at this moment. And I think depending on individual economies, in the case of Thailand, which is known for international tourism coming into the country, which is a big part of the GDP growth for Thailand, I think government and the corporates are doing all they can, trying to restore a pre-COVID type of environment, encouraging visitors to return to the country.

Many of the travel restrictions at this moment are being removed for Thailand. And from an equity market standpoint, some of these "reopening stocks", whether it's hotels, restaurants, or even medical tourism, hospital stocks, they have already started to react quite positively towards this new reopening policy or reopening trend. And having said that, I think people just need to be slightly more mindful how much of the returning to normalcy has already been priced into the stocks' valuations. So that's one thing. And in the case of Vietnam, I think actually other than a return to normalcy, I personally still feel pretty strongly about several positive structural tailwinds that Vietnam is enjoying as an economy. We have seen, as I mentioned, a lot of multinational companies are continuing their inbound investment into Vietnam, and Vietnam continues to take market share on some of the global export business orders, thanks to its very competitive labor cost and also a very positive population dividend because its workforce is just very, very young. And the government itself in Vietnam continue to pursue a market-friendly opening policy.

So all these are quite positive, multi-year tailwinds, that help the country to attract more foreign investment, and create better paid jobs for its workers. And that, in turn, becomes a very strong driver for the upgrades, for the growth, for domestic consumption, at many different sectors, at many different levels.

Well, the equity market in Vietnam at this moment is experiencing a phase of consolidation. We have seen a little bit of correction so far this year in Vietnamese stocks, which I think is actually a healthy development after a couple of years of very strong outperformance. So right now, for a number of well-run, high-quality Vietnamese companies, their share price actually has been correcting a bit, valuations as a result also have come down a bit. But I think these companies' ability to continue delivering well above-average earnings growth is very much remaining intact. And with a cheap valuation, that makes investing in Vietnam and picking a high-quality Vietnamese company a very interesting investment proposition.

ANDREW PATERSON: So I think you've touched on some of the Chinese internet names, obviously you've just discussed Vietnam as well. So I think this is now a good segue to move on to the final section of our discussion, which will focus on the Matthews Asia ex Japan Dividend Fund in a bit more detail. So just briefly, the Fund is a core growth strategy and it adopts a total of return approach to investing in Asia ex Japan. The Fund itself is an all-cap portfolio with a structural allocation to small mid-caps. That's been the case since the Fund was incepted back in 2015. And we believe that it's relatively unique in that it blends exposure to two buckets of companies, what we call dividend payers and dividend growers. But importantly, you and the team have flexibility to tilt exposure and blend exposure to these two buckets of companies through the market cycle. So Yu, maybe if we could just take that total return framework. Can you just elaborate a bit more on how the portfolio is currently positioned, and how you've taken advantage of the volatility year-to-date to adjust portfolio positioning?

YU ZHANG: Yes, I think for Asia ex Japan equity, overall, the valuation multiple has come down and is staying below its long-term 10-year average. At the same time, I think the earnings expectations also have been scaled back quite a bit. So expectations are relatively low at the moment. And between, let's say, more value type of stocks vis-à-vis some of the dividend growth stocks, I think actually we see, on a relative term, better value is sitting actually with some of the dividend growth names, whether it's the Chinese internet stocks as we discussed. And for the benefit of the audience, this strategy has never been very aggressive investing in Chinese internet stocks. For nothing else, many of the internet companies, they didn't pay dividends in the past, but the situation has changed quite dramatically this year. And we, as an income portfolio, even though it's a growth-minded income portfolio, we actually can now look at some of these Chinese internet companies as an income name.

So we are seeing better value sitting with some of these sold-off, but in our view, still quality growth names. On the other hand, another recent area that the portfolio has been allocating more towards is still focusing on our emphasis on mid-cap and especially small-cap Asian stocks. And we have seen, in few cases, some of these small-cap companies, they have a very clear idiosyncratic growth drivers, that are not at the mercy of overall macro trends. And so these small-cap companies with clear well-defined company-specific growth drivers, they are becoming quite an interesting area, while the broad market is being sold off. So those are the two, I would say, recent areas the portfolio has been positioning a little bit more towards. And on the more longer term structural growth basis, we are very still much positive on the structural growth stories in Asia. And that includes our large off-benchmark weighting in Vietnam, as we just discussed. We're seeing good opportunities to buy quality Vietnamese companies on a slightly more modest valuation at this moment.

On the other hand, the portfolio is a little bit more cautious on the technology hardware space. I think after a couple of years of very strong semiconductor supercycle, we are seeing an inventory correction and an industry downturn starting to unfold. So we have been lightening up our exposure towards the semiconductor areas. So that's one area we're being remaining slightly more cautious.

ANDREW PATERSON: Actually, Yu, just for the benefits of some listeners who maybe unfamiliar, the Fund actually transitioned earlier this year to qualify as an Article 8 strategy under the EU SFDR regulations. Just with this in mind, can you describe the Fund's approach to integrating ESG into the investment process and what impact, if any, did transitioning to Article 8 have on the Fund's investment universe?

YU ZHANG: The Article 8 designation on the Strategy, is just another way of formalizing, what we have always been doing, in terms of integrating ESG into our fundamental research process.

As a dividend portfolio, we always been honing in on a company's governance factor, thinking about what a dividend means, for a company's capital allocation decisions. But at the same time, increasingly, we think both the environmental and the social aspects of the business are becoming very important factors, that will determine whether any Asian companies can grow their underlying business, in a more sustainable way.

And we're seeing different stakeholders, including governments, in the form of regulation, or local workforce, or even the communities these companies are operating within, all have various degrees of impact, on the company's social and environmental aspects.

And for us, to get a full picture of the fundamental analysis right, on any Asian companies, I think, ESG all 3, just have to be part of the whole research package.

You can't overlook either one of them. So, with the Article 8 designation, even though this is not a sustainable investing strategy, we do promote certain social and environmental characteristics. So for instance, as one of the targets, we committed to good corporate governance and also, we committed our portfolio to have a lower than benchmark-average greenhouse emission impact. So, those are just some of the more explicit targets, we're putting out there with the article.

And in terms of whether the designation has any impact on our investible universe, I think, as a strategy, we run an activity and a norms-based exclusion list. So, there are certain specific industries, or certain type of business models, that will be on the exclusion list, but just to remind people, the overall investible universe for us is dividend-paying companies in Asia vis-à-vis the specific companies on the exclusion list, our ability to find attractive investments is nowhere near being restricted or constrained at all.

ANDREW PATERSON: Thanks. It's certainly an exciting and encouraging development for the Fund. So, just bringing things to a close, what would be your parting message, to investors, who are either currently invested in the Asia ex Japan region, or potentially considering an allocation, going forward?

YU ZHANG: I think the near-term volatility, for Asia, is expected to remain elevated. Having said that, I do think this strategy's total return approach does offer us the flexibility to capture the opportunities offered by the near-term market volatilities.

All in all, I think Asia ex Japan, is still a good place to look for growth and valuations are actually very attractive, with a reduced earnings' expectation. We still see a multi-year structural growth story remaining intact for some of the emerging economies in Asia, like Vietnam.

Even for the big economy, like China, a potential return to a more pragmatic approach, balancing its pandemic control and supporting its economic growth, could also spark an interesting reversal, in the recent poor sentiment towards the Chinese equities.

So, all in all, I think opportunities abound, and I remain quite constructive for the market.

ANDREW PATERSON: So, thanks for sharing your thoughts, it's been an enjoyable conversation. You quite clearly highlighted, that there are indeed several reasons to be cautious over the short term, particularly when it comes to China. But notwithstanding that, you also mentioned and relayed several reasons, for optimism.

And I think we feel like a strategy, such as the Matthews Asia ex Japan Dividend Fund, one that has some flexibility and its investment approach, is well suited to take advantage of the opportunities, as we see them moving forward.

So, that concludes our on-demand webcast today. We hope you found this update informative. So, on behalf of the entire Matthews Asia team, I'd like to say, thanks for taking the time to join us.

If you have any questions, please feel free to get in touch with your Matthews Asia representative or via the Contact Us page on our website. Thank you. Goodbye.

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