Global Insights

The Emerging Question: Investing in Emerging Asia

In our Nov. 2 Global Insights, we considered the limitations of making investment decisions on emerging markets as a whole and explored conditions in the category that could drive outperformance over the medium term.

Since then, Jonathan Garner, Morgan Stanley & Co.’s chief Asia and emerging market equity strategist, has added China to South Korea and Taiwan as an overweight in his APxJ/EM market allocation framework. This is noteworthy because Asia dominates the emerging markets category from a market capitalization standpoint.

Attractive valuations, moderate inflation, strong credit expansion and China’s reopening plans boost our outlook for the MSCI Emerging Asia Index (emerging Asia), and we recommend that investors consider adding exposure.

This issue of Global Insights is the final in a series dedicated to exploring opportunities in the emerging markets category. In this note, we focus on emerging Asia.
“When China sneezes, the world catches a cold,” is a common saying among investors. Today, that is almost certainly the case for the emerging markets category. China represents nearly a third of the MSCI Emerging Markets Index. India, Taiwan, South Korea and China together account for nearly 70% (see Exhibit 1).

Along these lines, we see evidence that investors are warming up to Asia ex Japan. According to EPFR Global, which tracks fund flows and asset allocation data, a net $91 billion flowed into Asia ex Japan funds in the 10 months through October, which compares to just $63 billion for developed market equity funds over the same period.

Still, across the region, there have been relative winners and losers (see Exhibit 2), and we urge investors to consider the unique characteristics of the different economies when weighing opportunities.

Since our Nov. 2 Global Insights, Jonathan Garner, Morgan Stanley & Co.’s chief Asia and emerging market equity strategist, has added China to South Korea and Taiwan as an overweight in his APxJ/EM market allocation framework. Although emerging Asia has faced an unprecedented number of shocks from supply chain disruptions, geopolitical tensions and weaker global trade, we think that green shoots are starting to appear for the category. We think that emerging Asia could benefit from 1) attractive valuations, 2) more modest price pressures than developed markets peers, 3) China’s credit impulse and 4) changes to China’s zero-COVID policy.
China’s credit impulse, which measures the change in the growth rate of its aggregate credit, generally leads performance in emerging Asia. In fact, according to the November 2022 Federal Reserve report, “What Happens in China Does Not Stay in China,” a policy-induced increase in China’s credit impulse of 1% of gross domestic product (GDP), boosts its own economy by 1.2% after one or two years. Furthermore, it is estimated to increase global GDP (outside China) by 0.3%. We think emerging Asia’s more modest price pressures compared to developed markets (see Exhibit 8) will help enable China to be more stimulative, which could foster higher regional returns (see Exhibit 4).

In our April 2022 Global Insights, “The Economic Cost of China’s Zero-COVID Policy,” we outlined how China’s zero-COVID strategy could hamstring the country’s growth. Although the unwinding of zero-COVID policy will take time, the potential benefits are clear.

Investor hopes for China’s reopening have brightened the outlook for emerging Asia. COVID-related restrictions in major cities have eased, demonstrations against China’s zero-COVID policy have faded and authorities recently announced a push to get the elderly among the population vaccinated. Although we expect positive developments in China’s reopening efforts, we realize that getting more people vaccinated is crucial. As of Dec. 1, only 65% of Chinese citizens over the age of 80 had completed the primary series of vaccinations, compared to more than 90% in the US.

Still, we think that the setup for emerging Asia remains compelling and believe that China’s reopening could boost global trade. According to the World Economic Forum, China is the second largest importer of global goods. While, admittedly, economic activity in China cannot be restored with the flip of a switch, a return to the pre-COVID trend could provide significant opportunities for key players in the region, like South Korea, whose exports to China have suffered the worst year-over-year drop since 2009 (see Exhibit 5).

With consumer demand likely to rebound in China, South Korea is poised to benefit. In 2020, China became the second largest importer of integrated circuits. Moreover, according to the Semiconductor Industry Association, China is also the world’s largest electronics manufacturing hub—accounting for 36% of global production.

Along these lines, we think that a pivot away from China’s draconian pandemic-related policies could provide a significant boost for South Korea, considering that semiconductors are its biggest export (see Exhibit 6). Furthermore, given China’s pivot away from low-value-added activities, such as manufacturing, packaging and testing, and toward design (see Exhibit 9), other top exporters of semiconductors stand to benefit as the trend evolves and conditions improve.
Exhibit 6: Semiconductors Are Becoming South Korea’s Primary Growth Engine

Source: Observatory of Economic Complexity, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2021

China’s reopening could also reboot global tourism—one of the world’s largest economic sectors. According to data from the United Nations’ World Tourism Organization, Chinese travelers accounted for almost 20% of international tourism spending in 2019. The removal of travel restrictions could provide a tailwind for China’s neighbors. For example, according to the China Outbound Tourism Research Institute, the number of Chinese tourists visiting Thailand is 97% below the pre-COVID level.

Although the impact of China’s reopening will not be immediate, the longer-term implications for neighboring economies could be substantial. In our analysis, we looked at Thailand, the Philippines, South Korea, Malaysia and Indonesia. To calculate Chinese travelers’ contribution to GDP, we considered the percentage of tourists to each of the countries who originated in China and multiplied that by each country’s travel and tourism contribution to GDP (see Exhibit 7).

Exhibit 7: China’s Reopening Will Boost Tourism Revenues

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2019

We found that Chinese tourists' impact was greatest on Thailand and the Philippines—accounting for 5.6% and 4.8% of GDP, respectively. To put this in perspective, the agriculture industry accounts for around 6% of GDP in Thailand, and the agriculture, forestry and fishing industries contribute nearly 10% in the Philippines. As China prepares to end its zero-COVID policy, emerging Asia stands to benefit.

Investment Implications

China is a major player in the region. Optimism about its reopening, attractive valuations, stimulative policy and modest price pressures could cause the MSCI Emerging Asia Index to outperform the MSCI World Index over the intermediate term. We believe there are opportunities in emerging Asia and think that investors should consider adding exposure.

Although we expect China to relax its zero-COVID policy, the process will be gradual and new outbreaks could trigger reimposition of sudden lockdowns. Investors should remember that the path to reopening will not be smooth. We encourage them to view risk-off declines in the MSCI Emerging Asia Index as opportunities to build positions.
Charts You Can't Miss

Exhibit 8: Asia Pacific Price Pressures Are Modest Compared to Developed Economies

Source: Bloomberg, Haver, Morgan Stanley Wealth Management Global Investment Office as of Sept. 30, 2022

Exhibit 9: China’s Semiconductor Industry Is Moving Away From Low-Value-Added Activities


Exhibit 10: Indonesia Has Been a Major Recipient of Chinese Investment


Exhibit 11: Semiconductors Are Becoming South Korea’s Primary Growth Engine

Note: 2020 and 2030 are forecasts.

Please refer to important information, disclosures and qualifications at the end of this material.
Current Readings From Our Quantitative Framework

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| Bottom 5       |        |         |          |             |         |
| UK             | Real Estate |       |          |             |         |
| US             | Consumer Discretionary |     |          |             |         |
| US             | Real Estate  |       |          |             |         |
| US             | Utilities    |       |          |             |         |
| EM             | Utilities    |       |          |             |         |


Ongoing Development Spotlight

China has been transitioning away from textiles, clothing and leather toward the exportation of high-value-added goods. A more educated workforce and movement away from a manufacturing-driven economy to a more services-oriented one are among the reasons that China has been able to pivot so quickly. There are also demographic factors at play; China’s aging population could lead to a reduction in labor productivity, and China has increased the number of college graduates per year tenfold since 1999. As a result, other countries in Asia have been able to pick up these low-value-added activities. Cambodia and Vietnam have benefited from this shift. In fact, over the past decade, Cambodia and Vietnam have seen their exports as a percent of GDP increase from 40% and 59%, respectively, to 72% and 91%. – Barron Thomas

Exhibit 12: China Is Moving Up the Value Chain

Source: Alpine Macro, Morgan Stanley Wealth Management Global Investment Office as of Nov. 31, 2022
Disclosures

Index Definitions

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestment solutions/wmir-definitions

Glossary

Important note regarding economic sanctions

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Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

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Yields are subject to change with economic conditions. Yield is only one factor that should be considered when making an investment decision.

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