CIO Special

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# Asia: recovery to prove resilient

## Key take aways

- Regional economic recovery is likely to prove resilient to continuing COVID-19 outbreaks, given more limited lock-downs and increased export demand from the U.S. and European Union.
- Chinese consumption will help drive China's recovery in the remainder of 2021. We continue to like Chinese equities due to the solid macro fundamentals. Further CNY strengthening looks unlikely.
- India's economic recovery will probably be assisted by a pick-up in vaccination rates and earnings growth expectations should support equities. RBI purchases and low repo rates will likely keep the yield environment benign.

## 01 Regional economic and market outlook

EM Asia should benefit from continued economic recovery. Some emerging market (EM) Asia countries are experiencing relatively high COVID-19 daily infections and vaccination rates are generally still low compared to developed market (DM) countries. However, their economies are still less affected by COVID-19 than last year, as many of the current lockdown measures are very targeted and localized. Most EM Asia countries are export-oriented and are therefore ready to benefit from further recoveries in external demand, especially from reopening developed markets. **We expect 7.9% GDP growth in EM Asia in 2021 and 5.6% in 2022.**

We expect better returns in Asia ex-Japan (AXJ) equities compared to developed market equities over the next 12 months. **Within AXJ, we are overweight on China and South Korea markets, are neutral towards the India market, and are underweight on ASEAN and Taiwan.** China's vaccination rates are higher compared to other Asian economies, which should be supportive of its domestic demand recovery. Chinese equities (especially Chinese tech) have corrected over the past few months and this may provide a good entry point for long-term investors. For fixed income, **we remain constructive on EM Asia credit** – as it should be supported by improving economic fundamentals, a still loose monetary environment, and investors' "hunt for yield".

## 02 China: opportunities after the recent correction

Our GDP forecasts for China are unchanged at 8.7% this year and 5.5% in 2022. We believe that Chinese economy will remain supported by export growth (Figure 1) and improving consumption.

China's GDP growth was 12.7% YoY in the first half of the year. We have seen uneven recovery in different sectors of the economy. Consumption growth has lagged behind expectations recently. Some Chinese cities saw a few COVID-19 outbreaks in June, which affected consumption in the month. Pent-up demand for purchases of big-ticket items (such as autos and mobile phones) has now been satisfied. However, we think **consumption will help drive the economy in the second half this year**, given higher household savings from last year, better labour market conditions and the continual normalization of service sectors.

Vaccination rates in China are also rising rapidly which should support consumption recovery.

Exports and investment expansion remains robust. Export growth reaccelerated to 32.2% YoY in June (vs. 27.9% in May). External demand, especially for mechanical and electrical products, has been strong. Exports to the EU and Southeast Asia showed particularly growth. We think export growth will be sustained in the rest of 2021 by continued economic reopening in U.S. and Europe.

China's PBoC surprised markets cutting the RRR (Reserve Requirement Ratio) by 50 bps in early July. This move reflects an adjustment in PBoC's tight monetary policy approach in the first half of the year. The RRR cut serves as a preemptive tool against a possible domestic slowdown, especially in consumption. China's average RRR rate is now at 8.9% and we could see more cuts in coming months. However, PBoC policies could become more flexible, dependent on the development of inflationary pressures domestically.

Downside risks to the Chinese economy include the possible escalation in U.S.-China tensions. In our base case forecast, we assume that the U.S.-China relationship will remain largely stable, especially on the trade front. We think tariff increases are not likely as the U.S. administration is currently focusing on rebuilding the economy. Higher tariffs on Chinese exports into the U.S. might lead to higher U.S. inflationary pressures and could affect the recovery in U.S. domestic consumption.

**We remain constructive on China/Hong Kong equities**. We think they will be supported by economic recovery momentum, the still-loose monetary environment and the continued improvement in corporate profitability. Chinese equities are currently trading at around 13x price to earnings (P/E) ratios, compared to the U.S. and European P/E ratios of above 18x.

**Chinese tech** stocks have recently fallen back: the Hang Seng Tech Index was down around 30% as of July 15 from its peak in February, due to the government's increased anti-monopoly and data security scrutiny of the large tech companies. The new Data Security Law enacted in June requires companies and individuals to get approval from relevant authorities to transfer any data stored in China to overseas entities, such as law enforcement agencies. The law takes effect September 1.

We do not yet feel there should be a change to our overall positive outlook for China, but more prudence should be there. Asia ex-Japan equities are still attractive to us because of the lower price to earnings ratios relative to Europe and U.S. That said, due to what has been going on in the region, we feel that there will be volatility in the coming months in the equities space.

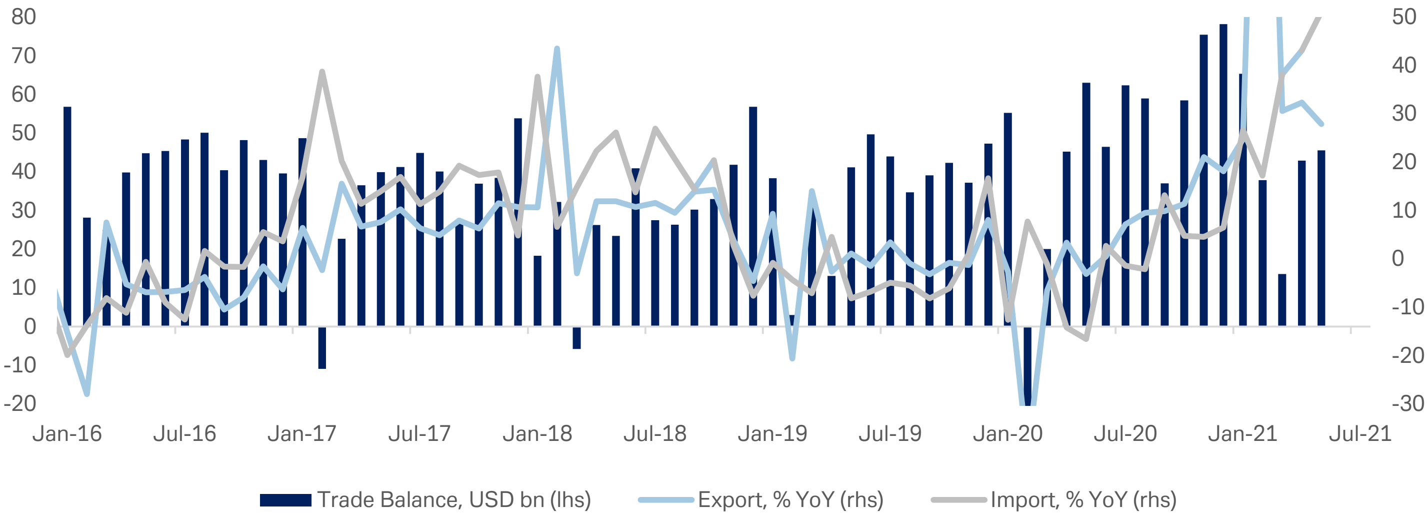
Capital raising is not a major obstacle for the development of Chinese tech companies, as most of them have sufficient sources of funding, such as commercial banks, PE/VC funds or government industry support funds. However, the IPO cycle could get longer because of the new rules, especially the listings in overseas stock exchanges. More Chinese tech companies could choose to be listed in Hong Kong instead of the U.S. due to the recent tighter regulations.

The policy uncertainty over China tech sector could stay for some time. However, for long-term investors, we think China tech remains quite attractive due to the solid fundamentals and positive earnings outlook. Any further weakness could be entry opportunities for long-term investors, in our view.

**On fixed income, we would be selective.** Market sentiment has been relatively weak in recent months towards Chinese credit, due to credit events for some state-owned companies and property firms. The PBoC implemented tight monetary policy earlier this year. As a result, China high yield has underperformed. Despite the RRR cut recently, the PBoC may continue to show tightening bias especially in property sector with their concerns over financial risks.

That said, Chinese credit overall is still attractive, in our view, due to its relatively high yield (compared to DM credit), improving corporate profitability in a recovering economy, and still loose global monetary policy environment. We would suggest a selective and diversified approach given the ongoing domestic targeted policy tightening efforts.

Figure 1: Chinese foreign trade

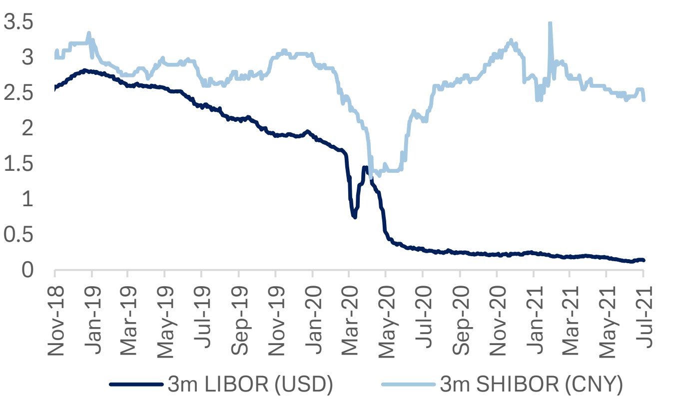



Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of July 2021

**Our 12-month USD/CNY forecast is 6.65.** The CNY (Renminbi) is likely to remain underpinned by strong exports and renewed capital inflows on the back of loose global liquidity conditions. However, the CNY may face headwinds in the second half of 2021, given a potential tapering announcement by the Fed, and this could result in CNY weakening again over a 12-month horizon.

USD/CNY's recent break below 6.50 has to be seen in the context of a weakening in the broader USD index (DXY) lows in recent months. DXY is now showing signs of strengthening again, with more signs that the Fed is considering tapering. Therefore the short and medium term situation remains fluid. From the PBoC's perspective, CNY gains might not be desirable if U.S./Chinese relations were to deteriorate. The PBoC will also want to discourage market expectations of one-way gains for the CNY, which would complicate future policy making.

Figure 2: Chinese/U.S. interest rate differentials.




Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of July 2021.

## 03 India: resilience amidst the COVID-19 second wave

India is currently recovering from a severe second COVID-19 wave. At the time of writing, daily new cases have dropped down below 40k – a 3-month low from a high of 400k+ last month. But while the pace of vaccinations has picked up recently, only around 10% of India's eligible population has so far been fully vaccinated.

Recent lockdowns have been shorter, localized and less stringent. Consequently the impact to economic activity impact has been contained, as compared to April-May 2020. Key indicators have proved relatively resilient (Figure 3).

We expect economic activity to start normalizing in the next quarter as lockdowns ease. The Indian economic recovery should be supported by a pick up in vaccination rates, fiscal policy (record government counter-cyclical spending) and monetary policy (RBI's bond buying programme). A robust global growth environment will also help. Nevertheless, we do expect some near-term impact to India's economic outlook given the lockdowns and have downgraded our forecast of Indian GDP growth in FY22 (financial year ending March 2022) from 11% to 10%. The key risk to watch will be the trend in COVID-19 cases (with the potential for a re-acceleration or third wave).

**Indian equity markets** have outperformed other emerging market peers over the past 12 months: the Nifty 50 is up 46%, while MSCI Emerging Markets (EM) is up 25%. YTD, Nifty is up 13% while the MSCI EM is up 4%.

After four years of subdued/flat earnings growth, India is finally seeing a multi-year earnings growth cycle. Earnings are currently expected to grow 38% in FY21-22 (ending March), and over 16% in FY22-23. This is already leading to a re-rating of the multiples Indian markets trade at, and provides some cushion for any corrections.

Nifty earnings per share (EPS) for FY 21-22 currently stands at INR725, valuing the market at 21.8x price to earnings (P/E). Sector rotation and mid/small cap outperformance have been the two biggest themes throughout this broad-based rally. Mid and Small caps are up 81% and 108% in the last 12 months while, sector-wise, Metal and IT stocks have been the outperformers.

**As regards Indian fixed income, the yield outlook is benign but watch inflation.** In April 2021, in a historic first, the RBI said that it would use its own balance sheet to buy government securities. Under the G-Sec Acquisition Program (G-SAP) 1.0 and 2.0, INR1tn (USD14bn) was committed for the June quarter and INR1.2tn (USD16bn) for the following quarter. Coupled with aggressive repo rate cuts (of 120bp since February 2020), this has kept yields low to support economic growth. The RBI is expected to use all tools (open market operations etc.) to keep yields lower and incentivize policy transmission across the yield curve. Investors should continue to look at accrual gains for the year, with the sweet spot in the 3-4 year tenure bucket.

However, the potential for further rate cuts has been reduced by the ongoing rise in commodity prices. Wholesale price inflation has spiked up, which is feeding into consumer inflation, up 6.3% YoY in May, slightly above RBI's target 2-6% band. Although no rate hikes are expected soon, inflation will be closely monitored.

From the perspective of the offshore/USD bond market, India's

Figure 3: Indian economic data like exports, PMI show resilience to 2nd Covid-19 wave

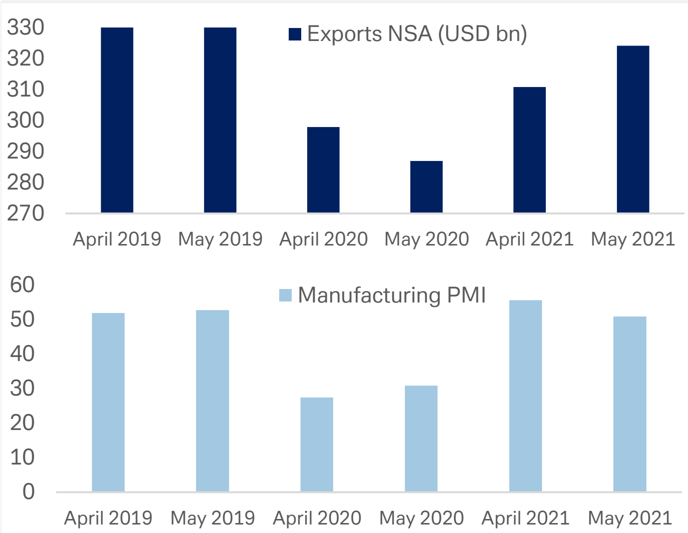



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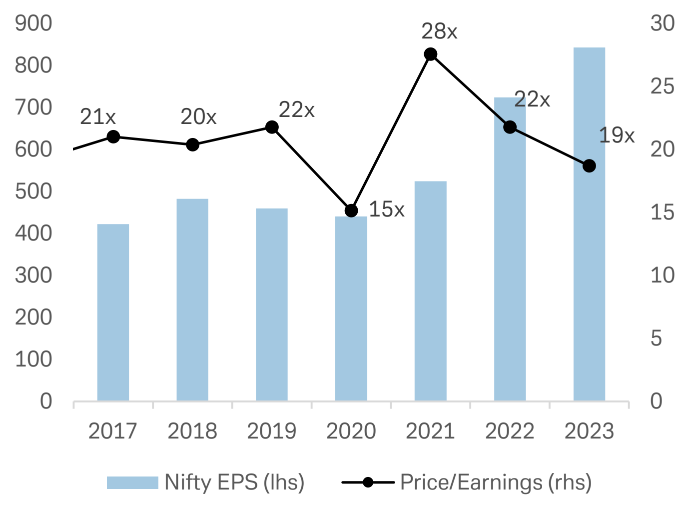
Figure 4: Nifty EPS and P/E projections




Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of July 2021.

sovereign rating continues to be borderline investment grade (BBB-, Baa3, BBB-). While the pandemic poses near-term risk to economic growth, we do not see any risk of India's downgrade into the category of a 'fallen angel' as rating agencies look towards more medium term indicators and, as noted above, we expect economic recovery to be sharp.

Assisted by lower trade deficits and large capital inflows, **India's foreign exchange reserves have continued to rise**, reaching a record high of USD608bn in mid-June 2021. India has now overtaken Russia to become the fourth largest FX reserve holder in the world after China, Japan and Switzerland. Existing reserves cover almost 18 months of normalized imports and put India in a comfortable position to withstand any adverse global shocks.

However, high inflation limits the RBI's scope for action to support the currency. **The RBI continues to face a classic a 'policy trilemma'** in its objectives of receiving large capital inflows, conducting independent monetary policy and having a stable exchange rate. One of these has to give way. To ease the currently high inflation, we believe the RBI may allow INR strength the second half of 2021, particularly if crude oil prices move up and the global demand outlook continues to improve as trade opens up. Making imports cheaper in local currency terms with a stronger INR could become a near-term tool for inflation management. **Our 12-month USD/INR target remains in the 72-74 range**, with risks of weakening contingent on resumption of broader USD strength globally.

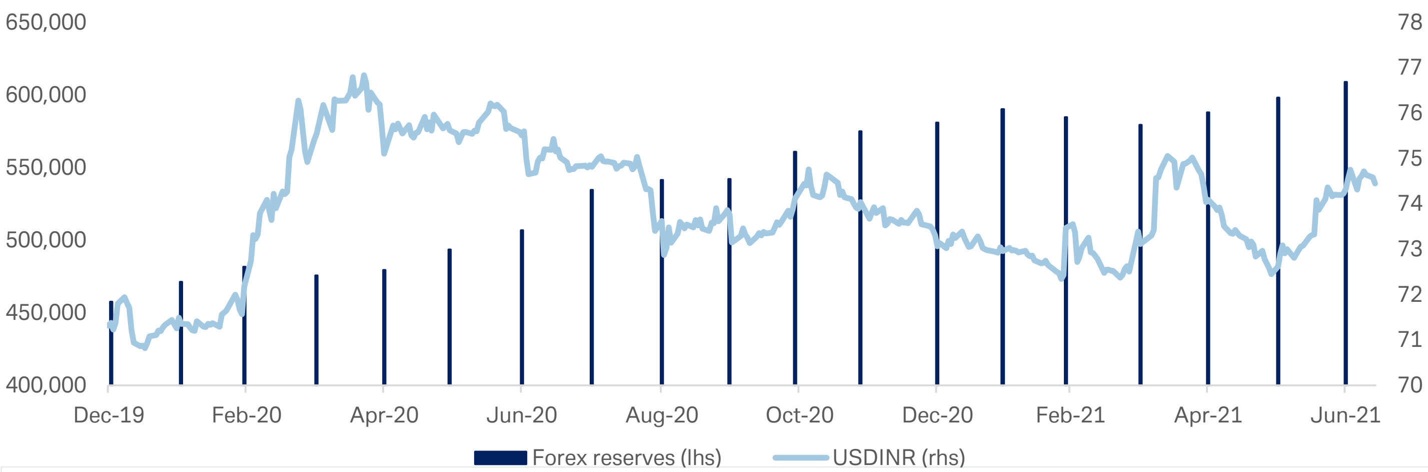
## 04 South East Asia: recovery vs. low vaccination rates

**We forecast the ASEAN-5 region to grow by 5.3% in 2021 and 5.6% in 2022**. Nonetheless, the IMF estimates that income per capita in the five economies will be 6% lower in 2024 than the level that was expected prior to the pandemic, with the Philippines down by 12%. In terms of monetary policy, most central banks are likely to remain on hold until year-end, after which a gradual reversal of COVID-related easing is expected.

**The key factor that will determine ASEAN economic recovery will be vaccination rates.** Currently, only Singapore has been able to vaccinate its population at a rate comparable to other countries/regions like the EU and U.S., with 38% fully vaccinated and 66% having received at least one dose of the vaccine. Indonesia and Malaysia have vaccinated approximately 13% and 24% with at least one dose, respectively. Overall, however, there now seem to be better prospects for vaccine exports from India to Asia as a whole, as the COVID-19 situation and movement restrictions ease there, and there are also better prospects of support from China, given its production capacity and progress towards immunity.

Supportive factors for Southeast Asia include international trade. The region's exporters quickly benefited a surge in demand for personal protective equipment (PPE), electronics, and other products as a result of working from home and an increased reliance on technology. As a result, Southeast Asia's exports had already recovered to above pre-pandemic levels by October 2020. Going forward, the outlook remains promising. While the global demand for PPE will be less pronounced as economies globally slowly return to normality, there will be continued demand for

Figure 5: Rising foreign exchange reserves reduce INR pressure




Source: Bloomberg Finance L.P., Deutsche Bank AG.
Data as of July 2021.

electronics, software equipment and semi-conductors, as U.S. and European consumers in particular start to spend their built up savings.

### Indonesia

The encouraging investment rise in Q1 2021 along with investment-friendly policy suggests that post-Covid, a renewed investment upturn will lead economic recovery. Higher potential GDP growth is expected, of 10% in 2021 and 6.5% in 2022, due to reforms and strong push for higher productivity/foster technological upgrades. CPI inflation remains below the central bank range of 2-4% and external balances are expected to stay in check with the current account deficit within 1-2% of GDP. Core inflation has averaged a softer 1.4% yoy in first five months of 2021, with the onset of the second Covid wave to soften demand impulses further (higher inflation in May was largely attributed to festivities of the Ramadan and Idul Filtri which put pressure on food and transport service prices). The central bank is focusing on strengthening the country's reserves, maintain a strong external balance and thus we expect it will stay on hold through the remainder of this year in terms of rate adjustments.

The decent external balance position, scope for foreign direct investment, coupled with higher energy prices and low inflation may suggest that Indonesian assets fare better this time than the last U.S. taper tantrum in 2013 when Indonesian assets suffered as a result of higher inflation, higher real rates and weak external balances. **USD/IDR target for June 2022 stands at 14,000.**

### Singapore

New outbreaks in May led to imposing of restrictions which have the potential to weigh on activity for the latter part of Q2. Indeed, this is reflected on advance estimates for Q2 growth, which show negative QoQ growth of 2%, a reversal from Q1's growth of 1.3% (while YoY Q2 growth is 14.3%, due to low base effects from last year's circuit breaker period). Nevertheless, the Ministry of Trade and Industry maintained its 2021 GDP growth forecast of between 4.0% and 6.0%, although there is still some degree of uncertainty regarding the macroeconomic environment because a full normalization of border reopening and restrictions lifting are not currently in sight albeit the speedy vaccination efforts. The recovery will be uneven across sectors. Trade oriented sectors such as wholesale trade are expected to benefit from the pick-up in external demand as well as low base effects, while tourism and aviation-related sectors are likely to see further delay in their recovery. As the economy still operates below full capacity and inflationary pressures are to stay muted, monetary policy is expected to remain accommodative until the recovery is well established.

## Glossary

The Association of Southeast Asian Nations (ASEAN) comprises Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar and Vietnam.

CNY is the currency code for the Chinese yuan.

The U.S. Dollar Index (DXY) is a weighted index based on the value of the U.S. dollar versus a basket of six other currencies.

An emerging market (EM) is a country that has some characteristics of a developed market in terms of market efficiency, liquidity and other factors, but does not meet all developed market criteria.

The Eurozone (EU) is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

The Hang Seng Index (HSI) includes the 50 largest companies traded on the Hong Kong stock exchange.

IDR is the currency code for the Indonesia Rupiah.

The Indian rupee (INR) is the currency of India.

LIBOR or London Interbank Offered Rate is a benchmark rate that some of the world's leading banks charge each other for short-term loans and serves as the first step to calculating interest rates on various loans throughout the world.

The MSCI EM Index captures large and mid cap representation across 23 emerging markets countries.

The Chinese National People's Congress (NPC) is the Chinese national legislature.

The People's Bank of China (PBoC) is the central bank of the People's Republic of China.

Private equity (PE) refers to funds or individuals investing directly in private, non-listed companies.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

The Reserve Bank of India (RBI) is the central bank of India.

Reserve requirement ratios (RRR) determine the proportion of banks' deposit liabilities that must be held as reserves.

SHIBOR is the Shanghai interbank offered rate - the rate at which banks are prepared to lend to each other.

USD is the currency code for the U.S. Dollar.

Venture capital (VC) is a type of private equity financing, typically to small, early-stage, emerging firms.

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