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DON'T LOOK UP (AND MISS THE COMING BOOM IN ASIA PACIFIC)

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Key Takeaways

- Tensions will linger over the Chinese balloon downed by America.
- Yet, for investors, the larger story is a growth boom quietly unfolding in the Asia Pacific.
- As confidence in the Asian economic cycle improves, expect a tsunami of capital repatriation back to the region. Global investment markets are nowhere close to pricing this in.

Ask Forstrong: What does China's re-opening mean for global investors, especially in the context of renewed geopolitical tensions?

People are looking up in 2023. Blame a Chinese spy balloon that drifted across Montana's skies and into the public consciousness. Blame Chairman Powell's hints at higher terminal rates. Or even blame those breathless alpine declarations of intent in Davos (which look less substantive at sea level). Whatever the case, the world is now transfixed on all things above.

To be sure, geopolitical risks are indeed elevated. After a brief détente in the world's most consequential bilateral relationship, tensions between China and America are again on the rise. As Cold War-type moments go, this is as close as it gets and there is a feeling that we may just be a few stray flying objects from a new catastrophe.

But let's not kid ourselves: attention spans are short these days. In the era of TikTok and viral videos, impact can be instantaneous. Investor moods can shift suddenly. The trick, more than ever, is to differentiate what is worth paying attention to and what is not. That is a question to which this author has now devoted more than two decades of rumination (as of last week, officially 20 years wearing Forstrong's team jersey).

The revelation that many come face-to-face with is that, to their surprise and often disappointment,

financial markets are not the study of statistics and formulas but of investors near-infatuation with stories — and of their limitless imaginative capacity to fall for them. Yet, most stories are short-term noise, a side show that distracts from the main event.

That usually means the known facts are not worth knowing; it's the unexplored truths that make you money. But finding them requires long-term focus, an atrophied muscle in the modern world. And, longer-term thinking can be difficult to sustain with an endless vista of doomscrolling to wade through online, not to mention having to look away from your friend's perfect kids and family vacations.
Still, there are zones of substance. For those looking at facts on the ground today, the largest macro story is not wandering inflatables or other aerial drama (let's be real: China and America have been spying on each other for years), but a growth boom quietly unfolding in the Asia Pacific region.

This is a remarkable shift. Following China's 20th Party Congress in October 2022, back in the pre-balloon era, the consensus could not have been more pessimistic. Many even believed China would be locked down forever. Beijing's harsh crackdown on property developers and takedown of Big Tech would perpetually limit the private sector. To most, the country was on an irreversible self-destructive path.

Since then, Beijing shocked everyone, abruptly dropping nearly all Covid restrictions in place for the last 3 years. But expectations are still low for the country. That shouldn't be surprising — China has consistently disappointed investors for the past decade. Yet investors are now underestimating the potency of its rebound. They shouldn't. In the span of a few weeks, over 80% of the Chinese population was infected by Omicron. The upshot is that herd immunity has been achieved rapidly, and China's re-opening is happening at a much faster pace than the episodes in other countries. Measures of mobility, traffic congestion and other daily activity are soaring. And the rapid dismantling of Covid restrictions is unleashing pent-up household demand, which now sits atop massive pandemic savings. (For more on China's opening dynamics, check Forstrong analyst and rising star Shibo Gu discussing the issue here).

China's Shifting Policies

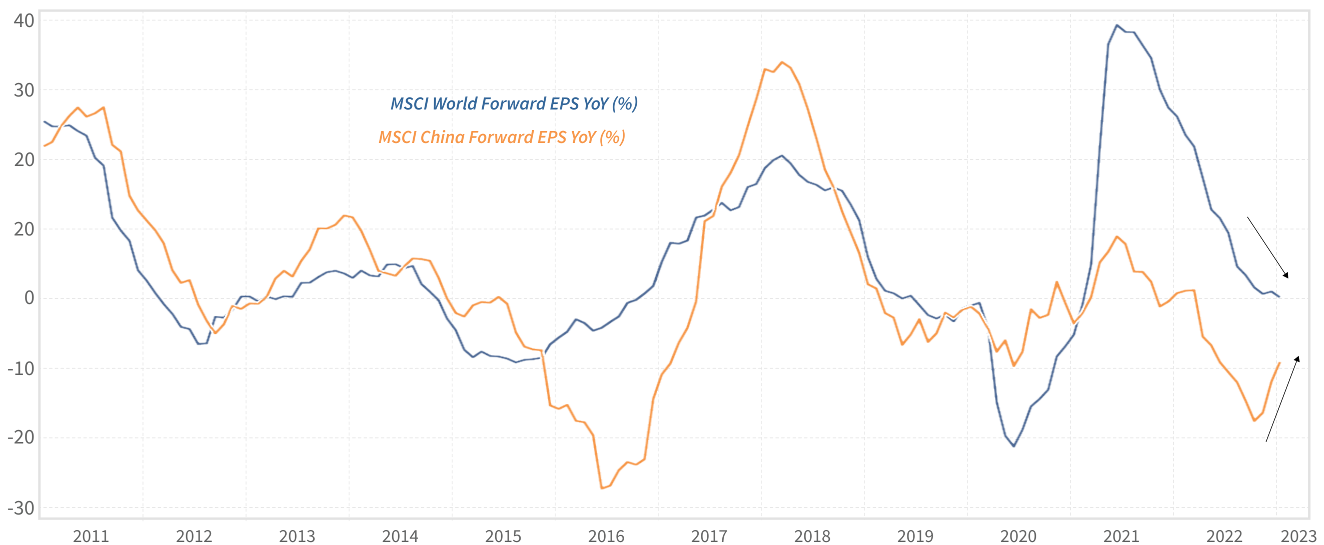
However, the story is more than post-Covid re-opening dynamics. Supporting a stronger thrust is Beijing's broader pivot towards a more growth-friendly policy path. Perhaps humbled by a series of balloon-sized policy blunders over the last decade (sorry, the puns write themselves) and the slowing growth trend over the last decade, Chinese policymakers have now turned

fully stimulative. The real estate sector, which crumbled under a draconian policy crackdown last year, has been listed as a key growth pillar by the authorities, with numerous funding and administrative support initiatives now in place.

Policymakers also recognize that their regulatory crackdown has dealt a heavy blow to business confidence. This is a key reason why Beijing's policy easing last year failed to boost capital spending and credit demand. Restoring business confidence is now a top priority. All this will usher in a sharp cyclical upturn in the Chinese economy and the country will once again make the single largest contribution to global growth in 2023.

If you think you have seen this movie before, it is because you have. After the Asian financial crisis in the late 1990s, the Chinese economy helped stabilize the region. Then, in 2003, China stimulated to overcome its SARS crisis and helped pull global growth higher. And most powerfully, after 2008's global financial crisis, China's policy stimulus helped stabilize the entire world economy.

Still, today's circumstances are a strange setup simply because China is at a very different stage of its profit cycle than other major global bourses. With higher interest rates, the West is heading into an earnings slowdown. Yet earnings in China have already contracted by a whopping 30% from a year ago (on par with some of the worst profit recessions since the Asian financial crisis). They will now improve markedly as the economy reaccelerates. This is the sweet spot for Chinese equities: depressed multiples, earnings set to improve and the policy environment turning stimulative.

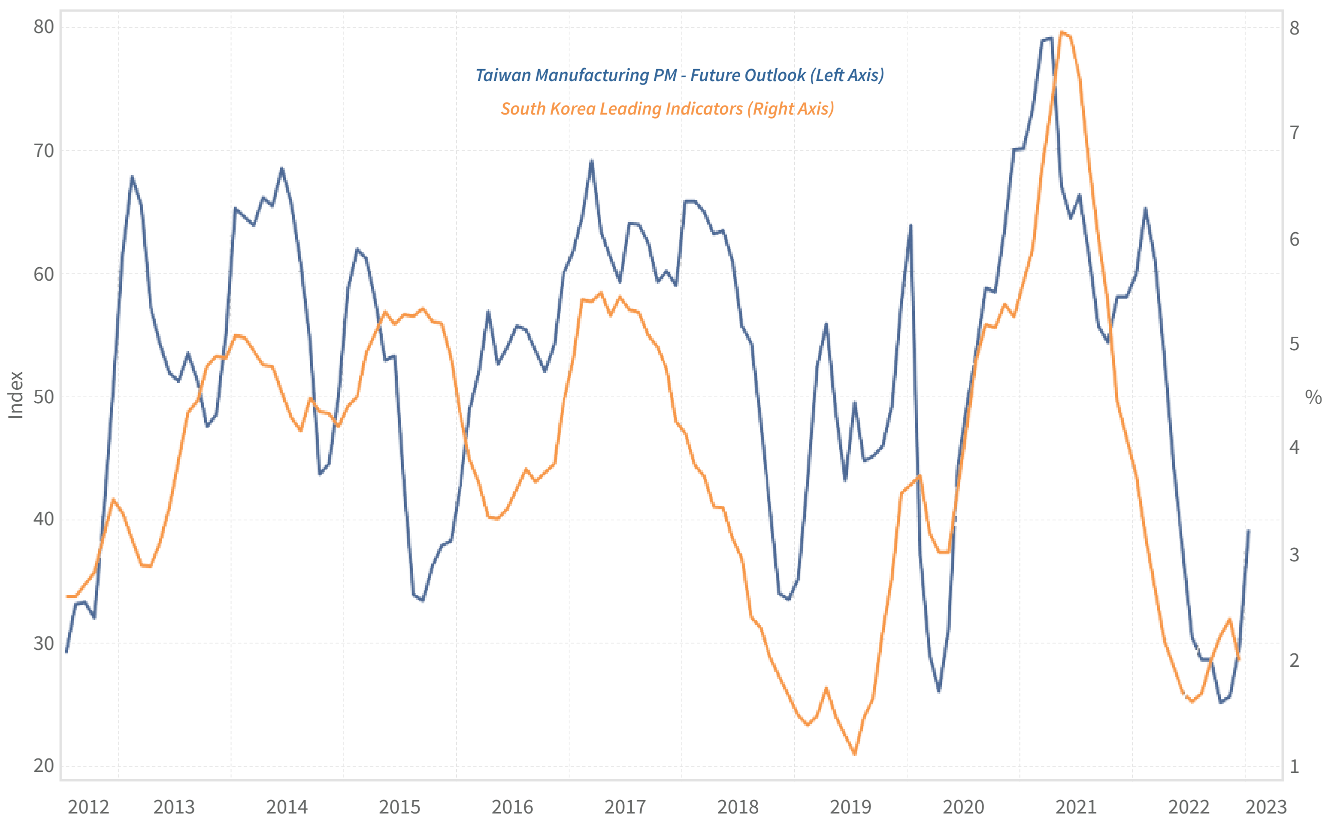


Sources: Macrobond, MSCI, Forstrong Global Asset Management

Wheels Up For Asia Pacific

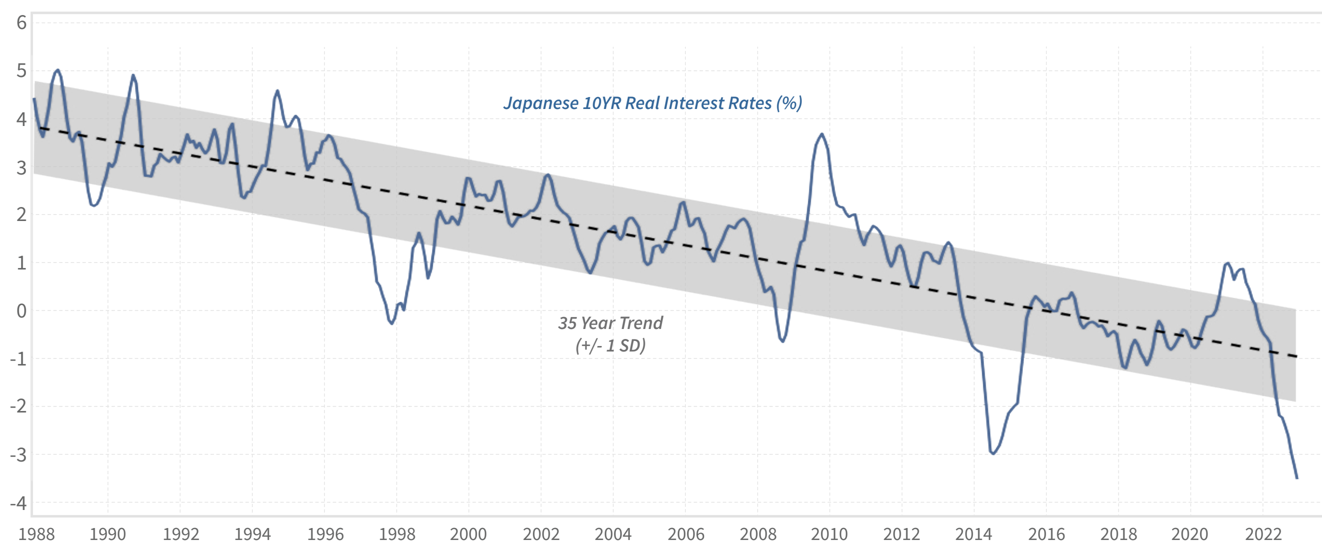
Elsewhere in Asia, other countries will take flight as they benefit from the upturn in China's business cycle. Most nations in Asia Pacific — and in fact most emerging markets — are either closely integrated into China's supply chain or are commodity producers. Given that China is the largest consumer of raw materials, its demand cycle drives key input prices and global commodities. Historically, China's business cycles have also led equity earnings in those regions. This time will not be different.

Take South Korea. One of the country's key export, semiconductors, have remained in a demand slump since mid-2019. Yet this is a durable good and has a relatively predictable replacement cycle of every 36-48 months. The biggest consumer of its semiconductors also happens to be China. Expect a profit upswing in South Korea to unfold in the period directly ahead.



Sources: Macrobond, Forstrong Global Asset Management

Even Japan, a country hopelessly snarled in zero interest rates and distorted by yield curve control for years, will benefit enormously from China's upturn. Many are now distracted with the nomination of academic economist Kazuo Ueda to succeed long-serving Bank of Japan governor Haruhiko Kuroda and the implications for future monetary policy settings. This is also a side show. Ueda now inherits the following macroeconomic conditions: inflation running at a 41-year high, nominal wages growing the fastest pace in 26 years and the ratio of new full-time job openings to applicants at its highest since the early 1970s. Rising incomes and employment was the missing element since Japan's asset price bubble burst in the early 1990s. Now, these dynamics will lead to strong capital spending — a virtuous cycle that will, at long last, lead to escape velocity for the Japanese economy. Anyone leading the Bank of Japan will be forced to pivot away from the massive easing that characterized the Kuroda years and into a policy regime change of interest rate normalization.



Sources: Macrobond, Japanese Statistics Bureau, Forstrong Global Asset Management
*3m moving average of (Nominal 10yr government bond yield - CPI)

All of the above has happened in Japan during China's lockdown. What happens now when China's acceleration will super-charge the Japanese economy? Confidence will return. Domestic capital, long turned off the prospects for their own markets, will start to come back home. In fact, this is already happening. Tokyo's megabanks and insurance groups, sniffing out regime change, sold foreign bonds at a record pace last year. With a deeply undervalued Yen and undemanding domestic stock market valuations, expect an acceleration of capital repatriation to continue — and for the same dynamics to unfold right across the Asia Pacific region.

Investment Implications

Measures of the market mood are currently throwing off conflicting and confusing signals. The near-universal pessimistic sentiment witnessed in late 2022, where our investment team concluded that the conditions for a market bottom had arrived, are no longer in place or as compelling. At the same time, investors continue to chase the rallies in lockdown favourites and all things technology (pro tip: don't do it, the macroeconomic conditions of the last decade have been punctured and it would be highly unusual for the old leadership to continue).

Throw in balloon dynamics keeping the world on edge and many may be feeling a case of vertigo. Yet investors should not be blown off course and over-complicate the setup here: Asia is accelerating, while the West is slowing as "higher rates for longer" sink in.

In this messy environment of volatile inflation and global growth divergences, investors should remain strategically oriented toward an unfolding recovery centered around the Chinese business cycle by investing in select Asian stock markets. By contrast, investors no longer need to be heroic with developed market assets — staying with short-duration corporate bonds yielding nearly 6% and short-duration equities, including the resource sector which is willing to pay shareholders astonishingly high dividends, will supply solid returns without taking unnecessary risk.

In other words, Asia will now strategically supply growth for portfolios, while the West will supply steady income. That means investment returns in 2023 will accrue more from masterly inactivity than bold moves on the chessboard. Investors should position that way — and keep looking ahead.

Tyler Mordy, February 2023