Schroder Asian Growth Fund

Investment Report

July 2024

Overview

Performance (as at end of July 2024)

Total returns in SGD

	1 mo. %	3 mo. %	YTD %	1 year %	3 years % p.a.	5 years % p.a.	Since inception* % p.a.
Portfolio	-1.6	1.7	8.3	1.4	-6.9	2.3	7.9
Benchmark**	-1.4	3.7	11.1	7.0	-3.7	3.4	5.7
Difference	**-0.2**	**-2.0**	**-2.9**	**-5.6**	**-3.1**	**-1.0**	**+2.2**

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Source: Schroders, Morningstar. Please note that past performance is not indicative of future returns. Performance above reflects that of the Fund's SGD Share Class.

* Inception date: 8th May 1991.

** On 01/03/2016 the benchmark changed from MSCI AC Far East ex Japan (NDR) to MSCI AC Asia ex Japan (NDR). The full track record of the previous index has been kept and chain linked to the new one.

Market Summary

Asian equities were almost unchanged in July but there was significant divergence in underlying market performance. Thailand, Malaysia, and the Philippines were the best-performing markets in the MSCI AC Asia ex Japan Index, while Taiwan, China, and South Korea were the worst-performing index markets in the month.

Stocks in Taiwan were badly hit by the sell-off in technology stocks towards the end of the month, with artificial intelligence (AI) stocks particularly affected. However, despite the monthly decline Taiwan remains the best-performing index market in the year-to-date period.

Chipmakers in South Korea were also weaker during the sell-off in technology stocks, with investors starting to question how the expansion in AI will benefit revenue. Major surprises in the US presidential election campaign and the delay in interest rate cuts by the US Federal Reserve also weakened investor sentiment in the month.

Meanwhile, equity markets in India achieved modest gains despite the initial volatility due to the Capital Gains Tax increase. The market cheered the Union Budget which focuses on strong long-term growth, with the government continuing its capex push and emphasizing fiscal responsibility. Asean markets also posted gains on investor hopes for a first Fed rate cut later this year on the back of weaker unemployment data in the US.

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Performance Review

Performance Review

Asian equities saw muted returns in July. China and Hong Kong were volatile as market expectations moved from being hopeful to disappointed pre and post the Third Plenum. This was then followed by some level of optimism after the more upbeat Politburo meeting towards the end of the month. Meanwhile, Taiwan was the worst-performing market amid large foreign outflows as IT/AI proxies within the tech-heavy market traded lower on the back of the US tech sell-off. Conversely, hopes for a first Fed rate cut in September saw US dollar weakening for the month, and boosted investor sentiment across the currency-sensitive ASEAN market. Against such backdrop, the fund registered a negative return, and performed in-line against the target benchmark during the period. At the regional level, stock selection in China, Hong Kong and Taiwan added to relative returns, while selection across India and Korea offset some returns. From a sector perspective, selection in industrials and technology, coupled with overweight in health care, were more positive, while selection in consumer discretionary dragged.

Our financial holdings in Hong Kong and China were among the key contributors to relative performance. In particular, HK-listed Standard Chartered gained on its strong set of 2Q24 results, while the USD 1.5bn share buyback announcement also bolstered share price. Meanwhile, China Pacific Insurance traded higher on expectations for better-than-industry new business growth thanks to its better core agent productivity and a shift towards more premium products. Outside of financials, China's industrial automation solution provider, Hollysys Automation, was another notable contributor as its share price rose towards the privatisation value after the announcement of acquisition by private equity firm Ascendent Capital Partners. Within industrials, HK-listed power tool maker, Techtronic Industries, performed on healthy growth recovery following a challenging 2023, while the positive read-through from peer results also boosted sentiment. Elsewhere, Taiwanese bicycle maker, Merida Industry, advanced on the back of stronger revenue data in June as destocking was largely coming to an end and inventory levels started seeing improvement.

Conversely, our semiconductor holdings across Taiwan and Korea, such as Mediatek, TSMC and Sk Hynix, detracted as stocks were hit by near term volatility and rotation out of high-flying tech outperformers YTD on the back of the US tech sell-off. Within consumer discretionary, Chinese apparel manufacturer, Shenzhou International, registered negative return as concerns over potential tariffs imposition under an increasingly likely Trump presidency weighed on investor sentiment. Hotel operator, H World, continued to drag amid increasing industry supply by second-tier players, causing margin concerns as price competition intensifies for the sector. In Macau, concerns over the sustainability of gaming demand recovery, underpinned by the persistence of softer China macro and consumption, saw casino name Galaxy Entertainment trading lower for the month. Outside of consumer discretionary, Korean battery material company, LG Chem, also declined amid weakness in the petrochemical cycle and challenging operating environment for subsidiary LGES given weaker EV demand globally and potential market dislocation from the new tariffs imposed on China EVs.

Market Outlook

Although regional indices ended the month broadly flat, under the surface, July saw increased volatility. Markets rose approximately 4% in the first two weeks of the month, only to give back all these gains later. This was mainly due to sharp swings in performance from large-cap semiconductor stocks, which continue to take their lead from Nvidia in the US, the bellwether stock for sentiment around artificial intelligence (AI). During the month, US equities saw a sharp rotation away from large-cap technology stocks – the so-called "Magnificent Seven" – which had driven much of the index performance year to date towards smaller companies and previously unloved segments of the market. This shift away from momentum as a winning factor in the US coincided with softer inflation data, increased concerns about recession risks, lower bond yields and a rapid increase in the number of expected rate cuts this year from two to three. Within Asia, this shift in US rate expectations favoured smaller ASEAN markets such as Thailand, Indonesia and the Philippines. Their currencies and capital flows had previously been pressured by a stronger US dollar and the more restrictive policy stance. At the same time, the weakness in semiconductor stocks saw the Taiwanese market pull back by 10% from its mid-month highs. The markets of Hong Kong and China were slightly lower over the month as the Communist Party's Third Plenum meeting failed to deliver any material shift in China's policy stance, despite the recent soft macroeconomic data.

Since the beginning of 2024, Fed fund futures have moved from pricing in six quarter-point interest-rate cuts this year to only one or two by mid-year. Despite this more hawkish outlook, sentiment towards equity markets has remained generally upbeat as investors continued to discount a soft landing for the US economy. This 'goldilocks' economic scenario (US growth not too hot, nor too cold, as inflation continues to fall and a recession is avoided) and the momentum behind large-cap technology stocks have provided a reasonably favourable backdrop for Asian equities – especially those industries more exposed to export demand, such as the key technology sectors in North Asia. More recently, however, as US employment and inflation data have weakened, markets have become more concerned that the Federal Reserve may actually be 'behind the curve' in easing policy and hence recession risks in coming quarters have increased, which in turn would undermine the earnings outlook for the US market. Coming at a time when investors have also started to question some of the more bullish assumptions for AI investment spending, and hence the high valuations for Nvidia and other leading tech stocks, this heightened economic uncertainty is leading to sharp pick-up in market volatility.

In addition to the powerful AI theme that has been dominating markets globally, investors are increasingly positioning for a broad improvement in demand and pricing for semiconductors and IT products in the coming quarters. End-market demand remains fairly soft, and inventories are still above average levels in some parts of the supply chain. However, recent comments from companies in the industry point to a stabilisation in the Chinese smartphone market and optimism about a modest rebound in personal computer (PC) and mainstream server demand through 2024. As inventories normalise, a more regular ordering pattern and improved pricing backdrop should allow for renewed topline growth and better margins. Apple and other consumer electronics companies are also starting to discuss a new generation of AI-enabled PCs and smartphones. These may help to encourage shorter replacement cycles and push up prices over time as semiconductor products continue to increase in sophistication. As a result, we continue to think that the underlying structural drivers for semiconductors will remain strong in the coming years.

However, as the last few weeks in semiconductor stocks have shown, when expectations and valuations are high, and market sentiment is very bullish, stocks are vulnerable to sharp corrections and increased volatility. Given the positive earnings revisions that we continue to see for many parts of the industry – and the huge long-term potential from AI-related applications – we are hopeful that this is more of a technical correction from very overbought levels, rather than the start of a more serious cyclical downturn. However, it reinforces the importance of focusing on genuine industry leaders with the strongest competitive positions and avoiding the more marginal companies that have been swept up in the AI hype less justifiably.

Alongside gains in semiconductor memory stocks, Korean equities have found support from hopes that a new government-led plan to improve local corporate governance – the "Corporate Value-Up Programme" - could trigger a market re-rating. A similar initiative in Japan is credited with driving more market-friendly behaviour by corporates in recent quarters and helping deliver strong equity-market gains. The upside potential in Korea could be significant, given that the market has historically suffered from a material corporate governance discount against international peers. However, making broad generalisations about the potential winners at this stage is difficult and important tax reforms are necessary to really improve incentives for the controlling families. We are yet to see detailed proposals from the government and regulators, and the response from the key industrial 'chaebol' groups is unlikely to be uniform, given their different ownership structures and internal priorities. Bottom-up, stock-by-stock assessments will be key to picking the real beneficiaries.

Indian equities have also performed strongly in recent months. Sentiment towards the local economy and its longer-term potential remains very positive, at a time when China's fortunes are increasingly being questioned by investors. Healthy domestic growth, geopolitical tailwinds, the scope to increase market share in global manufacturing at the expense of China and steady domestic fund inflows are all positive factors.

The recent national elections in India, however, delivered a negative surprise to most market observers, with the BJP winning fewer than expected parliamentary seats and losing its outright majority. This has forced Prime Minister Modi to form a coalition government with other minority parties, which in turn could constrain his policy flexibility over time. Although the initial reaction to the election result saw a sharp correction in the local market, the one-day setback after the election was soon shrugged off by local investors and the index is now 10% above pre-election levels. Foreign flows into India have been more volatile in recent months, and this strength in the market is another clear demonstration of the very high levels of optimism from local retail investors on the ground in India. Valuations remain elevated in many sectors, so a positive outlook is well-discounted currently – especially for small and mid-cap stocks that have been the focus of domestic buying, and where expansion in valuation multiples is most marked. We continue to see strong longer-term fundamentals in areas such as private-sector banks, healthcare and select consumer-related stocks, which remain core positions in regional portfolios.

While Taiwanese, Indian and certain Korean equities have performed strongly year to date, and sentiment in some parts of these markets has approached euphoric levels, this has been in stark contrast to China and Hong Kong. In these latter markets, local and international investors have been very cautious, pushing valuations close to historic lows. The slump in Chinese markets over the last year has been triggered by disappointing macroeconomic data and a lacklustre policy response. This has undermined investor confidence, not only in the near-term cyclical outlook, but also in longer-term growth forecasts. Geopolitical tensions between China and the US also remain a serious overhang.

Perhaps most importantly for the Chinese economy, the property market and the broader construction industry continue to deteriorate. Sales volumes have collapsed, and prices are under pressure as buyers step back from the market and deflationary expectations set in. Many of the largest private developers are facing solvency issues that are further undermining confidence in the pre-sale market as project completions are delayed in many cities. Given the huge scale of the construction industry, and all the related activities across China, this weakness remains a major headwind for broader economic growth. Property is also the largest store of household savings, so falling prices are likely to be significantly undermining consumer confidence and spending.

Despite the weaker headline macroeconomic data and property market troubles, we have felt for some time that after such a sharp de-rating, the China and Hong Kong equity markets were pricing in an overly negative outlook. The operating performance from the local equities we own, as reflected in recent results, has been more encouraging than the macroeconomic headlines would have one believe. This points to the broader economy outside of the property development industry being sluggish, but not in a downward spiral.

We share many investors' concerns about the structural headwinds China faces. A 'new normal' of much slower nominal GDP growth in China in the coming years is our base case. However, given the extremes of negative sentiment, there is still room for the authorities to surprise positively with better-coordinated policy support going forward. This was evident in April and May when markets bounced sharply, encouraged by talk of a more concerted central government plan to deal with excess supply in the residential property market. For the first time, the central government has allocated funding for local government entities to buy excess housing inventory from the market to both reduce the supply overhang and channel funds to developers. The sums involved so far are fairly modest, given the scale of the problem, and the mechanism for executing the buyback of inventory is fairly opaque. Consequently, it feels unlikely that these steps alone will be enough to reverse the tide and trigger a broader upswing in buyer confidence. However, once the authorities have started down this path to address the supply issue in a more concerted manner, it seems likely that further support could be forthcoming if conditions don't improve. Therefore, we take some encouragement that stabilising the property market and consumer confidence have likely moved up the government's priority list. Markets, however, remain impatient for more dramatic stimulus to support domestic consumption. The absence of any new measures announced in the last two months has undermined any earlier confidence, and stock prices, especially for consumption-related companies, have drifted back to earlier lows.

Although we are not expecting any sharp upturn in domestic consumption in China, better-managed businesses with stronger franchises can still deliver growth, even against a softer economic backdrop. There have also been signs of more 'self-help' among Chinese corporates recently, with a notable increase in dividend payouts and buyback activity, which is encouraging and may offer more downside support for stocks over time. Even after the recent rebound, share prices in many sectors in China and Hong Kong are not far off levels seen in the depths of the Covid period when the earnings outlook was far more uncertain. Given this mismatch in share-price performance and operating fundamentals, and the still very low expectations for the China and Hong Kong markets, we continue to see attractive opportunities in selective areas on a bottom-up basis.

Aggregate valuations for regional equities are close to longer-term average levels. However, behind these averages, there remains a very significant spread in multiples between those stocks and sectors in favour currently, and the apparently ‘deep value’ on offer in less popular areas. Markets such as India and Taiwan that have performed strongly over the last year are trading at marked premiums to their historical averages and expectations are very elevated. At the same time, the China and Hong Kong indices are sitting close to all-time low multiples as sentiment remains depressed. Asian investors are faced with a stark choice between chasing momentum in India and technology stocks or taking a more contrarian stance with the less fashionable value on offer in Hong Kong, China and parts of Southeast Asia.

Gains in Asian equities generally require a more stable global macroeconomic backdrop, a less hawkish US Federal Reserve, reduced volatility in US-China relations and a more positive Chinese cyclical outlook. These factors are important to attract flows back into the market from foreign investors. Visibility remains limited on many of these fronts – most importantly, the China policy backdrop in 2024 and the impact of the upcoming US elections. Nevertheless, we remain hopeful of a continued gradual recovery in activity in key stocks and sectors in China, and a rebound in technology sector fundamentals through 2024. This could underpin our preferred Asian equities over the medium term. In the meantime, we remain very selective in our exposure, given the continued uneven nature of the recovery in the region, and disciplined about valuations.

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China country risk: Changes in China's political, legal, economic or tax policies could cause losses or higher costs for the fund.

Counterparty risk: The counterparty to a derivative or other contractual agreement or synthetic financial product could become unable to honour its commitments to the fund, potentially creating a partial or total loss for the fund.

Currency risk: The fund can be exposed to different currencies. Changes in foreign exchange rates could create losses.

Derivatives risk: A derivative may not perform as expected, and may create losses greater than the cost of the derivative.

Emerging markets & frontier risk: Emerging markets, and especially frontier markets, generally carry greater political, legal, counterparty and operational risk.

Equity risk: Equity prices fluctuate daily, based on many factors including general, economic, industry or company news.

Leverage risk: The fund uses derivatives for leverage, which makes it more sensitive to certain market or interest rate movements and may cause above-average volatility and risk of loss.

Liquidity risk: In difficult market conditions, the fund may not be able to sell a security for full value or at all. This could
affect performance and could cause the fund to defer or suspend redemptions of its shares.

Operational risk: Failures at service providers could lead to disruptions of fund operations or losses. Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect risk: The fund may be investing in China "A" shares via the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect which may involve clearing and settlement, regulatory, operational and counterparty risks.

Capital risk / distribution policy: the expenses of this share class are paid out of capital rather than out of investment income. Capital growth will be reduced and in periods of low growth capital erosion may occur.

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