ASIA

US-Led Trade Dispute Could Present Opportunities in Emerging-Market Stocks

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Sukumar Rajah, senior managing director and director of portfolio management, Franklin Templeton Emerging Markets Equity, considers the potential fallout from the trade dispute between the United States and China. He explains why it could actually present investment opportunities in certain emerging-market economies.

Much discussion has been devoted to the escalating US-China trade dispute as of late, as both sides threaten tariffs on products ranging from pork to aircrafts.

This issue is another example of a trend of rising protectionism globally that remains a potential risk facing the markets. But despite the tit-for-tat measures we've seen between United States President Donald Trump and Chinese officials, we don't think this war of words will affect China in the long term.

In our view, the importance of bilateral trade for both sides should ensure they maintain stable relations.

Without stable relations, it would be more difficult for Chinese or US companies to navigate complex international supply chains.

The Bigger Picture

Meanwhile, we remain optimistic about the wider region, namely the ASEAN 5[1] countries and India. In 2018, economic growth in the East Asia and Pacific region is projected at 6.2%, double the estimate for global growth.[2] That leads us to believe that we can find domestic-focused stock opportunities in Southeast Asia's equity market.

Our research tells us that the domestic driving force begins with the nature of emerging-market Asia's manufacturing trade, which tends to be highly reliant on global value chains centered around China, a regional technology hub. ASEAN's indirect exposure to the United States through China is notably lower than North Asia's, likely due to the region's smaller role in the regional technology supply chain. Singapore and Vietnam would be exceptions here, as the former feeds into the regional technology supply chain and the latter plays an important role in mobile phone assembly, such that both countries have more exports to the United States than other ASEAN economies.

Elsewhere, we are optimistic about the prospects for India's stock market for a couple of reasons. We see room for the country's stocks to appreciate as it gradually shakes off the negative effects of recent government reforms. In addition, India's growing middle-class population could fuel a boom in consumption.

What's more, consumption already makes up nearly 60% of India's gross domestic product,[3] so such a domestically oriented economy could lead to India being less vulnerable to external factors, especially if the trade dispute drags on.

Indonesia's economic backdrop exhibits some similarities to India's. Both have an expanding middle-class population that could evolve into a large domestic investor base.

In addition, while foreign direct investment inflows to Indonesia have grown over the last 15 years, it still makes up a smaller share of the country's gross domestic product compared with other countries in the region.[4] And, if the US-China trade spat continues, we think the direct impact on Indonesia's mostly domestically driven equity market would likely be minimal for now, unless tensions escalate.

At the moment, we like domestically oriented and sustainable companies that could sidestep any notable effects of trade concerns, namely some ASEAN banks in Indonesia and Thailand. As a result, we're taking opportunities to scope out high quality companies that generate most of their income domestically or within the region.

Meeting Demand in China

Equally, perhaps counterintuitively, we think China's economic situation could be steadied in the short- to medium-term by Chinese President Xi Jinping's growing authority and consolidation of power. We believe the move lends confidence to China's transition from fast growth, to quality growth, which could benefit consumer-type stocks.

We would hope to see a continuation of the much-welcomed steps the Chinese authorities have taken to centralize its financial bodies and streamline bureaucracy, and carry on opening up the financial sector.

In our view, these changes should facilitate the country's near-term goals of deleveraging, reforming state-owned enterprises and tightening environmental regulation.

Foreign companies and business partners have previously complained about the lack of opportunities for foreign firms to compete on an equal footing with China's domestic companies in the financial sector.

In response, the People's Bank of China (PBOC) has promised it will implement a number of reforms, starting from June this year. These include raising foreign ownership limits to 51% in securities, fund management, futures and life insurance companies, financial leasing, and auto and consumer finance.

The PBOC also revealed its plans to launch a trading link between China's stock markets and the London Stock Exchange by year-end. However, we remain cautious about the significant level of government intervention in the market and how this could impact the long-term efficacy of China's financial system.

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All investments involve risks, including possible loss of principal. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets.

1. The ASEAN-5 includes Indonesia, Malaysia, the Philippines, Singapore and Thailand

2. Source: World Bank, Global Economic Prospects, January 2018. There is no assurance that any estimate, projection or forecast will be realized.

3. Source: World Bank, 2016.

4. Source: World Bank, Indonesia Economic Quarterly, June 2017.