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Asia's exceptionally high-yielding bond markets

Anticipating a moderate re-rating

Why investing with "purpose" makes sense

Why the 21st century belongs to Asian investors

Ten European surprises for Asian investors

Strategies that benefit from volatility

Indian economy: problems pile up for Narendra Modi

COLUMBIA THREADNEEDLE INVESTMENTS

2020

Asia's exceptionally high-yielding bond markets

The region's bonds stand out in a world of low and negative yields, but investors need to be picky.

There was a time when negative yields were a rare and unlikely curiosity. No longer: in late 2019, as much as US$16 trillion of bonds worldwide carried a negative yield,[1] although a more positive economic growth outlook means this number has since shrunk. Even so, plenty of debt still offers a meaninglessly low return.

Even places once considered frontier do not deliver in this environment. According to Morgan Stanley, around 30% of the universe of euro-denominated emerging market debt recently traded with a negative yield, including many corporate issuers.[2]

So where to go?

Investors can still find yield in emerging Asia, notably India and Indonesia. According to AsianBondsOnline, the debt market portal backed by the Asian Development Bank, Indonesian local-currency 10-year government bonds yield 7.08%.[3] Through much of 2019, Indian 10-year government paper offered between 4 and 5% over comparable US Treasuries, and Indonesia between 5 and 6%. China offers a deep and liquid high yield market.

International investors have been positioning for this opportunity for some time. According to AsianBondsOnline,[4] just under 40% of Indonesian local currency debt was held by foreigners at the end of June 2019, around 23% of Malaysian ringgit, and just over 15% of Thai baht.

Diverging markets

But it is not a free ride, and it would be an error to think of Asian debt as a homogenous block.

Even here, the plunge to lower yields seemed inexorable until recently. Sovereign bond yields in most Asian nations were expected to drift downwards, as central banks cut interest rates in order to spur economic growth, partly a consequence of the US-China trade war.

Consequently, yield curves inverted (meaning short-term yields are higher than long-term) in Singapore,

Thailand and Hong Kong, generally seen as a precursor of a recession. Yields fell everywhere in 2019, from China to the Philippines. A Reuters survey of over 40 fixed income strategists and economists in September showed that most expected yields to fall further for all countries bar Thailand; if the yield on China's 10-year sovereign debt had fallen to 3% at the end of the year, as the survey expected, it would have been the lowest level in three years. (In the event, it finished 2019 a little over 3%.)

But what's happening appears to be a bifurcation, not an outright pan-regional trend. Yields have been declining on paper from the region's most highly-rated nations: Hong Kong, South Korea and Singapore. They have also been declining in mid-ranked nations, including Malaysia and China. But they have stayed high in higher-yielding markets such as India and Indonesia.

The message that comes through consistently is that Asia is a place to pick and choose opportunity. So, for example, Chinese property dominates Asian high yield; a decisive call on that asset class is essential. With defaults rising as China has sought to deleverage at the same time as facing down a trade war, there are arguments that the sector is risky, yet careful credit selection can find very attractive investments.

A view on the currency is important too, with each under different pressures. The Chinese yuan was until recently depreciating amid a trade war and a slowing economy, for example, while the Indonesian rupiah is stable following the reelection of President Jokowi and a S&P Global sovereign credit rating upgrade.

No shortage of opportunities

Regional analysts from private banks have been quoted as expecting a 3% total return from Asian investment-grade debt over the next 12 months, and 6% from Asian high yield.[5] They judge short duration credits to be better, given the flatness of the yield curve, while a portfolio blending Asian investment grade and high yield should return over 4% in the next 12 months.

Better still, the risk involved is not as extreme as one might think: Bloomberg notes that the Sharpe ratio on Asian bonds, a measure of volatility-adjusted returns, is robust at 1.59 over the past five years. That is thanks to a strong regional investor base familiar with the asset class, as well as low corporate gearing ratios in the region.

And there is certainly no shortage of supply. Borrowers know they are not going to see opportunities like this every day, which is why dollar bond issuance in ex-Japan Asia hit an all-time record of over US$79 billion in the third quarter, according to Bloomberg data.[6]

There is plenty to look at, and good risk-adjusted yield can be found. But buyers need to be picky.

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2. Negative yields leave EM investors with nowhere to hide, Financial Times, 11 September 2019.
3. https://asianbondsonline.adb.org/, 09 January 2020.
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Anticipating a moderate re-rating

By Soo Nam Ng, Head of Asian Equities

The high stakes geopolitical tussle between the US and China overshadowed Asian equity markets in 2019 and will continue to be a risk in 2020, although one that appears to be diminishing.

At the beginning of 2019 there were optimistic expectations that a trade deal might be struck, however trade talks broke down in May. By mid-year, the two countries had reached a temporary truce and agreed to re-start bilateral trade negotiations.

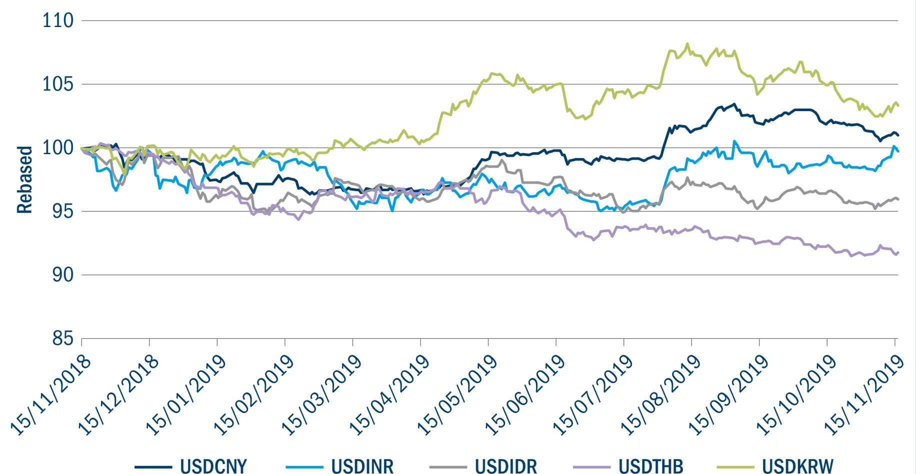
As we approach the beginning of 2020 (this article was written in late 2019), policymakers on both sides of the trade dispute appear worried about its economic fallout and are seriously trying not to escalate the tensions. Less encouragingly, the geopolitical undertones have become more intense, as US Republicans and Democrats alike fervently shout about "national security" concerns posed by the rise of China. The erosion of trust between US and China may take years to repair.

Beyond the trade war

Despite this cloud of uncertainty, there were positive developments in 2019 that bode well. Politically, the year's elections saw the incumbents – Prayut in Thailand, Jokowi In Indonesia, Modi in India – stay in power. This means that their economic agendas will continue, and they will have a stable environment for execution. It's especially important for India, which is facing economic slowdown.

The strength of activity in the technology sector was a major surprise, especially in the second half of the year, after initial concerns that the signs of lower global economic growth might start to weigh on technology product purchases

Figure 1: Major asia currencies have been resilient



Source: Bloomberg, as at November 2019.

China pushed ahead with an accelerated implementation of 5G telecommunications, despite the obstacles thrown at Huawei by US sanctions. This development spurred expectations that the tech cycle would step up a gear in 2020, based on the build-out of 5G network infrastructure and smartphone replacement.

More broadly, the US Fed's about turn on the economy, leading to lower rates, supported Asian economies and lifted the equity market in the second half. It also allowed Asian countries to also ease monetary policy.

A bright 2020?

Going into 2020, equity valuations remain cheap in Asia, especially for China stocks. Thus, barring unforeseen adverse events, we anticipate moderate upside for Asia ex Japan markets. If consumer confidence can be sustained even amid the trade war uncertainties of the past two years, all we need for 2020 may be less bad news for the economy to gain a stronger footing, and for equity markets to offer some re-rating.

Additionally, we think that corporates have been cautious in the last couple of years given the overhang of the trade discussions, resulting in more disciplined capex spending and a tighter rein on costs. This bodes well for future profits, provided macro-economic or geopolitical factors do not pose serious negative surprises.

Korea and Taiwan will benefit from the technology recovery cycle as 5G implementation goes into full swing. We anticipate that 5G equipment, including handsets and network equipment, will require more high-end components, further boosting the sector's rebound. For example, 5G network equipment and handsets are expected to use more multi-layered ceramic capacitors. Additionally, lens makers will benefit from demand for sharper imaging quality and security features such as facial recognition. Higher electric vehicle sales and the greater electronic content in all cars will also support technology components manufacturers.

In an unanticipated consequence of the trade war, Chinese technology companies such as Huawei and ZTE are likely to continue diversifying their supply chains away from US suppliers. What they lose Asian tech components suppliers in Taiwan and South Korea will gain.

Trade war rhetoric

But the high stakes geopolitical tussle between the US and China will be an ongoing risk. Key to evaluating a Phase 1 trade deal is not what has been resolved but what has yet to be agreed upon, for which there may be no solution that is acceptable to both sides. Can these outstanding issues be parked aside for the medium term, or might they stir up high-tension headlines to roil markets in 2020?

India remains a wild card, depending on whether recent policy action can turn the tide on decelerating economic growth.

In a US presidential election year, trade and national security issues relating to China may be played up by candidates on both sides. The rhetoric is likely to cap sentiment on China, which may continue to drag on Asia ex Japan equity returns in 2020.

Why investing with "purpose" makes sense

Environmental sustainability is beginning to affect a company's brand and competitive edge.

Just as anxiety about climate change and pollution mounts, so it is influencing which brands and products consumers prefer. So much so, in fact, that a company's perceived sustainability, including the environmental footprint of its products, is beginning to affect its competitive edge.

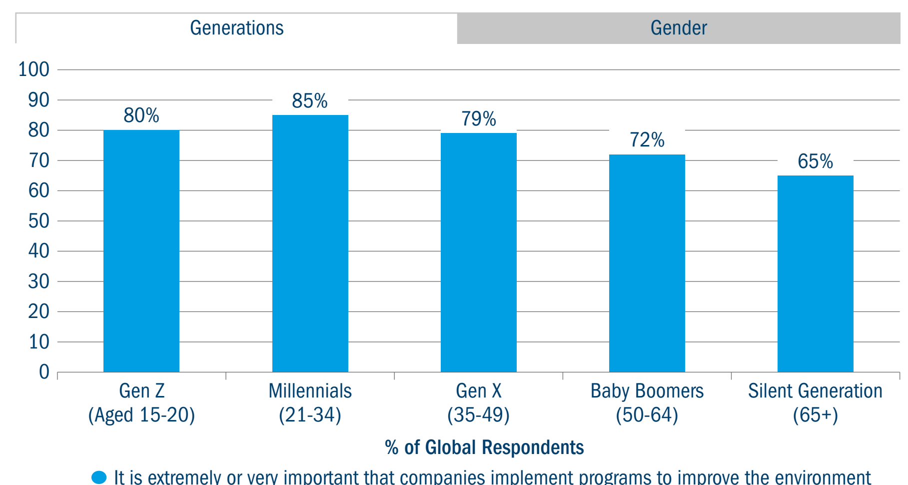
In a recent global survey, a huge 81% of respondents felt strongly that companies should act to help improve the environment. The millennial generation, Gen X and Gen Z are most passionate, but their elder peers aren't far behind (see chart).[1] Importantly, they are willing to drop brands that do not meet their expectations and find it easier now than ever before to find alternatives that do.

Thinking of new technology as disrupting entire industries has become commonplace. Yet corporate environmental practices are also a potential source of disruption. For an asset manager such as Columbia Threadneedle Investments, that judges its long-term holdings by virtue of their competitive edge, the "purpose" of a company – how it seeks to have a positive effect on stakeholders, especially with regard to the environment – is becoming an important factor.

At the centre of Columbia Threadneedle Investments' analytical framework is a model called Porter's Five Forces, named after Michael Porter, the Harvard business school professor who defined them. These five forces help to understand the

Figure 1: Gender and generations

Percentage of respondents who said that it is "extremely" or "very" important that companies implement programs to improve the environment



Source: The Conference Board Global Consumer Confidence Survey, conducted in collaboration with Nielsen, Q2 2017. https://www.nielsen.com/us/en/insights/report/2018/the-education-of-the-sustainable-mindset/

competitive structure of an industry. As consumers' tastes become more focused on the environmental sustainability of products, so their bargaining power increases. As new entrants emerge to meet these changing demands, and technology enables their marketing and distribution, so rivalry intensifies. Companies can no longer simply rely on a brand's power to support returns.

Greening the brand

When it comes to consumer brands, environmental sustainability is both threat and opportunity. Some businesses view it as a danger to their brands and competitive edge that they must adapt to; others see it as an opportunity both to do good for society and for their shareholders. Investors are aware of this and are increasingly asking about how the environment affects stock selection.

Unilever, the Anglo-Dutch consumer goods company, is adapting to changing attitudes and responsibilities, looking to underpin its future brand strength through reducing environmental impact throughout its business. It is acting to manage the potential danger to its brands as consumers become fervent about sustainability. Notably, it aims to make all its agricultural raw materials sustainably sourced by 2020. It's also targeting 100% fully recyclable packaging by 2025.

Similarly, Adidas is enhancing its brand among environmentally-aware consumers. In collaboration with Parley Ocean Plastic, it is using recycled ocean plastic to make running shoes. More broadly, Adidas has a target of only using recycled plastics by 2024. For Adidas, making running shoes that help to remove plastic from the sea is an opportunity to grow sales and look after the planet.

Embracing sustainability can also boost a company's competitive edge beyond simply its brand. Turning to a less well-known business, Trex is a US company that has recycling at the core of its business model and is steadily becoming more profitable. Trex manufactures decking from recycled plastic mixed with wood shavings and is one of the largest recyclers of plastic in the United States. Ninety five percent of a Trex deck is made from recycled plastic. In fact, a standard 16-foot (around 4.9 metres) Trex board contains approximately 2,250 plastic bags.

For Trex, recycling has proved exceptionally good business sense. Not only is it doing good for the environment, but also scrap plastic is far cheaper than the virgin plastic used by rivals. Further, a product that is easier to maintain than wooden decking is highly attractive. The result? Steadily rising revenues, a cost advantage over its peers and a growing market share.

A disruptive theme

If businesses do not act quickly enough to adapt to consumers' growing concern about the environment, they risk seeing their competitive advantages being undermined. These businesses are likely to be the losers over the long term.

In a world where consumer tastes are changing fast, environmental sustainability is becoming an increasingly important theme. In a similar way to ground-breaking tech businesses, sustainability pioneers can gain a powerful competitive edge. If they do that in a way that leads to predictable growth in profits, then they can be compelling investments.

ESG analysis, especially regarding the environment, has become an essential part of the long-term investor's tool kit. That is why companies with "purpose" should have a place in portfolios.

Sources:

1. Source: The Conference Board Global Consumer Confidence Survey, conducted in collaboration with Nielsen, Q2 2017. https://www.nielsen.com/us/en/insights/report/2018/the-education-of-the-sustainable-mindset/

Why the 21st century belongs to Asian investors

There is a huge shift in economic activity towards the east, all of which requires financing.

If the 19th century belonged to Europe, and the 20th century to the United States, then the 21st must belong to Asia. So argue many economists and investors.

It is easy to see why. Take China, clearly the major driver of Asia's economic transformation. Since 1990, the country's gross domestic product (GDP) per capita has risen over tenfold, much faster than the global economy and faster even than most emerging markets. Measured on a purchasing-power-parity (PPP) basis, which adjusts for the domestic cost of goods and services in local currency, the Chinese economy became the world's largest in 2013.[1]

Indeed, since 1979 when it first opened up to foreign trade and introduced free-market reforms, through to 2018, China has delivered real annual GDP growth averaging 9.5%, a feat the World Bank described as "the fastest sustained expansion by a major economy in history."[2]

These changes have been felt across the country. There are now less than 10 million people in China living in extreme poverty, down from 750 million in 1990.[3] At the other end of the scale, according to the Hurun Research Institute, there are over 600 billionaires in China, on a par with the US.[4]

From consumer power to infrastructure

But the Asia story goes way beyond China. Since 2015, Indonesia, the world's fourth largest country by population, has jumped 34 places in the World Bank's Ease of Doing Business rankings.[5] In Vietnam, between 2002 and 2018, more than 45 million people – almost half the population – have been lifted out of poverty.[6]

Asia is already home to over half the world's population. And, by 2030, more than 60% of the world's middle class will live in Asia-Pacific. Indeed, China and India will each

account for a greater share of global middle-class consumption than the US.[7] Since 2007, Asians have been buying more cars and trucks than people in any other region – by about 2030 they will be buying as many vehicles as the rest of the world combined, according to LMC Automotive.[8]

This belies a wider trend across much of Asia and in China in particular: a steady evolution of their local economies where imports are playing an ever more important role. From now until 2030, on the back of a burgeoning middle class, China's consumption growth is expected to exceed that of the US and Western Europe combined.[9]

But the Chinese government, a key driver of wider economic transformation across Asia, has much bigger ambitions than that. Under its "Made in China 2025" initiative, it has outlined 10 key sectors from biomedicine and IT to robotics, where it wants to be a leading global player. And through its forging of closer commercial and economic links across the Asia Pacific region via the Regional Comprehensive Economic Partnership (RCEP) – a proposed free trade agreement between the member states of ASEAN and six other members including China, India and Japan – this prosperity is likely to be shared across what will be the world's largest economic bloc.

Then there is Beijing's Belt and Road Initiative (BRI), a multi-billion dollar infrastructure investment project co-ordinated across almost 70 countries and designed to create a new commercial corridor, or 21st century "Silk Road", between East Asia and Europe. According to a recent study by the World Bank, BRI transport projects, if fully completed, could increase global trade by between 1.7 and 6.2%, and raise global real income by between 0.7 and 2.9%.[10]

Swelling financial markets

All this investment and economic activity requires financing. And this has helped underpin rapid growth in Asia's debt and equity markets. Today, Asian companies are the world's largest users of public equity financing.[11]

In 2017, a record number of 1,074 companies listed in Asia, almost twice as many as the annual average between 2000 and 2016. This strong initial public offering (IPO) activity reinforced Asian companies' status as the largest users of public equity markets globally. At the end of 2017, of the approximate 50,000 companies listed worldwide, almost half were listed on Asian stock exchanges, equating to around 40% of global market capitalisation.[12]

At the same time, Asia has grown in importance in the corporate bond markets. Between 2007 and 2017, Asia's global share of corporate bond issuances tripled to 32%.[13]

Asia has several of the world's largest economies, most of the world's foreign-exchange reserves, and is playing an ever more important role in global financial markets. Regional investors will increasingly find some of the world's best opportunities on their doorstep.

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2. Congressional Research Service, https://fas.org/sgp/crs/row/RL33534.pdf
3. The Economist, https://www.economist.com/graphic-detail/2018/10/27/the-chinese-century-is-well-under-way
4. Hurun Research Institute, https://www.hurun.net/EN/Article/Details?num=CE08472BB47D
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Ten European surprises for Asian investors

The continent hosts world-beating companies with competitive advantages which underpin robust growth and sustainable shareholder returns.

Emerging markets are the future, Europe is the past. That's what conventional wisdom would have you believe. But at Columbia Threadneedle Investments, we think differently. Exciting investment opportunities can be found all over the world and Europe in particular remains a hotbed of corporate growth stories.

We find a hugely varied range of investment opportunities, but they have one thing in common. Many of Europe's leading companies boast "economic moats" which keep the competition at bay. Using the Porter's Five Forces framework for analysing a company's competitive environment and pricing power, we find trailblazing European companies. The combination of moats and pricing power creates business models which can sustain high returns that the stock market should reward with premium ratings.

Despite Europe's recent lacklustre economic growth, it is home to many leading companies operating in international markets.[1] Formidable competitive advantages protect their expanding earnings, making them attractive investments.

Here are ten facts Asian investors might be surprised to learn about Europe.

1. Companies with a secret ingredient

Clean eating is more and more important to consumers across the globe. European companies pioneer the science behind natural ingredients. While they may be invisible to consumers, their products drive millions of consumer decisions every day. The probiotics in yogurt, the culture that ferments exquisite cheese and the essential enzymes in infant formula are all part of a portfolio of patents developed by the Danish company, Christian Hansen. Taking natural extracts, innovative Swiss and German companies such as Symrise, Firmenich and Givaudan produce the distinct flavours, fragrances and aromas that go into consumer products including fine perfumes, cosmetics, beverages and pet food. These are highly successful companies and command market share in their sector.

2. Spotify was founded in Sweden

When most people think of successful technology companies, US leaders like Google, Microsoft and Apple spring to mind. However, Europe too boasts a very successful technological ecosystem. Many of the world's leading talents in technology see the appeal of living and working in cities like Amsterdam, London and Berlin. So it's no wonder that companies like Rightmove, Takeaway.com, Adyen and Spotify were founded in Europe. Once they have introduced a key technology, these sorts of companies tend to grow quickly, leaving little room for competitors and creating a sweet deal for investors.

3. Some of the biggest crises turned into the biggest recoveries

That some European countries fell victim to the global financial crisis is well documented. But these countries have also engineered spectacular recoveries. Ireland and Iceland are two remarkable success stories.

Figure 1:
Iceland real GDP growth (%)

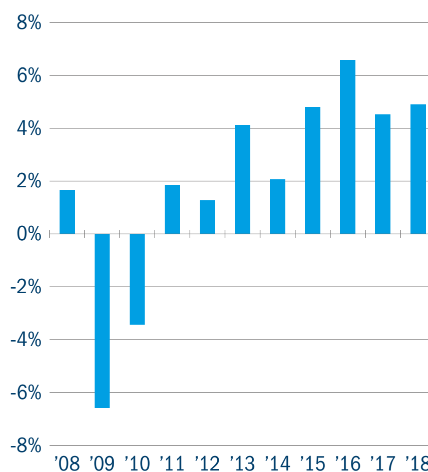
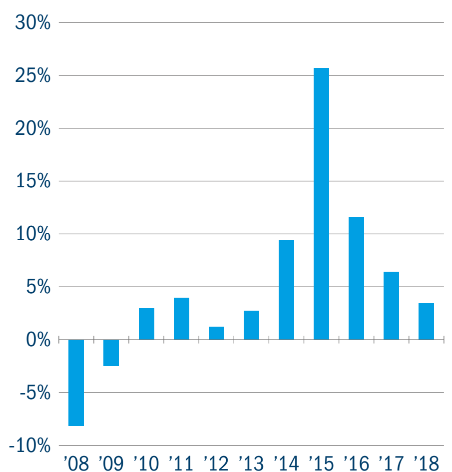


Figure 2:
Ireland real GDP growth (%)



Source: World Bank GDP data (data.worldbank.org).

4. European companies are turning the continent's ageing population into a positive

People in industrialised nations are living longer and populations in emerging and developing economies are growing – this puts tremendous pressure on healthcare. Europe has been facing the challenges of an ageing population for a long time, which has compelled European companies to become front-runners in offering appropriate solutions. For instance, European technology leaders in optics, Carl Zeiss and EssilorLuxottica, serve many critical markets including medical technology and semiconductor manufacturing equipment, as well as vision care. Those concentrated on specialized care such as Orpea provide the highest standards in services for the elderly.

5. European brands are a byword for luxury

It is very difficult to compete with the history and heritage of European luxury brands. Visit any shopping mall in the world and non-European brands are harder to find. Louis Vuitton, Hermes, Kering and Prada are global leaders in luxury leather. Commanding the highest market share in beauty globally, L'Oreal has an impressive portfolio of luxury cosmetic products. Some of the most distinguished brands in jewellery and luxury watches are owned by European companies such as Swatch and Richemont, which dominate their respective industries. After all, who can better the brand power of a Swiss watch, an Italian leather handbag or a French perfume?

6. Europe's businesses have global appeal

Investors may worry that Europe's largest businesses are vulnerable to the region's ups and downs, both political and economic. But many are global businesses with highly diversified sales. More than two thirds of the sales generated by MSCI Europe top 100 companies are from outside Europe, often in high-growth economies.

7. Fancy a premier branded beverage?

From Campari to Aperol, Pernod to Remy Martin, the main luxury wine and spirits brands are European. Some of this is an accident of history and indeed the brands, the vineyards and the production processes are centuries old. However, the Europeans are experts at fortifying their unrivalled brands. Champagne is a terrific example of a product with an economic moat: sparkling wine produced outside France's Champagne region cannot be called "champagne", and the same can be said of cognac in the spirits sector.

8. France revived the Olympics

Most people know that the ancient Greeks inspired the Olympics, where almost every nation in the world is represented. But did you know that the modern Olympics were revived by a Frenchman, Charles Pierre de Frédy, Baron de Coubertin? So French is always spoken first in any Olympic proclamations. Europe's stewardship of this world-renowned sporting event illustrates the powerful influence which dynamic Europeans can play on the world stage.

9. Six of the ten most visited countries in the world are in Europe

While Thailand's beaches tantalise some and New York's skyscrapers others, Europe remains the most popular destination for globe-trotting tourists. France is the most visited country in the world, with Spain in second place. Italy, the UK, Turkey and Germany also feature in the top ten. Europe may be hindered by slow short-term economic growth, but the power of history gives many of its tourist-focused businesses a major competitive advantage.

10. Lego is the biggest tyre manufacturer in the world

Forget Bridgestone in Japan, Danish company Lego is one of the biggest tyre manufacturers in the world (for use on vehicles in its Lego building sets).[2]

Sources:
1. World Bank GDP data (data.worldbank.org).
2. https://en.wikipedia.org/wiki/Lego_tire

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Strategies that benefit from volatility

While 2019 proved a buoyant year for all financial markets, the first weeks of 2020 have proved volatile. Asian investors who remember previous corrections are looking for sophisticated strategies fit for all market conditions.

Financial markets proved unpredictably buoyant in 2019. Although the fog of US-China trade frictions hung over them, and economic growth faltered, both equities and bonds ended the year far higher than they started it.

The MSCI AC Asia ex Japan Index climbed almost a fifth (18.17%).[1] Unusually, bonds also rallied, with US 10-year Treasury bond yields falling from 3.2% in October 2018 – when the US Federal Reserve was still raising interest rates – to 1.84% in early January 2020.[2]

Synchronised weakening in economic activity across the globe led the US Fed and other central banks to perform a policy U-turn in the first half of the year after the Fed cut rates twice in 2019. And, the European Central Bank controversially restarted quantitative easing.

Looser monetary conditions have proved a balm for financial markets, although volatility has returned in early 2020 as the rapid spread of the coronavirus in China has has sparked fears over what was already expected to be a muted recovery in economic growth. Indeed, the World Bank's most recent forecasts see global GDP growth picking up from 2.4% last year to 2.5%.[3] Even so, valuations in equity and bond markets remain relatively high, with the economic cycle ageing and trade friction undermining business confidence. This raises the possibility that still more market volatility could be around the corner.

An uptick in volatility could present rich pickings for long-short equity strategies, also known as "extended alpha". With their focus on fundamental stock picking, they benefit as companies' fortunes diverge. Unsettled markets trigger price dislocations, creating investment opportunities for the stock pickers who run these funds. They can navigate market volatility, through short selling and altering gross exposure to equities.

At the same time, the principle behind extended alpha funds is that your gains will be more closely linked to the difference between the best and worst performing stocks than the market's performance – and so less susceptible to volatility.

Matching long and short exposures

Over the last decade when low-cost beta strategies in the form of exchange-traded funds have become popular, long-short

strategies have continued to offer investors a highly effective way to source alpha. The managers behind these funds have ratcheted beta and alpha exposure up or down, depending on the market outlook and clients' risk appetites.

At Columbia Threadneedle Investments, we have a range of extended alpha strategies. We meet companies and conduct fundamental research, using our trusted stock picking approach that relies on Porter's Five Forces as a key tool to assess the pricing power of companies for our long positions. High-quality companies with strong pricing power can compound their earnings yields powerfully over time, generating outsized gains.

Most of the strategies' short books are made up of relative pair trades, which are expected to underperform the corresponding long holdings in the same sector. The portfolios also have short positions where events such as disappointing earnings, competitive product launches etc. are expected to trigger price falls.

Fine tuning market exposure

But not all extended alpha strategies are the same. Investors can choose between strategies that share the same investment approach, yet offer different levels of risk. The typical extended alpha strategy offers equity-like levels of market risk, while market-neutral funds are designed to offer absolute, or cash-plus, returns. This results from varying net market exposures: an extended alpha strategy might range from 90% to 110% and market neutral from -10% to +50%.

Taken together, the two strategies offer a unique combination that enriches the wealth manager's opportunity set, particularly in current market conditions.

The scarcity and appeal of high-alpha equity portfolios has increased with the rise of passive funds, making a strong case for long-short equity with high-alpha potential. These strategies allow for a full range of market exposures, and they can be used separately or combined to fine tune client portfolios.

Demand for sophisticated strategies

While the mood in Asian markets has lifted in 2019 and 2020, the equity market rout of 2018 is not long ago. That was the worst year in a decade for China's equity market – the Shanghai composite index fell by almost a quarter, or 24.6%,[4] unsettled by the trade war and a slowdown in growth.

That has resulted in many Asian investors looking for sophisticated strategies able to benefit, rather than suffer, from volatility.

Sources:

1. Source: MSCI.
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3. Slow growth, policy challenges; World Bank Group; January 2020.
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Indian economy: problems pile up for Narendra Modi

Amy Kazmin in New Delhi
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New Delhi's Gandhi Nagar market is one of India's largest garment wholesale hubs, jammed with inexpensive, ready-made garments for the aspirational but price-sensitive lower middle class. The vast array of kids' party wear, elaborately-embellished jeans and other clothes draws traders from across north India, who stock up on merchandise to sell in small-town shops and rural bazaars.

Typically, the run-up to the annual Diwali festival is the market's peak season, when the narrow lanes are so jammed with buyers hauling clothes it is difficult to move. But this year, traders complain, the festive shopping season has been gloomy, with sales falling precipitously as a deepening economic slowdown hurts ordinary Indians.

Hit by lay-offs, pay cuts and reduced earnings, anxious consumers are tightening their belts. "For common people, these are luxury items," says Sahil Nangru, 26, whose small business makes children's outfits, selling them wholesale for around Rs500 ($7) a set. "People do not have money in their hands these days. Businessmen do not have money to invest."

Weak consumer demand is fuelling a vicious downward spiral. In recent weeks, Mr Nangru and his partner, Pradeep Chawla, have shut down two of their four small garment-making workshops, and laid off 25 workers. "For the last three or four months, we've had absolutely no work," says Mr Chawla. "Now because of Diwali we've had some orders. But if we have no business, we have to let the workers go, it is natural."

The gloom at the market reflects the malaise in India's economy, now under the spotlight after the hoopla of prime minister Narendra Modi's security-focused re-election campaign – and his triumphant victory just six months ago.

Not that long ago India was revelling in its status as the world's fastest-growing large economy. It seemed on the cusp of its aspiration of growth rates of 9 to 10 per cent – the pace economists say is necessary to create sufficient jobs for the estimated 12m Indians entering the workforce each year.

But since the second quarter of 2018 – when gross domestic product grew at a brisk 8 per cent year on year, India's economy has steadily lost steam. GDP growth sank to just 5 per cent in the three months to June 2019, its slowest pace in six years. And as the economy skids, India's millions of self-employed, vulnerable contract workers and farmers have all taken a hit.

"People's businesses have collapsed," says Nidhi Varma, who runs a small shop in a Delhi mall, and has watched as other shops shut down around her in recent months. "People don't have enough profit to pay rent."

Before the election, Mr Modi's government had brushed aside warnings of economic fragility, dismissing them as too pessimistic and politically motivated. But with the deepening economic distress impossible to ignore, debate is mounting over precisely what ails the economy, the root cause of the slowdown, and how long it will last.

New Delhi insists the difficulties are a cyclical blip, brought on by tumultuous international conditions. But many economists believe the slowdown is of India's own making – the result of policy mis-steps, sluggish market-oriented reforms and Mr Modi's failure to resolve problems in the financial system left by over exuberant lending during the previous Congress administration.

"Blaming it all on the outside is too easy," Raghuram Rajan, former Reserve Bank of India governor, said in a recent lecture, his first on the state of the Indian economy since leaving the job in 2016. "India is poor. It has a lot of potential for growth on its own, without relying on the outside. Why aren't we growing at 7 or 8 per cent?"

Private investment has been muted for nearly a decade since the global financial crisis. New Delhi has little fiscal firepower left for stimulus, with an annual public deficit – including the centre, states, and state-owned entities – estimated at nearly 10 per cent of GDP.
Now, private consumption is faltering, as the public mood darkens, and easy consumer credit dries up after last year's shock collapse of Infrastructure Leasing & Financial Services, a major finance company.

According to the most recent RBI consumer confidence survey, Indians' optimism about their future prospects is ebbing away. Families have been living beyond their means, drawing down savings and taking loans, expecting better days ahead, government statistics

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Narendra Modi's cash ban invalidated overnight 86% of the country's currency in circulation

show. From 2012 to 2018, household savings fell from 23.6 to 17.2 per cent of GDP. Household debt has risen sharply, though at 11 per cent of GDP it remains low by regional standards.

"There is a general environment of extreme risk aversion," says Gagan Banga, vice-chairman of Indiabulls Housing Finance. "Today we have a situation where the business community in general is scared to invest, the consumer is scared to consume, and lenders are scared of lending both to business and consumers because they feel that the money will get stuck."

India's automotive industry – which accounts for around 40 per cent of manufacturing GDP – suffered a contraction in passenger and commercial vehicle sales of 23 per cent year on year from April to September. Sales of motorcycles and other two-wheelers – often a leading indicator of the strength of the rural economy – contracted 16 per cent. Other industries, from fast-moving consumer goods to aviation, are slowing.

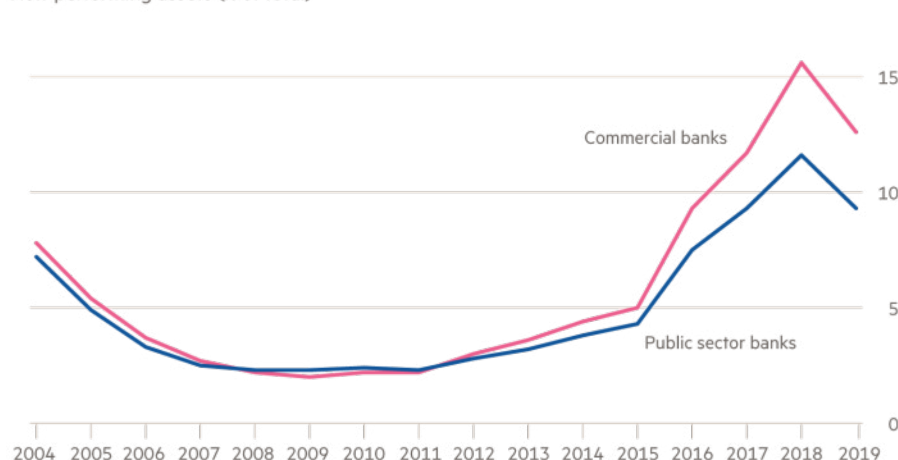
India is forecast to grow 6 per cent this financial year, but some see that as over-optimistic. Arvind Subramanian, the government's former chief economic adviser, dropped a bombshell in June, when he argued that India's official GDP statistics probably overstated growth by 2.5 percentage points a year from 2011-12 to 2016-17.

Though the government has rejected his claim, many economists in India and abroad have questioned the credibility of India's headline GDP growth in recent years, which have often appeared at odds with weaker underlying data. Mr Subramanian, who says he raised his concerns about the data when in government, believes India has been struggling since the global financial crisis.

"The malaise is not recent," he said recently. "Essentially, India never recovered from the global financial crisis. Investment and exports – the main engines of growth for developing countries – have never recovered."

India is trying to tackle its bad loans problem

Non-performing assets (% of total)



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Raghuram Rajan, former Reserve Bank of India governor: 'Blaming it all on the outside is too easy' © Bloomberg

Others believe Mr Modi's policies – to clean up and formalise a notoriously corrupt business culture – have also taken a toll, inflicting severe disruption on two of the country's most employment-intensive sectors.

His draconian 2016 cash ban – through which 86 per cent of the country's currency in circulation was invalidated overnight – and the chaotic rollout of a new tax system were knockout blows for millions of small, informal enterprises that had operated beyond the tax net. Many could not cope with either the goods and services tax's technical or financial demands. Real estate was also hard hit, leaving developers with a vast inventory of unsold and unfinished buildings.

"The sequence of demonetisation and the GST essentially was the straw that seems to have broken the Indian economy's back," Mr Rajan said.

The aggressive anti-corruption drive has also unnerved corporate India, deterring investment. Businessmen say officials seem to view all entrepreneurs as inherently suspect, and treat corporate distress as evidence of deliberate malfeasance.

"Many parts of business in India were like a dirty white shirt," says Uday Kotak, chief executive of Kotak Mahindra Bank. "India needed to clean it with soap and a wash, but we must take care that in the wash process, we avoid tearing the shirt."

But it has left many businesses struggling to deleverage and survive the crunch. "There was an underlying shakiness and shoddiness in lending and governance standards," says Saurabh Mukherjea, founder of Marcellus Investment Managers. "The general prosperity in the country and the abundance of black money masked that shoddiness. As the tide of black money goes out, you can now see who is standing naked."

It is a far cry from the kind of job-generating economic boom Mr Modi was expected to deliver back in 2014, when he promised to bring "good days" to a young, restless population. "It's a crisis," economist Abhijit Banerjee said days before he won the Nobel Prize this month. "People are poorer now than they were in 2014-15."

In public, Mr Modi, and his cabinet, still talk grandly of India – now a $2.9tn economy – growing into a $5tn economy by 2024. Finance minister Nirmala Sitharaman has blamed the auto industry's woes on millennials, who prefer using Uber to car ownership. A government minister pointed to the strong box office take for the latest Bollywood films on their opening weekend as evidence of India's sound economic fundamentals. Members of Mr Modi's Bharatiya Janata party insist that the recovery's "green shoots" are visible.

Independent economists warn that India's many serious vulnerabilities – including overstretched public finances and the fragile financial system, including shaky shadow banks – will continue to weigh on the country's prospects.

They say New Delhi has failed to recognise the severity of the financial system's non-performing loan problem, or the risks posed by the fragility of shadow banks and housing finance companies, which are themselves big borrowers from mainstream lenders. Rating agency S&P has also warned of the rising risk of contagion from the possible collapse of shadow banks.

"The financial system is jammed and firms are reluctant to invest – and this is at the heart of India's challenge," Mr Subramanian said, calling New Delhi's "under-recognition of how serious the problem is" a major hurdle.

New Delhi boasts of stopping politically-directed lending to influential tycoons, once a pillar of the state banks' business model. But as it struggles to revive growth, it is pushing lenders to ramp up credit to small enterprises and households instead. During a recent nine-day "loan festival", lenders pushed out $11.5bn in credit to small borrowers, raising questions about due diligence.

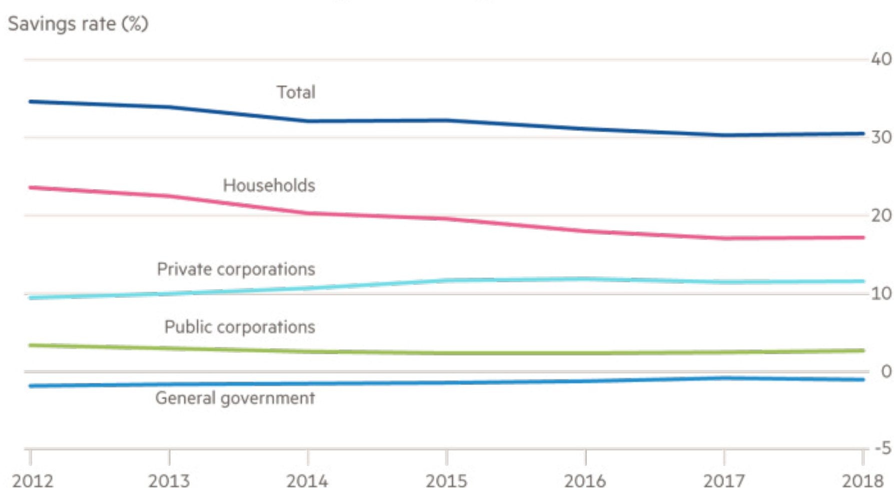
"A public sector dominated banking system cannot serve the needs of an expanding economy," says Ila Patnaik, professor at the National Institute for Public Finance and Policy in New Delhi.

Mr Modi's unassailable political position gives the government a freer hand to push through contentious, market-oriented economic reforms. New Delhi just announced a $20bn corporate tax cut to make India a more competitive investment destination.

Amitabh Kant, chief executive of Niti Aayog, a government think-tank, says privatisation of state enterprises, and major reforms in sectors like agriculture and mining, are on the agenda. He also insists recent painful disruptions will bear fruit with the emergence of a healthier business sector.
"This government is fully committed to a high trajectory growth path," Mr Kant says.

Mr Kotak is also cautiously optimistic that India will gradually bounce back, especially if fresh steps are taken to tackle the shadow banks. "We will take some time to navigate our way out of this – it's not something that will happen overnight," he says. "But in India, it's never as bad as it looks. And it's never as good as it looks either."

Additional reporting by Jyotsna Singh



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Inflation: Fight over onion prices makes farmers weep

India is one of the world's biggest exporters of onions, selling some 2.1m tonnes of the vegetable – worth nearly $500m – to foreign buyers in the past financial year. But last month, prime minister Narendra Modi's government roiled the global market when it abruptly banned all onion exports after unseasonal rains damaged much of the standing crop, driving local prices to a six-year high.

Surging prices for onions, staple of Indian cookery, have been known to ignite the wrath of Indian consumers. But the export ban highlights how farmers have been squeezed by New Delhi's focus on controlling inflation and ensuring stable food prices for urban consumers.

Spiralling food prices dogged the previous Congress-led government, contributing to its unpopularity, especially among urban voters. Through bulk commodity imports, sporadic export restrictions and limiting increases in the state procurement price for wheat, rice and other commodities, Mr Modi has successfully tamed food price inflation.

But the policies are fuelling rural distress, say economists. To ease the pain, the government is providing Rs6,000 ($85) in annual income support to each of India's 145m farmers, at a price to the exchequer of $12bn a year. The cash support follows the rollout of social welfare schemes, including the provision of cooking gas cylinders, toilets and health insurance to poorer families.

But former central bank governor Raghuram Rajan warns that without stronger growth and healthier public finances such initiatives are unsustainable. "The government has been fairly successful in expanding its welfare programmes, which gives it a lot of political capital among people," he says. "But you can't keep spending without generating new growth, so something will have to give."

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