On 24 February, Russian forces launched a military attack on parts of Ukraine. Various Western nations subsequently responded by imposing a range of sanctions. In this investment note, Ronald Chan, Chief Investment Officer, Asia ex-Japan equities, explains why amid great uncertainty, despite the prospect of higher energy prices and increased volatility, certain Asian equity markets could potentially add diversification to investors' portfolios.

The potentially defensive properties of Asian equities

Although Russia has maintained a significant military build-up on the borders of Ukraine for weeks, the full-scale military action still came as a surprise to investors.

In this environment of great uncertainty, it is impossible to foresee the future. However, we believe history may offer investors a base case for the potential trajectory and risks posed by current events.

In 2014, Russia annexed the Crimea Peninsula from Ukraine. Major western powers subsequently imposed sanctions (primarily financial), but military operations were limited. The current situation differs in some key respects, as the prospect of a military conflagration is now more significant, and sanctions could be stiffer. However, the events of 2014 did lead to two main outcomes: heightened market volatility and elevated energy prices. We believe these two features will influence the global equity landscape moving forward.

If that base case is roughly accurate, or at least the military conflicts are locally contained, Asia might offer diversification opportunities to equity investors. This potential benefit would largely depend on the duration of the conflict's impact on global growth, and whether the conflict expands to other geographies. A significantly longer or expanded conflict with more severe sanctions than those currently released would negatively impact global growth, which would also hit a still recovering Asia.

Market participants have recently been looking for opportunities outside of the US due to elevated inflationary pressures and the Federal Reserve's hawkish stance towards rate hikes. Some have chosen Europe due to favourable valuations and accommodative monetary policy. Yet, the continent is arguably more exposed to Russia and, in turn, market volatility through greater investment and energy ties.

Overall, we believe Asian equity markets remain attractive, as their valuation levels are below the historical average. Additionally, some of the region's markets could benefit from their lower (beta) correlation to global markets, continued reopening plays, and higher energy prices.

Dual flexibility for China: Energy and monetary policies

We believe China's equity markets should hold up relatively well. It is important to note the country will be affected by the conflict. As a voting member of the United Nations Security Council, it will need to provide important input on sanctions issued by Western powers, as well as the bilateral economic and political support it lends to Russia during the conflict amid greater public scrutiny.

Beyond that, the country's energy security has improved over the past five years. For instance, its rich coal deposits, although not a primary option with current decarbonisation priorities, could be relied upon to provide a stop-gap measure if other energy sources become too expensive. Additionally, Beijing

has just signed a 30-year agreement with Russia to provide natural gas via a Siberian pipeline.

Potential tailwinds for China A-shares and select ASEAN markets

From a market perspective, A-shares should remain resilient. The People's Bank of China has significantly loosened monetary policy, which provides countercyclical support to the economically important real-estate sector and could boost lagging consumption. With strong plays in the healthcare and sustainability space, coupled with potential support for exporters of basic and consumer goods, we are overweight in the market.

We are also positive on select ASEAN markets, primarily the oil-exporters that should be more resilient in an elevated energy-price environment: these include Malaysia, Indonesia, and Vietnam. Additionally, any slowdown in the pace of rate hikes due to the military conflict would also benefit emerging markets in Asia.

In contrast, we are underweight in India. Indian equities enjoyed a strong run in 2021 on the back of comprehensive fiscal and monetary stimulus, as well as robust earnings growth. This year has proved more challenging due to lofty market valuations. In our view, if oil prices remain near $100 a barrel for a prolonged period, this could reduce major companies' earnings and weaken the rupee. It could also amplify existing inflationary pressures and cause the Reserve Bank of India to normalise monetary policy faster.

On our radar: global growth and Fed rate hike

With this significant geopolitical event, it's important to monitor its macroeconomic implications, as most economies are now positioned for re-opening (for services like tourism) and rate normalisation (to cool down inflation). Indeed, with potential heightened geopolitical uncertainties, travel and cross-border activities might be confined, which limits the demand for consumer discretionary and services, and likely the global growth trajectory.

Although markets have widely expected the Fed will increase rates at its upcoming March Federal Open Market Committee meeting (15-16 March)[1], our base case for the Fed rate hike trajectory is that the Fed will normalise rates in the first half to tame rising inflation but will pause for a while before the mid-term election. Indeed, during heightened volatility and market uncertainties, liquidity is key to relieve stress from the system.

[1] For the remaining of 2022, Federal Open Market Committee will hold regular scheduled meetings in March, May, June, July, September, November and December.

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