Asia Market Outlook | Q4 2023

Slowing global growth remains a headwind but policies should be more supportive.

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Q3 Returns Recap: China Selloff Accelerates, Japan Banks Get Lift From BoJ Policy

The third quarter was challenging for the equity markets in Asia. The U.S. labor market stayed robust, raising worries of higher interest rates, while China economic data continued to slip, prompting cuts in growth expectations. Although interim results were largely in line, guidance tended to disappoint.

Energy and technology, the two leading sectors in the first half, saw divergent performance in the third quarter. The technology sector led losses amid a more tepid outlook on the global slowdown. The energy sector saw relatively robust gains as oil prices moved higher following Saudi Arabia's output cut.

Industrials, which gained 7.24% in the second quarter following buying of Japanese trading companies, fell back as global growth risks raise worries of a prolonged downcycle for machinery and equipment manufacturers.

Financial services gained as Japanese banks outperformed on news that the Bank of Japan is widening its yield curve policy. The consumer cyclical sector was relatively stable, helped by China e-commerce giant PDD's 42% jump following strong interim results.

Third Quarter Returns by Sector

The Morningstar Asia Index fell slightly, with relative strength in financials and energy offsetting a pullback in technology.

Cyclical Sectors	All	Sensitive Sectors	All	Defensive Sectors	All
Basic Materials	-0.74%	Comm. Services	-3.76%	Consumer Defensive	-1.44%
Consumer Cyclical	1.95%	Energy	7.13%	Healthcare	-3.93%
Financial Services	2.00%	Industrials	-3.06%	Utilities	0.33%
Real Estate	-2.50%	Tech	-6.15%		

Source: Morningstar. Data as of Sept. 30, 2023.

Energy Is Relatively Expensive but Almost Everything Else Is Attractive for the Midterm

While we were correct in our caution over the sensitive sectors in the third quarter after the group had largely outperformed in the first half of 2023, the rest of the markets minus the energy sector generally struggled.

The near-term news flow warrants further caution. As such, we would not be surprised to see energy and defensive sectors outperform in the fourth quarter. We think energy will remain in favor given the rise in geopolitical risks with the Israel-Hamas war. However, a quick resolution should lift worries. The risk to prolonged energy outperformance is the global growth slowdown. We think this is possible the longer that interest rates remain at a high level.

Regardless, we think value exists for investors willing to sit through the uncertainty. Looking through the cycle with interest rates likely peaking, we think second-half 2024 should be more conducive to Asian equities.

We expect increasing China fiscal spending to help put a floor to consumer confidence in the mainland. The recent Golden Week spending reflected continued consumer caution, but we believe we are seeing initial signs of some stability. Consumer spending data released by the National Bureau of Statistics is reflecting a gradual improvement over June-July lows.

Morningstar Price/Fair Value by Sector

Cyclical Sectors	All	Sensitive Sectors	All	Defensive Sectors	All
Basic Materials	0.85	Comm. Services	0.73	Consumer Defensive	0.87
Consumer Cyclical	0.81	Energy	1.06	Healthcare	0.84
Financial Services	0.87	Industrials	0.92	Utilities	0.69
Real Estate	0.72	Tech	0.88		

Source: Morningstar. Data as of Sept. 30, 2023.

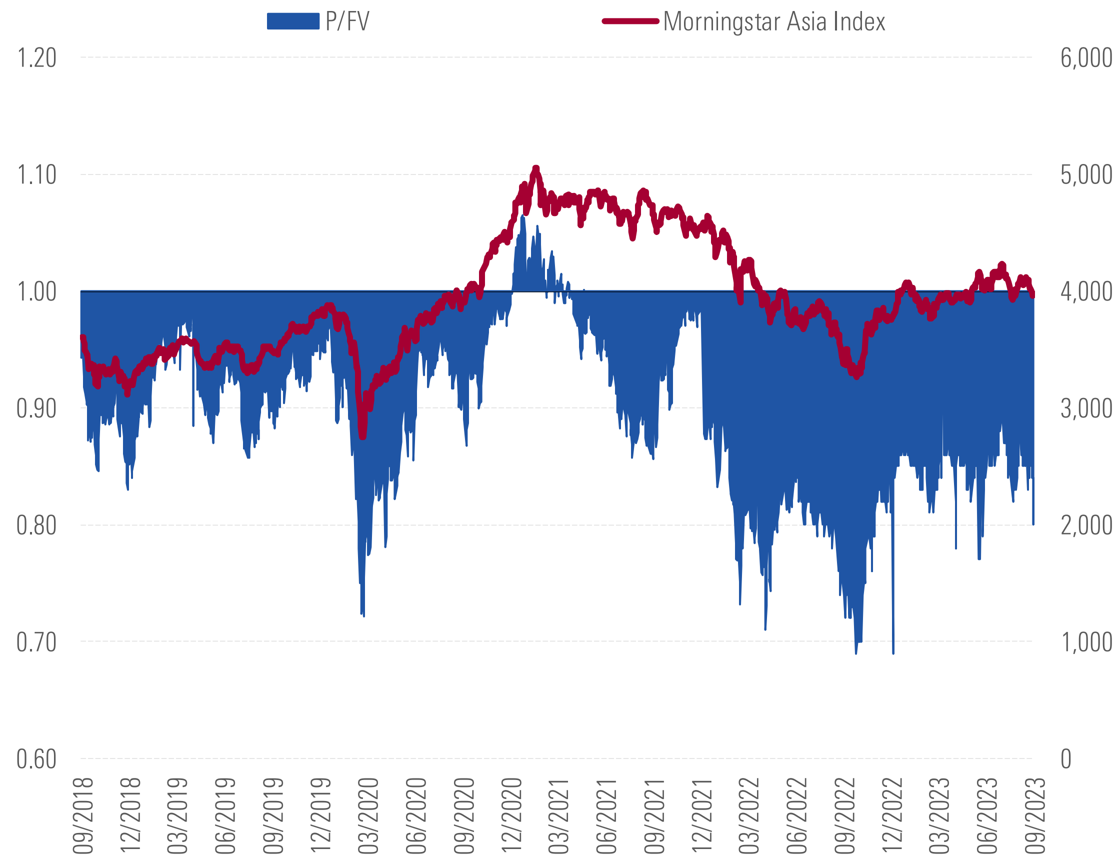
Discount Remains — Asia Drifts to a 16% Upside to Our Fair Value Estimate

Our coverage universe reflects a 16% discount to our fair value estimate. Much of this comes from the China issues, while Japan is close to fairly valued following its relative outperformance in the past six months.

While there is a broad discount, we see news pointing to continued risks from global macroeconomic factors such as weaker global growth, heightened geopolitical tensions, and interest rates being unlikely to reverse until the second quarter of 2024. As such, we prefer to remain selective. There are definite buying opportunities of quality names for investors willing to sit through the bottoming cycle in China.

The latest consumer spending data implies some stabilization, which we attribute to supportive fiscal and monetary policies. However, we think consumer spending growth in September at 5.5% year on year is off a low base and with real estate risks still lingering, there remains risks that confidence could still pull back. However, we do believe that China can afford to do more. This will have to be weighed against global growth headwinds.

Our Asia Coverage Is Trading at a 16% Discount to Fair Value

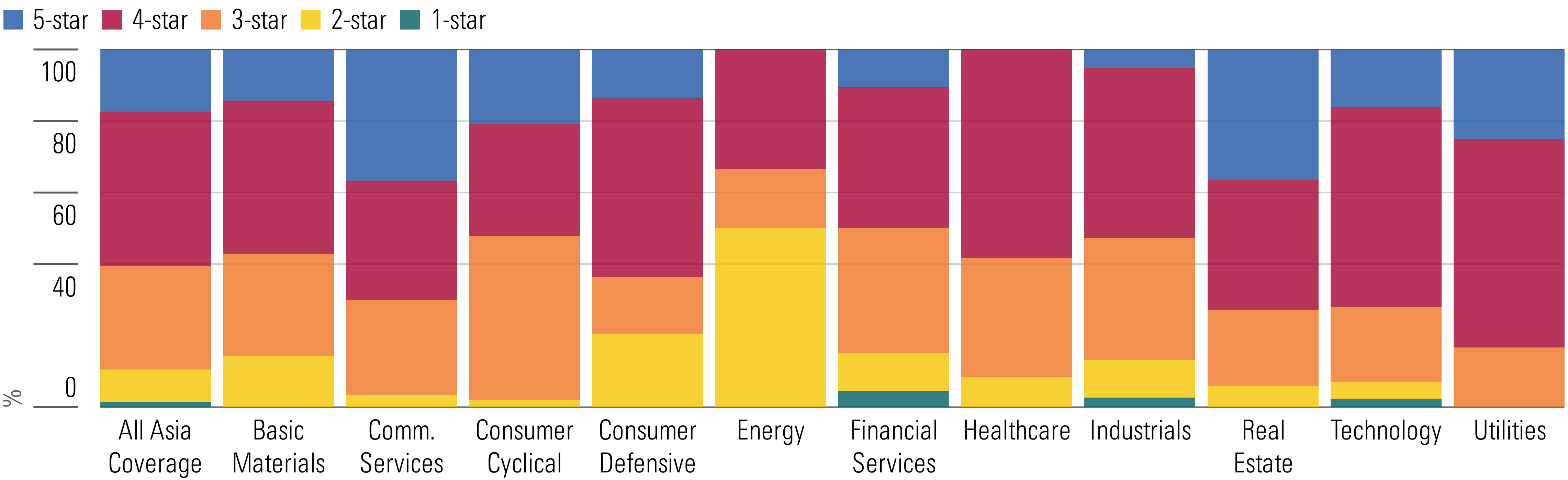


Source: Morningstar. Data as of Sept. 30, 2023.

Prefer Defensive Issues in the Short Term, Selective Sold-Down Opportunities

We see more buying opportunities than not in Asia. However, we think heightened geopolitical risks favors defensive issues in the fourth quarter. Within our coverage sectors, we see a larger portion of buying opportunities within utilities. Among the economically sensitive and cyclical sectors, the selloff in tech issues in the third quarter presents opportunities to collect shares in the sector. Real estate remains among the cheapest and we would be selective, with select REITs expected to outperform when interest rates reverse. We continue to expect a choppy and slow recovery in the China real estate sector, which favors select state-owned developers.

Star Rating Distribution by Sector



Source: Morningstar. Data as of Sept. 30, 2023.

Cyclical Sector: Top Picks

Our list of cyclical picks turned in a flat average return of 0.3% in the third quarter. This was nonetheless an improvement over the decline of 7.6% in the second quarter. We made two changes to our cyclical list, swapping in Agricultural Bank of China for China Merchants Bank and Wharf REIC for Swire Properties. While PDD's stellar performance last quarter leaves the stock with a 3-stars rating, we leave the name here as our near-term preferred China e-commerce pick.

Cyclical Sector Top Picks

Name/Ticker	Sector	Economic Moat	Currency	Fair Value Estimate	Price	P/FV	Uncertainty	Morningstar Rating
CNOOC (00883)	Basic Materials and Energy	None	HKD	18.00	13.10	0.73	High	★★★★
Anhui Conch (00914)	Basic Materials and Energy	Narrow	HKD	37.50	19.92	0.53	High	★★★★★
Tianqi Lithium (09696)	Basic Materials and Energy	Narrow	HKD	55.00	40.85	0.74	High	★★★★
PDD Holdings (PDD)	Consumer Cyclical	Narrow	USD	117.00	109.55	0.94	Very High	★★★
SJM Holdings (00880)	Consumer Cyclical	Narrow	HKD	5.80	2.97	0.51	High	★★★★★
Shenzhou International (02313)	Consumer Cyclical	Narrow	HKD	140.00	72.60	0.52	High	★★★★★
Yum China (YUMC)	Consumer Cyclical	Wide	USD	84.00	54.78	0.65	Medium	★★★★★
BOC Hong Kong (02388)	Financials - Banks	Narrow	HKD	35.50	21.50	0.61	Medium	★★★★★
Agricultural Bank of China (01288)	Financials - Banks	Narrow	HKD	3.50	2.88	0.82	Medium	★★★★
DBS Group (D05)	Financials - Banks	Narrow	SGD	41.00	33.79	0.82	Medium	★★★★
KB Financial (105560)	Financials - Banks	None	KRW	75,000.00	55,800.00	0.74	Medium	★★★★
Wharf REIC (01997)	Real Estate - Developers	Narrow	HKD	48.50	29.75	0.61	Medium	★★★★★
China Overseas Land & Investment (00688)	Real Estate - Developers	None	HKD	26.00	15.94	0.61	High	★★★★
Keppel REIT (K71U)	Real Estate - REITs	None	SGD	1.16	0.83	0.72	Low	★★★★★
Link REIT (00823)	Real Estate - REITs	None	HKD	59.00	37.20	0.63	Low	★★★★★

Source: Morningstar. Data as of Oct. 6, 2023.

Economically Sensitive Sectors: Top Picks

There is no change to our list of picks this quarter. This group saw a negative average return of 3.8% in the third quarter, but this was primarily due to two stocks: Harmonic Drive Systems and Win Semiconductors falling 28% and 21%, respectively. But the sector saw mixed returns overall. Relatively defensive issues such as China Unicom and ST Engineering led gains during the quarter.

Economically Sensitive Sectors Top Picks

Name/Ticker	Sector	Economic Moat	Currency	Fair Value Estimate	Price	P/FV	Uncertainty	Morningstar Rating
Tencent (00700)	Communication Services - Interactive Media	Wide	HKD	704.00	305.20	0.43	High	★★★★★
NetEase (09999)	Communication Services - Interactive Media	Narrow	HKD	226.00	156.90	0.69	High	★★★★
Baidu Inc (09888)	Communication Services - Interactive Media	Wide	HKD	180.00	127.80	0.71	High	★★★★
China Mobile (00941)	Communication Services - Telecommunications Services	Narrow	HKD	91.00	64.75	0.71	Low	★★★★★
China Unicom (00762)	Communication Services - Telecommunications Services	None	HKD	10.50	5.57	0.53	Low	★★★★★
Harmonic Drive Systems (6324)	Industrials	Wide	JPY	5,900	3,285	0.56	High	★★★★★
ST Engineering (S63)	Industrials	Narrow	SGD	4.72	3.84	0.81	Medium	★★★★
Win Semiconductors (3105)	Technology	Narrow	TWD	245.00	134.50	0.55	High	★★★★★
Taiyo Yuden (6976)	Technology	Narrow	JPY	5,700	3,632	0.64	High	★★★★

Source: Morningstar. Data as of Oct. 6, 2023.

Defensive Sector: Top Picks

Our picks for this list have not changed for the fourth quarter. In the third quarter the defensive picks continued to disappoint, averaging a loss of 6.1%. ENN Energy was notably weak, down 33% during the quarter following softer guidance as gas connection revenue remained soft in line with real estate newbuild activity. Wuxi Biologics led gains, rising 22%. Prospects for the company remain bright, although geopolitical risks remain a concern for some investors.

Defensive Sector Top Picks

Name/Ticker	Sector	Economic Moat	Currency	Fair Value Estimate	Price	P/FV	Uncertainty	Morningstar Rating
Asahi (2502)	Consumer Defensive	Narrow	JPY	6,400	5,514	0.86	Medium	★★★★
Kao (4452)	Consumer Defensive	Wide	JPY	7,500	5,505	0.73	Medium	★★★★
Tsingtao Brewery (00168)	Consumer Defensive	Narrow	HKD	80.00	63.80	0.80	High	★★★★
CSPC (01093)	Healthcare	Narrow	HKD	8.90	5.41	0.61	High	★★★★
Wuxi Biologics (02269)	Healthcare	Narrow	HKD	76.80	43.70	0.57	Very High	★★★★
China Resources Power (00836)	Utilities	None	HKD	25.00	14.42	0.58	Very High	★★★★
ENN Energy (02688)	Utilities	Narrow	HKD	107.00	64.60	0.60	High	★★★★★

Source: Morningstar. Data as of Oct. 6, 2023.

Basic Materials and Energy

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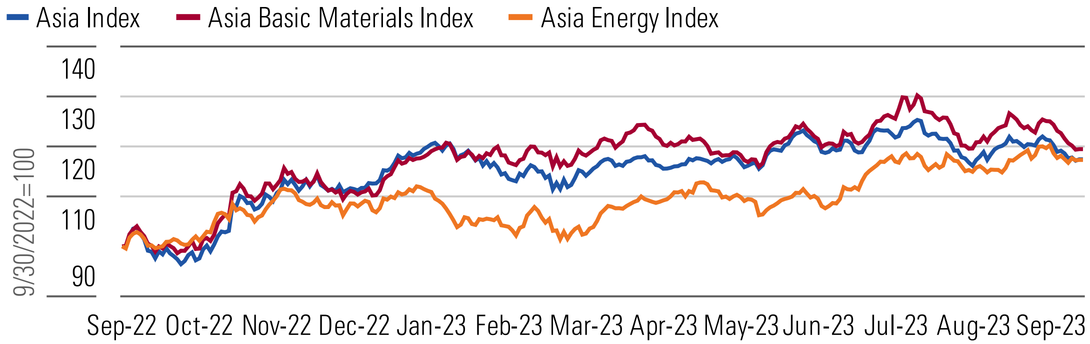
Supply Deficits to Support Oil Price in Q4 2023; Select Opportunities for Basic Materials and Energy

Benefiting from stronger energy prices, the Asia Energy Index outperformed the market and delivered a gain of 7.1% in the third quarter. We attribute this mainly to the ongoing oil market tightening actions taken by Saudi Arabia and Russia over the last few months, driving a large supply deficit. It remains to be seen if the 1.3 million barrels per day, or bpd, in cuts from the two countries will be extended deeper in 2024, much of which will depend on the level of oil prices, and whether it be enough for Saudi Arabia's spending needs. A more tepid Chinese oil demand outlook is certainly driving the Saudi Arabian and Russian decisions as well. With oil prices likely to remain high for the rest of 2023, we continue to prefer CNOOC given its cost efficiency (we expect average all-in cost at around USD 30 per barrel in our explicit five-year forecast periods) and oil and gas output growth. In addition, the dividend yield for its H-shares remains attractive for investors.

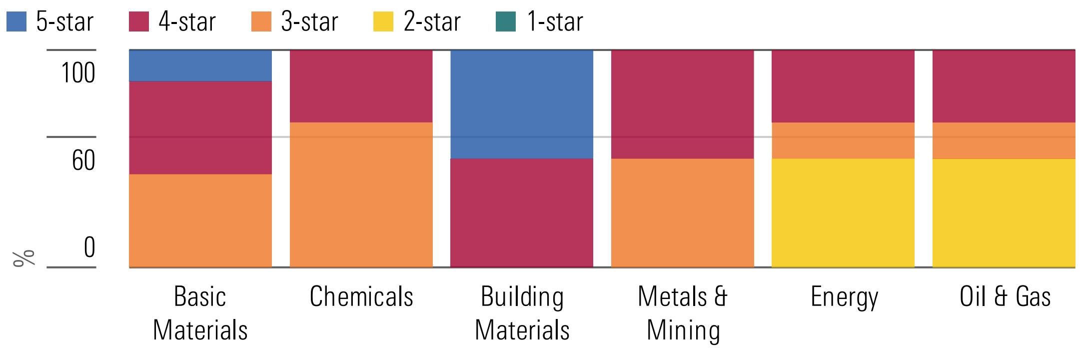
Anhui Conch's share price performance was muted in the third quarter of 2023 due to weak cement prices, as demand remains sluggish given the slow recovery of China's economic growth and a lackluster real estate market. That said, we believe downside should be limited as the negatives have been largely reflected in current share prices and Anhui Conch's strong balance sheet should allow the firm to navigate the down cycle. We have seen cement prices bottoming out in late September and we expect the easing policies in China to lead to a gradual recovery in the property market.

As third-quarter average lithium prices plunged more than 55% from a record fourth quarter in 2022, investor interest in lithium producers may be muted until lithium prices stabilize. However, with higher-cost new operations entering the market, this would further enhance leading producers' cost advantage in the long term. We like lithium producers Tianqi and Ganfeng, with a preference for Tianqi.

Asia Energy Stocks Outperformed in the Third Quarter of 2023



Select Opportunities Remain in the Basic Materials and Energy Sector

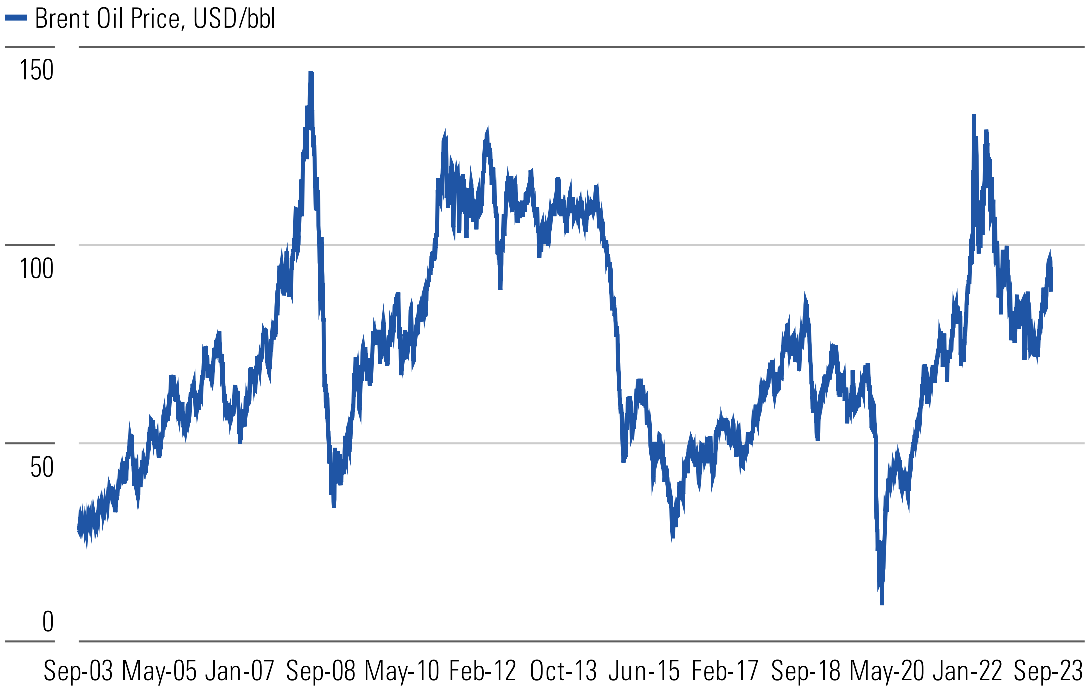


Source: Morningstar. Data as of Sept. 30, 2023.

OPEC+ Maintains Oil Output Cut; China Cement Prices Bottoming Out

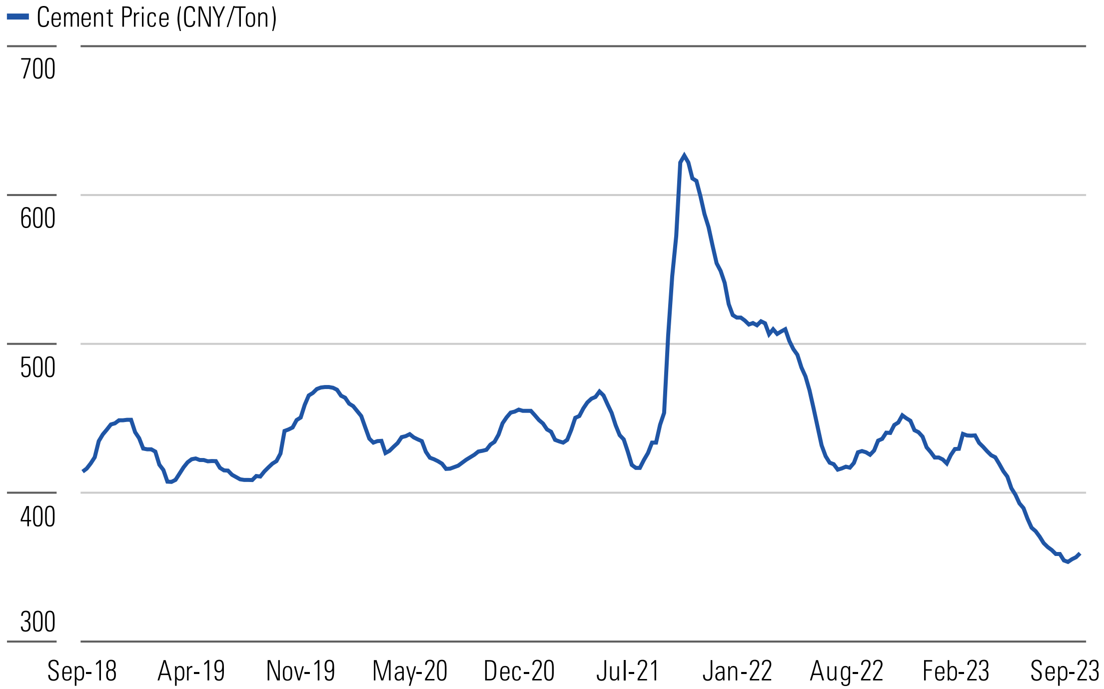
Global oil prices have increased 20% (WTI) and 27% (Brent) since the prior quarter. Meanwhile, OPEC+ decided to maintain oil output cuts in the October meeting. While we have seen volatility in oil prices in early October due to concerns about demand on the back of a slowing global economy and the high interest-rate environment, we believe geopolitical tensions and the production cuts should continue to tighten the market, supporting oil prices in the fourth quarter of 2023. Affected by the lackluster real estate market, cement prices in China have been on a downtrend in 2023. However, we are seeing some positive signs in late September as cement prices are recovering on the back of supply-side measures and producers' decisions to raise prices to reflect the higher coal costs.

Tight Supply to Continue Supporting Brent Oil Price (USD per barrel)



Source: CEIC, Morningstar.

China Cement Prices Bottoming Out

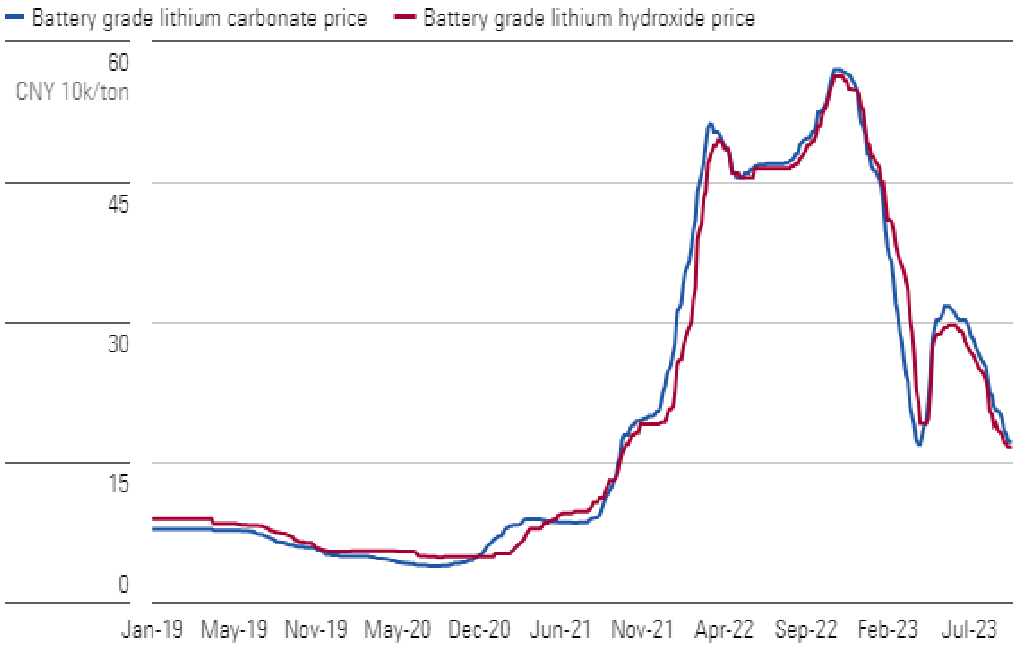


Source: CEIC, Morningstar.

Lithium Prices to Stay Lower Through 2023 With New Supply Coming on Board

The battery-grade lithium carbonate price in China dropped to below CNY 200,000 per metric ton since mid-September, from the peak of CNY 570,000 in November last year. While we anticipate lithium demand for new energy vehicle batteries to remain strong, we expect new greenfield supply to start production and ramp up yield in the second half of 2023 to 2024, which would ease the lithium supply deficit witnessed last year. Having said that, we expect the supply deficit to remain in place as demand growth from lithium battery production accelerates, which should generally result in prices remaining above the peak of 2018's boom—albeit lower than the 2022 peak. In addition, with higher-cost new operations entering the market, this would further enhance leading producers' cost advantage in the long term.

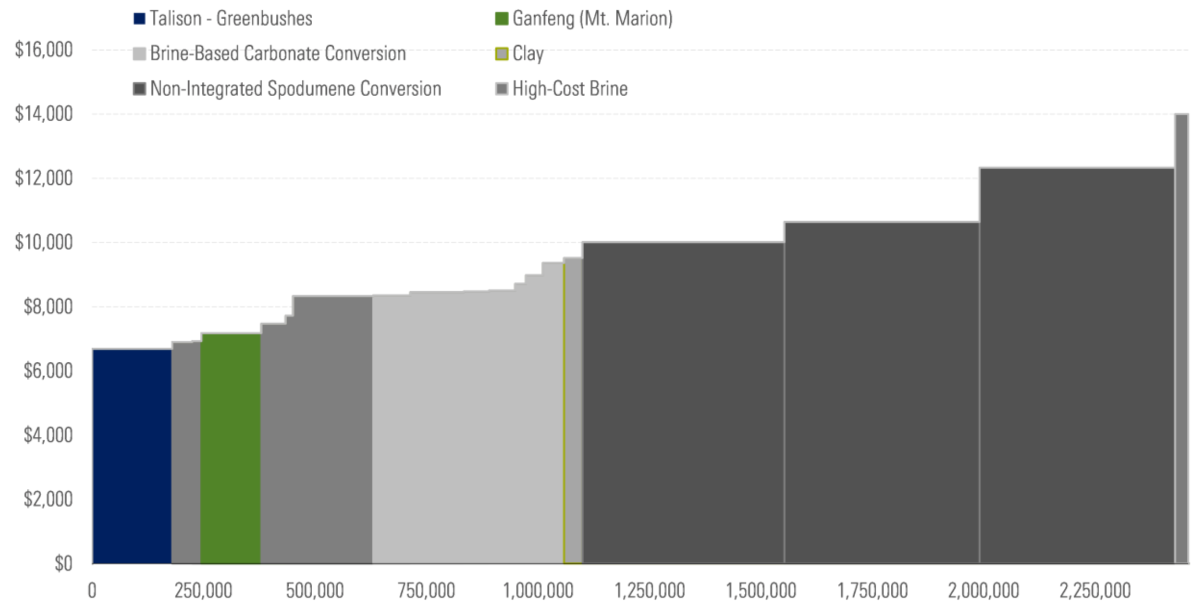
Lithium Compounds Prices Pulling Back From Record Levels



Source: CEIC, Morningstar.

Tianqi and Ganfeng Enjoy Cost Advantage

Lithium hydroxide cost curve on an all-in sustaining cost basis.



Source: Morningstar.
Note: Supply shown as forecast total capacity by resource by 2030, irrespective of ownership. All-in sustaining cost is used for each producer, which includes cash cost, overheads, royalties, and sustaining capital expenditure to standardize costs for all lithium producers.

Basic Materials and Energy

Company (Ticker)		Rating
CNOOC (00883)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 13.10	HKD 18.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 667.5	None	Standard

CNOOC is the upstream arm of China's third state-owned oil company, China National Offshore Oil. As a result, it's the most direct option for investors seeking exposure to China's energy security policy and long-term plans to increase its oil supply. As it does not have downstream activities, the company has also avoided a large legacy labor force. None of the company's sales are subject to government price controls. We think CNOOC is currently undervalued, given its cost efficiency. We expect CNOOC to keep its average all-in cost at around USD 30 per barrel in our explicit five-year forecast periods given the firm’s track record in containing costs. Hence, we believe the firm will remain profitable in the long term, even under our midcycle Brent oil price forecast of USD 60 per barrel.

Company (Ticker)		Rating
Anhui Conch (00914)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 19.92	HKD 37.50	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 133.3	Narrow	Standard

Producing more than 300 million metric tons of cement annually, Anhui Conch Cement is one of the largest cement producers in the world. Closely tied to infrastructure and real estate construction, China’s cement industry is challenged by the shift toward a less construction-intensive economy. However, we believe Anhui's strong balance sheet (net cash as of the end of 2022) and best-in-class mining assets position it best to weather slowing investment in China, capitalize on possible merger or acquisition opportunities, and achieve modest market share gains at the expense of overleveraged competitors. Cement demand growth is slowing from an abnormally high rate, and smaller cement companies with inferior cost structures and larger competitors with weak balance sheets are vulnerable to a downturn. We expect Anhui to further increase its market share as smaller cement plants are driven out of the market. Our earnings forecasts have factored in the slowing fixed asset and real estate investment, given China’s transition to a consumer-driven economy in the longer run.

Source: Morningstar. Data as of Oct. 6, 2023.

Basic Materials and Energy

Company (Ticker)		Rating
Tianqi Lithium (09696)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 40.85	HKD 55.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 71.4	Narrow	Standard

Tianqi Lithium is a leading lithium producer in China. The company is the largest producer of mined lithium globally in terms of output in 2021, according to Wood Mackenzie. It is also the world's fourth-largest and Asia's second-largest lithium compound producer, as measured by production output in 2021, according to the same source. Tianqi is the only lithium producer in China that has achieved 100% self-sufficiency and has fully vertically integrated lithium mines. We believe Tianqi will continue to benefit from the global vehicle electrification trend. We think Tianqi is undervalued, given its cost advantage supported by its access to low-cost and high-quality lithium resources from the Greenbushes mine. Our fair value estimate of HKD 55 implies a 2024 price/earnings ratio of 5.7 times.

Source: Morningstar. Data as of Oct. 6, 2023.

Communication Services — Interactive Media

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Continue to Expect a More Conducive Regulatory Environment; Tencent and NetEase to Benefit

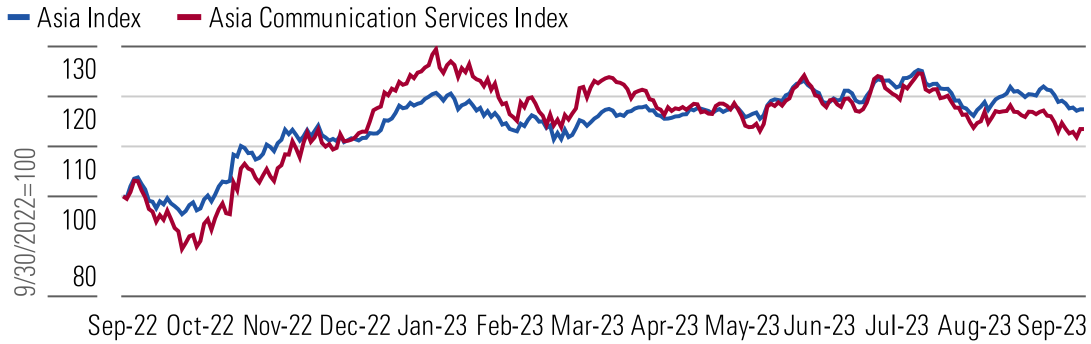
Positive regulatory news flow in the third quarter reaffirms our call of a more benign regulatory landscape. On Sept. 28, the Cyberspace Administration of China proposed new rules to relax the strict requirements for cross-border data transfer. The newly proposed rules provide several scenarios where businesses will no longer have to fulfil stringent regulatory requirements related to data protection, allowing easier transfer of data overseas. These relaxations will benefit multinational corporations and any companies that rely on free flow of data for basic operations. But more importantly, we think the implications of the latest rules also extend beyond data transfer, as they signal the government's continued pivot toward a more accommodating and progrowth approach to managing the economy.

We maintain our view that there will be more regulatory easing over the next few quarters. This was made clear by Chinese Premier Li Qiang's call in July for local governments to provide more support to internet firms, which he labeled as "trailblazers of the era". This was coupled with the premier's pledges to create a fair environment, reduce compliance costs, and pave the way to promote sound development of internet firms.

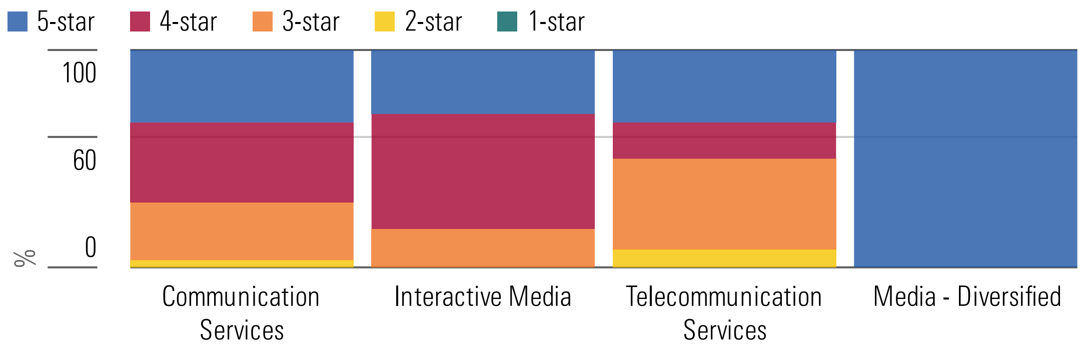
We expect both Tencent and NetEase to record double-digit revenue growth going into the next couple of quarters. For Tencent, growth would be driven primarily by the increased monetization of ad placements on video accounts, and releases of more commercial content for its established game franchises. NetEase's recent success with Justice Mobile indicates positive prospects for sales growth in the near term. Additionally, the forthcoming launch of Where Winds Meet presents an opportunity for the company to further capitalize on its growth momentum and potentially achieve even greater success.

Lastly, the flurry of interest in artificial intelligence functions, led by ChatGPT, saw Baidu's underwhelming introduction of Ernie. We are cautious on the short-term monetization of Ernie, as operating expenses may be front-loaded in its development. While it has the potential to be a long-term industry leader, there are still questions as to the regulatory and use-case aspects of the product.

Refocus on Growth, Reduced Regulatory Risks Helped Sector Recover



Attractive Valuation for Moaty Internet Companies in China



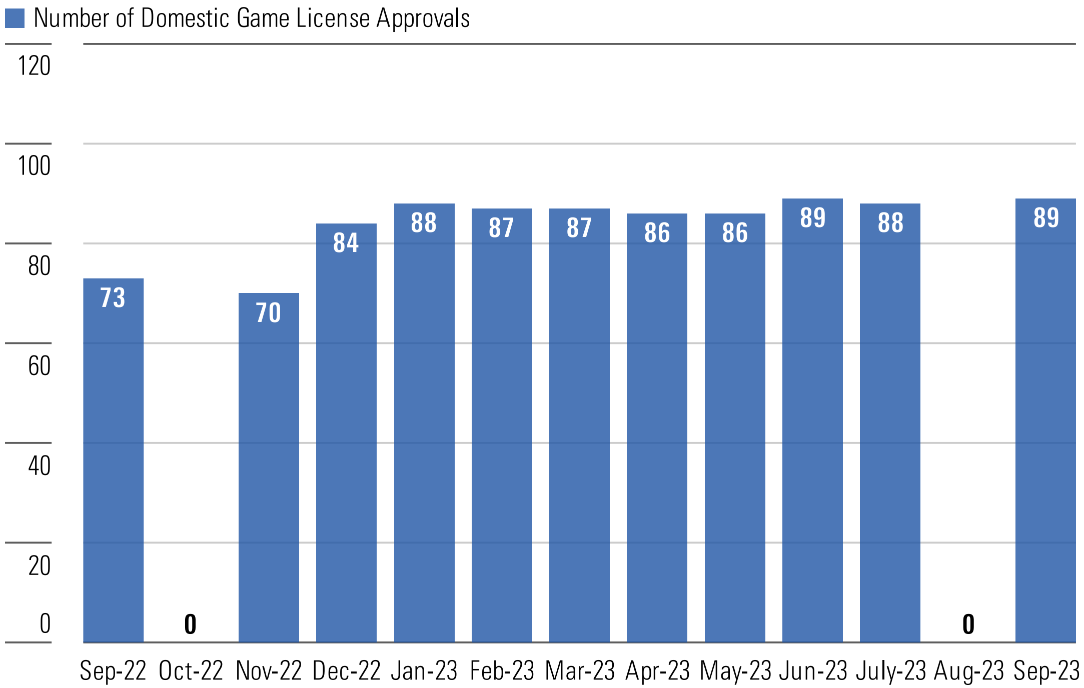
Source: Morningstar. Data as of Sept. 30, 2023.

Resumption of Game License Approval Drives Significant Growth in Game Bookings

After experiencing several consecutive quarters of decline, China's mobile game bookings finally rebounded and returned to growth in May 2023. Furthermore, this growth trend has been gaining momentum and continues to accelerate as we move into the fourth quarter. We attribute recent strong performance to new game launches (namely, Justice Mobile).

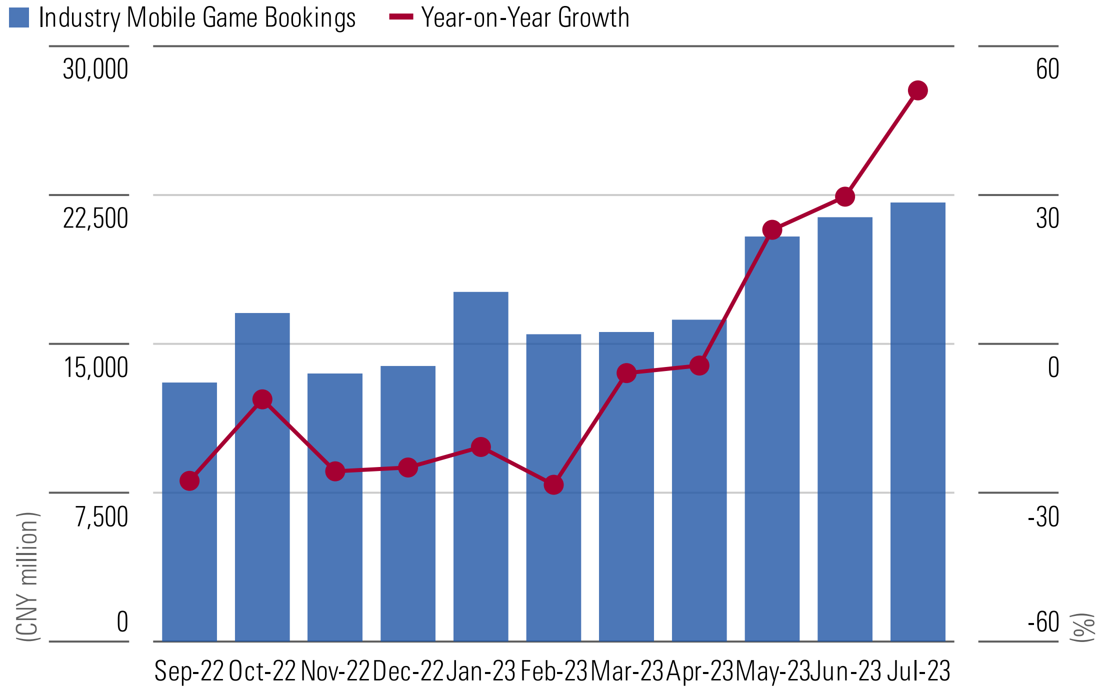
With regulators issuing game licenses on a relatively consistent basis (just three hiccups over the past 18 months), we feel confident in our forecast for accelerated game revenue growth for major developers under our coverage.

Game Approvals in China Accelerated Going Into 2023



Source: National Press and Publication Administration.

Mobile Game Revenue Finally Rebounded Following Multiple Quarters of Decline



Source: CNG New Game Research

Communication Services – Interactive Media

Company (Ticker)		Rating
Tencent (00700)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 305.20	HKD 704.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 2,931.5	Wide	Exemplary

We expect Tencent shares to rerate as the business reignites multiple growth engines. We are particularly excited about opportunities in video accounts and enterprise software, as both functions are closely integrated with the WeChat network, and we expect Tencent to leverage its strong network effect to drive user adoption. While game revenue could still face some volatility over the near term, it now has much better long-term visibility following Chinese authorities' resumption of game license approvals. We remain confident in Tencent's longer-term free cash flow potential and expect the business to deliver a 23% earnings CAGR over the next five years. With Tencent's shares trading at just 13 times core earnings, we view this as an opportunistic entry point.

Company (Ticker)		Rating
NetEase (09999)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 156.90	HKD 226.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 533.4	Narrow	Standard

NetEase's book of business is looking stronger than ever. The firm generates stable revenue from its legacy massively multiplayer online role-playing game, or MMORPG, franchises and continues developing some of the most revolutionary cross-platform games. We see plenty of revenue opportunities, both inside and outside of China. We expect strong performance to continue to be driven by Justice Mobile, Badlanders, and other new games that are scheduled to launch. We think investors should take advantage of market weakness to buy this narrow-moat business with 14% EPS growth CAGR but trading at just 15 times ex-cash core earnings.

Source: Morningstar. Data as of Oct. 6, 2023.

Communication Services – Interactive Media

Company (Ticker)		Rating
Baidu Inc (09888)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 127.80	HKD 180.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 363.0	Wide	Standard

We see Baidu shares as undervalued and believe margin expansion remains the key factor for its valuation. Despite slowing growth and risks to its nonadvertising revenue, we remain bullish in our investment thesis as higher operating margins should lead to greater earnings in our valuation, and current forward multiples appear cheap for a firm with a wide moat and dominant market position in its core advertising business.

We expect Baidu's core advertising business to remain resilient in the long term despite sentiment that newer platforms such as Douyin or Kuaishou are taking away advertising budgets from Baidu. While we expect push-based advertising to grow faster than search-based (or pull-based) advertising, Baidu maintains a dominant 85%-90% market share in the search advertising industry and does not have any major competitive threats. We believe that it is inappropriate to compare search-based platforms with push-based, as users will likely have different consumption behaviors and interests. Baidu's advertising niches are healthcare, travel, and local services, compared with push-based platforms where apparel and cosmetics account for the more impromptu ads.

Source: Morningstar. Data as of Oct. 6, 2023.

Communication Services — Telecom

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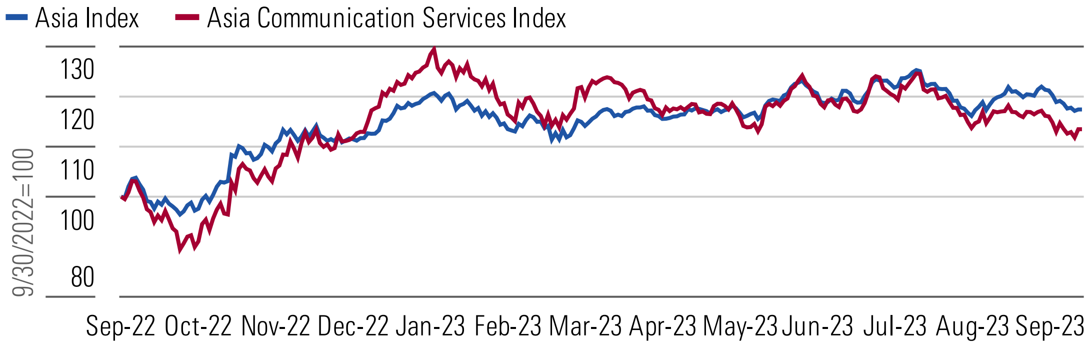
Chinese Telcos Continue to Take Cloud Services Market Share

Following the share price underperformance from the Asian telcos in the second quarter, we see even more value in the Chinese and Korean telecom markets.

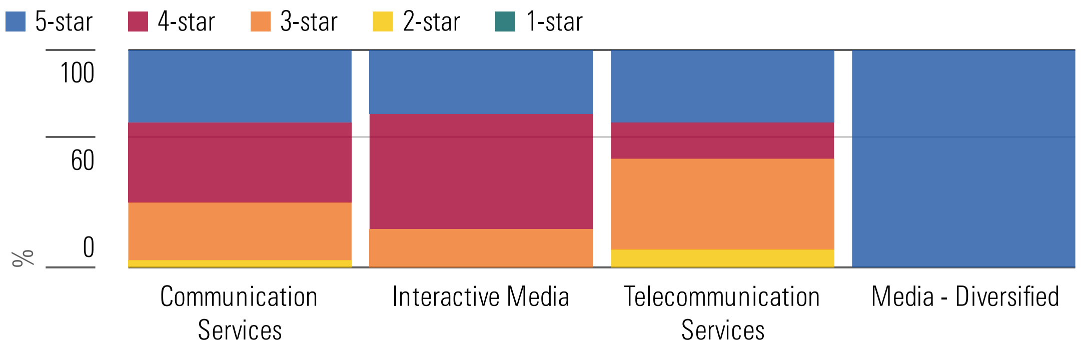
The Korean and Chinese telcos remain the least expensive on a simple multiple basis. The 12-month forward dividend yields of the Chinese telcos now range between 6.9% and 7.5%, with the 12-month forward P/E ratios sitting between 7.9 times and 10.3 times, with these still looking inexpensive compared with midteens international forward P/E ratios for telcos. The Korean telcos, KT and SK Telecom, also look inexpensive on these metrics, trading on 12-month forward P/E ratios of between 6.9 times and 10.9 times, and 12-month forward dividend yields of between 5.8% and 6.4%. We retain 5-star ratings on all three large Chinese telcos.

The first half of 2023 saw the Chinese telcos continue to gain market share in cloud service revenue. The three telcos grew cloud service revenue by 61% year over year in the first half compared with the other main Chinese companies with cloud service capabilities (Alibaba, Huawei, Tencent, and Baidu) which we estimate grew cloud service revenue by less than 10% year over year. In terms of reported cloud services revenue, China Telecom overtook Alibaba as the largest cloud service provider in China, with China Mobile and China Unicom taking third and fourth positions, respectively. We continue to see this cloud services opportunity for the Chinese telcos as a differentiator compared with most other telecom companies globally that operate in markets where cloud services are dominated by global giants such as Amazon, Microsoft, and Alphabet. Regulatory barriers make it difficult for the global cloud services giants to offer their services in China, leaving the burgeoning market for the local companies. The telecom companies' majority government ownership likely gives them an advantage in providing cloud services to government and other state-owned entity companies.

Telecom Stocks Within Communication Services Have Underperformed



We See Value in Chinese Telecoms

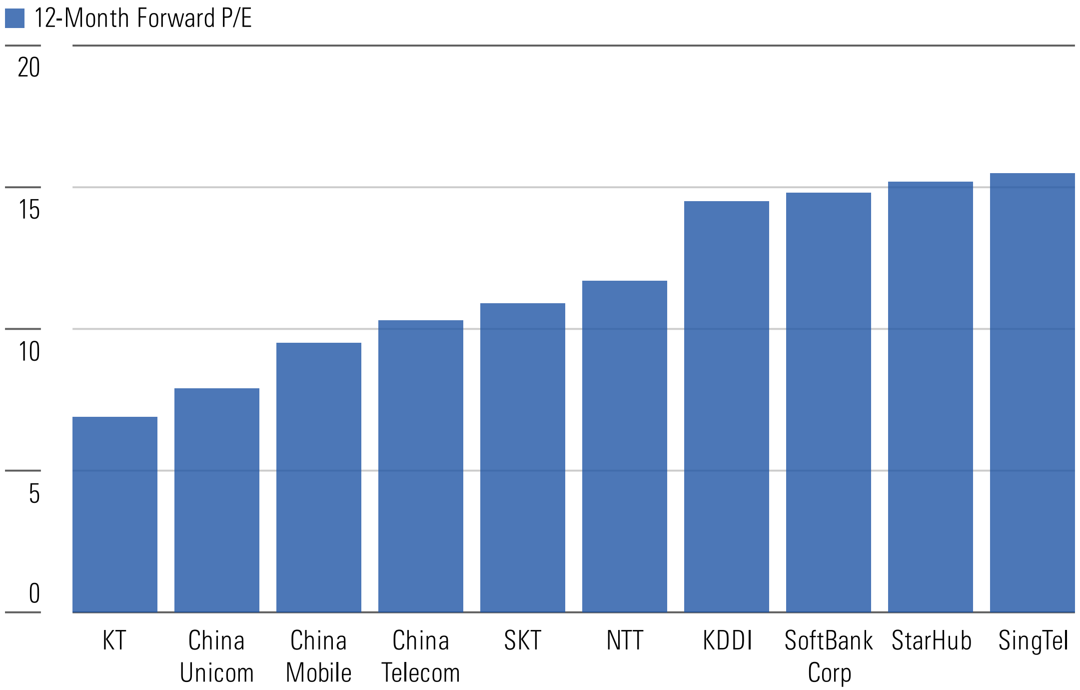


Source: Morningstar. Data as of Sept. 30, 2023.

Chinese and Korean Telcos Continue to Have Compelling Value

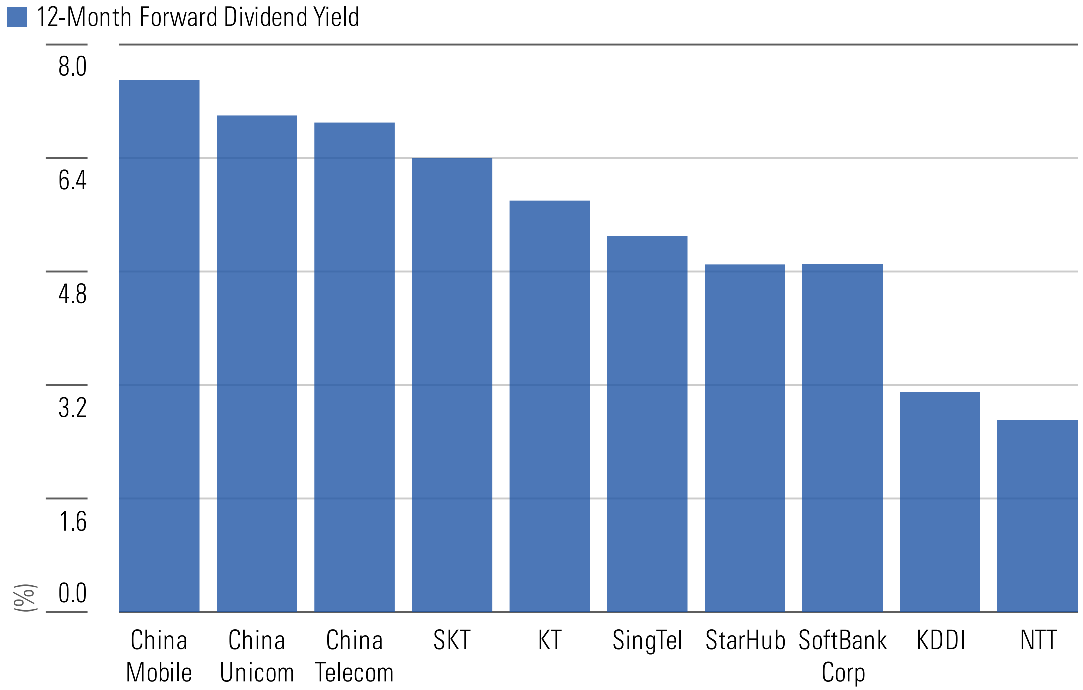
SKT has announced by far the most aggressive artificial intelligence strategy of the Asian telecom companies that we cover. It targets becoming a global AI company with revenue of KRW 25 trillion by 2028. The company plans to use AI to transform its core telecom business areas—such as mobile, broadband and enterprise—and use it to enter new business areas like mobility and healthcare to reach a new level of productivity and customer experience. It also plans to build a globally competitive personal AI assistant service by leveraging its telco and AI assets, likely in conjunction with Singtel and Deutsche Telekom, who have joined forces to form the Global Telco AI Alliance. The three telcos, along with SKT parent company, SK Group, will jointly develop the Telco AI Platform by combining their respective technologies and capabilities.

Twelve-Month Forward Price/Earnings Ratios Imply Inexpensive Valuation



Source: Company disclosures, PitchBook consensus estimates, Morningstar.

Twelve-Month Forward Dividend Yields Are Attractive and Generally Durable



Source: Company disclosures, PitchBook consensus estimates, Morningstar.

Communication Services – Telecom

Company (Ticker)		Rating
China Mobile (00941)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 64.75	HKD 91.00	Low
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 1,427.2	Narrow	Poor

China Mobile has a narrow moat rating based on efficient scale and cost advantage due to its scale advantage over the other two telcos. In 2022 China Mobile generated around half of the total industry revenue and around three fourths of total industry operating profit. It has also generated average annual ROIC of over 20% over the past nine years, which is well above our estimate of its cost of capital of 10%. While China Mobile frustrated investors for many years with a dividend payout ratio below 50%—despite generating strong free cash flow and having a very large net cash balance—it increased its dividend payout ratio to 66% in 2022 from 42% in 2018, with a target to reach at least 70% by 2023.

Company (Ticker)		Rating
China Unicom (00762)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 5.57	HKD 10.50	Low
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 172.6	None	Standard

We do not assign a moat rating to China Unicom as it does not earn returns above its cost of capital. However, share price declines over a number of years leave it looking good value in 5-star territory. The company had many years of poor cash flow and market share, but this turned around in 2017, with the company generating average free cash flow of over CNY 36 billion per year between 2017 and 2022, and its mobile market share is also stabilizing. We value the company at HKD 10.50 per share. We forecast operating income to grow at an average of 13% per year over the next five years, with operating margin forecast to recover to 5.0% in 2027 from 3.5% in 2022. As a reference, its closest comparable, China Telecom, reported a 6.9% operating margin in 2022. If China Unicom generated free cash flow at the same rate as it has averaged over the past five years, it would take only 2.4 years to generate its enterprise value at the current share price. It also trades at a forward price/earnings ratio of 7.9 times, compared with China Telecom at 10.3 times and China Mobile at 9.5 times.

Source: Morningstar. Data as of Oct. 6, 2023.

Consumer Cyclical

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The Traditional E-Commerce Companies in China Are All Pivoting to Value-for-Money Products

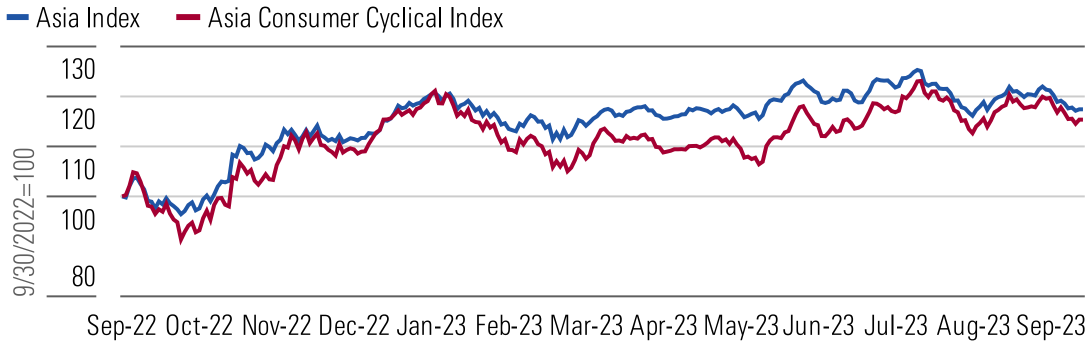
We expect the e-commerce sector to see year-on-year improvement in the fourth quarter, although we think the base for year-on-year comparison is relatively high. In the fourth quarter of 2022, online retail sales of goods rose 13% year on year, stronger than the 9% year-on-year pace in the first half of 2022.

Weak consumption growth in China should continue to put pressure on gross merchandise volume growth at Alibaba and JD.com in the quarter. In the near term, we continue to believe PDD Holdings will outperform its listed peers in terms of both revenue and earnings growth, due to its strong value-for-money positioning and success in increasing monetization. With Alibaba's business units becoming more responsible for their own profit and loss, we expect adjusted EBITA for the group to register year-on-year growth in the fourth quarter. JD.com should see better year-over-year revenue growth in the fourth quarter this year compared with the first half of 2023, due to a lower base for year-on-year comparison. In the third quarter of 2022, JD.com started to terminate the sales of certain low-margin and unprofitable products on its first-party platform, which led to a loss of revenue. JD.com's JD Retail registered a decline in operating margin in the second quarter, which suggests the challenge in maintaining its margin amid its strategy pivot to low-price products. This is a concern for the remaining quarters this year.

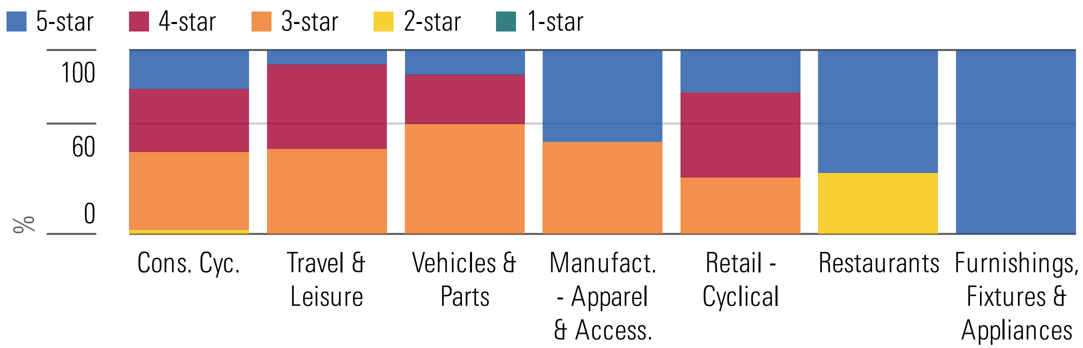
The announcement of a six-way breakup of Alibaba's business is encouraging for Alibaba to unlock its value and, more importantly, return capital to shareholders in the long run. But we expect the process to be gradual. Cainiao has filed its Hong Kong IPO A1 listing document, but Cainiao is insignificant in terms of its value contribution to Alibaba. Therefore, we don't expect to see significant value unlocking. Meanwhile, Bloomberg reported in September, citing unnamed sources, that Freshippo will hold off on its IPO amid weak valuation. We don't see any near-term catalyst for Alibaba's share price in the near term at least until the cloud unit is floated.

We still prefer PDD Holdings the most, followed by Alibaba and JD.com.

Consumer Cyclicals Struggled Against the Broader Market in Q3



Online Retailers, Travel, and Leisure Offer Attractive Valuations

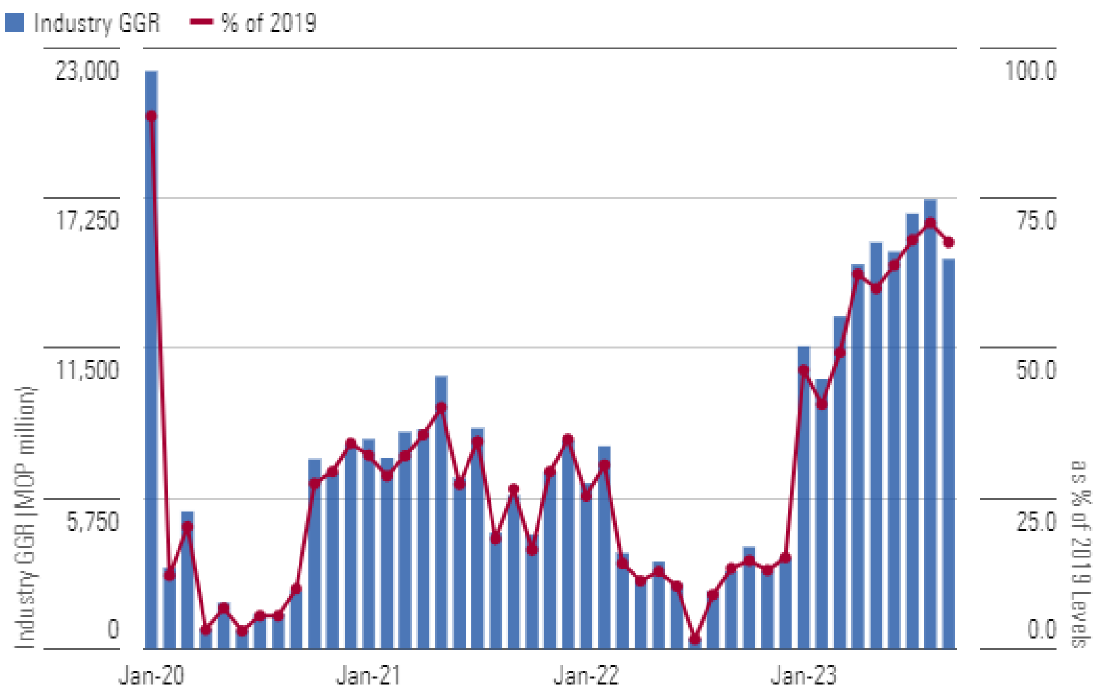


Source: Morningstar. Data as of Sept. 30, 2023.

Macao Seeing Solid Recovery; Further Uptick on Improving Airline Capacity and Nongaming Events

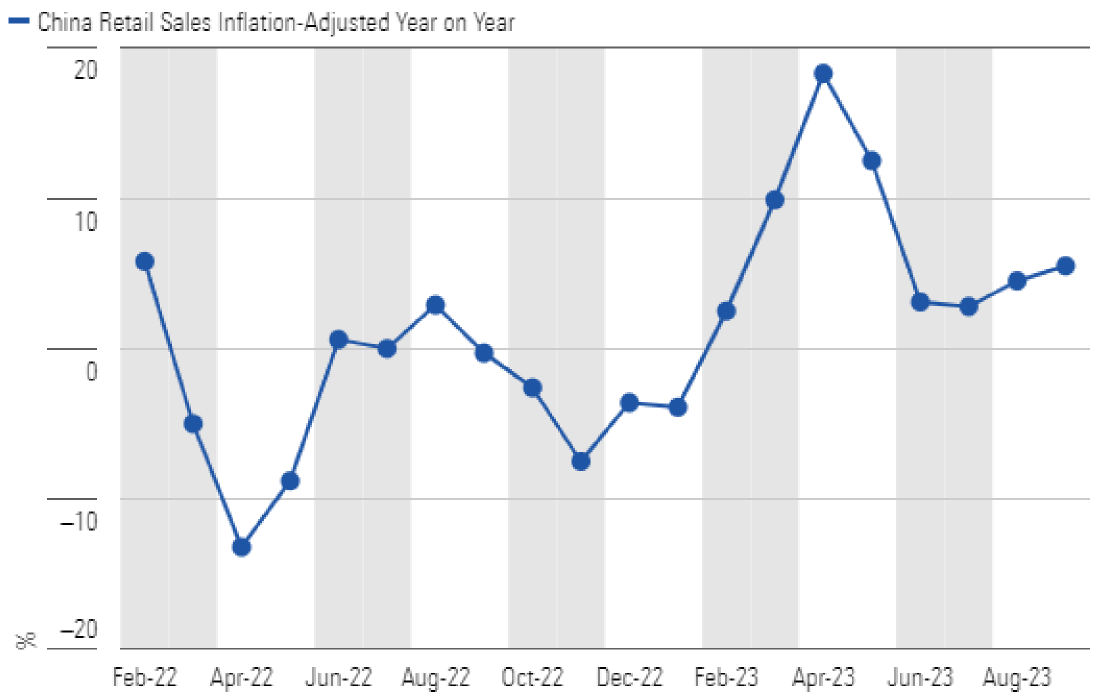
Macao's gaming industry gross gaming revenue, or GGR, rose strongly by 780% year over year to MOP 45.5 billion in the third quarter, representing 69% of the level seen in prepandemic 2019, up from 62% a quarter ago. We expect the strong momentum to extend into the coming quarters, with rising international passenger airline capacity, and various nongaming events across different casino properties, helping to maintain the demand growth. We retain our 2023 industry GGR forecast at 62% of the 2019 levels, and we believe all the six casino operators will return to profit and generate positive free cash flows in 2023. Among the six casinos, we expect MGM China to take the most market share, helped by additional table allotment, while SJM should experience the most profit improvement, with volume continuing to ramp up at its new Cotai property.

Industry GGR Extends Its Rebound Since China's Reopening in January 2023



Source: Macao Gaming Inspection and Coordination Bureau, Morningstar.
Note: GGR = gross gaming revenue.

China Retail Sales Stabilize and Creep Up

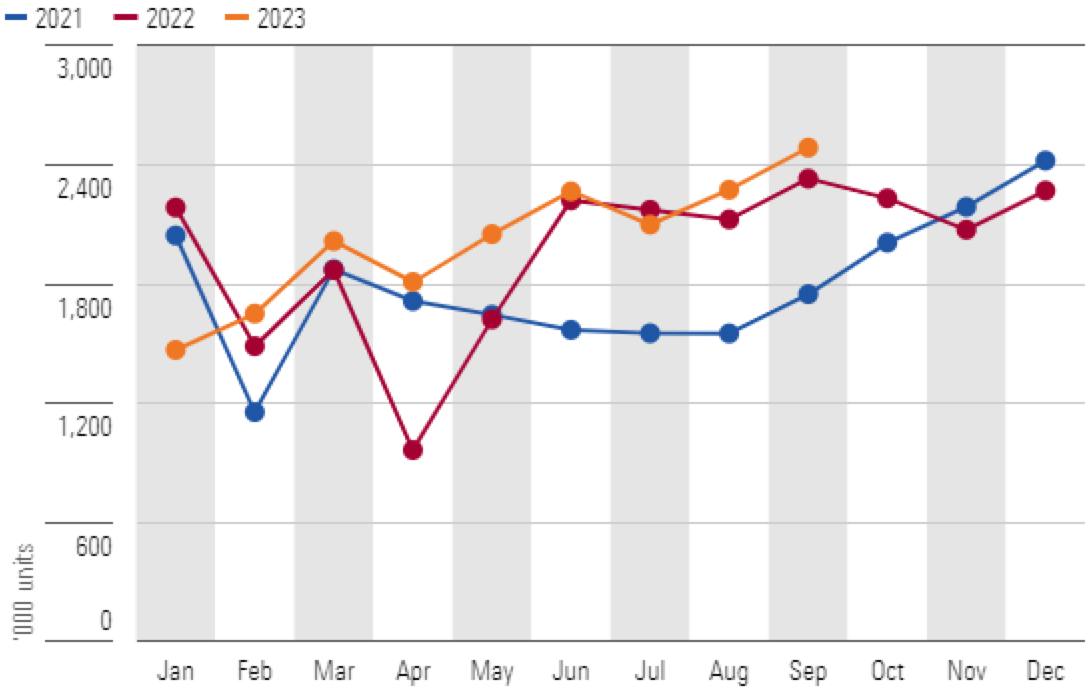


Source: National Bureau of Statistics.

New Energy Vehicles Continue to Take Share From Gasoline Cars in 2H 2023

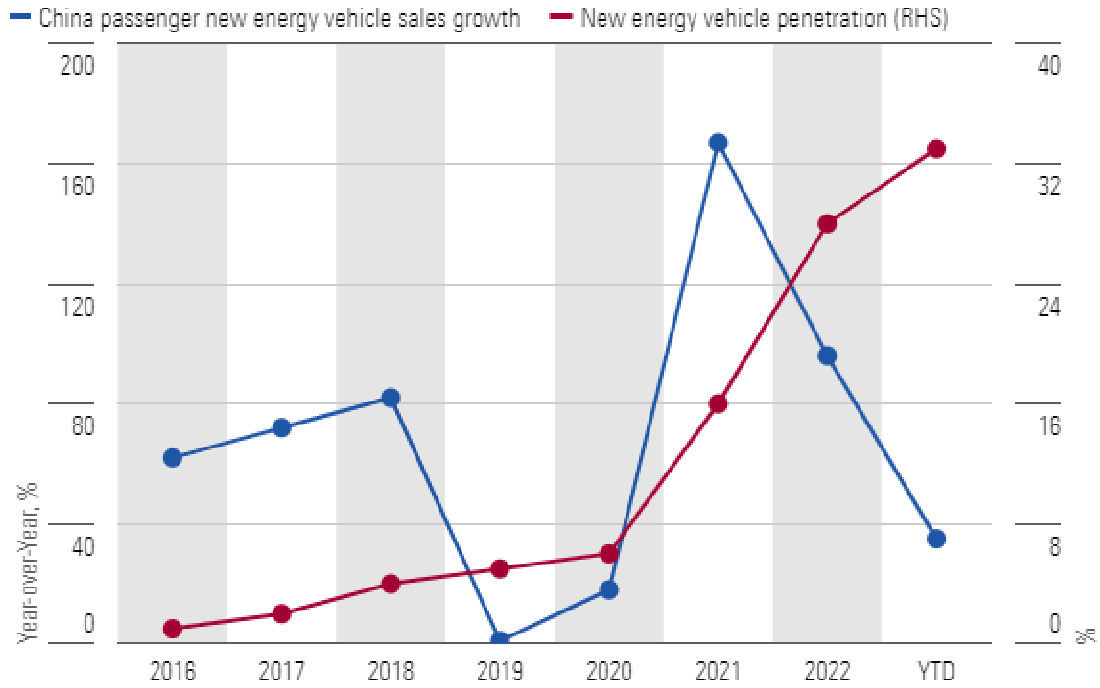
China sold 5.9 million units of passenger new energy vehicles in the first nine months of this year, with new energy vehicle penetration, as a percentage of total vehicle sales, reaching 33%. In September, the Ministry of Industry and Information Technology issued guidelines to stabilize auto growth, aiming to drive NEV sales up 30% this year to 9 million units. Together with some local government pushes, increasing consumer adoption, improving drive range, and increasing levels of vehicle intelligence and driving experience, we expect sales of new energy vehicles to remain solid and continue to take share from internal combustion engine, or ICE, cars. We like BYD for its diversified model portfolio and quality growth. We believe sales momentum will remain robust for BYD and recently launched new models should further solidify its leading position in the mass NEV segment.

China Passenger Vehicles Register Resilient Momentum Since Q2 2023



Source: China Association of Automobile Manufacturers.

China NEV Sales: Strong Momentum, Penetration Rate at Record Level



Source: China Association of Automobile Manufacturers. Data as of Oct. 3, 2023.

Consumer Cyclical

Company (Ticker)		Rating
PDD Holdings (PDD)		★★★
Price	**Fair Value**	**Uncertainty**
USD 109.55	USD 117.00	Very High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
USD 145.5	Narrow	Standard

In the near term, we continue to believe narrow-moat PDD Holdings will outperform its listed peers in earnings growth. With slow recovery in consumer sentiment amid macroeconomic weakness in China, we think PDD Holdings is the best positioned in the traditional e-commerce space due to its strongest value-for-money reputation. We have also seen PDD Holdings attracting brands to its platform while protecting its value-for-money base. As a result, PDD Holdings has outperformed its listed peers in top-line and earnings growth, delivering a strong increase in revenue of 66% and non-GAAP net profit of 42% in the second quarter, and we expect it to continue this year. PDD Holdings has managed its finances well despite Temu's strong traction overseas. Temu only launched in September 2022, but as per Bloomberg's Second Measure, in May, the spending on Temu in America was 20% higher than on Shein. As per 36Kr, Temu is on track to deliver GMV of CNY 10 billion this year, one third of Shein's USD 30 billion last year.

Company (Ticker)		Rating
SJM Holdings (00880)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 2.97	HKD 5.80	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 20.9	Narrow	Standard

Following the uptick in share prices since December 2022, boosted by a rapid easing of COVID-19 restrictions and the announcement of license grants, the Macao gaming sector is currently trading at 9 times 2024 EV/EBITDA based on Refinitiv consensus, compared with the sector's historical trading range of 8-12 times EV/EBITDA before the pandemic. For the fourth quarter, we think Sands China is favorably positioned with near-term catalysts from more rooms online amid the easing of the labor shortage issue and a stronger pipeline of nongaming events. But for the longer-term perspective, SJM remains our preferred name, which we believe will see the most upside, due to its turnaround story. We expect SJM's adjusted EBITDA to rebound to 62% of 2019 levels in the third quarter of 2023, up sharply from 43% in the prior quarter and 3% in first quarter. We think a durable recovery of Macao's gaming demand should help to improve SJM's profitability and cash flows, and the volume ramp-up at its new property Grand Lisboa Palace in Cotai would allow the company to take market share in the coming years. We expect SJM's adjusted EBITDA to be well above its 2019 levels in 2024.

Source: Morningstar. Data as of Oct. 6, 2023.

Consumer Cyclical

Company (Ticker)		Rating
Shenzhou International (02313)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 72.60	HKD 140.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 109.8	Narrow	Exemplary

We have a strong conviction in Shenzhou International's ability to continue serving as the dominant supplier for global apparel giants. The firm is well-positioned for growth, thanks to the combination of its strong research and development capabilities and entrenched relationships with leading brands. Shenzhou's business expansion would be driven by the growing demand for sportswear globally and brands' efforts in further consolidating their supplier bases. Efficiency improvements at existing plants and capacity expansions at new plants should enable the company to accept more orders, especially those from fast-growing brands like Lululemon.

Company (Ticker)		Rating
Yum China (YUMC)		★★★★★
Price	**Fair Value**	**Uncertainty**
USD 54.78	USD 84.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
USD 22.7	Wide	Standard

We continue to view Yum China as a long-term beneficiary of China's demographic shifts. We believe there is significant room for fast food penetration to go up, driven mainly by long-term secular trends such as: 1) longer working hours for urban consumers; 2) rapidly rising disposable income; and 3) ever-smaller family sizes. The recent successful revitalization of Pizza Hut should continue to boost the group's overall profitability while easing investor concerns over the long-term outlook for the brand in China.

Source: Morningstar. Data as of Oct. 6, 2023.

Consumer Defensive

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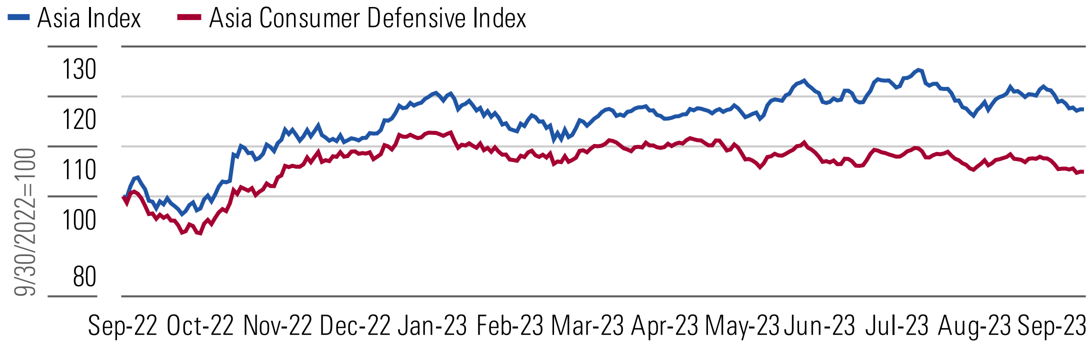
Price Hikes Continue to Temper Demand but Cost Pressure Should Ease From 2H 2023

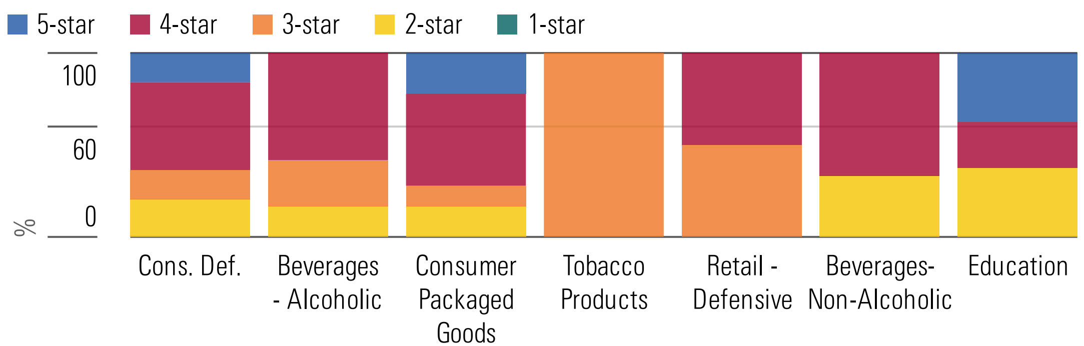
We note consumer spending in China during the Golden Week holiday remained selective as confidence is still gradually recovering. We continue to think beer and ready-to-drink beverages would outperform other staples categories such as instant noodles, dairy, and personal care as consumers favor social events after pandemic lockdowns. We think consumers in China would remain cautious about their overall spending until the economic outlook and income prospects improve. We also caution that the surge in oil prices throughout the third quarter and the uncertainty arising from the Israel-Hamas conflict could push up prices for polyethylene terephthalate, or PET, down the road. This could pose headwinds to ready-to-drink and personal care products manufacturers. We suggest investors focus on staples categories that have a better competitive landscape, which could discourage irrational price wars. We note consumers' tendency to purchase premium products could slow, but we think beer companies in China could benefit from lower input costs and rational competition in the industry.

Japan's food inflation remains elevated, trending above an 8.5% year-on-year increase during the summer. While we anticipate the wave of price hikes on consumer-packaged goods will largely end in November, an average 4.5% increase in minimum wages from October, coupled with persistent yen weakness and escalating crude oil prices, will likely keep prices high. On the other hand, cost inflation on most consumer product companies should start easing from the July to September quarter, although raw material costs may not fall during the first half of 2024 if crude oil prices continue to climb. Even though wage rise still lags that of inflation, we foresee household and personal care goods companies and dairy makers continuing to enjoy price-hike benefits while most food companies should see the positive impact cycle in the October quarter. The high temperatures through September should lift summer product demand, although the warm weather might deter winter product sales.

Consumer Defensives Again Outperformed the Broader Market in Q2



Value Remains in Japanese Consumer Names and Chinese Beer Companies

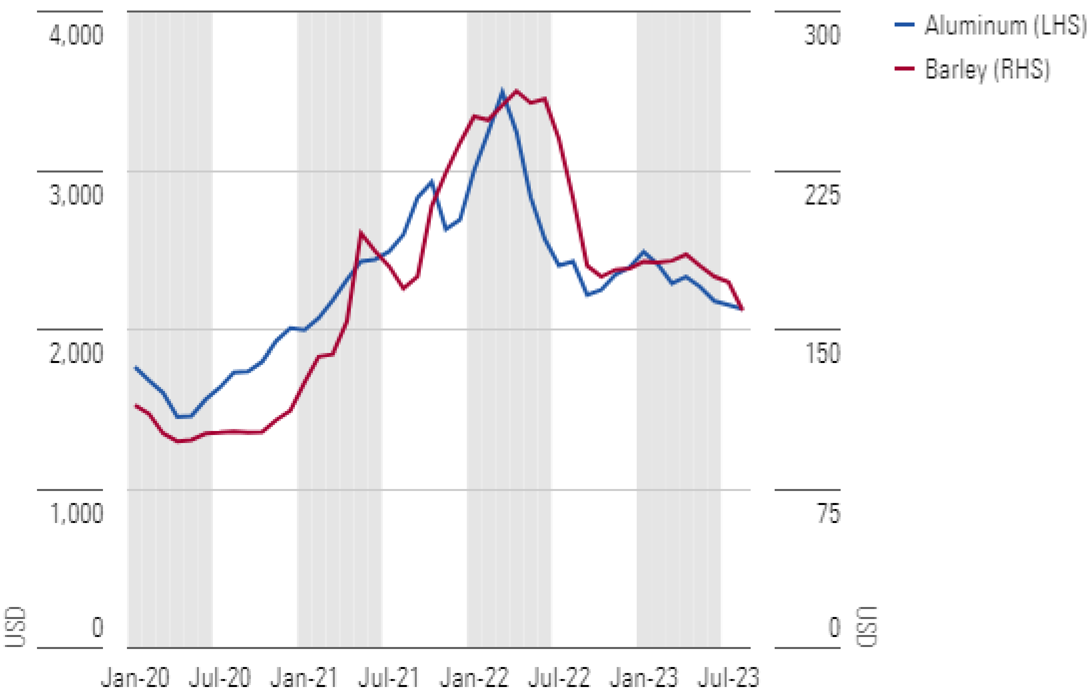


Source: Morningstar. Data as of Sept. 30, 2023.

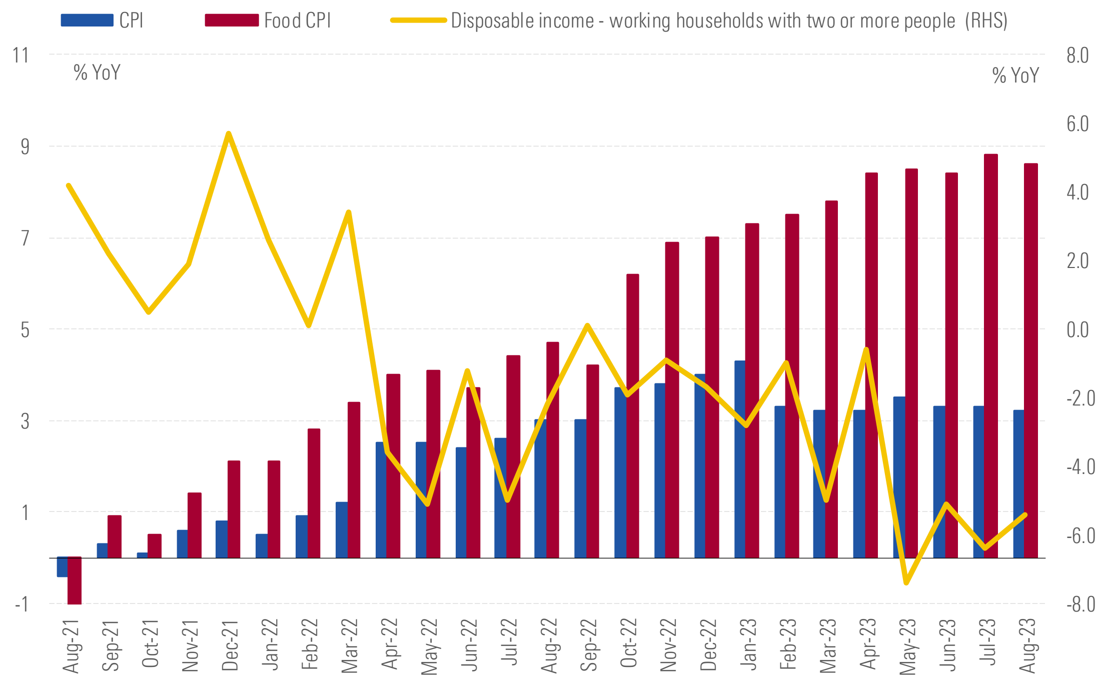
Price Hikes Continue to Temper Demand but Cost Pressure Should Ease From 2H 2023

Kao is the preferred name in our Japan consumer coverage, given attractive valuations and an improved profit outlook from the second half. Price hike efforts coupled with a decrease in some of the major input costs, including palm kernel oil and naphtha, should lift Kao's margins and profits from the July quarter. The hot weather is also favorable for selling sunscreen and laundry detergents, Kao's core strengths. Kao and Meiji were two names hit hard by commodity inflation and yen weakness due to Japan's high profit concentration, where price hikes were historically hard to pass through. Kao and Meiji may outperform the most from our consumer coverage if the global economy heads for recession, which often triggers yen appreciation and a decline in commodity prices. Yet, given price hikes on dairy products in August and another round of price hikes scheduled for November, a decline in sales volume—which usually takes around three months to recover—is likely to weigh on Meiji's profits until the end of 2023 or early 2024.

Aluminum and Barley Prices Retreated Notably in 2023



Kao's Profits Hindered by Cost Pressures and Weak Household Income



Source: National Bureau of Statistics, Ministry of Finance Japan, U.S. Bureau of Labor Statistics, YCharts.

Consumer Defensive

Company (Ticker)		Rating
Asahi (2502)		★★★★
Price	**Fair Value**	**Uncertainty**
JPY 5,514	JPY 6,400	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
JPY 2,830.3	Narrow	Standard

Narrow-moat Asahi is our top pick in our Japanese consumer coverage. Healthy growth of Asahi's domestic beer sales reaffirms our thesis that favorable excise tax rates imposed on beers will continue to prompt consumers to shift to beer, where Asahi holds a commanding lead and amasses a moat. Over the near term, on-trade volume recovery and price hikes implemented in October 2022 would alleviate cost pressure and bolster profits. Our fair value estimate is JPY 6,400, indicating an attractive 30% upside to our intrinsic value.

Company (Ticker)		Rating
Kao (4452)		★★★★
Price	**Fair Value**	**Uncertainty**
JPY 5,505	JPY 7,500	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
JPY 2,560.3	Wide	Standard

In the Japanese consumer space, we also suggest investors keep wide-moat Kao on their radar given attractive valuations. We anticipate a recovery in cosmetics and skincare sales, along with benefits of price hikes, to offset partial cost pressure. While we acknowledge Kao's ambitions of business transformation are likely to take at least a couple of years to bear fruit, we believe Kao's moats, underpinned by its intangible assets and a cost advantage, will allow it to deliver results. History has shown that Kao is able to bounce back from setbacks. Our fair value estimate of JPY 7,500 implies a handsome 36% upside.

Source: Morningstar. Data as of Oct. 6, 2023.

Consumer Defensive

Company (Ticker)		Rating
Tsingtao Brewery (00168)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 63.80	HKD 80.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 108.0	Narrow	Standard

Narrow-moat Tsingtao Brewery is the top pick in our China consumer staples coverage. Our fair value estimate of HKD 80 implies fiscal 2023 P/E of 23 times and enterprise value/EBITDA of 12 times. We think the company's pure focus on the beer industry—unlike China Resources Beer, which recently acquired a baijiu business—as well as Tsingtao's regional focus in Shandong and northern China, would make the company more defensive amid a rather adverse operating environment. In our view, major beer brewers in China are focused on premiumization opportunities and more rational in market competition, the latter of which could lead to better pricing power and avoid price wars that dampen profits. Tsingtao has dominant share in its core regions, so the company could leverage its distribution strength to drive mix upgrade, instead of pulling heavy weight in attempting to gain share in other players' core markets. We note China Resources Beer has also faced headwinds when trying to expand its subpremium portfolio in Budweiser APAC's core regions along the coastal provinces. Input prices could become more favorable as aluminum and barley prices moderate in the next few quarters. We also note Tsingtao Brewery demonstrated its ability to control operating expenses when the operating environment turned negative in 2022 amid channel disruptions.

Source: Morningstar. Data as of Oct. 6, 2023.

Financial Services

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Outside China and Japan, Cyclical Peak in Net Interest Margins Seems Likely to Persist in 2024

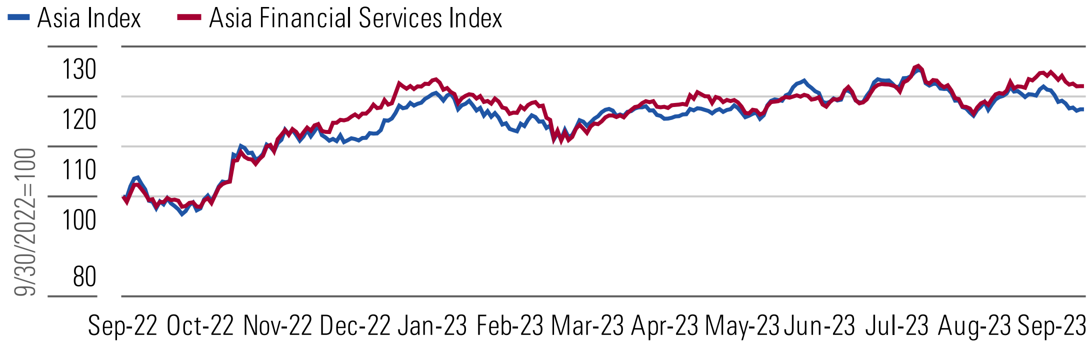
The Morningstar Asia Financial Services Index outperformed the Morningstar Asia Pacific Index in the third quarter with a 2.0% rise versus a 1.6% decline in the broader index, as strength in Japanese financials – which rose 14% in local currency and 3.5% in U.S. dollar terms – as well as Singaporean and Korean banks offset weakness in most Chinese financial shares.

As expectations for the U.S. Federal Reserve's rate cuts continue to get pushed out further into the future, previous expectations that net interest margins of Singaporean, Hong Kong, and Korean banks would start to narrow are being replaced with expectations for wide net interest margins, or NIMs, to persist for a while, at the same time that credit costs mostly remain under control. This combination is modestly positive for these banks' profit outlook in 2024 and 2025, in our view, and we are bullish on a majority of banks, while acknowledging the presence of tail risks for higher credit costs.

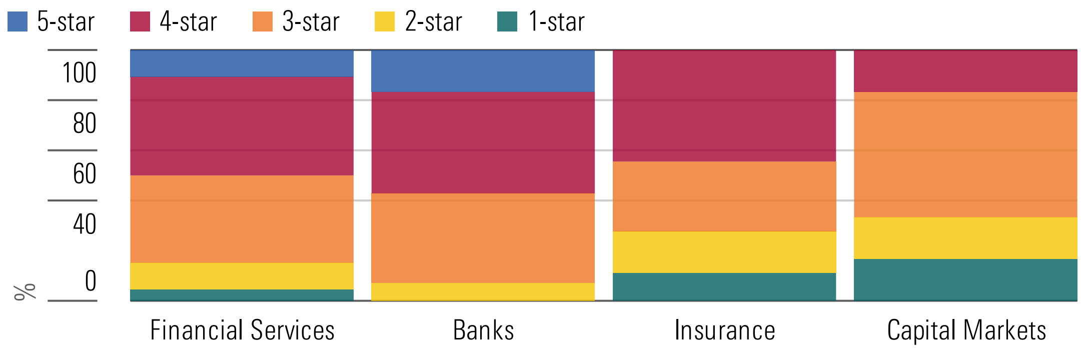
For Japanese banks, the widening of net interest margin is a secular rather than cyclical story, powering valuations to their highest in a decade. Japanese banks are still cheaper than most global peers but we think the prices are fair given that it will take time for the secular improvement story to be realized, perhaps longer than the market is hoping for.

The market has turned more positive after the July Politburo and the easing of property market curbs in late August, but investors remain worried about lingering revenue pressures and the property market downturn. As the banks' NIMs have yet to bottom, H-shares of most banks traded at a historic low valuation level of 0.2 to 0.3 times 2023 price/book, and offered attractive dividend yields of 9%-10%. Recent policy easing indicated that the stabilizing near-term economic growth has become a major priority to the government's top leadership. The supportive policy stance and recent signs of stabilization in the economy based on August macroeconomic data should mitigate near-term credit quality risks for large banks, but we are not overly optimistic about the fourth-quarter recovery, as Golden Week spending remained conservative.

Financial Services Outperformed the Asia Market in Q3



Banks in Asia Are Trading at Compelling Valuations

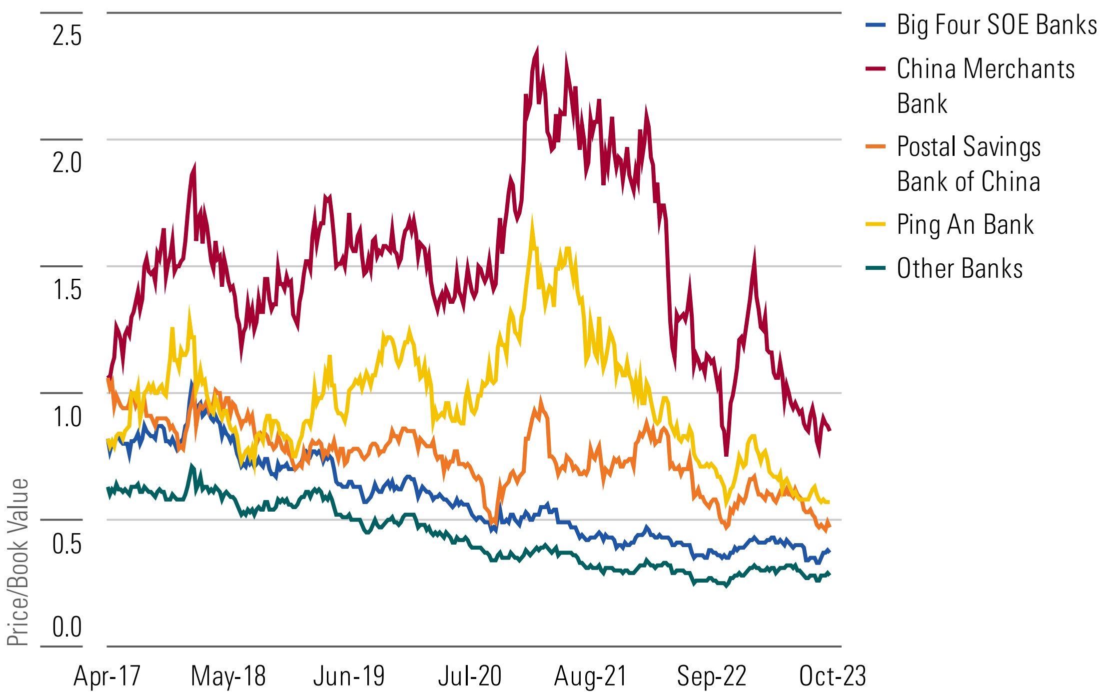


Source: Morningstar. Data as of Sept. 30, 2023.

Pressured by Falling Yields Amid Sluggish Demand, Banks Remain Significantly Undervalued

We prefer Agricultural Bank of China, or ABC, and China Construction Bank, or CCB, for their attractive valuation, high dividend yield, and resilient earnings growth despite mounting challenges. Leading retail-heavy banks, including China Merchants Bank, or CMB, and Ping An Bank, or PAB, remain key beneficiaries should consumer confidence recover. However, given that the recovery in consumer confidence and property sales is still out of sight, we have less conviction in near-term relative outperformance by these banks, as we expect they will be more adversely affected by the property market downturn for the remainder of 2023.

Price/Book Ratios of Chinese Banks



Source: PitchBook.
Note: SOE = state-owned enterprise.

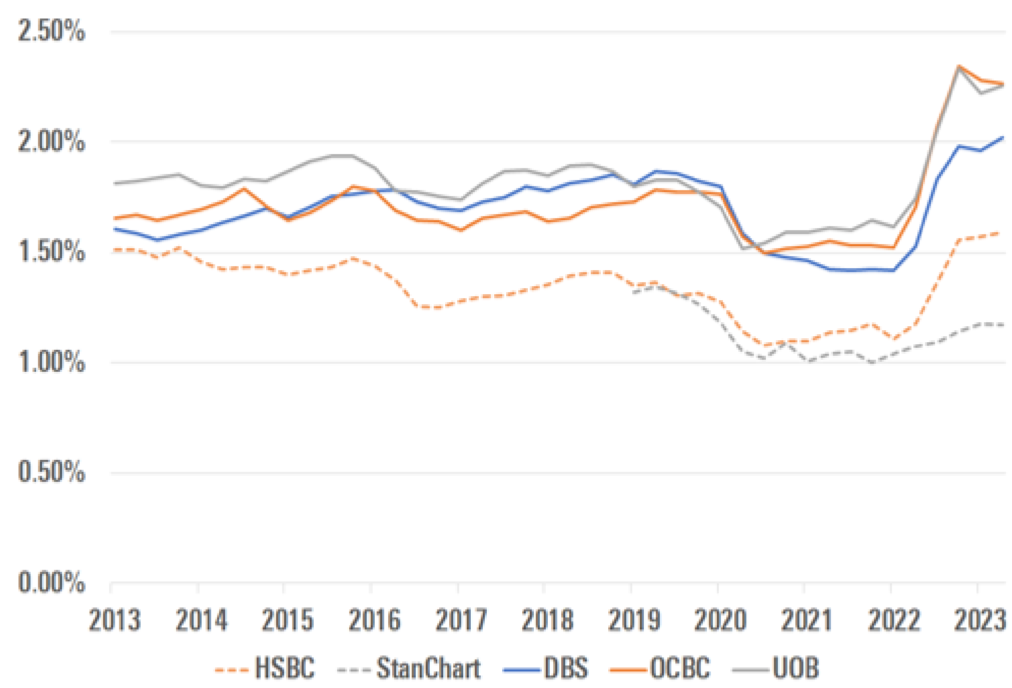
NIMs Trended Down on Monetary Easing for Chinese Banks

Source: Company disclosures, iFinD.
Note: CMB refers to China Merchants Bank.

Outside Mainland China, We See Opportunities in Asian Banks Based on Both Earnings Trends and Valuations

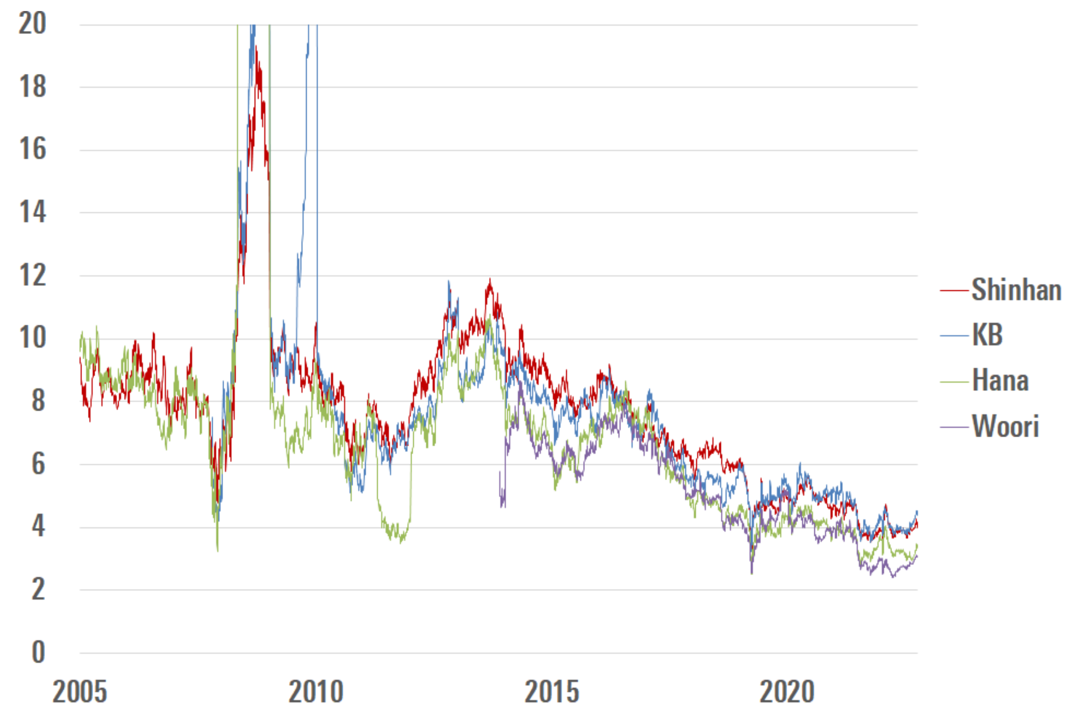
Outside of mainland China, we are generally bullish on banks in Hong Kong, Singapore, and Korea, and neutral on Japanese banks, which have performed well in 2023 and are near our fair value estimates. For Singapore banks, valuations are near long-term historical averages in terms of price/book, but returns on equity are improving due to still-buoyant NIMs as well as increasing wealth-management fees and cross-border opportunities between Greater China and the Asean countries, so we think valuations could rise above the past averages for some banks like DBS. For Hong Kong banks, valuations are below their long-term historical averages, but here too we see earnings upside, even if the trends are more mixed than in Singapore. Meanwhile, Korean banks face headwinds on the earnings front from credit risks, but valuations are very attractive, with the banks trading around 4 times earnings.

Rather Than Dropping, HK and Singapore Banks' NIMs Are Plateauing



Source: Company data; Morningstar.
Note: 2023 represents Morningstar forecasts.

Price/Earnings Ratios of Korean Banks Based on Forward Consensus



Source: Korea Exchange, Morningstar, Bloomberg.

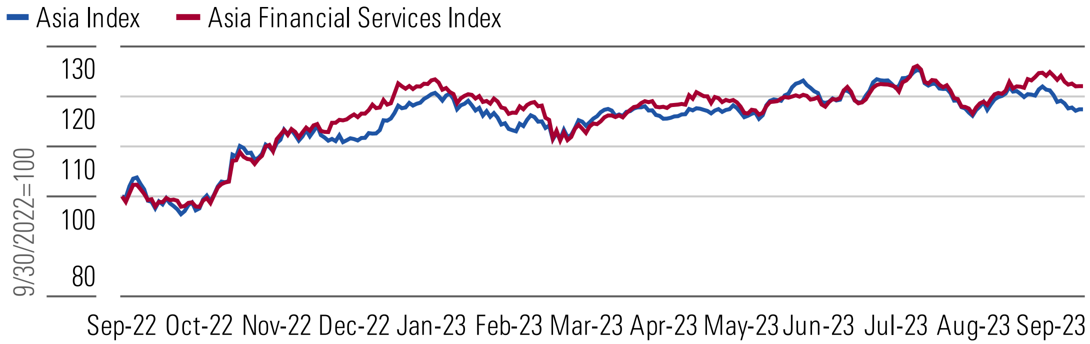
Select Chinese and Korean Nonbank Financial Entities Are Attractive; Japanese Insurance Somewhat Overvalued

As expected, Chinese life insurers reported solid third-quarter results with stronger-than-expected new business growths. However, premium growth dropped significantly in August across the sector after the regulatory guarantee rate cut in end-July. We expect this slowing trend will continue in coming months as the third and fourth quarters usually reported weak sales. Though the new bancassurance rules are likely to adversely affect premium growth in September and October, they should benefit life insurers' underwriting profitability by lowering commission rates in the longer term. With the recovery of protection type product sale is still out of sight, we expect new business margin to remain largely stable or slightly increase helped by guarantee rate cut and bancassurance commission rate cut. But new business value growth in the second half is likely to slow from the first half's level on higher base and slowing premium growth. We continue to expect double digit growth in new business value for 2023 on resilient product demands and stabilizing agent headcounts in the third quarter.

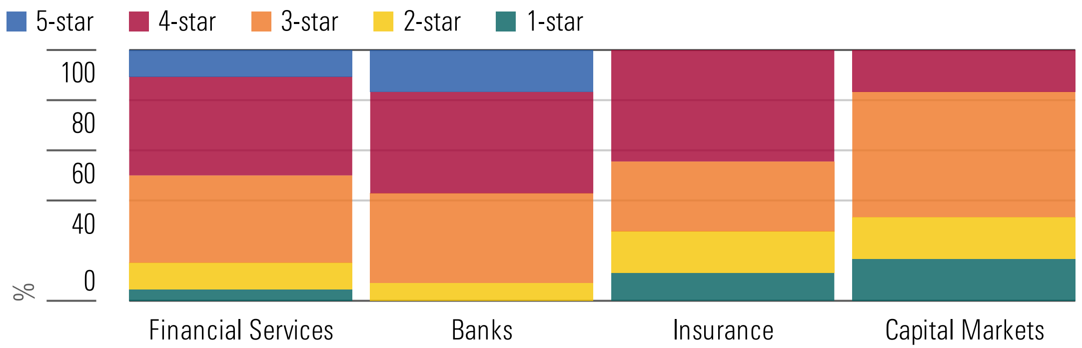
Premium growth also slowed at P&C insurers in July and August primarily on weaker sales of non-auto insurance segment including liability, accident and health insurance products, while auto premium growth slightly improved. We suspect the improved auto insurance premium growth was partly due to increasing sales contribution from higher-priced new energy vehicles policies. Our preferred shares among are Ping An Insurance and AIA. We like Ping An's improving new business momentum after the successful implementation of life insurance reform. AIA is also undervalued after a 19% decline in share price in the third quarter and we like AIA's better-than-peer long-term growth supported by market-leading position in all of its key Asian markets.

Japanese nonlife insurers' share prices have mostly proved resilient to a dual scandal around false claims at a major used-car deal and alleged cartel pricing for some corporate insurance products. We think they are somewhat overvalued currently given their priciness relative to historical averages and risks that these scandals could hurt earnings or at least limit future price increases in Japan. Japanese life insurance is also a bit above our current fair value estimate, though we acknowledge the benefits from higher bond yields.

Financial Services Outperformed Slightly Against the Asia Market



Positive Long-Term Trends Partially Priced Into Chinese Insurers



Source: Morningstar. Data as of Sept. 30, 2023.

Financial Services

Company (Ticker)		Rating
BOC Hong Kong (02388)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 21.50	HKD 35.50	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 228.4	Narrow	Exemplary

With strong fundamentals and a close connection with parent Bank of China, BOC Hong Kong is a beneficiary of rising economic integration in the region, in our view. The bank's key advantages are its cross-border banking services and connections with its parent bank. Earlier, we had concerns about the asset quality of the purchased entities from its parent, but asset quality remained resilient during the pandemic downturn. From a valuation perspective, the bank's Southeast Asia asset acquisitions were at the high end of valuation, in our view. Positively, the acquisitions differentiate the bank from local Hong Kong peers, with regional reach to capture long-term growth opportunities. The bank's risk profile should increase as the bank expands its footprint in Asia, but strong historical underwriting standards and a prudent balance sheet add comfort. We believe the risk is priced into the current share price.

Company (Ticker)		Rating
Agricultural Bank of China (01288)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 2.88	HKD 3.50	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 1,326.7	Narrow	Standard

As China's third-largest bank by assets, Agricultural Bank of China boasts a dominant position in county areas and has sector-leading network scale that reward it with low funding costs and a narrow economic moat. With over 20,000 outlets covering all county areas and a prestige brand for rural banking, ABC enjoys the largest deposit base. We believe ABC's industry-leading provision coverage and the improved credit quality after a three-year asset cleanup program should make future provision pressure manageable. Its deep roots in rural banking will benefit from growing credit demand in underserved rural areas, and we expect its better-than-peer loan growth momentum to partly offset the negative impact of falling interest rates.

Source: Morningstar. Data as of Oct. 6, 2023.

Financial Services

Company (Ticker)		Rating
DBS Group (D05)		★★★★
Price	**Fair Value**	**Uncertainty**
SGD 33.79	SGD 41.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
SGD 87.6	Narrow	Exemplary

DBS Group is the largest bank in Singapore by several measures. With the largest deposit market share in Singapore dollars and a high proportion in low-cost deposits, we expect the bank to benefit most from interest-rate increases in the medium term. We anticipate EPS rising 35% in 2023, reflecting the full impact of interest-rate increases in 2022. The high growth is also supported by the Citibank Taiwan acquisition. Our fair value estimate of SGD 41 represents a 2024 price/book ratio of 1.65 times. This is a moderate premium to DBS' historical average price/book ratio, but we forecast ROE above 15% across our forecast horizon, higher than DBS' 10-year average ROE of 11.3%. We think DBS Group is likely to benefit from rising wealth-management revenue and may pick up some share in this market following the consolidation of UBS and Credit Suisse.

Company (Ticker)		Rating
KB Financial (105560)		★★★★
Price	**Fair Value**	**Uncertainty**
KRW 55,800.00	KRW 75,000.00	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
KRW 21,748.5	None	Standard

We believe all major Korean banks have significant upside to their fair value estimates of at least 50%. Among them, KB Financial—the largest by total assets and roughly tied with Shinhan Financial for the largest by market cap—has the most upside currently to our fair value estimate. Like Shinhan, it has large nonbank financial businesses that contribute more than 40% of total profit and provide earnings diversification. KB has slightly larger exposure to household mortgage and jeonse lending, which we think provides room for a rebound if the Bank of Korea stops raising interest rates and a recent decline in property prices subsides.

Source: Morningstar. Data as of Oct. 6, 2023.

Healthcare

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Waiting to See Updates on Antigraft Campaign or Innovative Drug Launches to Boost Sentiment

The Chinese pharmaceutical sector continued to exhibit volatile stock pricing in the third quarter, and it underperformed the broader Asia equities market. Sentiment has been weak across the board, both for domestic drugmakers and contract services organizations with overseas clients.

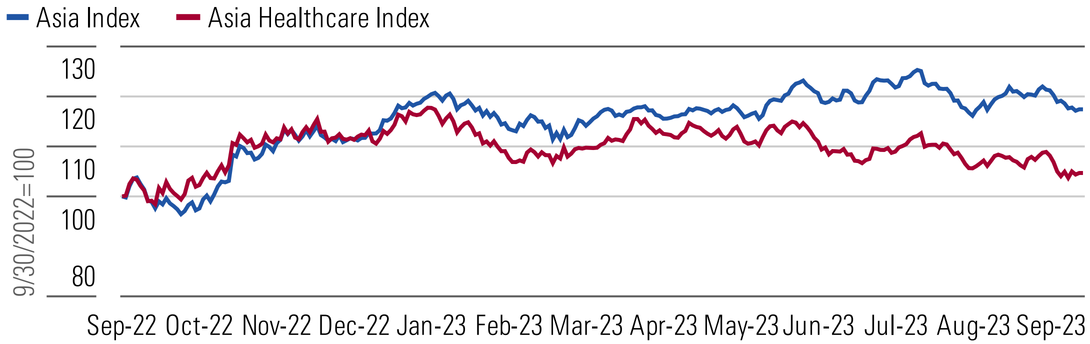
In line with our expectations, various near-term and midterm factors continue to weigh on valuations, including concerns that: 1) geopolitical tension between the U.S. and China will prevent innovative Chinese drugs from getting approval in global markets; 2) there will be a lack of highly innovative products in Chinese drugmakers' late-stage pipelines; 3) price controls will limit profitability in the domestic market; and 4) funding constraints for biotech drugmakers are unlikely to ease this year.

Additionally, some companies have recently signaled a decline in drug sales due to antigraft campaigns in China. Based on the historical pattern of the antigraft campaign in 2013, we expect the short impact on sales to gradually ease out by the end of the year or early 2024. From a long-term perspective, we believe there will be structural shifts in sale expenses and promotional packages for medical device companies. For instance, the previous model of selling large expensive medical equipment at a low price and then making profits by selling daily disposable materials is unlikely to be continued.

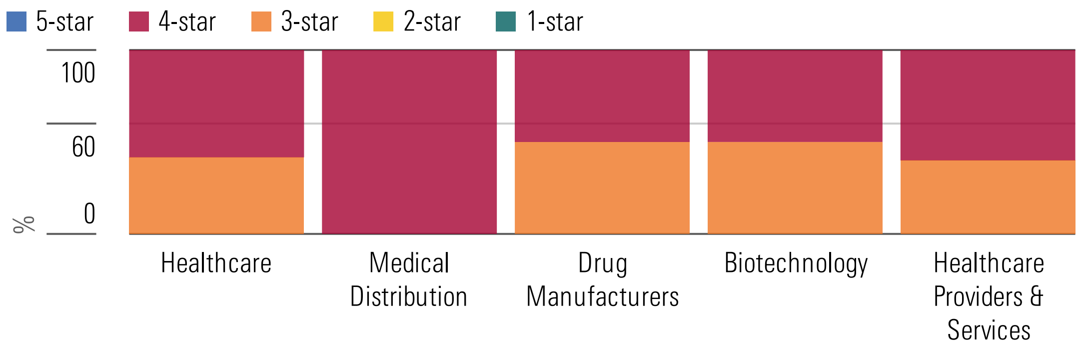
We maintain our view that China's domestic government policy is unlikely to tighten above and beyond the measures and framework already in place—that is, it will cut prices but still allow drugmakers to make modest returns on investment. The results of the 2022 national reimbursement drug list were relatively mild for key drugs such as PD-1 inhibitors, giving us some clarity on the price cut trajectory of other fast-follower drugs that make up the bulk of Chinese drugmakers' pipelines.

Looking ahead, we think the most material drivers for improving sentiment will be progress on clinical trials, approval of Chinese-developed drugs in the U.S. market, and successful commercial launches for fast-follower drugs in the China market, such as GLP-1s.

Healthcare Ends Q3 on Weaker Note After Outperforming



Policy Uncertainty Factored Into the Share Prices of Healthcare Sector Stocks

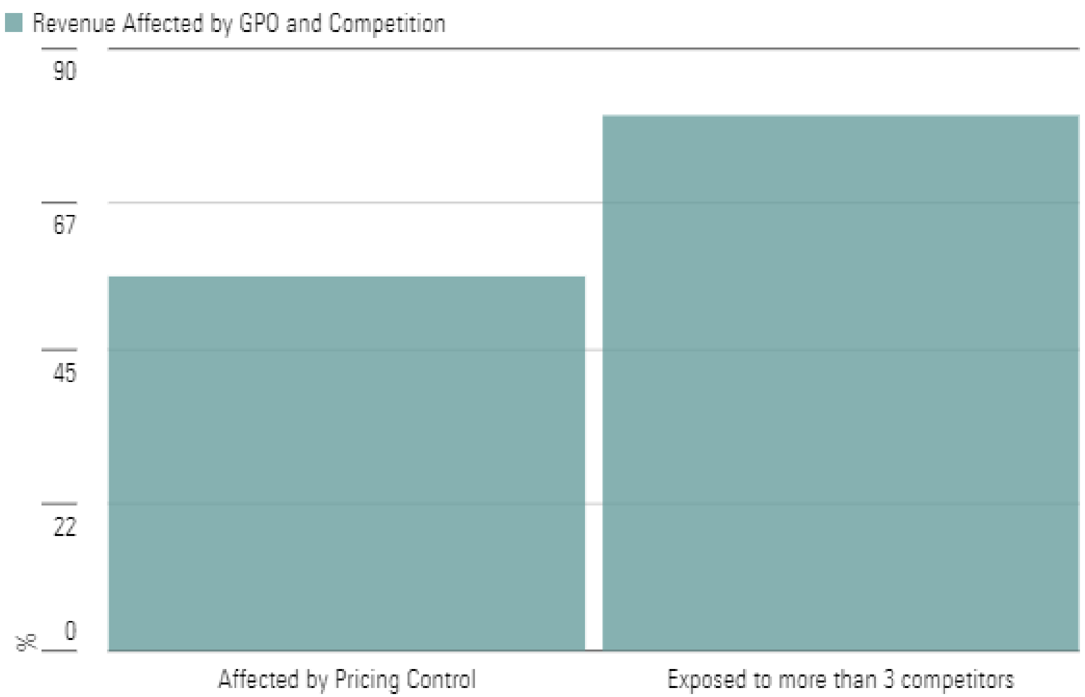


Source: Morningstar. Data as of Sept. 30, 2023.

Bullish on Long-Term Fundamentals of Chinese Healthcare, Near-Term Sentiment to Remain Choppy

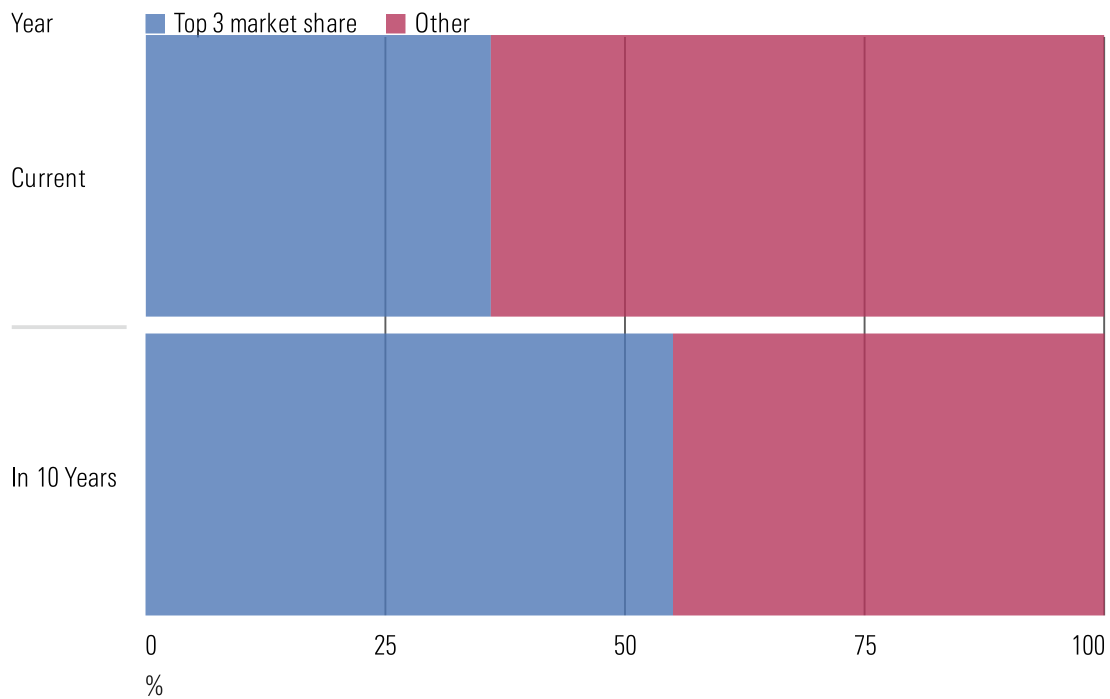
Regarding drug approvals, we still believe that Chinese drugs will continue to get approval provided they fulfil unmet clinical need and undergo multiregional clinical trials, with close coordination with the U.S Food and Drug Administration. This was most recently validated by the approval of BeiGene's zanubrutinib for chronic lymphocytic leukemia in January, and we expect an additional approval for Legend Biotech's Carvykti in earlier lines of multiple myeloma by the end of 2023.

Percentage of Sino Biopharma's Revenue Affected by GPO and Competition



Source: Company disclosures.

Market Share of Top 3 Drug Distributors to Benefit From Consolidation



Source: Company disclosures; Ministry of Commerce – statistics report on pharmaceutical circulation industry; Morningstar analysis.

Note: GPO = group purchasing organization program.

Healthcare

Company (Ticker)		Rating
CSPC (01093)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 5.41	HKD 8.90	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 65.7	Narrow	Standard

CSPC is one of China's "Big Pharma" companies, and we think the current price is an attractive entry point. The market is focused on slower growth in the company's older drugs, many of which are expected to have flat growth or will even see declines over the next few years. These include flagship drugs such as NBP and Keaili (albumin-bound paclitaxel). Nonetheless, we think the company has shown decent pipeline progress and we believe its future launches can largely replace lost revenue from older drugs. We think CSPC's long-term vision is organically grounded in its existing capabilities in lipid-based delivery manufacturing, which has recently been validated by the approval of its COVID-19 vaccine, the first domestic mRNA vaccine of any kind to be approved in China. Although this platform is unlikely to generate significant revenue in the near term, given the lack of large demand for COVID vaccines, we think there is long-term potential if CSPC can develop more vaccines for other diseases, such as influenza.

Company (Ticker)		Rating
Wuxi Biologics (02269)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 43.70	HKD 76.80	Very High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 190.1	Narrow	Standard

WuXi Biologics is the largest biologics contract development and manufacturing organization, or CDMO, in China and the third-largest globally. The share price has been depressed due to ongoing concerns of U.S. and China tensions, profit margin compression as WuXi brings more overseas manufacturing sites online, and fewer new projects due to a difficult funding environment for small-to-midsize biotechs. We maintain our view that Chinese CDMOs will not be excluded from providing services to U.S. biotech companies. We do not think WuXi will dominate its industry by pushing out competitors with much lower pricing, which is arguably one of the key reasons other Chinese companies have been targeted. Additionally, it is actively building out labs and production facilities overseas that can be inspected by U.S. and European regulators, aiming to further reduce its risk of being targeted by policymakers. From this perspective, we think its decision to bring its overseas sites online sooner rather than later is prudent. The entire biologics CDMO industry enjoys long-term secular tailwinds due to the increasing need for biologics manufacturing capacity and drug development services. Barring enactment of exclusionary policy by the U.S. government, we believe WuXi is well-positioned to take advantage of this trend.

Source: Morningstar. Data as of Oct. 6, 2023.

Industrials

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Continue to Focus on Laggards, Expect Outperforming Airlines to Ease

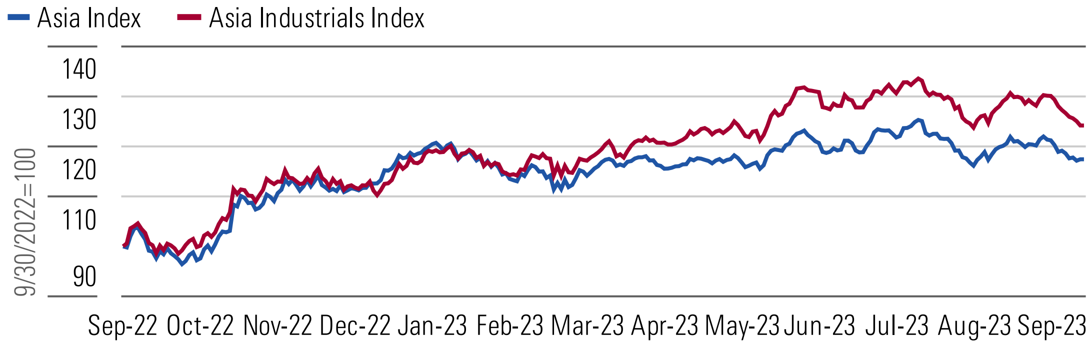
The industrials sector trades at a slight 8% discount to our fair value estimates after pulling back during the third quarter. We think disappointing guidance from the factory automation companies and some profit-taking in the airlines with jet fuel prices rising drove the weaker performance.

The Japanese industrials sector has continued to face declining new orders, due to weak macroeconomic headwinds in China and sluggish semiconductor-related investments. Consequently, this has particularly affected the share prices of those with higher regional and industry exposures. While we expect the Japanese capital equipment and industrials component manufacturers will face headwinds in the near term, we believe the market has already priced in much of these expectations. We see strong upside potential in companies like Fanuc, Daifuku and Nabtesco, as the wide-moat companies are well-positioned for further top-line growth from an eventual pickup in Chinese manufacturing/construction activity and semiconductor production toward the first half of 2024.

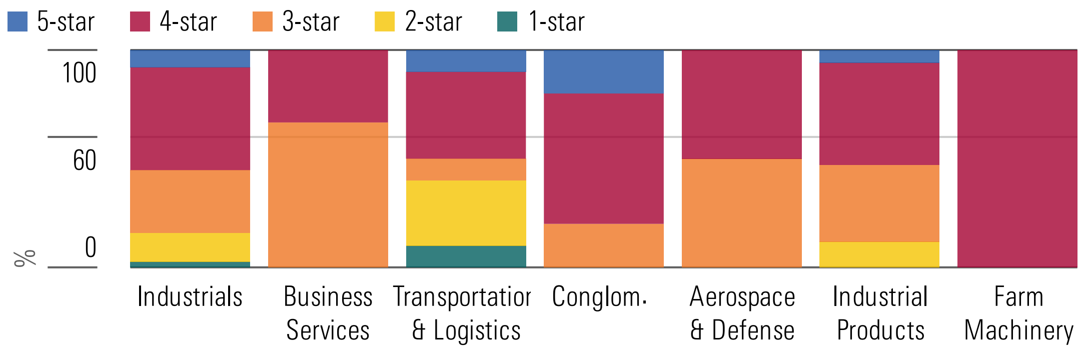
While average daily air passenger traffic during the Chinese Golden Week holiday increased by 12.6% versus the same period in 2019, this was lower than the Civil Aviation Administration of China's forecast. We think the miss was partly due to the airlines' pricing strategy that prioritizes yield over traffic. According to Flight Master, average economy class airfare during the holiday increased by 13.3% compared with the same period in 2019. However, the passenger traffic growth for airlines clearly lagged the over 20% growth for high-speed rail compared with 2019. The H-shares of Air China and China Southern Airlines are attractive after recent share price correction, but we prefer Cathay Pacific for its healthier balance sheet and lower foreign exchange and fuel price risks.

We continue to like ST Engineering. The stock performed relatively well in the third quarter, which we anticipate should continue. We prefer STE over the airlines as maintenance, repair and overhaul activity remains robust as air travel normalizes and there are still older aircraft that need to be certified and maintained, with new aircraft deliveries facing lingering delivery delays.

Industrials Outperform, Not as Cheap as Other Sectors



Limited Opportunities for Greater Upside, Favor Selected Laggards



Source: Morningstar. Data as of Sept. 30, 2023.

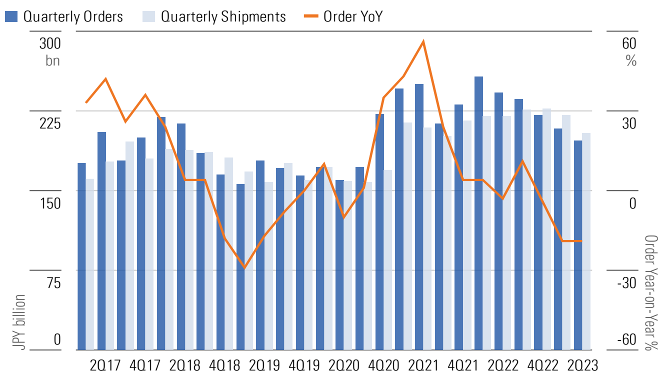
Japan’s Robot Orders, China’s Manufacturing Data Remain Weak; We Expect a Stronger Recovery in 2024

Global demand for industrial robots, as measured in Japan’s orders and shipments, continued to be sluggish in the second quarter of 2023. Second-quarter orders declined by 19% year on year, which was similar to the previous quarter, suggesting that demand is not unscathed by the ongoing macroeconomic headwinds. With EV-related investments likely to slow down, we expect continued headwinds in the factory automation space. However, we think robotics demand will recover in the first half of 2024, as electronics production picks up. Over the medium term, we think new robotic applications in fields outside the traditional automobile/electronics industries will drive demand.

Japan machine tool orders declined year on year for nine consecutive months, as capital equipment demand remains low from weak manufacturing activity. Investments related to semiconductor production equipment in Japan as well as consumer electronics in China have been stagnant throughout the year. However, we think orders have bottomed, as the 17% sequential monthly increase for September orders was stronger than the normalized seasonal increase. Although a stronger pickup in demand will likely be in 2024, in the meantime, we expect a gradual sequential order increase in select areas based on trends like continued aircraft production recovery.

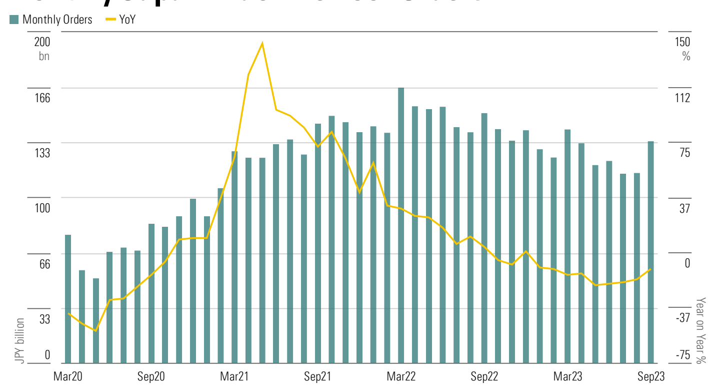
China’s manufacturing PMI rose slightly in September to 50.2, implying a slow expansion, after remaining below 50 for five consecutive months. With uncertainties over inflation likely to affect consumer confidence and capital investments, we believe momentum for growth in the near term will be limited without further government policy support. As such, we suspect that the fourth quarter will remain sluggish amid continued concerns over high interest rates. We expect manufacturing activity in China to pick up in 2024.

Quarterly Japan Industrial Robot Orders & Shipments



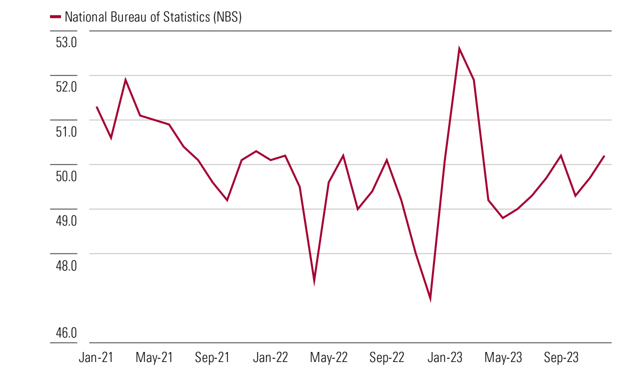
Source: Japan Robot Association. Data as of Oct. 9, 2023

Monthly Japan Machine Tool Orders



Source: Japan Machine Tool Builders' Association. Data as of Oct. 11, 2023

China Manufacturing PMI



Source: National Bureau of Statistics. Data as of Oct. 9, 2023

Industrial

Company (Ticker)		Rating
Harmonic Drive Systems (6324)		★★★★★
Price	**Fair Value**	**Uncertainty**
JPY 3,285	JPY 5,900	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
JPY 318.0	Wide	Standard

Harmonic Drive Systems manufactures and sells strain wave reduction gears, which serve as key components for industrial robots, semiconductor production equipment, and other high-precision capital equipment. Despite near-term orders likely being affected by a manufacturing slowdown in China as well as lower demand for small robots used in the electronics industry, we remain convinced that orders will not drop to levels of the U.S.-China trade friction in 2018-19. With its wide moat remaining intact and as the strain wave gear market leader, the company is best-positioned to capitalize on increased demand for high-end robotic applications (like for electric vehicle/battery production), collaborative robots, and newer types like humanoid/surgical robots.

Company (Ticker)		Rating
ST Engineering (S63)		★★★★
Price	**Fair Value**	**Uncertainty**
SGD 3.84	SGD 4.72	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
SGD 12.0	Narrow	Standard

The COVID-19 impact aside, Singapore Technologies Engineering is driving growth through improved utilization of its capital alongside a plan to contain costs. It has divested noncore activities to focus on areas that will provide synergies to its key aircraft maintenance and smart city activities. In this regard, it is adding proprietary product makers to its stable. Overall, we see STE's EPS growing a five-year CAGR of 15%, marking an improvement over the 2.7% prepandemic 10-year average, which reflects the pandemic recovery but also contributions from recent acquisitions. Concerns over its current high net gearing, which we estimate to be 2.36 times in 2023 due to the acquisition of TransCore in 2022, have been an overhang to share price performance. However, we expect net gearing to be manageable and to fall back to 0.87 times in 2027 on positive free cash flow.

Source: Morningstar. Data as of Oct. 6, 2023.

Real Estate — Developers

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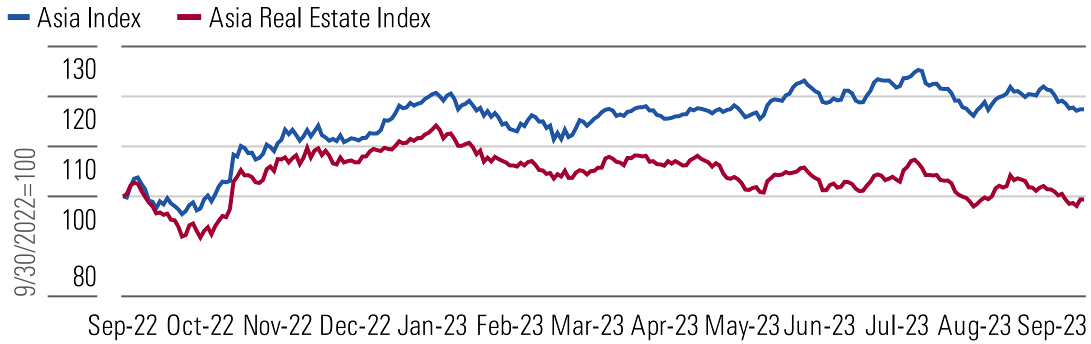
China's Real Estate to Recover Slowly On Policy Tailwinds, High Interest Rates Weigh on Hong Kong Housing

The Morningstar Asia Real Estate Index continued to underperform the broad Asia Index in the third quarter of 2023. Despite meaningful policy relaxation in China's Tier 1 and Tier 2 cities following the Politburo meeting in July 2023, housing demand remained weak as homebuyers' sentiment needs more time to recover. That said, site visits and transactions in some wealthy cities, such as Beijing and Shanghai, have started to improve in September, which gives us confidence that housing prices should gradually stabilize by end-2023. However, we believe inventory absorption in lower-tier cities is still challenging amid pronounced oversupply. Looking forward, we expect more easing on home purchase restrictions and the down payment ratio to restore homebuying confidence, as well as supportive measures for completing stalled projects.

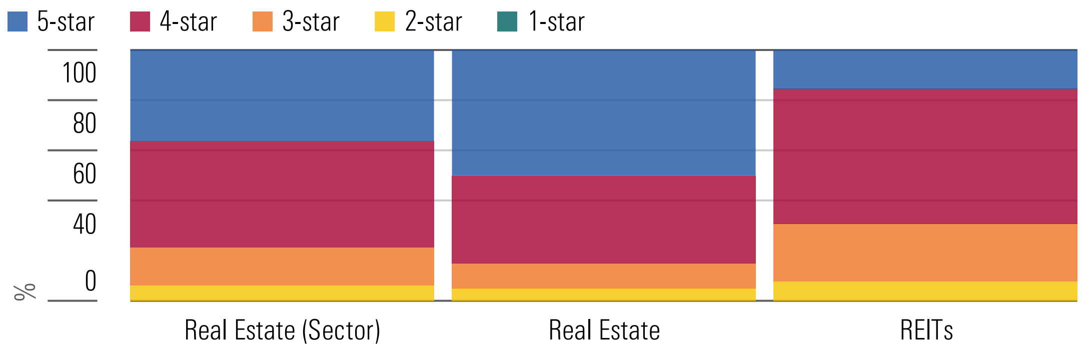
While the year-on-year sales drop persisted in the third quarter for most developers, large state-owned developers continued to outperform privately owned peers in general. We think this is mainly due to their stronger brand premium, better financial health, and landbank acquired in better developed regions. For the fourth quarter, we foresee new home sales to pick up sequentially under ongoing stimulus measures and promotional campaigns, with state-owned developers such as China Overseas Land & Investment and China Resources Land the biggest beneficiaries.

The high interest-rate environment, coupled with an uncertain economic outlook, have continued to weigh on Hong Kong's housing market. Developers are offering greater price discounts to move inventory and we expect margins to remain compressed as buyers remain cautious. Amid calls for the government to ease property cooling measures, we think market activity may receive a boost from demand of owners with multiple homes and non-Hong Kong permanent residents if the stamp duties targeting these groups are relaxed. However, housing prices should remain under pressure as mortgage rates stay high.

Real Estate Still Underperformed the Broader Asia Market in Q3



Real Estate Developers' Valuations Are Undemanding

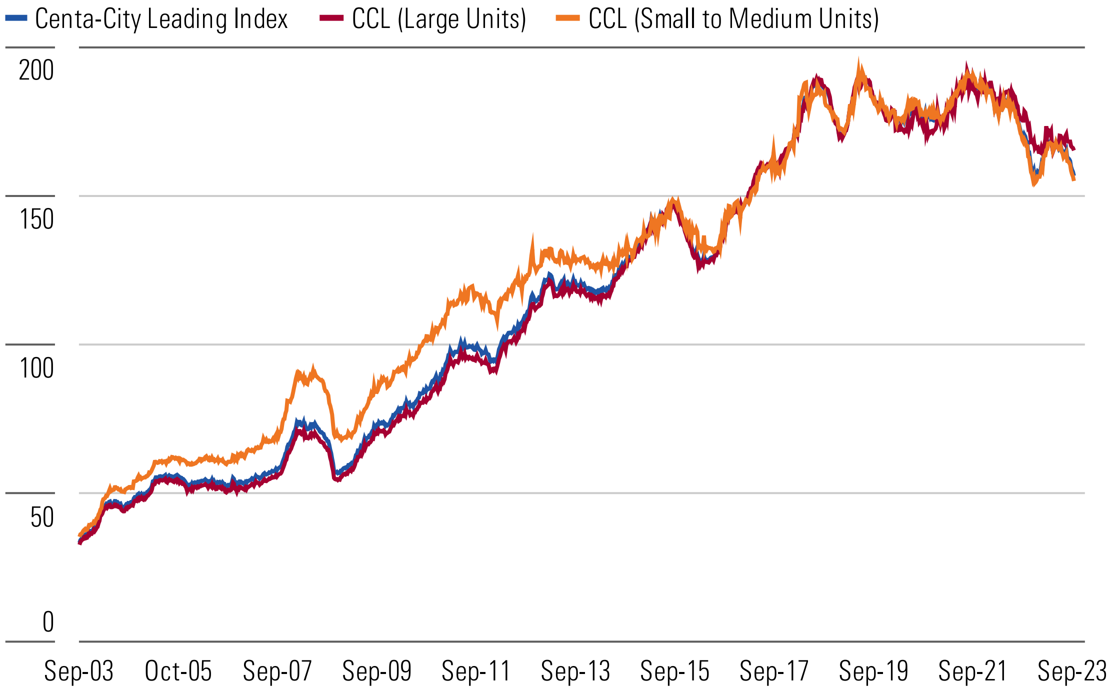


Source: Morningstar. Data as of Sept. 30, 2023.

China's Real Estate to Recover Slowly On Policy Tailwinds, High Interest Rates Weigh on Hong Kong Housing

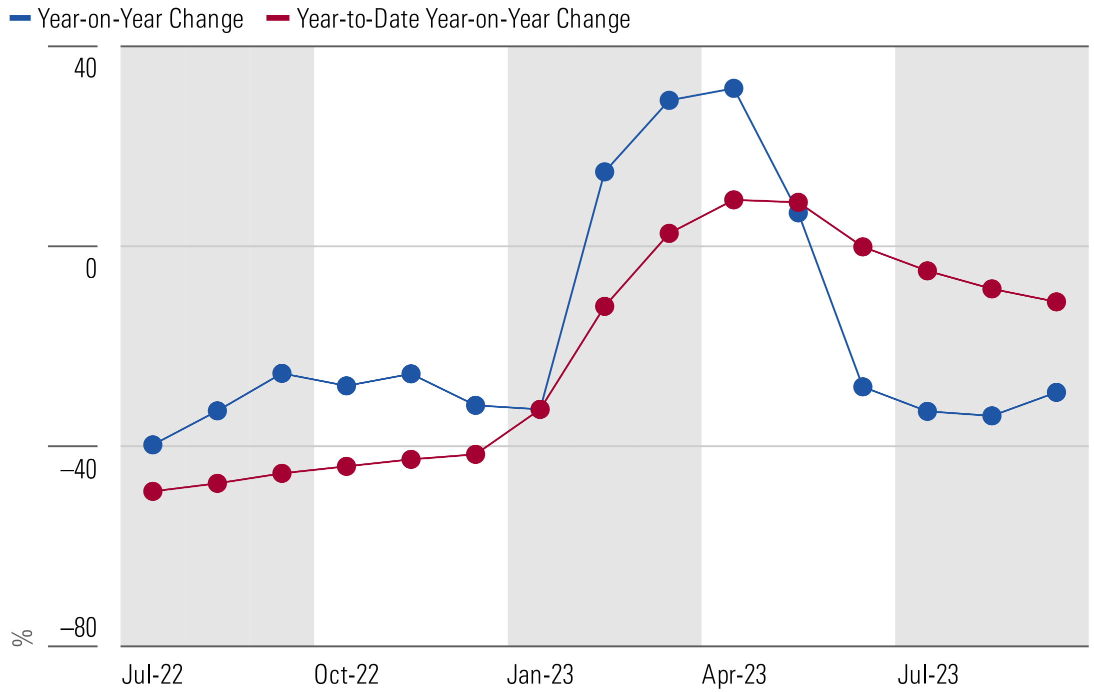
China home sales have not been able to sustain the initial rebound in early 2023 which disappointed the market. We expect a slow recovery with excess inventory weighing on confidence. We still expect sales to post single digit growth over 2022 level mainly due to a low base. We think supportive policies that lead to more stable prices will encourage buyers to nibble. This should help feed a more sustainable recovery through 2025.

Residential Real Estate Prices in Hong Kong Continued to Decline in Q3 2023



Source: Centaline.

Contracted Sales of China's Top 100 Developers Further Dipped in Q3 2023

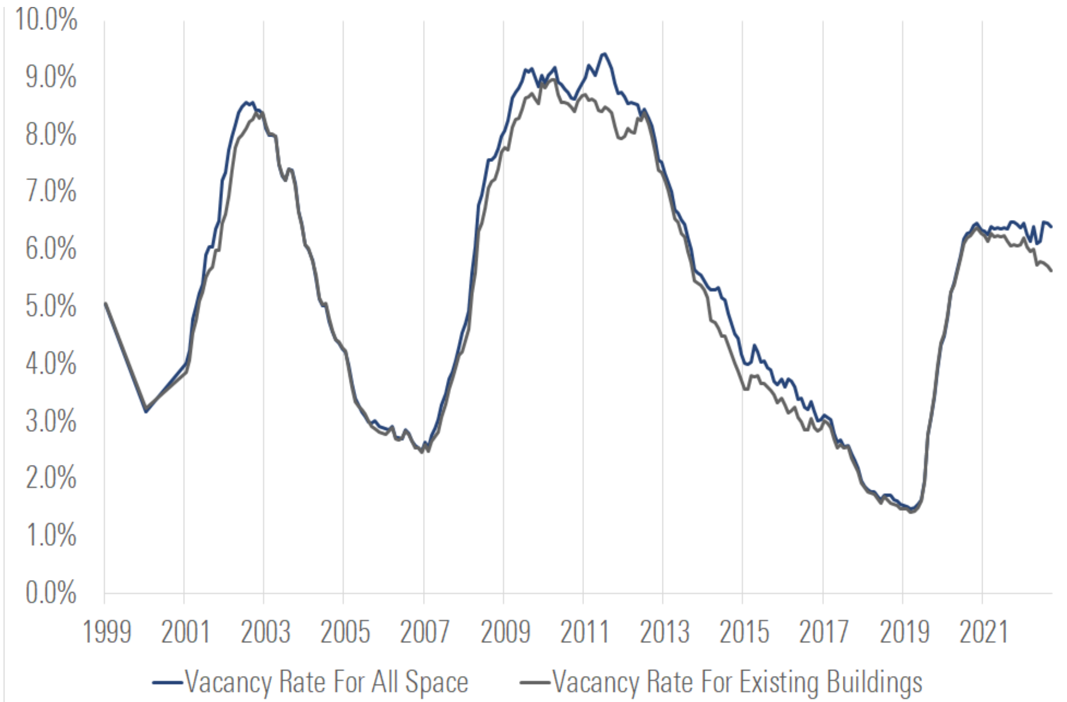


Source: China Real Estate Information Corp.

Japan's Office Market Is Improving, but Heavy New Supply in Late 2023 Must First Be Digested

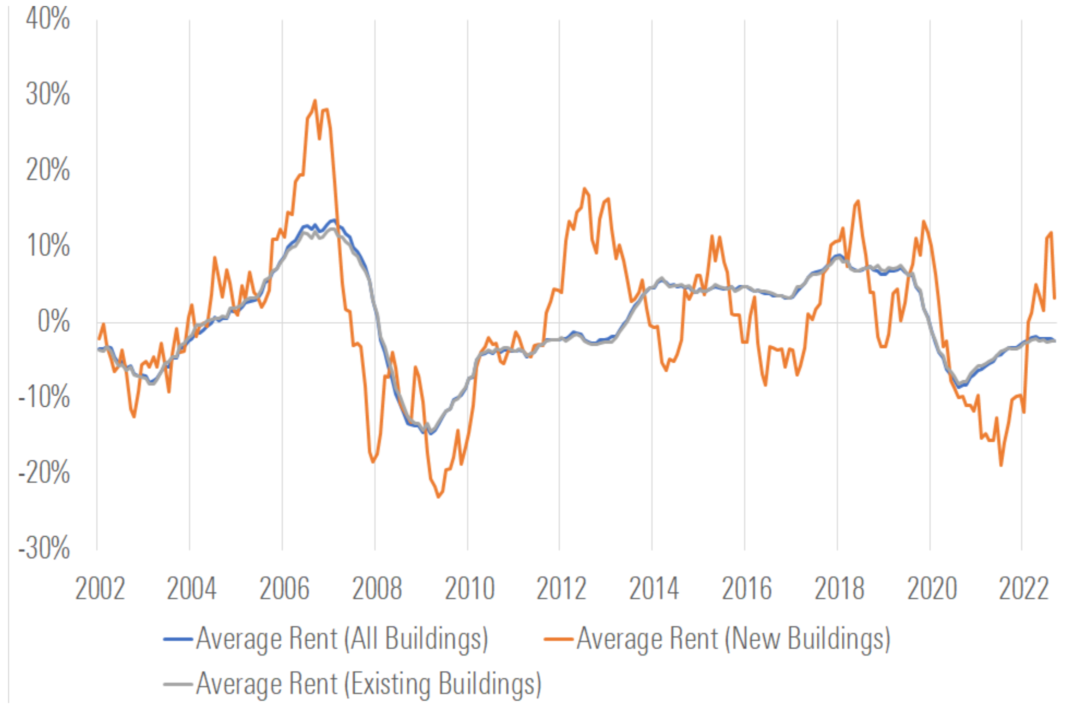
Demand for office space in Tokyo is improving, as seen in the decline in the vacancy rate for existing buildings since the beginning of the year. However, late 2023 is a period of heavy new supply, with the opening of a large mixed complex in Azabudai by unlisted Mori Building and two large buildings south of Shibuya Station by Tokyu Fudosan. As a result, the vacancy rate for new space is rather elevated and average marketwide rents are still declining year on year. We think average rents may stop falling by the end of 2024 if demand remains at current levels or improves further, as there is limited new supply scheduled to be completed in 2024.

Office Vacancy Rate in Tokyo's Five Central Wards



Source: Miki Shoji

Year-on-Year Change in Average Office Rents



Source: Miki Shoji

Real Estate

Company (Ticker)		Rating
Wharf REIC (01997)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 29.75	HKD 48.50	Medium
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 90.9	Narrow	Standard

Our fair value estimate for Wharf REIC is HKD 48.50, implying a price/book ratio of 0.75 and an enterprise value/EBITDA of 16.9 times. Wharf REIC's flagship properties, Harbour City and Times Square, are the largest retail assets in the respective area, and have collectively accounted for 8%-10% of Hong Kong's retail sales prior to the pandemic. While a change in consumption patterns in mainland China tourists could pose challenges to the Hong Kong retail sector, we expect Harbour City and Times Square to benefit from a consolidation trend, where luxury brands reduce their footprint elsewhere in the city, but expand their space within the Wharf REIC portfolio, as their properties remain tourists' preferred shopping location. We think shares are undervalued at the current price, with around 40% discount to our fair value estimate.

Company (Ticker)		Rating
China Overseas Land & Investment (00688)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 15.94	HKD 26.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 174.2	None	Standard

Our fair value estimate for China Overseas Land & Investment, or COLI, is HKD 26 per share, translating to a price/book ratio of 0.7 times. COLI is a large state-owned enterprise real estate developer in China with a strong balance sheet relative to peers. This allows the firm to possess more financial headroom under credit constraints and to fare well in the consolidation-heavy market by expanding its landbank in higher-tier cities. Funded by its core property development business, COLI is also posting solid growth in its commercial property portfolio with dual focus on offices and shopping malls for recurring income, which supports dividend growth. It is also in the early stages of developing diversified businesses around real estate development, including high-tech construction engineering and centralized building material procurement platforms.

Source: Morningstar. Data as of Oct. 6, 2023.

Real Estate — REITs

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Singapore REITs Fall on Uncertain Outlook and Interest-Rate Concerns; Real Estate Fundamentals Remain Strong

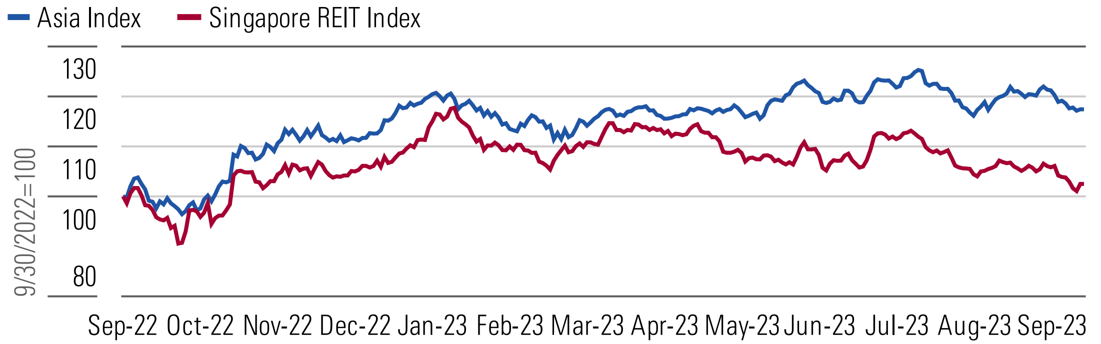
The Morningstar Singapore REIT Index fell another 4.3% in the third quarter of 2023, underperforming the overall Asia index. Aside from the elevated interest-rate environment, we think that investors are concerned over the diminishing near-term growth prospects as the postpandemic-driven recovery tapers off and the economic outlook becomes more uncertain. Nevertheless, we think that Singapore's real estate fundamentals remain strong, with a limited supply pipeline that should support rental performance even as demand moderates in the coming quarter.

Singapore's August 2023 retail sales grew 4% year on year, driven by the return of tourism. According to Cushman & Wakefield, leasing inquiries from international retailers have been healthy since the easing of border restrictions, with many fashion and lifestyle brands attracted to Singapore's small but affluent domestic market. While visitors from China have also recovered the top spot for visitor arrivals into Singapore, we see further room for recovery, given that August 2023 arrivals are about 54% of August 2019 arrivals.

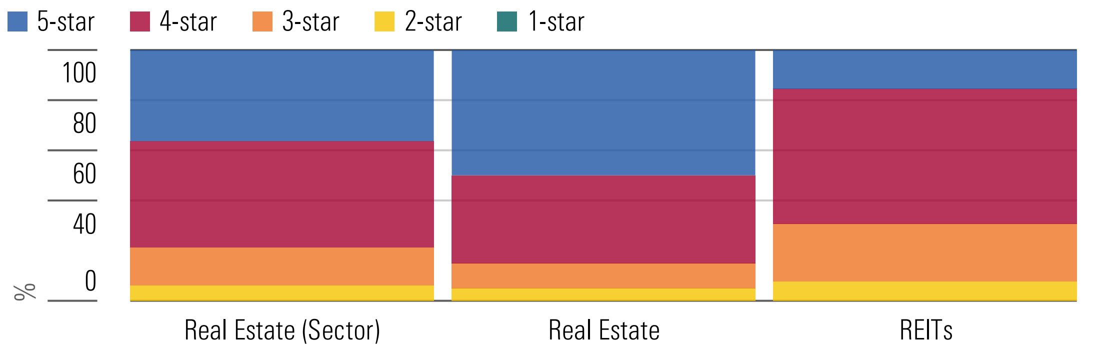
On the office front, we expect Singapore Central Business District Grade A vacancy rates to remain tight on the back of limited completion of office spaces in 2023. This will support rental growth and benefit office REITs under our coverage through positive rental reversions. That said, we expect managements to keep their cautious tone as office demand is expected to moderate along with the weaker economic outlook.

We continue to like landlords that invest in high-quality offices in supply-constrained CBDs, such as Keppel REIT. We believe its high-quality tenant register made up of government agencies and government-linked companies can weather any possible economic downturn. The trust is trading at an attractive 2023 dividend yield of 7.0%.

S-REITs Underperformed the Broader Asia Market in Q3



We See Value in High-Quality REITs Under Our Coverage

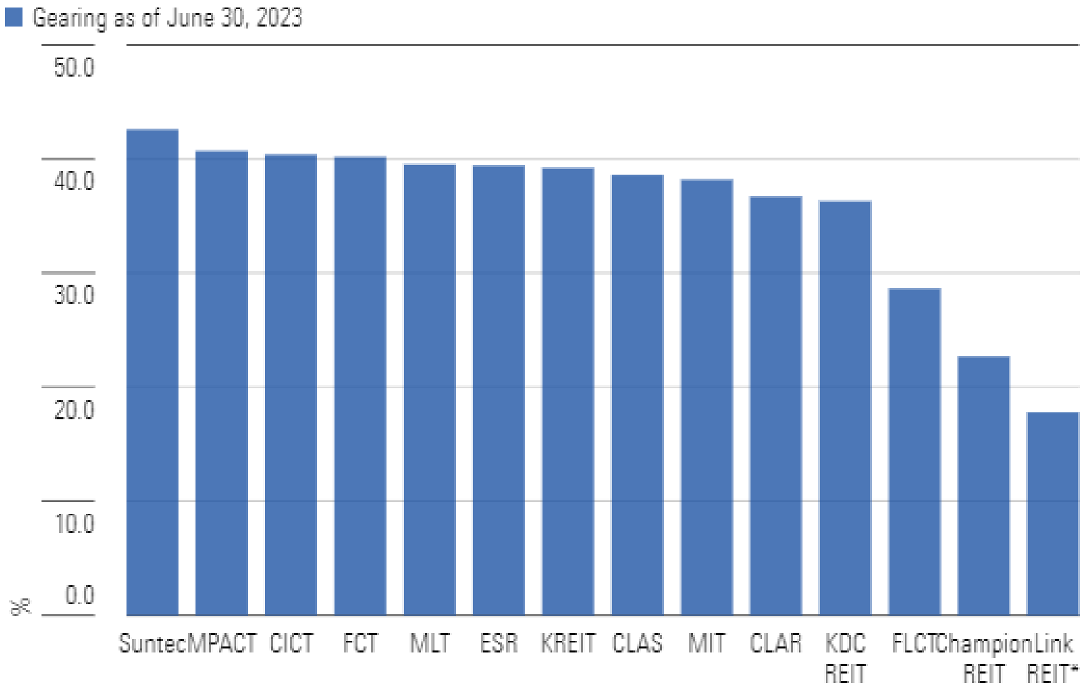


Source: Morningstar. Data as of Sept. 30, 2023.

Singapore REITs Fall on Uncertain Outlook and Interest-Rate Concerns; Real Estate Fundamentals Remain Strong

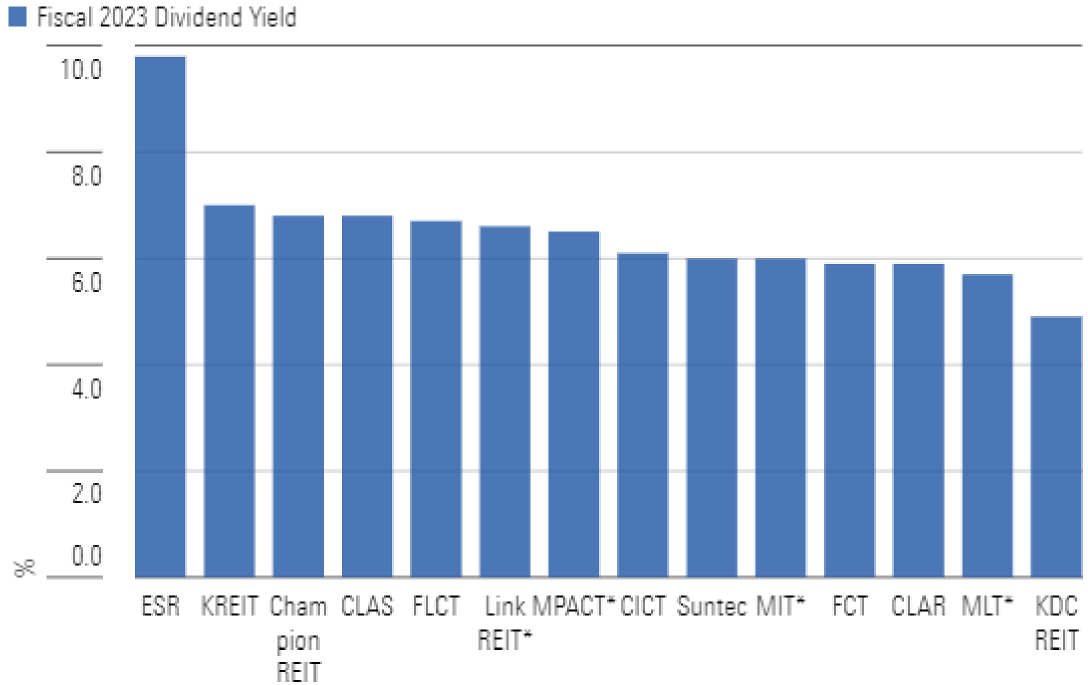
On the Hong Kong office front, we expect elevated vacancy rates to continue to weigh on office rents as leasing activity remains slow. As for retail, we note that tourism recovery may be slower than expected given a change in consumption patterns in mainland China, but we expect a consolidation trend where tourists will focus on spending in popular destinations such as Tsim Sha Tsui, Causeway Bay, and Central. We expect malls in these areas to demonstrate better retail sales growth than suburban malls that cater more to the locals.

We Prefer REITs With Stronger Balance Sheets in This Market Environment



CICT – CapitaLand Integrated Commercial Trust
CLAR – CapitaLand Ascendas REIT
CLAS – CapitaLand Ascott Trust
ESR – ESR-LOGOS REIT
FCT – Frasers Centrepoint Trust
FLCT – Frasers Logistics and Commercial Trust
KDCREIT – Keppel DC REIT
KREIT – Keppel REIT
MIT – Mapletree Industrial Trust
MLT – Mapletree Logistics Trust
MPACT – Mapletree Pan Asia Commercial Trust
Suntec – Suntec REIT
* Link REIT data as of March 31,2023.

Singapore and Hong Kong Listed REITs Are Trading at Attractive Yields



Note: *Fiscal 2024 dividend yield.

Source: Company disclosures, Morningstar.

Real Estate - REITs

Company (Ticker)		Rating
Keppel REIT (K71U)		★★★★★
Price	**Fair Value**	**Uncertainty**
SGD 0.83	SGD 1.16	Low
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
SGD 3.2	None	Standard

Keppel REIT holds a portfolio of high-quality office assets across Singapore, Australia, South Korea, and Japan. Most of its assets are Grade A office buildings located in CBDs, where they are highly coveted for good-quality office space and proximity to businesses and key transport nodes. Further, the trust's tenant base is one of the best in class, with government agencies and international banks in its register. In our view, the trust's high-quality portfolio and healthy balance sheet should enable it to weather any economic uncertainty and deliver good dividends for unitholders. We think the trust is undervalued at the current price, as it trades at an attractive 2023 dividend yield of 7%.

Company (Ticker)		Rating
Link REIT (00823)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 37.20	HKD 59.00	Low
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 96.1	None	Exemplary

Since its listing in 2005, Link REIT has delivered consistently high earnings and distribution growth, underpinned by positive rental reversion and higher occupancy rates. Despite a drop in rental revenue in fiscal 2021, Link's Hong Kong retail portfolio has demonstrated resilience through its above-90% occupancy throughout the pandemic, owing to its nondiscretionary nature. Link's mainland retail portfolio is also strong, with 9% rental reversion in fiscal 2022. While the COVID-19 situation in mainland China may see operational impact on the China retail portfolio in fiscal 2023, we expect gradual recovery from fiscal 2024 as border restrictions are relaxed. The company's expansion into the overseas market—through the acquisitions of office and retail properties in Australia, the U.K., and Singapore—is also expected to provide further diversification benefits. Its shares are currently trading at more than a 30% discount to its fair value estimate, with attractive dividend yield of around 6%.

Source: Morningstar. Data as of Oct. 6, 2023.

Technology

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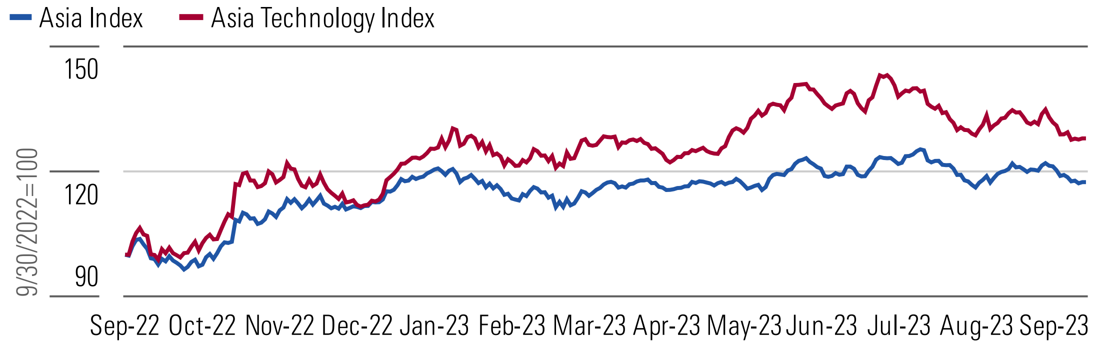
Remain Cautious as Demand Recovery Slows; Auto and High-Performance Computing Drive Long-Term Demand

As anticipated and projected in our third quarter outlook, the Morningstar Asia Technology Index stagnated in the September quarter. As expected, the inventory correction for smartphones and PCs was largely completed by the end of the June quarter, but the slow recovery in end demand, especially the economy slowdown in China, is becoming a concern. In addition, the negative impact of cost-push inflation and rising geopolitical risks will continue to weigh on the consumption. Therefore, while we believe the technology industry is undervalued on a long-term basis, we continue to recommend being more selective, as the industry lacks near-term catalysts for the time being.

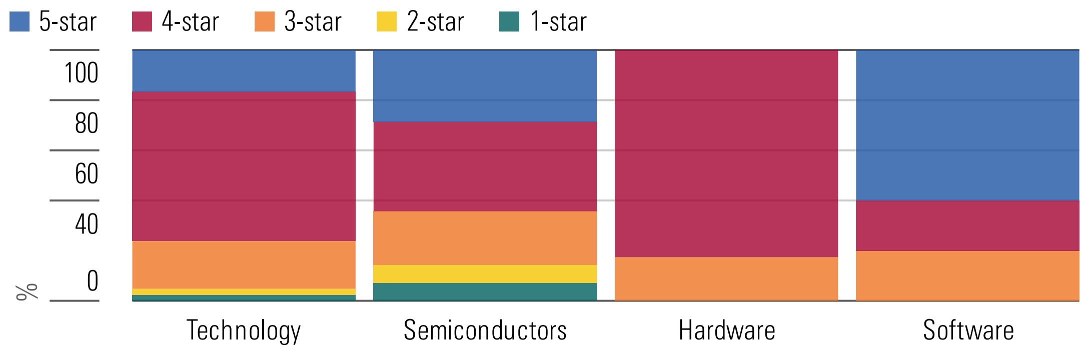
We believe the structural demand driven by auto digitalization and high-performance computing, including artificial intelligence servers, is relatively resilient, and decent shipments of high-end smartphones should also support demand for high-end components. We believe that the companies with high revenue exposure to these applications are oversold, as a better-than-expected product mix offsets lower shipments in commoditized products.

In 2023, we forecast a high-single-digit percentage decline in smartphone shipments and a low-teens percentage decline in PC shipments as higher inflation continues to erode consumer purchasing power. In 2024, we expect both smartphone and PC shipments to grow in the midsingle digits, driven by the replacement demand that has been pushed back further than we had assumed. Smartphone replacement demand is expected to recover, driven by advances in camera technology. PC replacement demand is expected to accelerate in late 2024 to 2025, driven by the higher specifications and the discontinuation of Windows 10 support.

Technology Underperformed the Benchmark in the September Quarter



Technology Names Are Mostly Undervalued

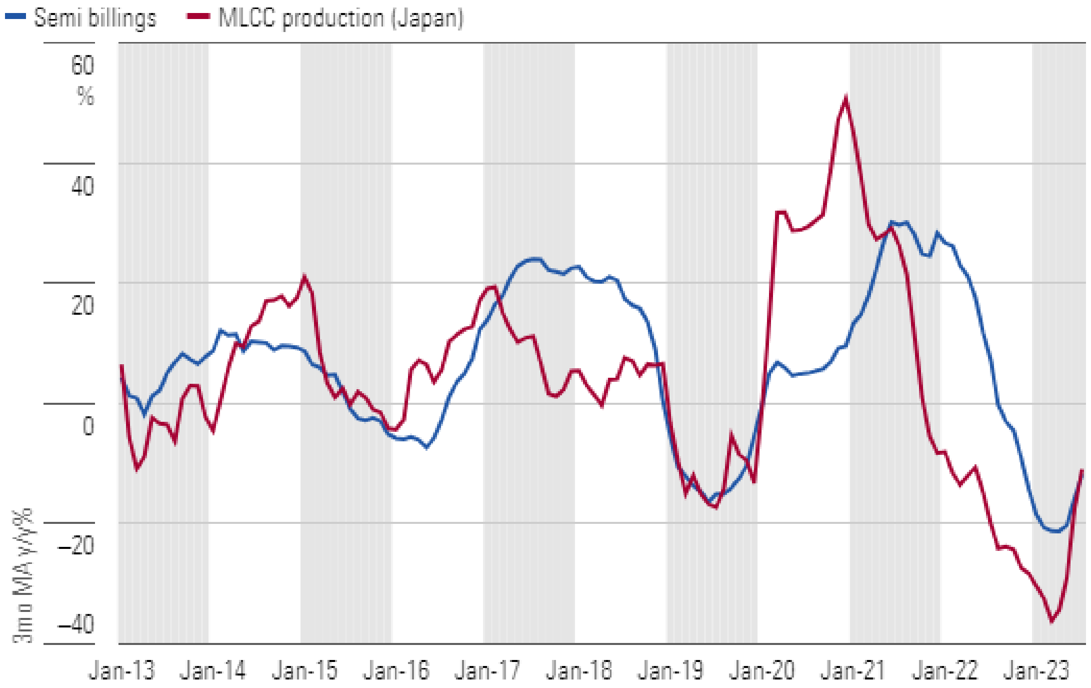


Source: Morningstar. Data as of Sept. 30, 2023.

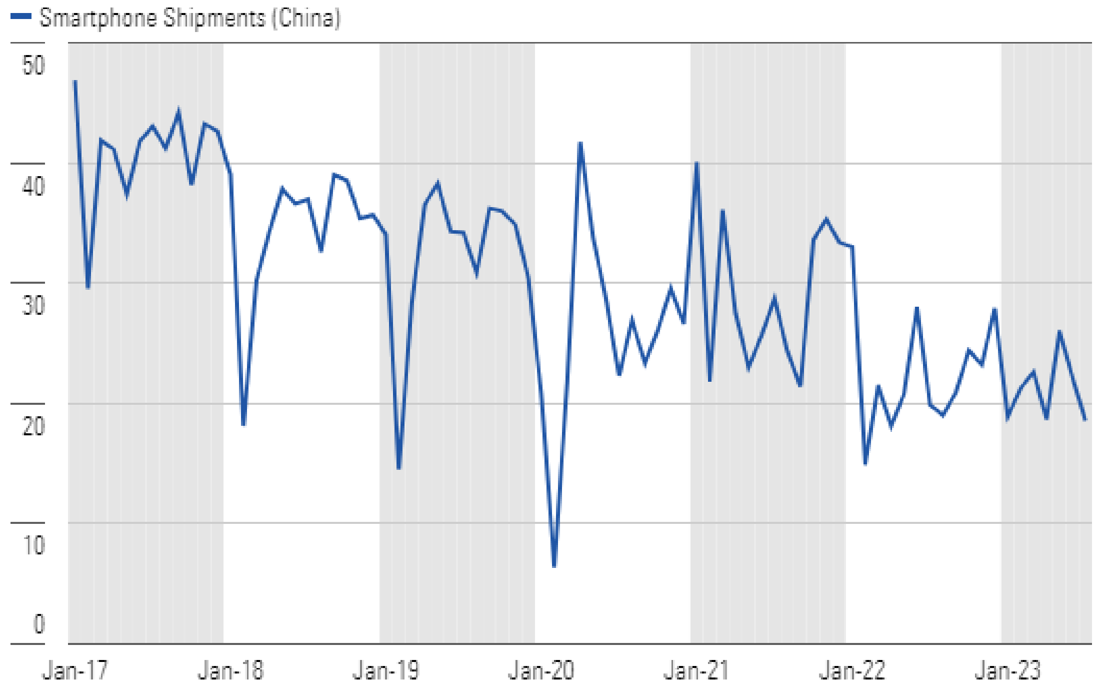
Remain Cautious as Demand Recovery Slows; Auto and HPC Drive Long-Term Demand

With the inventory correction for smartphones and PCs completed, orders for semiconductors and electronic components have bottomed out in the March quarter. Meanwhile, the inventory digestion on the server side would take a few more quarters due to the delay in investment amid the economic slowdown, and in addition, the recovery of the end demand appears to be sluggish. In particular, smartphone shipments in China remain more than 30% below the pre-COVID-19 levels. As a result, the recovery of capacity utilization is expected to be slower than expected, which may be a risk factor for fiscal 2023 earnings.

Semi Orders and Passive Components' Production Bottomed Out in Q1 2023



Chinese Smartphone Shipments Haven't Yet Recovered



Source: World Semiconductor Trade Statistics; Ministry of Economy, Trade and Industry, Japan; CAICT.
Note: MLCC = multilayer ceramic capacitors.

Technology

Company (Ticker)		Rating
Win Semiconductors (3105)		★★★★★
Price	**Fair Value**	**Uncertainty**
TWD 134.50	TWD 245.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
TWD 57.0	Narrow	Standard

Win Semi's share price remains weak, which we think is more due to macroeconomic factors than further industry weakness. Win Semi's outlook appears brighter—after third-quarter revenue grew 5.6% from the prior quarter, beating management guidance of a low-single-digit sequential growth—as Huawei's return with impressive camera phones may spur phone replacements and thus, component sales. Huawei's new releases and encouraging signs of iPhone sales lead us to believe we are in an early stages of a recovery. Win Semi's shares are trading at 13 times 2025 P/E, which we think is undervalued, considering management will resume its long-term plan to triple its production capacity by 2030, with incremental supply coming from automotive 3D sensing, satellite communications, and more integrated 5G connectivity products.

Company (Ticker)		Rating
Taiyo Yuden (6976)		★★★★
Price	**Fair Value**	**Uncertainty**
JPY 3,632	JPY 5,700	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
JPY 461.5	Narrow	Standard

Compared with its larger peers, Taiyo Yuden's share price recovery has lagged since the beginning of the year due to the greater impact of the utilization cut. However, we believe that the multilayer ceramic capacitor price erosion has been limited because: 1) unlike in the past, most major MLCC suppliers have not implemented an aggressive pricing strategy; 2) most of Taiyo Yuden's MLCCs are high-end products where there is less competition; and 3) strong MLCC demand from the auto sector has helped improve the product mix. As a result, we expect the company to recover to a high-single-digit operating margin in the second half of fiscal 2023 (fiscal year ending March 2024) and to a double-digit operating margin in fiscal 2024 as the capacity utilization rate picks up. We believe Taiyo Yuden's shares are undervalued, as the market is underestimating the margin recovery.

Source: Morningstar. Data as of Oct. 6, 2023.

Utilities

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Utilities Sector Attractively Valued With Abundant Opportunities

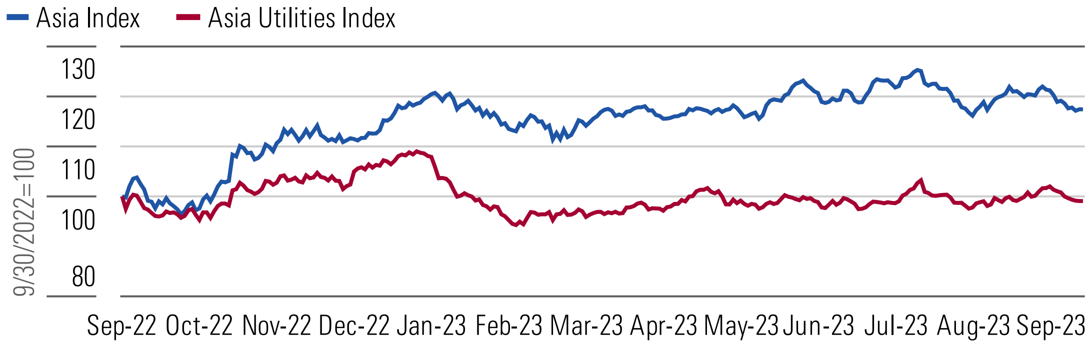
The Morningstar Asia Utilities index outperformed the broader Asia market in the third quarter of 2023, up 0.3% versus the market's 1.6% drop. We think the sector remains attractively valued with abundant buying opportunities.

Share prices of China's city gas players continued to disappoint in third-quarter 2023 due to the slow recovery in China's economic growth and the lackluster real estate market, which pressured gas sales and new residential connections. During its first-half results briefing, ENN Energy cut 2023 retail gas sales volume growth guidance to negative 5% year on year, from 10% growth. Meanwhile, China Resources Gas also lowered 2023 retail gas sales volume growth guidance to 7%, from double digits. On a positive note, both firms are still guiding for better dollar margins with improving cost pass-through. We think investors with long-term views should start buying select names. That said, we believe the market will need time to restore confidence and we expect these stocks to trade rangebound in the near term given uncertainty as to gas prices during the winter season.

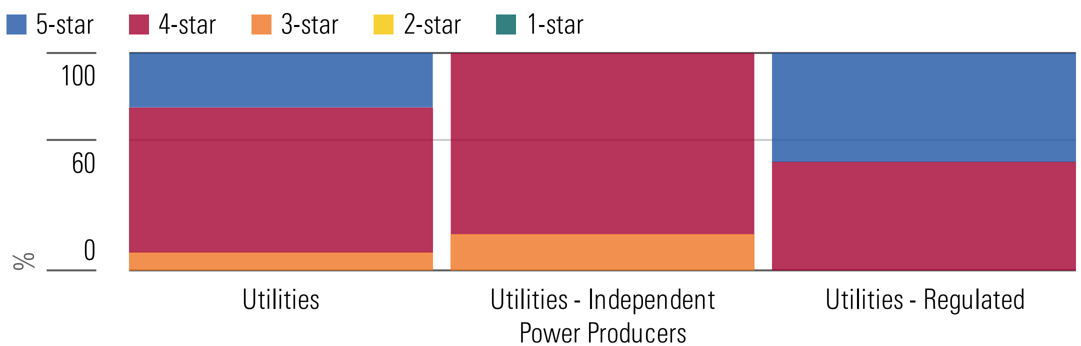
Meanwhile, nationwide electricity consumption in China for the first nine months of 2023 rose 5.6% year on year, indicating that demand remains resilient. This is on track to achieve the China Electricity Council's 6% growth forecast for 2023 and should be positive for electric utilities. We note that coal prices have rebounded recently, due to low inventory and output disruptions from increased safety inspections at coal mines. However, the China Coal Transport & Distribution Association expects coal prices to ease in late October as supply should increase following the completion of the inspection of Daqin railway. Hence, we continue to anticipate strong earnings recovery in 2023 for coal-fired power players.

While the Hong Kong utilities are relatively cheap, we think currency headwinds are likely to mean a somewhat softer profit translation and cash for dividends for U.K.-centric CKI Holdings. CLP is relatively defensive, given the more significant local contribution.

Utilities Outperformed the Market In the Third Quarter



Buying Opportunities Remain in Utilities

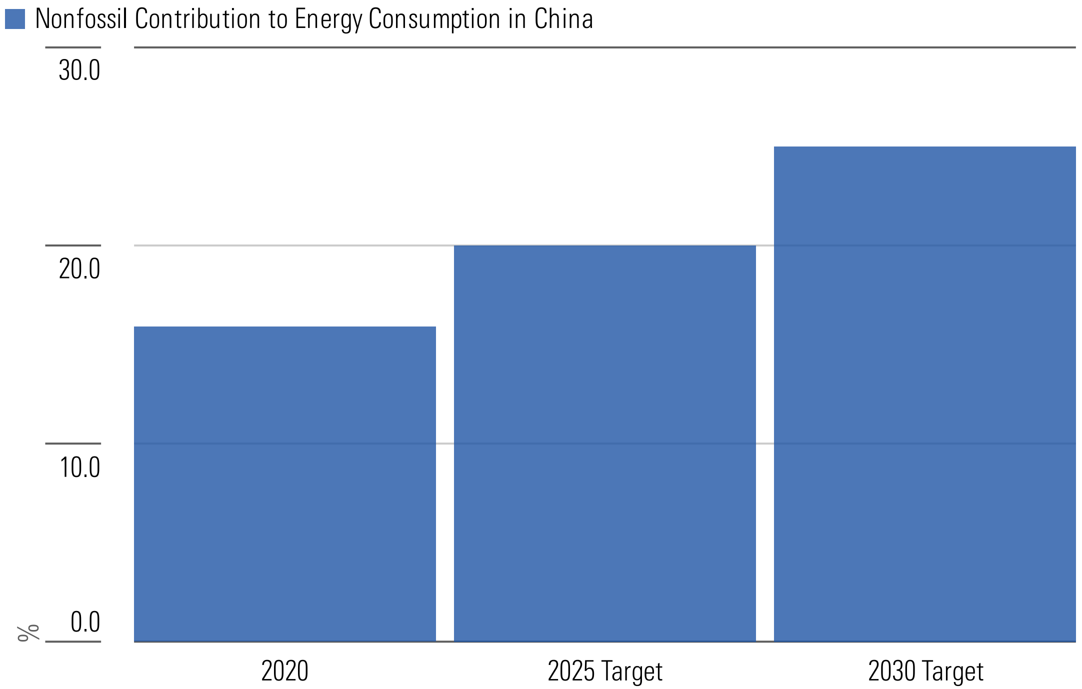


Source: Morningstar. Data as of Sept. 30, 2023.

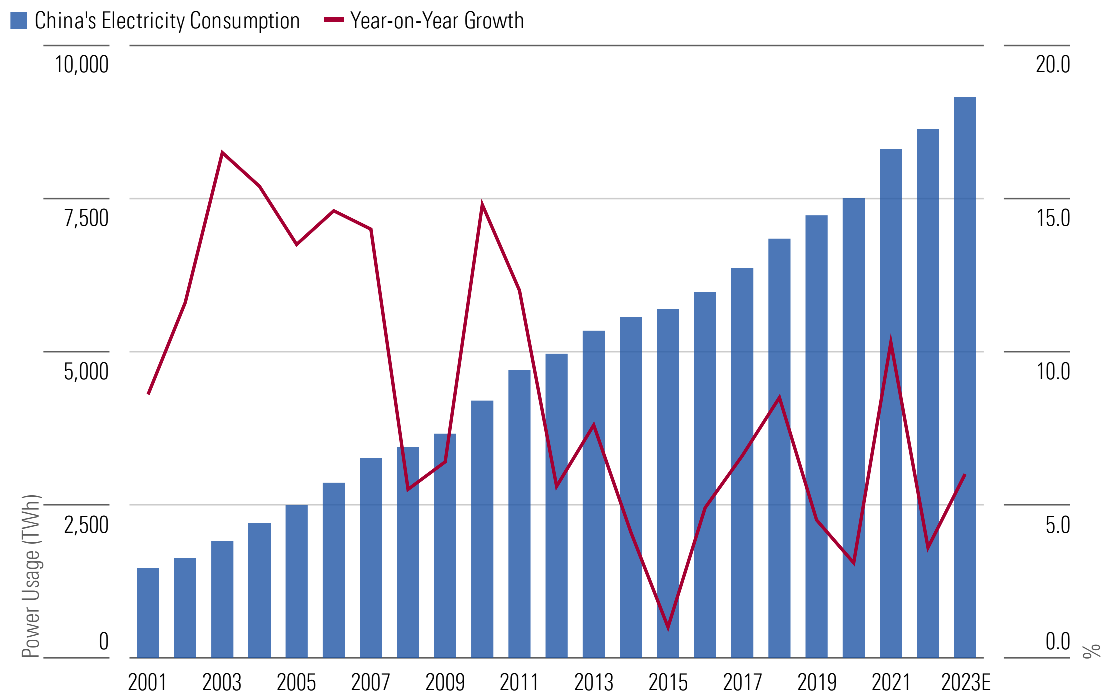
Remain Constructive on China's Renewable Energy Sector

We remain constructive on China's renewable energy sector as we expect investment in the sector to remain strong during the 14th Five Year Plan period (2021-25). We believe investors are worried about the declining power tariff, but the falling prices of solar modules and wind turbines should continue to support returns of renewable energy projects, in our view. We think the slow collection of subsidies is another negative and this may continue to weigh on renewable players' share price performance as their balance sheets will likely remain stretched due to aggressive expansion plans. That said, we expect them (especially the state-owned players) to be able to access the debt markets and enjoy low borrowing costs domestically. While we believe these concerns are valid, the negatives have been largely reflected in current share prices and we think the risks/rewards are attractive now. For example, China Longyuan recently announced share buyback plans for its H-shares, given the low valuation.

Nonfossil Contribution to Energy Consumption in China Expected to Rise



Electricity Demand Growth Expected to Recover in 2023



Source: China Electricity Council, Morningstar.

Utilities

Company (Ticker)		Rating
China Resources Power (00836)		★★★★
Price	**Fair Value**	**Uncertainty**
HKD 14.42	HKD 25.00	Very High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 69.3	None	Standard

China Resources Power, or CRP, is one of China's leading independent power producers, with high-efficiency power generation assets and an established operation track record. As of end-2022, the firm had a total attributable operational generation capacity of about 52.6 gigawatts. Thermal power plants accounted for 67.7% of its total capacity, with the remainder from wind, photovoltaic, and hydro power. We believe CRP is undervalued currently at our fair value estimate of HKD 25, with earnings expected to recover further in 2023 on the back of falling coal prices. In addition, CRP plans to spin off its renewable segment. We are positive on the proposed spinoff as it could help CRP fund its aggressive expansion plans and take advantage of the higher valuations for renewable energy stocks in the A-share market.

Company (Ticker)		Rating
ENN Energy (02688)		★★★★★
Price	**Fair Value**	**Uncertainty**
HKD 64.60	HKD 107.00	High
Market Cap (bil)	**Economic Moat**	**Capital Allocation**
HKD 71.4	Narrow	Standard

ENN Energy is a privately owned gas utility company in China engaged primarily in distributing and retailing natural gas. We are confident that ENN will generate returns above its cost of capital over the next decade, supporting our narrow moat rating. We believe China's goal to reduce pollution by increasing gas usage to 15% of the country's energy sources by 2030, from below 10% in 2020, will maintain long-term demand growth for gas. We estimate ENN's retail natural gas sales volume to grow at 7.8% CAGR during 2022-27. We think ENN's long-term gas supply contracts can help it to secure its gas source at a more competitive price and will reduce the risk of supply bottlenecks versus domestic alternatives. Furthermore, ENN's earnings will also be underpinned by growing contributions from integrated energy and value-added businesses, in our view.

Source: Morningstar. Data as of Oct. 6, 2023.

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