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BLACKFRIARS ASSET MANAGEMENT

Asia Insight

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MARKET REVIEW

The MSCI AC World Index gained 0.9% in July. The MSCI Japan Index rose 0.5% while the MSCI Asia ex Japan Index dropped 6.3% with index heavyweights China (-10.8%), Korea (-8.0%) and Taiwan (-7.3%) the culprits. India (+1.8%), Malaysia (-0.4%) and the Philippines (-1.4%) held up well. By sector, energy (-10.8%) and materials (-9.3%) faired worst although information technology and financials were not much better. Consumer, telos and utilities held up well. All of the above suited our portfolios.

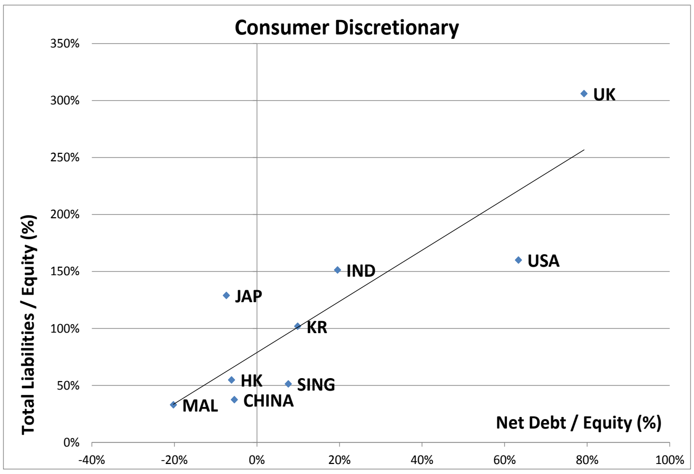
All returns above are stated in US Dollar terms.

RESULTS

Second quarter results announcements are coming in thick and fast. Indian holdings ITC, HDFC and Zee all announced solid numbers. In Thailand, profits at Siam City Cement slipped a touch with lacklustre domestic demand the culprit but the interim dividend was maintained. KT Corp and Shinhan also produced solid results. In Japan, Seven&I and Hitachi both produced decent results. Nidec's result were excellent and spiced up by encouraging comments from management regarding the haptic motor division.

By contrast both TSMC and Samsung produced slightly soft numbers reflecting the slowing demand for smartphones. HMI, a capital equipment supplier to the IC industry, also released weaker 2Q earnings and reduced revenue guidance but remains very bullish on the longer term outlook for its e-beam inspection machines. Recent purchase Globetronics announced flat revenues and earnings for 2Q.

None of the above should surprise; slowing nominal GDP growth makes top line growth difficult for the corporate sector although falling input prices are helping to protect margins and profits (the portfolios are devoid of commodity producers, full of commodity consumers). While earnings expectations around the region have been significantly pared back in recent months there is still room for surprises. For example CLSA estimate that 60% of 2Q Indonesian earnings announced thus far have missed consensus forecasts while just 15% have exceeded expectations. Our Hong Kong listed China plays will report in August. Judging by recent stock price behaviour expectations are low.

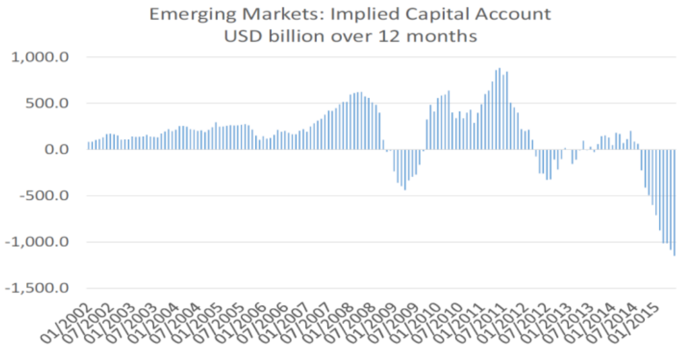


Source; Bloomberg

STAYING THE COURSE

CHA-AM's David Scott has produced some wonderful work recently imploring clients to ignore the traditional leverage measure of net debt/equity and instead to focus on total liabilities as a percentage of debt since, when push comes to shove, the gross debt (or liabilities) of a corporate prove the more relevant indicator of likely financial stress. We were fortunate to have a work experience chap in the office last month and his excel skills were put to good use. We reviewed all our holdings for net and gross leverage and, pleasingly, found no nasties. No surprise perhaps that this screen has proven to be very complimentary to the detailed cashflow analysis we already undertake. While nominal GDP growth is likely to remain illusive across the Asian region for the remainder of this year - and this will be reflected in corporate revenues - we are very confident that the cash flow and balance sheet characteristics of our portfolio holdings will allow these corporates to survive the current testing macroeconomic backdrop.

For fun, we broadened the universe to include FTSE100 and Dow Jones Industrial constituents. The chart on the previous column shows the results for the consumer discretionary sector. Asian corporates have modest net debt, if any, and generally limited gross liabilities as a percentage of equity. India, perhaps unsurprisingly, is the most aggressive at 20% net and 150% gross. But look at those two outliers in the top right corner! We read recently that some $15bn has been removed from emerging market funds and ETFs over the past two months. Much of this - we presume - will have been invested back into "safe" developed market equities. We are not quite sure how Andrew Hunt has calculated the numbers for the chart below but the size and direction of the implied capital flows is consistent with the recent performance of emerging market equities and currencies.



OUTLOOK

Being marked to market every day is a tedious reality of the business of public equity management. Short term swings in sentiment need to be placed in the context of longer term fundamentals including valuations. Asia ex Japan now trades at just under 1.5x book value according to CLSA, just a few percent above the lows established since markets recovered from the (Western induced) "global" financial crisis. Food for thought during a typical silly season.

HT&SD