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ASSET MANAGEMENT

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Asia Insight

MARKET REVIEW

The MSCI AC World Index fell 6.9% in August. The MSCI Japan Index declined 5.8% while the MSCI Asia ex Japan Index slumped 9.8%. Hong Kong, China, Singapore and Malaysia all posted double digit declines. Korea (-5.8%) was the least awful market! By sector, financials, real estate and energy also suffered double digit declines. The lack of significant divergence in country and sector performance suggests that "top down" asset allocation flows are the dominant force at present. LATAM and EEMEA posted similar declines as investors flee the currencies, bonds and equities of the emerging world. Our regional portfolios suffered absolute losses but declined less than the underlying MSCI indices; please refer to the individual fund factsheets.

All returns above are stated in US Dollar terms.

JAPANESE - 1Q RESULTS

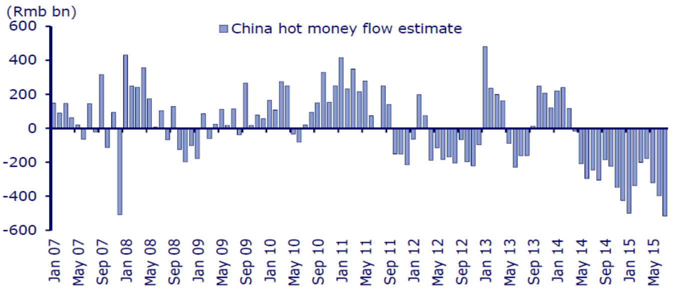
Corporate Japan posted a 24% increase in EBIT for the first quarter of the 15/16 financial year. Admittedly, this was assisted by a weaker yen and a helpful comparison (consumption tax was increased on 1st April 2014) but we thought we'd start this monthly on a positive note - it's not all doom and gloom!

CHINA - MUDDLED THINKING

What has been obvious to some for a while now appears to be understood by most following the shock "devaluation" of the renminbi on 11th August - the Chinese economy is not growing. It is difficult to decide who was most surprised following this decision. It certainly must have come as a nasty shock to those long renminbi assets (or earnings) and short US dollars but the PBOC appeared almost more surprised to discover that all they had effectively achieved was to reverse a one way currency bet that has been in place since mid 2005. The "market" was allowed to set the price of the renminbi for two days before the PBOC decided that the market was wrong.

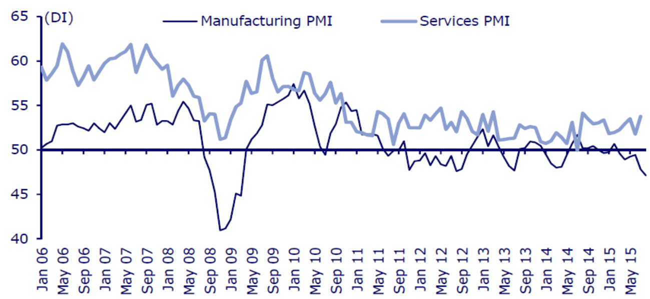
Capital outflows are now the norm not the exception, as the CLSA chart below illustrates, but this is not George Soros versus Norman Lamont. The capital account (although porous) is closed, the Chinese Communist Party controls the large domestic financial institutions and there is the small matter of $3tr plus of forex reserves. Not many central banks can cut interest rates, reduce the reserve ratio requirement and then watch their currency appreciate as happened in the last week of August! In short the PBOC is not short of draconian powers, moral suasion or firepower so a Soros style "victory" by speculators is extremely unlikely.

China hot money flow estimates

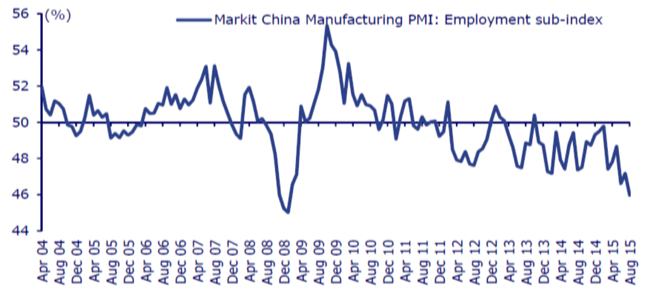


Source: Markit Group

China Manufacturing and Services PMI



China Manufacturing PMI: Employmnet sub-index



Source: Markit Group

TIGHT MONEY

Unfortunately the inversion of the one way bet is bound to see capital outflows continue and, despite various reverse sterilisation measures (such as RRR cuts), these outflows will further tighten a monetary policy that is already too tight (the real one year lending rate deflated by factory gate prices stands at circa 10%). To date, strength in the service sector has offset much of the weakness in the manufacturing sector (see top chart) but the authorities will be monitoring employment levels very closely given the weaker signals emanating from the manufacturing sector (see second chart). More rate cuts, more RRR cuts and a stimulus package lie ahead. The renminbi will slip but not slide.

In the portfolios we continue to avoid financials, commodities and other upstream industrials. Chinese exposure is almost exclusively in cash rich and cash generative consumer plays although recently announced 1H earnings illustrate how tough business is at present even in this defensive sector. Top line growth is elusive and competition intense but softer input prices have protected margins and profitability to a large extent.

OUTLOOK

Growth in China and elsewhere in the region continues to slow and the current cyclical headwinds will not abate in the near term. The longer term structural growth drivers have not, however, disappeared. This is especially true in countries such as India and the Philippines where demographic trends will support domestic demand. Although skewed by Chinese banks (circa 10% of the regional index and trading at a deserved 20% discount to book value) we note that investors have always made excellent long term returns when buying the region at 1.3x trailing price to book.

HT&SD