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Asia Insight

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Market Review

The MSCI AC World Index slipped 0.8% in November, the MSCI Japan Index fell 1.0% while the MSCI Asia ex Japan Index retreated 3.4%.

India (-4.8%) proved to be the worst performer while unloved Malaysia (+1.2%) had a rare moment in the spotlight as the only market in the region to gain ground, a move that was mainly driven by 1MDB's disposal of its power assets to China General Nuclear Power Corp at a tasty 25% premium to book value. While this transaction does not remove all of the question marks surrounding 1MDB, it does release pressure on the Government's financial position. By sector, energy and materials were weak while information technology and consumer staples held up well.

All returns above are stated in USD terms.

Chinese Steel - Cull Ahead

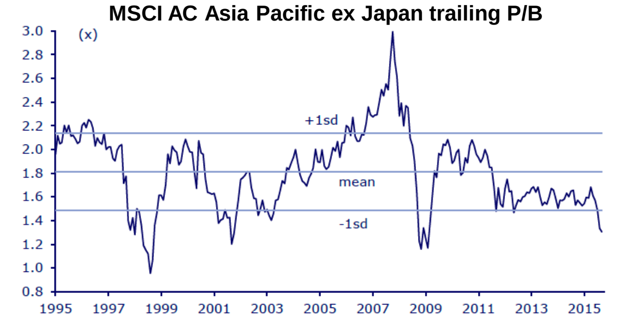
We have discussed the deflationary implications of China's credit and investment boom repeatedly in recent years. Nowhere was this boom more evident than in China's steel industry. Today, China accounts for approximately 50% of global steel production. It is estimated that there is some 300mt (25%) of excess capacity. Steel prices are massively depressed with even the largest, most efficient plants and companies losing money. The industry lost Rmb28bn in 9M15 (this figure includes gains booked on the disposal of non steel assets).

There is a growing realisation within the industry that demand has peaked. Domestic sales are 5-7% lower this year and forecast to fall further in 2016 as residential construction volumes continue to decline (see chart below).

More interestingly there is growing evidence of plant closures. China Reality Research estimates that 27mt of capacity has closed over the past year while the China Iron and Steel Association estimates that a further 100mt of capacity will close over the next two years. Generally speaking this is good news - the smaller, weaker players are being squeezed out and by 2020 perhaps, the industry will be in equilibrium, dominated by a handful of major players. This will represent a long overdue assertion of market forces.

Most, if not all of China's 300 steel mills are heavily leveraged. Caixin Magazine recently reported that Chinese financials' NPLs jumped by Rmb500bn (35%) in the first 10 months of 2015. Plenty more where these came from!

Source: CLSA



Source: Bloomberg

Infrastructure

It is fair to say that the ASEAN infrastructure boom which many predicted (including us) has been slow to turn up but we sense change. 6 separate stimulus packages in Indonesia over the past year are having an impact - infrastructure spending is expected to have risen by 30% in 2015. In the Philippines, 11 PPP projects worth $4.3bn have been awarded since 2010, another 19 worth $16.5bn are in the pipeline. In Thailand, the first double-tracking contract worth THB10.5bn was awarded last month and a further 6 contracts worth THB127bn will be awarded over the next year. In Malaysia, where some M$200bn of infrastructure projects have been awarded over the last few years, the disposal of 1MDB's power assets has stabilised the public purse.

After an admittedly slow start, the Modi administration is making good progress in areas such as roads where the value of contracts awarded rose fivefold in 1HFY16. Elsewhere the Indian Government plans to invest $140bn in the rail network over the next five years.

Growth rates across ASEAN and India will continue to compare very favourably to those of China and indeed much of the rest of the global economy. Rising infrastructure spending and decent demographics remain important drivers. Our portfolio maintains good exposure to these themes.

Outlook

The inclusion of the renminbi in the SDR by the IMF was expected and will take effect in October 2016. It will be interesting to see how this elevation to reserve currency status plays out in the context of the persistent capital outflows of the past year or so.

It has been another difficult year for Asian equities with only Japan in positive territory year to date. The MSCI AC World Index has risen 52% over the past five years while MSCI AC Asia ex Japan has managed only a 9% return. Needless to say we were relieved to note the cover of the Economist a couple of weeks ago (The Chronicles of Debt,14th-20th Nov) which, in time honoured fashion, will hopefully signal the end of the underperformance! Certainly valuations remain firmly on our side as the chart at the top of this column suggests. China will survive and much of the rest of the energy and commodity short Asian region will flourish in the coming five years. HT&SD