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Asia Insight

www.blackfriarsam.com
+44 (0) 20 7332 2270

Market Review

The MSCI AC World Index rose 1.5% in April while the MSCI AC Asia ex Japan Index declined 0.9%. The stronger yen was entirely responsible for the 4.7% improvement in the MSCI Japan Index.

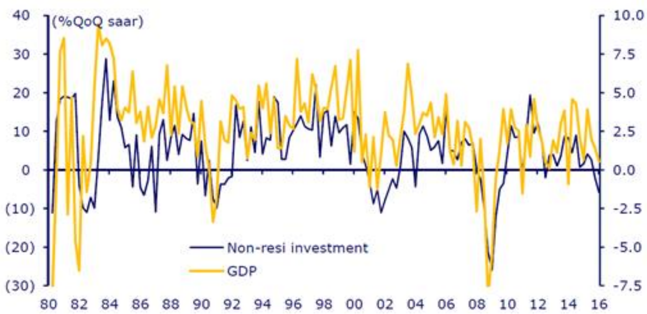
Taiwan (-5.3%) was the weakest regional performer. By sector, Consumer Staples (+3.3%) and Energy (+2.3%) outperformed.

All returns above are stated in USD terms.

Global Growth

After a strong rally from the February lows, global equities have retreated in recent weeks and the historically poor seasonal period is upon us (sell in May, etc.). Lacklustre economic data from the United States, especially the sharp fall in capital expenditure (-5.9% in 1Q16 q-o-q SAAR, see chart below), suggests that growth will remain elusive.

Non-Residential Private Investment vs GDP Growth



Source: CLSA, DataStream

In China, it is clear that the Chinese industrial sector is not recovering in any meaningful fashion. The April Caixin China Manufacturing PMI came in at 49.4 (the 15th consecutive reading below 50 implying continued contraction) and this despite a surge in lending in 1Q16 (see on). Korea's exports, which have essentially flat lined for the past three years, fell 13.3% y-o-y in the first quarter of 2016; capital expenditure fell 5.9% q-o-q SAAR. The Taiwanese economy contracted by 0.8% y-o-y: the third consecutive decline. Capex and exports continue to decline. All in all, it remains “hard yards” for the global economy: deflationary pressures remain, interest rates are going nowhere. At least China still has a solid domestic demand story as the service sectors continues to develop. Industrialised North Asia (Japan, Korea and Taiwan) remains exposed to flaccid global trade volumes while deteriorating demographics remain a persistent drag on domestic demand.

In stark contrast, most of less industrialised ASEAN & India are enjoying positive demographic trends that are propelling strong growth in domestic demand. The Philippines remains the economic poster boy of the region while Indonesia and India also have excellent stories to tell. All three should post GDP growth of 6-7% in 2016 and corporate earnings will reflect this. That said, both the Thai and Malay economies remain beset by domestic political problems and the likely election of “Duterte Harry” in the Philippine Presidential elections presents uncertainties.

Results

A number of portfolio holdings have reported decent 1Q16 earnings. Samsung Electronics' Galaxy S7 smartphone is selling well; the company reported a first quarter operating profit 11.7% higher y-o-y and announced a third tranche of share buybacks. Also in Korea, telecoms company KT Corp reported a 19.8% y-o-y rise in operating profit despite a flat top line: the restructuring is paying dividends. Hong Kong listed Samsonite reported flat sales in 1Q reflecting weakness in Hong Kong, Macau and China sales but this was offset by good growth in Europe, Japan and Australia. The positive impact of the recent Tumi acquisition will be felt in 2017. India's HDFC reported an 8% improvement in operating profit for the quarter and booked a large profit following a partial disposal of their life insurance company ahead of the IPO later this year. Ayala Land reported a 14% increase in net profits on an 8% increase in revenues. Less clever was our position in Malaysian electronics manufacturer Globetronics whose profitability has fallen victim to sluggish iPhone sales. We have sold the position. Many more quarterly results to come in May.

China – Banks and Credit

We commented on Chinese banks last month but the recently reported 1Q earnings are worthy of additional comment. As has been widely reported, Chinese fiscal and monetary policy was eased in 1Q16 with infrastructure projects fast tracked and credit growth ramped up. Total Social Financing rose 41.8% in the first quarter y-o-y with over US$1tr of new credit extended. This is a very big number and hopefully not reflective of the rest of the year. The net interest margins of the ten banks covered by Nomura fell from 2.54% to 2.37% during the first quarter. Credit costs rose from 134bps to 139bps, Non Performing Loans (NPLs) rose a more modest 4bps to 1.6%, but two of the big four (ICBC and BOC) reported NPL coverage ratios below the regulatory 150% minimum and NPLs will be dragged higher during 2016 by the sharp rise in special mention loans over the past year. The big four saw net interest income fall 5% y-o-y while pre-provision operating profit (PPOP) was flat, as was the bottom line. Equally important, over one third of the banking sectors' assets are securities on which no provisions have been made. These "securities" have grown rapidly as a balance sheet item over the past five years during the credit boom. Goodness knows what the quality of the underlying assets are but what we do know is that defaults in the onshore bond market - including a number of SOEs - are rising fast. According to Bloomberg, ¥3.7tr (US$570bn) matures over the next eight months. Short term fears over the currency have abated but falling net interest margins (NIMs), rising NPLs and increasing regulatory oversight remain major headwinds for the banking sector. In an excellent recent report CLSA's Francis Cheung estimates the true system wide NPL figure to be 15-19%. We continue to avoid Chinese financials.

Outlook

May is upon us so a degree of caution seems a wise course of action after the recent run. We continue to focus on investing in cash generative companies operating in relatively defensive and domestically orientated sectors.

HT&SD