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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

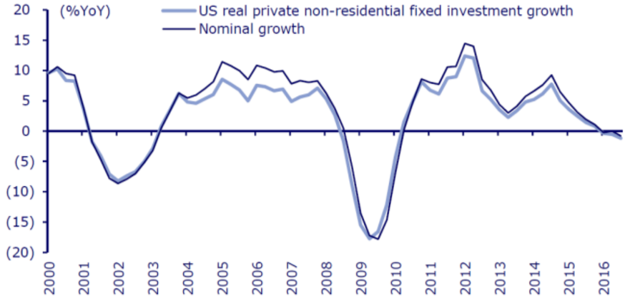
8th November 2016

Market Review

Global equities traded lower during October with the MSCI AC World Index falling 1.7%. The MSCI AC Asia ex Japan Index followed suit, declining 1.5%. Korea (-3.7%) and the Philippines (-3.2%) were the weakest performers while Taiwan managed to advance 1.4%. By sector, Energy (+1.7%) and Materials (+1.2%) continued to run while Telecoms (-3.9%) and Consumer Staples (-3.8%) lost ground.

All returns above are stated in USD terms.

US nominal and real private non-residential fixed investment growth



Source: CLSA, US Bureau of Economic Analysis

Be careful what you wish for?

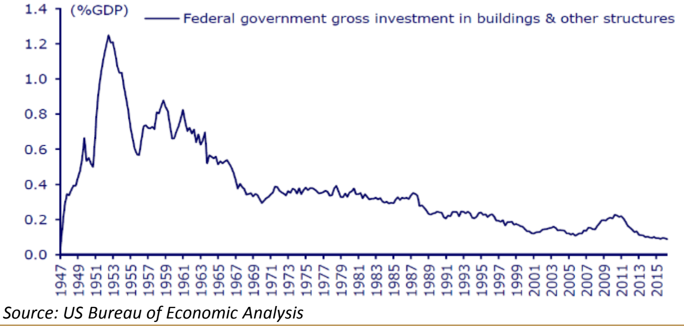
The outcome of the US Presidential election will be known within a couple of days. Regardless of the relative merits (or lack thereof) of both candidates, markets dislike uncertainty so a Clinton victory will be greeted with relief since it implies 'more of the same'. What, however, is 'more of the same'?

CLSA's Damian Kestel has produced some interesting statistics covering the period since President Obama assumed office in January 2009. Over the past eight years the S&P500 Index has risen 164% while S&P500 real earnings per share have risen 72%. Interestingly, CLSA also note that S&P500 operating earnings have fallen in each of the last seven quarters (to June 2016).

Since January 2009 US nominal GDP has grown 30% to US$18.7tr while the US Federal debt has risen 87% to US$19.8tr and the Federal Reserve's balance sheet has grown 117% to US$4.5tr.

What is clear from the chart above is that corporate America has not been investing, although leverage remains fairly high (the debt/equity ratio stands at circa 60%) as share buybacks continue. Neither is the US Government investing: according to CLSA's Chris Wood, the Federal Government gross investment in buildings and other structures declined to 0.1% of nominal GDP in 2Q16, the lowest level since 1Q47! (See the chart below).

US federal government investment in buildings and other structures as % of nominal GDP



Source: US Bureau of Economic Analysis

Helped by Obamacare, healthcare spending now accounts for 23% of personal consumption, up from 18% in 2000 and 10% in the early 1970s. None of the statistics above are heading in the right direction, but expect more of the same. While the 2.9% seasonally adjusted annual rate (SAAR) growth in 3Q16 GDP was ahead of expectations, the number was heavily flattered by rising inventories and a massive jump in soya bean exports to China. Slow growth (nominal and real) remains the new normal.

Thailand

We visited the region last month and met with a number of portfolio holdings. It was certainly an interesting time to visit Thailand, shortly after the passing of the revered King Bhumibol Adulyadej. The Government declared a formal one year period of mourning while entertainment and consumption was discouraged for a one month period. In an economy that has struggled to regain any real economic momentum in recent years, the prospect of a weaker fourth quarter looms.

Land & Houses, the largest residential property developer, will produce strong 2016 results as a number of projects are completed and transferred, but presales – a driver of development profits in 2018 and beyond – are proving more elusive, especially in the condominium sector where an increase in supply has left inventory levels elevated. It appears highly likely that the launch of new projects will be pushed out into 2017 given the current domestic situation. Land & Houses remains a leader in the more resilient single detached house segment and in recent years has built a portfolio of investment properties which generate substantial recurrent income. The company also receives significant associate income from a number of long term investments. The stock trades on perhaps 13x 2017 earnings and yields over 7.5%. Any short term share price weakness would present an opportunity to top up the position.

We also visited Siam City Cement (SCCC) which has suffered from weaker domestic demand and pricing over the past year. Much more interesting was the discussion of several recent overseas acquisitions, in particular the purchase of Holcim's Sri Lankan assets. Sri Lanka remains a cement deficit economy and demand is expected to grow at 7-8% per annum as the country continues to recover after the end of the civil war. SCCC is now the market leader and owns the only integrated cement plant in the country. Together with a couple of other regional acquisitions, we can look forward to solid growth in group revenues and earnings over the next few years, while a forecast acceleration in domestic infrastructure spending should see the core business recover in due course. SCCC remains highly cash generative. SCCC trades on a low teens 2017 earnings multiple and, with a dividend yield of over 5%, remains a solid holding.

Outlook

Meetings with a number of Chinese companies suggest to us that the stabilisation, or recovery, of the domestic economy is real and – more importantly – sustainable for the next few years, proving yet again that the administration's unique control over the financial sector and other key industries (not to mention capital controls) are powerful tools.

We remain encouraged by regional valuations that remain inexpensive in relative and historical terms.