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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

6th December 2016

Market review

The MSCI AC World Index rose 0.8% in November driven higher by the 3.7% advance in the S&P500 Index following the surprise election of Donald Trump. We note that the MSCI AC World ex US Index fell 2.3%. Long duration bonds fell precipitously as markets took the view that monetary tightening by the Federal Reserve would accelerate under a Trump economic agenda. The dollar strengthened.

The MSCI AC Asia ex Japan Index declined 2.9%. Not one market in the region rose over the month while the pain was felt most acutely in India (-7.5%) and across ASEAN with Indonesia (-12.5%) and the Philippines (-11.1%) hardest hit. By sector, Materials (+0.0%) and Financials (-0.1%) held up well while Consumer Staples (-5.1%), Real Estate (-4.8%) and Utilities (-4.1%) suffered. These moves were unhelpful to the regional portfolio although good stock selection limited the damage to an extent.

All returns above are stated in USD terms.

Mmm – more Modi magic

The Indian government's decision to remove and re-issue higher denomination bank notes has caused short term chaos in the economy. Without doubt, this was a very brave move designed to bring more commerce into the formal economy now that the vast majority of the population (over 1bn) have an Aadhaar (ID) card which, among other things, facilitates the opening of bank accounts.

For the law abiding Indian, demonetisation will come as a short term inconvenience but for the 97% who do not file tax returns, it might present other difficulties. A significant majority of this 97% don't earn enough to pay tax but it would be a great surprise if the number of registered India tax payers, currently less than 40mn or 2.9% of the population, does not multiply.

Much has been made of the potential short term windfall to the Reserve Bank of India but the longer term benefit of broadening the tax base is much more significant. Predictably described by the *Economist* as "a bad idea, badly executed", demonetisation comes ahead of the 2017 introduction of GST (general sales tax). Both policies have powerful longer term positives which, in our opinion, hugely outweigh any short term economic disruption. India remains the outstanding long term domestic demand story of our era.

Results and movers

Sun Art Retail posted better than expected 3Q results. SSS were flat y-o-y but higher gross margins and good cost control allowed net income to rise 12% y-o-y. The stock gained 20.3% over the month. Samsonite also posted excellent 3Q numbers. Revenues rose 23% assisted by two months' contribution from recently acquired Tumi, but the underlying growth of 8% impressed. Sands China also reported excellent 3Q earnings with gross gaming revenues (GGR) climbing 16% q-o-q, well ahead of the industry's 7% growth rate. Better than expected November industry GGR growth of 14% bodes well for the fourth quarter as Macau continues to recover from the anti-corruption induced slump. Samsung Electronics' third quarter results were always going to be affected by the Galaxy S7 recall; much more interesting was the late November announcement. The company will take steps to boost shareholder returns including the allocation of 50% of its free cash flow in 2016-2017 to dividends/buybacks, a 36% y-o-y increase in the 2016 dividend, the introduction of a quarterly dividend and a thorough review of its governance structure. It also announced the creation of a new governance committee and the appointment of an additional independent director. Despite gaining 37% thus far this year, this heavyweight stock is trading at a modest (30%) premium to book and on under 10x FY17 earnings.

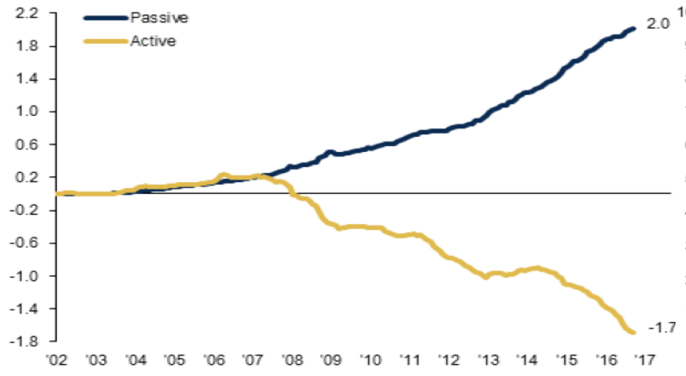
ETF'd

We generally try and insert encouraging charts in these Asian Insights but the two charts below, courtesy of Bank of America Merrill Lynch, are extremely depressing. While active fund managers often do not help themselves (fees, performance, etc.), the drift towards the socialisation of investment continues. Driven by increased regulation and compliance, this is perhaps the best example of the ongoing financial repression correctly forecast by Russell Napier in the wake of the GFC. We will continue to populate our portfolios with the thirty best companies we can find across the region.

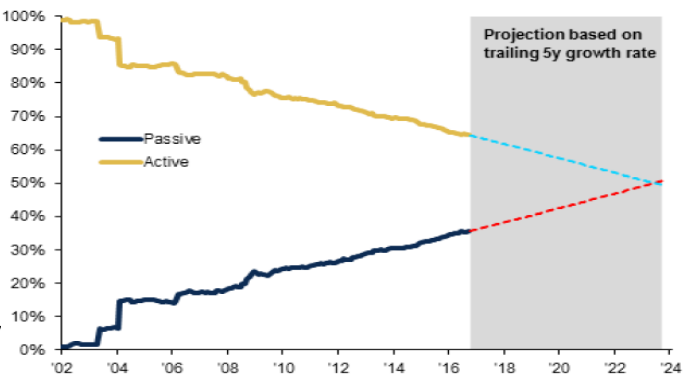
Outlook

The strength of the dollar, rising US interest rates and the uncertainty of Trumponomics (especially for trade dependent North Asia) present undoubted headwinds for Asia. Thankfully valuations remain reasonably compelling in a historic context.

Cumulative flows to active vs passive equity funds ($tn)



Share of active vs passive equity funds



Source: Bank of America Merrill Lynch