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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

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Market review

Global equities moved higher again in December with the MSCI AC World Index climbing 2.2%. The MSCI AC Asia ex Japan Index, however, declined a further 2.1% as regional markets continued to digest recent domestic and international developments. China (-4.1%) was particularly weak as investors fretted about rising hot money outflows, Trump trade rhetoric and the weakness of the renminbi. The Federal Reserve increased short term interest rates as expected.

For calendar 2016, the MSCI AC Asia ex Japan Index rose 5.4%, slightly behind the 7.9% advance in the MSCI AC World Index.

All returns above are stated in USD terms.

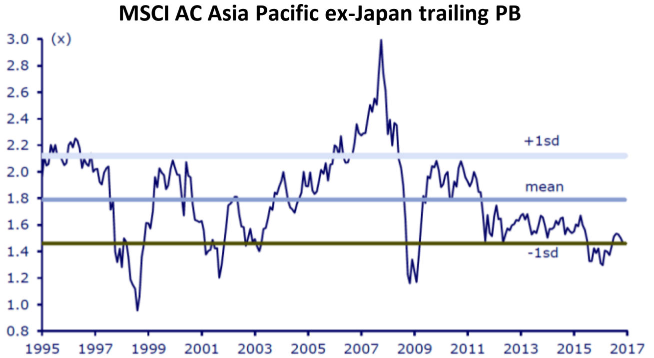
Asian equities – Trumped?

Asian markets underperformed significantly in the final two months of 2016 following the US presidential election which reversed what had been an encouraging six months of outperformance. In the fourth quarter, the MSCI AC Asia ex Japan Index fell 6.3% while the MSCI AC World Index rose 1.2%. On the one hand, President-elect Trump's promise to withdraw from the Trans-Pacific Partnership Agreement and vocal comments regarding Chinese imports are clearly a big potential negative for trade-orientated Asia (especially North Asia). On the other hand, a rather more hawkish Federal Reserve, perhaps troubled by the Trump promise to cut taxes and invest heavily in infrastructure, has placed pressure on Asian currencies and raises the spectre of tighter monetary policies across Asia (especially South Asia). It remains a moot point whether the Federal Reserve can 'normalise' monetary policy and also whether Trump can, in practice, effect his threatened trade tariffs.

Or self inflicted?

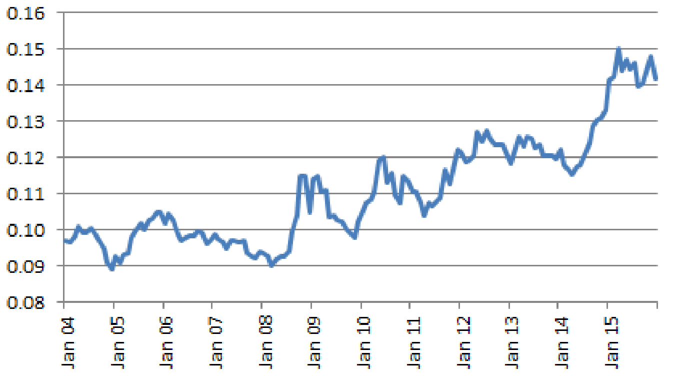
It is slightly unfair, however, to lay all the blame for recent underperformance at Trump's feet. In the Philippines (-12.8% in 4Q16), aggressive foreign selling has resulted following President Duterte's China 'tilt'. There are valid concerns that this change in foreign policy will derail the rapid growth in the BPO sector - a key driver of growth, employment and service exports in the economy - since Japanese and American companies account for over two thirds of the client base. In Korea (-5.6% 4Q16), the impeachment of President Park Geun-hye has been unhelpful, to say the least. This is, after all, the lady who has managed to make President Hollande look relatively popular!

MSCI AC Asia Pacific ex-Japan trailing PB



Source: Bloomberg

Chinese renminbi/euro rate



Source: Bloomberg

Elsewhere, an apparent increase in hot money outflows in the fourth quarter has resurrected fears that China (-7.1% in 4Q16) has lost control of the capital account and the renminbi. We remain of the view that the government remains firmly in control of both the capital account and the currency. The problem is dollar strength, not renminbi weakness. For example, the renminbi has appreciated by over 50% against the euro since 2008 (see chart above).

We covered India's (-8.0% in 4Q16) 'demonetisation' in some detail last month. Our view is unchanged: the country remains the best long-term domestic demand story of our era, but demonetisation is causing short-term economic disruption. It is interesting to note that Indonesia recently decided to replace all notes and coins in circulation (with questions being asked if deposits of old notes exceed a certain level). Certainly the long hoped for revival of the Indian investment cycle has been deferred, but it has not been cancelled.

In Malaysia (-8.4% in 4Q16) the 1MDB saga rolls on and if there is one economy in Asia to worry about in a macro sense, here it is. Short-term foreign debt stands at 83% of foreign exchange reserves (the range for other countries in the region is 16% to 36%) while foreign ownership of Malaysian Government Bonds stands at an elevated 50%. Arguably, the ringgit – now back to the 1998 and 2008 lows in both real and nominal terms – is pricing much of this in.

Outlook

Rhetoric and reality are unusual bedfellows and we must wait and see how the Trump presidency develops. The rally in commodities reflects some supply-side discipline but it has also turned into something of a momentum trade which we will not chase. To place the size of Trump's ten year infrastructure US$1tr spending plan in context, China spends more every nine months!

Following the recent sell off, regional equities again trade on a relatively modest 1.4x book value (see chart to the left) and on a low double digit earnings multiple. Net debt to equity, at under 30%, is also low. These metrics are not a bad place to start and we are hopeful of making good progress over the next twelve months, although bumps in the road can be safely predicted.