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

BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

2nd February 2017

Market review

A bright start to the new year with the MSCI AC World Index climbing 2.7% in January. The MSCI AC Asia ex Japan Index rallied 6.2%, reversing a good part of the recent underperformance. Singapore (+8.3%) was the best performer with Korea (+7.7%), Hong Kong (+7.7%) and China (+6.8%) not far behind. By sector, Information Technology (+8.7%) led the pack, driven by the 14.6% rise in portfolio holding Samsung Electronics. The regional portfolio also received a boost from double digit gains in Chinese consumer stocks Want Want, Sun Art Retail and Samsonite. The lack of exposure to Materials (+8.0%) was, however, less helpful.

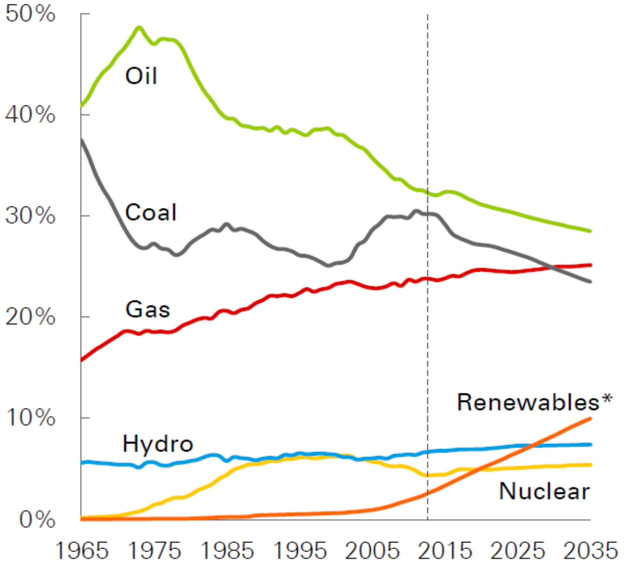
All returns above are stated in USD terms.

Oil

While most commodities continue to rally as evidence of supply-side consolidation in the Chinese coal and steel sectors continues to mount, oil declined 3.3% as increased US shale oil production offset recent OPEC output reductions.

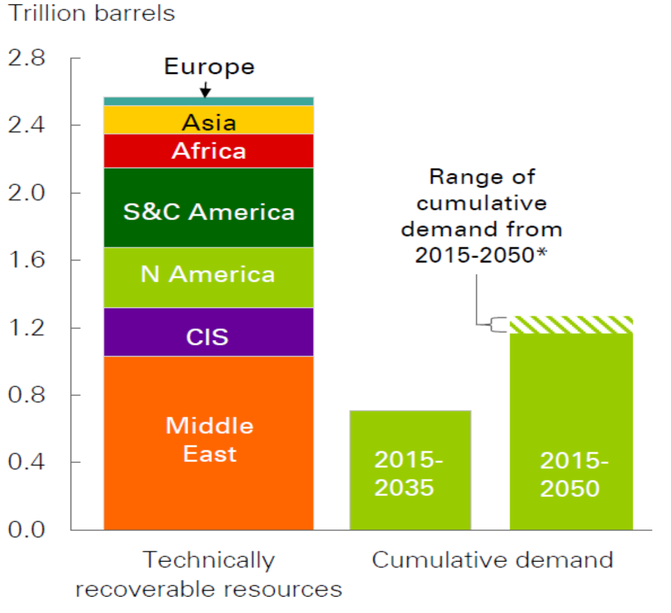
We were greatly interested in the rather sombre outlook for oil prices given by Spencer Dale, BP's chief economist. Energy demand is forecast to grow by 1.3% per annum in the 2015-2035 period (considerably lower than the 2.2% growth of the previous 20 years) with renewables likely to provide 40% of the additional energy required. The chart below illustrates the relentless loss of market share of both oil and coal. This is driven partially by carbon emission targets and the "greener" option of cheaper and abundant gas, but increasingly by the cost competitiveness of renewables. China is expected to add more renewable power than the US and Europe combined. Dale believes "peak" oil demand will occur sometime in the 2040s. Technically, recoverable oil (a category which measures resources that could be extracted using today's technology) is estimated to be around 2.6 trillion barrels, which is twice the forecast oil demand between 2015 to 2050 (see second chart).

Shares of primary energy



Source: BP plc

Estimates of technically recoverable resources and cumulative oil demand



Source: BP plc

This surplus is likely to spur producers to accelerate production in order to ensure they are not left with stranded assets. Further downward pressure on energy costs would be a real boon for growth prospects across the energy deficient Asian region. The 103 page presentation is well worth a read.

Results

Driven by strong DRAM and NAND prices, Samsung Electronics produced a cracking set of 4Q16 results in early January. The company later announced a 38% increase in the final dividend and a ₩9.3tr share buyback (over 3% of shares outstanding). Exploding phones and political issues aside, this regional monster (it remains the largest index constituent) retains great earnings momentum and trades on a single digit 2017 earnings multiple.

Our Indian holdings sailed through the 4Q16 'demonetisation' with ease. Zee Entertainment, ITC and HDFC all reported modest y-o-y growth in net profit in 4Q16. The Indian budget (announced on 1st February) included tax cuts for the lower income band, a continued focus on infrastructure with a 10% increase in FY18 spending and additional fiscal incentives for low cost housing. The forthcoming introduction of GST clouds the issue somewhat but this appears a sensible pro-business, pro-growth budget with the FY18 budget deficit set at 3.2%.

Outlook

President Trump has yet to turn his guns on China/Asia with respect to trade, and the proposed border tax – if pursued – will have significant implications for exporters in the regions, so some turbulence in regional markets is likely. Fortunately, regional valuations, at circa 1.5x book value, should cushion any "air pockets" encountered.