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

BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

2nd March 2017

Market review

The Trump rally continued in February as the Asian region moved smoothly into the year of the rooster. Driven primarily by the larger, more developed North Asian markets, the MSCI AC Asia ex Japan Index rose 4.7% thus slightly outperforming the MSCI AC World Index which gained 4.1%. ASEAN underperformed again as the prospect of the Federal Reserve lifting short-term rates prompted memories of the 2013 taper tantrum. We would argue conditions, especially valuations, are slightly different today. The limited exposure of the regional funds to commodity stocks and Chinese financials was unhelpful.

All returns above are stated in USD terms.

Chinese Financials

While the invisible hand of Adam Smith (generally defined as the unobservable market force that helps the demand and supply of goods in a free market to reach equilibrium automatically) is definitely playing a role in China's private sector companies, it has been the very visible, and somewhat heavy, hand of the state that has changed the dynamics in a number of key sectors – namely coal, steel and (indirectly) financials over the past year.

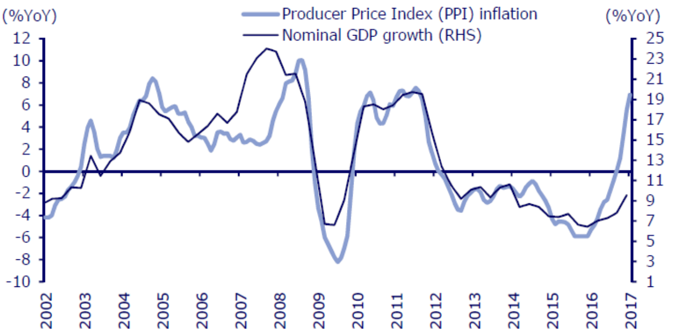
There is a government defined range for domestic coal prices – ¥470-600 per metric tonne (pmt) – with production across the country's mines adjusted to produce the "right" price. Smaller, less efficient mines are being closed as illustrated by the soaring market share of the four largest producers. CLSA's China Reality Research (CRR) estimated that the market share of the top four northern producers has risen from 50% to 70% over the past two years. Gross profit margins have jumped from circa -20% to +20% over the past twelve months.

It is a similar story in the steel sector where the government aims to eliminate some 140 million tonnes (mt) of capacity by 2020 which would (more or less) bring the industry into equilibrium, assuming unchanged demand. CRR estimate that most steel plants have already reduced their workforces by 10% or more.

We continue to believe that we can identify less cyclical, more interesting longer-term investment opportunities than coal and steel but the huge swing in gross margins in these industries has proved transformational for the banks. According to the *People's Daily*, the net profits of State Owned Enterprises jumped 25% in January 2017 y-o-y. Whether one believes that this is little more than an "extend and pretend" exercise with loans being rolled over or that the imposed capacity disciplines will restore long term profitability, there is no doubt that China's bankers are currently feeling rather more comfortable about the quality of certain sections of their loan book and this has been reflected in share prices over the past year.

Whether they will be sufficiently confident to continue to pay pretty "full" annual dividends is another question, especially since the sector continues to trade below book value and therefore cannot undertake any plain vanilla equity issues. Needless to say the ETF managers don't worry much about such concerns; they are only interested in the still substantial index weighting of Chinese financials!

China PPI inflation and nominal GBP growth



Source: CLSA, CEIC Data, National Bureau of Statistics

Results

The Philippines has been the most disappointing equity market in the region over the past six months, underperforming by some 20%. Ayala Land announced very steady 2016 results in February. Earnings grew 19% y-o-y, in line with forecasts, and the company remains optimistic. The company will accelerate residential launches in 2017 following a pick up in take up rates at recent launches. Meanwhile, parent Ayala Corporation plans a 13% increase in CAPEX for 2017. Recent investments in the energy and infrastructure segments will start bearing fruit over the next couple of years and help drive profitability.

Ayala Corp and Ayala Land trade at 18x and 21x forward earnings – down from 22x and 27x last August, and 28x and 40x in May 2013 respectively.

Indonesia's Astra International posted decent 2016 results that were held back only by provisions related to continued asset quality issues at 45% owned Bank Permata. Astra gained market share in both four and two wheelers: the auto financing business continues to grow strongly and listed subsidiaries United Tractors and Astro Agro benefitted from better commodity prices.

Finally, Sun Art Retail, China's second largest hypermarket operator, turned in decent 2H16 results. Same Store Sales have stabilised and the group managed to increase Earnings before Interest and Taxes (EBIT) margins. While the challenge from online competition remains, the group continues to see good growth opportunities. A slightly higher inflation rate, plus additional store openings, should help the top line in 2017. The final dividend was raised 21%.

Outlook

The recent North Korean missile launch, the murder of Kim Jong Nam and China's subsequent banning of North Korean coal imports serves to show that there is much more on the broader regional agenda than just President Trump and his thoughts on trade relations.

Trade growth around the region has finally picked up – in volume as well as value terms – and the most important consideration in the short term will be the outcome of the next meeting of the Federal Reserve.

Compliance: 4579, 2nd March 2017