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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

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Market review

Asian markets took the Federal Reserve's decision to raise interest rates in their stride. With Korea again leading regional markets, the MSCI AC Asia ex Japan Index rose 3.3% while the MSCI AC World Index gained a lesser 1.2%. Technology (+5.1%) led the way while Materials (+0.2%) took a breather and Consumer Staples (+1.5%) lagged. The regional portfolios had a good month.

All returns above are stated in USD terms.

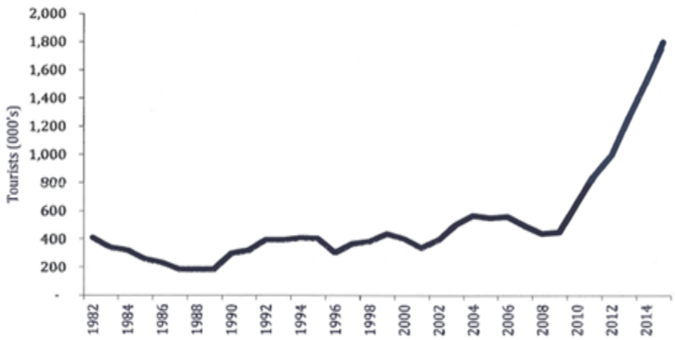
Sri Lanka – holiday here fast

Sri Lanka has had a tough ride in recent times. Over 80,000 people died during the civil war (1982-2009) while the 2004 tsunami claimed a further 40,000 lives. These are sizeable numbers for a relatively small country (population circa 20mn) and, at first glance, the macro backdrop appears very weak. The trade account deficit stands at a little over 10% of GDP, the budget deficit is running at 5-6% primarily due to the narrow tax base (13% of GDP), government debt stands at 75% of GDP, foreign exchange reserves stretch to just four months of imports and the currency is on a weakening trend. Little wonder perhaps that Moody's (B+) and S&P (B1) have the country on negative watch. This somewhat stark macro snapshot, and the small and illiquid nature of the local equity market, best explain why investors continue to shun the country (foreigners own just 4% of issued government securities).

Readers might be surprised, therefore, to learn that we departed Sri Lanka extremely upbeat and excited by the likely development path of this beautiful country over the next decade and beyond. We note that the IMF recently commended the authorities for "strong efforts in implementing their IMF-supported economic reform program with all fiscal quantitative targets through end-December being met" (the most significant step has been the recent increase in VAT from 11% to 15%) and further note that Fitch (B+) recently lifted their outlook from negative to stable. Our optimism rests on three factors.

The first is tourism. After twenty five years of stagnation, tourist arrivals have compounded at 24% per annum since the end of the civil war (see chart). The two million arrivals per annum are, however, little more than a rounding error compared to comparable destinations such as Thailand (30mn) and Malaysia (26mn).

Sri Lanka tourist arrivals 1982-2016



Source: John Keells Holdings

Needless to say, the fastest growing arrivals are from China and India (both circa 15% of total). Growth prospects are simply excellent. Tourism earnings are projected to reach US$4bn in 2017, almost 5% of GDP. We would expect these to double over the next three to four years and become a more important source of foreign exchange earnings than the US$7.5bn annual remittances by Sri Lanka's one million overseas workers.

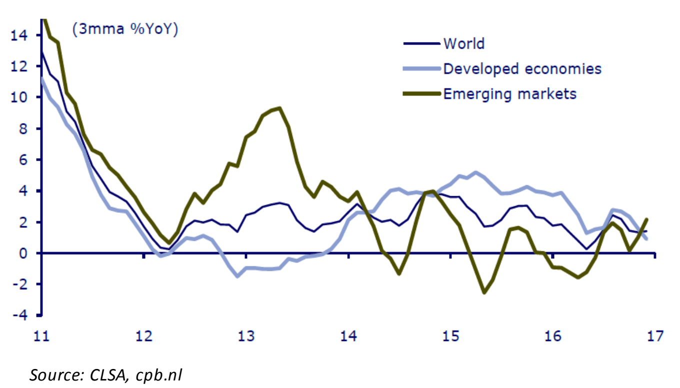
The second is the huge impact of Chinese investment into the local economy, part of China's OBOR initiative. As part of the Sri Lankan government's US$40bn plan to redevelop the country's capital, the Chinese are undertaking a 450 acre reclamation next to Colombo Port. Construction of the Colombo International Financial City will begin in late 2019. Further south, Chinese investors are planning to invest US$5bn developing a 1,235 acre industrial zone in Hambantota creating 100,000 jobs. Foreign Direct Investment, which peaked at US$1.5bn (2% of GDP) in 2014, is likely to soar over the next few years.

Last but not least is the high quality and low valuation of the majority of listed companies. Generally speaking, corporate governance is excellent and blue chips, such as John Keells, trade on low double digit earnings multiples while offering yields of 4% plus. Liquidity, as previously mentioned, is an issue but this is simply informing the long-term investor that the market is trading at the wrong price. The regional portfolios already have indirect exposure via Siam City Cement, which purchased the leading local cement producer last year, and has now established a modest position in Singer Sri Lanka, a leading retailer of household goods and consumer products.

Regional trade – on the up

We ended last month's commentary noting that trade trends were improving. Renewed growth in global trade is being driven by Asia and emerging markets. India, Korea, Taiwan, Indonesia and Singapore all recorded double digit y-o-y growth in exports in the first two months of 2017. Despite the December 2016 reduction in government tax incentives, total Chinese auto sales rose 13.1% y-o-y in the first two months of 2017.

World trade volume growth (3mma % y-o-y)



Source: CLSA, cpb.nl

As always, there is a lot going on in Asia and the vast majority of it is good. Markets may need to consolidate recent gains but we remain optimistic and hope to build on recent progress.