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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

5th July 2017

Market review

Asian equities continued their good relative and absolute run in June. The MSCI AC Asia ex Japan Index gained 1.6% and ended the first half 22.8% to the good.

All returns above are stated in USD terms.

China – MSCI, China A Share Inclusion

On 20th June MSCI announced that they would include locally listed Chinese shares (A shares) in the MSCI family of indices including the Emerging Markets Index and the Asia ex Japan Index. The inclusion of A shares was not unexpected; it has been a matter of when not if for some time. The surprise perhaps was the low level of the inclusion factor which was set at 5% and is being implemented in two stages over the next twelve months.

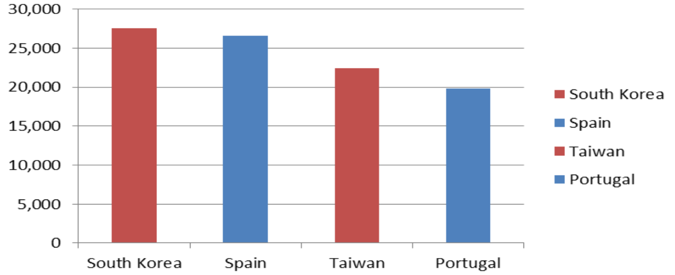
In a world where active investment management remains under the cosh (thanks to indifferent performance and relentless regulatory pressure on fees) and passive strategies continue to gain market share, changes in the composition of indices is a depressingly newsworthy item. It is hard to argue against the decision. For a start, China is the world's second largest economy and boasts the second largest stock market by capitalisation. The introduction of the Hong Kong stock connect trading channels, which has greatly simplified foreign investors' access to A shares, and an improvement in regulatory oversight of the domestic markets have clearly been important factors for MSCI.

There will, no doubt, be continuous speculation regarding the timing of further increases in the inclusion factor. With a 5% inclusion factor, China A shares will be 0.75% of the MSCI Emerging Market Index, lifting China's total country weight to nearly 28%. A 100% inclusion factor would lift the country weight to over 35% – some 10% larger than the combined weight of the next two largest emerging markets, Taiwan and South Korea.

Of course, if MSCI decided to promote these two very developed and high middle income economies to developed status (joining Hong Kong and Singapore) then China's weight would be just short of 50% of the MSCI Emerging Markets Index.

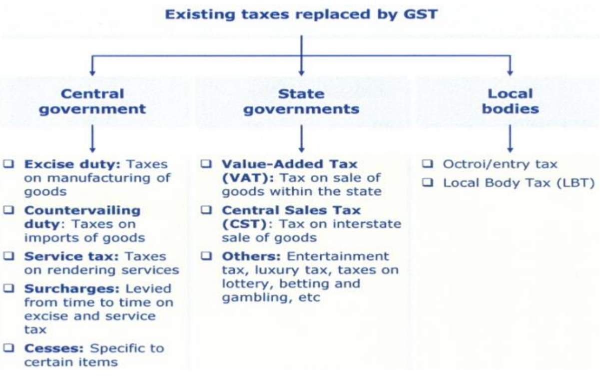
Since reforming and opening its economy to the world, China has influenced consumption trends worldwide by slashing the cost of manufactured goods, becoming the dominant consumer of most commodities and impacting tourist destinations worldwide. It will, over time, now play an increasingly important role in the performance of your (passive?) pension fund.

Nominal GDP 2016



Source: IMF World Economic Outlook Database-April 2017

India – GST introduction, nine taxes disappear

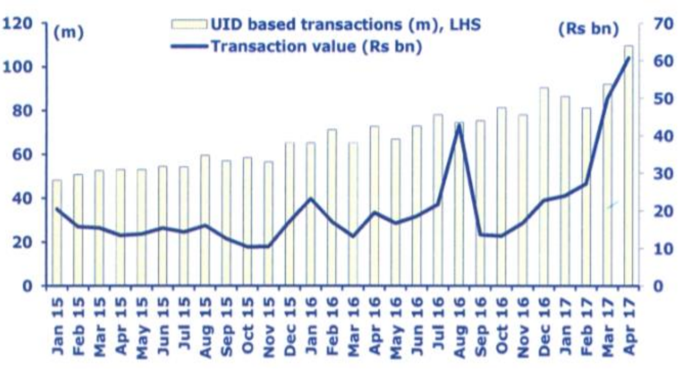


Source: CLSA

India

Rather more interesting has been the introduction of the GST (Goods and Services Tax) in India with effect from 1st July. As the chart above illustrates, GST will result in a huge simplification of India's multiple tiers of national, state and local indirect taxes. As with demonetisation last year, there will be short-term disruption but this is hugely outweighed by the longer-term benefits of improved efficiency within the domestic economy, as most barriers to interstate trade fall by the wayside.

100m+ UID transactions every month



Source: CLSA

We have discussed the roll out of the Aadhar (ID card) before. It is estimated that 99% of Indians over the age of 18 now have a UID. 283mn 'no-frills' bank accounts have been opened over the past three years and it is estimated that 90% of Indian households now have access to a bank account. Aside from financial inclusion, a key objective of the UID program was the payment of welfare payments and subsidies directly to the individual thus cutting out 'Del Boy' who, historically, has done what any self-respecting 'middle man' would do: take a cut. Today it is estimated that 95% of the US$25bn of welfare payments to individuals is paid directly into their bank accounts.

We concede that the Indian stock market is expensive but, unlike *the Economist*, we believe the future is bright.

A lull over the summer months may be appropriate given the strong gains of the first half but Asia remains in very good shape as we increasingly turn our eye to earnings and dividends in 2018 and beyond.