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

BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

2nd August 2017

Market review

Asian equities continued their good relative and absolute run in July. The MSCI AC Asia ex Japan Index gained 5.3% while the MSCI AC World Index rose 2.8%. MSCI China (+8.9%) led the way, taking over the baton from Korea (+3.2%).

By sector, Financials (+6.6%) had another good month but the key driver remains index heavyweight Information Technology (+7.0%) and, specifically, e-commerce stocks. We note that Alibaba (+10.0%), Tencent (+12.3%) and Baidu (+26.6%) alone now account for one third of the MSCI China Index. The portfolios have some exposure to the first two names but not at an index weight. These names look very overbought and, arguably, the increasingly narrow nature of the indices' advance is unhealthy.

All returns above are stated in USD terms.

Smoked

The Indian Government raised the cess (excise tax) on cigarettes shortly after the implementation of the Goods and Services Tax. So much for the 'tax neutral' promise. Portfolio holding ITC duly fell 14.5% over the month. Not a great start to the second half but, if any one industry can point to a strong track record of steadily rising profitability despite rising regulatory oversight and soaring excise taxes, it is tobacco. We remain very comfortable with ITC.

Consumed

Indeed, it was not only tobacco that suffered. The MSCI Asia ex Japan Consumer Staple Index fell 1.2% during July and the sector remains a disappointing performer. Whether staple or discretionary, we believe that the long term outlook for consumption across the Asian region remains extremely bright. While new online distribution and payment channels continue to cause disruption, and not a little confusion across the retail sector in particular, the rapid growth of e-commerce across Asia simply confirms the positive outlook for consumption.

India and ASEAN 5

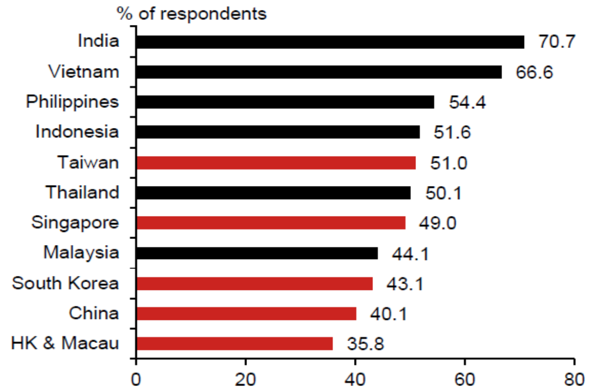
Nomura recently published an interesting research document predicting that FDI into India and ASEAN will jump from circa US$100bn p.a. today to US$240bn p.a. over the next decade, driven by large and growing domestic markets, better infrastructure, more liberal FDI regimes, political stability and relatively low labour costs.

The following chart rates Asian FDI destinations by relative attractiveness from a Japanese perspective.

Furthermore, as we have pointed out repeatedly, the demographics of South East and South Asia are considerably more conducive to growth with the total population growing from 1.9bn today to 2.1bn by 2025. That compares to the 1.5bn population of China and North East Asia, a number that will remain static over the next decade.

Consumption trends in South East and South Asia will outperform those of more developed North Asia significantly over time and our portfolios remain tilted in this direction.

2016 JETRO survey on future business plans: Japanese firms selecting expansion as approach to future business challenges in the next 1-2 years



Source: JETRO

Results

Earnings releases for the first half (and/or second quarter) have been pouring out. Shinhan Financial posted excellent 2Q profits, up 30.5% y-o-y. While net profits included a sizeable one off gain on the sale of an investment, key metrics such as net interest margins, net interest income, commission income, non performing loans, cost to income ratio and NPL coverage all moved in the right direction.

SK Telecom posted a 113% increase in 2Q17, net profit driven principally by the sharp increase in equity gains from 20% owned SK Hynix. Underlying operating profit grew a modest 3.9% y-o-y thanks to lower losses at SK Planet and tight cost control. Samsung Electronics posted a 42% y-o-y increase in 2Q17 operating profits, driven by higher DRAM prices. The DRAM supply/demand dynamics remain very tight at present.

In India, HDFC posted a 27% decline in 1QFY18 profits but, adjusted for one off investment gains last year and a higher tax rate, underlying earnings grew 15% in line with the healthy 20% growth in loans. Zee posted a 28% increase in pre-tax profit aided by strong domestic advertising revenues. Subscriptions revenues grew 14.5% (excluding the recently disposed of sports business) and further growth at this rate is expected over the next few years as digitisation continues across the country.

Sands China reported a 24% increase in gross gaming revenues and a 22% increase in non-gaming revenues allowing (hold adjusted) EBITBA to rise 17%. The recovery from the 2015/16 slump continues and Sands remains an excellent play on mass market growth. Finally, Astra International reported slightly soft 2Q17 earnings with only subsidiary United Tractors shining. With the Lebaran holiday season falling in June this year (July in 2016), it is difficult to make y-o-y comparisons. Net profit for the first half rose 31% y-o-y.

Outlook

Many leading, heavyweight stocks look and feel overbought.