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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

4th October 2017

Market review

Asian equities continued to consolidate in September. The MSCI AC Asia ex Japan Index slipped 0.1% while the MSCI AC World Index gained 1.9%.

Some smaller markets such as Thailand (+3.0%) and the Philippines (+3.3%) performed strongly while Taiwan (-3.4%) and India (-3.7%) gave up ground. By sector, Materials (-2.9%) and Financials (-2.8%) underperformed while Consumer Discretionary (+2.8%) and Information Technology (+1.8%) outperformed.

All returns above are stated in USD terms.

Federal Reserve quantitative easing – the beginning of the end

The widely expected announcement that the Federal Reserve would stop, or slow, the reinvestment of maturing Treasuries and mortgage backed securities duly materialised in September. The fact that the change of policy had been so heavily signalled to the market over the past few months is, perhaps, the significant difference to the 'taper tantrum' of 2013 that proved so destructive to many high flying Asian equity markets. While it remains unclear what the exact impact the shrinking of the Federal Reserve's balance sheet will have over time, it is of some comfort that policy makers have emphasised that they will remain flexible. As one would expect, the dollar has rallied.

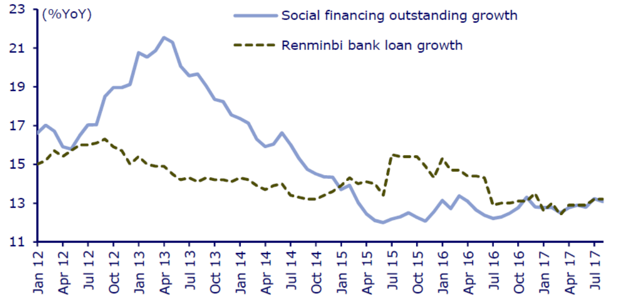
China – genie back in the bottle?

China bears have long pointed to the rapid growth of the shadow banking system as evidence that the entire Chinese financial system must, at some point, collapse. In a free market world they might well be correct. In China – where the state owns and controls the main players in many sectors but especially finance – their arguments increasingly fall on deaf ears.

The chart below, courtesy of CLSA, shows the year-on-year growth of total social financing and bank loan growth. During the post-GFC credit boom the genie was well and truly out of the bottle and threatening to cause chaos. We are certainly not suggesting that the post-GFC Chinese credit boom did not result in poor investment decisions, nor are we suggesting that significant (and unreported) NPL problems do not exist. Neither would we argue that the entire shadow banking system is captured by the social financing data.

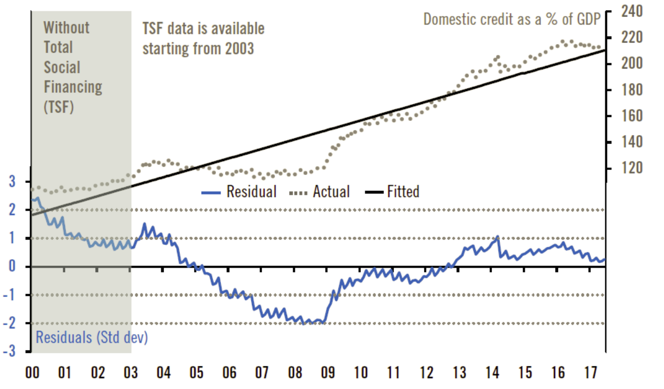
The important point is the obvious change in policy. Measures to contain, or squeeze, the growth of the shadow banking system in recent years have been remarkably successful.

China renminbi bank loan growth and social financing outstanding growth



Source: CLSA, CEIC Data, PBOC

China bank credit relative (% of GDP), 2000-2017



Source: Asianomics Group

Asianomics' Jim Walker (A Tale of Two Bubbles, 20th September 2017) argues that the People's Bank of China (PBOC) has acted proactively in recent years to unwind the identified bubble (in stark contrast to the Fed's denial of any bubble in the run up to the GFC). Walker notes that "real lending rates in China have moved up sharply since 2012 and fixed asset investment has slowed in response. The quality of bank lending and company borrowing decisions are likely to have improved dramatically in the last few years".

Yes, there are legacy NPLs and yes, the shadow banking system is still there but (as the chart above illustrates) China's bank credit relative shows no sign of excess.

It seems clear that the PBOC also believe the genie is back in the bottle. On 30th September they signalled a future cut in reserve requirement ratio (currently 17%) for banks who extend a sufficient proportion of new loans to SMEs, start-ups and rural areas. Not a loosening of monetary policy as such but a clear inducement to banks who direct funding towards favoured policy areas. The 19th National Congress of the Communist Party of China takes place this month and should give a good insight into policy objectives for the next five years and beyond.

ASEAN

It has been a tough year thus far for ASEAN equity markets with a return of just 60% of the broader regional index. Indeed, since May 2013 MSCI ASEAN Index has generated a zero return for investors compared to a near 40% advance for MSCI AC Asia ex Japan Index. Whether it is the Philippines (tax reform moving ahead, infrastructure spending ramping up), Thailand (strong growth in exports and tourism, the Eastern Economic Corridor initiative, rising infrastructure spending), Malaysia (more stable government finances, solid demographics, rising infrastructure spending) or Indonesia (rising capacity utilisation, infrastructure spending, demographics) the prospects for sustained growth look excellent. More competitive returns lie ahead.

Outlook

The region has performed well thus far this year and valuations are no longer so obviously compelling. However, as we turn to the prospects for 2018, we still see good investment opportunities across the region.