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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

8th January 2018

Market review

Asian equities closed 2017 in a positive fashion with the MSCI AC Asia ex Japan Index advancing 2.7% in December while the MSCI AC World Index gained 1.6%. ASEAN markets closed the year strongly with Indonesia, Malaysia and the Philippines all posting gains in excess of 5%. By sector, Healthcare (+8.1%), Consumer Staples (+6.2%) and Materials (+4.5%) outperformed.

For calendar year 2017 the MSCI AC Asia ex Japan Index climbed 41.7% while the MSCI AC World Index advanced 24.0%. By country, China (+54.1%), Korea (+47.3%) and India (+38.8%) were the top performers. By sector, Information Technology (+61.3%), Real Estate (+50.2%) and Consumer Discretionary (+41.2%) produced the best returns.

All total returns in US dollars

Sailing on smoothly?

The consensus among those strategists we listen to most closely is that while Asian equities have had a substantial move over the past couple of years (the regional index is up over 60% in US Dollar terms from the February 2016 nadir) there is good reason to remain optimistic regarding the prospects for 2018. The regional markets are obviously no longer at bargain basement valuations but neither are they obviously overvalued relative to historical norms. The global macroeconomic backdrop remains encouraging while the secular growth drivers of the region remain strong.

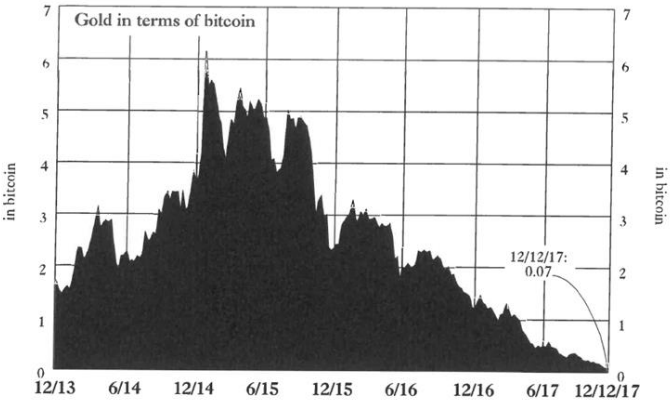
Cleptocurrency

It is therefore worth pondering the thoughts of a couple of other tried and tested global strategists. The most recent Grant's Interest Rate Observer comments on the ongoing issue of medium dated bonds in the Eurozone yielding 0.6% - 2.0% by corporates hanging on to investment grade status by their fingernails and jokes that perhaps the bull market will not crack until the issue of a zero coupon perpetual. Continued quantitative easing in the Eurozone continues to generate odd risk reward profiles. The paper then discusses the tightening cycle underway at the Federal Reserve and notes the already flattering yield curve. A pop is taken at China's debt problems, specifically in the power generation sector, but it is the analysis of the rise and rise of Softbank (and its largest investment, Alibaba) that is worth a read.

Fred Hickey's High-Tech Strategist also bemoans the low interest rate and free money era engendered by the Federal Reserve and other central banks. He argues that the flood of money moving from active to passive management is a considerable force in the ongoing ascent of the FANGS (Facebook, Apple, Netflix & Google), a subject close to our hearts - see on. There is also an excellent round up of the current crypto-mania where evidence of insider selling is rampant, as indeed it is in the FANG universe. He quotes a Korean Herald survey suggesting that 31% of Korean workers are speculating - sorry, investing - in cryptocurrencies.

Hickey's prediction for 2018? Gold bullion will outperform Bitcoin! The following chart (taken from Grant's) illustrates how far the age old store of value has fallen against brand new (and unproven) stores of value.

Disrupted?



Source: Bloomberg

Hickey notes that across the listed gold company universe there has been substantial insider buying. We suspect that gold related investments might outperform quite a few other asset classes as well.

TATS

In Asia the relevant acronym is TATS (Tencent, Alibaba, TSMC and Samsung Electronics). The regional portfolios currently hold modest positions in all four of these stocks which collectively account for almost 20% of the broader MSCI AC Asia ex Japan. These same four stocks account for over 41% of the narrower MSCI Asia Apex 50 Index. Last year the Apex 50 Index returned 48.9%, almost seven percentage points more than its comparable broader index. Indeed the Apex 50 Index has outperformed the broader index in six of the past seven years but never by such a huge margin. The remarkable rise of the passive investment universe continues apace, aided and abetted by regulatory pressures as much as anything else, but at some point this momentum will dissipate. Passive purchases of large caps will ease off as will the forced selling by active managers of 'non index relevant' mid and small caps.

It is difficult to gauge when this tipping point might occur but it is clear to us that there is tremendous value in some of the region's smaller markets and, for the same reason, it is not hard to find compelling investment stories among the smaller cap universe in the larger markets. We will continue to run a balanced portfolio without specific reference to market capitalisation or index weightings. We still rate TSMC and Samsung Electronics as wonderful long term investments. Over 70% of the portfolio is invested in companies with a market capitalisation in excess of $5bn and we do not see that percentage changing significantly.

Outlook

The change of leadership at the Federal Reserve is one of several events that may serve to upset markets as we trundle into 2018. However, as mentioned earlier, the macroeconomic backdrop across the Asian region is little short of excellent and, unlike some other asset classes we can think of, valuations are not excessive. The regional portfolios remain predominantly focussed on domestically orientated concerns with excellent prospects.