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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

7th February 2018

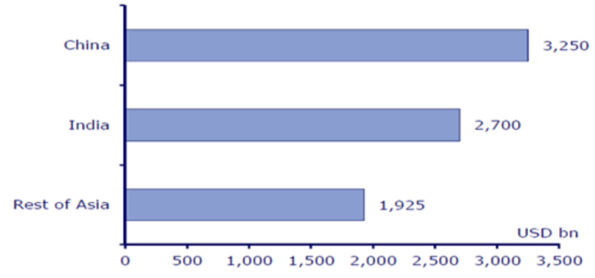
Market review

Asian equities opened 2018 as they left 2017 - on a tear. The MSCI AC Asia ex Japan Index advanced 7.6% in January while the MSCI AC World Index gained 5.6%. China (+12.5%) led the way while Thailand (+8.5%) also had a promising start to the year. The Philippines (-1.3%) lagged, as did India (+3.4%) and Korea (+3.7%).

By sector, Financials (+10.2%) and Energy (+10.0%) led the pack while lower beta sectors such as Telecoms (+1.2%), Utilities (+2.6%) and Consumer Staples (+2.5%) lagged.

All total returns in US dollars

Asia's Contribution to Next US$10tn Middle Class Spending 2015-2022



Note: Estimates are in PPP, constant 2011 USD.
Source: Kharas, H., The unprecedented expansion of the global middle class, February 2017

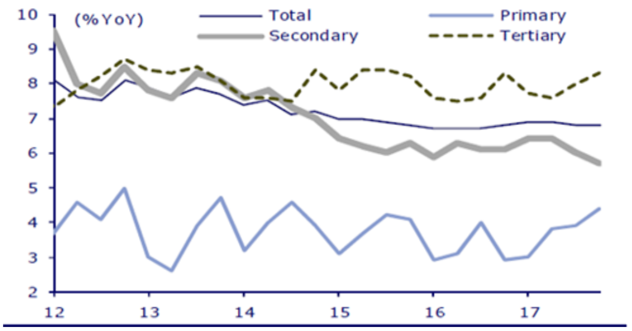
China – steady as she goes

China's real GDP rose 6.8% in 4Q17 and posted a growth rate of 6.9% for calendar year 2017 as a whole. Not bad for the world's second largest economy which was being written off as a busted flush by many less than two years ago! Rising consumption accounted for almost 60% of the growth while investment contributed a little over 30% (the balance of 10% was accounted for by a small improvement in net trade). The rebalancing of the economy continues apace with investment and exports playing second fiddle to a society that has embraced consumption. This can be seen clearly in the chart below which highlights the increasingly different directions of the secondary and tertiary sectors.

Perhaps more importantly, nominal Gross Domestic Product (GDP) growth accelerated from 7.9% to 11.2% in calendar year 2017. It is nominal (not real) GDP that represents corporate revenues and it is nominal (not real) revenues, cashflow and earnings that has allowed much of corporate China, and especially the indebted State Owned Enterprises, to 'right size' their balance sheets. Not everything is rosy, as the media spotlight currently shining on the HNA Group clearly shows, but stability has returned and another year of solid growth - driven principally by growing consumption - lies ahead. This is good news for the rest of Asia given that China is by far and away their most significant trading partner.

An excellent note by CLSA's Anthony Nafte, which draws on research undertaken last year by Homi Kharas of the Brookings Institute, points out that the rapid growth in consumption is not confined to China, indeed far from it.

GDP by Industry % YoY



Source: CLSA, CEIC

We have mentioned China's challenging demographic profile many times in the past few years and, while the second chart (above) illustrates that China will account for an estimated 40% of the total increase in Asia's 'middle class' spending between 2015 and 2022, it is the growth elsewhere in the region which catches the eye. The same study predicts that Asia's share of global middle class spending will rise from 36% in 2015 to 51% in 2025. The portfolios remains very heavily tilted towards companies benefitting from growing domestic consumption.

January portfolio highlights

Recent purchase Finetex, a Korean manufacturer of nano-fibres, gained 45.6% in January while another relatively recent purchase, JNBY (a Chinese designer clothes retailer) gained 25.3%. Sun Art Retail rose 28.4% while mid double digit returns from other old favourites such as HDFC, Sands China and Land & Houses also helped. Less helpful was the 11.6% fall in our favourite Nepalese casino. The company announced strong 4Q17 revenues at month end and, with the Tiger Palace Resort finally up and running, we remain extremely bullish on the company's prospects.

Indian Budget

Lower than expected Goods and Services Tax (GST) receipts and the looming 2019 general election required some nifty footwork from Finance Minister Arun Jaitley. Some minor fiscal slippage did not surprise although the forecast 2019 budget deficit of 3.3% of GDP is dependent (again) upon a significant increase in GST receipts. Social sectors such as healthcare (insurance for the 100mn poorest families) and housing (the PMAY housing loan budget was doubled) featured while the rural sector received a number of targeted handouts. The introduction of a 10% long term capital gains tax is hardly market friendly but it had been widely flagged.

Outlook

The accelerating sell off in bond markets and still more hawkish talk from the Federal Reserve should not be ignored. Historically Asian equities have struggled to perform well during US monetary tightening cycles. On the other hand Asian equities love a weaker dollar.

Perhaps a pause for breath as China celebrates the lunar new year and the arrival of the Year of the Dog.