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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

04th April 2018

Review

The MSCI AC Asia ex Japan Index retreated 1.5% during March slightly outperforming the 2.1% decline in the MSCI AC World Index.

Korea (+2.5%) and Taiwan (+1.3%) outperformed while Indonesia (-7.1%) and the Philippines (-6.0%) underperformed. By sector, Utilities (+3.2%) and Consumer Staples (+0.7%) held steady while Consumer Discretionary (-4.1%) and Financials (-2.8%) underperformed.

All figures above are total return and in US dollar terms. Source: Bloomberg.

Monetary Tightening Continues

The Federal Reserve duly raised short term interest rates in March and the consensus expects several more increases as 2018 unfolds. We note that the recent surge in longer term Treasuries has petered out, if not reversed, resulting in a flattening yield curve and, despite the rapidly increasing short term interest rate differential versus the Euro and the Yen, the Dollar continues to retreat. Historically, higher interest rates and tighter US monetary conditions are transmitted into Asia's economies fairly quickly and we note that the People's Bank of China swiftly increased the reverse repo rate by 5bps to 2.55%. The crackdown on the shadow banking system continues to the advantage of the formal banking system where the larger names recently reported solid 4Q17 results.

Elsewhere however, most Asian Central Banks appear content to wait and see. This may make sense in the bigger, stronger North Asian economies such as Korea and Taiwan, where domestic economic conditions do not appear to warrant a rate increase, but we fear the new Governor of Bangko Sentral ng Pilipinas (BSP), Nestor Espenilla Jr., missed a trick by leaving rates unchanged at 3% the day after the Federal Reserve increased rates.

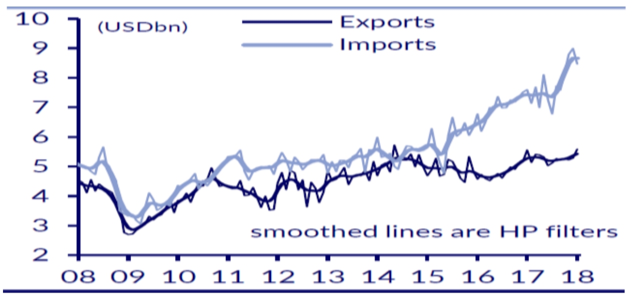
The Philippine economy is in rude health as evidenced by rising public and private investment levels, rapid credit growth, persistent consumption growth and a steady deterioration in the current account. While inflation remains in the BSP's 2-4% target range it is clear which way it is heading and a more proactive countercyclical stance by the BSP would have been welcomed by the currency markets in particular. While overseas workers' remittances and the growing business process outsourcing sector continue to offset much of the trade deficit, the Central Bank should be more concerned by the trends in the following two charts. The peso has depreciated by circa 25% against the US dollar since early 2013.

Current Account Breakdown (% of GDP)

% of GDP	2014	2015	2016	2017
Trade	**-6.1**	**-8.1**	**-11.7**	**-13.1**
Oil trade	-4.3	-2.8	-2.2	-2.9
Services	**1.6**	**1.9**	**2.3**	**3.0**
Freight	-0.7	-0.8	-0.9	-1.0
Travel	-2.0	-2.1	-2.0	-1.6
inflows	1.8	1.8	1.7	2.2
outflows	3.7	3.9	3.7	3.8
TCIS & business	4.9	5.2	5.0	5.3
Net income	**0.3**	**0.6**	**0.9**	**1.0**
Net transfers	**8.0**	**8.0**	**8.2**	**8.3**
Current account	**3.8**	**2.5**	**-0.4**	**-0.8**

Note: TCIS is telecom, computer & information services.
Source: CLSA, CEIC

Exports & Imports



Source: CLSA, CEIC

Trade and Trump

Recently announced plans to impose tariffs of 25% on US$50bn of Chinese exports are the first concrete plans backing President Trump's election campaign pledge to address the large bilateral trade deficit. On their own the US$50bn of goods subject to the 25% tariff are almost irrelevant given they represent just over 2% of China's total annual exports. The bigger question is whether this opening salvo is just the start of a broader and bigger 'tit for tat' escalation. While the Chinese administration will be sensitive to the livelihood of a manufacturing/export sector which employs over 100 million workers, the fact is that economic growth in China today is overwhelmingly domestically driven as we illustrated in last month's Asian Insight.

There are, of course, other geopolitical issues in play, not least of which is China's crucial role in the Korean peninsula situation where a delicate balancing act of supporting US-led economic sanctions while remaining North Korea's major ally continues. The surprise visit to Beijing by North Korea's Kim Jong Un, ahead of a meeting with South Korea's President Moon Jae in April and a possible meeting with President Trump in May, must be considered a major positive. While denuclearisation of the Korean peninsula and an end to hostilities between North and South Korea (who technically remain at war) are a long way off, there has certainly been a huge and welcome reduction in tempers and tweets.

Outlook

Asian markets ended the first quarter virtually unchanged and, with economic momentum and growth prospects remaining encouraging, we remain broadly optimistic despite rising US short term rates and the more vocal tariff chatter.

The setback in recent market leaders since the regional index peaked in late January has been quite pronounced. Both Alibaba (-13.4%) and Tencent Holdings (-10.6%) are well below recent highs. The recent US$9.8bn (2% of shares outstanding) placement in Tencent by major shareholder Naspers did not help. It ranked as one of top five capital raising exercises in Hong Kong's history. Call us cynics but we were amused by CLSA's Damian Kestel observation that of the 195 analyst recommendations on the TATS (Tencent, Alibaba, TSMC and Samsung) 94.4% are buys and 5.1% are holds. There is just one sell recommendation (on Samsung Electronics)!