

ASIA INSIGHT

9th July 2018

Review

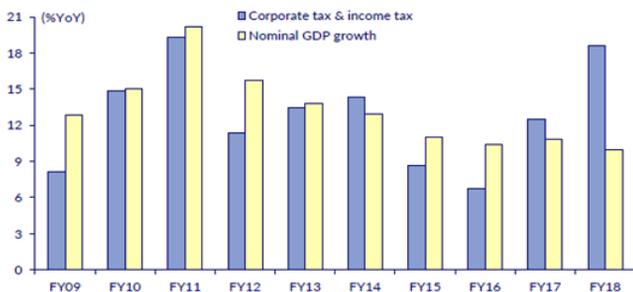
The MSCI AC Asia ex Japan Index fell 4.8% in June while the MSCI AC World Index declined 0.5%. Coincidentally this exactly matches the returns of the same two indices for the first half of the calendar year. India (-1.0%) and Malaysia (-2.8%) outperformed last month while Indonesia (-7.4%) and Korea (-6.7%) underperformed. By sector, Telcos (-2.6%) and Utilities (-3.1%) held up well while Industrials (-7.7%), Consumer Discretionary (-5.7%) and Financials (-5.7%) declined sharply.

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

Modi's Policies - Benefits Starting to Flow?

We have applauded almost every policy initiative of the Modi administration over the last four years since the broad thrust of these policies has been to improve economic efficiency and/or clarity (GFT introduction, RERA Act); shrink the black economy and reduce tax evasion and corruption (demonetisation); improve tax collection and reduce 'leakage' in public sector subsidies (by increasingly delivering subsidies direct to recipients thus removing the middle man). Modi has his fair share of critics but the chart below illustrates that tax receipts in the most recent financial year climbed at twice the rate of nominal GDP - an impressive result given that tax receipts grew slower than nominal GDP in seven of the previous nine years. Some fiscal easing ahead of next year's general election is inevitable (and much work is still needed to place the Government finances on a firmer long term footing) but we find this chart most encouraging.

India corporate and income tax growth vs nominal GDP growth



Source: CEIC Data, CLSA

US Monetary Policy

We would not claim to be experts of the intricacies of the bond market but it is noticeable that the US yield curve continues to flatten whether one observes the 5Y-1Y, 10Y-2Y or 30Y-10Y yield curves (the latter two are shown in the next chart). Assuming the Federal Reserve follow their own forecast of four 25bps increases over the next year, it seems inevitable that the yield curve will invert. An inverted yield curve is up there with 'Dr Copper' as a widely trusted indicator of slower growth on the horizon. Although this indicator has arguably been compromised by quantitative easing over the last decade, its validity and predictive value surely returns as US monetary policy normalises. The continued tightening of US monetary policy, a stronger US dollar and a potential slowdown in global trade (whether driven by a Trump trade war or other factors) undoubtedly point to tougher times for the dollar linked and trade orientated Asian region.

US yield curves (10Y-2Y and 30Y-10Y Treasury bond yield spreads)



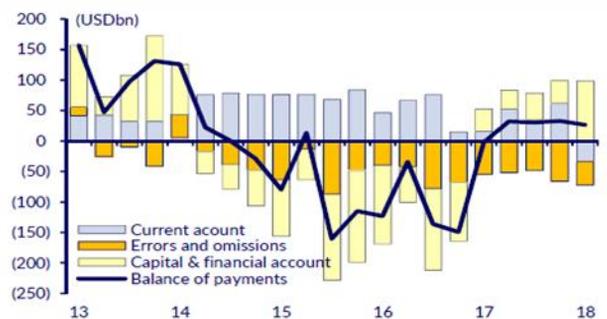
Source: Bloomberg, CLSA

Bank Indonesia raised rates by a further 50bps in late June and Bankgo Sentral will be under pressure to raise rates again after a June CPI 'print' of 5.4% y-o-y in the Philippines. Interest rate increases in Thailand are being mooted for the first time in eight years.

The question is how much of this is now priced into the ASEAN equity markets following the near 20% decline from the recent January highs. Nomura estimate that ASEAN is now trading at one standard deviation below the long term mean compared to one standard deviation above mean in at the January peak. If not exactly at rock bottom, valuations are looking considerably better and the downside risk therefore smaller.

Further North, investors are again fretting about China. The delicate balancing act of squeezing the shadow banking sector without causing systemic problems continues. Our opinion is that these fears are, in the main, misplaced. The reserve ratio requirement is still at a relatively elevated level (16.0%) and the People's Bank of China has plenty of room to ease any liquidity shortages. Domestic economic activity remains robust with the June Services PMI rising from 52.9 to 53.9.

China balance of payments (US\$, bn)



Source: CLSA, CEIC, Bloomberg

China posted a small current account deficit in 1Q18 (perhaps someone could point this out to Mr Trump?). Interestingly net errors and omissions (a 'best guess' at underlying capital outflows) fell sharply which is encouraging although this is a chart to keep a close eye on.

Outlook

It appears that, unlike the current weather in the United Kingdom, the forecast for Asia in the third quarter is cloudy with occasional showers.