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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

4th October 2018

Review

The MSCI AC Asia ex Japan Index fell 1.4% in September while the MSCI AC World Index climbed 0.4%. Thailand (+3.1%) and Singapore (+2.2%) outperformed while India (-9.1%) and the Philippines (-8.4%) underperformed. By sector, Energy (+5.1%) and Telcos (+2.1%) performed strongly while Consumer Discretionary (-5.2%) and Real Estate (-3.2%) declined.

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

Headwinds Persist

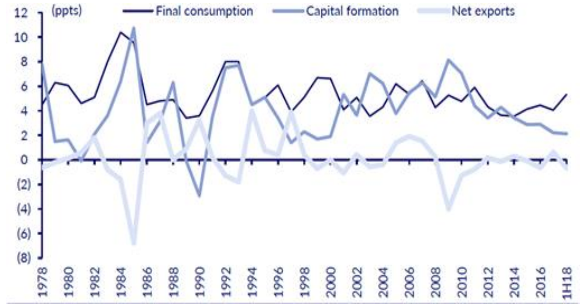
Asian equities continue to face multiple headwinds. Another increase in short term US interest rates was accompanied by a fairly hawkish statement. Looming sanctions on Iran have placed upward pressure on crude oil prices at a time when limited exploration activity by global oil majors and production issues in Venezuela and Libya are compounding the fear of supply shortages. Asia is energy deficient and rising oil prices place stress on the trade accounts and inflation profiles of Indonesia, India and the Philippines in particular. The Philippine and Indonesian central banks raised rates by 0.50% and 0.25% respectively last month.

Trade Wars

Now that President Trump has made peace with Europe and inked the new USMCA agreement with Canada and Mexico, it appears he is ready to turn all his guns towards China where it is increasingly clear that this confrontation is about much more than a trade deficit. The large chart below, filched from a presentation by Eurasia Group, says it all. Apart from much of the EU and all of North America, China now dominates global trade. We remember reading a report recently which noted that Chinese exports to Belt and Road Initiative recipient countries now exceed total exports to the US.

Importantly, however, Chinese exports account for less than 20% of GDP and growth in China remains primarily domestically driven. We remain upbeat regarding China's ability to continue to grow steadily. The smaller chart that follows illustrates the neutral impact of trade in recent years and also highlights the fact that the less cyclical consumption element is the main driver of growth rather than the more cyclical investment component.

Contribution to China real GDP growth



Source: CEIC data, National Bureau of Statistics

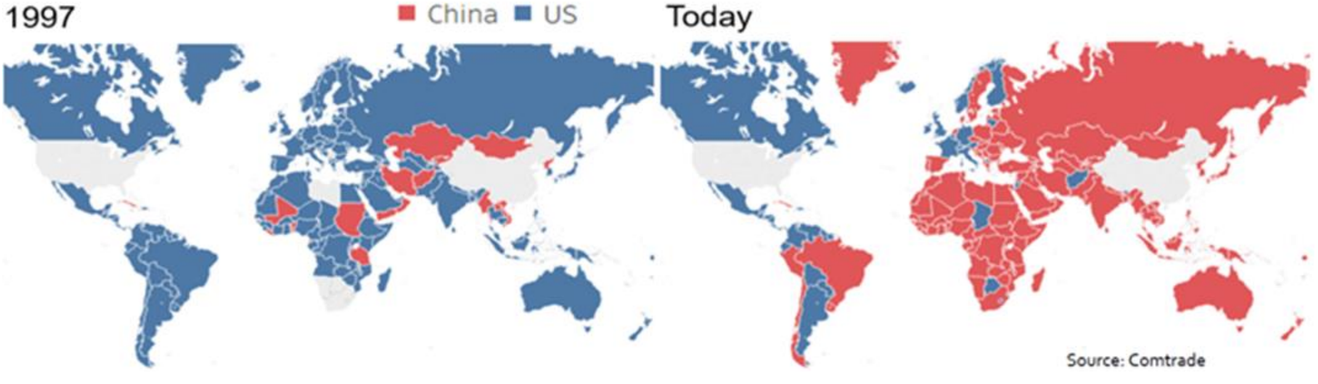
India

Indian equities received a battering in September much of which was due to the default of Infrastructure Leasing & Financial Services Ltd (IL&FS). IL&FS, established in 1987, has been a significant player in India's recent infrastructure boom. It has developed and financed projects worth over $25bn and has debt in excess of $12bn. Perhaps the general air of complacency shown by rating agencies (among others) until recently was due to the blue chip nature of major shareholders - the Life Insurance Corp of India, ORIX, AIDA, HDFC, the Central Bank of India and the State Bank of India. The Government has stepped in, calming market nerves, but selling assets and 'right sizing' the balance sheet will be a difficult and lengthy process.

Outlook

The headwinds mentioned earlier will not disappear overnight and the US/China trade dispute is equally unlikely to disappear any time soon. The question is whether the 15% correction in regional equities since the January peak is sufficient to price in these negatives. We note that we are (almost!) at the end of the period of traditional seasonal weakness in markets. Investors will increasingly look forward to the prospects for 2019 and we expect the Asian region to continue to grow steadily over the next few years. Regional equities, on 11-12x this year's earnings and trading at 1.4x book value, look increasingly attractive from both an absolute and relative viewpoint.

China's economic reach grows - Largest trading partner by total trade value



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