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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

9th January 2019

Review

The MSCI AC Asia ex Japan Index fell 2.7% in December while the MSCI AC World Index dropped 7.0%. Malaysia (+1.6%), the Philippines (+1.5%) and Indonesia (+0.9%) outperformed while China (-6.1%) and Thailand (-2.9%) underperformed.

For calendar 2018 the MSCI AC Asia ex Japan Index fell 14.4% while the MSCI AC World Index declined 9.4%. Thailand (-5.5%), Malaysia (-6.0%) and India (-7.3%) outperformed while Korea (-20.9%), China (-18.9%) and the Philippines (-16.5%) underperformed.

By sector, Utilities (+2.9%) and Consumer Staples (-7.0%) outperformed in 2018 while Consumer Discretionary (-32.1%) and Information Technology (-19.3%) underperformed.

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

Reasons to be cheerful

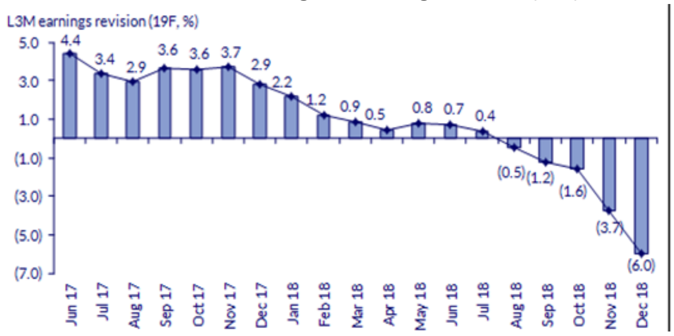
The sharp decline in US equities in the fourth quarter was overdue, all other equity markets - developed and emerging - have been struggling since early 2018. The combination of a stronger dollar, rising short term dollar interest rates, a contracting Federal Reserve balance sheet and increased trade tensions have taken their toll.

It is also abundantly clear that economic growth in major global economies such as Germany, Japan and China has slowed considerably while the latest purchasing managers index released across the Asian region suggest the first quarter of 2019 will be hard work. The Chinese New Year holiday period (first week of February) will cause the usual havoc with monthly data releases.

While economic growth rates in America remain robust, there is plenty of evidence to suggest that interest rate sensitive sectors, such as housing, are feeling the pain of rising rates. The bickering between President Trump and Jerome Powell has been a further distraction while Powell's comment last month that the balance sheet reduction was on 'auto pilot' was simply unnerving.

The credit markets reacted with spreads on high yield bonds spiking sharply while long term treasuries yields plummeted, pushing the yield curve close to inversion. Powell has subsequently backtracked and the threat of multiple further interest rate rises seems increasingly unlikely. Ceteris paribus, this is dollar negative which historically has been a big positive for the Asian and emerging market asset classes.

MSCI AsiaxJ – Rolling 3M earnings revision (19F)



Source: CLSA

China bank asset growth and nominal GDP growth

Source: PBOC, CEIC Data, National Bureau of Statistics

Reasons to be fearful

Our view for many years has been that it is a mistake to underestimate the ability of the Chinese authorities to conjure up a solution to a seemingly intractable problem, perhaps the recent supply side reform in the iron and steel industry would be the best example.

Russell Napier has recently pointed out that not only is the balance sheet of the Federal Reserve shrinking but so is that of the People's Bank of China (PBOC). While the authorities are talking of monetary easing (the reserve ratio requirement was cut again in early January), Napier notes that reserve money has fallen by 4.9% since December 2017. This contraction has been driven by PBOC transactions required to keep the Renminbi within its target range and - in that sense - it is outside of the control of the authorities unless they abandon the exchange rate targeting regime.

The deleveraging agenda of the past few years has been generally well received and applauded - the shadow banking genie has been put back in the bottle - but the consistent decline in the growth rate of broad money is of concern. The chart above (from CLSA) shows that asset growth of banks remains well below nominal GDP growth. Needless to say, a pause - or about turn - by the Federal Reserve would be very well received at the PBOC.

Market Outlook

The first chart illustrates the increased pace of downward earnings revisions by analysts in Asia, some of this will be simply be analysts 'following the market down' but it does underscore increased growth uncertainties.

To state the obvious, a weaker dollar and a trade deal would improve sentiment towards Asian equity considerably.

Regional valuations - at 1.3x as measured by the price to book ratio - remain at very attractive levels. Looked at another way, 57% of the stocks covered by CLSA yield more than the 10 year US Treasury.

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