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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

5th February 2019

Review

The MSCI AC Asia ex Japan Index rose 7.3% in January while the MSCI AC World Index gained 7.9%. China (+11.1%) and South Korea (+10.3%) led the way while Taiwan (+1.7%) and India (-1.9%) lagged. By sector, Consumer Discretionary (+13.2%) and Real Estate (+11.2%) outperformed while Materials (+3.1%) and Utilities (+1.6%) underperformed.

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

Volte-face

"Funny how things change when Powell is staring down the barrel of a stock markets decline that seemed to be spiralling out of control (this time not as a Fed governor, but rather the Chairman). The late December swoon proved too much for Powell to bear, and since then he has folded like a lawn chair on almost all of his hawkish guidance."

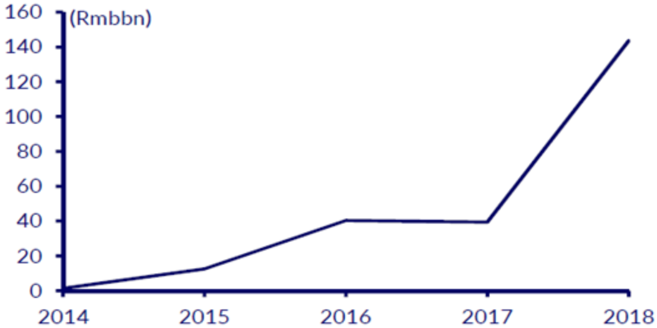
CLSA's Damien Kestel neatly sums up the about turn at the Federal Reserve. The market is now pricing in a cut in interest rates this year – an event not forecast by a single Federal Reserve Board member in the most recent 'dot plots' – while Bill Gross, in announcing his retirement, predicted that the Federal Reserve will end quantitative tightening later this year. The lack of any inflationary pressures remains in large part a consequence of the massive build up of dent over the last decade. This debt burden is inherently deflationary by nature.

China – corporate debt

We discussed the deleveraging agenda of the Chinese authorities last month and believe it is still fair to say that the worst excesses in the shadow banking sector have been unwound or contained. That said, total non-financial sector debt to GDP rose from circa 140% to 260% over the past decade and CLSA's Patricia Cheng's recent report highlights the challenges facing both the onshore and offshore bond markets.

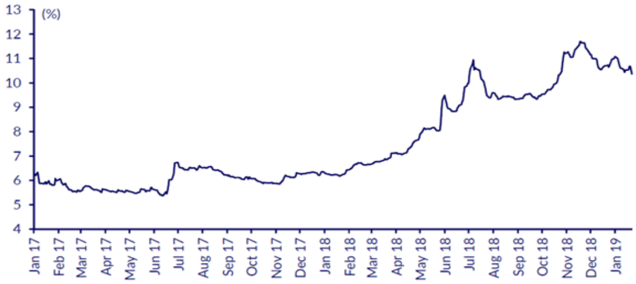
The chart below shows the rapid rise in onshore bond defaults from Rmb39bn to Rmb114bn last year. The defaulters are mainly private sector concerns in the industrial sector, many of which are listed on the A share market. Unsurprisingly the spread between AAA and A rated bonds has risen from 5% to 7% over the past year and the rating agencies are undoubtedly issuing many more downgrades than upgrades, particularly as the Chinese economy continues to soften.

Chinese onshore bond defaults



Source: Wind, CLSA

Effective yield for ICE BofAML Asian dollar high yield corporate China



Source: CLSA, Bloomberg

The chart above depicts the sharp rise in offshore bond yields which has risen from 6-7% to 10 – 11% over the past twelve months. Issuers from the real estate sector dominate the offshore bond market.

Excluding Sovereign and financial bonds, onshore bond maturities in 2019 total Rmb5.3tn (US $790bn) while offshore maturities total US$100bn. Expect further cuts in reserve ratio requirements and more vocal exhortations from the authorities to the large state owned banks to increase lending to the SME sector.

The authorities are, of course, primarily focussed on trying to get a 'trade deal' with America over the line by the end of February but should they fail we can expect more aggressive stimulus measures with negative connotations for the currency.

Usefully or otherwise, a strong warning came from the UN Conference of Trade and Development (Unctad) that there will be 'huge costs' if the trade war escalates. The report estimates that East Asian producers face a $160bn contraction in exports and that the consequences will be felt far beyond the region. The study also suggests that US firms will pick up only 6% of the $250bn of Chinese exports that are subject to US tariffs.

Chinese New Year is upon us, and we are fervently hoping that the Year of the Pig will generate a better outcome than the departing Year of the Dog. Aside from the Trade Dispute, there are national elections in Thailand, Indonesia and India (to name but three) to keep us on our toes.

Outlook

Developed markets spent January recouping December's losses while in Asia we have been encouraged by the fact that in late December the MSCI AC Asia ex Japan Index bounced neatly off the October lows and has started the year strongly.

The about turn by the Federal Reserve and the prospect of a more dovish monetary policy is, all other things being equal, a big positive for Asian equity markets and, despite the recent move, we note that valuations remain at attractive levels. There have been a number of trading statements from portfolio holdings in January, most of which met or beat expectations. There are many more to come in February.