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BLACKFRIARS ASSET MANAGEMENT

ASIA INSIGHT

6th March 2019

Review

The MSCI AC Asia ex Japan Index rose 2.1% in February while the MSCI AC World Index gained 2.7%.

Hong Kong (+5.9%), China (+3.5%) and Taiwan (+4.8%) led the way while Indonesia (-4.6%), the Philippines (-2.8%) and South Korea (-1.9%) lagged. By sector, Consumer Discretionary (+5.7%) continued on a charge while Financials (+3.1%) and Utilities (+2.8%) also outperformed. Telecoms (-1.2%), Healthcare (+0.6%) and Consumer Staples (+0.1%) lagged.

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

China – impact of MSCI, Bloomberg Barclays & passive

Readers will be aware that this investment manager is not a believer in passive investing, but - driven by cost pressures and increased regulatory oversight - it remains a powerful trend.

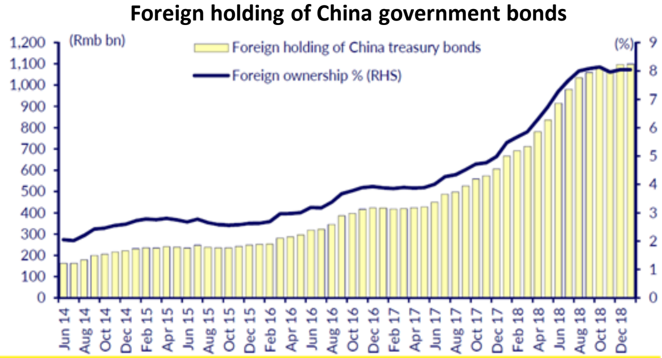
On 28th February MSCI announced that the China A share inclusion factor will rise from 5% to 20% in three steps between May and November this year. The weighting of China A shares will rise from 0.8% of the MSCI Emerging Market Index to 3.3%. Assuming the inclusion factor continues to rise over time, China's total weight in the index (A & H shares) will rise to 42% from the current 31%.

Perhaps less well known (at least to dedicated equity followers) is the imminent implementation of the inclusion of China in the Bloomberg Barclays Global Aggregate Indices (a fixed income index). Although this was announced almost one year ago, implementation starts this April with the inclusion factor rising 5% every month for twenty months. The Renminbi weight in the index will be roughly 6%, the fourth largest currency weight after the Dollar, the Euro and the Yen. Forget trade wars, spiralling debt levels and any other macroeconomic or political concerns - truckloads of passive money will be piling into China's equity and fixed income markets over the next few years.

Results

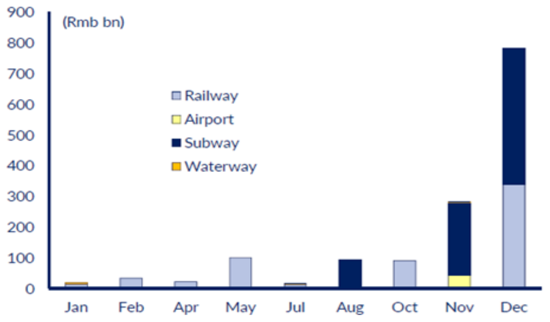
Various results announcement over the past month painted a mixed picture. Astra International's 4Q numbers were slightly on the weak side reflecting tough competition in Indonesia's auto market while KB Financial managed to disappoint the market again, in stark contrast to Shinhan's more upbeat results. Siam City Cement took another one-off charge which impacted reported earnings but cash flow generation remains very strong and the domestic demand outlook for cement is improving noticeably.

Foreign holding of China government bonds



Source: China Central Depository & Clearing (CCDC), CEIC Data, CLSA

NDRC infrastructure approvals



Source: CRR Macro materials monthly, 16 Jan, NDRC

Elsewhere TSMC met reduced expectations and becomes the first Taiwanese company to move to quarterly dividend distributions (unlawful until recently). Land & House produced very solid numbers against the weak backdrop in the Thai residential market. The dividend was maintained, the stock yields 7%.

The earnings report that both delighted and interested us the most was the sparkling interim report from portfolio holding JNBY, a leading Chinese retailer of designer clothing. Sales grew 23% y-o-y driven by rapid growth in recently launched brands although the 19% growth in the original JNBY brand was hardly shabby. Gross profit margins dipped a touch and same store sales growth (SSSG) slipped but good cost control allowed the company to report a 22% increase in net profits. The interim dividend was increased 40%. Despite the 32% move in the share price over the month we believe that, on a P/E ratio of 14x June 19 earnings and yielding over 5%, the stock has further upside. Many more results from various portfolio holdings are due in March.

Market outlook

Continued dovish comment in America and firm evidence that the Chinese authorities continue actively promoting domestic growth paint a promising picture. Income tax has been cut and this week President Xi Jinping announced VAT cuts at the National People's Congress. Aggregate finance grew very strongly in January (although be aware of Chinese New Year distortions) while banking lending growth accelerated from 13.2% to 13.6% y-o-y.

Perhaps most striking was the massive increase in infrastructure project approvals by the National Development and Reform commission in December. More projects were approved in December than in the first eleven months of 2018! See earlier chart.

We do not see the softening of 2019 GDP growth targets (from 6.5% to 6.0-6.5%) as a negative - indeed quite the reverse. The very specific annual target had become a target in its own right and a more nuanced approach is long overdue and to be welcomed. Needless to say a trade deal between the United States and China would be a bonus.