J O Hambro Capital Management Group

A View From Asia

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Swirl: An eddy, a whirlpool; an eddying or whirling body of water

Thankfully, I do not have to make predictions on markets. Looking back to January 2017, who would have guessed the direction and particularly the trajectory of markets in Asia? With that said, we are to some extent in the business of estimating future outcomes. By buying or holding certain stocks, I do make implicit assumptions of what I hope or anticipate might occur over time.

Questions, questions, questions

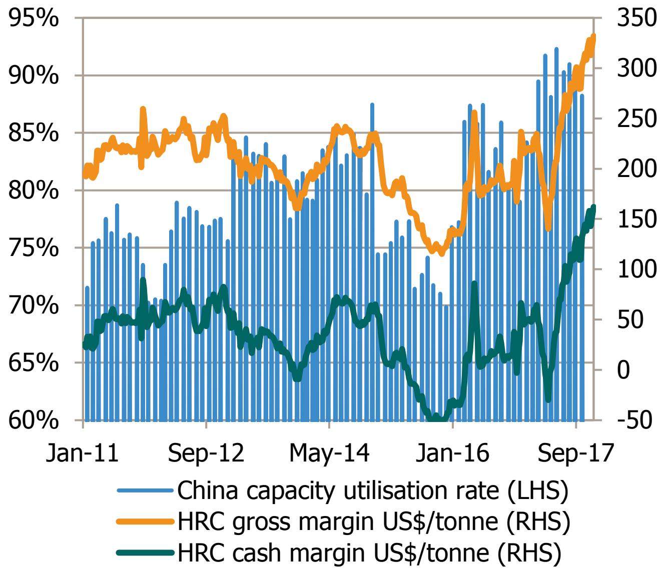
There are several big issues for markets to grapple with. We are in a synchronised global economic recovery. Commencing around mid-2016, growth has accelerated globally in 2017. How strong and how long it will last is the big question. Central banks, especially the Federal Reserve, seem to indicate a determination to 'normalise' monetary policy. Will the Fed raise rates four times in 2018? Will the unwinding of its balance sheet be smooth, or will it disrupt asset prices across the world? Geopolitics, both in the Middle East and around North Korea, keeps hitting the headlines. With President Trump seemingly embroiled in several unfavourable domestic issues, will the US resort to distracting domestic attention towards foreign entanglement? In my naïve analysis, signs of inflation seem to be sprouting everywhere – whether its commodity prices or wage inflation or in the general cost of doing business. Will inflation reflect in the numbers in the US and drive long bond yields higher? And, finally, a benign liquidity environment has powered a rally in momentum growth stocks. Does that pause or continue? Will out-of-favour sectors and countries be the beneficiaries if that happens?

Liking North Asia, tech and financials

By looking at the allocations in the portfolio, the tilts you can observe are towards North Asia for countries and technology and financials for sectors. Technology stocks have delivered high growth but valuations have expanded as well. With that combination comes susceptibility to a pause in momentum investing as well as a rise in bond yields which can impact valuations for these names. I am reviewing some of my technology holdings in the hardware manufacturing area with a high possibility that I could trim some of them.

A large allocation to China indicates my assumption of a benign outlook in China. GDP growth might not be stellar, but growth in cash profits and earnings for corporate China could be surprisingly robust. Internet-related companies are likely to sustain growth over time. In the 'old' economy, a couple of developments are worth noting. The resolve demonstrated by the government in removing capacity in the steel, cement, coal and aluminium industries has been, in my view, a significant event. Take steel as an example. By shutting approximately 7% of capacity in the past 15 months, the surviving companies are generating solid cash profits.

The very visible hand: Chinese steel industry capacity



Source: Macquarie Securities as at 1 December 2017.

After sustaining cash losses in 2015 and early 2016, the steel industry in China is now earning substantially higher cash margins per tonne of steel. Once considered a big negative in China – diktat by the government – now looks like the saviour. Whether it is due to environmental pressures or the threat of trade sanctions, these capacity restraints have helped the steel industry recover smartly.

Cynics will ask how long can this last. Can the government remain committed to these shutdowns? Will such high profits not tempt the industry to reopen those plants that were shut down? Of course there are valid questions and there is a risk of re-openings. However, in my view, apart from the survivors which benefit from capacity shutdowns, there is an unintended positive impact on China's banking sector. In the past, banks were directed to lend to companies that created jobs and resulted in GDP growth. Never mind that the rising capacities imperilled the profitability of borrowers and in turn hurt the banks due to rising non-performing loans. With several 'old' industries generating better growth in profit and cash flow, the banking sector in China is starting to see a positive change in the health of their leveraged borrowers. GDP growth might not be stellar, but, for a change, cash flows and profits for industrial China are growing. If this lasts, it will be positive for macroeconomic stability and for the banking system as a whole.

Rising Chinese bond yields

For banks and financials in China, another development worth noting is the rise in 10-year government bond yields.

The rising Chinese 10-year government bond yield

Source: Bloomberg as at 4 December 2017.

A rise in the cost of money is exactly what China needs. In the past, I've commented on the fact that money was too cheap and abundant in China, which in turn allowed growth in leverage and misallocation of capital. The clampdown by the authorities on capital outflows is likely one reason for this increase in cost of money. The shutdown of irrational borrowers, like the Anbang Insurance group or the HNA group, and the recent crackdown on fintech lending businesses (P2P lenders and micro-lenders) are signs of a return to some rationality in China. As these irrational borrowers disappear from the scene, the genuinely good financial institutions (yes, there are some in China too!) are starting to assert their competitiveness. We own two of them: Ping An Insurance and China Merchants Bank. If my analysis is right, not only will they benefit from higher margins but also from a large increase in market share at a time when economic growth is stabilising and profits for China corporates in general are better.

In sum, I am a bit more sanguine on profit growth in China, wary of momentum and aware that the biggest risk we face is a dislocation of bond yields if inflation reflects in numbers in the US. I do think we have a balance in the portfolio to mitigate some of that inflation risk, but, as always, time will tell.

I wish you a Merry Christmas and a prosperous 2018.