Samir Mehta, JOHCM Asia ex Japan Fund

A VIEW FROM ASIA

JULY 2020

Janus – In ancient Roman religion and myth, is the god of beginnings, gates, transitions, time, duality, doorways, passages, and endings. He is usually depicted as having two faces, since he looks to the future and to the past.

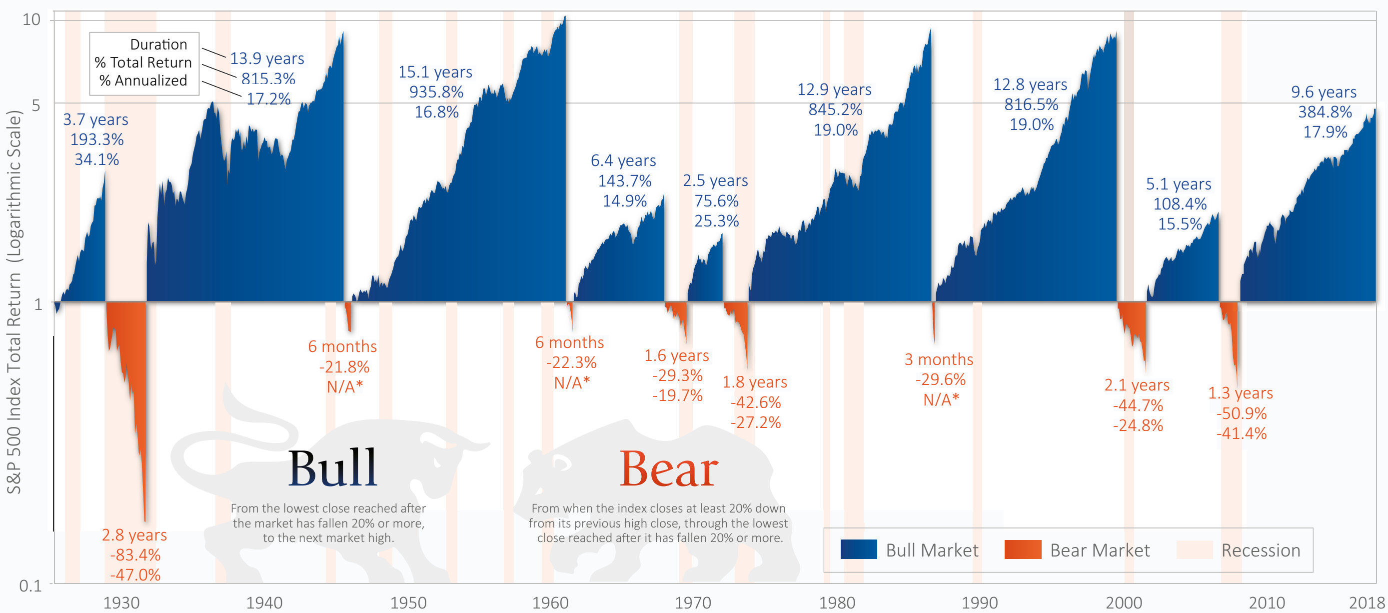
Polarisation is a fact of life. Finding ourselves in circumstances that most have perhaps encountered only in history books, we are left groping for fragments of evidence that sometimes affirm inherent biases. This pandemic, occurring at a time of increased income and wealth inequality and rapid technological change, lends itself to extreme views on most topics, particularly on the future direction of stock markets and the economy. It is not my remit to proffer any macroeconomic pronouncements, which would anyway be of no value whatsoever. However, as part of my remit to analyse stocks, businesses, valuations and liquidity conditions, it is inevitable that I wade into the realm of judging the current and future course of policy and its effects on markets.

Faced with the unknown in March and April – so many variables around the pandemic, responses on the medical and societal front – I adopted a very cautious stance. Subsequently, you would have noticed that I have run down the cash balance in the Fund and added stocks in the portfolio (Midea, Sheehan Circuits, Bajaj Auto, Hong Kong Exchange and Jubilant Foodworks) that are more cyclical in nature. I wanted to lay out the logic of why this is the case. I have to remain open to setbacks and reversals on many fronts and hence do not want to be committed to this outlook as if set in stone. Yet at this moment in time, given what we know, I am more amenable to look to the positives driving markets higher.

Many of these observations are based on commentary I have read – not all of it is original thought. However, I've drawn these conclusions.

1. **Recessions mark the END not the beginning of bear markets**. Historically, taking an example, the peak of unemployment is a lagging indicator – i.e. when unemployment peaks, it marks the end of a bear market. This current recession is/was unique – the worst effects were compressed in a span of approximately three months. Global economic activity fell precipitously, but since June the rate of change of deterioration has slowed. As businesses reopen, several indicators are suggesting a gradual return towards some kind of normality. I am not in the V-shaped recovery camp; it might take us a long while to go back to the pre-Covid-19 levels, but it seems highly likely that the worst is behind us.

History of US bear & bull markets since 1926



Source: First Trust Advisors L.P., Morningstar. Returns from 1926 - 9/28/18. *Not applicable since duration is less than one year.
These results are based on monthly returns–returns using different periods would produce different results. The S&P 500 Index is an unmanaged index of 500 stocks used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. This chart is for illustrative purposes only and not indicative of any actual investment. These returns were the result of certain market factors and events which may not be repeated in the future. Past performance is no guarantee of future results.

There still are cases of infections across cities and sporadic clampdowns reminding us of the presence of the virus. Yet the political realisation that a lockdown does more harm than good is now fully entrenched. There is no political will to impose another blanket shutdown anywhere in the world. From the market action, you can also observe that markets are looking to the availability of a potential vaccine and are not fussed as much about infection flare-ups. As to my comment that the worst might be behind us, historians will point to the Great Depression as one period when the economy and the stock market had a 'double top' – a situation that lulled us in believing things had started to normalise only to falter again. But there are some major differences between then and now.

2. **Policy action is the difference; technology is the icing on top**

- The scale and timing of actions by central banks on monetary policy and governments on fiscal policy – for the first time in memory, the Federal Reserve opened up its liquidity spigot without the failure of a financial institution and on a scale multiple times that of any other time in history.
- The rapidity and reach of fiscal measures introduced globally, but especially in the US and EU, have helped put a floor on a potential deflationary spiral.
- As we have discovered, a large part of the economy still worked thanks to technological innovations. Imagine this pandemic hitting us in the 1990s or even early 2000s.

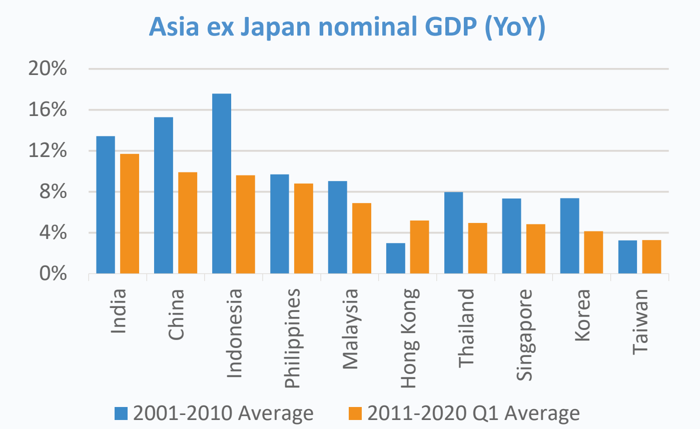
The debasement of monetary policy, the spiral in government debts and the unintended consequences will likely hit us in the future. On that there is little debate.

As of today's date, consumer incomes in the developed world, as measured by national statistics (including transfers from the government) have grown – yes, grown. Meanwhile, according to Eurostat data, the eurozone savings rate (defined by gross savings divided by gross disposable income) rose to 16.9% in the first three months of the year, its highest level since records began in 1999. In the US, it surged from 7.9% at start of the year to 32% in April before dropping back to 23.2% in May, according to the Bureau of Labor Statistics.

On conference calls with some US fast food chains, one comment by the CFO of Wendy's stood out. I quote: **"This is the first recession I have witnessed where wages in the U.S. have not fallen."** He explained the reasons: government transfers meant people have an alternative to stay unemployed and earn as much as from working, sometimes more; with a health emergency, fewer people were willing to work for lower wage given the risks; while societal pressures on addressing inequality are real. This combination of broadly preserved wages/earnings and severely depressed spending has led to forced savings. The glass half-empty view is the collapse in demand and impact on many businesses (airlines and hospitality, in particular). The other side of the coin is the pent up spending power. Additionally, there is a significant shift in demand, too. The dollars not spent on travel and restaurants are being spent elsewhere (online games, exercise equipment, groceries), even if not in the same quantum. It is safe to assume that precautionary savings will rise and that overall demand will be subdued, but it does not mean there are losers everywhere or that we face another Great Depression.

3. **Technology disruption has permeated every aspect of business and society.** The shift from offline to online commerce has accelerated. Grocery shopping is the perfect example. Adoption of online ordering and delivery in the past three months has scaled levels that industry participants expected perhaps over 5-7 years. The President of Instacart, specialists in grocery delivery in the US, mentioned that clients have moved from the front of the aisle (fresh) to the middle (dry goods), a change they had not anticipated would occur. Any business complacent about moving online has now been forced to do so. It is jaw dropping to witness the rapid rise of several leading technology stocks. Some express surprise, others indignation, at the lofty valuations at which these stocks trade. However, in my view, conditions are very different from the technology bubble in 2000/1. The genuine winners of this tectonic shift invariably have attributes of aggregators or platforms (see my comments in June 2020). Low asset intensity and rapid scalability with commensurate profitability present an almost winner-take-all situation. If you were to analyse the data, this rise in market capitalisation has come on the back of a significant increase of profits derived by these technology firms. The risks to this dominance are government regulation and competitive threats from other potential aggregators. In a world awash in liquidity and a commitment from central banks to prevent any large scale bankruptcies, the risks of a 'double top' in economies and markets seems low.

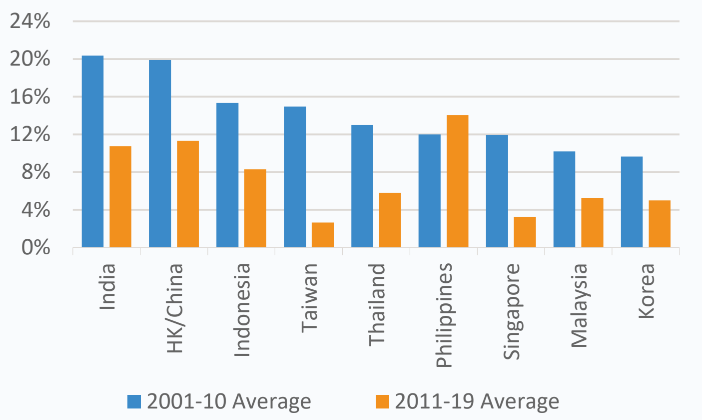
4. **Covid-19 hit us when global economic conditions were, in my opinion, already in the last phase of expansion that started post the last crisis in 2009/2010.** The US was boosted by tax cuts in 2017, but that economy was likely flagging. With a high degree of confidence, I can opine about the parlous state of Asian economies. China had faced serious damage post the devaluation-induced capital outflows in 2015/16, combined with the trade war in 2018/19. South Korea, Taiwan and ASEAN had suffered the effects of the trade war too. India's economy was reeling from the effects of the collapse of several finance companies and a general liquidity squeeze. All in all, this crisis has exacerbated prevalent poor economic conditions in the region. That leads me to another observation. Invariably, the tough



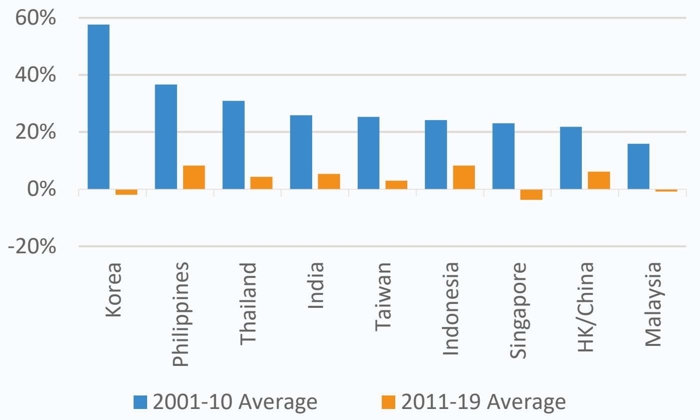
Source: Bloomberg, MSCI, Macquarie Research.

decisions needed to deal with reform are invariably enacted by policymakers when they have no choice. **Adversity concentrates the mind like little else.**

5. **With high levels of debt and after-effects of this pandemic, the rate of GDP growth could remain subdued.** Observe from the two charts below revenue and profit growth in Asia across two periods. It was as surprising to me as it might be to you that despite a large population, favourable demographics, low penetration levels and the potential for growth in per capita incomes, the last decade has delivered dismal growth for Asia. It is no wonder that the US stock markets have done so well compared to Asia and valuations in Asia languish well below those in the US.



Source: FactSet, Macquarie Research.



Source: FactSet, Macquarie Research.

There are several reasons for this disappointment: Asia started from a very low base after 2001; the integration of China into the WTO created huge opportunities for growth; the boom in commodities and inflation aided old economy sectors; and the stimulus from China post 2011 led to excessive debt and misallocation of resources, whereas the US restructured and has enjoyed a technology boom that has aided that economy much more.

Bulls and Zombies

You could argue that this low growth trend in Asia will continue for a long time to come. But it is equally possible that while GDP growth might not do as well, corporate profitability of listed firms could exceed expectations. A large part of this boils down to which countries and companies are able to break from the past and wholeheartedly adapt to newer ways of doing business. Evidence so far is that China, Taiwan, Korea and Hong Kong are certainly ahead in terms of this transition. Other countries might not be at the same level, but several firms in those countries are leading the charge in driving change. I am quite positive on Asia in that respect. And if the US dollar remains subdued, as many commentators seem to predict, that plentiful liquidity should help Asian stock markets for a while. With low expectations, a recession forcing hard decisions, adaption of technology and a benign US dollar environment could be the perfect set up for the start of a bull market in Asia. China most probably leads the way.

In times of difficulty, the weaker players usually should go bankrupt. This time around, banking systems will be goaded by governments to retain credit even to zombie companies. In sectors in which those zombie companies participate, low margins and low returns will dog their competitors. Yet it also could mean that swathes of people working at those zombie firms still retain jobs that might have otherwise been lost. In other industries where government support means little, the stronger players who adapt and change will likely consolidate their position. In a world increasingly driven by the 'winner-take-all' business model, the trend of dominant firms remaining so is high – subject to risks of regulation and potential competitors who can become aggregators or platforms.

But that is not the only universe I think will benefit. Some of the so-called cyclical names I have been adding are ones that could also become dominant in their own field and take profitable share of a slower growing pie. The difference between the technology sector winners and other sectors is the speed and scale of dominance that can be achieved. That difference boils down to digits versus atoms. Digital scale can and is global in nature and faces few barriers. Building scale in the atomic world encounters boundaries and national prerogatives – where trade wars and tariffs must be dealt with. My attempt in these cases is to try to identify companies that could become national champions in their industries, taking advantage of weakened competition and a revival in demand whenever we start to see it.

As you can see, I have adopted a glass half-full view; that the forced savings I mentioned will look for a home. It is firepower that will provide the support this time round after the initial support provided by governments to stave off a catastrophic depression. For these companies, too, conditions seem to be falling into place to grow profitably for a while to come.

JOHCM Asia Ex Japan Fund
5 year discrete performance (%)

Discrete 12 month performance (%):

	30.06.20	30.06.19	30.06.18	30.06.17	30.06.16
A USD Class	6.37	-0.68	-3.98	20.00	-8.57
Benchmark	1.61	-0.47	9.93	26.83	-11.98
Relative return	4.68	-0.21	-12.65	-5.39	3.88

Past performance is no guarantee of future performance.

Source: JOHCM/MSCI Barra/Bloomberg, NAV of Share Class A in USD, net income reinvested, net of fees as at 30 June 2020. The A USD Class was launched on 30 September 2011. Benchmark: MSCI AC Asia ex Japan NR (12pm adjusted). Performance of other share classes may vary and is available on request.