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A VIEW FROM ASIA

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Exogenous: having an external cause or origin; (of a disease or symptom) attributable to an agent or organism outside the body.

What a difference one weekend makes. Reports of COVID-19 cases in Italy (and subsequently across several countries including the US), along with a spurt in cases in South Korea, have materially changed the economic outlook across the world. Markets have responded accordingly. In a rapidly evolving situation, I too have recalibrated my views and my outlook. Surrounded by imperfect information and enhanced volatility in asset markets, I profess caution. We have to proceed with the mantra that ‘nobody really knows’; but I have to try to focus on weeding out stocks that are in clear danger, yet, at the same time, be open to buying businesses that could come through much stronger.

The over-riding narratives for businesses and economics are DISRUPTION and DEFLATION.

Few would have thought that in a world with rapid advances in science and technology, challenges from a pandemic could become amongst the most significant disruptors in recent memory. We are witnessing a demand and supply shock at the same time. That is definitely adding to the deflationary trend.

Last month I briefly mentioned the importance of China to global GDP and demand. Equally crucial is China’s criticality for supply chains across myriad products. That dislocation is leading to a deflationary shock at a time when debt levels have risen and interest rates are at historical lows. The crisis of 2008/9 was similar yet different. The biggest difference: during the 2008/9 crisis the global financial system clogged. Trust amongst financial intermediaries evaporated when asset prices were in free fall. As a remedy, after a series of rate cuts, the Federal Reserve rescued the system through quantitative easing and buying assets onto its own balance sheet.

This time around there are minor pockets of illiquidity but the financial system is intact. We can complain about high valuations due to a combination of low rates and easy money but the system still functions. The Fed cut rates on 3rd March; while useful, the potency of lower rates might be muted. The supply shock emanating from China is a far bigger variable and affects several industries across the world. Besides, in an era of globalised trade, imposing travel restrictions on people (and inadvertently on goods) has repercussions. Several countries overly dependent on China (e.g. Thailand) are reeling from demand destruction and face rising unemployment.

How should we position our portfolios? In my analysis, I’ve categorised five types of businesses:

- 1. Gainers** – the best businesses are ones that benefit because of the virus. Software as a service (SAAS) firms, online education and healthcare providers seem obvious beneficiaries. One name in our portfolio is the Chinese ‘A’-listed stock Shenzhen Mindray. It is a worthy competitor to GE, Philips and other multi-nationals. The company manufactures medical equipment, and their emphasis on internal R&D while acquiring companies with technologies they do not have has held them in good stead. Currently demand is quite strong.
- 2. Accelerators** – those that accelerate a trend and set the pace for changes in how we live our lives or do business. Online platforms, gaming and media companies fit this narrative. This structural trend will receive a boost for faster adoption. Perversely, the potential rise in unemployment will lead to an increased number of people willing to drive, deliver, or ‘work’ for these platforms, increasing their bargaining power. Tencent and Meituan Dianping (a super app for dining, entertainment and other services) in China, fall into this category.
- 3. Consolidators** – almost every other business will witness some negative impacts. However, the stronger amongst them will emerge as consolidators. The big will get bigger at the expense of the small, the inefficient, or the overly leveraged. In semiconductor manufacturing, Taiwan Semiconductor Manufacturing Company, Samsung Electronics and SK Hynix are likely candidates due to the capital-intensive nature of this industry. Demand for tech hardware will suffer, but most of it is postponed demand. Some consolidators will also get a boost from lower commodity prices in the short term.
- 4. Opportunists** – firms will take advantage of the accelerating shift of supply chains and manufacturing away from China. If the trade sanctions were a wakeup call for overdependence on China, COVID-19 imprints a definitive stamp of urgency. No government or board of directors can afford to stay put. Large-scale re-evaluation of risks to supply chains and dependencies on sourcing will necessitate costly but necessary duplication across firms. Nimble companies in countries with a government determined to provide good infrastructure and progressive labour policies could do very well. Venture in Singapore, an electronic manufacturing service company comes to mind.
- 5. Disadvantaged** – the companies that will suffer are also obvious. Asset-intensive, cyclical businesses, particularly those exposed to travel and tourism will suffer the most. Discretionary branded goods and retailers, state-owned enterprises (SOEs) and banks will be the prime losers from the fallout.



In my view, the policy of last resort remains fiscal deficits. I suspect it will be a combination of handouts and subsidies with a **stealthy nationalisation of problems**. SOEs will be called upon to do national service – taking over companies, cutting prices, giving better terms to struggling SMEs and the like. We are on the cusp of the biggest addition to zombie firms across the world. No governments can allow large-scale bankruptcies. Nationalisation could most likely be the answer.

Banks, especially state-owned ones will be at the forefront of a rescue mission. Regulatory forbearance on recognising non-performing loans, cajoling or forcing the extension of credit and the rollover of maturing debts could be the norm. We cannot rule out private banks being willing participants as they help ailing customers through tough times.

This analysis is in no way comprehensive enough. But it is the template from which I am looking at our holdings and deciding which remain and which ones we should own.

One final thought on the macro front. With monetary and fiscal policies currently to the fore, are we underestimating the potential for the start of an inflationary trend? On this topic, I have little to add. We will have to monitor this dynamic and the implications on high valuations of quality companies.

Over time, there is little doubt that the effects of the virus will subside. The economic damage in its wake is likely to be meaningful. Several if not all businesses could witness an alteration in the trajectory of their growth. Governments and SOEs will step in to nationalise losses. My gut feeling is, until then, we will have to live with higher volatility in financial markets.

JOHCM Asia Ex Japan Fund

5 year discrete performance (%)

Discrete 12 month performance (%):

	29.02.20	28.02.19	28.02.18	28.02.17	29.02.16
A USD Class	1.89	-17.17	22.23	19.31	-16.46
Benchmark	-0.01	-8.11	31.73	26.79	-20.42
Relative return	1.90	-9.85	-7.21	-5.90	4.98

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 29 February 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.

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