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A View From Asia

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It has been a challenging period, as evidenced by the performance of the fund. Last year's underperformance was more 'explainable' – the big cyclical rally combined with a couple of stocks that did not work for me on a relative basis. Yet I felt the outcome last year was in the range of expectations. This year to date has been just plain frustrating.

We came into 2018 with a few working assumptions. Global economic growth trends were strong and gaining momentum. In emerging markets (EM), after periods of varying headwinds there was evidence of stability and growth. Inflation particularly across EM seemed very benign.

If you recollect, China had been the vortex of financial instability in 2015 and 2016. There was an explosion of debt, especially off-balance sheet debt, slowing GDP growth and a changed management of the currency. Capital outflows at a time of rising US interest rates had pressured the Chinese economy even further. In 2017, the authorities did clamp down on rising debt levels. Specifically, they first regulated the peer-to-peer lending schemes. They also nationalised Anbang Insurance while curtailing operations of the HNA group – both these being the most egregious of firms that borrowed short-term capital to make acquisitions outside China.

Changes in incentives

Yet the bigger and more significant policy move was the focus by the authorities on pollution in China. As one commentator opined, there is a complete shift in the incentive system for the authorities at the national, provincial and city levels. Since 1980s, as the economy opened up, growth was the only metric to assess performance for various government authorities. Growth led to increased employment and rising per capita incomes. The cost of achieving that growth – pollution, high debt and overcapacity (through misallocation of capital) – did not matter. That changed in 2017. Recognition by the highest levels of authority, now conveyed down the chain, that pollution control and health of citizens needs to be as much a priority as growth has redefined the way governments approach growth. There have been shutdowns of capacity in the steel, coal, cement and aluminium sectors. This has resulted in higher commodity prices, which in turn have improved cash flows for the remaining firms in those industries. Consequently, China's banks witnessed a reduction in potential bad debt cases within the 'old' economy of China.

Valuations for cyclicals in general had risen from the depths of 2016, yet they were far from stretched. Our expectation was that continuing economic growth combined with capacity controls in China would lead to better cash flow/profit growth and this would sustain for much longer. On a relative basis, cyclicals could grow faster and were cheaper than the market in general. Even though we had considered the rhetoric of trade tensions as a risk, the passing of the tax cuts in the US meant that growth there could be stronger, in effect necessitating higher imports and possibly higher deficits for the US. We kept our exposure to cyclicals at the higher end of my allocations, adding to financials in 2017.

Sanctions create uncertainty

Since February/March of this year, the imposition of sanctions by the US on steel and aluminium sectors seems to be the turning point for sentiment towards Asian markets. Subsequent sanctions on Chinese technology and telecom companies (particularly Huawei and ZTE), in my opinion, are more consequential for future growth expectations. In 2017, Huawei's turnover was approximately US$95bn, while ZTE's was approximately US$16bn. These are large companies dealing with several customers and component suppliers across geographies. Apart from technology, some other sectors have come in for specific targeting. This has resulted in a retaliation from China on US exports from corn to wastepaper. In my view, it's not relevant to analyse which particular sectors might be targeted; it's the uncertainty this creates in business about the future path of friction free trade that matters.

The stakes are high for negotiations between China and America; both sides know that trade barriers are not good but domestic political compulsions will dictate events. There is still a chance that a compromise might be reached. That is our hope, but the reality is that we have to be prepared for a tougher trade environment. At the start of the year, from our projections for profit and cash flow growth in Asia, we felt comfortable about prospects in 2018. I have had to temper those expectations a bit.

From our regular screenings and our shortlist of prospective investments, we invariably find some good quality businesses that I am very comfortable

owning through tough times. In the past two months, I have been adding some new stocks into the portfolio. Last month I mentioned LG Household as one example. Another stock that I have been adding to is Philippine-listed Jollibee Corporation. It is the largest quick service restaurant (QSR) firm in Asia, with a small footprint in the US as well. Jollibee derives almost 80% of revenues from Philippines by serving customers across five different brands. In the second week of May, after meeting with management in Manila, we will be able to provide a bit more colour regarding the stock. The other positions are not yet at their full weights but should be, over the course of the next month or so. The common characteristics in all these companies is that they are relatively more insular, with decent growth prospects in face of the challenging macro-economic environment that we might face across our region. The risk at this point is whether the trade frictions escalate and whether that results in a rally in the US dollar as investors look for safety above all else. I am reasonably confident that the businesses we own can survive a downturn and that if stocks do sell off, this will give us opportunities to add to them.