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FOR PROFESSIONAL INVESTORS ONLY

A View From Asia

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Pacta Sunt Servanda – Agreements must be kept; really?

There is little insight I can provide on Asian equities this month. Broad strength in the US dollar trade-weighted index, amid signs of faster growth in the US economy and higher interest rates to boot, means risk assets outside the US are facing strains from slowing liquidity. In Asia, we have witnessed several months of outflows, first on trade concerns, now on geopolitical rumblings. On one hand, index providers are likely to increase their allocation to China 'A' shares, yet sentiment could not be softer.

India has finally found itself caught up in the selling bout. Its economy epitomises the macro weakness that are common in almost all Asian economies: a dependence on oil imports and excessive reliance on foreign capital flows.

Some months ago I had mentioned the relentless rise in unsecured lending in India. Overall credit statistics showed a benign picture. Yet, under the surface, some established and several newly created non-bank finance companies (NBFCs) took up the baton of lending from beleaguered government-owned banks. In the end, they repeated the classic mistake of an asset-liability mismatch, compounded by borrowing increasingly larger amounts from wholesale funding sources like money markets and commercial paper.

That has now come home to roost as rising oil prices, a depreciating currency and lower liquidity are exposing those who thought lending was an easy business. In my opinion, growth in India will disappoint. Higher oil prices and higher interest rates will affect demand. The additional driver that will dampen Indian growth will be the retrenchment of lending by these NBFCs. In the two years after demonitisation (remember that demon?) most of the NBFCs stepped on the accelerator to lend copious amounts of credit to the needy and the unsuspecting. Home loans, loans against property (nothing but a charade to provide working capital loans to SMEs by mortgaging their shops and offices), car loans, consumer durable loans, education loans, foreign travel loans and more. On a trip to Bombay about 18 months ago, I was surprised to learn that tailoring shops

associated with big branded fabric companies were willing to finance a purchase of a suit for your wedding. That cost 3-4 months' average monthly salary, yet there were many who did borrow on that scheme.

The paradox of India has always been that there are some very well-managed businesses able to operate in challenging macroeconomic conditions. In our portfolio, I have bought into what I think are some of those very businesses, knowing that we might face trying economic times ahead. As the market sell-off has continued into early October, it has given me an opportunity to add to some of our holdings. The direction of the currency is anyone's guess, while poor sentiment amongst domestic investors could lead to lower multiples for some names. I would welcome that development. Finally, it seems like valuations are coming down to levels that we can live with over the next 3-5 years. Given the state of markets and the sentiment, it is better to be cautious in adding to our names. I hope to be in a position to expound on some of these businesses in the coming months.

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