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Capital Management Group

A VIEW FROM ASIA

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- The march of the zombies
- Incentives drive behaviour
- 'Japanification'
- Forced savings can become future spend

JOHCM Asia ex Japan Fund

Rout: an overwhelming defeat

No, the title of this piece is not a prognosis of the electoral outcome in November. My reference is to the shellacking of bank stock prices around the world.

The march of the zombies

The latest damage to bank shares was inflicted by disclosures about lacunae in compliance procedures. However, in my opinion, that is the least of their worries. With the Federal Reserve indicating that low interest rates are likely to persist, banks' ability to generate internal capital is severely restricted. In this Covid-induced recession, banks are the long-term repositories (I would say indirect owners) of zombie companies across the world.

Zombie companies are defined as *'barely able to meet their interest payments on debt'* and require constant bailing out by fresh loans. A recent research note by Deutsche Bank classified 14% of all US companies as zombies. That number is probably higher across the world – that's my guess given that the banking sector dominates capital markets in Europe and Asia, whereas the corporate bond market plays a much bigger role in the US in capital-raising. All nations currently remain focused on preserving jobs. If that means cajoling or arm-twisting banks to keep technically bankrupt businesses alive, that will be the case.

This year many, including myself, have used the phrase "nobody really knows". In general, that still holds true. Yet, for some scenarios, it is unjustifiable to hide behind that excuse. Many politicians claim that the devastation brought about by Covid-19 was unforeseeable. Yet epidemiologists have warned for a few years about a Covid-19-type global pandemic.

Incentives drive behaviour

Alternatively, take climate change. For decades, there has been growing evidence and acceptance that changes in weather and temperature could, over time, have severe impacts across the world. Despite these warnings, humans have rebuilt homes at the same location where intense hurricanes or fires have previously demolished or ravaged property. Some might say it is in defiance of science, but I think there is a lot to do with structuring incentives.

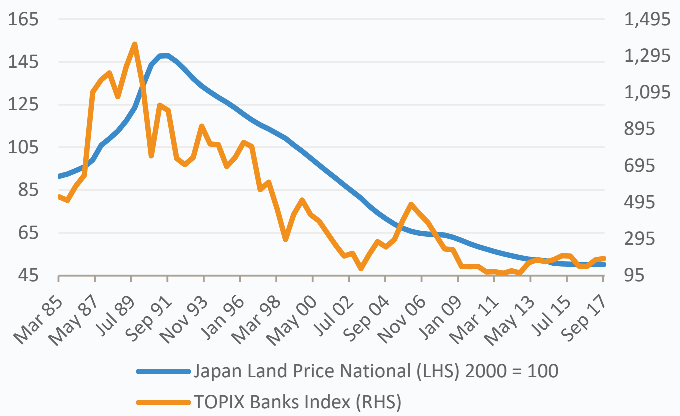
Taiwan has dealt with the pandemic much better than most countries. Its prevention and containment efforts started in December 2019. The results have been stupendous. In contrast, most other countries were ill-prepared for the virus.

Compounding that shortcoming on part of the governments is the pure capitalistic approach of profit maximization by private healthcare. Managements of healthcare firms strived for efficiency, cutting costs to the bone and leaving no slack. Any spare capacity was deemed untenable. Hospitals focused on the most lucrative procedures (measured by dollars per patient or procedure). This resulted in complete ill-preparedness in the case of public emergency. Imagine if cities ran fire departments on extreme efficiency. In the case of climate change, insurance policies cover homes on an annual basis. When homes undergo damage, the payout to the insured (with a possible rise in premiums) does not discourage homeowners to move away from locations highly susceptible to natural disaster.

'Japanification'

In a perennially low interest rate environment, bank management teams have no incentive to deal with non-performing loans (NPLs). Japanese banks are a template. After the 1990s bubble, they either failed to recognise or refused to write off NPLs to clean up their balance sheets. That decision seemed perfectly rational. Imagine you lent someone US$75 secured by land valued at US$100. After the real estate bubble burst, the value of land deflated over the next two decades. In tandem, interest rates in Japan collapsed to almost 0.25% p.a. As a result, that security you took against the loan is now valued at perhaps US$10. The cost of carrying those NPLs on your books is a measly 0.25% p.a. Banks hoped that land prices would rise at some point in time, and they could recover more in the future than they could by selling the collateral in the present. This problem of bad loans and zombie firms festered. Richard Koo, chief economist at Nomura, coined the apt phrase "the balance sheet recession".

The long slow slide to reality

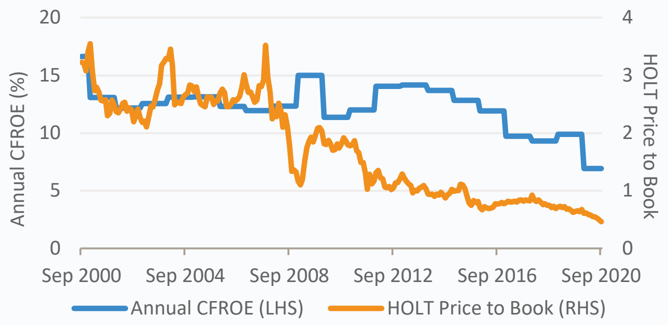


Source: Bloomberg.

Do not get me wrong. From time to time, as seen in the chart above, we do get a spurt in bank share prices. However, history shows that when an economy remains mired in deflation and interest rates are at rock-bottom lows, banks are a highly toxic leveraged vehicle. Their share prices do rise occasionally, but those rallies are short lived.

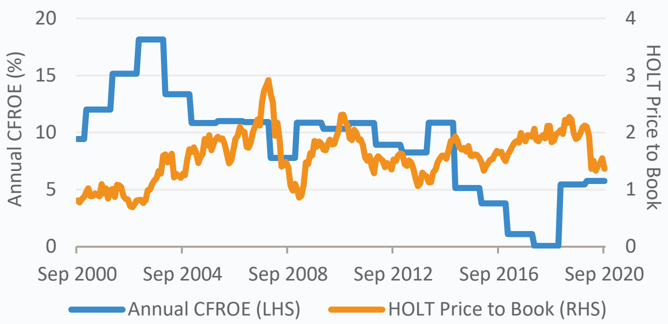
In my opinion, banks across the world are going through a 'Japanification' process. As mentioned earlier, governments are desperate to preserve jobs. This means ensuring, by way of subsidies at first and later by arm twisting banks to keep zombie companies afloat. From a societal perspective, it could result in fewer job losses, but economically it results in significantly lower returns on capital for a vast number of companies. The trend of lower interest rates over last two decades has already chipped away at the returns that banks made in countries as diverse as Hong Kong and India. The lower price-to-book valuations are a direct result of that falling profitability. This gloomy situation is unlikely to change anytime soon.

HongKong banks return profile – salad days behind us



Source: Credit Suisse.

Indian banks return profile – salad days behind us



Source: Credit Suisse.

Forced savings can become future spend

At the end of September, our fund has some cash build-up. I reduced our exposure to China 'A' shares. Companies like Foshan Haitian, Shenzhen Mindray and Wuliangye have delivered excellent returns and now trade at very high multiples. They are still well-managed businesses, and China's liquidity and growth environment remains benign. However, mindful of the risks that come from extremely high valuations, I have chosen to reduce exposure.

Conversely, I have added to our holdings in India, in particular Jubilant Foods and SBI Cards. I admit the optics of Covid-19 in India, the lack of a coherent policy response from the government and the border skirmishes with China all point to uncertainty in the economy.

I do, however, have stronger conviction in the forced savings situation for consumers across many countries, including India. In aggregate, job losses have hurt incomes. But at the same time, consumers have tightened their belts – forced in some cases by a lockdown or driven by extreme caution. That has hurt activity in the near term, but my view is this has helped build up consumer savings and balance sheets for those who remain employed or find new jobs as the economies open up. My aim is to find those businesses who benefit from the inevitable uptick in consumer spending in 2021 and beyond. Besides, with so many twists and turns this year including the latest shock of President Trump's Covid-19 diagnosis, holding some cash in October 2020 might not be too harmful. I remain constructive on several stocks and will, if markets correct, look to deploy that cash.

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

Discrete 12 month performance (%):

	30.09.20	30.09.19	30.09.18	30.09.17	30.09.16
A USD Class	24.76	2.34	-11.42	11.65	14.47
Benchmark	17.15	-3.60	1.59	22.56	16.82
Relative return	6.50	6.17	-12.81	-8.90	-2.01

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 September 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.