J O Hambro Capital Management Group

A View From Asia

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Rubble - waste or rough fragments of stone, brick, concrete, etc., especially as the debris from the demolition of buildings.

It would be logical, looking at the title of this missive, to subconsciously link it to the verbal pyrotechnics between Mr Trump and Mr Kim. Furthermore, knowing that both the US and North Korea (seemingly) possess nuclear armaments, it would not be far-fetched to quote Ecclesiastes 3: 20 from the King James Bible: 'All go unto one place; all are of dust, and all turn to dust again'.

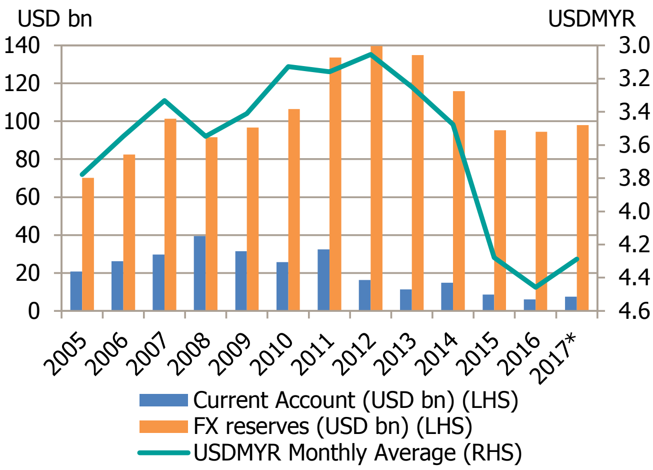
But some situations are best left to our imaginations or nightmares. I thought it better to rummage around with our screens in the markets in Asia. This year a confluence of factors have helped Asian equities propel higher. Invariably, a weakening US dollar trend is a benign setting for risk asset classes. Additionally, a semblance of stability in China's economy combined with a synchronised global economic recovery has helped Asian equities deliver stellar returns so far this year.

Malaysia: diamonds in the rough

In any bullish environment, it is a daunting task to find good quality stocks which have not yet caught the fancy of markets. Inevitably, stocks that have not participated in the bull market seem to have lots of flaws, else they would not be the market dregs. Luckily if, like us, you possess patience, that market rubble does throw up some investment opportunities. Most of the time they play into the cyclical part of our portfolio; occasionally I find a diamond in the rough.

This month I thought it fitting to shed some light on Malaysia. I remained on the side-lines till earlier this year after I had sold out of my last Malaysian holding in mid-2013. The allocation in the portfolio has now risen close to 6%. In the past four years, Malaysia has gone through its fair share of problems: the sell-off in commodities curtailed exports led to a decline in its current account surplus; the woes of the 1MDB scandal (https://en.wikipedia.org/wiki/1Malaysia_Development_Berhad_scandal) caused investors to lose confidence in the country, leading to capital flight; and, after 2013, the Federal Reserve signalled a tightening bias to monetary policy. These three events contributed to a significant weakening of the currency (approximately 35%) against the US dollar.

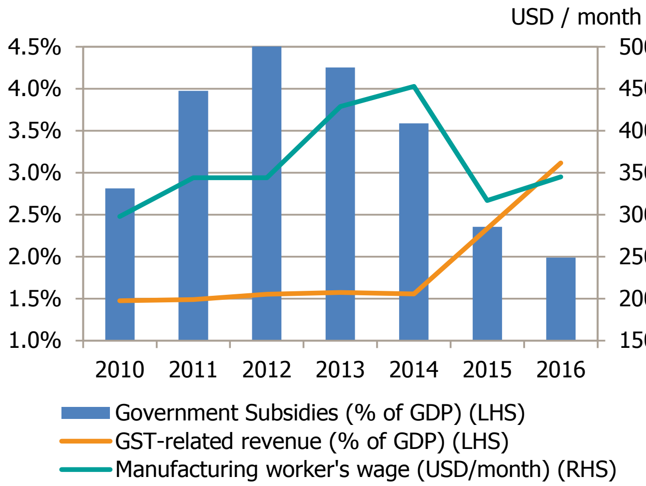
Malaysian economy under stress



Source: Credit Suisse *2017 Current Account and FX reserves are Credit Suisse's estimate. *2017 USDMYR monthly average is July 2017 data.

Meanwhile, economic conditions became harsher. Corporate profitability, as well as consumer disposable incomes, has stagnated or declined in the past four years. Under pressure from ratings agencies to control the budget deficit, the Government was forced to cut back on several subsidies. Consumer prices for electricity, LGP, petrol/diesel and sugar, amongst others, were raised significantly. And, in April 2015, a 6% goods and services tax (GST) was introduced for the first time. With a depreciating currency, inflation rose. The result was a big squeeze in consumers' disposable incomes, while businesses saw a sharp rise in costs.

GST and Subsidies

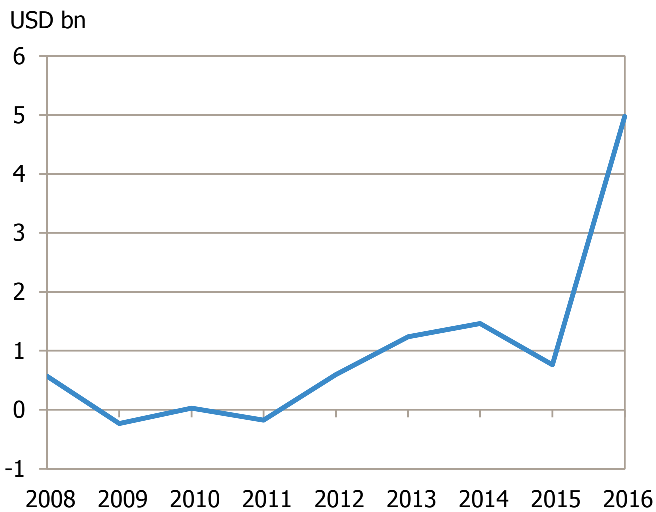


Source: Credit Suisse, Jetro Survey and Bank Negara Malaysia as at December 2016.

China swoops

However, I do see some silver linings. China has, in my view, taken advantage of this economic situation in Malaysia. Assisting Malaysia has a geo-political angle, helping China win over one more Asian country in its quest to dominate its perceived sphere of influence. As part of the 'one belt, one road' initiative, China is looking to deepen ports (Malacca), build new ones (Penang and Tanjung Pelepas), construct several roads, new rail lines, bridges and industrial parks. A few property companies from the mainland have bought large swathes of land in Johor to build new homes. Some reports suggest China will over the next five years, invest US$150bn in Malaysia while committing to import US$2trn worth of goods and services from Malaysia. These numbers sound gigantic. It would be naïve to take them at face value, yet the trend is unmistakable. Besides investments, the weaker ringgit has made Malaysia a very attractive holiday destination for Chinese tourists. One of the companies we own, Genting Malaysia, is in the process of completing a theme park in association with 20th Century Fox. Naturally, there is a simultaneous massive expansion of an existing casino next door, just in case the cheap ringgit does not do the job to rope them in.

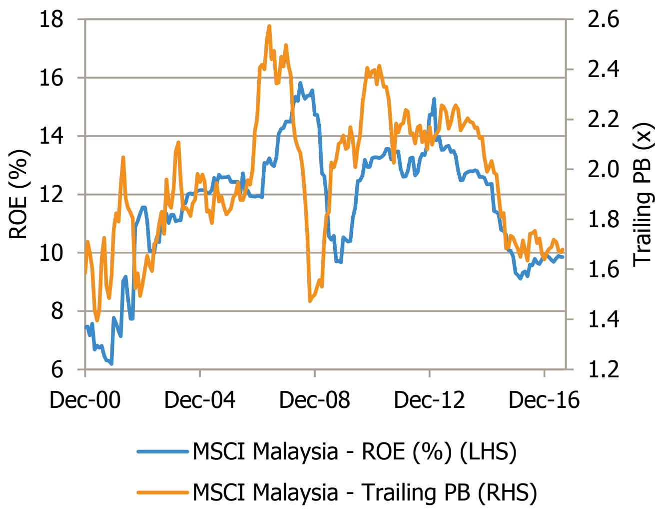
Chinese FDI into Malaysia



Source: Credit Suisse as at December 2016.

I have no illusions as to why the Malaysian stock market has been a laggard. Valuations of several stocks in Malaysia are cheap for very compelling reasons. Unlike in South Korea, we have not witnessed an earnings upgrade cycle. Unlike in China, there are no internet plays, nor is the consumer market massive. And unlike in India, the GST levy isn't touted to be the elixir that justifies sky-high valuations because of an impending structural change. You get the drift. There is a price to pay for having no hype. Yet, turned on its head, cheap valuations for someone with patience are a boon.

Subdued profitability and valuations



Source: Credit Suisse and MSCI as at 18 August 2017.

I can't say for sure what could or will change in Malaysia. But experience suggests that when a country's currency sells off, it is the first sign of the purging of excesses. Consumers and businesses have dealt with higher costs for the past 3-4 years. Like any economic participant across the world, they start to adopt and change behaviours to contend with tougher economic conditions. Things don't stay in the dumps for too long. As China starts to inject capital through direct investment and tourists recognise Malaysia for the bargain it has become, could these be the sparks that ignite investor interest? As always, the only conviction I have is that we won't lose too much money in Malaysia. Once you are rubble, it's hard to get crushed further. For a balance in the portfolio, I feel reasonably confident that Malaysia is an excellent risk-reward opportunity.