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A View from Asia

Samir Mehta shares his views on the outlook for Asia

Samir Mehta

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Catch 2022

“There was only one catch and that was Catch-22, which specified that a concern for one’s own safety in the face of dangers that were real and immediate was the process of a rational mind. Orr was crazy and could be grounded. All he had to do was ask, and as soon as he did, he would no longer be crazy and would have to fly more missions. Orr would be crazy to fly more missions and sane if he didn’t, but if he was sane he would have to fly them. If he flew them he was crazy and didn’t have to; but if he didn't want to he was sane and had to. Yossarian was moved very deeply by the absolute simplicity of this clause of Catch-22 and let out a respectful whistle. “That’s some catch, that Catch-22,” he observed. “It’s the best there is,” Doc Daneeka agreed” – Catch 22 – Joseph Heller

Inflation or growth. Punch bowl or Scrooge? To wait or not to wait?

Collectively, we naively believe or magically expect that the Fed knows what they are doing. Furthermore, we think they run a fine tuned machine into which they input data; using advanced AI techniques, they can calibrate outcomes. Alas, the reality is starkly different. After ditching the word ‘transitory’, the new phrase in their lexicon seems to be ‘incipient bordering on persistent’. As to AI and data analysis, even the most sophisticated companies such as Netflix can falter in assessing their own subscriber growth. Estimating GDP growth and inflation outcomes? That is the stuff of legends.

From prior experiences of quantitative tightening and/or rising interest rates, we can keep a few signposts in mind. This change in macroeconomic policy is a big headwind for assets. I am stating the obvious after January's stock market performance. I paraphrase Charles Gave of Gavekal – 'in the initial phase, only small fish die; ultimately, there will be a whale that is beached'. After couple of years of significant excess money creation leading to unguarded optimism, there are many areas of speculative excesses. If the Fed tightens to a point that is just a bit too tight for comfort (and I have no clue where that is), there could or most likely will be a financial accident.

Broadly speaking, the global banking system is far better capitalised than in 2007/8. Yet there was a staggering build-up of debt and explosion of excess liquidity this time around. A significant correction in asset values in areas which were beneficiaries of this excess is entirely possible. Candidates that come to my mind - companies with no profits (get scale at any price - give away money to buy turnover), concept or thematic stocks (memes; SPACs) are prime examples of small fish.

For the whale, my conjecture is either

a. the Chinese property and related sectors

b. the Euro zone (especially the Euro currency)

c. Private equity and venture capital backed firms (the Softbank model)

d. Sovereign debt of low-income countries (remember 1980's LatAm debt crisis and Brady bonds)

This is not based off rigorous data analysis, but observations of possible excesses built up over time.

The Chinese property market has been in the headlines already. The level of borrowings and the extent of speculation is extreme – not just amongst buyers of property but also the developers. Indications from policy makers suggest they are fully aware of the potential outcomes. It is difficult to assume that the efforts to deflate the bubble will be smooth and controlled. However, in my view, nationalisation of that problem is a distinct possibility. Private developers allowed to fail (equity holders lose value, helps foster more discipline) while their projects are taken up by SOE firms. Growth in China has slowed already. For 2022, the headwinds from property are not the only area of weakness. A zero-COVID policy means disruptions and halting consumer spending in services. Exports from China will also be lower. As monetary policy in the US tightens, not just demand for products but also the excess inventory in the system will be an overhang for exports from China. All in, there is a distinct likelihood that growth will not be robust. In this circumstance, it is likely that the PBOC will have little choice but to loosen policy to counter this slowdown. They will be measured. In face of a tighter US monetary policy, the risk to capital outflows and currency are paramount.

Hence, my lens of looking for opportunities remains on high quality businesses but specifically those that might be beneficiaries of pockets of demand resilience and strong cash flow dynamics. In a country as large as China, there are several of them. Timing is difficult to judge, but there is a good chance we get opportunities to add to China holdings this year.

Over the past decade, U.S. dominance has extended itself in economic growth as well as stock market performance. Perhaps a confluence of events might challenge U.S. markets this year. As of now, it would be foolhardy on my part to opine with confidence that this selloff in January in the U.S. is start of a prolonged bear market. The confidence that I do have is to suggest that prudence dictates diversification away from momentum-oriented assets. Asia fits that bill. The meme we should be guided by is VEPL. Valuations, Earnings Progression and Liquidity. On balance, this year we might see Asian equites come into the zone on all three metrics. WAGMI ("We All Gonna Make It")

An overview of the fund can be found here.

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