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## LLOYD GEORGE ADVISORY

May 2016

### Investment Outlook

#### The Deleveraging of China

The first four months of 2016 have seen some extraordinary gyrations in share prices and also in the price of oil and other commodities. Oil bottomed out at US\$26 per barrel in mid-February and rose to a recent level above US\$45. Iron ore jumped 40%, copper by 25%, and even soft commodities have experienced strong gains. Apart from gold, which is a natural safe haven for investors who distrust the current policy of central banks of creating large quantities of new money supply, we do not believe that there is a fundamental case for demand for industrial commodities. On the contrary, what we have seen in China in the last few months has been an extraordinary reflation of about US\$1 trillion in new “total social financing” or lending. Which has boosted the Chinese economy in the short-term, and property values in coastal cities such as Shanghai and Shenzhen, and in addition artificially stimulated speculation by retail Chinese investors in industrial commodities. By its nature, this effect cannot be sustainable, and we believe that in the next few months we will see a return to earth of these inflated raw material prices. The oversupply problems have not gone away. World trade and manufacturing continue to slow down. For the time being, the US dollar is weak, especially against the yen, but that also runs counter to the fundamental logic of the Bank of Japan’s massive money printing, which has far exceeded the Federal Reserve in the past year.



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We are reliably informed by senior Chinese sources that they expect corporate defaults and a growing number of problem loans to surface in the second half of this year. Although we are not distressed debt investors, we have been offered Chinese non-performing loans at 10 cents on the dollar in a recovery situation. This is the first time that there's been an open acknowledgement in China of their bad debt problems, which are possibly up to 15% of GDP or US\$1.5 trillion in size. Although it has in the past been a mistake to bet against Chinese authorities who are past masters at refinancing and reorganizing their financial system (as they did before listing their major banks in 2005), the size of the problem now is far greater than it was in the past, and it will have a significant impact on the future growth of the Chinese economy. This is the fundamental reason why we are becoming very cautious on the outlook for Hong Kong and China and trying to measure the effect this slowdown may have on the region, including Japan, Korea, and Southeast Asia. The only exception to this slowdown appears to be India, which has a continued momentum of its own, independent of the economic developments in North America, the EU, or China.

For the Indian market, the annual monsoon is always a concern; but recent forecasts are for better-than-average rainfall, which will boost the income of the largely rural population. Mr. Modi continues to make steady reforms, which are not always reported in the western press. The clean-up of the corporate sector, as well as the bureaucracy, is proceeding steadily. Infrastructure and electricity production have been improved and expanded. The recent announcement that the India/Mauritius tax treaty has been revised is a positive step for international investors concerned about the unpredictability of the fiscal regime in India. We remain more positive on Indian shares than any other market, with continued earnings growth and underlying momentum in the Indian economy, which is not affected by Brexit, Donald Trump, or a China deleveraging. We are also monitoring Sri Lanka, Bangladesh, and Pakistan - neglected frontier markets with good fundamental valuations and high real economic growth of 7% or more. In the same trend, we see Vietnam continuing to emerge as an important manufacturing competitor to China, which will benefit from China's slow-down, high manufacturing costs and a steady opening up of their economy and stock market to foreign investors. The recent election in the Philippines, with the surprise emergence of a Filipino Donald Trump in the shape of Mr. Duterte, has introduced an unpredictable element, especially with regard to relations with China as well as a more authoritarian and less democratic



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government than President Aquino in the last six years, who has provided a favourable climate for investors.

One market where we continue to find good values is Australia, where we are interested both in the gold mining industry -- Newcrest, Evolution (among other well-managed mining groups); and also the health care sector (Ramsay, Cochlear, Nanosonics, and Blackmore) who are pioneering new products and exporting not only to Asia but globally. The Australian dollar has shown a decent recovery against the US dollar, and we are comforted by the higher standards of corporate governance in that market.

Although the steady progress and global spread of the internet is an unsaid and invisible background for us as investment managers, it is important sometimes to step back and assess the impact that it has. High frequency trading (HFT) and algorithmic trading programs both impact the volatility of stock markets. As artificial intelligence progresses, the market becomes more unpredictable. Even if the systems and programs are built by human beings with market knowledge, the trend becomes magnified and multiplied by computerized systems. In addition, the almost complete erosion of privacy and secrecy has affected worldwide financial and banking systems, as the recent leaks in Panama and elsewhere attest. We wonder how this will impact currency values and believe that it is one more support in the case for gold as the only anonymous and global “hard currency” which is not politically manipulated. Market movements today are so greatly influenced by central banks, with their unpredictable policies, that it is comforting to find some areas unaffected by these manipulations.

Perhaps the other major influence on share prices in the next six months will be the combined geopolitical effects of (1) the situation in the oil market dictated by Saudi Arabia, (2) the Brexit vote in Britain on June 23<sup>rd</sup>, and (3) the US presidential election. Like many others we were too sanguine in dismissing the possible success of Donald Trump, who has now become the Republican nominee. If he should (by some improbable event) be elected president, there will be a great deal of uncertainty in the world, especially in Asia which is so much dependent on the USA for its export trade.



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We continue to believe that Asia, however, in comparison with Europe and North America, is a region of steady economic growth, political stability, and pro-business government policies, which will enhance the long-term returns for investors. Both China and the Southeast Asian countries are following the example of Japan, which has been the outstanding example of an economic recovery and renaissance since 1945. The difference in China is that it is still a Communist, centrally directed economy and society, and that is why the liberalization of their financial system, and the deleveraging of the corporate sector, poses greater perils than in a completely free system. China is now exposed to world trade in a way that it has never been before in history. If world trade contracts sharply (and China's recent export figures have indicated the beginning of that trend), then it will have a rapid impact on the employment and social situation within China and on the corporate debt situation as well. We, therefore, remain cautious about investing in banks and other companies dependent on Chinese financing. Through the Silk Road Initiative, China has had a significant impact on central Asian and other emerging markets, where it has been aggressively pushing construction projects and financing them with cheap loans. Many of these loans (for example, in Sri Lanka) are unlikely to be repaid; and it is not clear how China will deal with all these credit problems.

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