



An excellent read from our Hong Kong friend.

Enjoy!

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## LLOYD GEORGE ADVISORY

September 2015

### **Investment Outlook**

#### **The Tide Turns**

At last investor sentiment towards China and the Asian markets is beginning to improve, and the summer storm is clearing. Despite the fall of nearly 40% in the Shanghai Index, China's economy is not collapsing. The Renminbi has remained one of the strongest currencies in the world despite a slight fall of 3% against the US dollar and is likely to be adopted by the IMF next month into the Special Drawing Rights (SDR) as one of the five global currencies; and although world growth has slowed, we believe that there are still positive consequences for global consumers in the dramatic fall in energy prices. One topic that we would like to address this month is the secondary consequences of the fall in the oil price.

China's economy is now nearly US\$11 trillion. Even if the growth rate is falling to between 5% and 6% per annum, this means that China's impact on global demand, especially other emerging markets, is extremely important not only for commodities but also for consumer goods, automobiles, luxury goods and services. Our view is that commodities will stay flat for some years because they are in an over-supply situation, including oil; and China's growth will be less energy intensive going forward. In fact, we believe it will become much more like a European economy with the service sector exceeding 50% of GDP in the next five years.



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Foreign trade, which accounts for almost 50% of GDP in China, compared to 13% in the US, is enormously important to China. Although there will be a slowdown, China's overwhelming presence in many product markets will not go away. They have maintained a large trade surplus, nearly US\$60 billion in August alone, and have foreign exchange reserves of US\$3.6 trillion – far larger than any other country. There is no reason why the Renminbi should weaken significantly if Beijing wants to support it.

Unemployment is running at about 4% nationally, and we do not foresee a major social problem ahead. China's industrial production may slow down, but its labor force is also peaking out in this decade. Its debt situation is also manageable, with very little foreign debt and most local and municipal debt owed internally and, therefore, able to be managed by the central government. The property market in China has also reached a plateau with nearly 90% home ownership according to published figures, and growth will certainly slow, although we do not yet foresee a collapse in real estate prices.

The major focus today is on financial reform and innovation. The opening up of China's banking and securities industry will be the most significant change, and financial liberalization also means a larger outflow of Chinese capital into global markets. Beijing has also put its full weight behind the Asian Infrastructure and Investment Bank as a new vehicle to compete with the ADB and the World Bank, in its backyard, and also the "One Belt One Road" connecting Russia, Mongolia, and Southeast Asia with infrastructure, financing, and free-trade agreements as key elements. Finally we expect China to be more innovative in technology and medicine in the next decade, and the liberalization of the Shanghai market to allow easier start-up listings, like NASDAQ, will be important in encouraging innovative entrepreneurs.



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If we are right about China growing at 5% or better, this is still critical to the health of Southeast Asia and China's trading partners. In particular, we expect that Hong Kong and Singapore will benefit from the financial liberalization and growing Chinese capital outflow. The other ASEAN economies will experience high growth as a result of China's infrastructure program and 120 million Chinese tourists traveling overseas, as well as investment into hotels, factories, airports, and road and rail. We currently have exposure in Singapore and Thailand, but we remain cautious about currency risk in Malaysia, Indonesia, and the Philippines.

India is growing at a slightly faster pace than China, at about 7%. The Indian Rupee has remained fairly stable, and India is saving US\$100 billion a year on cheaper oil imports. Prime Minister Modi's reforms are beginning to take root, and there are improvements in tax and in administration as it affects foreign investors, particularly an attack on corruption, which (as in China), reduces business costs significantly. We are focused, with our partners Val-Q in Bombay, on the midcap sector of the Indian stock market, where we see earnings growth of around 20% in consumer-related companies with a market cap of US\$5 billion or less.

As a general comment, we still see deflation as the primary trend in the world. The internet is the ultimate engine of deflation. We need less space for shopping when we buy on-line; taxi medallion prices have plunged due to Uber's competitive pressures; and hotel room rates are feeling the heat from Airbnb.

In the next 3 months, we shall see a battle between deflation (the strong background trend) and reflation (led by central banks, and including competitive devaluation -- also deflationary, unfortunately). If oil plunges to US\$30 or even lower, the effects will be felt widely. Some of the world's largest equity investors, such as Norway, ADIA, KIA, and SAMA will have to reduce their new commitments. (Saudi Arabia has already drawn down US\$100 billion of reserves.)



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The secondary consequences of the oil price collapse will be felt most acutely in those marginal economies with high production costs – Venezuela, Colombia, Nigeria, Angola, Iran, the North Sea, and Canadian Tar Sands. We have already seen a sharp correction in oil currencies, and we are likely to see more distress in the coming year. When the oil price plunged in 1986 to US\$15, it brought about the fall of the Berlin Wall within 3 years and the collapse of the Soviet Union within 5. There may be similar geopolitical effects this time around, possibly in Saudi Arabia and the Arab world.

Robert Lloyd George  
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