



Will Inflation Return?

Happy New Year!

An excellent piece by Robert Lloyd George – China and India strong; end of bond returns; continued equity gains. Stock selection and growing dividends will be key factors – Georgian Capital's focus.

Comments and questions welcome.

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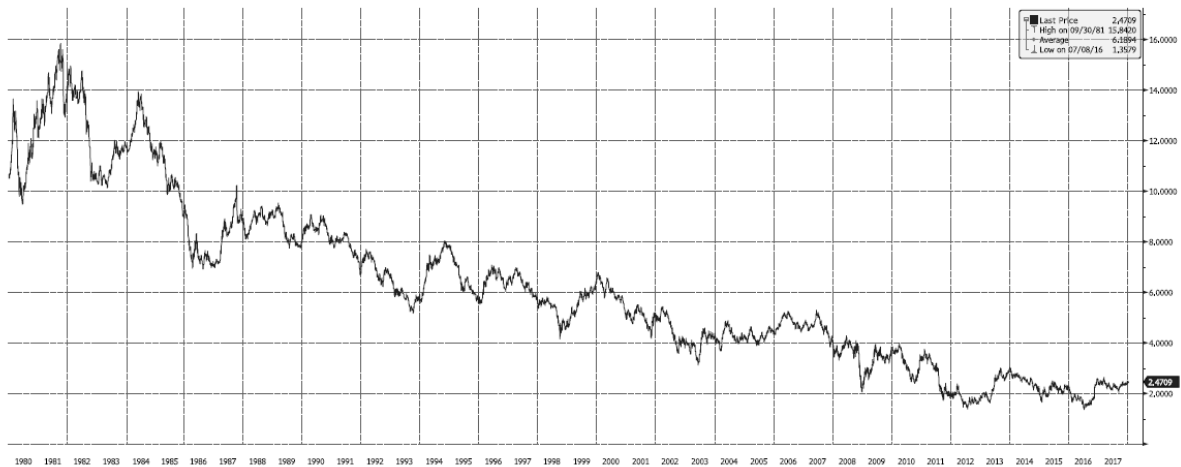
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Investment Outlook

Will Inflation Return?

With almost full employment, and with commodity prices rising, it is possible that 2018 (despite money supply slowing down) may see the first glimmer of a trend of rising prices. Many investors consider that the July 2016 low of 1.34% yield on 10 year US Treasuries marked the peak of the bond bull market, which has been going since 1981 (and Paul Volcker's crackdown on 15% inflation).

USGG10YR Index (US Generic Govt 10 Year Yield)



Source: Bloomberg

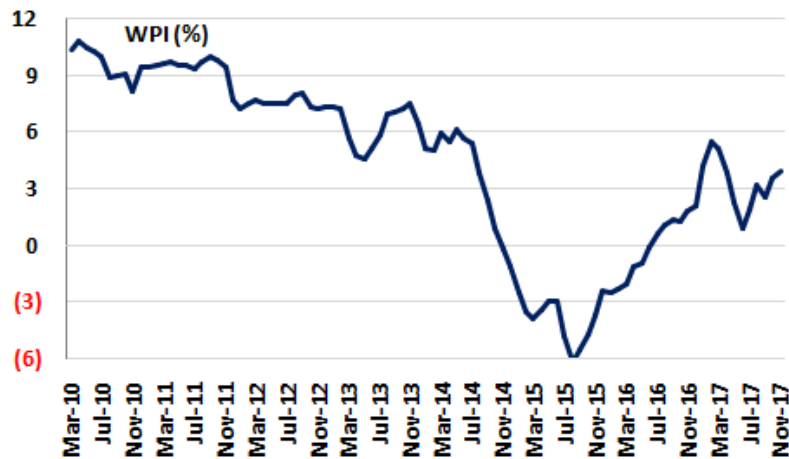
The surprising aspect of today's world is that despite the quadrupling of central bank's balance sheets since 2009 (and the quadrupling of global money supply), there is no apparent rise in CPI official inflation. But everyday experience tells us otherwise. (And we recall Disraeli's words, "There are three kinds of lies: lies, damned lies, and statistics.")



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Certainly in Asia, inflation remains historically low, although to take the example of Japan, which has been in deflation since 1990, there is now definitely a positive trend towards higher prices. (Japan’s central bank target is 2% CPI.) And in both China and India, we expect that the interest rate cycle and the inflation trend has bottomed out and will slowly trend upwards (as the Federal Reserve, under its new chairman, Jerome Powell, also expects).

Indian Wholesale Prices



Source: Office of the economic advisory

In our investment strategy, therefore, we are looking for the most laggard performing sectors of 2017 to surprise on the upside, notably mining and energy. We have recently added Vedanta to our Indian Ocean Fund portfolio: it is controlled by Anil Agarwal and has an excellent diversified portfolio of minerals, including copper, zinc, and aluminum as well as energy assets. We are reevaluating Reliance Industries as India’s largest oil refiner.

In East Asia, we see the rise of natural gas as being the key trend towards curbing pollution. While some Australian and international energy companies will benefit, there may also be local beneficiaries: Hong Kong China Gas, Sinopec Kantons and China Gas Holdings.



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We have confidentially received a recent report, made by a think tank in China, about China's coming energy crunch, which suggests that domestic oil production in China will peak in 2018 and that China is now scrambling, as a national security priority, to secure overseas energy assets. Part of this strategy is to secure the South China Sea through militarizing the coral reefs and laying claim to the undersea oil and gas basin that may be in that off-shore region. Also, China is rapidly investing in natural gas, both through LNG facilities and building ships, mainly to transport liquid natural gas from Australia and Papua New Guinea. Other suppliers may be Qatari, Middle Eastern, Russian, and Kazakhstan gas producers. Hence the strategic thinking behind the "One Belt One Road" vision of Xi Jinping. It is very much in China's long-term interests to have secure energy supply and military control over the supply routes, whether at sea or over land (on the Silk Road).

Although we are bullish on Indian GDP in 2018 and the first February national budget, which should be pro-business, we are also concerned about the gradual rise of inflation in India (Wholesale Price Index 3.9% and Consumer Price Index 4.9%). However, despite the rise in oil prices and the strange calm in the gold market, we see the Indian Rupee strengthening against the US dollar. It is now 64, which is the strongest level for over 2 years.

Regarding India, we have continually focused on the 'inclusion' of many poorer Indian citizens into the modern economy and financial system, epitomised by the opening of 300 million new bank accounts in the past 3 or 4 years, and the ownership of iPhones. This is symbolic of a larger change in the world which has seen such an extraordinary and positive progress in the past generation. Every day the number people living in extreme poverty (under US\$2 a day) goes down by 200,000. Every day 325,000 more people (according to Oxford University) gain access to electricity and to clean drinking water). As recently as 1960, a majority of the human population were illiterate and



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living in extreme poverty. Now these figures are less than 10% and some observers believe that the end of poverty is in sight by 2030. Recently, polio has been almost completely eradicated, along with a number of other debilitating diseases, in developing countries. India is a poster child for all these improvements and education, and electricity go hand in hand with the general economic improvement

The key to 2018 investment trends may be the direction of the US dollar, which continues to be weak against the Euro and Asian currencies. However, now that the Tax Reform has been passed, capital may very well flow back into the USA, with corporation tax reduced from 35% to 21%, (many nations will now have to compete.)

We remain confident that despite the possible rise in interest rates to 2.5% in the US, the bull market remains intact, especially in Asia where growth in trade and corporate profits remain strong, and currencies are still well-supported against the US dollar. We are contrarian investors and look for underpriced opportunities in places where other investors fear to tread or where there is a perceived risk, such as the Korean Peninsula (South Korean technology shares are looking very attractive). Our 5-year forecast continues to be that India will be the standout investment opportunity because of its economic and political transformation, which is now being translated into higher economic growth and stronger corporate performance, as well as a strengthening Rupee, under the leadership of Narendra Modi.

Robert Lloyd George
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Hong Kong



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