



Excellent, interesting perspective, as usual; particularly on commodities and China.

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LLOYD GEORGE A D V I S O R Y

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Investment Outlook

What's next for Emerging Markets?

The world is looking very different after the shock of the Brexit vote in June, which has not only caused a sharp drop in Sterling and in European markets, but also made it less likely that the US Federal Reserve will raise rates in the second half of the year. This is certainly positive for the Asian and emerging markets, but the question we have to ask ourselves is whether these very low (or even negative) yields on sovereign bonds in developed markets are, in fact, a positive signal for emerging market equities. Certainly there has been a recovery in some depressed markets, like Brazil, mainly because of better political news; but we do not see a sustained recovery in commodity prices, either in oil or metals, or in the more unpredictable food or soft commodities.

While visiting a major palm oil plantation company (Wilmar) in Singapore and Malaysia last month, we were interested to learn that there was very little more growth to be obtained from the China retail market selling cooking oil; and the only area in which the company saw any future growth was Africa. Not only do we appear to be at the end of a 30-year cycle of globalization and growth in global trade, but with a few exceptions, we have also reaped the demographic dividend and the urbanization dividend, for example, in China, and the enormous benefit of the end of the Cold War and the Communist Bloc. Today there is hardly any new geographic area to be exploited. However, within some of the larger countries, such as India, there are still large parts of the population which have not yet been brought into the modern financial and consumer economy. That is where we see the opportunity for well-managed companies supplying these new young populations, not only in India but in Pakistan, Bangladesh, Vietnam, and other relatively underinvested and under-researched markets.



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We've been investing in emerging markets for over 30 years, and we have seen a significant improvement in corporate governance generally. However, state-owned companies, whether in Brazil, Russia, or China, are still generally not good destinations for the capital of minority shareholders and foreign investors. In the past three years, there has been a significant shift away from commodity dependence (mainly oil and metals) in the emerging market index towards technology, which is now nearly 23% of the total capitalization. This includes Samsung Electronics, TSMC, Alibaba, Baidu, and Tencent, which together make up nearly 15% of the GEM Index - more than oil and mining stocks combined. Nevertheless, the emerging markets are still closely tied to the commodity cycle; and our view is that any short-term bounce in oil and metals will not be sustained. We have seen a real slowdown in global trade and global exports, especially from leading Asian countries, such as South Korea, Taiwan, and even China. In the past two years, exports from Korea and Taiwan contracted at rates between 14% and 16%. China, of course, is still the overwhelming influence as a trading partner and customer for all the emerging countries, especially the commodity producers; but China's new consumer economy is also driving demand for travel and tourism in Southeast Asia, as well as manufacturing and construction investment for instance, in the "One Belt, One Road" projects in Central and South Asia. That is why we watch what happens in China's domestic economy so closely.

Our current impression is that China's economy has stabilized, with a continuing slump in steel, ship building, construction, and heavy industry, being offset by government stimulus and consumer spending. Whether the economy is really growing at 6% is hard to say, but we do not expect an imminent collapse. The debt situation appears to be manageable, at least for the next six to nine months. The Renminbi is depreciating at a fairly steady, but slow, pace. The real risk in China is political rather than economic. Xi Jinping has apparently succeeded in overcoming rival factions, but nothing in Chinese politics is predictable (any more than Westminster). The setback to China, by The Hague Court ruling on their South China Sea claims, may have some political consequences. We are remaining cautious on most China investments, except special situations, and, therefore, on the global emerging markets.



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In fact, “Global Emerging Markets” does not seem any longer to be a useful category for investors. We are looking much more closely at regions (mainly at South Asia, centered on India) and at sectors, and technology, internet, health care, and consumer brands. Our portfolio management style is all about stock picking, and it is all about local situations. Indonesia, for example, has had a history of commodity dependence; but it is now moving into a new era, like India and China, of middle class consumer growth. We have recently added two food companies listed in Jakarta. With the help of our colleagues in Bombay, we now have a list of 12 mainly midcap, consumer, technology, media, and internet companies listed in India or overseas on our core conviction list.

Perhaps the greatest concern for investors, especially in developing countries, is whether the last generation of gains in Free Trade is over. The rise of Donald Trump reflects a deep backlash against the loss of manufacturing jobs - for instance, in textiles, to China - and of a stable middle-class income and lifestyle. “Brexit” is also a populist reaction against free trade within the EU; but, ironically, it may cause a slump in the agricultural sector (as well as London property) because the protectionist policy of the EU embodied in the Common Agricultural Policy is no longer affordable.

In conclusion, we believe that emerging markets may rally in the short-term, but within six months, may face headwinds of a stronger US dollar, weaker commodity prices, higher interest rates, and a flight to quality (if there are further aftershocks in Europe). In the next two years, we expect India to outperform, based on the real political and economic reforms which Mr. Modi is now undertaking, especially the introduction of a GST (Goods and Services Tax) before the end of 2016. We are reassured by the Indian Rupee’s stability and the continuity of strong RBI policy under a new Governor. Most importantly, we find the best-managed businesses in India, with excellent earnings growth of above 20%, selling on reasonable multiples; and that is why we are concentrating more of our Bamboo Fund into the Indian market.



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We will also launch our Indian Ocean product in September, which will include 75% India and 25% in the Asian frontier markets, including Pakistan, Bangladesh, Sri Lanka, and Vietnam. All these countries share the same demographic characteristic - half the population is under 25, and the governments have to encourage foreign investment (and a fair deal for foreign investors) in order to achieve growth and employment - just as China did 20 years ago.

Robert Lloyd George
14th July 2016

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