



From our Hong Kong friend, fascinating insights as usual. Seems to assume U.S. protectionism and higher inflation soon. All Far East and Emerging markets appear positive, which portends well for Canada (coking coal to China strong finally).

Ultimately, Robert is a fundamentally-driven, careful, stock picker – as are we at Georgian Capital.

Enjoy the read. Comments welcome.

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## LLOYD GEORGE ADVISORY

**October 2016**

### **Investment Outlook**

#### **Nippon Redux?**

As the US Presidential Election approaches, we may need to reflect on the influence that politics has had on markets in the past. In his book “War, Wealth and Wisdom”, Barton Biggs pointed out the extraordinary, even clairvoyant, character of stock markets in 1940 (UK) 1942 (USA and Germany) in anticipating the recovery, at the nadir of military expectations or of defeat for the Germans at the apparent peak of their advance into the USSR.

World markets bottomed only a week after the “Brexit” vote, evidently concluding that the economic and financial damage had been exaggerated. Will the election of a protectionist President (for the first time since before World War Two) be equally discounted by the market? It remains to be seen. In the past, Republican Presidents (for example Reagan in 1981) have had to administer tough medicine in their first year. In 2017, as in 1981, interest rates will have to rise, and speculative bubbles (high end real estate, private equity, contemporary art, junk bonds) may suffer a correction.

During a visit to Japan at the end of September, I was impressed by the resilience of the Japanese economy and society, which has always had an extraordinary strength and cohesion in the face of adversity, earthquakes, tsunamis, defeat in war and recession. Essentially since 1990, Japan has been in a deflationary cycle; the interesting question is whether we have now seen the end of this cycle? And, if it is time to think about



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reflation or even inflation. In Japan, unemployment is 3%, but female participation in the labor force is now 74%, and or higher than the United States. The Japanese have managed far better than expected, in dealing with the demographic challenge of an aging society (one third of the population is over 60, and life expectancy is nearly 88 for women). Although national debt is now 200% of GDP, it is 40% owned by the Bank of Japan because of their large JGB purchases.

We are likely to have a coordinated write-off of international debt within the next few years, and Japan represents the leading trend in the monetary laboratory experiment. They have been more aggressive in their reflation policy, and on monetary easing, and it is therefore encouraging to see, that they are now optimistic about being able to emerge stronger from this long deflationary period.

What would a coordinated write-off of debt by the USA, Japan and Europe actually mean for markets and for investors? I believe that it is likely to imply higher real interest rates and inflation, as in the end, debt can only be depreciated by inflation (as happened after the World War Two for example).

After the US election, we will have higher interest rates in the USA, and a stronger dollar initially, as the Yen and other currencies weaken. Inflation will begin to pick up, and this will mark the point at which the Super Cycle of debt and deflation bottoms out, and we will start a new cycle of growth (by say, 2020). Navigating this difficult period ahead is the challenge for investors, I cannot help believing that gold is an important anchor, in a portfolio, as the value of different currencies is going to be so volatile during this period.



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The other striking impression among my Tokyo meetings was that Mr Abe who has just been re-elected with a large majority, is likely to get his wish to make a constitutional change, allowing Japan to increase defense spending above 1% of GDP. On the day I visited, Chinese fighter jets had again challenged the Japanese perimeter over the Senkaku Islands, north of Taiwan, which has certainly encouraged popular support for a more robust military stance by the Japanese government. Altogether, there are a number of factors (a weaker yen, dividend growth, more defense spending, reflation) which may favor Japanese shares in 2017.

Elsewhere in Asia, we expect that 2017 will be characterised by economic stability in China at a lower growth rate (5 to 6%), since the background will be dominated by the September 2017 meeting to re-appoint President Xi Jinping and new politburo members for the next 5 years. China's consumer and service sectors will continue to grow in double digits and our focus remains on healthcare, education, and tourism. Due to the political background, we do not expect any debt crisis in China in the immediate future.

All of the Asian exporters including South Korea, Taiwan and South East Asia will feel the chill wind of protectionism coming from the USA. That is certainly one reason why we are focused on the new Frontier economies but especially on India with its robust domestic market of over 300 million middle class consumers, and the notable improvements in transparency, governance, and business conditions under Mr Modi.

In India, we have investments in food and beverage, auto parts, media, private sector banks as well as IT and consumer staples. We have just completed research trips to both Pakistan and Vietnam. In Pakistan, we are focused on power generation, banks, cement, oil refining, fertilisers as well as consumer staples. Whether or not China's pledge to invest US\$46 billion into Pakistan's railroad, power and pipeline infrastructure all materialises, the outlook remains promising. The demographic and



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consumer trends so clear in India are also apparent in Pakistan, as well as Bangladesh and Sri Lanka.

In Vietnam, we have been very encouraged by our company visits, particularly in the healthcare, IT, consumer, dairy and fishery sectors. The Hanoi government has become more friendly to foreign investors, and the capital market is developing in a positive and encouraging way with improving liquidity and governance.

Is automation a risk for low labour cost in emerging countries? At what level of cost does it make sense for a manufacturer of textiles, shoes, cars, or other machinery to switch from human to an automated assembly line? Certainly Foxconn (a Taiwanese contract electronics manufacturer in Southern China) has indicated that it targets 30% automation in its factories by 2020. But elsewhere in Vietnam, India, Bangladesh, we do not believe that the economics make sense yet. There are, in fact, more concerns (according to a recent Oxford Study) that many office jobs in Europe and North America may become obsolete in the next 10 years because of advances in Artificial Intelligence.

By November, we will have a clear idea of whether the 30 years positive cycle, of globalization and free trade, is likely to be maintained. Our investment strategy is to position ourselves for every eventuality, including the possibility that some emerging markets may suffer from increased protectionism; however, as the chart suggests, there are signs that the commodity cycle is turning and the capital is again flowing back into emerging markets. Overall, we remain positive on the outlook for the Pacific region in 2017.



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## MSCI Emerging Markets relative to MSCI AC World Index



Source: CLSA, Bloomberg

There are also signs of bottoming out in the shipping industry: in certain commodities, (oil, perhaps: nickel, recently) as well as interest rates. Perhaps we can be optimistic about a 2017 “Reflation Trade” in the emerging markets especially in Asia.

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