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Thoughts from our globetrotting, wise friend, Robert Lloyd George. We were all taught about inflation and the impact of same. What is this phenomenon called 'deflation'? What are the implications for commodities (i.e. Canada)?

To share and learn. Questions, and particularly answers, welcome.

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February 6, 2015

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February 2015

Investment Outlook

<u>What Does Deflation Mean For Investors?</u>

The mood in Asia remains upbeat, we have had a series of meetings with companies in South East Asia, India, and Hong Kong which underline the strength of the consumer spending boom which continues to drive the region. Whether China's headline GDP growth is really 7% or a lower figure matters less than the continued strength of the capital outflow from China both in investment flows into real estate and international companies, and also the consumer spending reflected in the growth of tourism.

The crackdown on corruption in the Mainland has of course affected the Macau casino business and to some extend the retail sector in Hong Kong but we regard this as a short term blip in a long term growth pattern. We are now researching for internet and online businesses catering to the Chinese consumers. Although international investors have been transfixed by the recent US listing of Alibaba, there are plenty of other Chinese internet companies, which deserve investors' attention.

The international background remains deflationary with the competitive devaluation of, first, the Yen, then the Euro, with the ECB program of quantitative easing. After the dramatic 50% fall in the oil price, and then the sudden revaluation of the Swiss Franc, the question that investors have to ask themselves today is - what else is unsustainable? One answer maybe the current exchange rate of the Remninbi. It has been extremely steady against the US dollar for some time but China may see its own interest in having a more competitive exchange rate, made more compelling by the competition from Japan and Europe.

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The impact of deflation around the Asia Pacific region will be uneven. In many cases it is a "good" deflation in terms of falling energy and food prices, favouring the lowest cost producers, and stable cash flow businesses, which have strong brands, or strong market share. In other cases, deflation can be destructive, in terms of the value of property, or pressure on wages. This is the type of deflation we have seen in Japan since 1990, and to a lesser extent in Hong Kong, and some of the more high priced labour and property markets. We continue to be cautious on Australia, for example, which has not had a recession for 23 years, and where the combination of falling commodities prices, high property values and a rapidly devaluing Australian dollar could make for a steeper recession.

Both Indonesia, and the Philippines, appear to be in good shape, in terms of low debt ratios, young consumer populations and stable reforming governments. However, both countries, at a closer inspection, have fairly severe infrastructure problems. We have invested in the power, infrastructure, water and telecom sectors, believing that these will be an important areas, of steady growth and cash flow over the next decade.

Many of these factors are equally true of India. This week's rapprochement between Prime Minster Modi and President Obama may be of geopolitical significance, but it is as yet difficult to discern an investment thesis based on deregulation, or foreign investment and foreign trade (US has only US$93 billion of trade with India compared to over US$600 billion with China). There is no doubt about the potential for India, with a combination of a young population, and the economic reforms under Modi.

For India, the fall in oil prices coupled with very low wholesale price inflation has put pressure on the governor of the Reserve Bank of India to cut interest rates. Indian Rupee deposits still earn over 8%, and thus a fall in energy and food inflation, will give much more benefit to India, than to countries with zero rates. We expect more earnings upgrades for Indian companies.

While I was in Bombay last week, the Vodafone tax situation has been resolved sending a strong signal to foreign investors that India is now open for multinationals. This will probably include the large supermarket chains, such as Walmart and Carrefour. Retailing in India is still very disorganized, with less than 10% of food being sold in supermarkets. We also visited Tata Consulting Services (TCS), which is hiring 60,000 graduate software engineers this year, adding to an employee total of over 300,000. They are extremely competitive and are benefiting from the continued trend to outsourcing by US and European multinationals. (Indian software engineer salaries start at about US$6,000 per annum.)

Another example of rapid growth in the Indian consumer and financial sector is Yes Bank, which has come from a start-up in 2005 to a bank with nearly 600 branches and $1.5 billion balance sheet today. The growth in bank accounts in India is astonishing, having added almost 100 million new customers to the total banking system in the past year. Another area which is growing fast in India is e-commerce, and we visited Blue Dart, the logistics subsidiary of DHL, located near Bombay airport, which is also looking for 50% growth in the next year -- but sells on a high P/E multiple.

The major change in the world is undoubtedly the drop in the price in energy and we are now trying to identify the secondary consequences of this huge transfer of purchasing power from producers to consumers, estimated by some analysts to be worth US$1.7 trillion. One example of a sector which should benefit is travel and tourism, airlines, hotels and also restaurants. In the Philippines last week, we visited two major fast food chains. Of all the countries in the world where McDonald's operates, there is only one in which it has only not succeeded dominating the market, but it in fact soundly defeated by its competitor Jollibee, which has 80% of the fast food market. With 10 million expatriate Filipinos working overseas, many of the local chains, are taking their brands into the new markets such as Middle East, Hong Kong and North America.

We believe that 2015 could mark a new era in Asia with low oil prices, competitive currencies, lower interest rates, and new political leadership and policies in numerous countries including in India and Indonesia. We have studied the last two cycles when oil prices fell rapidly both in 1985/86 and 2008/09, and in both cases Asia significantly outperformed the USA and Europe. Japan may be one of the main beneficiaries although it is important to measure energy prices in Yen, rather than in US dollars, to measure the true effect.

For the launch of our BAMBOO Fund at the end of February, we are now putting together a model portfolio of both blue chip Asian businesses with strong cash flow and good dividend yield as well as some small cap names that benefit from this consumer theme.

What we are going to experience in the next ten years is something akin to the 1870-1900 period of deflationary boom -- a Schumpeterian Cycle of creative destruction stemming from advances in technology, especially the spread of the Internet, which has already had a dramatic effect in pushing down prices. In our view, this process still has a long way to go, with the cost of financial services being one example of further competitive deflation.

It becomes much more critical to be selective in sectors. Even in China, we have seen some manufacturing companies which are now moving from highly labor intensive production towards increased capital expenditure on automation. Wage costs in China have risen at 20% per annum, and it is now increasingly attractive for manufacturers to replace people with robots, especially for highly-skilled and miniaturized production.

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In conclusion we are now in a time of competitive devaluation, and deflating commodity prices, which will include not only oil and mineral prices (excepting gold which we believe will outperform as a result of falling confidence in central banks), but also, eventually, food prices. As use of ethanol in fuel declines, so the demand for corn will be affected. We expect corn, wheat, and soybean prices to fall; and this will, in turn, impact the value of farm land in Britain, America, and other developed countries which have seen a 10-year bull market in land prices and now probably a bubble.

The growing tensions in the Eurozone, recently as a result of the Greek election and the split between northern and southern Europe, will eventually (and perhaps within a year) result in the breakdown of the single currency and the failed experiment of a centralized European financial structure. One possible result would be the collapse of the Common Agricultural Policy, which also will impact land prices and farming income around the European Union, including the UK.

We are bullish on equities in some of our key markets, despite these deflationary trends. Much of the money which has been invested in real estate, land, and urban property in the past ten years, as we pointed out in our last investment outlook, will now be redirected into equities. We have seen this trend in China in the last six months, and we believe that it will also result in higher share prices in other markets.

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February 2015