



Lloyd George Monthly – Always stimulating and thoughtful. Another China property warning, with implications for commodities and Canada.

Questions and comments will be answered or forwarded.  
Enjoy!

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## LLOYD GEORGE ADVISORY

April 2016

### Investment Outlook

#### Could Inflation Return?

Our investment universe has been dominated for some time now by the idea of deflation in raw material prices, in wages, and, most recently, reflected in negative interest rates. Central banks around the world have done everything possible to re-stimulate both the volume and the velocity of money supply without, it seems, much result. As oil and other commodities collapsed in price last year, the deflationary wave appeared to intensify. Now that we have seen oil bottom out at \$26 -- currently trading at nearly \$40 a barrel -- we believe there could be a turn in the tide coming. Independent of raw materials, service sector inflation, and rents have been running at about 3% year on year increases. Services and rents account for 75% and 42%, respectively, of the core U.S. CPI basket. Growth in total employee compensation is now running at 4.4%, and we have just heard that California has passed legislation to increase the minimum wage from \$10 to \$15 over the next 5 years (and so has New York).

In the UK also, the “national living wage” has gone up to £7.20 an hour and will reach £9 an hour by 2020, or around the same level as Australia and France, which have a relatively high minimum wage. (By contrast, China ranges from \$1.25 to \$3 in the south.) Of course, raising the minimum wage itself does not guarantee more employment. It may, indeed, have the opposite effect, if employers are not willing to employ younger people at high rates; but the overall effect may be inflationary as central banks run out of ammunition. There will come a time when rates will have to rise again to reflect this underlying trend in inflation. This could be a surprise for markets by the



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end of 2016, which would prick the bubble in high-end real estate as well as other markets, such as art and collectables, which have benefited from very cheap financing.

We tend to favour those markets where real interest rates continue to be positive, such as India, because the rate of return on capital tends to be more attractive. In addition, the Indian government is now at the same stage as China was 15 years ago, starting on a significant infrastructure improvement and large capital spending. India's foreign exchange reserves have strengthened recently and, as a consequence, the Rupee has also moved up against the US dollar. Although it may be a bullish consensus that India looks best of all the emerging markets with lower oil prices, better business conditions and earnings growth (and least exposure to trade slowdown in China, Europe, or the US), it is also true that foreign investors have not yet made actual significant commitments to Indian equities, which are under-owned. We have the advantage of having the Val-Q team on the ground in Mumbai, and we are already fully invested in Indian midcap stocks, such as Britannia (confectionery), Zee Entertainment, Force Motors, United Spirits (Diageo have taken over management from Vijay Mallya, and it is a corporate turn-around), and Yes Bank. All of these are showing double-digit profit growth and strong recent share price performance.

India remains the key part of our Indian Ocean strategy, which also includes well-chosen companies in Pakistan, Bangladesh, Sri Lanka, Vietnam and Mauritius. Pakistan's current account deficit has narrowed by 23% and its index is trading at a PE of slightly more than 8, with a dividend yield of 6.8%. Bangladesh is a key beneficiary of World Trade Organization concessions for the pharmaceutical industry. All of these economies benefit from the continued lower oil price, as well as the stimulus provided by China's One-Belt-One-Road policy, which provides investment in regional infrastructure in order to use excess Chinese industrial capacity.



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Turning to China we are still cautious about the substantial risks that we see in the property market. There is over 50 billion square-feet of residential real estate space under construction -- far more than demand justifies over the next three years. The same is true in the commercial property sector, which has multiplied by 5 times in the past 10 years. The property developers in China have also substantially increased their debts and are now leveraged by 5 times debt to equity ratio. As we commented last month, house prices have risen 60% in Shenzhen and nearly 30% in Shanghai in the past 12 months. With the correction in the Shanghai and Shenzhen stock markets, money has flowed back into property; and there is a high degree of speculation. Although there has been a short-term bounce in residential property sales, we do not expect that this will last and continue to forecast a 2017 correction in Chinese property, which will have many consequences globally. The demand for raw materials will slump again. There will be risks in the Chinese banking sector. Some of the acquisitions being made by Chinese companies in overseas markets (Syngenta in Switzerland and Starwood Hotels in the US) may prove to be “a bridge too far” because the funding for these acquisitions may not be as strong as it appears.

We remain confident in our AIA holding, with its highly diversified exposure across Asia. Their value-of-new business grew 19% in 2015, underwriting a 39% dividend increase. AIA's solvency ratio is a 'best-in-class' 4.3 times and our management visit with the company in March confirmed that a fall of 10% in Asian markets would leave a 2% earnings impact. With earnings season now concluded, the tumult of 2015 seems to have had limited effect on our key Chinese holdings, such as Tencent, the fourth quarter revenue of which rose 45%, with an increase in messaging app users of 39%, driven in part by their 'WePay' online payment system. China Lodging, which has been a consistent performer for the Bamboo strategy, nearly tripled profits in the fourth quarter of 2015 and they have finalized their joint venture with Accor.



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Meanwhile, China continues to favour liberalisation. Minimum prices continue to be enforced for rice and wheat, but corn, which trades at a significant premium in China to the international market, is now having controls lifted. The Dalian Commodity Exchange's corn contract for May fell nearly 15% in the second half of March, in advance of China's removal of a policy that set a minimum price for corn produced by domestic growers. China accounts for half the world's corn stockpile and its present opening is significant for global prices, farmers and consumers.

We are, therefore, being extremely selective in our stock picking as regards China and Hong Kong; and we have reviewed all the names we own and pruned many of them -- for example, Netease, which has faltering user activity for both its PC and mobile games. Our stock picks in India, Australia, Japan, Thailand and the Philippines are all performing well. Tourism continues to dominate as an investment theme. Chinese tourists continue to spend, particularly in Korea and Japan. Our holdings in Airports of Thailand, Amorepacific and Kao all benefit from this trend.

We believe that the political background both in Indonesia and the Philippines is becoming more favourable for investors. In Indonesia, President Widodo has taken the first steps to turning around the economy, and both the market and currency have responded positively. The election in Manila in May will, we hope, result in a pro-business, and "clean" administration, which would also be favourable for investors.

There is, I believe, a change in investor perception in the past few weeks of the political risk overhanging markets in 2016. Donald Trump is very unlikely to become US president (or even Republican nominee). "Trust the People" as Abraham Lincoln used to say, and David Lloyd George often echoed the sentiment. They will eventually see through the phonies and the conmen!



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Equally, the opportunists led by Boris Johnson who favour “Brexit” on June 23<sup>rd</sup>, cannot make a convincing case against those who soberly argue that the UK economy may suffer a 10% drop in GDP as a result. (And the consequences for Europe may be even worse.)

Protectionism, and fear-mongering about immigration, cannot win against the solid improvement in economic and employment opportunities gained from having an open economy (even one which is subject to continuous technological and social change).

None of these issues are immediately present in Asian economies, which could, however, feel the chill wind of anti-free trade policies very quickly (especially China and Japan). The lingering threat may be that of re-armament, especially in Japan and South Korea, in response to North Korean belligerence, especially if the US, under new leadership, decides to withdraw its nuclear umbrella and forward military bases. North Asia could experience an arms race, which would be a poor prospect for long-term investors.

We, therefore, continue to believe that South Asia (India and its neighbours) represents the best bet for the next five years, based on demographics, economic growth, political stability, and underdeveloped capital markets relative to economies.

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