



LLOYD GEORGE MANAGEMENT

Investment Outlook for 2nd Quarter 2013

In this quarterly report we try to help our clients and investors look ‘beneath the surface’ of events, and see the underlying trends and stories, especially in Asia, which are not generally reported in the media, or by the investment houses.

With this in mind, we have just made an interesting journey to Ahmedabad, in the state of Gujarat. Historically, the Gujaratis were the leading traders and exporters of Indian products, since the Middle Ages. Today they are again occupying that role, building new ports on the coast of Gujarat, and under the leadership of the chief minister, Mr. Narendra Modi, following a dynamic and ‘can do’ policy of government and business partnerships.

The success of the Mundra port and of the outstanding road system, water supplies and plentiful electricity as well as the planned ‘GIFT’, Gujarat International Financial Centre all testify to the viability of his approach. The interest of Gujarat is that we hear from all reliable forecasters that the BJP will have a majority of seats in the Indian parliament in the 2014 election and that Mr. Modi is most likely to succeed as India’s Prime Minister. This would result in a dramatically pro-business shift and a dynamic change in India’s potential GDP growth and exports. Despite the short term concerns about the Rupee and political outlook, we remain bullish on India.

Our main investment theme does not change - it is the Asian consumer - and in one interesting interview with Mr. Kishore Biyani, Chairman of Pantaloon, and a guru of consumer trends, he echoed what many commentators on China are also telling us - that if you visit the fifty second tier cities in India, you encounter a very dynamic growth in young middle class consumers, who are, for example, eating more chocolate, more breakfast cereals, wearing more western women’s clothes (rather than saris) and also buying many more children’s products, including diapers and baby food.

By 2015, the middle class in India is expected to form over 50% of the population compared to 25% in 2003. These trends are similar to what we have seen in our trips to Indonesia, Malaysia and the Philippines in recent months. We studied with interest Warren Buffett’s decision to buy Heinz recently and tried to think about what the key criteria were for such an investment, and whether we could identify similar companies in Asia. Steadily growing consumer franchises with conservative financing, run by managers of the highest integrity with a good return on equity and re-investment for higher rate of return - these will produce better earnings and dividend growth in the future.

One company we recently saw was Jollibee, which interestingly, has 80% of the Philippine fast food market after twenty years competition with McDonalds, which has only 20%. Jollibee is now expanding rapidly into China. We also saw Gruh Finance in Gujarat which makes smaller

mortgage loans, around US\$10,000 but has the same highly-competitive, quality-conscious culture as its parent company HDFC (Housing Development Finance Corporation) which has long been our favourite core investment in the Indian market.

On the bigger picture, we venture no opinion about the U.S. sequester, nor of the durability of the Eurozone. We are, however, continually monitoring the grey area of Chinese economics and while we believe that the Chinese economy has recovered from its low patch in 2012, we continue to see a slowdown in the consumption of commodities.

Our 10-year view (since 2003), has been bullish on industrial metals, oil, gold and property. In 2013-2014, we see this trend peaking. Already many metals such as copper, zinc, nickel and iron ore have experienced a marked correction, as supplies have increased; and China's apparently limitless demand has also slowed down, with a sharp growth of inventories. This will have a very important effect on all world economies, especially the emerging economies in Africa and Latin America, as well as coal producers, such as Indonesia and Australia.

A continued world slowdown, reflected in commodity price weakness, is perhaps our biggest concern in the next twelve months. In addition we believe that the frothy asset inflation which is a global phenomenon (and encompasses such products as modern art) is most vulnerable in the area of high priced property in London, New York, Hong Kong and elsewhere. Writing from our corporate head office in Hong Kong, it is very apparent that the average price of residential property is now in excess of 10 times average incomes. Although it is reliably reported that 30% of high-priced apartments and houses in Hong Kong are sold to mainland Chinese investors, even this demand will eventually slow down, as it has done in the jewellery and watch markets recently.

In addition the policies of our new Chief Executive, Mr. C. Y. Leung, are not friendly to property developers and investors. We expect that the rapid increase in buyer stamp duty will eventually have a cooling effect on the overheated property market and are, therefore, generally underweight the Hong Kong property developers. As far as the commercial office landlords such as Hong Kong Land, Hysan, Swire Pacific and others are concerned, we believe that they have stable, if not fast growing, income and good yields. The question for anyone visiting Central district of Hong Kong is whether tenants such as LVMH, Bulgari, Chanel and Gucci etc. can really sustain a sales growth to cover their high rental costs. At some point, this business model too, must reach a phase of exhaustion.

This decade-long theme of "investing in the earth" also encompasses oil and gas. Here the equation is much more finely balanced - while demand in China, India and the emerging nations is certainly growing a steady pace, the possibilities of new supplies from U.S. fracking, from new fields in the Arctic, in Africa, and even in the Mediterranean, are all hard to quantify. The recent demise of the Venezuela dictator, Mr. Chávez, might possibly spell a recovery in production from that large supplier; and in addition Mexico, under its new president, has indicated that it will espouse a more foreign investor friendly policy in energy. Mr. Obama may allow the Canadian pipeline to proceed, and supplies could suddenly become quite plentiful, with the result that the oil price could fall by 10% or 20%.

China and India by contrast are desperately short of energy and China in particular has spent almost US\$500 billion in recent years in overseas investments, 50% of them in trying to acquire oil and gas assets, including the recent purchase of Nexen in Canada, a large shale oil deposit. The problem with these investments is that they require at least US\$85 per barrel to achieve a break-even level. An historic shift occurred in the past month, when China surpassed the U.S. as the world's largest oil importer, with an estimated 6.1 million barrels per day, compared to the U.S. total of 6.0 mbd (and falling).

Finally, there is gold, which is notoriously difficult to predict. We have held to the view that over the next three to five years it would be likely to rise towards US\$5,000 per ounce because of the vast and uncontrolled money printing by all the major central banks in the world. In fact one calculation gives a figure of US\$6,250 per ounce to enable the Americans, to "back" their large debt and money supply. On the other hand, the market depends on demand from the new rich in the world, including for example, the Indian wedding market which amazingly bought US\$56 billion worth of gold in 2012. The Indian government is trying to dampen down this demand by imposing new taxes and duties, but it is unlikely that the age old cultural preference of Indian brides will be changed overnight.

China too has liberalized its gold market and is a steady importer. The central banks around the world have decisively turned from being sellers (such as the UK, disastrously, in 1999 under Chancellor Gordon Brown) to being buyers, such as South Korea, Russia among others. There is definitely an apprehension that further inflation or global disorder may be in the pipeline, and many countries have, for example, repatriated their gold holdings, including Germany. We therefore believe that at the current level of US\$1580, gold is a good long term buy, but investment in gold-mining shares continues to be a very unrewarding proposition.

As we enter the second quarter, we are becoming more cautious about equities after the sharp rebound in the last few months. Unless share prices are supported by fundamental economic improvement and earnings growth, there is likely to be some disappointment for investors over the summer months. For us, this will present attractive buying opportunities in the good consumer franchises which we are discovering in Asia as well as in Latin America and Africa.



Robert Lloyd George
15th March 2013