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Monthly Investment Commentary – December 2013

When this monthly investment comment started in April, our first historical perspective was suggested by the passing of Margaret Thatcher. This weekend we have seen the death of another political giant, Nelson Mandela, at the age of 95. His greatness of character, in being able to forgive and show courteous respect to his gaolers and apartheid opponents, was a rare human quality which made him stand out in any continent, even in Africa. His life, like Margaret Thatcher's, is worth studying in detail to understand the healing power of time, and the strength of the human spirit to overcome apparently immovable obstacles and intolerable regimes.

We may perhaps meditate today on some of the apparently immovable regimes that still exist in the world from Cuba to North Korea (where the dictator's uncle has just been executed), to Iran and other Asian 'non-democracies'. In Myanmar, for example we have also seen a thawing of dictatorship in favour of openness. The influence of the international community, and the desire to trade and to benefit from the new wealth in the internet-dominated world, is a powerful incentive. There could be further surprises in the next two or three years, just as South Africa surprised everyone back in 1994.

We are again standing at new highs in certain stock markets of the developed world (Nikkei up around 50%, NASDAQ around +32%, Dow around +20% and the DAX up some 20% year to date). This has led developed markets in aggregate to outperform the emerging markets, which are flat for the year. We believe this trend is likely to be reversed in 2014 with India already experiencing strong recovery in its market and currency in the past three months. China has also seen some recovery, with strong trade numbers and improving PMI numbers.

One of the keys to the 2014 outlook will be the increasing currency volatility in the world as capital flows grow and accelerate. There is in fact greater stability in some of the less tradable currencies - the Renminbi being the prime example - than in the Yen, Euro or Sterling. The greatest volatility has been in developing countries with an open capital and current account, such as the South African Rand, the Brazilian Real, the Indian Rupee and the Indonesian Rupiah, where concerns about inflation, political developments, or current account deficits, have a very immediate impact on the foreign exchange market.

The US economy is healing quickly: unemployment is down to 7%, annualised growth is up to nearly 3.5% and the probability of the Federal Reserve tapering by the spring is increasing. This would imply that the US Dollar should strengthen in the next six months as interest rates normalise. We would also expect therefore that commodities, oil, gold and agricultural products will see weakening prices in US Dollar terms. We remain underweight therefore in the energy and mining sectors in our portfolios.

The outlook for earnings in the Asian corporate world is still restrained by rising costs, however, and we believe more than ever that stock selection will be the key to our performance.

The other implication of 'tapering', or a reduction in QE, will perhaps be a gradual correction in inflated asset prices, such as London and Hong Kong high end properties, art and even the 'Bitcoin', which has gone from $13 to over $1,000 in 2013. A return to normality seems probable and the unexpected consequence of tapering might be the bursting of bubbles including those in the Chinese and Hong Kong property markets. Our Hong Kong team think that a 20% drop in property prices may be possible next year.

China's money supply has grown faster than US money supply in the past five years and will need to slow down. It is estimated that China's real GDP trend growth, which was 9.2% in the past 10 years, since 2003, will fall to 4.2% in the next decade up to 2023. This will, for example, reduce the demand for copper from 12% to 3% per year in the coming years.

Notwithstanding this headline figure, we see great opportunities in the consumer space in China. Online shopping, for example, has soared this year. And one business which is growing rapidly is health and beauty, to which Hutchinson Whampoa has a large exposure through its subsidiary Watsons. We see Hutchinson as one of the most undervalued blue chips in Hong Kong. The listing of profitable subsidiaries can have a powerful impact on valuations, and this may also influence HSBC which is reported to be considering a listing of its UK subsidiary, the former Midland Bank.

We have long admired the veteran Wall Street strategist Byron Wein, who compiles "10 surprises",that might change the investment markets in the coming twelve months. We have referred above to the possibility of positive surprises in seemingly hopeless countries. The recent breakthrough of US-Iran relations is one major factor in global markets, which have been haunted by fears of a clash in the Gulf for several years.

Investors are also increasingly conscious of the potential for China-Japan conflict, as the Beijing government has recently announced an "air defence zone" over the disputed Senkaku or Diaoyu Islands. This is provoking tension not only with Japan but also with the US, which tested the overfly zone first, followed by Korea and Japan.

According to our source in Beijing, the Chinese Navy has for some time been operating under the assumption that a military conflict with Japan could happen soon. The new administration is confident and aggressive about such a conflict and this might seriously impact trade and market sentiment in 2014.

The end of the year is also a time when we might look within our Emerging and Frontier markets for the most contrarian and downtrodden sectors (on the 'Dogs of the Dow' thesis). The most striking divergence in 2013 was the internet group of stocks, which has risen 70% and is now on a PE multiple of 35 times, compared to the resources group, which has fallen 10% and is on a forward multiple of 12 times. As Warren Buffett says, 'I like buying quality merchandise when it is marked down'. We are not advocating major mining exposure, but we do see some areas where valuations are attractive. On the other hand, the technology sector is now sporting multiples similar to 1999, when the last great bubble in NASDAQ stocks was about to burst.

One piece of bullish news was the recent breakthrough in the WTO talks in Bali, which has resulted in a substantial relaxation of free trade regulations, which will benefit not only the advanced economies in their service industries, but also some of the developing economies both in agriculture and manufacturing. For investors, any advance in free trade is always a plus, and we predict that exporting countries such as Korea and Taiwan will experience a strong export recovery on this expansion in global trade.

The view from our Asian and Emerging Market team is reasonably upbeat as the US economic numbers improve and this will help Asian exporters to improve their earnings growth in 2014. We are also positive about the outlook for India next year, although the Bombay stock market has already anticipated Mr Modi leading the BJP to victory in the May 2014 election.

There will also be elections in Indonesia, and we are taking a positive view of Indonesia's economic outlook and stability. Currency weakness in the emerging markets is a concern, especially in the commodity related currencies. One of the key overweights in our Emerging Market strategy is Mexico, which we continue to see as having an improving economic and political situation; and benefitting not only from better US growth but also a more liberal investment environment under President Pena Nieto. We are much more cautious about Brazil, with higher inflation and a weak currency.

Seeing a slight improvement in the European situation, we are looking for opportunities in Eastern Europe but there are limited listed companies that meet our investment criteria.

Finally, we continue to be overweight in sub-Saharan Africa because of the steady growth in consumer spending and improvements in education and telecommunications, which give many opportunities for multinationals, as well as local companies, to expand sales.

We would like to wish all our investors a merry Christmas and a prosperous New Year.

R. Lloyd George

Robert Lloyd George
12th December 2013