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INVESTMENT OUTLOOK

July 2020

Will Inflation Return?
And, The Second Wave

At present, in the midst of the Covid Pandemic, nobody expects rising prices despite the enormous stimulus programs and Central Bank money printing in the US, Europe, Japan, and China. Yet we see pent-up demand, after the 3-month lockdown in retail sales, in auto sales and in housing sales. Money is freely available at a very low cost.

As Walter Bagehot famously remarked in 1860, "John Bull can stand a great deal, but he cannot stand a 2 percent interest rate," meaning that, when rates reached what was then a rock-bottom level for the UK, undue speculation revived in Turkish loans, Egyptian bonds, and other developing nations offering yields of 10% because of their poor quality credit history.

Today, speculation is reviving among day traders (the recent case of the bankrupt Hertz is one instance). In Hong Kong, plenty of zombie companies are traded at ridiculous share prices. Property, commodities, bitcoin, and unproven medical remedies for the virus, have all been punted. As we highlighted last month, the divergent realities of the economy and the stock market have been striking. Since the end of March, government money-printing is the main stimulus behind the

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market's exuberance (though to be fair, the unexpected revival in employment and retail spending has somewhat vindicated the optimism of investors).

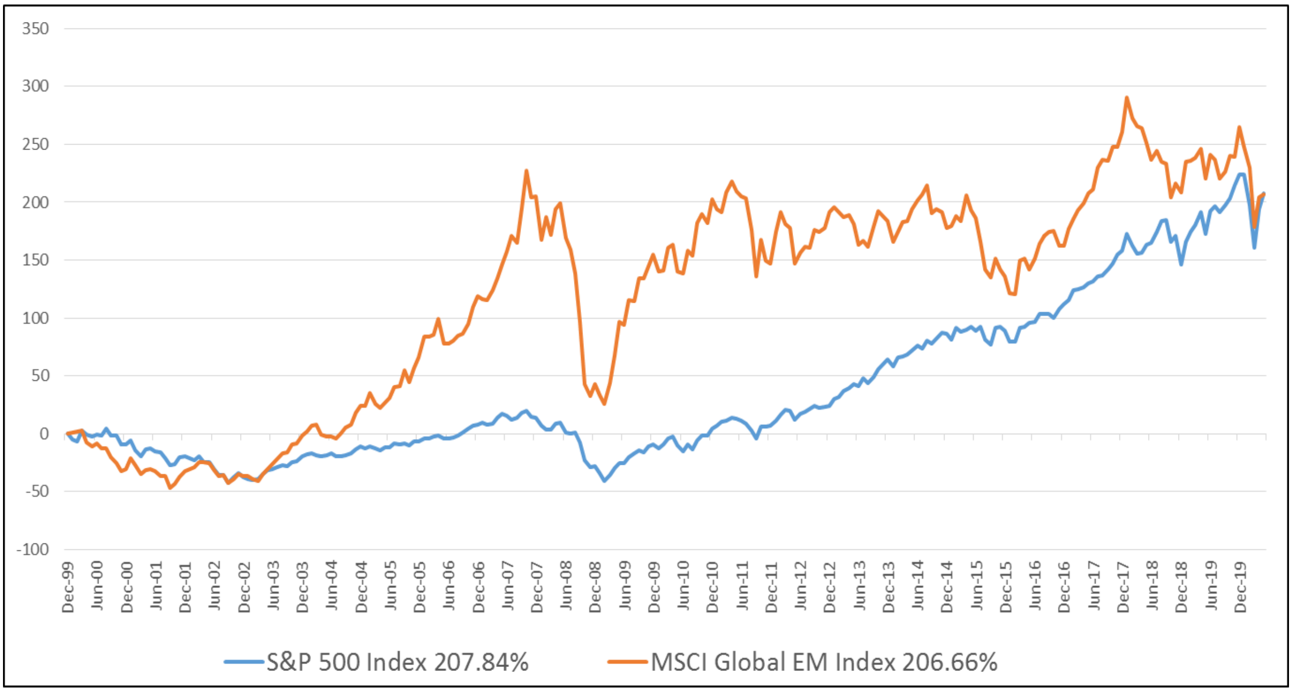
Russell Napier argues that the government guarantee, in Europe and the US, for bank loans will provide a trigger to finance consumption, and will produce 4% inflation by next year, though this is not yet implied by option or bond prices. Chris Wood ("Greed and Fear") also expects that the Fed's move to buy more junk bonds, and to do "yield curve control" may raise the potential for inflation readings to surprise on the upside. The Bank of England has implicitly underwritten the British government's spending plans, undermining the Central Bank's role to "lend, not spend." USM1 and M2 have risen 33.5% and 23.1% year-on-year, the fastest growth since data begun 60 years ago.

As for the second wave now occurring in Florida, Texas, Germany, and even Beijing (only about 300 new cases), there is an implicit commitment in the US and Europe not to shut down the economy again. We will, therefore, see numbers climbing again (now it is nearly 11 million infections worldwide and over half a million deaths); but, hopefully, the global economy will gradually revive and get back to its previous growth trajectory by the 4th quarter.

China was the "First In, First Out" major economy, and signs of a strong recovery in retail, auto, and housing sales are emerging. In particular, e-commerce is booming with the leaders, (Alibaba, JD.com, Suning, VIP shop), seeing sales grow between 20% and 50%. China's GDP will be in positive territory (+2% this year) after a sharp dip in the January-April quarter, though trade numbers may continue to be weak.

We want to focus on 2 important economies -- India, our favourite emerging market, and Vietnam, the top-performing frontier market. It is worth emphasizing that Frontier Markets total AUM has shrunk in the 6 years since 2014 from $50 bn to $5 bn. Emerging Markets have seen a $40 bn outflow this year alone. So the asset class is completely out of favour after nearly 10 years of underperformance.

Total Return Comparison S&P 500 Index vs. MSCI Global Emerging Market Index



Source: Bloomberg

But India (which has seen a $3bn inflow in the last month) has the best fundamentals compared to China, Brazil, Russia, Indonesia, and South Africa. It is a large domestic consumer economy, with a young population of approximately 1.35 bn. It has a democratic and pro-capitalist government under Mr. Modi, dedicated to streamlining bureaucracy and cleaning up corruption. It has a closer relationship today with the US and Europe, and Foreign Direct Investment is growing rapidly, doubling from USD 35bn in 2011 to USD 73bn in 2020. Investment was strong in manufacturing, communication and financial services – the top three industry recipients. Notable megadeals included the acquisition of Flipkart, by Walmart (United States) and more recently an investment of USD 5.7bn from Facebook into Reliance Jio platforms. The Rupee is stable, and the fiscal and trade deficit are reasonably under control. The Pharmaceutical industry (23 listed companies) is making rapid progress and partnering with US and European industry leaders, as many essential products will be "reshored" from China. We see considerable potential in the growth of the e-commerce market in India, which is still only 3% of total sales (40% in China). Reliance JIO is the leader in this sector. The Indian financial sector continues to lead the market (30% of market cap) led by industry leaders such as HDFC and Kotak Mahindra. Finally, our core conviction remains that the Indian consumer will boost spending as incomes grow – Hindustan Unilever, Nestle, Britannia, being among our core conviction positions.

Vietnam, meanwhile, has come out of the virus better than any other ASEAN nation -- only 300 cases. The economy will grow 5% in 2020 – almost the best in the world. Foreign multinationals – Samsung, Apple, Nintendo, and Google – are all moving manufacturing to Vietnam. Factory construction is booming. A very young population of 100 million has a thirst for education, for self-

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improvement, for better opportunities. The government is pro-business, and is fast tracking $10 bn worth of infrastructure investment including a North South Highway, 2 metro lines, and a new Ho Chi Min City (Saigon) airport.

Thailand is also coming out strongly from the virus, despite the sharp fall in tourism. Medical tourism will benefit as evidence of the high quality of their hospitals is underlined. Most of South East Asia (Indonesia, Philippines, Malaysia, Singapore, and Vietnam) also depends on tourism, which accounts for 10% of Global GDP, and millions of service sector jobs. So this will depend on when tourists from Europe and China overcome their fears of infection to venture overseas again.

Meanwhile, the US dollar is showing definite signs of peaking, as the prospect of a Trump defeat in November, a second wave in the south, and a weakening geopolitical position, impact investor sentiment. This could eventually result in 2 or 3 years in a more severe currency crisis – and a surge in the gold price – in the aftermath of the pandemic.

Meanwhile, our advice to investors is to focus on Asia, the best region in the world for economic growth and political stability, which will outpace all other regions of Emerging Markets in the coming recovery.

R. Lloyd George

Hong Kong
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