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INVESTMENT OUTLOOK

February 2021

RECOVERY AND REFLATION

As the Chinese New Year approaches on February 12th, we are trying to discern the trends in the year to come. President Biden has set out important new policies in his first 2 weeks, including a US\$1.9 trillion reflation package, and a continued tough line on China, both on trade and human rights. Xi Jinping has responded at the Virtual Davos by proclaiming his belief in free trade and openness, while, at the same time, putting military pressure both on India and on Taiwan. Meanwhile, markets continue to discount a rapid economic recovery from the Covid pandemic. In Asia and Australasia, ironically, the travel and lockdown restrictions are far tighter than in the USA and Europe, although there have been, for example, only one case in Singapore and only one case in New Zealand in the past 6 months. Southeast Asia will continue to lag behind the economic recovery of China as long as travel restrictions are in place.

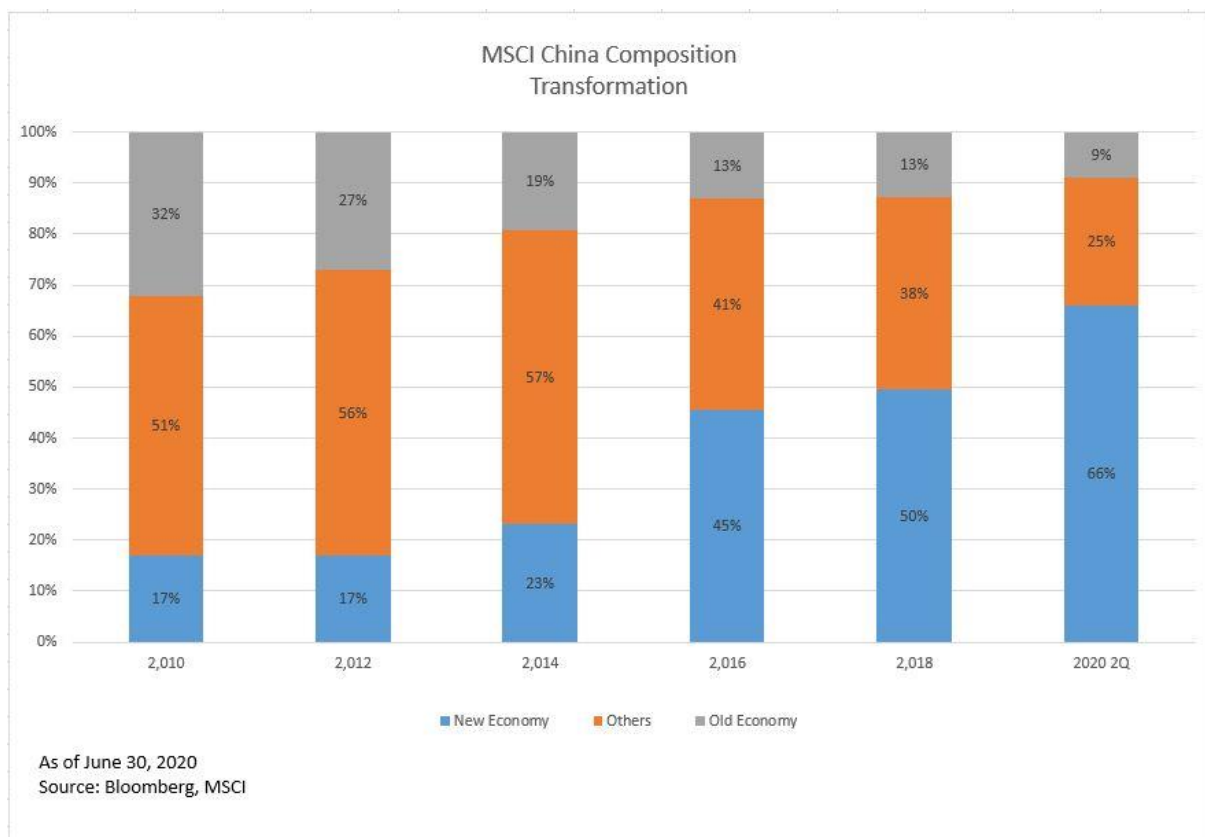
By contrast, India has had a strong recovery, with an 85% decline in Covid new cases and fatalities. A massive rollout of the vaccine is underway in the 1.4 billion population of India, which has a median age of 28. We see a strong recovery in the property market in India, and we have recently added Godrej Properties to our Indian Ocean Fund portfolio. Interest rates are low, in real terms, in India; and the need for new housing is pressing. This will also benefit the private sector banks, which we have long maintained as core positions – HDFC, ICICI Bank, Kotak Mahindra, as well as State Bank of India, which we have added in the past few months. Indian housing affordability is at the lowest level for



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nearly 20 years. We also see potential for recovery in both Singapore and Hong Kong property sectors, although these will also depend on a reopening to trade and travel.

In China, the striking fact is that the technology sector has increased from 17%, a decade ago, to 66% of the MSCI China Composition today.



This is an even more extreme ratio than in the USA, where the famous FAANGs are now about 15%, and technology is 28%, of the S&P 500. The question is really, how long will it take for vaccines to be rolled out, whether they will be successful against the new variants of Covid, and whether life will return to normal by this summer. If so, then the on-line businesses may suffer a slowdown as old line cyclicals - retail, hotels, restaurants, airlines, and trading businesses - recover their growth and profitability. Our best guess



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is that the technology sector continues to outperform on profitability. As Howard Marks has recently outlined in his interesting paper on growth and value investing, these are businesses with few capital costs, or tangible assets, but a high return on equity. We have, therefore, not touched our core positions in Bilibili, Shenzhen Innovance, and Wuxi Biologics, which constitute 22% of our portfolio. In addition, we are increasing our exposure to semiconductors, or DRAMs, both through Taiwan and South Korea, where, in addition to Samsung Electronics, we are investing in SK Hynix, the second largest semiconductor manufacturer.

The outlook, moreover, for emerging markets, relative to the US market, remains very promising, both in terms of valuations, and of earnings growth.



Source: Goldman Sachs

The discount to US equities has now reached the lowest point since 1999, at 47%. As we have often commented, over 70% of emerging markets are accounted for by China, South Korea, and Taiwan today, with a heavy technology component. This year, we'll see the



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rollout of 5G in China and in the USA, with 100 times the speed of 4G, which was introduced in 2010. Many smaller technology companies will benefit, in both major markets, from this development, which is likely to last for the next 5 to 10 years, and involve US\$17 trillion of investment in many areas, such as self-driving cars, the internet of things, Artificial Intelligence, and remote telehealth.

While the opportunities for earnings growth in China and India remain very attractive, the risks in the broader US market, are also worth considering, since they will impact global markets. There is a very high level of speculative activity, which is typified by Bitcoin, Tesla, and small cap stock activity. The real risk is that there may be a sudden reappearance of inflation. The new president has swiftly moved to raise the Federal minimum wage to \$15.00 an hour. Commodity prices are rising fast, particularly natural gas, and also palm oil prices in Southeast Asia. The Baltic Dry Index has surged 63% in the past 2 months. There may be many supply shortages after the pandemic ends, and pent-up demand for many consumer sectors and products. We, therefore, are of the camp that believes inflation can surprise by rising to 3% or 4%, instead of the Federal Reserve's preferred rate of 2%. Interest rates would have to rise, by the end of this year, to respond to this development. The other risk is a deterioration of US-China relations, particularly with regard to the Taiwan question, which has become more pressing - and Biden has followed Trump's lead in maintaining close relations with Taipei.

All of these are rather theoretical, and remote, risks at the present moment; but as the New Year of the Ox begins, we are conscious of the fine balance of risk and reward. This is one of the reasons why we are focusing on a conservative fund structure, such as the Pacific Income Fund, which will comprise 50% of Japan and 50% the rest of Asia, focusing on high-yield, low price to book names, such as Mitsubishi, Sumitomo (of which Warren Buffett has bought 5%), and also CK Hutchison, Jardine Matheson, and some high-yield



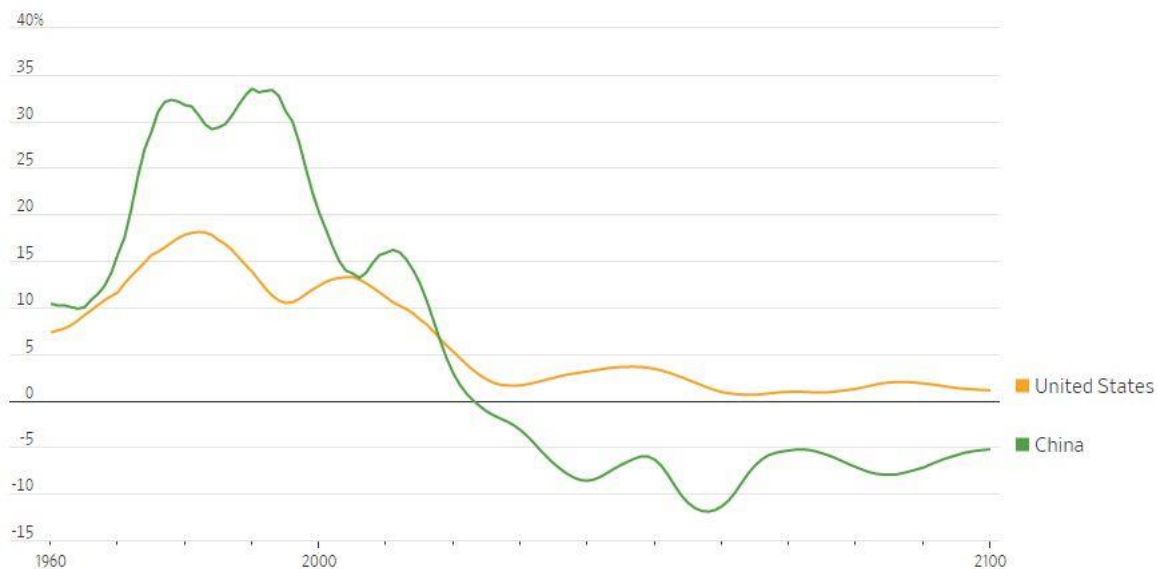
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names in Korea, China, and Southeast Asia. The two-tier market, between technology and the old cyclicals, will likely change this year, with a return to value and dividend yield.

After a record return in 2020, we are cautious about how long this rate of return can last. As one commentator put it, “Who would have predicted a US equity market return of 18% in 2020, in the face of nearly 25 million Covid infections, and over 420,000 deaths, an estimated GDP decline of 3.5%, earnings decline of 17%, and unemployment of about 11 million?” This year, the risk may be that, once we return to normal, the market itself will correct on the arrival of good news.

Predictions that China will overtake the USA by 2026/2030 are, perhaps, premature, given the demographics and productivity trends, which show a decline in China’s Total Future Productivity from 2.8% to 0.7% in the past decade.

10-year population growth of 20-65 year olds



Note: Data from 2020 onwards represent projections
Source: United Nations Population Division



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Nevertheless, we are bullish in Chinese technology and healthcare companies, which have powered our performance for 2 years.

In conclusion, we remain positive about the outlook for the Asian economies and markets, and wish our investors and readers a Happy Chinese New Year.

R. Lloyd George

Hong Kong

1 February 2021



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