Marlborough Asian Equities

Marlborough
Fund Managers

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Introduction

Each year the Asian team prepares a matrix of themes which it believes will impact markets over the coming 12-18 months. Some of these are multi-year, multi-country themes, whilst others will only impact a single country. We also consider those which generate clear ideas to avoid, which might stem, from (say) changes to the political system, competition or disruptive technology.

For each theme, we estimate a time horizon within which it might occur, trying to identify the specific sectors and stocks which might be impacted, both positively and negatively. We select a 12-18 month time horizon, as the furthest one can reasonably forecast with realistic accuracy. Lastly, we always include one or two "wild card" themes, which have the potential to be massively disruptive, but have an unclear probability of occurrence. These themes are overarching ideas which can lead us to a particular vein of research, or provide an overlay for existing and proposed holdings within the fund. The fund is not constrained to solely invest within these ideas, but we have found that this exercise has added substantial value throughout the years. We have included 2018-19 Themes in the Appendix. Previous years are available on request.

Review of the 2018-19 themes

Many of the themes we expected to arise in 2018 came to pass, although volatility in markets meant that few stocks were able to benefit consistently from them. Oil did trend in the $50 to $80 range, as anticipated, but then fell back so sharply at year end that much of the benefit was undone. Heavy pollution and attractive relative pricing drove Asian governments to seek far more gas than ever before and our portfolio benefited from holdings in CTCI, CIMC Enric and Power Grid in Taiwan, China and India respectively.

Our wild card theme of Korean rapprochement proved more perceptive than we could have hoped and led to exceptional performance in holdings in Hyundai Engineering & Construction and impressive relative outperformance against local indices by IBK and KEPCO. In 2019-20, we expect both of these themes to broaden and deepen. We had thought that rising rates might lead to policy errors, but we did not expect the raft of policy mis-steps in Beijing which led the Chinese economy to cool far faster than expected, as credit was withdrawn from Peer to Peer lenders. However, the theme did lead us to avoid the most egregious performers in the consumer discretionary sector, as auto stocks fell by 28% on average in USD terms and Tata Motors and Geely fell by 63% and 48% respectively and we avoided most auto players entirely. Slowing demand in China in 2018 outweighed the growth expected in cost-reduction strategies, but this multi-year theme from 2017 remains a feature of our thinking.

2018 was a year which saw the MSCI Asia ex Japan index overall fall by 14.46% in USD terms, so some stocks chosen for their thematic appeal outperformed, but fell anyway. The following are a few examples of successful stocks held in the portfolio in 2018 as a result of our thematic research:

Successful Stocks 2018

Stock	Theme(s)	2018 Total Return in $
Hyundai Engineering & Construction	Korean Rapprochement	+44.5%
CTCI	Gas Comes to Asia	+2.6%
DNL	Elections, Rising Rates	-3.4%
China Railway Signalling	Xi consolidates the world	-7.0%
MSCI Asia Ex Japan Index In $		**-14.46%**

Disclaimer: The stocks and ideas mentioned in this report should not be construed as a recommendation to buy or sell anything. This document is intended only as an illustration of the investment themes likely to prevail in Asia over the coming months and is based on our views at the time of writing. Opinions expressed are those of the Asian Equity Investment team and are subject to change without notice and do not take into account the particular investment objectives, financial situations or needs of individual investors.

Over the coming pages, we will explain the themes which we expect to impact the markets this year and those which we identified last year for comparison. 2019 begins with highly volatile markets, as increasing evidence of the rapid economic deceleration in China forces earnings downgrades everywhere and fears over the possible outcome of trade wars increase. Rising rates and high debt remain a problem globally, but in Asia, some countries will see these mitigated by pre-election pump-priming. As we expect Brent crude to trend between $55 and $75, most countries will see inflation pressures ameliorate. Trade looks likely to remain in focus all year, with large treaties starting and Asia increasingly seeking to trade with itself, rather than the problematic European Union or belligerent US. Whatever the result of US-China trade negotiations, companies are relocating from China to the rest of the region, especially ASEAN to escape tighter political controls and higher wages, which looks likely to boost industrial estates and makers of industrial equipment. The tech bubble in markets thoroughly burst in 2018 and many stocks are now heavily oversold, but the reality is that usage of the Internet of Things continues to deepen in our everyday lives, so we anticipate ample opportunities for investment in workplaces, homes and public spaces. Several of these themes should coalesce as India finally tries to tackle air pollution. It is notable that this year our Themes seem relatively upbeat, in contrast to our Asset Allocation expectations, which suggests that 2019 should be a good one for stock selection.

Theme Descriptions 2019-20

Global backdrop

With the Chinese economy faltering and the US economy showing signs of ageing, we expect the US Fed to raise rates only twice in 2019. Should the trade wars deepen, and China begin to flex its muscles in the US treasury market, even that may be difficult. This is likely to generate a softer year for the US Dollar, but not necessarily a weakening against Asian currencies. Constrained by high debt, whether in the household or the corporate sector, Asian central banks are already reluctant to raise rates and are likely to postpone until the differential vs the USD becomes too great. Some may have missed their chance and might now be unable to raise without severe political and economic damage. Any pause is likely to generate large rallies in HK-China, Singapore and the Philippines. In Europe, as soon as agreed Brexit terms are certain, we expect both the Pound and the Euro to rally strongly against the USD. The rise may be short-lived, but could be considerable, with Sterling potentially returning to the 1.45-1.50 range. If the Fed pauses in its rate normalisation at the same time, the rally could prove more sustainable. With around a third of Asia's exports destined for Europe, this will benefit exporters who have been badly wounded by Sterling and the Euro's falls of 2017 and 2018, particularly Taiwan. The Renminbi looks likely to be exceptionally weak in Q1 and probably for much of the year, but as 2019 is the 70th anniversary of the founding of the PRC, we expect it to be supported to rally again by year end. All regional currencies are likely to mirror its moves to some extent and its weakness is likely to damage Taiwan extensively. Tourism globally will suffer as the Rmb falls. The world seems to be on the edge of a precipice of corporate debt, with China, the US and the Philippines closest to the edge. If the US does raise rates more rapidly, then a wave of defaults may begin across the Belt and Road countries. Economic weakness is likely to lead to repeated rumours of and actual stimuli, although we expect these to be smaller than those in 2008-9. We expect oil to remain somewhat weaker than in 2018. Global demand is likely to be softer, capped by rising rates and slowing Chinese and US economies. Supply looks likely to remain relatively robust, as agreement amongst OPEC members still appears difficult to achieve. Consequently, we expect Brent to trend in a range of $55-75. This should be helpful to Korea, India, Taiwan, Indonesia and Thailand.

Major Themes

Further opening in North Korea

Progress towards more normal relations between the two Koreas has continued steadily throughout 2019 and the media's exclusive focus on the US-Chinese trade war has given helpful cover for negotiations to continue out of the lime-light. As the global economy softens, the need for new sources of growth will become more urgent. A 2018 summit between China, South Korea and Japan estimated that USD2trillion worth of infrastructure would be needed to bring the North up to acceptable modern standards of living. Kim Jong Un remains favourable towards the concept of denuclearisation, so we expect this theme to continue to broaden and deepen in 2019. Countries remain suspicious of the true intentions of the DPRK, so we expect progress to be incremental, with occasional bursts of higher-profile activity. Beneficiaries are South Korean infrastructure and engineering companies, South Korean family entertainment content providers, selected banks and heavy industrial companies in the RoK. In China, heavy engineering companies and North Eastern province entities are expected to benefit most. Steel, cement and heavy industry will begin to benefit once construction begins in earnest. The greatest loser from the opening up of North Korea is expected to be Vietnam, which has become a centre of South Korean outsourcing in recent years. As South Korean money represented 40% of stock market inflows into the HOSE Index in 2017, the broadening of opportunities to invest in the North's revival is likely to cause a heavy outflow from Vietnam.

Further growth of gas in Asia

With a stable Oil-Gas Spread expected, pressure from the US on every country to buy US shale and heavy oversupply from Australia, Asian countries are expected to accelerate the usage of gas again in 2019 (China alone expects to double gas usage by 2024). It produces lower emissions than coal and as the usage of electric cars grows, gas-fired power plant are likely to incrementally replace coal in many countries. Almost all purchases now are done on contract, but China hopes to establish a trading hub for LNG in Shanghai and settle in Rmb, shifting the currency toward a petroYuan status. These trends should provide Asian LNG transporters and equipment manufacturers with the opportunity for substantial improvements to revenue over the next few years, but will substantially change the relationship between the petrochemical crackers, depending on whether they utilise gas or oil. As Floating LNG (FLNG) has the potential to both release stranded assets and allow floating regasification, companies supplying this sub-sector may do very well. Storage in China stands at just 3% of national consumption, so this sector should also benefit. Positive for LNG carriers (MISC, COSCO Energy, CIMC Enric), pipelines (Kunlun, Petronet, Indraprastha Gas, Gujarat State Petronet, Petrochina), regasification facility builders (CTCI) and owners (Enric). Negative for heavy polluters and coal companies.

Solid growth in the IoT

With the hype over, it is time to invest in deepening the Internet of Things (IoT). Catalysed by the manufacturing diaspora from China, tight employment markets and rising interest rates, connected work places and public spaces will allow North Asia to cope more effectively with its ageing population and rapidly rising wages and build out manufacturing hubs across ASEAN. Beneficiaries include industrial equipment makers like Advantech, Hiwin, Ennocon, Airtac, etc; Hub /antennae manufacturers (eg Sercomm, Wistron Neweb, etc) and sensor makers; labour-saving items (eg E-Ink).

Multi-year themes

Indian environmental clean-up

India's air quality is now worse than that of China, even at the latter's most polluted. The Modi government has paid lip-service to the need for action to stem pollution, but as yet followed through with few credible policies to make much change. Now, however, the need for action has become imperative. Unpopular measures are precluded until after the election, but there should be a steady advantage for companies whose products help reduce pollution. Beneficiaries could be electric cars, charging network equipment providers, gas pipelines, gas. Losers will be coal miners, coal-fired power plant, steel companies, ICE cars.

Chinese Manufacturing diaspora

Tightening credit, more authoritarian control and rising wages have all been pushing companies out of china for some years already. The US-China trade wars have proven the final straw for many and businesses are seeking to relocate to avoid Made in China on their products. ASEAN seems to be the prime beneficiary so far. Demand for industrial estates, manufacturing machinery and other items is buoyant and likely to last for many years. India is also seeing some benefit, although the impact on the local economy is less pronounced. Beneficiaries include companies like Ennocon, Hiwin, Airtac, Advantech, Amata, Pakuwon Jati, etc.

Turning Japanese

Several countries in Asia have similar demographics to Japan, with rapidly ageing populations and some, having cut rates to ultra-low levels, may have missed their chance to raise (Taiwan, Thailand, China and Korea). The anticipated rises in US interest rates this year look likely to catalyse this theme. Thailand and Korea find themselves saddled with very high personal debt and increasing competition for their industrial capabilities from neighbouring countries. The Chinese manufacturing diaspora is benefiting Thailand at present, but with unemployment close to 1%, it looks most Japanese of all. If North Korea opens up, the South may avoid this trap, but it too sees its economy hollowing out to surrounding countries (mainly Vietnam and the Philippines).
For China, household debt remains low enough to sustain the economy at present, but high wages, tight credit and political policies are already pushing employment elsewhere, creating a similar hollowing out. We expect the process to progress similarly to that of Japan, favouring companies that can increase overseas distribution of their products (especially in the faster-growing EM world); shift up the technological value chain or provide products uniquely suited to the shifting demography (eg adult-care products). Deleveraging will take years, leaving banks under increasing pressure. Inbound tourism may offset some of the fall in consumer sales and generate demand for holiday homes. Beneficiaries include companies like Anta, Haier, Amata, WHA Corp, Xinyi Glass, Hana Microelectronics, Thai recruitment and personnel firms, convenience stores, Hengan, Taisun, LG H&H, DSG. Losers include traditional retailers, esp. department stores, banks, property, nursing homes.

Fortress Asia

As President Trump's attacks on America's trading partners have become more strident, Asian countries have accelerated their efforts to conclude negotiations and sign a series of major trade treaties. CPTPP covers China, Japan, Vietnam, Singapore, Malaysia, Australasia, Canada, Mexico and Chile and encompasses 13% of global GDP. This has been signed and ratified and came into effect on 30th December 2018. The Regional Comprehensive Economic Partnership (RCEP) is in its final round of negotiations, having started in 2010. With US-China trade wars accelerating, countries which had previously been dragging their feet, are scrabbling to agree terms. Following a highly positive statement after the November summit in Singapore, the treaty may be finally agreed in H1 2019. This treaty covers 39% of the global GDP (worth c US$45trillion) and 3.4bn people. As US trade wars and Brexit sniping intensify, we also detect an increasing tendency across Asia to turn its back on America (and on Europe to a degree, too). Companies are looking to increase their exposure to fast-growing Asian countries and lessen that in more problematic "Developed" countries.

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Themes for 2019-20

MAJOR THEMES	COUNTRIES	TIME HORIZON	STOCKS/SECTORS
Further opening in North Korea	North and South Korea, China, Vietnam	Q1 onwards	**Positive:** heavy engineering, steel, construction, infrastructure, selected banks, noodles, low end cosmetics, stock brokers, machinery, equipment, tourism, airlines(?), LG H&H, Kolmar, Cosmax . Negative: Vietnam,
Further growth in Asian gas	All, but especially Korea, China, India, Indonesia,	Q1 onwards	**Positive:** LNG carriers (MISC, Enric, COSCO), LNG shipyards (COSCO, Samsung Heavy, Hyundai Heavy, H. Mipo, Keppel, Sembawang), pipelines (Indraprastha Gas, Gujarat State Petronet, Petronet), gas-fired crackers, gasification facility construction (CTCI), PGAS, AKR Corpindo. **Negative:** Coal stocks, coal-fired power plant,
Solid growth in the Internet of Things	All, esp Taiwan, China, Korea, Thailand	Q2 2019 onwards	**Positive:** Hubs, connectors, sensors, industrial automation, ESL,
MAJOR/MULTI-YEAR THEMES	**COUNTRIES**	**TIME HORIZON**	**STOCKS/SECTORS**
Indian environmental clean-up	India	Q2 onwards	**Positive:** EV charging stations, gas pipeline, LNG gasification, LNG carriers, **Negative:** Coal, Coal-fired power
Chinese manufacturing diaspora	China, Vietnam, Thailand, Cambodia, Indonesia, Taiwan, Philippines	Q4 2018 onwards	**Positive:** Industrial estates, machinery and equipment, automation, personal consumption in recipient countries, Amata, WHA Corp, Jababeka, Bekasi Fajar, Pakuwan Jati,
Turning Japanese - countries that missed their chance to raise rates and now can't do so without damaging the domestic economy	Thailand, Taiwan, Korea, China	Thailand, Taiwan and Korea Q1 2019 onwards; China Q4 onwards?	Domestic manufacturing production hollowing out, retail sales buckling under the weight of lower demand (due to both debt and age) and internet shopping, bank loans eroding. Positive for labour-saving products, companies with overseas distribution (Xinyi Glass, Anta, Haier, etc).
Fortress Asia	All	Q1 Onwards	**Positive:** ASEAN and wider Asian region **Negative:** Importers of US / European products
MINOR THEMES	**COUNTRIES**	**TIME HORIZON**	**STOCKS/SECTORS**
Elections	India, Thailand, Indonesia, Philippines	Q1 onwards	**Positive:** Low-end consumer items, alcohol, infrastructure **Negative:** currencies where fiscal deficit targets missed because of this.
WILD CARD THEMES	**COUNTRIES**	**TIME HORIZON**	**STOCKS/SECTORS**
Rapid end to trade wars, globally coordinated monetary and fiscal easing, probably consumer-targeted	All, led up by US and China	February to March 2019 announcements	**Positive:** all, but especially tech, property, autos, consumer discretionary **Negative:** Insurance, banks, gold, utilities, telco, staples
Xi Jinping's power curtailed?	China	End 2019?	Potentially very disruptive, but ultimately positive for whole Chinese stock market. Most positive for financial stocks.

APPENDIX: Themes for 2018-19

MAJOR/MULTI-YEAR THEMES	COUNTRIES	TIME HORIZON	STOCKS/SECTORS
One Belt, One Road (Xi consolidates the world)	China + 65 countries globally. In Asia this should be positive for Malaysia, Thailand, Myanmar, Indonesia, Philippines and Pakistan and negative for Taiwan, Korea and Singapore	Q2 2017 to 2025	**Positive:** Machinery / Equipment companies, Doosan Infracore, Sany Heavy, Doosan Corp, port machinery, airport equipment, ST Engineering, SIA Eng, STATS, trade software, Sinosoft, trade financiers, cement, steel, aluminium, Rusal, bulk commodities, railway carriages & signalling, CRSC, Hollysys. Legal, clean commodities, Chalco, C Moly. **Negative:** Taiwan, Korea, Singapore, banks which compete with AIIB, overtly political stocks, companies doing "national service", environmentally undesirable products, railway tracks
Gas comes to Asia	Korea, Taiwan, China, Malaysia, Indonesia, Thailand, Myanmar	Q4 2017 onwards	**Positive:** LNG transporters, CIMC Enric, shipyards, Samsung Heavy, Sembcorp Marine, Keppel Corp, equipment companies, power stations, electricity grids in India **Negative:** Upstream gas providers, companies with revenue linked to falling gas prices.
Rising Interest rates	All, but most negative for corporates in Thailand, India, the Philippines and households in Thailand, Singapore and HK.	Q1 2018 onwards	**Positive:** undervalued cash-rich targets of M&A, companies capable of asset sales, restructuring candidates, cost reduction strategies **Negative:** companies prone to rights issues, consumer discretionary spend (eg large-ticket items and consumer-facing "green" items), SME banks, 2nd tier banks, manufacturers of capital-intensive machinery which is not labour-saving
Saudi Aramco float supports the oil price	All	Q4 2017 to Q4 2018	**Positive:** oil producing countries: Malaysia, Vietnam, Indonesia, Myanmar, Thailand. +ve oil services companies, Singapore, rubber, tyres, CPO, sugar, food prices, TSRC, Gajah Tunggal, SEAT, Apollo Tyres, Nexen Tire, Indian EPC, **Negative:** oil importing countries: Korea, Taiwan,
MINOR THEMES	**COUNTRIES**	**TIME HORIZON**	**STOCKS/SECTORS**
Elections	Indonesia, Thailand, Malaysia, India (2019) and Philippines (2019)	Q1 2018 onwards, Indonesia, Malaysia, Thailand, India, the Philippines, in that order.	**Positive:** infrastructure stocks in Indonesia, Thailand and the Philippines, small consumer discretionary in Thailand and the Philippines, Housing and rural stocks in India **Negative:** telecom operators, utilities, luxury sectors
WILD CARD THEMES	**COUNTRIES**	**TIME HORIZON**	**STOCKS/SECTORS**
North Korea	North and South Korea, China	Q2 2018 onwards?	**Positive:** construction, cement, machinery and equipment sectors **Negative:** defence equipment, "national service" companies in S Korea
Markets fail to rotate	All	Q1 to ????	All. Winners from 2017 get more expensive and markets narrower.