December 2018

Monthly Commentary

Asian Monthly Roundup

- Asian equities rise on hopes of easing trade tensions and Fed's dovish comments
- Oil price fall hurts energy sector, while oil-importing markets gain
- Chinese markets recover, tech stocks aided by **Tencent**'s improved earnings
- Japan weakens on economic contraction and concerns of further weakness

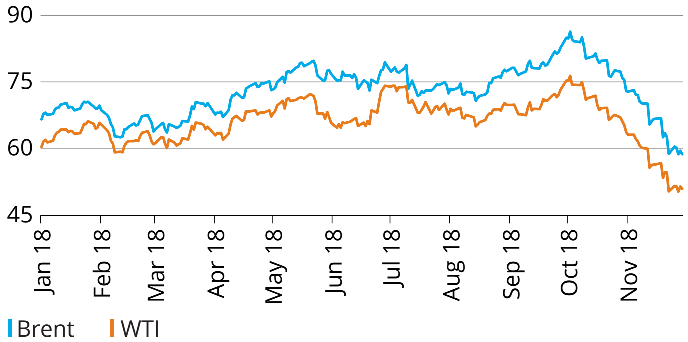
Asian equities rebounded in November. While the G20 summit closed the month on a pivotal note, the rest of November was just as eventful. Against a familiar backdrop of heightened US-China trade tensions, the start of the month saw oil prices in retreat. Subsequently, sentiment picked up as the US mid-term elections brought clarity, and improved further following the US Federal Reserve's dovish speak, and ahead of Trump's meeting with Chinese leader Xi Jinping at the G20 gathering. A positive outcome materialised, with the US agreeing to leave tariffs unchanged instead of lifting it to 25% in January. Both parties will begin talks to reach an agreement within 90 days.

Slippery slope

Oil had its weakest month in more than decade, with the international benchmark, Brent, sinking by over 20% from its October peaks to US$58.71 at end November. Prices declined after the Trump administration surprisingly granted waivers from Iran oil sanctions to several countries, swelling US stockpiles and lowering demand forecasts, which triggered concerns of a supply glut. President Trump's pressure on Saudi Arabia also cast doubt over the Organisation of Petroleum Exporting Countries' (OPEC) ability to control output ahead of its meeting with other oil producers.

Boom and bust

Oil price (US$)



Source: Bloomberg, November 2018.

The energy sector unsurprisingly declined. However, the lower oil price was positive for net-oil importers, such as Indonesia and India, which were among the best-performing markets. It also proved a boon for sentiment towards some companies in the materials and consumer sectors, as it is expected to help ease pressures from rising input costs and improve affordability for consumers. This added fuel to several of our Indian holdings, including fast-moving consumer goods major **Hindustan Unilever** and motorcycle-maker **Hero Motocorp**.

We remain comfortable with our lower exposure to energy stocks. The recent price volatility highlighted the cyclical nature of earnings in the sector, which we are wary of. In fact, our only position is concentrated in the liquefied natural gas (LNG) segment, via recently-initiated **Woodside Petroleum**, which we believe has an attractive long-term outlook, given an expected supply gap over the next decade.

Meanwhile, iron ore tracked crude prices lower, while copper was resilient. This hurt the shares of Australian mining giants, **BHP** and **Rio Tinto**, along with fears of softer demand for metals amid moderating global growth. Nevertheless, we are confident of these names due to their solid balance sheets and competitive positioning, underpinned by structural demand for bulk metals. We believe our holdings will continue to generate substantial cashflows and improve shareholder returns. For instance, BHP is returning the US$10.4 billion from selling its US shale business via share buybacks and a special dividend.

Dovish Powell, bullish markets

Global equity markets cheered Fed chairman Jay Powell's more measured policy tone, which investors interpreted as a signal that the pace of rate hikes may slow. However, the Fed is still expected to raise rates for a fourth time this year in December.

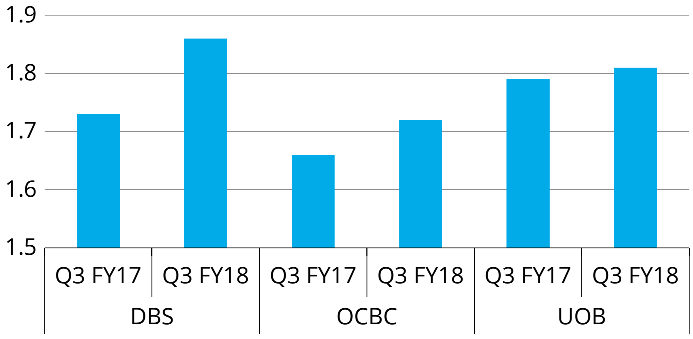
Aberdeen Standard Investments

But in Asia, central banks continued their tightening tilt. The Bank of Korea increased its benchmark rate for the first time since November 2017. It cited escalating property prices in Seoul and high levels of consumer debt, though there was concern that the hike may further slow a softening economy. Indonesia's central bank raised its key rate to manage a widening current account deficit. The increase was its sixth since May, totalling 175 basis points, and supported the rupiah. As a result, Indonesian shares posted their biggest monthly gain of 2018.

We believe the rising rate environment will continue to benefit most of our bank holdings. In Singapore, **OCBC**'s third-quarter results exceeded our expectations, with net interest margins (NIM) – a gauge of profitability of loans – expanding thanks to the re-pricing of its Singapore mortgage book and the release of excess liquidity, while **DBS**' NIMs also inched up. Although **UOB**'s margins weakened as it built-up deposits in anticipation of a more challenging environment, its profits met expectations. Overall, we are positive on Singapore banks, as we think loan re-pricing and pass-through from future US rate hikes will further lift margins, even though the margin expansion is likely to be more subdued than before.

Rising profitability

Singapore banks' net interest margins (%)



Source: Company data, November 2018.

In Southeast Asia, **Bank of the Philippine Islands**' profits improved, on the back of double-digit growth in margins and loans. It was a similar story for Indonesia's **Bank Central Asia**, and we think that its prospects are promising, given its sizable funding base, healthy asset quality and liquid balance sheet. It also appeared to be ahead of its peers in improving its fee-income business and cross-selling opportunities.

Elsewhere, we are more cautious about **Standard Chartered**. It continues to face several challenges, as weak credit growth and burdensome regulatory pressures have hurt profitability, while the de-risking of its balance sheet has led to lower revenue yields. That said, we were heartened by news that US regulators will end a period of supervision of the bank in December, imposed as part of a broader settlement in 2012 over its Iran-related dealings. This is a positive step away from its past compliance lapses. Its latest results also showed improvements, including a robust capital position that is supportive of its dividend outlook.

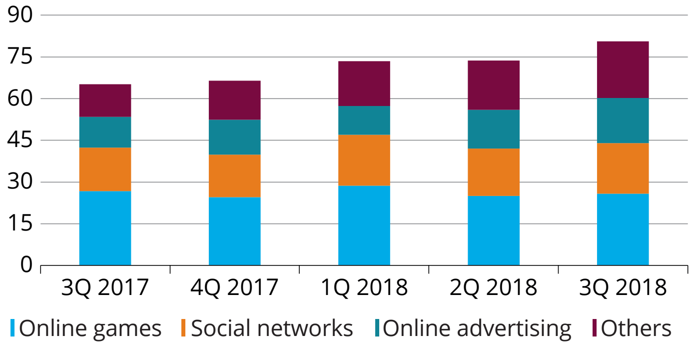
Some breathing space for China

Beleaguered Chinese stockmarkets got a reprieve, with investors focused on hopes of a thaw in US-China trade tensions ahead of the Trump-Xi meeting. But it was not entirely smooth sailing, as American authorities proposed limits on foreign investments in various sectors, including biotechnology, artificial intelligence, data analytics and robotics. This may hamper biological drugs contract manufacturing organisation **Wuxi Biologics**, as a large proportion of its revenues is generated from US clients. However, we remain comfortable with our position because most of Wuxi's technology is developed organically, and is unlikely to be affected directly.

The technology sector largely shrugged off the proposed restrictions, with additional support from **Tencent**'s better-than-expected results. The internet giant's third-quarter net profits rose by 30%, driven by good growth from its advertising, mobile payments and cloud businesses. This offset sluggishness from its online games segment, which was to be expected, given Beijing's ongoing clampdown on online game approvals. While Tencent's immediate outlook will remain hostage to regulatory uncertainty, our investment case remained unchanged, given its quality ecosystem.

Lessening reliance on games

Tencent's revenues by segment (Rmb bn)



Source: Company data, November 2018.

Overall, we think China's near-term outlook will remain challenging. Despite a truce in the trade war, worries persist over the moderating mainland economy. Notably, a survey of larger manufacturing firms showed that factory growth stalled in November for the first time since July 2016. Smaller businesses continued to struggle, while growth in new orders slowed. Property sector indicators, including land sales and construction activity, also weakened, which may push authorities to start loosening controls on the sector. Beijing is already attempting to boost infrastructure investments. It has also opted for more direct fiscal support by approving income tax cuts, which may signal further tax reforms, with lower consumption and corporate tax rates being considered. Longer term, China's growth remains underpinned by favourable demographics, rising wealth and urbanisation, as well as a huge domestic market.

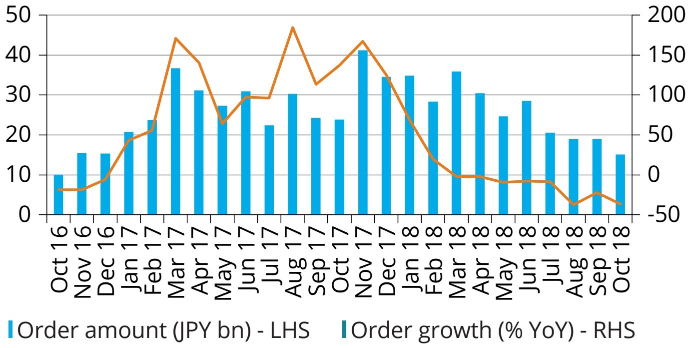
Tokyo troubles

China's economic slowdown is also hurting markets and companies elsewhere in Asia. Japan has been among those most affected, owing to Japanese companies' increasing exposure to the mainland. Orders of capital goods from the mainland have effectively stalled amid the uncertainty. Capital expenditure (capex) forecasts have also softened, reflecting companies' growing concern over potentially heavier tariffs. Although some companies reported that capital equipment orders appeared to be bottoming, a significant pick up remained elusive.

Consequently, Japanese corporates with substantial exposure to China, including factory automation company Fanuc, have seen their shares punished. We continue to be positive about **Fanuc**, which is the world's largest maker of industrial robots, with a leading market share in computerized numerical controls (CNCs), often referred to as the "brains of machine tools". Its huge installed base, the largest compared to all its rivals, makes it the natural choice for partners and customers to realise the benefits of its open-source Internet-of-things platform, FIELD, which allows Fanuc and third parties to develop "apps" for data analytics at a manufacturing site to improve equipment performance.

Collateral damage

Japan monthly machine tool orders from China



Source: Bloomberg, November 2018.

Separately, Japan's economy contracted in the third-quarter, as natural disasters hurt spending and disrupted exports. We think Japan's outlook for 2019 may be more challenging, especially due to the impending consumption tax hike. While the impact of the increase may be mitigated by certain policy responses, such as a reduced tax rate on food and beverage, we expect some disruption, given Japanese consumers' price-sensitivity.

Meanwhile, headlines were dominated by governance-related concerns, following the dramatic arrest of Nissan chairman Carlos Ghosn. Against the backdrop of a possible merger between Nissan and its alliance partner, Renault, the timing of the arrest looks suspect, with some commentators accusing Nissan of using the opaque criminal justice system to remove Renault's chief representative. While there are still many unanswered questions, the saga was a reminder of the politicised nature of the auto industry, and offered valuable lessons about governance practices. At the time of the company's 2017 data-falsification scandal, Nissan's lone independent director was a retired Renault employee.

The addition of two more independent directors, a former race car driver and a retired bureaucrat, also fell short of good-governance practice in terms of appointing qualified independent directors. Also notable was the absence of board committees at Nissan, even though three-quarters of Japan-listed companies have already adopted this structure. We are not invested in Nissan.

What else we've been busy with

In portfolio activity, we established a position in Australia's **Cochlear**, the global leader in implants to treat hearing loss. We are familiar with its business and management, having held the stock in our Australian funds since 2011. Cochlear's share-price has been hampered recently as fears over an old patent infringement case resurfaced. However, the company does not expect its business to be hurt, as the relevant patent had expired, although it could incur additional costs in the appeal. Despite these developments, we think Cochlear's long-term prospects are encouraging. It possesses significant intellectual property, continues to pursue research and development, boasts a well-established distribution network and has an embedded relationship with surgeons. It is also re-investing operating efficiencies via products and manufacturing. All this is underpinned by a healthy balance sheet, and it continues to perform well on a fundamental basis.

Elsewhere, we added to chemicals group **LG Chem**. The Korean company's cash-generative chemicals business is a solid base for it to maintain its leading position in the electric-vehicle battery market, where it has already garnered a broad customer base and growing backlog of orders. Against this, we took profits from **Samsung Electronics** following a good run.

Looking ahead

Asian markets are likely to remain sentiment-driven in the near-term. Despite the recent trade-war ceasefire, we doubt that a full compromise can be achieved. Consequently, this could exacerbate China's macroeconomic ails, with policy loosening likely to cushion, rather than reverse, the slowdown. Other risks are also familiar: tighter monetary conditions in Asia, softer global growth, and policy uncertainty surrounding upcoming major elections. That said, the bottom-up picture presents some grounds for optimism. Many holdings continue to forecast decent earnings growth, while margins are rising despite greater cost pressures. Longer-term prospects also remain bright. Secular trends, such as the premiumisation of products and services, expansion of disruptive technologies and growing infrastructural needs, support the continued expansion of companies in various sectors. Asian stocks are also now trading at a substantial discount to global peers, translating into attractive opportunities. We remain committed to our quality-focused philosophy, and are ever-watchful for opportunities to invest in well-run companies with compelling growth prospects.

We hold the companies highlighted.

Asian Equity Team
Aberdeen Standard Investments

For more information

Client Services Team
Tel: +65 6395 2701
Fax: +65 6632 2993

Aberdeen Standard Investments (Asia) Limited
21 Church Street
#01-01 Capital Square Two
Singapore 049480
Tel: +65 6395 2700
Fax: +65 6632 2998

aberdeenstandard.com.sg

Important information

Visit us online
aberdeenstandard.com
SG-121218-78652-23

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