THE DRIVE YOU DEMAND

Ubam – Best Selection Asia

Quarterly Comment | Q3 2019

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Market Comment

- US and ECB communications revealed divided opinions on the prospect for more aggressive stimulus looking ahead despite stress in US money markets. As a result, investors may face a 'gap' between limited monetary policy support and emerging fiscal support in mid-2020 in Europe and again in 2021, post-US elections leaving the prospect of renewed volatility for markets in 4Q19.
- Admittedly, a thaw seems to have emerged between the US and China following China's willingness to license 5G leader, Huawei's techonology for American use. Though volatile, a road ahead appears to be taking shape in Brexit negotiations with a UK election likely to be a prelude to a more durable solution.
- As a result, we continue to believe that an asymmetric approach is the anchor for investor portfolios until fiscal momentum emerges later in 2020. With volatility accelerating in equities, fixed income and precious metals markets over the past year, investors should expect this broadening bull market in volatility to continue into the year-end.
- US and China should remain the two main engines for growth next year, but costs of the trade war and their strategic confrontation weigh on growth in both economies.
- In China, activity remains on a moderate trend despite ongoing monetary and budgetary support to domestic demand. Growth is expected to trend below 6% next year and other selected measures on the monetary and budgetary sides should emerge in the coming months.
- In the US, the industrial and agricultural sectors continue to suffer from the trade headwinds, while consumption and services stay resilient. Growth may remain close to 2% next year, but deteriorating business sentiment, depressed investment and a lower trend in employment are fuelling downside risks in the outlook.

Performance Review

- In the third quarter, the strategy was down -3.59% outperforming the benchmark by 0.91%.
- This third quarter was particularly volatile with significant distortion from a country's perspective. The MSCI Asia ex Japan returned -4.50% QTD with China (-4.67%), Hong Kong (-4.72%), Taiwan (+5.58%), Singapore (+11.57%), South Korea (-4.87%), Thailand (-5.92%), India (-5.06%) and Indonesia (-5.25%); clearly South Korea benefited from another round of KRW weakness.
- We were well positioned in Q3. Overweight allocation in South Korea and underweight in Thailand led to positive performance while overweight in Indonesia was negative. Across sectors, overweight in information technology generated positive attribution while underweight in energy was negative.

Portfolio Activity

- Indonesian tobacco company Gudang Garam was hit hard by the unexpected 23% tax hike on its products. Indonesia had been hiking taxes on average by 8-10% on an annual basis but did not hike last year. The current 23% proposal was a negative surprise to say the least but our current view is that this is partly an offset to last year and that it is unlikely that going forward +23% is the new 'normal'. The stock has corrected hard and now discounts a lot of bad news. History suggests that tax hikes have a temporary volume impact which normalizes quickly but it will require team to recoup lost ground.
- Indonesian cement company Semen Gresik also corrected on weak volumes. We invest in Semen because after the acquisition of Holcim Indonesia Semen has >50% market share with strong pricing power. This thesis was proven by the relatively benign pricing trends but the stock corrected after a decent rally..

Outlook

- There are essential three main areas of discussion during this new phase of negotiation and President Trump hopes to sign a partial trade deal with President Xi at the APEC meeting in mid-November. They include opening up of China's financial services, protecting US firms' intellectual property right (IPR) in China and agreeing a currency pact similar to that signed in the US-Mexico-Canada trade agreement.
- In our views, these three issues are not tough for China to make sufficient concessions to meet the US's demand. Financial services reform is well underway in China and allowing increased foreign participation into domestic financial sectors (futures trading, brokerages, asset management, insurance, etc.) pose limited threat to local players since foreign market shares are basically negligible.
- From what we have learned, phase one discussion on IPR is centered on copyright and trademark issues excluding the tough and sensitive issues on cyber and information security as well as cross-border data flows.
- The currency pact discussion is essentially a return to what had already negotiated in February before trade talk broke down. It looks more like about adopting a market-oriented exchange rate and increased FX operational transparency but no demand for a RMB appreciation path mirrors that of the Japan's Plaza Accord in 1985. Again, it seems that something the PBOC should get around reasonably well given its increasingly open operation in daily fixing and the 'counter-cyclical' framework to signal RMB direction.
- The trade trace will provide some supports to investors and consumer sentiments, but is insufficient to meaningfully revive corporate earnings, capex plan, consumer spending, and China's growth, given lingering uncertainty on those core trade and market access issues as well as the structural slowdown of the Chinese economy is already underway.
- That said, we are constructive in the near-term and see positive momentum for China and Hong Kong equities from here to the signing of the phase one deal. The April/early May levels - where investors were optimistic about an interim trade deal – remain our upside reference for both markets. Any overshooting on the upside multiples and, in the absence of any breakthrough in negotiations in the phase two, caution is needed from risk and reward perspectives.

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