Chindia Equity Fund - April 2019

12 April 2019

Chinese equities continue to rally while Indian real gross capital formation rose YoY

Summary

- Domestically, Chinese equities (both onshore and offshore) continue to rally. The key catalyst is growing realisation by investors that twin deleveraging pressures of; a) pledged shares in the domestic A share market and b) corporate bond repayments due peaked in the fourth quarter of 2018.
- MSCI India returned 8.70% in March, underpinned by over US$4bn of net buying in India equities by foreign investors during the month. The ruling BJP party has enjoyed a surge in election support following the airstrikes in Balakot on 26 February.
- China's PE multiple has risen 13% YTD, whilst domestic business confidence is returning after a slump last year, which should bode well for forward looking investment spending. Various independent economic activity indicators From Bank of America Merrill Lynch point towards stabilization of growth, whilst China Inc.'s EPS growth estimate cycle appears to have bottomed in terms of analysts on the street downgrading their numbers.

Monthly performance

The Ashburton Chindia Equity Fund returned 1.91% in March, with the MSCI Emerging Markets 100% Hedged Net Total Return USD Index returning 1.34%.

Market update

China

MSCI China returned 2.44% in March. Market consensus now views the odds of President Trump's ability to secure a US-Sino trade deal as significantly improved following the Mueller inquiry's conclusion that he did not 'collude' with Russia during the presidential campaign.

Domestically, Chinese equities (both onshore and offshore) continue to rally. The key catalyst is growing realisation by investors that twin deleveraging pressures of; a) pledged shares in the domestic A share market and b) corporate bond repayments due peaked in the 4th quarter of 2018. Continued strong 'northbound' flow into domestic Chinese equities via the Hong Kong stock connect is further evidence that confidence is returning, and MCSI's decision to structurally increase A shares in key benchmark indices has been well received.

India

MSCI India returned 8.70% in March, underpinned by over US$4bn of net buying in India equities by foreign investors during the month. The ruling BJP party has enjoyed a surge in election support following the airstrikes in Balakot on 26 February, with Modi reaping the rewards of a robust response to the military skirmish with Pakistan. The BJP is now expected to get 41 out of a possible 80 seats in India's most populous state of Uttar Pradesh, compared with an estimated 29 in January this year.

With regards to the domestic macro story, the most encouraging data point has been a pick-up in fixed capital formation. Real gross capital formation rose by 10.6% YoY in 4Q18, up from an intermediate low of +3.9% YoY registered in 2Q17. With that said, the forthcoming general election will likely be held in the absence of an acceleration in aggregate economic activity.

Fund positioning

Our capital allocation model seeks to generate positive alpha on balance, through cycles, by actively tilting the country exposure between China and India. The model generates, on average, 1-2 signals per annum, remaining neutral c.70% of the time. The current model signal is neutral, advocating a close-to 50% allocation to both countries.

China

Fund positioning remained consistent with respect to stock selection this month. We have maintained high exposure to real estate, industrials and materials sectors, funded by significant underweights to information technology and communication services, relative to the MSCI China Index.

Note: sector positioning is an output of our bottom-up; quantitative-driven stock selection process and does not reflect a discretionary/thematic view.

India

A more active month in the portfolio during March. One core feature within our investment decision making framework is liquidity. The term can be interpreted in various ways but for us it is our ability to enter, but more importantly exit, individual stock positions, during times of heightened market stress and dislocation.

With this in mind, we have shifted the portfolio to a more large-cap bias in the short-term. A Nifty future position has also been taken; this will be scaled back and funds deployed as opportunities present themselves.

Outlook

China

MSCI China's PE multiple de-rated sharply in 2018, contracting to close to 30%. As mentioned above, headwinds for equity prices arrived in the shape of a deleveraging campaign by the authorities, defence competition with America and diplomatic frictions. All are now undergoing a process of reversal.

China's PE multiple has risen 13% YTD, whilst domestic business confidence is returning after a slump last year, which should bode well for forward looking investment spending. Various independent economic activity indicators From Bank of America Merrill Lynch point towards stabilization of growth, whilst China Inc's EPS growth estimate cycle appears to have bottomed in terms of analysts on the street downgrading their numbers.

This combined with a Fed U-turn, a pragmatic Peoples Bank of China and the potential for further fiscal easing globally suggests that as we stand here today, the path of least resistance for share prices is higher.

India

Putting the impending election fever to one side for the moment, a key issue is the prospect of fiscal deterioration in the government balance sheet. The fiscal deficit for current FY19 has been revised up to 3.4% of GDP from the previous target of 3.3% of GDP, whilst tax collections have risen by only 7.9% YoY in the first eleven months of FY19 compared with the government's revised full-year estimate of 17% YoY for FY19. There is clearly a growing risk of a revenue shortfall.

Thus far neither the bond nor the currency market seems unduly worried by fiscal developments, with the 10 year rupee government bond yield declining 83 basis points over the past 6 months and the rupee appreciating 6.8% against the dollar since last October's low. Investors appear to be taking a sanguine view that fiscal overshoot can be tolerated in the short-term if such flexibility leads to a Modi re-election.