Chindia Equity Fund - May 2019

21 May 2019

Trump's trade narrative with China continues and India's long-term domestic demand story remains intact.

Summary

- Team Trump's trade narrative with China continues to rumble on amidst positive comments from US Treasury Secretary Steven Mnuchin that the talks were nearing a conclusion. Domestically, recent data points in China have been received well by the market, notably on the credit side.
- Putting the short-term political noise to one side, India's long-term domestic demand story remains intact, driven by a fast growing services sector. The service sector has been growing at an annualised rate of c.8% according to official data and currently accounts for about 65% of the economy.

Monthly performance

The Ashburton Chindia Equity Fund returned -1.65% in March, with the composite benchmark (50% MSCI China/50% MSCI India, TR USD) returning 1.39%.

Market update

China

MSCI China returned 2.33% in April. Team Trump's trade narrative with China continues to rumble on amidst positive comments from US Treasury Secretary Steven Mnuchin that the talks were nearing a conclusion. A critical component of the announcement will be to what extent trade tensions may resurface down the road; this is likely to be determined by the stringency of conditions and the strength of enforcement on both sides. Overall, the likelihood of a downside surprise is higher than an upside surprise, given the sanguine view the market is adopting towards the deal currently.

Domestically, recent data points in China have been received well by the market, notably on the credit side. Depository corporations' asset growth rose to 8.2% in March from 7.7% YoY in February, the highest YoY growth rate since December 2017. This also marks the first time since June 2017 that depository corporations' asset growth has exceeded nominal GDP growth (7.8% YoY in 1Q19). Other releases worth mentioning are the rise in total social financing outstanding to 10.7% YoY in March from 10.1% YoY in February and an uptick in PPI inflation to 0.4% in March from 0.1% YoY in February.

India

MSCI India returned 0.56% in April. Putting the short-term political noise to one side, India's long-term domestic demand story remains intact, driven by a fast growing services sector. The service sector has been growing at an annualised rate of c.8% according to official data and currently accounts for about 65% of the economy. Services sector real gross value added, including construction and utilities, rose by 7.6% YoY in 4Q18. This compares with 6.7% YoY for manufacturing and 2.7% YoY for agriculture.

Another topic that is front and centre for India investors is the oil price, which makes sense given the longstanding correlation of -0.70 between the Brent crude oil price and the Nifty Index since 2011 (source: CLSA). A near term headwind would be whether the Trump administration extends the waivers allowing India to continue to buy Iranian oil. The waivers expire on 2 May, with reports circulating in late April indicating that the waivers would not be extended. Such a move would likely underpin crude oil price strength and act as a headwind on equity prices.

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

As a consequence of our recent initiative to move the China portfolio to quarterly rebalancing from monthly rebalancing previously (read more >>), fund positioning will remain consistent for the April to June period.

A key feature of our investment philosophy and process is that we are genuinely benchmark and sector agnostic, which is another way of saying we are comfortable being different from the crowd. We run a consistent active portfolio share of 90%+ through market cycles. Consequently, whilst we seek to deliver sustainable long-term outperformance, short-term results can deviate from the index and peer group, often significantly.

April is a good example of this, with the China portfolio underperforming the benchmark by 463 basis points.

Within China, our strategy has major investments in real estate, industrials and information technology sectors, funded by significant underweights to consumer discretionary and communication services, relative to the MSCI China Index.

India

During April, we took the decision to wind down our outstanding Nifty Futures position and invest the proceeds into direct equity holdings.

A new addition to the Fund is ICICI Lombard (India's market leader in general insurance). We have also purchased ICICI Bank as well as Gruh Finance, a company specialising in housing finance. The Fund previously held Gruh a few years ago but was sold on the basis of valuation concerns. The stock has been reintroduced following the announcement that the company is being merged with Bandhan Bank, India's pre-eminent micro-finance lender.

In the materials sector, we have added Asian Paints (India's largest paint company) and Aarti Industries, a specialist chemicals company with excellent growth prospects. Elsewhere, we have added Titan, India's largest listed jeweller that is part of the Tata group, and Emami, a consumer staples stock that is likely on the verge of a growth recovery.

Outlook

China

In last month's commentary we concluded that 'as we stand here today, the path of least resistance for share prices is higher.' This was predicated on a combination of depressed corporate earnings expectations (and consequently room for upside surprises) combined with a Fed U-turn, a pragmatic Peoples Bank of China and the potential for further fiscal easing globally.

Fast forward a month and it could be argued that the market has factored in much of the catalysts of the equity rally YTD e.g. the trade deal, stimulus and Fed easing; suggesting that the likelihood of a correction is growing. Nevertheless, sell-side research house CLSA suggests that both corporate capital expenditure and retail consumption will rebound in the second half of the year, led by a recovery in sentiment and the ripple effect of recent tax cuts, which will enable Beijing to prioritise quality over quantity of growth.

India

Election fever will build over the coming weeks, culminating in the counting of votes for all seats on 23 May. The market's view currently is that the existing BJP government under Prime Minister Modi will form the next government, albeit with a reduced number of seats.

An interesting development in this context has been highlighted by the local media; Mr. Modi has already requested that his bureaucrat and advisory team prepare an agenda for the next 100 days of government. Accelerating growth to 10% per annum over the next 5 years is the key deliverable, whilst structural reforms continue in earnest and include a manifesto pledge to double farming income and provide housing for all by 2022.

In that context, the ability of government to raise GST collections to fund structural reform remains key, and this objective will largely be achieved by improving compliance.