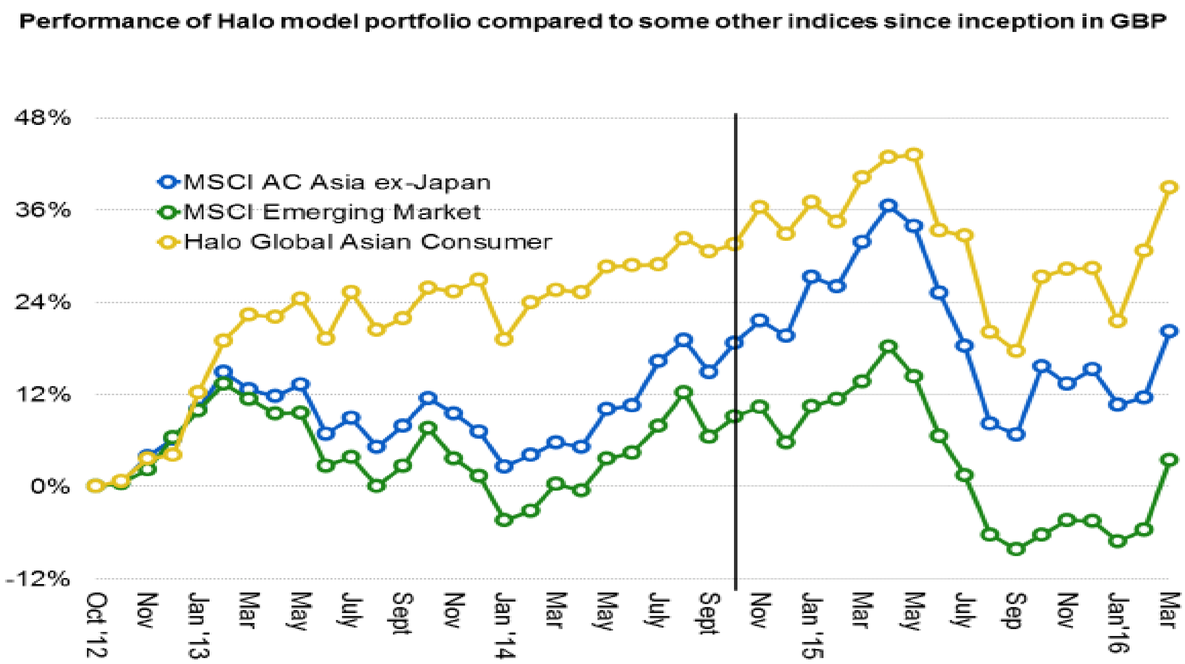
1st Quarter 2016

After markets recovered their poise in the 4th quarter we experienced a bout of volatility in the first quarter, with commentators highlighting that it was one of the worst starts to the year for markets. This was driven by concerns of a slowdown in US and China GDP growth along with China having to devalue their currency at some point as large capital outflows continued.

These concerns appear to have abated in the second half of February and March, with the help of the realisation that the US Federal Reserve will not be raising interest rates in the 1st quarter of 2016. This has allowed emerging markets' currencies to strengthen against the dollar and market fear of an emerging market liquidity crunch to recede. As a result, markets have bounced and the fund has moved with it, albeit by a greater amount due to strong results from a number of companies we own, up 5.5% over the first quarter of 2016, against a Morningstar peer group up 3.3% and MSCI Asia Ex Japan up 4.1%. I have already commented on these in the February and March fact sheets. Needless to say our relative performance against MSCI Asia ex Japan index and peer group looks respectable. As mentioned before it is still a short time period and we are more concerned with delivering an 8-12% return per annum over the medium to long term. If we do this, then I am sure any comparison to an index or peer group will look very healthy.

The forward 12 month PE multiple of the fund today is 14x as against 17x when we first started, with current expectations of 15% earnings growth for the fund over the next 12 months, the same as 3 and 6 months ago. The bounce in the value of the fund has principally been driven by the profit growth of the companies we own. The consumer in Asia is still very much alive and happy to spend, as they see their wages continue to grow and confidence in their own circumstances is improving in a number of countries. Which leads me neatly onto the topic of consumer confidence and Indonesia in particular.

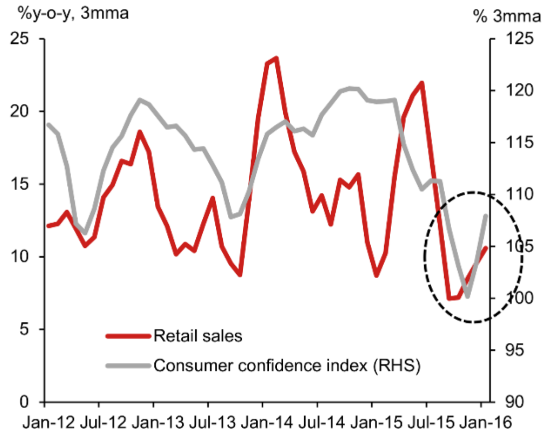


Performance shown to the left of the grey bar is of the model portfolio gross of fees and trading costs, to the right is the performance of the VT Halo Global Asian Consumer Fund £B Accumulation units inclusive of all costs. Past performance is not a guide to the future performance.

Indonesia GDP growth and consumer confidence

In the previous quarterly letter I touched on Indonesia and the expected acceleration in GDP growth to 5.1% in 2016, from 4.7% growth in 2015. Given the rise in consumer confidence in the last 3 months, which has seen a sharp rebound from the 100 level, retail sales are accelerating (see the graph below) and with the impetus on reforming the economy, which I will touch on later in this letter, the GDP number for 2016 may now have to be revised up.

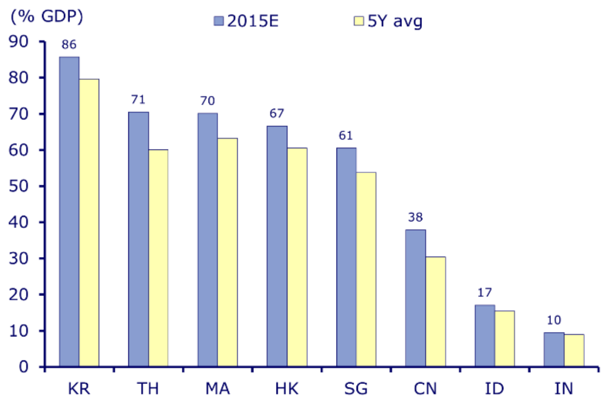
Fig. 6: Consumer confidence and retail sales



Source: CEIC, Nomura Global Economics

The Indonesian economy and consumer have a few factors in their favour, certainly when compared to their Western counterparts and, for that matter, other Asian consumers. The key factor to me which will remain relevant over the next few years is the low debt levels which both the government and the consumer have, as shown in the graph below. For a new credit cycle to begin, this certainly needs to be in place, as can be witnessed from places like Thailand and the US and UK. In Thailand the consumer debt is 70% and here in the UK for instance, it is over 100% and likewise in the US. Hence Central Banks in these countries have found when cutting interest rates it has had little effect in spurring consumer demand, as the consumer focuses on paying down debt rather than adding to it. Indonesia is very different, with household leverage at 17% of GDP, there is significant room to borrow. Note also how China at 38% and India at 10% are also low by comparison with the rest of Asia and extremely low compared to Anglo Saxon economies.

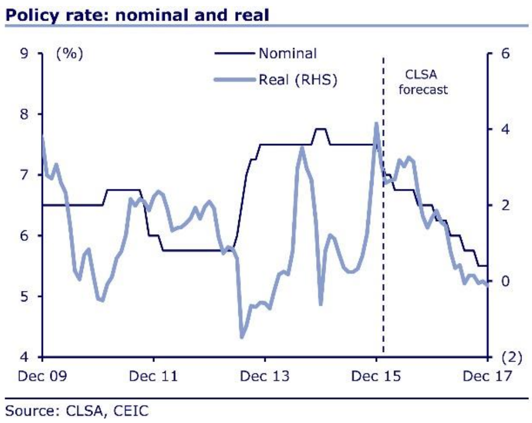
Household leverage across Asia 2015

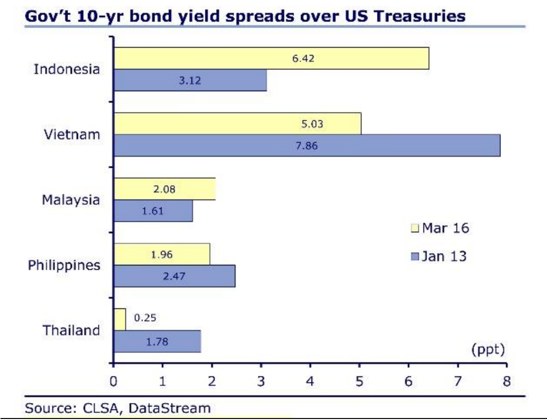


Note: BIS estimates use credit for households and non-profit institutions serving households. Source: BIS, CLSA

Why will interest rates fall and the consumer start to spend?

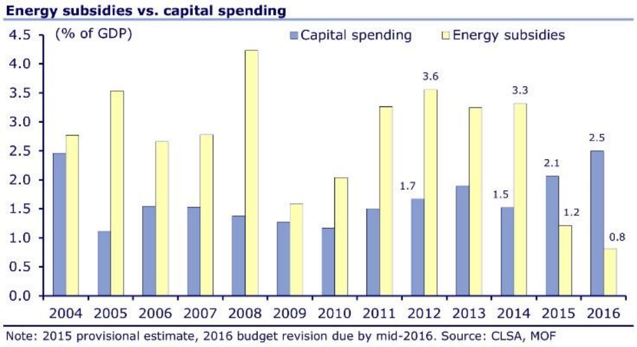
Indonesian inflation has remained stubbornly high due to inefficiencies in the economy and high minimum wage increases mandated by the government. This has resulted in high bond yields demanded by investors to compensate for the high inflation, as shown in the right hand graph below. Given the fall in oil prices, inflation has declined to 4.4% and is the only area in the ASEAN region where we expect inflation to be lower in 2016 compared to 2015, which is within the range of 3-5% targeted by the Indonesian central bank. The Bank had to maintain high real interest rates last year, (see the graph on the left), as these high real interest rates were used to defend the currency through import compression by suppressing consumption, to ensure the current account deficit started to fall rather than rise. Having seen the current account deficit be effectively reduced, the central bank now has greater confidence in its ability to cut interest rates and not see a run on the currency. So far it has cut interest rates by 25bps a month, in the first three months of 2016 and we should expect to see further cuts this year and next, with the market expecting them to fall to 5.5% in 2017. This is as long as we see further reform in the economy, which encourages foreign direct investment (FDI) and so ensures any current account deficit can be financed and the currency remains stable against the USD.





The key to this is the government providing the confidence to investors that they are serious about reform and hence encouraging further FDI, which can in turn finance the current account deficit. So far the signs are positive. A pro-business stance has been established by the government in the last few months and investors are starting to believe that President Jokowi is serious about reform having been initially disappointed after he came to power. The government have announced a number of reforms, such as making it easier for businesses to set up by reducing the number of days it takes for permits and licenses to be obtained. They are getting to grips with the infrastructure issues, which are enormous, as they recognise logistics costs in Indonesia are far too high and are focusing on delivering 30 key infrastructure projects in the time line specified, as in the past projects have been delayed due to issues such as land acquisition for road, rails and ports. Examples of this are companies mentioning that although manufacturing wages are half of Chinese workers, due to poor infrastructure, it is still more expensive to manufacture in Indonesia than China. Naturally building the infrastructure will help GDP growth and also increase productivity. They have also removed foreign ownership restrictions in a number of industries, with plans to remove import tariffs and be less obsessed over self-sufficiency.

Another key reform that investors had wanted to see has been the ability to remove wasteful fuel subsidies and redirect the funds to more productive areas of infrastructure investment. This is now happening as you can see below, with infrastructure spending as a percentage of GDP now considerably more than the wasteful energy subsidies.

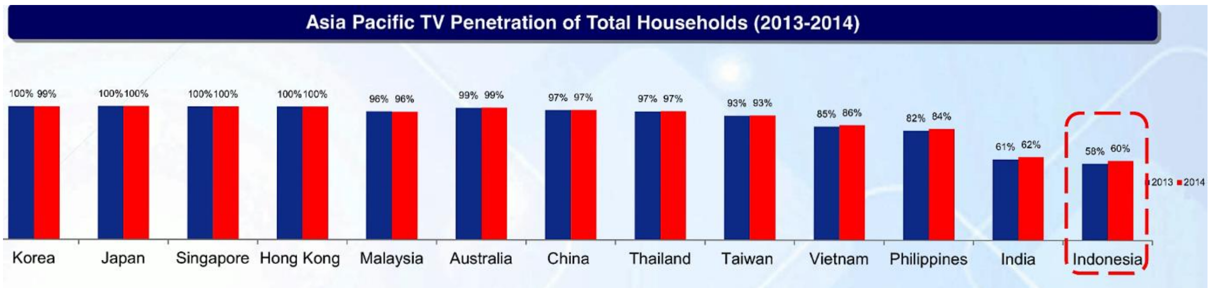


If the momentum continues then we should start to see a new interest rate cycle. With banks increasing in confidence to lend and consumers wishing to borrow, which in turn will improve retail sales, private capital investment and accelerate tax receipts for the government, leading to faster GDP growth.

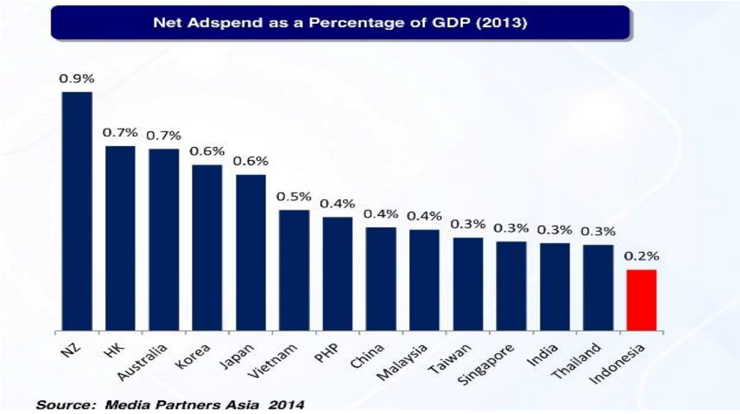
A play on the expected acceleration of consumer spending

One company that we own which is a play on rising consumer sentiment and spending is **Media Nusantara Citra** or MNC for short. This is the leading free to air TV broadcaster, whose revenue is derived from TV advertising, which in turn is driven by media spending by the fast moving consumer goods (FMCG) companies. The FMCG companies represent 80% of overall TV advertising spending in Indonesia and so owning a media company is a good proxy for FMCG goods. Typically FMCG increase ad spending each year in line with their sales growth but in 2015, whilst revenue growth continued to climb, albeit a lot more slowly than in previous years, they cut back on advertising. As a result advertising spending last year was down but you are now seeing a recovery in 2016, with SMCA the no.2 TV broadcaster raising guidance for total media advertising spending growth for 2016, from 5-8% to 10%.

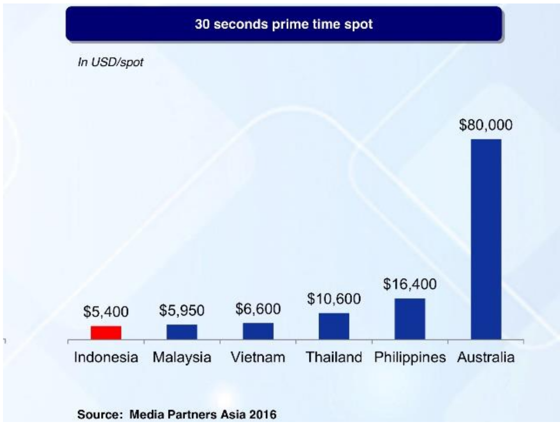
Some background as to why TV advertising looks such a promising prospect over the next few years are for the following reasons. TV penetration is comparatively low compared to other economies in Asia as shown below, at 60% in 2014, so one would expect penetration to increase over time leading to a rise in the total number of viewers. Also the amount spent on advertising is low, with locally based FMCG groups typically spending 3-5% of sales, which is half the amount based on a percentage of sales compared to their international peers who operate in Indonesia.



Source- MNC company presentation



The "rate card" for a 30 second prime time slot is exceptionally cheap (see below). Historically this was due to competition when there were numerous TV stations competing for market share. The market today is a lot more consolidated, which leaves room for annual price increases to be put through as they play catch up with the rest of the region. MNC have said themselves they expect price increases in the order of 10% pa over the medium to long term. For 2016 MNC are anticipating 14% revenue growth, having experienced a decline of 3% in 2015. Due to some exceptionally popular new primetime shows their overall audience share has increased and their revenue growth is tracking at 20% year on year in the first 3 months of 2016.



If this trends continues and advertisers become increasingly confident on the outlook as GDP growth and consumer spending accelerates, we can expect these trends to continue and 2017 will be a strong year for advertising spending as well. The shares today trade on PE of 15.5x 2016 estimates, a 60% discount to their main competitor, which is substantially more than the historical discount. This discount has been due to poor cash flow as they have recently spent a significant amount building their own studios to produce more local content themselves. This capital expenditure is now complete and the free cash flow will accelerate from here. I would also expect this year's numbers to be upgraded from the positive trading they are currently experiencing. As a direct beneficiary of consumer spending, we believe this is a relatively cheap way of playing it, albeit with some greater short term cyclicality as the more defensive consumer names in Indonesia trade on PE multiples of anywhere between 20-45x . Given we are long term investors we are happy to bear the cyclicality as we look to own these stocks through a whole economic cycle.

Brief comment on Chinese PMIs and Foreign Exchange reserves

I would just like to highlight 2 sets of data points that have recently been released at the end of March. Firstly, the National Bureau of Statistics, a government agency released the, PMI for manufacturing and the service sector in China, with both showing an improvement. The manufacturing PMI rose from 49 in February to 50.2 in March, the highest reading since June 15. The NBS service sector PMI rose from 52.7 to 53.8. To corroborate this the Caixin PMI, a private outfit showed the manufacturing PMI rise from 48 to 49.7 over the same time period, with their services PMI for March rising to 52.2 from February's 51.2. This highlights a re-acceleration in GDP growth but one still has to be aware this has been driven by further accumulation of debt by the government. So it is not all positive but, nevertheless this has reduced the markets' current anxiety over the obsession of China slowing down.

In addition data released on 7th April has shown China's foreign exchange reserves have actually risen by $10bn in March, against expectations of a fall of $15bn. Admittedly this is partly driven by a positive translation of Euro and Yen reserves into USD, with the benefit estimated to be $25bn, as both currencies have appreciated against the USD, but nevertheless it is still better than forecast. So the panic over China having to devalue the currency in the near term has subsided but again it is still not something to become overly complacent about, as one swallow does not make a summer and we will certainly consider hedging our foreign exchange exposure if we think it becomes at all likely.

Conclusion

This has been another quarter of volatility for markets, with concerns over global growth driven by the slowdowns in the US and China, but ending the quarter more or less back where we started. Sentiment for Asia has improved as the outlook for the strength of the USD has declined, providing some breathing space for Asia to put some policies in place to improve the sustainability of their growth, as highlighted in my comments on Indonesia. Expectations for overall growth in the region have not been reduced and the rise of the middle class is still on track. We have experienced more broadly decent results from the companies we own and the PE multiple of the fund remains at 14x, down from 17x when we launched. It would be great to see some multiple expansion again, but I would be happy for it remain at this level for 2016, with the net asset value per unit up 10%, driven by profit and dividend growth. Given the more positive backdrop than a month or two ago, I remain more confident that we can do this.

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