NESTOR Far East
Quarterly Report 2/2022

Singapore, July 2022

The Nestor Fernost fund declined during the second quarter by -3.4%, but outperformed a steeper decline in the Asia-Pacific ex-Japan index of -6.4%

Market Review

The broader MSCI AC Asia Pacific ex-Japan index declined by -6.4% in Euros during the second quarter of the year. Year-to-date Asian markets thus declined -9.6%. While negative, this puts Asian stock market performance ahead of developed markets, with the MSCI World and the Eurostoxx indices experiencing declines of -15.4% and -16.9% respectively. The German DAX index even declined by more than -20% so far this year.

Bank of America's well-followed "BofA Bull & Bear Indicator" ticked down from a reading of 0.2 on a scale from 0 to 10 to exactly 0.0. While it remains impossible to predict the future, studies of stock market performance subsequent to such extreme bearishness in sentiment indicators do suggest positive returns from such an environment.

In the Far East, China A shares seemed to have found a bottom, with a positive return of +12% in Euros for the month of June almost erasing losses for the year. We had written in prior letters about the possibility that Chinese savers will start to allocate more of their savings to the stock market as property is no longer the "go-to" asset class. While we have no definite data yet, we see early signs giving credence to that thesis, with the news that savings intentions are up meaningfully in the quarterly PBOC survey, with the propensity to save at over 58%, combined with a rise in the A share index during an otherwise challenging June for global markets. In the first instance this trend is benefitting domestic listing, but in past cycles southbound activity into H shares followed thereafter.

Performance Review

The China A share allocation contributed positively to performance, however it wasn't big enough to lift the fund into positive territory. The remaining exposure to China property contributed positively to fund performance as the stronger developers are being rewarded by the market as they gain a competitive advantage over weaker developers who have to cede projects.

Many of the Southeast Asian holdings detracted from performance last quarter, giving back earlier gains, with the notable exception of Indonesian healthcare holding Siloam Hospitals. Other negative contributions came from names associated with the technology supply chain.

Outlook and Strategy

A look at inflation and interest rates illustrates how different Asia is from the rest of the world. While consumer price inflation in the US and the Eurozone is running at high single digit percentages, composites of emerging Asia are peaking at 5% and consumer price inflation in China remains firmly below 3%. Ditto for interest rate rises, China is easing while the West is tightening. While one shouldn’t make generalizations about a heterogenous group of countries, it remains the case that interest rate rises in Asia are set to remain orders magnitude shallower than the more than 300 basis points anticipated for the year for the US.

There are signs that inflation in the West may be reaching a peak as the bullwhip effect is starting to work in reverse. Inventories are high in the US logistics system, with April corporate inventories up almost 18% year-on-year and inventories for non-auto retailers up slightly more at 20%. Walmart, Costco and Amazon, are reporting disappointing earnings and actively rectifying inventory levels.

In Asia, inflation has been better contained for a variety of reasons. First, Asia has seen much less fiscal and monetary excess in the Covid period compared to the West. Second, domestic service inflation is lower than goods level inflation, and economies below potential see no wage spirals. Third, some countries are investing their commodity long positions and central budget into price controls, buying lower inflation through their fiscal and current account surplus, notably Malaysia, Indonesia, India, Thailand, and Vietnam. There are some more hawkish countries. The central banks of the food and energy importer countries, Reserve Bank of India, the Bank of Korea and the Bangko Sentral ng Pilipinas have been forced to act more decisively and more in tune with the US Fed and US inflation data to be ahead of the curve.

In the Philippines, presidential and senate elections concluded with clear wins for newly elected President Bongbong Marcos Jr. (son of Ferdinand & Imelda, the one with the shoes) and Vice President Sara Duterte (daughter of the outgoing President Rodrigo Duterte). Our sources across both senior business people and everyday professionals and workers keep telling us that this political line up may surprise on the upside, and will be an upgrade to arguably the low bar of the outgoing Duterte administration. The new administration is expected to continue the infrastructure initiatives and the new welcoming approach to foreign investment. The appointments of the new finance minister Diokno (previously central bank governor) and his successor, Felipe Medalla, currently a member of the Banko Sentral ng Pilipinas monetary board, are both considered a safe pair of hands. During his last month in office, Duterte signed the Public Service Act to allow foreign participation in a range of sectors including telecoms, roads and airports. Some of this may be earmarked for participants from China, given the old and new government’s dovish position on the South China Sea and general embrace of China. There is a certain enthusiasm in Manila as companies are getting on with their plans, abandoning the wait-and-see approach prior to the elections. Meanwhile Philippine companies are cheap after a negative total return during the Duterte administration. We are tracking the key themes of domestic consumption and the further growth of the business process outsourcing industry.

The elephant in the room remains Zero Covid. Without going into excessive detail, this is very much Xi’s policy and part of his brand of having led China successfully in beating Covid during

2020 and 2021. It is immensely difficult for Xi politically to abandon this tight stance. But other factors also play a role. More pronounced but directionally similar as seen in Singapore or Taiwan, the population is genuinely afraid of the virus, and the elderly have been slow to get vaccinated. There may also be an element of favouring a tightly controlled country at the present moment. Accelerated vaccinations and the date of Xi's "coronation" in November to secure a third (and unlimited) term are the key dates to watch. Until then investors have to position for a longer time period of serial lockdowns in China and disruption, and the stimulus measures that are building up in the system will be having their desired effect only at that point. The good news is that while cities representing more than half of GDP were subject to restrictions in April, that number is now down to just over a fifth.

Following a five hour long telephone call with US Secretary of State Anthony Blinken, China's foreign minister Yi Wang is scheduled to visit Europe in September, and it has been announced that President Xi Jinping is going to attend the Asia-Pacific Economic Cooperation (Apec) summit in mid-November. This suggests that the all-important Party Congress will have taken place by then, which is also an important marker of the timing of policy changes in China.

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