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INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

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Nothin's Gonna Stop Us Now …?

Global shares rallied nicely in April as fears over trade wars eased and investors shrugged off new military flashpoints in Syria and Israel. Solid earnings reports seems to be the explanation, particularly from the US. The UK has fared especially well of late, driven mainly by the oil and mining companies on the back of rising underlying commodity prices. Fixed income continued to struggle as 10-year government yields in the US broke 3%. Elsewhere, sterling saw much of its recent gains against the dollar wiped out as expectations of UK interest rate hikes were scotched by an increasingly unpredictable Mark Carney.

Last month we discussed the importance of perspective and context when it comes to investing. This was driven by numerous media articles suggesting that the current investment climate has a sense of déjà vu about it and this feels like 1987 all over again. A headline containing '1987' is always emotive for investors. They all-too-easily remember that was the year of Black Monday, the largest daily percentage fall for share prices on record. Less easy to remember is how much the FTSE-100 was down during the course of the year.

Granted, some of the economic data has similar patterns, such as rising employment numbers, higher inflation and a change of Fed governor. However, given the changes elsewhere in the world, we think that drawing parallels is of little investment use. In 1987, had there previously been 10 years of interest rates below 1% or 10 years of rates above 10%? Were online retail sales £2.3 trillion or zero? Was Chinese domestic sales tax policy relevant to the UK retail industry?

These rhetorical questions only scratch the surface of how much has changed across the global economic and political system in the last thirty years. There are fundamental investment implications and more than ever before, looking forward seems more appropriate than looking back. Nowhere is this more relevant than in Asia.

The numbers speak for themselves:

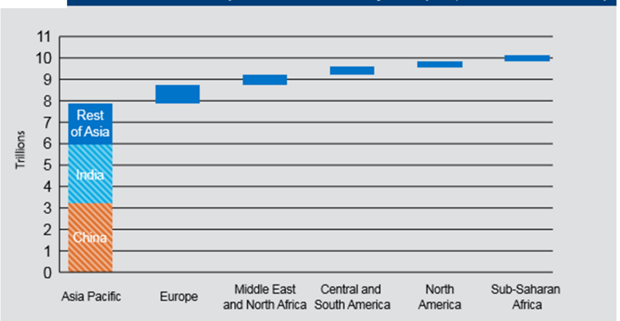
- Asia will add 2.5 billion people to the middle income earning bracket by 2030, which is more than there are now.
- China now has more than 100 cities containing over 1 million people; the US has ten.
- The Chinese urban population has increased by 500 million over the last 30 years and will be over 1 billion by 2030. As the Economist put it, "the biggest movement of humanity the planet has seen in such a short time".
- When people move to cities they increase their earnings by a factor of between 2 and 3 times.
- At the Consumer Electronics Show in Las Vegas this year, 1,551 of the companies were Chinese, almost the same as the US. In 2011 there were 400.

Some of these numbers are so huge it is difficult to comprehend. The following table and chart helps provide some perspective. The Asia Pacific row in the table tells the story. In less than five years there will be around $10 trillion more spent by the middle classes across the world and nearly $8 trillion will have come from Asia.

Spending by the global middle class (PPP, constant 2011 billion $ and shares)

	2015		2020		2025		2030	
	#	%	#	%	#	%	#	%
North America	6,174	18	6,381	15	6,558	13	6,681	10
Europe	10,920	31	11,613	27	12,159	23	12,573	20
Central and South America	2,931	8	3,137	8	3,397	8	3,630	6
Asia Pacific	12,332	36	18,174	43	26,519	51	36,631	57
Sub-Saharan Africa	915	3	1,042	2	1,295	2	1,661	3
Middle East and North Africa	1,541	4	1,933	5	2,306	4	2,679	4
World	34,814	100	42,279	100	52,234	100	63,854	100

The middle class could spend $10 trillion more by 2022 (PPP, constant 2011 trillion $)



Source: Brookings Institute

This is relevant for countless industries. The newly minted consumer has been hugely beneficial for low-cost flight operators, fashion brands and restaurants, but there are less-obvious winners. Demand for insurance is rocketing, and it is often one of the first things families buy once it becomes affordable. The link between meat consumption and higher GDP per capita is very clear and food companies that can handle the increased demand should fare well.

So how can investors benefit from these trends? One easy way is to get exposure through companies established in The West that benefit from a growing Asian customer base. In which case, why not just buy Louis Vuitton (LVMH), Diageo and McDonalds? The team managing the Mid Wynd Investment Trust would agree and LVMH is their largest position. Let's face it, people will always needs bags and sometimes things are best kept simple. Make no mistake, we rate Mid Wynd highly and this has been one of the best performing global equity funds of late.

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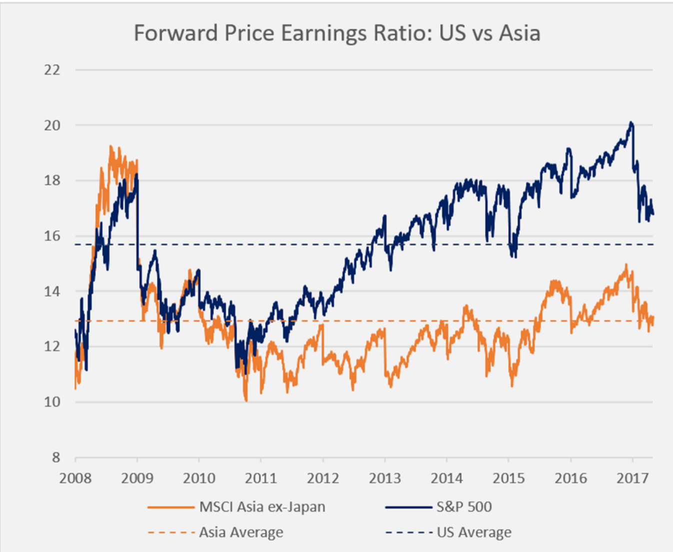
The team at Baillie Gifford can barely contain their enthusiasm. In a recent paper they note that the MSCI Asia ex-Japan index has underperformed for most of the last ten years due to a stronger dollar and unfounded worries over the Chinese economy. However, the global synchronised recovery has triggered a resumption of export growth across the region which should be seen as positive for equities. Indeed they argue that the "stars are aligning" and that the "outlook has rarely been better". As a result they are putting more of their own money into their Asia funds, putting skin in the game.

From a valuation perspective, it is difficult to argue that a forward price ratio below 13x for the index is in any way stretched, especially given the S&P-500's relative premium.

However, we do not suggest that investors buy an index tracker. Robin Parbrook from Schroders recently commented that some ETFs have been mis-sold on the premise that they will benefit from the rise of the consumer. In reality they track an index packed with state owned vehicles, cyclical industrial giants and commercial real estate operators which are often far removed from the dynamics of a growing middle class. We think that the correct approach is to go from the bottom up, and selectively buy what is most attractive on its own merits and it pays to be active. Parbrook's Schroder ISF Asian Total Return fund sold down its positions in Chinese technology companies Tencent and Alibaba, earlier this year and today having fallen back 10%, his team are revisiting the story.



Source: Bloomberg®

"We took money out of these stocks as they hit their target price but they are reaching interesting levels again. Tencent is the best company I have ever analysed," he said.

The funds that we particularly like include the Schroder Asian Alpha Plus fund and related investment trust Schroder Asia Pacific both run by Matthew Dobbs. The latter is trading at a discount to NAV of 12% which presents additional attractions. Fidelity Asian Values is another favourite, run by Nitin Bajaj, who we regard as one of the single most talented fund managers in the UK.

Scottish Oriental is another interesting fund that specialises in smaller companies and the growth potential is exciting. Having gone through a period of manager turnover a few years ago, the trust is now run by Vinay Agarwal from the First State Stewart Group. Investors Chronicle recently noted that "Scottish Oriental Smaller Companies' 10% allocation to China is significantly lower than MSCI Asia ex Japan index's and its sector peers' average weightings to it. This is because Mr Agarwal thinks that cheap debt has fuelled a misallocation of capital in businesses, particularly in China and Korea. He says companies in India, Indonesia, the Philippines and Sri Lanka are less leveraged so likely to do better over the long term." This highlights two key attributes that we like in a manager, namely willingness to stray from the benchmark and conviction.

The hope always is, especially within the small cap area, that a manager will unearth a hidden gem that everyone else has missed. The conditions are ideal, with a huge opportunity set of listed companies, spread across thousands of miles with little or no broker coverage, which creates an asymmetry of information flows and potential for mispricing. The opportunities are increasing further still as the mainland China A share market slowly opens up to foreign investors. The recent announcement that the Chinese authorities have allowed MSCI to add an extra 234 A-listed companies to its flagship emerging markets index is a major breakthrough. Make no mistake, there will be some corporate governance horror stories, but for those with the resources to perform their due diligence, expect some big winners, as Man Group explain here. Previously inaccessible, some of the companies are huge and play perfectly on the middle class theme, including drinks group Kweichow Moutai and white goods retailer Haier. Expect these to become much more familiar names over the next few years.

The attraction to Asia isn't limited to equities and we were very impressed by Christina Bastin, the lead manager of Muzinich Asia Credit Opportunities, who recently visited us. The opportunity here stems from a structural lack of support for Asian bonds and Chinese in particular. Quite simply the US either doesn't trust the market or is unwilling to commit resources to investigate it further and this is creating a significant yield premium for investors. At present this whole market is overlooked, yet in ten to fifteen years it could very well be larger than its US counterpart. We liked the non-benchmark thinking and the cautious approach, showing that Asia also has something to offer for those with a lower appetite to risk.

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So in summary, we believe that the investment opportunities across Asia are mouth-watering we will be continually assessing the investable vehicles available to us. There will no doubt be pullbacks along the way and we are well aware of the risks. However the long term could reap huge rewards and it is impossible not to feel optimistic.

Did we feel this way in 1987? Maybe some of us did, and Starship's Nothing's Gonna Stop Us Now (number one in the UK at this time for four weeks in May/June) was very much an anthem for the period. But as we have frequently said, it does investors little good to look back, when they should be looking forward. For lots of reasons.

Incidentally, the FTSE-100 wasn't down in 1987; after including dividends it was up 2% and by the same measure, the Dow Jones was up 5½%. This often comes as a huge surprise to people and is an excellent example of how negativity bias manifests itself, because few seem to further recall the fact that in 1987 the FTSE-100 was up an incredible 50% by mid- July. It is remembered for the 'monster' fall, but barely remembered at all for the monster rise.

To get a sense of what 1987 actually felt like, it is worth reading *Bonfire of the Vanities*. Coincidentally, the author Tom Wolfe died this week and many individuals in the investment industry, this one included, will remember him fondly. The novel brilliantly captured the mood on Wall Street, the politics of the US and life in New York in 1987. It is a moot point how much has changed in terms of the race relations, which is a key part of the book, but a quick flick through the pages reveals how much has changed elsewhere. The macho terminology when traders were *Masters of the Universe* has disappeared along with the hoards of brokers who lived off the never-ending crumbs of commission that came their way. New York is depicted as a congested, dangerous sweltering metropolis which bears little resemblance to the modern, thriving city that it is today. There has been huge progress, yet at the time the situation seemed hopeless. So, does it feel like 1987 all over again? Absolutely not.

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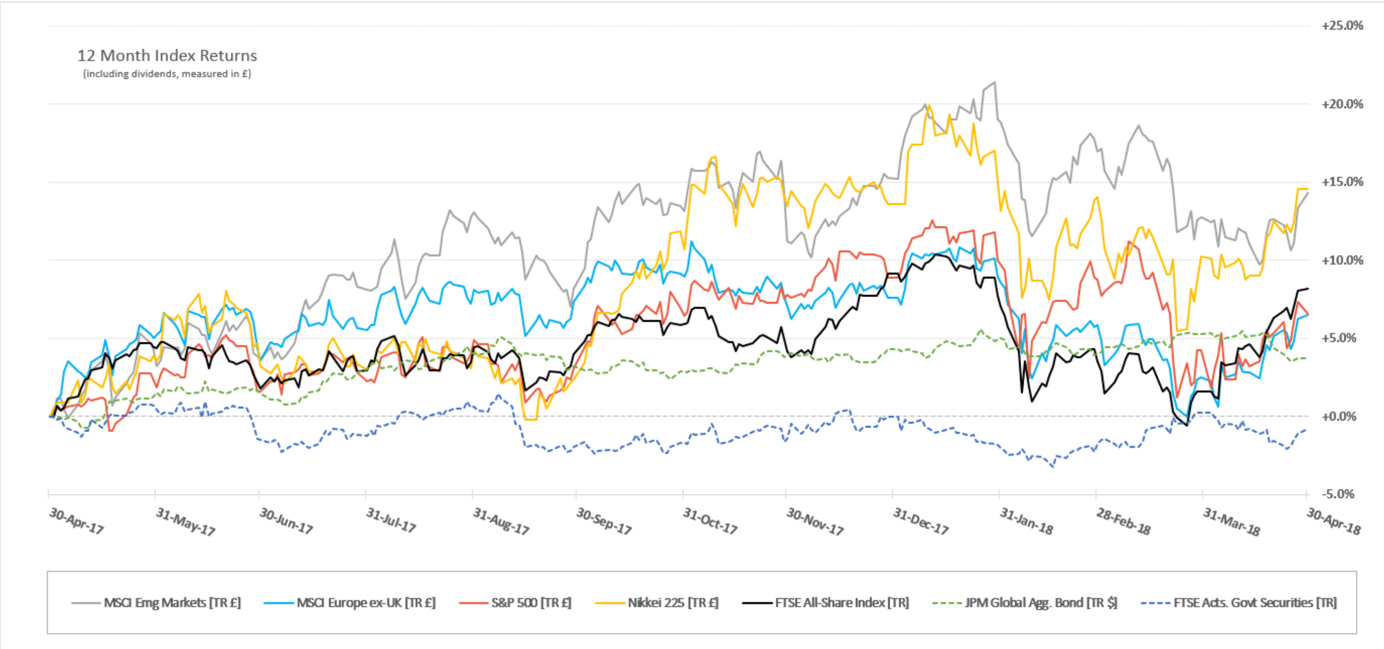
INDEX RETURNS

Index	Region/Asset Class	30 Apr 2018	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,509.3	+6.4%	+4.2%	+20.3%
UK Mid Cap	UK	559.0	+5.6%	+0.2%	+13.2%
UK Small Cap	UK	5,862.7	+4.8%	+6.0%	+27.8%
Dow Jones Ind Avg	USA	24,163.2	+0.2%	+15.4%	+35.9%
S&P 500 Index	USA	2,648.1	+0.3%	+11.1%	+28.2%
NASDAQ Comp.	USA	7,066.3	+0.0%	+16.8%	+48.0%
Nikkei 225	Japan	22,467.9	+4.7%	+17.0%	+34.8%
Euro Stoxx 50	Europe	3,536.5	+5.2%	-0.6%	+16.8%
CAC 40 Index	France	5,520.5	+6.8%	+4.8%	+24.6%
DAX Index	Germany	12,612.1	+4.3%	+1.4%	+25.6%
Milan Index	Italy	23,979.4	+7.0%	+16.4%	+28.9%
MSCI Emg Mkts (£)	Emg Mkts	571.0	+1.4%	+14.3%	+54.2%
IBOVESPA Index	Brazil	86,115.5	+0.9%	+31.7%	+59.7%
IMOEX Index	Russia	2,307.0	+1.6%	+14.4%	+18.1%
S&P BSE SENSEX	India	35,160.4	+6.6%	+17.5%	+37.3%
Shanghai SE Comp.	China	3,082.2	-2.7%	-2.3%	+4.9%
Hang Seng	Hong Kong	30,808.5	+2.4%	+25.2%	+46.2%
UK All Property	UK Property	132.6	+1.0%	+7.9%	+5.6%
UK Conv Gilts	UK Gilts	3,562.2	-1.0%	-0.8%	+7.3%
UK Index linked Gilts	UK IL Gilts	4,785.2	-2.6%	-4.4%	+20.0%
JPM Glob Agg. Bond ($)	Global Bonds	566.9	-1.5%	+3.7%	+1.9%
iBoxx Non-Gilt	UK Corp Bonds	336.3	-0.1%	+0.6%	+10.3%
WTI Crude ($/barrel)	Oil	68.6	+5.6%	+39.0%	+49.3%
LMEX	Base Metals	3,299.7	+3.0%	+18.6%	+36.7%
Gold Spot ($/oz)	Commodities	1,315.35	-0.7%	+3.7%	+1.7%
S&P Agri & Livestock	Agriculture	764.39	+2.3%	-5.1%	-11.7%
£1 = US$	Currencies	1.38	-1.8%	+6.3%	-5.8%
£1 = €	Currencies	1.14	+0.2%	-4.1%	-10.7%
£1 = Yen	Currencies	150.48	+1.0%	+4.2%	-3.3%



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