The ASEAN Reform Story

The most dominant themes in ASEAN broadly stem from reform initiatives and the implications of low oil. From a sector perspective, these translate into infrastructure (contractors, cement, property) and consumer (an optimally positioned company would be a branded staple producer that benefits from lower input costs, higher consumer disposable income, priced in the lower income segment which has higher marginal propensity to consume on lower oil, and a strong brand that can capture margin rather than pass it on). We look to invest in proven operators who have long term growth prospects and the management capability to exploit those opportunities. We will not overpay for these opportunities and are willing to be patient to secure of the best risk/reward entry points.

Philippines

The Philippines continued to grow strongly with +6.9% GDP growth during 2014. The outlook for 2015 remains strong as consumption is backed by a healthy banking system and burgeoning consumer class. BPO (Business Process Outsourcing) and overseas remittances continue to drive consumption while inflation remains benign. The country is not a heavy commodity producer benefitting it in the past few years and oil's fall is a strong positive for the country.

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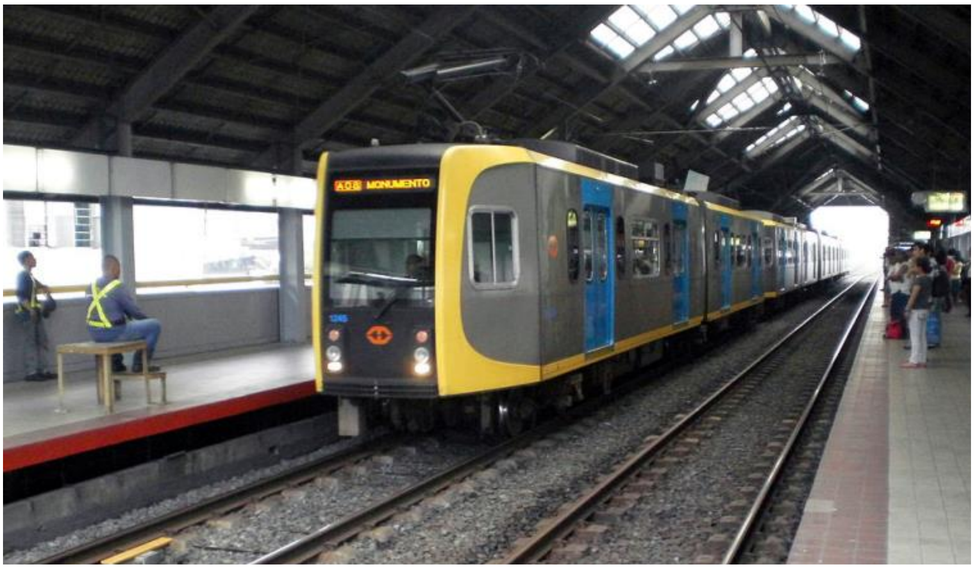

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The much talked about PPP (Public Private Partnership) infrastructure program has been sluggish so far. While some projects have got off the ground, the initial market anticipation was probably too generous. However during 2014 three projects were awarded. The largest project so far ($1.4bn) was awarded to a Metro Pacific/Ayala Corporation consortium to build an extension to the Light Rail Transit Line 1. The plan involves adding a further 10 stations to the line's 19 stations currently. This will help to greatly open connectivity from south to central Manila. We expect project awards to slow into 2016 as the political sphere focuses on the next election however infrastructure is almost certain to take centre stage during the election debate.

We believe the Philippine banking system is poised for a steady period of growth. A very cautious central bank has imposed tight capital requirements on the sector. A previously risk-averse system is now beginning to lend to the under-banked Filipino consumer which should imply increasing NIM's over time. In the past the banking sector has heavily relied on low margined large-corporate lending and investment gains to drive growth, however we feel this is now at an inflection point. In a potentially rising rate environment over time and a stronger economy to lend into, the low LDR (loan-to-deposit-ratio) banking model will change to a more optimized (higher LDR) lending based model. This is possible with recently improved banking infrastructure throughout the country and a large increase in branches in the past three years. As banks shift their loan books to the consumer sector and reduce their exposure to volatile trading gains, we should see more rational NIM's drive banking profitability. In the long run with rising NIM's and strong loan growth we feel the banking sector is a good place to be invested.

Thailand

After prolonged weakness, the Thai economy is set for recovery. Much of Thai economic growth was brought forward in 2012/13 via rice pledging schemes, the first car buyer scheme and post flood stimulus. Following this, political turmoil, a military coup, martial law and weak rice and rubber prices made for a challenged growth environment in 2014. Many of these headwinds have passed or turned more benign allowing for much more constructive growth this year.

Pent up demand spurred by low oil will see consumer optimism return. Within ASEAN, Thailand gains most from low oil resulting from a high import dependency (10% of GDP), but also from inefficient transport infrastructure. Thailand has one of the highest domestic freight costs in the region as 88% is transported via roads and only 2% via rail. Thailand's transport costs are 30% of energy, double the OECD average, and logistics costs account for as much as 15% of GDP. Lower fuel costs will translate directly in better corporate margins, lower prices and higher disposable income for consumers. Strength will not be evenly distributed however. The prices of rice, rubber and tapioca will determine upcountry economic strength and it was upcountry that saw the largest pullback in consumer spending. The NCPO government has already provided THB50bn in support and is planning another THB100bn via debt relief, low financing and injecting money into non-farming rural villages. These measures, along with lower oil costs, will aid a measured recovery in upcountry consumer spending. In greater Bangkok, which represents 44% of Thailand's GDP, the consumption rebound should be more pronounced. Same store sales growth was negative for most of 2014 but has recently turned positive. Thai consumer confidence is at an 18 month high, continuing a strong rebound from depressed levels. The recovery is still tentative, but sequential momentum should pick up and low base comparisons will see SSSG figures return to healthy levels and excite the market.

Thailand's energy intensity highlights the need for much awaited infrastructure spending in Thailand. THB2.4tr is planned over the next 8 years. Despite its strategic geographic location at the centre of ASEAN with access to China and India, road and particularly railway infrastructure will be needed to establish proper links. Given the NCPO government cannot retain power indefinitely (elections are promised in 2016) and to show it can govern effectively, it will need to execute the tendering process sooner rather than later. Much will focus on rail projects to rectify undue dependence on roads. These double track and broad gauge rail projects are well advanced and ready to proceed. Indeed, China and Thailand have just agreed on the north-south dual track and Prime Minister Prayuth will be visiting Japan shortly to proceed on the east-west rail plan. The direct stimulus to the economy will really only be felt into 2016, but government progress on infrastructure in 2015 will underpin both consumer and business confidence and unlock spending.

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Banks will enjoy better loan growth from a low base, returning closer to 10% from 5% growth. Despite a soft economy, NPLs remained largely contained due to healthy wage growth. Bank balance sheets are strong, deposit competition is benign resulting in rising net interest margins as interest rates decline. KTB is best exposed to infra spend as the main SOE bank. Tisco Financial and Thanachart banks, previously hurt by their focus on auto related lending, are exiting the worst. Auto sales were brought forward in 2012 by the first buyers' stimulus incentives. Three years on, domestic auto demand bottomed in 2014 and is showing recent sequential growth. Scheduled excise tax increases in 2016 will encourage purchases this year.

A unique aspect of Thailand in an ASEAN context is its different demographic profile. A falling dependency ratio has positive implications for many industries. The bulk of Thailand's population is in the 40-45 age bracket, employed and with high disposable income. Investable themes for this demographic relate to discretionary spending, health care, life insurance and retirement planning. Thailand has relatively low exposures to external risk. The Bank of Thailand sterilized successive excess QE liquidity flows into the country to avoid a credit bubble. The country has one of the lowest external debt to GDP levels at 38% and 50% government debt/GDP is below the 60% internal guided threshold which still provides sufficient room for planned infrastructure outlays. Thailand runs a strong current account surplus, has very high currency reserves, and a solid exchange rate. Overall debt to GDP is high though at 180% due to high household debt at 84%. This has been sustainable due to strong real wage growth, which will remain given exceptionally low unemployment. Finally, Thailand has far less commodity exposure than Malaysia and Indonesia. Interest rates are low, but given low inflation, strong currency and fiscal position, the Bank of Thailand will need to cut rates further. This will be a boon to indebted households, and aid in orderly deleveraging while allowing for continued consumption.

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Indonesia

Reform is off to a strong start in Indonesia following President Joko Widodo's inauguration in October 2014. A Jokowi led government holds the promise of a no-nonsense, performance-based, and reform-minded administration. Key pillars for reform centre around plugging economic leakage resulting from excessive subsidies, corruption, bureaucracy and low tax collection and redirecting savings toward productive use in the form of infrastructure, health care, social welfare and targeted tax incentives.

Jokowi has achieved much already in his first 4 months in office. Most important, wasteful fuel subsidies have been addressed as promised, first with a price increase, then unexpectedly taking advantage of oil price weakness to move to market based pricing, eliminating the subsidy entirely. In conjunction with fuel subsidy cuts, Jokowi outlined a clear mandate to reallocate the savings to badly needed infrastructure. The revised budget targets a IDR100tr or a +52% increase from previously budgeted infrastructure spend. 2015 will be the first year in at least a decade where capital spending will exceed energy subsidies. Projects over the next 5 years include 3,500km of new roads, 46,000 road improvements, 15 new airports, 24 new seaports, irrigation and flood prevention projects and 35GW of new power plants. Already begun, the Trans-Sumatra highway will be a key test of the land acquisition bill that has finally come into effect as of January 2015. Property will also benefit from improved infrastructure.

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A stable, pragmatic political environment, improved fiscal accounts and soon to be announced tax incentives will attract foreign investment in manufacturing, another focus of Jokowi. Indonesia's large consumer base is attractive to foreign companies. Indonesia was recently ranked as the top destination for investment in a Japanese FDI poll. By establishing local manufacturing, a structural burden on imports and the current account deficit can be alleviated while providing employment and FDI funds as a steady FX counterbalance to the trade deficit.

The lower oil price has been a blessing for Indonesia as a net oil importer. Cheap oil has handed Indonesia an easy out on its fiscal and current account deficits along with inflation. Barring a sharp return to $100/bbl oil, Indonesia has passed its most difficult times of high inflation, high interest rates, weak currency and requisite slower growth to right size its current account deficit. Inflation has already peaked, the Rupiah is showing signs of stabilization amidst dollar strength and the 10-year government bond yield has fallen to 7.1% against the 7.75% Bank Indonesia policy rate.

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With latest inflation at 7% and falling, interest rates should follow. Although the benefit of lower oil has been captured by the government, consumer spending should still benefit. Gasoline and diesel prices were initially increased by +30% but have since returned to pre-hike levels. The initial curb in demand as a result will be brief and sales growth will return. Indeed, Indonesian consumer confidence is near an all-time high. The dynamic to further oil price moves now shifts directly to the consumer as one-off subsidy removal is gone. Further oil price declines would be net negative to the fiscal budget, potentially impacting grand infrastructure plans, though funding issues remain a distant secondary challenge versus other project implementation hurdles.

We have high hopes for the long term prospects of the life insurance sector in Indonesia. The market is growing from a small base and there is great scope for upscaling the types of policies sold to people

Malaysia

Prime Minister Najib has arguably done a good job in driving investment in Malaysia the past several years which has fuelled above trend GDP growth. Consequently this economic policy is now somewhat constrained with a falling oil price. Malaysia's current account surplus will decline due to the terms of trade loss from the lower oil price. This has provided room for subsidy removal however, deflecting some of the hit to the fiscal budget, but has shielded the consumer from the benefits. As a result the consumer will remain weak in the short term due to ongoing fiscally responsible reform such as GST implementation and various subsidy reductions/removals. However these moves by the government are very positive for the long term health of the Malaysian economy.