JN Asia Infrastructure Fund SP

Newsletter QE 31st May 2018

Dear Investor,

This is the quarterly newsletter of JN Asia Infrastructure Fund SP ("the Fund" or "JNAIF") for the quarter ending 31st May 2018.

The Fund currently manages total assets of USD9.2 million as at quarter end.

For the quarter end, the Fund has delivered *positive* returns of 0.9% gross of fees and 0.64% net of fees. In this period, the reference benchmark (MSCI Asia-Pac ex-Japan) posted a *negative* 2.72% return.

Given the recent sharp rise in oil prices, how is your portfolio positioned?

In the JNAIF, our focus has been and will continue to be on Asset owners rather Asset builders. In that context, we try to avoid pure commodity exposure like upstream oil companies who are direct beneficiaries. As such, we don't take an explicit oil price view. However, within infrastructure, assets like oil and gas pipelines, LNG terminals, do get the benefit from higher oil prices reflecting in higher throughout. The gas distribution companies benefit from higher prices for substitute energy – in this case liquid fuel. There are other assets like Thai Hospitals, which benefit from medical tourists coming from Middle East.

The other fall out from higher oil prices is the currency impact on oil exporters as well as importers. Among oil and gas exporters, we have an overweight position in Malaysia, and among large oil importers with current account deficits, we have an underweight position in India. However, we also have an overweight position in Indonesia which is a large oil importer but unlike India, is a net energy exporter as its thermal coal exports (being the largest coal exporter globally) are larger than oil imports. Indonesia also is the largest crude palm oil (CPO) exporter, and prices of palm oil have tracked Brent oil prices historically with some lag effect.

Given large exposure to ASEAN markets, how are you managing risks in your portfolio in a rising USD environment?

While we have an overweight position in Indonesia which has a relatively weak external account, the current level of currency and stock valuations are attractive enough to retain a relatively large position in the country.

The other ASEAN countries where we have relatively large overweight positions are Singapore and Malaysia (both of which benefit from higher oil price environment) who have strong current account surplus positions which limit their currency depreciation in a rising USD environment.

How are you managing EM currency volatility?

As a fund manager for an Asia-Pac fund, managing currency volatility will always be a key challenge. Having said that, we don't take specific view on a currency and build assets around that view. Our focus always has been and will continue to be to build a portfolio using a bottom-up approach with a macro overlay on top of that.

In that context, we build our positions slowly in countries where external sectors could be vulnerable due to rising global risks or higher oil prices etc. Secondly, we aim to build a certain level of currency depreciation per annum while forecasting returns in individual stocks. Lastly, extreme level of panic in a particular currency historically proved to be a good entry point into local equity market.

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Technology disruptions: to what extent can your portfolio get impacted?

One of the key challenges faced by all active fund managers are technology disruptions in many traditional sectors. Internet/ ecommerce economies have de-rated many traditional sectors viz. retailing, finance etc. and lower their long-term growth potential.

Interestingly, most of the sub-segments of Infrastructure are largely unscathed by the onslaught of internet/ ecommerce. Sectors like Airports, Roads, Ports, Water, Waste management, etc continue to see strong demand from population growth, urbanisation and rising income level. Greater penetration of renewable energy is creating demand for investments in transmission grids. The growing online economy is unlikely to impact the need for any of these physical infrastructure assets. Despite the hype surrounding electric vehicles, the global economy has seen some of the best oil and gas consumption growth in past three years, which creates large demand for Oil & Gas pipelines, LNG terminals, Oil retail distribution outlets, etc. The need for social infrastructure like retirement houses and nursing care will keep rising in an ageing demography also.

Sectors like logistics, warehouses however get positively impacted by rising ecommerce penetration. An indirect benefit from the rising ecommerce penetration is the internet economy which is pervading disinflation globally keeping interest rates at lower levels relative to its history. This is positive for Infrastructure assets which have long dated cash flows.

What is the current volatility of the fund and how has this changed in recent months?

The current volatility of the fund is roughly 6% despite running a concentrated portfolio of 20-25 names. Since inception, the volatility range has been quite narrow and steady at 5 to 7%. The lower volatility mostly derives from underlying assets and their superior ability to generate cash flows at a steady rate. The sustainability of these cash flows and relatively uncorrelated nature (to broader market) leads to the lower volatility.

We believe our current approach of greater focus on Infrastructure asset owners with superior pricing power and cash flows should continue to produce lower volatility for the portfolio (figure 1).

How do you see portfolio developing as the global economy growth moderates from current level?

It seems that current year 2018 has many similarities to year 2010. 2010 was a strong year for Global GDP growth, and 2011 started with consensus belief of a synchronised global recovery. However, as year progressed, we witnessed full-blown EU crisis, surge in the US market volatility and a severe underperformance of Emerging markets. To that extent, after a strong 2017 when Global economy improved led by China and Europe, the consensus belief was a synchronised recovery of global economies in 2018. We are more cautious on this belief. The reasons being,

Figure 1 – Asset Owners & Asset Builders

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- China's continuous deleveraging effort causing a slowdown in fixed asset investments in the economy,
- Softening of leading growth indicators in Europe and
- A weakening of Japan's economy.

The Global export growth as reflected various PMIs seems to have peaked out in late 2017. Keeping this in mind, we continue to focus on companies which demonstrate a moderate earnings growth of 5-10% in line with Asia's nominal GDP growth without banking too much on the continuation of strong global growth. More importantly, we continue to focus on sustainable growth with long term revenue visibility rather than banking of cyclical growth. Thus, for any disappointment in global growth in the latter part of the year, we should see a limited impact on our portfolio.

We also continue to focus on assets which have a moderate pricing power in line with broader inflation in the economy. This protects their earnings if inflation picks up in a sustained manner and vice-versa.

Why does the portfolio continue to have underweight position in China which seems to be doing well?

We don't take any specific bullish or bearish view on the Chinese economy, which remains susceptible to government policy measures and they are difficult to predict. We focus on valuations, underlying market expectation for earnings growth and behavioural patterns of broader markets to government's policy measures.

In that context, there has been a complete 180 degrees turn in the market's view towards China in past two years. In early 2016, consensus opinion was

- A continuing RMB devaluation,
- A hard landing of economy,
- Continuation of capital outflows and
- Scepticism to supply side reforms.

The valuations, particularly for old economies, were 2x standard deviation below historic mean. Since then, a combination of

- A massive fiscal stimulus (through large infrastructure capex),
- Monetary easing (stimulating real estate in lower tier cities through policy banks),
- A stimulation of exports through weak RMB and
- Improvement in Global GDP

has helped China's nominal GDP to bounce back from low of 4% in early 2016 to current 8-9% as well as PPI (Producers Price Index) improving from a negative to a positive territory.

However, going forward, we believe the government is likely to its deleveraging agenda even though there could be micro-stimulus in between. There is a perceptible slowdown in property investment (excluding Land bank purchase) and the PPP (Public-private partnership) driven infrastructure capex has seen a marked slowdown (see fig. 2). The market's belief in supply side reform is completely consensual. A wall of investment continues however as it has moved away from old economies to new economies, where we expect excess capacities likely to be created in the medium term, thus diminishing returns. We have already seen this in renewable power viz. wind, solar and probably will see in segments like electric vehicles, batteries, automation etc. The risk of policy intervention remains high as was the case in the past. Lastly, the equity offerings by existing companies and new listings particularly from new economy continues unabated.

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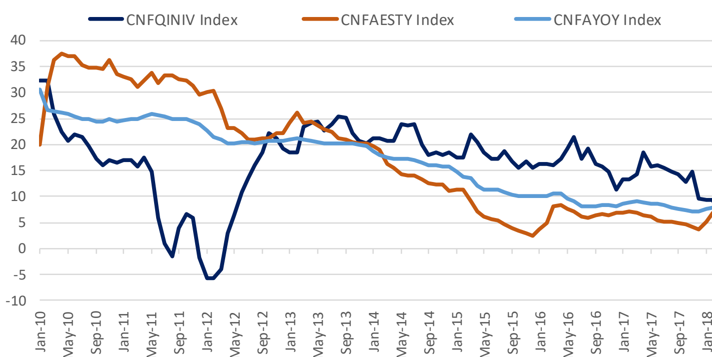
In this context, we continue to take a barbell approach focusing on companies which have long term revenue visibility, segments with lower market penetration, solid cash earnings ability and reasonable valuation. We continue to like Gas utilities, Transportation Infrastructure and select Logistic companies.

Figure 2 - China fixed asset investment growth



Note: Source Bloomberg
CNFQINIV Index = China Infrastructure Investment YoY 3 Month MA,
CNFAESTY Index = China Fixed Asset Investment Real Estate Cumulative YoY,
CNFAYOY Index = China Fixed Asset Investment (Excluding Rural Households) Cumulative YoY

Given that the Belt-road initiative focuses specifically on infrastructure, how will your portfolio benefit from that?

We believe the Belt-road initiative (BRI) of China will have a profound impact on regional infrastructure investment in the coming years. However, the beneficiaries of this capex programme are far from clear except for some of the Chinese EPC companies in the near term. Even for them, the domestic market remains a far bigger part of their order book and revenue pie. The current slowdown in PPP capex in domestic infrastructure segment will have a far bigger negative impact on their revenue and profit growth.

However, we believe over the medium to longer term that a number of economies in the region, specifically ASEAN countries, will benefit from this Belt-road initiative due to the two BRI corridors – Indo China Economic Corridor and Maritime Silk road. The committed investment of US$53bn works out as 2.5% of 5 large ASEAN countries' GDP. Infrastructure investment can improve their economy growth, uplift productivity as well as export competitiveness. BRI initiatives will improve trade and service connectivity. As per the World Bank estimates, the incremental GDP impact on growth could be 0.3-0.4% p.a. for ASEAN countries.

We have selective exposure in ASEAN region viz. airports, ports and logistics, which could benefit from greater trade connectivity as well as intra-regional travel & tourism. We continue avoid Chinese Asset builders in this context.

Table 1 –Portfolio Top 5 Country Allocation

Top 5 Country Allocation	Portfolio %
Australia	17.7%
China	14.1%
Singapore	10.8%
Indonesia	9.0%
New Zealand	8.1%

Table 2 - Portfolio Top 5 Company Allocation

Top 5 Company Holdings	Portfolio %
Jiangsu Expressway	5.9%
Pilipinas Shell Petroleum	4.4%
Westport Holding	4.3%
Sydney Airport	4.2%
China Resources Gas	4.1%

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