JN Asia Infrastructure Fund

Newsletter June 2021 Quarter

Dear Investor,

This is the June 2021, quarterly newsletter of JN Asia Infrastructure Fund ("the Fund" or "JNAIF").

The quarter saw divergent performance across Asian markets, sectors and various asset classes. We would categorise the last few months for equity market as being fatigued, volatile and directionless; awaiting confirmation on key global macro-economic trends. Asian tech stocks have been sideways or downwards, not able to provide the needed leadership to the broader markets. This trend was accelerated by Chinese government's anti-monopoly stance against big internet cos. e.g. online education, ecommerce and online gaming.

The tussle between **"long duration equity stocks"** – that focuses on high growth companies with no near-term earnings and distant future cash flows vs. "**short duration equity stocks**" – that have high near-term cash flow yield – has reached a turning point. We believe, going forward, market may reduce its bias towards long duration equity stocks. Short duration equity might finally start to find more favour with investors after years of neglect.

JNAIF stays focussed on **non-cyclical cash flow** yield with sustainable growth. Infrastructure assets enjoy **steady predictable earnings** over longer period due to their natural or regulatory monopolies. Our fund has three underlying thematic plays – a) **secular play** like waste management, gas distribution, data centres, warehouse etc., b) **reflation play** and c) **re-opening play** i.e. mobility and community related. The secular play is structural and leads to steady return on a compounded basis. However, the reflation and re-opening plays are interestingly poised in our portfolio; these are yet to play out and can help boost fund performance over the next few years. In line with our investment philosophy, the positioning in '**reflation/reopening'** trade is in **'lower volatility stocks'**; i.e. owning '**price setters'**. In other words, our fund should benefit from the reflation and reopening trade, at the same time have resilience to withstand a) intermittent setbacks in reopening of economies or b) high interest rate scenario (JNAIF is not a 'bond proxy').

For broader market, we continue to reiterate the three significant and perceptible risks on the horizon, which may particularly impact growth sectors or stocks not backed by earnings or cash flow. They are – a) inflation surprising on the higher side thus accelerating monetary tightening – the key topic of this newsletter, b) China continuing anti-trust measures against big-tech, which is now accelerating in other large economies as well (*June saw G7 economies agreeing to a minimum global corporate tax rate of at least 15%)*; c) China continuing with its tightening monetary bias to rein in massive surge in debt to GDP ratio in 2020.

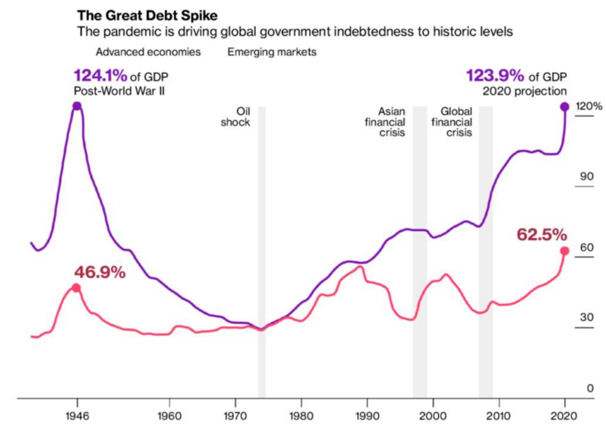
In this quarterly, we delve further on the first risk factor. That, **can the current enthusiasm about 'reflation trade' run into 'inflation scare' in the latter part of 2021.** Primary focus of this quarterly newsletter is to highlight some interesting characteristics about this round of inflation and how our Infrastructure portfolio may behave in that environment. We are not prognosticating the magnitude and durability of inflation as we leave that to the economists. Rather, we are looking for signs of pricing power returning to the labour market as economies opening up in the post COVID world; leading to inflation surprise.

Why do you think 'inflation' this time could be more durable and widespread unlike in post-GFC period?

Last year, in May 2020 quarterly newsletter, we talked about **potential above trend inflation**. Triggered by a combination of unprecedented monetary and fiscal policies (not seen since in World War -II). Unlike post GFC monetary policy, this time, a natural calamity didn't impact demand only it mostly postponed and preponed certain segments of demand. While, broader demand got further aided by debt driven fiscal stimulus and direct government

pay-out to a large section of society to prevent job losses. As highlighted below, this magnitude of global debt spike was last seen post World War II.

Chart 1: The Great Debt Spike

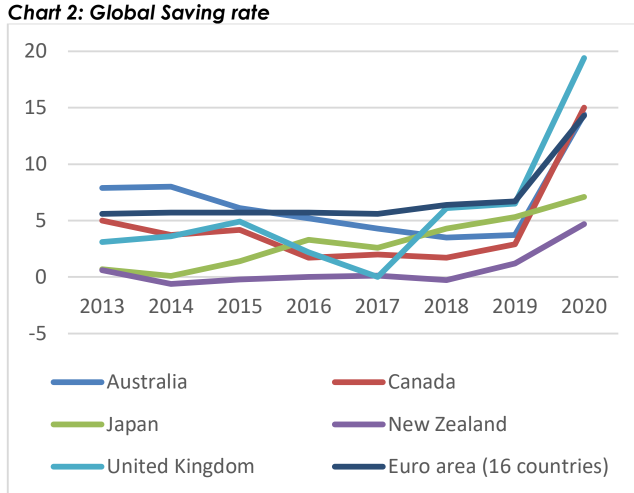


Source: IMF

Initially this **manifested in synchronised *asset inflation* viz. equity markets, housing markets, cryptocurrencies across the globe**. And, as we move into 2021, **it manifested in commodity and later into manufacturing inflation**. Particularly in the large exporting economies like China, Germany - which in turn have started exporting inflation globally. This should also translate into high CPI sooner than later.

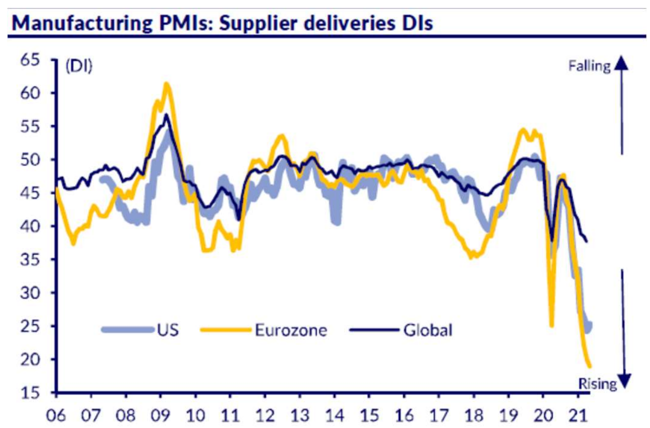
We believe both **demand and supply side** factors are contributing to the above trend inflation. On demand side, the fiscal stimulus (viz. direct pay-out, employment benefits) helped the masses to save their jobs. At the same time, financial savings in the economy surged to an unprecedented level in absence of spending in service sector (travel related). A part of this saving was however spent on durable goods, where demand skyrocketed. This coupled with supply side constraint, led to inflation across consumer goods as well as the directly linked commodities. The supply side constraint comes from lower upstream capex (mining, hydrocarbon) over past several years, COVID related supply chain disruption and geographically lop-sided capex in semiconductor industry.

Chart 2: Global Saving rate



Source: Bloomberg Intelligence

Chart 3: Supply chain stress and rising input prices



Source: CLSA, Markit Economics Ltd

As the service sector of the economy reopens, the **demand for high-touch services will pick up** particularly driven by large accumulated saving and pent-up demand. Here also, we will see supply shortage of low-cost labour as the labour mobility got severely constrained due to closed borders in many countries. Thus, we expect both supply and demand side factors will lead to higher inflation first in the goods sector and then in the service sector.

As shown in the graph below, while goods inflation is moving up, service inflation has been subdued. Thus, when service sector starts firing up in latter part of the year, along with additional fiscal stimulus across the US and other

developed countries it may lead to above the trend line inflation for longer. We believe, market may not be prepared for that outcome.

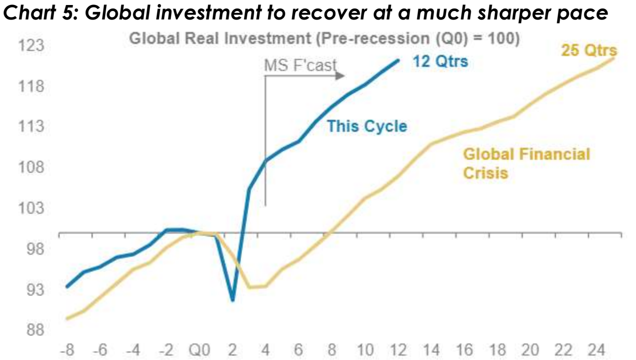
Chart 4: Global Core CPI may move up as service sector opens up

Source: JP Morgan

Importantly we believe this time the inflation may become **widespread and durable**. That is because we see structural reasons for higher inflation in coming years. This is quite contrary to what we saw in post-GFC period. While the structural impediment like ageing demography remains, the other structural impediment i.e. lack of corporate capex is slowly going away**.**

This is driven by - a) ***Massive Green Economy*** capex as part of broader ESG drive (renewable, Electric vehicles, transition to hydrogen economy, etc). This will be further aided by increase in mining capex particularly for Copper, Nickel, Lithium and Rare Earth minerals, which will play a critical role in *Green economy*; b) **Infrastructure capex** in developed economies like the US, Australia etc. to replace ageing infrastructure and improve productivity.

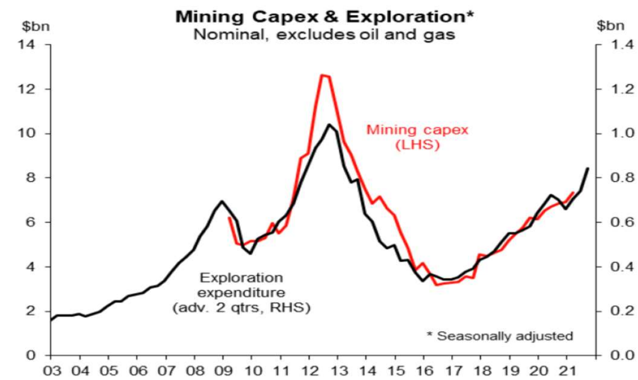
Chart 5: Global investment to recover at a much sharper pace



Source: Haver Analytics, national sources, Morgan Stanley

The global aggregate is a weighted average using PPP weights.

Chart 6: Mining Capex on rise



Source: ABS, Macquarie Macro Research

Table 1: Comparison of this cycle versus the last cycle

	Last Cycle (2009-15)	This Cycle
Private sector risk appetite	• Endogenous shock after aggressive leverage pick-up in private sector	• Exogenous shock
	• Financial shock triggered deleveraging mode	• Limited scarring due to active fiscal policy, aggressive monetary policy support
	• Risk-averse	• Animal spirits rekindled
Aggregate demand	• Below trend	• Moving above pre-COVID-19 path
Prices	• Lowflation persists	• Inflation likely to overshoot, especially in the US
Capex	• Lower return expectations, weak capex	• Corporate confidence strong, capex to rise above long-term trend
Macro policy backdrop	• Premature tightening leads to risk of dou-ble-dip	• Macro policies to remain expansionary well after recovery
Risks	• High risks of falling into secular stagnation	• Diminished risks of secular stagnation

Source: Morgan Stanley Research

On the demand side, the structural headwind of lower bargaining power for blue collared workers is changing. The key driver for dwindling bargaining power for labour market was rise in Internet economy led by tech giants exploiting a large army of freelancers. Most governments across the world led by China are now taking first step towards *wealth redistribution*. China has professed '*Common prosperity*' as part of their annual party meeting in March'21, which is tantamount to wealth redistribution. China has been working toward increasing earning of last mile delivery workers, at the cost of big tech corporate profits. The same thing applies in countries like the UK where Uber was forced to consider drivers as full-time employees or rising minimum wages in the US led by retail giants like Amazon, McDonald etc.

On top of that, the supply side constraints like border closure will restrictive mobility of low-cost labour in construction, hospitality, etc (in markets like Australia, New Zealand), thus

improving the workers' bargaining power. We are already seeing rising cost in construction sector in Australia. Also, air-ticket prices and hotel rates are surging in countries like the US, which are opening up its service sector.

What are the investment implications? How does Infrastructure asset class perform in inflationary environment?

We believe our portfolio is well poised not only for the broader re-opening of the Asia Pacific economies, but also in a moderate inflation scenario. Around one-third of the portfolio has direct linkage to inflation, and is likely to benefit from higher inflation in the economy. Secondly, the "***mobility assets' viz. Airports, Ports or Toll Roads,*** benefit indirectly from higher traffic if the inflation is a function of **demand-pull factors**. We play inflation through low-beta defensive assets, which are normally **price setters** due to their moat characteristics.

Our portfolio can be divided in 3 broad macro themes and 5 sectoral themes. The 5 sectoral themes include a) ageing demographics, b) sustainable environment, c) Aspiring middle class (mobility & community), d) digital infrastructure and e) supply chain logistics. Our infrastructure exposure in each of these segments is characterised by long dated predictable cash flows with repetitive business, having natural or regulatory moat features.

The 3 broad macro themes are - **a) structural growth, b) reflation beneficiaries and c) re-opening plays**. In the previous quarterly newsletter (i.e. Feb 2021) we talked about re-opening trades. In this quarterly we focus mainly on **reflation trades**.

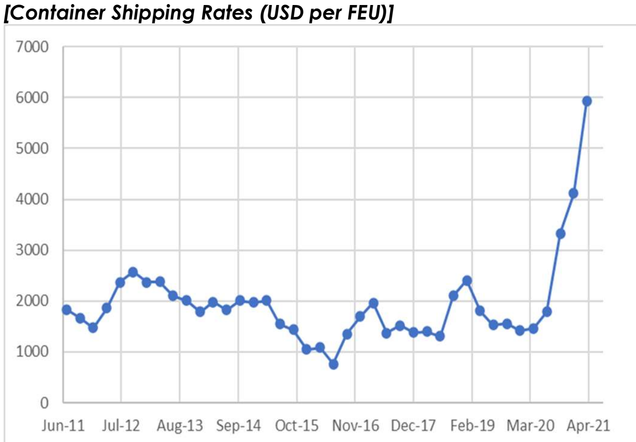
At present, the market is focused on two reflation plays - financials and commodities. Both of them are direct plays but cyclical in nature. However, as inflation cycle matures, we would like to hold ***defensive reflation*** plays like Infrastructure assets. The banks and financials face two structural headwinds - a) the Central Banks's objective to keep long term interest lower for longer even at the risk of much higher inflation, b) disruption from fintech and other tech players entering into digital payment.

In case of commodities, unlike the previous super-cycle, this time, it's likely to be far more selective given that the demand is massive but coming from a narrow sub-segment of *Green Initiatives* viz. renewable energy, electric vehicles, hydrogen economy, carbon capture etc. as a part of fiscal stimulus. On other hand, the supply disruption is visible due to a) temporary factors like COVID and b) structural factors like lack of mining capex in past 10 years. Historically we found these spikes are short-lived due to faster than expected supply response.

Through infrastructure, we play low beta reflation cycle which is more durable and avoid cyclical ups and down. JNAIF focusses on assets and businesses which are either – a) price setters because of moat characteristics or b) have CPI linked pricing mechanisms.

A) Price settlers: In this category, we have exposure to social infrastructure assets viz. ***retirement house*** benefitting from lower supply due to COIVD related disruptions and secular demand from ageing demographics. In similar breadth, our exposure to ***hospitals and diagnostics*** enjoys price benefit from higher demand in adjoining asset class and COVID related supply disruptions. The ***supply chain logistics*** is the other asset class, which enjoyed tremendous pricing power from super tight freight capacity – both in air and ocean. The pandemic related strong demand for medical supplies and consumer durable and absence of near-term supply, led to the favourable pricing environment.

Chart7: Drewry Hong Kong to Los Angeles Container Rate [Container Shipping Rates (USD per FEU)]

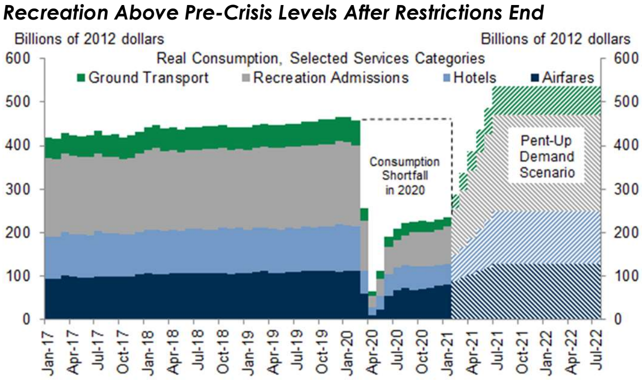


Source: Bloomberg, Drewry Shipping consultants

<u>B) Inflation linked pricing</u>: Most of the regulated and contractual Infrastructure assets enjoy CPI linked pricing. Like, **Long distance Gas pipeline, Airports, Ports, Toll roads**, they have CPI linked tariffs, which are reset every 3 to 5 years' interval and in some cases annually.

Secondly, the "***mobility assets' viz. Airports, Ports or Toll Roads',*** benefit indirectly from higher traffic if the inflation is a function of **demand-pull factors.** As discussed earlier, a high financial saving and large pent-up demand may lead to an unprecedented surge in travel demand across the globe, thus giving tremendous edge to these mobility assets both – pricing power and traffic growth.

Chart 8: Pent-Up Demand Could Boost Consumption of Travel and Recreation Above Pre-Crisis Levels After Restrictions End



Source: Department of Commerce, Goldman Sachs Global Investment Research

The regulated assets like **Transmission Grids, Water concessions,** see pricing reset based on prevailing inflation and the underlying capex, at the beginning of regulatory period, which typically lasts for 4-5 years.

In **renewable energy** and **waste management**, inflation linkage is both direct and indirect. In case of waste management, the municipal waste business is directly linked to CPI linked tariffs, while commercial and industrial business earn pricing power from uptick in economic activities and industrial capex respectively.

However, for **renewable energy,** the inflation linkage is less tenuous given that most of power tariffs are fixed during life of the project. While this works well in a low inflation environment, in rising inflation scenario, the project NPV starts declining. In merchant projects, the tariffs are exposed to market prices – a function of local demand-supply environment. Some of the renewable PPAs however have CPI linked tariffs.

The new age infrastructure assets like **Telecom Towers, Data Centres** in the region (ex-China) have inflation linked tariffs, set at various time intervals.

The above discussion also explains why we have limited exposure to **renewable energy segment** and **regulated infrastructure sector** which act as bond proxy. While the renewable energy segment has some minor inflation protection, the regulated segment gets re-pricing of their tariffs only at an interval of 4-5 years. ***Both the segments get hurt from rising nominal and real interest rates.***

What is the downside risk to this Goldilocks scenario?

A large section of investors is struggling with the **'recency bias'** which is further amplified by low interest rate environment. They firmly believe that the current high multiple ascribed to the fast growing, new economy companies are a permanent feature despite many of them having no path to profitability or cash flows.

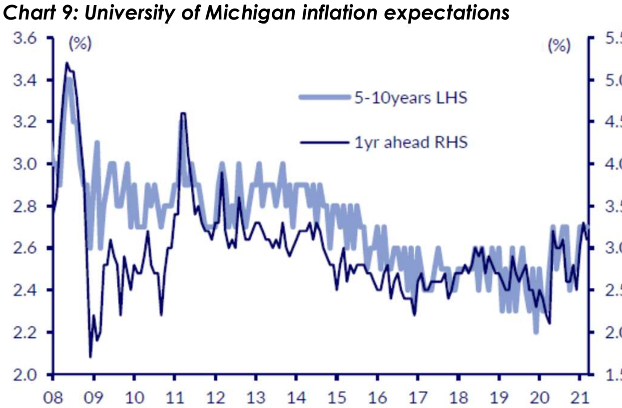
In first leg of *reflation trade*, arising out of pandemic related lockdown and related demand for durable goods, has led to higher inflation while boosting GDP growth in most of the exporting countries. The next leg is likely to be a **sustained inflation** (possibly above the trend) as discussed earlier, which may continue to benefit the **cyclical sectors** as well as **defensive inflation plays** benefitting from reopening of economies.

The key risk may arise if this *above the trend inflation* stays longer and translates into a **structurally high inflation**, which may force the central bankers to raise rates pre-maturely – something we saw in early 2000. The current level of 'negative real rates' in the US market is at historic high, which may only go up.

In the worst-case scenario, a premature increase in interest rates by the Central Banks may lead to **asset price deflation** thus bringing down demand in real economy, even though inflation stays high due to the structural factors viz. supply bottlenecks and a sustained wage increase. We may revisit 1970s kind of scenario with a **mild stagflation** in the economy. While this is not our base case and not in any market participants' forecasts, that kind of scenario is not improbable. It is needless to say that no assets class is impervious in that kind of environment except for the precious metals and commodities.

As Highlighted below, market participants still expect inflation to stay benign.

Chart 9: University of Michigan inflation expectations



Source: CLSA, Bloomberg

Chart 10: European Commission inflation expectations

Source: CLSA, Bloomberg

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JNAIF portfolio snapshot at end of May 2021

Country Allocation	Portfolio %
China	20.4%
Australia	20.1%
Singapore	11.8%
India	11.7%
New Zealand	8.4%
Hong Kong	6.9%
Taiwan	4.1%
Thailand	4.0%
Indonesia	3.7%
Philippines	2.7%
Malaysia	2.4%
Cash	3.7%
Emerging Markets	**49.1%**
Developed Markets	**47.2%**

Sector Allocation	Portfolio %
Industrial Real Estate & Warehouse	15.4%
Health Care Facilities	13.4%
Airport Services	12.5%
Gas Utilities	12.1%
Highways & Railtracks	10.8%
Air Freight & Logistics	8.0%
Waste Management	7.6%
Digital Infrastructure	5.4%
Telecom Services	3.7%
Education Services	2.4%
Renewables	2.3%
Others	2.7%
Cash	3.7%

Disclosures

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Calendar Returns	2017*	2018	2019	2020	2021^	Annualized
JNAIF Return	2.66%	-0.88%	19.88%	7.04%	8.12%	10.10%
MSCI Asia Pacific Ex-Japan Index	1.59%	-16.25%	15.85%	19.80%	6.44%	6.59%
MSCI Asia Ex-Japan Infra Index	1.08%	-8.65%	5.39%	-7.73%	-3.47%	-3.91%
MSCI World Infra Index	1.10%	-8.11%	17.77%	-2.71%	5.05%	3.17%

*2017part year from 8th November 2017 (Inception Date); ^ Till 31st May 2021;

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