
2019 Year Ahead

Asia Equities

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January 2019

After a very bullish 2017 and a bullish start to last year, investors were then confronted by a very difficult investment climate, with nearly every asset class delivering negative returns in 2018.¹ Latent concerns about USD strength, further tightening in global liquidity led by the US Federal Reserve and the China – US trade war dominated investors' minds. These uncertainties and fear led to significant declines in the global equity markets.

Despite the uncertain backdrop, we believe there are reasons to be cautiously optimistic for Asian equities in 2019. 2018 was a retracement from the highs of 2017 and Asian economies needed monetary and currency adjustments. With the pause in US interest rates, monetary policies can now be more accommodative, especially as inflation in Asia is so benign. Fiscal policies, particularly in China, are turning more stimulative to offset the economic downturn. The outlook for global growth continues to be led by Asian economies and the more accommodative policies will be supportive. Most importantly, Asian equities valuations are very attractive now.

Sector Perspectives

Due to the unusual de-correlation between business and the credit cycle in Asia in 2018, Asian banks delivered strong earnings growth and outperformed the general market. Looking forward in 2019, Financials continue to have the best earnings visibility of the key sectors in Asia due to continued top line growth driven by stable to improving margins and stable asset quality. Valuations of Asian

banks are also about 30% below their average which makes them compelling when combined with the earnings visibility we see in the sector.

We experienced a sharp adjustment in share prices in 2018 in Information Technology and Communication Services stocks. Despite the weak fundamentals that we see in early 2019, we expect the sector to find a bottom in 1H19 and we should take this opportunity to build on selective themes that have a secular trend. This includes electric vehicles, broadband communications and Internet/eCommerce leaders in China. We are less sanguine on smartphone-related names because it is no longer a growing sector. Unless there is a breakthrough in technology and innovative new features, the de-rating and price adjustments in this supply chain may take longer than many people think.

Asia Consumer sector's performance in 2018 was meaningfully impacted by Chinese stocks' gradual weakening, versus Indian stocks' resilience. Both countries remain our main countries of focus when it comes to the Asian consumer. In China, while the demand outlook is still hazy, we expect earnings growth in low to mid single digits and the Chinese consumer names have had meaningful multiple contraction already. In India, strong consumer companies continue to get stronger and deliver double digit profit growth. Rural demand has been outpacing urban demand and we see little reason for this to change in the run-up towards elections in May 2019.

Asia Equities team (as of 18 January 2019)

¹ Source: LOIM.

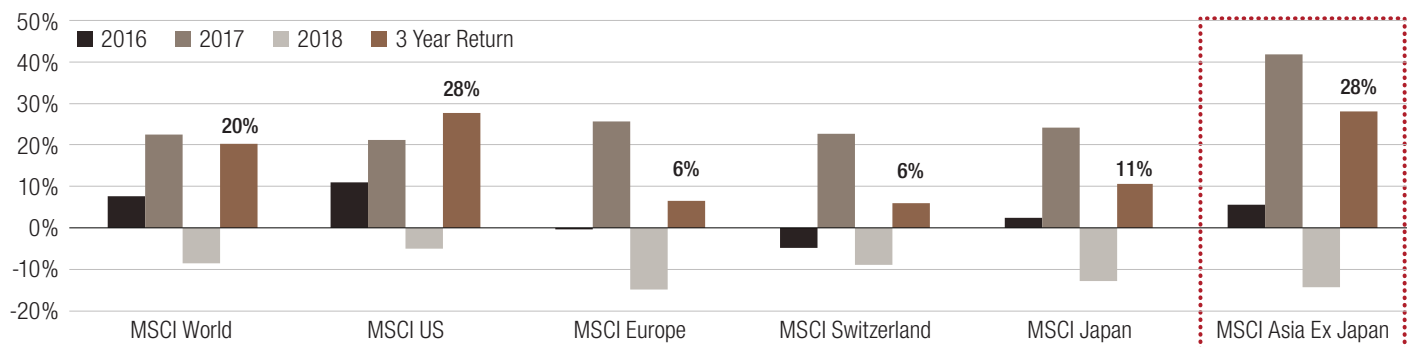
OUTLOOK FOR 2019

2018 at a glance

2018 was a difficult year for most investors, with almost all asset classes in the red. Asian Ex Japan equities were no exception giving up 14.4% (total returns in USD) compared to -9% for MSCI World. Asian equities 2018 performance also need to be viewed in the context of the strong performance of 2017 (+42%) and the crystallization of trade war turmoil between the US and China.

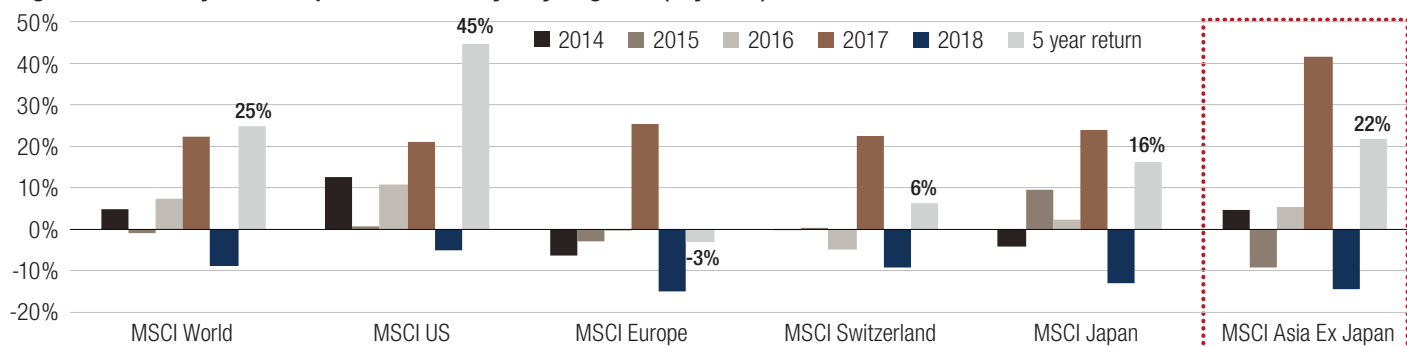
The longer term returns also look respectable with MSCI Asia Ex Japan tying MSCI US in performance over a 3-year period as the following charts will illustrate. On a 5-year basis, Asian Ex Japan equities produced in line performance with MSCI World. These return profiles (all in USD terms) support our view that Asian equities should not be viewed as optional exposure but rather a key exposure for investors interested in equities globally.

Figure 1 – Yearly market performance by key regions (3 years)



Source: Bloomberg. Past performance is not a guarantee of future results.

Figure 2 – Yearly market performance by key regions (5 years)



Source: Bloomberg. Past performance is not a guarantee of future results.

Macro backdrop for 2019 – policy flexibility

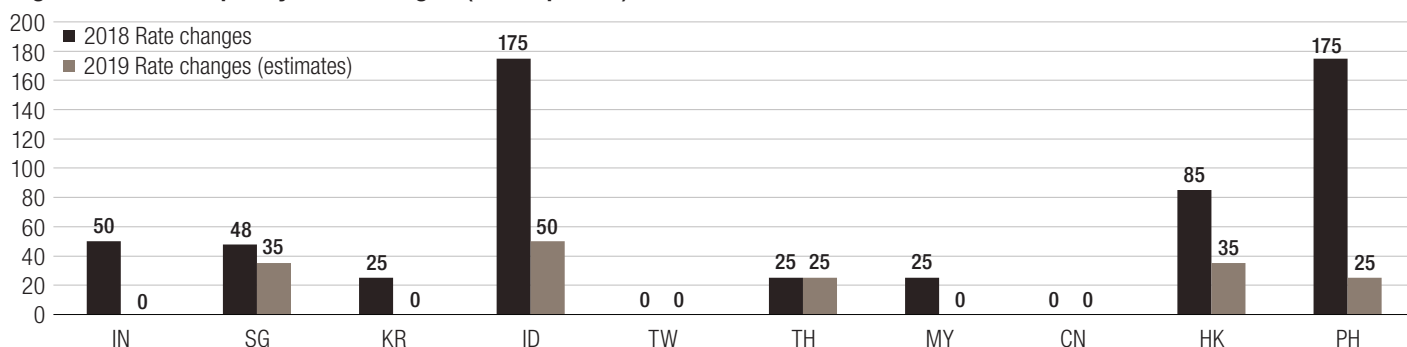
The key concern for clients and investors is how Asian equities would perform in 2019, given the difficult 2018. We see some reasons to be optimistic despite the cloudier outlook for Asian equities in 2019. Specifically, we believe that much of the monetary policy tightening and currency adjustment are complete and this will give policy makers more flexibility in 2019 to adjust their policy to be more supportive.

For most of 2018, Asian economies undertook adjustment to their macroeconomic policies and allowed their currencies to absorb much of the impact of the stronger USD dollar. There were moments of anxiety, particularly in the weaker currencies countries like India and Indonesia, but the prudent measures of hiking interest rates and preventing sharp FX movements through selective intervention

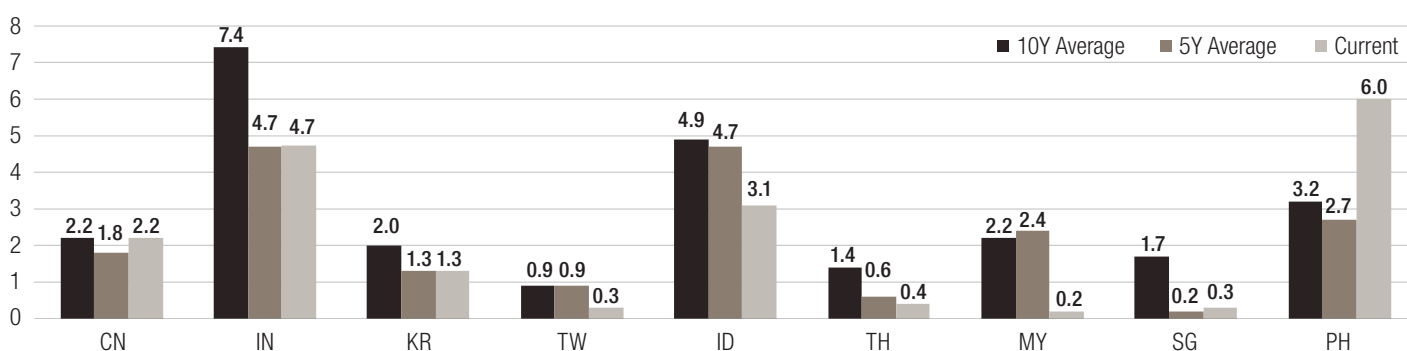
worked. The lessons learned from the Asian Financial Crisis and the Global Financial Crisis helped policy makers navigate this latest round of global liquidity tightening well. Looking forward with the Federal Reserve moderating its interest rate hikes outlook, global interest rate expectations have also moderated.

In Asian economies with inflation (with the exception of the Philippines) generally benign policy makers in Asia have policy flexibility for Asian economies to similarly slow or end their own interest rate tightening in 2019 without outsized impact to their currencies. As the following charts illustrate, in most Asian economies, current inflation levels are well below historical averages and well under 3%.

Short of runaway growth in the US, we are unlikely to see significant tightening in monetary policy in 2019 in Asia.

Figure 3 – Asia’s policy rate changes (basis points)

Source: Bloomberg, 3M HIBOR and SIBOR for Hong Kong and Singapore respectively, 2019 numbers are LO estimates.

Figure 4 – Historical and current Asia consumer inflation (percentage)

Source: Bloomberg, IMF World Economic Outlook Database, Credit Suisse Research.

Trade tensions – truce to agreement?

For most of 2018, investors in Asian and global equities were frustrated by the seemingly unending chaos surrounding the trade tensions between China and the US. These tensions peaked in 2H18 when both countries escalated rounds of retaliatory trade tariffs against each other. Both countries took a significant step towards easing the trade tensions in December when the two Presidents met at the G20 meeting in Buenos Aires, Argentina and declared a truce for 90 days. The chaos remained, however, as the markets' relief at the truce was disrupted by the arrest of Ms. Meng Wanzhou, the CFO of Huawei and daughter of company founder Mr. Ren Zhengfei.

The situation has continued to evolve since and both sides are more motivated to resolve the trade tensions now. For China, the trade war's impact is now visible with China reporting its weakest manufacturing PMI reading since February 2016 (49.4 in December: a below 50 reading indicates contraction). Beijing has increasingly eased its fiscal and monetary stance in response to the slowdown. For the US, its economy is also starting to slow and politically with the US government in stalemate and the Federal government paralyzed by the longest shutdown, the incentive to conclude a "successful" trade deal with China has similarly increased.

Given these recent developments, we believe the worst case scenario of a full scale trade war is less likely now. China has indicated its willingness to conclude a deal and has been frustrated by the capricious nature of the current US administration. The US political situation now, with President Trump beset by domestic political setback, is increasingly incentivized to reach some form of agreement with China, in our opinion. It would certainly not be a blue-sky scenario (rewind to pre 2017) but the worst case scenario that has been partly priced into Asian equities seem less likely at this point.

Within China, the government has been responding to the slowdown with fiscal and monetary easing. PBOC, China's central bank, has cut Reserve requirement ratios (RRR) for its banks four times since April 2018, cutting the amount banks need to place at the central bank and releasing cUSD 500 billion of net liquidity (offsetting medium term lending facility cuts) into the banking system. Additionally, PBOC has set up a RMB 300 billion re-lending facility for private companies, targeted at small and micro-sized companies, to assist small companies in borrowings. Finally, in the latest PBOC monetary policy meeting on December 26, the term "neutral" was removed from its monetary stance, indicating a shift towards more accommodative measures.

On the fiscal side, Beijing is increasing its budget deficit target in 2019 with the Ministry of Finance (MoF) proposing a 2.8% deficit, an increase from 2018. Further stimulus was announced when the State Council approved a USD 200 billion quota of local government bond issuances for 2019 to support local government projects in December 2018. It is also widely expected that China will cut its VAT tax in 2019 to further stimulate the economy and further income tax cuts are also planned.

Fundamentals matter – Asia’s valuation are compelling

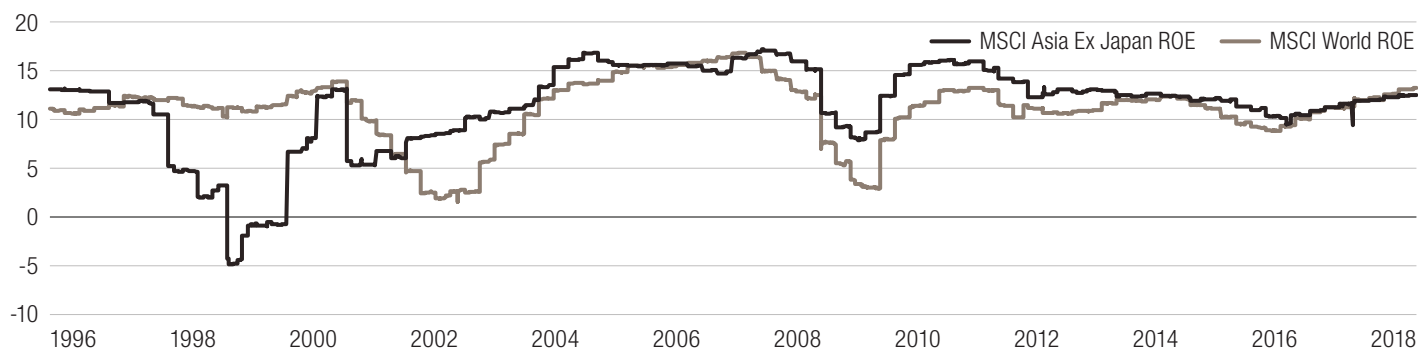
On fundamental measures, Asian equities look very attractive. MSCI Asia Ex Japan is now trading at 1.4 times price to book (PB), retracing back significantly from the recent high of 1.8 times PB and below the long run average of 1.7 times for MSCI Asia Ex Japan. Asian equities’ valuation look very reasonable at this level compared to MSCI World’s current 2.2 times PB for similar return on equities (ROEs).

Figure 5 – Price to book for MSCI Asia Ex Japan and MSCI World



Source: Bloomberg.

Figure 6 – ROE: MSCI Asia Ex Japan and MSCI World



Source: Bloomberg.

Asian equities are still cheap relative to MSCI World. Historically, Asia Ex Japan equities trade at a discount of 29% (2006 to 2018)

on a PB/ROE basis to MSCI World. Currently, that discount stands at 33%.

Figure 7 – MSCI Asia Ex-Japan – PB/ROE relative to MSCI World



Source: Bloomberg.

On foreign investor flows into Asia, we have reached a -0.7% on a 12 month rolling basis, below the recent lows of -0.6% in Feb 2016.

At this level, Asian equity is oversold and at one of the lowest points since 2008. We expect foreign investor interest to flow back into Asia.

Figure 8 – Net foreign buying as % of market cap (12 months rolling)



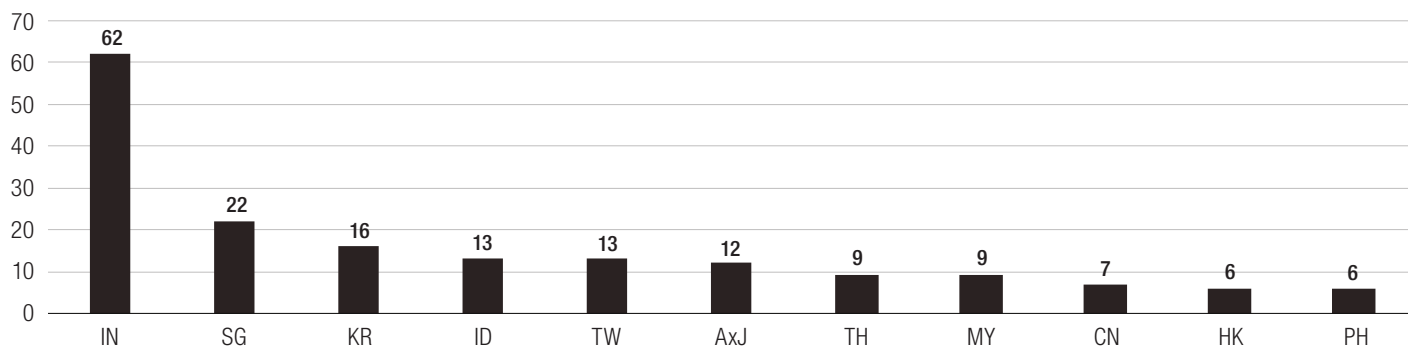
Source: Stock exchanges of India, Indonesia, Korea, Taiwan, Thailand, Philippines.

ASIAN FINANCIALS IN 2019 – CONTINUED EARNINGS GROWTH

In hindsight, our overweight in Financials in 2018, while contrarian, added value as Financials outperform the broader market (MSCI Asia Ex Japan Financials index declined 9% (total return in USD) in 2018 versus -14% in MSCI Asia Ex Japan Index). For Financials to outperform the broader market in a downturn is an unusual occurrence, but the recent credit cycle in Asia was an unusual one.

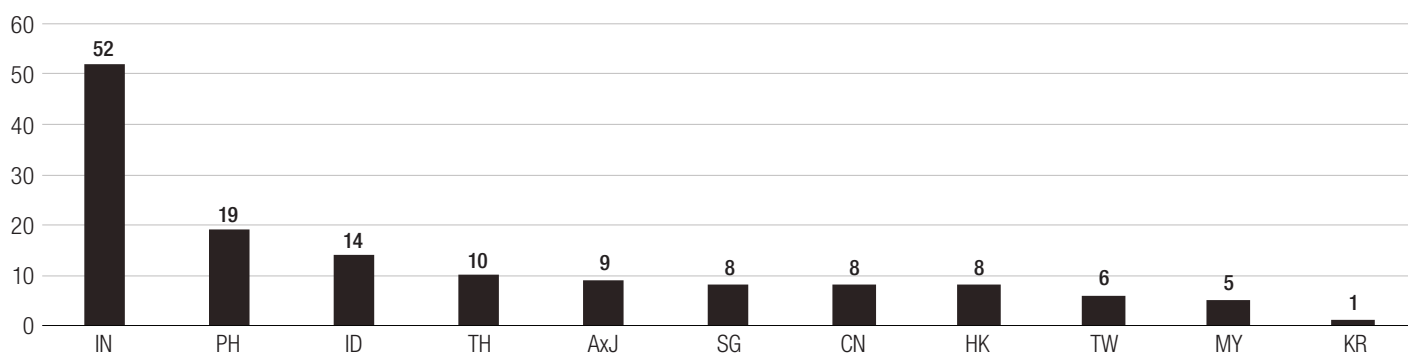
Key to the better earnings environment for Asian banks was the fact that the credit and business cycles were out of sync in the last few years. Between 2015-2017, Asian banks experienced a mild credit cycle and the subsequent provisioning requirements dampened earnings, but largely did not impact book value during this period. In 2018, the improvements in non performing loans as well as margin improvements led the earnings recovery for Asia banks. We expect this trend to continue at a more gradual pace in 2019.

Figure 9 – MSCI Asian banks 2018 EPS growth (YoY, %)



Source: Thomson Reuters, Credit Suisse Research.

Figure 10 – MSCI Asian banks 2019 EPS growth (YoY, %)



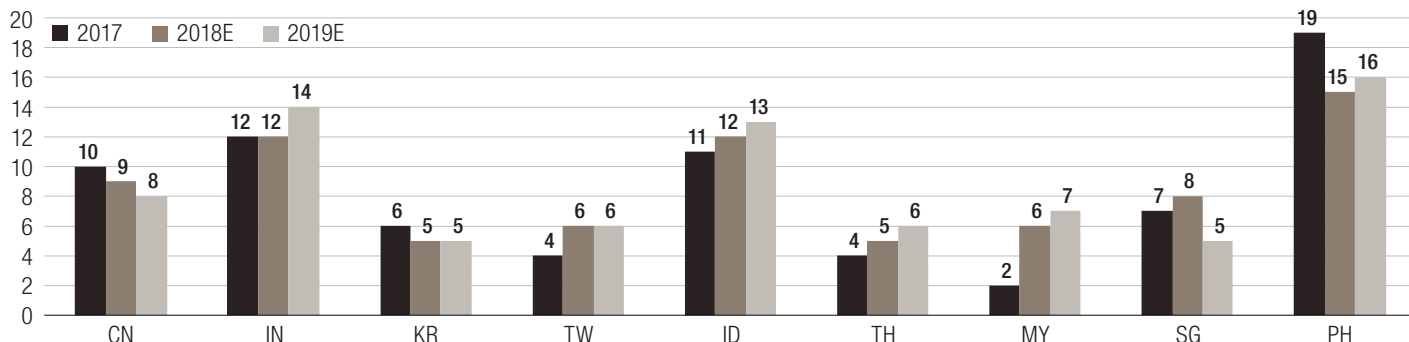
Source: Thomson Reuters, Credit Suisse Research.

Good earnings visibility

The slower earnings growth in 2019 is largely due to the tailwind of lower provisioning costs going away in most Asian banks. We continue to see stable loan growth and margin improvements

to support top line growth. Most economies in Asia will likely continue to see loan growth in 2019 after the lows of 2016. This is positive for top line growth.

Figure 11 – Asian banks’ loan growth (in percentage)

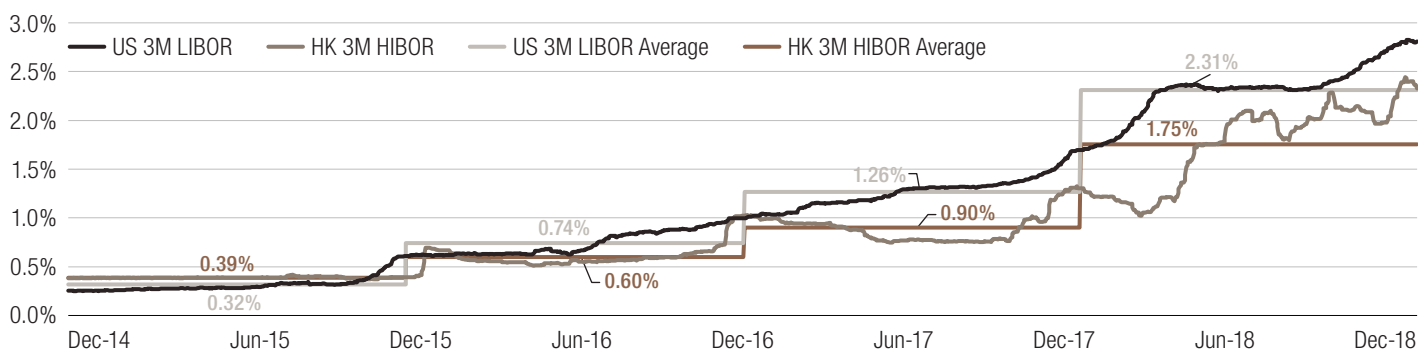


Source: Company data, Credit Suisse Research.

On bank's net interest margin, we saw further increases in interbank rates in 2018 and this will continue at a moderate pace in 2019.

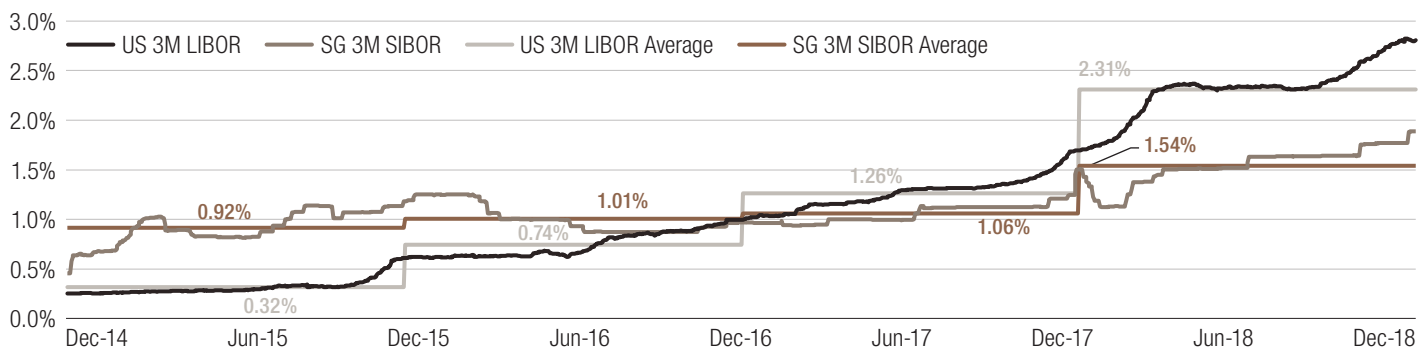
This will lead to stabilization in banking margins in Asia after the increases in 2019.

Figure 12 – US and Hong Kong 3M Interbank rates



Source: Bloomberg.

Figure 13 – US and Singapore 3M Interbank rates

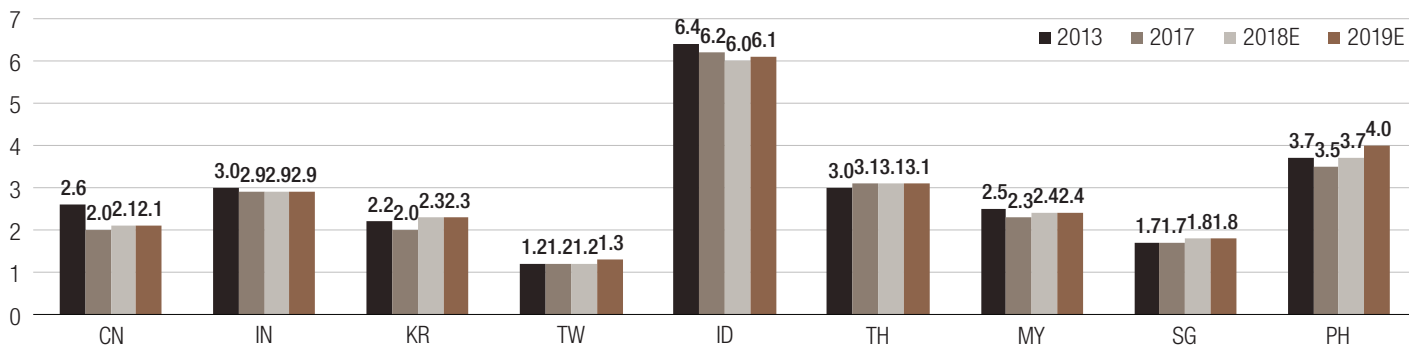


Source: Bloomberg.

Outside of the liquid economies like Hong Kong and Singapore, margins should continue to slightly rise in 2019 as Asian banks continue to regain some pricing power, particularly as the gap

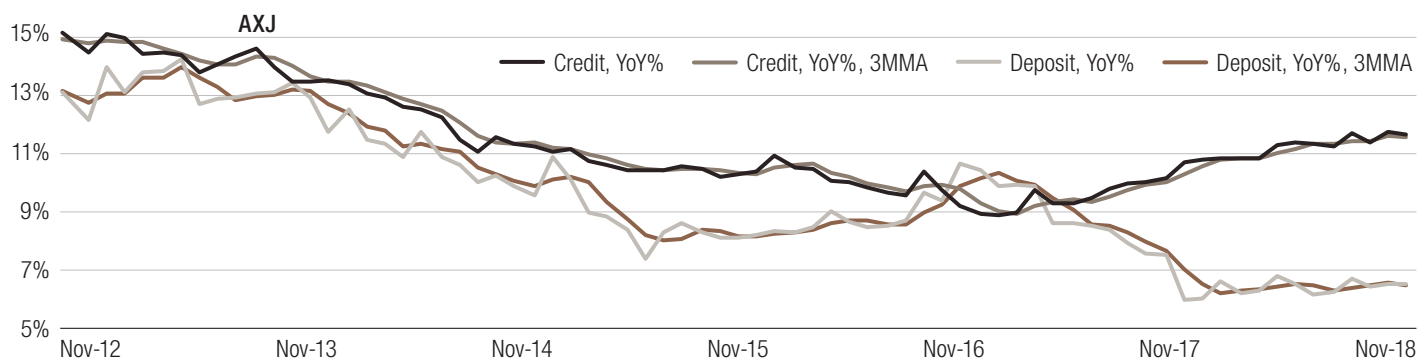
between deposit growth and credit growth widens in Asia. This will lead to pricing power continuing to return to the banks in our view.

Figure 14 – Asian banks’ net interest margin (in percentage)



Source: Company data, Credit Suisse Research.

Figure 15 – Asia Ex Japan credit and deposit growth



Source: CEIC, Morgan Stanley Research.

Credit cycle is still benign

With the economic outlook less certain, investors are naturally worried about whether Asian banks are at the cusp of another credit cycle. While we are certain Asian banks will experience another credit cycle in the future, we are relatively confident that it is still too early for another round of non performing loans (NPLs) to hit Asian banks so quickly. Indeed, as we highlighted last year,

NPL ratios peaked in Asia in 2017. Across the board in Asia, we saw non performing loans fall or stabilize in 2018. The mild credit cycle between 2014-17 dampened earnings only and when NPLs stabilized in 2018, we saw substantial earnings improvement. NPLs will likely reach a low in 2019-2020 period and this will anchor loan loss provisioning at low levels.

Table 1 – Asian banks' NPL ratio (in percentage)

GROSS NPL RATIO (%)																								
(%)	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18E	19E	
CHINA							16.0	11.2	3.5	3.0	2.5	2.5	1.6	1.2	1.0	1.0	1.0	1.2	1.7	1.7	1.6	1.5	1.5	
INDIA – GOVT				12.4	11.4	9.7	8.2	5.9	3.7	2.9	2.6	2.2	2.5	2.5	3.3	3.9	4.3	4.7	8.9	9.3	13.0	10.6	8.6	
INDIA – PVT				4.6	9.3	7.5	3.9	2.5	1.5	1.8	2.4	2.9	2.7	2.2	1.9	1.7	1.7	1.9	2.6	4.1	4.7	3.5	2.7	
INDIA	11.7	14.0	12.6	11.8	9.6	9.0	7.2	5.0	3.1	2.5	2.5	2.4	2.6	2.5	2.9	3.3	3.6	3.8	6.7	7.4	9.9	7.7	6.1	
KOREA	5.9	7.3	13.4	8.0	0.7	0.6	0.5	0.4	1.3	0.9	0.8	1.3	1.3	1.7	1.3	1.4	1.5	1.3	1.1	0.9	0.8	0.8	0.8	
TAIWAN	3.7	4.4	5.1	4.6	5.7	2.0	2.5	2.1	1.6	1.6	1.4	1.3	1.1	0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	
INDONESIA	2.4	66.7	49.7	16.0	10.7	6.5	5.8	4.0	10.9	7.7	4.8	3.2	3.0	2.5	2.1	1.8	1.7	1.8	2.1	2.6	2.4	2.3	2.3	
THAILAND	16.5	47.9	50.4	25.8	19.1	19.6	15.8	13.7	10.7	8.8	8.2	6.4	6.0	4.7	3.7	3.1	2.9	2.8	3.3	3.6	3.9	3.6	3.4	
MALAYSIA	3.2	8.3	10.3	9.3	12.4	11.6	10.7	8.7	7.0	6.1	4.6	3.4	3.5	3.8	2.9	2.1	1.8	1.7	1.8	2.0	2.0	2.0	1.9	
SINGAPORE	3.6	10.7	12.9	9.1	8.3	7.9	6.8	5.1	3.8	2.8	1.5	1.7	2.4	1.6	1.2	1.2	1.0	0.9	1.1	1.4	1.6	1.6	1.5	
AUSTRALIA	1.0	0.9	0.8	0.7	0.7	0.6	0.4	0.3	0.4	0.5	0.6	1.1	1.7	1.9	1.7	1.5	1.2	0.9	0.8	0.9	0.8	0.8	0.8	
PHILIPPINES				12.0	11.3	11.9	10.3	7.4	8.9	7.0	5.6	4.6	4.1	3.6	2.8	2.4	1.6	1.3	1.2	1.2	1.1	1.3	1.3	
PAKISTAN									6.2	7.3	7.5	7.9	10.4	11.5	12.4	12.4	0.8	9.9	8.6	7.5	7.6	7.0	6.8	
VIETNAM																	2.3	2.8	2.5	1.8	1.7	1.7	2.1	2.3

Source: Company reports, Credit Suisse estimates.

We are relatively comfortable that provision levels have peaked and while the decline in loan loss provisions will be milder in 2019, this will still lead to a lower provisioning burden for the banks.

Table 2 – Asian banks' loan loss provisions (in basis points)

P&L PROVISIONING (BP OF LOAN)																								
(%)	97	98	99	00	01	02	03	04	05	06	07	08	09	10	11	12	13	14	15	16	17	18E	19E	
CHINA			206	76	205	102	133	80	62	67	84	138	56	52	59	53	52	73	99	100	103	108	107	
INDIA – GOVT							272	197	149	106	85	75	84	119	139	127	141	150	269	245	433	251	127	
INDIA – PVT							125	49	87	134	150	167	184	104	71	71	74	79	139	195	207	156	91	
INDIA	245	228	178	197	187	181	240	160	131	115	106	103	112	115	120	111	122	129	226	227	349	214	112	
KOREA	105	380	561	383	264	114	231	156	66	49	51	105	110	116	66	75	66	56	52	43	37	34	38	
TAIWAN	59	67	129	128	157	316	203	110	150	232	88	84	69	17	16	13	30	18	7	21	23	20	24	
INDONESIA				-198	711	235	170	120	157	216	167	223	233	145	54	47	66	84	137	201	142	121	117	
THAILAND	250	494	731	286	100	122	90	77	40	132	160	86	74	57	74	76	90	83	138	139	165	139	124	
MALAYSIA	201	359	238	151	194	142	99	103	106	92	70	71	70	44	27	18	23	22	38	50	38	30	28	
SINGAPORE	138	224	150	23	69	83	63	19	19	15	30	69	98	44	34	24	26	26	27	38	38	17	21	
AUSTRALIA	29	33	27	29	35	30	26	22	18	17	28	60	70	39	30	31	22	16	17	19	15	13	15	
PHILIPPINES				180	115	138	120	116	143	176	165	94	148	132	77	69	95	52	31	47	43	39	45	
PAKISTAN									138	103	194	148	229	155	139	97	7	19	59	20	-9	22	31	
VIETNAM																	146	163	143	187	206	270	242	253

Source: Company reports, Credit Suisse estimates.

Against this general backdrop, we see Asian Financials showing the best earnings visibility in 2019 of the large sectors that we cover

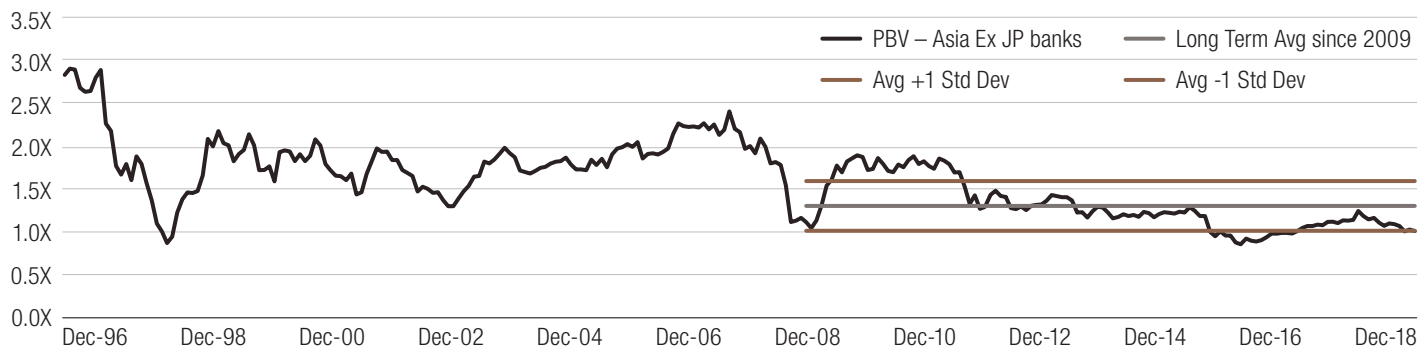
given the top line growth and continued support from lower loan loss provisions.

Valuation is supportive

Asian banks valuation remain quite attractive in our view with the current Price to Book (PB) of Asia Ex Japan banks at 1x

PB, which is one standard deviation below its 10 year average of 1.3x PB.

Figure 16 – Asia Ex Japan banks, price to book ratio



Source: RIMES, Morgan Stanley Research.

ASIA TECH IN 2019

Asia Tech stocks pulled back substantially from an elevated level in 2018 and their valuation in general has become more reasonable now. Many crowded trades fell from a forward earnings multiple of 30x-40x to >20x or even in the teens levels towards the end of 2018. At the beginning of 2019, we are seeing inventory buildup in the semiconductor and electronic component supply chain. Taiwan Semiconductor Manufacturing Company (TSMC) is seeing semiconductor inventory levels increase from a few days above seasonal trend (high) to 10 days above trend (very high) in January 2019. Some of it was due to component supply constraint in the earlier part of 2018 and some of it could be related to the pull in of shipments to the U.S. to avoid the additional tariffs that may be imposed on Chinese goods in January 2019. There was also a sudden drop in demand since the beginning of 2019. The strong growth in the Internet and eCommerce sector is still intact but increased regulatory measures and intensifying competition are affecting company's earnings projection, as all the low-hanging fruits have been realized over the past 5 years and they now have to invest more to compete. We expected this to affect their valuations going forward.

In 2019, we expect share price to continue to be weak in the first half because of weak fundamentals in hardware tech. The macro slowdown in China is also affecting internet/eCommerce companies. However, we do see opportunities in 1H19 to accumulate some stocks if their valuation goes from reasonable to cheap, and most of the weakness for the year is priced in. Areas of interest include electric

vehicles (EVs), internet/eCommerce and companies that can benefit from building more bandwidth in telecommunication infrastructure.

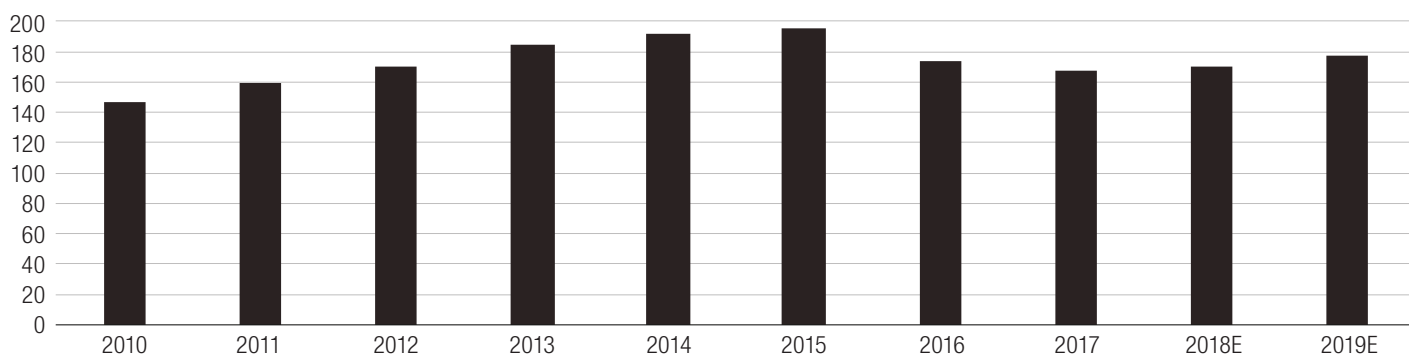
5G – Too early to get in

We should see the first phase of 5G launch in 2019/2020 but we expect a pause afterwards, because there is no readily available applications that can utilize the full power of 5G. This is why the global wireless capex is expected to be still below the 2013 levels. No one would pay a premium for a mobile plan that a normal smartphone user cannot tell the difference. If not many people are willing to pay a premium for a 5G plan, telco operators will not continue to invest into something that cannot get the return on investments. This is similar to the 3G service in 2000. It did not take off until the iPhone launch in the mid 2007. In fact, it triggered rapid transition to 4G because users were willing to pay a premium for the higher data rate to enhance a good user experience of using a smartphone.

Bandwidth – Always need more

In contrast to the 5G market, the bandwidth infrastructure builds should continue over the next decade. We see optical communication components continuing to benefit from this trend. One of the main risks is that many of these component companies are also exposed to ZTE and Huawei, which may potentially be banned by the U.S. and some other developed countries. Some of them are also affected by the low adoption rate of the 3D-sensing biometric market for smartphones. We will continue to monitor this segment before we make any investment decision.

Figure 17 – Global wireless capex (USD billion)



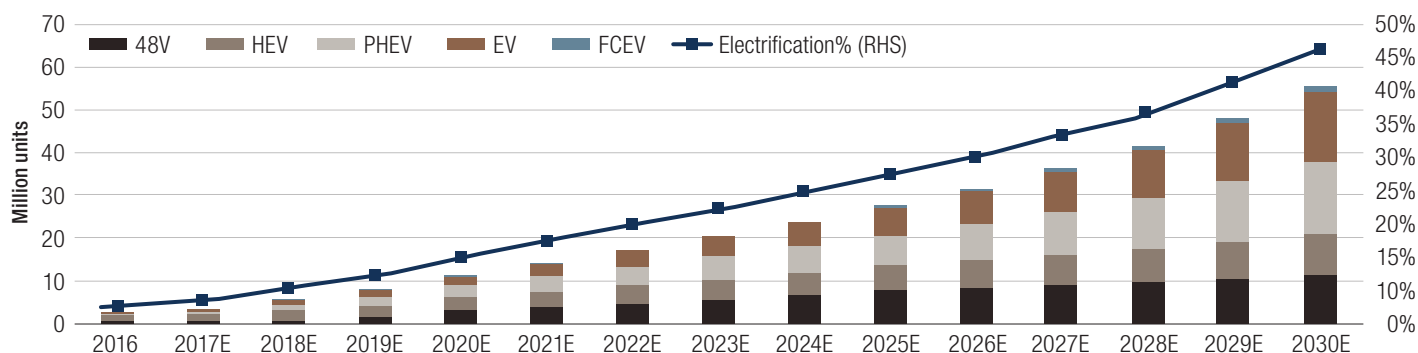
Source: Credit Suisse estimates.

Electric Vehicles (EVs) – The beginning of a secular trend

As the EV (Electric Vehicle) industry continues to improve, the driving range of many EVs are now comparable to ICE (internal

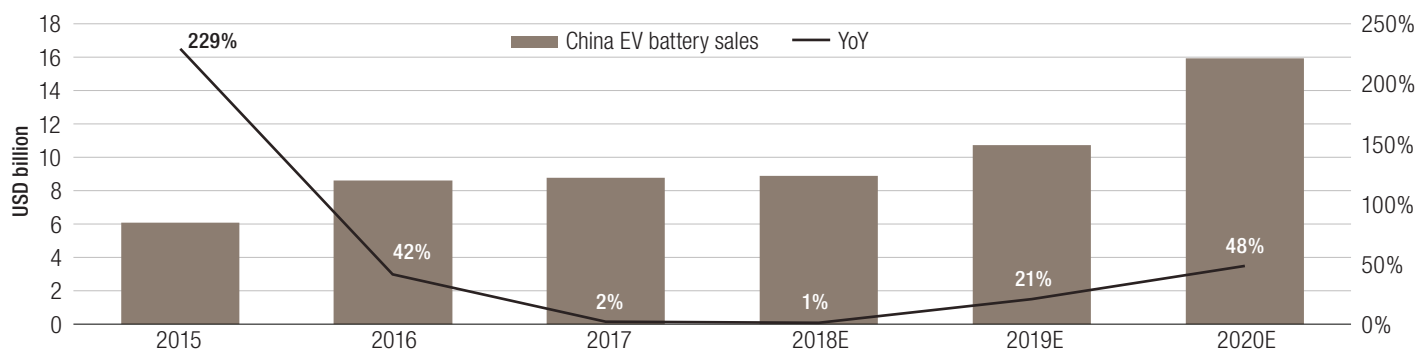
combustion engine) passenger vehicles. EV/hybrid penetration rate is expected to surge exponentially to 45% in 2030 from only 6-7% today.

Figure 18 – Electrification percentage of the global auto market 2016-2030E



Source: Marklines. IHS. Credit Suisse estimates.

Figure 19 – China EV battery sales



Source: Company data, Macquarie Research, October 2018.

The Chinese government is expected to cut EV subsidies every year and phase out subsidies in 2021, when the average price of an EV will be similar to an ICE vehicle. With so many up-and-coming EV brands in China, it is not easy to identify which brand(s) will become

a winner in future. Therefore, we believe EV component makers with good technology and market share will likely benefit most from this secular trend. EV batteries and battery materials could be an interesting area of potential investments in the long term and

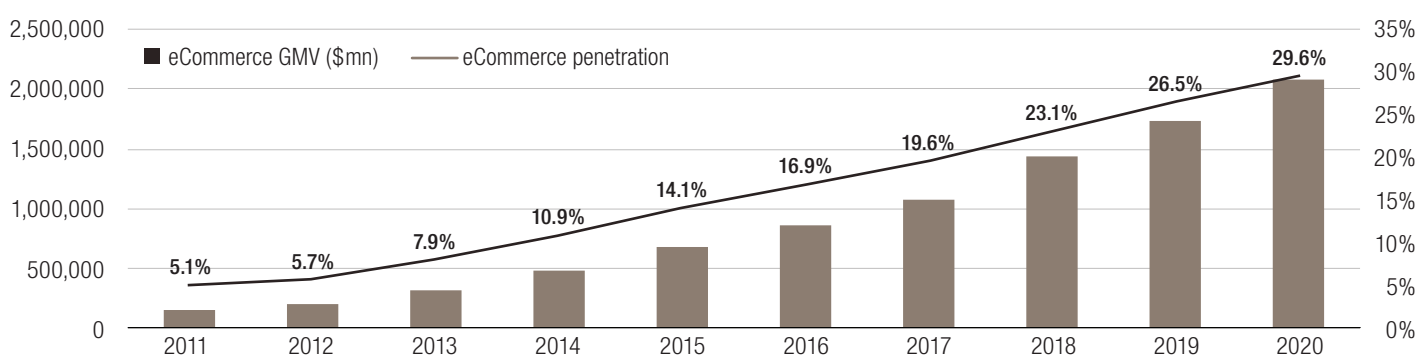
growth is expected to accelerate in the next 3 years. However, the valuations of these companies has continued to be a challenge for us. We will continue to monitor this sector closely to gain exposure in this sub-sector.

Internet & eCommerce – Competition heating up; stick with the leaders

We still expect a structural CAGR of 15-20% for the Internet and eCommerce sectors in China. Our only concerns are a changing regulatory environment, the macro slowdown as well as the intensifying competitive environment. The whole sector is no longer as straightforward as before but still an area of great interest for

us particularly because of the long term potential. Valuation has become more important in making investment decisions. In the long term, we will likely see the Chinese internet/eCommerce giants trade closer to the multiples of their US counterparts, which are at forward P/E multiple in the teens versus >20x today. Tencent should be less affected by the macro slowdown as compared to Alibaba because of the nature of its business model, which relies more on games. The tightening of regulations in the game sector in 2018 also formed a low base for Tencent for longer term investment. The stock has de-rated from >40x forward P/E to roughly 27x based on Bloomberg consensus.

Figure 20 – China online retail GMV (gross merchandise value, USD million) and penetration rate



Source: BofA Merrill Lynch Global Research estimates, company data.

Smartphone – Don't look back

Smartphones are no longer a secular driver for the tech sector. It would be similar to the PC market after the year 2000. It would be a market driven mostly by replacement demand, with a growth rate of less than 5% in a good year and slightly negative growth in a bad year. Samsung will probably launch its first foldable phone in 1H19. The success of this new phone depends on its value proposition to consumers and the retail price. Even if the phone is successful, it may only lead to a shift from a rigid phone to a foldable one, which is a bit similar to the shift from desktop to a notebook PC 15 years ago. It will not be new secular demand driver for the overall smartphone market. With an expected price tag of USD 1,500-2,000 for a foldable phone, it may take a few years of cost reduction to make it reachable to the mass market at below USD 1,000.

ASIA CONSUMER/HEALTHCARE

China and India remain our main countries of focus in the Asian Consumer sector, with 65% of our ex-Alibaba positions wholly or heavily exposed to China, and another 15% to India. The Asia Consumer sector's performance in 2018 was meaningfully impacted by Chinese stocks' gradual weakening, versus Indian stocks' resilience. In 1H18, consumer stocks in China (staples and discretionary) outperformed sector peers in other Asian countries – as volumes generally accelerated and price increases were implemented. It was the reverse in 2H18, as consumer confidence was impacted by the crackdown on peer-to-peer lending and weak housing prices. China consumer companies' sales until Q3 were solid, however the outlook on Q4 18 and Q1 19 has been unequivocally cautious. Meanwhile, aggregated retail sales numbers have weakened.

Figure 21 – China consumer staples: Underperformed strongly in 2H18 as P2P lending crackdown hit and macro concerns grew

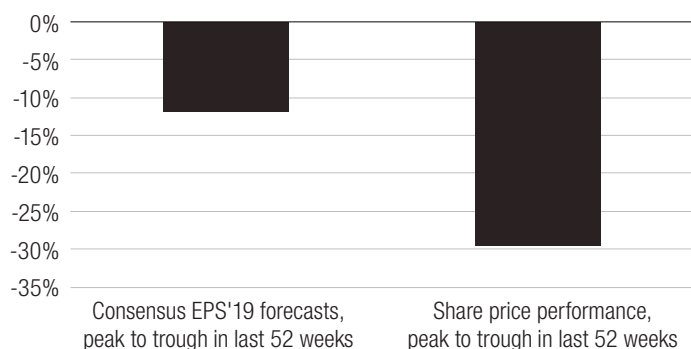


Source: Zenith Optimedia, Newzoo.

It is important to note that China consumer stocks' valuation levels at this point have come down meaningfully more than consensus EPS forecasts, and a number of stocks are trading on high operating free cash flow yield levels (between 5% and 9%). While this is not a catalyst per se, it explains why we are comfortable holding

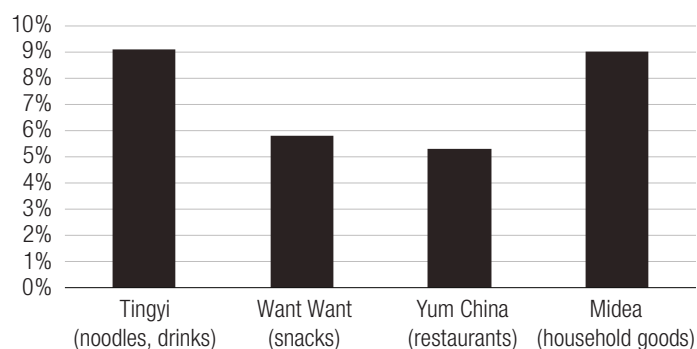
a high portion of China Consumer stocks in the portfolio at this point. Additionally, a major positive difference with the Chinese consumption slowdown of 2014-15 is that players have become a lot more disciplined on the distribution side, and as a result channel inventory levels are lower than at the time.

Figure 22 – China consumer valuations have declined much beyond forecast revisions



Source: Bloomberg, average of 17 consumer staples and discretionary stocks.

Figure 23 – Selected China consumer stocks free cashflow yield



Source: Company reports, LOIM estimates.

China

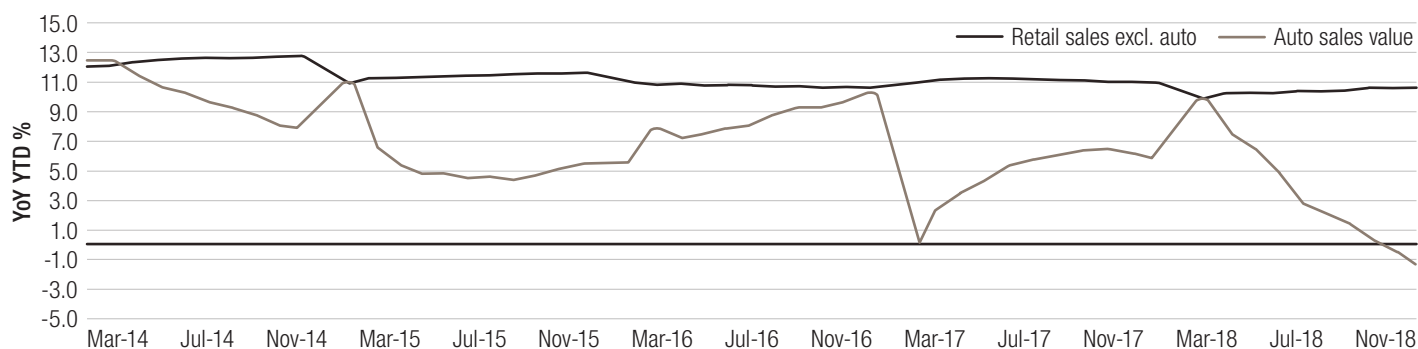
China consumer trends have slowed since late summer 2018. Softness had already been clear for several months in Autos (which account for an estimated 10% of China's retail sales) and Household Goods, due to the clampdown on peer to peer lending in early 2018 and a high 2017 basis. Excluding these two sectors, China's retail sales growth has slowed by c1% across 2018 to c10% in November. Online retail sales are still growing solidly but also slowing: growth YTD in November was 24%, of which September/October/November were distinctly lower (+19%/+16%/+15% respectively). Baidu and other advertisers have given soft guidance on expected advertising spending growth in 2019.

The impact of 2019 income tax breaks on consumption should be quite negligible at this stage: the draft document published on the

subject in late 2018 provides for higher income thresholds and deduction of various expenses (healthcare, education, mortgage costs). However, the estimated impact would be an increase of only 2%-4% on the relevant taxpayers, and there are a mere c20 million of such taxpayers in China.

At this point, we expect top line growth in low/mid-single digits for most Chinese consumer companies in the portfolio in 2019 (staples, retail, dining) and low double digits in specific segments (e.g. travel-related). Indeed, trading up and more frequent usage is a feature in more discretionary sub-segments (e.g. travelling, high-end yoghurt, health supplements, dining out, air-conditioning devices), and these sectors generally outperformed consumer staples even during the 2014-15 downturn.

Figure 24 – China retail sales ex-Autos still solid – YTD YoY growth of retail sales



Source: CLSA.

We do not expect margin expansion in 2019, despite subdued raw materials prices, as consumer companies are investing to capture higher growth. In 1H18, ad spend and/or selling costs increased by two thirds for the 15 top consumer companies we monitor in China. The fact is that numerous consumer categories in China are already well penetrated, and competition is plentiful and aggressive regardless of the macro cycle, meaning that growth comes at a higher cost. This has been a clear trend not just in consumer staples but also reported for instance by Ctrip (rising cost of servicing clients better) or Alibaba (rising cost of content).

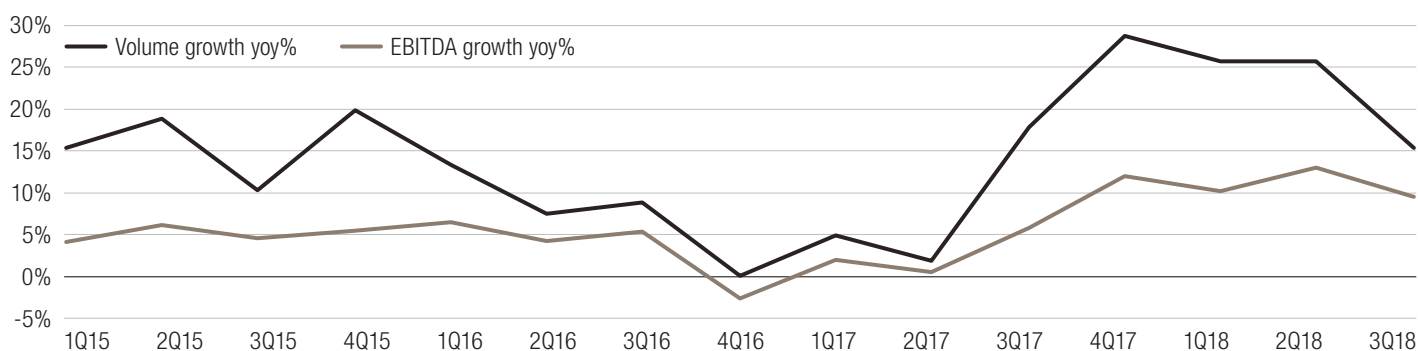
A defining feature of 2018 in China was the regulatory changes implemented by government in various segments, initiating in 1H 2018 (e.g. in online lending, shadow banking, electric vehicles) and accelerating from the summer (education, healthcare, online gaming, e-commerce, duty-free spending). Given the ground covered in 2018, we expect regulatory pressures to stabilize/abate in 2019. Though some of these changes significantly modify the business models of private companies in the short term, it is useful to remember that most of them are intended to protect/support consumers' disposable income and well-being, and ultimately raise consumption's share within China's GDP.

India

The Indian market could be quite volatile in 2019 as investors focus on election noise and outcome, and the government's fiscal discipline. On a relative basis, however, we expect consumer-related stocks to outperform most other sectors, as any populist decisions will be aimed at supporting rural consumers. In addition, the last reported quarter (July-September) confirmed that India top consumer companies' had recovered from 2017 demonetisation and GST reforms. Across our core coverage group, average volumes rose 9% and EBITDA rose 15% despite a sharp acceleration in the comparison basis. Most companies reported some price taking, continued stronger growth in rural areas versus urban (driven by decent monsoons and an increase in minimum support prices earlier this year) and a generally positive outlook.

Within the sector, our preference goes to companies with very high brand recognition, proven execution within the distribution network, a large/growing exposure to rural areas, and a product portfolio offering multi-year trading up potential. Although valuation levels are not cheap, these types of companies tend to deliver results very consistently.

Figure 25 – India top consumer companies' volume and EBITDA growth have recovered from 2017 fiscal reforms



Source: Company reports, LOIM estimates, calendar quarters shown.

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