Matthews Asia

# Matthews India Fund

## Period ended 30 June 2018

For the first half of 2018, the Matthews India Fund returned -5.76% while its benchmark, the S&P Bombay Stock Exchange 100 Index, returned -6.44%. For the quarter ending 30 June, the Fund returned -2.54% while its benchmark returned -0.12%.

### Market Environment:

During the first half of the year, India's equity markets were less volatile in the second quarter compared to the first quarter. We continued to see investors shun small- and mid-cap stocks, however, in favor of larger-cap stocks.

Monetary policy tightening started in the second quarter with the Reserve Bank of India (RBI) increasing repo rates by 25 basis points (0.25%) at its June policy meeting. Rising oil prices and hardening inflation trends likely forced the RBI to act. An RBI inflation survey suggested that household expectations on future price increases have risen meaningfully over the past three months.

The Indian rupee depreciated by -5.05% against the U.S. dollar in the second quarter. Rising oil prices heightened fears around fiscal slippage. Investors also were wary that the government led by Prime Minister Narendra Modi would be forced to increase fiscal spending in rural India in order to woo voters as this is the last year of his five-year term. Recent announcements around sharp increases in minimum support prices for paddy (unmilled rice) confirmed those fears. Collections of the Goods and Services Tax (GST) continue to lag expectations, which has fueled further fiscal concerns.

Investors also were jittery about the Modi-wave losing steam. Modi's party performance in the elections for the large southern state of Karnataka was behind expectations, creating speculation that Modi may not get a majority coalition in the next general elections in 2019.

### Performance Contributors and Detractors:

For the six-month period, the portfolio's higher allocation to small caps hurt performance, though this was partially mitigated by stock-specific factors within our mid- to large-cap holdings. For both the second quarter and year-to-date periods, the portfolio's lower allocation to macro- and policy-driven sectors such as energy, utilities, telecom and metals also helped performance, though this was offset by relative underperformance by our consumer staples stocks and some small-cap health care stocks.

Our small-cap health care stocks held up well relative to peers in the benchmark in the first quarter of 2018, but the market was less discerning in the second quarter when it came to small-cap stocks. Given the relatively high valuations among small caps, we have been trimming our exposure to relatively expensive small caps over the years, except in the health care and information technology sectors, where we felt valuations still provided some upside.

Similar undercurrents within our consumer staples holdings hurt our portfolio performance in the second quarter, though stock-specific factors also were responsible for our relative underperformance. After the implementation of demonetization and GST in India, many domestic consumer companies' underinvestments in their distribution systems—be it usage of technology and data analytics, or expanding direct retail reach—have come to light. One such holding has been Emami, whose excessive reliance on wholesalers to distribute its products did not augur well for its performance. The company seems to have learned its lesson and has tried to correct its mistakes. In the medium term, we expect that its performance could revert to normal.

## Notable Portfolio Changes:

During the second quarter, we exited Bharat Financial Inclusion, a microfinance lender recently acquired by another of our holdings, IndusInd Bank. We also exited a couple of relatively smaller positions across the financials, consumer discretionary and technology sectors, where our conviction levels diminished over the years. We also added Natco Pharma, a pharmaceuticals company primarily focused on complex generic drugs for the U.S. market but that has recently turned its attention to India. The company's share price has been generally expensive due to its performance but has corrected, in line with the shares of most health care companies. The near-term outlook on its earnings also has been a concern, given the lumpiness in its business. But we also view that as an opportunity for long-term investors like us to buy shares of a well-managed company.

## Outlook:

India's domestic economy is likely to strengthen in 2019. Disruptions related to demonetization, GST and real-estate reforms are largely over and demand for services and goods continues to recover gradually. Gross capital formation is also likely to pick up amid the government's heightened focus on employment creation ahead of elections via infrastructure spending. Management teams have indicated that there are signs of private capital expenditure beginning to pick up.

We believe corporate earnings also should continue to recover in 2019, led by normalization in the consumer-related, pharmaceutical and financial sectors. Consensus expectations for earnings growth, however, seem highly optimistic. Valuations seem to be close to historical averages, though growth expectations remain high.

Oil prices can be a spoilsport. Oil constitutes a large part of India's import basket and directly feeds into its current account balance. A sharp increase in oil prices beyond US$80 a barrel most likely would have an adverse impact on India's currency and could lead to a sharp pick-up in inflation and cost of capital (in general). In the past, such an environment has not been kind to equity investors. Amid all this volatility and noise, we remain committed to our long-term and bottom-up investment approach.

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Investors should not invest in the Fund solely based on the information in this material alone. Please refer to the Hong Kong Offering Document for further details of the risk factors.

Sources: Brown Brothers Harriman (Luxembourg) S.C.A, Matthews Asia, FactSet Research Systems, Bloomberg