

Hong Kong Trip Report

Hong Kong, February 25 – 26, 2016

Executive Summary

The outlook for both global economic growth and growth in China remains murky, but the hedge fund community in Hong Kong anticipates no hard landing

In their view, the Chinese economy will stabilize in 2Q 2016 and then deliver tepid growth for the remainder of the year, as the Chinese authorities have ample room to support the economy

In January, the sharp correction in the Chinese stock market was driven by the liquidation of levered A share funds, by small and mid-sized domestic insurance companies liquidating their equity portfolios, and by evaporating liquidity ahead of the China Lunar New Year

The challenges in China are well known and once the macro picture stabilizes, sentiment will turn and investors will flock back to the Hong Kong stock market

International investors are heavily underweight emerging market stocks, even though valuations look compelling

Capital flows to emerging markets will resume once the USD strength is waning and commodity prices are bottoming

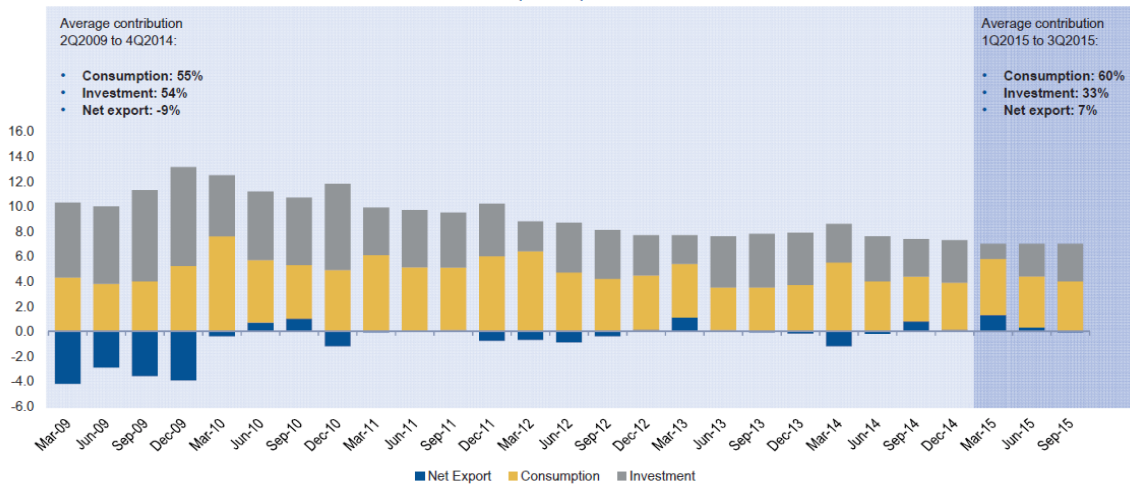
Macro and Equity View

1. China: An economy in transition, but no hard landing for now

China's economy grew an average 10% for 30 years, lifting 500 million people out of poverty and making a few people extremely rich. Now its leaders are ditching the old investment and export-led growth model in favor of a model where markets, consumers and services rule. The chart below visualizes how the transition is playing out. The contribution of consumption to GDP growth is rising (c. 60%) and that of investment is falling (c.33%), while the export-led growth model is maturing (c. 7%):

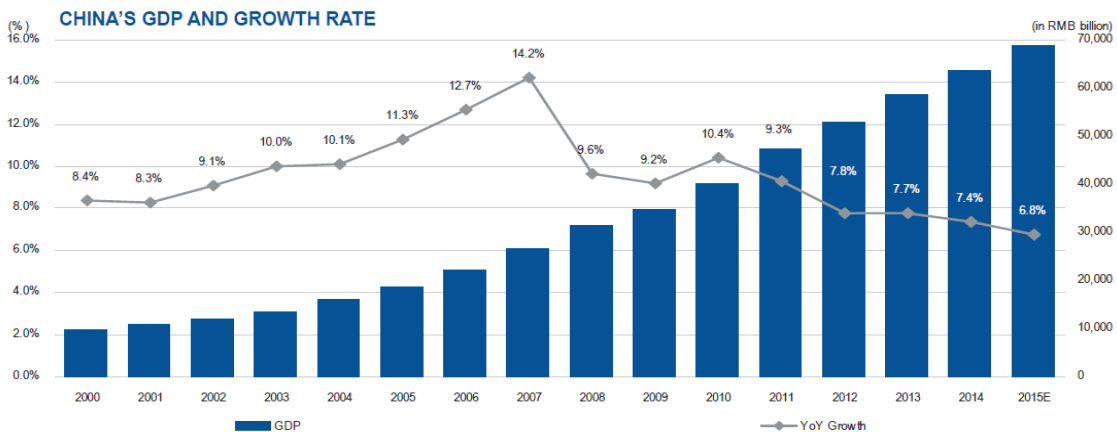
The consensus view on China continues to be based on the same post-GFC investment-driven growth framework, whereas the country's economic structure is clearly changing

SHARE OF CHINA GDP GROWTH BY EXPENDITURE (QoQ%)



Source: CEIC, as of October 31, 2015.

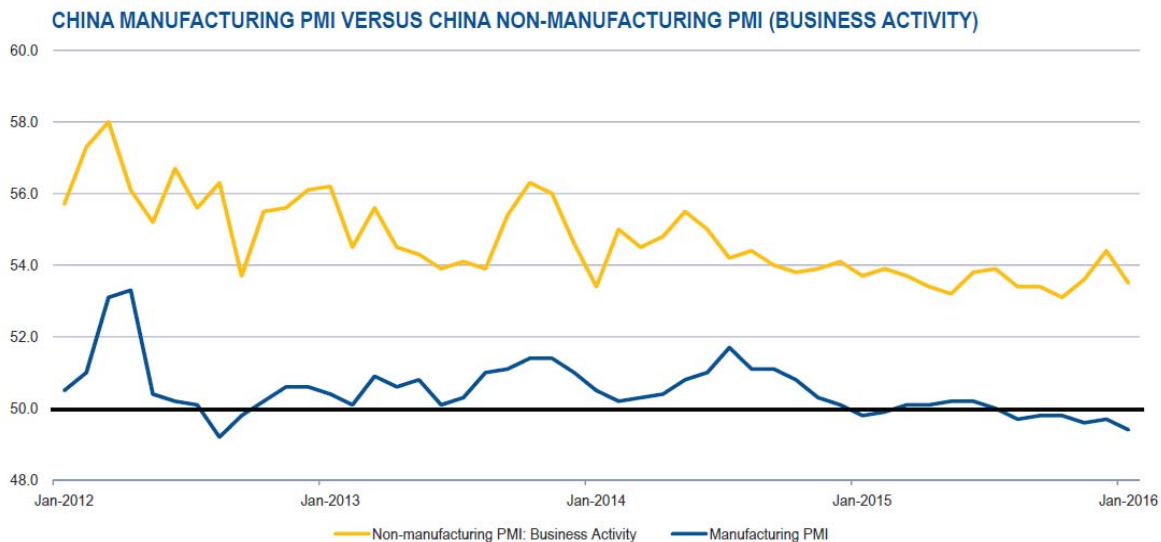
Clearly, the Chinese government is willing to tolerate lower growth as long as employment remains stable. The stated goal is to guide the economy to a more sustainable, but lower growth trajectory, seeking quality - and not excessive - growth.



Sources: International Monetary Fund, World Economic Outlook Database as of October 2015.
1. China Daily "Lower GDP target is healthier." March 7, 2012.

But given the emergence of China as a global force in the world economy in recent years, any slowdown and change in the composition of its GDP growth can bring about significant spillovers to global growth, to its trading partners and to emerging market commodity exporters.

For some time now, China has lived with a two-speed economy, which is quite confusing for international investors. China's state-owned industrial firms in sectors linked to real estate, steel, cement, coal and construction equipment all suffer from massive overcapacity, while private companies producing goods, services and internet-related activities for a growing consumer market have taken over from manufacturing as the engine of China's growth. These companies are mainly clustered in megacities along China's Eastern seaboard (Shenzhen, Guangzhou, Shanghai, Beijing) and their success is closely tied to global networks of knowledge, finance and talent. The service sector continues to grow at double digit rates, while the "old economy" industries have lapsed into a recessionary environment.



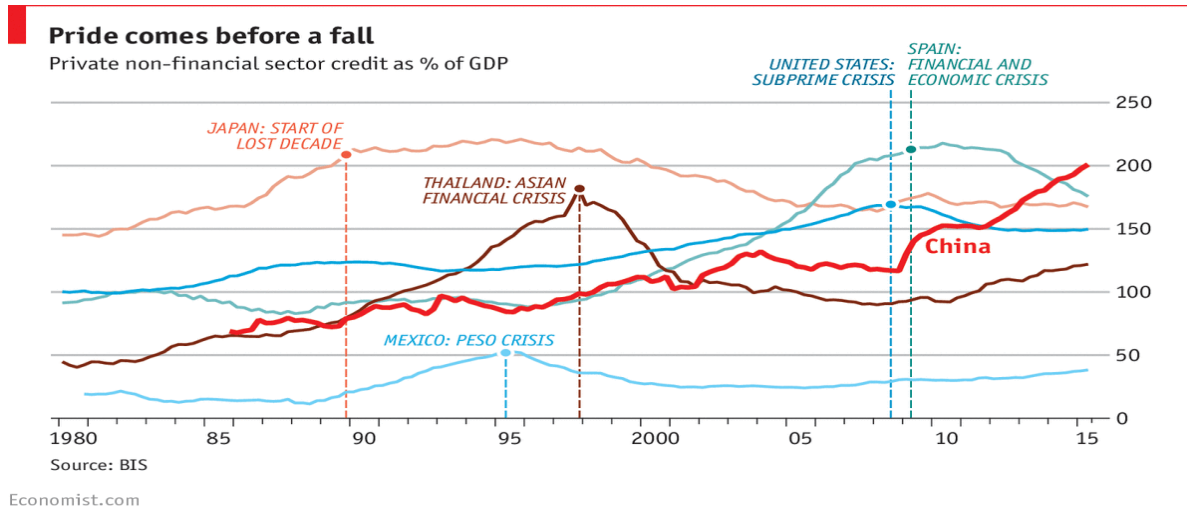
Sources: Wind Information Co., as of January 31, 2016.

Source: Neuberger Berman, 2016 (slides 1 to 3)

On the back of company visits and their own economic research, our managers in Hong Kong maintain a cautiously optimistic outlook for 2016 and believe that the Chinese authorities still have enough firepower and policy tools to avert a hard landing. They expect to see a bottoming of the Chinese economy in March and April, followed by tepid growth for the rest of the year. That China's official PMI index increased to 50.2 in March from 49.0 in February is an encouraging sign. The sub-indices tracking production, new orders, import prices and new export orders all improved. This suggests that the pickup is relatively broad-based. Recent optimism among manufacturers appears to have been boosted by greater stability in the yuan, the bouncing Chinese stock markets and economic goals outlined in the country's next Five Year Plan.

Yet our managers are also mindful of the structural problems and do not expect that the market will return to a very bullish sentiment soon. Challenges remain, such as overcapacity and high debt. Weighing down the economy is significant overcapacity in

real estate and heavy industries such as coal, mining and steel, rapidly rising corporate debt and four years of falling industrial prices. In 2015, China's banks reported their slowest profit growth in 10 years amid rising bad loans. Despite six interest-rate cuts since November 2014, several reductions in required bank reserves and ramped-up infrastructure spending, China's economy has not yet gained traction.



Before a new bull market can develop, our managers suggest that the government needs to address four key issues:

- Fiscal cliff: Government income from land sales has declined -30% in 2015, while government spending picked up by +50% in 2H 2015. How will they deal with that problem? So far, monetary easing did no work to stimulate the economy. They will now tackle the supply-side and clamp down on overcapacity in materials and consolidate the market.
- Bad debt in banking system: Unofficial figures are much worse than the published numbers. Many corporations in China are under stress, notably in the old economy. In March, they will publish the latest figures about non-performing loans. They could surprise to the downside and potentially trigger a short-term scare.
- RMB depreciation: Devaluation will happen in the medium term, as more and more people seek to take money out despite the capital controls.
- Restructuring of the “old economy” (i.e. bringing the reform agenda back on track):



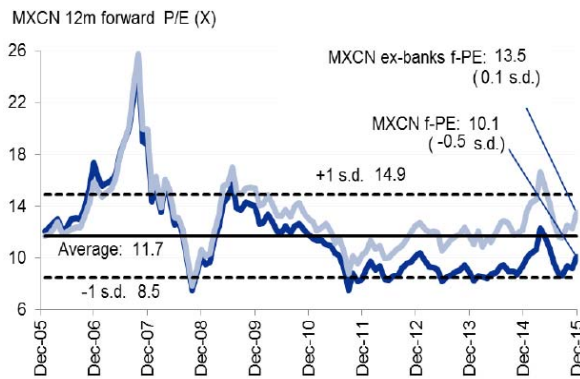
Fixing the problems will take time, as most of them are structural and cannot be solved overnight. The market expects therefore to see a continuation of this bumpy transition phase and that China will muddle through in 2016.

2. Investment Implications

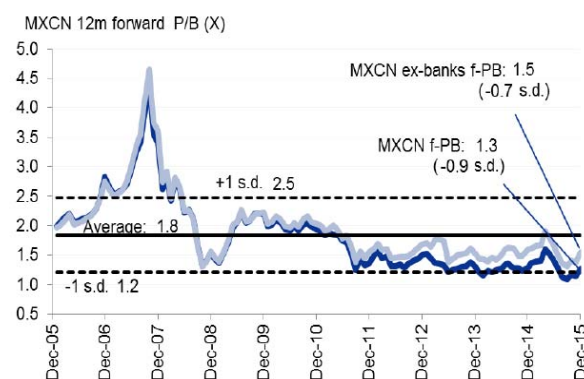
Our managers emphasize that Chinese stocks in Hong Kong (i.e. H shares) offer attractive terms and better values than stocks in China's domestic A share market. While it is true that Hong Kong will also be affected by the spillover effects of any setback in the A share market, Hong Kong's advantages look compelling: The domestic A share market is still very much a standalone market and not fully open to foreign investors, while Hong Kong is an internationally recognized, liquid and free market dominated by institutional and professional investors. In addition, the Chinese A market is highly policy driven and largely dominated by retail investors (about 90%), who in turn act very sentiment-driven and with a short investment horizon.

Valuations of Hong Kong stocks have dropped to a very compelling level, recently trading at a discount of c. 40% to the policy-driven A share market. At the end of February, H shares traded at 0.6x P/B and with a forward P/E of 6x. The MSCI China compares with a P/E of 10x also very favorably to the valuation levels of both Asian and global markets. Yet international investors are strongly underweight emerging market stocks in general and Chinese stocks in particular.

MSCI China 12 months forward P/E



MSCI China 12 months forward P/B



Source: Value Partners, January 2016

Global stock markets are still facing headwinds and China's economic growth outlook remains challenging. But this is where active asset management comes into play. Our managers are not only able to go short "old economy stocks", but they have also identified those investment themes which will be benefiting from China's new growth engines, such as the insurance, pharma, and consumer shares as well as those firms which are the likely beneficiaries of the reform agenda underpinning the next Five Year Plan. Prices have already discounted much of the negative effects of the reform and the anti-corruption campaign. Investors can now find value in China. It is up to them to get back into emerging market stocks in the near future, capitalizing on attractive entry levels once the macro picture stabilizes.