

Hong Kong Trip Report

October 3 - 5, 2016

Executive Summary

The leading indicators point to an acceleration of growth in China with container and railway freight volumes picking up

A global growth surprise could benefit Asian markets as the valuation is considerably lower than in the USA

A potential trade war between the US and China could however dampen the prospects for 2017

The frequency and severity of political shocks have risen and there is more to come, especially in Europe with elections in France, the Netherlands, Germany and possibly also Italy

The view in fixed income is that inflation will remain low forever, yet commodity markets have started to disagree

The inclusion of China A-Shares to the MSCI could revive the market in 2017 after a disappointing 2016

The devaluation of the Chinese and other Asian currencies compared to the USD will continue

Shanghai and Shenzhen Connect

The launch of the Shenzhen - Hong Kong Stock Connect making it increasingly easy for overseas investors to access China's historically 'closed' markets, whilst also helping pave the way for potential A-share inclusion in the MSCI EM Index in 2017.

The Shenzhen and Shanghai - Hong Kong Stock Connect programs now provide overseas investors' access to 1477 mainland China listed stocks, with a total market cap of around US\$6.5 trillion. This includes 722 stocks that are not constituents of the MSCI China A Index and are now accessible for overseas investors searching for alpha opportunities in the China A-share markets.

Many of the names listed in Shenzhen are high-growth companies, including prominent consumer, technology and healthcare names, which represent the 'new' China. With both Shanghai and Shenzhen Stock Connects available, active managers have access to a wider universe enabling them construct more meaningful strategies, whilst passive managers will be able to minimize tracking error against broader indices.

The launch of the Shenzhen Hong Kong Stock Connect also means that investors now have access to all but 59 names (4.1% market cap) of the MSCI China A share Index's 814 constituents.

MSCI China A Index is now easy to replicate via the Stock Connect programs:

	MSCI China A Index	SH-HK Connect*	SZ-HK Connect*	Not in Connect
No. of stocks	814	372	383	59
Free float market cap (US billion)	1773.2	1030.2	670.2	72.7
% of MSCI China A Index free float	N/A	58.1%	37.8%	4.1%

**Please note these figures comprise only of stocks available via the Connect Programs that are also included in the MSCI China A Index*

Macro View

Below some thoughts of Lloyd George in Hong Kong which we fully support.

Many Western observers have got China wrong in the past few years. It is indeed difficult to ascertain the true economic and political situation of the People's Republic of China. Next year will be a key year with the end of the five year term of President Xi Jinping and Prime Minister Li Keqiang which normally will be renewed for another five years until 2022. There are, however, rumors that by the time of the September National People's Congress meeting, Xi Jinping will have succeeded in changing the rules so that he is not compelled to retire after 10 years but can be President for life (as President Putin has managed to achieve).

The risk in China is political rather than economic. There will continue to be factional fighting and disagreement about the direction the Communist Party should take. What is relevant for investors is economic policy and the direction of the Renminbi (RMB) which we fully expect to continue depreciating. Now nearly 7 RMB to the USD, we expect that it will reach 10 RMB to the USD within the next two to three years. China's exports will continue to slow down and whether or not the GDP number reflects this, the overall economy will slow. In 2016 what was surprising to many observers was the extraordinary resilience of the Chinese domestic property market. Over the first half of 2016, Shenzhen, Shanghai, and Beijing have risen by 63%, 33%, and 47% respectively.

The PBOC is printing money and much of this additional money supply (as in the West) is coming into the hands of major financial institutions, Chinese banks and also state enterprises (SOEs). These in turn are leveraging their Chinese property assets in order to buy overseas assets. Most major SOE and financial institutions have now purchased their own headquarters building in Hong Kong. Chinese investors continue to pump up to USD 50 billion a year into property, not only in Hong Kong, Singapore and Thailand but also Australia, Canada, USA and even Europe. This wave of money (which is not very cost conscious) has artificially distorted many local markets, not least Hong Kong, because of the eagerness with which Chinese investors pay top dollar for flagship properties. We believe this cycle will come to an end by the second half of 2017, and there will be a global impact with lower property prices in all those locations affected by Chinese capital.

For the time being, we remain very positive about the outlook for sectors such as travel and tourism, education, healthcare, the internet and consumer spending. The middle class in China is now at least 300 million and is travelling and spending, if anything more than their American counterparts. It is important to Western observers and investors not to underestimate the vitality and energy of China's burgeoning private sector. The shift from exports (which may benefit from a weaker RMB) to a domestic consumption driven economy is happening faster than expected. "Singles Day" on November 11th was another record sales day for Alibaba. On-line shopping by the millennial generation in China is more advanced than in the USA.

The Chinese impact on the world is very large and important but if it slows down, it will have a significant global impact.

The key question for Western markets is whether the Chinese government will be able to control the capital outflows. In October, China's foreign exchange reserves declined by \$45.7 billion compared to \$18.8 billion in September, but hot money outflow increased from \$53 billion in September to \$92 billion in October, which was the highest level of outflow since January. According to sources in Hong Kong and China, the government is now planning to "close the gate" and severely restrict these overseas investments by individuals as well as Chinese corporates. We already see Hong Kong's high-end real estate suffering from a dearth of transactions (with very high stamp duty), and prices are beginning to fall. Over the next two years, we confidently expect this correction to become deeper and more prolonged.

The other major unanswered question is how will China navigate the trade issue once Trump has cancelled the TPP. Will the other Asian countries be willing to sign up to a new free trade agreement with China which may be very much in favor of China's low cost exporters? TPP would have been a boost to the ASEAN countries, especially Vietnam and the Philippines, because they would have gained access to the US market. As China depreciates its currency, it is restoring its competitive position compared to Vietnam, India, Bangladesh, Indonesia, and other low cost exporters in the textiles, shoes, and consumer products markets.

The fact is that China is still highly dependent on easy access to the US market and has the bulk of its foreign exchange reserves invested in US Treasury Bonds. This Sino-American relationship is critical to the world economy, and the next two or three years may see some severe strains as Chinese imports slow down, or are restricted, and US Treasury yields rise faster than expected.

Elsewhere in Asia, we see sharp falls in the JPY and other currencies since Trump's election. Japan should be benefiting from reflation, from stronger domestic spending, and defense spending, and the maintenance of the US/Japan Defense Treaty. In Southeast Asia, perhaps the symbolic point of world trade pressure, is Singapore, which has recorded very weak economic growth this year as oil prices have remained low and trade volumes also deteriorate. We do not expect oil to recover strongly, and our best guess is that it will trade around \$50-\$60 a barrel in the coming year. Most of the benefit of these weaker commodity prices are accruing to the large importing countries, such as India and its neighbors, as well as the East Asian countries.

The key to much in Asia is the new US policy. If US corporate tax is cut from 35% to 22%, this will surely boost capital spending and economic activity. The benefits will accrue not only to the USA but to globally competitive producers.