Shanghai Trip Report

Recovery and Re-Acceleration or Trade War?

April, 2018

Executive Summary

Chinese equity markets led the global rally in 2019, as a technical rebound from the sharp sell-off in 2018 and the Fed's volte-face to a dovish stance in January 2019 propelled equity markets higher

The improving trade war narrative, the powerful pro-active fiscal and monetary stimuli by the Chinese government, and the opening up of the domestic capital markets to international investors through MSCI inclusion were the three main drivers behind the strong bounce of Chinese equities

China announced VAT tax and fee reductions totaling CNY 2 tn for 2019 in an attempt to shore up domestic consumption and to counter the impact of the trade war

China's longer-term transformation towards a globally leading high-tech industry will only be slowed down by a trade war, but it will not prevent China from building its own high-tech companies and industries

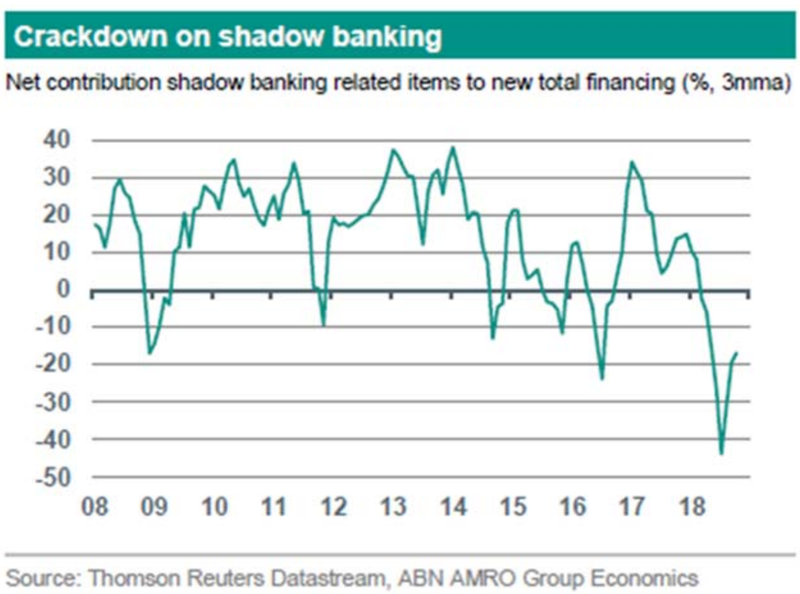
The rise – and increased consumption - of domestic China brands (such as Huawei, Geely, and Anta), lifestyle upgrades, SOE and financial reforms, and China's aspiration to move the economy up the value chain will transform the country for years to come so that global investors ignore or underweight the second largest economy of the world at their own peril

Between Temporary Headwinds and Structural Tailwinds

1. Policy Missteps and Unfavourable Economic Headwinds in 2018

In 2017, world equity markets benefitted from synchronised global growth, while in 2018 only the U.S. experienced a strong economic momentum and growth sagged in the rest of the world. As a result, it had been a challenging year for equities and for Chinese stocks in particular. The Shanghai Composite Index ended the year below the threshold of 2'500 – about 25% lower than its final close of 2017. All 10 sectors of the index were down significantly, with information technology, as the worst performer, plunging -34%. Even the best performer, utilities, dropped -11%. All in all, it was Shanghai's worst performance since 2008, when it plunged more than -65%. Massive losses were also encountered elsewhere in China, with the Shenzhen Composite Index collapsing more than -33% in 2018. As shares on the mainland exchanges took a beating, Hong Kong stocks performed better. The Hang Seng Index notched a decline of only -14%.

Two major factors unsettled the Chinese markets for much of 2018: The slowdown in China's own economy as a result of a deliberate deleveraging effort by the Government and the ongoing Sino-American trade war unleashed by President Trump. Investors realized that they had significantly underestimated the highly negative impact of the government's push to clean up the shadow banking system. In order to tackle the high debt levels and in an effort to prevent a systemic crisis, the authorities stepped up their campaign to rein in the lending boom.



The government notably took aims at the shadow banking sector that provided financing to small and medium-sized enterprises and to private individuals. While the authorities have succeeded in draining the huge shadow banking swamp, the (unintended?) collateral damage was also massive and had started to derail the economy. The private sector was desperately struggling to find alternative sources of finance, as the state-owned large commercial banks rather preferred to lend to other state-owned enterprises than to private sector companies that were considered riskier. As the deleveraging took place at an aggressive pace in the centrally managed command economy, it quickly caused a credit crunch, especially for the SMEs. This was the main reason for the economic slowdown in the second half of the year. When President Trump unleashed a trade war that culminated in severe punitive tariffs on Chinese imports, it did not only hurt China‘s economy, but also affected international trade, global supply chains, capital spending, and the risk appetite of investors. The situation was exacerbated by a strong US dollar and rising oil prices that weighed on global growth in the first three quarters of the year.

2. Changing Global Macro Story

Yet the continued slowdown and the prospect of a trade war with the U.S. prompted the Chinese government to react, as economic stability is one of the central tenets for the Communist Party. It quickly remedied its policies in summer, especially its focus on deleveraging. In an effort to check the downturn, policymakers promised further tax cuts in 2019, increased infrastructure spending, an „appropriate“ monetary easing, and an improved access to credit markets for small and medium-sized enterprises.

In January 2019, the global macro story also started to change. Plunging equity markets across the globe in Q4 2018 and a sharp decline in crude oil prices in the same period conjured up the specter of a global recession. These developments prompted the Fed to reconsider its interest rate policy, and in January they hinted at pausing from further rate hikes as it assessed the direction of both the global and the U.S. economies and the impact of its previous policy moves. As a result, risk free rates across different markets continued to fall, with German Bund yields turning negative again and China’s total social finance system, a broad measure of credit and liquidity in the economy, reaching a new high (RMB 4.64 tn) in January. Thus, we are now almost back full circle to the situation in 2017, when central banks were reflating the economies. Then, as today, a global synchronized central bank “put” seems to be back in place to prevent equity markets from rolling over.

After the weak ending to 2018, global equity markets started with a strong opening in Q1 2019. The rally surprised investors not only by the breadth, but also by the amplitude and the speed by which it occurred. Many equity markets have seen returns of 10% and more in just a few weeks. A significant part of this is a technical rebound from the sharp decline in 2018 and another important driver of the re-rating is the perceived central bank “put” discussed before.

Chinese equity markets led the global rally, performing strongly in the first four months of the year. We can discern three main drivers behind this feat: The continued, improving trade war narrative as negotiations between the U.S. and China appeared to make progress, pointing to a sensible resolution in the near future. Secondly, fiscal stimulus and monetary easing in China were considered another very positive factor, as it highlighted the unflinching commitment of the Chinese government to pro-actively support the economy and to at least partially offset the impact of the trade spat. And, finally, the further opening of the domestic capital market, notably the A shares to global investors through MSCI inclusion, emerged as a powerful, long-term structural opportunity to both domestic and international investors to participate in China’s growth story at a very attractive valuation level after the sharp sell-off.

3. Additional Stimulus Measures in China in 2019

The government announced tax and fee reductions totalling CNY 2 trillion (c. USD 298 bn) this year. That is almost twice as much fiscal stimulus than originally planned. Last year, China made CNY 1.3 tn in tax cuts as the economy showed signs of slowing amidst a simmering trade war with the U.S. Consumer spending accounted for more than 75% of GDP growth in 2018 and has become the floor on which the Chinese economy stands in case of tariff escalation from Washington. Beijing therefore has an eminent interest in boosting – or at least sustaining - domestic consumption in an attempt to stem the slowdown. Cutting the VAT and social security tax (SST) are therefore the major components of the announced package for 2019. VAT rates are reduced to 16% from 19% for manufacturing and 9% (from 10%) for agriculture, transport service, construction, leasing services, wholesale and retail sales and real estate, while the VAT rate of 6% bracket remains unchanged for financial, telecom and other services.

To support the tax and fee cuts for the corporate sector, Beijing is asking state-owned banks and some of its SOEs to hand over larger portions of their profits. This is a potential headwind for the A share market, which is heavily invested in Chinese SOEs and banks. This essentially means that the government policy is biased to support consumption and the private sector at the expense of public sector funding and that the market is not driven by a further cyclical credit expansion as many had anticipated.

4. Outlook for 2019/2020

In 2019, growth in the U.S. is expected to slow down, as the fiscal stimulus is petering out while a persistent weakness in housing and the potential fall-out of the trade war on U.S. exporters, consumers, and farmers is a cloud hanging over the market.

The longer-term structural growth perspectives of China‘s economy continue to look attractive, as a rapidly growing middle class increasingly focuses its consumption on higher value goods and services. At the same time the government seeks to modernize the economy, pushing it towards innovation and towards a globally leading high-tech industry under the label „Made in China 2025“. Another priority is to refocus the economy to an ecologically compatible model.

As long as the domestic economic and corporate fundamentals remain solid, China will remain the biggest driver of global growth. With valuations towards the low end of the historical range and at a significant discount to developed markets, investors appear too focused on short-term uncertainties and are ignoring the fundamental improvements that have taken place. Clearly, the renewed uncertainties around the trade war have rattled the market. But the base case still assumes that both countries need a deal – China to push through further reforms and Donald Trump a political win to re-invigorate his re-election campaign. While the trade talks can easily erupt into chaos and renewed tensions, the longer-term perspectives for China look differently. Investors simply can no longer ignore the transformation and the growth of the second largest economy of the world. The domestic A share market will be driven by the impact of the counter-cyclical stimulus measures, the push for innovation, the MSCI inclusion, the pace and scale of the structural reforms in the financial sector and of the SOE's as well as the urbanization plan which will relax the existing Hukou residency restrictions for about 100 milion rural citizens, encouraging them to move to smaller cities.

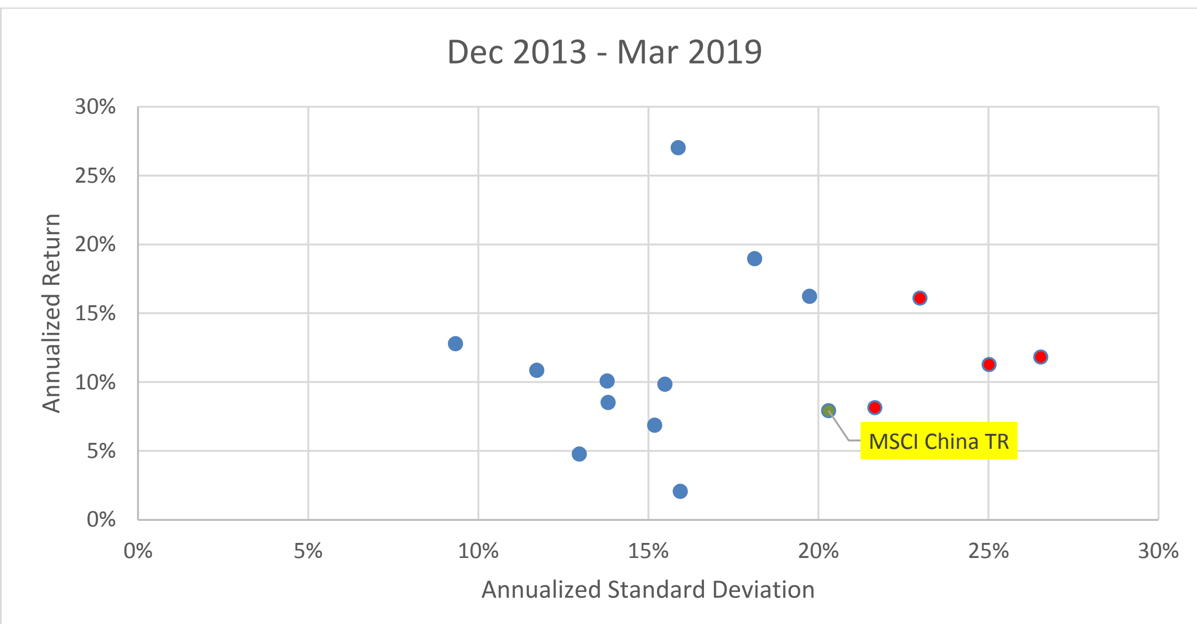
Short-term volatility can be taken for granted and political and event risks remain high, but China's aspiration to move the economy up the value chain will transform the country, boost consumption, investment and employment and drive China's growth for years to come.

5. Manager Selection is Key

Investors can gain access to the Chinese equity markets through a wide variety of fund types and vehicles. One of the conclusions from our recent trip to Shanghai is that the stable of investable managers is growing, as an exciting wave of talented managers has spun out of the established asset management shops in order to start their own business and run their own funds.

Investors searching for the best managers and gateways into China need to make three key choices: Do you want to invest in China through a Pan-Asian equity fund (where China typically accounts for about 35% to 40% of the regional allocation, while also largely driving the economic fate of the neighbouring countries)? Do you want to invest in a Greater China equity fund, i.e. in companies whose operations are focused mainly in, or that derive a significant amount of earnings from, the Greater China region (China, Hong Kong, Taiwan, Singapore and US listings and US ADRs, etc.)? Or do you want to invest in a country fund focused on the domestic A share market (i.e. on the stocks listed on the Stock Exchanges of Shanghai and Shenzhen)?

The next decision to make is: Do you want to invest through a long-only vehicle (in the chart below represented as red dots) or through a long-short, absolute return vehicle (i.e. the blue dots)?



The risk/return scatter graph highlights that manager selection is key, as the performance dispersion between the best (annualized return of +27% with a volatility of c. 16% in the reporting period) and the worst manager (annualized return of +2% with a volatility of c. 16%) is astounding and massive. And the chart also indicates that absolute return managers can add value in China. We are happy to discuss the implications with interested parties.