Crossbow Partners
Experience & Discipline

Hong Kong Trip Report

May 2 - 4, 2018

Executive Summary

Despite a strong equity market year in Asia in 2017, valuations do not look stretched after a difficult 2018 ytd

Manager are cautious as the political landscape becomes more unpredictable and a trade war between China and the USA seems to unfold

The development of the Chinese financial markets creates more opportunities through the inclusion of Chinese stocks in global market indices and the launch of CDRs as local trading instruments

M&A activity in Asia has increased from about 15% to 20% of global volume since the financial crisis 10 years ago

Long-term interest rates are expected to trend higher, but it is happening slower than the hikes on the short end which could result in a rather dangerous inverse interest rate term structure

The trade war and sanctions have had an impact on currencies which led to the depreciation of the Chinese RMB and other Asian currencies as a consequence

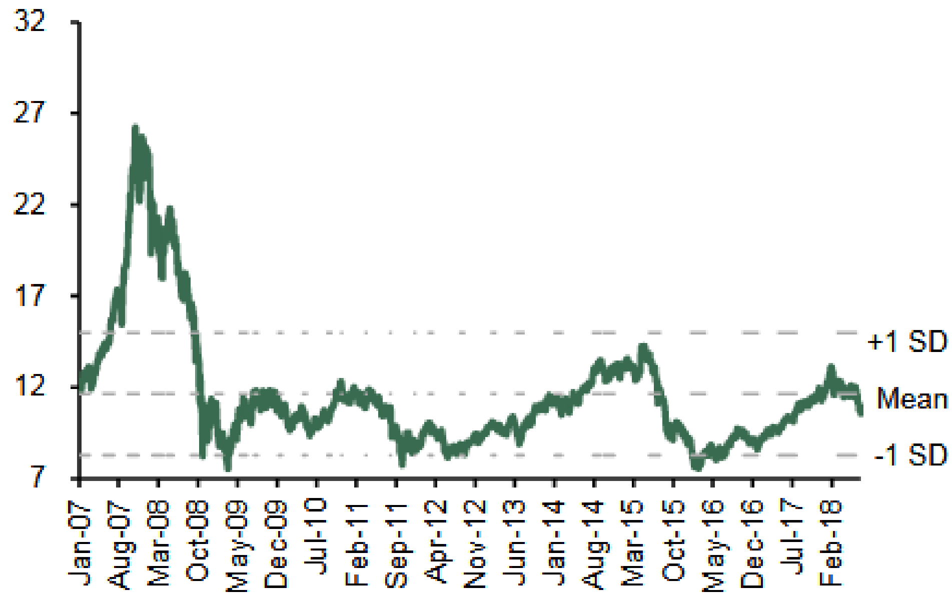
The USD is expected to remain strong until growth in the US starts to slow which would release some pressure from EM currencies

Asian Opportunities

The recent market correction has resulted in valuation multiples for key Chinese indices moving towards the lower end of historical ranges. Immediately after the additional US tariffs became effective on 6 July, the Chinese markets moved up sharply. This relief rally could be characterized as the reverse of the 'buy on rumour, sell on news' phenomenon.

The trade-related frictions could continue for some time and will offer attractive entry points for Chinese stocks which are trading at a P/E of only about 10.

Hong Kong Hang Seng Index, PE and +/- 1 SD



Quality stocks are preferred. Quality has many definitions but the focus should be on strong cash flows, excess returns, deleveraged balance sheets, reasonable valuations and robust earnings estimates that keep moving up, even in bad times.

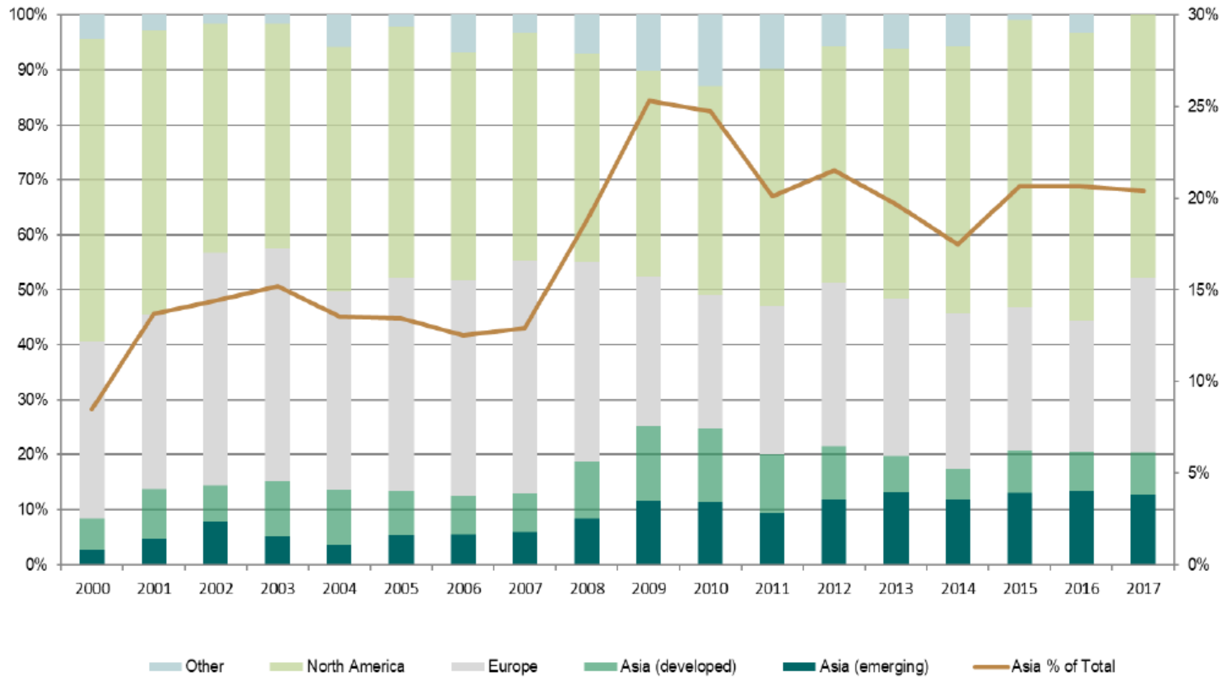
M&A Market in Asia

Activity levels generally are significantly up in 2018. More than USD 100 bn in deals (by aggregate target market capitalization) have been announced in Asia in the second quarter 2018. The activity levels themselves have been pretty spread out, with Japan and Australia both seeing a large increase in deals, including a lot of transactions over USD 2 bn, which tend to be more heavily traded. Hong Kong has remained the busiest market across Asia. In addition, there are material outbound investments from Asia into Europe and the US.

While North America remains the largest M&A market with about 50% of total volume, Europe follows with 30% and Asia has been steady at 20% for the past 10 years. More than half comes from Emerging Asia.

Asian spreads remain materially more attractive on an annual basis than in other parts of the world, although the deal break risk has been historically lower. The corporate world is still dominated by large families who are more concerned about deal breaks than the institutional players in the West. On the other side, Asia is still less covered and liquidity is lower which leads to better spreads.

M&A Transaction Volume from 2000 - 2017



Commodities vs Equities

In a heavily indebted world, we still like commodities, hard assets and hedge funds (instead of cash). Stocks are a better buy when the deficits are smaller and real rates are positive. With rates so low, you cannot trust asset prices today. It is amazing how cheap commodities are in comparison to equities. As mentioned in our latest newsletter, every cycle comes to an end and then commodities look much more attractive than equities.