Q2 2019 Review

June 2019

PRESCIENT
CHINA

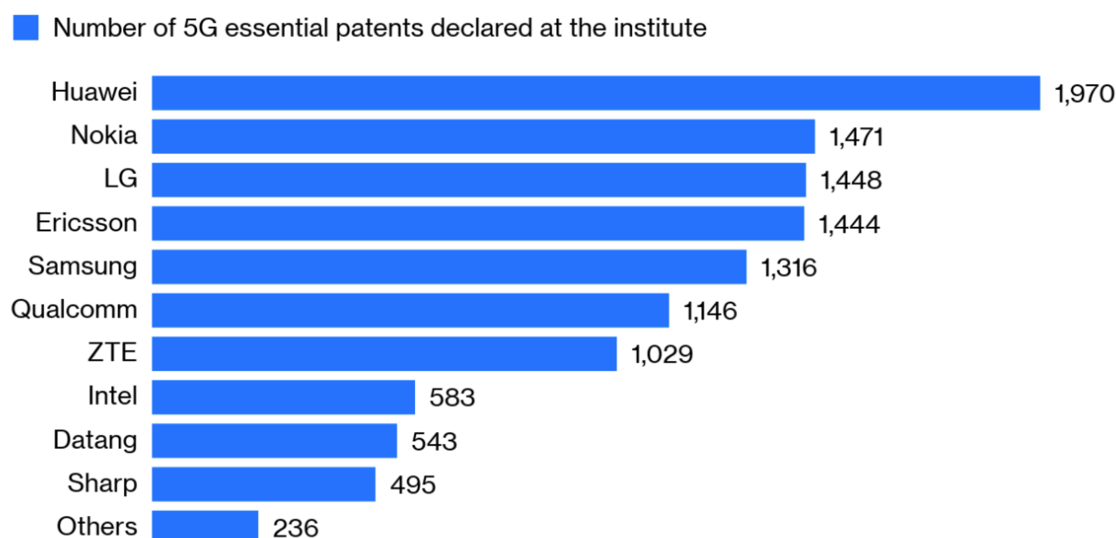
TRADE WAR REDUX

After the 30% plus return seen in Q1 2019, Q2 began on the front foot with continued momentum from Q1. Unfortunately, this did not last as trade talks between the US and China fell apart, which meant the Chinese equity market ended Q2 around -3% in the red.

The trade war escalated in May when the US accused the Chinese of reneging previously agreed points and proceeded to hike tariffs by 15% on US$ 250 billion of goods, and further threatened another 20% tariff on all remaining Chinese imports valued at US$ 250 billion.

Moreover, China agreed to pretty much all of the US's demands. As such, they agreed to increase agriculture and energy imports from the US where possible. They also agreed to open up more sectors of their economy to free and fair competition, with the exceptions being the finance, military supplies and infrastructure sectors. To this end, they even agreed to set up new laws to treat foreign companies equal to domestic companies. Despite this, the US had two demands that the Chinese were unable to fulfill. One of these demands was a unilateral enforcement mechanism whereby either side can monitor whether the other is sticking to the trade deal agreement. China said this was impossible to implement citing that it would restrict their sovereignty. They added that no nation would agree to this. The second US demand that the Chinese were unable to accomplish was putting an end to support for what the US calls key state organizations that invests in future technology. Research and Development is typically extremely resource intensive. The initial stages of research especially are not commercially viable. As such, the Chinese government will not abandon state organisations such as research institutes. This is no different to the US where for example, NASA has often done the research before private firms commercialized the technology.

Furthermore, the US placed Huawei on a restricted entities list, one designed for entities under sanction from countries such as North Korea or Iran. This severely restricted US companies from doing business with the Chinese telecommunications giant. Huawei is certainly a technology leader in China and a global leader in 5G technology. These restrictions dealt a large blow to Huawei's globalization plans and ensures that a Chinese company is not setting the standard for 5G that will become ubiquitous in the near future.



Once the trade war broke out, both the Chinese and US equity markets took a substantial hit. China wrote a white paper outlining its positions with the basic message that it is willing to walk away if certain red lines were crossed. Our core thesis has always been that a deal negotiated via underlings was never going to work between China and the US. Furthermore, both countries have a lot to gain by striking a trade deal whilst the failure to reach a deal will certainly have negative impacts on both economies as well as the coming 2020 US election. This last bit of posturing allows President Trump to both be the hero by solving the trade war and squeezes China for the last bit of concessions by testing whether the stated red lines are maneuverable. This is an effective and probably sound negotiation tactic.

Then sure enough, a freeze in the trade war was agreed upon at the G20 summit, were Trump also agreed to ease restrictions on Huawei. Trump then set off to make history by becoming the first American president to visit North Korea where he shook hands with North Korea's Supreme Leader Kim Jong-un (co-incidentally Xi Jinping was in North Korea just before the G20 summit). A little give and take goes a long way in geopolitics!

In other news, the Chinese economy has not seen the expected improvement. Our economic model in fact shows broad based weakness across most economic indicators with the only positives coming out of the property sector.

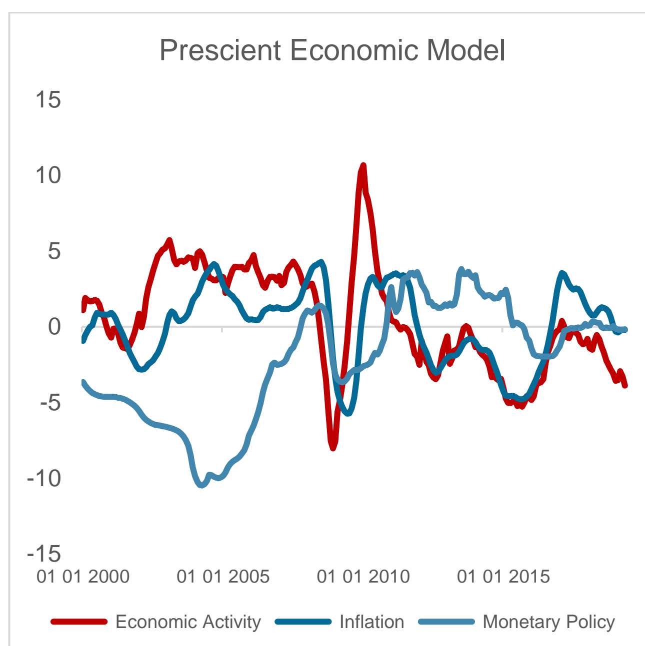


Figure 1: Source Prescient Data to end of June 2019

Figure 2: Source Bloomberg Data to end of June 2019

As previously mentioned, we have been and will be very data centric. This has meant we reduced equity exposure by some degree. It will continue to be monitored extremely carefully where further changes to our fund positioning will be made as the market changes.

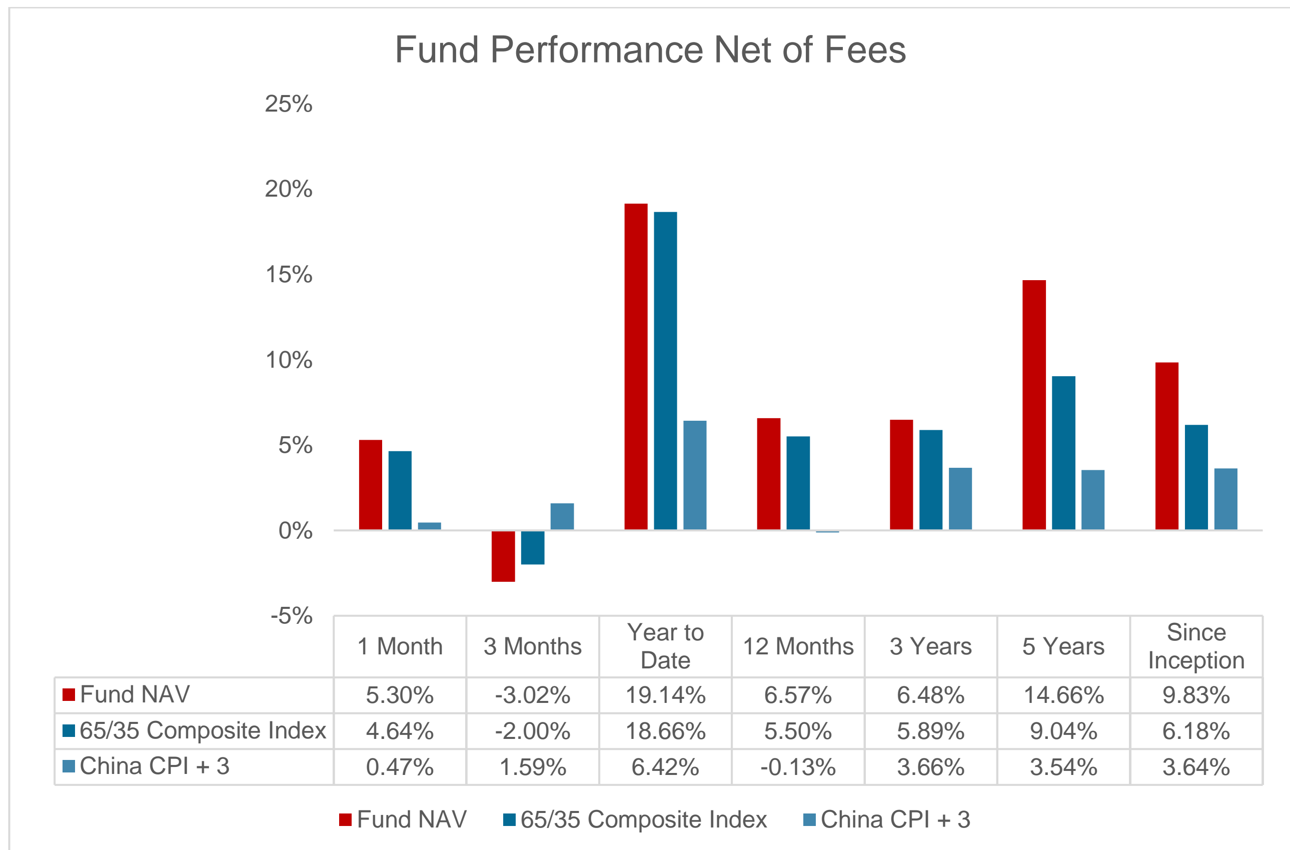
Fund Positioning

As economic data turned disappointing, equity exposure was reduced by 5% in total to be 85% of the Fund. Sentiment and valuations are still positive for China, so larger interest rate cuts are not yet warranted. As things currently stand, we are well positioned to increase or decrease equity exposure based on how China's economy moves.

In pure equities, focus remains on risk control by maintaining exposure to the behavioral biases we have identified, whilst at the same time, taking special care in hedging out the risks in such an environment. The chance that the trade war escalates, leverage and currency exposure are some of the aforementioned risks we will focus on in a market that is currently volatile with risks present on both sides.

Performance

The second quarter saw the Prescient Balanced Fund underperform the 65/35 composite due to the overweight (90%) allocation to equities at the beginning of the quarter. Over the longer term, the Fund has delivered an annualized 10% real return over the past 6 years, handsomely rewarding investors with high real returns and diversification benefits.



	1 Month	3 Months	Year to Date	12 Months	3 Years	5 Years	Since Inception
Fund NAV	5.30%	-3.02%	19.14%	6.57%	6.48%	14.66%	9.83%
65/35 Composite Index	4.64%	-2.00%	18.66%	5.50%	5.89%	9.04%	6.18%
China CPI + 3	0.47%	1.59%	6.42%	-0.13%	3.66%	3.54%	3.64%

Figure 3:Source Prescient data to end of March 2019 net of fees 1% fee class

The Prescient China Equity Fund saw a slight underperformance vs its benchmark over the quarter, mainly due to the poor performance of the value factor. Our risk control once again delivered on minimizing negative alpha when the factors underperformed.

At present, we believe there should be decent opportunities for alpha looking ahead where expectations are for strong forward-looking growth in the next cycle.

CONTACT INFORMATION:

For more information, please contact:

Liang Du – Executive Director & CEO
Gaurav Maleri – President Global Sales

Tel: +86-21-54566578
Email: liang@prescient.co.za
gaurav.maleri@prescientchina.com

Office 3703, K'Wah Center
No. 1010 Middle Huaihai Road
Shanghai 200031
People's Republic of China

www.prescientchina.com

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