2Q 2018 Review

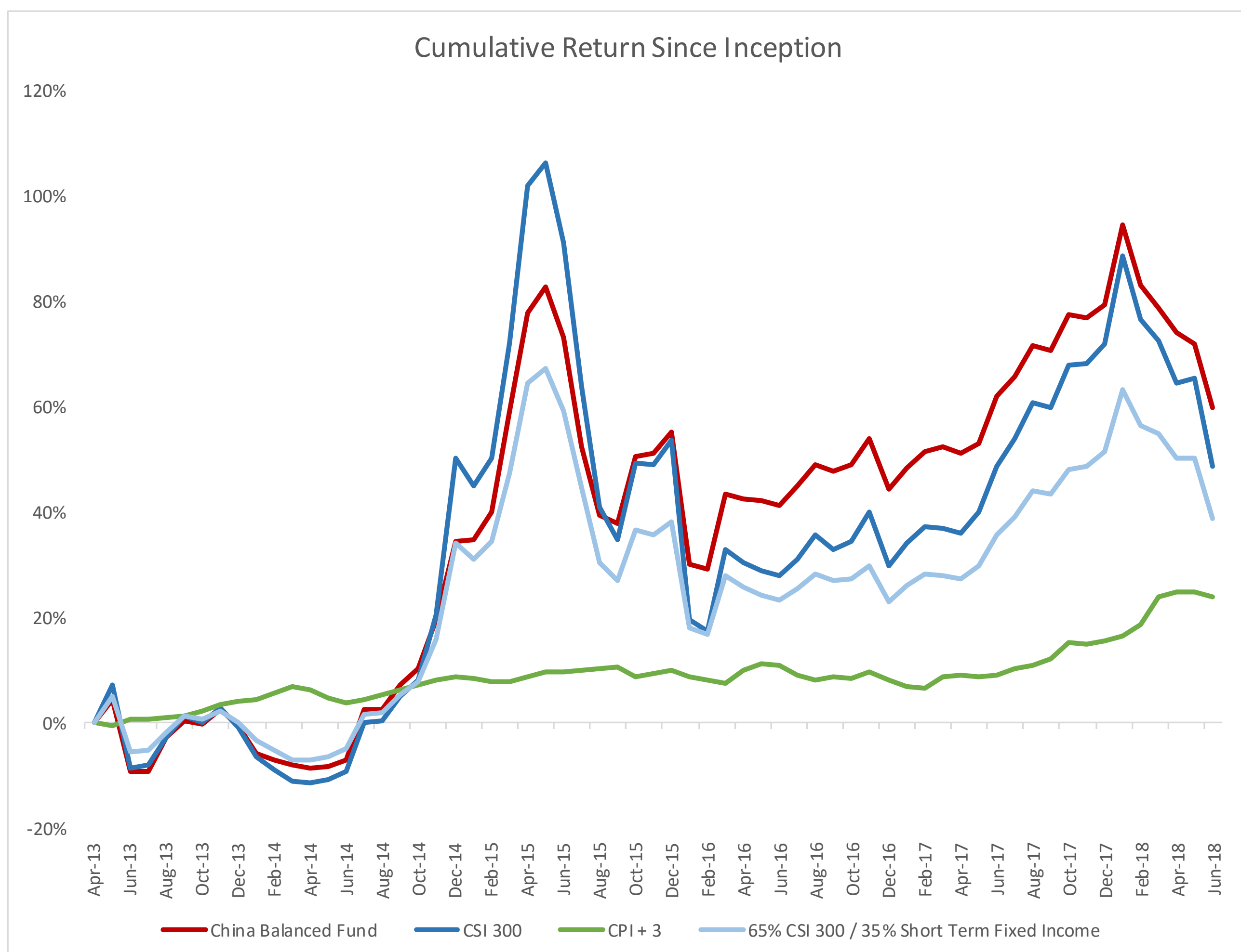
30 June 2018

PRESCIENT
CHINA

Trade Wars and Elections

For most of 2018 we emphasised the importance of asset allocation, especially within the context of a strong global bull market, potential trade wars and Chinese deleveraging. June was the month in which all these factors collided spectacularly, with a slowing economy and weak sentiment resulting in one of the worst months for Chinese equities in the past three years, down almost 7% in CNY and 10.1% in US$. The last time the Chinese equity market was this weak happened during the bear market in 2015.

Fortunately, we can report that the Fund entered June with close to the lowest equity exposure since inception, at 55%, compared to the long-term average of around 72% and the maximum targeted allocation of 95%. With the Chinese equity market falling by 7% for the month in local currency, the Fund was down approximately 4%. Since inception the Fund comfortably outperforms 100% equities, even after fees, and despite current weak market conditions has delivered around 10% p.a. in US$, after fees. The chart below shows the cumulative returns of the Fund after fees compared to the benchmark and the equity market index, the CSI300.



Our thoughts on the current market conditions; asset allocation decisions are always driven by our models, although they take a lot of the news into account, some topics have been rising more prominently than others. Arguably the hot topic is Donald Trump's trade war. We covered this in detail in our March update and our views have not changed.

The table below shows the contribution to revenue from total exports on the entire listed Chinese market of goods and services. Overall 7% of revenue is derived from exports. Most Chinese companies currently derive their revenue domestically. Detailed geographical breakdowns are harder to determine but assuming around half of these exported services and goods end up in America and trade reduces by 20-30%, we are looking at around 1% of revenue being affected.

	Revenue from export	Total Revenue	%
Financials	198,657,520,301	6,291,975,000,514	3.16%
Real Estate	6,204,799,140	1,121,497,018,790	0.55%
Health Care	8,353,587,975	354,630,240,922	2.36%
Industrials	732,673,005,180	5,974,427,088,275	12.26%
Materials	187,641,408,450	1,810,334,778,826	10.37%
Consumer Discretionary	361,784,513,166	2,723,637,701,005	13.28%
Consumer Staples	10,314,829,819	436,852,227,804	2.36%
Information Technology	226,953,176,609	666,246,743,973	34.06%
Utilities	13,256,128,902	466,405,817,644	2.84%
Energy	68,600,220,927	5,146,454,582,329	1.33%
Telecommunication Services	90,868,893	282,998,644,985	0.03%
Total	1,814,530,059,361	25,275,459,845,066	7.18%

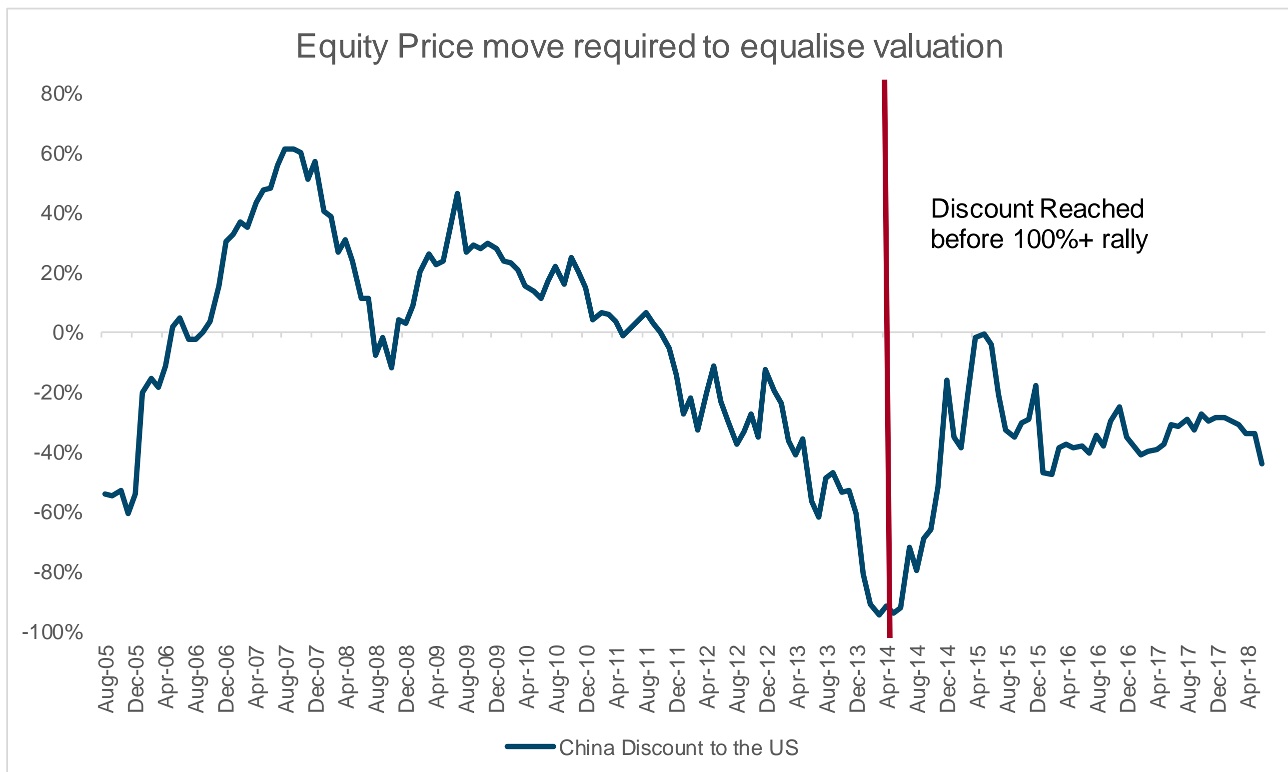
Table 1: Export Revenue by sector, Source: Wind

Of course, certain sectors have more to lose. The one most at risk is the IT sector, with companies such as ZTE (wiped out by the sanctions though one may argue is not strictly a victim of trade war, rather than poor governance of its own doing) and BOE Technologies (one of the biggest display makers in the world). Overall the impact, though meaningful, is likely to be small, especially considering the case that only the US is on the warpath, whilst the rest of the world tries to maintain free trade. The trade war is a sentiment damper rather than a fundamental train smash. What is also interesting to us being invested in the Chinese market is that the Chinese market is the only one reacting to the trade war threat. Should it escalate, retaliatory tariffs on American companies would be inevitable, with China the largest destination for American companies such as Apple, Boeing etc., the logical conclusion to the trade war would be a similar correction in the US market. Instead in the current environment China seems to be the only country which has discounted these risks in the market.

Early this year in January and February we discussed our own economic models showing a slowdown which contributed to our negative stance towards equities, at a time when news tended to be very positive on Chinese numbers. Surprisingly, the end of June was the first month we saw an uptick in the economic data, mainly expansionary PMI's combined with strong electricity, steel, rail traffic and vehicle sales which moved our overall model into positive territory. It is still too early to confirm that we are back to expansionary territory, but we are monitoring both the economic fundamentals in China and policy response from the Chinese central bank very carefully.

The final topic, quite important and more domestically focused, is the ongoing deleveraging campaign in China. Since the Great Financial Crisis, debt creation in China happened at a speedy pace. Only in the past three years has the government started to tackle this properly. Very simply put, the Chinese government has streamlined regulatory authorities to ensure less regulatory arbitrage, clamped down on shadow sources of financing, is forcing all players to remove implicit guarantees and move money away from short term products to long term funds managed by professionals. These reforms are much needed and during last year's bull market, as the products matured, the money just flowed into funds. In the past few months, on the back of negative sentiment, this flow has not yet occurred and as such the market is quite negative. We monitor both policy and sentiment carefully for signs of change and will act accordingly to take advantage.

What is exciting to us with all these negative things happening is that valuations are once again starting to look attractive. The chart below shows the valuation discount of China relative to the US. This chart shows by how much Chinese equities need to rise for the Chinese market to trade at the same valuation as the US market.



Although the market is not close to the previous extremes in valuation discounts, what is clear is that we are getting into very attractive territory. With the Fund coming into this correction with very low equity exposure and safe fixed income exposure, we are hungry for opportunities that this mini-crisis can bring.

We are monitoring policy, sentiment and economics extremely carefully, looking to increase our exposure to risk assets and benefitting from the next big rally.

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