3Q Commentary

September 2019

PRESCIENT
CHINA

MORE TRADE WAR AND HK OPPORTUNITY

China celebrated its 70th anniversary October 1st. Travelling during the national holidays truly reminds you of the scale of China, with over 700 million domestic trips booked during the national holidays and growth in travellers from fourth tier cities clocking in at over 25%, showing just how far China has come, but also how much more it needs to do, reducing poverty for the masses.

During the third quarter of 2019 it became even more apparent that global growth is undoubtedly slowing with the trade war a contributing factor. The Chinese market was down 3% in US$ over the 3rd quarter mostly due to currency depreciation while the market actually trading flat for the quarter in local currency. Despite the trade war volatility, the Chinese market have started to shrug off continuous worries about that. The market is rather focusing on the underlying fundamentals with earnings remaining steady.

Figure 1: Source Prescient, as at 30 September 2019

Looking at the Chinese stock index and earnings, we can see that the impact of the trade war has been limited so far, as we have always expected the direct impact would be relatively muted. Earnings, though not spectacular, is growing around 6% over the past year, slightly below nominal GDP growth of 7.6%.

Although the overall market levels are not affected by recent market actions, opportunities in arbitrage have increased in the last quarter. With growing protests in Hong Kong, dual listed shares that trade both in China and in Hong Kong have seen the respective Hong Kong prices fall by over 40% relative to their Chinese counterparts. These levels are some of the most attractive we have seen in the last 5 years. We took the opportunity to switch as much as we can without adding additional risk to the portfolio when compared to our benchmark. The chart below shows the levels that we entered the H shares. Though starting a little too early, the opportunity is fantastic, entering at current levels with overall discounts of 37%, and when the H shares revert to their A share levels or vice versa, the alpha contribution at Fund level is expected around 2%.

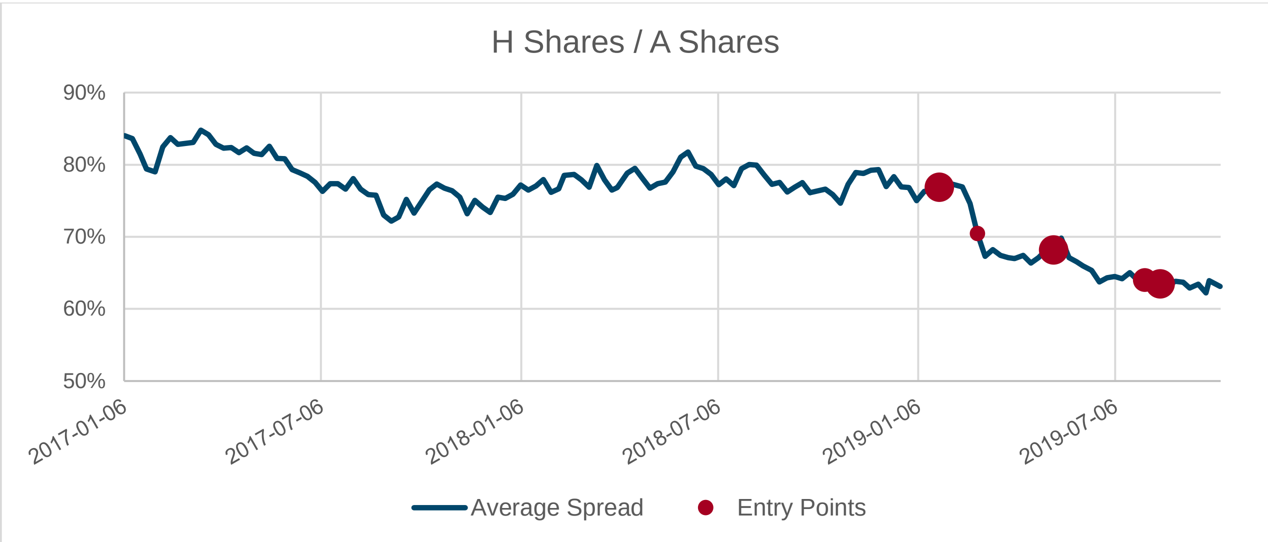

Figure 2: Source Prescient and Bloomberg as at 30 September 2019

Furthermore, futures in mainland China also started to trade at a discount. Currently there are no cheap ways for investors to short the market apart from essentially requiring a stockbroker to purchase the share, then allowing you to short it. Given that brokers require a return on capital, shorting individual stocks typically costs 8% p.a. at the moment. As such the only instrument available to short is a futures contract, and in periods of stress, futures are pushed into discount, currently sitting at around 3% p.a.. In combination with arbitrage opportunities, our equity portfolio moved from no dedicated arbitrage related strategies at the beginning of the quarter to 50% at the end. The combination of arbitrage strategies alone is expected to contribute around **3-4%** in alpha over the next 12 months at the Fund level.

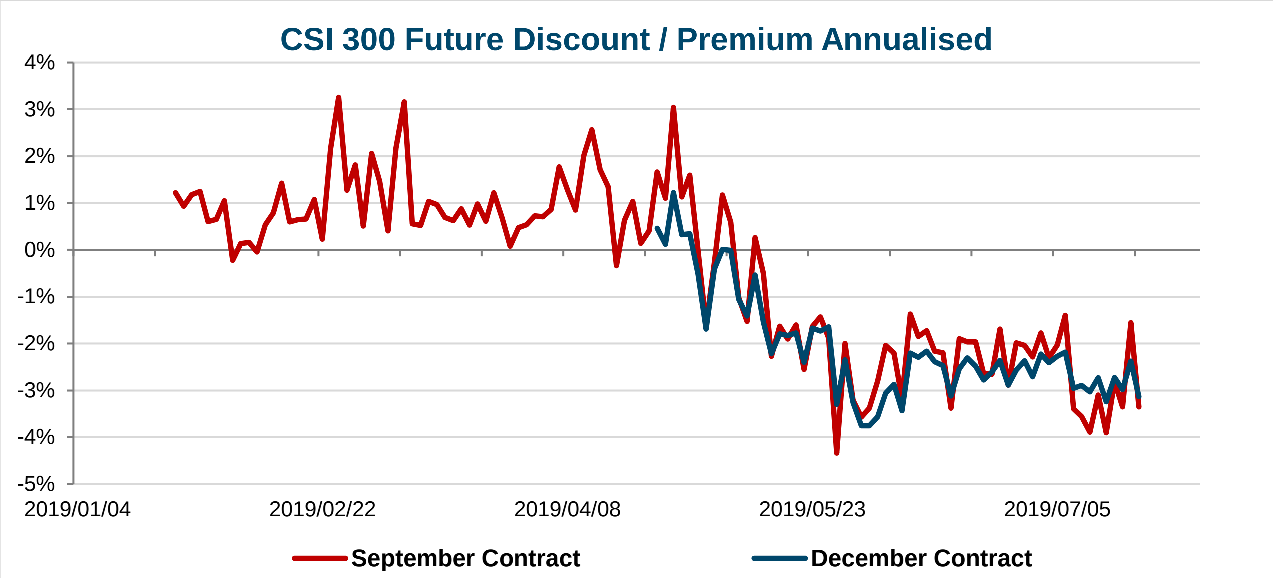

Figure 3: Source Prescient, as at 30 September 2019

Overall a combination of weaker economic fundamentals but still positive sentiment and cheap valuations, means we are constructive / positive on the Chinese stock market, we remain very focused on the data looking for risks and opportunities. Our economic model softened during quarter three, pointing towards a further weakening in China. Although headline inflation is high, primarily due to swine flu decimating massive stock of pork, core CPI remains low when excluding the impact of food inflation. Our own inflation model is consistent with that, showing higher headline CPI despite almost all the underlying components being on a downward trend. This combined with a small fiscal deficit means there are plenty of firepower available to both the Chinese central bank and Chinese government should the need for stimulus arise.

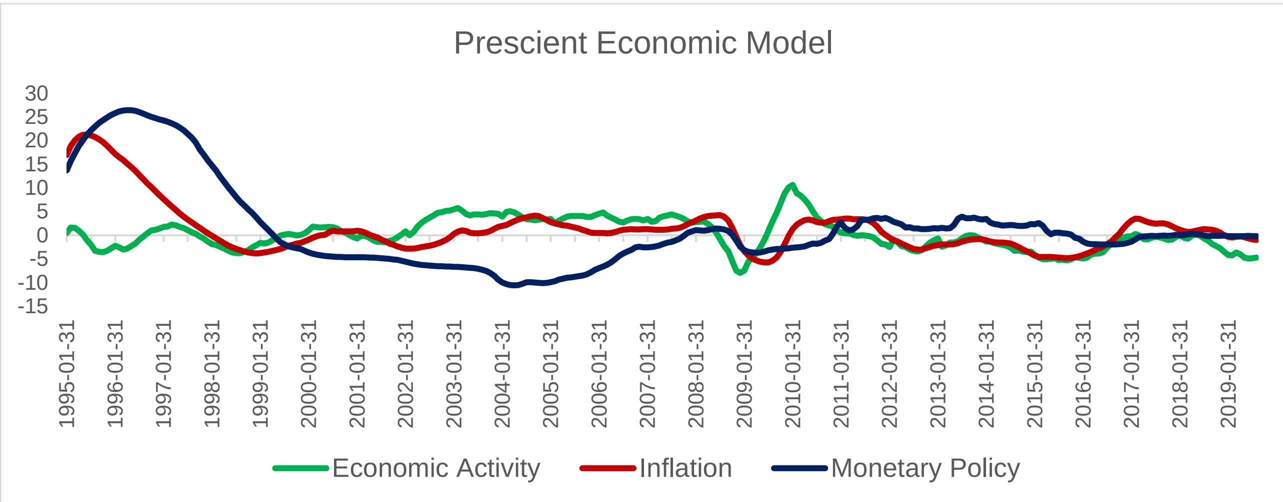

Figure 4: Source Prescient, as at 30 September 2019

With so much noise in headlines over China, combined with reasonably stable earnings fundamentals, attractive valuations and arbitrage opportunities, we remain overweight Chinese equities at the moment. We are very data driven, ready to increase the equity allocation further should the economic situation improve, or decreasing it if sentiment and economics deteriorate from here.

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