Q1 2020 Commentary

April 2020

PRESCIENT
CHINA

THE START OF A GLOBAL RECESSION

What a huge difference three months makes. At the start of the first quarter of 2020, the world looked like it was ready to continue on the path of the biggest bull market in history. Fast forward to the beginning of the second quarter of 2020 and it is pretty clear that there will be a global recession over the next two quarters, at least, with only the duration thereof uncertain.

In these extra-ordinary times, our China team has experienced and lived through the entire Covid-19 virus cycle and seen the social as well as economic implications. This may bring about some perspective on potential outcomes, perspective which is perhaps different to what nations under lockdown are experiencing.

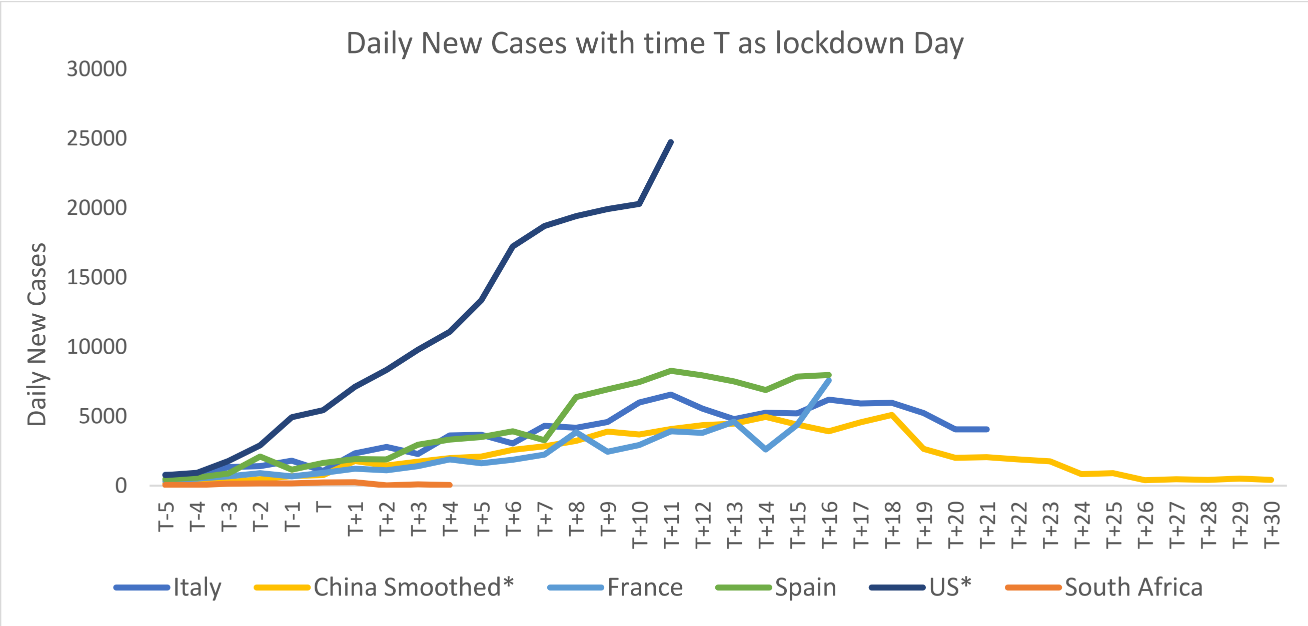
The Covid-19 outbreak in China started towards the end of December 2019 and by the 22nd of January 2020 the Chinese government had realised the severity thereof. Containment measures were taken very quickly. At that point in time, there were around 400 confirmed cases in Wuhan and another 200 in the rest of China. With only the information at hand, the Chinese government decided to place the entire country in lockdown by the 27th of January 2020. Thereafter, no one was allowed on the streets or in the shops, factories were closed, and mobility was strictly limited. By the 27th of January 2020 cases in Wuhan had risen to over 1400, the rest of China following suit with an additional 1400 confirmed cases.

The lockdown had an immediate impact on the transmission of the virus. Social distancing proved extremely effective and with a strict lockdown, new infections and incremental cases were contained extremely quickly. While infections that occurred prior to the lockdown were worked through the hospital system, new cases peaked around two weeks after the strict lockdown was imposed. China started phasing in the return to work from the 10th of February 2020. As at the 31st of March 2020, local transmissions had all but ended and life as well as the economy were almost back to normal. The Chinese population are aware of the dangers of imported cases and strict contact tracing and temperature checks aim to limit the risks of a secondary outbreak. In the event of another outbreak, the authorities would revert to stricter measures. As it stands, the economy is returning to normal at a rapid pace, with most restaurants starting to fill up and almost all services being restored. The entire cycle was spread over roughly two months. The first two weeks were extreme with the economy limping along with no work being done; however within four weeks, work resumed following a phased approach

So, what does the Chinese experience showcase as possible takeaways for rest of the world?

1. Italy went into a serious lockdown around the 10th of March 2020, with the rest of Europe following suit around the 14th to 15th of March 2020.
2. Prior to the lockdown, new infections occurred and currently these infections are working their way through the hospital systems.
3. We are already seeing the impact of the Italian and European lockdown; new cases in Italy and Spain seem to have peaked.

4. Europe as a whole started to impose lockdowns later than when China did. They are hence likely to experience far more cases than what China did. This is as a result of the exponential spread of the virus.
5. However, there is no reason to believe that the European lockdown would not have made an impact on overcoming the terrible virus. In fact, latest data clearly shows the peak in Europe has passed and a recovery phase is already in progress.
6. The US is about another week behind Europe in terms of action time frames. Worse yet, the US started the lockdown later than any other country and even as we speak, the lockdown has only taken place on a state by state basis.
7. South Africa took decisive action much earlier than the US or Europe did. As such, if our detection is similar, we should see an outcome significantly better than the US or Europe. After fifteen days of lockdown in SA, it is clear that SA has escaped the worst. SA should still be vigilant like China has been.



Source : Wind as at 31 March 2020

Note : China data was smoothed for different testing standards in Hubei, when testing kits were low. Total number was unaffected. The Chest x-ray diagnostic cases were smoothed over the previous week.

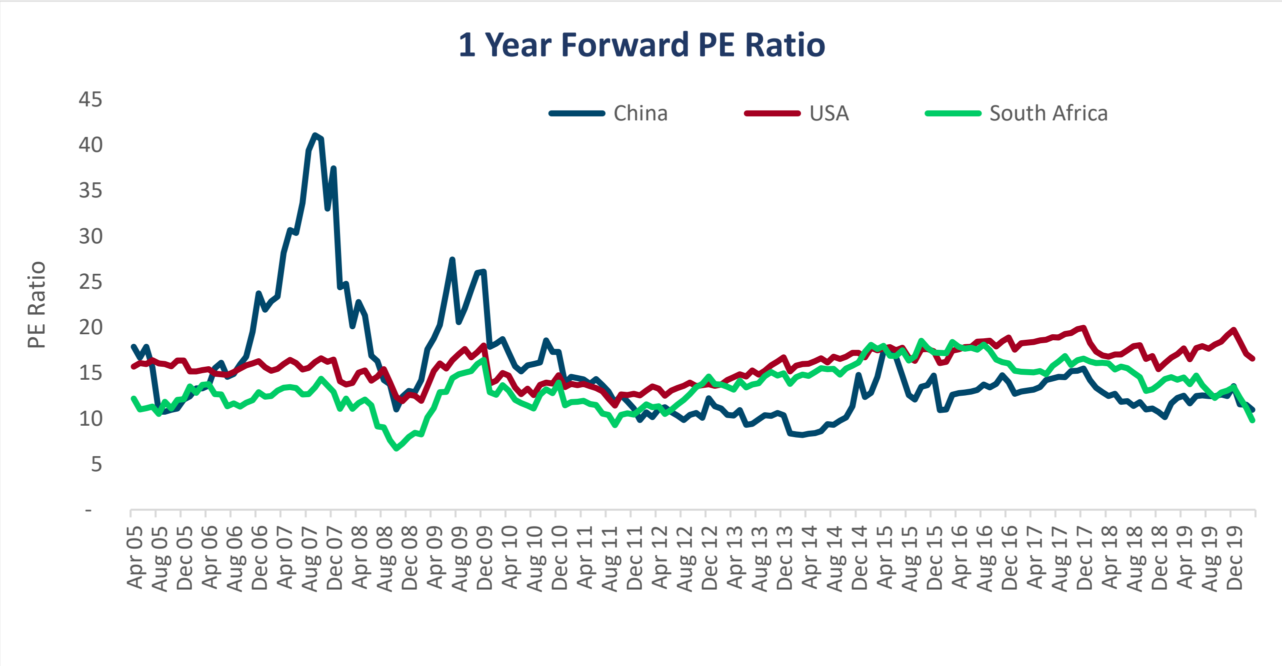
Looking at our two funds:

From an asset allocation perspective, we reduced equities when new cases in France and Germany increased by 100 per day. Having witnessed it in China, it was clear that the only outcome would be a lockdown, which when extrapolated to the largest and second largest economies in Europe, would imply a slower recovery for China. This resulted in the Fund cutting equity exposure down to 50% when the market was within 5% of its peak.

Global central banks have announced that large scale monetary stimulus (unlimited quantitative easing in Europe and the US, even via directly purchasing investment grade bonds and ETF's), as well as some of the largest fiscal stimulus in history (the US stimulus of US$ 2 trillion is double the size of the 2008 crisis bailout) are on the way. China is slowly dribbling in fiscal stimulus news into the market on a daily basis, but overall, early analysis seems to indicate a package of around 5-8% of GDP. This will be mostly in infrastructure such as 5G, tourism and high- tech industries, as well as support for small enterprises. No fiscal stimulus will be useful until the virus is under control. As such, strict lockdowns are crucial.

Valuations are currently cheap, sentiment is negative and policy extremely supportive. As such, we are keeping a very close eye on our proprietary indicators. We stand ready to increase risk when they show a recovery, either in the real economy or in sentiment.

Chinese equity valuations fell away much sooner than those seen in the rest of the world owing to it being the place where the coronavirus started. However, it was also the first country to recover from the virus, and much like back in 2009, chances are China will lead the global recovery. It is also the reason why the Chinese equity market has escaped the worst of the correction.

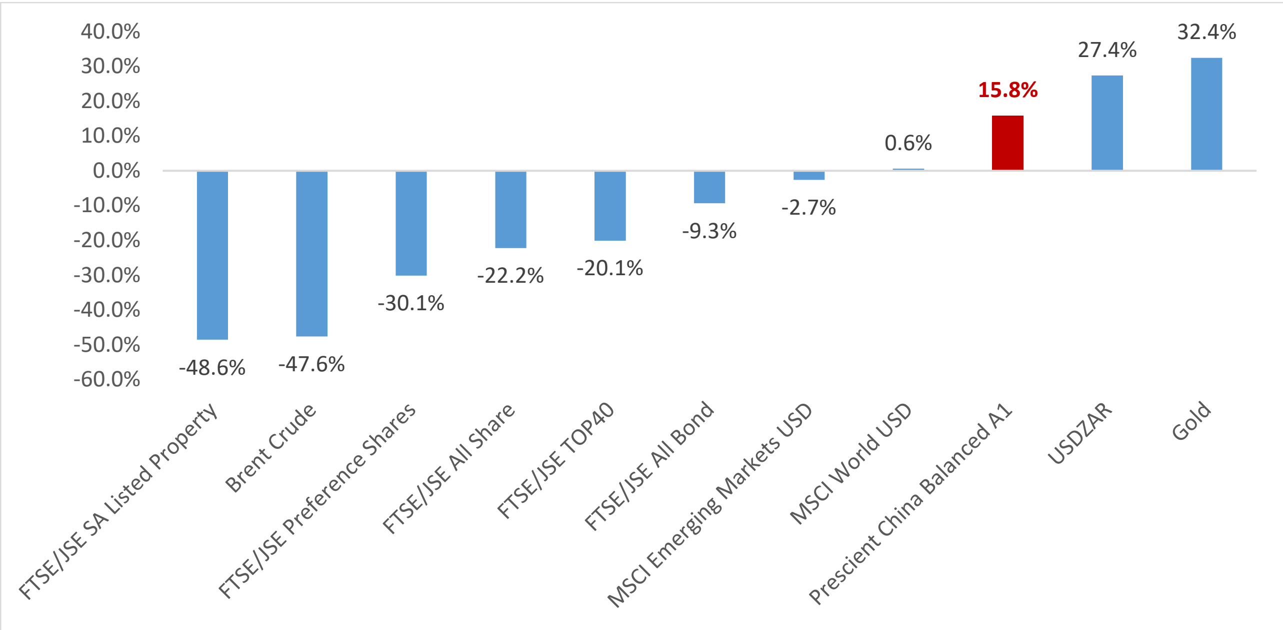


Source: Bloomberg as at 31 March 2020

We have always said that China is not a normal emerging market and the coronavirus highlights it even more clearly. Both the equity and currency as well as the economy handled the coronavirus outbreak much better than most developing and developed markets. As a large and united country, it was also easier to approve stimulus measures and implement ways to restore the economy. The result was as expected. The Prescient China Balanced Fund was (and is) a fantastic diversifier over these periods, providing a strong counterbalance in a period of very weak returns.

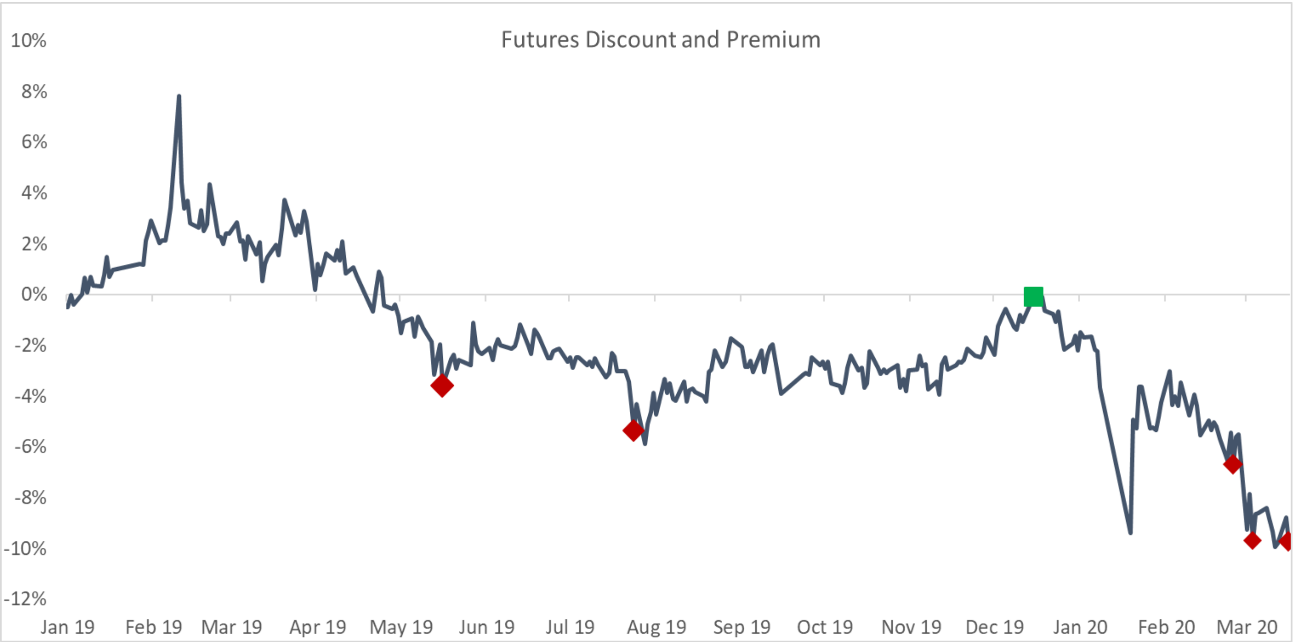
Global markets are currently experiencing unchartered turmoil, with virtually all asset classes selling down aggressively. Returns for some of the major asset classes for the period **1 January 2020** to **31 March 2020, further highlighting the diversification benefit of the Fund**:

Returns of major asset classes



Source: Bloomberg, 1 Jan 2020 to 31 March 2020

From an equity perspective, arbitrage opportunities are increasing. Combining this with a global liquidity squeeze and the ability to invest both onshore and offshore, we are seeing a lot of opportunities to add alpha. With stimulus targeting smaller enterprises, and considering their underperformance over the past 3 years, this market segment is showing some of the best opportunities in a decade. With the selloff often indiscriminate, historic factor relationships are pushed to the limit. We are increasing tracking error in the Fund and targeting a doubling of tracking error over the next year.



Source: Bloomberg as at 31 March 2020

Both A/H arbitrage and futures arbitrage strategies rose to all-time highs during the recent crisis. Over the next year or two we will benefit from unlocking these opportunities.

We are finding some of the best opportunities in almost a decade in the current dislocation. The Prescient process has always been to quantify and take risk when being paid to take it. This is undoubtedly the best time since the Fund started. As a team based in China, the initial Western reaction seems to be that the coronavirus was a Chinese virus that would not affect them. Italy shattered that illusion with other Western countries experiencing the same viral spread. Similarly, the current sentiment in the West seems to be too negative, with people touting social distancing for over 18 months. Although most cities are going to have a heightened awareness, the reality of full lockdowns should last between 3-5 weeks before we can expect to see a material decrease in the number of new virus infections. With the same virus and similar measures taken there is no reason to believe that China's outcome will not be replicable around the world.

Once the virus impact has been contained, 5-10% of GDP stimulus should be more than enough to kickstart the global economy. The longer-term impact of global money printing will remain to be seen, i.e., the monetization of fiscal deficits could prove the end of low inflation or modern monetary theory could still prove true. Yet in either case, real assets would be a better place to be than in cash. To the team here in China, it looks like a great opportunity to do research and start increasing risk.

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