JASPER CAPITAL

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The Global View

The global macro environment remained robust in July, although many data points that consoled investors earlier in the year continued to lose their patina as the "potential" of geopolitical disruption became reality. Tariffs were shot across the Pacific and Atlantic, with deleterious effects on manufacturing output and industrial confidence as export orders collapsed. While July Services PMIs hint at a deceleration, the outlook components of most PMIs remained resilient as domestic demand recovers following a slower-than-anticipated first half. The United States stands alone, however, with growth and confidence across the economy relatively untrammeled, supported by the twin ballasts of late-stage fiscal stimulus and tightening labor markets.

While growth remained resilient, according to the IMF, the balance of risks has "shifted to the downside" as trade tensions escalate.

Indeed, even the IMF contends that the current expansion may have reached its peak, and, most crucially, "growth has become less synchronized" with the balance of risks "shifted further to the downside."[1] The implementation of $34 billion in China-specific tariffs, with another $16 billion set to become effective in August, seems to be just the beginning as the United States Trade Representative has been instructed to seek public comment on raising tariffs on $200 billion of Chinese imports to 25% from 10%. If this comes to pass, then roughly half of China's exports to the U.S. will face 25% tariffs. This $62.5 billion in tariffs is small relative to both the size of total exports (~$2.4 trillion) and GDP (~12.2 trillion).[2]

There have been calls for reason on behalf of the Trump Administration, and for the U.S. to return to bilateral talks. But, the talking part is over. In the eyes of U.S. trade hawks, a decade of Strategic Dialogues went unheeded[3]. As the saying goes, "there's a new sheriff in town," and he's not one that cares very much for talking or traditional diplomacy. As U.S. Commerce Secretary Wilbur Ross recently stated,

> "*The reason for the tariffs to begin with was to try and convince the Chinese to modify their behavior. We have to create a situation where it's more painful for them to continue their bad practices than it is to reform*."

This is highly illustrative of their approach. Basically, the United States is fresh out of patience, and carrots are also out of stock. All that is left is a pile of sticks.

As with any external shock born of malice towards some, there will be damage to most participants in the international system. Supply chains will be damaged[4] and economic models developed over the last couple of decades will become challenged[5]. For the IMF, this is a concern for global stability. To investors, the dispersion of economic fortunes represents opportunity, particularly since the actual economic consequences will be delayed. And how these ultimately materialize cannot be estimated with a high degree of certainty given the broad opportunity sets for substitution and trade diversion.

"The time for talking is over…"

For now, it seems that neither the United States nor China will back down.

The economic effects will take time to materialize, but equity markets have been forecasting winners and losers.

However, equity markets, in all their imperfect beauty, will quickly discount which corporations have margins exposed to these geopolitical dynamics. This is why volatility has been concentrated in equity markets. The difficulty for investors is in adequately isolating uncorrelated returns that can be extracted systematically.

The China Dimension

After a sequence of economic and survey data pointing to a deceleration in real activity coupled with what has been described as "over-tightening" in credit conditions, authorities have taken steps to stabilize and enhance the transmission of credit and support for the real economy, while striving to continue with the deleveraging campaign. Many think this to be an overly ambitious undertaking, having to simultaneously ease and tighten selectively across the economy. But, given the diverse set of credit channels

[1] IMF World Economic Outlook, July 2018
[2] Both figures for 2017
[3] The "Strategic Economic Dialogues" started in 2006 with then-Treasury Secretary Hank Paulson and continued in their annual, multi-track form until 2017.
[4] We have already seen evidence of supply chain disruptions causing stockpiling and pricing pressures taking effect as noted in July Markit manufacturing PMI surveys.
[5] South Korea's Trade Ministry reportedly stated concerns about the outlook for intermediate goods exports. *Reuters*

and incentives in the financial system, tightening can be achieved by keeping local governments on a short leash and continuing with property market curbs. Meanwhile, enticing banks to absorb souring credits by offering to relieve capital pressures and providing preferential liquidity injections depending on the nature of the operation assists in the selective easing. The net increase of medium-term lending facility (MLF) slightly shifts the monetary stance to the easier side of "prudent" when combined with the three reserve requirement ratio (RRR) cuts from earlier in the year. Up until July, RRR cuts had been, effectively, sterilized due to either MLF expirations or no new net MLF injections.

With growth indicators decelerating more than expected, credit channels tightening, and the looming external threat, Chinese authorities have acted to stabilize the economic outlook.

What is shocking, however, is just how schizophrenic international investors are when it comes to the Chinese economy and market. Essentially, everyone wants markets forces to play a bigger role, but people panic once they do take the reins. The rise in defaults is a natural sign of the functional repricing of credit risk in a market that for years suffered from a not-so-invisible hand being present.

While authorities chose an antiquated policy response, it remains effective albeit with diminishing returns. However, it has been implemented with an intention not to derail the progress made in deleveraging and to continue supporting future drivers of growth.

Once that hand starts to allow market forces to move the currency and reprice risks, foreign investors and financial press panic, evangelizing the "beginning of the end."

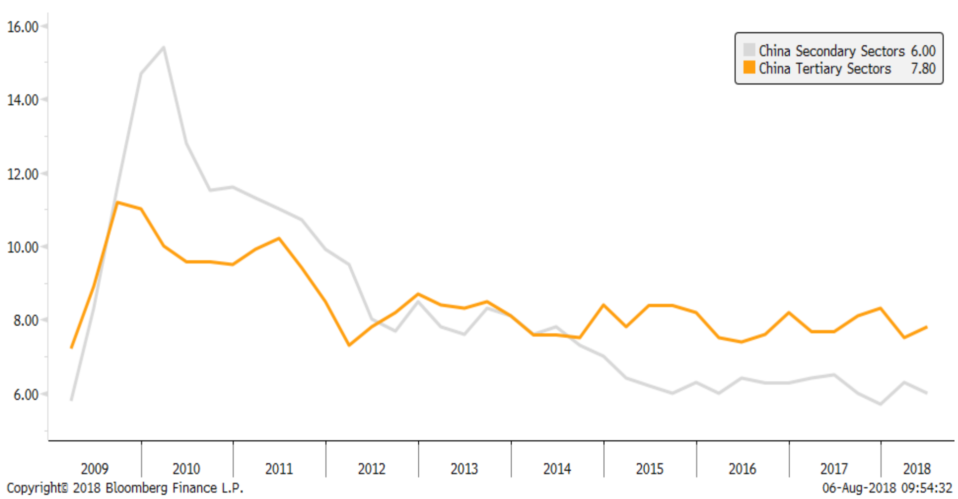
It is only natural to fear the removal of the training wheels…

With a trade dispute escalating and the slowdown clearly being faster than Beijing would like, it is easy to forget what is important to the long-term success of the Chinese economy and, thus, the bullish case for the onshore market. No matter what happens, it is crucial that the domestic rotation remains in full swing.

Currently, growth in the services sector (tertiary industry) continues to outpace that of the industrial sector (secondary industries). We believe this trend is set to continue as the Chinese economy advances into a post-industrialist state, particularly given the need to sustain growth while removing excess capacity in heavy industries. This transition has increased the necessity to develop more fundamental signals, particularly those derived from alternative data.

We must "…stop the practice of disorderly borrowing…"

—Liu Kun, Finance Minister



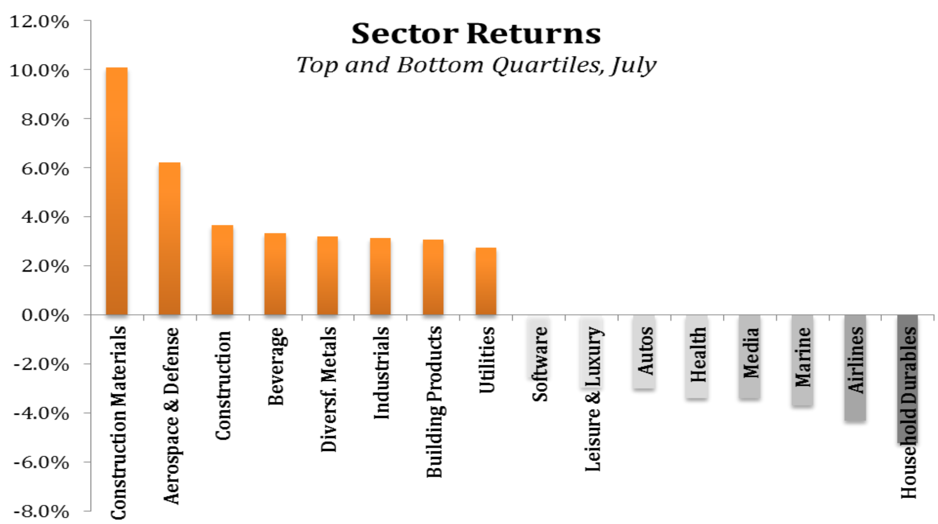
It is also encouraging to know that the rotation continues to have the full support of the Politburo given their recent emphasis on long-term capacity reduction and controlling the property sector, while regulators have maintained the need to control debt. In the words of Finance Minister Liu Kun, the economy must "stop the practice of disorderly borrowing." More progress has also been made in improving the efficiency of state-owned enterprises, as well as to increase quality control of listed companies by exchanges. The IMF has acknowledged progress, with the Executive Board recently concluding that:

> *"Recent strong growth momentum and significant financial de-risking progress reduce the probability of a near-term abrupt adjustment. Rebalancing accelerated in some dimensions, especially as the current account surplus continued to fall and growth became less dependent on credit.[6]"*

As the IMF puts it, authorities must "fix the roof while the sun is shining."

Naturally, there is a lot that still needs to be done, and China's future prosperity is path dependent. The choices policymakers make today will have profound effects on the trajectory for the economy and the market. As the IMF puts it, authorities must "fix the roof while the sun is shining." It is also confidence-inspiring to see that Beijing's response to Washington's stance is further opening.

But, given that the economy remains in transition, policies to boost investment and output still happen to be extraordinarily effective in supporting growth and improving confidence. This much was certainly reflected in sectoral returns in July, when the policies were announced.



And, ultimately, confidence is what is needed to support domestic demand.

[6] 2018 Article IV Consultation for the People's Republic of China, IMF Staff, July 2018

Lastly, a shift in fiscal stance is not unusual in the world today—the U.S., Japan, Australia, and South Korea are all implementing looser fiscal policies to support growth in the wake of either tightening or neutral monetary policy stances. What China is doing to guard its economy is well-warranted and indicative of a political, economic, and regulatory apparatus preparing for an external assault.

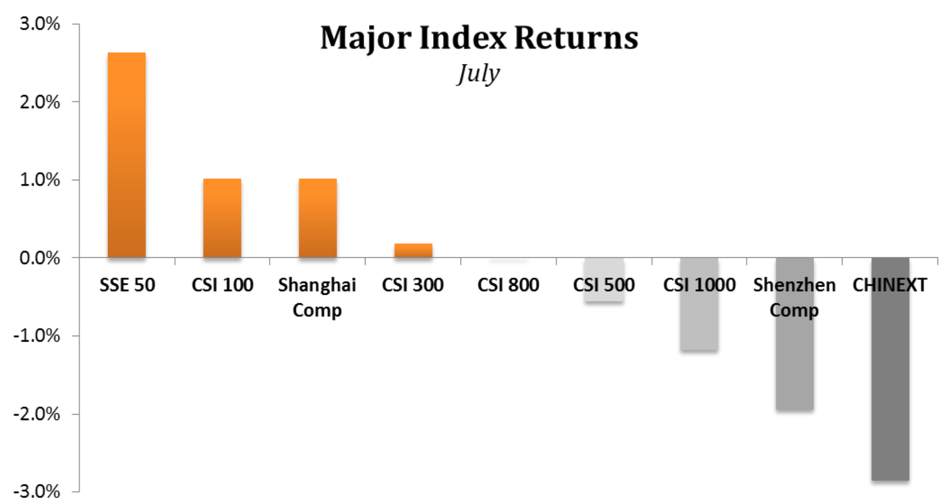
Sectoral returns in July reflected this playbook of stimulating the "old economy."

The Market's Tea Leaves

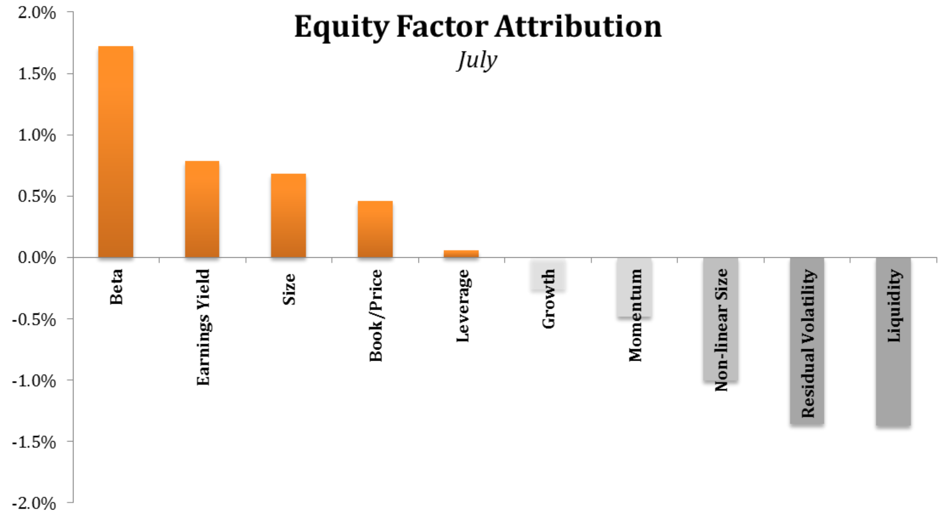
As the policy response harkens back to "the good ole' days," then one must break out that playbook as equities follow the flow of credit. As noted in the chart above, "old economy" sectors outperformed in July. These sectors had been out of favor for the last several months given their tight margins (if they existed), ongoing balance sheet repair, and as they faced headwinds from tighter financial conditions, stricter credit availability, and increased regulatory scrutiny. As all of these headwinds have since faded to a certain extent, equities responded in kind.

This notion was similarly reflected at the index level with indices skewed to the largest companies (with implicit subsidies, hence lower financing costs), outperforming. This is how effective central government support is, not only for the success of an industry but for the reallocation of private capital.

"This is how effective central government support is, not only for the success of an industry but for the reallocation of private capital."



The induced revitalization of this "old economy" trade sparked a rotation as many had seen this before. This was on display in the uptick of Northbound flows, as well as on display in equity factor returns. Growth, momentum, and residual volatility underperformance reflects a policy-driven regime shift where "new economy" equities underperformed in favor of a rotation into "old economy" stocks. One would assume that industrial companies that tend to be larger with significant tangible assets and high earnings yields (lower earnings growth) would be favored in a market that is viewed as undervalued, in aggregate.



Following the manifestation of external shocks and subsequent policy responses meant to stabilize the domestic trajectory, Jasper Capital's systematic approach should continue to provide value to long-term investors, particularly as our models continue to adapt to the market environment. ■

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