THE JASPER CAPITAL NEWSLETTER

August 2018 China Market Analysis

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The Global View

The geopolitical landscape did not change much in August, however, there were seedlings of macro data that suggest the global decline in new export orders has reached an inflection point in major economies. This inchoate rebound, which is still too early to be labeled any other way, comes despite the trade conflict between the United States and China continuing to escalate, as expected. In fact, we started August with President Trump upping the ante and calling for 25% tariffs, instead of 10% tariffs, on the next tranche of $200 billion in goods. An ultimate determination will be known in the first weeks of September. But we ended the month with U.S. negotiators resolving key differences with their Mexican counterparts in their effort to redraw NAFTA. While this is good for North America (we will soon see how Canada responds), the success has emboldened the hawkish wing of the White House, led by the U.S. Trade Representative himself. As we mentioned in the *July Jasper Capital Newsletter*, the China hawks in the

It's [been] too one-sided for too many years and too many decades, and so it's not the right time to talk. But, eventually, I'm sure that we'll be able to work out a deal with China.

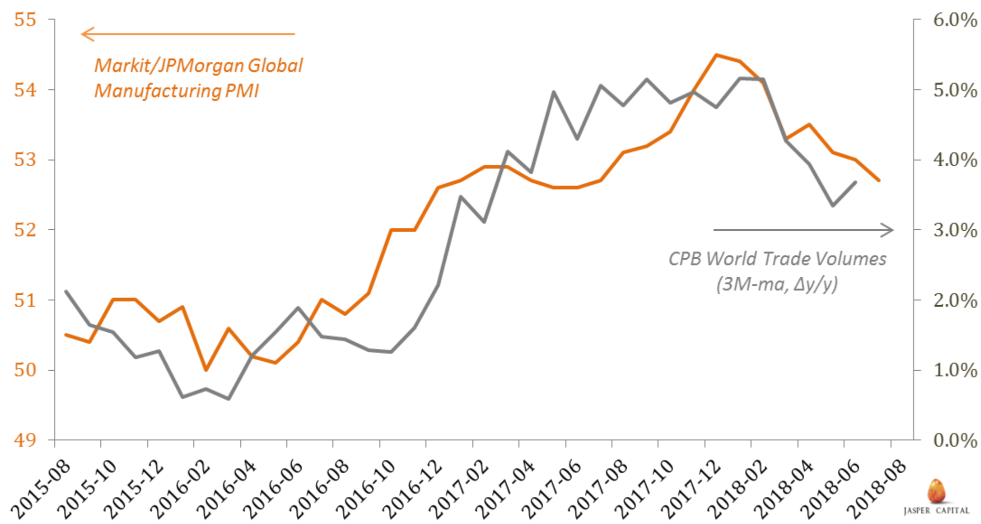
White House feel that the time for talking has long since been over. And President Trump reflected this sentiment following the announced deal with Mexico, declaring:

So, there will be more tariffs. There will be further escalation.

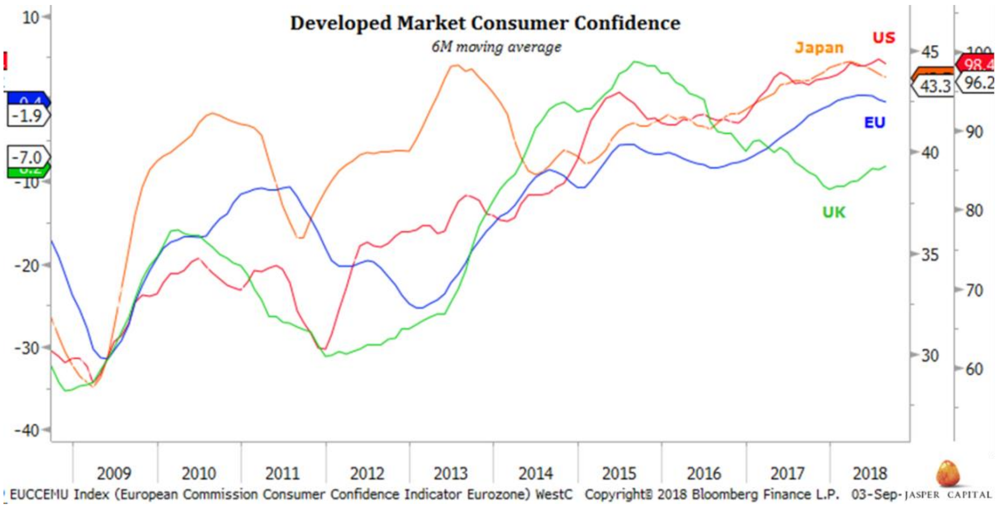
The Trump administration aims to ratchet up the pressure and squeeze harder. This has been Trump's political philosophy since the 1980s, so why would he change his opinion now? After all, the same companies that have complained about China's trade practices are also complaining about the tariffs. They want the results by different means. This has been the case in American politics for decades. Trump is trying something new. Rather, he is doing it his way. The question still remains whether we are starting to see a real economic effect from the tariffs?

While the new export orders subcomponents of a few countries may be improving, global trade and manufacturing activity are still on a downtrend in most corners of the world (*chart below*). However, more data is needed to truly determine if the real decline in global trade volumes is directly related to the increase in protectionism.

So far, tariffs implemented by the U.S. to the world, and to world back to the U.S., together make up a fraction of global GDP and about 1.0% of global imports. Can this possibly lead to the sharp fall in global trade volumes? Or is this all just cyclical?



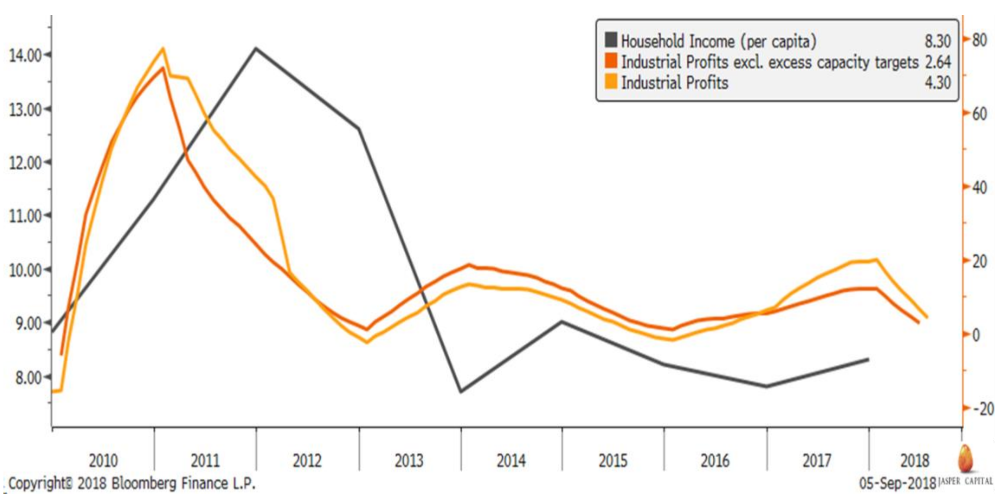
Relatedly, consumer confidence in Japan, Europe, and the United States also continue to temper, sequentially declining from recent highs (*chart below*). The UK seems to be the exception, with consumer confidence rising after being depressed for several quarters. While the correlation of consumer confidence to spending diverged years ago, confidence still plays a vital role for risk appetite and equity returns. So, the moderation of confidence adds to the existing pressures of declining activity indicators and trade volumes, which will weigh on equity prices.



The China Dimension

China’s natural reaction to trade frictions has been to meet force with force, responding with their own set of tariffs for every volley from the U.S. But after the next round of tariffs take effect, China will have run out of room for tit-for-tat responses. How will they respond if escalations continue?

Domestically, surveys show that export sales have declined consecutively since April and sentiment with the outlook has been diminished as the trade war looks more likely to continue. However, exports to the United States have boomed this year. Domestic demand is also slowing as net new business measures are trending lower in both the official and Caixin PMIs. Yet, production increased as its fastest pace all year and the outlook for future output continued to rise, suggesting that supply is increasing while demand is declining. This is not a recipe for success. Basic logic would conclude that rising supply amid diminishing demand begets lower prices and profits. This is also not a good sign for consumption as there is a tight, though lagged, correlation between industrial profits and household spending.



It is important to note that this deceleration in activity has little to do with trade and mostly to do with the domestic situation. As we saw in mid-July, Chinese authorities started to earnestly address mounting concerns with economic growth.

"The country will stick with prudent monetary policies and refrain from resorting to a deluge of strong stimulus policies." – Li Keqiang

It is also important to emphasize that implemented measures are meant to stabilize the economic trajectory; not change it. It is clear that authorities are comfortable with the path—maybe not the recent pace—and want to ensure that the changing composition of growth is sustained. Chiefly, that consumption is supported and that services continue to proliferate while excess capacity in heavy industry is reduced and financial risks removed.

We are in the camp that the impetus for recent easing was in response to overtightening. The need to drain shadow-banking credit from the system and control the proliferation of local government off-budget financing necessitated the squeezing of credit channels, which had the consequence (intended or not) of raising *real* borrowing rates in the economy. Naturally, this negatively affected activity and reduced investment, particularly in infrastructure given that local governments were prime participants in shadow banking credit. This is not set to change anytime soon.

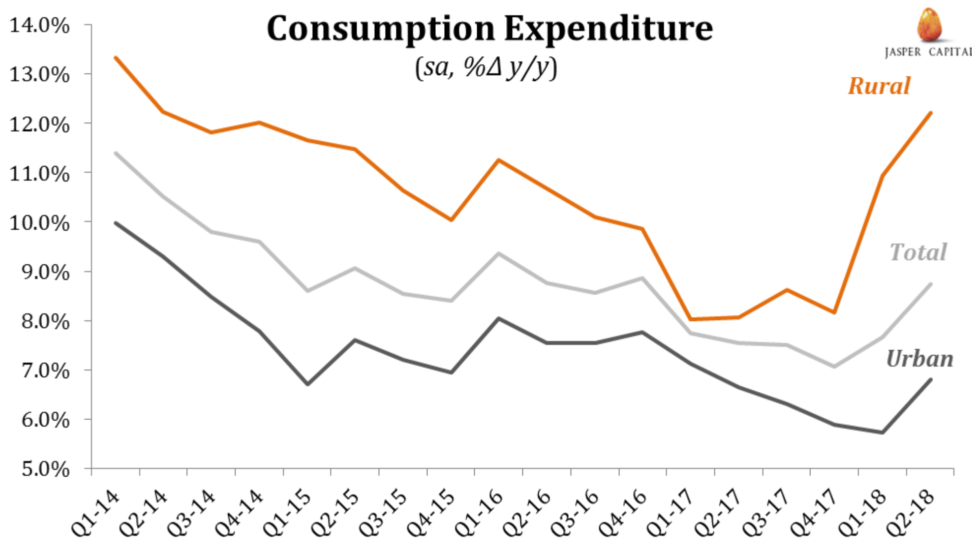
"How much impact does the trade war have on the current economy? In fact, the impact is not large, or basically has no impact. But now the economy has indeed undergone considerable changes." – Liu Shijin

The main recipients of targeted easing have been small- and medium-sized companies (SMEs), or private businesses. In fact, the State Council met to discuss lending to SMEs, followed by every major Ministry and Party organ, including the Financial Stability and Development Committee. The PBoC also created incentives for banks to lend to SMEs as they are among the riskiest businesses to which one can lend as they have no implicit or explicit public support and, thus, have a higher probability of failure.

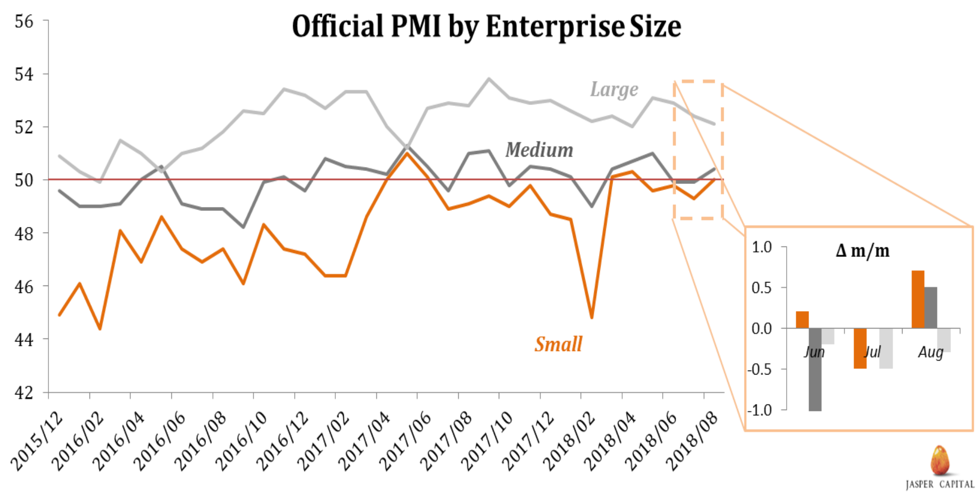
As an aside, the existence of subsidized lending to state-owned enterprises skews the entire credit profile of the economy, making pricing credit risk that much harder. One need only see the ratings drift between Moody's and domestic rating agencies to understand why domestic investors and banks consider AA-credits to be among the riskiest, and thus refuse to buy these bonds or lend to these companies without administered incentives to do so. This represents a structural problem of the market.

"An incentive mechanism linking performance of financial institution with the amount of loans they issue to small and micro businesses will be established." – Li Keqiang

The National Development and Reform Commission (NDRC), responsible for infrastructure projects, also emphasized stabilization and not re-acceleration. At the same time, the NDRC and other officials, such as Liu Shijin, outlined a need to expand consumption with Liu specifically wanting to support the continued development of rural income growth…and consumption. This is a wise move, as rural consumers have led spending recently and have the most catch-up to play.



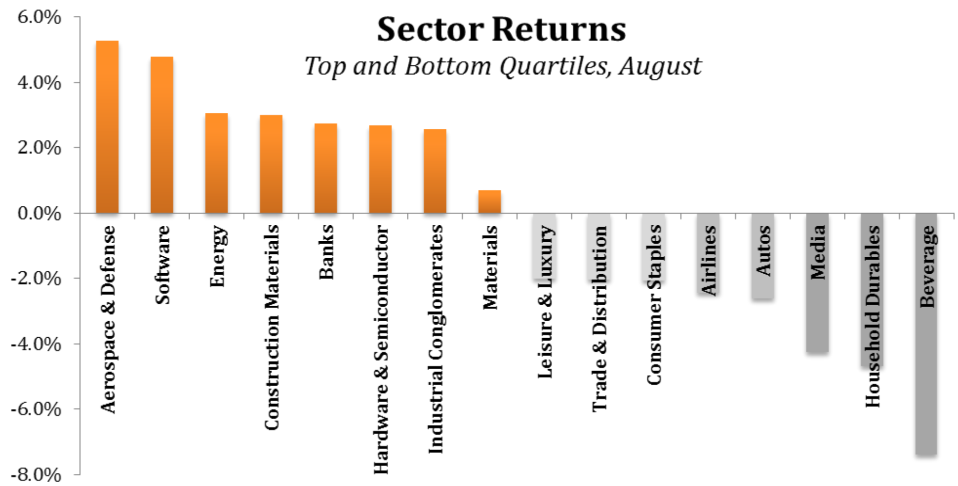
In short, by listening to policymakers and instruments of the Party, we take the view that recent measures have been made to stabilize the trajectory while ensuring that the next generation of growth engines continue to receive the funding needed to ensure their survival during such a pivotal time. And recent official PMIs indicate that the policy is working.



Taken together, the policy initiatives support our view that economic growth will continue to be dominated by "tertiary industries," which, technically is the residual of primary (agriculture production) and secondary (industrial production) sectors. Essentially, that leaves construction and the myriad services industries that have been experiencing the most dynamic growth. As the Chinese economy matures into generating next generation technologies and intellectual property instead of producing goods from heavy industry, the services sector will have no choice but to increase productivity, which should generate generous cash flows for investors.

And the signals provided by markets continue to demonstrate this. Even through the market volatility over the summer certain sectors, such as aerospace (a strategic sector), have delivered solid returns in each of the last three months. In August, software and semiconductors, also strategic sectors, made a comeback.

"Innovation drive is becoming the main focus of China, a country that is transforming and upgrading the economy and new drivers replacing old ones. Fueled by the new-economy sector, the first-tier cities are witnessing rapid economic growth. At the same time, the quality of supply has improved significantly, and such innovation is unleashing consumption potential." – Andy Zhao, CEO of Nielsen China



Finally, northbound Stock Connect flows were net positive throughout August[1]. In fact, they have hovered in positive territory all year long despite index-level declines. While China's financial markets are not as sensitive to foreign inflows as other emerging markets, such as Indonesia, the fact that offshore capital is flowing into the A-share market is positive.

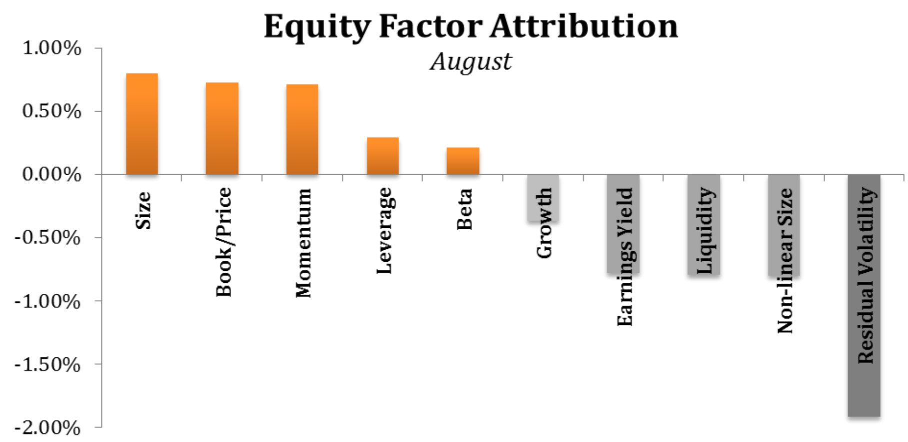
The Market's Tea Leaves

Contrary to many headlines, onshore equities have been influence by more than just trade-related factors. There is no doubt that prices are effected whenever trade frictions materialize or new statements from either side arise (mostly from the U.S.), however, the price impact tends to be concentrated at the index-level as this is the main transmission mechanism from global investors to the Chinese market. In our view, the country's ongoing economic rotation has had a more significant impact on the dispersion of returns across sectors, factors, and single-names. Furthermore, we also believe that equity declines in response to the trade dispute constitute an overreaction by investors, particularly domestic retail investors that still lack the sophistication to adequately interpret these gyrations, which is understandable. All of this is new to them.

Whereas last month's index and factor returns were highly influenced by policy actions, allocation preferences are gradually shifting back to natural drivers of returns, such as exposure to safe haven equities like those with the size to absorb external frictions and domestic rotations. However, there is no better indication that risk assets are starting to

[1] In other words, the balance of Stock Connect purchases between Hong Kong and mainland China were overwhelmingly tilted towards inflows into China.

return to more natural drivers than the reemergence of momentum (*chart below*). Like the dove to Noah following the flood, the return of momentum is a welcome sign to active investors.



This bodes especially well for systematic strategies, such as *Jasper Capital's α-shares*, and proves that excess returns can be extracted even during months where index-level returns were negative across the board. Jasper Capital's systematic approach continues to provide value to long-term investors looking to capitalize on a market that is constantly evolving, and in an economy that is experiencing a tectonic transformation that will soon see new efficiencies, new growth drivers, and new investment opportunities.

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