THE JASPER CAPITAL NEWSLETTER

September 2018 China Market Analysis

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The Global View

There is little doubt that the third quarter will not be soon forgotten by global investors and geopolitical analysts alike. The two largest economies are engaged in a battle of gamesmanship where the weapons of choice are economic and financial in nature. The current status quo is less chess and more checkers, with each side firing shots in a "you did it first"-fashion that reminds one of the schoolyard—where reason gave way to emotion and nothing was ever resolved until a teacher interjected. Indeed, "Trade Wars" are in full swing and there is little sign that they will end anytime soon, as both participants are steadfast in their resolve (each ratcheting up rhetoric at home and abroad) and both are too big, economically and financially, for any third party to play the part of a truly neutral mediator in the dispute.

This includes international institutions, such as the World Trade Organization (WTO), which has been marginalized under the declaration that archaic rules and their disparate application have yielded unfair advantages and disadvantages that have culminated in the current situation. President Trump has threatened to leave the WTO, and even China's Premier Li Keqiang admitted that the global trade system requires an upgrade.[1]

"If they don't shape up, I would withdraw from the WTO. I don't know why we're in it. The WTO is designed by the rest of the world to screw the United States." – President Trump

There is no true historical comparison for the current environment, where the two largest economies in the world are involved in an escalating trade dispute, and institutions, both international and domestic, are facing unprecedented attacks from all sides as both public discontent stemming from gargantuan inequality meets the populist vitriol from heads of state. This combination is eroding institutional effectiveness at playing the equivalent role of the teacher on the playground.

"Some WTO rules do need to be improved." – Li Keqiang

As we have stated before, President Trump is a man of action when it comes to trade. There is little use for more words if no one has cared to listen. China certainly never listened during the decade of Strategic and Economic Dialogues. And the EU was also content to ignore the diplomatic efforts of Trump's predecessors and continue with business as usual. Sure enough, those who bemoaned the dominance of the United States in global affairs were first to call for its reengagement once Trump implemented his doctrine of nationalism, and policy of extorting a price for continuing with business as usual (e.g. NATO countries need to either buy more U.S. energy or pay their fair share).

"The WTO system is slowly grinding to a halt. It is probably in its deepest crisis ever…" – Cecilia Malmstrom, European Commissioner for Trade[2]

So, while Trump issued a verbal warning to remove the U.S. from the WTO, in the meantime he has sought to paralyze the international trade body by blocking the appointment of WTO appellate members. Without at least three members, no decision can be made on trade disputes by the second half of next year.[2]

Canada is currently attempting to salvage the global trading system and Europe has stepped up its efforts on reforms as well. Canada has recently sought to create momentum in reform efforts by outlining a proposal that seeks to "modernize the WTO's rules to address 21st century trade practices involving digital trade, international investment, domestic regulations, state-owned enterprises, industrial subsidies and trade secrets.[3]" Canada has called a meeting of large trading nations, notably excluding both the U.S. and China, as other economies attempt to lay the groundwork to revamp the WTO ahead of ministerial meetings in late October.

Is it too late?

We think not. But Europe will have to move faster than they usually do if they hope to end the current trade schism, which has the potential to consume the world. Some major U.S. and European companies are already issuing profit warnings due to higher costs and softness in demand…all linked to trade. It is particularly important for Europe to step up efforts as recent data suggests that the EU's aggregate economy,

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1 https://europeansting.com/2018/09/24/chinese-premier-li-keqiangs-speech-from-world-economic-forums-annual-meeting-of-new-champions/
2 https://www.reuters.com/article/us-trade-wto-eu/eu-lays-out-wto-reform-ideas-to-keep-us-on-board-idUSKCN1LY1FV
3 https://www.bloomberg.com/news/articles/2018-09-11/canada-proposes-new-alliance-to-reform-world-trade-organization

which experienced a slowdown in the first half of the year, is showing nascent signs of re-acceleration. Europe still faces tremendous challenges and global trade free of conflict is needed to maintain stability in its fragile economic and political structures. Italy's threat of a standoff on its proposed budget, which breaks EU fiscal rules, is definitely not helping the cohesiveness of Europe.

We believe the current trade dispute, while destructive in the near-term, has the potential to cleanse the system and lead to more sustainable globalization, which has long avoided addressing structural issues. It is incumbent upon global powers to help address these issues if not for the selfish reason of each individual nation's survival. China's reformers, for one, are using the opportunity to press for more reforms that move the country in the right direction, insisting that policy actions remain in-line with long-term goals. We have discussed these actions in previous issues of the Jasper Newsletter. But what has changed in September?

The China Dimension

The trade narrative was no different in September as the U.S. moved forward with their second round of targeted tariffs of 10% on $200 billion in Chinese exports (less bad than expected, but nonetheless moved the needle in the wrong direction). Unsurprisingly, China responded in kind with levies of 5% or 10% on $60 billion in U.S. exports. Economic actors on both sides of the Pacific, in all their glorious competitive spirit, have consistently seen the operational risk of tariffs as high probability events, and have sought to frontload orders. Unfortunately, this has exacerbated the bilateral trade balance for the last few months, distorted economic statistics, and has added to the bouillabaisse of risk factors brewing in the trade dispute.

"The trade war is not just a measure for the U.S. to gain more economic benefits, it is also an important strategy to contain China. With the US labelling China as a strategic rival, Sino-US relations will experience a deep structural change." – Long Guoqiang, State Council Development Research Center[4]

While the tariff numbers are small in economic terms, markets are vacillating to discern which corporate operating margins will have to absorb these new taxes. China, for its part, is implementing fiscal policies meant to buffer domestic industries from tariffs, while their U.S. counterparts are content with dynamic growth, resilient consumer confidence, and favorable tax treatment providing some cushion to U.S. companies instead of adding new support.

President Trump and his economic and trade teams at the White House have continued to tighten the screws, and are expected to continue to do so. This public antagonism has been absorbed in China with negative consequences, as one can imagine. Many voices in the leadership of the State Council and among state-sponsored media outlets have labeled the current trade dispute as a "New Cold War.[4]"

Indeed, the rhetoric in China, once conciliatory and open to dialogue, has soured. The People's Daily as well as other instruments of the Party have been hardening their stance domestically, and China's trade authorities recently rebuffed diplomatic overtures from the U.S. Treasury (largely powerless in this Administration when it comes to trade).

[4] https://www.scmp.com/news/china/diplomacy-defence/article/2161889/expect-deep-structural-change-ties-between-china-and-us

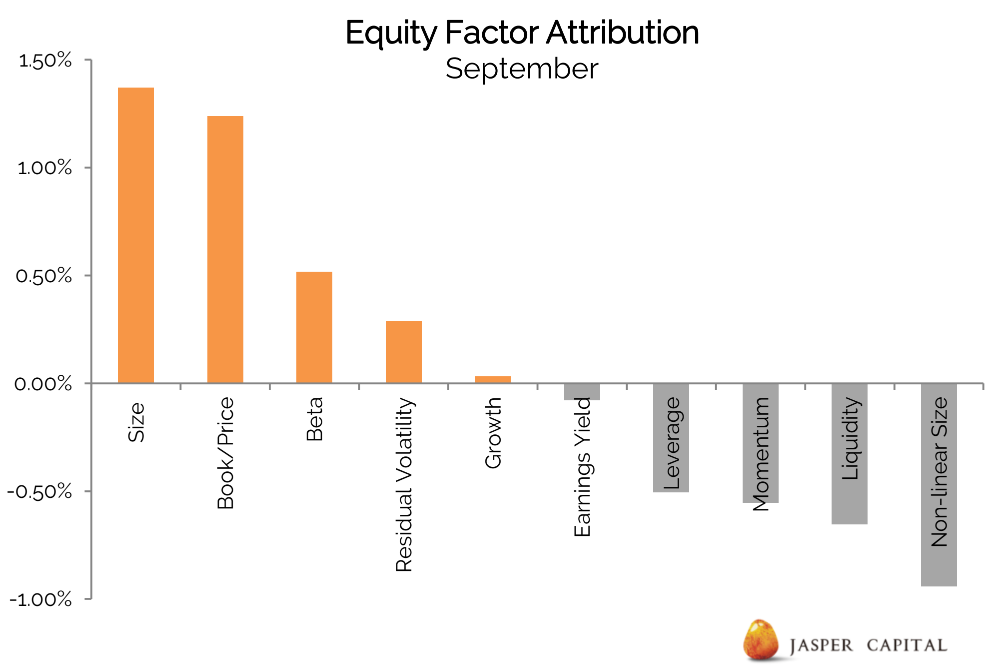
As we have mentioned previously, the trade dispute has increased authorities' resolve to address structural issues at home as the study of the U.S.-Soviet Cold War yields one universal lesson—economic success is essential.

To that end, policy planners have continued to walk the fine line of giving with their right-hand while taking with their left. For instance, authorities approved a piece of fiscal stimulus in the form of income tax revisions while fiscal authorities also strengthened tax and social security collection mechanisms on local governments, who also continue to be pressured to straighten up their books, deploy environmental safeguards, and invest in infrastructure without tapping shadow banking channels. Instead, they must issue bonds, which financial regulators have made much easier for domestic banks and foreign investors to purchase. State-owned enterprises (SOEs) were also provided with guidelines for reducing debt burdens and generally cleaning up balance sheets. Essentially, the third phase of the financial de-risking continues with local governments continuing to get whipped into shape while SOEs are now next in line.

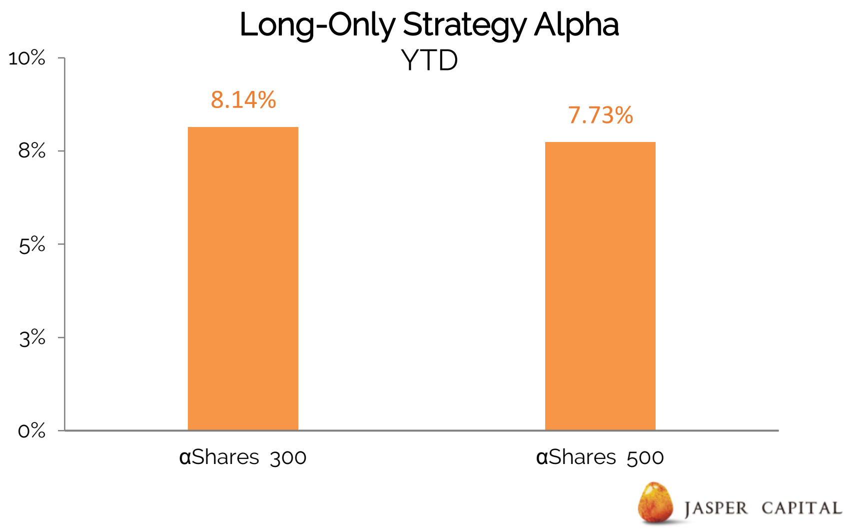
The State Council, with regulators following, has also issued guidance to remove administrative burdens for starting new businesses, are continuing to support small and medium-sized enterprises (as we have previously discussed), and are making exporting easier while also using reciprocal tariffs to provide support for certain affected industries.

"If we do not have fair regulation, then we will not have fair competition." – Premier Li Keqiang

The careful balance of withdrawing and providing support strategically seems to be passing-through to equity prices in-line with our expectations (for now) in that larger companies are outperforming as they are better able to absorb margin pressures, have dominant market positions, stockpiles of cash, and government support (either implicit or explicit) that provides monopolistic access to opportunity, which is always a welcome element when deciding where to allocate in volatile times.

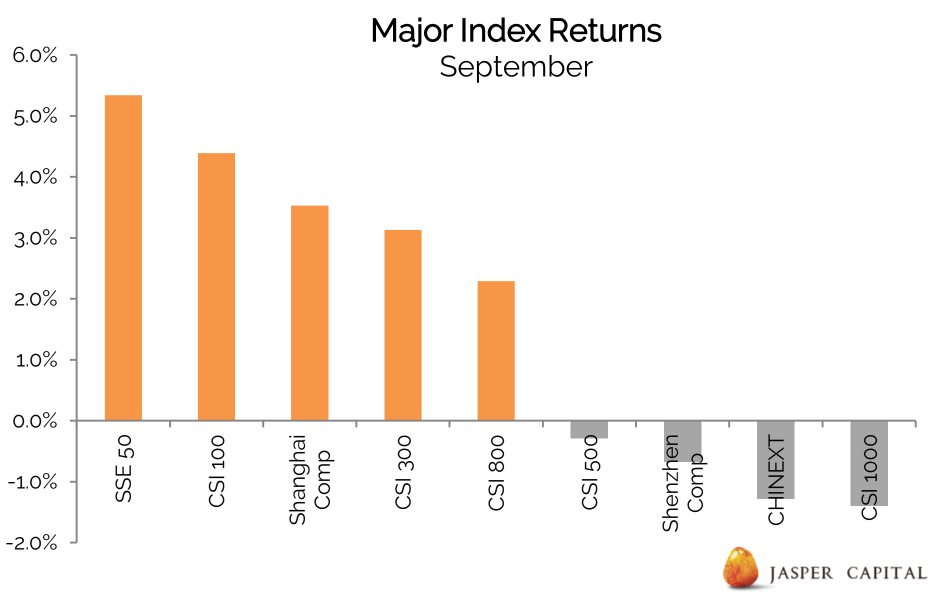


However, the mediocre performance of beta in September shows that the there is a clear advantage provided to active investors, such as Jasper Capital, over passive investors. Our quantitative strategies generate a majority of excess return from stock selection, and Jasper's long-only strategies (i.e., α-Shares 300 and α-Shares 500) have provided our investors with 814 and 773 basis points of excess return so far this year, respectively, with little monthly variation.



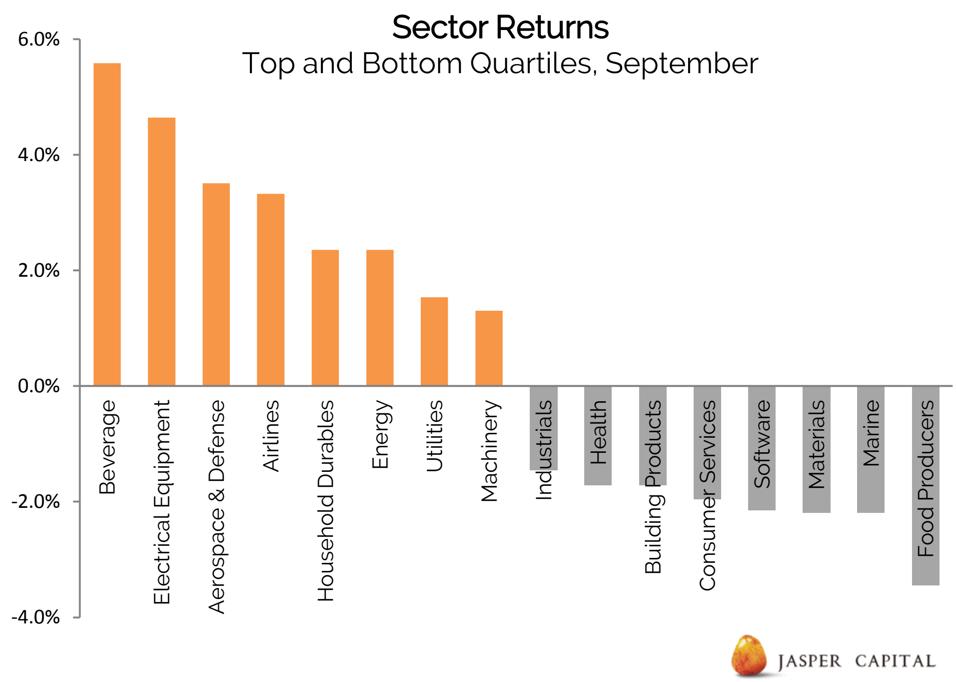
The Market's Tea Leaves

The persistence of the size factor in the onshore market makes sense within the context of the abovementioned fundamentals, but it also makes sense when considering more technical aspects, such as the structure of trading volumes. Essentially, as retail flows decline in tandem with the persistence of negative index-level returns, particularly those tracking small- and medium-sized enterprises (SMEs), remaining trading volumes tend to be more institutional, which, almost by definition, tend to focus on large-cap names. This has been reflected in larger-capitalization indices rallying on the month while those that track smaller-capitalization and technology stocks (e.g. CHINEXT) underperformed.



However, there is an inherent risk in tilting factor exposure to size, namely regulatory risk that is both unpredictable and subject to translation by market actors. At Jasper, we believe in controlling the risks we understand and mitigating those we do not. In this case, we maintain a neutral-bias to size. This allows for more consistency of excess returns while avoiding swings in the fortunes of state-owned enterprises (SOEs) and other large corporates with government sponsorship that are subject to the whims of Beijing. We have already mentioned why we think SOEs are bad for a market—mainly, they skew the credit profile of the entire economy and take away from the private sector as they do not have government support. While SOEs are central to the state capitalist model and will remain so according to President Xi, their inherently low returns on equity and invested capital make them unattractive for factor tilts. After all, our strategies also include fundamental alpha signals.

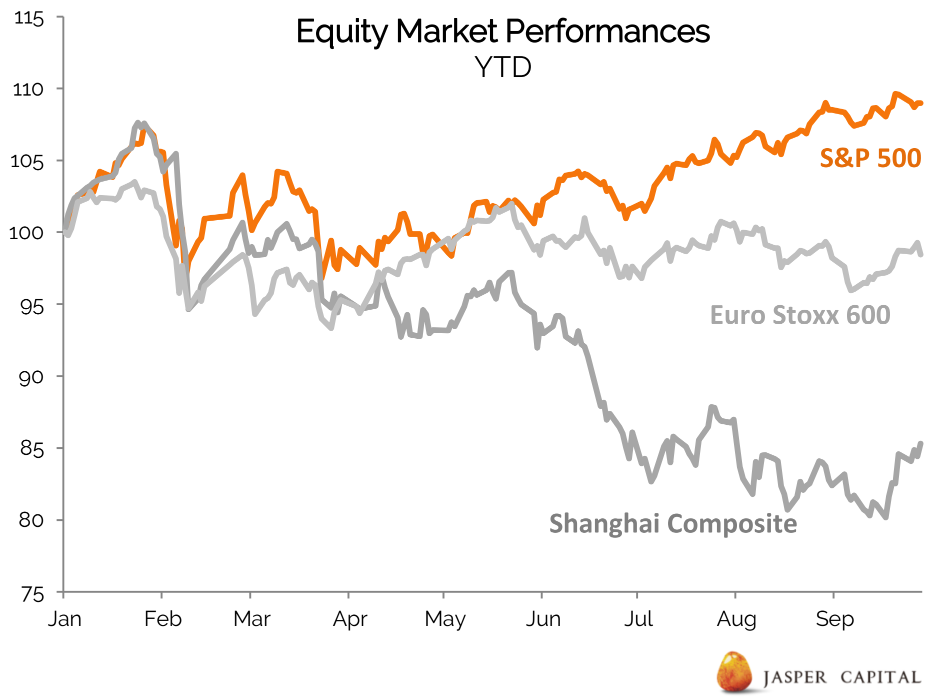
Luckily, political leaders have remained focused on the task at hand, namely stabilizing the economy and supporting the development of future growth drivers, such as SMEs. The small fiscal stimulus related to tax is adding to consumer confidence on the outlook for domestic purchasing power, particularly for Beijing's target group—rural households. This can explain the resurgence of the durable goods sector and others facing the consumption of strategic sectors, such as aerospace, which continues to benefit from the trade war as Beijing has shifted its view of the dispute from economic to one of geopolitical superiority. The trade war is already bleeding into other diplomatic arenas, such as military exchanges.[5]



5 https://www.reuters.com/article/us-usa-china-military/u-s-mattis-looks-for-way-ahead-after-china-scraps-military-talks-idUSKCN1M42NQ

Certain sectors are already showing the effects of the trade war as food producers (e.g. soybeans from the U.S.) as well as shipping (e.g. aggregate trade volumes) and software (e.g. regulatory barriers in the U.S.) feel the bite from higher costs, slower orders, and restrictions. This will soon be a global phenomenon and should make for an interesting October as third quarter earnings start to show the effects of trade. Already we are seeing the downward revisions of profit expectations from suppliers in the U.S. and Europe. According to history, the effects of negative global impulses are always first felt in the private sector but, ultimately, the true force is always bore by households. This has yet to pass-through to the U.S. market.

To that end, Chinese corporates and households have been weathering the storm and the onshore market has been discounting these effects for a number of months. We believe that once these deleterious effects hit Western markets, Chinese equities will gain favor once again as domestic resilience, the continued economic rotation, and the fruits of summer stimulus provide the impetus for domestic retail investors to dive back in and expand the alpha generation opportunities our strategies exploit.



The outperformance of our strategies relative to their respective benchmarks illustrates our ongoing ability to provide our investors with consistent alpha no matter how difficult the market environment as we closely monitor evolving domestic and external risks, grow our pool of alpha signals, and adapt our models to the changing nature of the market.

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