JASPER CAPITAL

THE JASPER CAPITAL NEWSLETTER

November 2018 China Market Analysis

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By Carlo Passeri, Director of Research and Macro Studies

The Global View

The central concerns that drove the sharp risk-off moves for most of the year—weakening global growth, slowing Chinese growth, deteriorating sentiment, a Federal Reserve maintaining its tightening path, and an escalating trade war—were not solved in November. Our interpretation is that a patchwork of political gestures converted peak pessimism into nascent inklings of hope that will soon fade. As the great philosopher Vince Lombardi said, "hope is not a strategy." Furthermore, political gestures mean nothing in the world today; just ask Iran.

The dinner summit between President Trump and President Xi ended with a 90-day détente in the escalation of hostilities, with most concessions coming from the United States. As we have mentioned time and again, the two sides are speaking past each other. The United States feels completely justified in applying tariffs. "Why have rules if no one respects them?" Similarly, China feels completely justified in doing what is necessary to advance. "We did not make the rules, so why abide by them?"

So, the market was rightfully circumspect of the dinner's "achievements" given the utter lack of specifics and, most notably, a very visible divergence between how each side interpreted the agreement; the natural consequence of a failure to produce a joint statement. [1, 2]

The Trump Administration wants very specific actions to be taken by Beijing that President Xi is no longer able or willing to provide either because of tools available or public opinion. And Beijing already faces hard choices for the economy.

"The situation facing new graduates is 'complicated and severe.'" – Lin Huiqing, Vice Minister of Education[3]

With respect to the trade war, the best thing Beijing can do is to slow it down as much as possible. After all, U.S. demands are antithetical to Beijing's plans for economic and national development, and they are too inconvenient to be addressed in their entirety right now because of the slowdown. So, there can be no true agreement in the near-term. China will only execute policies that overlap with domestic needs making concessions where strategically necessary as we see today.

"We will work in accordance with the clear timetable and road map to negotiate in areas of mutual benefit." - Gao Feng, Commerce Ministry Spokesman

This has always been the Chinese strategy; take action only when the Party deems it necessary. This was the case with excess capacity cuts in heavy industry. The United States had been complaining about Chinese excess capacity for years. But the action-forcing events were domestic—the economic pivot to services, the need to control pollution, and the need to materially improve state owned enterprise profitability.

Therefore, the real strategy for the trade war has to be to delay. In this case, China just needs to hold out for another year before the U.S. starts focusing on the next election cycle. In the meantime, China will focus on fixing domestic issues and consolidating power. This has been a central lesson in military strategy for centuries, and is a fundamental reason why the United States was victorious in the Cold War.

But that is not to say that policymakers will not waste a crisis.

After all, some trade issues also align with domestic priorities, such as increasing the role of the Party in all aspects of society, restructuring state owned enterprises, opening the financial sector, internationalizing the renminbi, fixing credit transmission channels, improving quality and consumer safety standards, and upgrading intellectual property protection.

Indeed, as a nation, China has been spending ever-increasing amount on research and development. So as it starts developing intellectual property of its own, it will need a system to protect it. In the wake of the G-20, Chinese authorities have moved to implement new rules governing punishment for intellectual property violations.[4]

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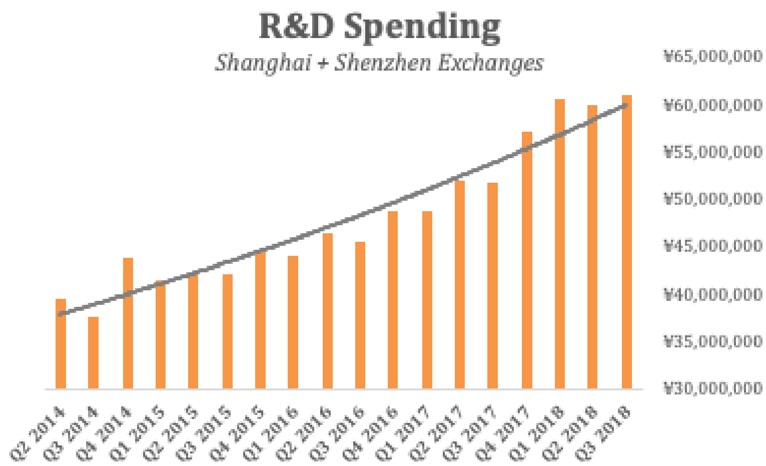
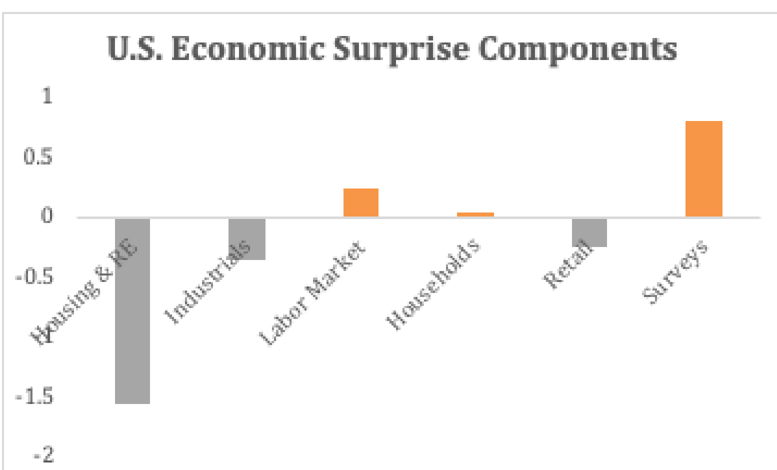
[1] https://www.bloomberg.com/news/articles/2018-12-02/u-s-china-trade-truce-side-by-side-comparison-of-statements?mc_cid=75d47e3763&mc_eid=00be17290d
[2] https://www.bloomberg.com/news/articles/2018-12-03/china-partly-censors-u-s-embassy-statement-on-trade-truce?mc_cid=75d47e3763&mc_eid=00be17290d
[3] https://www.caixinglobal.com/2018-12-05/with-record-number-of-graduates-china-eyes-employment-incentives-101355811.html
[4] https://www.bloomberg.com/news/articles/2018-12-04/china-announces-new-punishments-for-intellectual-property-theft



In the end, both sides have diametrically-opposing views of the world, and this will take more than 90 days to resolve. If more common ground issues get resolved, then maybe a lasting détente is possible. Certainly, the trade frictions between the United States and its major trading partners have hurt sentiment and activity globally.

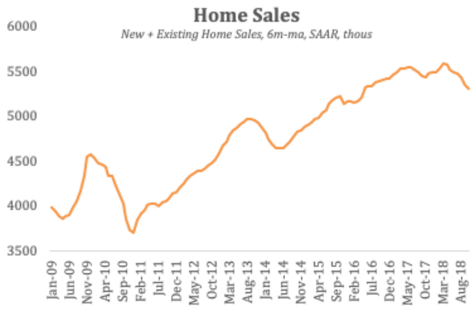
The other major event that happened in November was the acknowledgement by Federal Reserve Chair Jerome Powell that the U.S. economy, and indeed the global economy, is slowing. We believe Powell's New York Economic Club speech was the culmination of recent communications by a host of monetary policy officials and international institutions signaling that slower growth lies ahead.

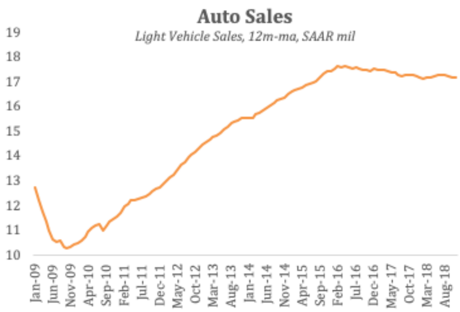
It must have been a shocking revelation to the Fed that only 125 basis points in rate hikes were needed to compel a slowdown in both portfolio flows and real activity of interest rate-sensitive sectors. As we mentioned in previous Newsletters these sectors have been stagnating, and macro data in these sectors have consistently disappointed since the summer.

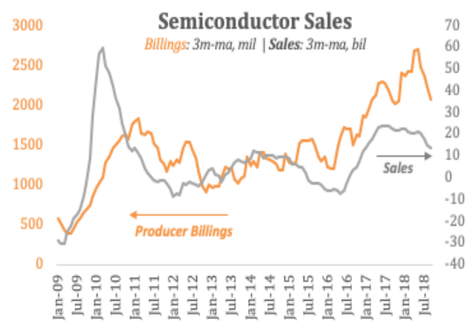


"The economic effects of our gradual rate increases are uncertain, and may take a year or more to be fully realized." – Jerome Powell, Chair, Federal Reserve Board of Governors

We believe the Fed has signaled that growth concerns now take precedence over price stability, given the currently benign nature of prices and the elusiveness of wage growth. It is clear that the U.S. construction, housing, and auto markets are rolling over, as illustrated below. More crucially, business investment has slowed, and semiconductor sales have been on the decline. And, the total 200 basis points in rate hikes so far have yet to pass-through completely to the economy.







"Downward economic pressure has increased, and hidden risks accumulated over time are starting to come to light. We must strengthen countermeasures. But we must aggressively focus on implementing existing policy announcements." – Politburo

Still, the U.S. consumer remains healthy as household balance sheets are okay (e.g. household financial obligations ratios are declining despite rising debt levels). The labor market continues to tighten but wage growth remains subtle. This is most likely due to structurally weaker productivity growth, and the successful absorption of disability labor. Hence, the data mix still signals at least two or three more rate hikes. Eurodollar futures show this view is being discounted away from the dot plot.

"We will not resort to massive stimulus. We'll make adjustments as appropriate." – Premier Li Keqiang

"We will stimulate economic vitality and foster growth momentum by reforming." – President Xi

This discounting should ultimately be positive for emerging markets, particularly if the dollar and oil prices stabilize. Oil price stabilization would be particularly beneficial to financial conditions given the positive impulse into high yield spreads. These positive externalities should help bolster sentiment for A-shares in addition to the boost that will be received from tax cuts and other possible fiscal stimuli.

The China Dimension

Whereas 2018 was defined by policy divergence in the U.S. (tighter monetary and looser fiscal policy), China had one, unified direction—tighter. Tighter macroprudential policy and deleveraging efforts slowed growth organically by accelerating the decline of the old economy. But this also had unintended negative consequence for the private sector. This dynamic collided with a trade war, which exacerbated already damage sentiment and furthered the slowdown.

The Politburo recognized these risks and acted as best it could. But more crucial than what authorities have done[5] is what they have not done. Authorities have not stimulated wantonly as in previous episodes. Rather, they are attempting to control the decent instead of arresting or reversing it.

Even in the wake of such uncertainty and deteriorating sentiment, authorities have refused to roll back necessary reforms, such as disciplining local government operations, and daring to move forward with SoE reform. During the push over the summer to arrest the decline in infrastructure investments, central authorities refused to let local governments revert back to using nebulous financial instruments, which ultimately resulted in the pockets of risk currently in the financial sector.

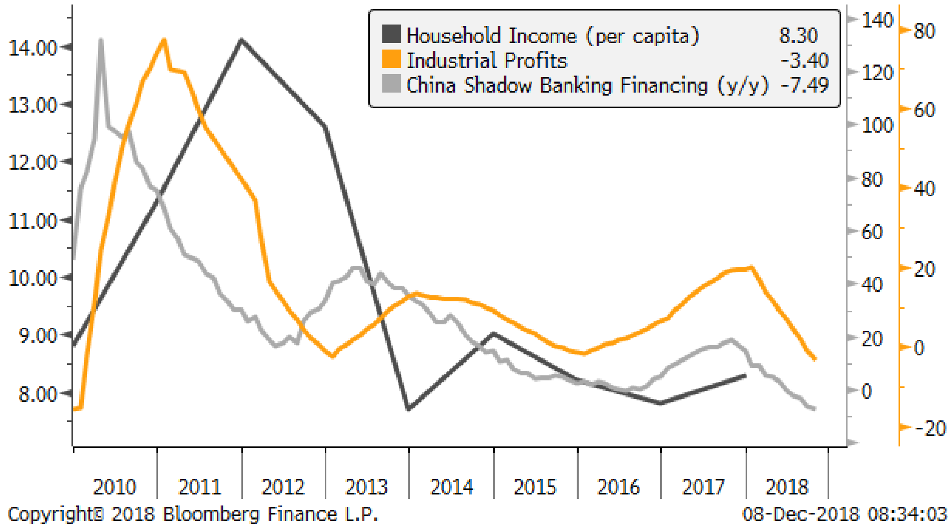
We fully respect the argument that this policy mix breeds confusion and does not improve sentiment or confidence. To a large extent this is true. Authorities are trying to tackle a lot of goals simultaneously. But we believe that to understand China, one must focus on the details. Furthermore, this concurrent restrictive-stimulatory / hard-soft / yin-yang policy mix is the only way forward given the small amount of breathing room policymakers have and the tremendous amount of changes that must be implemented.

This is why local governments are being asked simultaneously to be fiscally prudent while cranking up infrastructure spending. This is a complicated and confusing task. But we feel that pressure on local governments is to upgrade methods, increase transparency (to Beijing), and ensure implementation of central government policy at the local level. So, local governments are being asked to issue debt instead of using shadow banking channels, which is a way to stimulate while enforcing behavioral changes that are needed to fix institutional weaknesses.

This type of yin-yang policy mix corresponds to the State Council target of controlling the decline. This means slower but higher quality growth, which is the Party's bottom line objective.

The truth is there is precious little that authorities can really do to help ameliorate the current situation. The overall debt burden largely limits the set of policy tools available. This happens everywhere. And the need to remove shadow banking credit from the system in favor of more traditional capital markets solutions is extraordinarily important. But growth will suffer for it because the most productive sectors have grown reliant on the cheap credit provided by shadow banking.

[5] Caixing has an excellent summary of these measures. https://www.caixinglobal.com/2018-11-19/in-depth-chinas-unprecedented-private-sector-rescue-101348929.html



The Ministry of Justice will push forward the revision and annulment of laws and regulations that have hindered private businesses, thus enabling private businesses to have equal access to government investment grants and subsidized loans. – Fu Zhenghua, Justice Minister

Banks have resisted calls to lend to these companies not out of choice but out of a lack of skill. Unfortunately, Chinese banks have not yet developed methods to assess the credit risk of private companies (who have no collateral but positive cash flows) in a market dominated by state-owned enterprises (who own significant collateral but have little cash flow). As we mentioned previously, this skews the credit risk profile of the economy as the most unworthy are given the best credit profile while the worthy are left without credit access. Hence, the proliferation of the shadow banking sector. It is also no surprise that private sector companies had to seek private sector credit solutions as the formal banking sector is completely dominated by state-banks…to support state companies.

But it is now clear authorities realize that in order to achieve quality growth the weak must perish and future sectors must be nurtured. For this reason, to us, the most important policy that has been rolled out over the last month was the plan to systematically introduce "survival of the fittest market mechanisms."

The capital cycle in China got stuck on the investment phase for decades. In order to maintain market share and sustain razor-thin margins, amid a crowded competitive landscape, a huge pile of debt accumulated over time. This debt was concentrated in a cavalcade of "zombie" companies that exist only by the grace of government subsidy. Authorities are now officially pulling the plug.

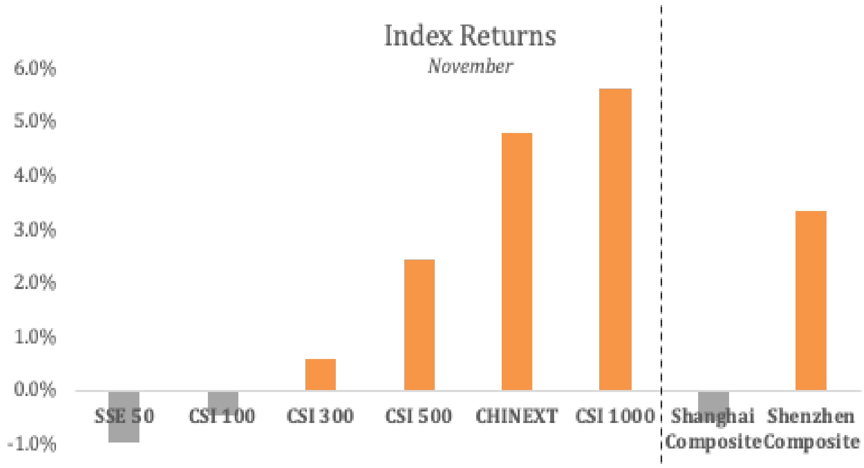
In a coordinated effort across 11 regulatory agencies, the government is resolving the systemic weakness that created "zombies" by changing the way government funding is provided and implementing accountability measures for delivering products. No more free riders. Further, local governments and state-owned asset management companies are systematically finding "zombies" and submitting plans for their restructuring or dissolution by 2020. [6]

This is all extraordinarily positive for the longevity of the Chinese economy. Unfortunately, it still has much healing to do. But, as we mentioned previously, to understand China you

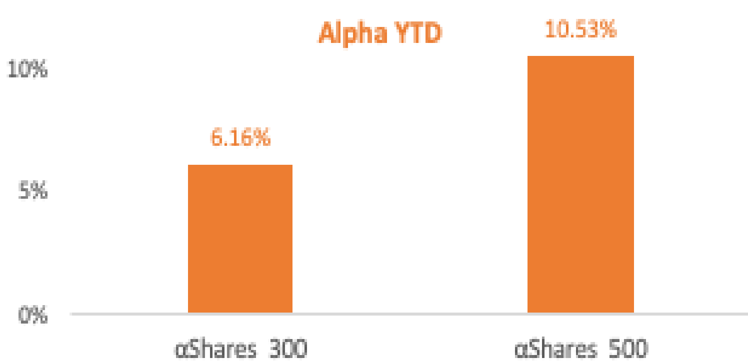
[6] https://www.caixinglobal.com/2018-12-05/china-sets-deadline-to-deal-with-zombie-companies-101355950.html

must pay attention to the details. And right now, the details are continue to point in the right direction, particularly for consumers and services, despite the deceleration in the macroeconomy and the consequences for incomes (as illustrated in the chart above). The implementation of tax cuts and other fiscal stimulus to also help households deal with debt servicing and purchasing power.

And this is evidenced in the dispersion of returns across indices and subsectors in the onshore market with indices tracking private sector companies that tend to be smaller (CSI 1000) and technology driven (CHINEXT and Shenzhen Composite) outperforming those dominated by large, blue-chip names that tend to be SoEs.



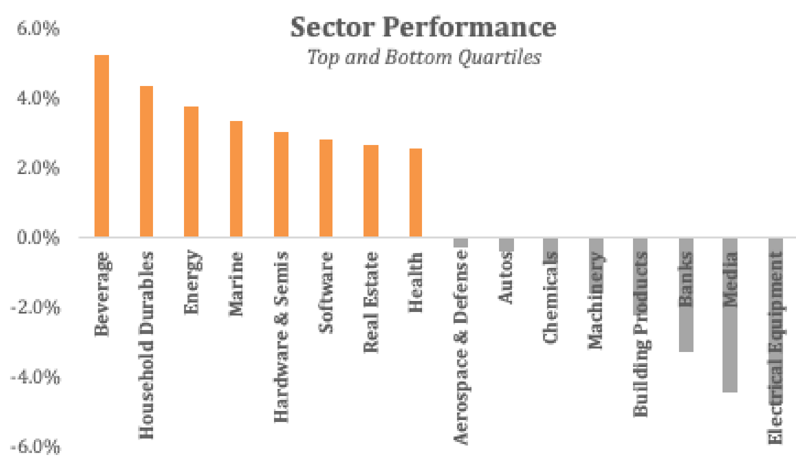
This rapid change in the fortunes of large versus small cap stocks is the reason why Jasper Capital has intentionally remained neutral to size as a factor. As we mentioned in September, this allows for more consistency of excess returns while avoiding the swings that largely involves timing the market, which requires less scientific rigor and more luck. As quants, we believe in rigorous analysis and empirical evidence to deliver excess returns.



The Market's Tea Leaves

We still remain positive on the Chinese consumer story and the proliferation of services, despite the prevailing headwinds faced by the economy. And there have been several data points to support this contention, which we will outline below. There is no doubt, however, that spending will continue to decelerate as (1) income growth slows in tandem with the macroeconomy (see chart on page six), and (2) household debt servicing ratios continue to rise.

However, fiscal stimulus in the form of tax cuts and reduced import tariffs are aimed squarely at improving both of these dynamics. And the dispersion of returns across sectors in November shows us that consumer-facing sectors are starting to price this new dynamic. For us, there is much more room for improvement.



Upfront, we acknowledge that there was significant weakness in auto sales as policy distortions were removed. More fundamental changes have also occurred in the auto market, such as ownership limits, pollution controls, and a burgeoning used car market that will continue to weigh new car sales.

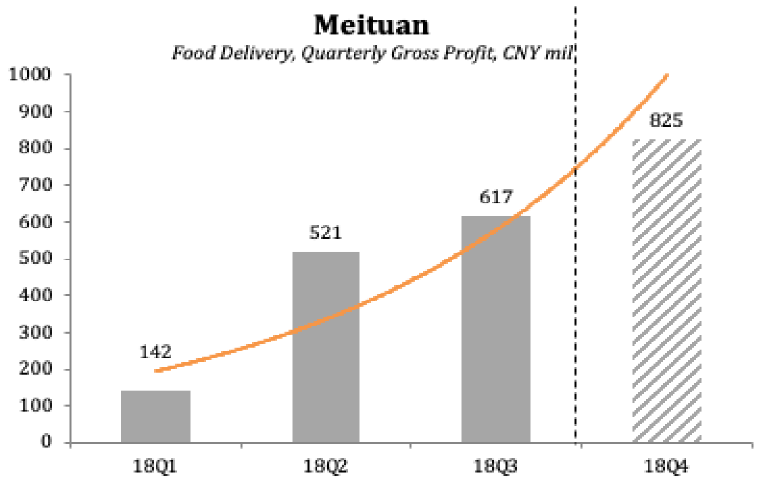
But as a broader topic of analysis, government intervention is common in China and will continue to happen for the foreseeable future. That is the essence of state capitalism. But just as government interference can be bad, so can lack of government oversight, as we found in the examples of Changsheng Biotechnology and Wuhan Institute of Biological Products. These companies fabricated production and inspection data, and used expired inputs for their respective vaccine lines. Consequently, consumer product upgrading is now in motion, supported by central authorities.

A middle class wants to know what they are getting for their money. This is a titanic shift in consumer mentality. With competition comes choices and relative value propositions.

In other words, consumers are flexing their purchasing power and are making their voices heard with their money. Now they can chose who is the winner and who is the loser (see Dolce & Gabbana and the entire onshore milk industry).

It is not just where Chinese consumers spend, but how. We are all familiar with WeChat and Alipay, which are literally the "how" of transactions. But the surge of online purchasing and delivery will continue to change the landscape of the Chinese consumer market. This makes tracking consumption patterns much more interesting as now we dive into the battleground of innovation.

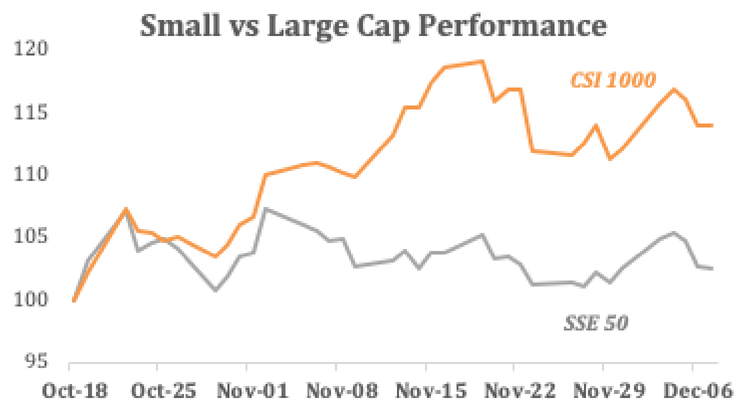
Our example starts with Meituan—the lord of delivery in China. Gross profits—a better indicator for consumer volumes—show that the company has been growing their customer base all year (4.5x year-to-October) and is expected to continue gaining market share, according to most analysts.



Some analysts have harkened the "ceiling" of online retail growth. However, 25 – 30% annual growth rates in consumer volumes is a staggering pace. That means money will continue to be made. And it is not just retail trade volumes but also the proliferation and mobilization of services, which are increasingly advertising and thriving in online marketplaces.

In fact, the eco-system is so integral to economic transactions that Meituan, Alibaba, and other e-commerce platforms have started to provide microloans to small business using their platforms. In November, Meituan issued $720.6 million in asset-backed securities, the proceeds of which will be used to provide low-cost loans to small enterprises on their platform. At the time of the issuance, Meituan boasted more than 300 million users, 4.4 million merchants, and < 1% non-performing loans on his loan book that started last year. Ant Financial, Alibaba's financial affiliate, as well as Didi Chuxing, have also placed asset-back securities, collateralized by business loans, to increase liquidity for merchants and households, thus boosting the consumer sector.

Support for the consumer and private businesses in the form of fiscal and macroprudential policy should provide a positive impulse into Chinese equities. The economy will continue to slow and incomes will follow. But one thing that we know is that the economy is not the market. This is a truism that is particularly relevant in China where retail participation dominates trading volumes. We maintain that the successful outperformance of small cap relative to large caps continues to provide evidence that markets are starting to price these macro impulses.



In summation, the macro story will continue to be the same, but the market is starting to turn, led by small caps. We at Jasper Capital stand ready to profit from these shifts and maintain that 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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Contact Information:

Carlo Passeri
Director of Research and Macro Studies
Email: carlo.passeri@jaspercapital.com
Tel: +86 185-8840-2440