THE JASPER CAPITAL ANNUAL NEWSLETTER

2019

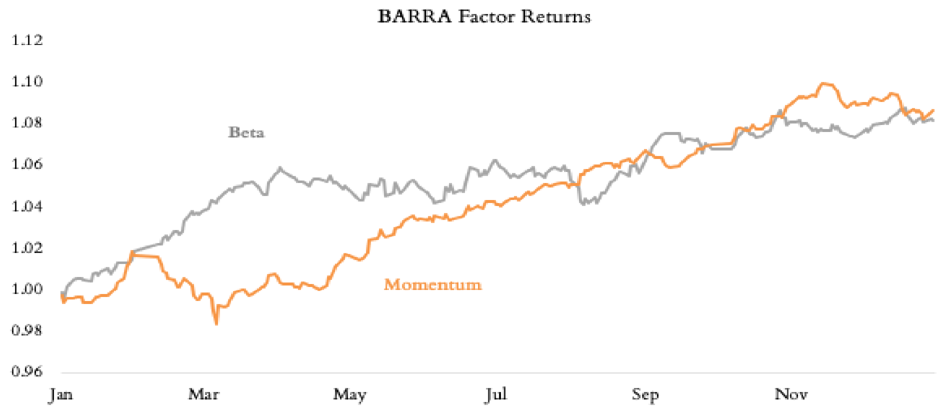
By Carlo Passeri, Client Portfolio Management

Transient Normality

猪年(“The Year of the Pig”) was a banner year for Chinese equities in many ways, and we believe this harkens a template for a new yet transient paradigm for the equity market. We say “transient” not in least part because nothing in China lasts forever (politics aside), particularly when it comes to A-shares. But also because the nature of the economy—amidst the middle of a transformation away from heavy industry to services and consumption.

This transition, as we have previously mentioned, is wrought with difficulties and hard choices that are the embodiment of the idea of “the lesser of evils.” That is to say, that there are few good options and a litany of bad ones. So, the prescription has been to do just enough. Whereas in prior slowdowns the kitchen sink was thrown at problems, the lessons of yesteryear have compelled a pivot to “wait and see, and act where necessary.” Yet, troublesome as the domestic macro environment is and tense as the external environment remains, The Year of Pig was true to its preordained characteristics divined in the zodiac whence it was derived.

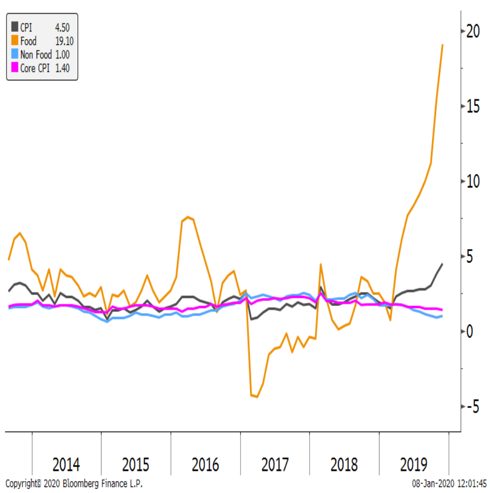
The correlated price paths of beta and momentum, the latter untrammeled by external momentum perturbations such as those twice experienced in the U.S., illustrates the bullish technical undercurrents that drove the stellar returns of the Chinese equity market.



The pig symbolizes wealth and fortune, its chubby face and plumb belly the result of excesses yielded as the consequence of good luck in commerce. Yes, the ancients were wise as we were very fortunate last year. Chinese equities were among the top performing asset classes in 2019, bested only by Russian and Greek equities.

The irony of the Year of Pig actually being the worst year for actual pigs is not lost on us. African swine flu ravaged the domestic pig industry, leading to CPI inflation rocketing upwards at a time when deleveraging, heavy-industry consolidation, and an economic slowdown weighed on PPI inflation. Industrial profits and consumption slowed as a result.

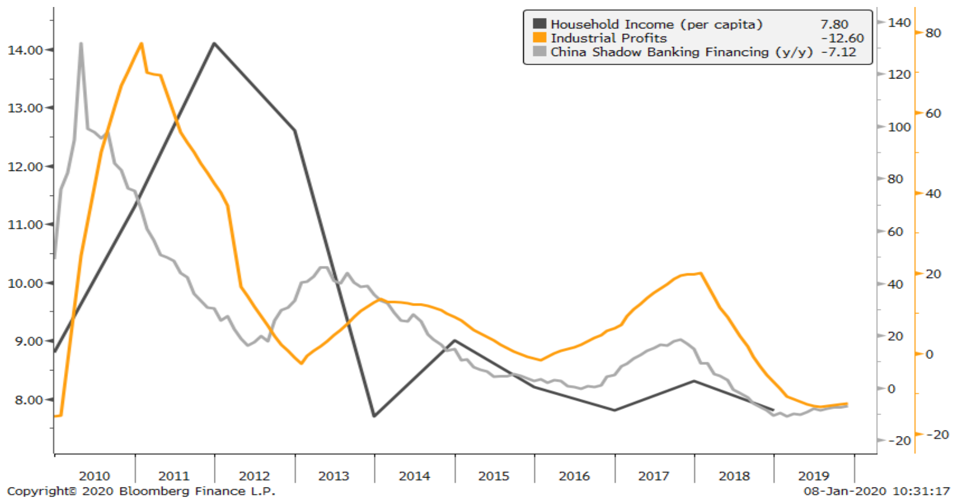
China CPI Components



PPI vs Industrial Profits

However, the recovery in shadow banking financing supported activity and, hence, household incomes should prove to have recovered moderately. Despite inefficient credit transmission channels, there was a positive credit impulse into the economy last year via financial conditions, with positive spillovers into sentiment and perceptions of wealth (despite a tepid property market, which is the preeminent source of wealth effects in China).

China Macro Drivers

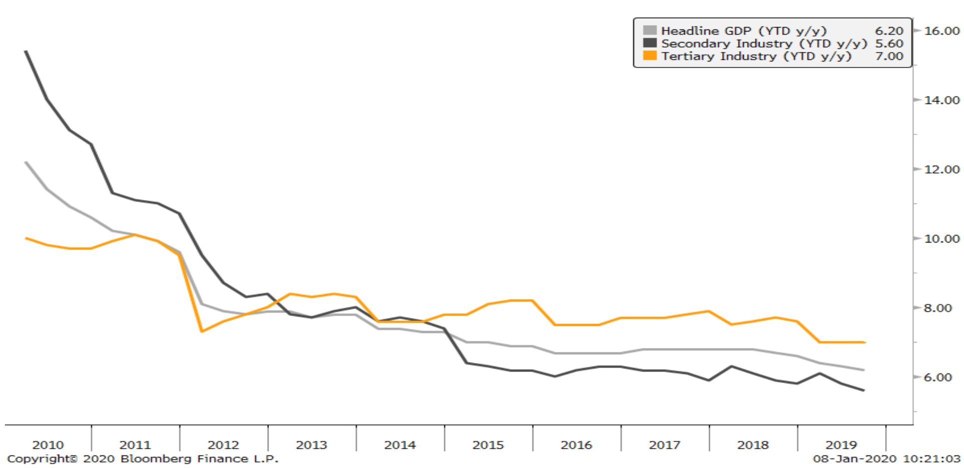


Amid this transition and the new, transient normal that it has begotten, it behooves us to take stock of critical factors worth watching during this phase as it will help us to understand inflection points. The first step is to discuss what is making the economic transformation tortuous, and then what is the promise of the future structures that are being built.

The highest order structural problem for the country has been and will continue to be China's debt overhang. It is a problem that reared its ugly head in magnificent fashion several times throughout the year with rolling defaults and the implosion of several regional banks. Indeed, the beneficiaries of the exuberance of industrial China are now the sickly entities impeding the emergence of AI China.

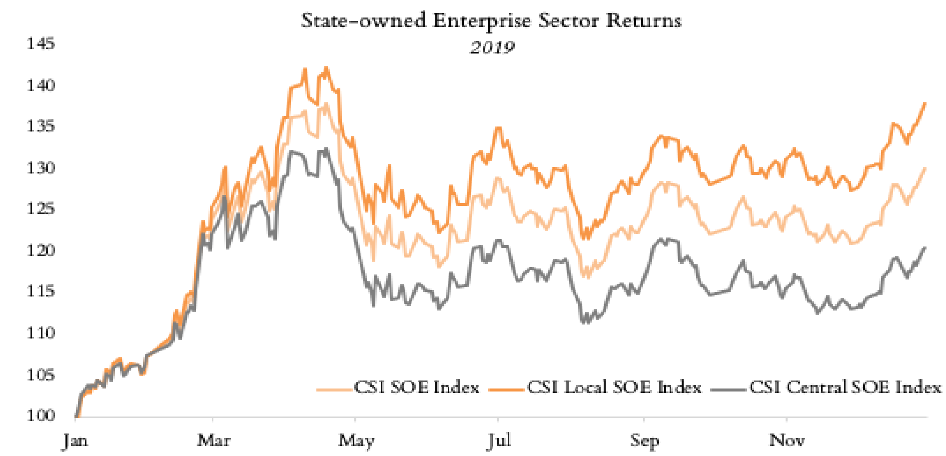
Last year witnessed a precipitous decline of secondary industries, particularly relative to tertiary sectors ("New Economy" sectors such as services and internet among others). A centrally planned economy defined by Socialism with Chinese Characteristics inherently posits the question of how best to deflate the largesse with minimal impact to employment and wealth while protecting the promise for a moderately prosperous Chinese society by 2020.

China GDP Components

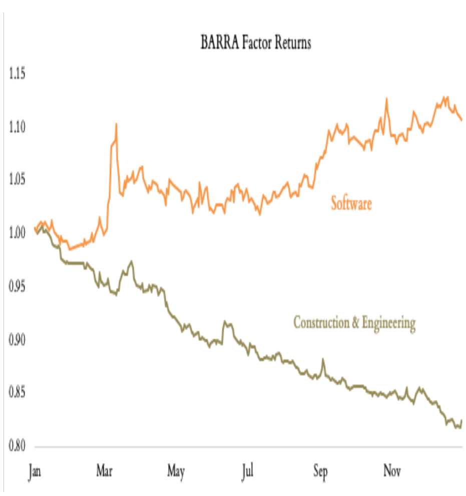


These bloated and unproductive vestiges of China's 20th century monotonic economy are a conundrum. They did what was requested of them in the name of cheap growth and are now a liability. How do central planners excise the necrotic tissue and save the flesh of these zombies whose purpose has been served? Trimming the fat, as it were, is a rather difficult task and left unattended leads to the negative results as we witnessed this year.

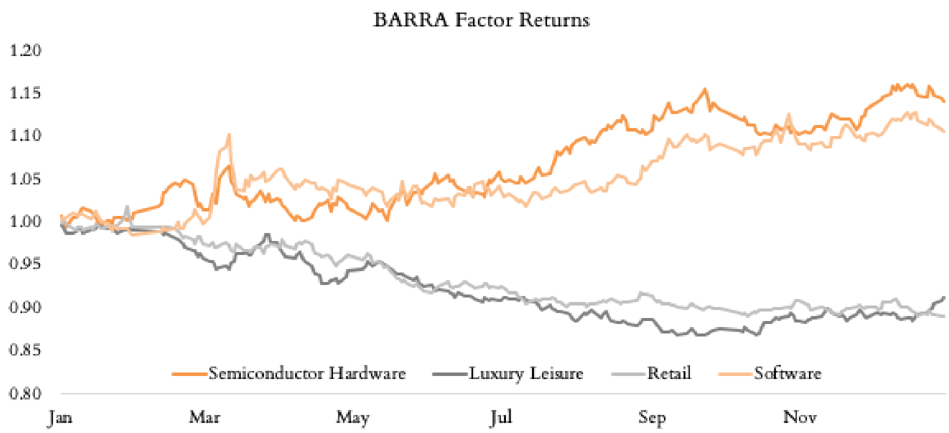
Consolidation of heavy industry state-owned enterprises (SOE) and the banks that financed them is the preferred method, made feasible with the subsidized balance sheets of even larger state-owned enterprises. What this means for returns is clear; central SOEs responsible for this absorption will underperform local SOEs whose goal is stimulating local economies; now with more stringent reporting requirements and financing guidelines. We saw this dynamic play out in the otherwise robust market that was 2019.



This is a behavior that is also broadly reflected in the microstructure of the equity market, where factor returns associated with heavy industry, "Old Economy," also exhibited erosion particularly versus the "New Economy." In other words, keyboards over shovels and silicon over steel. Beyond the notion that consolidation will cripple sector balance sheets, fiscal prudence, a more discerning development committee, and a significant ramping up of party discipline means a more limited opportunity set and, thus, revenue potentials.



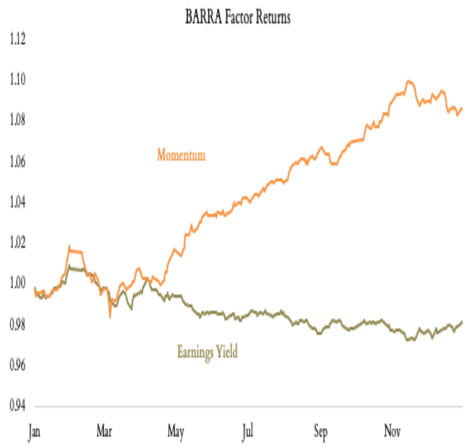
But because we are in a transient phase in an economy with huge wealth disparities, there are bound to be segments of the new economy that underperform because they are still sensitive to cyclical factors and sentiment swings, while others will outperform due to investor appetite, revenue generation, and profit potential. This bifurcation is seen in the disparity of returns played out accordingly last year.



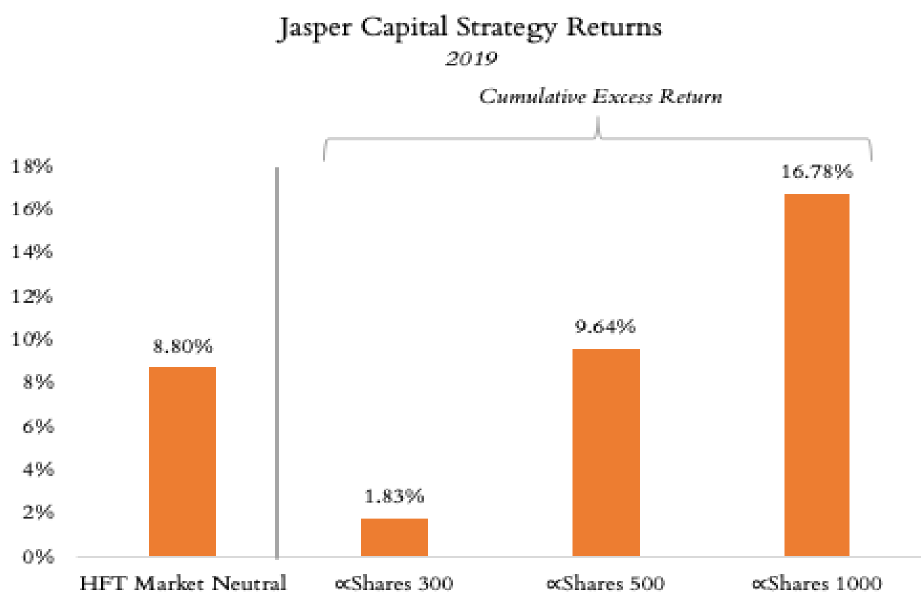
While many pointed to outstanding growth in Singles Day sales numbers as evidence of a robust consumer, we posit that last year's data demonstrated the price sensitivity of most Chinese households—who waited for the deepest discounts of year to concentrate their purchases. Domestic luxury retailers as well as the broader retail group all underperformed, while foreign luxury brands continue to post robust sales figures for the Chinese market. This is because the wealthy exhibit inelasticities of demand. They buy Gucci sneakers because they can.

These fundamental stories are excellent at understanding the forces shaping the Chinese economy and the dynamics affecting sectors. They are very helpful for formulating a top-down view of the market, informing macro-factor overlays and sectoral tilts. However, they lack real applicability in the calculation of expected returns given inherent problems with the reliability and credibility of macro and corporate financial data along with a generally fractured pricing mechanism for credit risk. This breakdown in the linkage between economic incentive and price discovery make the principals of fundamental analysis difficult to apply. Hence, a software company applying artificial intelligence to drug development may have a high probability of misreporting revenues and profits, but the growth potentials of the company and the sector have a high probability of being positive, particularly when considering the rapid growth rate of the market in general. Further, Sino-US relations and the spillover effects to global supply chain shifts and what these forces mean for price discovery are difficult to forecast. This is troubling given that these forces can be expected to increase in importance in the years to come.

The centrality of policy interferences in onshore markets have also altered investor incentive structures making deep networks in Beijing necessary for long-term survival of active fundamental managers. This essentially means that information asymmetries and policy-derived inefficiencies make the A-share market more appropriate for technical investors in normal market conditions, which gained traction in April and accelerated into the fourth quarter.



The erosion of quantamental factors and those factors associated with the Fama-French/BGI view of the world further compels the case for strategies that rely on technical signals. Having witnessed the paradigm shift in market mechanics in the post-2017 quant washout, Jasper Capital moved to invest in our infrastructure and research capabilities in the higher frequency domain, which culminated last year with the launch of our high frequency market neutral strategy. We also deployed higher frequency technical signals in our aShares systematic long-only suite of products with excellent results.



We believe that A-shares will enter the new decade in the same way it left last. We expect double-digit returns at the index level with technology stocks continuing leadership as Chinese technological prowess becomes more obvious to global investors, particularly when it comes to 5G technology and the applications of artificial intelligence to solve problems in complex systems. Advancements in biotechnology and pharmaceuticals, particularly oncology, are also evolving rapidly as are medical technology and telemedicine. The evolution of consumer and business services are also burgeoning. The new transient normal that started in 2019 is expected to continue over the next several quarters. Our view is supported by expectations for much of the same virtues of 2019 to continue to play out over this timeframe, after which a new paradigm will define the Chinese market. We outline these themes below.

Most of the problems that defined 2019 will continue in 2020 and most likely in the quarters beyond. With Beijing short of viable solutions that will not cause headaches in the future, the current path of selectively acting to dampen the deceleration where possible is set to continue. In this regard, the market converged to our views, and we believe this expectation is now firmly discounted by most investors.

Defaults will continue to accelerate, and debt levels will continue to grow . Local governments are now under close watch from the Party on keeping accurate statistics and not being profligate in their spending. The debt burden is something not many in Beijing know how to address without suffering the consequences that market economies inevitably face. It seems that the temporary instability of creative destruction is not wanted.

However, recent policy signals on the loosening of IPO and secondary offerings shows that the government is seeking methods to finance companies without further inflating credit markets. This broadens the opportunity set in equities as arbitrage opportunities that once existed, and in which Jasper excelled, are set to reemerge, such as those related to secondary offerings and direct financing. Last year, the STAR technology market was started as a pilot project to offer new routes for equity capital raising. Next year, more will be done on this front.

Further, increasing foreign investor interest in the A-share market and continued pressure from the likes of MSCI and other institutions on regulators to fix distortions will continue to develop the market and loosen the regulatory grip that inhibits the deployment of many strategies. The opening of foreign wholly-owned financial institutions will also bring in much needed competition and financial innovation that will, hopefully, breathe new life in to the market. The pace of these changes remains uncertain but the direction remains the same.

We remain bullish on Chinese equities. China is facing many internal and external problems, but these are largely known, and we believe are set on steady paths. The economy is changing, but we know the contours of those changes and where capital is being allocated. The external environment remains challenging, as we believe trade is far from solved, but the internal transition somewhat addresses these exposure risks. As for the portions of the economy that remain exposed, they present challenges to Beijing and fundamental investors alike, but not to those who do not care so much for the name or economic function as we do for price and volume patterns. This familiar path forms the base of our bullish thesis, supported by our investments in infrastructure and talent in order to harness and convert them in viable strategies.

We look forward to the Year of Rat as we have spent time expanding our competitive advantages in our niche domains. We have learned a great deal from the increasingly competitive landscape and have been adjusting accordingly. We continue to evolve our capabilities as we constantly seek to maintain our edge in providing our global investors with consistent alpha in China's A-share market.

Contact Information:
Carlo Passeri
Client Portfolio Management
Email: carlo.passeri@jasperhk.com
Tel: +852 2666 0807