The Rest of the West and Viewing the World through New Lenses
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Date: 7th February 2017

With 2017 now in full swing, we have suddenly been plunged into a world of incredible uncertainty. Volatility has become a daily news item where we wake up to see what the 'great' Donald has tweeted overnight and caused which sectors and markets to react violently. What seems to be lost in amongst what has become the norm across newswires is that China is only being highlighted for the risks that supposedly are related to the South China Sea, the status of their "currency manipulator" award as well as the well anticipated trade war to come with the US. I would like to discuss these issues in a broader context compared to what we are reading daily and provide some analysis as to what that means for the world, investment markets and how we should re-align our thinking to the East, and allow the "Rest of the West" to begin which in itself is no bad thing.

Let us start with a macro outlook for China. Moving on from the standard talk about what growth rate might China achieve for 2017, let us consider China 2.0 – being the transition of the old industrial economy to one driven by consumption through services. Unfortunately, over the last decade there has been a continual thirst to source a particularly negative set of economic data to prove the ultimate demise of the economic giant. I believe that it is about time our mindsets are to change and to at least try to comprehend the size and diversity of the country (did you know if you overlay China's land mass over Europe, it is about the same size? How diverse is Europe?) As part of the 2.0 mission, China is embarking on creating its own new financial system. What we do need to remember is that while the West continues to criticize the way they are going about creating their system, China never asked for their opinion on the matter in the first place. The West focuses on tight capital controls, and lack of free market capitalism. But in actual fact, China is using a measured and gradual approach to opening their markets to ensure overheating doesn't occur like we've seen in the West through the joys of deregulation. If nothing else, through the use of aggressive QE, the West has continued to weaken its efficacy as a combined superpower to resuscitate global growth and inflation via its 'almighty' financial system. A great example of this gradual approach is through their stock market whereby they slowly opened a two way channel to trade shares between Hong Kong and the mainland via the Shanghai – HK Stock Connect program, which was recently followed by the Shenzhen – HK Connect program. Now I'm not here to state 'alternate facts' by claiming the programs were volatility or risk free, but China does continually revise its reforms, allowing them to adapt to new market conditions. We must also re-frame our interpretations of Chinese planning. Can you predict what will happen in the US or even Europe over the next 5 years? Of course not! But in China, they have a five year plan, providing the framework for leaders to adhere to, while providing a roadmap to its citizens in achieving reforms to benefit the population at large.

The US and China Relationship
There wouldn't be a single reader of this article that couldn't recite Donald Trump's slogan for the American economy, but let me ask, do you know what Xi Jinping's motto for the Chinese economy is? It is the "Great Rejuvenation of the Chinese Nation." One of the advantages that China has over the US is that both China's fiscal and monetary policy is in sync. So what do we mean by this? When the PBOC

(People's bank of China) wants to turn on the tap, it does so very quickly and it is done by new money directly injected into the economy into the sectors that the central government targets. Same can be said for fiscal policy where the control and command framework for government truly shines. If the central politburo wants to build infrastructure they do; if they want to build a new city that's focused on sustainability and environmentally friendly initiatives they just do. Contrast this to the US. The US Federal Reserve is fundamentally separated from the executive branch of government and since 2015, the world continually holds economist consensus surveys as to when they may start raising rates. Furthermore, remember Trumps ambitions of building infrastructure? Can he simply do it the same way China does by hitting the ground running? Good luck……even with both houses under Republican control.

Moving onto the issue of trade, and an impending trade war for that matter, we all need to accept that the way the US is going with its isolationist policies is not good for themselves or the world long term. Based upon the Donald's threat of implementing a 45% tariff on Chinese imports into the US, it could hit Chinese exports by up to 60% or $270bn USD but if you think that it would happen with a flick of a switch, you would be sadly mistaken. In today's world of globalization, supply chains are becoming ever so complex and combining this with many exports being of a technological nature, how it would practically work is very hard to see. Furthermore, if you think China would just accept this tariff (if it was to be implemented) lay down and play dead, you literally would be dead wrong. If history is any indicator, over the last 5 years, there have already been trade wars ranging from chickens to tires. Most recently in September 2016, the US decided to impose tariffs on steel imports and China responded in October with extending duties on imports of caprolactam from the US which is a chemical used in textiles.

At the latest Davos World Economic Forum, we saw a rather interesting event of President Xi Jinping recommitting China to globalization and free trade. I view this as one of those watershed moments where the world's tectonic plates start silently shifting signaling change. President Xi went as far as likening protectionism to "locking oneself in a dark room." Given the Donald's domestic agenda and hostility against climate change, China has positioned itself as taking the baton to lead both global trade and environmental policy agendas. Furthermore, since Trump taking office, China and Germany have begun talks (specifically between Chinese Premier Li Keqiang and Chancellor Angela Merkel). Both share the same aim of stabilising global trade. Remember China's "One Belt One Road" policy? Let it be clear that the Chinese leadership is not making everyone guess what they want to achieve and how they will do it (unlike the US), they want to open up the paths of trade to benefit all who sit along this belt – from China all the way through to Europe.

From a local perspective, Australia needs to make a definitive and committed decision soon as to who it wants to hitch its wagon to over the next century (both economically and investment wise). We have battled for long enough internally about who our allegiances lie with and while it is clear which one serves Australian interests over the long term, will we actually make it? For all intents and purposes, without the US at the table, and lackluster interest by China, the TPP is dead in the water. But what is the alternative? Has anyone heard of the RCEP being publicised? If you thought China was going to be happy picking up the scraps left by the TPP, think again. The RCEP or Regional Comprehensive Economic Partnership is China's alternative to the TPP which has been brewing for some time given the US's pushback for China’s inclusion in the TPP. In fact, at the latest 21 member APEC economic leaders meeting in Peru last November, President Xi reaffirmed that China and the members of ASEAN invite with open arms any TPP member nations wanting to join the RCEP.

Moving slightly from trade and into the world of forex markets, remember when Trump on his campaign trail stating clearly that he will name and shame China as a “currency manipulator” on day one of his presidency? It never happened but has anyone bothered to analyse why? The fact is that there is a criteria set by the US Treasury department as to what constitutes a currency manipulator. They are:

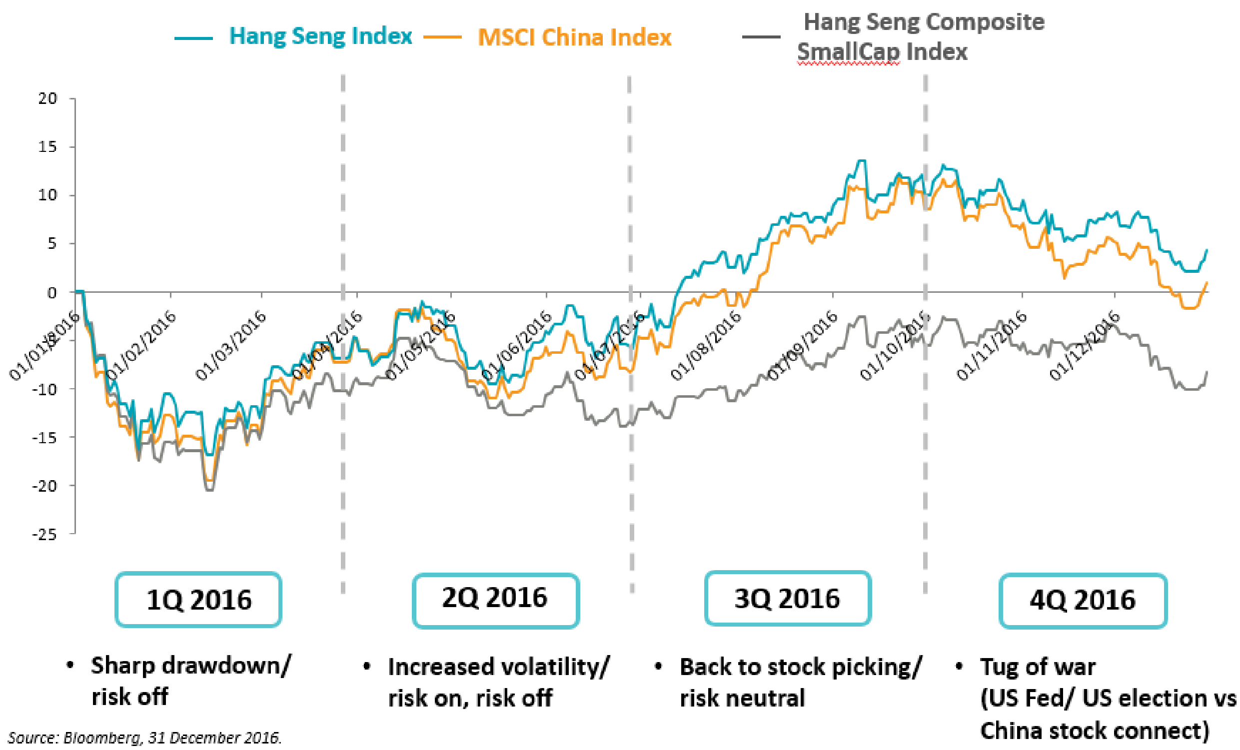
- A bilateral trade surplus greater than $20bn USD
- A current account surplus above 3% of GDP and
- Persistent one-sided FX intervention

Right now, China only fulfils one of the three criteria being that the trade surplus is in fact by last count greater than $250bn USD. China currently runs a small current account deficit and China is in fact trying to keep its RMB higher, not lower. The more of these promises that Trump doesn’t follow through on will lead everyone recalling the classic story of the boy who cried wolf.

The final piece of the Sino China relationship that needs to be discussed is with regards to the South China Sea. Conflict risk is high here, but what truly astonishes me is that while Trump has provided rhetoric to the point that the US is no longer the global policeman, they still want to meddle in matters where they have no business to? What would you think if China started sticking its nose into the US conflict with Mexico on the wall and deployed forces defending Mexico? Would you find that absurd? Just let that sink in for a while….and consider taking off the rose coloured glasses when looking at the US…..

Investment Implications and Strategy for 2017

So what implications does this all have for investing into the region? Firstly, if we reflect upon what happened to the Chinese equities market in 2016, it was one which had taken a lot of volatility. If you refer to the chart below, I have split 2016 market performance on a quarter by quarter basis. Rational behavior was only exemplified in Q3 where the macro risk outlook seemed to have tapered off somewhat. In all of the other 3 quarters, it was either a matter of a continually swinging lever of risk on or risk off, or the impact of hot flows in and out of the region. As you can see, both the HSI and MSCI China indices finished off the year pretty much where they started (albeit a slight positive return), but investors had to endure through all the volatility in the meantime (hence the rise of the term ‘return free risk’).



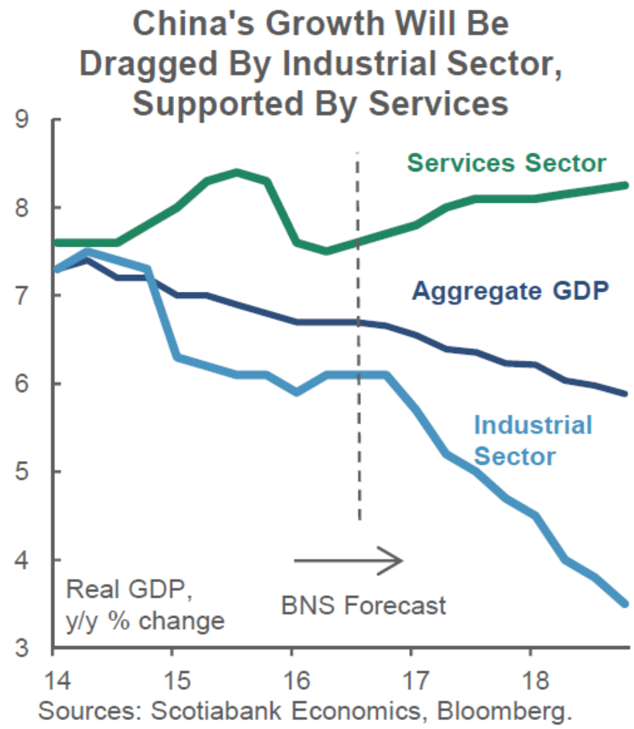
Source: Bloomberg, 31 December 2016.

At a stock level, the strategies that benefitted most last year were ones which targeted traditional "defensive" stocks such as TSMC (in Taiwan), HSBC and MTR (in Hong Kong) which while rallied strongly, were amongst some of the most expensive (and irrational trades) where value managers stayed away from. This is reflected in the chart where the HS Composite Small Cap Index lagged the performance of its large cap sibling. We believe the trend is set to reverse in 2017 given a somewhat less volatile outlook (compared to last year).

Structural reforms is something we are a big advocate of, which allows us and our managers to see catalysts for investment. Hong Kong is one of those rare markets globally which does not suffer from home market bias (for better or for worse). This means that when hot money comes and in out of the HKSE, there is no stabilising buffer like we have in Australia or the US. While this does increase volatility, it also means that when upward swings occur, they are rapid in nature. From a local investor's viewpoint, it would be wise to invest in Greater China equities with a long term focus and accepting that timing the market is an exercise in futility.

In the medium term, we see one stabilising factor which to date I have never seen any local analyst discuss – mainland monies. Earlier in this piece, I touched on both the stock connect programs which started allowing capital to cross borders between Hong Kong and China bourses. Flow figures show that since the programs were launched, there has been a net inflow from China of $45bn USD via the connect programs. Mainland firms are falling over each other trying to access cross border trades and this will be a strong investment theme in the future. As a value manager, this positions us well for the influx of monies over time. The conclusion to this is that China will act as the stabilizer for Hong Kong with insurance and sovereign monies looking for a long term home across the border from the mainland – and thus being the catalyst to start building long term allocations into the region.

We also believe that if fundamental investing returns to favour in 2017, cyclical stocks will provide a strong source of alpha. Across the Asian region we believe that South Korea (along with its own structural and market reforms), Taiwan and Greater China present the most opportunities for undervalued stocks. The upcoming earnings season for China equities in March/April we see as very strong and should reflect positive sentiment for the market. All companies within current portfolios are either meeting or exceeding their previous earnings forecasts.



As part of the China 2.0 transition, the industrial sector will continue to drag while the services sector flourishes. Overall, there will be a drag on GDP growth, but since when does gross GDP growth in China factor into an investment thesis (it's not like we do that in Australia). Giving this theme time to play out and allowing the services sector to further penetrate into the everyday economy (from e commerce to communications) will create a strong base line for the economy going forward. Technology sector plays continue to be attractive albeit they do carry a warning where some of these companies suffer from stretched valuations.

My observations over the last 15 years have continually shown that we as an investment sector are more than happy to take the wealth being generated in China by Chinese companies and the citizens that make up those companies, but conversely are far less willing to invest back into those same companies ourselves (a double standard perhaps?). This is reflected through pitiful and pathetic asset allocation decisions to Greater China equities and bonds coupled with the nature of hot flows in and out of the markets made by Australian advisers and researchers in general. Change needs to be embraced and those who are willing to embrace it early will reap the rewards. By accepting the "Rest of the West" you are taking your first step in adapting to global change.