Areté CAPITAL ASIA

MARKET OVERVIEW
July 2017

EXECUTIVE SUMMARY

CURRENT MARKET ENVIRONMENT

- Overall we are TURNING SLIGHTLY CAUTIOUS on the risk/reward environment
- Many economies have increased their debt load substantially, some haven't spent more prudently than others
- Valuations have advanced ever higher, especially for a few sectors. May be tough to support
    - Investors have been attracted by what Behavioral Finance terms "FOMO" (Fear of Missing Out)
- There are plenty of geopolitical issues that can sour the environment in the short/medium term
- There are increasing signals that Central Banks will remove the "punch bowl" of global liquidity.
- Consider hedging risk positions if possible. A true hedge is "Heads I win, Tails I don't lose (much)"

ASSET CLASSES GENERAL COMMENTS

- Equities
    - US - reduce exposure, good time to selectively take profits and look for better entry points
    - European stocks have a number of favorable economic and political winds in their favor
    - Asian equites offer strong demographics, decent growth all at relatively attractive valuations
- Bonds
    - A 30 year bull market in bonds is coming to an end. Its only a matter of "WHEN?"
    - Avoid: G7 Gov't Debt, "Questionable" issuers – highly levered Corporates/Serial Defaulters/etc
- FX
    - USD soft in 2017 = good for Rest of World. Expect USD to regain footing in later in 2017
    - EUR is in a technical break out, but the ECB is wary of a strong EUR. Stand aside for now
    - May be possible to Long USD vs. JPY on the short side in months ahead, if we see USD weakness

RISK MANAGEMENT

EQUITY VOLATILITY IS LOW…..MAYBE TOO LOW….

- Most major markets have the same metrics – very low volatility. This has encouraged risk taking activity and pumped up equity valuations.
- There has been a Goldilocks environment of GDP "not too hot and not too cold". Inflation has been existent but tame
- But volatility can change, and historically tends to spike constantly

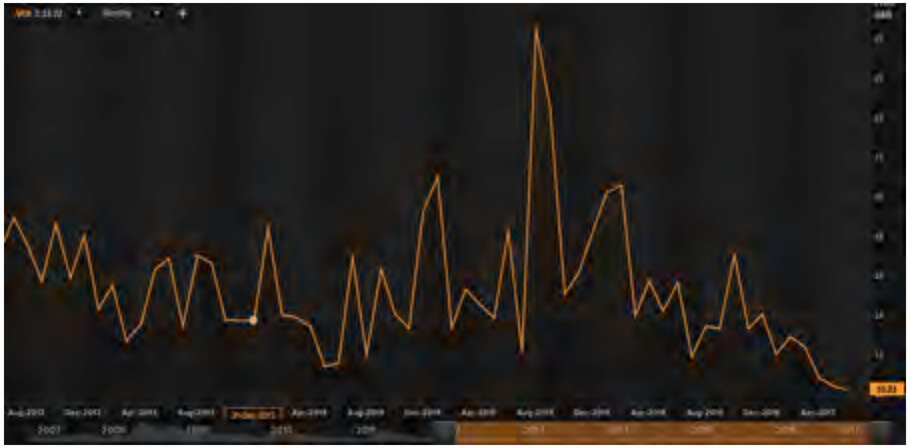
FIXED INCOME LIKEWISE IS PRICED FOR PERFECTION

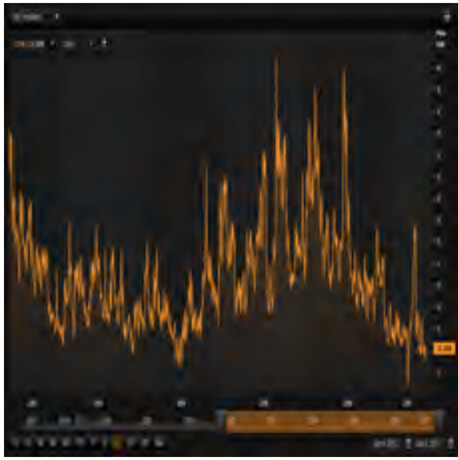
- Numerous borrowers have come to market to build cash war chests or to fund acquisitions
- Bonds not only offer very low yields, but also have been including a lot of clauses that favor the bond issuer
- All of this is good for the issuer, bad for the investor
- Reconsider financial strength/clauses in portfolio bond issues

BE AWARE OF THE CROWDED TRADES

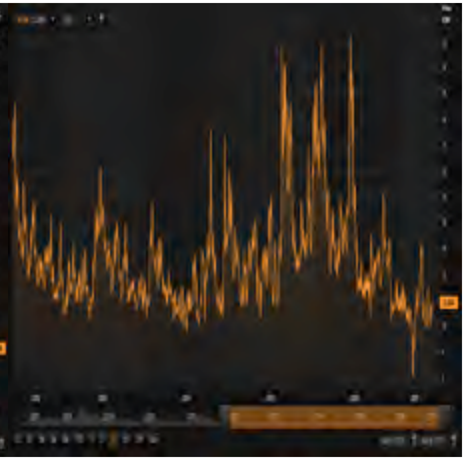
- We are seen a number of crowded trades un ravel in these past few years:
    - Long USD vs. JPY and EUR at any price
    - Short Oil & Energy (when it was already down)
    - And now…Long large cap tech stocks

CBOE Volatility Index





EuroStoxx 50 volatility index



FTSE volatility index

LONG TERM INVESTMENT THEMES

FINANCIALS RETURN TO STRONGER PROFITABILITY

- After several dark years, silver linings finally emerge
- Return to upward sloping yield curves improve net interest margins
- Decreased regulations in US & Europe to support bank build out

CHINA – EVER RISING MIDDLE CLASS

- Per capita GDP at USD 8500 is squarely middle class
- Service economy/credit/insurance support middle class affluence
- Tech savvy population = huge dividends for digital economy

SOUTH EAST ASIA COMES OF AGE

- Population of 650m with very strong demographics & education
- A rapidly growing middle class that supports local economies
- Increased governance and solid financial resources

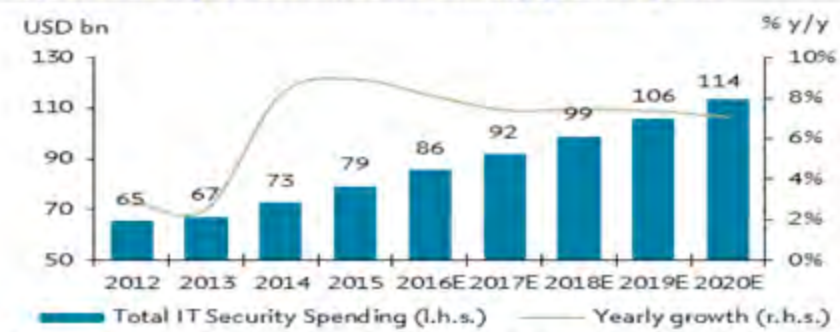
NEED FOR IMPROVED CYBER SECURITY

- Increased cyber attacks targeting antiquated infrastructure
- Target platform approach where one platform ahs the ability to solve for multiple potential problems

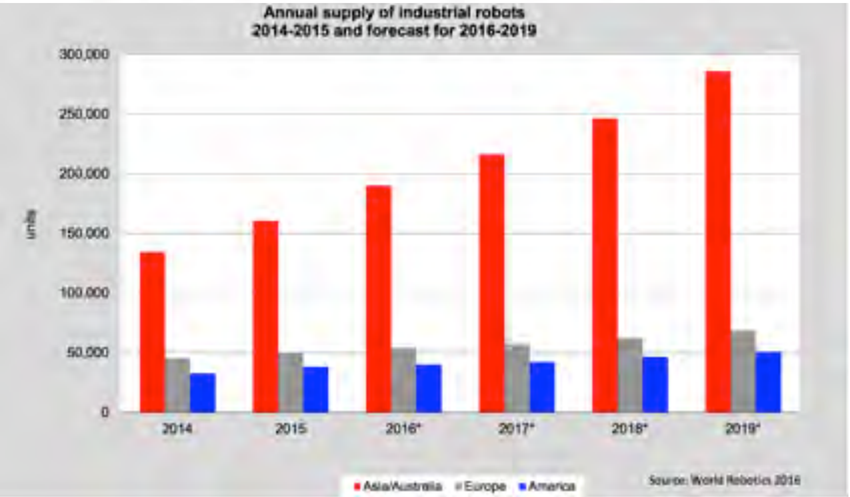
RISE OF ROBOTICS/ARTIFICIAL INTELLIGENCE

- Controversial yet steady march towards replacement of various tasks by machines
- Very binary: big winners and big losers from this trend

Cybersecurity to continue its strong growth path



Source: Gartner, IDC, Forrester, Citigroup, Jefferies, Julius Baer; Note: market includes IT security services such as consulting; E=estimate



TECH – A GOOD COMPANY VS. A GOOD STOCK

TECH – "A FEW BIG WINNERS TAKE ALL"

- In the analog world, there is more room for competitors and new market entrants. – example: Nike vs. Adidas vs. Puma
- The digital world veers towards a "Winner Take All" approach
  - Strong network effects – much of the user experience is depending on size of network. Bigger = Better.
  - This leads to greater financial metrics allowing for R&D, acquisitions – to further widen the lead
  - Example: Online Retail: Amazon/Alibaba/Flipkart

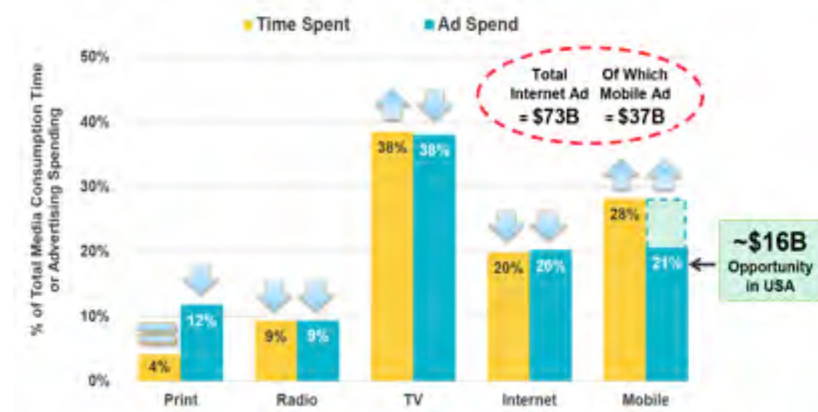
MOBILE SERVICES (BUT NOT SMARTPHONE SALES) STILL PLACE TO BE, MOBILE ADS HAVE ROOM TO GROW

- Smartphone shipments are slowing down, only AAPL has the ability to really make money in Smartphone sales
- Online advertising still UNDER INDEXED vs. time spent online
- Android operating system & online ads favor Google

BUT WHEN STOCKS GET AHEAD OF THEMSELVES….

- Solid balance sheets with very manageable debt
  - Growing top line and bottom line
  - High gross margins, strong free cash flow
- BUT, market has bid up the price of many large players
- Tech rally very concentrated in a few names (FAANG, etc)
- Acceptable to have exposure, but not adding new money

Source: KPCB Internet Trends 2017, Morgan Stanley Research (5/17)



Source: KPCB Internet Trends 2017, Internet and Mobile advertising spend based in IAB and PwC data for full year 2016 Print, Radio and TV advertising spend based on Magna Global estimates for full year 2016.

EQUITY PRICE MOVEMENTS – 5 YEARS

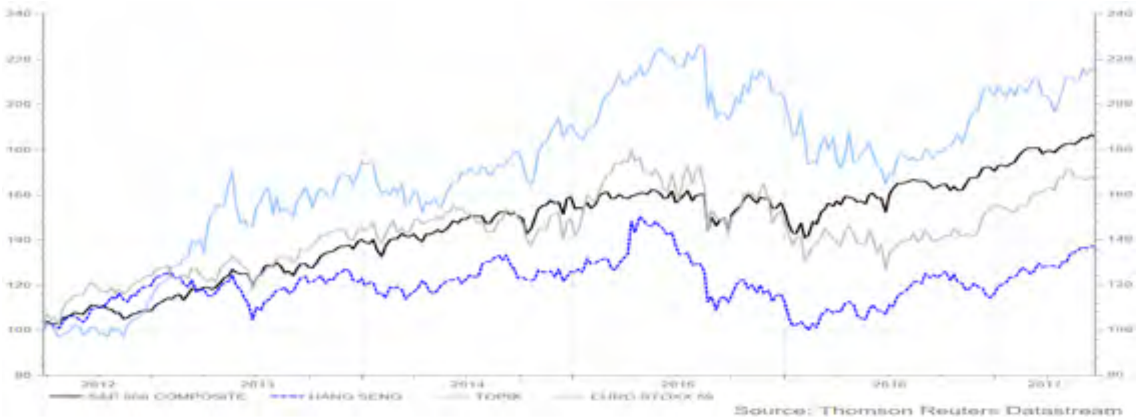


Chart: Indices - Price – 5 years

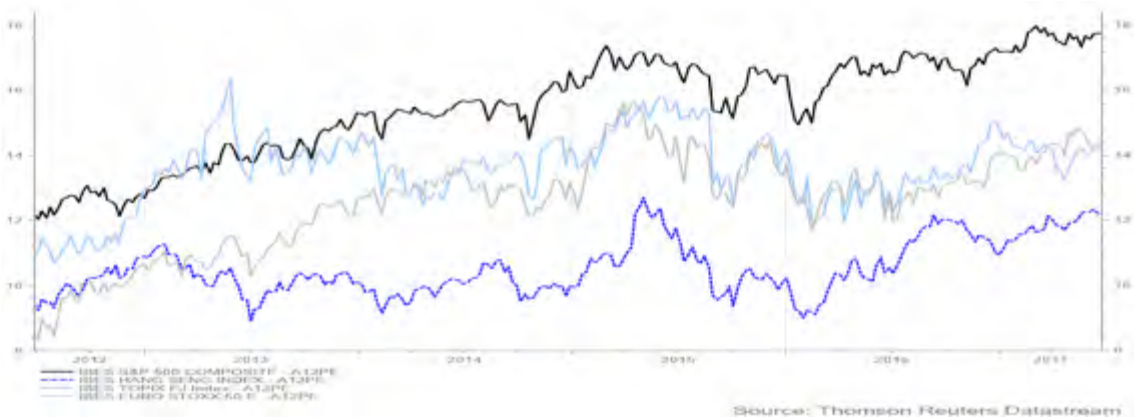


Chart: Indices - Forward 12M P/E – 5 years

- All major markets have shown growth in past 5 years
- US Large caps have been one of the best performing markets, with least volatility
- As the US economic recovery gets older, time to look at cheaper valuations in other markets
- Emerging Markets equities have hugely underperformed and this may begin to change

Index	Trailing P/E 1 year	Forward 12M P/E	Dividend Yield
S&P 500	18.75	17.77	2.37%
Hang Seng	8.89	12.22	3.18%
TOPIX	12.68	14.16	1.90%
Euro Stoxx 50	20.28	14.32	3.33%

THREE EQUITY SUPPORT FACTORS

1) CHEAP OIL ACTS AS A TAX CUT

- Particularly good for oil importers such as East Asia & India – resulting in strong equity markets
- Cheap oil is a "tax cut" for consumers allowing them to spend more and support economies
- For now price of oil may be capped at USD 55, but it is not a certainty the cheap oil will be around to support equity prices

2) SOFT USD SUPPORTING LARGE CAPS

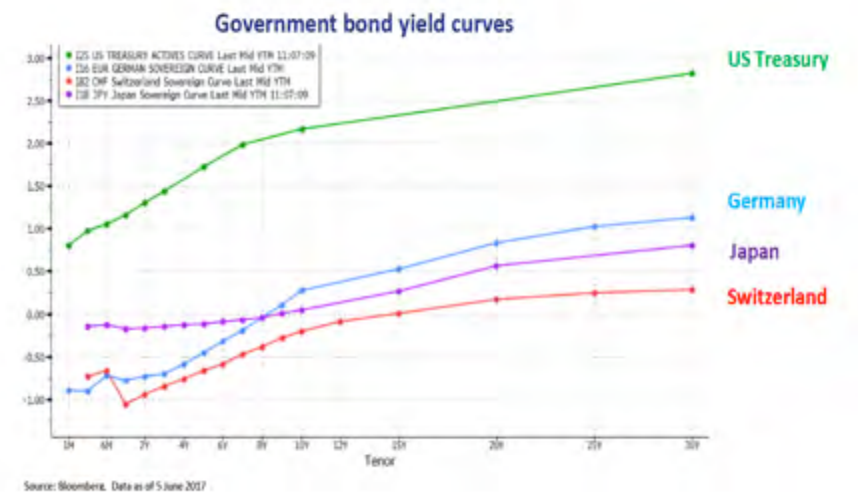
- S&P 500 has about 45% of sales outside US
- Large caps acquire assets overseas, which appreciate in USD terms
- Trump has so far not followed through on strong rhetoric to enact trade barriers and cut the US trade deficit
- A strong USD hurts Countries/Corporates with mismatch in USD borrowings vs. local currency revenues

3) INTEREST RATES STAY QUITE LOW….. FOR NOW…

- US has been only major country so far promoting higher rates
- ECB & BOJ concerned about strength of recovery, thought ECB may be changing tone

WILL EQUITY MARKETS GET CONTINUED SUPPORT FROM THESE POSITIVE FACTORS? THEY WILL NEED IT TO MAINTAIN POSITIVE MOMENTUM.

Chart: ICE-Brent Crude Oil price – 5 years



US EQUITIES – FAIRLY PRICED

US ECONOMY DECENT BUT NOT AMAZING

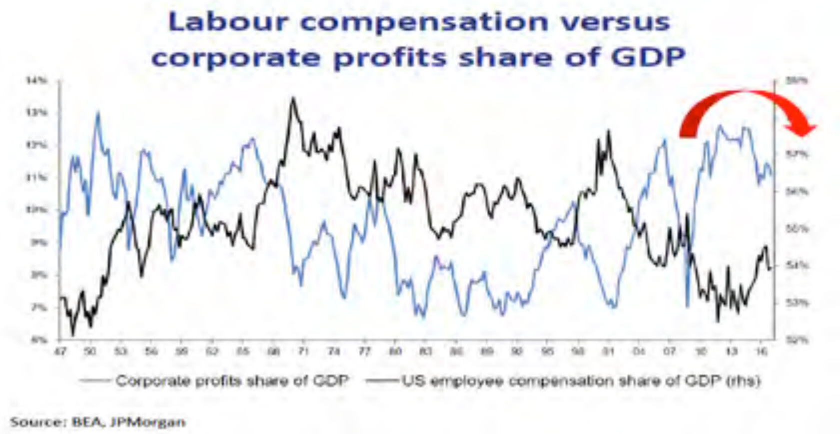
- The profits cycle looks to be slowing down. This will eave less money left for stock buys backs, which given higher share prices have started to slow anyways.
- Job Growth quality is mixed
- Local economies are very different. The East/West Coast doing well, Middle USA not as good

TRUMPONOMICS MORE TALK THAN ACTION

- Tax Reform – Not this year. At most a Tax Cut
- Infrastructure Spending is exaggerated
- The one area that we are seeing positive action on is a cut in regulations and red tape
- Earnings growth expectations already very high and getting baked in to prices.

CONCENTRATED ADVANCE

- **FAANGS** market cap about same size as France.
- Financials – Money Center banks have done well and may continue to do well. Favor quality such as JPM.
- Domestically focused US companies – exposure to the US Consumer, who has been recovering from the financial crisis



EUROPEAN EQUITIES – CATCH UP

BEGINNINGS OF THE RECOVERY

- European earnings vs. US have bottomed after years of underperformance
- Recently economic releases have shown modest, yet positive growth
- Europe is much less advanced in their recovery stage and it is still relatively early days
- We suggest overweight Euro zone equities for those companies with a domestic demand bias

POLITICS & THE ECB

- Expect a Merkel victory in September, cementing a strong working relationship between Germany and France
- Italian bank bail shows important in that it shows a measure of flexibility, which will soothe fears against greater integration
- The ECB themselves smell a recovery underway and may begin to withdraw stimulus in due course

FINANCIAL MARKETS

- The European stock markets trade at a discount to US peers
- Years of a cheap currency has allowed companies (exporters) to rebuild their reserves
- Investors may boost allocations European equities in H2 2017 (so far not much money has flowed through)

- BLUE LINE: EURO STOXX 600 FORWARD EPS
- GREY LINE: S&P 500 FORWARD EPS

Cycle-adjusted PEs

	Current Cycle adjusted P/E	LT Median	Upside to Median, %
Italy	13.5	24.9	84%
Japan	24.9	40.8	64%
Spain	14.2	18.5	30%
Portugal	10.6	13.5	27%
Eurozone	16.3	20.2	24%
France	20.2	22.1	9%
UK	16.7	17.9	7%
Germany	19.9	19.6	-1%
World	23.9	23.2	-3%
Switzerland	23.3	21.3	-8%
US	28.1	23.1	-18%
Netherlands	24.8	14.4	-42%

Source: Datastream, JPMorgan

CHINA EQUITIES – MIXED BAG

A MODERATELY SLOWING ECONOMY

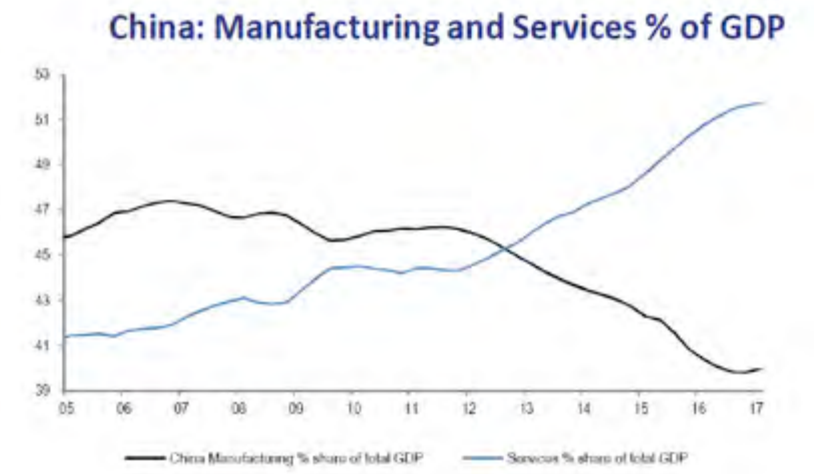
- The economy in China is definitely slowing from previous years breakneck speed (proof: watch electricity usage)
- Still, the Gov't has ample policy levers that they can use to moderate the slow down
- SOE reform hasn't happened and Govt doesn't seem to have the stomach to tackle this at the moment

THE SERVICE ECONOMY ROARS AHEAD

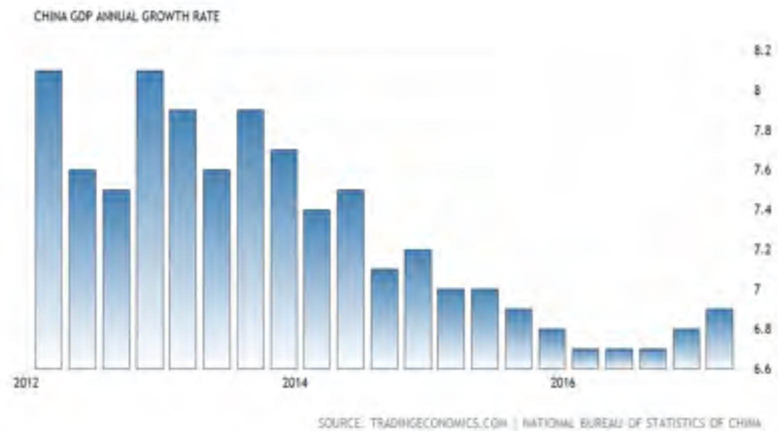
- The slow down in Industrial has been offset by an increase in Services. Since then even the Industrial slowdown has bottomed
- Leadership is well aware that enabling entrants into the middle class is the key to continued growth and prosperity
- Middle class consumers broaden from consuming goods to various financial/legal and other services

THE CHINESE DIGITIAL ECONOMY - ROOM TO GROW

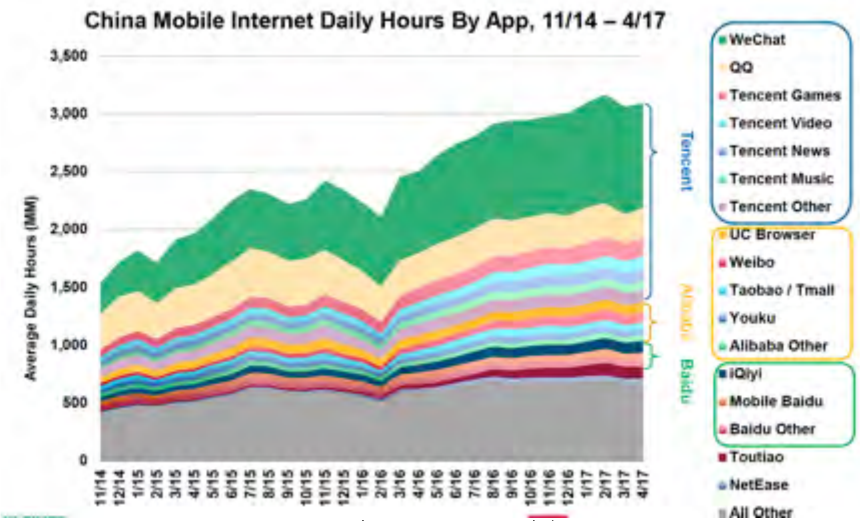
- Solid user growth, deepening use of tech platforms
- Innovations within entertainment increase monetization
- Local champions in payment infrastructure
- Huge e-commerce market and growing advertising
- But the advance is also narrow….
  - **<u>TATS:</u> T**encent **A**libaba **T**SMC **S**amsung is 50% of the MSCI Asia Apex 50 over the past 6 months.



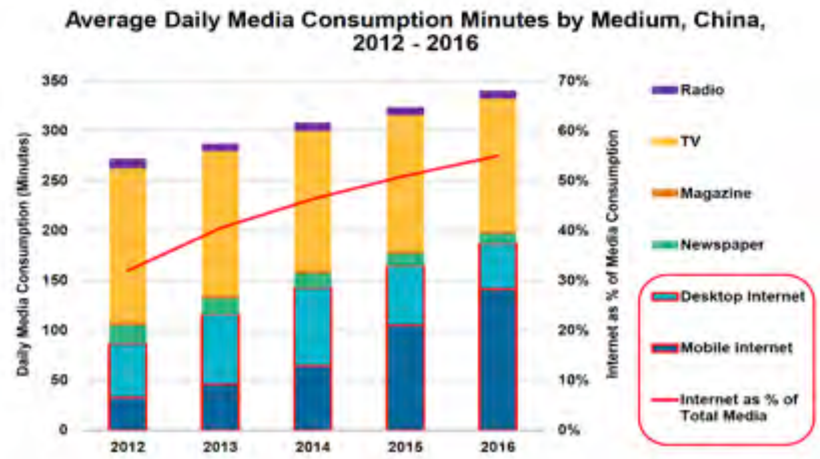
Source: SSB, JPMorgan



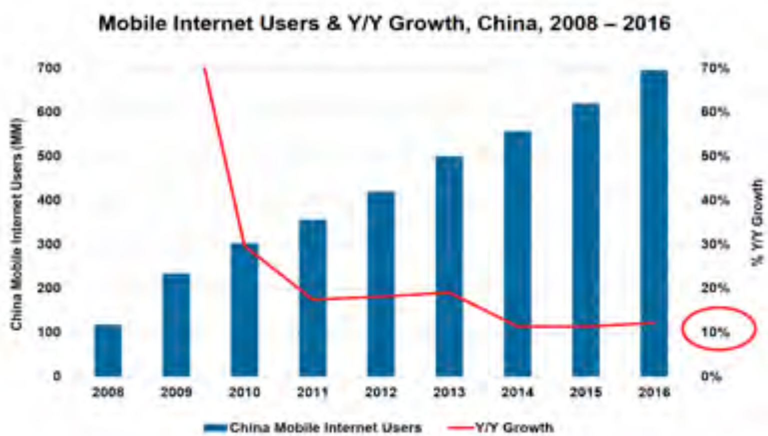
CHINA – THE DIGITAL ECONOMY



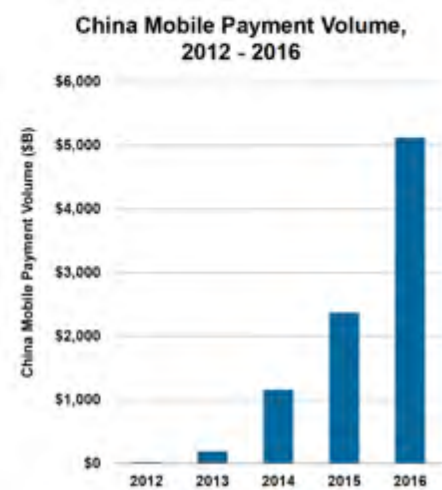
Source: KPCB Internet Trends 2017, QuestMobile



Source: KPCB Internet Trends 2017 Zenith Optimedia



Source: KPCB Internet Trends 2017 CNNIC



Source: KPCB Internet Trends 2017 Analysys

JAPANESE EQUITIES

STEADY MARKET IMPROVEMENT….

- Japan's birth rate has slowly improved in last 10 years from 1.25 to 1.45 children per woman
- We have seen Increase in jobs available per applicant
- Corporate Japan has a large cash hoard and best of breed technology. Now, where to find the demographics to support that technology?

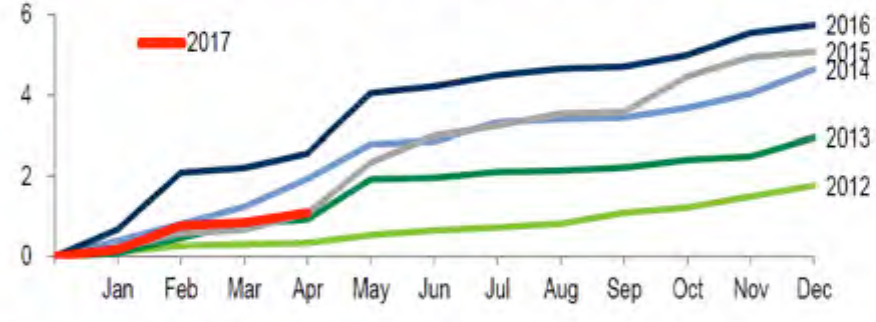
VARIOUS CORPORATE CATALYSTS

- Governance/Accountability to shareholders has improved = more independent board members
- Share of dividends to be paid to shareholders is rising
- Stock buy backs are gaining momentum
- Corporate activity: M&A is increasing

GOVERNMENT FOCUSED ON REFLATION

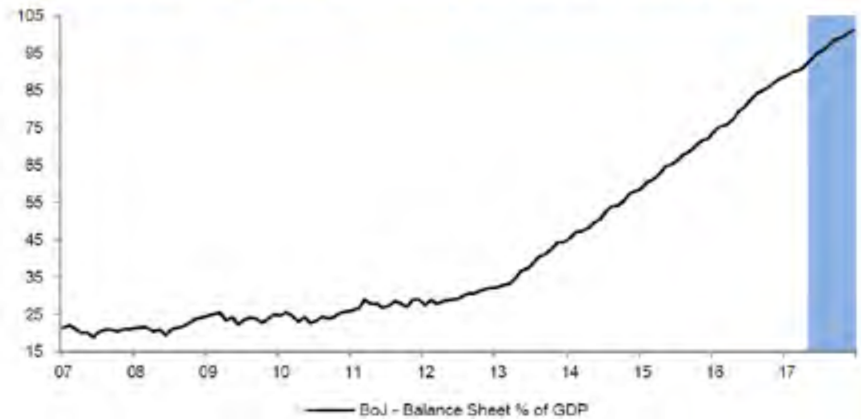
- Japan still maintains the most aggressive stimulus measures, relative to the size of the economy
- Mr. Abe understands that this is likely Japan's last chance to attempt to escape the deflationary spiral

Share buyback plans
TSE1, JPY trn, as of April 28, 2017



Source: Company data, QUICK, Nikkei Value Search, Goldman Sachs

Bank of Japan's balance sheet as a % of GDP



Source: JPMorgan

FIXED INCOME THEMES

A 30 YEAR BULL MARKET IN BONDS COMING TO AN END

- Interest rate lows are at near or all times lows in most markets around the world
- In addition, Corporate/Emerging Market spread over Treasuries also at all time lows
- The only way to go is up – ITS ONLY A QUESTION OF TIMING

REASONS FOR CORPORATES BORROWING?

- Some corporates borrow to add to cash war chest, others to expand their asset pool when assets are high, or for share buybacks. Yet others expand into Non Core businesses.
- Beware those expanding too fast or into Non Core
- Corporates realize that funding rates will rise in the future, thus the rush to borrow now

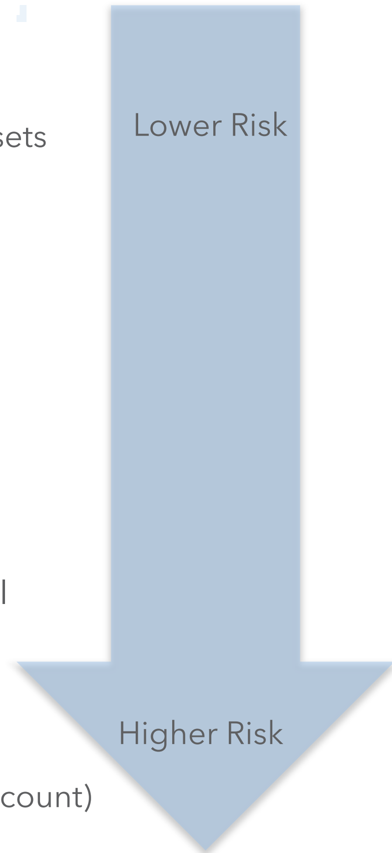
NEED TO BE VERY SELECTIVE ON CREDITS/ISSUERS

- Favor issuers that can deal with the unexpected – a melt up in USD or geo politics leading to an oil shock
- Emerging Market bond yields are also very tight, wait for a blow out in spreads before adding exposure
- Peripheral European names could become quite volatile.

FOR 30 YEARS US TSY YIELDS HAVE DECLINED

CAPITAL STRUCTURE OF BOND ISSUERS

Senior Liabilities	Senior Secured	• Senior Liabilities, secured by specific assets • Relatively less common
	Senior Unsecured	• Senior Liabilities, not secured by specific assets
		OUR PRIMARY FOCUS
		POSSIBLE AS WELL
Subordinated Liabilities	Lower Tier 2	• Debts (maturity > 5 years)
	Upper Tier 2	• Perpetual subordinated bonds • Revaluation reserves from fixed assets • General provisions (max. 1.25% of RWA)
Equity	Hybrid Tier 2	• Innovative and non-innovative hybrid capital
	Core Tier 1	• Ordinary shares • Retained earnings • Minority interests • Reserves (Share premium / Profit and loss account) • Perpetual non-cumulative preferred stock



ONE NEEDS TO BE COMPENSATED PROPERLY IN ORDER TO ACCEPT A HIGHER RISK WITHIN THE CAPITAL STRUCTURE!

FIXED INCOME STRATEGY

Duration	Credit	Volatility	Capital Structure	Currency
Cash ★	USTs/Munis/agencies	Simple Non-Callable ★	Senior Secured ★	All U.S. dollar ★
★ Intermediate duration	Asset-back bonds	Callable bonds / Step-up agencies	Senior Unsecured ★	★
	A-AAA corps bonds ★	LIBOR range notes	Lower Tier 2 ★	Non$ - G7
	BBB corps bonds ★			
	Structured credit products	EM range notes	Upper Tier 2	Emerging Markets
▼ Long duration	▼ High yield/emerging markets	▼ Puts/calls	▼ Perpetual/Tier 1	▼ All Non-US dollar

AT THIS POINT IN THE CYCLE:

- Maturities: 5 years or less
- Credit Ratings: BB+ to BBB or higher
- Bond Type: Simple, non Callable, Bullet Maturity
- Coupon: Fixed
- Issuer Profile: Prefer Sovereign backing. Some corporates possible
- Currency: USD focus. Other G7. Stay away from EM Local Currency
- Bond Price: try not to pay a big premium over 100 when possible

- WE LOOK FOR FIXED INCOME TO EARN A DEFENSIVE YIELD, NOT TO TAKE BIG RISK FOR SMALL EXTRA YIELD
- AT THIS POINT IN CYCLE, AT BEST WE LOOK FOR BOND PRICES TO HOLD THEIR VALUE, NOT PRICE GAINS

FX - TRENDS EMERGING

USD LOOK FOR YEAR END COME BACK

- Despite current softness don't count out USD yet
- Trade weighted USD tends to rally in relatively longer cycles and this cycle believe is not done yet
- Fed/Yellen are not looking at day to day economic prints, they are forecasting where the economy will be in future

EUR NOT A BULL MARKET YET

- Much reduced political risk and successful/controversial Italian bank bail out
- Eurozone economic recovery is still fragile and EUR strength could easily choke it off
- We prefer to fade any excessive strength in EUR – meaning if EUR gets too strong our stance possibly look to short

JPY POSSIBLE SHORT IF TOO STRONG

- Other Central Banks may slowly reduce stimulus Japan continues with largest stimulus of all (relative to GDP)
- Divergence with US will be increasingly real by year end
- Short term soft USD may allow JPY strength. Possible short

AUD SHOULD DECLINE BUT VERY STUBBORN, STAND ASIDE

- Real concerns about household debt, inflated property sector, and banks thin balance sheets and big exposures

DXY USD DOLLAR INDEX

Source: Bank of Singapore

ABOVE ARE ONLY SOUND BYTES. FX MARKETS ALWAYS REQUIRE CONSTANT RE-AVALUATION AND RE-ANALYSIS.

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