MARKETS: OCTOBER 18

CHANGING WORLD ORDER

There can be little disagreement with the fact that the relatively stable world order we have enjoyed during the first years of this century is now changing. The US and China in particular are finding disputes with one another on many fronts: military expansion, trade imbalances, attempts to move to a non-dollar method of payments, intellectual property and cyber security …. and the list goes on. Other issues bringing uncertainty include

- Fractions within Europe with Brexit and Italy
- Proxy wars are proliferating in the Middle East and Iran will soon face restricted exports due to not being able to appease the US view on its nuclear capabilities
- The West's relations with Russia seem to be turning more towards cold war than peaceful co-existence, with the US and Russia threatening to walk away from standing nuclear weapon treaties
- US is renegotiating many of its trade agreements

This greater uncertainty has completely overturned the consensus investment view at the beginning of this year – a continuation of a steady global synchronized expansion!
Commodities have also responded to this uncertainty

- Oil was around $65 in January and now trading around $80 and trending higher
- Copper has fallen more than 15% in 2018

– both of these price moves are not a good indicator for continued economic growth

The US is leading the trend to tightening – with QE being unwound and clearly signaling future interest rate increases, despite criticism from the President. The Fed has seen the need to tighten given continued relatively easy fiscal and monetary policy.
The Eurozone is also tightening. Most global interest rates are increasing. The only big economy lagging this tightening is Japan.

EXERTING OUR INDEPENDENCE

Given we are a truly independent financial advisor, we have used our 'freedom of selection' to source a few innovative solutions that have been incorporated into client portfolios to provide good growth potential and simultaneously have defensive qualities when the downturn comes.

At Arete Capital, we really have the capability to offer the better solutions amongst several providers – we will advise the solutions most suitable for our clients.

A Global mandate, promoted by many banks, is not exactly the ideal solution in todays uncertain markets. We have recently made several good investment recommendations and many of them are on our website. We encourage you to go take a look and see for yourselves what a truly independent adviser can offer.
www.arete-asia.com

All people with some wealth are impacted by the movement of markets, some more directly than others. This year has brought more than a few unexpected scenario's and many asset prices have faced declines.
We write this article that includes some pertinent, interesting views from the world of investing.

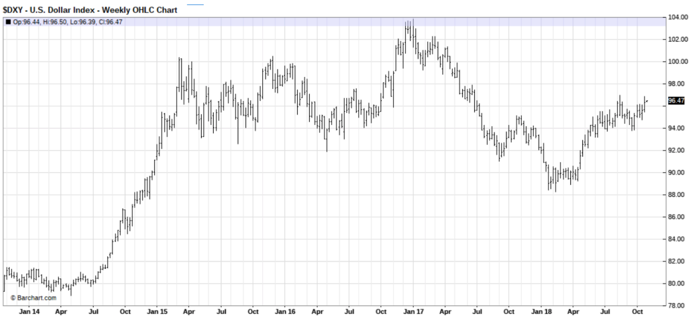
This presentation (the "Presentation") has been prepared by Arete Capital Asia Limited ("ACAL") and is directed at Professional Investors (as defined under applicable regulations) only and is not intended for, and should not be used by, persons not Professional Investors. The Presentation contains proprietary information and is confidential to its recipient and, subject to applicable law requiring its disclosure by the recipient, may not without the prior written consent of ACAL be reproduced, sold or redistributed, or its contents otherwise disclosed, in whole or part by any recipient to any person other than the recipient's professional advisors. The Presentation may not be distributed in any jurisdiction where it is unlawful to do so.

ASIAN EQUITIES FOLDING

- Bear markets are generally acknowledged as a decline of 20% or more. China's equity markets have been hit hard from their peaks (particularly in USD terms) with the Shenzhen, CSI, Shanghai bearing falls greater than 30%. Philippines also down 30%.
- These markets have fallen more than 20% since their recent peaks – Karachi, Jakarta, Hong Kong, VNI, Kospi and Colombo.
- These falls have taken place when the S&P has posted good gains. It is not comforting to think what will happen to Asian equities if the US market sells off?
- A turning point could be near - will investors open positions in Asian equities given significant falls and weak local currencies to capitalize on potential gains in asset values and favourable currency moves
- On most measures of value, Asian equites are considerably cheaper relative to the US market (price earnings, cyclically adjusted PE, price to book) … more so after the declines in Asia!

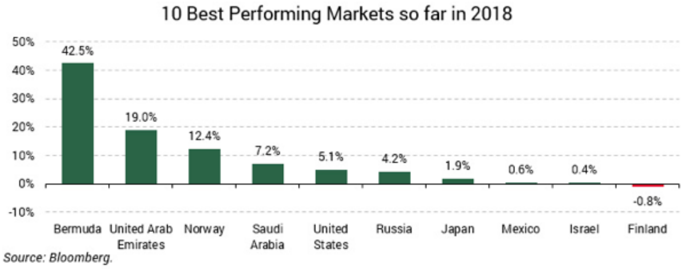
THE DOLLAR

- The US dollar has been very strong this year. All Asian currencies, with the exception of TWD, are down more than 10% from their highs after the global financial crisis.
- IDR and INR are the weakest ever. PHP has not been this low since 2005. These Asian currency weaknesses have been part of the reason behind the withdrawal of funds from these countries, and the subsequent equity declines.
- An unexpected trade deal between US and China would be dollar bearish. If markets believe Powell is not immune to Presidential criticism could also reverse this dollar trend

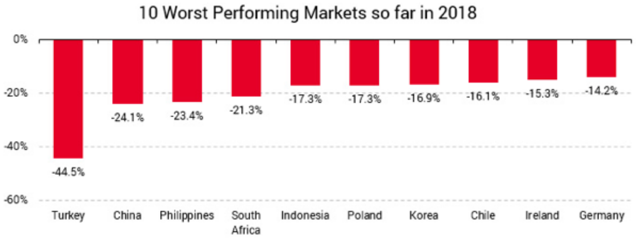

$DXY - U.S. Dollar Index - Weekly OHLC Chart

EQUITY MARKET PERFORMANCE COMPARISONS

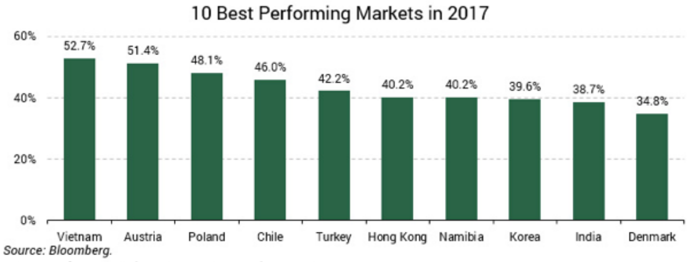
Some of the best performing markets in 2018 have undoubtedly been helped by the increase in oil prices


10 Best Performing Markets so far in 2018

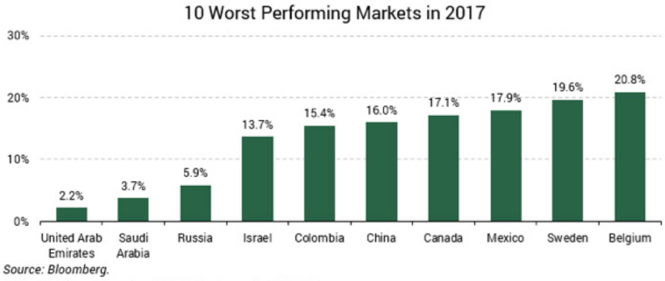
Source: Bloomberg.
Note: Data from December 31, 2017 to October 12, 2018.
Main index in each country was chosen to calculate the total return
All in US$ and including dividends.


10 Worst Performing Markets so far in 2018

Source: Bloomberg.
Note: Data from December 31, 2017 to October 12, 2018.
Main index in each country was chosen to calculate the total return
All in US$ and including dividends.


10 Best Performing Markets in 2017

Source: Bloomberg.
Note: Data from December 31, 2016 to December 31, 2017.
Main index in each country was chosen to calculate the total return
All in US$ and including dividends.


10 Worst Performing Markets in 2017

Source: Bloomberg.
Note: Data from December 31, 2016 to December 31, 2017. .
Main index in each country was chosen to calculate the total return
All in US$ and including dividends.

This presentation (the "Presentation") has been prepared by Arete Capital Asia Limited ("ACAL") and is directed at Professional Investors (as defined under applicable regulations) only and is not intended for, and should not be used by, persons not Professional Investors. The Presentation contains proprietary information and is confidential to its recipient and, subject to applicable law requiring its disclosure by the recipient, may not without the prior written consent of ACAL be reproduced, sold or redistributed, or its contents otherwise disclosed, in whole or part by any recipient to any person other than the recipient's professional advisors. The Presentation may not be distributed in any jurisdiction where it is unlawful to do so.

INVESTMENT METHODS

It is probably when people are nursing losses on their investment portfolios, that they are most open to 'out of the box thinking'. The recent market declines in Asia have been quite steep and of course the sheer momentum drags most things down to earth.

The least effected market to date is the US equity market, which until very recently, was still in positive territory for the year. However, the difference between the US and Asian equity valuations will not remain at todays levels. A decline in the US index seems likely.

In times like these, financial institutions will revert to suggesting new financial market investments – its their lifeblood ….. a few percentage point shifts in allocations within a discretionary portfolio is not moving the dial. Of course, we at Arete Capital also advise on existing financial portfolio's. (see last box)

But I would highlight that for the last year, we have been showing clients investments in real estate and small companies in the private equity market (that are not so affected by the wild swings of the public markets). Both of these suggestions look very attractive compared to Asian publicly listed equities.

We are always strong believers in holding real estate as part of a global portfolio of assets … not advice you will hear from a bank since a client woukd be withdrawing assets to make the purchase!

October: This is peculiarly one of the most dangerous months to speculate in stocks. The others are July, January, September, April, November, June, May, March, December, August and February!

Mark Twain.

SMARTER ETF's

- The AIEQ ETF (NYSE: AIEQ), established in October 2017, has recently set a milestone. The ETF, seeks to outperform broad US indices with similar volatility. Investing in US stocks and REITS, AIEQ has (narrowly) outperformed the S&P over the first year since listing.
- The fund uses Watsons IBM computer to scan a huge universe of stocks. This last year may be a one off situation, but bodes poorly for active managers (mutual and hedge funds) that have under-performed the index and generous fees.

We have seen the tremendous rise in passive investing over the last few years. A staggering volume of invested funds are passive – and much of this is not price sensitive (ETF's, share buy backs to name just two!). There are many discussions as to whether the 'market signaling mechanisms' are still effective today. Passive investing should not only be about lower fees….

Some of the robo portfolios I have seen are an insult to a reasonably knowledgeable investor. The point is, that an investor needs to make some wise choices about trackers, robo's, ETF's, etc. For instance, a bond ETF is certainly not an instrument I would recommend

For sure, some of these products are now becoming very sophisticated. I would be very interested to learn more about the AI element in AIEQ, but I suspect the managers are not so willing to reveal much – and I don't blame them!

So advice is not to rush into passive investing. Believers call out the correct assumption that fees will be generally be reduced and those with good tracking will deliver close to index performance. But there is so much more to consider (tracking error, risks, liquidity in times of stress, asset pooling to name a few) before joining the party!

This presentation (the "Presentation") has been prepared by Arete Capital Asia Limited ("ACAL") and is directed at Professional Investors (as defined under applicable regulations) only and is not intended for, and should not be used by, persons not Professional Investors. The Presentation contains proprietary information and is confidential to its recipient and, subject to applicable law requiring its disclosure by the recipient, may not without the prior written consent of ACAL be reproduced, sold or redistributed, or its contents otherwise disclosed, in whole or part by any recipient to any person other than the recipient's professional advisors. The Presentation may not be distributed in any jurisdiction where it is unlawful to do so.

THE ELEPHANT IN THE ROOM – CHINA

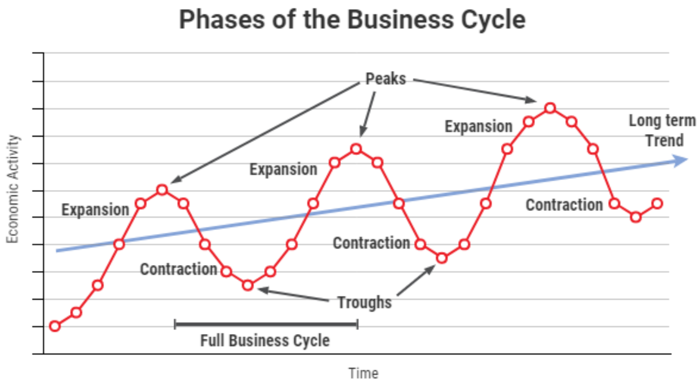
In the investing world, China really is a main talking point. The worlds second biggest economy and growing far faster than any major economy.

- China equity markets have fallen the most of any major economy since their recent peaks (even more in dollar terms). …a particular contrast to the performance of their main adversary in the 'trade wars', the US S&P index
- There are many articles referring to the huge recent build up of debt in the system.
- More recent headlines have covered the issue of pledged A shares.

There is a more technical side to this sell off. The backdrop is that China has been successfully (so far) waging a big deleveraging campaign which is reducing the liquidity in financial institutions. The regulators have also stopped, since March, non-banks from selling the A shares they hold as collateral, which left the brokers with no other option than to sell other (non-pledged) assets. This situation led to a run on the ChiNext index, of smaller China companies.

Last Thursday and Friday, this index had fallen to a key support at 1200, when China authorities co-ordinated and intervened to drive the market up. They introduced several measures to relieve the pressure on selling pledged shares and the market has rallied 7.5% since. These moves also provided banks some liquidity and are now able to provide loans to more smaller corporates – also the authorities desired outcome.

Concurrent with these liquidity issues, the Q2 & Q3 has seen the peaking of local bond maturities and repayments from listed A share companies. These last few weeks could be seen as China navigating through one of its tighter financial periods for the last few years. After such declines, there is certainly some reasoning to consider China A shares to be at or near their bottom.



TALK OF RECESSION

- Near the top of the economic cycle, we witness an economy that is growing above its potential with declining unemployment rates. The Central Bank responds to the tight labour market by raising rates. This tighter monetary policy is evidenced by a flattening yield curve
- This is what we see in the US today, with the Fed given further impetus to take action since real interest rates are close to zero in the US
- Near the end of the economic expansion, one sees a decline in leading economic indices, a sharp slowdown in payroll growth and increases in the unemployment rate. This gives rise to a reduction in consumer spending.

As this long economic expansion comes to an end in the US, there is certainly less room to maneuver given that rates cannot be reduced significantly given they are at historically low levels. Furthermore, the US economy certainly has another burden to carry – a very large budget deficit!

The Fed is leading the path globally to tighter fiscal conditions after the financial crisis, however, Southern Europe, Japan and China in particular have several issues to address when their respective authorities need to tighten policy. Spain, Italy Portugal and Greece will likely face strident political opposition to any economic tightening while their economies are still relatively weak.

In Japan, the BoJ has limited room for monetary policy action. And China has to arrange itself while also dealing with a massive increase in debt in the system. (see previous box)

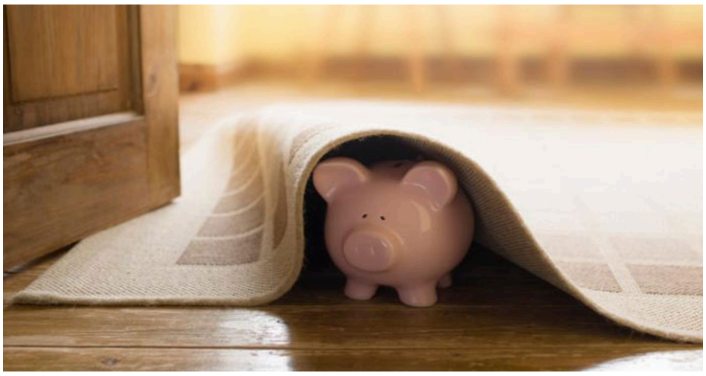
This presentation (the "Presentation") has been prepared by Arete Capital Asia Limited ("ACAL") and is directed at Professional Investors (as defined under applicable regulations) only and is not intended for, and should not be used by, persons not Professional Investors. The Presentation contains proprietary information and is confidential to its recipient and, subject to applicable law requiring its disclosure by the recipient, may not without the prior written consent of ACAL be reproduced, sold or redistributed, or its contents otherwise disclosed, in whole or part by any recipient to any person other than the recipient's professional advisors. The Presentation may not be distributed in any jurisdiction where it is unlawful to do so.

MARKET PERSPECTIVE

We have compiled a short list of points of interest we have read recently. A few of these definitely make you consider your terms of reference on your perspective on the markets ……...

- China has the most individual stocks that have fallen more than 30% from their peaks in USD terms
- US corporate balance sheets have never been so leveraged. The debt binge has funded unprecedented financial engineering (share buy backs with little price sensitivity) rather than a big rise in corporate America's capital base.
- India has many stocks trading on huge PE's (many stocks with PE > 50)
- Bondholders of some US corporate debt are not in a good space given some managements have increased debt substantially without growing revenues – particularly when debt is rated just above investment grade!
- Tencent and Alibaba have become perfect instruments to short on the basis of China suffering from the US-China trade wars
- Financial advisers would recommend that an individual does not have debts, including mortgage, more than 2.5x your income. In corporate America, that ratio is more than 6.5x.
- Italian bonds have been volatile, but there is there is almost no prospect of an Italian default in the near term

INVEST WHEN YOU ARE SCARED?



OPPORTUNITIES IN THE CARNAGE?

After substantial market falls, it is certainly worth keeping an eye on value. There are certainly potential opportunities developing amongst the carnage.

Here are a few investment themes we are watching:

- Chinas online gaming industry is huge, with USD31bill of revenues in 2017 and 20% projected growth in the coming years. This phenomenon has created a social issue, but it is a huge business
- Asia Pacific has become a lot cheaper to USD based investors given the big market declines and weakness of local currencies. S&P has outperformed Asia X Japan by over 20% so far this year
- An unloved sector has been Telco's. Their defensive qualities have already been identified by a few given they have outperformed the market the last few months (outperformance over 10%)
- A local bias, but Asia is in a strong relative position
    - Asian balance sheets are stronger, with far less debt than the US
    - Asian balance sheets have much higher tangible asset backing (US has a lot of intangibles)
    - Asian equity prices have not been fueled by buy backs
    - Asian equity valuations (PE & PB) are not inflated way above their long averages

We have run many stock screens. A few ideas where putting a toe in the water around these levels does not seem so crazy …...

- ➢ Huge China bank with dividend yield of 5.5%, down 31% from its 52wk peak
- ➢ Philippine developer, trading at 78% discount to NAV, div yield 3.2%, priced near 5 year low
- ➢ Large cobalt producer (electric vehicles) down 60% from recent highs, with Cobalt undersupply very likely
- ➢ Macau gambling stock, fallen 50% in last 12m, div yield over 8%, huge ROE
- ➢ Japan car makers with low values of tangible book and high levels of net cash
- ➢ Philippine bank near 5yr lows, PE & PB almost 2 standard deviations lower than 5yr average, strong capital base with good opp to grow
- ➢ Many banks look interesting in a rising interest rate environment

….. and there are many more we are happy to share

This presentation (the "Presentation") has been prepared by Arete Capital Asia Limited ("ACAL") and is directed at Professional Investors (as defined under applicable regulations) only and is not intended for, and should not be used by, persons not Professional Investors. The Presentation contains proprietary information and is confidential to its recipient and, subject to applicable law requiring its disclosure by the recipient, may not without the prior written consent of ACAL be reproduced, sold or redistributed, or its contents otherwise disclosed, in whole or part by any recipient to any person other than the recipient's professional advisors. The Presentation may not be distributed in any jurisdiction where it is unlawful to do so.