Areté | CAPITAL ASIA

ACAL JUNE 2022: DISSECTING THE WORLD

COMPETITION HEATS UP

It is not exceptional that the world becomes more competitive as time progresses – this may partially explain why our perception that years seem to pass quicker when we grow older. For sure, over the past two decades, the pace of nearly everything we touch seems to have accelerated. The development of the internet and mobile phones have made information readily available to all, multiple transactions can be concluded at the press of a button on your phone, and an array of entertainment is available anywhere and everywhere at any time. These relatively simple developments have allowed many of us, individuals and corporates, rich and poor, the opportunity for greater efficiency, greater life flexibility, and a better quality of life.

In this newsletter, we dig deeper into supply chains and the way in which they are changing and being used. We look at a financial system that is in a tight corner and markets that, despite the recent sell-offs, are in uncertain times.

Are there any safer havens in the world of investments? We also consider the implications of the superpowers carefully bending the world to their advantage and prosperity and how to potentially benefit from this.

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 today's uncertain markets. We have recently made several good investment recommendations and a few 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

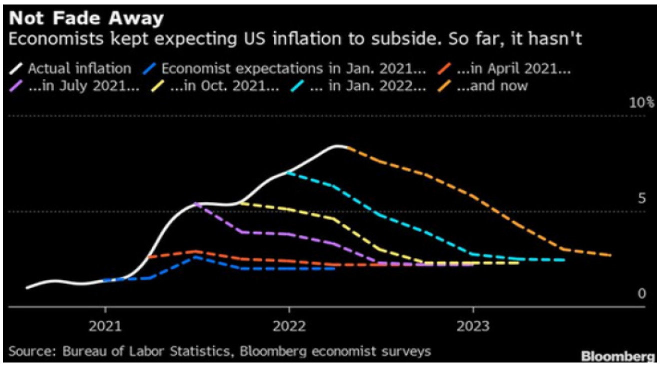
Everyone to a certain extent are impacted by the movement of markets, some more directly than others. This year has brought more than a few unexpected scenarios and many assets have faced declines in price.

We hope you enjoy the read.

Terry Leeworthy
Chief Investment Officer
& The Arete Capital Asia Team

INFLATION – BEYOND TRANSITORY

For the best part of 2021, the Fed has been confidently brushing aside any warning signs of inflation. For many years, the sourcing of products from Asia and cheap manufacturing have been partly deflationary. The internet and mobile phone age have certainly allowed many tasks to be conducted online – reducing the time and cost of many services. Hence there are some supporting reasons why central banks have largely ignored inflation warnings in 2021. …… The perception of sticky lower inflation It may be inherent in the way group think works today …… <u>below are actual inflation figures (solid line) and the expected inflation projections (dashed lines) from a survey of numerous economists.</u> **<u>The Fed was not alone</u>.**

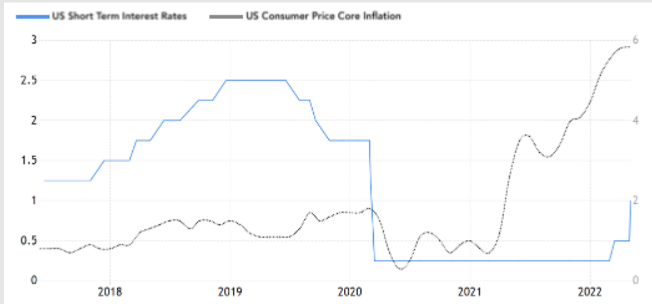


We are in the first half of 2022 and there are big inflation prints all over the place - the frequency and scale of these figures are difficult to ignore with many figures at multi-year highs!. The Fed's earlier incorrect view of inflation is part of the reason why the Fed now has to talk strongly about fighting inflation and rising rates. Their newfound enthusiasm is no doubt helped by political pressure from the democrats that will face midterms in November with low popularity ratings.

Yet with all the strong language from the Fed, there remains a gulf between their words and their actions. We could interpret this as the Fed being very smart – their stronger talk has driven markets to do a lot of the heavy lifting – US 10 yr. rates have moved to around 3.0% from 1.5% at year-end (although fallen some laet May) This upward surge in rates has absolutely started to deflate asset prices. In terms of actions – the Fed has raised rates by only 75bp, from record lows, in the first 5 months of 2022, they are still net buyers of bonds (QE) albeit at a reduced rate. Inflation is 6.0 - 8.5% and the Fed funds are at 1.0%. The chart shows US Core CPI and the Fed funds rate – on different vertical scales – de-emphasising the difference.

INFLATION – Cont.

The Fed is some way behind the curve!



The market is very focused on this situation since the Fed is in a difficult situation. Having responded late to inflation concerns, the Fed has been forced to show a more aggressive intent to raise rates. However, these rate rises will occur when the boom in covid consumer spending (thanks to government largesse) is peaking and supply chains are changing rapidly with costs undoubtedly increasing.

All of this being playing out against a backdrop where companies are having difficulty hiring people and data is less reliable after the unique covid disruptions.

This has definitely not been a good time to be holding any longer dated bonds, in any currency. The big question, and the reason for the razor like focus of markets, is "Will Fed Chair, Jay Powell, do another 'pivot' and change tack to more Quantitative Easing (QE) when the economy and markets are slowing?".

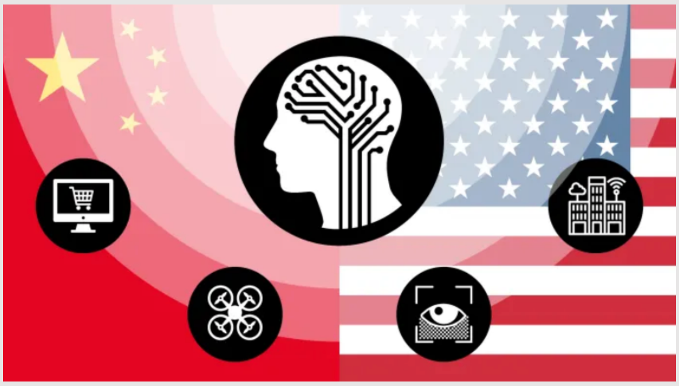
By end May, the Fed has signalled two 50bp increases - their current response to inflation. The Fed will observe data before making any desions about the interest rate environment come the end of 2022. These rate decisions, accompanied by a strong dollar and rapidly changing supply chains are rippling through the world economy, impacting the rest of the world.

UNRELENTING COMPETITION

When China joined the World Trade Organisation in 2001, many hoped for a path forward leading to closer integration between China and the Western world. More harmonisation certainly did come in the following decade, but this period can probably be considered as "peak" globalisation.

Over the last 5 years, for numerous reasons, we have watched our globalised world become more and more fragmented. In nearly every dimension, the US and China are now locked in a tussle for superiority. - Technology, Information, Trade, Resources, Crypto, Cybersecurity, Military Capability, Trade Routes, 5G Territory, Influence, Seas and even Outer Space.

Every move is calculated to bring greater benefit to themselves, versus to the other side, or more damage to the other side of this divide.

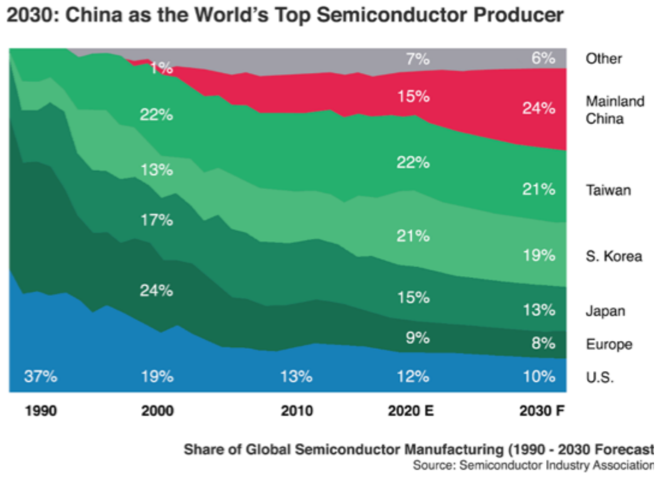


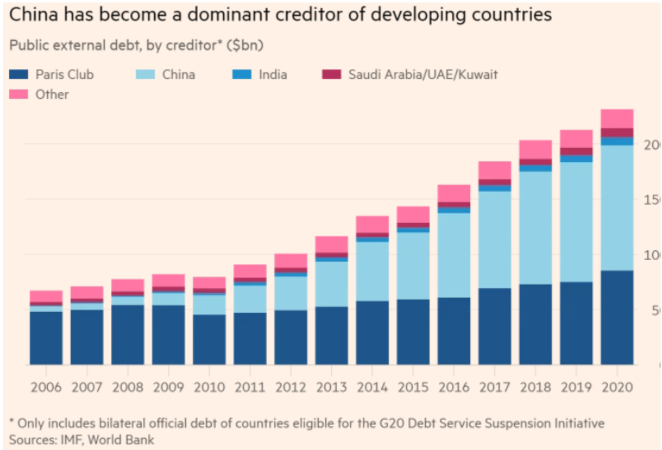
As we have witnessed at the United Nations, and played out in similar situations, many countries are trapped in the middle of this great tussle since voting for one side will mean voting against the other side. To protect their fortunes, these countries have little choice other than to abstain from voting. The situation becomes a lot more complicated if you are a corporate operating both sides of the divide.

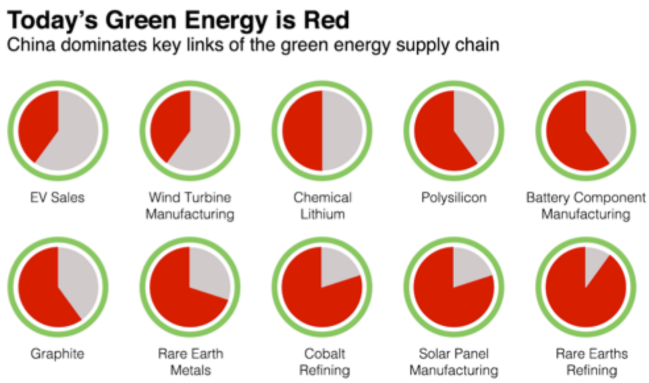
The cold war between US and Russia seems relatively simplistic by comparison to today's Sino/US struggle. The biggest threat was the military complex. Although the world could get a lot more complicated if Russia and China develop closer bonds.

We show a few charts (right side) to indicate the scale of competition between these two superpowers – with big implications for our world as we know it.

UNRELENTING COMPETITION – Cont.







When considering investments, it makes sense for any given strategy to be on one side of the fence given the uncertainty about this volatile US/Sino relationship. In a few situations, you may find some surety in the countries/industries sitting on both sides (Tesla may be one) but the risks are very evident.

We like the **Resource,** as well as the **Technology** space on both sides of the fence. The next section covers some of our thoughts concerning technology.

US TECH STOCKS

We are not alone in believing the FAANG's acronym is outdated. Netflix is falling from a leadership position – despite producing programmes at a phenomenal (and expensive) pace, their content library is much smaller than most of their rivals - Disney et. al. Microsoft on the other hand, has been considered an outsider (slower growth but still producing big earnings) but with cloud services, Microsoft certainly heads in the same direction (big data, processing centres, etc). They all have built strong 'moats' and are very able to hinder or buy competitors.

This group of stocks remain expensive: they were more expensive 6 months ago, They are down 40% this year, and have now only gained 23% in the last 3 years (assuming one stayed invested)…..but they all continue to generate huge revenues and produce strong growth in their businesses.

They are supported by the US government given they stealthily provide many services to this government, including data on their citizens. These companies are heavily restricted in China and face strong headwinds in Europe since they are fierce competitors (with tax priviledges) and the continent has no champions of its own. These 5 companies, GAFAM say, generated a huge USD 1.4 trillion in revenues last year with an average growth of 30% last year. Still very much growth stocks.

Given their ability to deliver unique services that people are buying and their potential unbridled expansion to other sectors, they are going to be driving markets for some time to come.

Our view is that there is more pain to come. The Fed is only just starting to actually tighten – though they may relax late in the year. As important, as demonstrated by Snap's recent results, there are a lot of questions about advertising revenues when the user base is ill-defined.

The recent falls have been painful. Though for those properly allocated and with spare liquidity, there will be buying opportunities in the coming months.

SUPPLY CHAINS POST GLOBALISATION

Supply chains have adapted to changing circumstances for years and they have proven they are more than able to adjust to *incremental changes*. On the other hand, they are *not so good* at adapting to **shocks**. Shocks have led to shortages, in some cases even famine; industrial stoppages (which are expensive if you run a smelter), and price increases that are very damaging for politicians and leaders.

Supply chains in the 21st century have been built with a dominant focus on P/L and margin. They were efficient, but the supply chain's design has barely considered the resilience to deliver a given product at a given time. A great example of this was the great disruption due to a container ship stuck in the Suez canal in March 21.

It is interesting to consider the main supply chain disruptions in recent years. They can be classified in a few ways:

a) *the consequences of an arbitrary event or happening*,
b) *an intention to cause the disruption* or,
c) *when high levels of dependence become uncomfortable*. This view may be controversial, see box below, but <u>many of today's supply chain failings have been presented as covid related – **they are not.**</u> It is worth noting much of the chaos in global trade is willful - an important distinction when trying and make sense of the situation.

Unintended Trade Disruptions
- Covid lockdowns
- Ukraine situation (food and fuel)

Intended Trade Disruptions
- US bans on China hardware (Huawei, etc)
- EU regulates trade on Irish border
- US bans on Xinjiang produce
- US raises import duties on China goods
- China stops buying any Australian coal

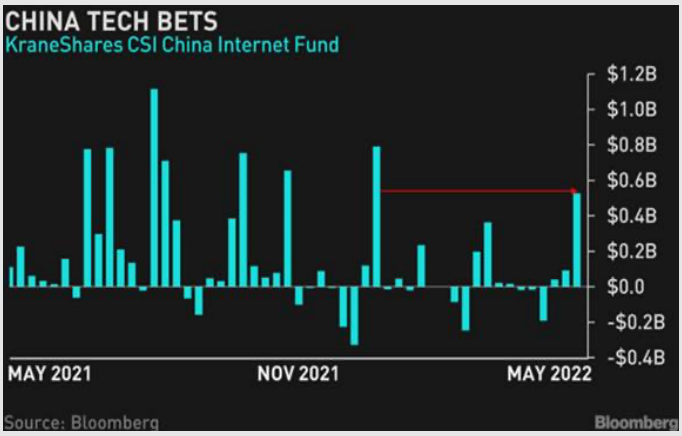
Greater Resilience is required
- Chip manufacturing concentrated in Taiwan and S. Korea
- China owns many rare earth producers

ASIAN TECH STOCKS

Mobile phones, cheap labour, and online/internet finance have unleashed colossal opportunity in the Asian tech space – servicing the biggest middle-class population growth in the coming decades. Alibaba, SEA, Tencent, Gojek, Toss, and several others have a massive online presence, huge numbers of users, and plenty of growth opportunities. Many, including Alibaba and Tencent, are expanding into other Asain countries to continue their rapid growth.

The Chinese authorities have clamped down on several sectors over the last year and valuations have suffered. While the party has its reasons, we believe they will relax some of the reins on the tech sector (provided the company leaders play ball – they seem more compliant these days). They are healthy robust businesses that help society and can certainly help other Asian countries up the curve. With a few major problems to resolve, China will release (to some extent) the least of its problems. The fallout from developers is a lot to digest.

We see some bottom fishing in the China tech sector. The KraneShares CSI China Internet Fund received USD 529 million fresh cash w/ending 20 May.



Another facet of Asian tech, the vast majority of critical components in consumer goods, silicon chips, and in particular, the higher-spec chips, are manufactured in South Korea or Taiwan – uncomfortably close to China's sphere of influence. Their manufacturing dominance will likely continue, given their research and technological leadership, but they already build manufacturing facilities in alternative geographies.

ASIAN TECH STOCKS Cont…

Its concerning that there are new signs that China is willing to insulate itself further from the world – some corporates informing they will not make payments on global bond issues, severely reducing the number of citizens able to travel. With the US very actively promoting a new trade deal with Asian countries, China exports could be under a lot of competition and pressure.

In this light, we like national champions that can export their business model to other countries (Tech Platforms: Gojek, Alibaba, Fintech: Toss) we will sit and wait on exporters since they will come under increasing pressure.

LONGER TERM INVESTMENT THEMES

Our changing world always throws up a few opportunities:

Defense Spending

For the West to simply replace the arms already sent to Ukraine will boost many defence contractors. Add onto this increased demand the many countries that will significantly increase defence spending to dissuade an aggressive neighbour from making an unwelcome advance. Defence contractors have already appreciated with more to go.

Diversification of Energy Sources

The global need to move to a decarbonised world is clear - the eco warriors have raised the profile and laid out a path to be taken. The energy transition will not include today's extremes, but the energy sector will undergo great change. And in change comes opportunity. Every renewable energy source will need to be developed to the full extent possible to address greenhouse gas emissions.

De-Dollarisation

The US has used its hold over the worlds financial system to sanction Russia. This has included feezing clean assets in the west (collateral, gold, etc). This will definitely accelerate the development of an alternative payments system. China and Russia are the obvious main sponsors, but lets not forget the many countries that are caught in the middle of this tussle. The development and growth of an alternative payments system is almost assured.