



Market Insights: Asia Research Trip

May 2019

INTRODUCTION

- Frontier's Capital Markets and Asset Allocation team recently completed a research trip to Hong Kong
- The trip included:
 - Attending the Credit Suisse Asian Investor Conference; and
 - Meetings with representatives of:
 - BNP Paribas – China Macroeconomics;
 - UBS Asset Management – Asia Fixed Income;
 - Nikko Asset Management – China Equities;
 - Gavekal Economic Advisory – Emerging Markets;
 - Emerging Markets Advisors Group – China

KEY INSIGHTS

- Central Banks are likely to continue to be supportive
- Possibility of near-term lessening (perhaps not worsening) of trade concerns, China economic improvement and related bottoming (perhaps rebound) in Europe and Japan economies
- Need to be careful about getting too pessimistic as risk assets could perform well in this scenario
 - However, with global capacity tightening a lot of the easy gains have already occurred and strong market performance in 2019 suggests a lot of the positive outlook is already priced in and markets are more likely to be surprised on the downside
- Longer-term it seems that the base case is increasingly competitive, volatile interactions between China and US, but that hopefully self-interest of maintaining global stability will prevent conflict
- The pessimistic view is that we are entering a new era of confrontations and adversarial competition between world super powers and that cyber and commercial wars are inevitable and military conflict is probable
- China capital markets are opening up
 - Risks, pricing and other restrictions may limit the attractiveness of the opportunity but the relative global size of the bond and equity investment markets requires consideration of allocations

US FEDERAL RESERVE



Charles Evans

President and CEO
Federal Bank of Chicago

*“Inflation target is symmetrical”
(i.e. 2% target is not a cap)*

“Cautious”

“Watching data”

“Risk aware”

“Mindful”



Eric Rosengren

President and CEO
Federal Bank of Boston

“Inflation up to 2.5% would not be concern”

“Worried about fall in inflation”

“Labour market is strong”

“Labour market is strong”

“Labour market is strong”



Janet Yellen

Former Chair of the
Federal Reserve

“Economic growth around 2% which is slower than last year, but still healthy and around potential”

“Fiscal stimulus boost will be less in the future”

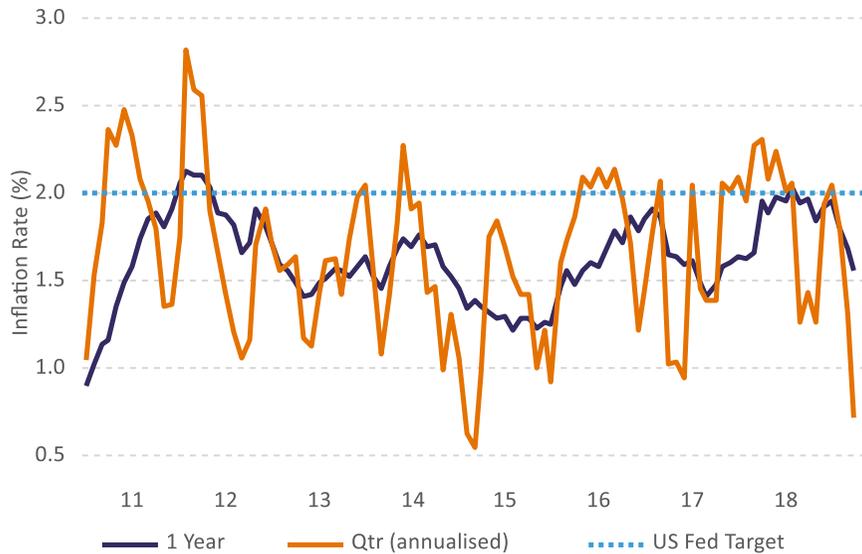
“Interest rates will not increase till 2020 and maybe later”

“Central Banks can do a lot more if required”

“worry Central Banks have limited capacity to respond”

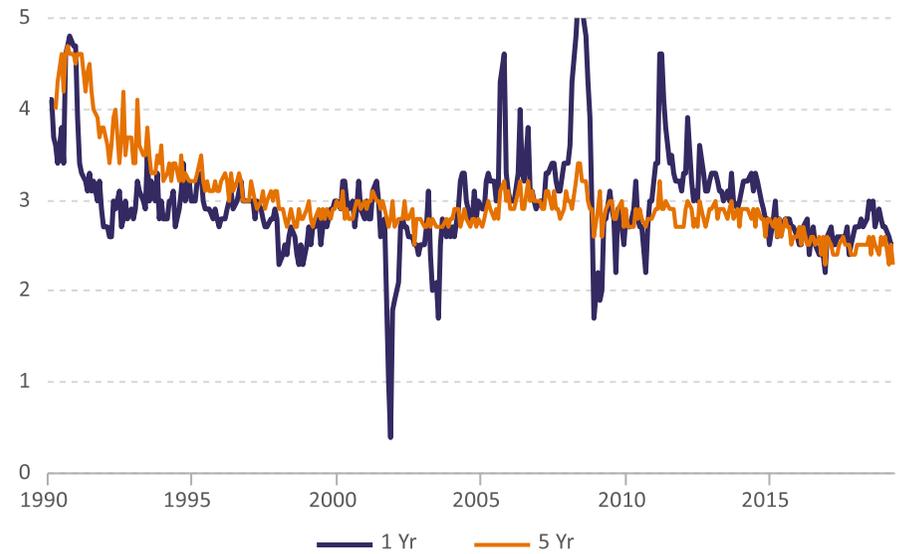
US INFLATION

US Core PCE



Source: Thomson Reuters Datastream

University of Michigan Survey Median Inflation Expectations Ahead

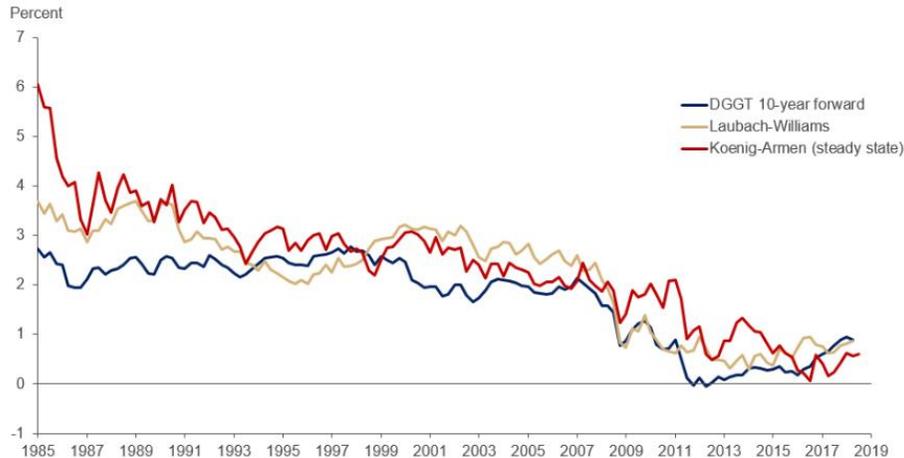


Source: Thomson Reuters Datastream

- US inflation is near the 2% Fed target but the concern is that inflation will be lower going forward
 - Leading indicators (consumer surveys, breakeven inflation) indicate low future inflation expectations
- Central Banks are likely to err on leaving monetary policy accommodative for longer as the balance of concerns are weighted far more to inflation being too low rather than high
 - US Federal Reserve Chair Jerome Powell - “low inflation is one of the major challenges of our time”

US NEUTRAL INTEREST RATE

Estimates of the US Long-Run Real Neutral Rate



Source: Federal Reserve Bank of Dallas

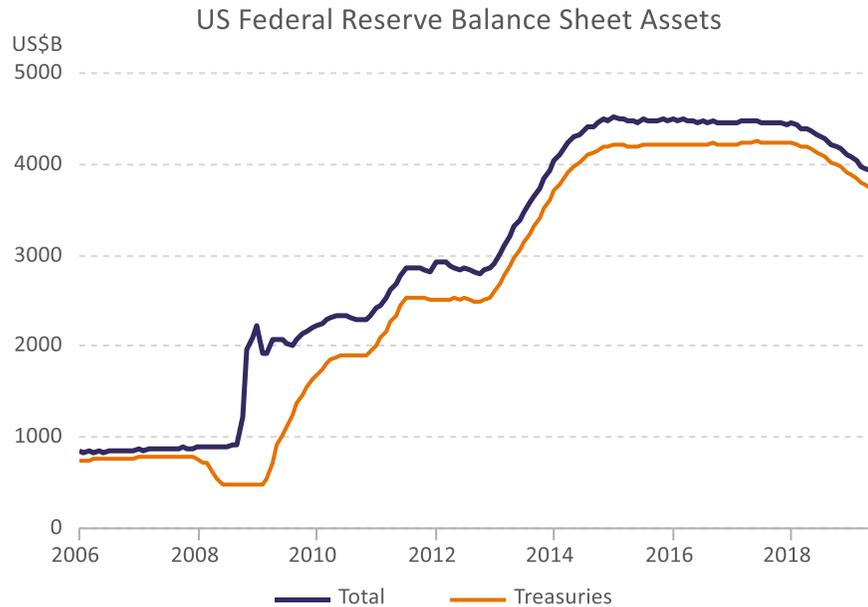
US Fed Funds Rate vs Taylor Rule



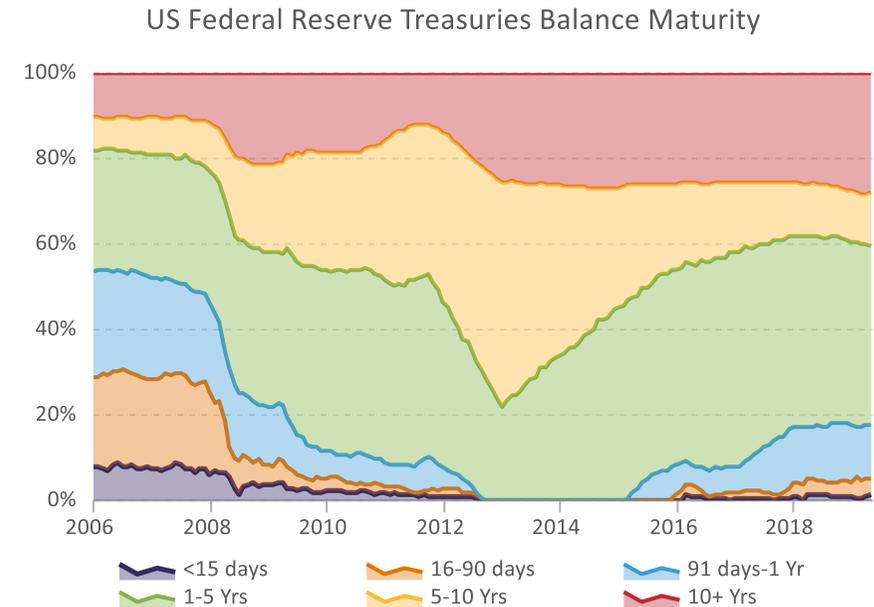
Source: Thomson Reuters Datastream

- The neutral rate is the theoretical rate at which monetary policy is neither accommodative nor restrictive
 - There is general consensus that the neutral rate has declined and Fed research suggests it is now less than 1% real
- The Taylor rule is an estimate of the appropriate interest rate based on inflation and economic growth relative to potential
 - The Taylor rule indicates current interest rates in the US are still too low. This suggests that higher inflation will result, but if the “neutral” interest rate is now lower the Taylor rule is an overestimate

US FEDERAL RESERVE BALANCE SHEET



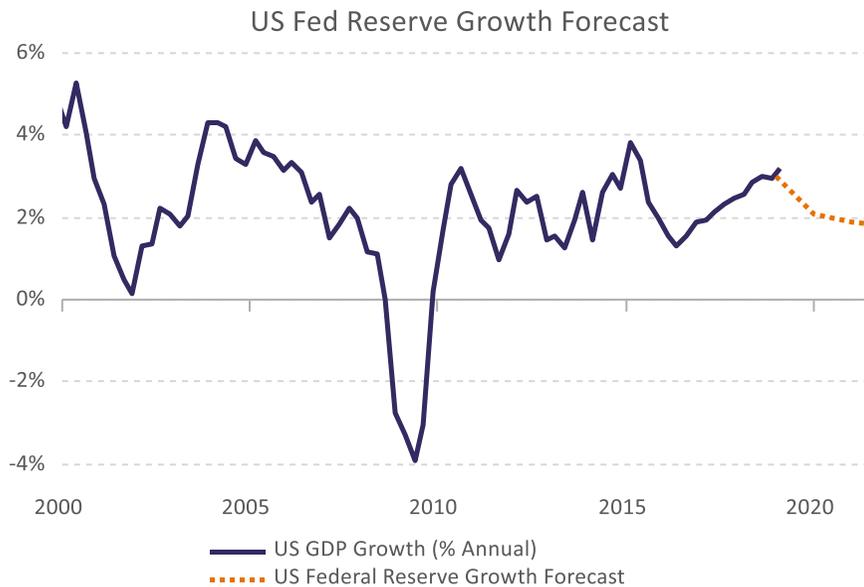
Source: Thomson Reuters Datastream



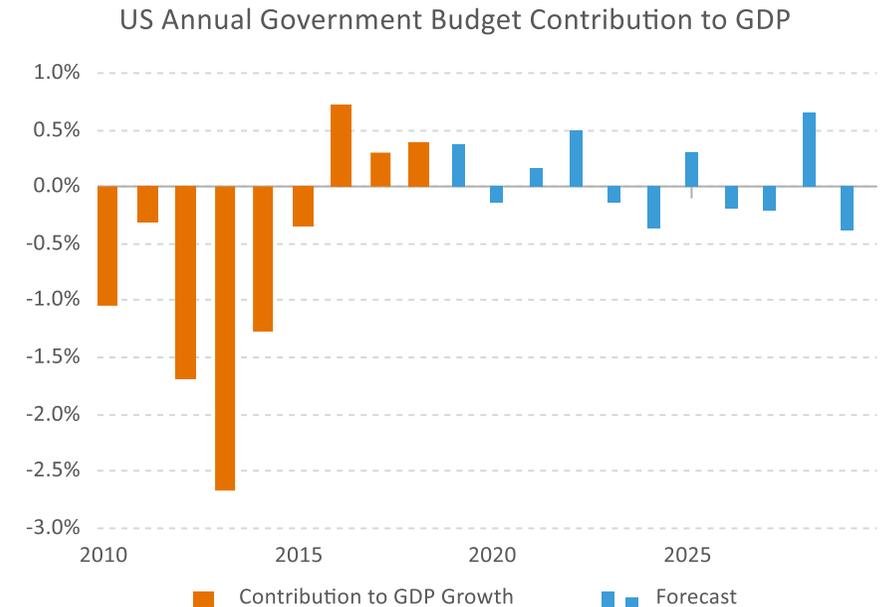
Source: Thomson Reuters Datastream

- Quantitative tightening (QT) has reduced the US Federal Reserve balance sheet recently but it will never get back to pre-GFC levels and may not get a lot smaller than the current balance
 - USD as global reserve currency and natural growth in liabilities means a larger balance sheet is reasonable
- The Fed will continue to use the balance sheet as a monetary policy mechanism, including managing the duration of assets
 - Maturity of Treasuries is a lot longer dated now but being reduced as part of recent tightening process

US ECONOMIC GROWTH



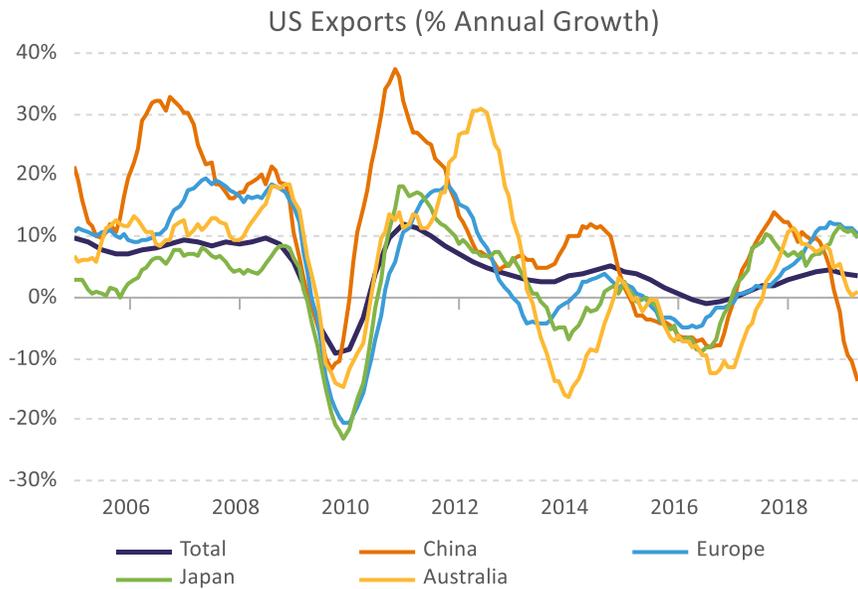
Source: Thomson Reuters Datastream



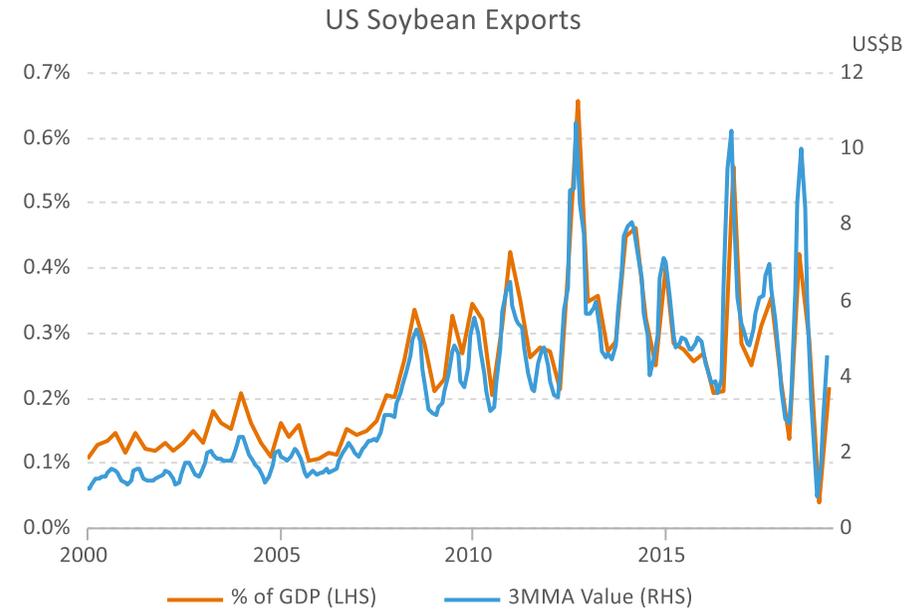
Source: Thomson Reuters Datastream, CBO US

- US economic growth is expected to slow to 2% or less, which is lower than 3% growth last year but still a solid outcome and around potential growth
- It is logical that economic growth slows as the fiscal stimulus fades
 - There are political risks to authorisation of spending programs and the debt ceiling but historically this produces only short-term disruptions
 - There is the potential that Trump will attempt to stimulate further in the last year of his Presidential term

US TRADE



Source: Thomson Reuters Datastream



Source: Thomson Reuters Datastream

- US export trade growth has slowed with a decline in exports to China over the last year
- Soybeans is a politically sensitive market that has been particularly disrupted by the trade tensions between the US and China
 - US soybean exports and prices have fallen significantly in recent months

CHINA ECONOMIC OUTLOOK

- Chinese economic growth has been slowing, driven by the focus on deleveraging and then the trade impact; in response Chinese authorities have been moving to more stimulatory policies

China Policy Announcements

Date	Announcement
Apr 2018	• 1% VAT rate cut
Apr 2018	• Announced 100bps cut to RRR
Jun 2018	• Announced 50bps cut to RRR
Jul 2018	• Allowed issuance of RMB 1.35tn of local government special bonds at a faster pace (for infrastructure projects)
Oct 2018	• Announced 100bps cut to RRR
Oct 2018	• Individual income tax deductions
Dec 2018	• Announced special temporary individual income tax deductions to be in effect on 1 January 2019
Dec 2018	• Announced cut or scraping tariffs on some imports and exports in 2019
Dec 2018	• Approves early issuance of RMB 1.39tn (~USD 200bn) local government bonds for January 2019 (usually occurs in March)
Jan 2019	• Announced 100bps cut to RRR
Feb 2019	• Tax deduction for individuals who starts a business or hire the needy
Mar 2019	National People's Congress (NPC) announcements: <ul style="list-style-type: none"> • Plans to sell general and special local government bonds totalling RMB 930bn • Central government to spend RMB 577.6bn on infrastructure • Invest RMB 800bn in railway construction • RMB 1.8tn in road and waterway projects
Mar 2019	• Cuts to tax, fee and social security contributions by businesses
Mar 2019	• VAT rate cut for imports • 16% VAT rate to 13%, 10% VAT rate to 9%
Apr 2019	• Top 5 SOE banks to increase lending to SMEs by over 30% and cut financing costs by 1% in 2019 • RMB 200bn (~USD 30bn) of loans guaranteed by state financing guarantee fund for SMEs in 2019
Apr 2019	• More optimistic tone from politburo meeting announcement put in doubt further government stimulus measures
May 2019	• PBOC announced RRR for mid- and small-banks to be reduced to 8%

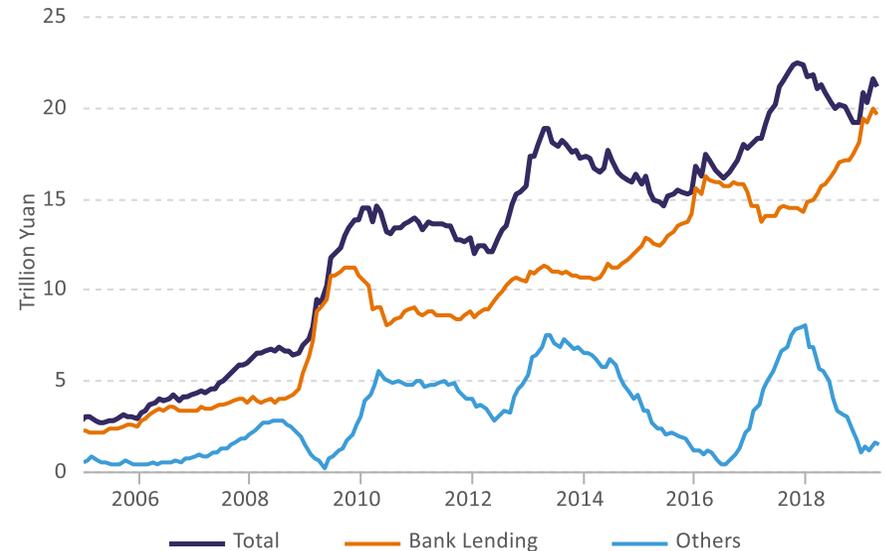
CHINA DELEVERAGING

China Debt as % of GDP



Source: Thomson Reuters Datastream

Total Social Finance Components (12M Sum of Flows)



Source: Thomson Reuters Datastream

- After very fast growth in previous years, China's total debt as a proportion of GDP has been flat recently
- Deleveraging has been specifically targeted at shadow banking ("other")
- In recent months, total lending has started to increase again

CHINA CONSUMER SLOWDOWN

China Retail Sales (Consumer Goods) 12 Mth Growth



Source: Thomson Reuters Datastream

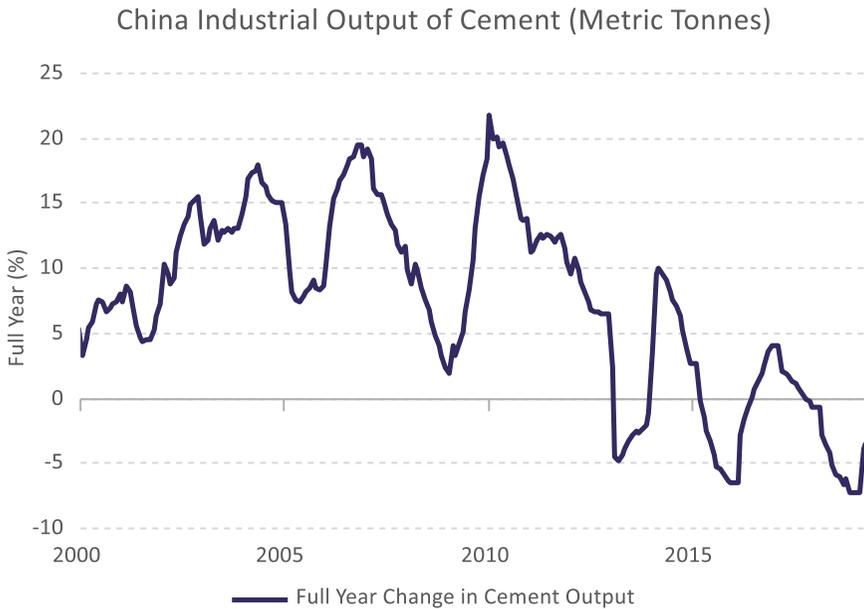
China Automobile Sales 12 Mth Growth (MoM 3MMA)



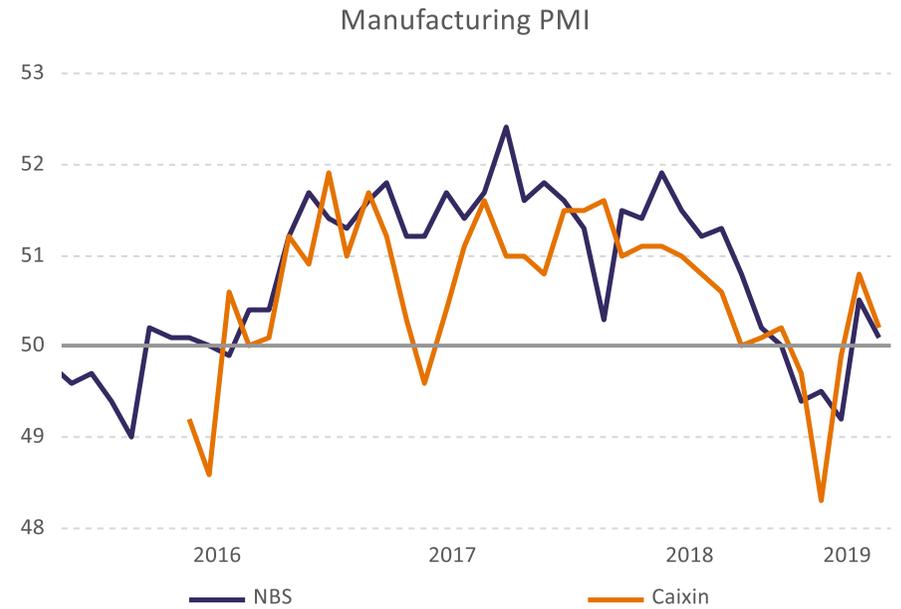
Source: Thomson Reuters Datastream

- The slowdown in Chinese economic growth has also been apparent in a slowdown in consumer spending
- The contraction in automobile sales in China has been particularly stark
 - There are specific tax and tariff related reasons that have contributed to the decline last year and it is expected to improve in the year ahead
 - However, for a market that has typically experienced high growth a large decline is a major impact

CHINA INDUSTRIAL PRODUCTION SLOWDOWN



Source: Thomson Reuters Datastream, NBSC

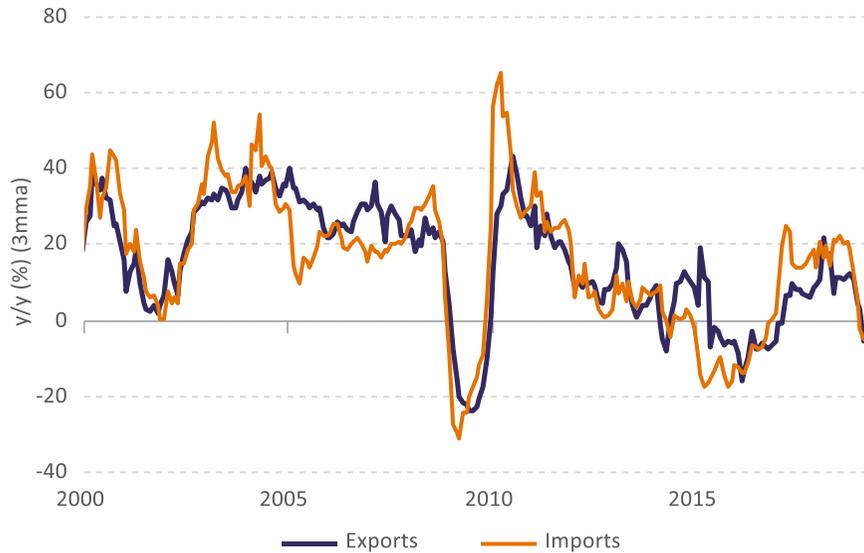


Source: Thomson Reuters Datastream

- Aggregate Chinese GDP and industrial production data indicates only a moderate slowdown
- However, Chinese activity data, such as cement production indicates how significant the slowdown has actually been
- The most recent China Manufacturing PMI Survey results provide green shoots of possible improvement

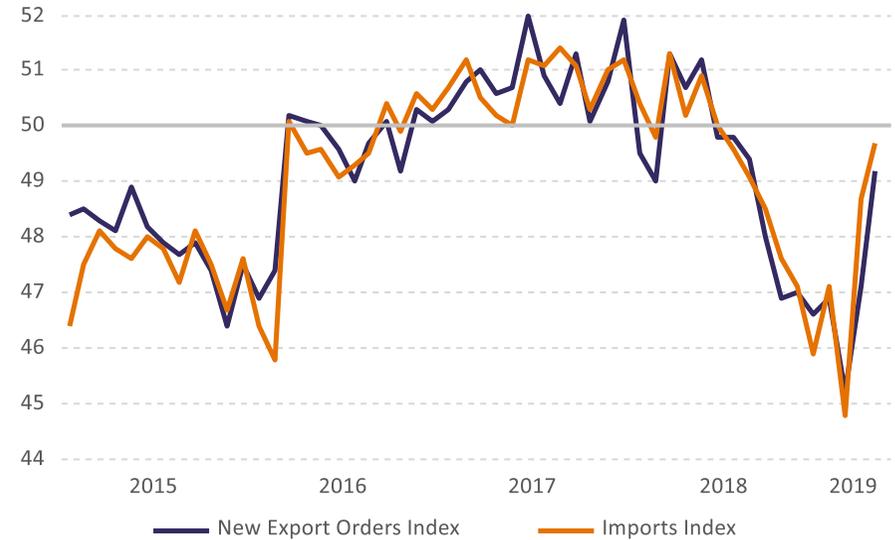
CHINA EXPORT SLOWDOWN

China Trade 12Mth Growth (MoM 3MMA)



Source: Thomson Reuters Datastream

China NBS Manufacturing PMI (Trade Components)

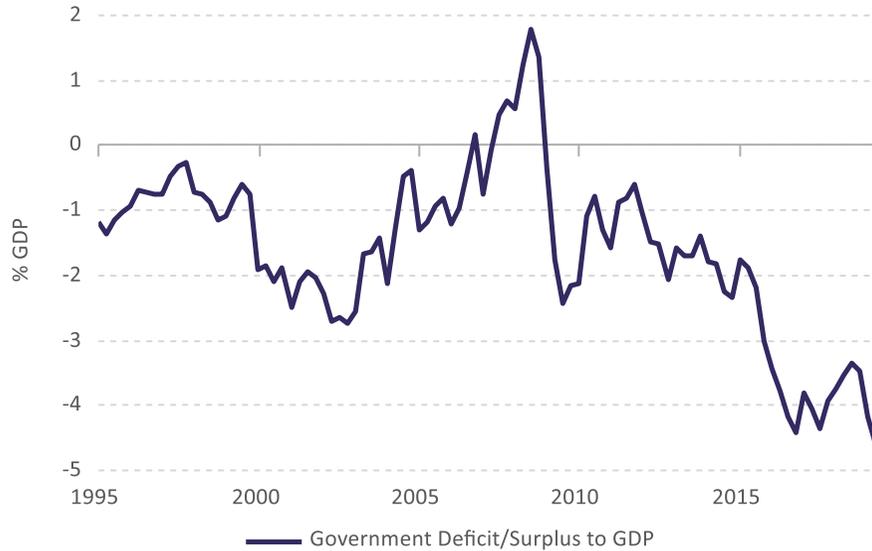


Source: Thomson Reuters Datastream

- Trade tensions are impacting China trade and investment
- The market expectation is that there will not be further escalation of trade restrictions
 - But the impacts are real and although the outlook is improved it is still negative

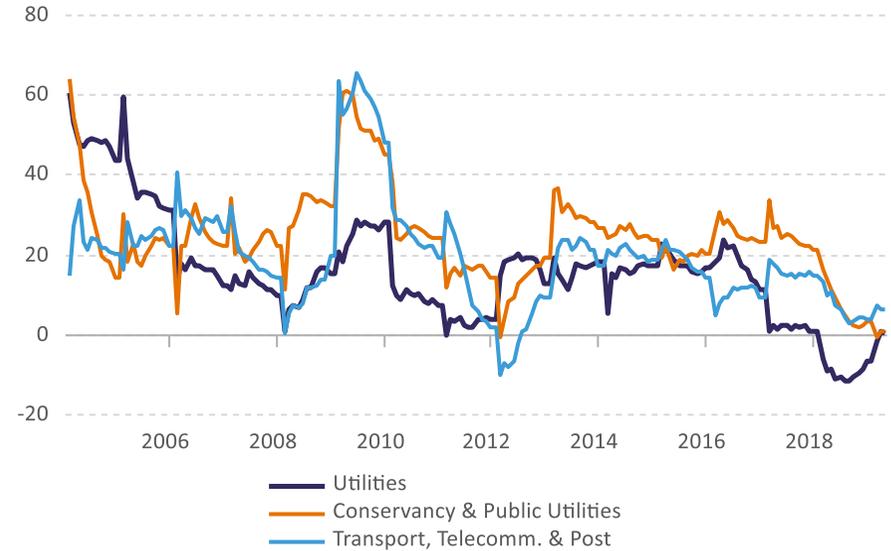
CHINA FISCAL POLICY

China Government Surplus/Deficit to GDP



Source: Thomson Reuters Datastream

China Infrastructure Investment Growth (Subsectors)

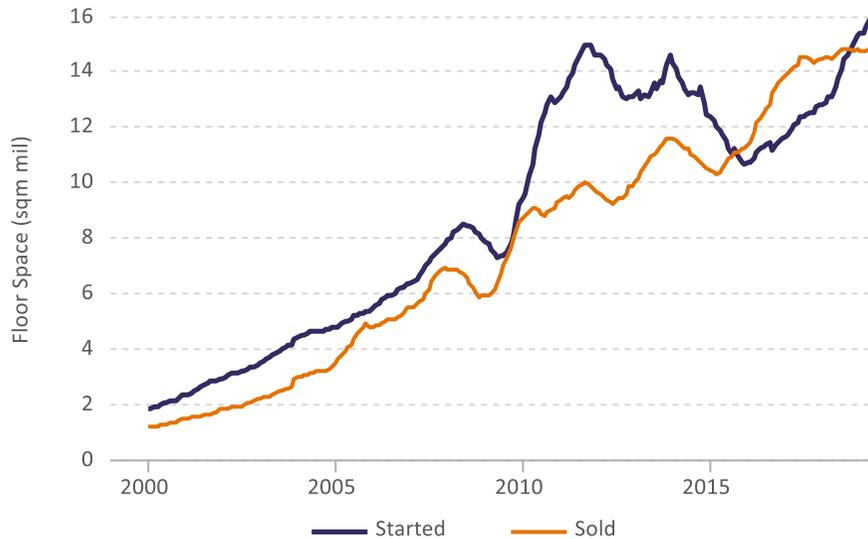


Source: Thomson Reuters Datastream

- China has indicated it will provide some fiscal support to the economy but it is not expected to be like the large stimulus provided in 2009 and 2016
- Infrastructure investment growth appears to be improving but it remains relatively low
 - The requirement for infrastructure investment is less as the population peaks and urbanisation slows

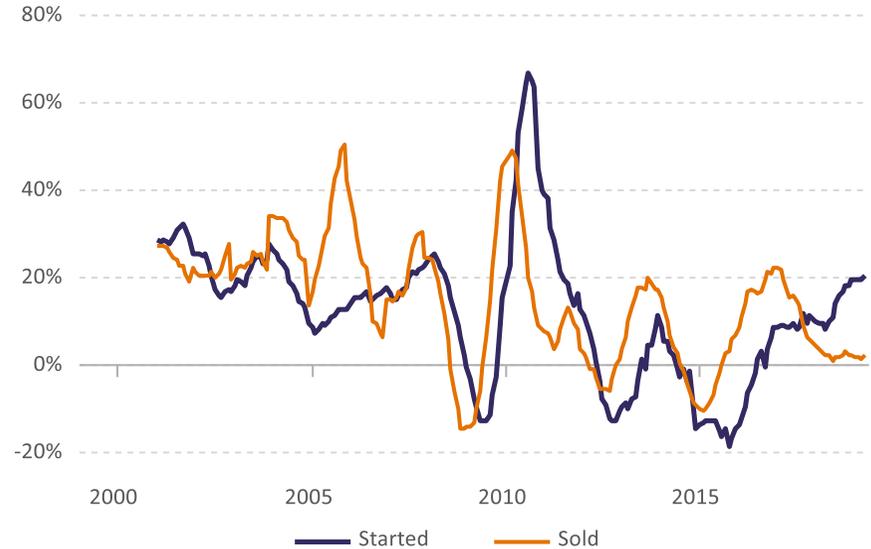
CHINA PROPERTY MARKET

Residential Floor Space Started and Sold (12M Sum)



Source: Thomson Reuters Datastream

Residential Floor Space (12M Growth)

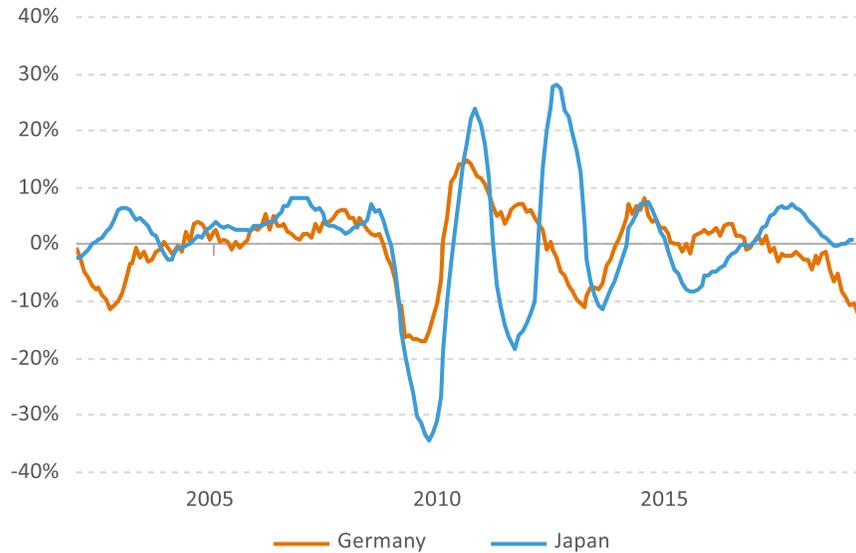


Source: Thomson Reuters Datastream

- The property market is a key contributor to growth in China, particularly in lower tier cities
- Construction activity remains robust but slowing sales and price growth suggests demand is weakening
 - “Shanty town redevelopment” policies that have boosted construction activity are due to finish

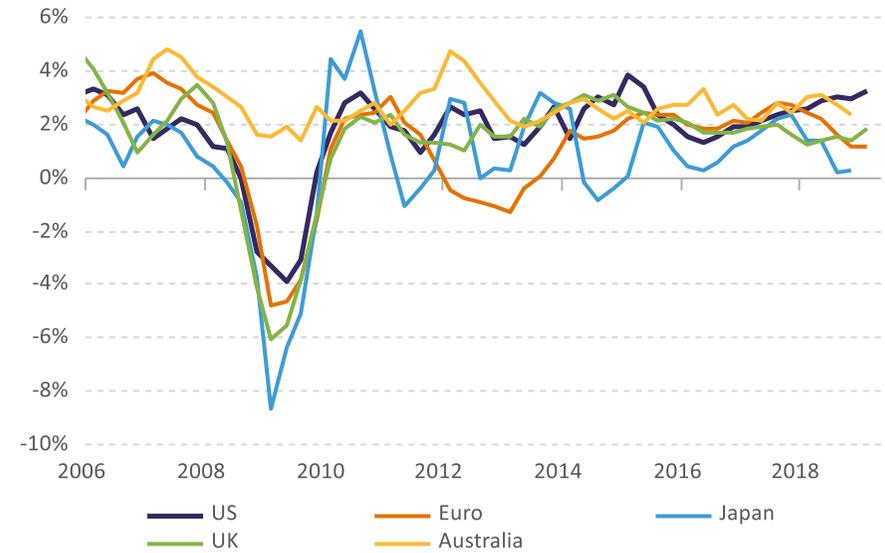
GLOBAL IMPLICATIONS

Production New Cars 12 Mth Growth



Source: Thomson Reuters Datastream

GDP Growth



Source: Thomson Reuters Datastream

- As we noted after our China research trip in 2016 - “China is an increasingly important driver of global economic growth and equity markets”
- The impact of China auto sales decline is particularly apparent in the sharp production fall in Germany
- China’s slowdown is a key contributor to the global economic growth slowdown, particularly in highly trade exposed Europe

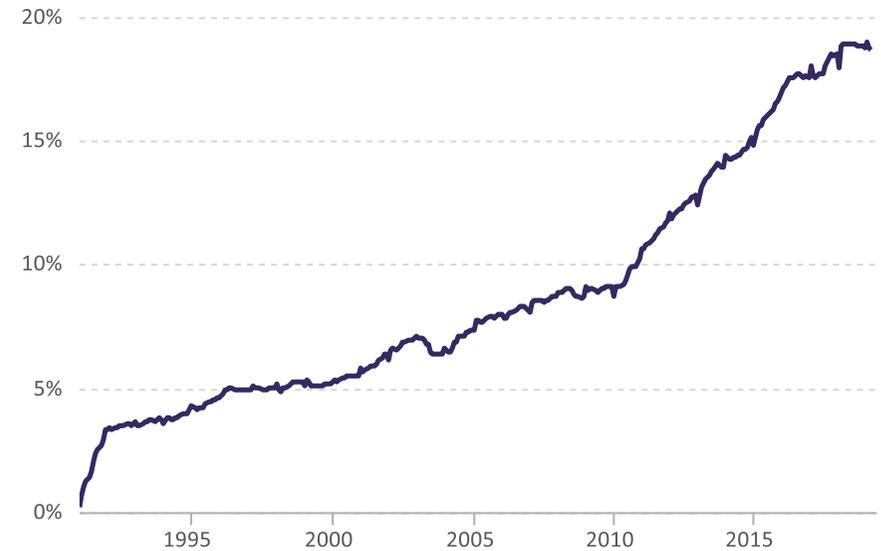
CHINA TOURISM

China Tourism Foreign Expenditure as % of GDP



Source: Thomson Reuters Datastream

China Proportion of Foreign Visitors to Australia

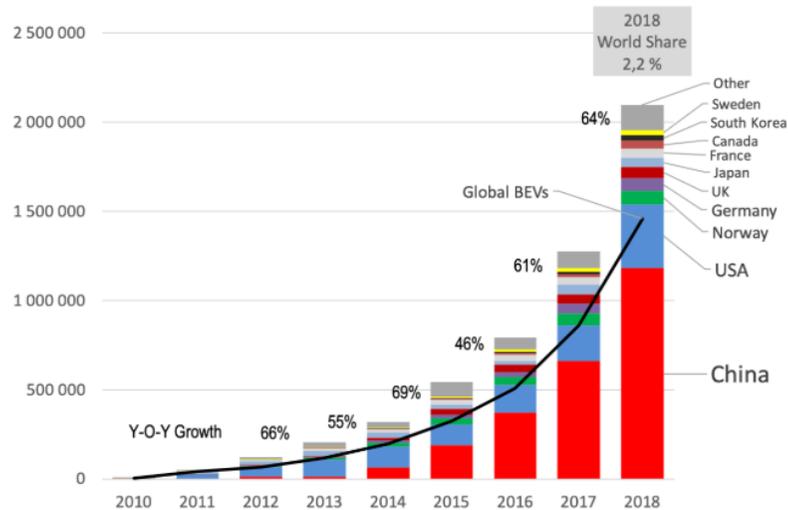


Source: Thomson Reuters Datastream

- Growth in Chinese middle class has seen large growth in Chinese tourists
- China now provides the largest foreign tourist expenditure in the world
- Tourism is a material trade deficit for China
- Chinese tourists are an increasingly important contributor to the Australian economy

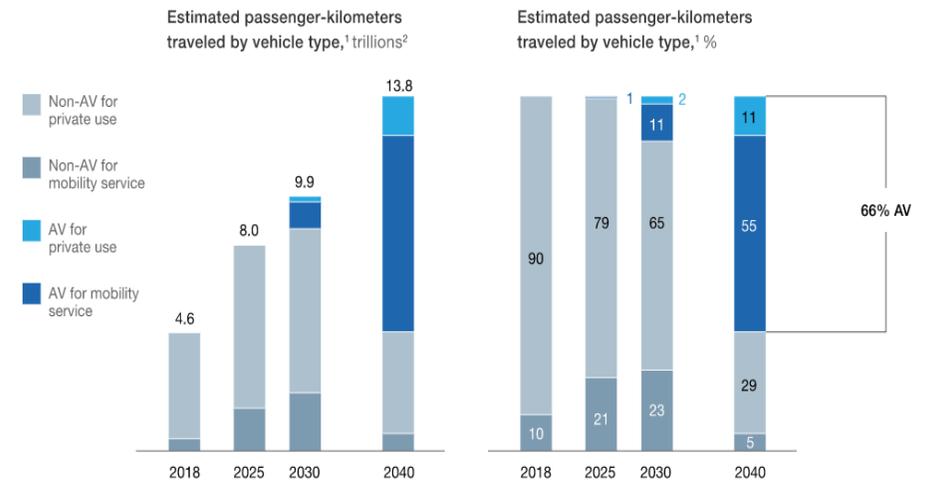
CHINA ELECTRIC VEHICLES AND AUTONOMOUS VEHICLES

Global Electric Light Vehicle Production



Source: EV-volumes

China Passenger Vehicle Travel

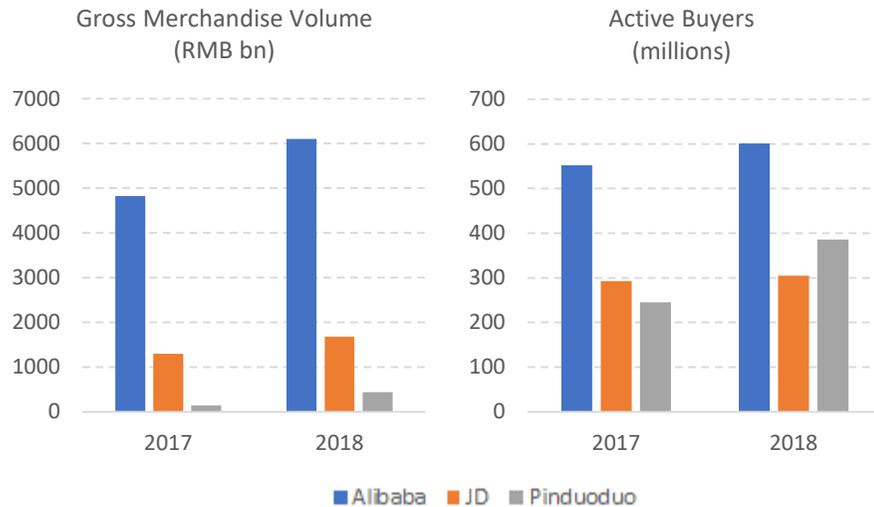


Source: McKinsey& Company
AV = Autonomous Vehicles

- With government support and less onerous regulation, China is expected to increasingly be a global leader in a number of new technologies
- Although there was a decline in overall vehicle sales in China, electric vehicles production grew strongly
- Fully autonomous vehicles could be operational in China within ten years, which is expected to be significantly earlier than in most developed market countries

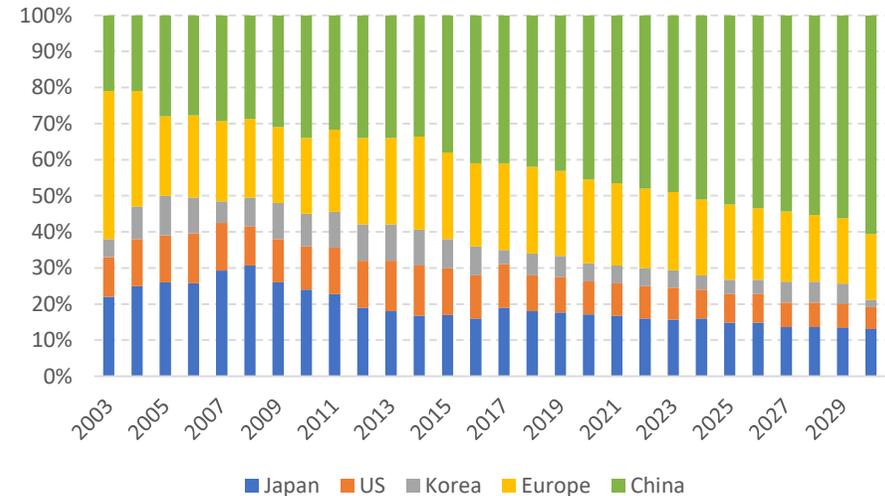
CHINA CONSUMER

China Online Retail Businesses



Source: HSBC

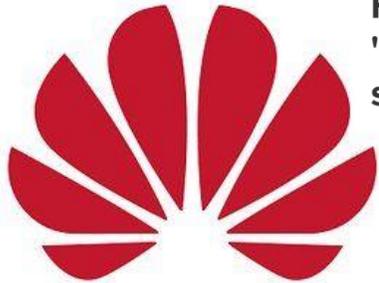
China Car Sales by Brand Origin



Source: Nikko, Credit Suisse

- The Chinese market remains highly dynamic
 - Pinduoduo is an online retail company founded only in 2015 but in a short time it is now a major player with more than 300 million users and a market capitalisation of more than US\$20 billion
 - It has a larger exposure to lower tier cities and women in its customer base and its business model is built on smaller value orders
- Key themes are Chinese consumers increasing quality upgrade demand and the growth in Chinese brands

CHINA-US RELATIONS



HUAWEI



Huawei's equipment poses 'significant' security risks, UK says

The New York Times

Huawei's New Front in the Global Technology Cold War: Australia



NEWS

Huawei finance chief Meng Wanzhou arrested in Canada



Business Markets World Politics TV More

WORLD NEWS AUGUST 27, 2018 / 10:54 PM / 8 MONTHS AGO

U.S. blocks WTO judge reappointment as dispute settlement crisis looms



Osaka, Osaka Pref.
G20 Summit Meeting
June 28 to 29, 2019

CHINA GEOPOLITICS

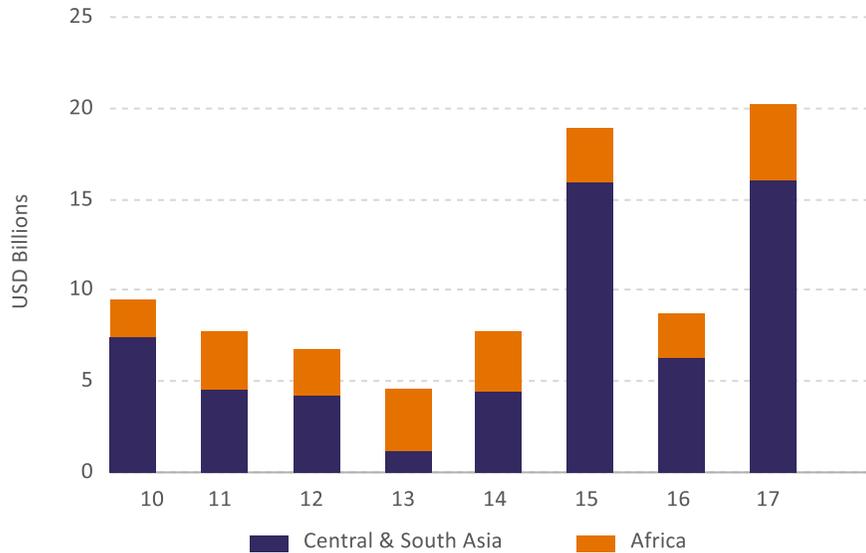


CHINA GEOPOLITICS

- Lot of interesting (and differing) views on geopolitics – difficult to separate fact from fiction but critically important to the future of the global economy and markets
- US/China relationship
 - China is willing to negotiate, that it wants to work within the WTO and other global rules systems, but the key issue is the unpredictability and the inconsistency of US policy under Trump
 - China can be patient, as observed from May-November 2018 when there were no talks until the stock market “taught” Trump that trade was important and he called Xi
 - The expectation is some reprieve on increasing trade restrictions but long-term increasing volatility in the relationship
- China politics
 - President Xi’s power is not absolute
 - High expectation that he will remain in power after his second term ends at the National People’s Congress in 2023 but still some uncertainty on what could evolve over that time
 - Suggestion that recent explosions while Xi was travelling overseas might be a demonstration of internal unrest
 - Chinese politics is very opaque resulting in a large amounts of rumours and interpretations of signals
 - Corruption crack down continues, including the former Head of Interpol being jailed recently
 - Mao’s legacy – hero vs villain (70% right?) – is Xi the return of “strong-man leader”?
 - Xinjiang – 100,000’s of Uyghurs in “re-education” camps
 - Surveillance – mobile app tracks usage and flags “dangerous” behaviour; CCTV facial recognition; social credit system

BELT & ROAD INITIATIVE

China Outward Direct Investment



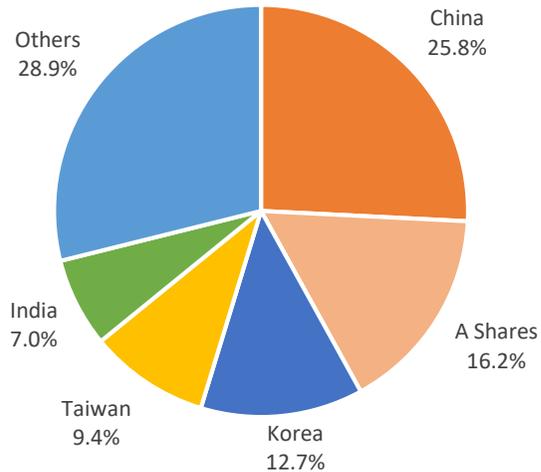
Source: Thomson Reuters Datastream



- Belt and Road Initiative (BRI) has seen significant foreign investment by China
 - Continues to be a key policy priority
- Xi visit to Europe including memorandum of understanding with Italy to join BRI

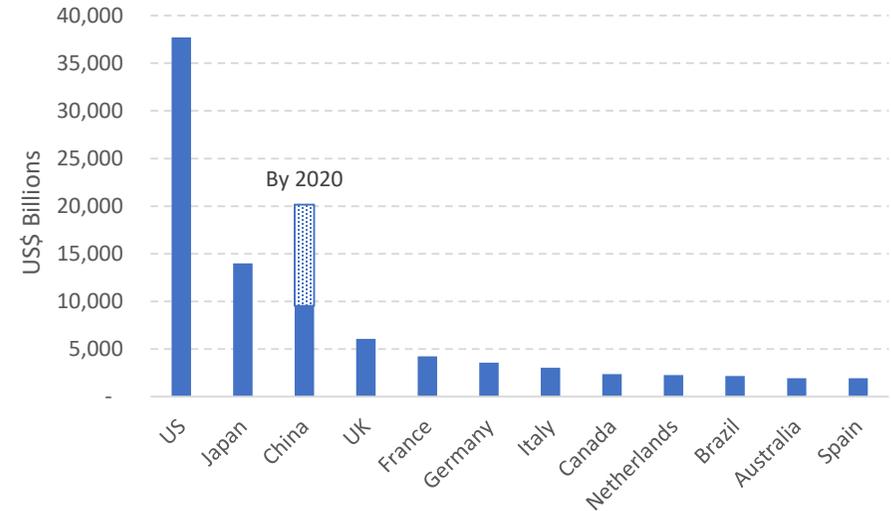
CHINA CAPITAL MARKETS

MSCI EM Index (with 100% China A-Shares)



Source: MSCI

Global Bond Markets

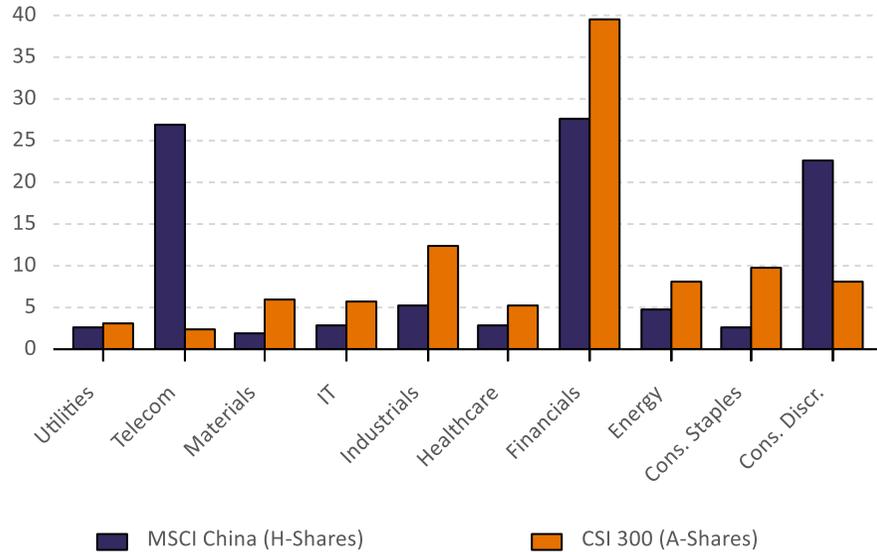


Source: Standard Chartered

- The inclusion of China onshore stocks and bonds in global investment indices is expected to progress in the next few years
- China could become more than 40% of the MSCI EM Index and the Chinese bond market is the second largest in the world

CHINA A-SHARES

MSCI China and CSI 300 Sector Weights



Source: Thomson Reuters Datastream

China Equities Manager Performance to December 2018

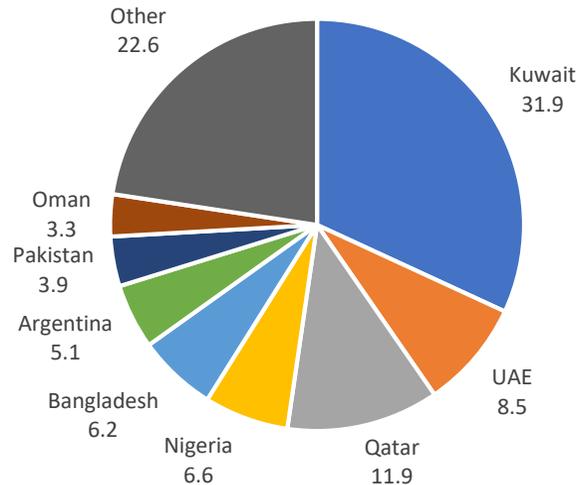
Returns	1 yr (% p.a.)	3 yr (% p.a.)	5 yr (% p.a.)	7 yr (% p.a.)	10 yr (% p.a.)
MSCI China					
Median China manager	-9.6	7.6	10.1	14.4	10.2
MSCI China index	-9.9	9.2	9.8	12.8	8.2
Median Excess	+0.3	-1.7	+0.3	+1.6	+2.0
No. of managers	33	31	28	25	20
China A-Shares					
Median China A manager	-14.9	1.1	16.1	17.8	13.1
China A Onshore index	-25.6	-12.3	5.4	7.4	4.9
Median Excess	+10.7	+13.5	+10.8	+10.5	+8.2
No. of managers	19	17	16	13	6

Source: Bloomberg, eVestment

- China A-Shares can provide a different and more domestic focused exposure with greater allocations to financials, healthcare and consumer staples
- China A-Shares managers have delivered strong long-term returns but also higher levels of volatility
 - Noting limitations of the eVestment data which is based on a small sample size of essentially foreign managers with China A-Share funds
 - The high proportion of retail investors in the Chinese equity market provides an alpha opportunity

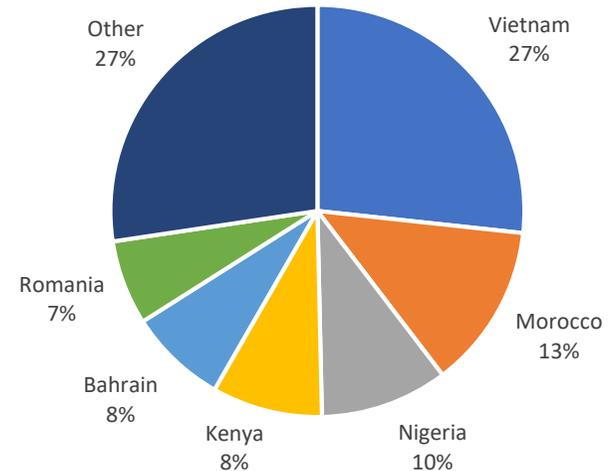
FRONTIER MARKETS

MSCI Frontier Markets Weights 2010



Source: MSCI, Factset

MSCI Frontier Markets Weights (ex-Argentina & Kuwait)



Source: Datastream

- MSCI has announced that Argentina will be reclassified to Emerging Markets status and it is consulting on the potential reclassification of Kuwait – the composition of the index will change significantly
 - After the changes, the largest exposures will be Asian growth (Vietnam) and Africa (Morocco, Nigeria, Kenya) compared to in 2010 when around 60% of the index was in the Middle East
- However, MSCI Frontier Markets Index (ex-Argentina and Kuwait) has only around US\$70 billion in market cap, compared to the Emerging Markets Index which is currently US\$5.4 trillion market cap

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