Q1 2018 Review

31 March 2018

PRESCIENT
CHINA

Trade Wars and Elections

The first quarter of 2018 was massively volatile with markets ending in negative territory. The Fund ended flat over the same period. The year began with equities rising by over 9% in January on the back of continued strong fundamentals and sentiment following the bull market of 2017. For the past few quarters we've been saying that China is low risk and that the risk is instead likely to emanate from the US. Even we did not anticipate just how prescient this would be. We then moved into February with the inverse VIX products collapsing in the US. These products served no purpose other than speculation and this resulted in a spike in the VIX which then spread to equities, which in itself further exacerbated the VIX rising. The event was not based on fundamentals and resulted in a short and sharp correction. It was very soon followed by the first salvo of Donald's Trump's imposition of tariffs on Chinese imports and the potential for a global trade war. As a result, markets dropped by 6% in February and further 3% in March.

Lessons from the 1930's would show that the idea of a trade war should largely be discredited. Back then, Smoot/Hawley passed the Smoot/Hawley Act that applied tariffs to over 20000 imported goods into the US. Electrification in the 1920's resulted in massive productivity gains and although wages kept up with inflation, wage increases did not match productivity gains resulting in worker discontent (does this sound familiar?). The tariffs were designed to protect American farmers and manufacturing but the act immediately resulted in tit-for tat retaliation from trading partners (sound even more familiar …?), which at the peak resulted in a 33% global trade drop, with US imports and exports falling by 66% and 61% respectively. It was no great surprise that the tariffs did not help the great depression, nor the economy although the trade deficit did shrink. Over one thousand economists petitioned against the act and many CEO's tried to engage with President Hoover on the issue asking for a veto. Although President Hoover himself called it "vicious, extortionate, and obnoxious" he followed the Republican Party line and signed the bill. As expected, with no great improvement in the economy, both Smoot and Hawley lost their respective seats in the upcoming elections and Franklin D. Roosevelt would go on to defeat Hoover to become the next president. In 1932, he spoke out against the act. (The next US election is in 2020, they say history does not repeat, though it does rhyme…).

The modern "trade war" is likely to be far less severe than in the 1930s. In the 1930s the reaction was global, whereas currently, almost all other countries are strictly against these trade tariffs. Moreover, central banks then were still monetarists and tightened liquidity, whereas today, central banks at least have learned from the 1930s. And finally, the 1930s trade war occurred during the great depression, while today, global economic growth is quite healthy. What then does the current trade war mean? China has never been a country to fold under bullying tactics. Indeed, it has almost always done the complete opposite. Force will thus be met with more force and President Xi has absolutely no political pressure. In fact, it will be massively popular standing up to the US. Trump however, would also not easily step down from his current position. The most likely outcome is for China to accelerate some opening reforms, which have been long identified, such as opening the financial sector, stronger intellectual property protection and perhaps accelerated free float of the Renminbi. In return, Trump can declare victory and return to more 'fair' trade by ending the trade war.

The market reaction to all of this has been very clear, both the US and China sold off (and some markets such as Japan, Korea and Europe) are selling off even more. The US is the number one market in the world, followed closely by China. The market fall places Trump under more pressure with a looming election in 2020, where absent the tariffs and trade war, he has seen growing popularity in the US with his tax overhaul policy. Although the risk of a tail event has increased with the recent tariffs, it should not be the base case scenario. Economic fundamentals are still strong, central banks are independent and only the US is a willing participant. It may however mean that there is some volatility from now until the resolution of the trade dispute. In the Fund, as sentiment turned negative, we cut our equities to 65% and further cuts will only be warranted should the economic and earning fundamentals deteriorate. Thus far both remains extremely strong.

5 Year Anniversary

March 2018 represents five full years since the inception of the Fund. Over this period, we have faced numerous scares from a growth slow down in China, a property collapse, to a debt default and currency depreciation. Investing in China is therefore certainly never boring.

Our investment management processes over this period has returned 15% per annum and has significantly beaten Chinese inflation. The returns resulted from good asset allocation decisions as well as superior stock selection over the period.

On a cumulative basis, the Fund returned around 100% over the five year period and delivered returns that were uncorrelated with the rest of global markets. To all our clients, thank you for supporting us and we will strive to continue delivering robust returns over the next five years. Impressively, our Fund is now part of the top 3% of global flexible allocation funds in the Asia-Pacific region according to Bloomberg data.

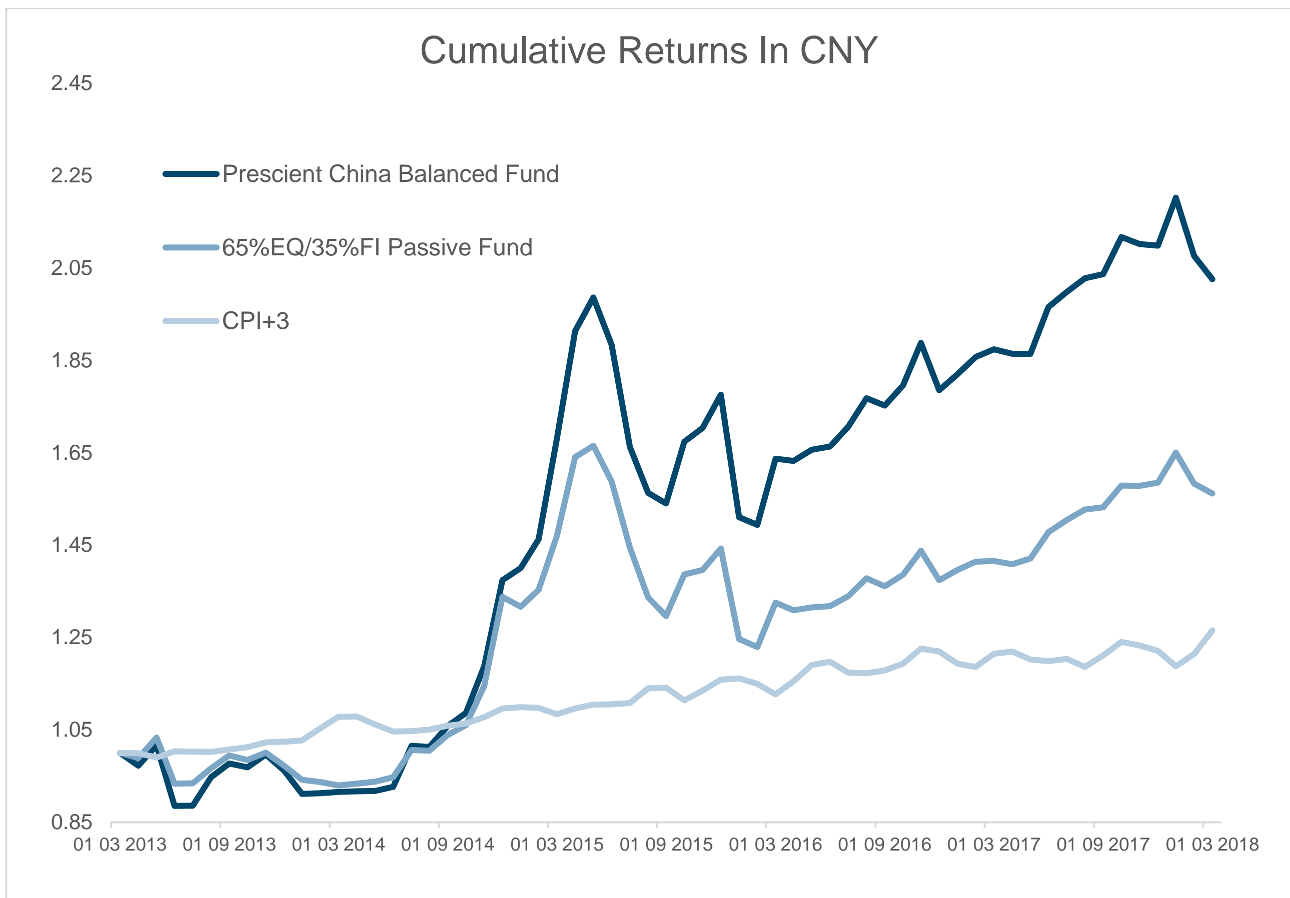

Figure 1: Cumulative Returns since inception to End of March 2018 (Zero fee class)

As aforementioned, the Fund ended the quarter somewhat flat. The quarter started extremely well but February and March were both negative months. 2017 was a great year for our asset allocation model but in the first quarter of 2018 proved to be tricky, which resulted in underperformance as our model swung strongly positive at the end of January due to both strong sentiment and fundamentals. Sentiment suddenly fell away in February and this meant that we cut our equity exposure only after markets had already fallen 7%. The asset allocation model underperforms in regions that have big turning points but generally outperforms during all other periods.

After a tough 2017, our equity model started to recover. Value was flat for the quarter while mean reversion staged a strong comeback and quality continued to perform well. After a weak 2017, mean reversion is up 8% in the month of March, which is the first strong recovery in the last 15 months.

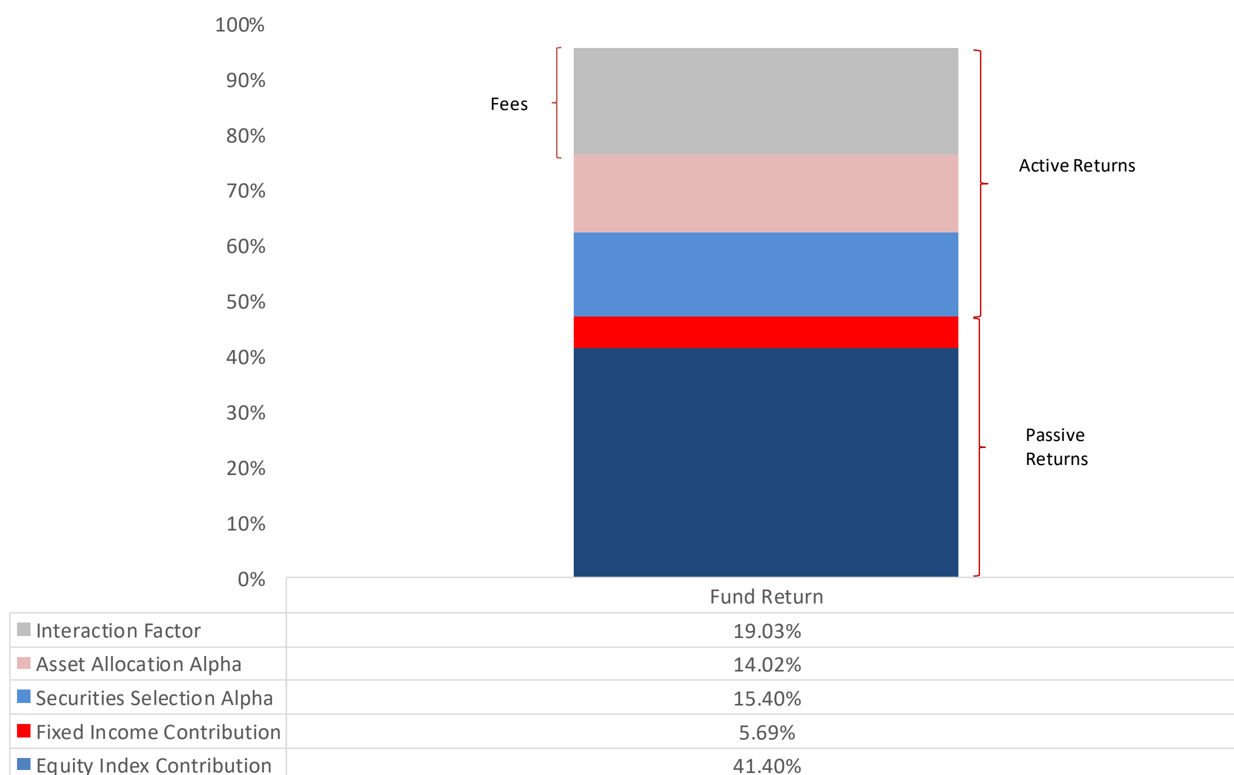

Figure 2: Full period return attribution since inception March 2013 to End of March 2018

Looking ahead, we will constantly attempt to provide superior performance. In light of this, our factor family will likely grow after the next quarter to include a volatility factor. This should result in additional alpha and stability going forward.

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