Prescient
INVESTMENT MANAGEMENT

PRESCIENT CHINA QUARTERLY COMMENTARY

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QUICK VIEW

A lot has happened over the quarter, most notably the all but certain default of China's largest property developer and junk US dollar bond issuer – China's Evergrande Group. This has been observable, and we have been aware of this risk for years. When Evergrande began raising US-dollar debt at 8% in 2018, it was clear to us that it was a group in trouble. This quarter, we cover some common questions relating to the expected default of Evergrande and how we would navigate such events as a quantitative manager.

Political noise continues to dominate media publications related to China with one exception – thawing relations between China and the United States. The turning point was arguably the release of Huawei CFO Meng Wanzhou, and we expect and hope for further warming of relations between the two superpowers.

In terms of performance, our Prescient China Equity Fund[1] has performed well in difficult conditions for 2021, with year-to-date US dollar returns slightly negative at -0.82% after fees, compared to the benchmark CSI300TR return of -4.16%, an outperformance of 3.34%. The Prescient China Balanced Fund[2] did better in absolute terms given its lower equity exposure, returning -0.13% after fees year-to-date in US dollar terms. Facing turbulent and challenging market conditions, we continue to focus on risk management, diversification and dynamic asset allocation to consistently add value and outperform over the cycle.

1 USD A Class net of fees
2 USD D Class net of fees

CHINESE PROPERTY SECTOR AND EVERGRANDE

BACKGROUND ON CHINESE PROPERTY

The Chinese property sector has grown extremely strongly for the past few decades. Given capital controls and the seemingly neverending growth in the property sector, many Chinese investors chose to put their savings into the property sector instead of the stock markets. This has resulted in a large and expensive property market. Developers, including Evergrande, have historically benefitted from these unique market conditions. Evergrande, betting heavily on this trend, raised huge amounts of debt to bid for land and develop properties, with the hope that by the time buildings were completed, prices would have risen significantly, making equity holders a huge profit. Since 2018, the Chinese government has been worried about the financial risks in the property sector, from hidden leverage in shadow banking to excessive leverage of property developers. Over the past three years, the Chinese financial regulators systematically closed down channels of shadow banking. They created the “three red lines” of leverage limits for property developers, where strict deleveraging measures were enforced if the lines were crossed.

Evergrande group is the largest property developer in Mainland China, both by assets and debt, and was also a company that crossed all three red lines. With the major banks unwilling to fund their risk and the shadow banking route more strict, Evergrande was forced to raise expensive capital in the offshore market, further exacerbating its problem. This all came to a halt this year, as the post-Covid-19 economic rebound started to fade, but the stricter shadow banking rules remained, meaning we have come to the end of Evergrande’s liquidity runway.

WILL EVERGRANDE BE CHINA’S LEHMAN BROTHERS?

We believe this is unlikely, although the company’s distressed situation will likely significantly impact the Chinese property sector. Major Chinese banks have been very cautious in their approach to Evergrande for some time, and exposure to Evergrande in large Chinese banks is expected to be limited. The Chinese government also foresaw debt issues in the sector, so it created the “three red lines” of leverage limits to force the property sector to deleverage. Evergrande was one of the few companies that breached all three red lines, meaning it could not grow its debt to fund historical debt.

Significant amounts of Evergrande’s debt are believed to be held by hedge funds and other off-balance sheet shadow banking structures to suppliers (deferred payments etc.), staff and individuals. This means less systematic risk but more social risk compared to the Lehman Brothers case.

WHY WE BELIEVE EVERGRANDE WILL NOT COLLAPSE LIKE LEHMAN BROTHERS?

The Lehman lesson taught global regulators that the cost of moral hazard is far lower when compared to the cost of a systematic banking crisis; hence we expect the regulator to focus on minimising systematic risk. We expect an equity wipe-out for Evergrande, debt restructuring, including haircuts for debt holders, and a controlled dissolution process, as with other headline cases, such as HNA and Anbang. We do not expect a systemic crisis due to lessons learnt from the Lehman Brothers case and the competency and efficiency of the Chinese regulators, especially given that they benefit from the hindsight of the US Lehman Brothers example.

Social risk will be another critical risk the regulators are expected to manage carefully. We see homebuyers and suppliers, along with their employees and contract workers, as the key stakeholders in the situation. The regulators will want to ensure unfinished homes are built for delivery to homebuyers and any cash flows coming in from sales of new homes and other assets to flow to higher priority suppliers. This will be key to maintaining social stability and protecting the most vulnerable of the stakeholders while at the same time also ensuring a somewhat more orderly impact on the Chinese property market.

HOW WILL EVERGRANDE IMPACT MARKETS?

We believe the impact will be significant and, along with curbs put on the property market by the government, it will have a cooling effect on the property market. Evergrande has over CNY 1 trillion of inventory that will need to be systematically sold to fund liability payments, likely at discounts to speed up cash generation. Given the situation, consumers are more likely to hold out on purchases to observe what happens in the market, especially as property is a considerable investment. We have already seen significant drops in secondary property market transactions, along with price cuts, although the primary market where developers are directly affected has been less affected so far. Chinese economic growth, in which the property and construction sectors have significant weightings, will likely be negatively impacted going forward.

The end result should be similar to what we have been expecting; mania stocks counting on excessive growth from the Chinese consumer sector are likely to be most impacted. Extreme valuations, when faced with slowing growth, is highly risky. On the other hand, historically, almost 60% to 70% of Chinese household wealth has been in properties, compared to 20% to 30% in the West. A rebalancing away from the property sector towards other more productive sectors will ultimately benefit the Chinese economy and ordinary citizens. Evergrande is likely the event that signals the end of speculation in residential properties in China. A slow rebalancing over the next decade, with capital moving from property to other more productive businesses, will ultimately drive the next phase of growth for China. If successful, the shift could increase GDP per capita from the current US$10k to US$20k, with the added benefit of housing becoming more affordable overall. However, the path to get there is unlikely to be smooth, with monetary policy and fiscal policy expected to adjust as we go along.

THAWING CHINA – US RELATIONS

MENG WANZHOU RELEASE, GESTURES OF GOODWILL

The long-running case for the extradition of Huawei CFO Meng Wanzhou to the US has been somewhat a symbol of the geopolitical rivalry between China and the United States, ongoing since December 2018. US prosecutors reached a deferred prosecution agreement (DPA) where Meng pleaded not guilty but admitted to misleading a financial institution about Huawei's operations in Iran. Sounds a little confusing and contradictory right? Reading the news as numerical nerds, we think so too, especially given that the DPA will in all likelihood result in the dismissal of charges entirely by 1 December 2022.

As weird as the logic for Meng's release appears, the result of this agreement is quite clear and not as unexpected. The release of Meng was part of the "List of Key Individual Cases that China Has Concerns With" presented to Deputy Secretary of State Wendy Sherman during the Tianjin meetings. It was one of the easier action items that the US could do to help improve bilateral relations and a clear sign of goodwill which will be well received on the Chinese side. Whether the Biden administration will receive a better deal in return for the release of Meng compared to the Trump administration remains to be seen. What we can perhaps conclude with more certainty from this case is the fragility of assumed and claimed judicial independence, especially when faced with enough political will and national interest. With this episode of "hostage diplomacy" coming to an end, one might have doubts on who really invented the practice, but we can enjoy the good news for now and leave that for another day.

TRADE WAR BEGINNING TO EASE?

If there was any doubt of progress on better China – US relations, US Trade Representative Katherine Tai announced early in October that the US "will start a targeted tariff exclusion process" on Chinese imports. Although criteria for goods and details on tariff exemptions are yet to be released, the announcement will be largely welcomed by businesses both in the US and China. The Biden administration has made it clear that further escalations on trade tensions with Beijing is not something they want to pursue.

Since the announcement, Katherine Tai had a video call with her Chinese counterpart Liu He and agreed to resolve bilateral economic and trade disputes through consultation. This is their second call since May and adds to the continuing stabilisation of economic relations between the two superpowers. We expect US Commerce Secretary Gina Raimondo to lead a US business delegation to visit China in the near future as bilaterial relations slowly improve.

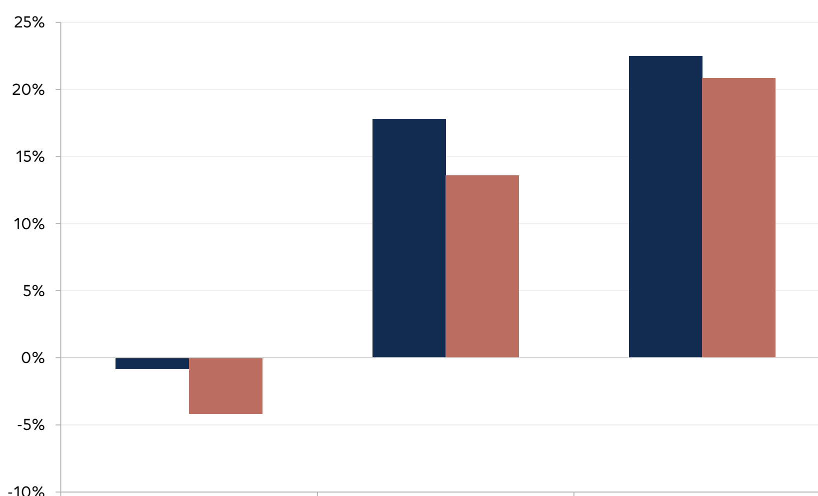
There is still a long way to go but we believe the first step of a long journey has been taken, toward a new stable competitive relationship between the two superpowers. This direction is positive for global markets and probably for humanity as a whole.

FUND PERFORMANCE

CHINA EQUITY STRATEGY

Market conditions have been very volatile in China since the beginning of 2021. For the 3rd quarter, Mainland Chinese equities[3] were down -6.2% in USD total return terms. Our Prescient China Equity Fund[4] outperformed the market by 0.8% over the quarter with a return of -5.4% after fees. Year-to-date, the Prescient China Equity Fund is down -0.8% compared to the market being down -4.2%, an outperformance of 3.4%.

Prescient China Equity Fund (Class A) – Returns in USD net of fees



	Year to date	1 year	Since inception
Prescient China Equity Fund (Class A)	-0.82%	17.79%	22.48%
CSI300TR	-4.16%	13.58%	20.83%

	Fund	Benchmark
Highest rolling 1 year	59.95	58.23
Lowest rolling 1 year	-8.65	-7.93

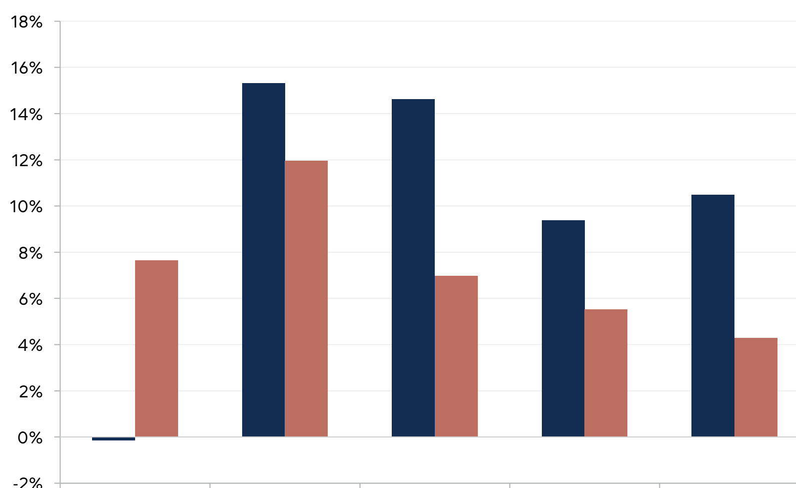
Source: Prescient, Bloomberg (as at 30 September 2021)
Inception date: 31 October 2018

3 As measured by CSI300 Total Return in USD
4 USD A Class net of fees

CHINA BALANCED STRATEGY

The dynamic asset allocation process in our Prescient China Balanced Fund continued to help us. Year-to-date returns after fees for Prescient China Balanced Fund was -0.13% and for the quarter, down -3.1%. Lower equity exposure over the quarter helped the fund avoid a significant portion of equity downside.

Prescient China Balanced Fund (Class D) – Returns in USD net of fees



	Year to date	1 year	3 years	5 years	Since Inception
Prescient China Balanced Fund (Class D)	-0.13%	15.32%	14.61%	9.38%	10.48%
China CPI+3	7.64%	11.95%	6.97%	5.51%	4.29%

	Fund	Benchmark
Highest rolling 1 year	99.61	17.08
Lowest rolling 1 year	-22.33	-2.43

Source: Prescient, Bloomberg (as at 30 September 2021)
Inception date: 31 April 2013

PRESCIENT POSITIONING

We had zero Evergrande equity exposure and are currently ready to selectively take on limited Evergrande bond exposure if pricing drops significantly below 25 cents. An equity wipe-out is all but guaranteed. Given that a Lehman style moment will not be allowed to happen, with government intervention at the extreme, we believe a 75% discount to par value on Evergrande's Mainland Chinese bonds provide good investment opportunities. As always, the fund will have extremely limited exposure in a risk diversified manner. At most, such an exposure will make up less than 1% of our position. In terms of overall property sector exposure, we have just under 1.8% exposure in our China Equity Fund and around 0.9% in our China Balanced Fund, both of which we are comfortable with given current market conditions.

We continue to focus on risk management, diversification and dynamic asset allocation to best navigate through uncertain market conditions. Current equity exposure within our China Balanced Fund is below 50% and we remain cautious of market developments in China and globally.

LOOKING AHEAD

CURBS ON CHINESE PROPERTY SECTOR

The current curbs on the property sector seem the most determined by the Chinese government to date. A very clear message has been sent to the market – houses are for living in and not for financial speculation. Any declines in the property sector will be expected to be gradual and smooth.

- If consistent poor property sector data is released in the coming quarters, there is the possibility of limited stimulus. The correct stimulus policies with a cooling property sector will be positive on the stock market.
- If data releases point to no significant systemic risk, the Chinese government can continue to push for deleveraging of the property sector. Such a push will be painful in the short-term but positive for the overall economy in the long run as declining property prices can translate into higher future disposable income to drive consumption. This is in-line with China's "Common Prosperity" drive.
- In the short term, we expect the PBOC to ensure ample liquidity in the market at low rates given the expectation of more bad news from the property sector. This will significantly reduce systematic risk as property companies in general are already facing increased costs as well as difficulty in obtaining credit.

CHINA US RELATIONS

We have been saying for a while now that China – US relations had very little room to deteriorate further and it was easier to work on improving relations. We are relieved to see positive steps taken by both sides and are hopeful for a gradual end to trade disputes in the interests of both China and the United States. These expectations will of course be positive for the markets overall. There is however the risk of unpredictability of politics, although that risk appears to be lower under the Biden administration. Either way, we are hopeful for the better but continue to focus on robust risk management of our portfolios.

SUMMARY

With all the negative news on China lately, it has been refreshing to see some positive developments. Chinese stock markets both in the Mainland and Hong Kong remain some of the cheapest in the world. With tapering expected in the US and improving China – US relations, we continue to view China as one of the most attractive allocations for investments worldwide, both in terms of equity and fixed income assets. In a challenging global environment and extremely elevated valuations globally, China remains one of the few markets in the world that can still be expected to deliver some positive real returns off current valuations.

We hope to share further positive news for the next quarter.

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Annualised performance shows longer-term performance rescaled to a one-year period. Annualised performance is the average return per year over the period. Actual annual figures are available to the investor on request. Highest and lowest is returns for any one year over the period since inception have been shown. NAV is the net asset value represents the assets of a Fund less its liabilities.

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