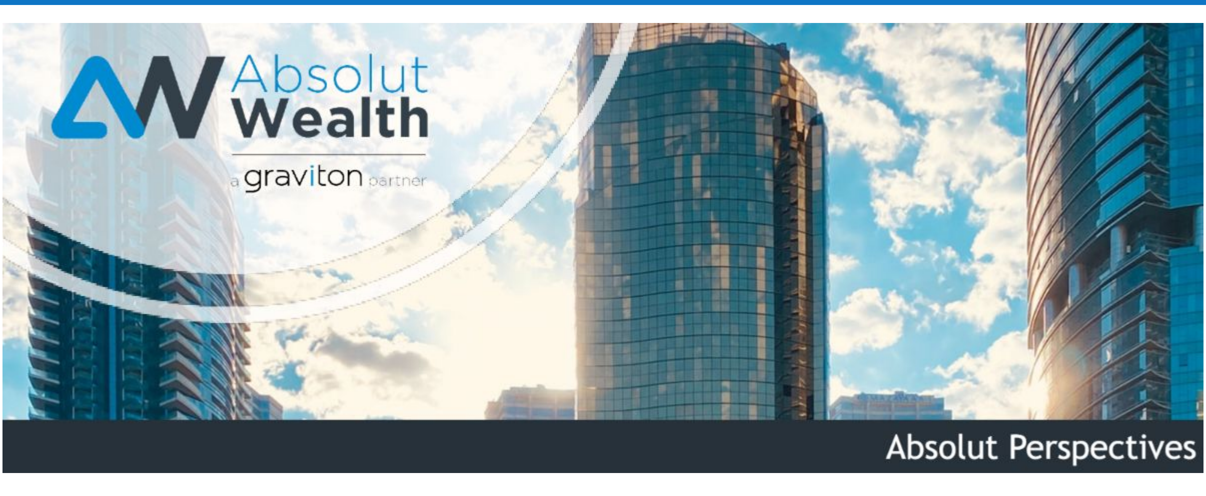


Are We Paying Enough Attention to China?

Richard Harris | August 2022

Over the past 2 years, we have been continuously testing and updating our investment thesis on Asian countries and more specifically, investments within China itself.

In 2021, the share prices of many Chinese-related technology companies nosedived as Chinese regulators made brash (and almost without notice) decisions to intensify their stance on common prosperity and regulate any companies that may be seen as a threat to this agenda.

The announced regulations placed focus on 4 main categories:

i. Anti-Trust - *Regulations that encourage competition by limiting the power of any single firm.*

ii. Capital Markets - *Regulations that attempt to enable the capital market to function more competently and fairly.*

iii. Data Security - *Sets guidelines for the collection and processing of personal information.*

iv. Social Equality - *Regulations that ensure that all individuals within a specific society have equal rights, liberties and status, and equal access to public goods and social services.*

These regulations put severe pressure on the growth aspects of said technology companies and we saw earnings and revisions plummet as a result.

Despite the significant reduction in earnings, regulation has been common in China for years. Many investors started placing bets that a turnaround would occur, and as a result, the share prices of these companies would rocket due to their relative "cheapness" to international peers.

It is now over a year later and investors (including ourselves) have seen no capital appreciation on these investments, irrespective of global market movements.

On review of our Asian exposure and potential head- and tailwinds that are likely to be observed going forward, we uncovered some concerning potentialities. Although the probability of some of these deteriorating to a point of catastrophe may be somewhat low, they are numerous, and the demise or continuation of any single point could have severe consequences on Chinese investments in general. I will touch on a few below:

(1) The Current State of the Chinese Economy

It has been common knowledge that the Chinese economy has been fragile for many years now. Q2 2022 GDP growth was the slowest since the COVID-19 breakout, debt-to-GDP remains above 300%, manufacturing activity continues to print lower, and despite the Chinese Communist Party (CCP) targeting 5.5% growth for 2022, many economists think otherwise whilst remaining concerned on the accuracy of economic data released by the ruling party.

(2) China's Zero Covid Policy

To stop the spread of COVID, Chinese authorities implemented a zero-COVID policy, whereby strict lockdowns were enforced nationwide, combined with mass-testing. This ruthless response has significantly impacted the Chinese economy as residents have been unable to continue with their daily lives and work activities.

For example, large factories including iPhone-maker, Foxconn, have been closed without notice due to minor COVID outbreaks, constantly derailing production which is adding to the global supply chain crises we are experiencing.

(3) An Impending Housing Crisis

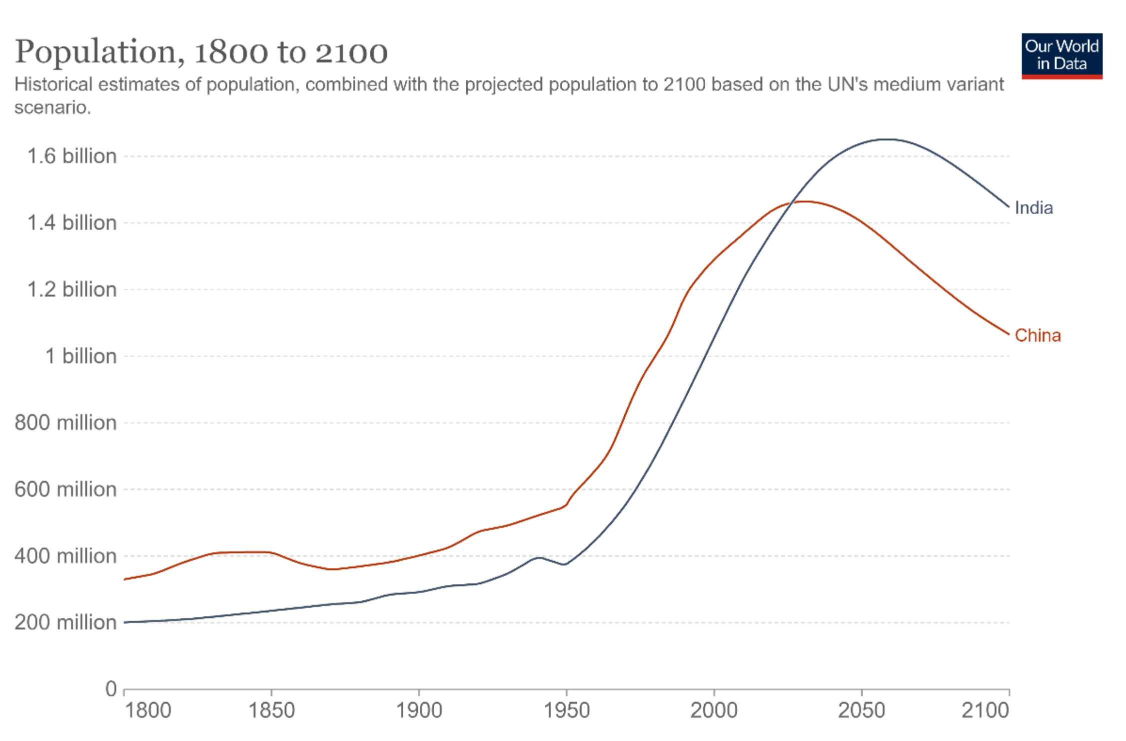
Over the past few months, and despite Chinese media doing their best to sensor it, there is a mortgage crisis unfolding in China with large companies like Evergrande showing significant signs of balance sheet deterioration due to risky lending. Further concerns surround current mortgages not being backed by physical assets due to developers rather using these proceeds to invest in new projects than build property under current contracts.

Many mortgage holders have stopped repayments in a stand of protest of non-delivery and the contagion effects are likely to be serious, especially considering the degree of Chinese wealth invested in the property market. As the size of the Chinese property market exceeds $9Tn, this could have serious adverse effects on the already highly indebted Chinese banking and financial system.

(4) China's Demographic Problem

In 2023, India will replace China as the most populous nation. In 2020, China's population increased by 2.04million and only by 480k in 2021. The Chinese population is rapidly aging due to their one-child policy, established in 1980.

The chart below shows a projection of China's population versus India to the year 2100. China's population is slowing significantly and is expected to reduce by ~400-500million by 2100. This, together with an aging population, will impact growth prospects for China in the decades to come.



(5) Potential Invasion of Taiwan

Over the past few years and more recently after Nancy Pelosi's visit to Taiwan, China's military presence in the area has intensified significantly, leading to further concerns of a potential invasion of Taiwan to assert control.

China has made it very clear that they will not back down and continue to push the narrative on their view that Taiwan is a "province" of China.

Should this happen, sanctions will be imposed on China by the West (as in Russia), and we are likely to see a similar scenario play out to what we saw in Russia earlier this year. Most Russian assets had to be marked down to 0. Taiwan also produces the majority of global semiconductor chips (which are used in all electronics). Interruption of this supply would have a significant impact globally.

On the 29th of August, the Biden administration signalled its intent to sell $1.1Bn in missiles and radar support to Taiwan, supposedly the largest sale of this nature in years.

(6) The Nature of Chinese Company Listings Abroad

Chinese companies are listed in the US and Hong Kong indexes using a structure called a Variable Interest Entity (VIE). These structures do not give offshore investors voting rights as the controlling interest in these companies is arranged via a contractual relationship rather than direct ownership. This gives Chinese or American authorities the ability to invalidate contracts with each other should any geopolitical tensions rise.

There has already been conflict between Chinese and US authorities regarding these structures and the US has threatened to remove some listings due to lack of financial transparency from Chinese businesses (Alibaba was added to the list of possibilities last month).

The world has become accustomed to the draconian nature of Chinese authorities and the manner in which they make decisions. Despite this stance, there will be a time when China offers a good environment for international investment; however, the points listed above all offer cause for concern and should not be ignored. On this basis, and based on the fact that we believe perceived risks are currently greater than short-medium term reward, we have cut our Chinese exposure until further clarity can be established.

Unlike their Western counterparts, law and regulation in many parts of the East are established by a small elite without much notice or national debate, the result of which can be catastrophic, much like what we have seen with Russia and Ukraine. Given current political tensions in the world and the movement towards deglobalisation as a result, low probability events of the past are becoming more and more likely.

Market Review

August saw another volatile month across global indexes with no shortage of news flow coming from all angles.

We saw markets move higher from start to mid-month after a slew of bad economic data led some investors to believe that the Federal Reserve would slow rate hikes and monetary contraction in the US. This theory was quickly put to bed when Federal Reserve Chair, Jerome Powell, spoke at Jackson Hole (the annual symposium of US Central Bankers) and told the world that they will do whatever it takes to bring inflation back to their 2% target, even if it meant hurting the economy and equity markets.

The Federal Reserve has 2 core mandates; (1) to keep inflation under control and (2) to ensure a strong labour market. The above comments from Jerome Powell, coupled with stronger than expected employment data, caused US markets to back off ~5% in the last few days of trade.

The US NASDAQ led the way down for August giving back 5.2%, closely followed by the German Dax (-4.8%) and the S&P500 (-4.2%). The only index in the green was Japan's Nikkei (+1%).

On the hard commodity front, we saw pain across the board with Silver taking the wooden spoon, down 11.4% on the month.

Natural Gas prices on the other hand rose to extreme levels as Europe currently finds itself in an energy crisis and at a tug-of-war with Russia who provides the zone with most of its energy supply.

This will definitely be something to watch as the Northern Hemisphere goes into winter and the Eurozone becomes more reliant on fossil fuels to stay warm.

The local ALSI and Top40 Indexes treaded water, losing just over 2% each for the month of August despite the broad-based commodity index being down 6%. This is largely due to continued Rand-weakness as investors once again flocked to the US Dollar based on a global "risk-off" environment. The Rand started the month at R16.50/$ and ended at R17.03/$ (-3%).

Our market outlook, both locally and offshore, remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We are defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios. Although we believe that there is more volatility to come, we have started deploying capital to certain opportunities and will look to deploy further into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Chart of the month:

It is important to note that China is a global superpower and a country that the world depends on for its manufacturing capabilities. Should tensions continue to rise and we see further geopolitical deterioration and possible sanctions imposed, we could see a significant slowdown in global production and a further rise in inflation as a result.