The View from Atlantis

2H 2018

Message from the Chairman and Chief Investment Officer

As the US-China trade tensions continues to escalate, China and Hong Kong market both experienced big corrections and high volatility in the first half and so far this year. Other concerns including expectations of a RMB depreciation and credit tightening have also put pressure on the markets.

Looking forward to the second half of the year, RMB depreciation is probably unavoidable; we see it as a costly policy option but it will continue at a slower pace for the second half compared to the second quarter. A key difference between today and 2015 is that the government has much better control over capital flows, and thus we have much stronger confidence that outflows would be significantly less than 2015/2016: as observed, capital flows have been largely stable in 2017 and so far in 2018.

Notwithstanding, the trade war will not end in the short-term, and it will affect the economic development of both China and the US, but we still see an opportunity for tensions between the two counties to ease slowly. However, we are not particularly concerned about systemic risks, given on-going reform, relaxation of loan quotas, and a favourable business environment for good companies. In addition, we believe that all negatives are have already been priced into stocks, and that the darkest period has passed. We think it is a good opportunity for portfolios to accumulate-on-the-dip now. We believe that fundamentals of many stocks are quite solid and the Hang Seng Index is expected to generate single-digit to double-digit earnings growth in the coming three years.

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2018 Second Half-Year Outlook:
China and Hong Kong Outlook with Yan Yang (Fund Manager)

Can you summarize market performance year-to-date?

We found that capital markets in the first half of the year exhibited "high volatility, low return" risk characteristics, causing deep suppression of investment sentiment. The global stock market fell for a total of $10 trillion for half a year, which exceeded the total market value of the increase of $9 trillion last year. In terms of return on assets, other than a slight positive return on oil, US dollars, JPY, S&P500, Asian sovereign debt and US dollar high interest debt, other asset classes recorded negative performance.

On the Chinese market, the on-going trading frictions between China and the United States since the start of this year and RMB depreciation have made the Shenzhen Component Index and the Shanghai Composite Index the first and second worst performing indices, recorded at -15.04% and -13.90%, respectively. In the same period, the Hang Seng Index and the Hang Seng China Enterprise Index fell -3.22% and -5.43%, respectively. Although the depreciation of the RMB will help China's exports improve its competitiveness in the context of the trade friction between US and China, with the acceleration of RMB depreciation, the foreign capital outflow of A shares and the Hong Kong stock market has spiked; and all stock markets in the Asia Pacific region experienced a significant outflow in June.

What have been the key themes driving this market action in 2018 so far?

Four sectors have been driving this market so far - education, consumer, energy and healthcare. On the other hand, technology sector has underperformed in 1H2018. Among these sectors, consumption, healthcare and energy have become the main investment themes in the first half of the year; it is not difficult to find that as China's per capita income increases and its population ages, more funds choose non-cyclical sectors against a backdrop of market volatility and slowing economic growth in emerging economies in Europe and Asia. As a result, consumption upgrade related companies such as education (adult education & online education), food and beverage, cosmetics, and healthcare related companies such as bio-pharmaceuticals and Chinese medicines have performed well. Energy sector has performed well this year mainly driven by the global economic recovery, the rise in crude oil prices and the continuing of domestic destocking.

What is your view on the potential US-Sino trade friction, and how did this prospect affect your previous investment?

The trade friction will not end in the short-term, and it would affect economic development of both China and the US, but we still see an opportunity for tensions between the two counties to ease slowly. July is critical for China to deal with the first round of trade tariffs and we expect a rational tone from the China side. We believe that the growing list of Chinese exports subject to US tariffs should have a small impact on China but potentially a large one on a few firms such as ZTE (763 HK). Therefore, we expect the market could show a rebound in July and August when market liquidity is high and valuations hit new lows.

What is your view on China’s focus on reducing leverage while supporting domestic demand? Would these further reducing China’s growth?

Deleveraging of corporates is a short-to mid-term pain: however, for long-term gain, orderly deleveraging will continue, particularly for off-balance sheet shadow credit. Without doubt, deleveraging has been a success, as self-circulating funds have been reduced. June 2018 TSF, or Total Social Financing, at Rmb1.18trn, has been attributed to slower credit growth of shadow banking and rising bond defaults. Banks have turned much more conservative since 2Q18 although loan growth stayed resilient. Looking forward to 2H18, we expect the loan growth will accelerate to compensate shrinking off-balance sheet lending, which means high-quality companies should still get loans easily with lower interest rate, and the market would clear away more low-quality companies.

Under the current complex internal and external environment, the importance of China's consumption growth to the overall contribution of the economy has been further enhanced. In the first half of the year, consumption, investment and net exports contributed 78.5%, 31.4% and -9.9% respectively to China's GDP. The growth rate of the economy in the second half of the year will be more dependent on domestic demand. In addition, China's consumption contributes 53.6% to GDP, comparing to the United States’ 80%, China's consumption still has some room for improvement. Therefore, the level of deleveraging in the second half of the year will likely not be further strengthened, and the government may further boost residents’ consumption by tax cuts.

What are your views on long-term effect of the recent MSCI inclusion of Chinese equities?

The inclusion of 234 A-shares into its EM benchmark index obliged ETF and other investors in that index to add RMB-denominated stocks to their portfolios. Moody’s estimates that A-share inclusion will attract US$11 billion in international inflows in the short term. Over time, full inclusion could bring China’s weight in the index from 30% to nearly 45%. Therefore, in the medium and long-term, China’s A shares market will further benefit from the continued inflow of global capital, and the trend of internationalisation of A shares will be further consolidated. However, as the overall size of the global MSCI EM index market cap continues to decline from the first half of the year, the probability of a large inflow of foreign capital through MSCI mechanisms is small. Nevertheless, we believe that from a global comparables-valuation point of view, the current valuation of A-shares is at an all-time low, and combined with capital liquidity data analysis from the first half of the year; it is not difficult to see the market is getting more attention from foreign capital.

What are some of the key investment opportunities you see in the second half of 2018? Do you think now is a good time to invest in Greater China market?

The healthcare and consumer sectors will continue driving the market in the 2H2018. We also believe that there are some trading opportunities in the technology sector especially software, hardware and internet area, and as well as the real estate sector.

In the short term, we will pay more attention to the trend of China's macroeconomic data and the future developments of Sino-US trade frictions. We believe that the investment market in the third quarter is still likely to face a variety of uncertainties. With the mid-term elections in the U.S. in the fourth quarter and the economic development strategies in China becoming further clarified, there may be some investment opportunities.

However, from the perspective of valuations and corporate earnings, the average PE valuation of the Shanghai Stock Exchange is only 12.89X, the Shenzhen Stock Exchange is 21.29X, and the Growth Enterprise Market is 40.77X, which are all lower than their historical average valuations, respectively. Moreover, the average PE valuation of the Hang Seng Index is 11.06X and the Hang Seng State China Enterprises Index is 9.32X, are also lower than the historical average. Therefore, we believe that after the peripheral factors have become clear, A-shares and Hong Kong shares markets will continue to be ideal asset allocation choices.

Sector Opportunities with Yan Yang

Property:

Our attitude towards all cyclical sectors is cautious in 2H2018. However, we think the property sector is the best to invest amongst all cyclicals. Negatives exist in the market but seem overplayed; all concerns, including trade wars, tight credit and determined policy tone, are largely priced in, although sentiment does takes time to recover. We are very positive towards consolidators with sufficient land bank, robust YTD sales, disciplined land banking strategy and strong financing capability.

While the industry growth rate has peaked already, the total sales volume would be maintained for years to come, thanks largely to an increasing urbanization rate and upgrading demand. Acquisitions of market share of leading names have just started. Our top ten developers account for 29% and 20% market share in terms of sales value and sales volume, respectively, and the largest developer only has 6%. In the coming three years, the top 10 would take up 50%, mainly from consolidation. This means continuous earnings growth of leading names are in high visibility.

We also observed increasing financing capabilities of major developers, such as annualized interest costs around 2% less compared with 3 years ago. At the same time, market sentiment in onshore and offshore-bond markets improved as bond issuances resumed at reasonable costs.

The property sector is currently trading at 5.9x 18PE and 4.5x 19PE compared to 2015 at 4.5x, and offers dividend yield of 6.2% and 7.6% for 2018 and 2019, respectively. We believe the leading companies with sustainable earnings growth and reasonable gearing ratio should deserve higher PE multiples.

Education:

The education sector has seen quite a rally in 1H18, with our tracked education index* recording a 28.0% return YTD vs. MSCI China -2.2%. In a volatile 1H18 market, strong interests from investors mainly came from the defensive nature of education business and the high secular growth visibility in China. As China continues to advance its urbanization process (with urbanization ratio improved to 58.5% in 2017 vs. 36% in 2000), plus the rising urban disposable income per capita (+480% from 2000 to 2017), the imbalance of education resources (i.e. quality school seats) in all city tiers stirs even fiercer competition among K12 students and calls for more high-quality education supplies. Meanwhile, since the official launch of Private Education Promotion Law in September 2017 and provincial implementation guidelines in the following months, more private education institutions have finally cleared their route to capital market access, evidenced by a surging number of new IPOs (8 in 1H18 vs. 10 in 2017 and 4 in 2016).

Following the industry theme, we continue to favour the K12 after-school tutors (to answer the competition) and degree-providing educators (both K12 and post-secondary, to provide quality supply) in 2H18. We believe that, though the education industry is not a “winner-takes-all” game due to its regional barriers and high demand for customization (“因材施教”), leading players can leverage their brand advantage and centralized system to consolidate the market. We will continue to focus on industry leaders with proven operation track records (organic and inorganic enrolment growth, high facility utilization, above-industry margins) and reasonable valuation (0.8-1x PEG or below 25x 2019 P/E).

*Including key education names in both China ADRs and HK market (EDU.US, TAL.US, BEDU.US, FEDU.US, REDU.US, RYB.US, 839.HK, 2001.HK, 6068.HK, 6169.HK, 1317.HK, 1569.HK) on an equally-weighted approach.

Asia Pacific Ex-Japan Outlook with Joseph Wat (Fund Adviser)

Can you summarize market performance year-to-date?

The markets have been volatile: we went from +10% gain at the beginning of the year to -5% decline by the end of June. Optimism on synchronized global growth amidst a benign inflation outlook at the beginning of the year gave way to fears and uncertainty surrounding a trade war triggered by the US.

Emerging markets have been very volatile this year. As an equity investor, what is your view?

The structural long-term growth in emerging markets is still there. With the sell-off in both the stock markets and currencies, valuations are extremely cheap in USD terms. The past few years have seen not only fund flows flowing back from emerging markets into US but also into technology sector. However, the recent 20% selloff in Facebook in one day highlights the nervousness and lofty valuations on the technology stocks. Earnings must not only exceed expectations but also company guidance needs to accelerate. With the outlook on technology murky and with US rates possibly peaking in 1H 2019, we could see flows reverse back into emerging markets.

How does Asia stand out in this environment? What is your view on US interest rate hikes that cause money outflow from Asia presently?

Asia stands out amongst emerging markets, having recovered from the Asian Financial crisis 20 years ago with concrete reforms and with the emergence of China. Although China has her own problems, other parts of Asia are doing well: ASEAN, for example counts on a young energetic population, rising urbanization and connectivity to propel its economy forward. We believe that US interest rate hikes could peak sooner than what the street is forecasting. Combined with the threat of a trade war, we believe that the Fed will err on the side of caution.。Some countries like Philippines and Indonesia have already started raising rates to defend its currency and curb any inflationary threats. Indonesia, for example, has been proactive in raising interest rates (100bps) to curb any further currency weakness due to the US interest rate hike. We believe we have seen the worst of the outflows.

What is your view on geopolitical tensions in Asia?

Geopolitical risks have markedly declined in 2018. The denuclearization of the Korean peninsula took a marked turn of improvement with the signing of a declaration by the US and North Korea. Whilst questions still exist on the timing of the disarmament, we cannot deny that this is an improvement from the past with war-games and missiles flying into the Japan Sea. Politically, we have seen a peaceful change in the Malaysian government with the toppling of the incumbent coalition, Barisan Nasional who had ruled for more than 60 years. There is an upcoming Indonesian Presidential election next year, and we think that the incumbent Jokowi will be elected for a second term given his track record in moving infrastructure projects during his tenure.

What are the key risks to this outlook? How do you protect portfolios versus these risks?

The key risk to our view is the ongoing trade war between the US and the rest of the world. The trade war between US and China is especially troubling. We believe that a full-blown trade war will not materialise, but if one arises, it will be dire for global trade and for inflation.

There will be no winners. Even the US, if they choose to embark on one, will see rising inflation and businesses relocating out of the US causing unemployment, which is the reverse of what Trump campaigned for: creating jobs.

What are some of the key investment opportunities you see in the second half of 2018?

Given the nervousness surrounding technology and its lofty valuations, we believe that money could flow back into old world economies stocks. These stocks have been de-rated over the past few years with PE having shrinked and dividend yields rising. Value investing could be in vogue again!

Japan Outlook with Taeko Setaishi (Fund Manager)

Some of the positives include continuing low money rates and the expectation that the government will continue its easy money policy for some time. We also expect corporate earnings to continue to expand for the current fiscal year and hopefully the following year ending March 2020. Unemployment is the lowest since 1992, most companies are hiking summer bonuses, exports and private capital investment are improving, the yen is stable, and inflation remains near zero.

However, most investors are worrying more and more about a possible world trade war. Geopolitical problems including possible border problems with China, Russia, South Korea, and a series of scandals involving Prime Minister Abe and the ruling Liberal Democratic Party (note the current cabinet's popularity has been increasing recently) are also making the market anxious.

The Japanese economy is doing okay, there are no outstanding financial problems about to emerge in Japan, as far as we know, and Japanese companies are in the best financial condition in years.

In fact, we think that any weakness in the market represents a very good opportunity for the Fund to pick up Japanese stocks at very reasonable prices, in some cases at bargain prices.

Atlantis Fund Managers

Yang LIU, Chairperson & Chief Investment Officer

Yang is the Chairman and Chief Investment Officer of the Atlantis Investment Management Group. Yang has over 20 years of experience in investing in the Greater China region. In 2001, Yang was Head of China Equities at First State Investment Management (HK). She joined CMG CH China Investment Ltd in 1993, where she was the CIO of CMG CH China Fund (renamed New Era PRC Fund later), which was also the first closed-ended China Fund listed on the Australian Stock Exchange. She started her career at CITIC Group in Beijing in 1988. Yang graduated in 1988 from the Central University of Finance and Investment in Beijing with a Bachelor in Economics. She then received a Graduate Diploma in Applied Finance and Investment from the Securities Institute of Australia in 1998.

Joseph WAT, Fund Adviser

Joseph joined Atlantis in 2008 and helped establish Atlantis's affiliate in Singapore. He was appointed as the Fund Adviser to the Atlantis Asian Fund in April 2009 and is currently the Chief Executive Officer of Atlantis Singapore. Joseph's experience in managing Asia ex-Japan investments spans more than two decades. He was formerly a Director at Deutsche Asset Management, managing institutional segregated accounts and was a key member of the team that launched the Deutsche Vietnam Fund in 2007. Prior to joining Deutsche Asset Management in 2004, Joseph was an Associate Director at Invesco Asset Management, where he was the manager of the award-winning Invesco GT ASEAN Fund and outperformed blue-chip peers in the six years that he managed the fund. Earlier in his career, Joseph held roles at Schroders Securities, DBS Bank and Arthur Andersen. Joseph earned a Bachelor of Accountancy (Honours) from the National University of Singapore.

Yan YANG, Fund Manager

Yan is the manager of Atlantis China Healthcare Fund and the Head of Research in Greater China region. With over ten years' experience in roles of increasing seniority in equity research and portfolio management, her responsibilities include making investment decisions and leading Atlantis's research team. Prior to joining Atlantis in 2017, she was employed by the Hong Kong firm Value Partners where she served as a fund manager. She was previously a property analyst with SWS Research and CLSA. In 2011, Yan was recognized by The Wall Street Journal as one of the world's leading Asia analysts. She holds a Bachelor's degree in Economics from the Shanghai Institute of Foreign Trade, and earned an MBA from China Europe International Business School.

Taeko SETAISHI, Fund Manager

Taeko is the manager of Atlantis Japan Opportunities Fund. With over 28 years experience in securities research and asset management in Japan. She joined AIRC in 1996, is a Japanese citizen and is based in Tokyo. After graduating, she joined Schroder Securities. In 1986, she worked with James Capel and in 1993 joined Schroder Investment Management as an Analyst and Fund Adviser. Taeko is a graduate of Pitmans College.

About Atlantis

Atlantis Investment Management was founded in London in 1994 by three star ex-Schroders fund managers. Ms Yang Liu, now Atlantis's Chairman and Chief Investment Officer, joined Atlantis in 2002 as a Fund Manager. As Yang grew to become one of the most recognized names in China investing, she acquired the Atlantis group in 2009. Under Yang's direction, Atlantis' s center of gravity has shifted to China. Our headquarters is now in Hong Kong, where we occupy the 35th floor of the Centrium skyscraper high above the Central district. Since inception, Atlantis has been dedicated exclusively to Asian equity strategies.

Our two main investment focuses, China and Asia ex-Japan, are operated independently and led by our dedicated portfolio managers. While the non-investment functions (risk management, legal and compliance, trading, operations, marketing and investor relations) are provided from Hong Kong, our investment and research professionals are based regionally in Asia – Hong Kong, Shanghai and Singapore. This enables our investment professionals to focus on what they do best and provide us our key advantages: local, street-level intelligence.

Atlantis currently offers a wide range of services for global institutional investors through the Atlantis funds and via segregated mandates.

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