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The View from Atlantis

2019

Message from the Chairman and Chief Investment Officer

In 2018, Global stock markets witnessed unprecedented turbulence. US-China relations faced unprecedented challenges with the trade tensions upsetting entire market’ s sentiment. The events in 2018 brought out the possibility of a worldwide economic crisis, which may erupt in 2019. With the markets’ unexpected behaviour, we are forced to re-evaluate relative risks and relative positioning of different countries ’equities in the market: China and the US are at different stages of the economic cycle and thus monetary policy and industrial activity are likely to be misaligned if not at times moving in opposite directions. Currency systems became a critical indicator to monitor as signals for greater economic mechanisms at work. The traditional value investment theorem is being upended by systematic and quantitative investment techniques such as Artificial Intelligence and Machine Learning. Fintech led investment strategies are sharpening our thinking and behaviours in a fast changing world, and are landing in Greater China markets. 2019 will undoubtedly be a beginning year that challenges traditional investment approaches and patterns.

Almost every Chinese Index posted double-digit negative returns for the year regardless of market capitalisation. We have learnt that the stock market has been more easily influenced by political events and news trends than fundamental valuations. Therefore, our top-down approach should bring us better returns in 2019. China’ s SOEs delivered remarkable profit results in the 2018 calendar year, which created a total profit of Rmb1.7trillion, an increase of 16.7% compared to that of 2017, while companies elsewhere felt the effects of depressed liquidity. We will focus on H-shares for 2019, as we believe that 2019 will be the year for H-shares where stocks are priced cheaper and companies are more profitable as proven in most difficult times.

We expect to see a re-rating of China’ s entire equity market in 2019 if the trade conflicts between US and China are resolved. As such, capital inflows will be attracted by the value of China’ s companies more than ever before.

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2019 Outlook:
China and Hong Kong Outlook with Yan Yang (Fund Manager)
Asia Pacific Ex-Japan Outlook with Joseph Wat (Fund Adviser)

China and Hong Kong Outlook

What significant market movements affected us in 2018?

Yan: Major global markets including those of China concluded a turbulent 2018. Trading has been highly volatile throughout the year due to concerns over the unsolved US-China trade tensions, global economic slowdown and US rate hikes. The Shanghai Composite lost 24.6% for the full year, the worst performance since 2008. The Hang Seng Index was down 13.6% from the start of the year, the worst performance since 2011.

For China, we strongly believe the worst of times has passed as the negative factors we have worried about began to improve in the fourth quarter of 2018. For example, China and the US agreed to a 90-day trade truce to hold further talks to resolve their differences over trade. China also intensively introduced stimulus policies, including RRR cuts and reduction in taxes, to stabilise its economy.

What is your view for the stock market in Greater China in 2019?

Yan: I am bullish on the stock market. The key reason is the expectation of an economic downturn has already been sufficiently priced into stock prices. While the market could be volatile again when the downturn does happen, but in our perspective, the market will also bottom out at the same time.

We expect China will see both asset shortages and fund shortages in 2019. Asset shortage refers to the lack of low-risk assets with reasonable returns, which are favoured by banks. The shortage of funds means that faulty assets will continue to find it difficult to gain access to capital markets no matter if the company is listed or not. The country' s regulatory policy in terms of lending remains relatively strict, and that is why capital will only flow to good assets. Therefore, there are still many structural opportunities that lay ahead.

We expect China A shares will outperform Hong Kong while Hong Kong will outperform the US. China still has abundant capital in the market that should bode well for Chinese equities.

Concerning the macroeconomic outlook, are there any overarching themes that may influence the market?

Yan: With China and the US resuming trade talks, we are heading in the right direction. China will continue its RRR cuts in 2019, with our forecast of four cuts, while US Fed policymakers have indicated they would slow down rate hikes in 2019, with our expectation of only one rate hike. After the markets slumped in 2018, we believe most negative news has been sufficiently priced into the stocks. On the other hand, the main negative factor for 2019 is that we are yet to know in which quarter China' s economy will reach bottom, though we believe it is likely to be in the second quarter.

In terms of fiscal policy, we are still waiting to see more tax cuts and some subsidies released. Just in December, the Deputy Chairman of the NDRC said that China would announce a new set of incentives to encourage the sale of autos, household appliances and other durable goods this year to boost consumption. If the supporting policy is implemented, we expect that brown goods will be the biggest beneficiary as brown goods would likely see a large demand for replacement from consumers. Its high price elasticity also means the stimulus may have the biggest effect on its sales compared to other categories.

Asia Pacific Ex-Japan Outlook

Can you summarise market performance for 2018?

Joseph: 2018 Market performance had been tough after a strong 2017. Twin headwinds from the trade war between China and the US as well as the continued US rate hikes reversed the spectacular gains seen in 2017. To compound the weakness, the resultant strength in the USD further forced countries with current account deficits like Indonesia and Philippines to hike more than the Fed 100bps hike. Indonesia had to do a pre-emptive rate hike 7 times by 175bps despite benign inflation to stem the outflows. However, the more dovish tone by the US Fed in December led to some stabilisation in these countries.

What is your view on 2019 surrounding with geopolitical tension environment and slow economic growth economies in Asia?

Joseph: Trade Tension remained high as the trade war now has escalated to a more longer term issues like intellectual property rights and transfer of technology and opening up of the Chinese domestic markets. However, there seems to be communication at the highest levels and all eyes are on the 1 March deadline to see if a deal is struck.

The Korean de-nuclearisation deal struck in June has now been stuck in limbo. However, there is a second summit in Hanoi at the end of February and it is anybody' s guess if North Korea will dis-arm its nuclear missiles.

In the ASEAN region, Thailand and Indonesia will go to the polls. For Thailand, it is the first polls after the junta government took over 4 years ago. An elected government would probably bring stability to the country which has been lacking for more than a decade since Thaksin came into power. In Indonesia, a vote for the incumbent President Jokowi would signify a big endorsement to the President' s corrupt –free regime and who has accomplished many infrastructure projects in his 5 year reign which the 3 previous presidents could not achieve in the past 15 years. A further 5 year term would allow him to continue this policy and focus on other longer term issues and make Indonesia an economic powerhouse in ASEAN.

How do you protect portfolios against these risks?

Joseph: Some of these predictions may not pan out as expected. Our only insurance is investing in value where there is a catalyst to unlock this in the longer term. Market timing is always difficult. There might be short term underperformance but ultimately in the long term value will be crystallised.

What are some of the key investment opportunities you see in 2019?

Joseph: We believe that those countries which had been harshly hit by the rising USD rates would outperform, namely Philippines and Indonesia. As they have been doing pre-emptive interest rate hikes, we expect them to be the most aggressive in terms of easing when Dollar risk abates. We also see opportunities in the Chinese trade war tensions with the US. Particularly some of the sectors that have been harshly beaten on the back of a worst case scenario.

Sector Opportunities with Yan Yang

Healthcare:

The sector experienced a huge reversal since June due to the concerns about the incoming GPO tenders in coming 2019. Looking forward to 2019, we are still in a challenging cycle of industry restructure and new regulatory regime based on medical insurance reform. Drugs price cuts and medical service price increases are the right trend in the long term. We expect some industry-wide headwinds for drug manufacturers this year, and we also forecast that some companies with large exposure in generics would have pricing pressure in the near term. However, there is no doubt that, we are going to step into a new era of innovative drugs and biotech. For innovative drugs, we think our pharmaceutical leaders are already well positioned since 5 years ago; Hengrui, Sinobiopharm and Fosun all have solid pipelines. Biological products only account for 15% of total pharmaceutical products in China and we expect double-digit CAGR in the next 5 years.

We are positive on healthcare stocks and stock selection will be based on: 1) accelerated approval of innovative drugs; 2) sector-wise valuation reaching reasonable levels; and 3) certain large names entering into harvest periods for their innovative drug development in 2019.

TMT:

In the long run, we are optimistic about the prospect of the sector’s leading companies with solid technology infrastructure such as Tencent and Alibaba. While their core revenue may come from games or e-commerce, contributions from other sources of income are rising quickly. These tech giants have already become platforms in the tech ecosystem and have invested in many small tech companies, so their potential is huge. The ultimate question remains whether they are worth 40 times valuation. In a bull market, these companies could definitely reach that level, and after the stock slump in 2018, we think their share prices are now in a reasonable range.

Hardware manufacturers will face some difficult headwinds in 2019. With the high penetration rate of the mobile phone, the length of time for which consumers hang on to their phones continues to increase. This will lead to two problems: one is that phone manufacturers will press parts suppliers’ margins, second is that winner takes all, and thus the bargaining power of top names such as Huawei will be even stronger. The sector will unlikely find new opportunities unless the innovation of the mobile phone industry chain accelerates. However, we do think the software industry may have some growth opportunities, given that U.S.-China trade tensions have pushed many Chinese companies to turn to purchasing domestic software, such as cloud services.

Education:

The sector was significantly hit by the government’s tightened policies on private kindergartens in the second half of 2018. The core idea of the policy is that the state believes that education should be equal. It is feared that the rise of private kindergarten will give the public an impression that if you don’t have money, you can’t go to a kindergarten. However, the fact is that China is relatively short of education resources. If the private sector is not allowed to participate, or is restricted on making money from their operations, no one will open a kindergarten. Eventually, we think such policies will be adjusted in 2019. Meanwhile, we are positive on college operators, as they are not affected by recent policy changes. The existence of these colleges is a way to help the country solve its employment issue, allowing students to postpone job-hunting four years later. These operators’ cash flows are also very strong as the tuition fees they charge are prepaid. Also, the college education penetration rate remains low in China, so this sub-sector has a lot of potential.

Infrastructure:

The infrastructure sector is likely to perform well in 2019. Infrastructure investment is pivotal to driving the growth of the economy, thus local governments will continue to issue bonds to fund infrastructure projects in 2019. The sector’s valuation looks reasonable at present. Going forward, we will see an increase of local railway and municipal infrastructure projects in the near future.

Japan Outlook with Taeko Setaishi (Fund Manager)

Many investors, both overseas and domestic, have become confused about where the economy is going and what will happen to the major world stock markets.

Perhaps we should reiterate some basic facts. Most Japanese companies are in excellent financial shape and have lots of cash, positive free cash flow, and above all, have been experiencing improving profit margins and rising earnings.

Many women have been returning to the work force and many men have continued to continue to work even after their official retirement age. The unemployment rate is now around 2.5% and there is a shortage of skilled workers. Car sales are now flat to slightly higher and housing sales slightly lower. There is very low inflation and in December consumer prices were up only 0.9%. Wages are rising slowly and real wages are slightly positive. We expect that the government will continue to support the stock market, at least for the next few years.

Major challenges remain unchanged and include geopolitical events, slowing economic growth for many countries, hesitation by some companies to boost their capital investments, fiscal problems in coming years, low consumer confidence and low investor confidence among both local individuals and private institutional investors.
From October 2019, the consumption tax will be hiked from 8% to 10%. We would expect a splurge of buying from around August to the end of September. We would expect weakening GDP growth for the December quarter and then a slow but steady recovery from summer/ early autumn of 2020.

Despite the terrible December 2018 stock market, the overall economy will hopefully remain steady but we, like other investors, worry about what is happening in major economies including the US, China, Europe, and Asia and the possible escalation of the US/Chinese trade war.
In our opinion, the current market weakness will continue to provide long term investors with some very interesting investment opportunities in a wide range of areas from specialty store chains to semiconductor manufacturing equipment, labour saving equipment, discount hotel chains, medical equipment, and many more. Our basic investment strategy remains unchanged and we will continue to seek out well managed, fast growing companies that can hopefully grow earnings for the next several years or longer.

US Outlook with Jianling Ying (Head of Systematic Investment)

The U.S. growth outlook for 2019 is, at best, mixed. However, I would highlight that the consumer sector looks solid. For December 2018, UMICH Consumer Sentiment ticked up while CB Consumer Confidence ticked down a little but remained at a high level. Consumer spending should grow into 2019 on the back of elevated consumer confidence, from $97B in incremental individual tax cuts and increases in broad wages. Business confidence however has rolled over – the recent reads on both CEO Confidence Index and Small Business Confidence Index are down.

Bond yields and credit spreads confirm the short-term reprieve experienced by equities: 10-year yields slicing through 2.7% surely do not help to inspire a great deal of confidence. The ISM Manufacturing survey reported on January 5th, 2019 was very disappointing, with the index coming in at 54.1 for December, down from 59.3 in November. The New Orders component registered an even more dramatic drop. The trailing PE multiple of the S&P 500 has contracted by 19%, the 14th biggest decline in the last 92 years; the correlation of returns of the Big Growers spiked to 62%, a level never seen before. Utilities became the momentum leaders and the relative price-to-sales ratios of metals and mining stocks fell to an all-time low. Given investors' fears portrayed by the U.S. equity markets for the past two weeks, the downside risks and the market volatility for 2019 could be substantial. As a result, our style rotation is turning towards defensive. We favor short-term growth, earnings yield, dividend yield, short-term reversal, and low leverage while avoiding book-to-market, earnings revision, and illiquidity. Our sector rotation overweighs Health Care and Info Tech while underweights Energy and Financials. For asset allocation, we favours US treasuries and are cautious on REITs, commodities and crude oil.

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, 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.

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.

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' 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.

Jianling YING, Head of Systematic Investment

Jianling is the Head of Systematic Investment at Atalntis, who joined in 2018. As an expert in quantitative investment techniques, Jianling is responsible for leading the Systematic Macro Investment team, and for designing quantitative models and infrastructure. Prior to joining Atlantis, Jianling was, from 2011 through mid-2018 a Senior Vice President and Portfolio Manager employed by Voya Investment Management in New York. Here, among other duties, he designed and managed an S&P 500 enhanced high tracking error equity strategy with AUM of $1.2 billion. The product was awarded five stars by Morningstar. Before this, he was, from 2009 to 2011, a Senior Analyst and Portfolio Manager with Piedmont Investment Advisors LLC and was, from 2005 to 2008, a Senior Researcher with Numeric Investors LLC, a leading equity hedge fund advisor. Jianling began his career at Goldman Sachs Asset Management in New York, where he was a Research Analyst from 2000 to 2005.

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, 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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