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Silverhorn Perspective

China Big Picture: How to allocate capital amid the uncertainty

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To start with the obvious, China is experiencing a roller coaster ride on many levels. There is plenty to worry about, including the current economic slowdown largely induced by China's dynamic zero-COVID policy, stress and distress in the property market, wealth inequality, high corporate debt levels, a long-term challenge in demographic structure, geopolitical uncertainties, etc. The old adage "when it rains it pours" describes China's current state of affairs well. In this kind of environment, the tendency to fall victim to our innate "negativity bias" does not help in maintaining an objective point of view. Accordingly, sentiment towards China is depressed and equity markets are in a deep bear market. To be precise, the MSCI China Index lost ~50% since its peak in mid-February last year.

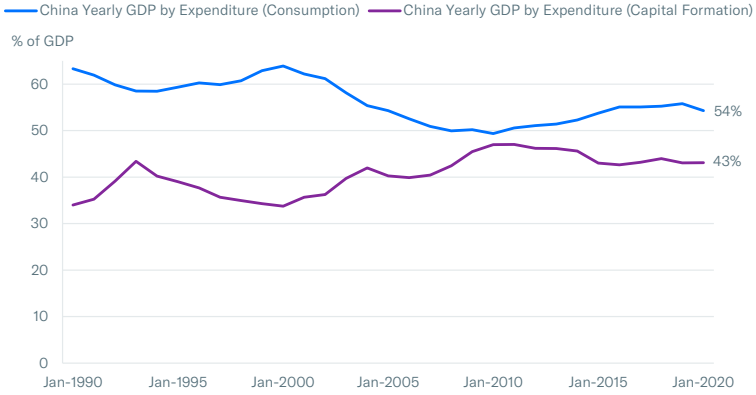
So is the sky truly falling upon China? Or is this just another temporary episode where the market is moving from manic to depressive — creating interesting opportunities in the process? In order to answer this question, let us step back and look at some relevant big picture considerations.

Big Picture

Over the past 40+ years, China's economy grew at an unprecedented scale and speed. The economy grew 60 times from USD 303bn in 1980 to USD 17.5tn today. That might create the impression that this was all a smooth ride. Nothing could be further from the truth. In the last decades, China has experienced several major political and economic/financial crises, including the Tiananmen incident in 1989, the 1998 Asian financial crisis (which was followed by a state-owned enterprise crisis and banking

crisis in which an estimated 40% of all bank loans became non-performing), and the 2008 global financial crisis. While China has continuously been reforming since the late 1970s, those deeper crises were always followed by a doubling down on reforms. In other words, China's government has an exceptionally strong track record of learning from crises, and then designing and implementing the necessary reforms. Nowadays, it is often forgotten that going through a crisis and a subsequent cleansing process is a healthy exercise. This is why we believe that the ongoing property sector deflation and restructuring — while very painful in the short-term — is a necessary process that will lead to more sustainable and equitable growth in the long run.

China yearly GDP by expenditure: consumption vs capital formation as a % of GDP



Source: Bloomberg

Through 1990-2020, China's average gross capital formation was 41% of its GDP and average consumption was 56% of its GDP. To compare, according to the World Bank, capital formation and consumption are at 22% and 55% for the European Union, 21% and 66% for North America, and 23% and 60% for OECD members.

The biggest and most important challenge for China is the transition from its current investment-led economic development model to a more consumer-oriented one. Many of the previously mentioned challenges, such as high corporate debt levels or the property market crisis, are a direct consequence of this economic imbalance. In other words, China has been building too much for too long (gross capital formation) and has consumed too little (final consumption expenditure). This transition is absolutely critical and will not be easy. However, the government is aware of this and has announced and started to implement an entire range of reforms, of which many fall under the concept of "Common Prosperity". In very simple terms, the idea behind Common Prosperity is about making the economic pie larger (prosperity) and distributing wealth in a fairer way (common). It is also about providing equal opportunities, but not equal outcomes. In fact, many elements of Common Prosperity are akin to a "social market economy" as we would find in Germany and Northern Europe. Eventually, the goal is to create an olive-shaped income distribution, where the majority of the people are part of the middle class, which would lead to a consumer-oriented economy.

Again, this transition is by no means an easy task and the current uncertainty around Xi Jinping (his apparent concentration of power, the cult of personality, and his Leninist tendencies) do not bolster confidence in the government. However, for the time being we remain of the view that Xi Jinping has the right intentions and that he essentially requires a certain level of power to successfully restructure and reform the Chinese socioeconomic structure, as powerful entities and factions will want to protect their interests.

If we are right about Xi Jinping, we have little doubt that the government can and will successfully restructure and reform its economy. Over the last four decades, the Chinese Communist Party has developed and internalised a particular philosophy around reforms that is based on the notion "practice is the only standard for testing truths" and "crossing the river by touching the stones". The former is reflected in China's "trial and error" or "test on a small scale, evaluate, learn, and implement on a large scale" approach to reforms. The latter essentially means to reform thoughtfully, carefully, and in a

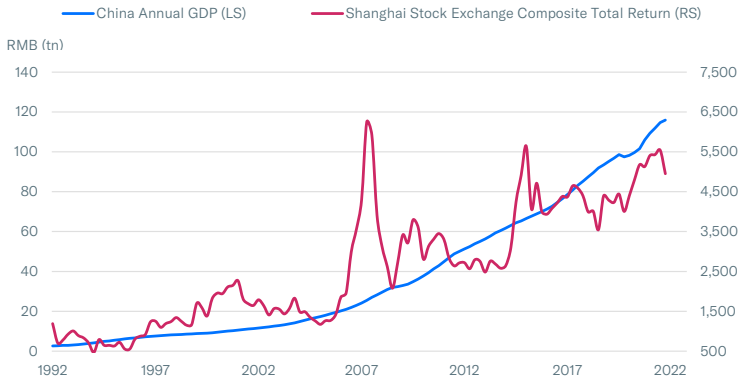
measured pace. Besides this systematic approach to reforms, China's success comes down to the pragmatic, well-educated, and technocratic government, and the highly entrepreneurial and hardworking population. In fact, it is still widely underrated how entrepreneurial and brutally competitive most sectors of the Chinese economy are today. Notwithstanding COVID, real estate issues, tighter regulations, and geopolitical uncertainties, this entrepreneurial spirit will not go away. Nor will China's 4.7 million STEM graduates, nor its top-notch infrastructure, nor its world-class industrial base. At the same time, China continues to have the fastest-growing middle class across the world[1], with another 406 million households aspiring to reach the upper middle class (i.e. an annual income of USD 7,300 to 18,250)[2].

All in all, despite the current range of challenges, the ingredients for continued long-term growth — albeit at lower levels compared to the last 40+ years — still very much exist. However, the short-term will continue to be volatile and potentially painful as uncertainty remains highly elevated, particularly around China's zero-COVID policy.

Positioning

First, it is important to reiterate that China has never been a long-only "beta" market for us. Its capital markets exhibit a range of structural inefficiencies, including restricted market access, high retail participation, limited analyst coverage, underdeveloped derivatives markets, and the presence of non-economic players. These inefficiencies create many "alpha" opportunities on a micro level, i.e. security selection and arbitrage, but also lead to massive boom-bust cycles that create trading opportunities (see graph below).

China GDP and Stock Market Development



Source: Bloomberg

Chinese equity and corporate bond markets have significantly corrected over the last couple of months, which has led to very cheap valuations — on both a relative and absolute basis. This has created a highly attractive opportunity set for selective bargain hunting. For example, we are exposed — via some of our specialist managers — to Weibo, Chindata, and Powerlong, which are three examples of companies trading at depressed valuations:

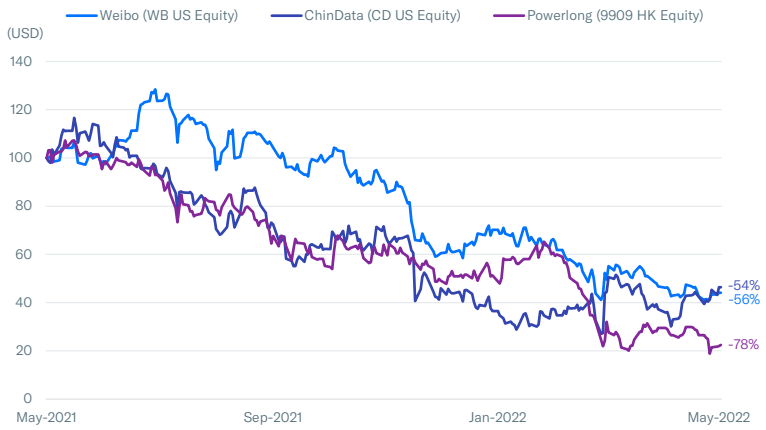
- **Weibo** is a leading Chinese social media platform with approximately 600mn monthly active users. The company has been growing its earnings steadily over the last five years at an average rate of 55%, with the most recent 1-year EPS growth at 58%. Weibo has a balance sheet with net cash of more than USD 600mn and an overall cash balance that amounts to 60% of total market cap. And yet, the company is trading at a P/E of 8.5x and a P/E excluding cash of 3.3x.

[1]CKGSB Knowledge
[2]Based on the income band classification by Pew Research Center

- **Chindata** is one of the major independent hyperscale data centre operators in China with a footprint in India and Malaysia. The company has been growing extremely fast, from essentially zero revenue in 2018 to USD 440mn in 2021. Last year Chindata broke even and its earnings are now on track to grow over 150% this year. Despite this being a high capex industry, the company carries net debt of less than USD 220mn. Nonetheless, the stock is trading at an undemanding 2022 EV/EBITDA of 8.4x.

- **Powerlong Commercial Management** is a real estate services provider that offers residential property management, office building management, and serviced apartment management. This is one of those real estate service companies (note that this is not a real estate *development* company) that is guilty by association, i.e. it was violently sold off (–80% since its peak in May 2021) merely by being part of the overall real estate complex. Over the last 4 years, the company more than doubled its revenues and increased net income from USD 20mn to USD 70mn. The company has USD 500mn in net cash, which is equal to its market cap. Moreover, the company is offering a dividend yield of 7.3%. Yet, the company trades at a 2022 P/E of only 5.7x.

Performance (1-Year) Normalised at 100 as of 17 May 2021



Source: Bloomberg

Unfortunately, this highly attractive value opportunity set remains overshadowed by some of the previously mentioned uncertainties, and most importantly by China's dynamic zero-COVID policy which continues to supress economic activity[3]. As a result, we remain relatively cautious and highly selective with regard to directional positioning ("beta") in equity and corporate bond markets. However, we keep quite a bit of cash as a "reserve" that can be deployed to build up more directional exposure as either (a) valuations become even more depressed or (b) markets start to stabilise, for example because there is more visibility around an exit path from China's COVID strategy.

But for the time being, the majority of our China allocation continues to be with "alpha" focused strategies, that have limited directionality such as long/short equity with positive but relatively low net exposure and long/short credit, or no directionality at all such as long/short equity market neutral and convertible arbitrage.

Coming back to the initial question of whether the sky is truly falling upon China or if this is just another market cycle where we go from manic to depressive, we hope through our comments it is clear that we believe in the latter. In the short term, this does not make investing in China any easier, but we take comfort in Robert Arnott's conclusion: "In investing, what is comfortable is rarely profitable."

[3]The exact reasons why China continues to pursue a dynamic zero-COVID policy are unclear. However, it is obvious that the virus will not disappear and that a zero-COVID policy is not sustainable in the long run. Thus, we believe that China will have to adapt within the next few quarters as the economic pain will become too strong and the population will likely no longer accept the recurring lockdowns.

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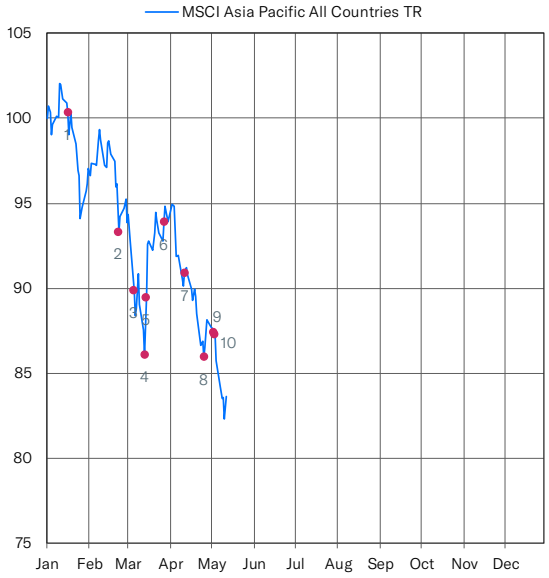
Monthly Market Dashboard

as of 13/5/2022

Major Events 2022



No.	Date	Event
1	Jan 18	People's Bank of China cuts policy rates for the first time in two years, signalling the beginning of an easing cycle.
2	Feb 24	Start of Russia's invasion over Ukraine. Equities slide and Brent touches USD 100.
3	Mar 07	EURCHF reaches parity. AUD appreciates 9% against EUR in a month.
4	Mar 15	The largest China Tech ETF in the US (KraneShares CSI China Internet Fund) wipes out nine years of gains.
5	Mar 16	China issues a 'whatever it takes' policy statement and Chinese equities soar.
6	Mar 29	5-yr and 30-yr Treasury yields invert for the first time since 2006, fueling recession fears.
7	Apr 13	JPY slumps to two-decade low against the dollar as bond yield differentials intensify.
8	Apr 27	China policymakers see strong growth headwind. Xi announces infrastructure push.
9	May 04	EU proposes gradual ban on Russian oil.
10	May 05	Fed delivers the biggest interest rate increase (50bps) since 2000 to fight inflation.

Stock Market Returns (in %)

	YTD (LC)	YTD (USD)	QTD (USD)
S&P 500	-15.1	-15.1	-11.3
Euro Stoxx 50	-12.0	-19.5	-9.3
TOPIX	-5.3	-15.7	-9.2
KOSPI	-12.4	-18.5	-9.5
CSI 300	-19.2	-24.3	-12.5
MSCI China	-23.1	-23.7	-11.8
TAIEX	-12.9	-19.1	-13.5
Sensex	-9.1	-12.5	-12.5
SET	-2.9	-6.9	-9.7
PSEi	-9.4	-11.5	-11.8
VNI	-20.9	-21.8	-22.8
KLCI	0.2	-5.0	-7.3
STI	4.2	0.8	-7.7
JCI	1.5	-1.2	-8.3
ASX 200	-2.7	-7.4	-12.4
NZX 50	-14.3	-21.7	-16.2

Bond Market Returns (in %)

	Yield (YTW)	YTD (LC)	QTD (LC)
Asia High Yield Bonds*	11.7	-14.1	-4.5
China High Yield Bonds	14.9	-22.9	-0.5
Asia IG Bonds*	3.2	-9.6	-3.4
China IG Bonds	3.5	1.5	0.8

* in USD unhedged

Exchange Rates

		Spot	YTD (%)		QTD (%)
USD Index		104.6	9.3	9.3	6.0
Gold		1812	-1.0	-1.0	-5.9
Europe	EUR/USD	1.04	-8.4	-8.4	-5.7
Australia	AUD/USD	0.69	-4.4	-4.4	-7.4
Japan	USD/JPY	129	12.3	12.3	5.5
South Korea	USD/KRW	1284	8.0	8.0	5.6
China	USD/CNY	6.79	6.8	6.8	6.7
India	USD/INR	77.4	4.2	4.2	2.2
Singapore	USD/SGD	1.39	3.3	3.3	2.6

Sovereign Bond Returns (composites, in %)

	YTD (LC)	YTD (USD)	QTD (USD)
US	-8.8	-8.8	-3.1
Germany	-8.6	-16.4	-8.3
Japan	-1.9	-12.8	-5.5
Korea	-5.2	-12.0	-5.8
China	1.5	-5.0	-5.7
India	-1.2	-4.9	-3.3
Singapore	-3.0	-6.2	-3.4
Indonesia	-3.8	-6.5	-5.2
Australia	-11.8	-16.1	-11.1

Sovereign Bond Yields (10Y, in %)

Current	Low	Range (L12M)	High
2.9	1.2		3.1
0.9	-0.5		1.1
0.2	0.0		0.2
3.2	1.9		3.4
2.8	2.7		3.2
7.3	6.0		7.5
2.7	1.3		2.9
7.4	6.0		7.4
3.4	1.1		3.6

-2.0 0.0 2.0 4.0 6.0 8.0

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