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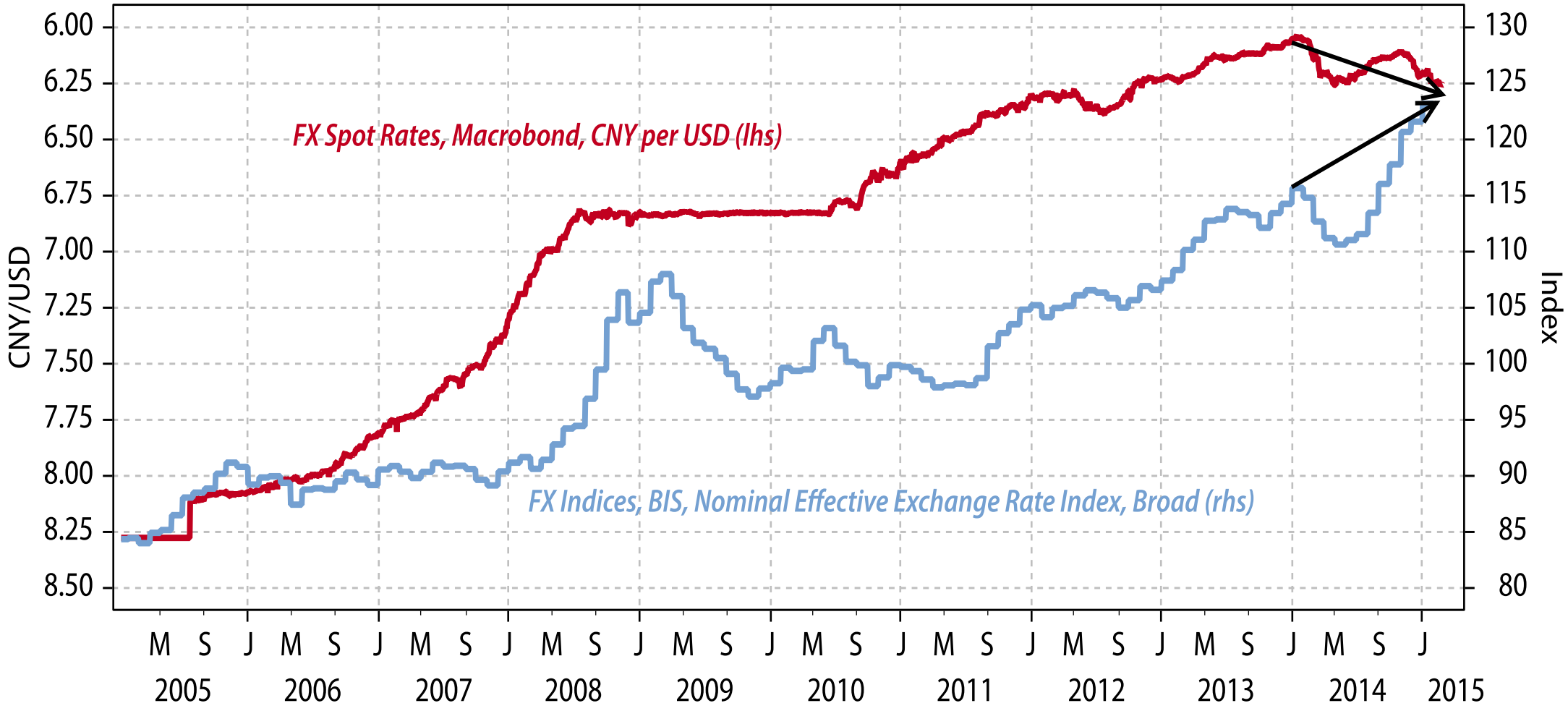
Gavekal Investor Call

March 2015

RMB: a two year low against the USD, all-time highs against everyone else

Has the RMB been weak or strong?



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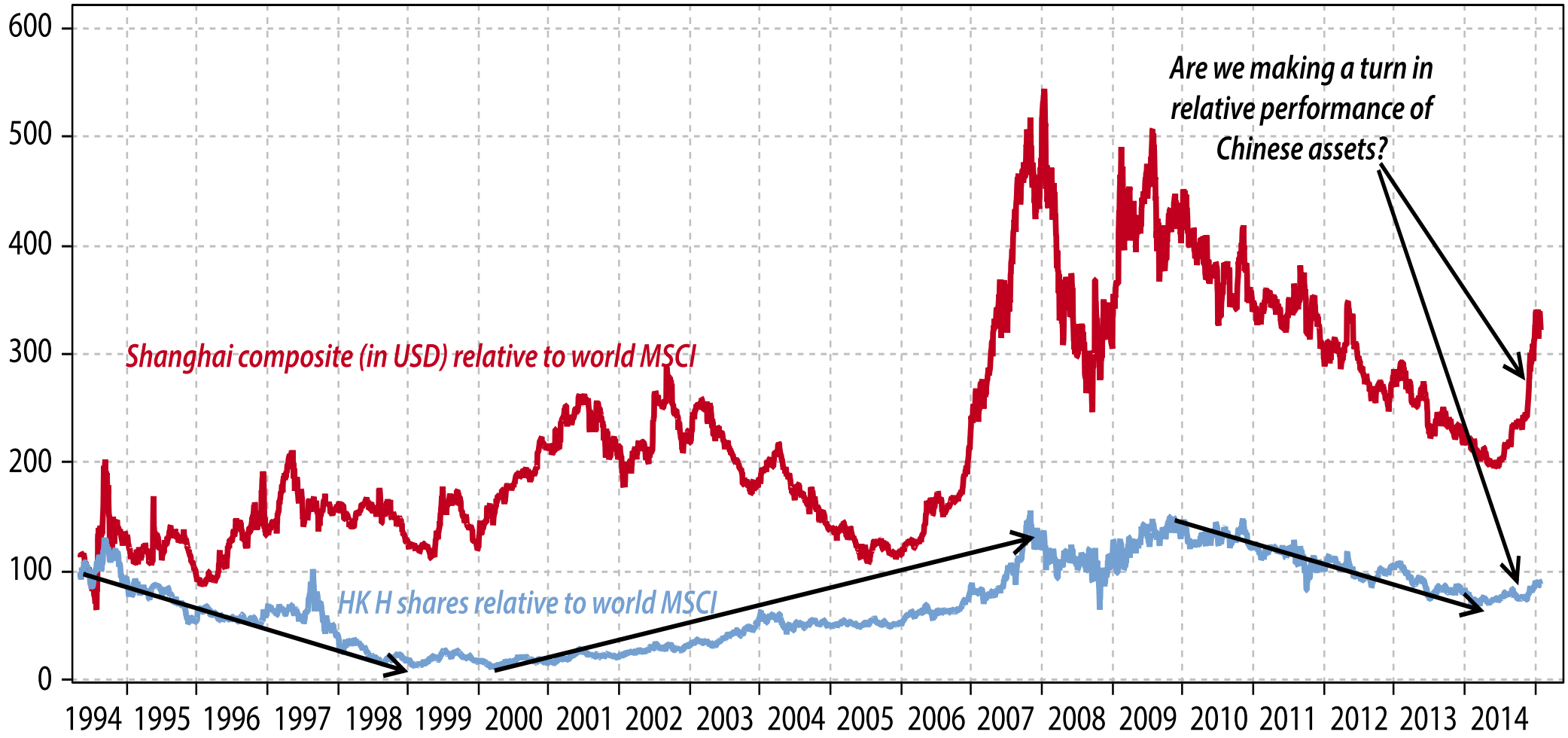
Chinese equities remain broadly unloved – but why?

Shanghai A Shares and HK H-shares relative to World MSCI since 1994



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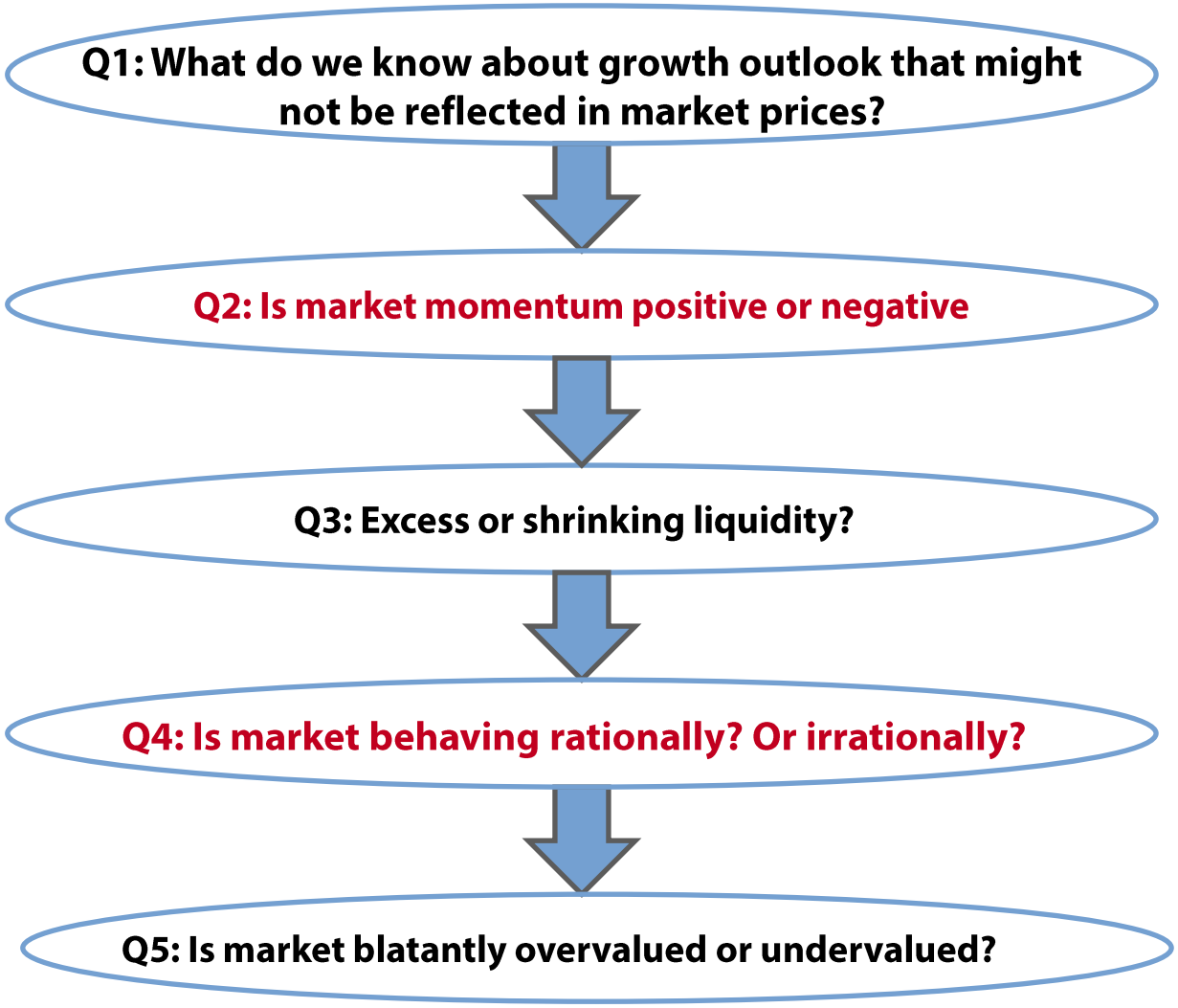
How we look at country risk



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1- China growth – Where the concerns lie?

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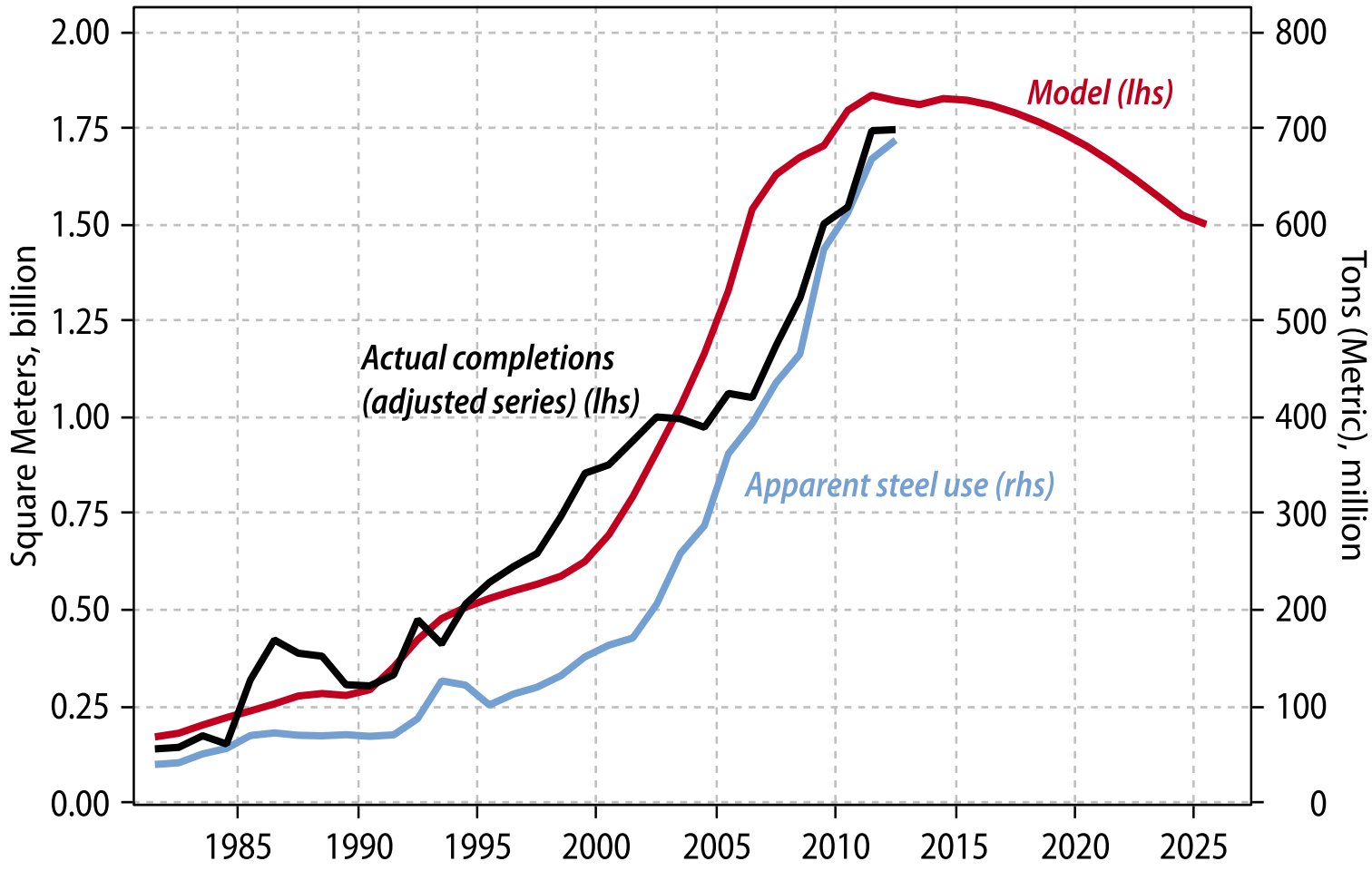
Construction volume has plateaued and will start falling

China's construction and steel demand are peaking and set to decline

Gross residential completions, actual and projected, and steel use



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China's housing market has completed its high-growth phase.

According to our models, housing demand has been hovering around its peak level since 2011. In coming years total housing demand will gradually decline, with the model projecting construction volume to fall roughly 15-20% from current levels by 2025.

This trajectory is a function of demand for housing getting more saturated: future increases in income will lead to smaller incremental gains in demand for housing.

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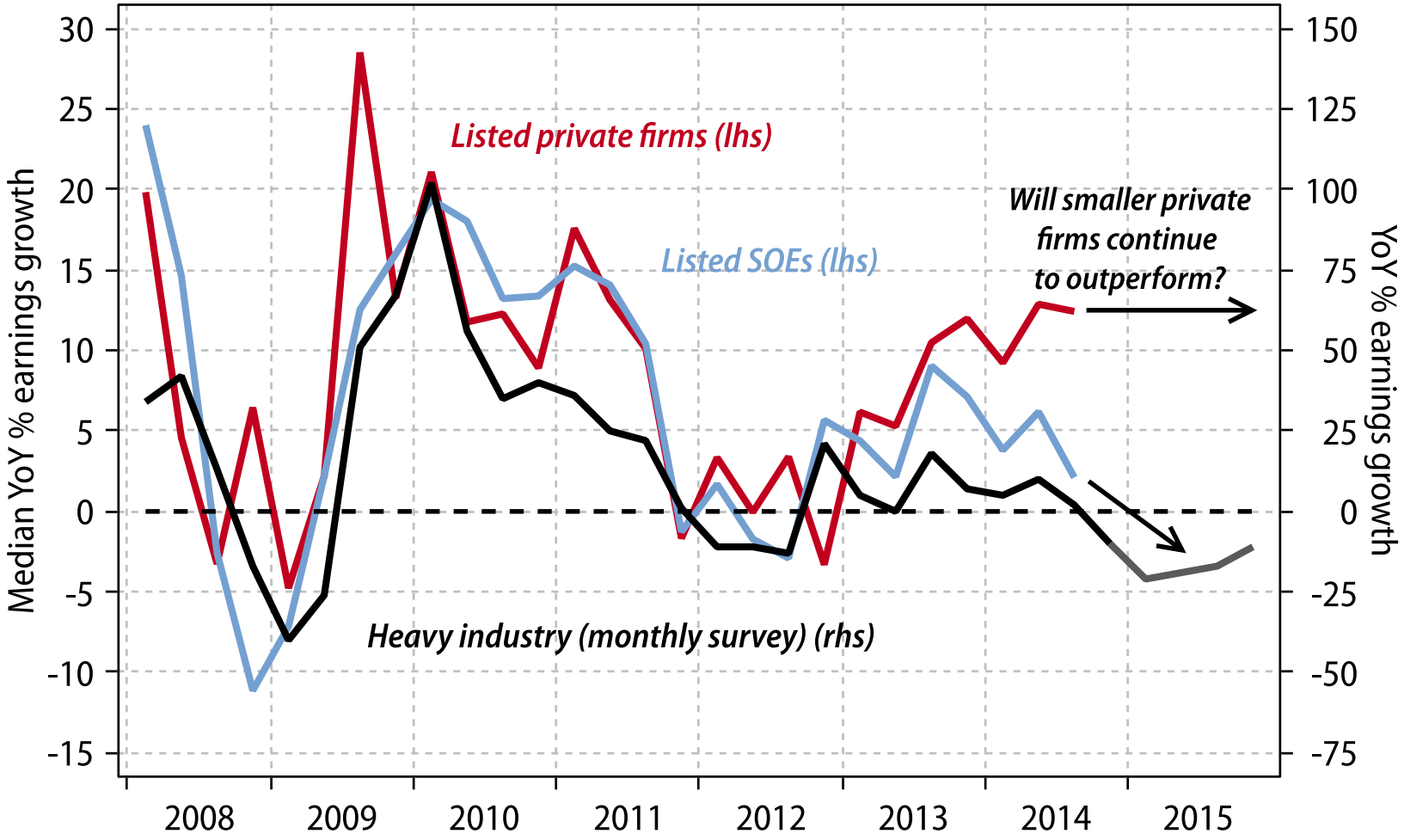
Corporate profitability is on the wane in the big SOEs

China's listed SOEs will see profits fall in 2015

Aggregate and median earnings growth, industrial survey and listed non-financial firm reporting



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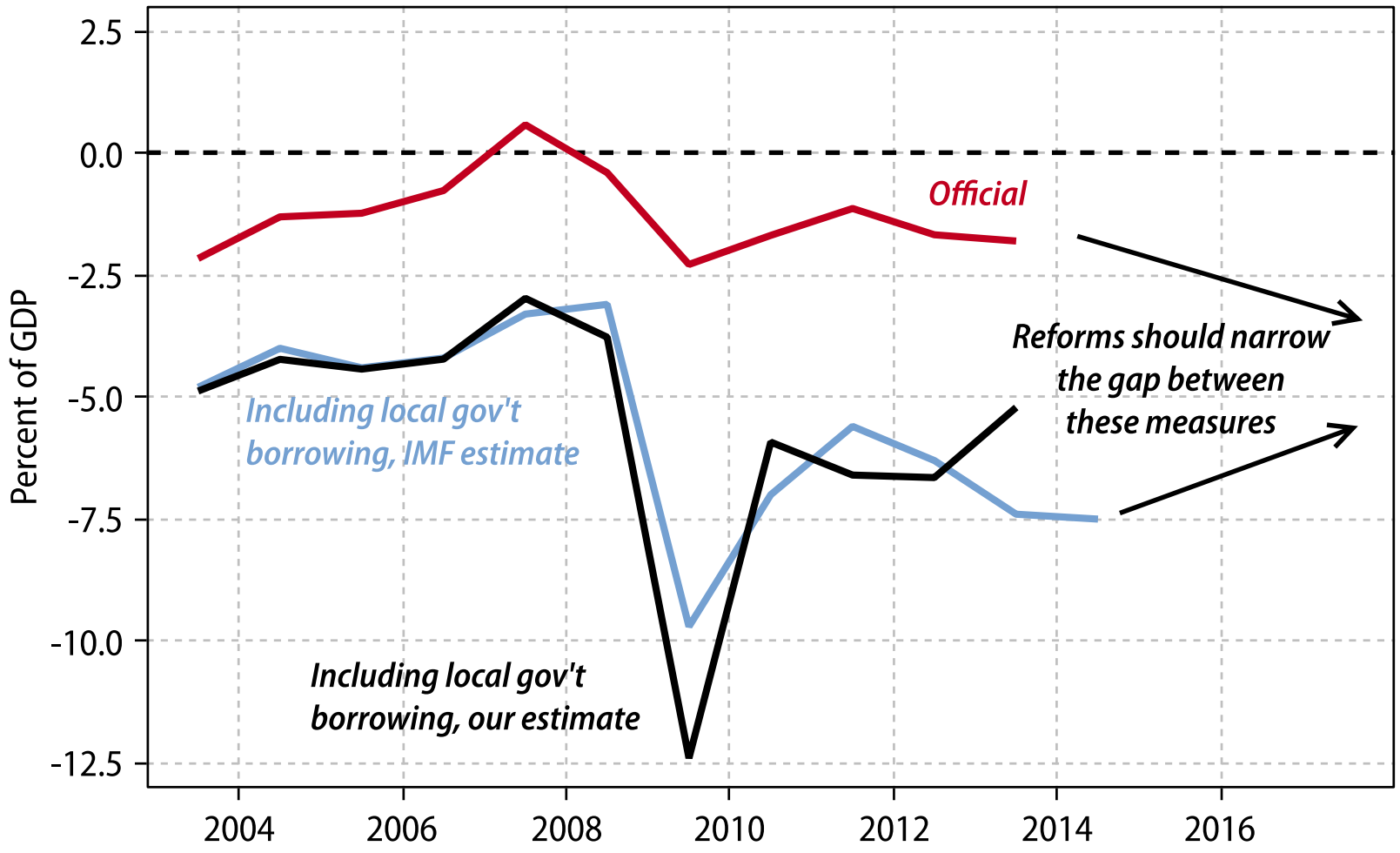
A more challenging fiscal outlook

For China's real fiscal position to get better, it will have to look worse

General government fiscal balance, official vs alternative estimates



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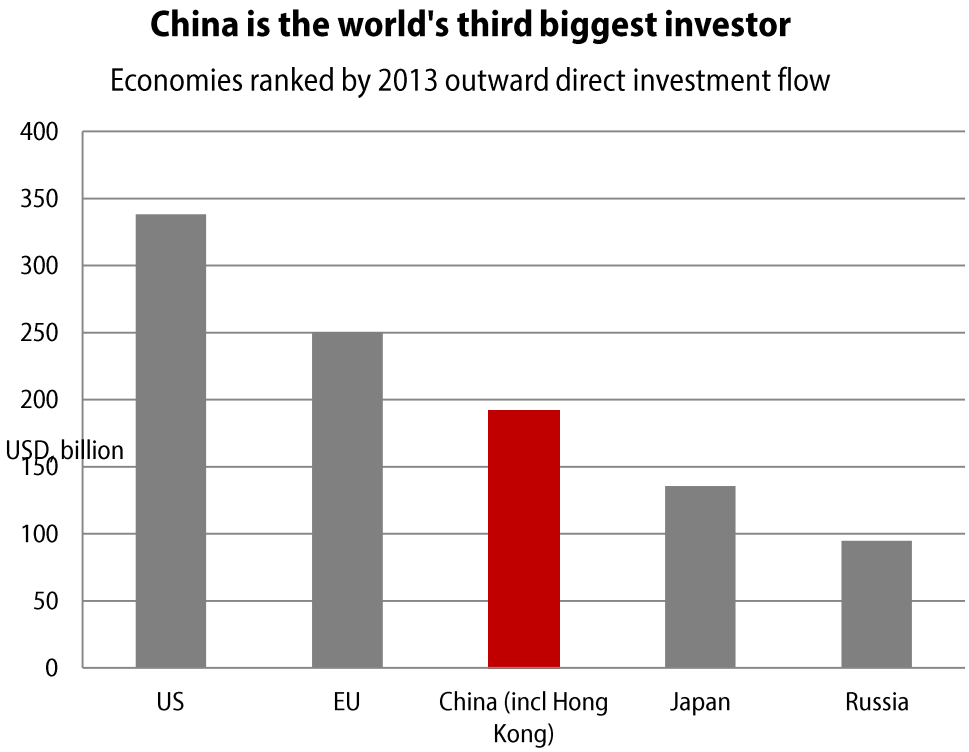
And simultaneously, strong ambitions on the international front



China estimates its companies will invest US$1.25trn abroad over the next decade. It is wooing its neighbors with big infrastructure investments, competing with Japan to become Asia's leading investor and financier.

Many investments are financed by China Development Bank and China Exim Bank, but China is keen to use multilateral banks to allay its neighbors' fears of economic over-dependence. Yet the US and Japan have blocked its attempts for greater voting rights in the World Bank and Asian Development Bank.

No longer content with its minor role in the Bretton Woods institutions and their affiliates like ADB, Beijing is working to set up alternatives. It has persuaded 20 countries to join it as founder members of the AIIB, which is widely seen as a competitor to the ADB. The New Development Bank, sponsored by the BRICS countries, will also be headquartered in Shanghai.

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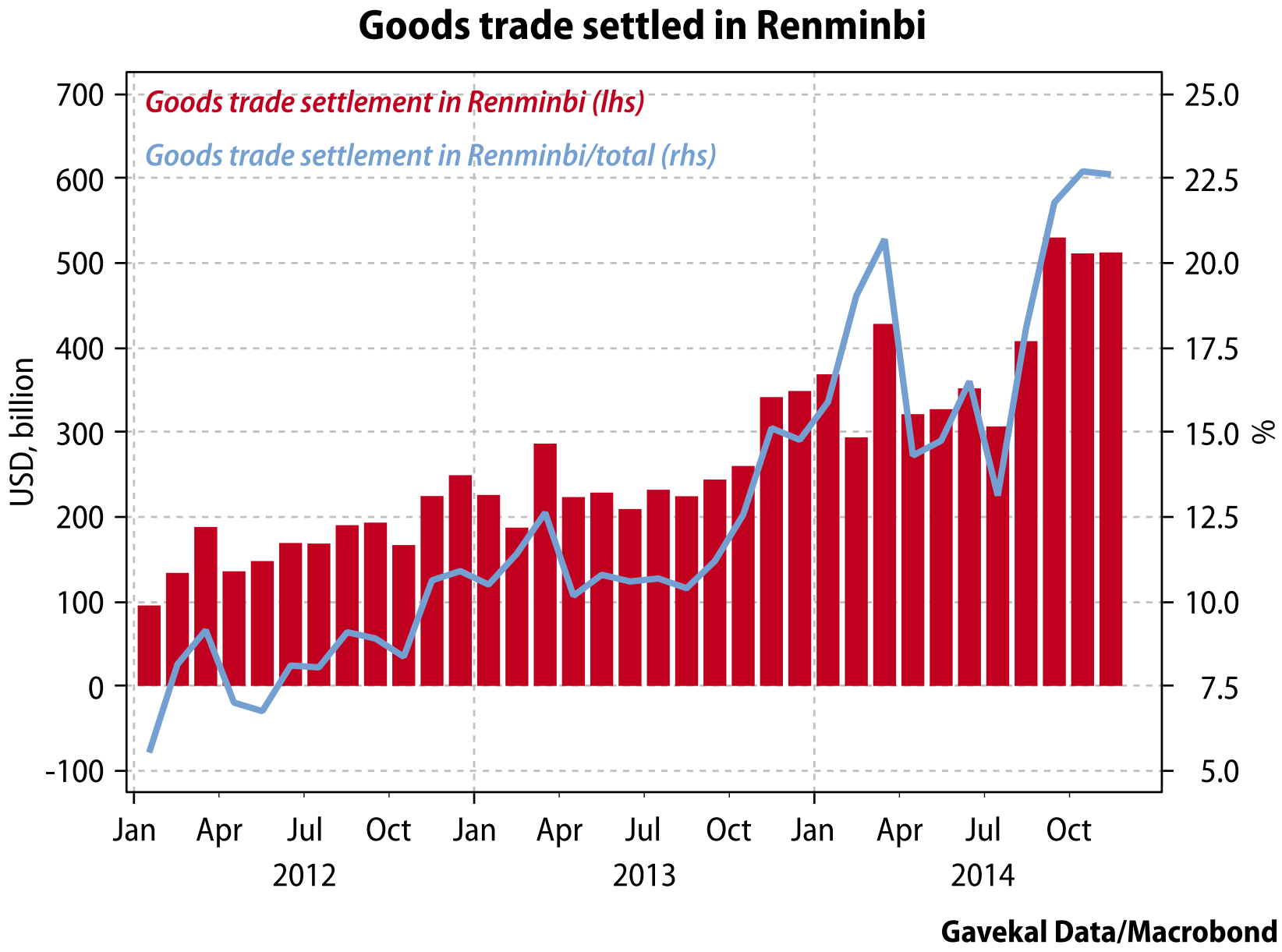
The RMB is fast becoming a trading currency (now fifth largest in world)



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We could go on but the known positive & negatives look like this

Negatives for growth

- Anti-corruption drive
- Real estate overhang
- Falling profitability at SOEs
- Excess debt at local authority levels
- Demographic roll-over
- Tensions with neighbors
- Slower structural GDP growth

Positives for growth

- Banks have been re-capped
- Central bank easing
- Lower commodity prices
- Continued pace of financial reform
- Optimization of past infrastructure spending
- Dramatic improvement in quality of labor force
- China increasingly becoming the economic and financial center of Asia

Are we moving towards an environment of much lower growth, but much reduced capital waste (less large white elephant infra spending, less corruption, less debt build-up…) at the same time? And if so, is that positive or negative for the return on Chinese equities? And the RMB?

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2- The solid momentum of the market has taken most investors by surprise?

For all the bad debt talk, banks are performing in line with the market

Chinese banks relative to Shanghai Market

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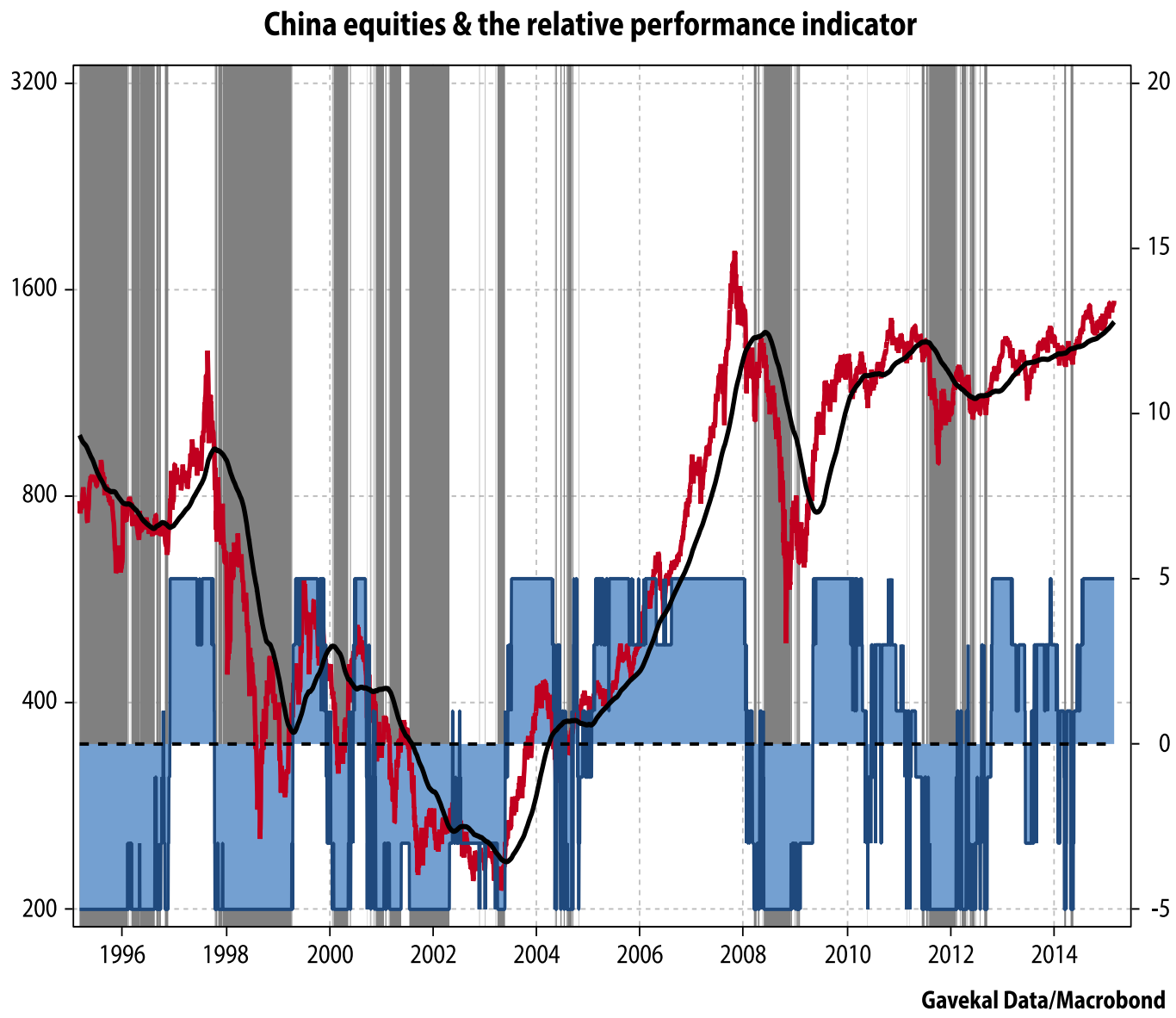
Momentum Analysis – the trend is your friend



Because there are few large, domestic, institutional investors, in most Asian markets, the marginal buyer is either a) foreign investors or b) the retail investors. Unfortunately, these two sets of investors tend to do the same thing at the same time, namely chase (and hereby amplify) momentum.

If we put ourselves in the shoes of a domestic retail investors, then that investors will typically have the following investment opportunities: a) cash, b) local bonds, c) international bonds, d) gold, e) international equities, f) local equities.

When local equities outperform the other five asset classes, then local equities are more likely to see fund flows from both domestic, and international investors.

The reverse is also true: when local equities underperform all five, then we should assume that outflows will amplify. At least until stocks become very undervalued.

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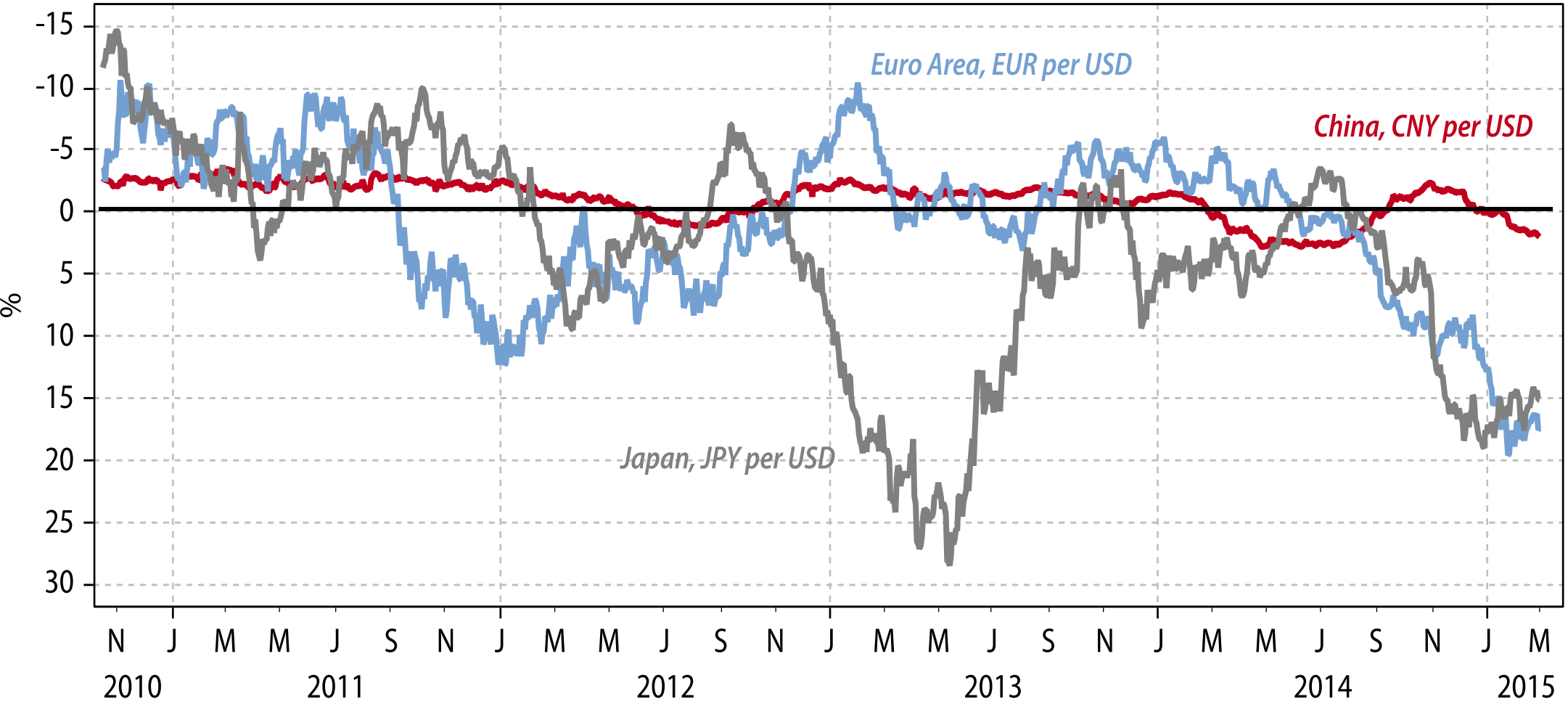
Compared to any currency, the RMB has been amazingly stable

6 Month % Changes in Euro, JPY and CNY vs the USD



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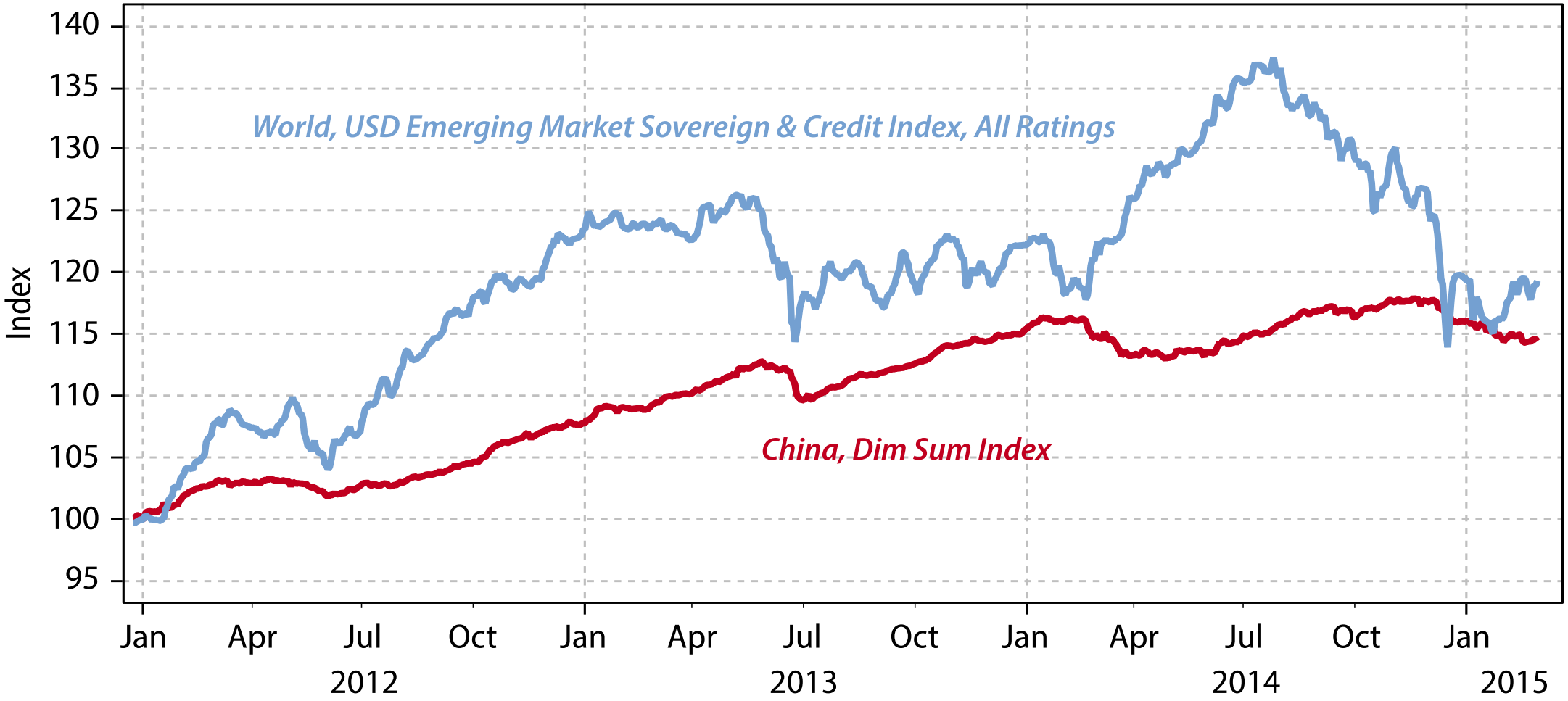
And Chinese bonds remain a good volatility dampener for portfolios

Chinese bonds have performed in line with EM bonds, with a lot less volatility



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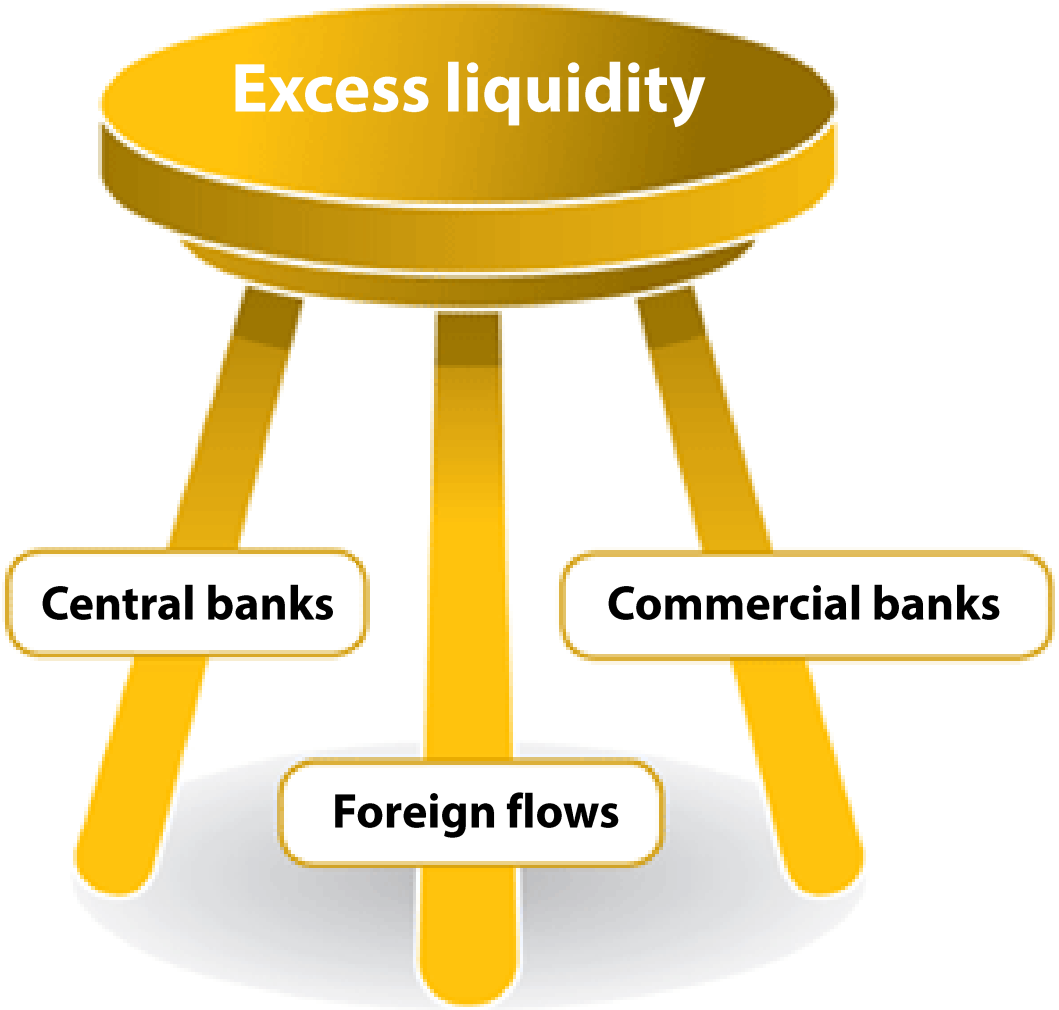
3- Liquidity growth: the end of the hangover?

Where does excess liquidity come from?



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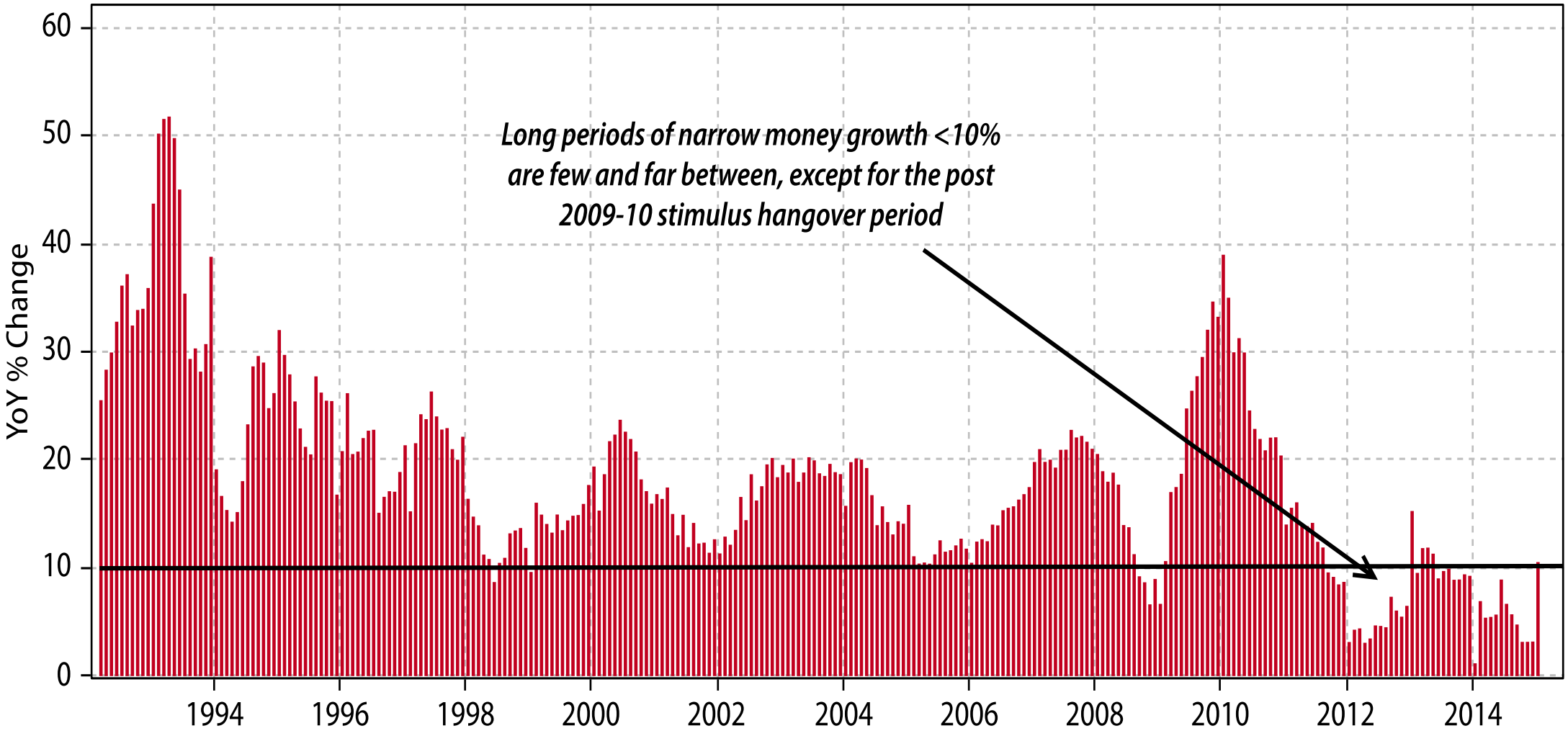
PBoC has been one of the few central banks NOT working the printing presses

China Money Supply, M1 - YoY % Change



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Falling inflation opens the door for easier monetary policies

China CPI and non-food CPI

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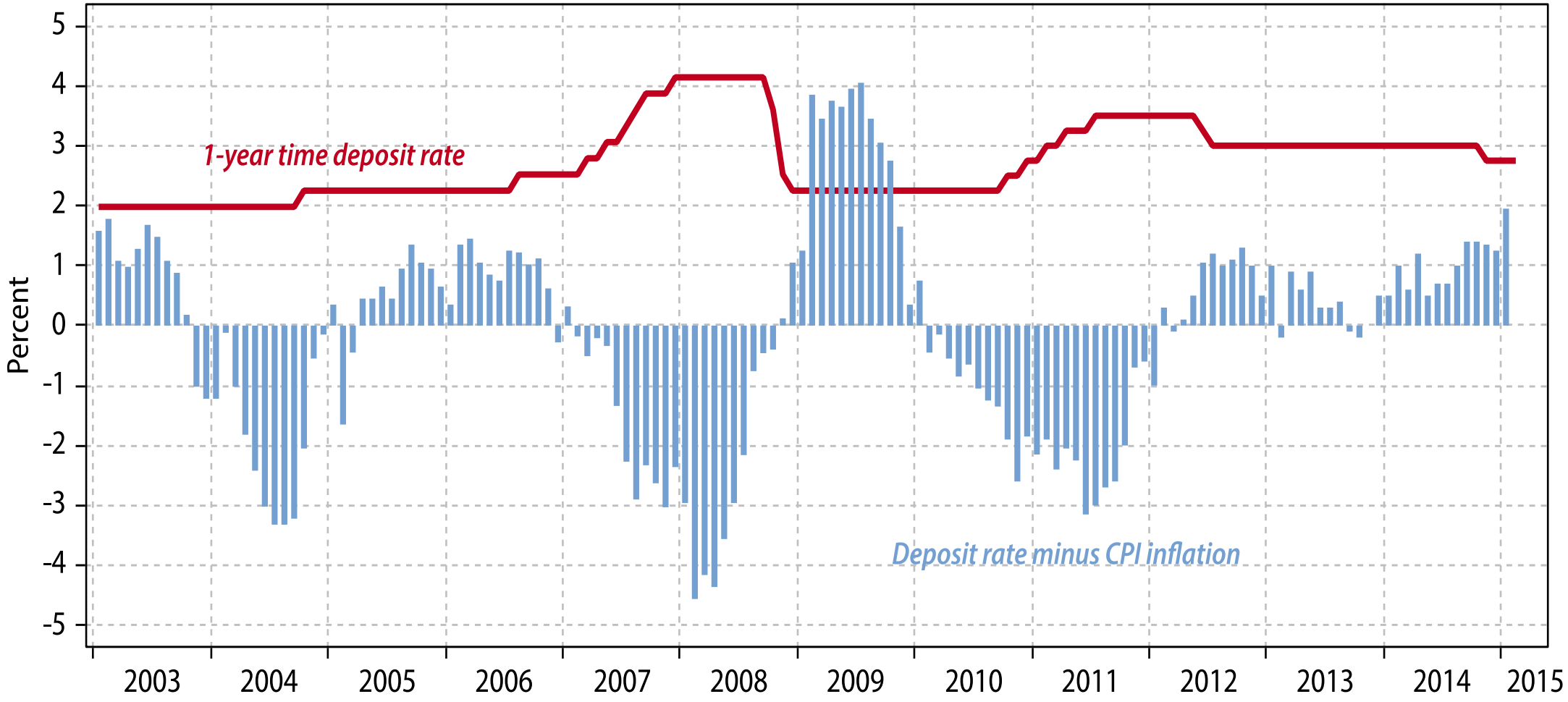
China is one of the few major economies where savers are not penalized

China's real deposit rate has been mostly positive since 2012



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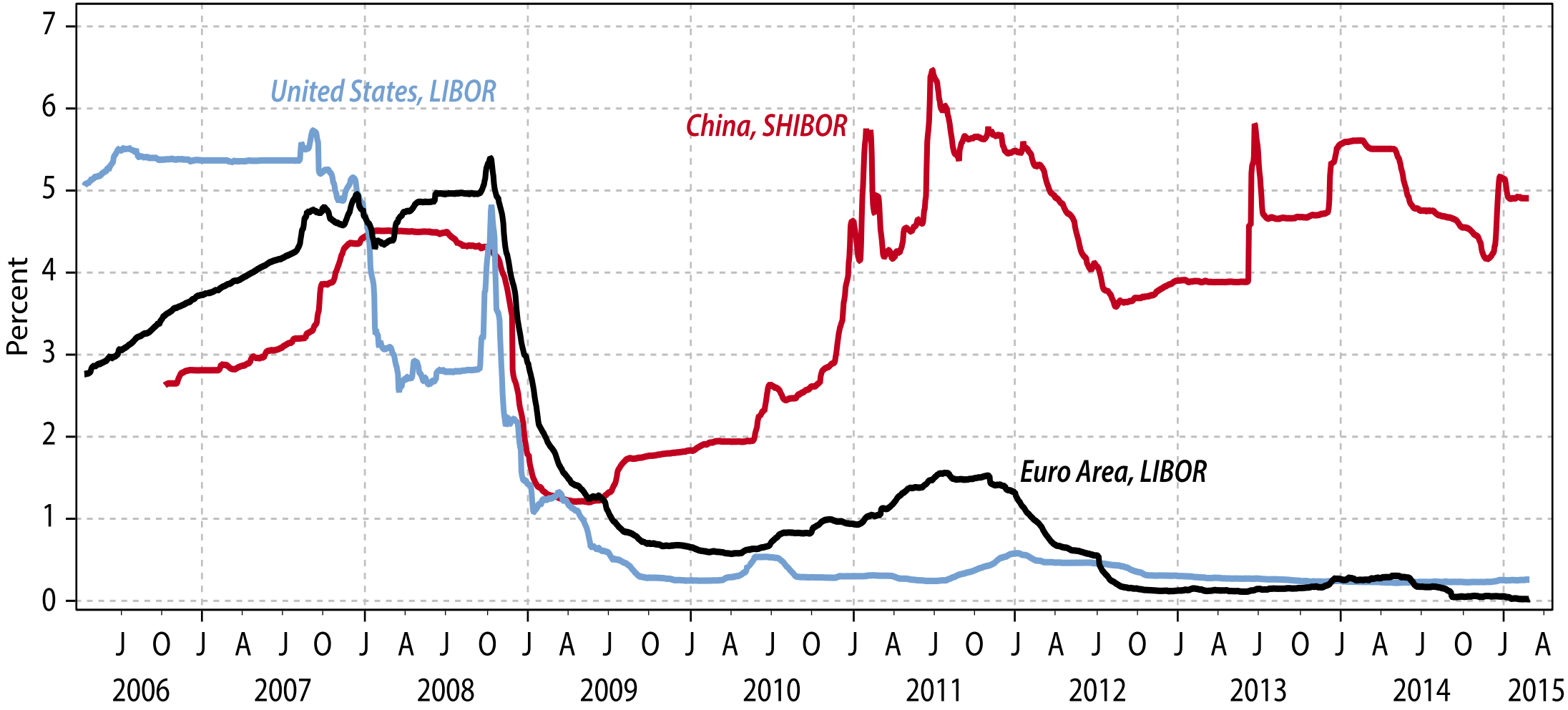
Where will we see interest rate cuts in the world in 2015?

Interbank Rates, 3 Month, Fixing



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China stands out as the major economy most likely to embrace easier policies

Japan? A further easing of monetary policy out of Japan seems unlikely now that the Kuroda-Abe relationship is reportedly more stressed (following Abe's decision to call a snap election right after the BoJ eased again).

Europe? Perhaps. Although the ECB has already announced a very large QE program and the ECB will likely want to see the impact of this initial QE program before announcing any new incremental measures?

USA? The US is now more likely to be on a tightening path.

UK? The UK is now more likely to be on a tightening path.

South Korea? Possibly – although if the Yen has stopped falling, then the pressure on the BoK will abate.

Australia? Very likely. Aussie rates are probably heading lower?

China? we are there! China is already cutting and short and long rates will likely go down from here.

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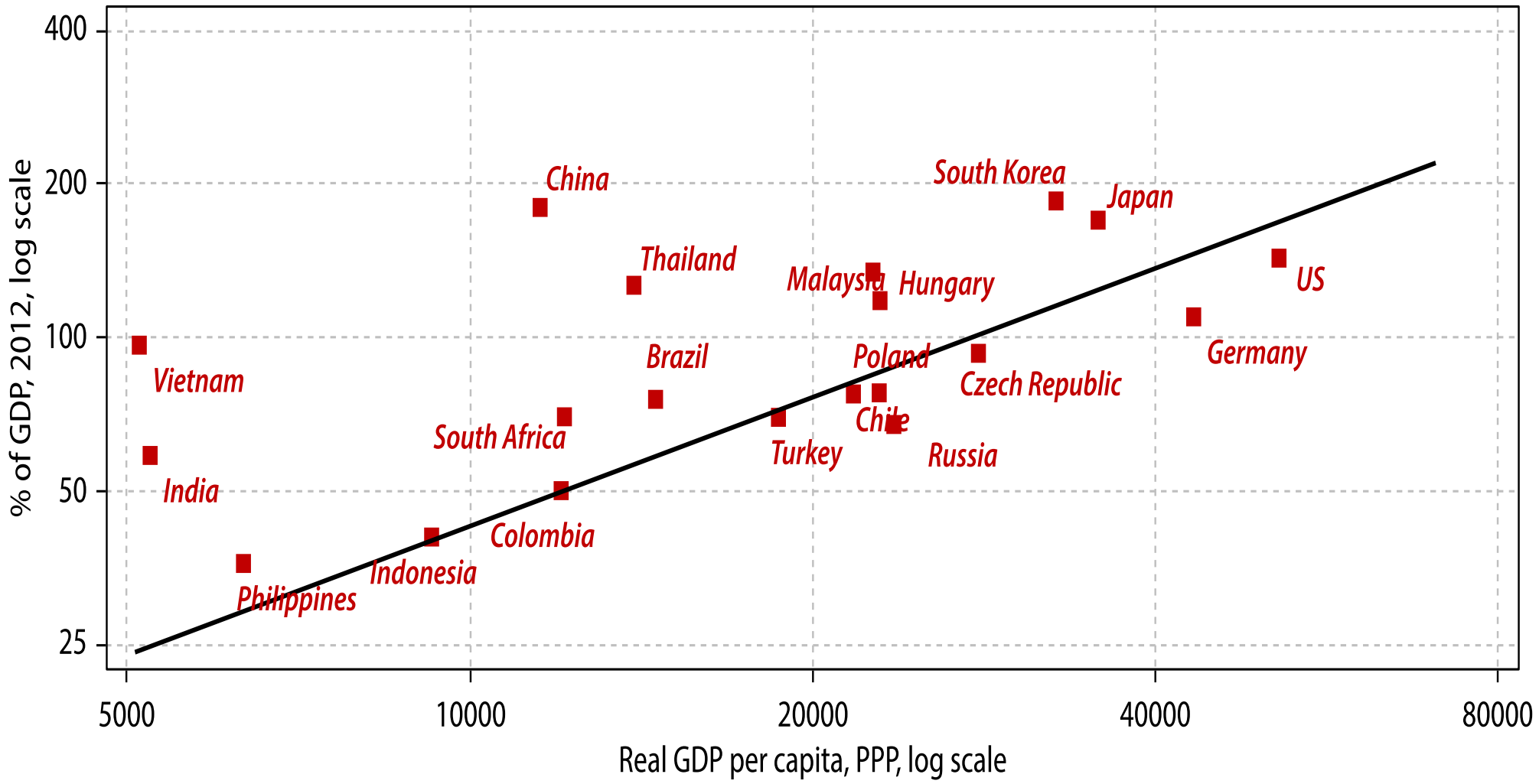
One concern: the ability to expand balance sheets may be limited

Credit to private sector from all sectors vs GDP PPP per capita



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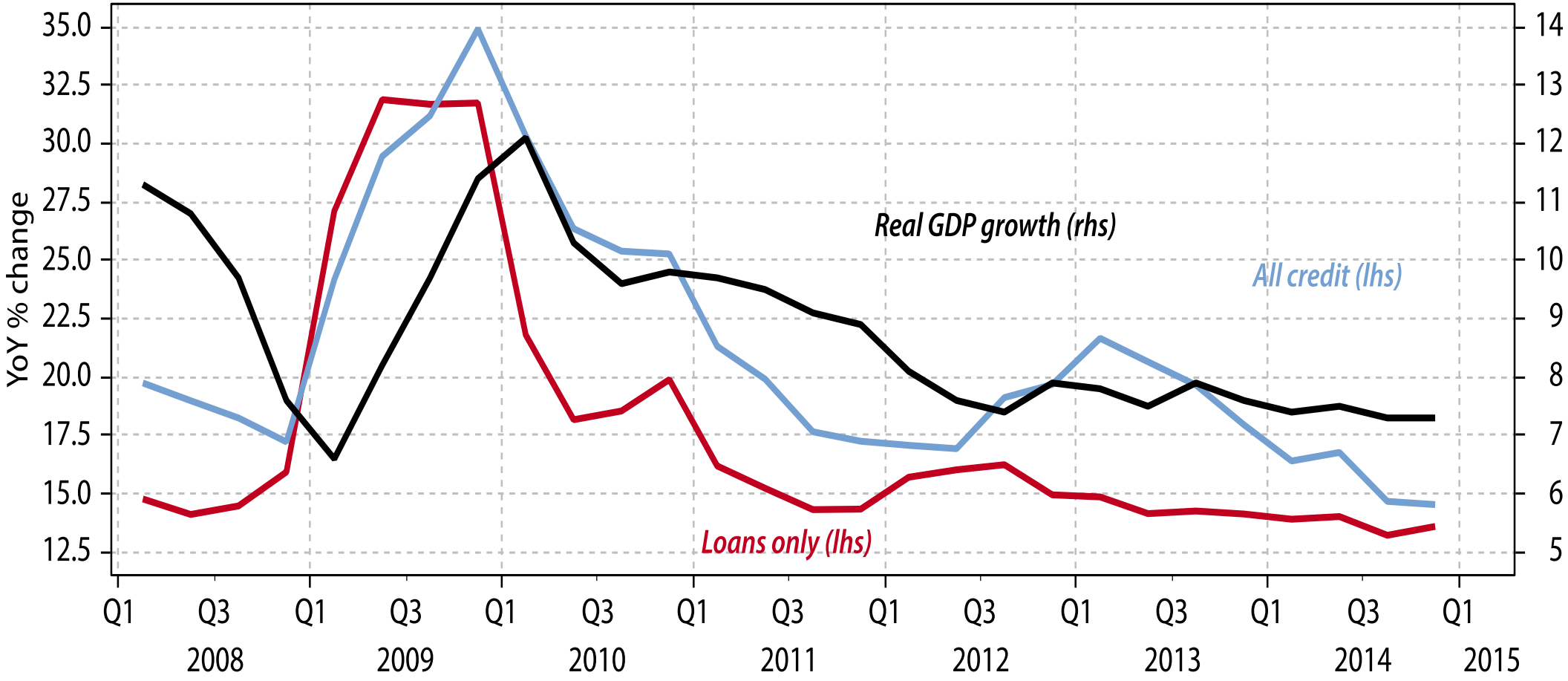
And, like in the West, it is hard to imagine a rapidly expanding credit cycle

Credit growth continued to slow down due to high base

Growth in stock of outstanding credit, by type



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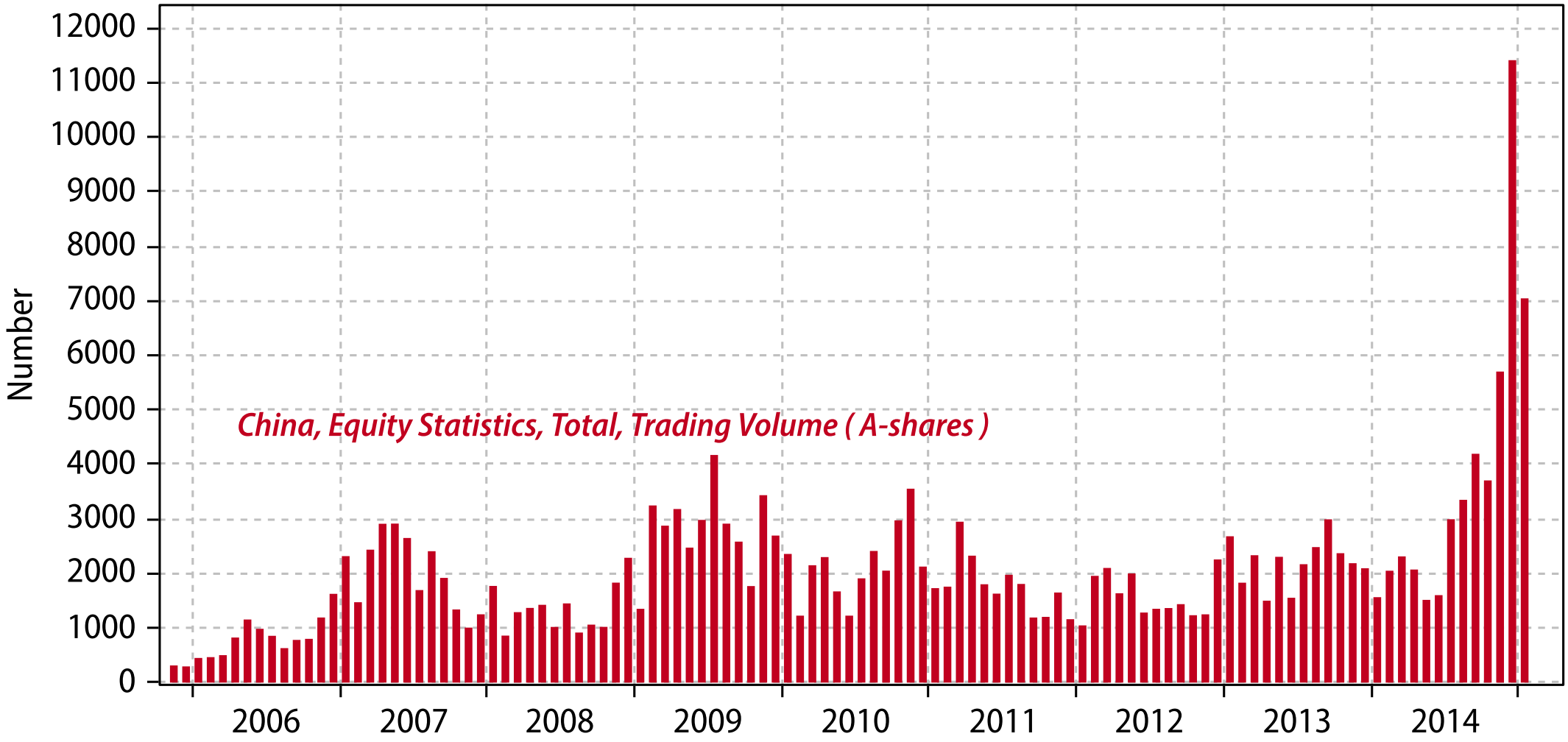
Still: how many foreign institutions have 10% of AUM invested in China?

Volumes have soared, but foreigners have yet to participate



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4- How is the market behaving?

How we look at markets: are equity markets behaving rationally, or not?

Large equity drawdowns, credit rate spikes, currency devaluations etc, are rarely due to exogenous shocks on economies. They typically come from endogenous short-dated and long-dated feed-back processes which can drive economic and financial systems far out-of-equilibrium. Unfortunately, large gains and large losses tend to belong to the same risk regime, meaning that, on a behavioral finance front, if you want to cut out the outsized losses, you need to follow rules that will also keep you out of markets for outsized gains.

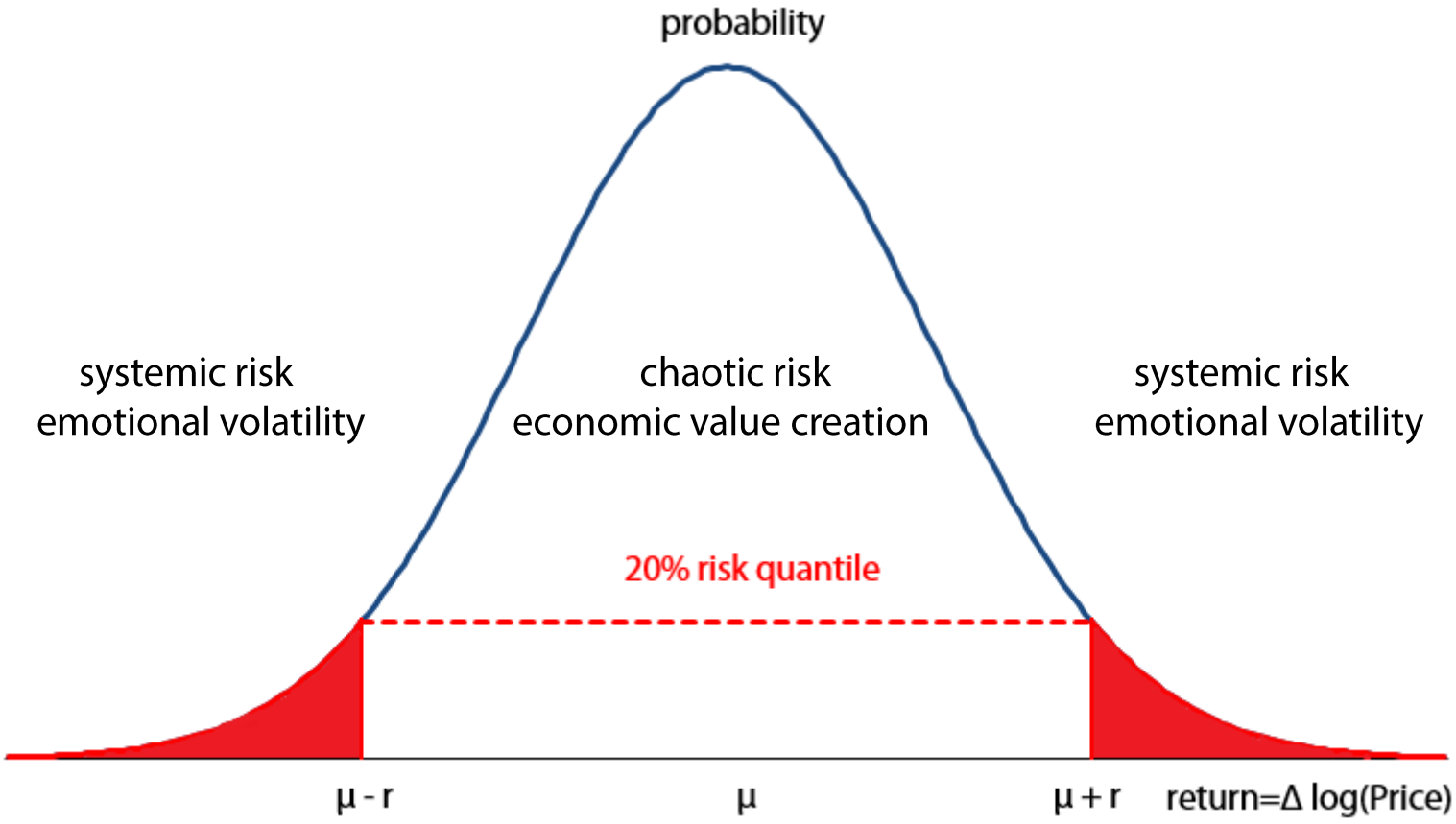

illustration: distribution of equity returns

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Anti-corruption drive remains a key theme

China corruption plays triple the benchmark performance in 2009-2011

Luxury goods exporters and HK jewelry and watch cos, equally weigthed, quarterly rebalanced

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State-Owned Enterprises are back to underperforming

The relative performance of SOE vs POE

SSE, State-owned Enterprises 100 Index / Private-owned Enterprises 50 Index

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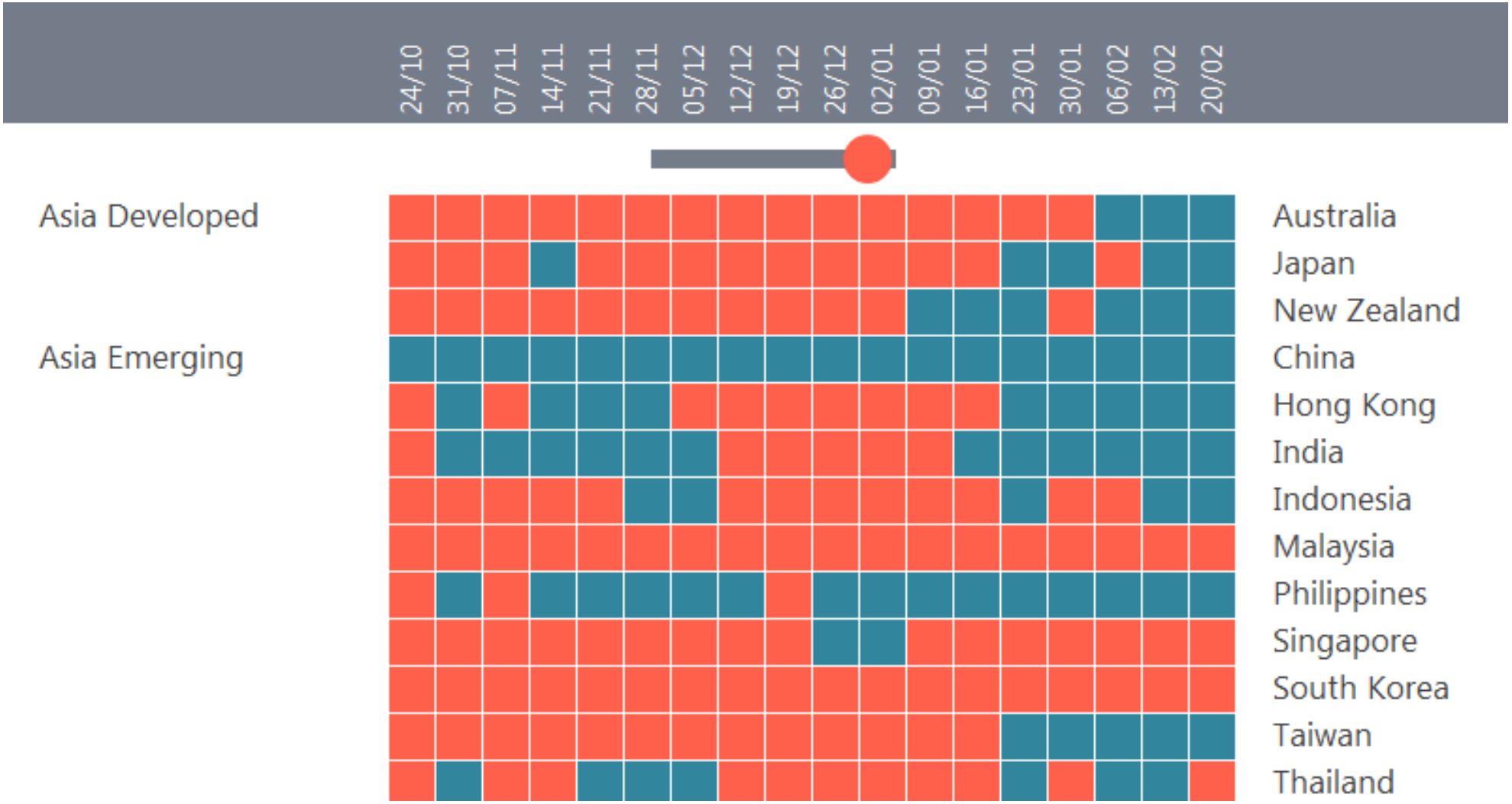
China has been separating the sheep from the goats for months



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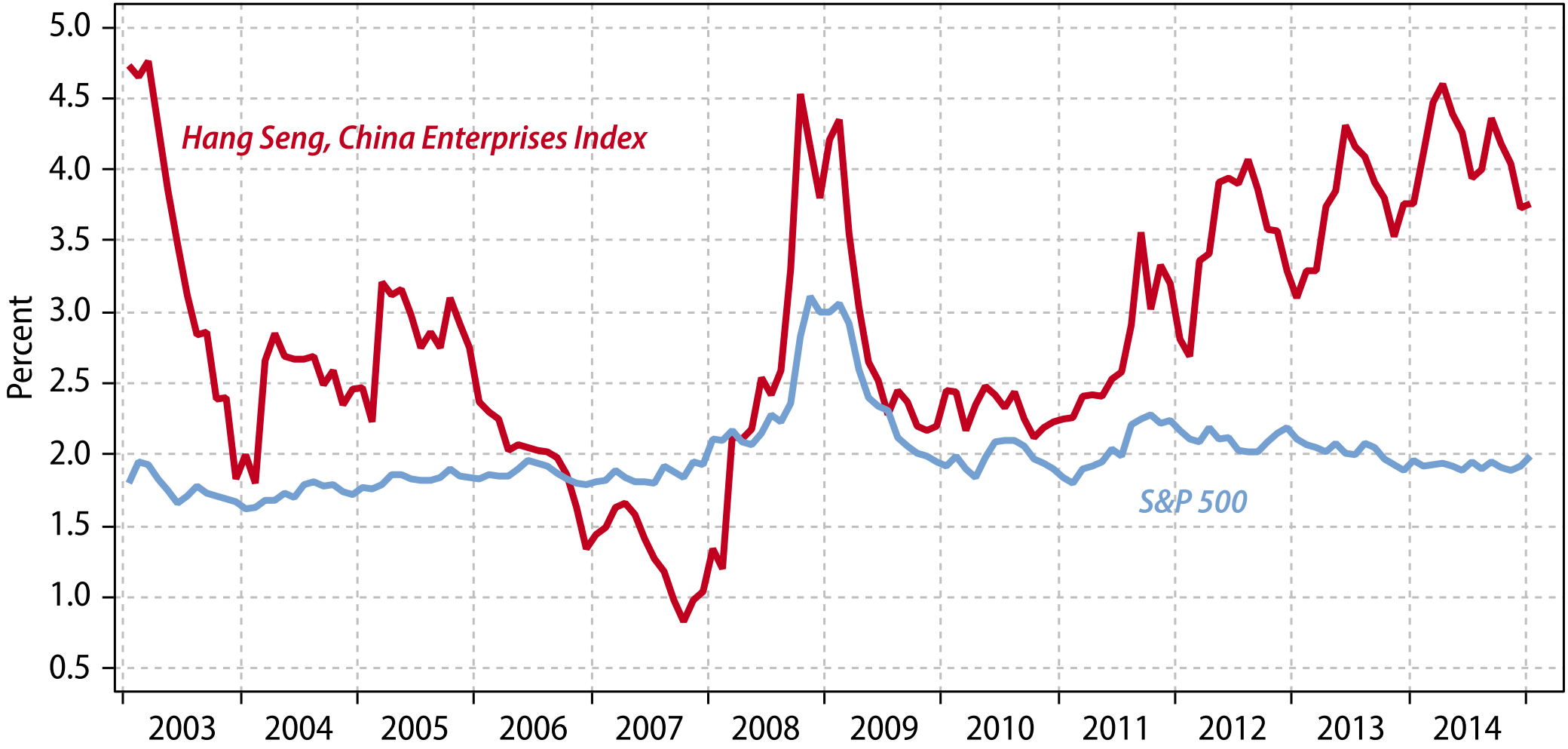
5- Valuations

H-shares today yield twice as much as US equities

Dividend Yields on S&P 500 & HSCEI



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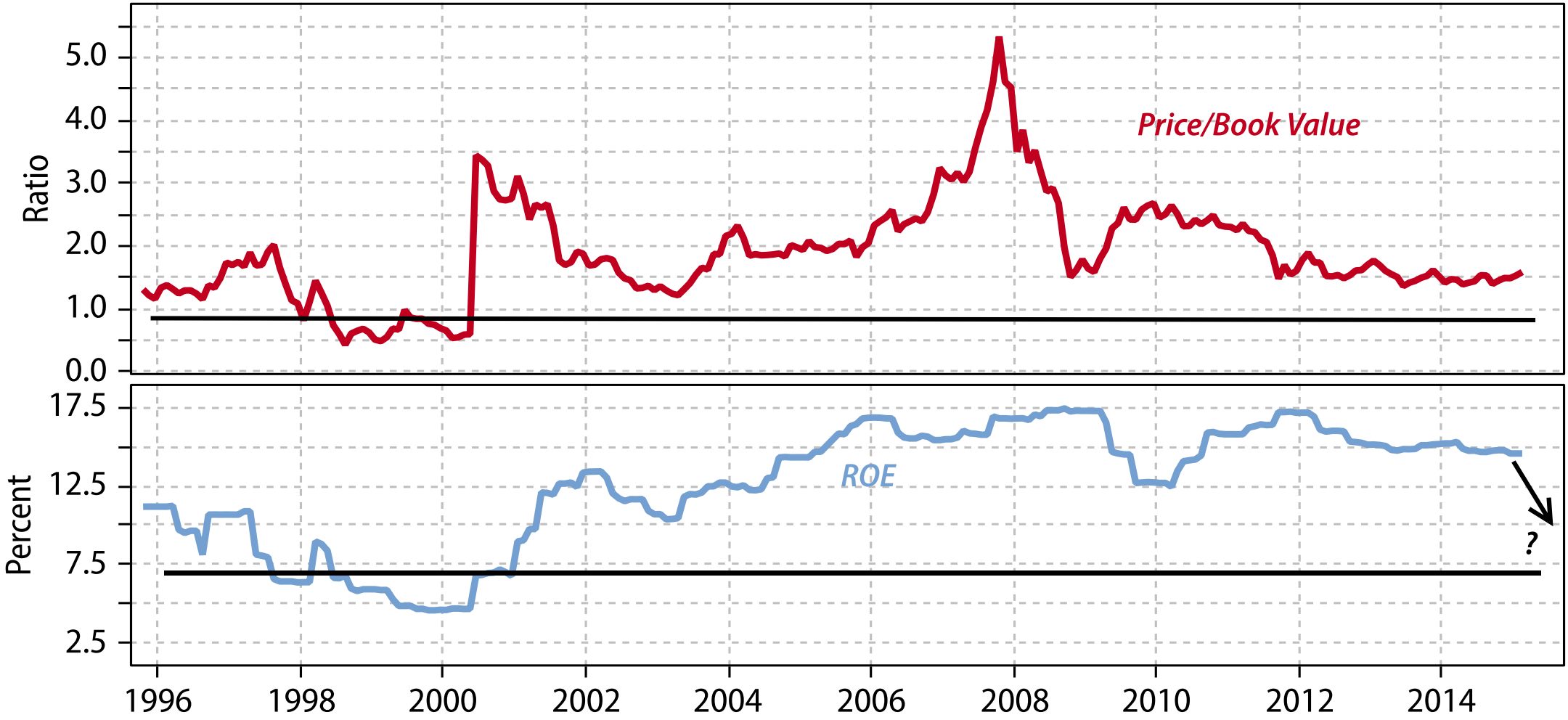
Valuations in China do not price in much good news

Current valuation of Chinese equity markets assume a collapse in ROE



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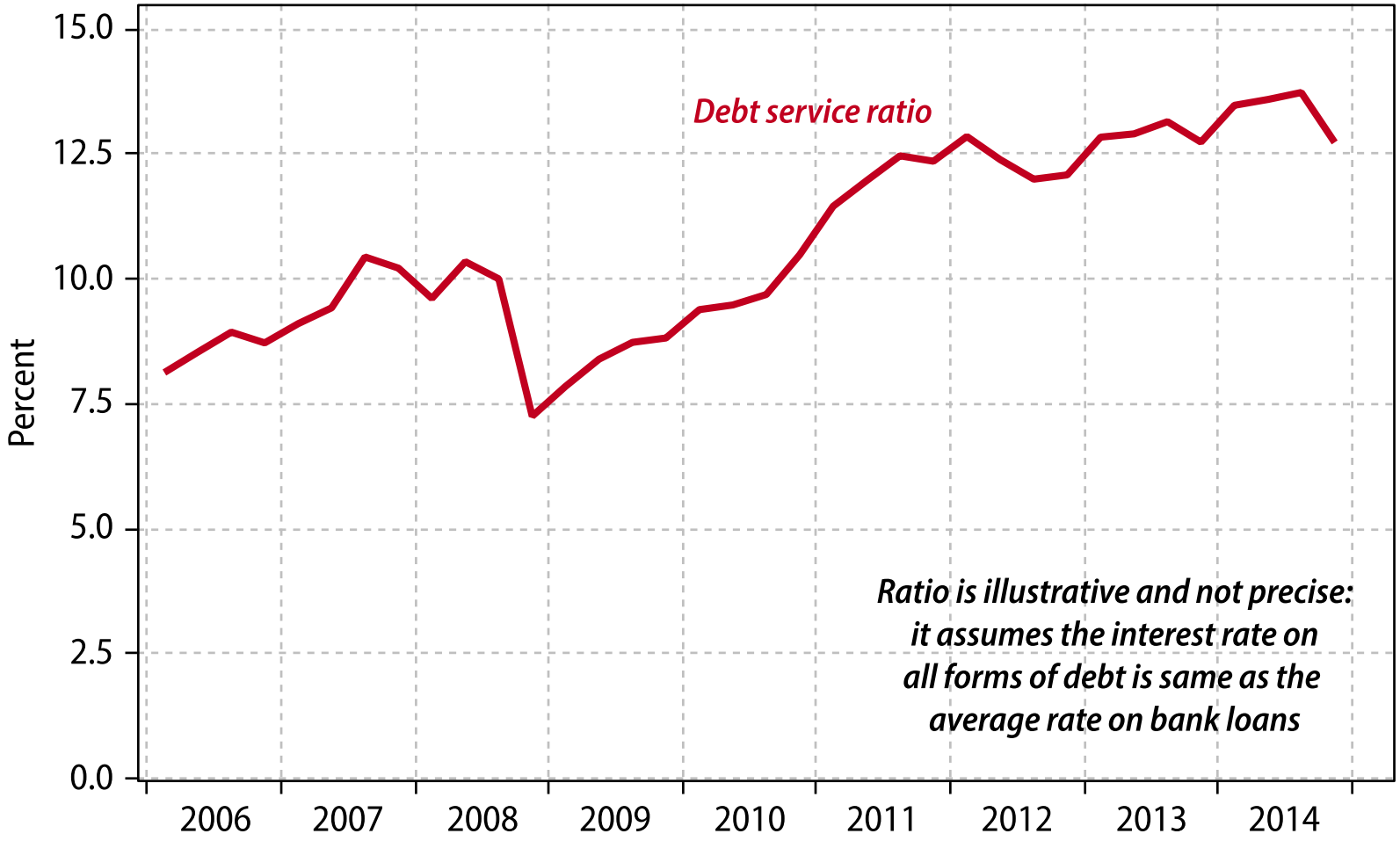
Is a collapse in RoE likely as interest rates come down?

China's debt service ratio

Debt servicing costs on total credit to the private sector, ratio to annual GDP



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Interest rates in China could easily come down 50-100bp

Spread between Chinese & US/German 10 Year Government bonds

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6- Conclusions

China will not be a negative drag on Asian markets in 2015

1. Chinese growth is slowing down, but the economy is not imploding.

2. In 2015, China may well be one of the few major economies to experience pronounced monetary easing. In other markets, monetary easing proved to be highly supportive of asset prices (if not of economic growth). Should we expect China to be any different?

3. An important question is whether China's monetary easing will have a negative impact on the RMB? We think it won't because China still maintains capital controls and the policy choices continue to place the strength of the RMB as a key goal. In fact, if needed, growth would likely be sacrificed to maintain value of RMB.

4. This makes Chinese interest rate sensitive assets particularly attractive (bonds, utilities, financials, high dividend yield plays etc…).

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The value of all investments and the income derived there from can decrease as well as increase. This may be due, in part, to exchange rate fluctuations in investments that have an exposure to currencies other than the base currency of the Funds. The value of commodity and derivative investments such as options and futures can be extremely volatile. The Funds may invest in securities of distressed companies, illiquid securities and non-publicly traded securities.

Past performance is no guide to or guarantee of future performance. Unless otherwise stated, returns are after trading costs, administration, management and incentive fees ("Net"). Persons considering investing in the Funds should read the risk disclosure in the Prospectus.

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