Atlantis 西澤

理想財富 西成東就

The View from Atlantis

2018

Message from Yang Liu, the Chairman & Chief Investment Officer

As a first-generation fund manager in China, I embarked on my investment journey at the very inception of the modern Shanghai Stock Exchange well over two decades ago, and my experience and expertise in Chinese investing also grew with the country's economy. During my 17 years in Hong Kong, my investment style has evolved and transformed from what is commonly known as "value" investing to multi-dimensional theme investing. I now focus on identifying and riding on elements such as momentum, economic cycles and capitalizing on trends.

This year, China's economy finds itself in a new era with a shift from pursuing rapid expansion to the quest for high-quality growth and development. Industrial upgrading, supply side reform, consumption, and "Green China" remain the best investment themes, and these will have a cascading effect on sectors and stocks across the economy in China and beyond. We believe that the new economy sectors such as e-commerce/technology, education, entertainment and leisure will serve as proxy for the "consumption upgrade" theme, and will be in favor for four to five years from 2018 onwards. From a bottom-up perspective, we anticipate that healthcare, insurance/financials and properties are likely to deliver particularly attractive returns in the later cyclical rotation.

Hong Kong's position as the Asian financial center will be further strengthened, bolstered by its increasing significance in the execution of the OBOR initiative. And, as with 2017, we think the Hong Kong bourse will continue to be the major hub for both Chinese and global investors looking for investment diversification. We envision Hong Kong will be key to China in becoming its own independent asset class in the near future.

We appreciate your tremendous support as always. We wish you a very prosperous 2018 and good fortune in the Year of the Dog.

劉央

Q Looking back on all you have achieved in 2017, what worked well and what lessons have you learnt?

Y Optimism prevailed on Chinese equities as the Hang Seng Index rallied through most of 2017. For the most part, equity funds targeting investment returns over a long-term investment horizon did fairly well. The best performing sectors during the year were autos, properties, financials (led by Ping An) and technology (led by Tencent). Overall, I would say the market was mainly driven by beta in 2017.

J Value worked well in the first half of 2017, then underperformed significantly in the second half as growth momentum stocks, especially in the internet space, outperformed substantially. Lesson learned: the bull market party can last longer than one may fathom. But over the longer term, sanity will prevail, and ultimately it boils down to valuation and whether the companies will be able to meet expectations.

Q Among the successful stock picks in your portfolio, can you share the story of ONE stock pick that would summarize the volatile market environment in 2017?

J We bought into PT XL Axiata towards the end of 2016 at around Rp2,500 after the stock derated from Rp4,000 levels due to the carrier facing network quality problems. We, however, believed that this would be sorted out eventually and the stock went back to Rp4,000, where we sold.

Y With the aid of Southbound inflow, the capitalization of Sunac China Holdings increased fivefold so that it is now a large-cap stock and no longer mid-cap. The outperformance of the Hong Kong market was mostly driven by investing from mainland China funds, which sent HKD300bln south, but overseas investors also invested HKD140bln.

Q What is your view on the threat of a more protectionist approach to trade policy to emerging markets earnings growth in the near-term?

J We believe the talk of erecting trade barriers is no more than hot air. It is not easy to duplicate the supply chain overnight to a totally different region. Within the next 5 years, if a shift occurs, the impact will be manageable. By then, the emerging economies would have adapted.

Q Are there any other downside risks we should watch out for?

J 1) Globally, high net worth investors have been more leveraged. The bond market is now at close to its high and yields at their lowest. If interest rates move faster than expected and as U.S. 10-year government bond yields head towards 3%, the bond bubble may burst and that would have serious implications to all asset classes including equities.

2) Emerging markets assets have been supported by accommodative policy in the West. Any sharp reversal to normalisation would be negative for emerging market assets, although EM is better positioned to weather this storm if it happens.

3) Geopolitical risks

Q What are the geopolitical risks you worry most about, and how have these risks change over the last year?

J The biggest geopolitical risk is the threat of a nuclear war. Second, would be racial/sectarian and terrorism risk which is a threat in the Middle East where substantial oil reserves sit and to a still uncertain extent may spread to Malaysia and Indonesia. And it does not help that the U.S. has publicly acknowledged Jerusalem as the capital of Israel, adding to tensions.

Performance and Trading Volume – PT XL Axiata[1]

Performance and Trading Volume – Sunac China Holdings[2]

Source: [1,2]Bloomberg as at 29 December 2017.

Q What is your view on the SOE reform in China going forward?

Y I think that the impact of SOE reform will not truly be felt until there is more clarity in terms of the specific leadership composition for each division post the 19th Party Congress. We also think indications of when the anti-corruption campaign is going to wind down will be important.

We believe that the reason for the consistent undervaluation of China's state-owned assets in the past was the lack of an incentive mechanism, leading to widespread inefficiency. Looking back, although the rate of return on these assets has historically been low, some of them are still valuable, and therefore, their revitalization has become extremely important.

At present, the total amount of state-owned assets is about RMB100tln. In our view, implementing mixed ownership through encouraging private capital participation in the SOEs, or even resuming management role in local SOEs will be the direction of SOE reform in the next 5-10 years.

The first phase of SOE reform is targeted for completion by 2020. As the quality of listed SOEs varies, we think that cost reduction will be the mostly likely reform for such companies in the next three years. As of now, the key tone of the central government has remained combating corruption for public integrity as well as cost saving. We have not seen major initiatives for improving efficiency yet.

Q What is the outlook for China's economy following the 19th Party Congress?

Y While the continued southbound capital inflow from the Mainland through the Stock Connects will remain a pillar to support the liquidity and valuation of the Hong Kong stock market, we expect international investors will also return to Hong Kong in the coming year.

These foreign investors will revalue Chinese assets on the back of the resilience embodied in China's economic recovery, the commitment and political stability demonstrated by the new generation of leaders, and the expansion of the huge base of middle-class consumers in China.

Q MSCI's announcement that it would include Chinese A-shares in its emerging markets index is another milestone in the progressive liberalization of China's capital markets. This comes at the same time as measures to allow a significant increase in the share of foreign ownership in the onshore financial sector. What are the implications of these changes for investors?

Y The internationalization of A-shares will continue full speed ahead.

First, the connectivity mechanism has provided a sustainable channel for foreign investors to buy into A-shares. Since the launch of the Stock Connects, over RMB290bln has flown through the scheme, of which 60% of the inflow has been concentrated on 20 headline names. This trend of focusing on blue chips is spurred by their relatively cheap valuation compared to global equities, in line with the consumption upgrade story and the support given to "national brands" – a definite pattern of value investing into brand-name stocks.

Second, the policy guidelines show that China's government is committed to continue opening up the country's financial markets to foreign funds and investors, and further easing the limits on foreign ownership of financial services groups. Global investment institutions such as Fidelity International, UBS Asset Management, Singapore's Temasek, and London-listed Man Group have been invited to establish wholly foreign-owned enterprises in China, and have been issued onshore Private Fund Manager (PFM) licenses.

Third, following the A-share inclusion in the MSCI in 2018, the Chinese market will become one that is impossible to ignore. This will also set the stage for China achieving the status of an independent asset class from 2018 onwards.

An Index Inclusion Factor (IIF) of 5% in 2018 for the 222 A-shares will bring US$14 billion capital inflow; considering a factor of 100%, the Chinese market will weigh as much as 40% in the MSCI Emerging Market Index.

Q Asian equities have performed well over the first ten months of 2017, returning more than 30% in US dollar terms. After such gains, do you see some moderation in the coming months?

J Yes, we definitely predict some moderation after the gains we have seen. But sector and country rotation may happen in 2018, and it could very well be the year for value investing. Our top country picks are Indonesia and Malaysia.

Q Compared with other emerging markets, is the Asian market growth theme intact?

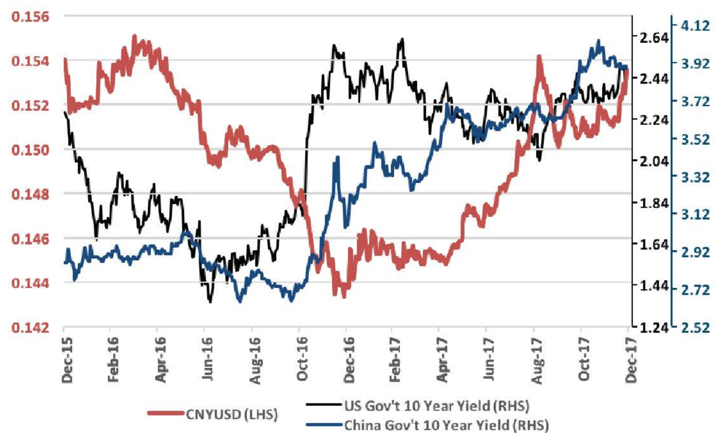
J Yes it is. We have geographical advantage as we are closer to China, India and ASEAN, and all 3 regions have embarked on wide-ranging economic reforms since the Asian financial crisis of 1997. Together they account for more than half of the world's population with a vast growing middle class.

Q While other Asian currencies have been falling in the face of rising geopolitical tensions between the U.S. and North Korea, the Chinese yuan has recovered much faster than expected this year. How do you see the US Fed's latest move to increase interest rates affecting China's monetary policy and the CNY?

Y In 2018, the country's monetary policy will be consistent with the PBoC's "twin pillar" operational framework. The first pillar is a neutral monetary policy that focuses on the overall economy with an emphasis on financial stability. Because of this, we believe that the probability of an interest rate hike is low. The second pillar is the macro-prudential policy which aims to prevent systematic financial risks. Since these two tools can complement and reinforce each other, the market interest rate should remain at a relatively high level without a hike. It is expected that the liquidity will remain tight, especially after the implementation of the RRR cut at the beginning of the year.

At present, the relations between China and the United States have evolved from their being trade allies in the past to more of a "strategic alliance" and "monetary union". From a global perspective, we think that the spread between U.S. treasury bonds and Chinese government bonds has somewhat stabilized, meaning a sharp change in the 18-year exchange rate is unlikely. Even though the USD/CNY may fluctuate in a narrow range in the foreseeable future, compared to other international currencies, we believe that the RMB will probably appreciate. This monetary environment is good for equity investment, especially for overseas investors.

CNYUSD[3]



Source: [3]Bloomberg as at 29 December 2017.

Q AI, big data and fintech are booming in Asia as investors bet on ideas that could potentially transform the way we live, including cryptocurrency markets and peer-to-peer lending, but will it prove to be another bubble?

Y We believe that application change led by AI technology is the general trend. AI can, indeed, replace low-tech, highly repetitive job functions in the next 5-10 years. Going forward, however, the advancement of AI technology also depends to a large degree on the development of its applications. There is no doubt that AI technology has great potential in improving efficiency.

One of the key attributes of blockchain is to improve efficiency by decentralization, and its future development may affect the existing centralized national organizations, such as the Federal Reserve and the other central banks. The countries are expected to step up in regulating bitcoin and other blockchain developments down the road. We think the future development of blockchain will chart diverse courses, with a range of different derived products. Its short-term impact depends largely on the penetration of the application. Therefore, we believe that blockchain will not be a mainstream investment in the next 3-5 years.

J Yes, I believe that AI, big data and fintech are here to stay. Their applications are broad and diverse. The challenge is for businesses to harness these applications to improve their productivity, lower cost and improve the marketing to reach a wider audience. Those who are able to successfully implement these will see improvements in profitability and perhaps see an expansion in their valuations.

At this point, some areas like cryptocurrency and peer-to-peer lending are unregulated. We expect regulation to tighten and this will level the playing field. This will be particularly so in the realm of cryptocurrencies where there are already fraud cases in China, Korea and Japan. There are many moving parts and no one knows for sure what and when it will happen. One thing is for sure though: the longer the party lasts, the longer and more severe the hangover.

Q What does this mean for the old-economy stocks in the traditional sectors?

J Everything has a price. Given that market valuations are not cheap due to the skewed high valuation of the tech sector, there may be a switch to old economy stocks in 2018. We are also on the lookout for companies who embrace AI, Big data and Fintech and their applications. The challenge is to successfully integrate these new technologies into their businesses to improve topline and productivity. These new technologies will also level the playing field between the smaller and larger firms. Over time, we expect that the valuation gap between the smaller and larger firms to converge.

Y Recently, the HKEx has started to encourage more "new economy"-like companies to list in Hong Kong. We believe that the market is undergoing a process of new economy injection, and there will be more listings of companies from the non-traditional industries in the future.

As China's economy shifts from high growth to mid/high growth, we are seeing a surge in consolidation activities as more industries mature, implying smaller companies with lower quality simply cannot survive and will be forced out of the game sooner or later. Leading companies are the winners of this new round of economic

cycle, as they started to integrate their internal resources while enjoying the benefits from financial advantages and the economies of scale. Given macro conditions remain largely unchanged, the size and the market share of these leading corporations have improved significantly, along with their earnings performance, often beating expectations.

Q What are the main drivers for the "big healthcare" theme of the past few years and will this theme continue?

Y The healthcare industry is an aggregation of subsectors from drug manufactures to medical services providers. Even though the entire industry is undergoing consolidation at the moment, hospitals, being the center of the supply chain, still face a lot of problems.

While the public hospital reform has been ongoing for 5-10 years, significant progress is yet to be seen, as the public hospital sector - the huge revenue generator - is reluctant to change. Most of the existing private hospitals are struggling to match the care standards offered by the public healthcare system, largely due to challenges in attracting and retaining quality doctors. Currently healthcare services consumption is highly dependent on the local government and SOEs.

We are optimistic about the prospects of the non-core derived medical subsectors, for example elderly-care, maternal and child health (MCH) centers, etc. For pharmaceuticals, with the enforcement of the new policy on efficiency and quality consistency assessments, some smaller companies will be squeezed out of the market one by one. The national policies will continue to press on quality and cost control with the result that the quality of medicine, especially essential drugs, will improve gradually in the coming years.

At present, the macro environment is favourable to the development of large enterprises in the pharma industry, but large-scale reform is still very challenging. Medical payment problems persist: even though health insurance subsidies may be provided by the government, support is limited at the moment, and therefore, the lack of implementation still poses a threat to drug price cutting.

In addition, we are also confident about the future prospects of biopharmaceuticals. Europe, the United States and China have made heavy investment in this area, despite the relatively narrow application of DNA sequencing.

Q Do you foresee any major changes in macro outlook and political shifts in 2018, and how will you position yourself?

J We don't see major changes in macro outlook. Economic growth is on track again and the Fed has indicated gradual normalisation to monetary policy.

Y Entering into a new year, we remain upbeat on global equities. The global economy is on a solid growth track, with limited downside risks in sight. The current P/E ratio of global equities (21x) is in line with long-term basic valuation and does not appear poised for a correction. However, the odds of replicating the double-digit annualized return of recent years is relatively low. We believe that this is the first year of the rerating of Chinese assets and in the next few years, they will become one of the most valuable mainstream investment asset classes in the global market.

We think that an overweight in China was not only the best investment theme for 2017, but also the best strategy in play for the next three years from 2018 onwards. We are in an era where we are witnessing a historic transformation: the liberalization of RMB assets and the internationalization of RMB bonds. There is no doubt that all this will draw more attention from global investors and will lead to a continuous revaluation of the RMB asset class.

Q What are the key market trends and top sectors for 2018?

J For Asian markets, we believe that the performance of tech stocks is not sustainable. We expect value and old economy stocks to recover given their huge underperformance in the last 2 years and cheap valuations. As we have noted, we see opportunity in the Malaysian and Indonesian markets.

Y In 2018, we highlight three investment themes for Hong Kong equities:

1) Sectors in later cycle rotation including healthcare, financials and properties, with improved fundamentals, will continue to perform for 2-3 years;

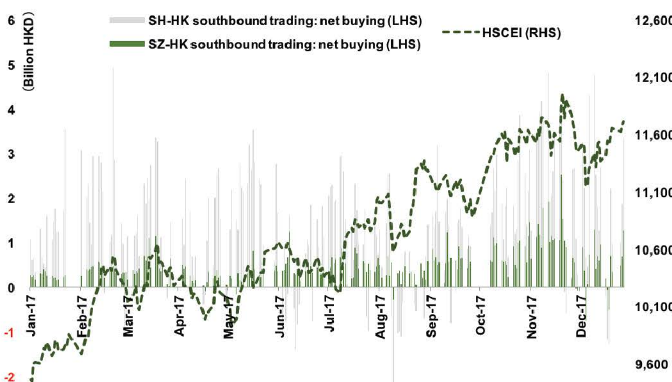
2) Technology and electronic sectors are worth investing in, as consumer electronics are still going strong;

3) "Consumption upgrade" and "high-end manufacturing" will not only be key investment themes for 2018, but will also go on to extend into the next four-to-five years. Consumption upgrade related themes look to be unquestionably the best play: for instance, auto supply chain, mobile phone manufacturing chain, home appliances, entertainment, travel, medical beauty and the derived "consumer finance" related names, such as those in installment credit and credit payment. As illustrated in the primary market, Chinese startups Didi Chuxing, Xiaomi, Meituan Dianping, Toutiao and Lu.com became global top-10 unicorns in 2017. We believe that companies focusing on "new consumption and new economy" technology and strategy in transforming the way you live are of tremendous upside potential.

Moreover, "smart cities" will be another interesting investment theme if we look at the urbanization ratio and the infrastructure allocation standard in other developed countries in the world. The sectors in play include security, 5G technology and online medical. We think "Made in China"-related industries or companies, e.g. 5G technology, will be particularly chased by inflow.

In addition, the implementation of unmanned technology on a global scale in the next 3-5 years is very likely, and therefore, from an industrial integration perspective, there is a good chance of explosive growth in China's EV industry.

South Net Buying:
Shanghai Stock Connect vs. Shenzhen Stock Connect[4]



Source: [4]Wind as at 29 December 2017.

MSCI Asia ex-Japan Information Technology Index – Price Earnings[5]

Source: [5]Bloomberg as at 29 December 2017.

About the Portfolio Managers

Yang LIU, Chairman & 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.

Key Words for 2018

VALUE and VOLATILITY.

As market valuations becomes elevated, investors will be more concerned and sensitive to sectors with lofty valuations. Some money will return to value investing.

Volatility will also increase and can come in any forms: switches between asset classes, growth versus value, geopolitical instability, high valuation stocks/sectors which do not meet earnings expectations.

QUALITY.

We expect that the equity market environment in 2018 will be slightly more challenging than that in 2017, but the overall economy will extend its quality growth supported by an improved regulatory backdrop. Our focus on companies with quality performance will continue: their superior earnings in 2017 were prominent, aiding the upward momentum of equities across industries; in 2018, we believe that companies in the later cycle rotation are likely deliver return.

2018 Sector & Theme Focus

Value and OBOR stocks which should benefit ASEAN.

For the long term, banks, healthcare and consumer staples are our top-pick sectors of the year.

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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