

Thousands of red dragons

Lorenzo La Posta

About twelve meters long, with four clawed paws and adamant scales, able to fly without having wings, the Chinese Long¹ is possibly one of the most ancient species of dragons on our planet. Longs typically are mysterious creatures with a volatile temper and of a variety of colours and characteristics; they can affect the global climate, cause extreme weather patterns and are thought to control rainfall, typhoons and floods (even though I suspect this last part is only a legend). They have for a long time only dealt with locals and a few worthwhile “qualified” foreigners, while shying away from the rest of the world. Today, however, the gates separating us from more than 3500 Chinese dragons are opening² and we are finally being given the chance to get closer to them, to better understand them and spot good investment opportunities. Did I say dragons? I meant stocks.

On the Shanghai and Shenzhen stock exchanges more than three-and-a-half thousand stocks (A-shares) are currently traded, accounting for around \$7.6 trillion in market capitalisation. These markets are not yet entirely open to foreign investors but thanks to the existence of QFII (Qualified Foreign Institutional Investors) licences since 2003 and Connect schemes since 2014, the gate between onshore China and the rest of the world is today substantially easier to pass through.

Compared to H-shares (traded on the Hong Kong Stock Exchange), A-shares are far more representative of the domestic economy and are highly diversified across sectors, offering a vast opportunity set that has remained unexplored for a long time. Around 40% of the stock market is made of “new economy stocks”, i.e. technology, health care, consumers and telecommunication companies; this proportion has been steadily increasing for the last 12 years with all such companies benefitting from improving living standards and a maturing economy. Also, the country’s economy is reshaping the composition of its GDP growth, with consumption now representing a more significant component and contributing more than three times as much as investments.

However, as any expert would agree, you should not approach a dragon with bare hands and without preparation even after years of experience with similar beasts. Similarly, investing in onshore Chinese equities requires additional care. The A-shares market is in fact highly volatile, as more than 80% of the volume is made of more sentiment-driven retail investors; the legal framework surrounding financial markets is still somewhat immature, corporate governance is often overlooked and reporting is opaque. Additionally, global investors have historically had concerns around the extent of government interventions, limits on capital repatriation and lack of direct ownership rights.

Gradually, tighter regulation and a stronger presence of international institutional investors should help reduce such risks but the extent and the speed of such a transition are uncertain. At the same time, this large, rich opportunity set warrants focus and should not be ignored. Here at Momentum we do not shy away from palatable opportunities, hence we have been building our knowledge through deep and continuous research to be best positioned before taking any investment decision. Protecting our client’s capital while delivering the expected outcome is a delicate balance between value creation and risk management: we want to make sure we approach dragons with as many precautions as we can, as our portfolios require only the best Longs.

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“you should not approach a dragon with bare hands and without preparation”

“we do not shy away from palatable opportunities”

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¹“Dragonology: The Complete Book of Dragons”, Dugald Steer, Templar Publishing, 2003

²“China awakens”, Momentum Weekly Digest, Jerome Bertrand, 4th June 2018

Market Focus

- » US large-cap benchmarks again reached new highs
- » The International Monetary Fund further reduced its global growth outlook
- » Brent crude rallied 1.6%, ending the week at \$63.5 per barrel
- » Gold prices fell 0.5% to \$1418.7 an ounce

Europe

- » Germany's manufacturing PMI fell to 43.1 in July, down from 45.0 in the previous month, and hitting its lowest level in seven years. In France, the manufacturing PMI fell to 50.0 for the month, right on the line that separates expansion and contraction.
- » The European Central Bank (ECB) kept interest rates unchanged in its July meeting but altered its forward guidance on rates, suggesting it would ease policy further to revitalise the ailing eurozone economy.
- » In response to the ECB's signal for further monetary stimulus, Greece's 10-year yield fell to 1.99%, a record low and down from the all-time high of 48.0% seen in March 2012.
- » Continental European equities advanced 1.1% on the week.

US

- » 145 S&P 500 companies released their earnings in the past week. Positive investor sentiment caused the S&P 500 to move above 3000 for only the fourth time in history.
- » The US economy grew by an annualised 2.1% in the second quarter of 2019, beating market expectations of 1.8% and followed a 3.1% expansion in the previous three-month period.
- » The US manufacturing Purchasing Managers Index (PMI) fell to 50.0, its lowest level since September 2009, whilst the services figure rose 0.7 points from the previous month to 52.2.
- » US equities were the strongest performer out of developed markets, returning 1.7% over the past week.

Rest of the World/Asia

- » The International Monetary Fund (IMF) revised its World Economic Outlook and cut global growth forecast by 0.1% for 2019 and 2020 to 3.2% and 3.5%, respectively.
- » Chinese importers have started arranging the purchase of US agriculture products, an indication of goodwill between the US and China and hints towards the resumption of trade talks. Chinese equities ended the week up 1.7%.
- » The Turkish central bank slashed the benchmark borrowing rate by 4.25% to 19.75%. The Turkish equity market returned 1.0% for the week.

UK

- » On Tuesday, Boris Johnson was elected as the new leader of the United Kingdom's Conservative party and Prime Minister. Johnson made it clear that he aimed to reach a new deal with the EU, that included removal of the backstop, and confirmed his aim to leave the EU by the 31st October with or without a deal.
- » The UK large-cap index returned 0.5% on the week.
- » UK gilts returned 0.3%, while investment grade bonds returned 0.6%.

Currency returns					
Asset class/region	Currency	Week ending 26 July	Month to date	YTD 2019	12 months
Developed markets equities					
United States	USD	1.7%	2.9%	21.7%	8.2%
United Kingdom	GBP	0.5%	1.6%	14.8%	2.9%
Continental Europe	EUR	1.1%	1.6%	19.2%	3.7%
Japan	JPY	0.5%	1.3%	6.6%	-8.9%
Asia Pacific (ex Japan)	USD	-0.7%	0.0%	12.2%	-0.4%
Australia	AUD	1.4%	2.7%	22.9%	13.6%
Global	USD	1.0%	1.8%	19.1%	4.5%
Emerging markets equities					
Emerging Europe	USD	-0.6%	-0.3%	20.1%	13.2%
Emerging Asia	USD	-0.4%	-0.2%	9.5%	-3.7%
Emerging Latin America	USD	-1.9%	0.7%	13.4%	9.0%
BRICs	USD	-0.2%	0.5%	14.3%	1.6%
MENA countries	USD	-0.8%	1.9%	11.0%	6.2%
South Africa	USD	-3.8%	-2.4%	8.6%	-6.0%
India	USD	-1.1%	-4.0%	6.0%	2.1%
Global emerging markets	USD	-0.8%	-0.1%	10.4%	-1.2%
Bonds					
US Treasuries	USD	-0.2%	-0.4%	5.0%	7.7%
US Treasuries (inflation protected)	USD	-0.3%	0.1%	6.4%	5.7%
US Corporate (investment grade)	USD	0.2%	0.2%	10.1%	10.4%
US High Yield	USD	0.5%	0.5%	10.5%	7.1%
UK Gilts	GBP	0.3%	1.8%	6.9%	7.0%
UK Corporate (investment grade)	GBP	0.6%	2.2%	9.3%	8.5%
Euro Government Bonds	EUR	0.3%	1.2%	7.2%	7.7%
Euro Corporate (investment grade)	EUR	0.6%	1.3%	6.7%	5.7%
Euro High Yield	EUR	0.7%	1.0%	8.8%	5.1%
Japanese Government	JPY	0.2%	0.1%	3.0%	4.0%
Australian Government	AUD	0.8%	0.7%	8.6%	12.3%
Global Government Bonds	USD	-0.4%	-0.7%	4.6%	5.4%
Global Bonds	USD	-0.3%	-0.5%	5.1%	5.5%
Global Convertible Bonds	USD	0.1%	0.6%	8.1%	2.8%
Emerging Market Bonds	USD	0.4%	0.7%	11.6%	10.1%

Source: Bloomberg. Past performance is not indicative of future returns.

Currency returns					
Asset class/region	Currency	Week ending 26 July	Month to date	YTD 2019	12 months
Property					
US Property Securities	USD	0.8%	0.7%	18.0%	10.6%
Australian Property Securities	AUD	0.0%	3.3%	20.6%	17.4%
Asia Property Securities	USD	-2.5%	-1.3%	11.3%	7.0%
Global Property Securities	USD	-0.5%	0.7%	15.7%	8.0%
Currencies					
Euro	USD	-1.0%	-2.1%	-2.9%	-4.6%
UK Pound Sterling	USD	-1.0%	-2.5%	-2.8%	-5.7%
Japanese Yen	USD	-0.9%	-0.8%	0.9%	2.2%
Australian Dollar	USD	-2.1%	-1.5%	-1.9%	-6.5%
South African Rand	USD	-2.8%	-1.4%	0.6%	-7.6%
Swiss Franc	USD	-1.2%	-1.7%	-1.1%	-0.1%
Chinese Yuan	USD	0.0%	-0.2%	0.0%	-1.2%
Commodities & Alternatives					
Commodities	USD	-0.2%	-1.5%	6.0%	-6.5%
Agricultural Commodities	USD	-0.9%	-2.3%	-3.4%	-9.0%
Oil	USD	1.6%	-4.6%	18.0%	-14.9%
Gold	USD	-0.5%	0.6%	10.7%	15.6%
Hedge funds	USD	0.2%	0.8%	5.1%	-1.4%

Source: Bloomberg. Past performance is not indicative of future returns.

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