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INVESTMENT OUTLOOK

June 2020

Divergent Realities: and the Hong Kong Situation

There are two topics this month. One is the divergent directions of the US and world economy and of the US and global stock markets, and the second is the situation of Hong Kong. Last week, the Chinese National People's Congress passed a new security law covering Hong Kong, which covers treason, secession, subversion, and terrorism. I believe that there is a legitimate cause for concern in the circumscription of freedoms: free expression, free press, the right of peaceful protest in Hong Kong; but there is no excuse for violence, and the effect of last year's demonstrations has now come home to roost with China taking a much more active, and direct, rule in the territory. The "One country, Two systems" concept is finished in 2020, rather than in 2047, and China's military and intelligence people will now be present in Hong Kong. Many of the 85,000 Americans, who live in Hong Kong, may be questioning their future, and some companies will, undoubtedly, move to Singapore.

But these fears should not be exaggerated. Hong Kong will always have an important function and purpose for China as a conduit for foreign capital, and also for Chinese capital going overseas. Now many of the Chinese companies listed in New York, including Alibaba, and many other large technology groups will move their listings to Hong Kong, adding an estimated \$1 trillion to the

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market capitalization and supporting the Hong Kong Exchange. Chinese money has been flowing into Hong Kong shares already, and the surprising thing is that the market is at exactly the same level, if not higher, as it was before the NPC decision.

Most Valuable Chinese Companies Listed On U.S. Exchanges

Company	Market Capitalization (\$ Billions)	Sector	YTD Stock % Ch.
Alibaba Group	\$535.9	E-commerce	-4.9%
PetroChina	\$106.0	Energy	-32.0%
China Life Insurance	\$88.5	Financials	-33.3%
Pinduoduo	\$82.3	Internet	71.6%
JD.com	\$73.0	E-commerce	49.3%
China Petroleum & Chemical	\$68.0	Energy	-24.9%
NetEase	\$48.0	E-commerce	26.0%
Baidu	\$35.6	Search Engine	-14.2%
TAL Education	\$31.5	Education	18.9%
ZTO Express	\$24.1	Logistics	37.7%

What comes next may be a vote by the US Congress to remove the special status enjoyed by Hong Kong under the US/Hong Kong Policy Act of 1992. It is possible that sanctions might be imposed



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which would impact Hong Kong's role as an international finance center. As the Secretary of State said, "No reasonable person can assert today that Hong Kong maintains a high degree of autonomy from China." But Hong Kong's role, as one of China's leading cities, will still be important and, although property has been weak during the Covid 19 crisis, we do not expect a collapse, considering that neighboring Shenzhen and Guangdong property is almost as pricey. The Hong Kong Dollar Peg with the US Dollar will not change and, despite heavy media coverage, we expect that leading companies such as HSBC, China Light and Power and many of the leading Hong Kong property developers, will find a way of maintaining and growing their business in the future. We are, ourselves, moving to a new office near Hollywood Road in July.

So, why, when the US economy has had its steepest fall since the Great Depression, and unemployment has reached 14.7% or 40 million people out of work, has the stock market rebounded by over 30% since its low on March 23rd? One explanation is the explosion of liquidity, engineered by the Federal Reserve, which amounts to almost \$5 trillion, or about 25% of GDP, in the course of less than 2 months. Also, investors look not only at the short-term (and there is no question that 2Q earnings, to be released in July, will show a collapse), but look forward several years, to see the future stream of earnings and dividends in order to value shares. On this basis, the market is not, yet, as overvalued as it was in 2000, or even in 2008. We expect interest rates to stay low, although the price of oil, gold and silver will continue to strengthen as economic activity picks up, and inflation may reappear in 2021.



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The extraordinary thing about stock markets is how they anticipate and, in some mysterious way, understand the future trend, before it is apparent in the economic or political headlines. In his wonderful book, War, Wealth, and Wisdom, Barton Biggs points out that the London Stock Exchange bottomed out in June 1940, shortly after the evacuation of Dunkirk, but before the Battle of Britain, when it was by no means clear that Hitler's planned invasion of the island could not succeed. The New York Stock Exchange marked its bottom at the Battle of Midway in May 1942, which also marked the extreme expansion of Japan's conquests in the Pacific. And finally, the Berlin Stock Market peaked on the day that the German army reached the outskirts in December. So it is not so extraordinary that the S&P500 bottomed on March 23rd, which was actually at the moment at which the Coronavirus was at its fiercest, with nearly 1 million infected and now 100,000 fatalities in the US, the lockdown just beginning and unemployment rising to new highs. What did the stock market see? Looking ahead, it was anticipating a V-shaped recovery, possibly a vaccine, and a relatively short-term effect of the virus. For the economy and corporate earnings, the key point was the support of the Federal Reserve for the economy.

In Asia, the lockdown has not been quite so severe as Europe and the USA. Nevertheless China, and recently, South Korea, have seen a 24% fall in exports. One of the major reasons why we still see opportunities for investing in Chinese companies, is that China is becoming an increasingly domestic-oriented economy. Chinese consumers will buy Chinese brands, they will take their holidays in China and there will, at least this year, be a continuing caution about public events, conferences, sports



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events, in the face of the Covid 19 risk continuing, and a second wave occurring in East Asian countries.

This pullback by China will have a chilling effect on some of the economies, such as Thailand, Malaysia, and Singapore, which have depended on Chinese tourism and investment. Tourism, as an industry, accounts for 10% of world GDP; and it is hard to see airlines and hotels demonstrating a rapid recovery.

Nevertheless, we maintain our long-term constructive approach to the opportunities in India and Southeast Asia. These low income, large, and young populations, have the ability to take up much of the manufacturing, which will now move out of China. Indonesia, and other ASEAN countries, are undertaking large infrastructure projects, as is India. There is also a degree of currency and political stability in the region, which is important for investors.

One reason we are bullish on India, is that our largest position in the Indian Ocean Fund, Reliance Industries, has a wholly-owned subsidiary JIO, India's largest wireless carrier, which has attracted \$10 Bn. of overseas investment in the past month, including Facebook (\$5.7 Bn.), KKR, and Silver Lake. JIO has 400 million users and, so far, 40% of India's vast population have internet access: the potential for e-commerce (only 3% of retail sales), is considerable, in our judgment.



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We have recently looked at “Dividend Aristocrats” in Korea, Taiwan, and Southeast Asia, with the emphasis on a high-dividend cover and good dividend growth. In many cases, such as Singapore, we can find excellent companies, with 5% dividend yields, in a hard currency, such as the Singapore dollar. Here, again, we emphasize sectors, such as healthcare, e-commerce, telecommunications (5G), and infrastructure. We eschew any exposure to airlines, hotels, and consumer luxury goods.

It is also true to say that much of the capital flowing into the market (mainly institutional and hedge funds, rather than retail) has focused on the giants of e-commerce and software, such as Amazon, Microsoft, Facebook, and Google. The smaller manufacturing names of the Russell 2000 have been left behind, and this does reflect economic reality.

Will Asia, and Emerging Markets, start to outperform at last, compared to the S&P500? We believe that this is a probable trend, beginning with a weakening of the US dollar, and a gradual rise in consumer prices. It is, of course, true that China still has an outsized influence on commodity prices, and on many developing nations whose largest trading partner it is.

A handwritten signature in dark ink, reading "R. Lloyd George". The signature is written in a cursive, slightly slanted style.

Hong Kong
4 June 2020



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Central Entity No. BEL384

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