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Kyiv and Hong Kong

Robert Lloyd George's musings about very uncertain markets. We send along his monthly note since he expands our fundamental information on the fast growing, largest countries – China and India. He is very knowledgeable but we, Georgian Capital, focus on North American equities.

Enjoy the read. Comments or questions always welcome.

David Knight | Partner | Georgian Capital Partners
Scotia Plaza, 40 King Street West, Suite 3405 , Toronto, ON M5H 3Y2
Toronto: (416) 640-4100 | E-mail: dknight@georgiancapital.ca
www.georgiancapital.ca

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INVESTMENT OUTLOOK

March 2022

Kyiv and Hong Kong

We are watching the Ukraine situation daily and the outcome is still uncertain. The market has reacted sharply on the day of the invasion, February 24th, with gold and oil rising and most shares correcting. It is therefore not clear what the impact on Asia will be, although Europe is much more affected by the possible interruption in natural gas supplies. However, the resistance put up by President Zelensky and Ukrainian volunteers is almost as inspiring as Winston Churchill's defence of London in the summer of 1940 when threatened by invasion. The wider impact on the global struggle between autocracy and pro-liberal democracy is also important to consider. If Putin fails to complete his conquest of Kyiv and the Ukraine, this will deter other autocrats from similar adventures. The rise in the oil price will also impact growth everywhere and especially in the oil-importing nations, such as China, India, Korea and Japan. It is also important to note that Ukraine supplies almost 60% of the world's wheat exports and India depends largely on Ukraine as a source of edible oils.

Turning to Hong Kong; I have been unable to complete my planned two-week quarantine and visit to Hong Kong because of the recent sudden surge in covid cases and the threat of an almost total lock down based on China's zero covid policy. The situation has deteriorated to the point where there are 34,000 daily cases and almost a complete suspension of daily business meetings and appointments. The real issue is if Hong Kong can recover with its unique position as a global financial centre when so many expatriates are leaving town, and there is increasing uncertainty about the extent to which China will exert control over every aspect of daily life. Xi Jinping was supposed to come for the 25th anniversary of the July 1st, 1997, handover by Britain to China, but the covid surge has created some uncertainty about these plans.

LLOYD GEORGE MANAGEMENT (HK) LIMITED
UNIT 21 & 23 HOLLYWOOD BUSINESS CENTRE, 2/FL CASEY BUILDING
38 LOK KU ROAD, SHEUNG WAN, HONG KONG
TELEPHONE (852) 3468 7278
EMAIL: INFO@LLOYDGEORGEADVISORY.COM

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We do believe that Hong Kong will bounce back and even those international companies, like HSBC, Cathay Pacific, and Jardine Matheson and major Chinese groups will retain Hong Kong as their centre of operations. It may take some months, but the present situation is not likely to damage the city deeply over the long term as long as the Hong Kong Dollar (linked to the US Dollar at 7.8 since 1983) remains freely convertible, and the Renminbi is not. In addition, the British legal system endures, with all the certainty of contract and secure property ownership, which underwrites a free capitalist system. Low income and corporate tax rates have been maintained at sub 20%, with no dividend or capital gains tax. And, finally, the relisting of many of China's leading companies, from New York to Hong Kong, will reinforce its role as China's international financial centre. Both property and shares in Hong Kong look set to have a good year in 2022, after a dismal 2021 for the Hong Kong stock market. China's large corporations and wealthy businessmen continue to see Hong Kong as their Switzerland, a safe place to park their wealth, especially in property.

It is, at least, certainly possible to forecast a slowdown in the extraordinary infrastructure build-out in China and the world since 2000 (witness the 880 km highway over the Karakoram Himalayas from China to Pakistan costing $65 Bn). The demand for steel, copper, concrete and other basic materials may slow, impacting Australia's mining industry, Chile, Africa, and so on. The demand for oil seems to remain vigorous and growing, and much will depend on the supply side.

China has large stockpiles of commodities, all the industrial metals, oil and food after having anticipated some of the geopolitical trouble this year. We believe that the scarcity of supplies in many of these strategic raw materials will be dependent on China's policy in handling these inventories and this will impact the global inflation outlook. It is possible that these anticipated interest rate rises in the US will not be as fast as anticipated if the Russia-Ukraine situation causes higher oil prices and a global slowdown.

According to our trusted China consultant, the situation in China is complex with the October re-election of Xi Jinping approaching, a successful economy is a sine qua non for maintaining the "mandate of heaven" or the right of the CCP (Chinese Communist Party) to rule. On the other hand, it is clear that China's economy is slowing down; In fact, growth is at the slowest pace over the last 30 years. The latest GDP estimate for 2022 by the IMF has fallen to 4.8% and even that is dependent on uncertain Chinese statistics. Moreover, while there are opposing voices in the international arena of Xi's re-election in 2022, there is also disquiet within the rest of the current members of the Standing Committee of the Central Political Bureau of the CCP, who are all expected to step down except for Xi. Is Xi's re-election driven by personal ambition, or is it a sign of a weakening CCP, or is it for the higher purpose of China's economic development, and to see through the re-unification with Taiwan (ROC) - is anyone's guess. Hence his re-election is not a foregone conclusion, according to our sources.

Xi Jinping is a disciple of Mao and therefore has great concerns that the fast-growing middle class in China might one day constitute a threat to the CCP's power, and his power as well. The so-called "common prosperity" policy and his recent interventions in the property, internet and education sectors, are ostensibly to address the debt problem in the property sector, the privacy issues in the internet giants, and to restructure the education domain to be more equitable, but, in reality, are also a guise to transfer power back to the CCP from the private sector, particularly the rich, or the wealthy entrepreneurs to the party. Jack Ma, for example, has been forced to donate $500M towards rebuilding the country.

In addition, our China advisor believes that, although the number of patents filed by China is higher than in the USA, the quality of US innovation remains higher in critical sectors, such as biotechnology and IT. More and more Chinese students are opting to stay in the West after they complete their studies. All these factors taken together are undermining the vitality and entrepreneurial energy which has propelled China in the last 20 years and will have serious consequences over the longer term.

The property market outlook remains gloomy with sales volumes and prices down, and with an estimated 30% of Chinese GDP dependent on construction, it will certaintly slow down growth. Local governments and municipalities have depended on land sales for years to finance their budget and this option is no longer there. We do, however, believe that China's monetary policy will be easing throughout 2022 and that equities in certain sectors supported by the government, such as green technologies, electric vehicles, batteries, and Chinese consumer brands, will continue to perform better than the market. It is also highly probable that the Chinese authorities will open the taps and stimulate the economy with increased money supply, lower interest rates, and lower reserve ratios for banks. Once the election is over, we do expect China's growth to pick up again as the CCP gets back to the real agenda of economic development.

We remain optimistic for the outlook for the Southeast Asian nations to reopen to trade and tourism. Singapore has taken the lead and is now fully open again - Malaysia, Thailand, Indonesia, and the Philippines will follow. Vietnam has a higher number of cases but has never closed its economy. There is pent up demand and appetite for consumption in all these countries which constitute over a 600 million population. This is also true in India where we see a sharp recovery from the covid situation and renewed spending and infrastructure development following the positive budget recently. Indonesia is exhibiting rapid growth in capital investment, with its $35 Billion project to build a new capital on the south coast of the tropical island of Borneo, (Kalimantan).

Our portfolio continues to be a balance between these three areas with an underweight in China, compensated by an overweight in India and increasing commitment to Southeast Asian Shares. We are, however, almost completely out of high tech, high PE growth sectors and invested in oil, banks and value shares with good dividend yields and balance sheets.

It is very impressive to see that South Korea remains open to business with an election pending in March and yet it has the highest covid count with 170,000 cases daily, higher than the USA, with a total population of only 52 million. This is striking as the "living with covid" policy is now nearly adopted in all Southeast Asian economies with the single expectation of China/Hong Kong. The outcome of the Korean election remains uncertain but could be positive for business confidence. We have had 5 years of left-wing, redistributive policies, and a soft line with North Korea, which has been bad for business confidence.

We remain overweight and bullish in Taiwan because of this particular scarcity value in semiconductors and semiconductor components/materials. TSMC and Unimicron, respectively, are the leading companies in these areas. In Unimicron's latest earnings call, management noted that the supply tightness for substrates, a key semiconductor material, will last beyond 2027.

We continue to overweight India and see the recent Indian budget as being positive for growth and corporate earnings. Spending on infrastructure will increase by 35%. Tax revenues have risen sharply. The Indian government revenues benefited from Mr. Modi's policies in the past 8 years since he came to power, and we believe that we are midway through a very positive transformation of India's economy and political scene.

R. Lloyd George

Hong Kong
1st March 2022

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