Investing During the US-China Trade Conflict

Throughout 2019 the markets have been buffeted by the trade wars between China and the US. While many investors are inclined to de-risk and wait it out, recent market performance has shown that remaining uninvested has its costs too. Instead, Hong Kong investment manager Premia Partners believes a more appropriate strategy is to identify the equity winners regardless, minimise correlations, and buy into truly risk-free assets as a hedge for any doomsday scenario. David Lai, Premia Partner & Co-Chief Investment Officer, and Aleksey Mironenko, Partner & Chief Distribution Officer, paired up for a fascinating Workshop at the Hubbis Independent Wealth Management Forum.

"TODAY," MIRONENKO BEGAN, "WE WILL FOCUS ON THREE OF OUR ETFS, NAMELY CHINA NEW ECONOMY, VIETNAM AND THE TREASURY FLOATING RATE." And with that he offered an interesting overview of Premia Partners (see article below on Premia raising its profile in Asia), and set the scene for the discussion.

He used an excellent slide show (see attached link) to illustrate the impact on the GDP of China and the US, noting that if fully implemented, the tariffs would impact the US just as badly as China, if not worse, yet both markets are still in great favour with investors.

He also noted that fixed income remains extremely popular with investors. "To me," he stated, "that seems almost insane, because we know the story line of USD17 trillion of bonds now at negative yields, but the bigger issue is that if you want to get 3%, you're buying Brazil or Mexico, such is the world we live in today. Basically, the only market where the yield today is anywhere similar to the 10-year average is Korea, while everything else is far below, yet investors are still ravenous for fixed income."

He remarked on an interesting headline about Toyota Motor having issued a 0.0% yield 3-year bond recently. "How anyone thinks that can be a profitable trade is beyond me but yet the markets are still hungrily buying these types of bonds."

He also referred to activity to offset the potential of a doomsday scenario. "So everyone has stocked up on gold," he

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explained, "but the problem with this trade is that it has largely already happened, so not only is the price near all-time highs but ETF holdings of gold are at all-time highs, central bank holdings of gold are at all-time highs. So, basically the bet on gold is a bet that those two groups go well beyond their all-time highs and in fact the traders already started to unwind somewhat, with gold falling from 1550 to about 1480 in the first three weeks of October." And with that he handed the floor to his colleague David Lai.

"Whether the trade conflict between both the US and China economies will continue," Lai observed, "and exactly how much damage it will inflict, nobody knows for sure, but we see that both sides have their own point of view to try to minimise the impact. As we heard, almost 30% of the world's investment-grade debt is already negative yield, but buyers are still queuing up for it, meaning they are chronically risk averse in accepting that if they hold to maturity, they will receive back less than they paid. And as we know, gold is also a major beneficiary of this global risk aversion."

He added that with indicators increasingly pointing to the potential for a recession in the US, and with core inflation in the US about 2.4%, probably as a result of tariffs, the combination of slower economic growth and higher inflation is potentially threatening for the equity market.

China – despite headwinds, still advancing

Over in Asia, the assumption might be that China would fare badly in this environment. Yet China 'A' shares have returned nearly 30% YTD, with China adjusting fiscal policies and therefore reducing debt costs in the corporate world and the economy at large, thereby providing a boost to domestic consumption. Moreover, China has been intent on policy measures to boost consumer activity, in such areas as promoting e-commerce, green/smart home appliances and other measures to help encourage overall consumption. And tax cuts for the corporate and personal/retail markets, with particular knock-on benefits for 'A' share listed corporations.

Lai then focused on China old and new economy stocks, highlighting how it is important to be selective, not to view Chinese equities as a whole. "You can see that the China New Economic Index - mainly consumer stocks, healthcare and IT - are growing much faster than the average," he explained. "Domestic consumption, technological upgrading, urbanisation, infrastructure - the high-innovation end of this, and tech/IT; these sectors are all driving towards stronger growth in the near future."

Vietnam – a remarkable story

Vietnam is currently a key beneficiary of the China-US trade conflicts. Aside from Vietnam's core economic fundamentals as it transits from a frontier to an emerging market, the trade wars are delivering a boost from the shifting of China production into Vietnam itself, and at lower costs. Moreover, while the ASEAN currencies such as Thai Baht and Philippine Peso have been robust against the dollar year-to-date; Vietnamese Dong has exhibited very low volatility during the same period of time.

"China's exports to the US have dropped, but Vietnam's exports to the US have surged by about 33% in the first half of 2019" said Lai.

It is not only China shifting production. Vietnam offers comparatively appealing labour costs for China and other countries in the region. And the infrastructure is improving rapidly. Moreover, a lot of investors may only focus on the growing trade activities of Vietnam but miss out the consumption potential of the country. With close to 100 million people, most of them still at a very low-income bracket, and with a rapid expansion of manufacturing and general activity, there is markedly faster consumer spending across all segments.

"Vietnam's spending has been more than 50% centred on food and beverage, in other words, necessities," he reported, "but a whole range of areas from financial services to healthcare, housing, retailing, and other sectors are now rising rapidly as spending power rises and as more spending is focused on these growth areas. And tourism is growing very rapidly, with the government targeting 10% of GDP from this sector as more Asian and other visitors flood in."

China New Economy stocks shine bright

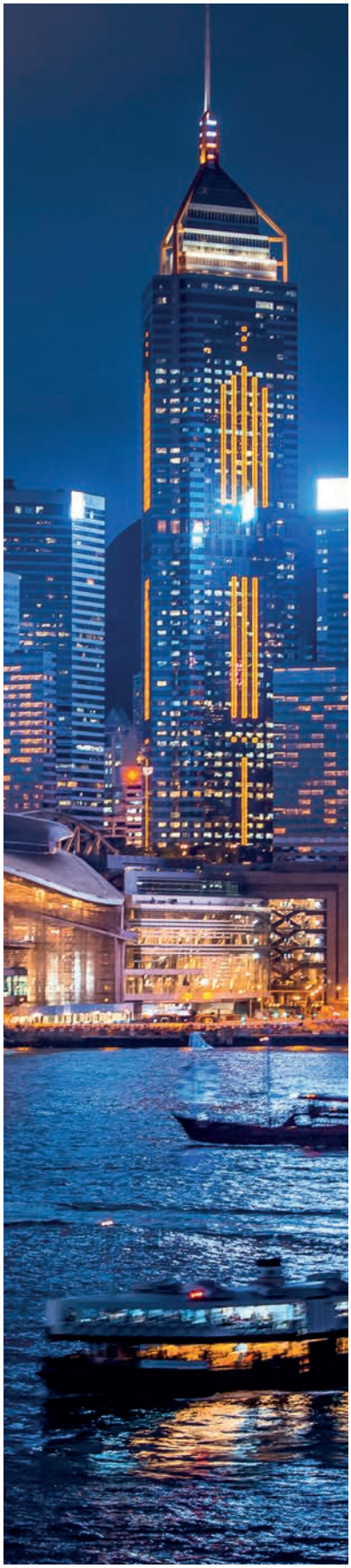
Premia thus far has two China ETF strategies and is very bullish on prospects there for equity investors. Mironenko reiterated some of Lai's observations on China and explained that all of the key developments Lai had talked about will benefit China's 'A' shares market, which is also being propelled by new foreign investment coming in through the Stock Connect programme driven by MSCI inclusion from Q2 in 2018, pulling in more and more foreign investors.

He reiterated how structural change is also central to the uptick in China interest, as the country's emphasis is on the new economy. Domestic consumption contributed some 37% to GDP growth in the past decade, but it is nearer 80% today. The new economy exposure in the index, including consumption, IT and healthcare, used to be about 20% and today is 32.5%, so new economy exposure in the capital markets is also gaining weight.

The **Premia CSI Caixin China New Economy ETF** offers access to this universe of China A 'new economy' stocks and is tilted toward asset-light, accounting conservative and quality growth stocks and has outperformed comparable alternatives, including ChiNext, since its creation nearly two years ago with less volatility.

Great performance YTD

China New Economy is actually one of the best performing China 'A' share ETFs globally year to date, having risen 28% by the end of September.



"The New Economy definition is industries that are skilled talent, advanced technology, asset-light, sustainable growth, and my personal favourite for China, policy supported," he elucidated. "That is just not our definition, this is the definition of the New Economy PMI that is published in China and what we are simply doing is taking the industry definitions they included in PMI, and we convert them to stock subsectors."

The problem is that the universe is then still 900 stocks. "So, not only do we focus on new economy stocks, but we then narrow the field down to focus on quality, low debt, efficient inventory management, nimble leadership, targeted, efficient R&D spending and other key factors," Mironenko explained. "We like asset-light firms, those who are there to benefit from China's long-term transition from the old economy to new economy. We also want low net operating assets and low accruals, because you will be shocked how many companies in China have fantastic earnings and have negative cash flow."

The universe is thereby trimmed from 900 to 300 stocks. "Financials and real estate don't feature in new economy," he reported. "The government is going to use that sector to promote New Economy in our view, meaning net margins will fall. But what we overweight are sectors such as consumer discretionary, healthcare, technology/IT, innovative infrastructure, so for example not the businesses that lay the railroad tracks but the businesses that build the bullet train engines. In other words, high skill, high complexity, high tech industries, and of course robotics, which is far from old economy. All these key areas can be accessed efficiently through the Premia CSI Caixin China New Economy ETF."

Vietnam – getting into the detail

Mironenko shifted his attention to Vietnam, for which **Premia on July 18 listed its Premia MSCI Vietnam ETF (2804 HK/9804 HK)**, making it easier for investors to access this dynamic and fast-growing market.

Vietnam offers strong economic growth and a young, large and fast-growing workforce. The country is enjoying rising FDI and trade, with increasing inflows and trade value that is overtaking neighbours. The country also enjoys rapid growth of the consumer as Vietnam moves from relative poverty to emulating its ASEAN neighbours such as

Thailand or Malaysia. Improved macroeconomic conditions include stable credit growth and monetary policy alongside solid currency control and strengthening reserves. And Vietnam is arguably the biggest beneficiary of the trade war and the resulting review of global supply chains.

The country, therefore, has many key positives, including government support via privatisation to boost the equity market, faster growth than most of ASEAN, conducive liberalisation, and growing foreign investor interest. It also offers a 60% labour cost advantage vs China, a large and willing-to-work population and increasingly improving infrastructure for global supply chains.

With a large and fast-growing population of around 97 million, Vietnam's story opens the door to investment opportunities in all sorts of key consumption sectors, from retail to education to healthcare and IT.

Growth will be faster than in broader ASEAN. It all means that in the next decade Vietnam will benefit from the growth as high as 7% per year, so for those investors that missed the early years of China's boom, Vietnam will probably be the next one they should be looking into.

The country offers robust growth in earnings, growing at least at double-digit rates for the next two years. And on the regulatory front, the authorities will remove the foreign ownership limit of most listed companies by early 2020, which might coincide with the upgrade to EM status. And with growth rates of about 7%, they are already growing faster than China," Lai added.

The equity market size is now only 60% of GDP, but the government has a target to raise that in 2020 to 100% and by 2025 to 120%. Surprisingly, Vietnam has already surpassed Singapore to become the biggest IPO market in any ASEAN country. The stock market should roughly double in size within six years.

A pure Vietnam play

The ETF offers pure Vietnam exposure, as the strategy tracks the MSCI Vietnam Index, which consists of only public Vietnam listed companies and may one day be added to MSCI EM, hopefully, sooner rather than later.

The ETF offers physical replication, in other words direct low-cost access to the Vietnam stock market. It is cost-efficient with ongoing expenses of only 0.75% p.a., vs 1%+ for existing foreign-listed ETFs and 1.5%-3% for active funds.

As it is Hong Kong-listed, and available in USD or HKD, it offers easy access for investors and in the same time zone as the underlying market and without any US withholding taxes.

Borne out of a need

As with every Premia product launch, the Vietnam ETF was borne out of client frustrations, and offers single country exposure that was not available through Premia's ASEAN ETF, and it improves on what Premia considers other less viable avenues, such as synthetic or US domiciled ETFs, or those that invest in non-Vietnam stocks or even PE.

"Our mission," Mironenko explained, "is to improve the Asian beta landscape and solve investor challenges into Asia, and with this ETF we offer a low cost, rules-based access, and 100% physical replication strategy to the fast-growing Vietnam market. It is the first ETF tracking MSCI Vietnam index globally and will benefit

directly if there is an upgrade from frontier market to emerging market status, which will pull in a lot of foreign interest going forward."

Putting cash where cash can yield

Lastly, Mironenko focused on another new strategy launched in July in the form of the **Premia US Treasury Floating Rate ETF (3077HK/9077HK)**, which helps investors mitigate trade conflict risks by generating risk-free USD yield.

He highlighted the investment case for US Treasury FRNs. Cash and dry powder are needed, with many investors increasing cash levels as the cycle gets long in the tooth and uncertainties pile up. Bank yields remain low and readily available cash doesn't pay very much. Cash with risk seems to be the norm - credit risk in money market funds, counterparty risk in repos, timing/duration risk in long-dated deposits. And cash is not operationally straightforward - rolling t-bills and time deposits, identifying the best yielding bank product all takes time away from more important investment thinking.

The Premia solution offers the shortest duration instrument, with only one week of duration with coupon resets weekly. There is no credit or counterparty risk, as there is 100% physical exposure to US treasury obligations only. It offers a high risk-free yield, translating currently to a 2.1% gross yield, higher than all US treasuries up to 10 years.

Keep floating

Mironenko explained why the ETF buys into floating-rate US treasuries, not fixed-rate obligations. "With the Fed Funds at 2.25%," he reported, "it's obvious that investors seek out alternatives. But if you buy into money market funds these might typically offer a higher yield of course, but they are run actively and invest in not just Treasuries, but in commercial paper, longer-dated government securities, repos, so there is either credit risk, counterparty risk, or interest rate risk. The fees are also higher. Yes, they are professionally managed and there is nothing wrong in principle with this type of cash management approach. But remember 2008 and just how quickly things can go wrong, as investors fled prime funds to the safety of government-only investments."

Time deposits, he noted, are also another popular way to invest cash, but have several problems - they need constant rollover and scrutiny for the best rates, the buyer is 100% exposed to the default risk of the bank, retail and institutional rates are different, and the investor is locked in and cannot use or reinvest the cash until the time deposit is finished.

Finally, many investors simply buy t-bills and roll them on a regular basis themselves. But for relatively smaller sizes, this is quite difficult as treasuries typically trade in increments of at least USD100k, and even at that size, the pricing is inefficient.

In short, there's no perfect solution for cash," he concluded. "But our US Treasury Floating Rate ETF was borne out of these client frustrations. In our view, floating-rate Treasuries can function as a core alternative for short-term bond exposure with reduced interest rate and credit risk." ■

Hong-Kong Investment Manager Premia Partners Raises its Profile in Asia

Premia Partners (Premia) is a Hong Kong-based investment manager that began life some three years ago and that offered its first ETFs just two years ago. The firm's stated goal is to be a trusted ETF partner for investors by curating a best-in-class range of ETF tools and solutions that enrich and empower its partners and investors in Asia and for Asia. In only a few years since inception Premia has propelled itself to the eighth largest manager in Hong Kong by assets under management (AUM), from a standing start.

The Premia team comes from a variety of global leading firms and have always focused on Asia before they came together to build an Asian ETF company. Premia today boasts a team of 20 members with hands-on execution experience from leading firms.

The firm has garnered a wide range of leadership and managerial experience from global institutions including Marsh & McLennan, BlackRock, China Asset Management, Mirae, Value Partners and other firms.

"And only just over two years after our first ETF launch," Mironenko reported, "we are now eighth in Hong Kong out of the 26 providers when we launched. In fact, since we began, three have either suspended or closed their ETFs here completely, so we are now bigger than 15 of the remaining 23 providers. Why have we been so successful? Because we build products that are relevant for Asia, relevant for investors seeking exposure to these markets, and that offer lower-cost entry and a more incisive selection of investments."

He explained that Premia has listed six products so far, each with a compelling investment thesis. The strategies include China A, specific areas of Asian growth such as the Southeast Asian consumer and North Asian tech innovation, a new vehicle for Vietnam and a risk-free US Dollar cash yield product for risk-off investments.

Premia was founded on three core beliefs. First, there is enormous scope for innovation in Asian ETFs, and plentiful opportunities to introduce global best practices for Asia. Second, Asian investors should not have to trade in New York or London or Frankfurt to find the best products the ETF industry has to offer. And finally, Asian investors deserve better solutions than available today and technology allows Premia to make them a reality.

"The firm's ideology is to offer investors a vision of 'smart investing', aiming to create a reliable, curated ecosystem that is conducive to ETF investing, optimised with the best technologies, tools, and platform," Mironenko explained. "This all adds up to the bold yet straightforward goal to reshape the landscape for ETFs in Asia." ■