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The View from Atlantis

2H 2019

Message from the Chairman and Chief Investment Officer

It was an eventful six months under review in 2019. The unstopped trade war, the unusual credit cycle and the fast regulatory shifts in the A-share market have dominated the investors' behaviour and that led to a mixed performance of different share classes and market caps. We have noticed this change earlier this year and started our process to actively add weight of large and blue chips into the Fund. Although the Fund continued to recover in May and June amid market "panic selling", it closed the first six months with by underperforming the MSCI China Free Index by 18.9%. SMEs and P-chips did not help us to perform well even though we tried to make switches; we did not have enough time to reach our target by the end of June as market conditions only came into our favour in June. We continue to switch out of SMEs and P chips and switch into large and blue chips in the next six months and increase weightings on A-shares as well.

That said, we believe the marginal effects of the trade war are declining, investors are getting used to the "new normal" in US-China relations; their focus should be back to companies' revenue and earnings. Going into the interim results season, we expect that interim results could show widened divergence between industry leaders and smaller players in various industries amid the current economic downturn. Investors will continue to be enthused about large-cap stocks that deliver good earnings.

In terms of investment strategy, we believe in increased weighting in China's A-shares: We will hold steady our market weighting in financials and healthcare, reweigh internet/high-tech and consumer brands, and trade on dividend yields. These are the most needed cyclical and dynamic mixed strategies to pursue in the second half of 2019.

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2019 Second Half-Year Outlook:
China and Hong Kong Outlook with Yan Yang (Fund Manager)
Asia Pacific Ex-Japan Outlook with Joseph Wat (Fund Adviser)

China and Hong Kong Outlook

What drove China and Hong Kong equity markets in 2019 so far?

Yan: Stock markets rallied around the globe in the first half, buoyed by easing trade tensions between the US and China and a dovish shift by the world's leading central banks, which follows the US Federal Reserve putting rate hikes on hold in January. China's major indexes has become the top performers worldwide: Shanghai composite and Shenzhen Component jumped 19.5% and 26.8%, respectively. In Hong Kong, the Hang Seng Index also climbed 10.4%.

The region's outperformance was largely driven by China's credit easing measures. Liquidity has come roaring back after a dry spell during most of 2018, when Chinese government deepens its financial reforms with a nationwide deleveraging campaign. In January to March, banks opened floodgates, extending a record RMB5.81 trillion of new loans to help boost the real economy. Second quarter turns more volatile as investors were shocked by the sudden collapse of trade talks. Worries over a full-blown trade war sparked "panic selling" as Northbound trading into the mainland China through the Stock Connect programme recorded a net outflow of RMB53.7 billion in May. In June, we are pleased to see the world's two biggest powers agreed to restart trade talks at G20, which restored some market confidence.

Do you think trade war headlines will continue to dominate market sentiment going forward?

Yan: We think the Sino-US relationship is entering a new normal, with both cooperation and competition increasing. In the coming quarters, we will probably see repeated cycles of tensions increasing and relieving, with neither a happy ending or a cold war. Ultimately, we don't expect a final deal to be made soon. That said, we believe the marginal effects of trade war are declining. Investors are getting used to the "new normal" between the two countries. With interim result season coming soon, investors' attention would return to companies' revenue and earnings.

The second quarter was a good entry point. We observed that the valuations of many stocks with solid fundamentals were very attractive, and some have rebounded around 20% in the last few weeks in June.

What are the major trends and opportunities investors should be looking at for the second half?

Yan: If we look at the longer economic cycle, clearly, for China, we are very close to the bottom now, but we need a few more quarters to stabilize our economy. With the current tenuous situations, we expect that China won't likely stop monetary easing soon, and will increase stimulus on domestic consumption and infrastructure. In the meantime, policies on the property sector could remain mild to support the economy.

In this context, Hong Kong and China indexes are likely to be volatile because on one hand the economy is slowing down, on the other hand the liquidity will continue to be abundant on the market. We expect that interim results could show widened divergence between industry leaders and smaller players in various industries. Leading companies will grab more market share under current market conditions. Thus investors will continue to scramble for large caps with decent earnings in both Hong Kong and China as these stocks command a certain premium. We see the market still have many structural opportunities in the coming quarters. However, we remain cautious on smaller names and certain sectors as our market look like to be driven by event and sentiment rather than fundamentals.

Asia Pacific Ex-Japan Outlook

Can you summarise what happened in Asian equity markets so far?

Joseph: From the start of the year, Asian equity markets steadily climbed with vigour, peaking out only in April. The key reason was the change in US interest rate outlook, which resulted in the benchmark 10-year bond yield retreating from a high of 3.2% in 4Q18 to a low of 2% in June 2019. Markets were also boosted by the easing of trade tensions as witnessed in 2018. After the meeting between President Trump and President Xi at the G20 meeting in Argentina, both sides resumed their trade talks in January with optimism built in that a trade deal was imminent. However, talks broke down in April and sparked the imposition of another round of tariff hikes by the US and further retaliatory measures from China. May turned out to be a bloodbath as the MSCI Far East ex Japan lost 10% in a month and erased two-thirds of the gains from the first four months of the year. The markets recovered in June when Trump and Xi again agreed to meet at the G20 meeting, which was held this time in Osaka. Another issue that was hovering on the horizon of China is the ban on US companies doing business with some Chinese companies, including Huawei for infringement on intellectual property (IP) issues.

What is your view on 2019 surrounding with geopolitical tension environment and Fed rate cut?

Joseph: Notwithstanding imminent rate cuts in the US, the ongoing trade war between the US and the rest of the world is the more serious issue facing our economies. If it happens, the consequence would be devastating. Whilst we believe that companies have been diversifying out of China, there will be a transition period where there will be vacuums of slower demand and hence supply side disruption. On one hand, Trump needs to do a deal before his re-election in November 2020 and Xi needs to seal one to avert a sharp slowdown in China's fragile economy, which is already seeing its slowest growth in 2Q19 in the past 27 years. Whilst we believe and hope that sense will prevail to avert a full trade war, there remains a small risk of it happening.

As the outlook for USD strength dimmed, Asian currencies strengthened and alleviated pressure for pre-emptive rate hikes to defend the currency. Philippines kicked off the rate cuts. Indonesia eased by cutting the Reserve requirement for its banks. Elections were held in Indonesia, India and Thailand. As expected, both incumbent presidents in Indonesia and India won with a higher majority, which means that both countries are likely to see further reform push in their final terms. The same could not be said of Thailand, who did not win the majority and the junta PM was re-appointed after forming a coalition.

What are some of the key investment opportunities you see in 2019?

Joseph: We believe that the Fed will probably err on the side of caution in its rate hikes given the uncertainties in the global trade order. The diversification of the supply chain out of China should benefit the ASEAN countries given their cost structure. In particular, we are very bullish on Indonesia given that the country has put in place key infrastructure and eased bureaucratic red tape. The country is also probably going to see aggressive rate cuts given its benign inflation and stable currency.

China Sector Opportunities with Yan Yang (Fund Manager)

Healthcare:

We take the view that the pilot Group Purchasing Organization (GPO) programme in 11 cities plan would be the most stringent, and that there would be more alleviating policies to be rolled over. We have already observed different actions by different provinces in recent months. For example, Shandong didn't apply the prices represented in the "4+7" policy.

Although investors may feel like many of the policies from the first half of the year are akin to major noise, we would like to reiterate that China's medical reform is working towards a more effective regime, with long-term goals for improving drug quality and eliminating excess profit margins from low-quality generic drugs. We do acknowledge that the first round of GPO resulted in overly harsh impact and consequently several companies endured huge price cuts in order to retain sales volume. Given the similarities across cases in other pilot cities, we expect that the second round of GPO policies will be refined accordingly and that the policies introduced will be more reasonable in nature this time.

We now expect both opportunities and challenges: opportunities for big pharma companies with solid R&D, where innovative drugs of big pharma companies could offset the price-cut of generic drugs, and challenges for small drug makers without blockbusters products. We also think that challenges lie ahead for overseas generic medicines. With the improvement of manufacturing standards, our sector leaders are likely to gain control of more market share which has been occupied by overseas companies with high quality generic drugs.

For our current investment strategy, we feel simple is best: we are going to buy more quality names in the dip and hold them for long. Recently, China has approved the first biosimilar antibody from Henlius, a unit of Fosun Pharma, which is a copy of Roche's Rituxan. We continue to see meaningful progress for biologics development in China, led by a number of companies with strong ability to develop innovative drugs.

Property:

The policy direction so far this year is in line with what has been adopted since 2018, that is, “Housing is for living, not for speculation” and “One City, One Policy”. We don’t expect a big policy shift in 2019. While home-buying restrictions and selling price caps remain strict in the first-tier cities, we have observed some policy relaxation in second-, third- and lower-tier cities to support the sector. Given relatively easing policy and credit environment, we believe the sector should outperform many other sectors throughout the year. Strong earnings visibility will be another key contributor to the sector performance.

As China’s housing market is near saturation, market consolidation has been accelerating in the past few years. Top 10 developers now occupy close to 30% of market share. Rather than watching beta in the property sector, our focus is looking at alpha in individual stocks, seeking for stocks with high quality growth such as competitive products, execution capability and funding channels.

Hardware:

In the first half, the hardware sector faced headwinds amidst both an economic slowdown and saturation in the end markets, although share prices have been running ahead of fundamentals. While the US-China trade tensions has been dialed down, other trade conflicts are emerging, such as the disputes between Korea and Japan, which will continue to weigh on the sector. Heading into the second half, we expect divergence in performance; companies with share gains or secular growth drivers from 5G/cloud infrastructure/AI commercialization will continue to enjoy strong growth and multiple expansion, while for companies with limited exposure to the growth sectors, will start to underperform.

Japan Outlook with Taeko Setaishi (Fund Adviser)

Since 1949 when the Tokyo Market reopened, there has been a fairly close relationship between the trend of the economy, corporate earnings, and the direction of the market. In most cycles stocks usually lead the recovery acting as a pretty good guide to where the economy and corporate earnings are headed.

At present Japan's economy is only moving sideways to only slightly higher. However there are some positives including the steady rise in corporate dividends, low PERs and PBRs, steadily improving balance sheets, low unemployment, and accommodative monetary and fiscal policy. Eventually we expect a gradual shift to investor interest in Japanese equities.

In fact we are very encouraged by the fact that some higher quality money is now quietly moving into Japanese equities and also the J-REITs. We think that the ruling Liberal Democratic Party will do well in the coming July 21st election for the Upper House.

We also expect that the hike in the consumption tax will go ahead as scheduled for October 1st of this year. The government has been implementing tougher tax rules which should over time result in a peaking out of the national debt, and eventually a slow but steady drop in government borrowings.

As in the past, we will continue to pay attention to geo political events including the China/US trade war, world economic growth, especially in the major economies. We also expect a continuing easy money policy in most major economies.

Due to current geo political problems, many Japanese companies have postponed or reduced their capital investments and Japanese consumers have become even more price conscious. However we think that most of the bad news has already been discounted. Perhaps the greatest risks are geo political events and national disasters.

We also think we must continue to remain extra careful in assessing risks for the companies we are considering buying. At present we have around 60 stocks and this helps spread the risk and prevents us from racking up big losses when a few of our investment go wrong.

Atlantis Fund Managers

Yang LIU, Chairperson & 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.

Taeko SETAISHI, Fund Adviser

Taeko is the Fund Adviser of Atlantis Japan Opportunities Fund. With over 28 years experience in securities research and asset management in Japan. She joined AIRC in 1996, is a Japanese citizen and is based in Tokyo. After graduating, she joined Schroder Securities. In 1986, she worked with James Capel and in 1993 joined Schroder Investment Management as an Analyst and Fund Adviser. Taeko is a graduate of Pitmans College.

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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