Taking Advantage of Emerging Asian Opportunities

Make a guess: How many of the largest ten cities of the world are located in Asia? Six would be the correct answer! The top three being Tokyo, Beijing and Seoul. This is not necessary a travel recommendation, but it clearly shows where population growth will be strongest. These days 60% of the world population is living in Asia whereas only 10% are living in Europe.

From an economic point of view it is not an easy time, neither for Asia nor for Europe. Both regions struggle to push for growth. But it is the challenge to re-invigorate growth that presents opportunities. Almost 20 years have passed since the Asian Currency Crisis of 1997 and the consecutive crash in financial markets. The reasons of the crash are still widely debated. The large current account deficits combined with the fixed exchange rate mechanism, which still prevailed at that point of time, were certainly aggravating the problem. Indonesia, South Korea and Thailand were the most affected ones, but they managed to recover relatively quickly as their currencies were depreciated and the IMF provided significant support. Since then the Asian landscape has changed in many respects, but it still presents the following interesting and attractive characteristics.

1. DISTINGUISHING ELEMENTS OF THE ASIAN MARKET

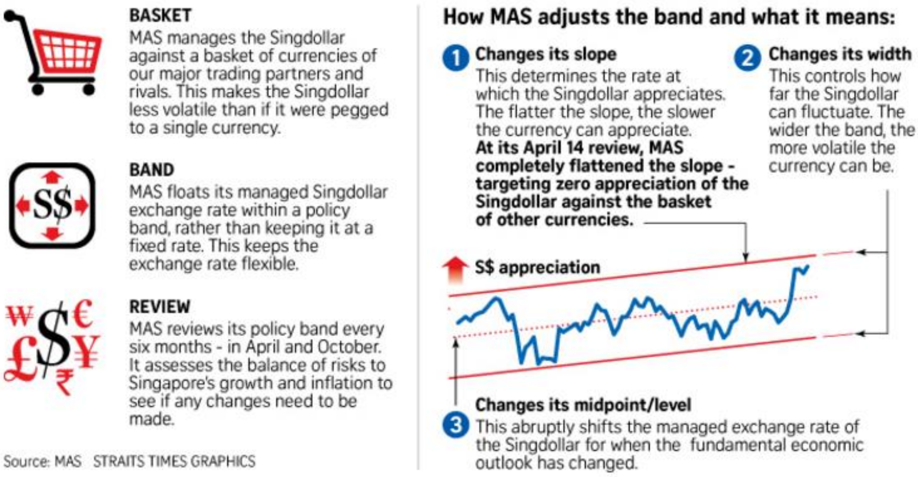
Diversity

Despite being summarized in one term, Asia is far from being homogenous. The individual components have very different and diverging profiles. While some nations are highly developed e.g. Japan, others can still be characterized as emerging markets, e.g. India, Malaysia. As a consequence, economic growth and the resulting monetary policies look quite different. While some nations import commodities such as China, others like Australia and New Zealand are suppliers of commodities. South Korea, usually classified as an emerging economy, has the most liquid market in the world for options on single stocks. Another important aspect is the large portion of retail investors in several Asian stock markets: In 2013, retail investors accounted for 63% of the market capitalization of Korea’s tech index, Kosdaq, and 20% of the Kospi index.

Influence of the Government

In numerous Asian economies, government intervention is relatively high. Currency controls are still quite common across Asia, not just in China. In Singapore for instance, the Singdollar is pegged to an undisclosed basket of currencies. In April 2016, the Singaporean Monetary Authority MAS took steps to dampen the appreciation of their currency.

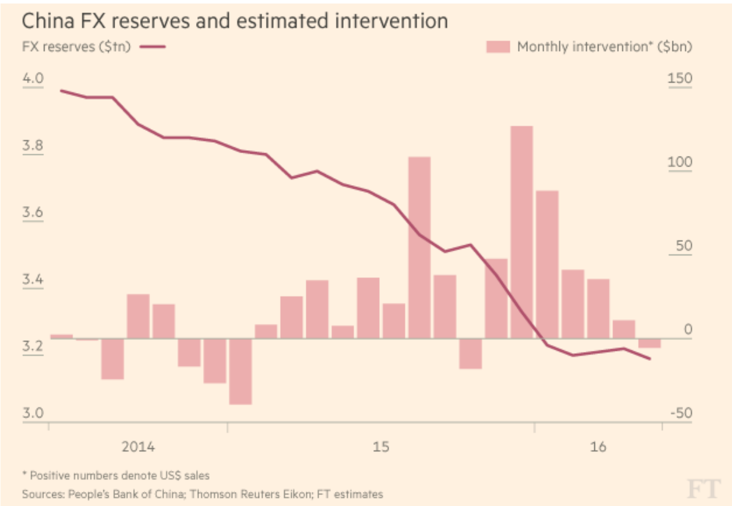
Chart 1: Monetary Authority of Singapore (MAS) and its Mechanism of Exchange Rate Band



China dominates the headlines in terms of intervention:

- Since August 2015, the People's Bank of China has spent USD 473 billion[1] in foreign reserves to support the currency and implement an "orderly" devaluation.
- Moreover, China introduced "circuit breakers" in early 2016 to prevent the stock market from sharp plunges. This mechanism intended to impose a pause on the stock exchange after the index moved more than 5% in a limited amount of time. Only shortly after the system had been introduced, it was suspended as it did not succeed in curbing volatility. This example illustrates how interventions failed to reduce volatility and unfortunately end up achieving the opposite.
- A new "Volatility Control Mechanism" is planned to be launched in August 2016.
- In June 2016, the People's Bank of China took steps to loosen their currency controls and to bring the offshore and the onshore exchange rates closer together. South Korea and Taiwan have also revised their thinking on capital controls and consider more liberal ways.

Chart 2: Chinese Intervention to Support Renminbi



[1] Source: Financial Times, June 21st 2016 "China spent USD 470bn to maintain confidence in Renminbi"

Market Liquidity and Volatility

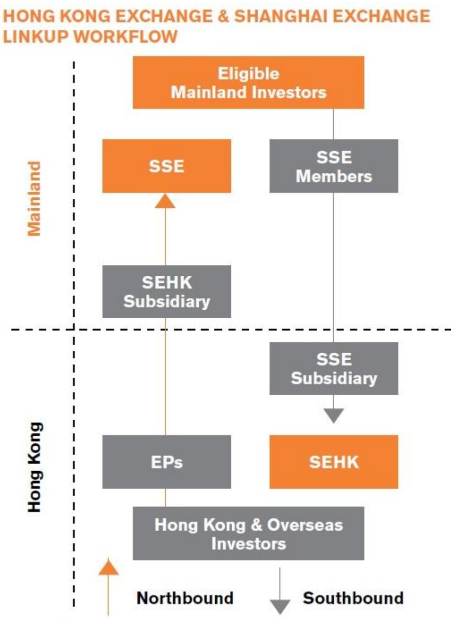
Volatility still tends to be higher in emerging markets as swings are more pronounced. Historic market volatility of the Chinese market is about three times as high as of the US stock market. A shortage of reliable information and transparency (e.g. available company data) poses substantial challenges to diligently analyse a stock from a fundamental point of view. Therefore, momentum factors tend to have more lasting effects and sharp risk-off episodes are more common. Similar to the South Korean Kosdaq index, the participation of retail investors in China is paramount to the market: More than 80% of China's stock market investors are retail investors. They naturally have a shorter time horizon and less patience than institutional allocators.

In general, market liquidity tends to be rather shallow. For example, it is quite challenging to find an appropriate Asian volatility product in Asia comparable to COBE's VIX index, which is a proxy of the S&P 500 volatility. Similar products have been created, e.g. V-Nikkei and V-Hang Seng), but the liquidity in these products is still rather low. On the other hand, in certain markets, you may find better liquidity than in the developed world e.g.: South Korea is one of the most liquid markets for single stock options.

Complex Structures of Stock Exchanges

China's "Shanghai-Hong Kong Stock Connect" scheme, launched in November 2014, was the first controllable and expandable channel for mutual market access between the mainland and Hong Kong, allowing mainland investors to buy Hong Kong listed shares and foreigners to invest in Shanghai listings. It opened the then already overheated A-shares market to foreign investors.

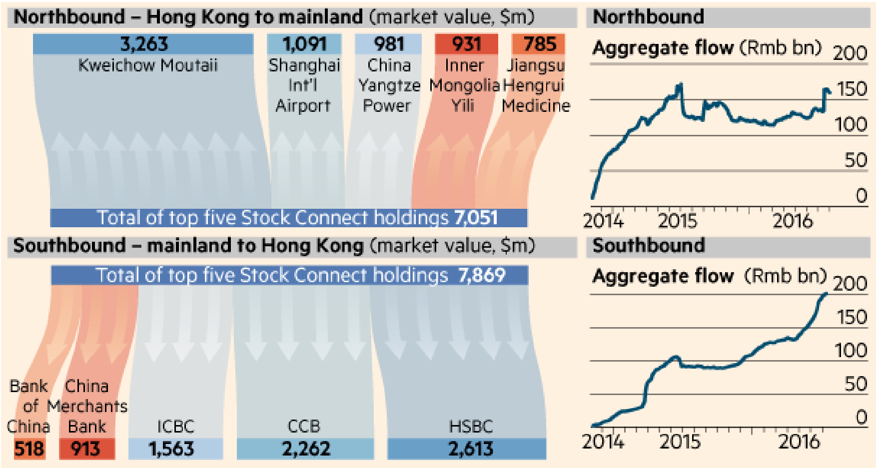
Chart 3: Stock Connect Mechanism



Source: hkex.com.hk/

Two very different worlds and views are connected via Stock Connect: Taking a look at the flavour of Stock Connect in June 2016, the Chinese investors allocating to Hong Kong were focussed on banks, whereas, the appetite of foreign institutional investors allocating from Hong Kong to mainland China is quite different: These emerging market managers avoid banks and rather allocate to infrastructure titles as well as to Tencent, a Hong Kong listed Chinese technology name. It reflects the Chinese investors' interest to look for a safe harbour for their assets. At the inception of Stock Connect, investors from mainland China rather ignored blue chips names and looked for small and mid-sized names of mainland companies with a listing in Hong Kong. Obviously, the substantial drop in A-share performance in the recent past has had an impact on the investment preference.

Chart 4: Hong Kong / China Shares: Diverging Views



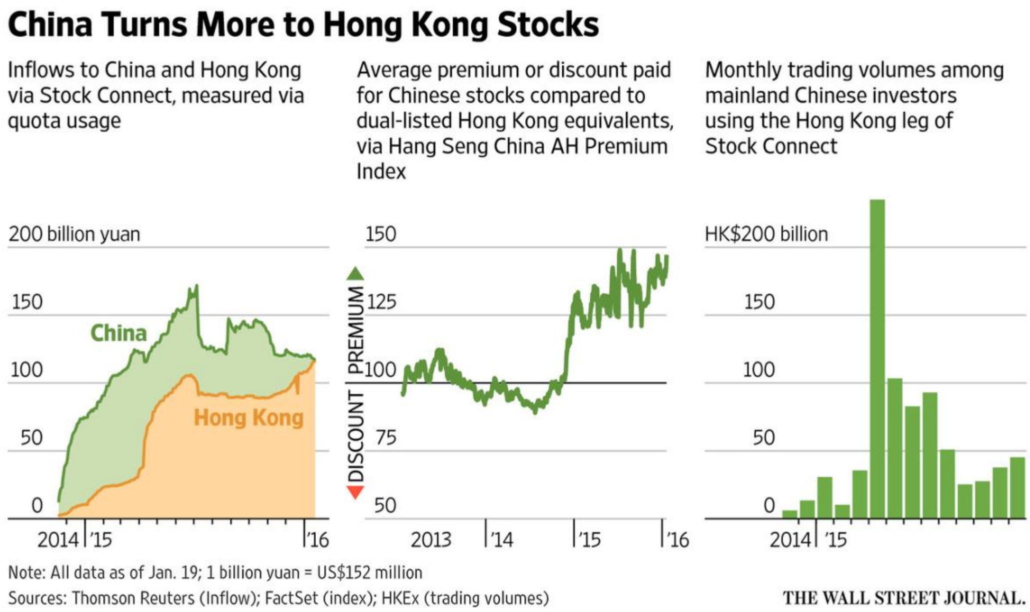
Source: FT July 29 2016 "Hong Kong/China shares: unreliable connection"

Flows started to reverse already at the beginning of the 2016. While at the launch of Stock Connect more money was invested into the Shanghai market, the investments from China into Hong Kong surpassed the flows into China in early 2016. During the summer of 2016 the Chinese investors used almost 80% of their quota, while foreign investors only used half of their permissible amount. However, in relative terms the impact on the Hong Kong market is limited with an average of 2-3% of the weekly market turnover.

In 2015, the picture also reversed from a different angle: While mainland China A-shares traded at a discount to their Hong Kong listed equivalent throughout 2014, it turned to be at a premium throughout 2015 and into 2016. The spread between these listings poses recurring opportunities for hedge fund managers with a view on the future development.

In August 2016, China decided to strengthen its efforts in launching the second exchange link: By the end of 2016 the Shenzhen stock exchange should be connected to the Hong Kong stock exchange the same way as the Stock Connect link between the Shanghai and the Hong Kong exchange. As a consequence foreign investors will be able to invest into 880 additional Chinese stocks over and above the 567 already available via Stock Connect. The spectrum of potential investments of the Shenzhen stock exchange looks quite different: roughly 75% of the Shenzhen's index are privately owned companies (compared to state related companies), which is substantially more than in Shanghai. Moreover the Shenzhen index provides different characteristics with numerous "new economy" companies focussing on healthcare and technology.

Chart 5: Stock Connect Trends

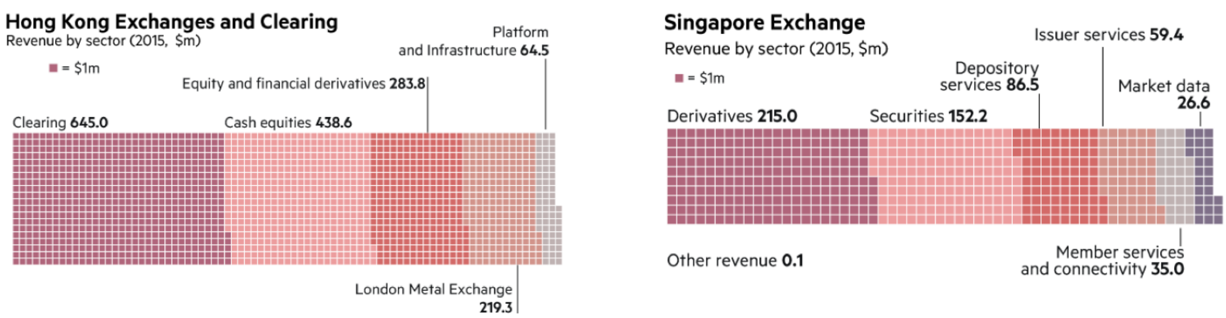


Source: Wall Street Journal January 19, 2016 "Hong Kong/China shares: unreliable connection"

Stock Exchange Specialisation

Whereas Europe experiences a consolidation trend among stock exchanges, this development does not seem to currently take hold in Asia. The Hong Kong stock exchange and the Singapore exchange rather work hard on differentiating each other. They fight to be the Asian centre for cross border trading in as many asset classes as possible, as cash equity trading levels off. In addition, they try to expand to derivatives. In 2012, the Hong Kong stock exchange acquired the London Metal exchange. Moreover, the Hong Kong stock exchange definitely has the lead in Asia when it comes to IPOs and it works hard to position itself as the main gateway for all China related products. The Singapore stock exchange tries to look for diversification with the effort to add the Baltic stock exchange, which would provide access and expertise in freight derivatives. This would naturally work well with the Singapore's characteristic as a substantial container port.

Chart 6: Hong Kong and Singapore Stock Exchange Comparison



Source: FT 29 July 2016 "Singapore-Hong Kong bourse battle heats up"

2. INVESTMENT OPPORTUNITY SETS IN ASIAN MARKETS

As outlined above, these different structural components of the Asian market have led to a wide and diverse set of opportunities, of which hedge funds aim to take advantage. We would like to emphasize on a few of these below:

Arbitrage Opportunities

Double-Listings

A very popular aspect of trading has been to exploit the difference between companies listed in mainland China A-share (onshore listing) as well as in Hong Kong (H-shares).The convergence trade was most attractive for a long time, which involved buying the then cheap A-shares and sell the corresponding H shares against it. As the local Chinese market saw tremendous growth, the trade lost attractiveness. Nowadays, with the Chinese local market at substantial lower index levels, the incentive for investors might reappear.

Perception

It has been observed that Asian markets sometimes react quite differently to news than the developed markets. On the one hand, the ripple-on effects might be different. On the other hand, the perception sometimes varies: While in the Western world, for example, Samsung is purely perceived as a tech name and is expected to respond in line with the Nasdaq, the recognition in South Korea is quite different. In its home market, Samsung is viewed as a conglomerate rather than a pure tech name and its business components on the industrial side and its involvement as a financial service provider are more taken into account. Overnight arbitrage is able to pick up on these opportunities based on time and local perception differences.

Index Arbitrage

Rebalancing of the index and its components leads to temporary dislocations. The trade does not only involve the index versus the cash instrument, but also includes ETFs as well as futures.

Event Driven & Corporate Actions

Rights Issue

A rights issue is an invitation to existing shareholders to buy new shares of the company at a discount. Until the date of the purchase, the “rights” may be traded on the exchange just as the shares are traded. This right acts as the compensation for existing shareholders for the dilution of their stock value. The company is able to raise new capital through rights issues. This route of raising cash may be used by troubled companies to pay off their debt. As well demonstrated with the trade example below, the 1:1 rights issue announced by United Engineers, a Singaporean company, was viewed as a negative signal. The fund was able to benefit through its short position.

Chart 7: Trade Example Rights Issue United Engineers

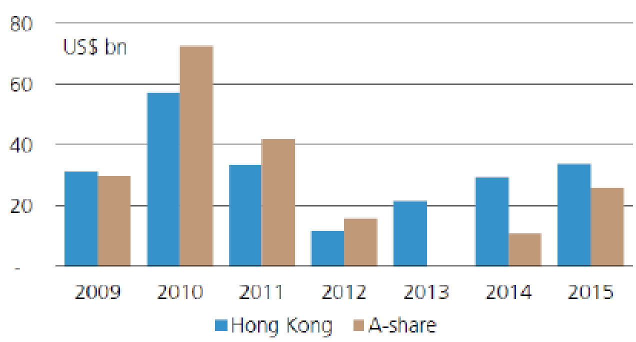
Source: Hedge Fund

Block Trades and IPOs

As investment banks continue to cut back activities, which involve the bank's balance sheet, hedge funds start to engage more in some of these areas. An example is the wind down / sale of large equity holdings, where the initial seller wants to stay anonymous. Usually, these are significant stake holders like private equity investors or strategic holders. The hedge fund takes on the position and slowly sells it in the market.

During 2015, the Asian market provided numerous opportunities in the IPO market. Hong Kong surpassed New York as the world's top IPO destination. Financial companies accounted for more than half of the capital raised. In 2016, the overall volume is much lower due to the current market conditions. Nonetheless, the Hong Kong IPO market did still better than its US counterpart and has again outpaced New York in terms of number of issues and volume transacted. The trend of Chinese companies to look for means to reduce their debt level is likely to further support this trend.

Chart 8: Size of IPOs in Hong Kong and A-share Market



Source: Hedge Fund

Banking Regulation

Capital Requirements

Small and mid-sized banks are undercapitalized in many Asian countries, particularly in Japan. A new opportunity is represented today by Australian banks. It was only back in 2015 that they last conducted a large round of capital raisings in an effort to strengthen their balance sheets. However the Australian banking supervisor APRA recently released an updated report stating that further strengthening of capital ratios will be required. APRA stated that forthcoming international policy developments, such as Basel 4, will mean that Australian banks need to continue to improve their capital ratios in order to at least maintain, if not improve, their relative positioning. The final Basel 4 rules will be decided by the end of 2016, until then it is difficult to estimate the quantum of capital the major banks may need to raise. While regulators will give the banks a period of time to reach these new capital benchmarks, the market is unlikely to be as generous. As globally seen since the financial crisis the 'prisoner's dilemma' could result in raisings occurring sooner rather than later. Managers located in the region have better tools to extract value from the volatility that the sector is presumably going to show.

Capital Structure Arbitrage

Equity vs Debt

China's debt-to-GDP ratio has risen from 154% in 2008 to 249% in 2015, a 95% increase. This ranks in the 98th percentile of debt build-ups in modern history, and is higher than debt levels in most advanced economies including the US, Australia and Germany. A recent report from Goldman Sachs discusses this topic further and mentions that after such debt booms, policy interest rates are often cut to support debt repayment and economic activity, which is regarded as a positive signal for equity markets. One of the possible options for Chinese corporates to reduce their debt load is to raise equity. The market has already seen several large Chinese IPO's and many more deals are in the pipeline. In fact, mainland companies remained the major source of IPOs in Hong Kong in the first half year of 2016, accounting for 68% of the funds raised.

Thematic Investing

One of our Global Macro hedge fund managers indirectly implements trades on the Chinese slowdown and its effects on global commodity prices. The fall in commodity prices further impacts the entire sector. An example is the dramatic widening of the CDS spread of Glencore related to the drop in the Chinese market in August/September 2015.

<u>**Chart 9: Glencore CDS Spread**</u>

Source: Bloomberg

Systematic Opportunities

Within the Asian market, there are extraordinary talents on the quantitative side. These regions offer a different profile since the levels of liquidity are lower, as some markets attract fewer participants due to the time delay. Moreover, the relative high involvement of retail investors lend some markets a different spin as they are more dominated by momentum moves and less fundamentally driven. Markets in Asia are highly fragmented and these regional differences offer a broad spectrum of inefficiencies. It takes local experts to understand the behavioural aspect of the market.

As with any investment, returns are a key consideration. On the one hand, investors obviously want to enhance returns and diversification. On the other hand, the focus remains on the search for investments which offer symmetric or uncorrelated return profiles.

Your Ayaltis team, 24th August 2016