Monthly Newsletter

August 2019

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Darkness Before the Dawn

August has historically been a difficult month for global risk assets with less liquidity and less market participants as they take summer holidays. On top of that, markets are faced with a mountain of concerns this summer:

- Escalating trade wars
- Yields: inversion & negative
- Global economic data worsening
- Argentina
- Italian debt stress
- Possible German recession
- Brexit
- China slowdown & Renminbi breaking 7
- Hong Kong Protests

I will not dwell too much on the last point but it hits home particularly hard and needs to be addressed. Some protesters have openly voiced out that they do not care about the economic health of Hong Kong and plan to ruin it by holding Hong Kong's economy hostage. It is clear that the protestors have achieved their goal and more, with daily lives impacted, businesses paralyzed and Hong Kong's destination for tourism and status as Asia's financial hub at risk.

Hong Kong retail sales for June were down ~7% YoY vs. estimate of down 2% (protests started to escalate in July). Streets once packed with tourists and shoppers are now empty, hotel occupancy rates have plummeted to as low as 20% and retail sales are on track to be down high double digits. Tourism will continue to struggle, and retail operators are at risk with many expecting to not be able to make rent. Several property developers have cancelled flat sales and upcoming economic data will not be encouraging. Unfortunately, there is no clarity as to how this will end and even if the protests subside, the economic damage will take some time to restore. It is always darkest before dawn and I am a strong believer that Hong Kong will not fail. Sensitive topic but happy to discuss more offline.

It has been a difficult summer and we have managed risk relatively conservatively. In July, we started the month with circa 40% of risk primarily allocated to Asian equities, with net risk ranging from 20% to 60% through the month. We have avoided much of the US and Europe markets as their market entered into an overbought status, leaving the book focused on Asia and Emerging Markets.

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PIER 8 ended the month of July with minimal risk into FOMC due to the over-expectations of the Fed cut.

Into August, we benefitted from protection via SPX puts into the FOMC and managed to take profit after the event as Quantdamental signalled a slightly sanguine risk environment. The race to the bottom for rates has not helped EM or Asia from the overhang of i) the Japan-Korea trade battle, ii) the Hong Kong Protest creating the uncertainty for the SAR, and iii) the spike in volatility from Trump's 10% tariff tweet immediately after FOMC.

Given the amount of headline-driven risk we have seen over the past couple of months and with anticipation of more to come in the near term, we have tweaked the model slightly. To maintain the integrity of the model, the choice of indicators has been tilted to reflect more short-term fluctuations in sentiment. Currently 75% of the factors have 5 days or less of lag as compared to 62% prior to the adjustment.

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Valuations Look Expensive, Stay Defensive

Heading into July, the positioning for the RACS portfolio was defensive as credit valuations looked expensive. Expectations are that fixed income returns will be mainly driven by coupon rather than capital appreciation in the second half of the year. Using HYG (high yield ETF) as a proxy, credit has returned nearly 10% YTD and it is unlikely the second half will produce further capital gains especially given the expectations of Fed easing has already been priced into the market.

However, given the pressure for central banks to be accommodative, it is expected rates globally will edge lower and remain low. Therefore, higher quality investment grade paper with longer duration will benefit from this trend. We prefer infrastructure, transportation, utilities and telcos for this theme. In Europe, banks have called previously issued AT1s and earnings have not been as bad as investors feared. We like the AT1s from Barclays, Soc Gen, and Santander. Valuation wise, we took profit on some short-dated positions because of valuations and corporate actions. We took profit in Powerlong 2020s and Central China 2020s. Also note that Capitaland sold its entire 24.09% stake of Central China.

In July, property developers contract sales by the top 100 Chinese developers fell 29% month-over month, and the value of land sold in 300 cities tracked dropped approximately 16%. The decline was mainly due to the tightening of trust loan financing. However, the results amongst developers varied, with some continuing high sales turnover. Those most affected by the tightening of trust loan financing will be those with high off-balance sheet borrowing, such as CAPG, ZHENRO, RONXIN, TIMES PROPERTY, and ZHONGNAN. We prefer GREENLAND, GZRF, LOGAN, LGUANG, JINKE. Please contact us for more details regarding research and trading opportunities in these credits.

RACS currently holds 32 different credits, with a purchase yield of over +9%. The average portfolio duration is 1.4yrs.