Platinum ASSET MANAGEMENT

Platinum Asia Fund

(Quoted Managed Hedge Fund)®

(ARSN 620 895 427 | ASX Code: PAXX)

Quarterly Investment Manager's Report

30 September 2018

Platinum ASIA FUND (QUOTED MANAGED HEDGE FUND)

Investment Update

Platinum Asia Fund (Quoted Managed Hedge Fund) (PAXX)

Joseph Lai
Portfolio Manager

Performance
(to 30 September 2018)

	QUARTER	6 MTHS	1 YEAR	SINCE INCEPTION PA
PAXX	-2.7%	-3.4%	5.2%	6.9%
MSCI AC Asia ex J Index	0.5%	-1.3%	10.0%	10.6%

PAXX's returns are net of accrued fees and costs, are before tax, and assume the reinvestment of distributions. Inception date: 12 September 2017.
The MSCI Index returns are those of the MSCI All Country Asia ex Japan Net Index in AUD. Refer to note 1, page 11.
Source: Platinum Investment Management Limited, FactSet.
Historical performance is not a reliable indicator of future performance.

The Platinum Asia Fund (Quoted Managed Hedge Fund) (ASX code: PAXX) is a feeder fund that primarily invests into Platinum's flagship Asian equity fund, the Platinum Asia Fund ("PAF"), which was established on 3 March 2003.

The following is the 30 September 2018 Quarterly Investment Manager's Report prepared for PAF by its Portfolio Manager. Please note that in this report, the "Fund" refers to PAF and portfolio details, such as portfolio disposition, top 10 holdings and currency exposure, pertain to PAF's portfolio. Please be aware that PAXX and PAF (C Class - standard fee option) have different fee structures and therefore different returns. PAXX's returns may also vary from PAF's performance fee (P Class) returns due to different cash holdings as well as gains and losses arising as a result of PAXX's market making activities.

The Asian market (ex Japan) was down 1% over the quarter in local currency terms. This was mainly the result of concerns over rising US interest rates and the escalating trade dispute between China and the US.

Stocks that contributed positively to the Fund's performance this quarter largely consisted of companies with strong market positions to service Asia's burgeoning middle class, such as India's Axis Bank (+20%), China Merchants Bank (+16%, A-share), and Ping An Insurance (+17%, A-share). Oil refinery companies also did well as crude oil prices continued to rise. Reliance Industries and S-Oil were up +29% and +25% respectively. In spite of the weakness across emerging markets, our Philippines and Thai holdings generally added to performance, including Ayala Land (Philippines property developer, +6%) and Kasikornbank (+11%).

Cyclical stocks generally detracted from performance, with MMG (copper miner) and Yanzhou Coal down significantly. On the whole, it was a challenging quarter for investors, with industry champions such as Tencent and Alibaba (marque internet darlings in China) both down in excess of 10%.

Changes to the Portfolio

Weakness in the share market over the quarter gave us further opportunities to reposition our portfolio, adding to domestically-focused champions and cushioning the Fund against the direct impact of the ongoing trade friction.

The Fund's net invested position is around 80% as at the end of September, with a minimal exposure to the Australian Dollar. We have very limited exposure to the regions that are most susceptible to the rising US Dollar and oil price (Indonesia, Malaysia, Philippines), with positions in a few select domestically-focused companies.

As valuations in the region are becoming more and more attractive, particularly in China, we have cut positions that we believe to have reached their fair value and used the cash to add to the following key positions:

- **Reliance Industries** – an Indian conglomerate that owns the world's largest oil refinery and India's newest and largest 4G mobile network that is set to dominate the country's mobile internet and associated services.

- **Geely Auto** – one of China's fastest-growing home-grown car makers and the owner of Volvo, Geely's affordable, high-quality cars are geared for China's mass market and the company's sales volume is growing at 30-40% a year.
- **AIA Group –** the leading life insurer in Asia, with a dominant position in the huge Chinese market.
- **3SBio** – a leading biologics manufacturer in China, 3SBio is growing 30% a year in earnings and, in our view, has considerable growth potential for years to come as it expands to meet the needs of a still under-penetrated Chinese healthcare market.

While the Chinese stock market has overall been rather out of favour with investors, there are some extravagantly valued companies. The Fund initiated a short position in a well-liked Chinese consumer goods stock during the quarter. Trading on an unjustifiably lofty valuation, the company's narrative of rapidly expanding margins, in our view, is going to be very difficult to fulfil in China's highly competitive market with numerous foreign and domestic brands fighting fiercely for market share.

Disposition of Assets of PAF

REGION	30 SEP 2018	30 JUN 2018	30 SEP 2017
China^	41%	45%	54%
Hong Kong	4%	6%	3%
Taiwan	2%	1%	2%
Korea	13%	11%	10%
India	11%	12%	11%
Thailand	5%	4%	5%
Philippines	2%	2%	4%
Vietnam	1%	1%	3%
Singapore	1%	1%	1%
Malaysia	1%	<1%	1%
Indonesia	<1%	1%	<1%
Cash	19%	16%	6%
Shorts	-1%	-3%	0%

^ Inclusive of all mainland China-based companies, both those listed on exchanges within mainland China and those listed on exchanges outside of mainland China.

See note 2, page 11. Numbers are subject to rounding adjustments.
Source: Platinum Investment Management Limited.

Net Sector Exposures of PAF

SECTOR	30 SEP 2018	30 JUN 2018	30 SEP 2017
Financials	25%	22%	20%
Information Technology	20%	18%	20%
Energy	9%	9%	4%
Industrials	6%	8%	7%
Real Estate	6%	6%	6%
Health Care	4%	3%	2%
Consumer Discretionary	4%	7%	15%
Materials	2%	4%	6%
Telecom Services	2%	2%	2%
Other	1%	-3%	1%
Utilities	1%	2%	4%
Consumer Staples	<0%	3%	7%
TOTAL NET EXPOSURE	80%	81%	94%

See note 3, page 11. Numbers are subject to rounding adjustments.
Source: Platinum Investment Management Limited.

Top 10 Holdings of PAF

COMPANY	COUNTRY	INDUSTRY	WEIGHT
Samsung Electronics	Korea	IT	4.1%
AIA Group	Hong Kong	Financials	3.7%
Ping An Insurance Group	China	Financials	3.6%
China Merchants Bank	China	Financials	3.5%
Kasikornbank PCL	Thailand	Financials	3.4%
Alibaba Group	China	IT	3.0%
China Oilfield Services	China	Energy	2.8%
Naver Corporation	Korea	IT	2.4%
Tencent Holdings	China	IT	2.4%
China Overseas Land & Investment	China	Real Estate	2.3%

As at 30 September 2018. See note 5, page 11.
Source: Platinum Investment Management Limited.

Net Currency Exposures of PAF

CURRENCY	30 SEP 2018	30 JUN 2018	30 SEP 2017
Hong Kong dollar (HKD)	27%	33%	34%
US dollar (USD)	17%	15%	16%
Indian rupee (INR)	15%	13%	12%
Chinese yuan (CNY)	15%	14%	13%
Korean won (KRW)	13%	11%	10%
Thai baht (THB)	5%	4%	5%
Philippine piso (PHP)	2%	2%	4%
Australian dollar (AUD)	2%	5%	<1%
Taiwan new dollar (TWD)	2%	1%	2%
Vietnamese dong (VND)	1%	1%	3%
Malaysian ringgit (MYR)	<1%	<1%	1%

See note 4, page 11. Numbers are subject to rounding adjustments.
Source: Platinum Investment Management Limited.

Commentary

It has been a challenging quarter, and the selling pressure was particularly acute for the Chinese stock market. Three factors coincided to create a perfect storm.

1. **A strong US Dollar and rising US interest rates have been negative for emerging market stocks.**

The US Dollar went from strength to strength in the year to date. However, given that most Asian currencies have already depreciated against the very strong US Dollar, the extent to which the US Dollar will appreciate further is not at all a certainty. The US government's fiscal stimulus plans, which will increase the country's fiscal deficit and necessitate the raising of more debt, may indeed tamper, if not reverse, the US Dollar strength.

2. Signs of a consumption slowdown started to emerge.

Consumption weakness has so far been most evident in the sales of cars and household appliances, while consumption numbers in most other areas have remained generally healthy. Car sales in China this year are down about 10% as some government subsidies began to phase out. The drop also came from a rather high starting point as the year 2017 saw particularly high sales volumes, thanks to the generous subsidies given to consumers.

Another reason for the mild consumption slowdown is the de-leveraging or de-risking effort undertaken by the Chinese central bank (the People's Bank of China or "PBoC") over the last two years. Loan growth in China has slowed from round 15% in 2017 to 8% so far this year – quite a dramatic slowdown considering that the economy is growing at about 9% or so.

Growth in infrastructure spending has also slowed from some 20% in 2017 to around 5% in 2018, another unsurprising sign that the PBoC's credit tightening efforts are having an effect on the broader economy.

Despite the drastic slowdown in loan growth and infrastructure spending, macroeconomic numbers in China have generally held up well. Concerned by the incipient slowdown in consumption, infrastructure and other segments of the economy, the PBoC began to put in place a series of loosening measures since July. It cut banks' capital reserve requirements and lowered the 1 month Shanghai interbank rate from about 4.5% a few months ago to around 2.5% of late! By late September, the PBoC has lent an equivalent of A$150 billion to banks, on track to be the largest net liquidity injection in two years. September also saw China's government bond issuance reach an equivalent of A$120 billion, the largest monthly issuance since July 2017. All of these monetary easing policies, we expect, will translate into greater economic activity and will likely portend at least a short-term improvement for China's stock markets.

3. Increased trade tension with the United States.

The imposition of tariffs by President Trump on Chinese exports has dominated media headlines over the past months. While the headlines look shocking, in our view, the bark is likely louder than the bite.

Firstly, while China remains a big export country, its economy has been gradually shifting away from export-dependence towards greater domestic consumption. Exports as a proportion of economic output have shrunk dramatically to around 20%. Secondly, exports to the US only account for 18% of China's total exports (which translate to approximately 4% of GDP or US$505 billion). Of the US$505 billion, the percentage of value-added exports is likely to be quite low. For instance, while all Apple iPhones are made in China, the Chinese contract manufacturers only capture low single digit margins, with the vast majority of value captured by Apple as well as key component manufacturers like Samsung and chip makers in South Korea, Taiwan and the US. Therefore, the US$505 billion headline number gives a somewhat inflated picture of reality by counting the full contract manufacturing price.

Overall, while the escalating US-China trade tension is no doubt a source of concern, it is worth remembering that 80% of China's exports are destined for countries other than the US, and its vast export sector will not disappear overnight following President Trump's latest tariff-threatening Tweets.

However, it cannot be denied that prolonged trade stand-offs will likely lead to an increase in unemployment, and the likely response, which we are already seeing, will be greater policy relaxation domestically in order to ameliorate the slowdown in economic activity.

The upshot

The Chinese markets have come off significantly since their peak in January. Price-to-book (P/B) ratio is down to around 1.5 times, and price-to-earnings (P/E) ratio is down to about 11 times estimate 2018 earnings. Strong internet companies, the darlings of investors, have taken sizeable falls in the year to date, with Tencent down 32% and Alibaba down 20% from their respective peaks in January. Many stocks are now on "recessionary" valuations, in other words, their prices imply that investors are expecting the onset of a recession in China.

The good news is that the Fund has been booking profits and raising cash over the course of the year, and is ready to deploy capital into some of the very interesting opportunities that have unveiled themselves during the recent sell-off, upgrading the portfolio in the process. While still holding a fair proportion of the portfolio in cash, it would be remiss to focus too much on the short-term market weakness and forego the opportunity to invest in some very attractive companies.

We are focused on finding companies with extremely attractive valuations and promising long-term growth potential and, moreover, companies that are unlikely to suffer significant direct impact from the trade problems. Apart from China, where the Fund has an approximately 41% exposure, we are also finding plenty of opportunities in other Asian countries such as India, Vietnam and Korea, each with their own interesting and sustainable growth dynamics.

The following table sets out the key valuation metrics of several of the Fund's top holdings:

COMPANY	P/E	EARNINGS GROWTH	P/B	ROE
China Merchants Bank (H-share)	7.9x	14.6%	1.5x	15.8%
Ping An Insurance (H-share)	10.4x	22.0%	2.6x	20.6%
Weibo Corp (ADR)	22.3x	38.1%	19.3x	36.4%
AIA Group	17.2x	23.0%	2.3x	15.9%
China Overseas Land & Invt	6.3x	18.9%	1.0x	16.7%
Geely Automobile Holdings	7.9x	25.7%	5.9x	35.7%
Samsung Electronics	6.6x	1.0%	1.7x	21.0%
Kasikornbank PCL	12.5x	13.3%	1.6x	10.2%

Source: FactSet

Outlook

It is possible that US interest rates and oil prices will continue to rise in the coming months, and no imminent resolution is yet in sight for the US-China trade dispute. We should therefore expect to see market volatility persist in the near term. However, we are encouraged by the number of attractive long-term opportunities that we are finding, and we will continue to deploy the Fund's capital with a view to carefully capture those potential long-term winners.

Macro Overview

by Andrew Clifford, CIO, Platinum Investment Management Limited

US-China Trade Tension

The trade war is the issue that has been preoccupying investors over the last quarter. At the end of June, the US applied a 25% tariff on US$50 billion of Chinese imports, and followed up in late September with a 10% tariff on a further US$200 billion of imported goods from China. And of course, President Trump has tweeted that he will put tariffs on all remaining Chinese imports if they don't toe the line. China has followed suit and has now applied tariffs on almost the entirety of their US$130 billion worth of imports from the US. The questions that arise are "for how long will this go on" and "what is the impact on the economy and markets".

The consensus view is that President Trump will not back down and that on the trade issue he generally has bipartisan support. It is also expected that China will not passively accept the US actions and will continue to respond with countervailing measures. The conclusion of this consensus view is that we are entering a new era of rising protectionism and trade friction. The problem for investors is that, when faced with a political issue such as this, no amount of reference to any logical reasoning will provide one with a definitive answer as to what will happen. One can only try and assess the significance of what has happened so far and attempt to make observations about possible outcomes.

The obvious place to start is to consider the importance of trade to both sides in this dispute. For China, exports to the US, totalling US$505 billion, represent around 4% of GDP, and so far approximately half of these exports are subject to tariffs of 10% to 25%.[1] While this will lead to some loss of economic activity in China, there are a number of reasons why the impact will be well short of losing the entirety of these exports.

Firstly, one would expect the exchange rates to move, offsetting in part the price rise for US buyers, and indeed the Chinese Yuan has depreciated 8% against the US Dollar since April this year. Of course, the US administration may accuse the Chinese of currency manipulation, but as China's foreign exchange reserves have remained stable, the accusation will be difficult to substantiate.

Many goods will be difficult to source from other locations. An interesting article in *The Wall Street Journal* cites a study on the value added in smartphones which found that the Chinese labour cost in the assembly of iPhones accounted for as little as 1% of the finished product's value.[2] The study concluded that assembly of such phones in the US would raise the price to the end consumer by approximately US$30, a fairly small increase relative to the total retail price ranging from US$449 to US$1,099. However, to transfer the assembly of US-bound iPhones to the US would require finding approximately 60,000 workers. The article cites the example of Motorola who, in 2013, wanted to assemble a line of its smartphones in the US, but ultimately couldn't source the labour. And this won't be the only challenge. Chinese assemblers are able to rapidly find large numbers of labourers as production ramps up for a new product launch, and then lay them off when volumes recede. The benefit of Chinese assembly is not just the slight improvement in cost, but also the extraordinary flexibility in production that it brings to the smartphone producer, something that labour laws in most parts of the world, including countries such as Indonesia and India, simply do not allow.

Of course, some Chinese production will move to other low cost locations such as Vietnam and Mexico. However, many lower value-add activities, such as textile and shoe manufacturing, have to a large extent already migrated to alternative locations. While this may reduce the US's trade deficit with China, it is unlikely to substantially change the country's overall trade imbalance. Indeed, returning to the smartphone example, the same study showed that key components for the iPhone are sourced from Japan, Korea, the UK, Taiwan, the Netherlands and the US! Moving where final assembly occurs will hardly shrink the size of the US deficit by very much.

To the extent that the US and China are unable to find substitute sources for their imports, then, the tariffs will either be passed on in higher prices or reduce the profit margin of the supply chain, or a combination of both. There does remain the potential for many unintended

1 The latest round of tariffs on US$200 billion of Chinese goods are applied at 10%, with the possibility of increasing to 25% in January 2019 if the Chinese don't accept US demands for various changes.

2 "Bringing iPhone Assembly to U.S. Would Be a Hollow Victory for Trump" by Greg Ip, *The Wall Street Journal*, 19 September 2018, citing a study on the value added in smartphones by Jason Dedrick of Syracuse University and Kenneth Kraemer of the University of California at Irvine.

consequences. As we highlighted in our June Macro Overview, the application of tariffs on imported steel and aluminium had left US companies at a disadvantage when competing with offshore producers not just in their home market, but also in export markets. However, if we simply treat the tariffs as a tax on the US economy and assume that the announced tariffs are collected on the full US$250 billion of imports, they will amount to approximately 0.16% of US GDP, a paltry amount particularly when compared with the individual income and corporate tax cuts passed earlier this year, which will amount to 0.9% of GDP per year in the first four years.

The initial conclusion, based on the actions taken by both the US and China to date, is that the impacts are likely to be relatively small across the broad economies of both countries. The concern, of course, is that it may not stop here. Indeed, the last round of US tariffs on US$200 billion of Chinese imports will rise from 10% to 25% in the new year if China doesn't accede to US demands, and President Trump has tweeted that he will apply tariffs on all Chinese imports, if necessary. Indeed, why stop at 25%? Why not 50% or 100%? Perhaps it is all part of the theatre of the US mid-term elections that will be held this November, but who would know!

Meanwhile, the discussion from the US side has shifted from the size of relative trade deficits and surpluses to the alleged intellectual property theft and forced technology transfer by China. This change of focus is hardly surprising. As we enter 2019, the proponents of the trade war will need to start explaining why their trade deficit hasn't at least fallen to some extent with the imposition of tariffs.

The question of technology transfer is an interesting one. It has no doubt been a central part of China's industrial policy to require foreign companies wanting to access its domestic economy to set up local production, usually with a local partner. In this way, general know-how is gained by local employees who may ultimately end up enabling new local competitors. Of course, there are also examples of more blatant theft of proprietary intellectual property, which can be difficult to prove, particularly when the local legal system in unlikely to be especially helpful to the foreign partner. So the issue of intellectual property does appear as one that may be fought over and may well cause some friction in the foreseeable future.

But even this debate of "IP theft" seems to be a futile exercise. Arguably no foreign company is "forced" to transfer its technology to China or a Chinese joint venture partner, that the choice was always there to not enter China, though many chose the path. The rationale is simply down to the traditional market forces of competition. You either did it or stood by while watching your competitor move its operations to China and gain an immense advantage through higher profits and greater scale.

The automotive market is the perfect example. China's passenger vehicle market is now the largest in the world, 40% larger than that of the US,[3] and for the foreign OEMs with strong positions in the market, such as GM, Volkswagen and BMW, it represents as much as a quarter to a half of their profits.[4] In recent years, local producers have been gaining back market share as the quality of their products has improved significantly, as demonstrated in quality surveys by the likes of JD Power. The ability of the local players to improve their products is a function of the broadening "know-how" within China, which undoubtedly is a result of a strong local industry led by the foreign players. Indeed, a significant local components industry has developed, which now exports nearly US$17 billion of auto parts to the US.[5]

Has there been any misappropriation by local Chinese companies of foreign OEMs' or their suppliers' proprietary intellectual property? Almost certainly yes. But even in the "wild wild east", suppliers stealing IP would be excluded by foreign OEMs and from the export markets of developed countries. It is also worth observing that leading local auto producer, Geely Automobile, most certainly uses foreign "intellectual property" and know-how in its production. Its method of accessing this know-how was to acquire a struggling western auto producer, Volvo. Today, M&A is the way through which the best Chinese companies are acquiring technology and know-how, as seen in a plethora of transactions from Midea Group (Chinese household appliance maker) buying Kuka AG (German robotics and automation supplier) to Weichai Power (Chinese heavy duty Diesel engine maker) buying a controlling stake in Kion (German supplier of forklifts and warehouse systems).

Finally, it is worth noting the following investment projects by foreign companies in China, all of which have been announced since the beginning of July this year: BASF of Germany announced a US$10 billion chemical plant in Guangdong province, ExxonMobil of the US a US$10 billion petrochemical plant also in Guangdong, and Tesla a US$5 billion plant in Shanghai. Each of these investments is to be fully owned by the foreign company, which typically is

3 Based on new car registration data between January and December 2017: www.statista.com/statistics/269872/largest-automobile-markets-worldwide-based-on-new-car-registrations/

4 24% for GM, 28% for BMW, 30% for Mercedes, 37% for Ford, 49% for Volkswagen Group, and 56% for Audi (based on 2016 China profits before tax as a percentage of global total). Source: Evercore ISI and Financial Times.

5 Source: US Department of Commerce, Bureau of the Census, Foreign Trade Division; Bureau of the Census USA Trade (https://automotiveaftermarket.org/automotive-aftermarket-imports-exports/).

not permitted in the industries concerned. These announcements suggest that the Chinese have already begun to modify their approach and that major foreign companies remain confident to invest in the country.

So while the differences between the US and China on the issue of trade seem intractable, the question is "what really can be done". The opening-up of China to foreign investment and trade has allowed the likes of Apple, BMW and Nike to earn enormous profits, and has given consumers access to new technologies and affordable running shoes. The system has delivered massive benefits to businesses and consumers across the globe. This is the hard economic reality that policy makers face. While they may be enjoying the political theatre of it all, the current pathway of ever rising tariffs, if continued, will simply result in lower consumer spending power, lower profits, and a loss of jobs, in both countries. This should provide both sides to the dispute with a compelling reason to start looking for solutions once the noise and excitement of the fight dies down. The drama may take some time to play out and no agreement is yet forthcoming, but ultimately a negotiated resolution seems to be a more likely outcome than returning to a trading system akin to that of the late 1970s and early 1980s with commensurate falls in global living standards.

Other Developments

While the verbal battles of the trade war raged on, there have been some significant ongoing developments elsewhere that need consideration.

As we have discussed in our March and June Macro Overviews, China has been implementing a significant reform of their financial system, bringing the shadow banking activities back onto the balance sheets of the banks. This has resulted in a tightness in credit availability during the first half of the year, which has led to distress in some parts of the economy. Notably, peer-to-peer lending networks[6] have come under pressure, and as a result individual lenders have suffered losses from investments in these loans.

The concern is the potential impact the credit tightening will have on consumption expenditures. Indeed July and August monthly passenger vehicle sales in China are down 5.3% and 4.5% respectively from a year ago. Into this potentially weaker economic environment, then there is the issue of the impact of the trade war on business confidence where, unsurprisingly, there is evidence of a cutback in investments by the manufacturing sector. Softness in infrastructure spending was also evident in the first half of the year as local governments faced a lack of funding following tightening measures directed by the central government.

Investors are concerned that a more generalised slowdown may have begun in China. Whether that is in fact the case remains debatable. Construction activity remains strong, as are sales of residential property. Steel production remains at near record levels. Nevertheless, Chinese policy makers have acted pre-emptively, presumably concerned by the potential impacts of both the trade war and their own financial reforms. Initiatives include extending the time frames for banks to bring back shadow banking assets onto their balance sheets, and granting approval to roll over existing loans. Funding for approved infrastructure projects is being made available. Tax cuts for individuals and businesses worth 1% of GDP[7] have been announced. While these and other measures may seem far more modest than the stimulatory policies put in place during previous periods of economic weakness, it is also the case that, for the moment, the softness in the economy is not as apparent as it had been in past cycles.

The US economy continues to grow strongly, helped along by the tax cuts put in place this year. Employment remains robust, consumer and business confidence is high, and while inflation is on the rise, it remains at relatively subdued levels. During the last week of the quarter, the Federal Reserve increased interest rates by 0.25% for the seventh time this cycle (since late 2015), bringing the federal funds rate to 2.25%. As we have stressed in past reports, while rising rates will eventually bring an end to the current economic cycle, it is difficult to assess when the impact of higher rates will be felt. Conventional rules of thumb, such as the steepness of the yield curve, do not suggest any imminent downturn.

In Europe, growth has slowed through the first half of the year as the region deals with the UK's messy exit from the European Union (EU) and concerns around the economic policies of the new Italian government. However, the region continues to grow employment with 2 million jobs added over the last year, and with countries across the EU close to achieving fiscal balance, there remains capacity for their governments to increase spending. Further, a current account surplus of 3.5% of the Euro Area's GDP places the region on a strong footing for future growth.

The Japanese economy also remains in good health. Employment is strong with 1.1 million jobs added in the last year, and the ratio of open positions to applicants is running at 1.6, the highest level in 43 years. Wages are growing at just over 2% per annum. There is potential in the country, and

6 Peer-to-peer (P2P) lenders are intermediaries, typically online platforms, that match people who have money to invest with people who are looking for a loan. Well-known P2P lending companies include Lending Club in the US, RateSetter in the UK, and Society One in Australia. Chinese P2P lending platforms are largely similar to these.

7 www.fitchsolutions.com/country-risk-sovereigns/economics/chinese-policymakers-speed-tax-cuts-and-infrastructure-projects-28-08-2018

many businesses still have excess labour. If higher wages can attract labour into more productive endeavours, the benefits to the broader economy could be quite significant. Japan's labour costs are now globally competitive which should underwrite ongoing investment. Finally, it is worth noting that nationwide land prices registered the first increase in 27 years.

Market Outlook

The potential of a China slowdown, exacerbated by the trade war, and the impact of ongoing rate rises in the US, have seen investors once again become risk averse. Specifically, this has meant avoiding companies that face any degree of uncertainty and focusing instead on companies that are perceived to be immune from external factors like trade tariffs. Often this is expressed by commentators as a preference for “growth companies” over “cyclical businesses”, but many more companies have been caught up in the sell-off than the traditional cyclicals, extending to sectors such as financials and lower-growth technology stocks. The exception has been energy stocks which have been helped by higher oil prices over this period.

Geographically, this has translated into significant outperformance by the US market as it has a much higher representation from those strongly performing sectors than the rest of the world (the technology, healthcare and energy sectors together account for more than 47% of the MSCI US Index, compared to approximately 28% for the MSCI AC World ex US Index). Generally, the weaker geographic markets have been those with a greater weighting in cyclical and financial stocks throughout this period. Additionally, the emerging markets have suffered as a result of the stronger US Dollar increasing the cost of funding for external debts, most notably in the case of Turkey.

From an investment point of view, it is worth observing that the strong performances in areas such as technology and healthcare have been driven by stocks that, based on our research, were already expensive by historical standards. Software stocks and internet companies that have been central to the strong performance of the technology sector in recent months are now valued against their revenue base at levels only exceeded in the technology bubble of 2000, as illustrated in the two **charts** on the following page.

While the valuation of biotech stocks is not so readily demonstrated by reference to comparable historical data, there are signs that valuations have become stretched in many cases. The record number of new biotech IPOs[8] is also strong confirmatory evidence. By stark contrast, six months ago, the deepest value was to be found in the North Asian markets of Korea, China and Japan, and yet these markets have performed poorly over the period.

8 There were 47 biotech IPOs in the first nine months of 2018, already more than both the full years of 2016 and 2017. (Source: Renaissance Capital)

MSCI All Country World Sector Index Net Returns (USD)

SECTOR	6 MONTHS TO 30 SEP 2018
Health Care	13.7%
Energy	12.9%
Information Technology	10.1%
Consumer Discretionary	6.0%
Industrials	3.0%
Utilities	1.9%
Consumer Staples	0.8%
Materials	0.7%
Telecommunication Services	0.4%
Financials	-3.3%

Source: FactSet.
Total returns over time period, with net official dividends in USD.
Historical performance is not a reliable indicator of future performance.

MSCI Regional Index Net Returns (USD)

REGION	6 MONTHS TO 30 SEP 2018
All Country World	**4.8%**
Developed Markets	**6.8%**
Emerging Markets	**-9.0%**
United States	11.0%
Australia	4.2%
Germany	-4.5%
France	2.4%
United Kingdom	1.2%
Italy	-11.5%
Spain	-6.6%
Russia	-0.3%
Japan	0.7%
China	-10.7%
Hong Kong	-2.1%
India	-2.8%
Korea	-8.5%
Brazil	-21.9%

Source: FactSet.
Total returns over time period, with net official dividends in USD.
Historical performance is not a reliable indicator of future performance.

US Software Companies – Enterprise Value / Sales

Source: FactSet

US IT Service Companies – Enterprise Value / Sales

Source: FactSet

This has led us to conclude that, outside of the favoured growth stocks, markets are pricing in a future that is substantially different from the world that can be observed today. Essentially, cyclical stocks are factoring in a significant slowdown in global growth. While this could be the case, there are a number of reasons suggesting that the picture may not be quite so grim:

- As outlined above, the scope and impact of the trade measures put in place to date are limited relative to the broader economic backdrop. As such, the trade war would need to ratchet up significantly to further impact on markets.
- There is an underlying futility to the trade war that needs to be resolved with a face-saving political solution for its proponents. It is instructive that the US has now come to an agreement with Canada and Mexico on trade that achieves little substantive improvement on the existing North American Free Trade Agreement (NAFTA), but represents a political win for the Trump administration. While a resolution will take time and there may be further damage before one is reached, it is not entirely unrealistic to expect a deal with China at some point.
- Meanwhile, China has moved to stimulatory policies to underwrite growth. As they have done in past, such policies will likely achieve some of their intended effect.
- While higher interest rates should ultimately slow the US economy, given the existing strength in labour markets and the availability of ongoing fiscal stimulus, a slowdown may well be further out on the horizon.

To sum up, markets are currently positioned in a very defensive manner, and any lessening of the fears that have driven stock prices in recent months could well see them move higher. Of course, there is always the possibility of some new issue arising, especially in a world where balance sheets are weak and interest rates unsustainably low. But for the moment, investors appear to be leaning very heavily in one direction. More often than not, it pays to head in the other direction.

Notes

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3. The table shows PAF’s effective net exposures to the relevant sectors as a percentage of PAF’s net asset value, taking into account direct stocks holdings and both long and short derivative positions (stocks and indices).
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