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K2 Asian Equity Update
Quarterly Report - 31 March 2017

Market Review

Global equity markets started 2017 without skipping a beat. Despite a few hiccups late in the quarter, investor optimism persisted with any dips disappearing faster than a pick-pocket on the Champs-Élysées.

Trump's Healthcare bill remains stuck in the "pits" much like Daniel Ricciardo at Albert Park. As politicians and engineers alike work feverishly to make it to the starting grid, the world still waits for details on proposed US tax reform and infrastructure spending plans. We can safely assume that the Republican Party currently resembles the same level of productivity and co-operation as a French farmer.

After lagging the initial post-Trump election rally in November and December, Asian markets made up for lost ground in Q1. Hong Kong rallied 8.9% as strong corporate earnings buoyed investors in a market that was already cheap relative to global peers. This was supported by its big brother China, with the H-Share index increasing +8.6%. Chinese linked markets Korea and Taiwan both benefited from the goodwill climbing 5.7% and 5.8% respectively. India advanced +12.0% while Australia was the laggard of the bunch, staggering higher by a mere +2.3%.

Asian markets generally benefited from Asian bank's linkages to higher US interest rates as they access off-shore funding, while the improved corporate news flow excited investors. A stabilising Chinese property market combined with a range of tightening measures announced by Beijing to clamp down on rampant speculation also settled investor nerves. The oil price (WTI) retreated 5.8% to $50.59 as concerns mount over increasing US stockpiles and the impending wall of shale. The AUD closed March at 76.29 US cents, up +5.8% for the quarter.

Outlook

Equity market headlines have been preoccupied with the latest musings from President Trump. The reality in markets, however, has been rather different. They are not pricing faster growth or inflation with US inflation expectations falling. In fact, the US 5Y5Y (nominal 5y bond minus 5y US inflation-linked bonds) forward breakeven has now moved back near 2%, similar to levels seen immediately following the US presidential election.

Expectations of further interest rate rises in the US have firmed with continuous hawkish rhetoric from the Federal Reserve underpinning a minimum of two more rate rises in 2017 on top of the 25bps increase in March. Now that markets are firmly entrenched in a tightening rate cycle, we are skeptical of the ability for bond proxies to continue their post-GFC re-rating and thus are actively avoiding or shorting assets that fall into this arena, including property, infrastructure related assets, yield plays with no underlying growth and expensive consumer staples. Excluding these assets, we still see numerous opportunities within the US market. These include banks who are significant beneficiaries of rising rates, economically sensitive cyclicals that had been forgotten since the GFC and structural growth plays including leading technology names.

The fund continues to run an overweight position in Australia's leading resource companies. We believe that global conditions will continue to support commodity prices throughout 2017 and hence resource company profits still have meaningful upside. Since early last year the major global resource companies have resisted their normal tendency to respond to higher commodity prices with a surge of supply and capital expenditure. This new found discipline has resulted in a significant improvement in shareholder returns and gearing levels. We feel that more is instore and that most sell side analysts are still behind the curve.

The China bears shouting from the rooftops have once again been silenced as Chinese economic indicators have remained positive through the quarter, with PMI indicators steadfastly resilient above 50, industrial production higher at 6.2% and the release of Q4 GDP at a better than expected 6.8% while CPI inflation came in at a lowly 0.8% yoy. A standout on valuation, Asia represents some of the best value on global equity exchanges with Chinese companies, trading on a forward P/E of 10.7x (vs the US on 17.6x). Australia has also de-rated now trading at 14.3x forward P/E, while the markets quality as defined by the Return on Equity achieved continues to rise. Asian bourses such as China, Korea and Hong Kong seem significantly mispriced relative to global peers and represent significant opportunities.

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Currency

The Fund maintains a net equity market exposure of ~84%. At the beginning of the quarter we increased our AUD hedging from 49% to 91% as the USD (and linked currencies including the Chinese Renminbi and Hong Kong dollar) were overbought on a number of our internal indicators:

- The Republican Party's inability to pass their own legislation has raised uncertainty regarding Trump's reform agenda.
- Even if agreement is reached on US infrastructure upgrades, time lags of 1.5-2 years before project commencements are likely.
- While global growth is becoming more synchronized which is net positive for the commodity price environment, some of this good news is already discounted in the prices of resource companies and commodity based currencies such as the AUD.
- Australian economic growth is looking patchy at best and the policy responses and reform initiatives to maintain the extended upside are looking decidedly underwhelming.
- Australia's last trade number was somewhat disappointing, although the trend should remain positive.
- Actions by the Australian banking sector to raise interest rates on housing loans will help alleviate the necessity of the RBA to raise official cash interest rates in the short term.

Portfolio Insight: Guangzhou Automobile Group (GAC)

China is the largest global car market with nearly 29m passenger and commercial vehicles sold in the year ended February 2017, up from 22m sold in 2013, and accounting for more than a quarter of vehicles sold globally. GAC is entrenched in this growth sector through the production of high quality Chinese made vehicles for the Chinese market under the Trumpchi, Gonow and Changfeng Motor marques.

Much of GAC improvements have come through its JV with Honda (and other international car makers) where it produced cars for the JV partner in China for the Chinese market. Our recent visit to GAC's headquarters and plant in Guangzhou gave us a clear insight into the company's manufacturing capability and product placement where significant headway is being made into the SUV market led by the Trumpchi GS8. With the shares trading on 8.7x 2017 P/E, net cash on balance sheet and the strong product lineup, GAC looks well placed to capitalise on its domestic growth opportunity.