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INVESTMENT MANAGEMENT & STOCKBROKING

MARKET COMMENTARY

November 2017

From Red Chips to BATs

Of the key global equity markets that we monitor (as shown on the back page) all are now up over 1 month, 1 year and 2 year time periods, with the single exception of Russia. Down 0.6% in October, the region is a solitary red spot in an otherwise sea of green. The last two years have been extremely rewarding for stock market investors, although it is easily overlooked given the negative headlines over Brexit and the various political issues at home and around the world. Although mostly in positive territory last month, the story hasn't been quite so positive for bond investors, especially over the last year, but this is hardly surprising given the tightening monetary conditions. Elsewhere, gold and precious metals edged lower as Korean tensions have eased, but oil is rallying back to 2-year highs as OPEC and Saudi constrain supply and inventories diminish.

It is something of a relief to see October now behind us, given its link to so many unpleasant anniversaries such as the onset of the Global Financial Crisis (9 years), the Asian Financial Crisis (20 years), Black Monday (30 years), the Wall Street Crash/ Black Tuesday (88 years) and the Panic of 1907 (110 years). At this time of year there are numerous editorials drawing parallels with the past and suggesting that history may be about to repeat itself and it is unnerving. It does seem a peculiar coincidence that all of these calamities all occurred in the same month but the evidence clearly suggests that October Effect is just an illusion.

Nevertheless, it is a timely opportunity to look back and question what progress has been made, what lessons have been learned. That is a subject well beyond the scope of this short document, but as a general observation it is striking how the Asian Financial Crisis changed the mentality of policy-makers in the region. Ultimately, the IMF bailout forced reform and as a result these so called Tiger Economies radically changed for the better. Very crudely, the problems stemmed from a combination of high current account deficits, inadequate banking regulation, a reliance on overseas investment, fixed exchange rates and dollar denominated debt. As a consequence the Thai baht halved in value against the dollar, its stock market fell 90%, Indonesian inflation hit 80%, South Korea saw widespread corporate loans default and speculators ravaged the Philippines and Malaysian financial markets.

Notably absent from most of this saga was China. Though the handover of Hong Kong to Beijing occurred in 1997, trading links with its neighbours were still relatively limited and it was not until membership of the World Trade Organisation was granted in late 2001 that material change got underway. China's main involvement in the crisis, which on reflection was really more of an association, was through the flotation of the so called *Red Chip* companies. Indeed, this side-story was more a symptom of the crisis than a cause. These were part state-owned enterprises, listed in Hong Kong that gave overseas shareholders the opportunity to gain exposure to the potential rapid economic growth in mainland China.

This caught the imagination of huge numbers of speculators, who were prepared to overlook the murky corporate governance and opaque business plans in order to get a piece of the action. The big names at the time included Beijing Enterprises and Guangdong Investments which floated in 1996 and 1997 respectively but by mid-1998 their share prices had fallen 90%.

Today, the region is almost unrecognisable and not just the physical change in terms of building, construction and urbanisation. Crucially there has been a shift in how free-enterprise has been allowed to provide solutions to consumer and business and this is proving transformative. Not so long ago the image of Chinese businesses, particularly in manufacturing were cut-price, fly-by-night imitators. Increasingly they are seen to be innovators with a long-term view and a steely financial discipline. The story is maybe best told by looking at the following five companies. The first three are colloquially referred to as the BATs, but we felt that it would be amiss not to mention the other two given their heady growth prospects.

Alibaba

Founded in 1995 this online retailer is often referred to as the Chinese Amazon. Responsible for 11% of all retail sales in China, the group is benefitting from the growth in the middle class and has 507m active mobile device users per month. Amongst many other services it also hosts nearly 40% of all websites in the region, operates a payment system (Alipay), monitors traffic flow and operates a YouTube-like website. Some of their recent developments look set to be replicated in the West, such as Alibaba's Ant Financial software which allows users to pay for goods by simply smiling into a camera. Alibaba is therefore more than a just retailer and the data that the conglomerate has amassed could prove vital in its aspirations to master the laws of artificial intelligence (AI).

With its primary listing on the NYSE, the company has a market capitalisation of $480m. Revenues in the financial year to March 2015 were $76bn, by the 2018 year end they should be closer to $240 billion. By 2036 the company believes it will effectively become the world's 5^{th} largest economy, ahead of Germany, India and the UK.

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Tencent

Tencent is arguably at the forefront of the Chinese internet-led evolution, with a huge network of investments in technology companies across the region. It owns products in instant messaging (WeChat), gaming, and a wide range of online financial and social media apps. Much of its revenues are derived from advertising. It also has a 15% stake in JD.com, discussed later on.

Right now the company is best known for WeChat which is almost a combination of the key features of Facebook and WhatsApp, but can handle purchasing and payments, and is becoming the app that does everything. By the end of the year it could easily reach one billion active users. One of the attractions is the ability to send gifts in the form of a virtual 'red packet' and 14.2 billion were sent last New Year.

Baidu

This is the Chinese equivalent of Google, with a 76% share of the local search engine market. It offers services such as mapping, a music streaming service with over 200 million monthly users and an online encyclopaedia. It also has AI ambitions and by 2020 aims to have its own self-driving cars.

Given its privileged position in the region, (competitors such as Google are not allowed to operate in mainland China), the barriers to entry are huge, which should add a premium to the valuation yet the forward P/E ratio of 26x seems cheap.

Weibo

Launched in 2009 Weibo (pronounced 'way-bwo') is a Chinese microblogging website similar to Twitter. With 159 million daily users and 361 million monthly users, it is one of the most popular social media sites in China with a similar market penetration to that of Twitter. The product has evolved into a comprehensive platform which incorporates the major features of other social media sites such as YouTube and Instagram. Censorship in China has allowed Weibo to flourish as a result of blocking many competing sites, including Twitter and Facebook. Alibaba has a 32% stake.

Unlike Twitter, Weibo is currently profitable. For 2017, revenues are expected to surpass the billion dollar mark as a result of 66% revenue growth, with net income of $357 million. In comparison, Twitter revenue is fairly static around the US$2.4 billion mark, with maiden profits expected at the end of this year.

JD.com

Known in China as Jingdong, this e-commerce group has rapidly grown to become the world's third largest internet company in terms of revenue. The group's business to customer model allows for a broad range of goods from food to luxury goods, to property. In common with the other Chinese internet giants, and their US counterparts, the group's CEO Liu Qiangdong is a colourful character with very aggressive growth plans. He has invested heavily in distribution and building out infrastructure and it will be fascinating to see how his focus on robotisation develops.

The chart on page 4 shows the relative size of sales and market values of the companies and what immediately jumps out is that there doesn't appear to be a clear link between sales and market value. The answer here is the businesses' ability to convert sales into profits, and that varies considerably. Facebook have demonstrably been able to achieve this in recent years, Twitter have not, but interestingly many of the Chinese companies seem happy to forgo margin today in order to cement their user base and hopefully create bigger margins tomorrow. Indeed, this is one of the messages to be drawn from this fascinating video put together by the team at Fidelity showing how millennials in China live their lives.

The other feature is that, prima facie, the valuations do not appear to be at crazy levels. Amazon is pushing 70x next year's earnings, but these earnings are real and set to be four times higher by the end of 2021. Such heady growth rates are similar across the board and if we revisit this chart in three years, the left hand scale will likely be measured in trillions of dollars. If forced to buy shares in just one, we'd go for Baidu.

In contrast to the red chips of yesteryear these companies are well-supported by some of the biggest and most respected names in the fund management industry. Baillie Gifford's hugely successful Scottish Mortgage Trust, now worth almost £6.5 billion, has Tencent, Alibaba and Baidu in its top ten holdings. Here, Linda Lin discusses the investment case for Alibaba.

A word of warning, however. There are plenty of sceptics who regard the surge of interest in these companies as evidence of bubble behaviour. Tencent's recent acquisition of a 12% stake in unproven Snapchat for a huge $220 million has a whiff of excess to it as does the 600-times oversubscribed IPO of China Literature, an online bookseller.

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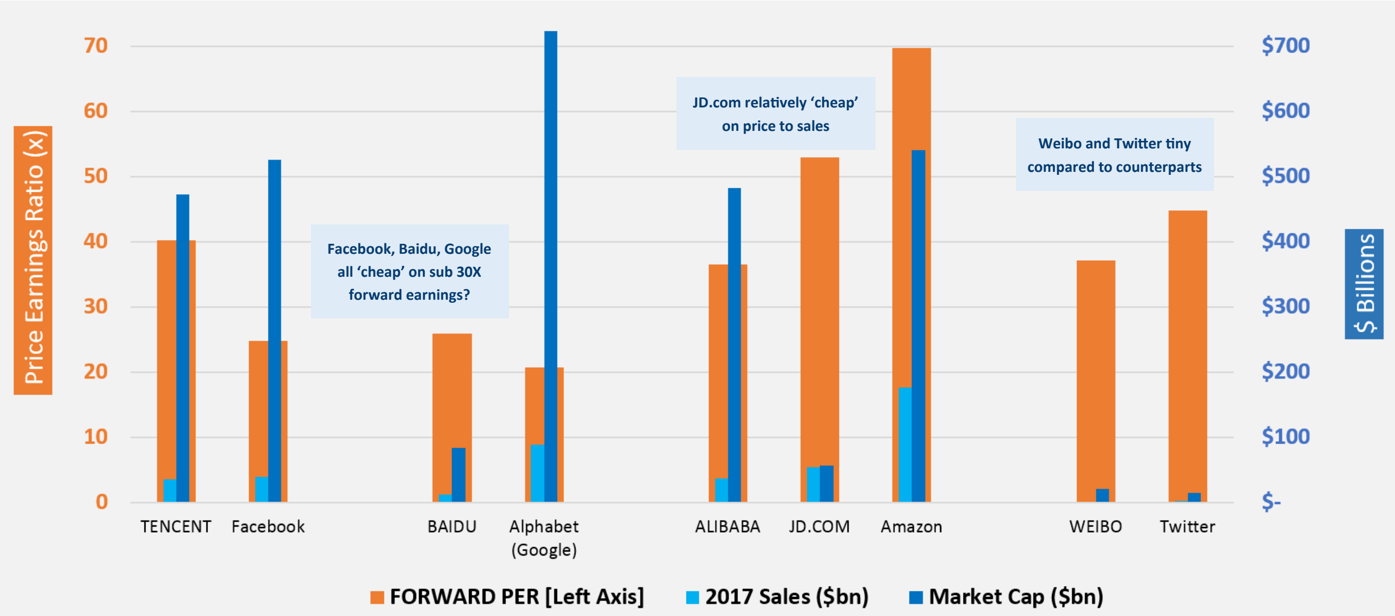

Source: Albert E Sharp, Bloomberg®

At a recent conference that we hosted, Roberto Lampl, fund manager at emerging markets specialist Alquity, raised more fundamental questions. In all the hype it seems to be forgotten that the Chinese government is central to this entire story and the extent to which it is prepared to support or tolerate these companies' increasing wealth, knowledge and, ultimately, power remains unclear. Any new limitations could be disastrous for share prices given the lofty valuations. CNBC's Jim Cramer is actively suggesting that investors should avoid Chinese IPOs altogether, suggesting that getting reliable information on which to conduct any analysis is near impossible. That said, he concludes that investors stick with Baidu.

At the time of writing, stockmarkets are hitting new all-time highs, valuations are at the top end of historical ranges and volatility is at all-time low. Spanish essayist George Santayana once said that 'those who do not remember the past are condemned to repeat it' and although the comment was pointed at politicians, it is often seen as an important lesson for investors. However, the history books aren't always much use in the face of brand new, disruptive technologies that are about to fundamentally change how billions of people live their lives. Of the five Chinese companies mentioned in this article we suspect that at least one will have a value over $1 trillion by the end of 2020. Sometimes it is more valuable to use today's facts in an attempt to predict where we are going, than it is to use yesterday's facts to explain how we got here.

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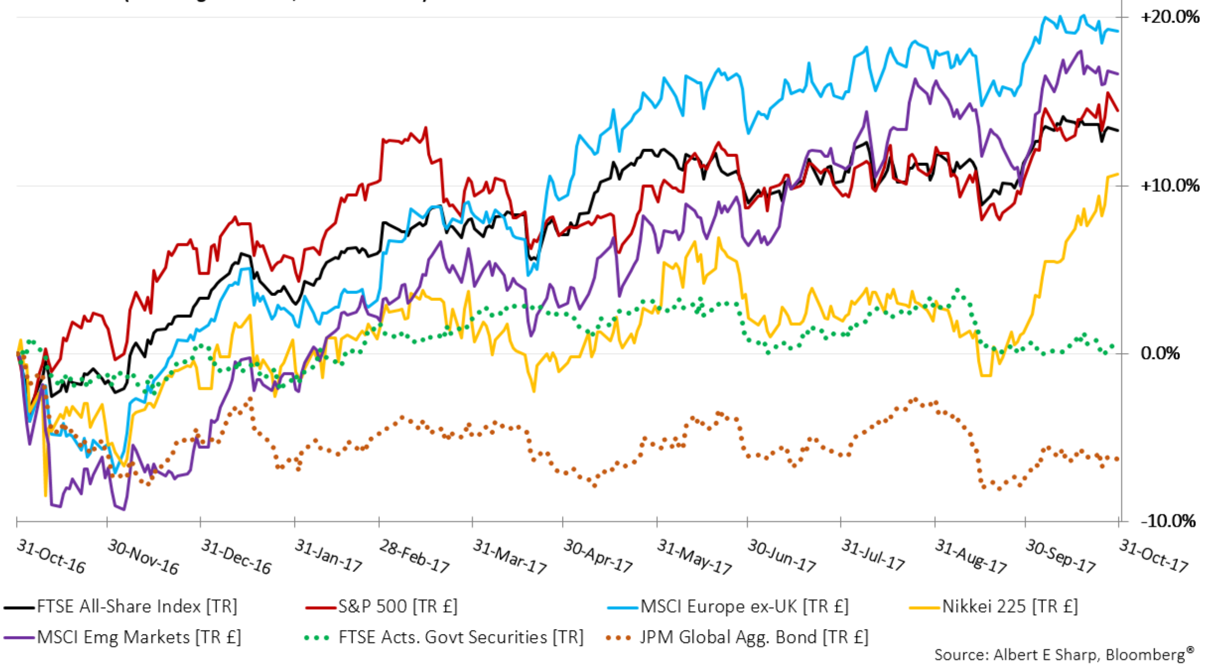
Index Returns

Index	Region/Asset Class	31 Oct 2017	1 Month Change	1 Year Change	2 Year Change
UK 100	UK	7,493.1	+1.6%	+7.7%	+17.8%
UK Mid Cap	UK	562.6	+1.4%	+11.0%	+11.8%
UK Small Cap	UK	5,833.8	+2.1%	+17.3%	+26.8%
Dow Jones Ind Avg	USA	23,377.2	+4.3%	+28.9%	+32.3%
S&P 500 Index	USA	2,575.3	+2.2%	+21.1%	+23.8%
NASDAQ Comp.	USA	6,727.7	+3.6%	+29.6%	+33.1%
Nikkei 225	Japan	22,011.6	+8.1%	+26.3%	+15.3%
Euro Stoxx 50	Europe	3,674.0	+2.2%	+20.3%	+7.5%
CAC 40 Index	France	5,503.3	+3.3%	+22.0%	+12.4%
DAX Index	Germany	13,229.6	+3.1%	+24.0%	+21.9%
Milan Index	Italy	22,793.7	+0.4%	+33.1%	+1.6%
MSCI Emg Mkts (£)	Emg Mkts	565.1	+4.6%	+16.3%	+60.7%
IBOVESPA Index	Brazil	74,308.5	+0.0%	+14.5%	+62.0%
MICEX Index	Russia	2,064.3	-0.6%	+3.8%	+20.6%
S&P BSE SENSEX	India	33,213.1	+6.2%	+18.9%	+24.6%
Shanghai SE Comp.	China	3,393.3	+1.3%	+9.4%	+0.3%
Hang Seng	Hong Kong	28,245.5	+2.5%	+23.2%	+24.8%
UK All Property	UK Property	7,045.4	+0.8%	+6.8%	+7.3%
UK Conv Gilts	UK Gilts	3,529.7	+0.3%	+0.6%	+10.1%
UK Index linked Gilts	UK IL Gilts	4,784.2	+0.9%	-2.4%	+21.5%
JPM Glob Agg. Bond	Global Bonds	798.9	+0.7%	-6.8%	+24.2%
iBoxx Non-Gilt	UK Corp Bonds	335.9	+0.5%	+3.7%	+14.5%
WTI Crude	Oil	54.4	+5.2%	+16.0%	+16.7%
LMEX	Base Metals	3,261.6	+4.4%	+30.3%	+40.8%
Gold Spot $/oz	Commodities	1,271.07	-0.7%	-0.5%	+11.3%
S&P Agri & Livestock	Agriculture	772.98	+1.7%	-4.2%	-13.5%
£1 = US$	Currencies	1.33	-0.9%	+8.5%	-13.9%
£1 = €	Currencies	1.14	+0.6%	+2.3%	-18.7%
£1 = Yen	Currencies	150.93	+0.1%	+17.6%	-18.9%

12 Months to 31 October 2017

(including dividends, measured in £)



Source: Albert E Sharp, Bloomberg®

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