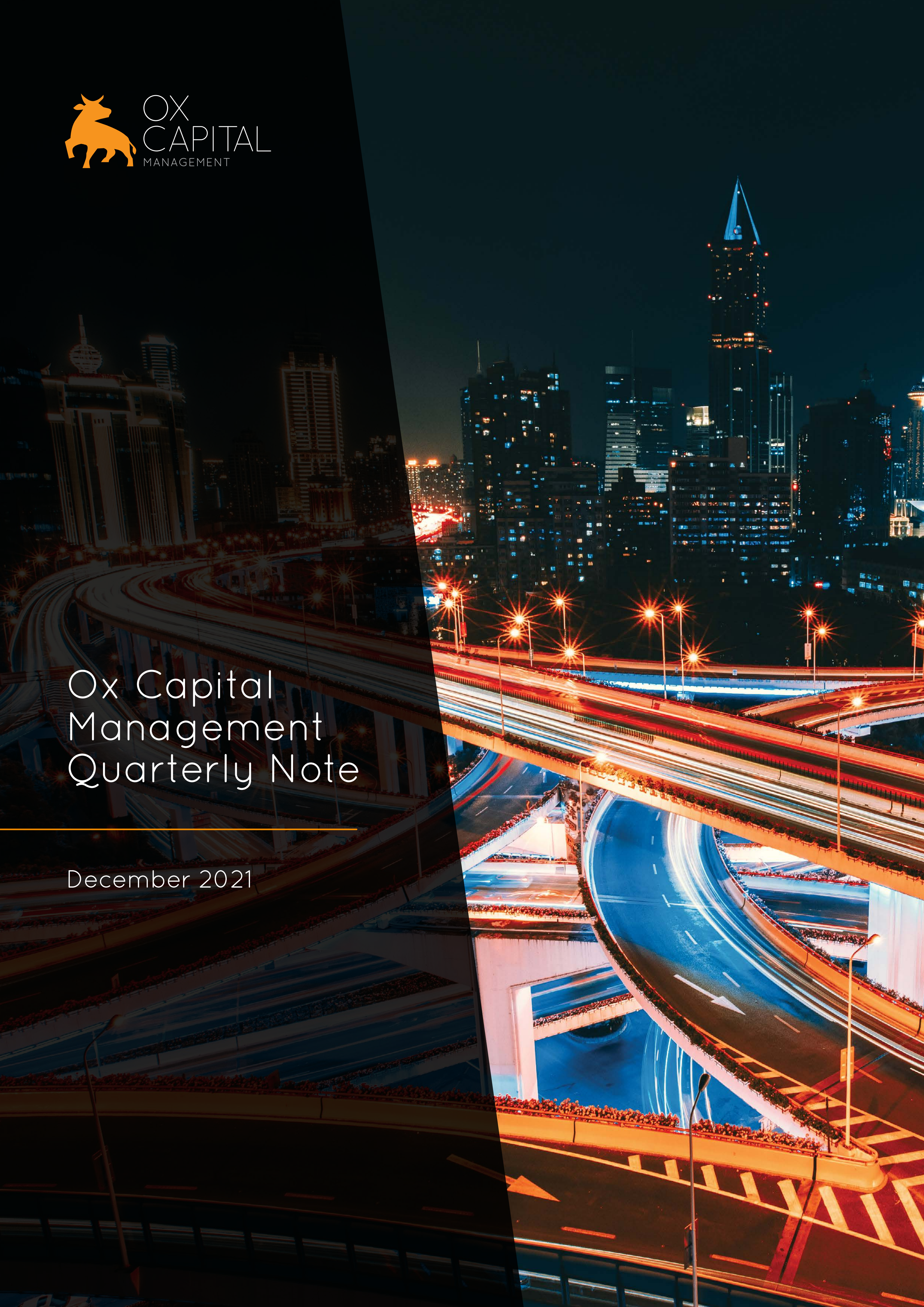


OX CAPITAL MANAGEMENT

Ox Capital Management Quarterly Note

December 2021

Executive Summary

In this inaugural Quarterly Note, we would like to provide context as to why we are excited about the prospect for emerging markets and address some obvious concerns.

Negativity towards China, and emerging markets in general, reminds us of the negativity towards the US post the global financial crisis. It was wrong to avoid the US market more than a decade ago, and we believe it is a mistake not to invest in emerging markets today.

Economic prospects are improving for emerging markets and can sustain for the coming decade. China has spent the last decade cleaning up its debt load and structurally higher energy and commodities prices are a positive for emerging markets in general.

These markets provide the rare combination of growth and attractive valuation. Valuations of emerging markets are close to multi-decade lows as investors have focussed on the developed markets in the last ten years. Low growth, low inflation and low interest rate environments favoured developed markets; this is unlikely to persist in the years ahead. Further, starting valuation is one of the best predictors of long-term returns, and we are decidedly positive on the longer-term performance of these markets.

In the near term, emerging countries' growth is set to improve with the Chinese authorities relaxing policies. Thanks to their quick tapering of stimulus when it was clear that the pandemic was well controlled domestically, they are ready to relax just when the rest of the world is tightening. There is very little inflationary pressure in China and a lot of air which existed in asset bubbles was squeezed out. Their capacity to further relax policies is significant, benefiting Chinese and emerging market equities.

In contrast, many developed countries spent aggressively during the pandemic. This felt good as it artificially stabilised the economy, but at the cost of assets and goods inflation, and debt load to the economy. To fight rising inflation, the US Federal Reserve is expected to raise rates multiple times this year, and an economic slowdown in the US is likely. Valuation of the equity market in the US is still expensive despite the recent sell-off!

Another feature of this coming decade is high energy prices. We believe high prices will prove structural in nature. Decarbonisation permanently adds cost to energy projects and is getting factored in by energy companies in their investment decisions. Even at today's high energy prices, and with the prospect of more economic opening post pandemic, energy companies are reluctant to invest in new capacity. In the meantime, demand for gas – and to a lesser extent, oil – will continue to grow for many years even as the world transitions to carbon zero.

Emerging market countries such as Indonesia will benefit from this dynamic through favourable export prices. Domestic consumption tends to benefit from a trickling down effect. The Indonesian market has been largely overlooked the past five years, with foreign ownership of equities in Indonesia currently at a 10-year low and good companies on extremely attractive valuations.

Brazil will also benefit from higher energy prices going forward. The country has lifted interest rates significantly in 2021 as inflation took off. They have slowed the economy, but equities valuation has corrected. We can identify many longer-term secular growth opportunities available at a fraction of the price available in developed markets.

Debt and regulatory risks are front of mind for the potential emerging markets investor. The reality is that debt levels of emerging countries are much lower than that of developed countries. In particular, China is one of the few big countries that has spent the last five years reducing debt load. Crackdown is not new but is a recurrent feature of China as the authorities catch up with the breakneck pace of change and growth. We believe the intensity of this cycle of crackdown has also peaked at the end of 2021. In the past, this has marked the bottom of equity markets.

The Ox Capital investment process involves deep fundamental and bottom-up research. We adopt a long-term view on our investments and look for companies aligned to strong secular trends. As a result of this process, we can look past transitory fear in the market and take advantage of attractive valuations for quality businesses. Emerging markets are currently prospective using our process. We believe the time to look for opportunities that can double in next three to five years' time is now.

A comparison of Developing and Emerging Markets

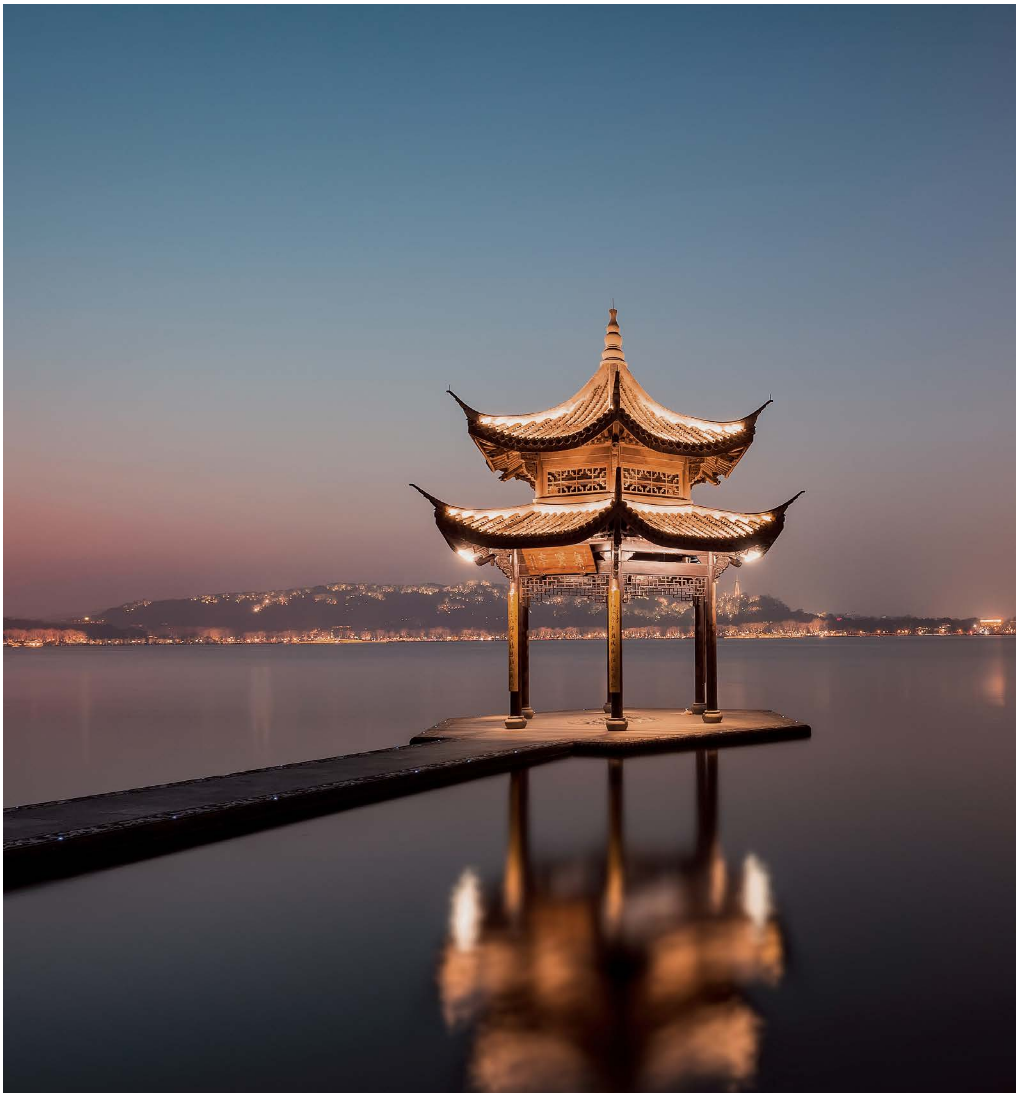
Post Global Financial Crisis, the US was seen as un-investable but delivered stellar returns over the next decade

The Global Financial Crisis (GFC) of 2008 was a result of financial markets crumbling under the weight of mountains of property related debt. There had been a long period of poor lending by banks and other financial institutions and investment banks were capitalising on the boom by creating large amounts of derivative instruments called collateralised debt obligations (CDOs) which were based on mortgage lending.

When the property bubble burst, the debt and related derivatives started defaulting all at once. Asset values collapsed, triggering a catastrophic impact on the financial system. Due to the interconnectedness of the system, it was not clear which financial institutions were insolvent. Fear of a long and arduous global depression similar to that of the 1930s took over the market, and the US was seen as un-investable by the majority.

It was a shocking time for those of us who experienced living through the GFC as an investor. It was not intuitive to invest in the US share market at the time. What good could come from investing money into an economic abyss? However, going against the consensus at the time delivered stellar returns over the subsequent decade.

Since the GFC, the US share market has appreciated significantly. The S&P 500 has gone up over five times, the Nasdaq has gone up over 10 times, and the overall re-rating of US technology companies has been significant. However, the sentiment immediately post-GFC was anything but inviting.



China is seen as un-investable now

This time around, China is seen as un-investable. The year of 2021 was a volatile year for Chinese stocks, particularly Chinese technology companies listed in the US. We saw the Chinese Government crack down on technology, property, education, and other sectors, all the while tensions between China and the US have been escalating. There was also concern around Chinese companies de-listing from the US and what that might mean for investors.

Despite the volatility, growth has not slowed down. Some of these companies are growing at over 20% a year and are valued at all-time lows. After the most recent sell-off, we see a large number of companies trading on single digit earnings multiples. After many years of investing, it is a rare event to see such an array of opportunities ignored by the market.

We believe that there is some similarity between the US market post the GFC and the Chinese market presently. Fear is driving the consensus.

Stimulus post-GFC: US vs China

The way the central banks of the US and China handled the GFC in 2008 was very different.

In the US, the central bank printed money to bail out banks, insurance companies and other financial institutions who had become insolvent under the collapse of the lending and housing markets.

In China, like most other emerging markets, the financial system was not particularly impacted by the GFC, as they did not own many mortgage-backed derivatives. Instead, they were concerned about the demand destruction emanating from the US due to the GFC. To counter these concerns, the Chinese central bank created credit to be spent on the real economy. This led to a short but powerful boom in commodity prices from 2009 to 2010. It was a time when US and Chinese central banks co-ordinated their actions to rescue the world economy from almost certain doom. Those were the times!

Impact of the stimulus

The central bank actions in the US and China had long-term implications on their respective economies.

After the central bank bailout, the US banking system recovered. The insolvency problem had been resolved by the money which had been injected into the economy by the Government. Economic activity was slower, but insolvency was no longer.

Gradually, talks of bottoming in economic activities and "green shoots" dominated the narrative. Due to the lack of growth, interest rates stayed very low, and financial markets blossomed from very low levels. The US central bank did not have to deal with inflation, but rather had to fight deflation. Companies that did well were ones who provided solid earnings growth over the next decade.

As the economic recovery took hold, growth companies came into their own. Investors were more than willing to pay up for these more-risky sectors, bidding valuations to stratospheric levels.

What followed in China as a result of the GFC was quite different.

China ended up having to deal with the aftermath of money printing for a prolonged period. After pumping trillions of dollars into its economy, and by extension the global economy, the Chinese economy was left dealing with massive piles of debt and inflationary pressure. Worse yet, as stimulus in China supported real activity it had to be ramped down gradually and could not be shut off immediately without risking an abrupt recession.

As they continued to provide stimulus by printing money, the debt load grew even further. The banking system went from clean to impaired. This necessitated the frequent and painful deleveraging cycles we saw in China over the last decade. The stop-go economic growth dynamic contributed negatively to stock market performance for China and emerging market equities.

After the GFC, developed economies saw their balance sheets repaired and economic activities gradually ramped up. The limited stimulus that went into the real economy meant that there was little inflationary pressure. These economies enjoyed a slow-burn, long duration, and ultimately powerful equity market. The emerging market economies did not have to recapitalise their banking systems, but they stimulated hard. Money went into real activities, leading to piles of debt and immense inflationary pressures, which necessitated periodic monetary tightening. Asset values were lacklustre.

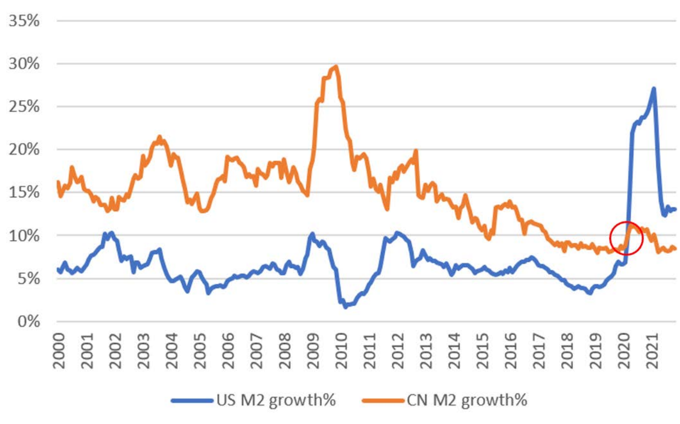
Fast-forward to today, the roles are reversed

M2 is a commonly used monetary aggregate that signifies the amount of money created in the real economy. Post the GFC, China created significant M2 growth, while in the US M2 growth was much less enthusiastic.

Fast forward to today, the role is reversed. Stimulus provided in the wake of COVID-19 in developed markets has created a significant amount of M2 growth, that is, money available for spending in the real economy. The result has been that US equity markets and property values are close to all-time highs, and significant inflationary pressure has emerged.

That chart below shows M2 growth in the US and China over the last two decades, and how the roles have reversed post COVID-19.

Figure 1: China M2 growth and US M2 growth (%YoY)



Source: Federal Reserve, PBOC, Ox Capital Research

Inflationary pressures in the US today have the potential to trigger a significant slow-down

In the US, inflationary pressures have built-up so strongly that to deal with them would require significant monetary tightening. Equity markets are at all-time highs, wages are rising, consumer prices are rising, housing prices are rising, and energy prices are rising, to name a few. The data below shows some key indicators of the immense inflationary pressure that has built-up in the US.

i. US share market is at an all-time-high

The US share market has delivered stellar returns, particularly in the last two years since the initial COVID-19 induced crash. A large part of the return was driven by significant re-ratings of stocks, that is, an uplift of their price to earnings or price to sales multiples, rather than earnings growth. This suggests stocks have gotten a lot more expensive!

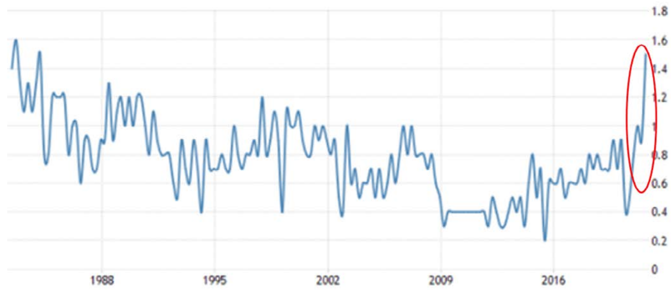
Figure 2: S&P500 price to sales ratio

Source: Ox Capital Research, Bloomberg

ii. Wage levels are rising quickly

Wages are going up quickly for the first time in more than two decades. This could be a result of a number of changes brought about by the pandemic. For example, early retirement of some workers who lost their jobs and didn't bother getting new ones, deglobalisation of the labour market due to travel restrictions, and higher demand for workers in some industries which saw elevated consumer demand during the pandemic.

Figure 3: US Wages Growth (% QoQ)



Source: US Bureau of Labour Statistics

The number of labour disputes in the US also appears to have inflected upwards after almost three decades of downdraft, and there are more frequent calls for unionisation in the workforces. This reflects the stronger bargaining power of labour and suggests wage pressure is more persistent than transient.

Unemployment has reduced and the labour market is tight. Job vacancies are at multi-decade highs. The economy will have to be slowed quite significantly to stave off the wage pressure.

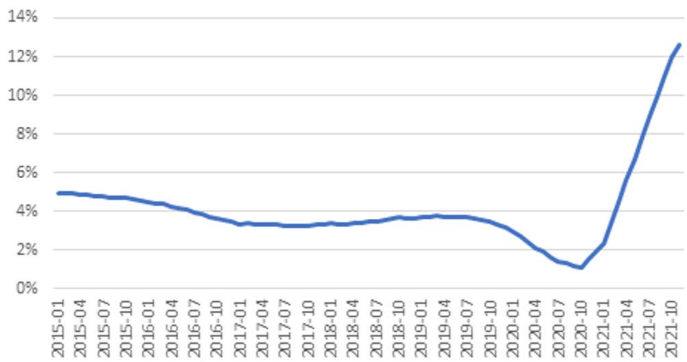
Figure 4: Job Vacancies in the US

Source: US Bureau of Labour Statistics

iii. Property prices are rising

The cost of accommodation is going up across the US. Rents are roaring back to life after many years of dormancy.

Figure 5: US Rental Growth (% YoY)



Source: Zillow

iv. Energy prices are going up

Energy prices are rising as the result of severe underinvestment in capital expenditure over recent years. Underinvestment in energy has been driven by poor energy prices and climate change pressures. Despite ESG pressures by investors and the community alike, fossil fuel is likely to continue to grow for a decade or more. There will be a gradual transition to a world of net-zero rather than an abrupt switch unfortunately. Energy price inflation is discussed in our thought pieces on carbon pricing and the oil and gas sector.

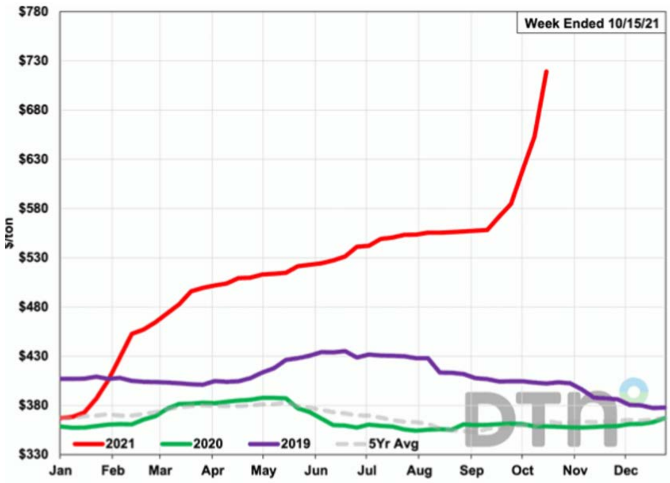
Oil is showing strong price momentum. This surge is despite the fact that global oil consumption is below pre-pandemic levels and air travel is far from normalising at this point. Demand for oil is set to surge upon the re-opening of the global economy – and in turn the travel industry – however, supply will likely remain constrained.

Figure 6: Crude Oil Brent Prices (USD/Bbl)

Source: Trading Economics, BBC

Food prices are likely to be impacted by high energy prices too, as energy prices are linked to urea, a major fertiliser. Farmers can delay full application of urea to their fields over the short-term, however, crop yield will eventually be impacted if this continues. Thus, the need for urea will likely push up food prices. We can already see a sharp spike in urea prices in red for 2021 below.

Figure 7: Average Weekly Urea Prices (USD/tonne)

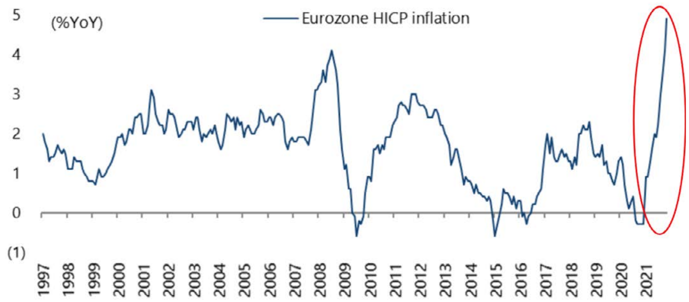


Source: DTN

v. Consumer prices are rising across developed markets

The annual inflation rate in the US crossed 7% in December 2021, the highest rate since 1982. This is not just a US phenomenon; the chart below shows rising inflation across Europe. A similar story is seen in Australia and other developed markets too.

Figure 8: Eurozone HICP inflation

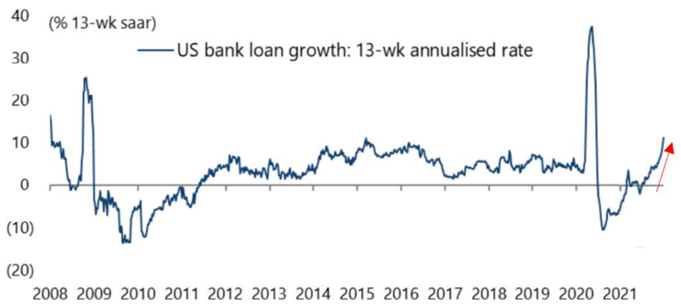


Source: Jefferies, Eurostat

vi. Credit growth is rising in the US

It appears that developed market central banks are well and truly behind the curve in tightening monetary policy with respect to inflation. However, their economies appear to still be going strong. US banks have ultra-loose lending standards and loan growth is picking up even as inflation pressure is growing.

Figure 9: US bank loan growth



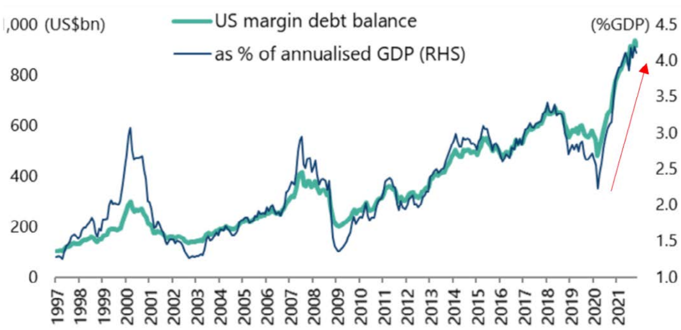
Source: Jefferies, Federal Reserve

vii. Despite the apparent need to raise interest rates, the markets appear complacent

Real bond yields reflect the actual cost of funding after adjusting for inflation. Theoretically, the neutral level is around zero percent. If it is negative, that means interest rates are too low. In the case of the US, real bond yields are highly negative. This suggests a lot of catch up is needed in order for the Fed to deal with immense inflationary pressures.

As a result of negative real interest rates and positive loan growth, the US market sentiment until recently has been very bullish. Margin debt, which is the amount of money an investor borrows from a broker using a margin account to buy or short sell a stock, is close to multi-decade highs. There will be big risks ahead if the Fed is forced to tighten policies aggressively.

Figure 10: US margin debt balance



Source: Jefferies, FINRA, Bureau of Economic Analysis

More growth-oriented indexes like the Nasdaq have been weakening of late. This is perhaps an indication of worse to come. Supposed 'risk assets' in the US, such as trading platform Robinhood, internet-connected exercise equipment retailer Peloton and crypto-exchange Coinbase, have all come off significantly on the share market. This could be seen as an early indication of an imminent slowdown.

The developed market economic situation resembles China a decade ago

Paradoxically, the economic situation faced by developed markets today is akin to the one faced by China just over a decade ago. In 2010, the Chinese economic situation was characterised by massive credit creation, building up of government debt, inflationary pressure, property bubble inflation, wages pressure, bullish equity markets and high valuations. They aimed to stimulate so as to lift the world out of the GFC.

The Chinese economy was the first major economy to recover from the GFC, and the refrain of the day was that "you cannot go wrong betting on Chinese consumers". Valuations of consumer-related stocks went skyward, not dissimilar to fast growth US tech stocks today. However, the subsequent decade proved that statement far from correct, and some "defensive Chinese consumer growth stocks" like department store operator Parkson, lost over 98% of its value as a result of a changing mall preferences by Chinese consumers and a severely high starting valuation.

However, not all stocks would stand to lose at much value as Parkson did, even if the equity index in developed markets entered a prolonged bear market. Developed markets' high starting valuation is not an attractive starting point for a long-term investor.

A popular measure of overall market under – or overvaluation, and therefore subsequent returns, is the cyclically adjusted price-to-earnings (CAPE) multiple. The CAPE multiple uses earnings per share over a 10-year period, to smooth out the impact of different economic influences. Currently, the US sits just below 40, that is, it looks severely overvalued by this metric. This could be indicative of an imminent downturn, and subsequent poor returns to come. If we contrast this to the CAPE ratio seen in Hong Kong, which is currently below 20, better returns in the near term could come from the Asian emerging market region.

Figure 11: US CAPE Ratio: 1982 to 2021

Source: Barclays

There is a striking resemblance in market sentiment towards China now and similar sentiments that were aimed at the US post the GFC. The table below shows a similar pattern between some key economic and investment indicators in developed markets in 2010 and China in 2022.

Table 1: Economic and investment indicators 2010 vs 2022

		Developed Markets	China
2010	M2 Growth	Limited	Significant
	Government Debt	Moderate	Significant
	Inflation	Limited	Significant
	Property inflation	Limited	Significant
	Labour inflation	Limited	High
	Equity Valuation	Low	High
	Investor Sentiment	Pessimism	Optimism
		Developed Markets	**China**
2022	M2 Growth	Significant	Limited
	Government Debt	Significant	Moderate
	Inflation	Significant	Limited
	Property inflation	Significant	Limited
	Labour inflation	Significant	Limited
	Equity Valuation	High	Low
	Investor Sentiment	Optimism	Pessimism

Source: Ox Capital Research

Japan: A story of asset bubbles and government debt

A country which has gone through huge equity and property bubbles, credit creation cycles and government debt inflation, is Japan. The Japanese equity market lost over 75% of its value in the collapse of their stock market bubble in the late 1980s and is still yet to fully recover.

Figure 12: Japan Stock Market Index (JP255)

Source: Trading Economics

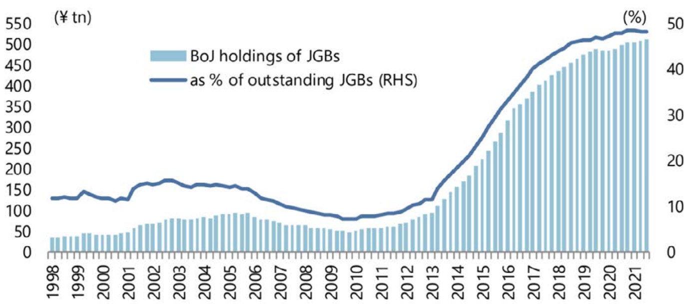
After the stock market bubble burst in Japan, the country struggled to grow economically. Japan was faced with an ageing population and significant indebtedness in the corporate sector. Some domestic commentators termed this a "balance sheet recession", referring to a lack of desire by the private sector to borrow, despite ultra-low interest rates and money printing. Corporates were largely already indebted, and not optimistic about their future economic prospects.

To spur economic demand, the Japanese Government began printing Japanese Yen to fund the purchase of Japanese Government Bonds and equities. This was an attempt to encourage asset bubbles in order to sustain economic demand.

An inherent weakness of this economic model is that it can only achieve its desired effect if inflationary pressure is low, thus allowing interest rates to remain low. When inflation rises, interest rates need to be revised upwards causing asset bubble dynamics to reverse, economies to slow abruptly, and asset prices to decline.

To date, the Bank of Japan (BoJ) owns ~50% of the Japanese Government Bonds (JGB) on issue and buys USD70B equivalent of Japanese shares a year.

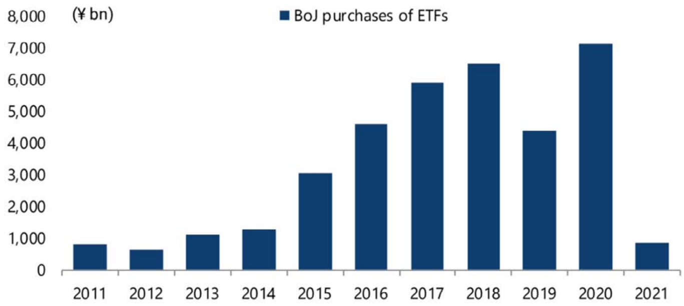
Figure 13: Bank of Japan ownership of JGBs



Source: Jefferies, Bank of Japan, Flow of Funds Accounts

BoJ has been gradually increasing its purchases of equity ETFs since 2014, with the exception of 2019 and last year. In 2021, purchases were heavily tapered as inflationary expectations rose. In Japan, the 10-year breakeven rate re-entered positive territory in 2021 and ended the year up over 50bps to 0.53%.

Figure 14: BoJ purchases of ETFs



Source: Bank of Japan

It's not all doom and gloom in developed markets like Japan

The economic prospects of the developed world are perhaps less gloomy compared to that of Japan, thanks to more favourable demographics and a willingness to print money to fund government spending. So called, Modern Monetary Theory (MMT), means that central banks are printing more money than ever to fund spending in the economy. COVID-19 related stimulus spending can arguably be the beginning of such actions. In 2021, we saw the US print trillions to provide transfer payments to the people who spent on TVs, smartphones, and PCs!

Inflationary and political limitations to monetary policy easing

The long-term cost of MMT is difficult to know. The limiting factors in the short-term might be inflationary pressure, however, in the long-term we need to consider how such transfers of wealth will influence the social composition of society. The wealth disparity between the haves and the have-nots, and the young and the old.

We are witnessing significant polarisation in society and politics. Whether the governments of the world can afford to print money to create asset inflation, and propel nominal economic growth, or to disenfranchise the asset poor and the young at the same time, remains to be seen. Over the longer term, the creditworthiness of the currencies and sovereign bonds of those governments may falter.

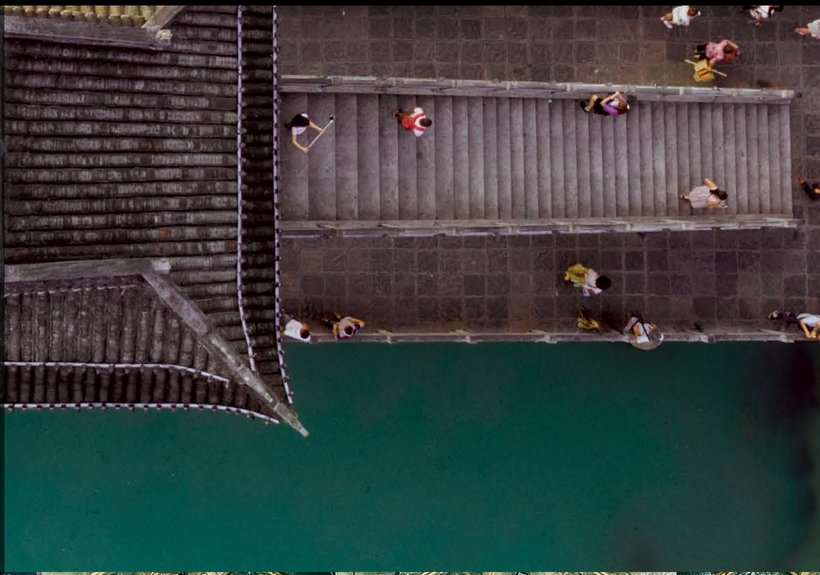
It is also worthwhile to think about the incentives provided to the people in this dynamic. For instance, 2021 can be characterised by a pattern of punting on asset appreciation, as seen in the rise of crypto-currencies and ever more expensive technology stocks. If this continues, would such behaviour come at the expense of innovation or work ethics?

EMERGING MARKETS: Why we are bullish on the next decade

We believe the fundamentals are in place for emerging markets to outperform. Here we focus on three key drivers for the sector.

Part 1: China

Regulatory reforms, a decade of deleveraging, consumption-fuelled growth and an abundance of savings – just some of the reasons we like China.

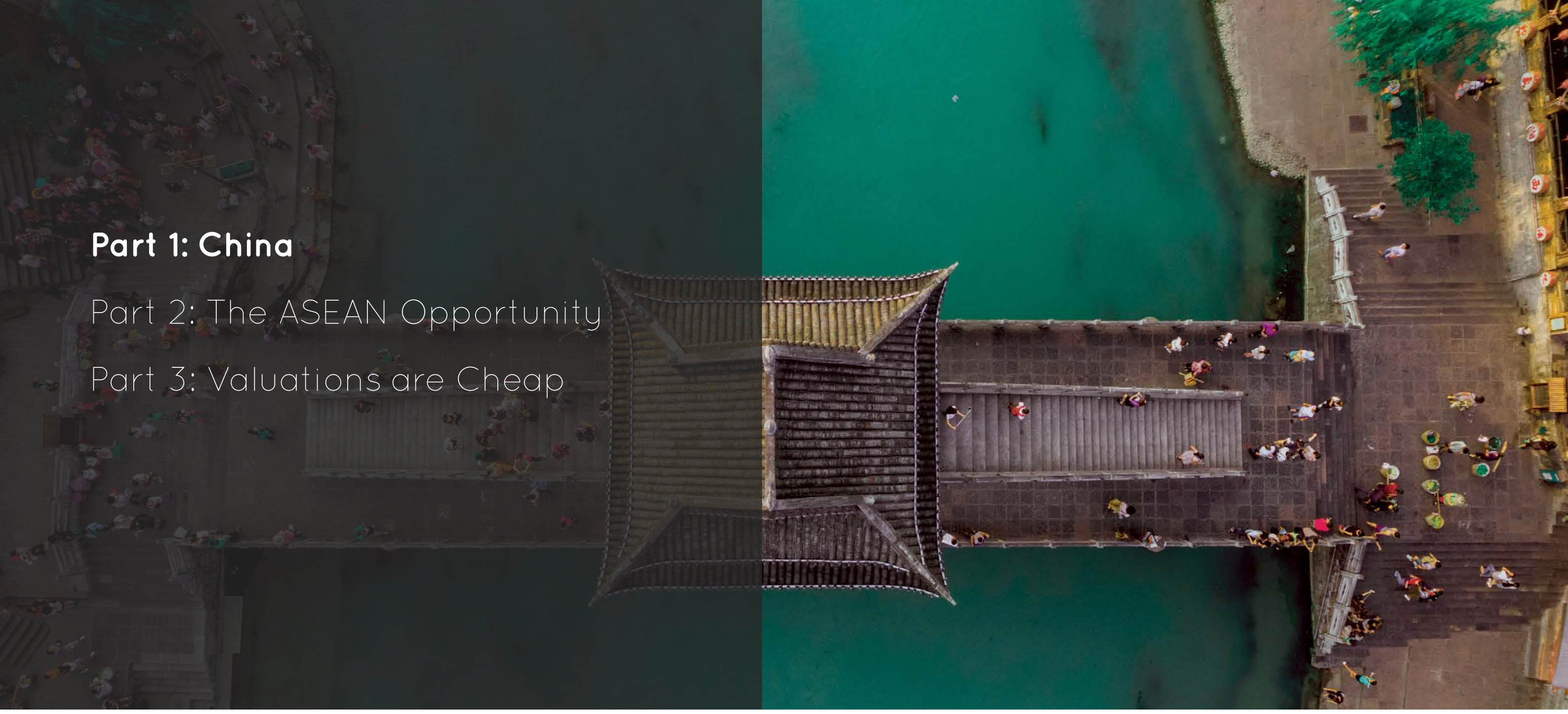


Part 2: The ASEAN Opportunity

Primed with a young labour force, enhanced trade agreements, and key commodity exports, ASEAN is an exciting but largely overlooked investment opportunity.

Part 3: Valuations are Cheap

We examine why emerging markets are comparatively cheap and look at the difference in valuations between leading US and Chinese technology companies.



Domestic consumption is fuelling the growth of China

China has driven global economic growth but is not just the 'manufacturer of the world'. Domestic consumption is fuelling the growth of China.

China is the world's second largest economy and undoubtedly the world's biggest manufacturing economy. However, the majority of the manufacturing sector in China is used to serve to its domestic market, with exports to the US remaining in the low single digits as a percentage of its GDP.

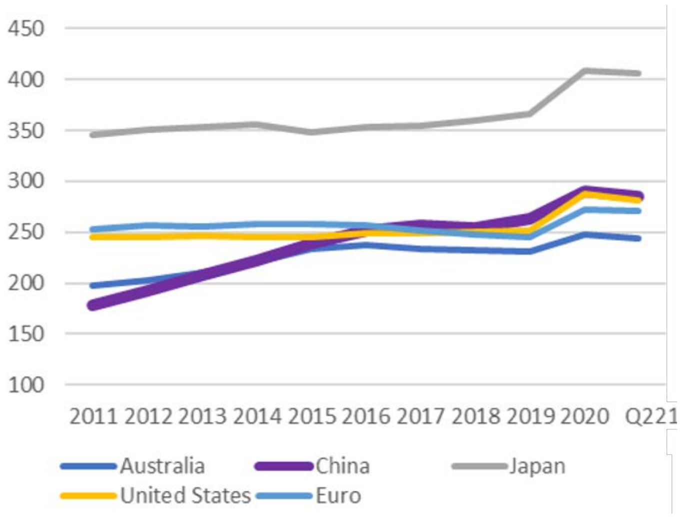
Chinese factories complement factories in the other Asian countries, such as Vietnam, to manufacture for the majority of the world. Irrespective of the noise over the US and China trade dispute, the global supply chain is going to remain firmly entrenched in the Asian region for years to come, with factories moving mostly within Asia to take advantage of changing and differing labour costs.

China has been deleveraging over the past decade

Economic growth has been led in emerging markets by the locomotive of the huge Chinese economy. China has spent the last 10 years cleaning up its balance sheet. Further, it continues to undertake the necessary reforms of its private and public sectors.

Multiple rounds of deleveraging in China has been painful for companies and investors alike. China had to wean itself off huge stimulus post the GFC, then clamp down on speculation which existed across the housing market and lending space. The level of indebtedness has stabilised as a result of many rounds of reforms and crackdowns. China's total debt is now not that different to that of many of its developed country peers.

Figure 15: Total Debt to GDP

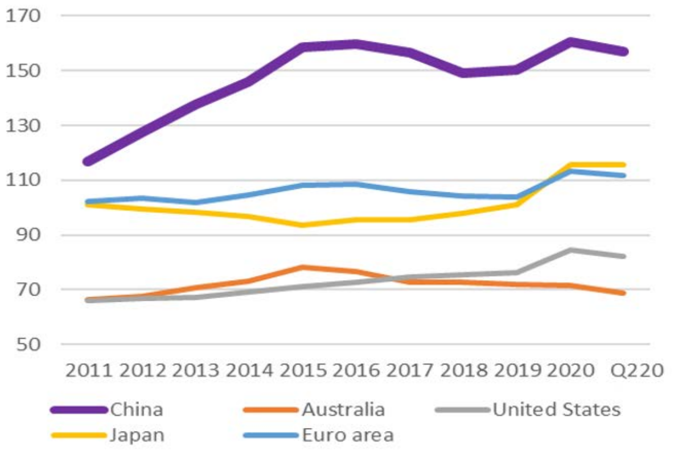


Source: BIS

The one segment of debt that China leads against developed market peers, is its high level of indebtedness to corporates. However, it is important to unpack where this debt is being placed. In China, the majority of corporate debt is related to state-owned enterprise (SOE) lending. These loans are used to build infrastructure projects for the public such as bridges and tunnels, or upstream plants for say the aluminium or cement industry.

Demand for investment in such infrastructure has been much less enthusiastic recently due to dampened economic activity. In fact, the regulators have put in very strict rules over new investments in this area. The level of corporate debt in China has largely held steady for the last five years. This is a promising sign!

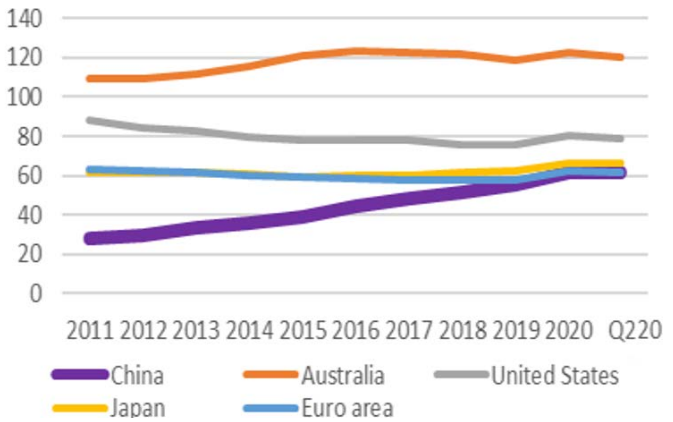
Figure 16: Corporate Credit to GDP



Source: BIS

There has been persistent concern over China's property market. However, the level of mortgage loans, as reflected in household credit to GDP, is not high compared to that of many developed markets.

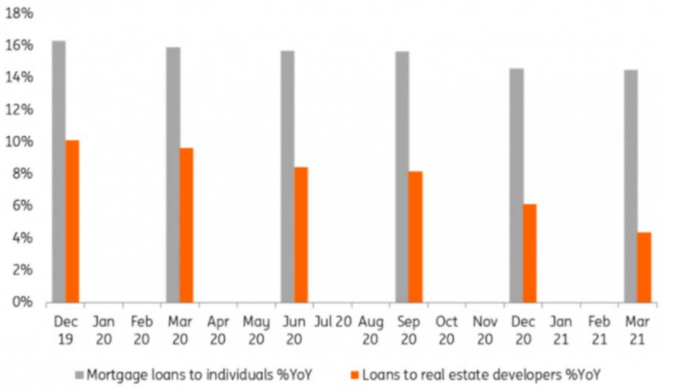
Figure 17: Household Credit to GDP



Source: BIS

Loans to property developers have also been growing at a slower rate. No doubt this will slow even more after recent regulatory crackdown on property developers.

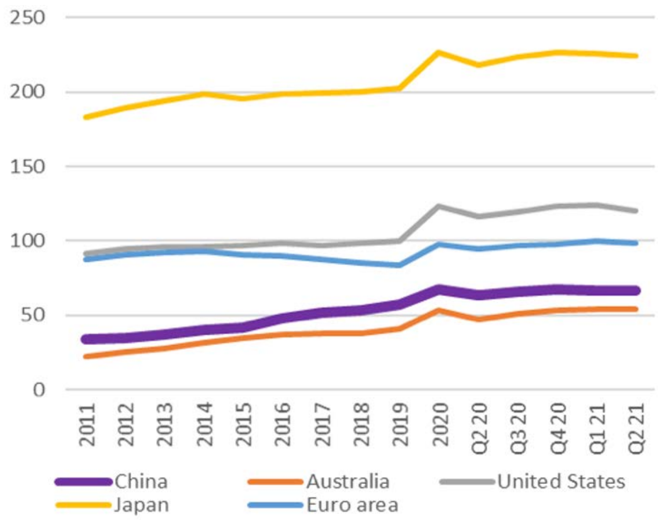
Figure 18: Mortgage Loans to Individuals and Loans to Real Estate Developers in China YoY Growth



Source: Think.ing

Some would be surprised to learn that government debt to GDP is also significantly lower in China compared to the US, Europe, and Japan.

Figure 19: Government Debt to GDP

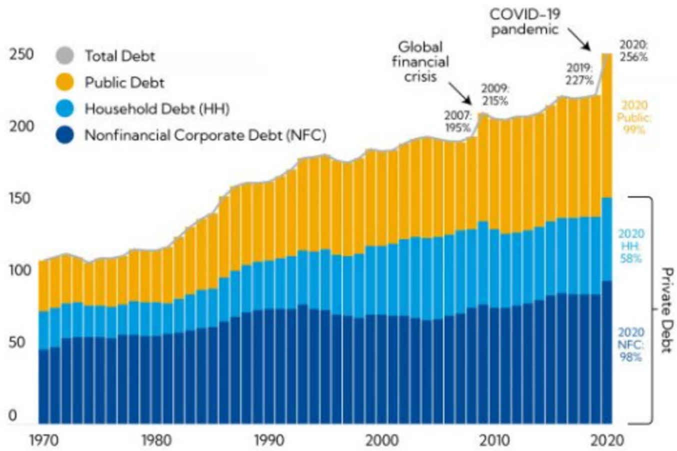


Source: BIS

Emerging markets have not stimulated as much as developed markets during the pandemic

During the pandemic, global debt surged to a record high. The use of debt during the pandemic has been particularly aggressive in developed markets, who borrowed heavily to stimulate their economies and support their ageing populations.

Figure 20: Global debt as a percentage of GDP



Source: IMF. Note: Estimated ratios are weighted by each country's GDP in USD

Emerging markets as a whole have been more fiscally responsible during the COVID-19 pandemic than developed markets. We can see this through in lower levels of fiscal and monetary stimulus as a percentage of GDP. Emerging markets are coming out of strict lockdowns with a small portion of the stimulus compared to developed markets.

Figure 21: Fiscal and monetary stimulus over the COVID-19 pandemic: 2020/2021

Country	Fiscal Stimulus ($B)	Monetary Stimulus ($B)	% GDP
Italy	973	547	76%
Germany	1,722	1,051	72%
Japan	1,832	1,435	63%
UK	892	756	58%
Bulgaria	21	18	58%
Sweden	73	227	56%
Poland	171	161	56%
France	762	739	55%
USA	6,992	4,694	54%
Romania	54	58	53%
Denmark	84	96	51%
Spain	329	381	51%
Australia	274	305	51%

Country	Fiscal Stimulus ($B)	Monetary Stimulus ($B)	% GDP
Brazil	221	10	12%
Tunisia	1	-	12%
Turkey	87	-	12%
Hong Kong	37	7	12%
China	903	405	9%
Norway	39	-	9%
Mexico	20	94	9%
South Africa	30	-	8%
Kazakhstan	13	-	7%
Indonesia	76	-	7%
Philippines	13	6	6%
Russia	89	-	5%
Argentina	25	-	5%

Source: BofA Securities. Note: Figures in USD

China has cracked down on bubbles in the economy in the past

Regulatory crackdown in China is nothing new. China has been cracking down on various sectors for over 15 years.

Across popular media, the crackdown in China has been largely attributed to a more assertive Chinese Government and leadership. We are not here to dispute this. However, we prefer to focus our efforts on the economic and investment question: what is the longer-term economic impact of these reforms?

We have written about the regulation crackdowns previously. Our firm belief is that while it is impossible to know the absolute outcome, reforms have been a recurrent – and will be an ongoing – feature of any economy in rapid transition and economic development.

The intention for the most part is to improve the economic prospects of the country, by putting in guard-rails and rules to reduce dysfunction. Firms negatively impacted by reform obviously suffer from the crackdowns. We have seen this in rock-bottom valuations across much of the Chinese internet sector in 2021.

These reforms also demonstrate the authority's willingness to forgo the economic interests of a small proportion of people for the betterment of the masses. Our work suggests previous big crackdowns have led to better outcomes for the economy. In the years following the changes, weighty returns have been seen in the indexes which correspond to the sectors which saw large reform.

Table 2: Regulatory research summary

Sector Impacted by Regulation	Railway	Alcohol	Healthcare
Beginning of regulation	**Feb 2011**	**Dec 2012**	**May 2018**
What happened	Railway ministry head, Liu Zhijun, was dismissed from office for bribery. Railway capex was cut, and an investigation into the railway ministry followed.	Anti-corruption drive. Central government released a series of standards on entertainment budgets and governance.	Changsheng Biotech supplied faulty vaccines to the health department. Rounds of investigation into the vaccine supply chain and the tendering process.
Stock correction	-50%	-51%	-35%
Duration	**11 months**	**14 months**	**8 months**
When it ended	**Dec 2011**	**Dec 2013**	**Dec 2018**
How it ended	Investigation finished and the Central government improved operational process of the Railway Ministry.	Anti-corruption campaign ended with significant improvement in government departments governance.	Improved manufacturer vaccine certification and tendering process.
Subsequent return	600%+	400%+	200%+
Time taken	**2.5 years**	**4 years**	**1.5 years**
Policy goal	Improve quality of and safety of railways.	Better governance and fairness in the system combined with better incentive structure for government officials.	Improve security and safety.

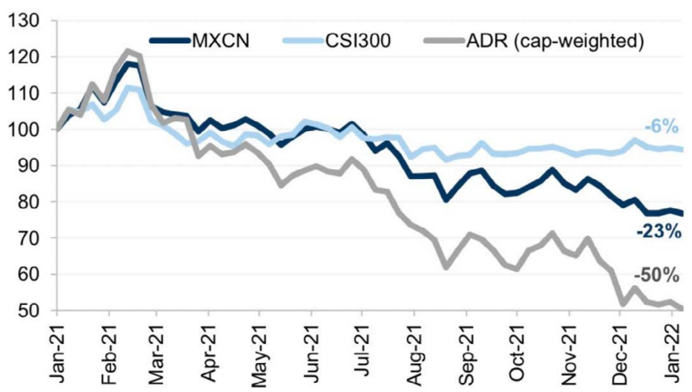
Source: Ox Capital Research

The numerous crackdowns over the last decade have also acted to reduce risk in the Chinese banking system. The last and most recent crackdown on the property market was famously seen through the case of Evergrande and other less publicised but highly indebted developers. Developers that are cavalier users of debt have lost their businesses. Property prices had gone up during the COVID-19 period in 2020, like most other countries, but this round of credit crackdown squeezed a lot of air out prices. These obviously have short-term implications on consumption and equity prices, but longer-term we see this as positive.

Chinese ADRs are a very attractive opportunity

Domestic investors are much less concerned about China's economic prospects than the press would have its readers believe. Share market performance in 2021 of China's domestic markets, which are mostly made up of local investors, held up much better than Chinese stocks listed internationally. This is clearly evidenced below, where we see a significant divergence among Chinese equity markets. Domestic Chinese-listed A-shares stayed resilient in 2021, however, US-listed ADRs halved in market value.

Figure 22: Chinese equity market performance in 2021



Source: Jefferies

Our thought piece on Chinese ADRs evaluates the risks of Chinese stocks de-listing in the US, the opportunity for Chinese technology companies listed in the US, and the huge financial market dislocation which exists between these companies and the rest of the world.

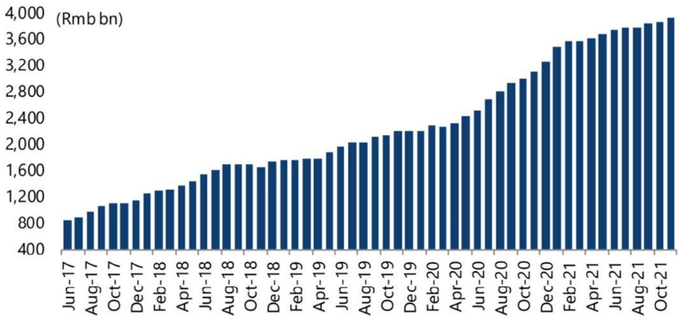
China is going through a slowdown due to pre-emptive monetary policy tightening

Chinese authorities tightened monetary policy early in 2021. The pandemic was well contained, and they were able to cut off stimulus early. The cost of cutting off stimulus was weak asset prices; however, the benefit came in reduced inflationary pressures, which are inherent when printing money.

Tightening of Chinese monetary policy has meant that real interest rates in China are closer to neutral compared to that of developed countries like the US, which are still way below zero.

As a result of China's prudent policies, foreign money has continued to pile into Chinese Government bonds.

Figure 23: Foreign holdings of Chinese Government Bonds

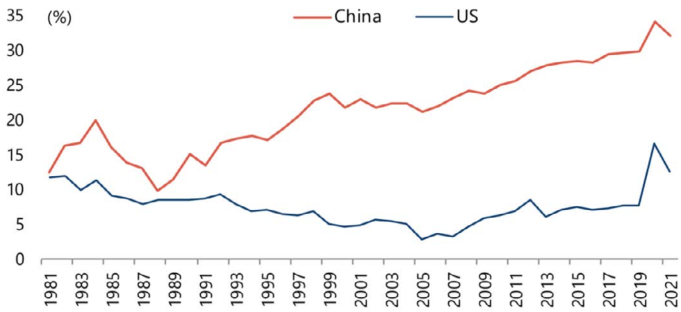


Source: Jefferies, China Bond Connect, CEIC Data

Savings abundance in China

Much has been said about the savings levels of US consumers, particularly changes as the result of COVID-19 related transfer payments. If we compare personal savings as a percentage of disposable income between the US and China over the past 40 years, we see a clear savings differential. Chinese personal savings accounting for over 30% of disposable income in 2021, whereas in the US this figure was below 15%, or less than half.

Figure 24: China and US personal savings as a percentage of disposable income



Source: Jefferies, China National Bureau of Statistics, CEIC Data, US Bureau of Economic Analysis

Commodity prices and their relationship to EMs

The other part of the emerging market story historically is commodities, and more specifically their prices. Many emerging market countries are commodity producers. While China is transitioning from being a construction-led to a consumption-led economy, demand for certain commodities will persist. Although, demand growth for commodities will be less rosy than it has been in the past. The good news is this slowed growth has not been missed by commodity producers and supply discipline is in place. Investment project approvals for commodity producers is few and far between these days. Further, the ESG movement has introduced reputational risks for these producers, further limiting supply.

A smoother but slower Chinese economic growth rate, and a less supplied commodities sector, in a less globalised world, will likely lead to a higher level of inflation. This is a breath of fresh air in emerging markets, who have suffered the go-stop Chinese economic engine and oversupplied commodities over the past decade or more.

To summarise, emerging market economies are very much less indebted compared to the developed world, valuations in stock markets much more attractive, and interest rates have already been adjusted up, making investment in emerging market more prospective going forward.

Part 1: China

Part 2: The ASEAN Opportunity

Part 3: Valuations are Cheap

ASEAN (the Association of Southeast Asian Nations) is an attractive opportunity which is largely over-looked by global investors. South East Asia has over 600 million people, or about 9% of the world's population, and is growing fast. Over a quarter of the region's population is between 15 to 29 years old. The size of the middle class is growing, and demand for consumer goods such as electronics, cars, education, leisure, healthcare is rapidly increasing.

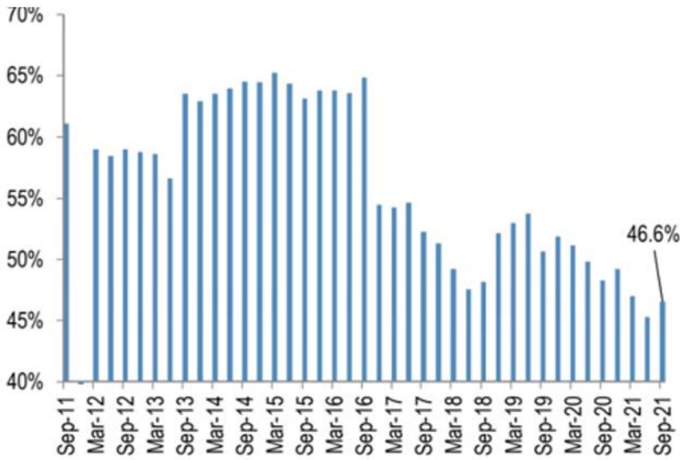
Recently, the Regional Comprehensive Economic Partnership (RCEP) was developed to enhance trade cooperation between countries in Asia Pacific, including Australia, New Zealand, China, Japan, Korea and the 10 countries in ASEAN. RCEP is now the world's largest trade block, accounting for a quarter of global trade.

At a time when Chinese labour costs are increasing due to rapid economic development, the young labour force in ASEAN countries will benefit from a migration of supply chains to the region. South East Asian countries have also been increasing their share in global exports recently. Tariff cuts through RCEP are likely to boost regional trade over the next decade.

Countries such as Indonesia, who are key commodity exporting nations, will benefit from a rise in energy prices. Indonesia is a major exporter of coal, still an essential fossil fuel required during the transition to clean energy, and of nickel, a key commodity required for electric vehicles. Such a rise would act to boost the Indonesian economy.

Despite favourable foreign investment laws in Indonesia, such as the Omnibus Law, foreign ownership of Indonesian equities is remarkably low and has contributed to the low valuations in the region. We think this could be on track to improve over the coming years, as market fundamentals improve.

Figure 25: Foreign ownership of equities in Indonesia



Source: J.P. Morgan

We are excited by the opportunity presented in the ASEAN region and continue to focus its on high-quality businesses for potential investment opportunities. A detailed note of the opportunity in ASEAN has been highlighted in our recent thought piece on the matter, as well as a closer look at the opportunities in Indonesia in our Country in Focus.

Part 1: China

Part 2: The ASEAN Opportunity

Part 3: Valuations are Cheap

Emerging markets are cheap from a comparable valuation perspective.

It cannot be disputed that equity valuation in developed markets is high relative to its own history, as seen in the CAPE numbers on page 7, and high compared emerging market valuations currently. Emerging market equities have historically outperformed developed markets over the long-term. This recent bout of underperformance, largely over the last 10 years, is an anomaly. We believe that this is a result of over-indebtedness and high starting valuations over a decade ago in emerging markets. We explore the case for emerging markets further in our notes *The Case for Emerging Markets: Part 1 and Part 2*.

While it is not entirely accurate to compare companies from different regions given the different demographics, regulatory environments, and execution risks, it an interesting exercise is to look at some of the Chinese technology companies and compare them to their counterparts in the US. The difference in valuations between US and Chinese technology companies currently is significant.

Table 3: Valuation comparison

Company	Market capitalisation (USD Mn)	EV/Sales (x)	P/E 21 (x)
E-commerce			
Amazon	1,724,479	4.0x	83x
Alibaba	331,002	3.1x	14x
Social			
Twitter	34,375	8.7x	188x
Weibo	7,182	4.5x	10x
Music streaming			
Spotify	45,068	4.5x	–
Tencent Music	10,663	2.1x	16x
Search			
Alphabet	1,888,289	7.7x	26x
Baidu	49,455	2.4x	17x
Dating			
Match Group	35,852	16.4x	55x
Hello Group (Mono)	1,782	0.7x	6x

Source: Capital IQ consensus estimate. Data as on 20-Dec-21

Let's take the example of **Alibaba**. Last year, Alibaba had over 1.1bn active annual users who transacted over USD1tn. This represents over 17% of China's total retail sales. Its cloud division is the third largest in the world and grew revenues over 50% last year. Further, it owns 33% of Ant Financial, the largest payment company in China, who processed over USD18tn in 2020.

Alibaba is the largest online advertising eco-system in China and is becoming more relevant to users in China every day. In its core business, it has the potential to not only grow users, but also grow its take rate as it handles more fulfilment, logistics, advertising, and other services for its merchants. In its non-core business, the opportunity to grow its payments, cloud, and international e-commerce businesses are significant.

However, if we look at Amazon, which performs some of the same functions in the retail, fulfilment, and advertising space in the US, they are valued over 6x higher on a P/E multiple basis.

In a similar light, let's look at some of the Chinese internet companies listed as ADRs in the US.

Weibo is a platform similar to Twitter in China with over 500m monthly active users (MAU) and 240m daily active users. Weibo has become the centre of news in China. It has assumed greater social importance in China than Twitter in the US and over 75% of its users are under 30. Weibo is backed by Alibaba and has an ADR listing in the US and a dual listing in Hong Kong.

Weibo's market capitalisation is USD7bn with over a quarter of its value in cash and investments. However, it is trading at nearly half the EV/Sales valuation of Twitter. By contrast, Twitter is a USD34bn market capitalisation company with under 400m MAU. While there is increased competitive pressure from Kuaishou and Douyin, Weibo has built trust with celebrities and content creators. Weibo is a very attractive platform for advertisers and has become the go-to platform for news consumption in China.

Tencent Music is the largest music streaming platform in China and can be likened to Spotify. Tencent Music had over 640m monthly music streaming users last year and 240m monthly social entertainment users who engage in activities such as karaoke, live streaming, and other services. The company is hosting concerts both online and offline, pushing into podcasts and audio books, creating intellectual property for artists, and investing significantly in technology.

Tencent Music has a market capitalisation of over USD10bn, valued at 16x PE, with over 40% of its market value in cash and investments. Tencent Music owns 2.5% of Spotify and 2% of the Universal Music Group. By contrast, Spotify is valued at USD45bn, and is not yet profitable. While Spotify has to compete with the likes of Amazon and Apple, Tencent Music is the clear market leader in online music in China.

Similarly, there's the 'Google of China', **Baidu**, which is the dominant search engine in China and is also a leader in autonomous driving. Further, Baidu has an investment in the 'Netflix of China' called **iQiyi**. Baidu is trading at 17x PE, while, Google is at 26x. The 'Tinder of China' is a dating platform called **Momo** which has 80% of its market capitalisation in cash! The list goes on.

Concluding thoughts

Ox Capital aims to deliver consistent returns for our investors. The current market dislocation has created a very significant opportunity for investment in emerging markets. We aim to identify long-term secular trends and invest in high-quality businesses which correspond to those trends. High quality businesses will have pricing power, leadership in their field and long runways for growth. In the past decade, we saw developed markets generate stellar returns. However, going forward, we believe outstanding returns will be dominated by emerging markets. The fundamentals are now in place for emerging markets to outperform. The time to invest in emerging markets is now.

Contact us

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