SARANAC
PARTNERS

Investment roadmap

SEPTEMBER 2023

AT A GLANCE

— This month's main feature is on **China's equity market**, which has been a material global underperformer over the short term and the long term. The relative strength in China's economy has not translated into equivalent growth in earnings for shareholders. A key factor in this context has been the lack of profit focus by state-owned firms, and state interference in the private sector.

— More generally, China may be hitting the 'middle-income trap', failing to transition cleanly from a cheap-labour economy focused on exports to a more flexible productivity-driven structure. More recently sentiment towards the market has collapsed, although the scope for recovery in the short term is dependent on more vigorous policy action than has been taken to date.

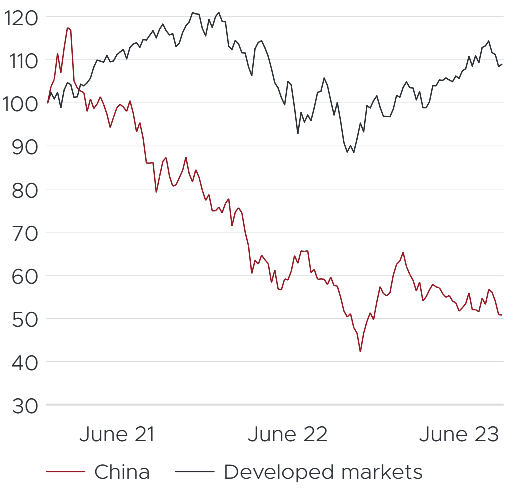
— Saranac avoids broad exposure to the Chinese market, implementing instead through a small number of selected Hong-Kong listed companies, a long/short hedge fund with regional expertise and an active manger positioned to benefit from an expanding middle class.

— Our private markets focus is on the impact of higher interest rates on **leveraged buyouts**. The sector boomed in a low-rate environment, but the world has changed. Higher interest rates are a clear negative for the sector. However, there have already been some significant adjustments. Valuations and debt levels in the sector have begun to decrease, back to levels last seen in 2016. Interesting entry points are becoming available for investors looking to deploy capital in this area.

— The **global economy** has held up better than many expected at the start of the year, and a sharp decline in profits has failed to appear. Inflation has fallen, and markets are discounting that tightening cycles are close to ending. However, we expect a challenging growth environment into next year, and is inflation likely to remain somewhat higher than central bank targets. Rate cuts may well be some way off.

— Our **market views** are broadly unchanged. Equity valuations remain somewhat stretched, particularly in the US, but longer-term government bonds are in the broad range which is around fair value. Our portfolios still tend to hold lower weights in equities than usual, and more in corporate credit – investment grade rather than high yield – and a diversified selection of alternatives.

Chart 1: Equity performance: China and the developed markets (US$)



Source: Bloomberg/Saranac

Chart 2: MSCI China equity total return after inflation

Source: Bloomberg/Saranac

One of the reasons often cited for investing in equities is to capture, through rising profits, the benefits of economic growth.

What's wrong with Chinese equities?

The underperforming Chinese equity market

In a troubled world, China has emerged over the past year and more as a particularly problematic area for equity investors. In dollar terms, equities in developed markets have recovered strongly from last autumn's trough, rising by some 20%. By contrast, Chinese equities have made negligible gains in this period, and indeed are some 50% down from the peak of early 2021 (chart 1). On a longer-term basis, after allowing for inflation, over the past fifteen years, the return to Chinese equities has been negligible (chart 2).

A range of challenges have become evident. Over the past twelve months, material problems have emerged in the real estate sector, there has been only a slow rebound in economic growth following the easing of the covid-related lockdown, political and economic tensions with the US in particular remain elevated, and concerns persist over the government clampdown on the activities of some private sector firms. Superficially, this may appear simply as the perfect storm, and all storms pass eventually. However, it is important to put this in a longer-term context. Chinese equities have been systematic underperformers relative to many other equity markets over an extended period, phases of sharp outperformance notwithstanding, and there are good reasons why this has been the case.

Strong economic growth is no guarantee of strong equity performance

At first sight, this may seem curious. After all, one of the reasons often cited for investing in equities is to capture, through rising profits, the benefits of economic growth. China has been the fastest growing of the major economies for an extended period, which in principle could have provided the foundation for systematic equity outperformance, as the Chinese corporate sector participated in the long economic boom. The apparent self-evident nature of this argument has been the longstanding source of some investors' attraction to emerging markets exposure in general.

However, whatever the superficial attractions, economic growth has been a very unreliable guide to a successful global equity strategy. Over the

Chart 3: Relative performance emerging vs developed markets (US$)

Source: Bloomberg/Saranac

very long term, across multiple countries and time periods, it has been difficult to establish any systematic relationship between rates of economic growth and equity performance. As a specific example, in the past decade and more, economic growth has been much faster on average in emerging markets than in developed markets, around 5% a year against 2%, but emerging market equities have nevertheless been systematic underperformers (chart 3). Chinese equities have been an important component of this underperformance, and the divergence between economic growth and equity returns has been of an exceptional magnitude. Since 2008, the Chinese economy has grown by some 7.5% a year on average, while delivering paltry returns to equity investors.

Why has this relationship between economic growth and equity outperformance in general been so elusive? One issue historically has been that emerging equity markets have tended to be commodity-intensive, so that the success or otherwise of these exposures was strongly dependent on the global commodities cycle. For example, the last period of extended equity market outperformance by emerging markets was in the commodity-price boom prior to the 2008 crash. China was an importer of commodities in that period, but the strength in its economy was a significant factor supporting that surge in basic materials prices.

However, while commodity prices have clearly had periods of extended booms, there have also been extended busts, and over the long term it has been a struggle for many commodities to keep pace with more general measures of inflation – hardly a robust foundation for sustained profits growth. This material exposure to commodities has become less evident in recent years, since commodities now comprise a much smaller proportion of emerging market, and indeed Chinese, equities. Nevertheless, the general point is helpful. Any equity investment is not in the broad and rather nebulous concept of the 'economy' but often very concentrated components of it.

The last period of extended equity market outperformance by emerging markets was in the commodity-price boom prior to the 2008 crash.

Other more ‘micro’ factors also matter for equity investors. For example, strongly growing economies have significant requirements for capital to finance investment. To the extent that this is financed through the issue of new equity, existing shareholders’ claims are diluted, so that even if profits grow in aggregate in the long-term, it may be divided across a cumulatively larger pool of investors. Moreover, these same equity holders may be particularly exposed in crisis periods when new equity can be required to ‘plug a hole’ in companies’ balance sheets. As a result, strong profits growth in aggregate may not find its way into individual shareholders’ returns. This has been highly relevant in China’s case, with around $100 billion in new equity raised by investors since 2015. Chinese companies which foreigners can invest in are very over-represented in this capital-raising, despite accounting for only a relatively small proportion of the market.

Company quality matters

Equity investors are likely to benefit more when their interests are ranked highly relative to other stakeholders in a firm. This is not, however, the Chinese corporate culture. Overseas investors in Chinese companies typically find themselves junior partners with less influence than a larger and more powerful investor, the Chinese government, whose objective do not appear to be primarily commercial. The government has material influence on many companies, in particular the State-owned Enterprises (SOEs), and it has also intervened in the operations of companies which are notionally privately owned. SOEs account for some 25% of the economy and listed SOEs represent around 40% of the quoted equity market.

Many of these companies were originally state bureaucracies and, going back a couple of decades or so, they were seen as good reasons to invest in the Chinese market, on the back of a material corporate restructuring theme. A vigorous reform programme was implemented, incorporating modern governance structures and targeted improvements in profitability and investment in the SOEs. The Chinese government also allowed private sector companies to displace SOEs in many areas.

Equity investors are likely to benefit more when their interests are ranked highly relative to other stakeholders in a firm.

Chart 4: Chinese listed company earnings (after inflation)

Source: Bloomberg/Saranac

However, this programme did not last beyond the 2008 crisis. Under Xi Jinping, SOEs have been seen more as a means to strengthen his and the Chinese communist Party's position – providing public services, stabilising the economy and supporting government industrial policy and other initiatives. The SOEs occupy significant roles in many of the economy's commanding heights – energy, finance, telecoms, aviation and transport. SOEs have even been at the forefront of strategically important technology industries, such as semiconductors. These firms have also been involved in China's foreign policy, through participation in many projects under the banner of the Belt and Road initiative, which involves extending Chinese influence abroad.

Failing SOEs were also encouraged to merge rather than shut down, and SOEs have benefited from plentiful capital – cheap government finance and implicit guarantees of support. The firms which receive such support do not seem to have become particularly more efficient. By contrast, the activities of even highly successful technology companies have in some cases become severely constrained in recent years, for political rather than economic reasons. Competition has been limited still further as the ability of foreign firms to compete is in many instances formally limited by law.

The prime objective of many Chinese firms is not, therefore, to deliver profits, and many have been very successful in this respect. The profits cycle in China is highly cyclical, with the good times very good and the bad times very bad. However, looking through this volatility, the current level of earnings per share for listed Chinese equities, after allowing for inflation, is materially below its level in 2013 (chart 4). By comparison, profits in developed equity markets rose by some 30% in this period – despite materially slower economic growth.

The prime objective of many Chinese firms is not to deliver profits, and many have been very successful in this respect.

The middle income trap

This feeble profits performance was delivered in a period in which, in many respects, was one of significant tailwinds for the economy. Export markets opened up, there was a large population shift from the land to the cities, and investment to support development was very strong. The environment now is very different, and these supports are becoming constraints, as evidenced by the material decline in the Chinese growth trend in recent years.

Chinese access to foreign markets and technology is being limited by economic and political tensions. The working age population has been declining for some years and is set to fall further in coming years – a material demographic challenge. Perhaps most importantly, the investment boom is looking more like a mirage, as there is a strong case that much capital has been misallocated. This is most evident in the real estate sector, where there is material evidence of excess capacity, but also in the broader economy, where productivity growth has slowed to a very low rate in recent years.

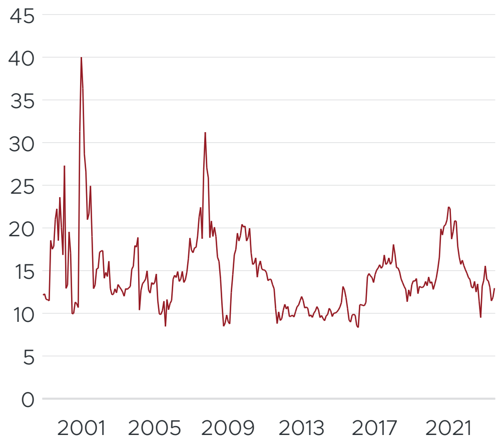
In a broader context, China is confronting the 'middle income trap', a phenomenon used to describe emerging market economies which never actually emerge. As a broad generalisation, the growth model which pulls a developing economy away from a very low average standard of living typically involves export-driven low-skill manufacturing. However, at per capita income of approximately $10,000, the historic experience of many countries has been that the effectiveness of this model deteriorates, and needs to be replaced by a more innovative economy, higher productivity and an ability to compete with higher value-added competition at home and abroad.

Chinese per capita income is at present just below this level. A few emerging economies have made the adaptation to a more sophisticated economic structure (Korea, Taiwan) but most do not (Mexico). The 'dirigiste' policies followed by the Chinese government in recent years suggest that the Chinese economy will struggle to breach the barrier. This suggests that the ability to generate the sustained profits growth required to support a long-lived bull market is likely to remain in abeyance.

China is confronting the 'middle income trap', a phenomenon used to describe emerging market economies which never actually emerge.

Targeted Chinese equity exposure
What are the implications for potential equity investors in China? We have pointed out the pitfalls in this article, but would temper the broadly pessimistic conclusions for a range of reasons.

Chart 5: MSCI China PE ratio



Source: Bloomberg/Saranac

First, recent months have seen capitulation by many foreign investors. There has been material foreign (and domestic) selling, and overseas exposure to China seems to be extremely low. Pessimism is strong and widespread, allowing in principle for upside surprises. The economy is losing momentum, but there are no obvious signs of collapse.

Second, in line with this pessimism, the valuation of the equity market is very low, albeit not at the single digit levels which prevailed between 2011 and 2016 (chart 5). Most SOEs trade below book value, especially the banks.

Third, there are some dynamic and globally competitive parts of the market in the private sector, which at the individual stock level have been dragged down, possibly too far, by the broader market pessimism.

Fourth, we have seen widespread calls for market support and stimulus, particularly measures aimed at the ailing domestic property sector. Markets have generally heard a supportive tone from authorities. Some measures have been announced in recent weeks, and investors are hoping for a more concrete stimulus policies that have a high likelihood of reducing uncertainties in the property market and helping the Chinese consumer. Sentiment may have improved ever so slightly in recent weeks. However, there is still a long way to go before the international investment community feels confident about reallocating into Chinese stocks, particularly in an uncertain geopolitical environment.

Finally, there are interesting investment themes, for example, the potential for stronger consumption from the rising middle classes. At the same time, China's performance in some 'industries of the future' such as electric vehicles has been very robust.

The case for some exposure to these targeted areas remains more attractive than broad exposure to the full Chinese equity market. As a result, we have selected specific Hong Kong-listed stocks directly for clients, are using an active manager exposed to companies which may benefit from the growing middle-class, and have also invested in an Asia long/short hedge fund that primarily focuses its activities in China.

China is a source of interesting investment themes, such as the potential for stronger consumption from the rising middle classes.

Public markets

EQUITIES

Valuation

Earnings

Positive
Energy; Healthcare; Japan

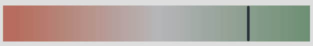
Negative
IT; Financials; Emerging Markets

Market background
August saw equity markets consolidate after a couple of months of robust gains. Weak macro data and central bank messaging helped equities bounce from the August lows late in the month. The energy sector bucked the negative trend as OPEC continued to exhibit production cut discipline and demand/supply factors begin to shift to a deficit.

Targeted exposure
Mega-cap tech share prices have risen with minimal earnings growth causing valuation multiples to move meaningfully higher. This is why we are more restrained in our IT allocation. We expect the energy transition will lead to an imbalance between demand and supply which is why we back the energy theme. We also favour some cheaper and more defensive areas of the market that exhibit some growth potential such as healthcare and industrials.

GOVERNMENT BONDS

Short maturity



Long maturity

Positive
US TIPS, nominal and inflation linked Gilts

Negative
>5 year European sovereign bonds, Japanese government bonds

Market trends
Longer-term bond yields have in general been rising since the spring, with many central banks continuing to raise policy rates as inflation pressures remain significant and unemployment rates are low. Some upside risks to policy rates persist, but the peak of tightening cycles may well be close. However, we are sceptical that rate cuts will be delivered rapidly, and there may well be an extended period in which policy remains on hold.

Targeted exposure
Rising yields have made duration more attractive, and we have raised this exposure somewhat in recent weeks. Yield curves are strongly inverted, particularly in the belly up to around five years, and these areas are relatively attractive. There are still risks at the very long maturities – particularly fiscal risks – which do not appear fully priced. Market-based inflation expectations are low, and we see scope for upside surprises.

Public markets

CORPORATE AND EMERGING MARKET DEBT

– Asset class outlook +

Investment grade credit

High yield

EM debt

Positive
£IG credit, 0-5Y €IG & $IG credit, short-dated subordinated bonds, AAA/A securitization, US Agency MBS

Negative
US HY, long-dated US IG, High Yield Emerging Markets

Market background
The trend since the spring has been for credit spreads to tighten, although this process has stalled more recently. The narrowing in spreads partly reflects the more ‘risk-on’ phase market. In general, there has been a normalisation of spreads from relatively high levels, but we find high yield spreads at below 4% relatively unattractive given the scope for default rates to rise as economic activity weakens.

Targeted exposure
The market background has changed in recent months. We see limited room for further spread compression from current levels, and bond yields are higher. This has facilitated a moderate risk transition in portfolios from credit to duration risk. This is appropriate given the potential for a slower growth environment to emerge. We have a constructive view on UK rates and £ investment grade, and find interesting opportunities in parts of the US market.

STRUCTURED PRODUCTS

– Asset class outlook +

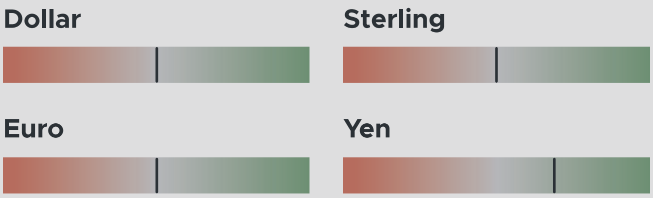
Market background
The picture continues to remain the same in structured product space. That is to say that the current volatility selling environment in equities, G10 FX and credit remains unattractive, in our view, while in rates there are some interesting opportunities. As before, this remains an interesting window to look at hedging levels. There are attractive opportunities to fund equity hedges by selling rates hedges at present, with rates / equities parameters increasingly at odds. For investors who are looking to add equity exposure, capital protected structures or outright calls also work well here. In light of attractive funding levels and low volatility, we are looking for opportunities to buy volatility to play interesting thematic trades.

Public markets

HEDGE FUNDS

Strategy spotlight: equity long/short
Equity market valuations are generally expensive relative to history and there is evidence of crowding in certain areas as the market rally has been increasingly driven by just a small subset of stocks such as artificial intelligence and semiconductors. While a soft landing should be supportive of risk assets, there are clear risks of reversals and rotations. However, dispersion has improved, and pair-wise correlations are falling, resulting in a much better environment for fundamental stock pickers. In addition, the market is expected to become increasingly micro-driven as macro variables, such as rates, inflation, and growth expectations, begin to stabilise. Expecting dynamic net exposed strategies, considered through a disciplined valuation lens, will be a solid performer in this environment.

CURRENCIES

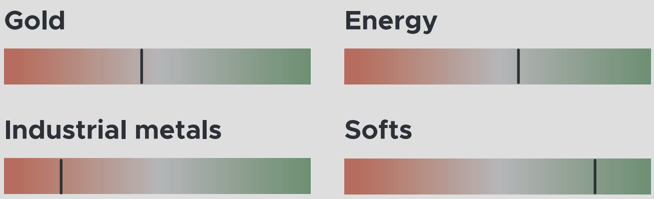


Market background
The trade-weighted US dollar has been on a steady rise since the middle of July (+4.9%) and despite a generally balanced message from Fed Chair Powell at Jackson Hole, the US economy continues to outperform peers on a relative basis. US inflation has continued to show signs of stickiness, meanwhile European and Chinese macro data have deteriorated meaningfully, the former of which has seen EUR/USD trade back down to the 1.07 level. Markets are increasingly pricing in a Fed that has reached peak rates and it is becoming increasingly doubtful that the ECB has the potential to hike much more given macro softness.

Targeted exposure
FX action in Asia remains very dynamic, with the Japanese Yen reaching levels where authorities have historically intervened. Meanwhile, a weaker JPY is eroding the competitiveness of Chinese exports, creating the case for further CNY weakening.

Public markets

COMMODITIES



Market background

Commodity price action continues to be volatile, also demonstrating a high beta to developments around stimulus (or a lack of it) in China. Brent Crude this week shot through $90/bbl after Saudi Arabia said they would extend production cuts of 1m bpd until December, while soft commodities have rallied from their August lows and industrial metals remain weak as Chinese property weakness intensifies. Our views here are relatively unchanged over the month – we continue to hold a structurally positive view on both energy and soft commodities through both our equity positioning and also direct commodity exposure, with the recent addition of the Agriculture ETF underpinning this. We are incrementally more negative on industrial metals, with the view that Chinese demand weakness can persist for some time.

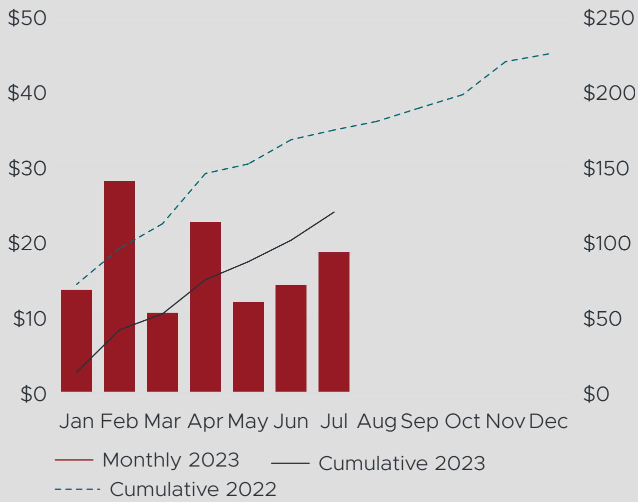
Private markets

LBO strategies
A higher rate environment has resulted in a completely different set of market dynamics for those deploying capital into private market strategies. One area where this has completed shifted is Leveraged Buyouts (LBO). Over the past few decades LBO strategies have benefited from an environment of free money, which has allowed those fund managers to apply a number of levers (mostly leverage related) to drive outperformance – with most doing so very successfully. However, we have now moved away from those favourable dynamics to an environment with higher rates, lower levels of liquidity and an uncertain macroeconomic outlook. Hence, the question now becomes are the glory days for LBO over? We don't think so.

Before jumping to any conclusion, I think its important to understand the key factors that have led us to where we are and therefore why we see a route back. Over the past 18-months the tighter monetary policy and a weak economic outlook have meant that financing costs have increased significantly, and capital has withdrawn from the market – creating a somewhat self-fulfilling cycle. As a result, we have seen leverage loan issuance materially come down from 2022 levels, both in the US and Europe.

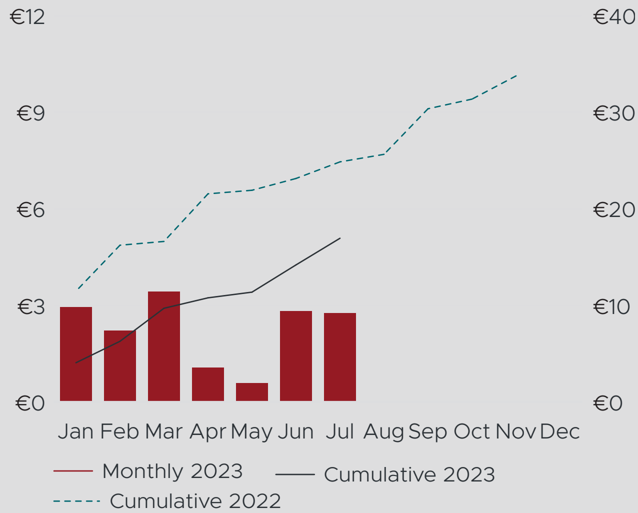
This withdrawal of capital and much higher cost of capital has meant that deal making activity has also dramatically retracted. Consequently, traditional participants have now had to materially increase their quality threshold for deals they want to complete. Therefore, to compensate for this much tougher environment we believe that valuations need to come down and equity as a proportion of deal value needs to increase for transaction activity to see an uptick and investors to be sufficiently compensated for the risk relative to the risk-free rate. This is something we have started to see. LBO managers seem to have adjusted as we expected they would need to, and as we have moved through 2023, we have started to see valuations and debt levels decrease across the board. EBITDA multiples now stand in-line with valuations seen in 2016 and debt follows a similar trend.

US institutional leveraged loan volume ($B)



Source: PitchBook/LCD

Europe institutional leveraged loan volume ($€)

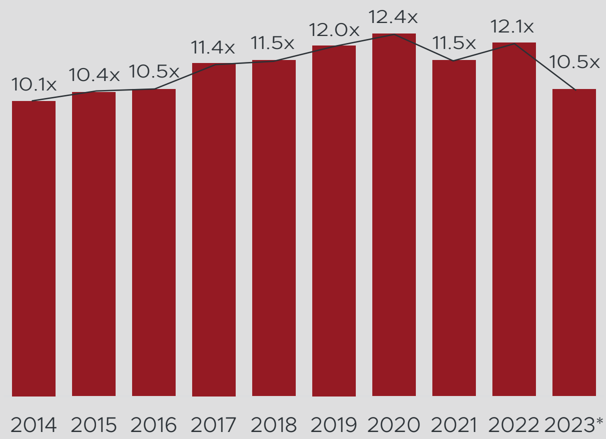


Source: PitchBook/LCD

Private markets (continued)

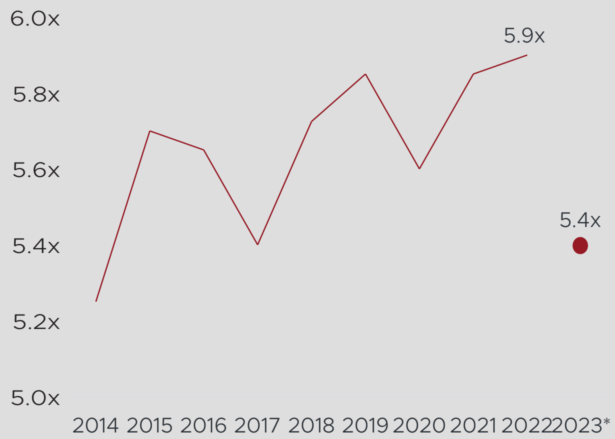
As a team, we have largely been negative on deploying capital into LBO strategies for the last 12–18 months as we thought valuations and debt levels were becoming too high for comfort. However, as we see this trend reverse (and we still think some more could come – marginally speaking) we think this could make a good entry point for long-term investment for those that have been seeking to deploy capital.

Median PE EV/EBITDA multiples



Source: PitchBook
Geography: North America and Europe
*As of 30 June 2023

Average PE debt/EBITDA multiples



Source: PitchBook/LCD
Geography: US
As of 31 May 2023

Private markets

ALTERNATIVE SOURCES OF RETURN

Secondaries

Record levels of secondary volume as investors seek to rebalance portfolios has resulted in a very attractive pricing environment

Special situations

Favourable market environment given the likely stress corporates will face in a higher rate environment

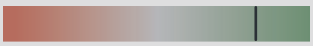
Venture capital

Early-stage venture has benefited from the correction in late-stage valuations, providing an opportune time to invest in long-term productivity gains, labour replacement and other venture investment qualities

Infrastructure

More attractive given supply chain issues and geopolitical uncertainties

Real estate



Pricing is unattractive given the narrow spread (in some cases negative) between cap rates and the risk-free

GP stakes and financing

Opportunity of higher yield and greater downside protection as a result of attractive secondary pricing dynamics

Real assets

At risk from weak growth environment

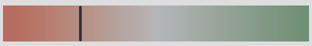
Private debt

A negative economic outlook with the potential for above-trend default rates and extension risk make private direct lending unattractive on a risk-adjusted basis

Leveraged buyouts

EBITDA multiples have begun softening and hence in time valuations could again become attractive

Mid-market growth



A prolonged period of weak/negative earnings growth as a result of a weak economic environment and increased cost of capital will see valuations struggle in the short term

ABOUT SARANAC PARTNERS

We founded Saranac Partners to do things differently. To create a community based around like-minded people, shared wisdom and collective learning. To work as partners, creating compelling opportunities and effective solutions. To offer unfailing support, honest challenge and thoughtful inspiration.

Our business combines the personal touch of a private office with the capability and breadth of a large institution. Our firm has strategic shareholders, outstanding technology, broad capabilities and the highest standards of corporate governance. Saranac Partners is a signatory to the United Nations Principles of Responsible Investing (UNPRI).

OUR SERVICES

We start with the question. We listen and seek to understand. We don't make assumptions or force solutions. Rather we co-create a path with our clients.

Strategy. Planning, governance and oversight

Financing. Access to diverse sources of capital

Investments. Allocation and deployment of capital

Corporate advisory. Supporting corporates and business owners

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