K2 Asset Management
Level 32, 101 Collins Street Melbourne Victoria 3000 Australia
Telephone 61 3 9691 6111 **Facsimile** 61 3 9691 6170
Website k2am.com

K2 Asian Equity Update

Quarterly Report - 30 June 2018

Market Review

The K2 Asian Absolute Return Fund returned -0.5% for the quarter and 6.5% for the 12 months ended 30 June 2018.

The Fund targets a through the cycle return of 10% p.a., by limiting fund drawdowns in non-favourable market conditions, through the use of holding cash, short equity positions and active currency management. The strategy allows the Fund to protect capital and compound returns off a higher base post market pull backs.

The second quarter of 2018 was initially stirred into life by company reporting season, one that showed continuing positive results from listed companies in China and Hong Kong, while regional results elsewhere were a little more mixed. We noted a tone of caution relating to top down geopolitical issues in the commentary surrounding results and thus corporates were uncertain how these may play out. Towards the end of the quarter, these concerns manifested themselves in the "Trump Trade War", pushing Asian bourses lower and placing pressure on a number of emerging market currencies. Due to our concern over emerging market currencies, the Fund maintained a significant exposure to the US dollar or USD linked currencies, with over 70% of the Fund's currency exposure to the USD. The Fund is approximately 12% hedged back to Australian dollars.

The heavy market sell off through June unwound much of the good performance of the prior months, however the capital protection strategies through currency, cash and selected short positions helped buffer the fall. The total Fund return for the period of -0.5%, outperformed the MSCI Asia Ex Japan index by 1.3%. The largest detractor to performance over the quarter was long equity. Long equity suffered as Asian financials came under pressure with Ping An, CCB and Haitong Securities amongst the largest detractors. Resources and the oil & gas sectors led markets over the quarter. The Fund's exposure to these sectors delivered a significant contribution through Alumina, BHP, Sinopec, PTT PCL and CNOOC.

With volatility becoming more prevalent, the cash allocation and short equity component of the portfolio were utilised to help offset the uptick in market volatility and provide a greater degree of capital protection if the markets were to see a significant correction. Although the cash allocation fluctuated during the quarter, by quarter end, cash and shorts accounted for 20% of the Fund. With markets mildly down over the quarter, cash proved to be a positive while our short equity positioning also contributed to performance.

Global Economic Data

Economic data shows that activity is picking up and moving in the right direction. May releases including the all-industry global PMI, trade reports from Asia, and US payrolls have been upbeat and we expect further positive news to follow from China's monthly data dump. However, risk is skewed between developed and emerging markets. In emerging markets, the downside is concentrated in a few countries with rising policy risk and external imbalances, mainly Brazil and Turkey. In developed markets, the biggest source of concern is the Euro area, which we had expected to participate in the mid-year growth pick-up. Although a modest pick-up in retail spending is underway, Euro region industry is not rebounding from a Q1 2018 contraction.

China reforms highlights shift towards globalisation

There has been a significant shift in Chinese financial reform in recent weeks. The PRC Government has verbally intervened to stabilise the Chinese (RMB) currency. The Government has also lowered the Reserve Requirement Ratio (RRR) for banks allowing extra liquidity into the economy as credit defaults have increased this year within China. The implications of this should not be underestimated in our opinion; particularly given global USD interbank tightness once more becomes an increasing global concern, even as the Chinese further commit to RMB globalisation. During the quarter 14 African nations met to discuss the utilisation of the RMB as the regional reserve currency given the levels of Chinese lending in the region (an issue only increasing more broadly across the region with China's OBOR initiative and topical within Australia as we see Chinese influence increasing across the Pacific). Rule changes for NPL recognition to add to the 15 major financial reforms to have been announced since the Boao summit in April.

Trade War

Since Trump was elected nearly two years ago, the US-China trade war has been brewing. It has now come to a crescendo with sanctions due to start July 2018. On announcement of US trade policy by Trump, Beijing immediately responded to match the US's USD50bn tariffs dollar-for-dollar in order to deter the US from going ahead with further escalation. Trump quickly directed his government to identify an additional USD200bn for tariffs at 10% and the tit-for-tat continued.

K2 Asset Management
Level 32, 101 Collins Street Melbourne Victoria 3000 Australia
Telephone 61 3 9691 6111 Facsimile 61 3 9691 6170
Website k2am.com

To place these tariffs in context, USD250bn is about half of what the US imports from China, leaving Trump further room to move. On the other hand, China only imports USD155bn from the US and thus its ability to match the USD200bn is curbed. As the US economy is circa 1.5x larger than China's, the tit-for-tat tariff policies can only run so far before China runs out of runway. This explains why Trump is not worried about tearing up what has been achieved by previous trade talks with China.

China does have other avenues to help combat US trade tariffs, the most obvious being its currency. Over the quarter, the Chinese Renminbi (RMB) declined in value by 5.5% relative to the USD. Trump has on numerous occasions called China a currency manipulator, as the Chinese government fixes its currency within a band (or peg). This fixing of the currency has historically made China more competitive than it would otherwise be. Likewise now, by letting the RMB depreciate, China is using other means to fight this trade war.

It has been estimated that for a 10% tariff by the US, China would suffer a 1.6% loss of GDP over time. China's balance of payments would also suffer, bringing new downward pressure on the RMB. It is likely currencies will be the hidden war behind the tariff bluster.

Sector in Focus: Oil

The oil price (Brent) has rallied over 150% from its low point in January 2016 to just under USD80 at the end of June. The recovery has been driven by a combination of broad based fundamental demand growth together with supply side constraints ranging from OPEC cuts to geopolitical trouble in major oil producing states. Furthermore, US shale production, which was largely expected to fill the hole left by OPEC, is showing signs of growing pains. Commercial inventories are being rapidly depleted and the market remains extremely tight with further risks to supply. Even Trump's best efforts to encourage Saudi Arabia to increase production, hoping for a lower oil price, had the exact opposite effect.

Significant upgrades to consensus oil price forecasts have just begun and the sector is re-rating accordingly. We believe that favourable industry dynamics will persist with the following catalysts:

- High degree of compliance to announced cuts from OPEC and "friends" with recent messaging suggesting less than expected output increase
- Broad based global demand growth running above expectations
- Saudi Arabia seeking USD80 oil price to support imminent Aramco IPO
- Iranian sanctions and political turmoil in Venezuela
- US shale, considered to be the world's marginal producer, is logistically constrained, evidenced by a stabilising rig count
- Capex discipline for the big oil companies still scarred from 2014 price collapse

The K2 Asian Fund has exposure to the oil sector through holdings in CNOOC (China), Sinopec (China) and PTT (Thailand).

PTT, the Thai oil company continues to show strong growth credentials from its gas and downstream business offsetting what is a more cyclical petrochem and refining business. With earnings set to rise through 2018 driven by higher oil price and cost savings at existing projects driving margin. PTT's gas business is experiencing volume expansion from the Phase 2 commission of its LNG regasification terminal. PTT's gas business is a near monopoly within Thailand and with further project expansions and rising demand for gas should drive further earnings for its gas business. For many years, we have talked about ensuring that a stock holding has multiple ways of winning, in the case of PTT, we are also pushing for the company to list its retail fuel business. This transaction should unlock value and increase cash-flow and act as a further catalyst for shares.

CNOOC is a leading Chinese upstream oil and natural gas exploration and production company. With a strong production pipeline CNOOC is currently at the beginning of a long-term growth cycle. Potential to significantly re-rate as investor confidence in a sustained higher oil price improves.

Sinopec incorporates a significant refining division within the company, while its exploration & production (E&P) unit is smaller than its Chinese peers. With the probability that the company's E&P division should turn profitable in 2018 with USD65/bbl seen as the breakeven point, most of the company's growth is stemming from its reinvestment in its refining and chemical divisions. Due to Sinopec's differing composition, it is less geared to the oil price than most of its listed peers.