

Macro Overview

by Andrew Clifford, Co-Chief Investment Officer

We have taken a different approach to our Macro Overview this quarter, adopting a 'Q&A' format, with investment specialist Douglas Isles asking CEO and co-CIO Andrew Clifford the key questions on many of our investors' minds, covering China regulation, income inequality/redistribution, rising inflation and what it all means for global markets. An edited transcript of the conversation is below and the full interview is available on The Journal page on our website.

DI: It's been a very eventful quarter, particularly in China. With your 30+ years of experience investing there, can you provide some context?

AC: I think one of the issues that people struggle the most with in regards to China is the idea of government interference in the economy. There's been a lot of discussion, not just in the last three months but over the last several years, about China returning to a command economy. This is in stark contrast to the China that I know and have invested in. From my experience, China is one of the most market-based economies in the world, and indeed, that is the reason for its enormous success.

Over the last decade we have seen a period of constant regulation coming into what is just a very fierce market environment. Probably the most important of these was the reform of the shadow banking system. Entrepreneurs and banks were finding loopholes in the regulations that had been introduced to restrict the funding of activities such as property development. In response, the government implemented new rules to clamp down on that behaviour, and slowly all those assets and liabilities have been brought back onto bank balance sheets.

In recent times, there's been a lot of focus on the regulation of the tech sector, but most of it is not that different to what we're seeing in the rest of the world. Europe, for example, introduced restrictions on the use of private data by e-commerce companies. The Chinese regulators are incredibly sophisticated in their approach to regulation, they study best practice around the world. Where they feel that free markets have gone too far, they introduce rules, which for the most part are very much modelled on the European approach.

DI: It seems that every time there is a reform program in China, the rest of the world reacts badly to it, why do you think that's the case?

AC: It's important to remember that in China there is a different process to enact change. For us to implement new rules around the use of data or controlling the behaviour of large e-commerce or social media companies, it would be a drawn-out process and there would be significant pushback. For example, in the US, the Federal Trade Commission case against big tech companies is likely to be a protracted affair. However, in China, it's quite the opposite, the rules appear to change 'overnight'. While the process may be different, the political motivation is not that different from ours. These changes are being made because people are unhappy with the behaviour of big tech in China, just as they are elsewhere.

DI: Property developer Evergrande received considerable media attention over the quarter. The property market in China has been an area of scrutiny for many years, what are your thoughts?

AC: We don't own Evergrande in any of the Platinum portfolios. Its issues were widely known, and while it is naturally unsettling for investors, we don't believe it will be a systemic event. At Platinum, we talk a lot about the role of cognitive biases in investing and the need to go beyond our intuitive responses, or our System One thinking as Daniel Kahneman would put it, and move to System Two thinking, where we really try to understand the realities of the situation. There has long been this story about the great Chinese property bubble, but let me share some numbers. Over the last decade, in the six largest cities, residential property prices increased in the order of 8-10% p.a. In the tier two and tier three cities it was much lower at around 4-5% p.a. Now, 8-10% p.a. is a big appreciation over that timeframe, but this needs to be seen in the context that

nominal GDP in China is around 9% p.a. Additionally, you need to consider who's buying property in China, it's not the average household, it's the wealthy households and their incomes are growing even faster than that.¹

There is also a lot of focus on the number of apartments that are being built, and yes, since private ownership of property was allowed in 1999, about 200 million apartments have been built. But you have to remember that's the entirety of the modern housing stock in China, because everything else prior to these newbuilds was pretty much communist-era housing. So, given there are around 300 million urban households and 900 million people living in urban areas, we haven't even built enough modern housing stock yet.²

We hear a lot of talk about the 20% of apartments that are sitting empty, but in China, investment properties typically aren't rented out because the laws are quite harsh against landlords. Interestingly, in Australia, at any point in time, around 10% of our homes are unoccupied and I'm not talking about home rental vacancy, these are properties owned by people who own more than one home and leave them unoccupied.³

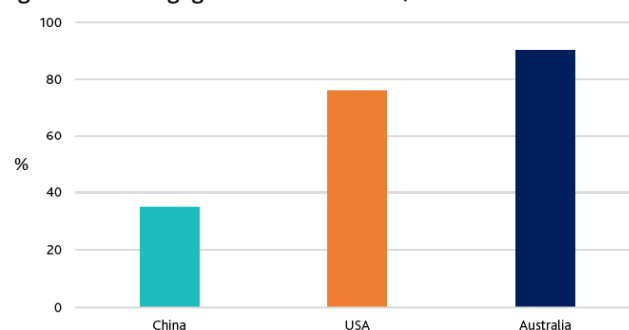
I would add that it's actually been difficult to get a property loan in China in recent years. A 30% deposit is required to buy a first property and 50% for a second. Mortgages have grown very quickly from being almost non-existent a decade ago, to be around 35% of GDP, which is well below what pure mortgage debt is in Australia or the US.

Property is a booming and important part of the Chinese economy, but if house prices get out of control, it becomes a political issue. It's a well-founded market, not a bubble by any standards that I can see.

DI: When the ultimate goal of the government is one of "common prosperity" is it fair to say that housing is front and centre for that?

AC: Absolutely. For the last decade there's been continued efforts to keep property prices down. The sentiment that "property should be an end-user asset not a speculative asset" is often attributed to President Xi Jinping, but this was around long before he was President. China has the same problem that the rest of the world has on that front. I think the real issue here for the world economy is that the latest regulations are trying to control not just the price that property is sold at, but also the price that developers pay to acquire land to develop properties. It's a thoughtful approach

Fig. 1: Pure Mortgage Debt as % of GDP, 2020



Source: PBOC (China); Federal Reserve Bank of St. Louis (USA); Business Insider Australia, OECD (Australia). As at Q4 2020.

to my mind, as it is essentially trying to regulate property development in a similar fashion to how utilities, such as electricity or gas businesses, have been regulated over the years. While there is a risk that this approach may not be successful in a market like property development, with developers already stepping back from buying land and property buyers now nervous, I think the concern of any great disaster is overstated. Past experience tells us that as soon as the Chinese authorities take their foot off the brakes, even in the slightest way, buyers come flooding back in, and if it gets to that stage, that's what I would expect here as well.

DI: Over the last decade there has been a clamp down on corruption, supply side reform, financial reform, and now "common prosperity". On balance, do you think they have done a reasonably good job for China over that period?

AC: When you look at the government's approach to introducing thoughtful, sensible regulation and rules in their economy, I think they've done an extraordinarily good job. As I said earlier, a lot of it is modelled on what the rest of the world does and I think there's nothing to be feared there. The recent event where they basically banned after-school tutoring due to cost concerns, is a bit more of an extreme measure, but again, they're very important social issues the government is reacting to, just like a democratically elected government would react to important popular issues.

DI: Let's now look at the rest of the world, particularly the other large economy, the US. Inequality is something that the Chinese and US governments are both trying to address, can you reflect on how it's being approached in the US and what the implications might be for investors?

AC: I think that income disparity is behind a great deal of discontent across much of the world. In the last decade or so, people keep referring to the world being in a low-growth environment, but that's actually not the case. The world economy grew pretty much the same rate in the decade from 2010-2020 as it did in the prior decade, but what has

¹ Source: CSLA; FactSet Research Systems.

² Source: CSLA; State Council of the People's Republic of China.

³ <https://www.abc.net.au/news/2021-04-14/house-prices-australia-climbing-not-for-the-reason-you-think/100065644>

changed is the disparity of income, with lower-income groups clearly not doing as well as the top 20 or 40%.

Ultimately, everyone gets a vote and it then becomes an issue. I think one of the really interesting things the pandemic has shown politicians is that a lot of the support payments which have been introduced or increased during the pandemic, have clearly helped lower-income households far more than the average. And with that, I think politicians have seen the benefit of redistributing income toward lower-income groups. China faces the same issue. In fact, there are far more extremes between those who have benefited from China's prosperity than those who haven't. The call for "common prosperity" is thus one of redistributing income through the economy.

A number of years ago, we wrote about the huge benefit to economic growth of putting \$100 in the hands of lower-income households vs. high-income households through tax cuts. The latter group will most likely save it and buy another property or more shares. The lower-income households on the other hand, will most likely spend it on basic necessities. On that basis, I think it would be very good for global growth if we get some degree of income redistribution that is being discussed across the world.

DI: On the topic of economic growth, inflation is a hot topic right now for markets, what are your thoughts on that front and expectations for interest rates?

AC: As we've been talking about for some time, the creation of money through quantitative easing and funding government deficits this way is unquestionably inflationary. For a long time, inflation has mainly appeared in asset prices, the stock market, private equity infrastructure assets and house prices, which has been much more extreme in the past 18 months. But now we are seeing inflation in goods and services. There's always a lot of discussion of whether this bout of inflation is due to temporary shortages. As we mentioned in our June quarterly report, the market economy is good at dealing with temporary shortages. We have seen this in iron ore and lumber where there were huge price increases and then for one reason or another, supply adjusted and the prices retreated. But we're also seeing many 'sticky' prices. We can't get enough semiconductors to meet motor vehicle demand currently or a whole range of other projects that require semiconductors. The cost of shipping a container from Shanghai to Los Angeles is up six-fold or so. Gas prices are up four- or five-fold in Europe and thermal coal prices have pretty much doubled in recent months.⁴ So, there are price increases coming through everywhere. Adding to the

mix, is a shortage in labour at a time when the jobs market is as strong as we've ever seen, which is a bit odd given that we're still not fully out of the pandemic, but this is what all the numbers tell you. We are seeing companies raise prices at record rates. There is also anecdotal evidence, with UK gas bills, for example, doubling in the last couple of months. This is going to cause real pain in households, not to mention rising rents, so we have a real problem here and it's a question of how it unfolds.

While central banks are all saying they won't raise interest rates soon, we shouldn't pay too much heed to that, because their whole role is to set our expectations, and they will increase rates when they see fit. This poses a real dilemma though. People are going to start struggling to pay their bills following these price moves. How will governments respond? Will they spend even more money and announce yet another round of rescue packages, which are inflationary again? I think the end destination here, one way or the other, is interest rates are going up and there's a risk this happens earlier than many expect.

DI: How do you think this changing interest rate dynamic will play out in the markets? Will we see a reversal of fortunes in stocks?

AC: The beneficiaries of cheap money and inflation in asset prices have been the sectors that everyone is so excited about in the stock market, the so-called 'disruptors'. Consequently, there's been plentiful buyers of their shares and some crazy valuations of private companies that are raising capital at 20, 30 or 40 times their revenue. Yes, they are great companies and are growing fast, but many are losing money. The point is that they can only keep the game going while there are investors who are willing to fund them, and in many cases these investors are their own employees who are paid in stock. It's hard to go a day without hearing about a new start-up developing software to solve problems for companies or individuals. There's huge competition for the corporate IT budget or your personal budget to spend on all these things. That is the area, where the combination of valuations and the fact that they need money to keep going, that is a big risk for investors. It won't be a good place to be when the music stops.

On the other hand, there's a whole other part of the economy that people haven't wanted to fund, high-quality businesses at the centre of the future growth areas of the economy. Semiconductor companies like Microchip, for example, who makes microprocessor units used in electrical switches for a whole range of items, from microwaves to car windows. This is a very profitable business and it's growing because there's increasing demand for its products. Over time, as electronics usage increases, we will need more of

⁴ Source: <https://tradingeconomics.com/>; <https://www.cnbc.com/2021/10/05/gas-price-surges-to-a-record-high-in-europe-on-supply-concerns-.html>

their products. But here is a company that's unable to deliver enough product to meet the demand in the auto industry, due to under-investment. And this has been a theme across a range of sectors for the last decade. This includes commodities like copper, for example, a vital component for all manner of things, such as electric vehicles (EVs). The world's going to need an extraordinary amount of copper, but there hasn't been any significant investment in finding new reserves for seven or eight years.

So, to me, the other side of all this capital that has been invested in the new, exciting and innovative areas is that there's some really interesting, growing businesses that haven't been able to access capital, who now find themselves in a very nice position where their product is in demand and they're able to exercise good pricing power simply because of shortages.

DI: What do you think will ultimately make the 'music stop' so to speak?

AC: If you are looking for a catalyst, I think the most obvious is interest rates. While we are now seeing bond rates trending up again, we all struggle to ever be very precise in knowing when central banks will change official interest rates.

As an investor, I believe it's important to build a portfolio of stocks that are well positioned in terms of the markets they're in. I have given the example of Microchip, but in autos, we have BMW or Toyota, who are both very well positioned for the EV world. There are other themes too, such as travel, which is also a growth industry. Many travel stocks are very high-quality businesses, whether it's the online travel agents like Booking Holdings or Trip.com, which is the Chinese equivalent, or aerospace companies like General Electric, Safran and MTU Aero Engines, who are involved in the production of engines for aircraft - and again, based on the rate at which aircraft orders are coming in, we're potentially not going to have adequate capacity to produce enough engines. There's a whole array of opportunities out there and you need to buy each knowing what they can earn in a good period and assess against that.

MSCI Regional Index Net Returns to 30.9.2021 (USD)

REGION	QUARTER	1 YEAR
All Country World	-1.1%	27.4%
Developed Markets	0.0%	28.8%
Emerging Markets	-8.1%	18.2%
United States	0.3%	29.9%
Europe	-1.2%	28.0%
Germany	-4.3%	16.5%
France	-2.0%	34.3%
United Kingdom	-0.3%	31.2%
Italy	-1.1%	33.4%
Spain	-3.3%	31.4%
Russia	9.5%	59.4%
Japan	4.6%	22.1%
Asia ex-Japan	-9.3%	14.4%
China	-18.2%	-7.3%
Hong Kong	-9.4%	15.0%
Korea	-13.2%	27.8%
India	12.6%	53.1%
Australia	-3.0%	31.7%
Brazil	-20.2%	21.0%

Source: FactSet Research Systems.

Total returns over time period, with net official dividends in USD.

Historical performance is not a reliable indicator of future performance.

MSCI All Country World Sector Index Net Returns to 30.9.2021 (USD)

SECTOR	QUARTER	1 YEAR
Energy	2.8%	63.9%
Financials	1.9%	49.6%
Information Technology	0.5%	30.3%
Health Care	0.2%	18.3%
Utilities	-0.2%	10.1%
Real Estate	-1.8%	22.2%
Consumer Staples	-2.1%	10.2%
Industrials	-2.1%	27.3%
Communication Services	-2.6%	28.9%
Materials	-5.0%	26.8%
Consumer Discretionary	-5.2%	17.6%

Source: FactSet Research Systems.

Total returns over time period, with net official dividends in USD.

Historical performance is not a reliable indicator of future performance.

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