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THIRD QUARTER
2017

# GLOBAL Foresight

## Aging Bull

### Where we see investment opportunities after eight years of rising markets

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**Yesterday Once More; Tomorrow Never Knows**

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**DAVID P. HARRIS, CFA**
*Chief Investment Officer*
212.549.5210
dharris@rockco.com

Eight plus years into the market recovery, we see valuations extended as most of the gains since 2014 have been driven by multiple expansion rather than earnings growth. In this issue of *Global Foresight*, we highlight potential investment opportunities, as well as challenges to sustaining this bull market. We examine emerging markets with Jimmy Chang focusing on China, and Michael Seo on South Korea. We also comment on corporate governance in an article by Dr. Mariela Vargova.

## The Charging Bull

The lifespan of a bull market typically lasts many years, at times ending abruptly. Conversely, the statue now on Lower Broadway known as *Charging Bull* had a very short-lived initial run on Wall Street. It is not widely known that *Charging Bull* was never commissioned by the City of New York nor by any one of its major investment banks. Rather, the three-and-a-half-ton statue was simply unloaded one December day back in 1989 by a private citizen in front of the New York Stock Exchange.

The benefactor was Italian sculptor Arturo di Modica who created *Charging Bull* to demonstrate his belief in the strength of the U.S. economy after the stock market crash in 1987. Hours after di Modica delivered his statue, it was removed by the NYPD and was not expected to be resurrected. This was not the end of this bull's run, however, since its removal generated an amazing amount of media buzz—particularly noteworthy considering this happened before the internet was available to the general public, so "going viral" was not even a concept. After a couple of weeks of public pressure, *Charging Bull* was retrieved and installed at its current home at the intersection of Broadway and Whitehall, where it has been a staple for tourists' photos ever since.

The current equity bull market may have more years left, but its age and valuation make the case worth revisiting. As we assess potential investment opportunities, we see valuations elevated in the U.S. market, while we believe Europe is likely to continue its cyclical rebound. We are also encouraged by political developments on the continent. We believe there are a number of attractive emerging market (EM) opportunities, but are mindful of the challenges most of these once-rapidly-growing economies face. Frankly, it is not just the bull market that is aging; it is most of the world, which has important sociological, economic and investment implications as demographics and debt are likely to constrain long-term global economic growth.

## The Challenge of High Valuations

In 1998, professors Robert Shiller and John Campbell conceived the cyclically adjusted price-earnings (CAPE) ratio, which averages earnings over a 10-year period to minimize the impact of economic cycles when valuing equity markets. The CAPE ratio has been widely cited as evidence of U.S. stock market overvaluation. The present U.S. equity CAPE ratio is the highest it has been except during two famous market peaks—1929 and 1999. We believe the CAPE ratio is cause for concern, but not alarm. It most likely suggests that U.S. equities will have subdued future returns. However, unlike the market's prior peaks at the end of the Roaring Twenties or the dot-com era, we do not believe we are in the midst of an economic or market bubble. If there is a benefit to the subdued economic recovery we have recently experienced in the U.S. where GDP growth has been averaging about 2.0%, it is that the economy has not built up the excesses that it did during past peaks in the CAPE ratio. By contrast, during the 1920s, U.S. real GDP growth averaged 4.2%, and from 1996-1999 it grew at least 4.3% in each calendar year. Since the CAPE ratios in those periods calculated off a base of very strong economic activity and earnings, those periods were more susceptible to crashing than today's more muted environment.

NEW YORK POST

SPORTS EXTRA

SATURDAY, DECEMBER 16, 1989 / Cloudy and windy, mid 20s, today; clear, low teens, tonight / Details, Page 2

40¢ in New York City 35¢ elsewhere

BAH, HUMBUG!

N.Y. Stock Exchange grinches can't bear Christmas-gift bull

LEVERAGED PRY OUT: A three-ton bronze bull left in the middle of Wall Street in front of the New York Stock Exchange was meant to stand as a symbol of the "power of the American people," according to the Italian artist who created it. But to the Scrooges who run the exchange, it was more like a traffic hazard. They had the ornament to optimism hauled away yesterday. See Page 13.

NEW YORK POST MAGIC DOLLAR GAME

LAST CHANCE TO WIN A BUNDLE

...0,000 HOME IN POCONOS UP FOR GRABS TODAY. Pages 2, 32 & 42

Source: New York Post

## EM Growth?

CAPE ratios are lower outside the U.S., with emerging markets even lower than those in developed markets. While we have been more constructive in recent issues of *Global Foresight* on non-U.S. opportunities, we believe there is limited relevance of CAPE ratios when comparing the very deep, diverse set of companies in the U.S. with most other markets. While valuation from 30,000 feet looks better in many places, there are reasons to discount CAPE as a reliable valuation tool when analyzing smaller markets. As an extreme example, Russia has the lowest CAPE ratio in the world, but its equity market is very concentrated in commodity businesses whose earnings are highly cyclical.

TABLE 1 highlights data from the 10 largest emerging markets, which account for 89.2% of the MSCI Emerging Markets Index. The growth prospects of this group appear surprisingly tepid. The median real GDP growth for the next five years is forecasted at 2.5%, while population growth is expected to be less than 1.0%. The term "emerging markets" was coined in the 1980s, but frankly, most of these economies have already "emerged." The countries with the most long-term economic growth potential are arguably those with young, growing populations—namely, India, Indonesia and Malaysia. However, these countries have small equity markets that, when combined, do not even equal South Korea's in size.

TABLE 1: **KEY DATA FROM THE TEN LARGEST EMERGING MARKETS**

| COUNTRY | INDEX WEIGHT | LAST 5 YEAR GDP GROWTH | FORECAST NEXT 5 YEARS GDP GROWTH | ESTIMATED POPULATION GROWTH TO 2021 | INFLATION RATE | MEDIAN POPULATION AGE | FISCAL DEBT/GDP | LEADING MARKET P/E | 10-YEAR BOND YIELD | SOVEREIGN DEBT RATING |
|---|---|---|---|---|---|---|---|---|---|---|
| CHINA | 27.7% | 7.3% | 6.4% | 0.6% | 2.0% | 37.1 | 46.2% | 13.6 | 3.5% | AA- |
| SOUTH KOREA | 15.4% | 2.8% | 2.7% | 0.4% | 1.3% | 41.2 | 38.6% | 9.7 | 2.2% | AA |
| TAIWAN | 12.2% | 2.1% | 2.2% | 0.2% | 1.4% | 40.2 | 35.7% | 13.8 | 1.0% | AA |
| INDIA | 8.8% | 6.3% | 7.5% | 1.3% | 5.0% | 27.6 | 69.5% | 18.8 | 6.5% | BBB |
| SOUTH AFRICA | 7.0% | 1.6% | 1.5% | 1.6% | 6.3% | 26.8 | 50.5% | 15.9 | 8.4% | BBB- |
| BRAZIL | 6.7% | -0.4% | 1.8% | 0.7% | 8.8% | 31.6 | 78.3% | 12.0 | 10.7% | BB |
| MEXICO | 3.7% | 2.5% | 2.4% | 0.9% | 2.8% | 28.0 | 58.1% | 18.7 | 7.1% | A |
| RUSSIA | 3.3% | 0.5% | 1.5% | -0.1% | 7.1% | 39.3 | 17.0% | 5.8 | 7.6% | BBB- |
| INDONESIA | 2.5% | 5.6% | 5.3% | 1.3% | 3.5% | 29.9 | 27.9% | 15.7 | 6.8% | BBB- |
| MALAYSIA | 2.4% | 5.1% | 4.6% | 1.7% | 2.1% | 28.2 | 56.3% | 17.9 | 3.8% | A |
| SOURCE | MSCI *AS OF MAY 31, 2017 | BLOOMBERG | BLOOMBERG | IMF/ BLOOMBERG | BLOOMBERG | CIA WORLD FACTBOOK | IMF | MSCI/ BLOOMBERG | BLOOMBERG | S&P |
| TOTAL | 89.7% | | | | | | | | | |
| | MEDIAN | 2.7% | 2.5% | 0.8% | 3.2% | 30.8 | 48.4% | 14.8 | 6.7% | |
| | AVERAGE | 3.3% | 3.6% | 0.9% | 4.0% | 33.0 | 47.8% | 14.2 | 5.8% | |

Sources: Bloomberg, IMF, CIA World Factbook, MSCI, S&P

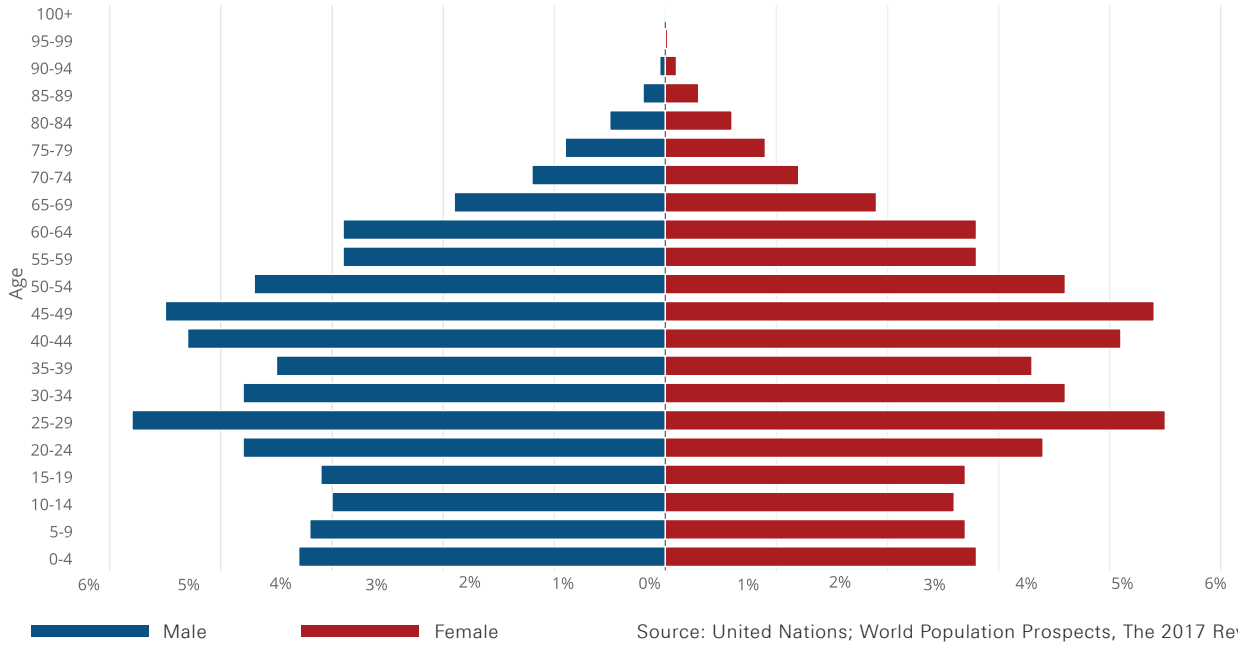
China is a market that has looked attractively valued at times relative to its growth prospects. However, China has already had a spectacular recovery from a correction that rattled markets globally in August 2015 and again in January 2016. China is the largest emerging market and a vital trading partner for many other key emerging markets, such as Brazil. While China remains an important source of long-term global economic growth, it faces some cyclical and structural challenges that Jimmy Chang discusses in his article.

South Korea is an emerging market that has screened well for valuation and poorly for governance. As the second largest emerging market after China, we believe that South Korea is an important economy and source for potential investments. We cover it in more detail in the articles from Michael Seo and Dr. Mariela Vargova.

## Aging Populations

A major challenge South Korea and China already face, is an aging population. Countries that are major economic powers are aging rapidly, while most of the youth in the world is concentrated in the poorest nations. One useful country demographic is the median age of its citizens. The U.S., with a median age of 37.9 years (half of all Americans are 38 or older), ranks 62 out of 230 nations, making it one of the older nations in the world, though one of the world's younger developed markets. Aging in the U.S. is dwarfed by comparison to most of Europe and Japan. Japan and Germany have median population ages of 46.9 and 46.8, respectively. Remarkably, if people in the U.S. ceased having kids for the next nine years, only then would we have a median population age approaching those today in Japan and Germany. Europe has a median age of 42.7 as a region and is nearly five years older than the U.S.

CHART 1: **CHINA POPULATION DISTRIBUTION 2015**




Source: United Nations; World Population Prospects, The 2017 Revision

While we consider demographics as an important long-term factor for investing (as discussed in the Third Quarter 2015 issue of *Global Foresight: Investing for the Ages*), in the short run, it is eclipsed by economic cycles and political changes. For instance, Japan's and Germany's economies have each been performing well over the last few years, despite being the second and third oldest countries in the world with the median population age of 47 years (Monaco has the world's oldest population at 52 years). However, in the longer run, demographics factor into economic growth as consumption declines dramatically in your 50s and 60s from where it is in your 30s and 40s. Health care burdens also increase and presumably need to be funded with higher taxes that will eventually weigh on the disposable incomes of younger workers.

> "...in the longer run, demographics factor into economic growth as consumption declines dramatically in your 50s and 60s from where it is in your 30s and 40s."

The largest emerging market, China, has a median age comparable to the U.S. and arguably has far worse demographics as China faces a big decline in new workers over the next ten years when the number of retirees may exceed the number of new entrants into the labor force as shown in CHART 1.

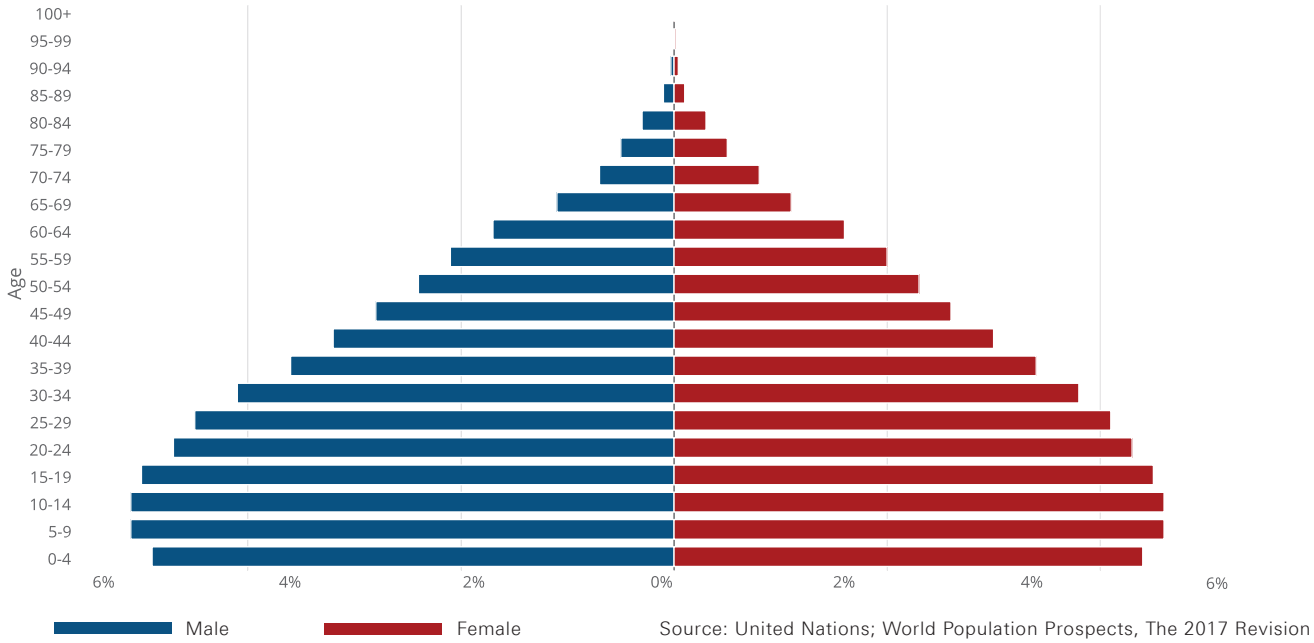
South Korea is the oldest emerging market with a median age of 41. East Asian economies, including Japan, have grown over the years due to migration from villages to urban centers, resulting in productivity gains that have fueled economic expansion. Although this migration may continue a while longer, EM investors should understand the reality that the economic growth case outside of South Asia and Southeast Asia is mostly limited to productivity gains. India has the best demographic profile of any major emerging market as shown in CHART 2, with progressively younger population brackets getting steadily larger, indicating a stable increase in labor force for long-term economic growth.

## Young Ideas

Japan has seen a long, steady economic recovery behind the market-friendly policies of Prime Minister Abe. The U.S. has experienced slow but consistent growth, arguably being driven more by its culture of innovation and leadership in the tech sector that has led its market's returns. By comparison, Europe has been plagued by infighting and rotating economic and political crises for most of the last nine years. In addition, when we consider the challenges to growth Europe faces longer-term as a result of its aging populations, it would seem difficult to make the case that the bull market centered in the U.S. may see its next leg driven by its counterparts across the Atlantic. However, we see the European continent energized by the electoral success of 39-year-old Emmanuel Macron, who not only won the French presidency in May, but also a strong party majority in its legislative body, the National Assembly. This mandate should pave the way for economic reforms that we believe investors will embrace. It is a massive change in sentiment from six months ago when markets were fearing the "anti-European Union" rhetoric of since-defeated Marine Le Pen.

Unifying Europe is no easy task, but the best chance appears to be in the hands of a political outsider with pro-business and economic policies that manage to be sufficiently mainstream to keep France from fracturing into far-left and far-

CHART 2: **INDIA POPULATION DISTRIBUTION 2015**




Source: United Nations; World Population Prospects, The 2017 Revision

right camps. So far, Macron has fostered a good rapport with German Chancellor Angela Merkel, whom we expect to be re-elected in September. The political risk in continental Europe is now centered in Italy, but we were encouraged that its far-left Five Star Movement suffered key defeats in recent regional elections, which could bode well for their next national election, likely to occur next spring.

In addition to Italy, Brexit remains a large political risk for 2018 as the weakened Tories will be negotiating with at best a tenuous alliance with the Democratic Unionist Party (DUP) and at worst may face another election and lose power altogether. We believe it is too soon to make major portfolio shifts based on Brexit, but we are watching this closely as substantial progress in negotiations will need to materialize months ahead of the March 2019 deadline. By this time next year, we would expect to see traction in negotiations and stability in Parliament or begin to consider reducing exposure to the British pound and companies exposed to that economy.

## Aging Business Models

The "FANG" stocks—Facebook, Amazon, Netflix, and Google—have disrupted countless business models while seeing their own revenues and market values soar. Empty storefronts from Manhattan to malls in Middle America are evidence of the disruption facing rapidly aging business models like brick-and-mortar retail. When you include Apple and Microsoft in the FANG stocks, the six companies account for 12.83% of the S&P 500 Index. At the start of this bull market on March 9, 2009, these companies had a market value of $326 billion. Today, their market value is $2.97 trillion. Their sheer size alone suggests that they cannot keep compounding like they have. To maintain its ascent, the U.S. bull market will need new sectors to emerge as market leaders. The challenge will be economic growth. Companies that disrupt mature businesses, like many of the FANG stocks have, typically have not relied on a robust global economy to generate their amazing revenue growth. Most other sectors in the S&P 500 Index, however, would likely benefit from a stronger economy.

## Summary and Conclusion

Many bull markets have interesting back stories as to how they begin and end. The latest bull market can arguably be traced back to March 9, 2009 when the CEO of Citibank, Vikram Pandit, released a memo to employees announcing that the company was having its best quarter since early 2007. The market embraced that memo as a sign the worst was over, especially for the beleaguered banking sector. The S&P 500 rallied from that day and eight years later is up nearly four-fold. As we consider future returns, valuation matters. In March 2009, the S&P 500 was selling for roughly 10 times depressed earnings and is now selling for about 18.7 times. The U.S. market leads the world in innovative companies and is priced for it.

As we look for opportunities overseas, we see political fortunes improving in Europe with some lingering headwinds that may appear in 2018. We could argue the same in the U.S. as the leadership in the House of Representatives can easily switch parties next year. If Europe can continue its economic improvement, we see the potential for more gains ahead for the region after a robust start to 2017.

The emerging markets offer some attractive valuations, but are not likely to be a panacea for global growth as the largest ones face the same challenges of aging and maturing development that confront most of the developed world. This bull market may keep moving, but like all of us past a certain age, not at a pace that we are used to. ●

JIMMY C. CHANG, CFA

*Chief Investment Strategist*

212.549.5218

jchang@rockco.com

# Yesterday Once More; Tomorrow Never Knows

## China's housing boom once again fueled global growth, but how long will it last?

Let us begin with a trivia question—what was the most consequential publication in 1776? With this article being published around July 4, you would probably think we are hinting at the *U.S. Declaration of Independence*. That would be a good response, but unlike the laws of physics or mathematics, there is not exactly a right answer to such a question.

One could also point to a book published on March 9, 1776, that has had a transformative impact over time. It has a long title: *An Inquiry into the Nature and Causes of the Wealth of Nations,* and is generally referred to as *The Wealth of Nations*. This seminal work supposedly took Scottish economist and philosopher Adam Smith 10 years to complete, and was based on notes and observations spanning 17 years. It challenged the mercantilist and physiocratic economic theories that dominated the intellectual debate during the mid-18th century. Mercantilist theory held that countries grow wealthier by maximizing domestic production and exports, and was the basis for European imperialism. Physiocratic theory postulated that the wealth of nations was derived from the value of agricultural and land development, and could trace the inspiration to China's agrarian traditions.

*The Wealth of Nations* marked the birth of modern capitalism and also had an influence on our Founding Fathers. James Madison cited the treatise in arguing against the need for a central bank in 1791; Thomas Jefferson referred to it as the best book on money and commerce. In February 1977, in celebration of America's Bicentennial, the Federal Reserve Bank of Richmond published the paper *The Relevance of Adam Smith.* It pointed out the striking similarities between the intellectual spirit of *The Wealth of Nations* and the *Declaration of Independence.* Both railed against the heavy hand of the state, and emphasized individual liberty and the harnessing of individual self-interest to the welfare of the greater society.

So it is perhaps a tie between these two publications. One gave birth to modern economics that created the greatest prosperity in human history, and the other marked the founding of arguably the most powerful and wealthiest nation ever.

### Do Not Bet Against the House

At around the time that America celebrated its Bicentennial, China reached a historic turning point. Chairman Mao passed away in September 1976, and a month later, the arrest of the Gang of Four marked the end of the decade-long Cultural Revolution. Deng Xiaoping then returned to power and embarked on reforms that powered roughly 10% real GDP growth per annum for the next four decades and lifted more than 800 million people out of poverty. Today, the Chinese economy is the largest in the world based on purchasing power parity.

Interestingly, China's rise had little to do with Adam Smith's free-market capitalism. While China's unprecedented economic ascension was indeed fueled by unleashing the energy and the profit-seeking self-interest of the individual, its development has always been shaped by the government's heavy hand. Successive Five-Year Plans, which first started in 1953, continued to guide social and economic development, and key industries remained mostly state-owned. Some argued that China has been pursuing a mercantilist policy in building up its manufacturing base to drive exports and accumulate foreign exchange reserves. Indeed, its share of global exports has remarkably grown from about 1% in 1980 to around 15% by 2016, the largest in the world. Some claimed that China even produces more sombreros than Mexico.

In the wake of the Global Financial Crisis in late 2008 and early 2009, China realized that the country's growth model could no longer depend on external demand, and responded by unleashing massive stimulus for infrastructure projects. It worked so well that China's growth skyrocketed, asset prices shot up, and the housing market became overheated. Globally, China's reflation and the Fed's quantitative easing generated an echo bubble in commodities and emerging market stocks.

By early 2011, China had to cool the economy and tackle the rising leverage and speculation. Policymakers also declared a shift in China's growth model to be more consumption-driven. The transition probably turned out to be more complicated than Chinese policymakers may have expected. Unlike the infrastructure-driven growth model under which the pace of growth could be controlled by adjusting the pipeline of construction projects, a consumption-driven model would let the "invisible hand" of self-interested consumers exert more influence. In other words, a consumption-driven model would cede more control to market forces and experience more unpredictability. While variability in realized growth versus projection is a fact of life in the rest of the world, Chinese officials have sought to minimize this uncertainty as the failure to hit growth targets could affect confidence.

With an estimated homeownership rate around 90% and many families holding multiple apartments as investments, China's housing market has an outsized impact on wealth, consumption and construction, as well as the general economy. As shown in CHART 1, the rapid housing price increases in 2010 and 2011 prompted regulators to cool the housing market, which resulted in price declines in 2012. However, the slowing economy soon pushed them to relax home purchase restrictions. Predictably, housing prices rebounded as a response, with double-digit increases in tier-one cities, prompting measures to tame the bubble once again by 2014.

It is quite clear that there is a momentum-driven herd mentality among Chinese buyers, as expressed in the Chinese adage "buy up market, not down" (买涨不买跌).

In an attempt to wean investors off real estate and channel their capital to highly leveraged state-owned companies, policymakers engineered a stock market rally in the second half of 2014. As the rally gained momentum, the herd flocked in (buy up market, not down) and pumped up a huge stock bubble that eventually blew up by mid-2015. This was followed by the renminbi's official devaluation in August 2015 to alleviate the pressure from the surging U.S. dollar.

Confronted with slowing economic growth, declining foreign exchange reserves, rising capital flight, and a collapsing stock market, Chinese policymakers shelved the reform agenda and went back to the proven playbook—infrastructure and real estate buildout. China even eased property investment rules for foreign institutions and individuals. The result was perhaps the biggest housing bubble ever in China's tier-one cities—prices surged over 30% year-over-year by the spring of 2016. It is as if China was validating the old physiocratic economic theory which postulated that the wealth of a nation lies in its land development.

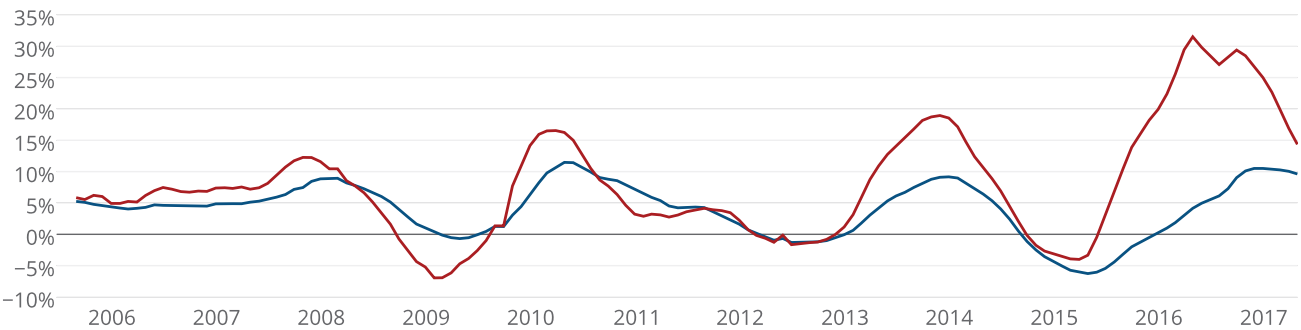
For years China has justified its rapid property price increases on the basis that it is just catching up to global metropolises such as London, New York, Hong Kong, Tokyo, etc. The latest price surge has indeed accomplished that and more. For example, a run-of-the-mill two-bedroom apartment in Beijing's financial district now costs more than $2,000 per square foot. Skyrocketing domestic property prices have also distorted many Chinese investors' views of foreign properties—they are bargains relative to prices in Beijing, Shanghai and Shenzhen. It is no wonder Chinese investors have bid up property prices in many major cities around the globe. As a sign of the times, Warren Buffett's Berkshire Hathaway HomeServices has recently teamed up with China's Juwai.com to bring American residential property listings to China.

## An Under-Appreciated Reflation Story

According to a U.S. State Department memo released by WikiLeaks, when Chinese premier Li Keqiang was serving as the party secretary of Liaoning Province in 2007, he supposedly told a U.S. ambassador that he did not have confidence in the provincial GDP data. He preferred to monitor three indicators to assess the state of the local economy: the rail freight volume, electricity consumption and bank loan volume. In 2010, *The Economist* introduced the Li Keqiang Index, which takes the weighted average of these three metrics' annual growth rates to track Chinese economic growth.

The Li Keqiang Index has indeed tracked the direction of China's reported GDP data as shown in CHART 2. There was a clear growth deceleration in 2015 and a strong rebound in 2016.

CHART 1: **YEAR-OVER-YEAR CHANGE IN CHINA NEW PROPERTY PRICES**




China 70 Cities New Apartment Prices  China First Tier Cities New Apartment Prices  Source: Bloomberg

CHART 2: **THE LI KEQIANG INDEX VERSUS CHINESE REAL GDP GROWTH**


Source: Bloomberg

Furthermore, CHART 3 shows that, directionally, the Li Keqiang Index maps pretty well to the ebb and flow of Chinese property prices, confirming the thesis that property prices have much impact on the Chinese economy.

A close examination of CHART 2 raises an interesting observation: Lately, the Li Keqiang Index has accelerated much more than the reported GDP growth. One could surmise that China's actual GDP growth (measured on a year-over-year basis rather than on an annualized sequential change) may have been greater than the reported 6.9% in the first quarter of 2017. This could be rationalized by the conjecture that the actual growth in early 2016 may have been lower than the reported 6.7%.

One indicator of China's strong growth is the year-over-year changes in its imports as shown in CHART 4. Imports surged 24% year-over-year in U.S. dollar terms, and 31% in renminbi terms during the first quarter of 2017. To be fair, part of the surge was due to the rebound in commodity prices. However, China's $58 billion import from Germany and Japan, two non-commodity countries, was still up an impressive 17% year-on-year. In the first quarter of 2016, China's imports from those two countries had declined 10%.

We believe China's strong reflation, thanks to the infrastructure buildout and the unprecedented property price increases in major cities, may have been the most impactful yet under-appreciated catalyst that fueled the synchronized global economic recovery since the summer of 2016. The good news is that China's growth is likely to remain healthy for the remainder of 2017, as stability is paramount ahead of the quinquennial power transition this autumn. However, the uncertainty starts to rise as we look beyond 2017.

## Shadow Boxing

Over the past few years, China watchers have been urging Chinese policymakers to introduce bold reforms and market forces to tackle the country's rapidly growing leverage, over capacity, and housing bubble. However, with stability being of utmost importance, policymakers could not afford to take a chance with the market's invisible hand. Tough reforms in the context of slowing economic growth also ran the risk of jeopardizing social stability. Now, however, with the economy on a much stronger footing, Chinese policymakers have started to push through some needed reforms.

CHART 3: **LI KEQIANG INDEX VERSUS YEAR-OVER-YEAR PRICE CHANGE IN CHINESE PROPERTIES**


Source: Bloomberg

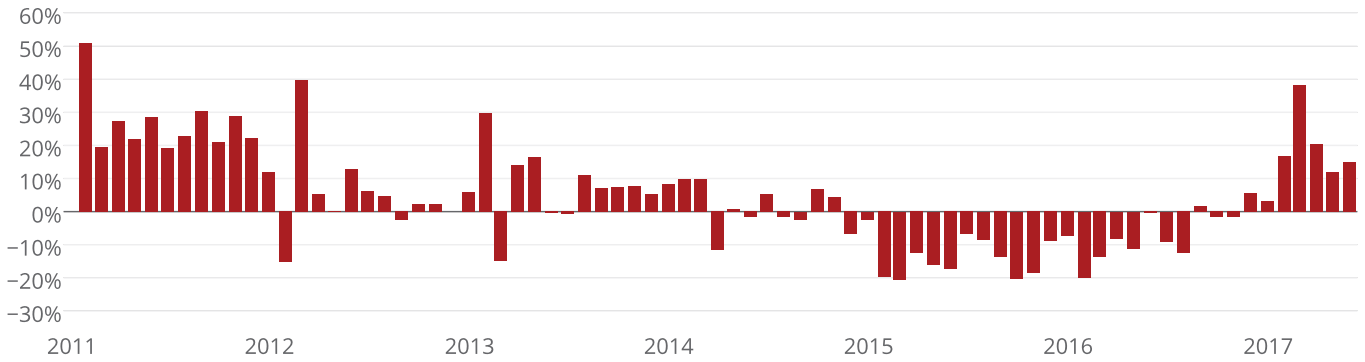
With Chinese President Xi calling for a heightened effort to reduce systemic financial risk, regulators have started to tackle the bloated shadow banking system. Since taking office in February, Guo Shuqing, China's top banking regulator—with the nickname "Whirlwind Guo" for his no-nonsense management style—has already issued a series of directives to reduce leverage. For example, banks were asked to implement higher standards for interbank lending and for selling third-party wealth management products (a primary source of funding for the shadow banking system). In April, China's top insurance regulator was detained for corruption, and the regulatory agency has since taken disciplinary actions against some high-profile insurance companies that have deviated from the core insurance business by using shorter-term funding to finance corporate takeovers, as well as overseas acquisition sprees.

## Tomorrow Never Knows

While we believe China's economy should hold up well going into the 19th Party's Congress this autumn, its growth is likely to decelerate, and the lagged effects of the tightening measures on the shadow banking system and on the housing market could become quite visible by 2018. Housing price changes could be flat or even negative by this time next year.

If the past is any guide, Chinese policymakers may once again loosen property purchase restrictions next year to stimulate growth. Therein lies the moral hazard—it is well known that Chinese policymakers would not risk a sizeable correction in the housing market, and therefore would reflate again to strengthen economic growth. However, with property prices in China's tier-one cities already on par with or even exceeding those of major global cities, it will be hard to rationalize another round of substantial price increases. In other words, using the property market as a lever to stimulate economic growth is not a sustainable long-term solution.

CHART 4: **YEAR-OVER-YEAR CHANGE IN CHINESE IMPORTS (BILLIONS OF USD)**




Source: Bloomberg

These measures have driven up China interbank lending rates, as well as corporate bond yields. The squeeze on the shadow banking system has led to a big jump in aborted bond issuance. In May, China's net corporate bond issuance dropped to a record low of *negative* 217 billion yuan as some bond issuers were unable to roll over their maturing bonds.

On the housing front, various cities have rolled out new administrative measures with the aim of keeping housing prices flat. A few cities even resorted to the draconian measure of a *10-year* lock-up period for new apartment purchases—buyers of new apartments built on recently auctioned off land are prohibited from selling their units for a decade.

China has also continued to stem the capital outflow. Starting this July, Chinese banks and financial institutions have to report all domestic and overseas cash transfers of more than 50,000 yuan ($7,700), compared to the prior threshold of 200,000 yuan ($29,338). Funds transferred overseas are prohibited from purchasing properties, investments, and insurance products. Various new restrictions have also been placed on Bitcoin trading exchanges, as well as overseas use of credit cards. In short, it appears that capital flight from China will get somewhat more difficult for ordinary citizens.

Although equity volatility picked up some in June, most equity investors still appeared to be basking in the glow of a synchronized global recovery. However, the canary in the coal mine may be iron ore: having rallied from the December 2015 low of $37.50 per metric ton to nearly $95 in February 2017, it has lost roughly 30% to $65 a metric ton by the end of June.

In the final analysis, the global economy has benefited from China's rapid growth. However, China will likely be at a crossroads as President Xi embarks on his second term in 2018. Will policymakers inflate the housing bubble further to support economic growth? Will they find new levers to keep the economy growing above 6% per annum, or will they settle for a lower but more sustainable pace? The law of large numbers portends that the next five years will likely be more challenging for Chinese policymakers than the last five years. ●

MICHAEL D. SEO, CFA

*Director of Equity Research*
212.549.5232
mseo@rockco.com

# Leveling the Playing Field

## Investment opportunities in the changing South Korean landscape

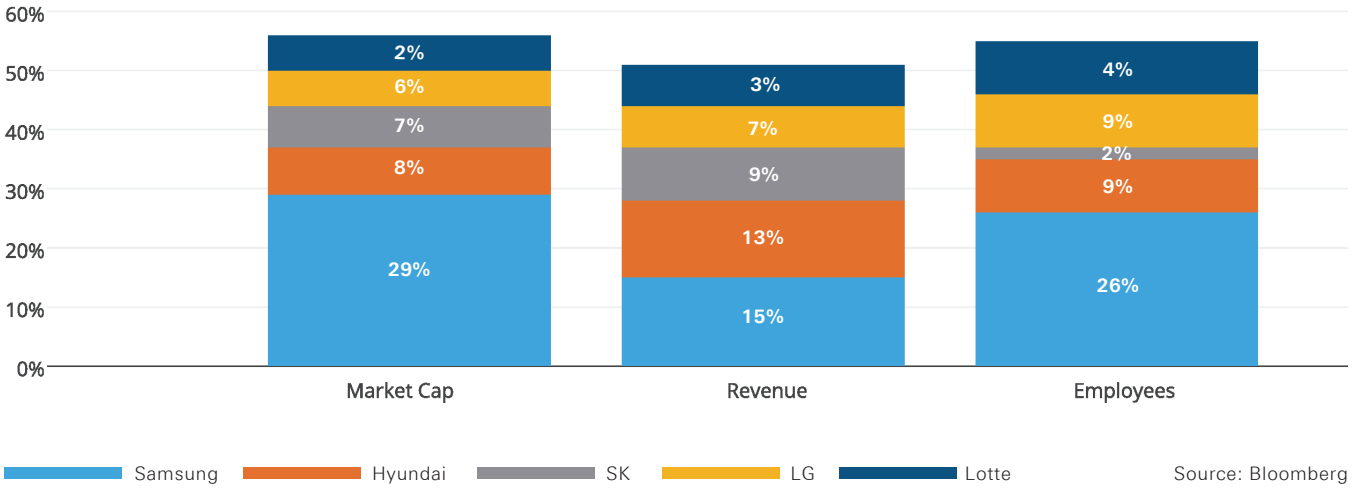
South Korea has grown over the last 50 years from a poor mostly agricultural economy to a powerful exporter with the 11th highest GDP in the world. Its growth has been built on the back of its *chaebol* system – conglomerates of companies that are family-controlled, often spread across multiple industries. While this structure has served Korea well in terms of rapidly developing its industrial base, it has also been associated with ongoing governance issues. The risks associated with investing in Korea have historically resulted from its stock market having a much lower valuation than those of comparable economies.

As an example of recent governance issues, consider that Chey Tae-Won, chairman of the SK chaebol, had been serving a four-year prison sentence for embezzling $40 million from the SK companies. He was pardoned by former President Park Geun-Hye in the summer of 2015 and soon found himself back in the familiar leadership role of his family conglomerate. Political actions such as this pardon or nepotism within large publicly traded corporations are common, if not expected, in Korea. Throughout its history, the nation's gyrating politics and powerful businesses maintained a symbiotic relationship that propelled tremendous GDP growth while tarnishing the political reputation of a nation. The cultural and regulatory disregard of misconduct is at the root of Korea's corporate governance, especially among the chaebols.

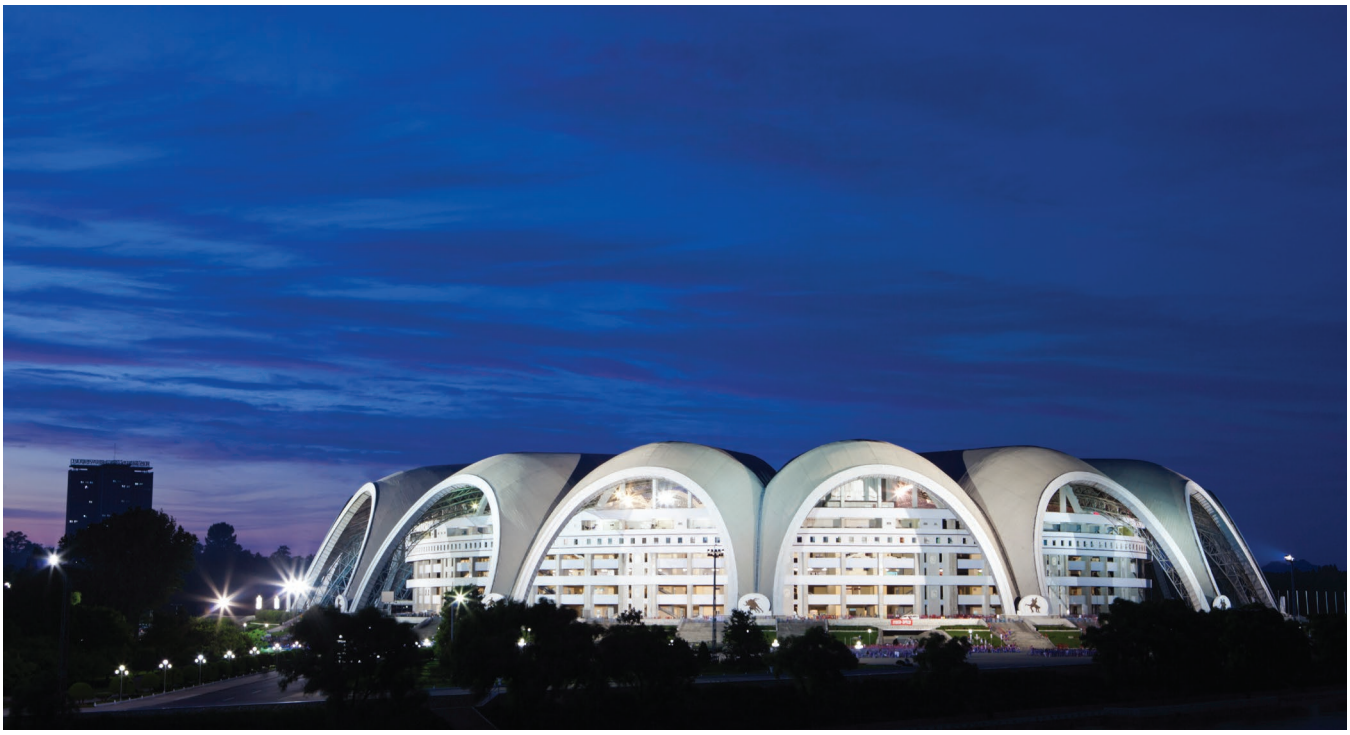
The five most recognizable chaebols as shown in CHART 1 (Samsung, Hyundai, SK, LG, and Lotte) collectively represent over 50% of the market capitalization of the Korea Composite Stock Price Index (KOSPI) and 47% of its revenues. Samsung Electronics alone represents a 21% share of the KOSPI market capitalization and 21% share of employees which is emblematic of the chaebols' influence in Korean society.

During Park Geun-Hye's 2012 presidential election campaign and political career, Ms. Park had been critical of past presidents who had abused the power to pardon individuals and sought to limit the government's role in granting pardons. Her decision

CHART 1: **CHAEBOL % SHARE OF THE KOSPI INDEX**




Source: Bloomberg



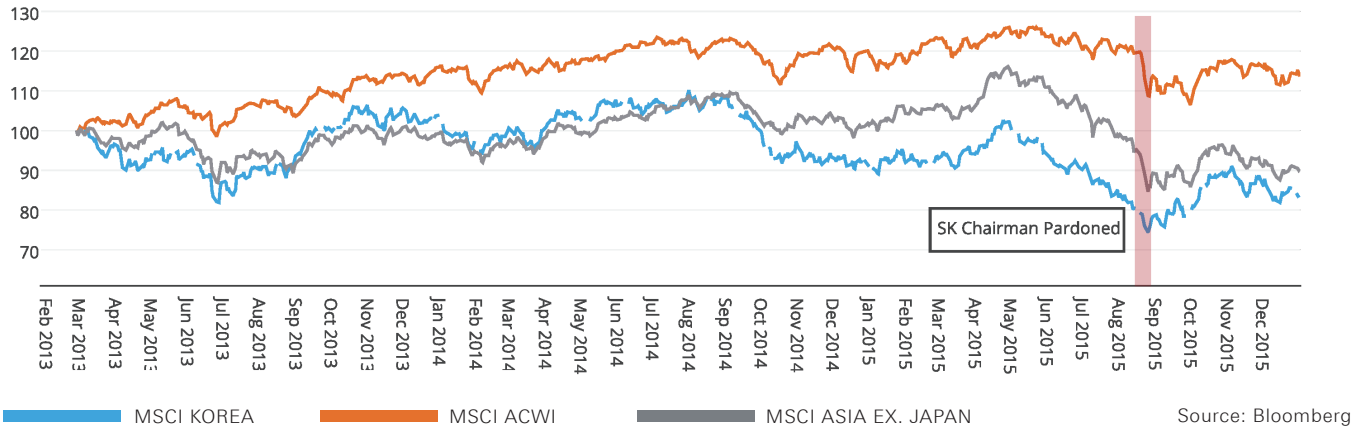
Pyongyang, North Korea, is home to the largest stadium in the world with a seating capacity of over 114,000. Source: Getty Images

to release Chey Tae-Won accelerated the demise of her political career. Ironically, she finds herself in prison awaiting trial while the Korean stock market continues to trade at a discount to peers. In addition, MSCI Korea's relative valuation is also suppressed by the mercurial behavior of North Korea whose recent missile tests have dominated global headlines.

A truly embarrassing South Korean political scandal emerged in the fall of 2016 when a journalist discovered a computer belonging to a personal confidant of President Park Geun-Hye. The contents of the device, belonging to Choi Soon-Sil, revealed that she had access to confidential presidential documents including speeches that were ultimately altered and influenced by Ms. Choi Soon-Sil. In the weeks following this revelation, the mighty chaebols of Samsung, Lotte and SK were once again linked to the current political impropriety. It is alleged that members of these chaebols (among others) were coerced into contributing large sums of money to a foundation established by Ms. Choi Soon-Sil in order to maintain a positive relationship with President Park Geun-Hye.

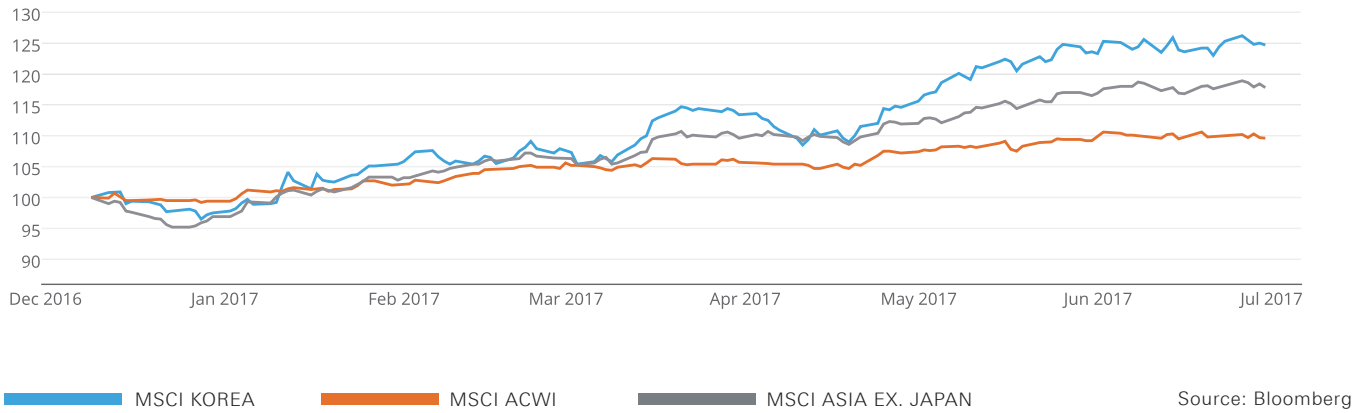
The Korean stock market languished as a result of President Park Geun-Hye's miscues as shown in CHART 2. The performance of the MSCI Korea Index starting from the beginning of President Park Geun-Hye's term was down 25% by late August 2015, which coincided with Mr. Chey Tae-Won's pardon in the week prior. The Korean market drastically underperformed the MSCI Asia ex. Japan Index which was down 14% and the MSCI ACWI Index which was up about 9% during that period. Korea's recursive political environment was frustrating for many Koreans. It is widely believed that chaebols sapped the entrepreneurial vigor of small business owners and young adults who were experiencing unemployment rates of over 9%. However, the decision to impeach President Park Geun-Hye on

CHART 2: **PERFORMANCE SINCE PARK GEUN-HYE INAUGURATION**




Source: Bloomberg

CHART 3: **PERFORMANCE SINCE DECISION TO IMPEACH**




Source: Bloomberg

December 9, 2016 proved to be a pivotal point for the country. The large-scale protests seeking a permanent change from the cronyism that runs rampant within Korea were finally being heard.

It is no coincidence that since December 9, 2016, the MSCI Korea Index has outperformed as shown in CHART 3 the same indices it lagged during President Park Geun-Hye's tenure. Investors and Korean citizens alike were finally sensing hope with the leading presidential candidates. Moon Jae-In's eventual victory on May 10 secured the belief that a president in the Blue House was working for the people and not exclusively for the chaebols.

President Moon Jae-In has increased investor expectations for corporate reforms and it is critical for the nation to continue down this path of weakening family ties that maintain a stranglehold on the Korean economy. President Moon Jae-In has quickly appointed key members for advisory and cabinet roles that are aligned with the vision of eliminating corruption, enhancing corporate governance, and revitalizing a fractured economy.

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Korea's decision to install the Terminally High Altitude Area Defense system (THAAD) under the prior administration resulted in escalating political tension between China and South Korea. In the weeks leading up to President Park's impeachment hearings, China discouraged its citizens from traveling to Korea and restricted the sale of Korean consumer goods. President Moon Jae-In has moved swiftly to improve the crumbling relationship with China by reevaluating the deployment of the system. A friendly call with President Xi Jinping after his election gradually improved the relationship and is expected to help navigate the complex political relationship with North Korea.

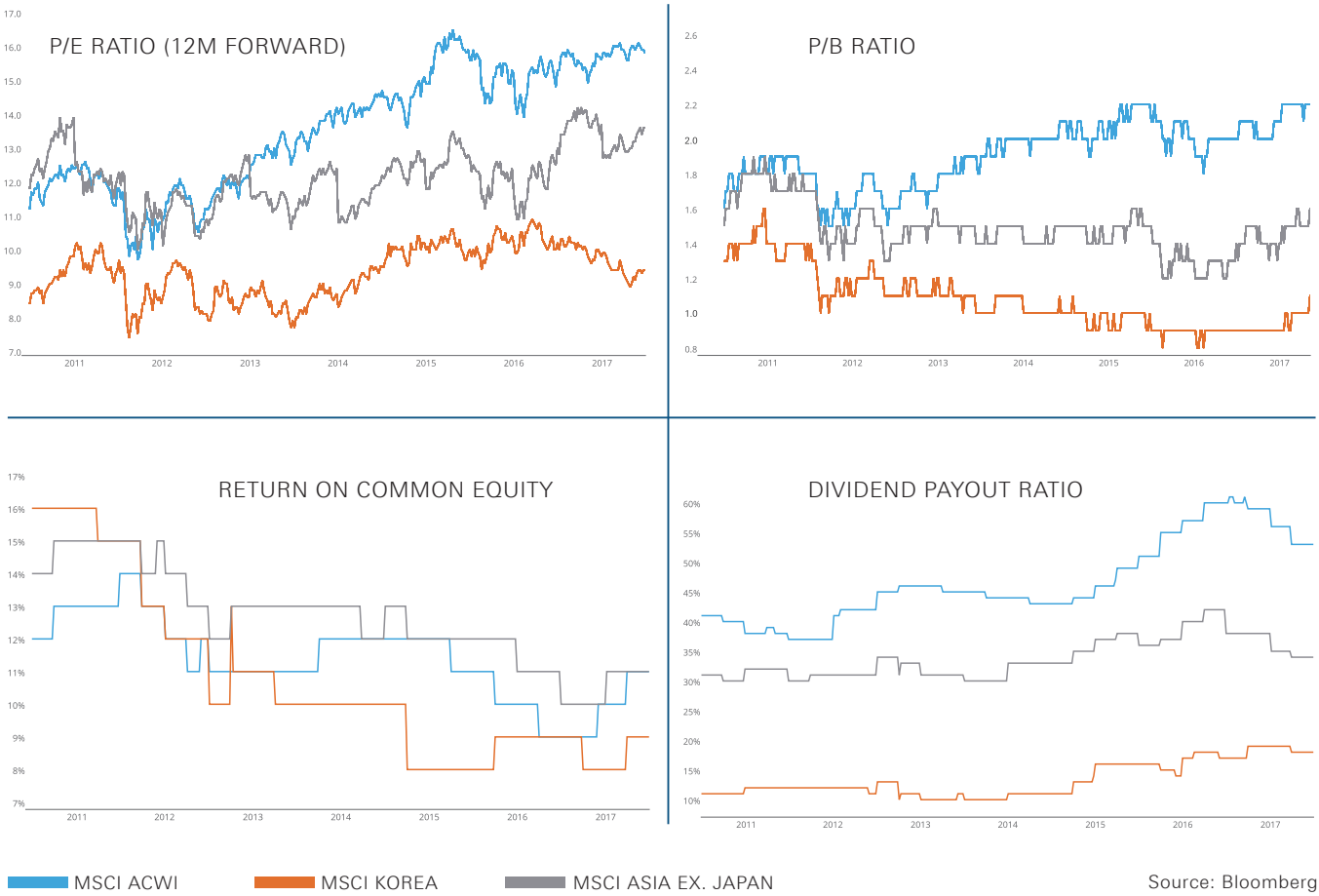
President Moon Jae-In, who was once the Chief of Staff to President Roh Moo Hyun (1998-2008), assisted President Roh in implementing the "Sunshine Policy." The Sunshine Policy was an attempt by the South Korean government to engage North Korea with a softer, humanitarian stance in an effort to build a peaceful relationship. President Moon will likely reengage communications with North Korea in a similar manner.

The president appointed Jang Ha-Sung, formerly the dean of Korea University's Business School, to the position of Chief of Staff for Policy. Jang Ha-Sung is a familiar face within the world of corporate reform as the founder of the People's Solidarity for Participatory Democracy (PDSD), a civil organization pursuing shareholder reform. The PDSD was formed in the late 1990s and successfully fought for minority shareholders in legal battles against SK Telecom, Samsung Electronics, and others.

Another governance advocate with a boisterous history of shareholder activism, Kim Sang-Jo, a professor of economics at Hansung University and executive director of "Solidarity for Economic Reform" (SER) was appointed as the Head of the Fair Trade Commission (FTC) in early June. Kim Sang-Jo and Jang Ha-Sung are longstanding allies in the field of corporate activism with Mr. Kim succeeding Mr. Jang as first chairman of PDSD's future organization in 2006.

The Korean stock market has been a star performer in 2017 with the KOSPI up approximately 24%, year-to-date in $USD basis and outperforming neighboring markets, such as Japan,

CHART 4: **REGIONAL VALUATIONS**




Source: Bloomberg

Hong Kong and China. Despite the recent strong performance, the market is still inexpensive relative to other regions and indices. MSCI Korea's price-to-book (P/B) ratio of 1.1x and price-to-earnings (P/E) (12 month forward) ratio of 9.4x are 30% and 31% lower than MSCI Asia ex. Japan Index, respectively as shown in CHART 4.

Three Korean industry groups or sectors currently offer compelling relative valuations when contrasted against other geographies. The Korean Automobiles and Components industry group currently trades at a P/B ratio of 1.0x which compares favorably to Japan's P/B ratio of 1.4x. When comparing the automobile original equipment manufacturers (OEM), Korean OEMs trade at a P/B ratio near 0.5x book, which is a steep discount to their Japanese rivals. The Korean Automobiles and Components industry group appears undervalued when you also consider the fact that the five-year average return on equity (ROE) was 14.4% versus 11.8% for the Japanese group.

Utilities is another sector where the valuation disparity is stark. Korea's largest electricity producer currently trades at a P/B ratio of 0.4x despite three stellar years of strong operating margin and prudent capital discipline. By comparison, the Japanese utility sector currently trades at P/B ratio of 1.0x with the Tokyo regional electricity producer trading at a P/B ratio of 0.6x despite ¥10 trillion of possible unreserved liabilities stemming from a 2011 nuclear disaster. Finally, Korean banks are currently trading at a P/B ratio of 0.8x, which compares favorably to Japan's 1.0x and Italy's 0.9x. It is estimated that the loan portfolios of the Korean banks have improved in recent years as evidenced by improving ROE. In the most recent fiscal year, Korean banks generated ROE of 7.7%, outperforming Japan's 7.5% and Italy's 6.7%.

These discrepancies in valuation have just started to close with the new president and the formation of his cabinet, but Korean market multiples have the potential to converge closer to global levels with a successful execution of corporate reform. We are not advocating that the new government implement heavy-handed methods to incite change among the chaebols. Instead, we believe that working with the chaebols in enhancing governance, minimizing cross holdings, creating board independence and minority shareholder protection, would be well received by global investors and mostly rewarding to chaebol valuations. For a further look at corporate governance in South Korea, please see the following article by Dr. Mariela Vargova.

MARIELA M. VARGOVA, PH.D.

*Senior Vice President, Senior Sustainability and Impact Analyst*

212.549.5236

mvargova@rockco.com

# The Promise of Governance Reform—South Korea

In his inauguration speech on May 10th, the newly elected South Korean President Moon Jae-In vowed to put chaebol reform at the forefront of his political and economic agenda. "Under the Moon Jae-In administration," he asserted, "the collusive link between politics and business will completely disappear."[1] The promise of meaningful governance reform comes in the wake of the biggest political corruption scandal in Korea that saw the impeachment and the arrest of democratically elected President Park Geun-Hye on charges of "collecting or demanding $52 million in bribes"[2] from Samsung, one of Korea's largest family-owned conglomerates, known as chaebol.

The presidential scandal in Korea also led to the latest high-profile corporate arrest in the country. In February, Jay Y. Lee, vice chairman and acting leader of Samsung's conglomerate empire, was arrested on accusations of bribery to former President Park and her inner circle in exchange for securing a controversial merger of Samsung Construction and Trading Corporation and Cheil Industries. While the image of a handcuffed Lee sent shockwaves across the business world, his arrest was not unprecedented. In the past, his father Lee Kun-Hee, current chairman of Samsung, was convicted twice of corruption and pardoned. Similarly, in 2007, Hyundai's Chairman Chung Mon-Koo was found guilty of fraud and pardoned. And in 2013, SK's Chairman Chey Tae-Won was convicted of embezzlement and later pardoned.[3] The family-owned conglomerates have long dominated the economic life of modern Korean society, accounting for roughly 50% of the total share of the Korean stock market. Their close ties with the government and state bureaucracy have fueled growing public distrust and frustration with the nation's leadership and has led to increased shareholder discontent.

## Korea's Governance Practices

The collusion of politics and business in Korea highlights the poor practices of corporate governance and business ethics. Corporate governance studies on Asia consistently rate Korea as lagging in governance behind leaders in the region.[4] Korea underperforms its peers in the areas of board independence, ethics and transparency in corporate governance.

Korea, however, has not always been viewed as the laggard in Asia's governance landscape. Right after the Asian Financial Crisis of 1997-1998, the country underwent important governance reforms that sought to quickly and significantly increase corporate board independence and the overall governance of publicly-traded Korean companies. For instance, the proportion of listed firms with at least one outside director grew from 34% in 1999, to 62.3% in 2000, to reach 94% in 2007.[5] In 2001 and 2003, the country's Security Exchange Acts required large listed companies (those with about $2 billion in market capitalization) on the Korea Exchange and KOSDAQ to have at least three outside directors and for one half of their boards to be independent. In 2004, the board independence requirements were further strengthened with the stipulation that there be a majority of independent board directors for large companies. This is on par with leading international best practices in corporate governance. The Korean Commercial Code also stipulates that outside or independent directors must not be related to management while acting as fiduciaries.[6] This resonated with the impetus towards greater board independence to mitigate the role of corporate insiders and create new independent auditing structures within Korean corporations.

In 2012, the Korean Commercial Code was revised to further enhance the board's fiduciary duties. It required the approval of two-thirds of directors for all internal transactions and for new business dealings with third parties. If transactions or deals benefit founding families or management at the expense of minority shareholders, the approving directors will be personally liable for the losses.[7]

Notwithstanding these developments towards good governance, ethics controversies involving Korean chaebols surged over the past several years. A prime example is the notorious Hyundai Motor land bid in 2014 for which the company paid the excessive price of $10 billion, three times the land's market value of $3 billion, angering investors and hurting shareholder value. According to reports, while the boards of directors of Hyundai consortium companies voted to unanimously approve the deal, the company's outside directors were kept in the dark about the price as it was considered by management to be a confidential matter. All these instances point to a serious lapse in the

enforceability of existing corporate governance rules and a lack of accountability. They call into question the true independence of the boards of Korean conglomerates and the ability of outside directors to effectively oversee management and protect all shareholders' interests.

Recent research on Korean-listed companies shows strong social ties between independent directors and management of Korean conglomerates. While 87% of boards are in theory independent, only 62% are when one considers social ties.[8] The composition of Korean boards also poses concern as the percentage of directors with business or management backgrounds has decreased from 45.2% in 2004 to 28.4% in 2011.[9] This, while the number of former public officials has sharply increased from 2.7% in 2004 to 8.9% in 2011. Interestingly, in Korea's boardrooms, the inclusion of professors and lawyers as independent directors has become common. The need for stronger independent oversight and monitoring of management is especially important for Korean chaebols as they concentrate the managerial power into the board's chairman, a member of the founding family. The chairman's control over all subsidiaries of the conglomerate through the management council and appointment of management of all affiliated firms has been a serious concern for minority shareholders seeking more accountability and managerial transparency.

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## Protecting Shareholder Interests

At the core of Korea's governance challenges lies a structural problem at the chaebol: the complex system of cross-shareholdings. On average, the founding family of Korean conglomerates owns about 10% of the parent company's shares, while other listed subsidiaries own more than 30%.[10] The founding family is a shareholder in the other chaebol subsidiaries, and the subsidiaries reciprocate by owning shares in the other companies. The circular ownership structure has been of investor concern as it provides a framework for related party transactions and potential conflict between family shareholders and external shareholders. For many, these concerns have been factored into what has been called for over a decade the "Korean discount."

With the promise of sweeping governance reform by the new President Moon Jae-In, foreign investors are looking today for better protection of minority shareholder rights and stronger constraints on chaebol businesses. On the politico-economic reform agenda are topics such as: 1) reforming the Korean Commercial Code by mandating separate elections for audit committee members, 2) allowing shareholders of parent companies to sue directors of subsidiary firms, 3) lowering eligibility thresholds for filing representative lawsuits, 4) regulating compensation for controlling shareholders and management, as well as 5) introducing mandatory electronic and cumulative voting.[11]

One of the most ambitious goals includes proposed amendments to Korea's Monopoly Regulation and Fair Trade Act, introducing constraints on chaebol businesses and banning all existing circular ownership structures of chaebols within three years.[12]

The calls for big governance reform in Korea were first publicly voiced by chaebols' shareholders themselves. In 2015, at Hyundai Motor's annual general meeting, shareholders openly confronted management about the controversial land deal and proposed a new governance committee to strengthen oversight and accountability. In an unprecedented fashion, their shareholder action prompted the company to set up a separate Corporate Governance and Communication Committee consisting of four independent directors, and to engage in shareholder outreach. In 2016, Hyundai Motor officially announced its new "Corporate Governance Charter" in an effort to enhance transparent business management and to promote shareholder rights.[13] Similarly, in November 2016, Samsung announced a "Comprehensive Roadmap to Enhance Long-term Shareholder Value Creation," committing to improve governance by increasing its board's independence, as well as the diversity and breadth of experience of its directors.

## Changing Korea's Business Culture

The expected governance reform in Korea is an opportunity not only to disentangle politics from business, but also to create better institutional protection for all shareholders. It also serves as an opportunity to change the culture of investing in the country.

In February, Korea's Financial Services Commission introduced the country's first Stewardship Code, encouraging big investors like pension plans and asset managers to actively engage with investee companies and to monitor their management decisions. This trend towards investor stewardship and active ownership echoes the progress already made in other Asian markets such as Japan, Hong Kong, Malaysia, the Philippines, Singapore, and Thailand. With the adoption of a Stewardship Code, our expectations are that shareholders in Korean equities, and especially in chaebols, will use their voice more actively to promote positive governance change and long-term shareholder value creation. ●

ROCKEFELLER & CO.

ROCKCO.COM

insights@rockco.com

**New York, NY**
10 Rockefeller Plaza
3rd Floor
New York, NY 10020
212-549-5100

**Washington, DC**
900 17th Street NW
Suite 603
Washington, DC 20006
202-719-3000

**Boston, MA**
99 High Street
17th floor
Boston, MA 02110
617-375-3300

**Rockefeller Trust Company, N.A.**
10 Rockefeller Plaza
3rd Floor
New York, NY 10020
212-549-5100

**The Rockefeller Trust Company (Delaware)**
1201 N Market Street
Suite 1401
Wilmington, DE 19801
302-498-6000

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[2] https://www.nytimes.com/2017/03/04/business/south-korea-samsung- bribery-lee.html
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