HEIJIN CAPITAL

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

June 30th – July 14th, 2019

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Investment Commentary
June 30th – July 14th. 2019

Global Portfolio Holdings Weekly

Executive Summary

→ WTI Crude Oil

WTI Crude Oil rose by more than 4% this week as tensions in the Middle East grew and a tropical storm that is hurting the oil supply in the Gulf Coast. Iranian boats made an attempt to block a British tanker in the Strait of Hormuz. Fortunately, a British warship was accompanying it, and thus the Iranians retreated. Events like these have made some tankers remain in ports to wait for tensions to settle. This is causing supplying to be tighter in some regions. On top of that, the tropical storm in the Gulf Coast that has now transformed into Hurricane "Barry" has put 30% of oil production in that area offline (44% of NG production was shuttered in the area). All in all, this amalgamation of bullish events for oil has made sure that Trade War or recession worries faded.

→ U.S. Markets & FED talk

Both the DJIA and S&P 500 hit an all time high this week by breaching the USD$27,000 USD$3000 mark respectively. This was in part thanks to the June FED meeting minutes that were released on the 10th July. Powell held a dovish stance and pointed to a rate cut in the near future. This boosted equity markets significantly whilst weakening the USD, which in turn helps U.S. exports namely WTI Crude Oil.

INDEX	CLOSE	2 WEEKS	YTD
Dow Jones Industrial Average	27,332	2.30%	17.07%
S&P 500 Index	3,013	1.67%	20.07%
NASDAQ	8,244	1.89%	23.68%
10-yr Treasury Yield	2.11%	0.11%	-0.57%
Oil ($/bbl)	$60.29	3.5%	32.8%
Bonds	$110.79%	-0.3%	5.6%

*bonds are represented by the iShares Core U.S. Aggregate Bond ETF

Market Summary & Strategy

Global Macro

EU Debt and FX Developments

European sovereign bond yields have been sliding as Europe faces heightened risks or a serious economic slowdown. Euro area real GDP growth is forecasted to slow to 1.2% in 2019 from 1.9% in 2018. This slowdown has the attention of the ECB and it's departing Governor Mario Draghi, which has ruled out rate increases within the next year while hinting at new stimulus measures. The European economic slowdown is being driven by a slowing global economy and trade, high levels of uncertainty, and weakness in the manufacturing sector. The European economy is facing significant downside risks relating to international trade. A "no-deal" Brexit, a potentially exacerbated US/China trade war, and the effect of US monetary policy on distressed emerging markets threaten to further pressure international demand that Europe depends on for growth.

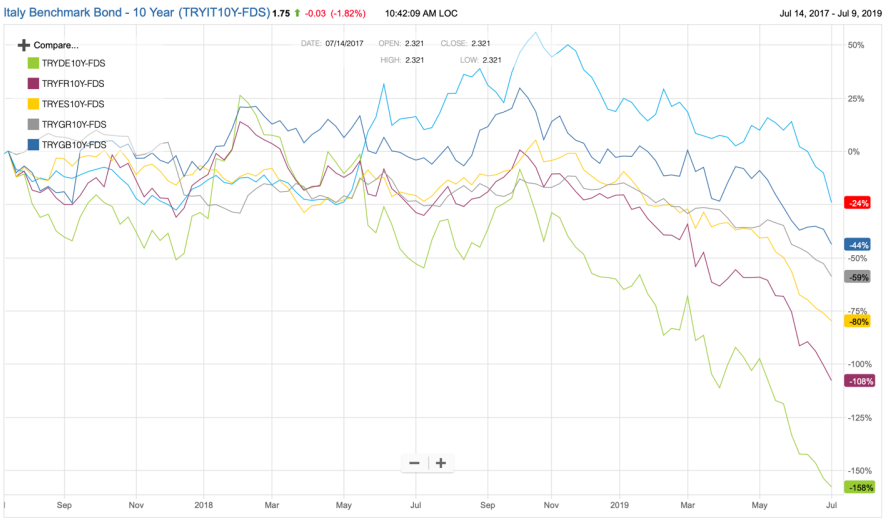
In 2018, slowing international trade and weakening of the European manufacturing sector weighed on GDP growth. YoY growth of euro area exports effectively halved from 4.3% in 2017 to 1.7% in 2018 (European Commission). Growth in euro area manufacturing output slumped, led by a decline in German automobile production.

In 2017, euro area growth was largely driven by international trade and a favourable exchange rate. These drivers were dampened in 2018. A global economic slowdown and trade tensions muted the international trade growth driver. Coupled with the weakening manufacturing sector, these drag on European growth is forecasted to continue into 2019. In their Spring Economic Forecast, the European Commission forecasts these conditions to improve by 2020. However, significant improvement in the European economic outlook has yet to be demonstrated in 2019.

ECB Governor, Mario Draghi, recently announced in Sintra, Portugal that "further cuts in policy interest rates and mitigating measures to contain any side effects remain part of our tools. And the APP (asset purchase program) still has considerable headroom". This openness to rate cuts and a possible return to quantitative easing has driven a broad decrease in European sovereign bond yields. French and German 10-year bond yields slid into the negative-yielding territory. The slide in sovereign bond yields is reflective of the bond market factoring the possibility of stimulus from the ECB.

Notably, Italy has been in the spotlight. Italian public debt currently hovers around 132% of GDP. This puts Italy as having the 6th highest public debt to GDP ratio, behind Japan, Greece, Sudan, Venezuela, and Lebanon. The Italian populist government has recently been at odds with the European Commission regarding its debt and deficit levels. The European Union's Stability and Growth Pact requires EU bloc members to keep their deficit below 3% of GDP and debt under 60% of GDP. Countries with debt levels above the 60% threshold must be decreasing their debt levels at a satisfactory pace to the European Commission. This clashes with the agenda of the Italian populist government, which hopes to establish a 15% flat tax rate to stimulate its economy as it comes out of a small period of contraction in 2018. Implementing this measure would cost an estimated 1.5% of GDP and increase the public debt to GDP ratio to about 135%. In the first

half of 2019, Italy was at risk of the EU implementing the excessive deficit procedure (EDP). The EDP could result in sanctions of 0.2% of GDP. As of July 1st however, the Italian government reached an agreement with the European Union to modify its budget to lower its debt levels. The Italian government passed legislation to freeze about €1.5 billion in savings on welfare and pension reforms. The agreement sent Italian bond prices soaring with yields nearing May 2018 lows.



Although this temporary reprieve has been well received, as signalled by Italian sovereign bonds, a greater structural issue remains. In order for Italy to pay off its debt, it must either grow its GDP at an astronomical rate, implement fiscal austerity, or use currency deflation. Firstly, Italy's GDP growth rate has averaged 0.4% since 1999. Italy's GDP would have to grow at 1.3% per year to just to stop its debt ratio from rising in the next 5 years.

Given global tailwinds aforementioned, this is extremely unlikely. Second, fiscal austerity in Italy has an ineffective track record. In the past 25 years, Italy has run a primary budget surplus for 23 of them, with no marked decrease in the public debt to GDP ratio. Finally, EU bloc countries have virtually no ability to apply monetary policy. As part of the EU, Italy has no ability to implement this sort of monetary policy and the ECB will not allow inflation across the eurozone simply to aid the Italian debt situation. Therefore, Italy may eventually have to default or restructure its debt. Given this situation comes at a time where Italian populists become less EU friendly in tone, Italy eventually leaving the EU does not seem impossible.

UniCredit's Exposure

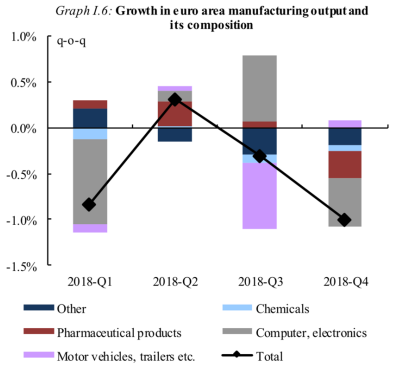
In the past 3 years, UniCredit has improved its financial health and sustainability in the near term, strengthening its position relative to its Italian peers. Strong management and an improved balance sheet should be near-term catalysts as the ECB takes expected stimulus actions. However, UniCredit's exposure to Italian sovereign debt and its tie to the Italian economy for growth doubles its exposure in the case of European or Italian economic downturn.

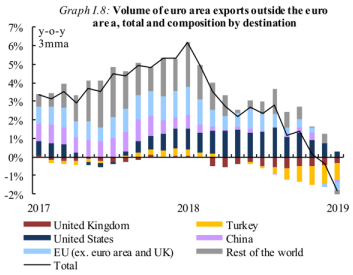
UniCredit currently holds about €58.7 billion in Italian sovereign debt, with a weighted duration of about 3.17 years. This represents about 7% of its total assets and 52% of its sovereign debt securities. UniCredit has been decreasing its Italian sovereign debt exposure along with sales of delinquent debt in an attempt to improve the bank's financial health. These improvements prelude UniCredit's possible takeover of Commerzbank. UniCredit already owns HVB, a large

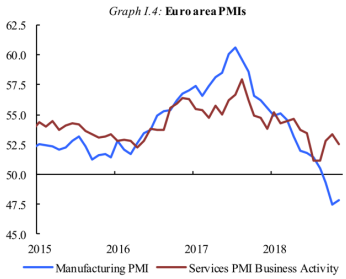
German lender based in Munich. However, as Italian economic health remains at risk, diversifying internationally could be intelligent.

In the near term, easy monetary policy and stimulus from the ECB, combined with the greatly decreased possibility of the EDP being implemented against Italy, UniCredit stands to gain. However, UniCredit remains the largest Italian holder of Italian sovereign debt. This exposure leaves the bank highly vulnerable to economic downturn in the euro area and specifically Italy. Despite recent agreements with the EU to bring debt levels down, it is unlikely that the Italian government will be able to control its debt problem in the 2-3 years. The overall Italian economy has yet to show signs of significant improvement, meaning UniCredit's cash flow is likely to remain weak in 2019. If the Italian or European economic situation were to worsen, UniCredit stands to lose much despite its financial improvements. In the medium term, UniCredit has the most to lose when the Italian debt situation reaches a breaking point. If an Italian debt crisis were to occur, Italy's financing requirements would exhaust the existing capacity of the European Stability Mechanism's bailout funds, or €410 billion, in just a year. In the case of defaults, UniCredit's earnings and revenues would be depreciated by both their Italian sovereign debt exposure and their dependence on the Italian economy for business.

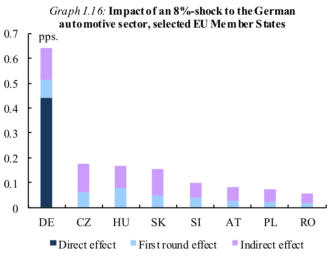
Appendix







Source: Markit



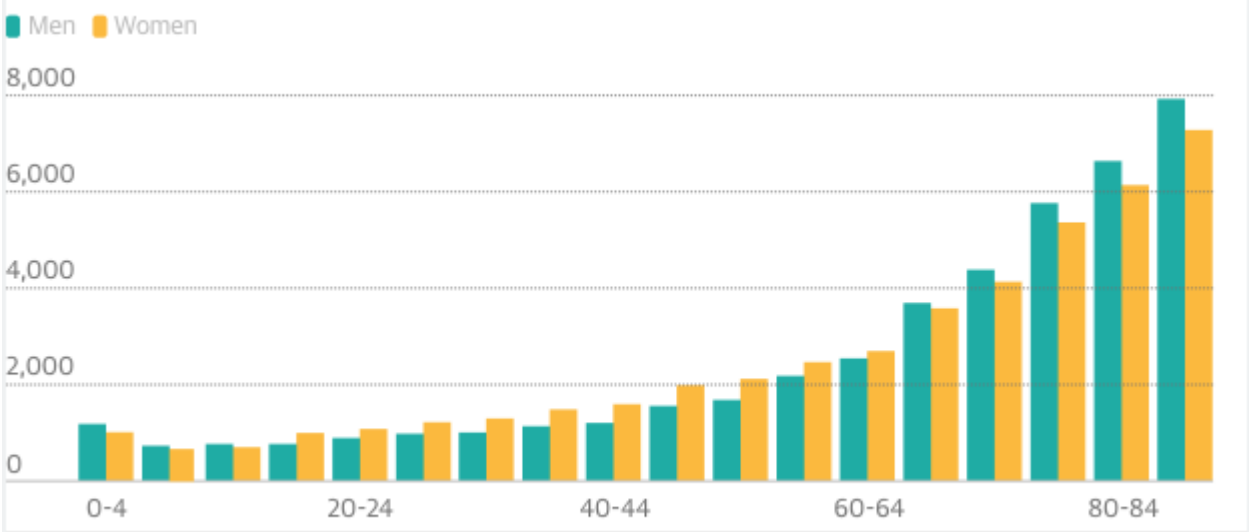
Note: The impact refers to the GDP loss in each Member State as a result of the shock to the automotive sector output.

Guest Writer: Ocean Salazar-Ferrer, Founder & CEO of Studioso

Investment Analysis

Investing Into An Ageing Population

Population ageing is a modern-day phenomenon. Over 60s currently makeup around 10% of the world's population, a figure that is set to at least double by 2050. Obviously, this will begin to have cataclysmic effects on the labour force, tax yields and largest of all, healthcare spending. If we take the United Kingdom, for example, the NHS average cost per person skyrockets after the age of 50 (see figure below). With over 20% of national health spending given to over 65's, a figure that is only set to rise. Despite the obvious issues of such a global demographic time bomb, it also provides ample opportunity for generating alpha.



Source: Estimates from the Nuffield Trust

One very promising firm that roused interest close is Welltower (NYSE:WELL). Welltower is a REIT that delivers the health care infrastructure necessary to provide better treatment at lower costs and keep patients out of the hospital. They provide real estate capital to leading seniors housing operators, post-acute care providers and health systems.

Welltower specialises in three main residential real estate projects for the elderly:

1. **Senior Housing -** Welltower was one of the first to invest in senior housing on such a large scale. Their centres provide assisted living, as well as numerous activities that aim to preserve and promote mobility and social interactions.

2. **Post Acute Care -** There are high impact rehabilitation centers, bridging the gap between hospital and home. The centers help eldery patients recover for surgery as well as some minor ailments. The goal of these centers is getting patients recover and home faster than a usual hospital ,as well as relieving strain on public health services.

3. **Outpatient Medical -** due to the advances in medical technology, the complexity of operating certain medical equipment has been reduced significantly. This will allow many minor procedures to be performed outside of hospitals. Welltower invest in outpatient centers that are much more consumer friends and comfortable that the cold wing of a hospital ward. Further reducing strain on public healthcare services.

The REIT has undergone a bit of a shift , over two thirds of their income comes from senior housing and outpatient medical facilities. More interestingly however, almost 100% of the portfolio is private contract based, which is deemed more stable revenue and better margin, than government-dependent payments such as NHS and medicaid.When it comes to senior housing, Welltower's strategy is to focus on expensive markets. In fact, the company is currently investing in two new senior homes in New York, a seemly untapped market where residents want to grow old in 'their own' city , but with the assistance of such a home. Their high quality building coupled with their comparatively lower costs due to their economies of scale means that they are blowing their competitors out of the water.

Welltower has an exceptional and very stable dividend rate of 4.11% a year, placing it in the upper quartile of dividend payers in the market. Moreover, it is currently trading at a 15% discount to its 'real' value. Welltower is indeed a long term play, the baby boomer generation represent the largest generation in the western world. Furthermore, a sizable amount of this demographic are entering retirement age. This will produce a massive surge in demand for products and services that firms such as Welltower provide. Thus, Welltower will be closely monitored by Heijin for the foreseeable future.

Industry Analysis

Massive Modernisation of the French Armed Forces

The French armed forces have, since the Charlie Hebdo terrorist attacks in 2015, launched a major modernisation effort thanks to an increase in funding initiated under François Hollande. This effort spans throughout the three branches of service: *l'Armée de Terre, l'armée de l'air* and the *Marine Nationale.* This modernisation offers the possibility to invest in the French and even European defence industries at a time of steady growth and interesting prospects. France spent in 2018 10.2 billion euros on equipment. This includes both maintenance and the acquisition of new systems.

Navy

The *Marine Nationale* published earlier this year it's new equipment acquisition strategy for the 2030 horizon entitled *Plan Mercator*. It puts forward the decisive role of innovation to maintain operational superiority. This new accent on innovation has been a ministry wide trend and is a common point to western armies and to a certain extent increasingly seems to be the approach chosen by China.

To ensure its technological dominance in the years to come, the French navy intends to acquire a variety of new vessels going from patrol boats for French Polynesia to plans for the next aircraft carrier. The great majority of these vessels are bought for Naval Group. Naval group collaborates very closely with its clients to conceive its vessels and also benefits from France's geopolitical influence and operational experience. This gives it a great competitive advantage over its competitors, both on a European scale and an international scale. The naval group is complemented by Thales Group, which manufactures radars and combat systems exported all over the world.

Army

The modernisation of the French Army is motivated by two factors, the elevated age of certain equipment (especially it's armoured personal carriers) and a renewed coherence of conventional forces. Heighten international tensions have forced NATO countries to reconsider their strategy, mostly oriented towards counterterrorism operations. A conventional confrontation has become more plausible than in years 2000 and as such, nations are reequipping themselves accordingly. This is best reflected in its investment into new training capabilities and the heightened recruiting quotas. The decision to equip French forces with a German designed and produced rifle (the Heckler & Koch 416) puts forward the level of integration of the European defence industry in France's Army. (Note that like all other western countries, France still buys a non-negligible share of its equipment for the United States)

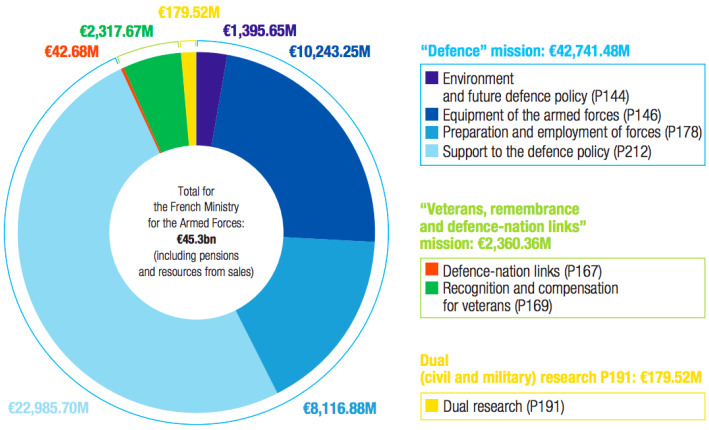
The French army relies heavily on Nexter Systems for its various terrestrial weapons systems. Like many French companies, it develops its weapon systems mainly for the French army and then offers them on the export market. This is illustrated by the contract it won on the 11th of July in the Czech Republic for 62 Titus APCs worth 240 million euros.

Air Force

Unlike the Army and Navy, the French Air Force is not pushing forward modernisation of the same scale. It focuses its efforts on the policing of French airspace and air to ground strike capabilities (both conventional and nuclear). Yet again, major defence companies play a crucial role in the development of already acquired capabilities and the acquisition of new one to remain dominant. Dassault Aviation is the main industrialist collaborating with the Air Force. It most notably is the manufacturer of the *Rafale* multirole fighter. This aircraft has proven itself to be very reliable during war missions. It is the backbone of the French air force, accounting for 45% of its combat fighters (this share is increasing as more *Rafale* are delivered). This aircraft is continuously being brought to new standards to further its capabilities, making Dassault Aviation the uncontested leader in military aircraft in Europe, directly competing with American giants such as Boeing or Lockheed Martin.

The *Rafale* has the backing of the French government on the export market. Dassault has already won contracts in Egypt, India, the United Arab Emirates and Qatar with several other potential contracts. It is complemented by MDBA the European missile manufacturer. MBDA offers its clients a wide array of offensive and defensive weapons for aerial, naval and terrestrial launching platforms.

2.2 Breakdown of budgetary credits by programme (overseas operations and including pensions)



All in all, the French defence industry has proven itself to be over the last decade increasingly competitive on both a European and Global scale. It offers a wide array of investment opportunities. However, because of the very delicate nature of the technology developed by these companies, some of them are government-owned and the government watches closely any investment of considerable size. However, this should not be seen as a drawback but rather as ensuring stability.

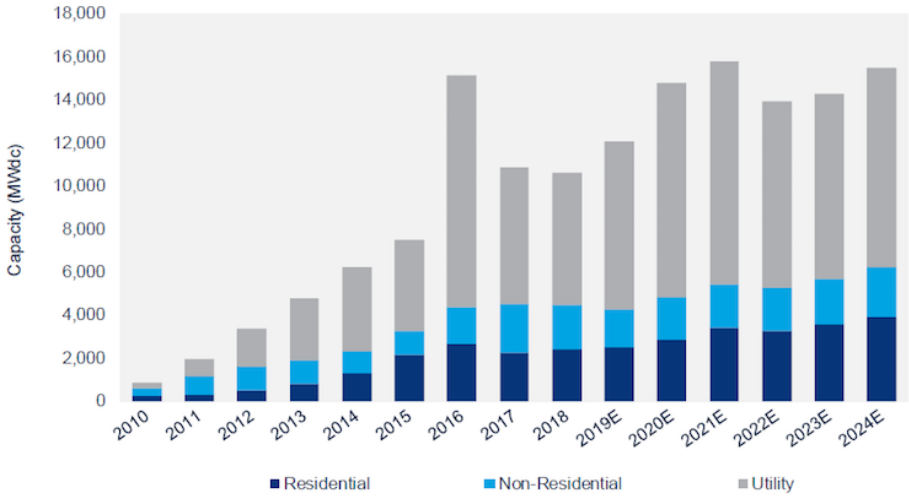
Guest Writer: Malo Pouliquen, Research Intern (Geopolitcs & Defense)

Investment Analysis

Enphase Energy - Sleek Investment into US Solar Power

That renewable energy is the next "big thing" is no secret as most countries around the world try to implement policies to reduce and possibly revert global warming. Besides the shutdown of coal plants and other non-renewable energy power plants, the current shift towards electric vehicles will significantly boost the demand for electric energy preferably coming from renewable sources.

Hereby, Wind and solar energy are the main competitors to replace current energy sources, as they are very versatile, well-developed and relatively cheap. Hydroelectric power would be another big contender - it's cheaper, more efficient and better controllable than wind and solar power - however, hydroelectric plants cannot be built everywhere, and where they can be built, they usually exist already. Lesser known forms of energy generation such as geothermal energy or wave energy might also experience significant growth; however, these are still relatively young technologies and it will take some time until they can be deployed in big quantities.



Given the macroeconomic favorable environment for wind and solar energy companies, we tried to identify the best companies to benefit from the situation. Hereby, we identified a very interesting player in the solar energy sector: Enphase Energy (NASDAQ:ENPH).

The production of solar panels and plants for retail clients in the US is a very competitive market scattered amongst many companies such as JinkoSolar (NYSE: JKS), SunPower (NASDAQ: SPWR) and many more. Consequently, it is very difficult to identify the companies which will in the end have the biggest market shares. Solar Energy ETFs would be one way to limit this risk; however, ETFs invest in both the winners and the losers which would negatively impact returns. A better way to benefit from the boom in solar power is through Enphase Energy and its microinverters.

Microinverters are simply devices that transform the DC current generated by solar panels into AC current. The benefit of microinverters over conventional inverters is that there is one inverter per solar module. Although having multiple inverters might seem inefficient, it is not since it makes solar modules independent from each other. These independence is important, since shades or defects on one solar panel can disproportionately affect the output of the whole solar system if all the modules are attached to the same inverter. Moreover, microinverters improve the output of the solar panels, since it allows the separate optimization of each to the amount of sun it is exposed to (Maximum Power Point Tracking).

Enphase Energy is the leading manufacturer of these microinverters which are used by almost all residential solar power plant systems. Thus, it will benefit from most solar power plant installations in the US, regardless of which companies will end up with the biggest market shares. Thus, Enphase Energy is a great way to gain exposure to the solar energy boom while mitigating the risk of investing into solar panel and plant producers that will underperform.

Year-to-date Enphase is up around 300% which demonstrates the enormous confidence investors have in this company; however, at the same time it also raises the question whether the company is overvalued or not. Indeed, $0.02 EPS and a $2.17 bn market cap for yearly sales of $316 million and a net loss of $11.6 million seems to be quite expensive. However, the last two quarters were the first profitable quarters of Enphase and the company seems to have scaled their sales enough to be sustainably profitable and finish their first profitable fiscal year. Moreover, at the current point in the economic cycle many companies have extreme high valuations which are a lot less justified than Enphase's expensive price.

Heijin is generally bullish on Enphase as it operates in a favorable environment from all three standpoints: macroeconomically due to subsidies for renewable energy (despite Trumps denial of global warming); sectoral due to the steadily decreasing price of solar energy and the eco-trend; on a company level due to the big market share of Enphase and a weak competition. However, we do not expect another 300% rally as we have seen so far this year. The biggest risk for Enphase is of systematic nature, namely that the entire stock market will have a correction from its current extreme high valuations. However, this requires a discussion whether equities are the best investment product at the moment, which goes beyond the scope of this article.

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