Heijin Capital

HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

January 1st – January 13th 2019

Global Portfolio Holdings Weekly

Executive Summary

- **WTI Crude Oil and Brent Crude are making a comeback**. It payed off to hold our long thesis on oil these past two weeks as prices of WTI Crude stormed back into the $50/bbl territory. Most PADDs experienced either flatlining or reductions in their inputs and production. Our oil mid-cap holdings recovered 10-20% due to this data (+ trade tensions reducing slightly).

Product / Region	Current Week	Last Week		Year Ago		2 Years Ago		Four-Week Averages		
	1/4/19	12/28/18	Difference	1/5/18	Percent Change	1/6/17	Percent Change	1/4/19	1/5/18	Percent Change
Refiner Inputs and Utilization										
Crude Oil Inputs	17,566	17,760	-194	17,323	1.4	17,107	2.7	17,521	17,348	1.0
East Coast (PADD 1)	1,073	1,120	-47	1,046	2.5	1,033	3.8	1,053	1,104	-4.6
Midwest (PADD 2)	3,960	3,945	16	3,780	4.8	3,708	6.8	3,957	3,784	4.6
Gulf Coast (PADD 3)	9,421	9,548	-128	9,315	1.1	9,264	1.7	9,433	9,308	1.3
Rocky Mountain (PADD 4)	633	619	14	616	2.8	620	2.0	609	598	1.9
West Coast (PADD 5)	2,479	2,528	-50	2,565	-3.4	2,481	-0.1	2,469	2,555	-3.4
Refiner and Blender Net Production										
Finished Motor Gasoline[3]	9,392	9,533	-142	9,525	-1.4	9,666	-2.8	9,851	9,880	-0.3
Finished Motor Gasoline (excl. Adjustment)[4]	9,115	9,637	-523	9,126	-0.1	9,227	-1.2	9,840	9,816	0.2
East Coast (PADD 1)	2,919	3,069	-150	2,725	7.1	2,830	3.2	3,151	3,026	4.1
Midwest (PADD 2)	2,264	2,399	-134	2,323	-2.5	2,386	-5.1	2,475	2,481	-0.2
Gulf Coast (PADD 3)	2,231	2,418	-187	2,356	-5.3	2,318	-3.7	2,398	2,500	-4.1
Rocky Mountain (PADD 4)	280	297	-17	242	15.7	310	-9.8	302	270	11.7
West Coast (PADD 5)	1,420	1,455	-35	1,480	-4.0	1,383	2.7	1,514	1,538	-1.6

- **Global markets experienced colossal drops in the space of two months.** With the S&P 500 and DJIA falling upwards of 20% from their highs. Poor economic data globally, ongoing Brexit volatility, reductions in expectations for 2019. Nevertheless some economies retaining strength in some areas, such as the U.S. where in some cities open jobs are greater than the demand for them.

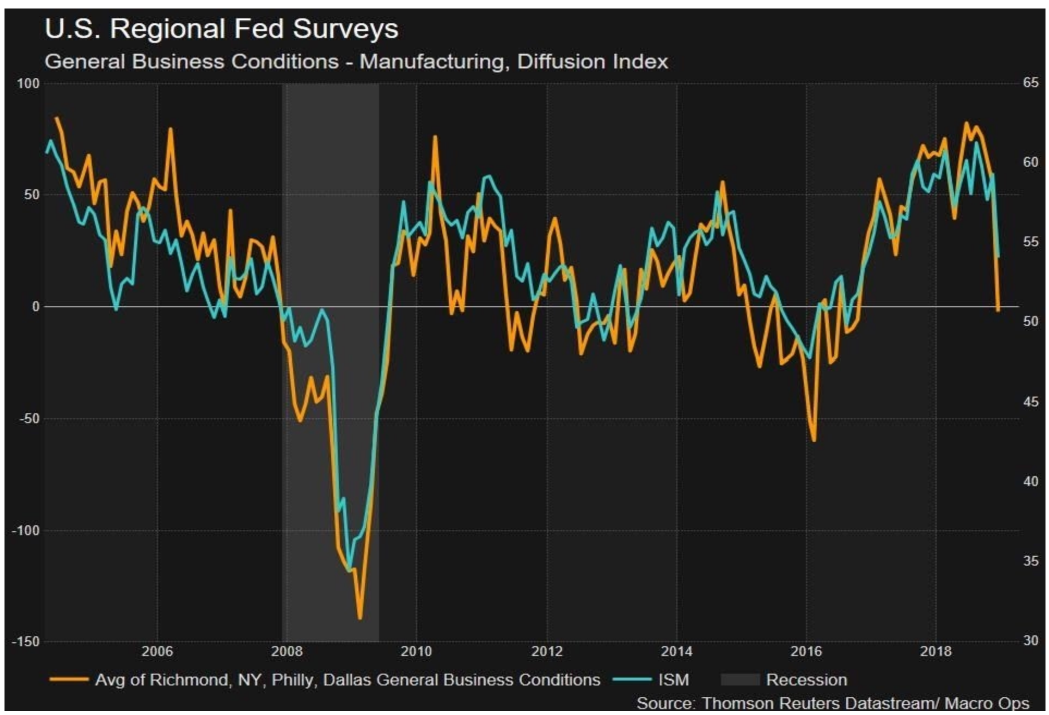
Market Summary & Strategy

Global Macro

The months ahead… should we be worried?

It has been nearly two years since the Heijin Team started to be concerned about some aspects of the global economy and financial system; due to several scenarios we had laid out that probability wise would likely deteriorate. On top of that, we had projected that even if only a handful ended up severely deteriorating - it would generate shockwaves, and thus making markets more turbulent. But, today all of a sudden everybody seems worried? Why is that?

We've seen a changing sentiment in this market, whether this was by talking to other firms, investors, or even by simply looking at news outlets such as theFT and Bloomberg. All of a sudden many market players (direct or indirect) went from being incredibly bullish to having an incredibly pessimistic outlook (bearish). This may create a self-fulfilling prophecy, or simply accelerate the process of ending this cycle, which is not the best piece of news to start 2019 with.



Generally, it's vital to take into account the ISM indicator, as well as the Business Conditions indicator (average of Richmond). These have proven to be reliable metrics to get a sense of what is coming economically and financially speaking. And both have experienced severe drops quite recently, which is a valuable backing to the worries.

On top of that, the ultimate reason why the sentiment in markets may suddenly shift is due to a significant reduction in expectations; whether this is for corporations or for a country's economy. Expectations on growth of earnings or growth of GDP face the similar problem of real estate in terms of making projections. In real estate there is a significant lag, as the property boom will set data for growth projections, which firms will base developments from, and will expect these projections to hold out until their development is out on the market. But this doesn't happen due to the lag. That is why in regions where property is booming there is often a recession that occurs in which there ends up being massive amounts of developments completed, with absolutely dislocated market figures compared to before.

The same thing occurs when analyst make projections on corporate earnings growth and etc. They are based on hundreds of variables and factors that these days can change in a matter of months since so many firms depend directly or indirectly on the global economy and trade relations. And as it turns out the amount of revisions to corporate earnings targets and such are accelerating on an unprecedented scale - similar to that of 08.

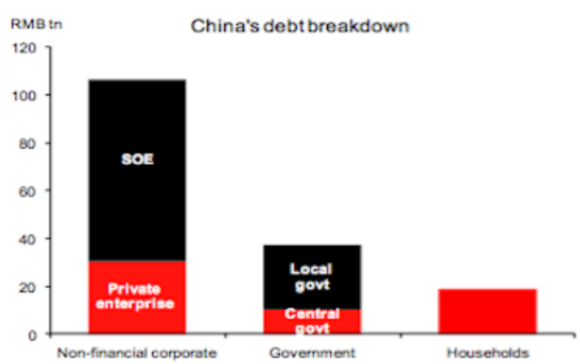
In financial markets it tends to be that the market is inefficient, i.e. the revisions to predictions come first and the market usually follows. And according to the Citi Global Earnings Revision Index we've still got a long way down to go. If these revisions are correct, it seems as though we are about to face a steep and quick recession like in 08. George Soros states that often "the bust is short and steep because it involves the forced liquidation of unsound positions. Disillusionment turns into panic, reaching its climax in a financial crisis". Despite this, from the research we've conducted it has become apparent that there are a lot of structural issues that need to be dealt with if we are to enter the next cycle in a healthier manner.

In the end, investors should be wary of risks in the months ahead, but all this increased volatility is bolstering the opportunity to purchase heavily discounted products in many regions and beat the algo-driven funds.

China's Debt Problem

Over the recent years China has developed from being a showcase economy of the world to being the probably biggest problem child of the world economy. Although the country still posts astonishing yearly GDP growth rates, the most recent one being 6.9%, the high debt levels are increasingly worrying economists. Since the Great Recession of 2008, the second largest economy in the world was subject to a credit boom as few precedents exist, i.e. Japan in the 1980s and the US in the 1920s. The most important reason for the insane debt boom was the response of Chinese Authorities to the Great Recession. Before the financial crisis, China's net exports to had been close to 9% of its GDP, which was not economically nor politically sustainable. In consequence of the Great Recession, China's net exports to GDP ratio slumped by 6% in the years from 2007 to 2001. This immense decline in external demand needed to be permanently offset somehow, as the Chinese economy would otherwise have collapsed. The solution to this was a government funded huge investment program of the size of 12.5% of China's GDP, which is probably the biggest peacetime stimulus that has ever existed. The financial stimulus resulted in the in 2007 already extremely high gross investment to GDP ratio of 41% to soar to 48%. Consequently, China was able to maintain a high GDP growth rate, but in the long term, the increased investment rate led to the devilish combination of more debt and slowing economy.

Fig 89 Corporate leverage is high in China

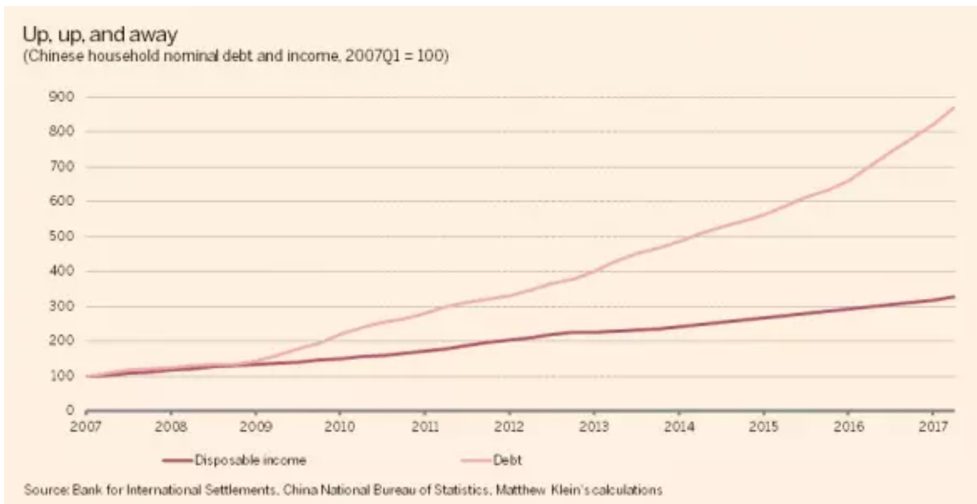


Source: CEIC, Macquarie Research, January 2017

Fig 90 China's debt breakdown

Source: CEIC, Macquarie Research, January 2017

Nonetheless, the financial stimulus is just one part of China's debt problem, the other side is the increasing household debt. The biggest problem with household debt, not just in China, is that it is most always a non-productive investment. Different from the government's financial stimulus that invested in infrastructure and manufacturing capacity that might one day be useful, household debt provides no long-term benefit for the economy. Even worse, increased household debt has statistically been a predecessor of slower income growth and higher joblessness. Notably, compared to other countries, China's household debt is not essentially higher than the mean. As of mid-2017, Chinese households have had a debt of 106% of its disposable incomes wherase this value in the US was at 105%. However, the difference is that the average household debt in the US has decreased steadily since 2007, whereas China's household debt has steadily increased since the Great Recession and there are no signs that suggest that it won't continue in this direction. Furthermore, it is problematic that Chinese households' disposable income does just benefit very slightly from the GDP growth, because the increasing national income is mostly captured by government-controlled enterprises and their managers. This means that Chinese households will have to pay for their debts out of their existing wages and cannot expect to pay them with increasing wages. Michael Pattis formulated a possible solution to the debt problem: "The trick for Beijing now is to bring non-productive investment down as rapidly as it can without causing unemployment to rise to dangerous levels. Because it has proven difficult to replace non-productive investment with productive investment (and, I have long argued, unrealistic even to expect it could happen), the only way to do so is to replace it with consumption. But levered consumption obviously cannot solve the problem of rapid debt growth, so rising consumption must be driven by rising household income, even as declining investment causes workers on investment projects to be fired. In the end this may be politically a difficult problem, but economically it is just an arithmetic problem about wealth reallocation."

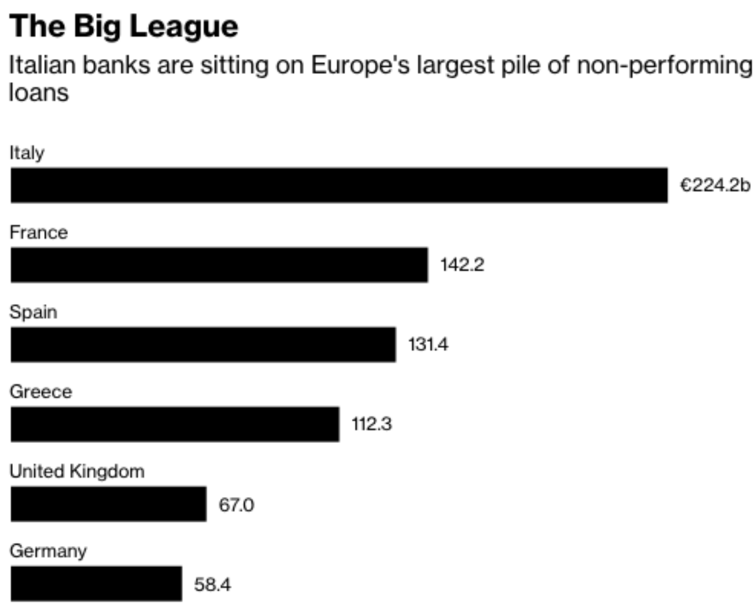


Another side of china's debt problem has recently been revealed by S&P Global Ratings, namely that China may be sitting on a hidden debt pile of 40 billion yuan ($6 billion). This debt has been issued by Chinese local authorities in order to fund local infrastructure projects and thereby keep the economy running. However, in order to avoid lending limits set by central authorities, Chinese local governments have begun using so-called local government financing vehicles (LGFVs) in order to keep their debts off their balance sheets. Analysts said that "That's a debt iceberg with titanic credit risks, … [the] ratio of government debt to GDP could have reached 60% in 2017, an alarming level." Even more alarming is that the default risk for many LGFVs is rising, which has recently been underlined by their downgrading by rating agencies. Beijing is aware of the problems with LGFVs and has recently opened up the possibility for them to file for bankruptcy, but this doesn't solve the problem, since it is just shifting it from local governments to central authorities.

Heijin Capital has a very bearish view on the future of the Chinese economy given the immense debt problem, the potential upcoming housing crisis described in prior investor commentaries and the trade war leveraging all those problems. At Heijin we believe that China's decades of economic boom will soon experience an end of the cycle. Furthermore, we are not turning down the idea that potential crisis in the second largest economy would be able to trigger the global recession that we are predicting for the upcoming years, especially if the trade wars and the consequent financial stimulus by the government continue to raise debt levels. Thus, we are starting to prepare our portfolio accordingly by reducing our exposure to Chinese companies and evaluating how we could benefit from an economic downturn in China. For instance, besides more usual investments like Chinese bear ETFs (e.g. CHAD), we are evaluating an investment into 7 year Credit Default Swaps of the Chinese Government, LGFVs and Chinese companies. However, we are not expecting to open bearish positions on China in the near future, as a positive outcome of the trade talks between China and the US might extend China's debt cycle by some years.

Italian Debt

In an earlier commentary we spoke about the threats to the Italian banking sector and bond market in addition to institutional weakness in their economy. Throughout 2018, the Italian banking system lost nearly 30 percent of its market value. Following weeks of deterioration, the European Central Bank finally took control of Italy's Carige bank on the 3rd of January, following the resignation of the majority of its board members. This is just another knock to the already failing Italian economy. Whatsmore, with the current yellow vest movement spreading from France to the UK and other European nations, the uncertainty in the banking sector could add fuel to the fire as political tensions rise in Italy.



Despite the growing concern from the global community about the state of Italy's affairs, this is nothing new. Italy still hasn't been able to recover from 08', with output still 5% below pre crisis levels. Since the Eurozone debt crisis European banks, in particular Italian banks, have systematically failed to make real in rows in the treating the root causes of such events. Instead treating merely the symptoms and relying on central banks for a bail out. A weak bond market, stagnating economy and poor productivity means that Italy is overwhelmingly unprepared to deal with a crisis, and what's more, there is still a worrying amount of exposure to bad debt. 17% of Italian bank loans are bad, even in the darkest hours of the eurozone crisis and 08' the sour debt was less than a third of this.

The tremendous levels of debt both in italy and across the eurozone make for a very precarious situation, with 2019/20 being a pivotal year which will see with the salvation, or downfall of the Eurozone, triggered perhaps by Italy.

Equities - United States:
EOG Resources Inc. Investment Analysis

Overview:
EOG Resources, Inc., a Delaware corporation organized in 1985, together with its subsidiaries, explores for, develops, produces and markets crude oil and natural gas primarily in major producing basins in the US, China, Trinidad and the United Kingdom.

At December 31, 2017, EOG's total estimated net proved reserves were 2,527 million barrels of oil equivalent, of which 1,313 million barrels were crude oil and condensate reserves, 503 MMBbl were natural gas liquids (NGLs) reserves and 4,263 billion cubic feet were natural gas. At such date, approximately 97% of EOG's net proved reserves, on a crude oil equivalent basis, were located in the United States, 2% in Trinidad and 1% in other international areas.

PEER GROUP: Oil, Gas & Consumable Fuels

Ticker	Company Name	Recent Price ($)	Market Cap ($M)	Price/ Earnings	Net Sales TTM ($M)	Net Income TTM ($M)
EOG	**EOG RESOURCES INC**	**89.97**	**52,174**	**10.52**	**15,898.34**	**4,956.74**
COP	CONOCOPHILLIPS	62.18	71,584	12.31	34,870.00	5,968.00
CNQ	CANADIAN NATURAL RESOURCES	24.97	30,108	8.16	22,335.00	3,763.00
PXD	PIONEER NATURAL RESOURCES	134.73	22,966	17.54	8,943.00	1,320.00
APC	ANADARKO PETROLEUM CORP	44.46	22,420	15.94	12,843.00	1,489.00
CXO	CONCHO RESOURCES INC	106.86	21,399	14.76	3,864.00	1,040.00
CLR	CONTINENTAL RESOURCES INC	42.27	15,894	9.67	4,607.46	1,632.49
FANG	DIAMONDBACK ENERGY INC	96.16	15,778	14.53	1,943.69	653.57
HES	HESS CORP	42.39	13,143	NM	6,336.00	-2,955.00
MRO	MARATHON OIL CORP	14.62	12,153	18.28	5,428.00	678.00
DVN	DEVON ENERGY CORP	23.52	11,012	NM	11,009.00	2,098.00

The peer group comparison is based on Major Oil & Gas Exploration & Production companies of comparable size.

Industry Analysis:
The Oil, Gas & Consumable Fuels industry is cyclical in nature and is one of the most important globally because it touches so many others. It is broken down into three component parts by the nature of activity performed:

- Upstream activities are related to finding and producing commodities
- Midstream refers to the transportation of product from the wellhead to intermediate customers
- Downstream includes the refining, transformation and marketing of related products

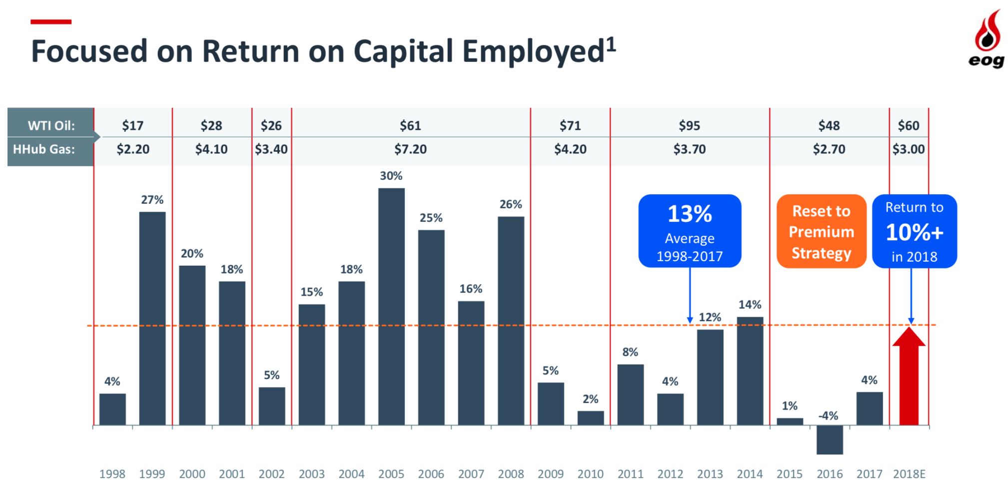
Close to two-thirds of the world’s energy needs are satisfied by hydrocarbons (crude oil and natural gas). Although conservation, increased efficiency and substitutes (such as renewable sources) are gaining in prominence, they are not likely to significantly reduce this dependence in the near future. n 2004, West Texas Intermediate (WTI) crude oil broke out of its historic trading range of $10 to $40 per barrel on a steady climb to more than $145 per barrel in June 2008 before crashing to under $40 by the end of 2008. Since then the price of spot crude has climbed back near the $90 to$110 range before falling again. Natural gas prices, responding to excess supply, have retreated to the $2 to $4 range per million BTU (British thermal unit). Coal prices are dependent on the energy content of the type of coal considered and its location, but it, too, has climbed significantly over the past few years.

Financials:

EOG's very impressive revenue growth greatly exceeded the industry average of 27.2%. Since the same quarter one year prior, revenues leaped by 76.0%. Growth in the company's revenue appears to have helped boost the earnings per share.

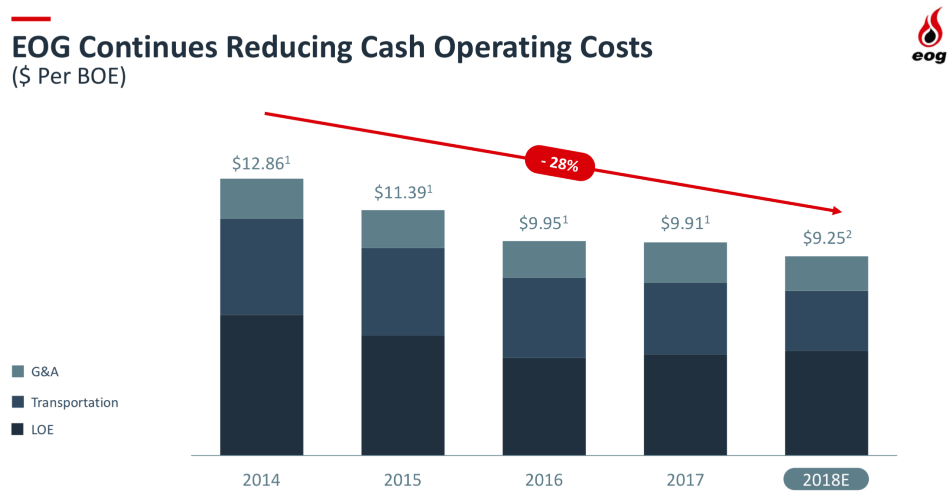
EOG reported significant earnings per share improvement in the most recent quarter compared to the same quarter a year ago. The company has demonstrated a pattern of positive earnings per share growth over the past two years. We feel that this trend should continue. During the past fiscal year, EOG RESOURCES INC turned its bottom line around by earning $4.46 versus -$1.99 in the prior year. This year, the market expects an improvement in earnings ($5.78 versus $4.46).

EOG continues its strategic shift toward oil projects, which started around 2010. However, beginning in early 2016, EOG refined its liquids strategy further, and now focuses on a "premium drilling" strategy. The company defines a premium well as one which can generate a direct after tax rate of return (ATROR) of at least 30% at $40 crude oil. In 2017, where average realized prices were above this $40 mark, EOG generated a direct ATROR of more than 100%, including 143% in the Eagle Ford and 115% in the Permian Basin. The premium drilling strategy accounted for 50% of total wells in 2016.



The company's net income increased by 1084.5% when compared to the same quarter one year prior, rising from $100.54 million to $1,190.95 million. The company's current return on equity greatly increased when compared to its ROE from the same quarter one year prior. This is a signal of significant strength within the corporation. Compared to other companies in the Oil, Gas & Consumable Fuels industry and the overall market, EOG's return on equity significantly exceeds that of both the industry average and the S&P 500.

Reduced cash operating costs:
As of early 2018, EOG forecasts that about 60% of its drilling and completion costs have been secured at competitive pricing. EOG also notes that about 25% of its completed well costs are self-sourced (such as, for example, by owning a sand mine for the sand needed in proppant), which offers a measure of protection against general oil services cost inflation. In late February 2018, EOG forecasted for the combination of growth capital spending and dividends to comprise $6.0 billion combined, which, at $60 oil, it thinks can generate $1.5 billion in free cash flow in 2018.



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