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HEIJIN CAPITAL BI-WEEKLY INVESTMENT COMMENTARY

August 25th – September 8th, 2019

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STRATEGIC INSIGHTS

Executive Summary

→ General Market Notes:

Markets over the world finished in the green after these past two weeks where the Sino-US Trade War tensions slightly eased as a meeting is set to occur in Washington in October between Xi Jinping and Donald Trump. Despite this, we share the same view as others which may interpret this Trade War as the beginning of a new Cold War whereby essentially China is in a position where it underwhelms the U.S. as the global hegemon. This is supported by the Power Transition Theory in which internal factors such as GDP growth and population growth are significant contributors. Even though these days war is more 'economic' or 'information-based' rather than military-based, these Sino-US tensions could still last for years. But, of course, that is not a reason to shy away from markets since even selling post-the-Pearl Harbour attack would have turned out to be foolish since after all let's face it war generates business for many industries. And on top of that, a fairly sombre remark about war is that usually in most places on earth absolutely nothing is happening and that is why at Heijin we may begin to incorporate these Sino-US tensions as a permanent economic component in our models for the foreseeable future.

INDEX	CLOSE	2 WEEKS	YTD
Dow Jones Industrial Average	26,797	3.47%	14.78%
S&P 500 Index	2,978	3.49%	18.67%
NASDAQ	8,103	3.17%	21.56%
10-yr Treasury Yield	1.56%	0.03%	-1.13%
Oil ($/bbl)	$56.62	4.5%	24.7%
Bonds	$113.67	0.1%	8.8%

*bonds are represented by the iShares Core U.S. Aggregate Bond ETF (NYSEARCA:AGG)

Market Outlook & Strategy

Global Macro

Potential Bubble in Fixed Income Markets

We live in interesting times. That's probably the only thing people who follow financial markets can agree upon. Over the past couple of months, there have been huge inflows into bond markets, which means that investors are taking in an increasingly defensive stance on the world economy. But what's next? Wait until the global economy crashes? Move back to equities and more aggressive securities?

Well, to understand the current situation better it is essential to analyze why investors are expecting a big hit. A very common argument for an upcoming recession is usually the yield curve inversion which so far has done a marvelous job at predicting economic turmoil. Indeed, all the recessions in the past 50 years and more have been preceded by a yield curve inversion. However, the yield curve inversions do not cause a recession themselves, but they are rather a measure of investor confidence. Moreover, since to our knowledge, there has never been a recession expected by so many people, the yield curve inversion might be a death circle.

Another popular reason why the economy is about to crash is that it has so far been the longest bull run in history. Also, this argument is pretty much invalid since one of the first reasons in financial markets is that something that worked in the past does not necessarily work in the future. Moreover, the argument is invalid because there has never been such an extensive usage of negative interest rates as there is today, and negative interest rates are promoters of bull runs.

The list of potential causes could continue ad infinitum with reasons such as Brexit, geopolitical tensions, Venezuela, Italy, Argentina, etc. However, it is very unlikely that such reasons could trigger the world economy to tank because these problems are all too small to have an impact on a global scale. Global recessions are caused by structural problems in the way the global economy works or extreme geopolitical problems; however, most of the causes currently publicized are none of them.

However, the fear from a potential market downturn and the connected rate cuts has dominated markets this summer with investors fleeing into fixed income. Investors moved to bonds before their yields would fall due to lower interest rates and more demand. But the inflow into bond markets seems to be overdone. Recent remarks by Fed officials and economic data shows that further rate cuts and an economic downturn are not a sure bet as the US economy seems to still be in very good shape with low unemployment, healthy wage growth, strong consumer confidence, etc. Ray Dalio, manager of the biggest hedge fund in the world who predicted the

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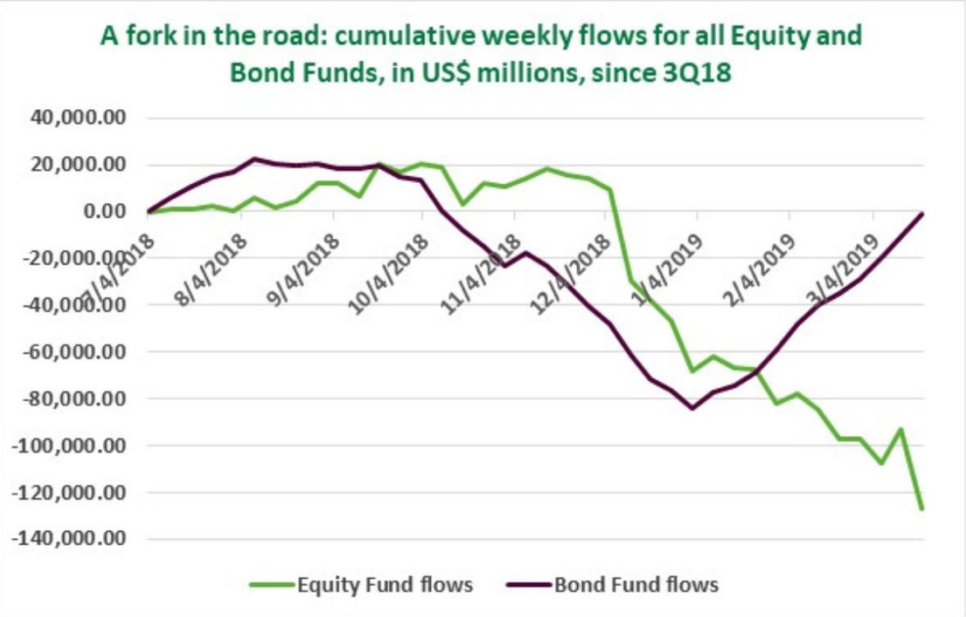
Great Recession in '08, said that there is just a 25% chance of a recession this year or the next year. Markets, on the other side, are currently pricing in a recession for early next year.

This week, some companies seem to have realized that the bond markets inflow might be overdone with Bloomberg announcing that there have been 49 bond deals in 30 hours and issuance of $79 billion in investment-grade bonds. Furthermore, Bloomberg projects at least $50 billion more bonds to be issued until the end of the month. It seems that companies have realized that bond markets have rallied too far and that the expected rate cut at the end of September is not a sure bet. Thus, they still want to issue bonds in the low interest-rate environment before the interest-rates rise.

Heijin Capital believes that the chances of a micro-bubble in fixed income markets are high. We think that bond yields are too low for the current economic environment and that the priced-in rate cut might not happen. If our thesis holds, we expect outflows from the bond market in the next couple of months and inflows into stock markets, which has stagnated since April. However, with the current president of the United States, we are very cautious with investing in our thesis since one tweet can be enough to destroy our thesis and render it useless.

Moreover, we encourage investors to shift their focus to China and Europe if they want to predict the next recession, since the US's economy is still healthy. China, on the other side, seems to have bigger problems with its ballooning debt, lowering consumer demand and companies moving their supply chains out of the country. For instance, the country cut loan loss provisions this week and is increasingly taking in an easy money policy, both signs of economic turmoil.



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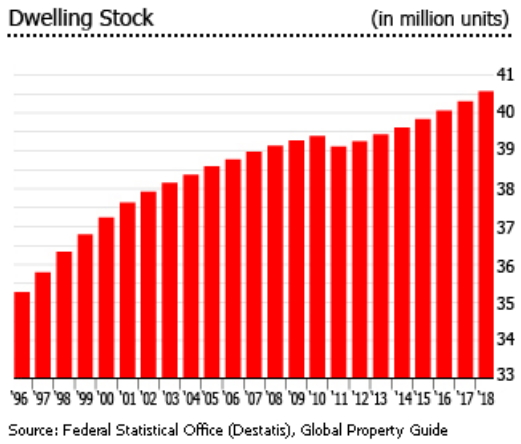
Real Estate

Germany Housing Market: Part 2

In the last commentary we talked about the general overview of the German housing market and its suitability as a long-term, income-yielding investment. We have had positive feedback about the piece and as promised, in this commentary we will be sharing with you some numbers from Germany's 5 largest cities. But first, a few words about the German RE investment ecosystem.

Foreign investors, particularly from Israel, France, and the UK, represent about a quarter of direct residential property investments in Germany. According to Savills, of the purchasers in 2018 known by name, almost 38% were investing in the German residential market for the first time in the last ten years. This further growth in the investor base is likely to ensure additional high levels of investment activity in 2019, with the transaction volume likely to exceed €15bn once again.

Moreover, Germany took in around 1.1 million asylum seekers in 2015 and another 280,000 refugees in 2016. In September 2017, Chancellor Angela Merkel agreed to cap the number of refugees Germany accepts at 200,000 annually. To house the refugees, the German authorities have turned to public buildings, including former schools and sports centers, as well as a concert hall in Thuringia and an old barracks in Brandenburg. But even these are not enough. Aside from tight housing supply, another problem is that refugees tend to locate themselves in big cities, such as Berlin, where the housing supply is even tighter. They compete for housing units with locals and migrants (mainly from other parts of Europe) who are in the country to work, resulting in a further surge in house prices.



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Berlin

Germany's capital, Berlin, is the seventh most populous urban area in the European Union. The city's residential sector has been supported by its young population and growing reputation as a European creative and media hub. It hosts numerous renowned universities, orchestras, museums, entertainment venues as well as other creative industries. For several years, Berlin has recorded a high population growth of about 40,000 to 60,000 annually, mainly due to inward migration. In 2018, Berlin had a population of around 3.75 million. It ranked 13th out of 231 cities included in the Mercer's 2019 Quality of Living Index.

However, Berlin is currently facing a severe housing shortage. While there were around 12,790 housing completions in 2018, current annual requirements are for more than 20,000 residential units. If the excess demand of about 70,000 units over the past few years is added, it is estimated that Berlin will require around 194,000 new units by 2030.

Hamburg

Hamburg is "Germany's Gateway to the World", and it is home to the third-largest port in Europe. It is Germany's second-largest city and the eighth largest in the European Union. It is a significant tourist destination, and its Speicherstadt was declared a World Heritage Site by UNESCO in July 2015.

The city has thriving small and medium-sized enterprises, as well as successful international trade and business services sectors. Hamburg's population growth exceeds 5% between 2013 and 2018. But like Berlin, construction activity in Hamburg is well below demand. In 2016 and 2017, housing completions averaged 7,000 units annually, less than half of the estimated annual requirements for 15,000 homes, according to JLL. Hamburg Senate recently set a new-build target of 10,000 homes per annum, which was expected to have been achieved in 2018.

Munich

Munich is Germany’s third largest city and is home to many major universities, museums, and architectural attractions. It is a traffic hub and is one of Germany’s fastest-growing cities. It ranked highest (overall: 3rd out of 231 cities) among major German cities in Mercer’s 2019 Quality of Living Index. Residential construction activity remains strong in Munich, so it seems possible that the city’s annual target of 8,500 completions will be achieved in the coming years. Nonetheless, the city’s housing market continues to be tight, amidst high demand. In the past five years, housing supply grew at only about 3.5% annually while demand increased by around 5%. According to the Federal Institute for Research on Building, Urban Affairs and Spatial Development (BBSR), about 15,000 to 20,000 units should be built annually to absorb the excess demand from previous years. Construction activity in Munich has shifted increasingly from the city centre and downtown neighborhoods towards the outskirts and less densely developed districts in the past few years.

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Despite the city government's efforts to solve the housing shortage, the problem is expected to linger amidst robust population and economic growth.

Cologne

Cologne, Germany's fourth largest city, hosts more than thirty museums and hundreds of galleries.With population growth of about 4% since 2013 and supply growth of barely 2%, there is clearly a housing shortage in the city. Completions were just between 2,000 and 3,000 units in recent years, significantly lower than the local government's target of 6,000 new apartments annually, including about 1,000 planned subsidized units. Significant developments over the next few years include the Clouth site in Nippes, the Sürther Feld in Rodenkirchen and the Deutz AG site in Mülheim.

Frankfurt

Frankfurt is the fifth largest city in Germany and the last city on our list. It is Germany's financial centre and is known for its major trade fairs such as Messe Frankfurt, one of the largest in the world; Frankfurt Motor Show, the largest motor show in the world; and Frankfurth Book Fair, also the largest in the world. It ranked 7th in the Mercer's 2019 Quality of Living Index.

The city's population - which has climbed to about 760,000 in 2018 - is forecast to reach over 820,000 by 2035. Population growth is focused on the large new-build districts such as Riedberg in the north (peripheral districts) and the Eu ropaviertel (City Centre I). Housing completions averaged around 3,500 annually over the past five years. However, well below current demand for almost 6,000 units annually, amidst strong population growth.

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Investment Analysis

Will the La Perla listing increase its probability of survival?

La Perla is a luxury lingerie focused clothing brand, which targets the wealthy consumers with its >$200 price tags. The company was founded in 1954 by Ada Masotti in Bologna, and so this year it is actually celebrating its 65th anniversary. The company didn't expand much until it got acquired in 2008 by JH Partners, a San Francisco private equity firm. But the real global footprint was thanks to the strategy laid out by Pacific Global Management that acquired La Perla for €69m in 2013.

Today, La Perla is owned by the slightly controversial german financier Lars Windhorst via his Sapinda Group. Despite being a more consolidated brand after a cost-cutting strategy was revealed whereby it would cut products that were not directly related to lingerie, it still booked a €91m loss. A significant improvement when compared to the €179m loss for FY 2017.

When researching the company we quickly realised that the core issue was the number of boutiques they had (150) and the rents they were paying. It makes absolutely no sense for such a small focused brand to have a 5-floor shop on Bond Street in London or a 3-floor building on the most expensive street in Hong Kong. Furthermore, why on earth would La Perla need a 3-floor flagship shop in Hong Kong when they already had two other shops in the city. Just to put things into perspective, La Perla pays >USD950,000 **per month** for their Hong Kong flagship store and £5m annually for their shop on Bond Street. What's more, La Perla was almost evicted after failing to pay rent for two straight months in Hong Kong and were thus involved a court battle with the landlord.

If we take into account La Perla's total revenues for FY 2018, which stood at ~€100m it would mean that two of their boutiques alone eat up >16% of that as a small portion of their total current liabilities. Clearly, even their new CEO (ex-Burberry executive) is not making much of a difference. And, what makes matters worse is the fact that the owner (Lars Windhorst) has no shame in issuing tonnes of bonds and has personally gone bankrupt in the past. Thus, it is no surprise that La Perla has decided to conduct a listing of its shares in Paris (not as an IPO) in order to access capital markets with more ease. Previously, La Perla issued bonds in private and usually they were bought by H2O, with whom Lars Windhorst has a "special" relationship with. Post the listing of shares that occurred this Friday, La Perla will, of course, have an easier time

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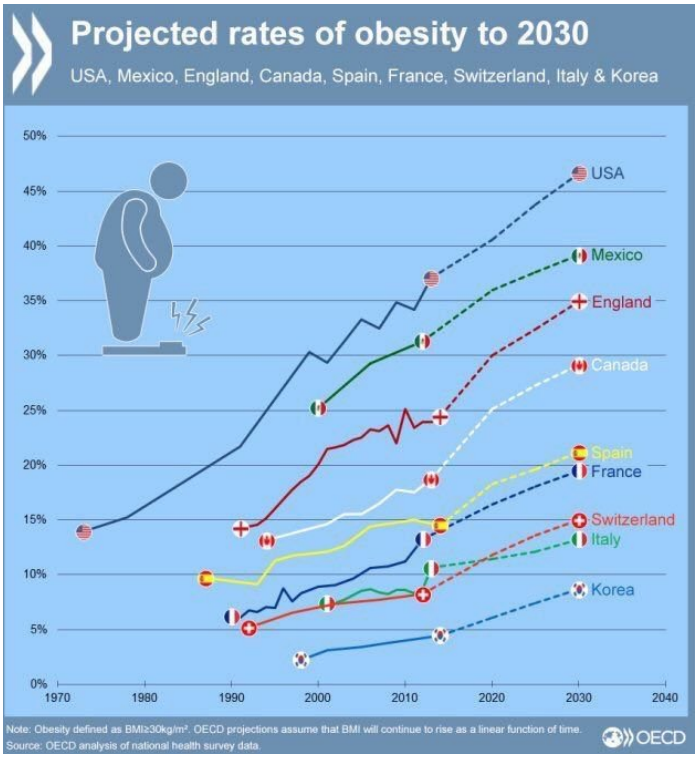
raising capital but will investors really commit to this loss-making lingerie business? In our view, a strict boutique closing strategy should be implemented with re-thinked locations and size of the location since if that does not occur we at Heijin do not see a path to profitability for La Perla unless in some miraculous way revenues double.

Investment Analysis

Could health/diet stocks add weight to your portfolio?



It is no secret that the world is getting fatter. Obesity has tripled since 1975 and is getting worse each year. We are now at epidemic levels of obesity with over 30% of the world's population categorised as obese! Therefore it is no surprise that the health and wellness industry is worth an enormous $4.2 trillion, which grew by 12.8% between 2015 and 2017. The sector covers such as a wide range of interesting sub-sectors than are experiencing an individual boom. For example, Health clubs are rapidly growing their consumer base with about 16% of the American population (about 50.2 million) currently holding gym memberships, an increase of over 10% since 2016.

In addition to personal goals, companies are now taking more active roles in the health and wellbeing of their employees with free gym memberships, mainly due to the greatly reduced insurance premiums for healthy workers. Another key area of the health market is the seemingly unmissable wearable fitness technology. Customers can receive a breakdown and monitor personal statistics and track progress in their blood pressure, weight, calories burnt, daily steps, etc. The market for these goods alone has almost tripled with more than 245 million wearable devices sold in 2019, with fitness trackers accounting for almost 2/3 of sales, with Garmin, Apple Watch and Fitbit taking podium sales positions. These are just some examples of the breadth of products in the health and wellbeing market, so which firms do we have our eye on?

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1. Lululemon (NASDAQ: LULU) - Lululemon Athletica is a Canadian athletic apparel retailer. Lululemon is a self-described yoga-inspired athletic apparel company for women and men and operates at the mid-high end of their respective field. Lululemon has been on our radar for well over a year, their steadily growing market share coupled with brilliant profitability has caused it to become one of the best-performing stocks of 2019, up over 60% YTD. It's notable that Lululemon has seen its gross profit margin improved by over seven percentage points since 2016 to above 55% of sales. Lululemon is hitting that athleisure area of the market (clothes smart enough to wear outside the workout sphere, yet functional for training) perfectly. And a lot like the rise of Nike, compared to similar sports-related (albeit unsuccessful) brands such as BBB (big baller brand), comes down to that unquantifiable quality of "cool", which seems to possess in bucketloads.

2. Fitbit (NYSE: FIT) - Fitbit, Inc. is an American company headquartered in San Francisco, California. Its products are activity trackers, wireless-enabled wearable technology devices that measure data such as the number of steps walked, heart rate, quality of sleep, steps climbed, and other personal metrics involved in fitness. Of course, 'Fitbit' is now a household name, will millions of people tracking their daily progress through their wearable technology. Fitbit has been trading at around 10% of its IPO price and obviously is surrounded in bearish sentiment. However we believe that Fitbit has the capability, through new premium services, initiatives and products to turn themselves around back into profitability. To do so they will need to distinguish themselves from many of the 'gimmicky' fitness trackers and market themselves as a serious aide to people's health. And with their latest initiative with the FDA , they seem to be doing just that. Moreover, Fitbit have recently launched the Singapore initiative which is a government-backed scheme to equip residents with fitness trackers as Singapore has seen rising rates of diabetes and heart disease over the past few years. The customers won't pay for the device but will agree to a minimum of 1 year on the Fitbit $10 per month subscription plan, that would generate $120 million in recurring annual subscription revenue. This in addition to their completed its clinical trials for sleep apnea detection and their new worldwide premium service, has led us to believe that despite the obvious risks, Fitbit has the potential to swing back from the circumstances in which they find themselves and could easily become the 'comeback' story of 2020.

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Contact Details

Gregory Laurent Josi
Founder, Managing Director & CIO
gregory.laurentjosi@heijincapital.com

Pasha Tinkov
Executive Director & COO
pasha.tinkov@heijincapital.com

Moriz Martiner
Analyst
moriz.martiner@heijincapital.com

James Schofield
Director
james.schofield@heijincapital.com

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