Principal Finisterre

Principal Asset Management[SM]

FINISTERRE EMERGING MARKETS TOTAL RETURN BOND FUND

Update on Country Gardens and China

AUGUST 22, 2023

Did Finisterre have any Country Garden exposure when the payment issue occurred?

Yes. We have been holding a small stake in it since the depth of last year's meltdown which we bought in late Oct/Early November 2022, starting at $9c in Price. We acquired this stake at an average 34 Cents. The initial fund exposure was about 0.5% which subsequently peaked at 1% at the turn of the year as prices rose to the 70 cents handle, before it all melted down back to the current lows at around 8 cents.

What is the list of holdings in Country Gardens in the Finisterre Funds as of Friday, August 18, 2023?

Finisterre EM Total Return Bond Fund:

Type	Ticker	Issuer	Positions	Price	YTW	Current Yld	Z-Spread	Mod Dur	Finisterre EMTR 40-act Fund % Exposure
			CHINA						0.13%
Bond	COGARD	COUNTRY GARDEN HLDGS	COGARD 2.7 07/12/26 USD CCC / B	8.01	121.19%	33.72%	12060	1.46	0.01%
Bond	COGARD	COUNTRY GARDEN HLDGS	COGARD 4.2 02/06/26 USD NR / B	7.89			15881		0.05%
Bond	COGARD	COUNTRY GARDEN HLDGS	COGARD 5.4 05/27/25 USD NR / B	8.25	228.53%	65.45%	23155	0.63	0.01%
Bond	COGARD	COUNTRY GARDEN HLDGS	COGARD 7.25 04/08/26 USD NR / B	8.03	161.86%	90.32%	16266	0.76	0.07%

As of August 18, 2023. Source: Finisterre Portfolio Management System. **Yield to worst**: lowest potential yield that can be received on a bond without the issuer defaulting. **Z-spread:** measures the spread that the investor will receive over the entire Treasury spot rate curve. **Modified duration:** measures the change in the value of a bond in response to a change in 100-basis-point (1%) change in interest rates.

Why and when did you decide to invest in bonds from Country Gardens?

The reason to buy those bonds in the first place was part of our search for several key "China reopening trades" which we wanted to have on from mid to late October 2022, in expectation of a policy change on the "zero-COVID" approach. A sub-1% position in Country Gardens, alongside of a 1% position in Macau gaming names Melco resorts and Studio City, and another 1% long in IG tech credits Tencent and Prosus, were the ways we chose to express what was largely a top-down macro view on the broad reopening theme.

The idea was to identify the most powerful potential recovery trades in the Chinese spectrum, as the zero-COVID restrictions were lifted and the Chinese government came up with a support plan for the property sector (including Country Gardens) in late October 2022.

Hence, our view of Country Gardens was much more based on top-down considerations, i.e. proven and likely ongoing support from the Government and key policy Banks for one of the key property actors which would receive a blend of liquidity and refinancing support to keep it in activity, given the policy role it had to play, esp in tier 3 and 4 cities which represent approximately 60% of its projects.

We knew all along that the company accounts, like those of most Chinese developers, were at best highlighting serious liquidity and refinancing pressures. Country Gardens has remained to this day, one of the most credible private actors, receiving repeated support in the past few months to either repay foreign or local bond maturities, or through placement of local bonds (the latest 1.3bn CNY issue was in May, when many were cut off from the market) but, like many others before them, and despite being four times larger and less indebted than its failed peer Evergrande, they finally succumbed to months of cash burn.

The decision not to pay an 11m USD interest payment on our 2026 bonds may still be a call for government support within the 30-day grace period, or the trigger for restructuring discussions with bondholders. They have a 544m$ maturity on Sept 2, which they obviously won't pay, and which makes that restructuring possibility more plausible.

Either way, we believe that the current price levels at 6-8 cents for an aggregate 0.13% of the Funds, already reflect an almost total loss of any recovery with no restructuring in sight. This represents pure optionality and has virtually no more negative bearing on portfolio performance going forward. Hence our current stance to keep the position and exit if we see a plan being put together.

We still argue that letting Country Gardens totally go under does not make much sense for the government, who still needs some residential property development to satisfy a growing need for affordable housing, esp. in Tier 3 and 4 cities. Country Garden, as one of the largest national developers should be part of that plan one way or another.

What is your aggregate exposure to China as of August 18, 2023?

Our aggregate net exposure to China across our Funds is negative at around -9.7%. Although we retained exposure to Country Gardens the position is now around 0.1% of the portfolio, so de minimis. We remain with a couple of long positions in China USD credits taken around the covid reopening rally in late 2022, namely in select Macau gaming names (Melco Resorts, MGM China and Studio city) which we see as the quintessential reopening trade (Chinese tourists flocked to Macau as soon as borders reopened, bringing fresh money in), and some exposure to Prosus 2032, the Dutch listed and South African owned entity holding 30% of China tech giant Tencent.

Beyond this, we have been structurally short Chinese Yuan Offshore (CNH) for most of the year (currently -2.5%) and have also been holding a basket of 3-year credit default swaps (CDs) protection on the four main China policy banks, initially as an insurance policy against any risks related to China-Russia, China - Taiwan. However, this position would also likely perform well on a worsening of macro risks around local government, property or shadow banking debt refinancing issues, whose resolution would almost certainly require those policy banks to step in as lenders/buyers of last resort at the behest of the government and at the cost of worsening credit quality.

On the currency, we have long been of the view that a Chinese recovery would remain structurally negative for the Chinese Yuan Onshore (CNY), and as such, have broadly held a short CNH position ranging between -2% to -6% since late 2022. We argued that the combination of a consumption led recovery, a dearth of foreign investments fleeing to other destinations because of geopolitics, low investment confidence among local entrepreneurs, and a potential recovery in outbound tourism would all combine to worsen China's balance of payments (BoP) dynamics and put pressure on the currency.

Finisterre EM Total Return Bond Fund – China positions as of August 18, 2023:

Type	Ticker	Issuer	Positions	Price	YTW	Current Yld	Z-Spread	Mod Dur	Finisterre EMTR 40-act Fund % Exposure
			CHINA	1.56	-2.56%		91		-9.61%
CDS	BCHINL	Bank of China Ltd	Buy BCHINL SNRFOR USD 100 Dec 2025	99.81		1.00%	102	4.21	-2.56%
CDS	CCB	China Construction Bank Corp	Buy CCB CDS USD SR D14 SNRFOR USD 100 Dec 2025	99.71		1.00%	104	4.20	-2.28%
CDS	ICBC	Industrial & Commercial Bank of China Lt	Buy ICBC CDS USD SR D14 SNRFOR USD 100 Dec 2025	100.48		1.00%		4.26	-2.30%
CDS	SDBC	China Development Bank	Buy SDBC CDS USD SR D14 SNRFOR USD 100 Dec 2025	100.30		1.00%	91	4.25	-2.01%
Bond	COGARD	COUNTRY GARDEN HLDGS	COGARD 2.7 07/12/26 USD CCC / B	8.01	121.19%	33.72%	12060	1.46	0.01%
Bond	COGARD	COUNTRY GARDEN HLDGS	COGARD 4.2 02/06/26 USD NR / B	7.89			15881		0.05%
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FX	USDCNH		FX USD:CNH|25/Aug/23	7.31	-2.56%			0.02	-2.36%
Bond	MGMCHI	MGM CHINA HOLDINGS LTD	MGMCHI 5.25 06/18/25 REGS USD B+ / A	94.53	8.22%	5.55%	364	1.67	0.30%
Bond	MPEL	MELCO RESORTS FINANCE	MPEL 5 5/8 07/17/27 REGS/144A USD BB- / A	88.08	9.07%	6.38%	498	3.35	0.27%
Bond	MPEL	MELCO RESORTS FINANCE	MPEL 5.25 04/26/26 REGS USD BB- / A	90.84	8.92%	5.78%	459	2.37	0.10%
Bond	MPEL	MELCO RESORTS FINANCE	MPEL 5.75 07/21/28 REGS USD BB- / A	85.09	9.49%	6.76%	544	4.07	0.54%
Bond	PRXNA	PROSUS NV	PRXNA 4.193 01/19/32 REGS USD BBB- / AA	81.51	7.08%	5.14%	315	6.74	0.47%
Bond	PWRLNG	POWERLONG REAL ESTATE	PWRLNG 4.9 05/13/26 USD CCC- / BB	8.55	136.85%	57.34%	13669	1.09	0.01%
Bond	PWRLNG	POWERLONG REAL ESTATE	PWRLNG 6.25 08/10/24 USD CCC- / BB	8.25	526.35%	75.76%	56666	0.24	0.01%
Bond	STCITY	STUDIO CITY FINANCE LTD	STCITY 6.5 01/15/28 REGS USD B+ / A	81.93	11.73%	7.93%	764	3.59	0.07%

As of August 18, 2023. Source: Finisterre Portfolio Management System.

What is your fundamental view on China at this juncture? Is there a risk of debt deflation a la Japan in 1990?

The recent disappointments of previous stronger growth expectations were arguably not part of our initial scenario, yet they continue to favour our existing positioning on short CNH and long CDS, although they reduce the appeal of any long credit positions. The weaker CNH is probably one of the cleanest macro expressions of the current mix of deteriorating confidence, disappointing growth and rising uncertainty. We note that the authorities seem to have stepped up their intervention on the currency lately, via leaning on the CNY fixing and tightening funding rates. While we acknowledge that Chinese authorities have expressed unease with foreign exchange (FX) weakness, at this stage it seems to us that these are an attempt to manage the *pace* of depreciation, rather than defend a specific level.

Broadly speaking, the latest macro data pointing to both growth disappointments and potential deflation has drawn parallels with the Japanese debt deflation of the 1990s, leading some to wonder if China, faced with similar "3D" challenges (Demographics, Debt, Deflation) would not follow the same path as Japan 30 years on. We will not weigh into this debate just yet but we are forced to acknowledge that the current cocktail of slow growth linked to high precautionary savings by consumers (spooked by insufficient social and retirement safety nets), surging unemployment for young graduates, hesitant and increasingly less efficient government stimulus, deflationary pressures, the complete destruction of the property sector as an investment driver for the economy, the indirect connection to the property sector of large parts of the financial system now in need of refinancing, (be they wealth management products or bonds from local governments) leaves China between a rock and a hard place.

Not all parallels with Japan 1990 hold, however. To start with, although property sales have collapsed because of a confidence crisis around developers, property "prices" have not, thus limiting the collateral damage on the financial system. Also, it is worth noting that the over-indebtedness looks far less pervasive than in Japan then, as household and non-financial private corporates do not feel much deleveraging pressure. In addition, demographic trends in China are weak but not as weak as Japan's in the 1990s and China's underlying growth rate – while slowing – is stronger than Japan's was. Finally, although the fiscal stimulus weapon is far less powerful than 20 years ago and comes with unwelcome side effects, the central government and public banks balance sheet can still absorb a fair share of refinancing pressures, in a financial system which remains largely closed and ringfenced from cross border influences. Hence for now the main risk in China is more around sentiment and the uncertainty related to a disappointing policy response, less so about an imminent macro collapse.

What is the impact and relevance of the China situation for the rest of EMs today?

Speaking about fundamentals first, the main transmission channel remains on commodity producers (mostly Oil, Iron Ore, Copper, and food producers to a lower extent), and neighbouring Asian economies through trade and investment flows. We have long moved on from the 2000s era where the EM world was much more in tune with China's initial surge, based on furious investment by State Owned Enterprises. Since 2012, and more so since 2015, China's business model evolution towards a broader mix of consumption, property investment and infrastructure spending has diversified and complexified its interactions with the rest of the world, with the result that other EMs have had to learn to rely a bit less on Chinese demand. This translated into lower external surpluses and lower potential growth since 2012 for most EMs but has also forced many of them to look for alternatives and broaden their business models. Interestingly, the initial post-COVID China rebound late last year was supposed to massively benefit the rest of Asia and EM commodity producers. In the end, we found that the impact was much milder than previously thought, which now helps cushion the negative impact of Chinese disappointments. A number of EM countries are even benefitting from the rethinking of international and geopolitical trade relations through the relocation of global investments away from China (Mexico, Latin America mainly, but possibly also Turkey, Eastern Europe and some Northern African countries). Finally, against all odds, for various supply/demand reasons, key commodity prices (Oil, Copper, Iron Ore, Food prices) have not reacted much either to the past three months of disappointing China data.

Now, if we look at the direct relevance of China as an investment destination and index allocation for EMD investors, it has massively dwindled. The demise of the China property sector has left China USD credit as a handful of IG quasi sovereign credits which just give you some U.S. Treasury exposure with a tight spread. China retains 10% of the local currency GBI-EM index, but its contribution in terms of yield, risk and return has become very modest in terms of historical FX and rates volatility, so that in aggregate, no EMD investor these days will ever make or break their annual performance from an exposure to China.

This is in sharp contrast to the EM equity world where China remains 33% of the universe, and just four Asian countries (China, South Korea, Taiwan and India) represent 75% of the market capitalisation. Hence the recent noise around China has really had more of a negative impact on EM equities, but for EMD investors it only impacted through sentiment and perception channels. We remain much more impacted by the outlook for the U.S. economy, interest rates and the USD.

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