July 2018

Niche AM

NEWSLETTER

Inside this issue

Appendix at the back of this newsletter contains an important disclaimer

¥ The great pretender

Funny how the market tends to follow pre- determined patterns. As humans do. In times when slavery was lawful, few people challenged this view, despite it was obviously flawed. The same applies to voting right for women or Jews persecution in the '30s in Germany. How many smart and sensitive people in Germany were convinced that the persecution of the evil Jews was right?

This is in part due to misinformation and in part to the way we are. Humans, like monkeys, are pack animals and tend to follow the flow like sheep, when the shepherd is strong and convincing enough. Nowadays, many are still the non-senses that we tend to follow. Bad treating and eating animals is something obviously cruel, that will be seen by our gran-children as primitive. Tolerating extreme inequality, pollution and tobacco or arms trade are other habits that will be abolished over the time.

As markets are made by humans and reflect their behaviour, this phenomenon applies also to them.

With this respect, we are used to expect emerging markets tensions during the end of the expansionary monetary policies. The global dollar liquidity is soaked up by the Fed interest rate hikes and this reduces the carry trade strategies on EM bonds, so the narrative goes.

Outflow from EM can affect countries with external deficit and significative reliance on foreign currency.

Oh Oh yes I'm the great pretender
Pretending that I'm doing well
My need is such I pretend too much
I'm lonely but no one can tell
Oh yes I'm the great pretender
Adrift in a world of my own

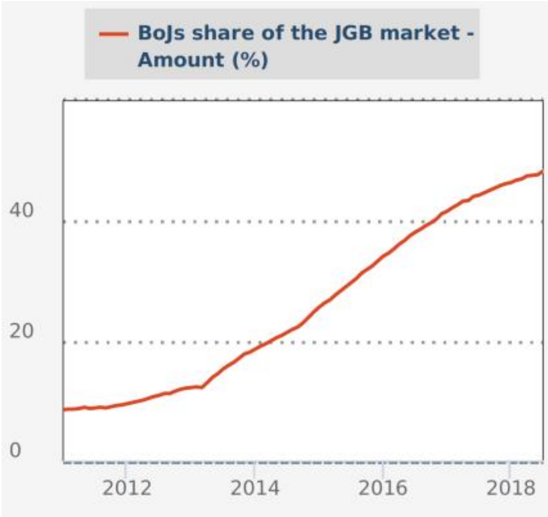
This makes sense. That said, EM today are much stronger that they were and also outliers like Turkey, SouthAfrica, Brasil and even Argentina, are a far cry of the incredible weak countries they were 20 years ago. As a consequence, the contagion fear from Turkey and Argentina we are now experiencing is likely to be overstated.

At the same time the market tends to consider safe havens some asset classes, despite those are unequivocally crippled and dangerous in time of growing inflation and interest rates hikes.

This happened to the US real estate ten years ago; at the time "historically" considered a rock-solid asset ("We've never had a decline in house prices" and "this is not something that will affect the national economy" Ben Bernanke, 2005). The point is that things change and securitisation (a relatively new phenomenon, as so not caught by previous statistics) allowed an unprecedented level of non-prime assets overvaluation.

Something similar is cooking in Japan. I am not referring to the equity market, that looks very attractive indeed. Nor to the negative- yielding bond market (though at these levels it should not be the widow-maker it was used to be for those shorting

it) due to the fact that most of its debt (all but 1.4 tn usd, ie 10% of the outstanding gov debt) is held by Japanese savers, Japanese Institutions and the Central Bank. The BoJ continues to buy and now owns about 40% of Japanese public debt (more than 50% of the outstanding JGBs) and this debt is now at a record level of 237% of GDP. To put things in context, the FED owns about 12% of US public debt (this is now 105% of GDP) and the ECB owns about 17% of Euro-area public debt (this is now 87% of GDP).



What is looking like a brewing disaster is the yen. The record issue of samurai bonds this year (yen-denominated bonds issued in Tokyo by non-japanese companies) could be the canary in a coal mine. And curiously, the recent crisis in Turkey did not activate the (fool) yen's safe-haven status.

Let's assume that interest rates globally increase. The BoJ will stick to low interest rates to keep such a high (Japanese public) debt sustainable. However, the BoJ will have to print more money to purchase more bonds and keep the market yields low. At this point, it will appear overly clear that the monetary base of Japan is hugely inflated, and this will trigger a growing outflow of foreign and domestic investors chasing higher yields. Pushing the BoJ to continue to print. The yen at this point will fall a big way down.

Eventually the BoJ will have to write its JGBs portfolio off. Inflation will be back in Japan together with growth and competitiveness. Equity will do extremely well. Bonds will go down. Japan will be left somehow poorer in dollar terms, but probably more dynamic and happier.

Maybe this is an extreme outcome, however if you want to be long yen, think twice!

Real and unreal

Here below a table with the differences between the 10-year government yield and the latest CPI, by country

	10Y yield	CPI last	Diff.
Hong Kong	2.1%	2.4%	-0.3%
China	3.6%	2.1%	1.5%
Japan	0.1%	0.7%	-0.6%
India	7.8%	4.2%	3.6%
Korea	2.5%	1.5%	1.0%
Russia	4.8%	2.5%	2.3%
Thailand	2.6%	1.5%	1.1%
Indonesia	8.0%	3.2%	4.8%
Malaysia	4.1%	0.8%	3.3%
SIngapore	2.4%	0.6%	1.8%
Taiwan	0.8%	1.7%	-0.9%
Turkey	21.2%	15.85%	5.35%
Australia	2.6%	2.1%	0.5%
Philippines	9.9%	5.8%	4.1%
Pakistan	6.8%	5.7%	1.1%
Vietnam	4.9%	4.5%	0.4%
New Zealand	2.6%	1.5%	1.1%
Italia	3.0%	1.5%	1.5%
USA	2.9%	2.9%	0.0%
Germania	0.3%	2.0%	-1.7%
UK	1.2%	2.5%	-1.3%
Francia	0.7%	2.3%	-1.6%

Steamed Turkey

Turkey's President Recep Tayyip Erdogan has steered his country through a period of extraordinary changes. During his 15 years tenure, the country's economic growth has been meteoric, lifting millions of people out of poverty. At the same time those years have seen the Islamisation of Turkey, a clampdown on civil liberties, a deterioration of its relationship with the West together with the more recent meltdown of its currency and risks of a financial crisis.

In 1994 Mr. Erdogan, a fiery orator, was elected Mayor of Istanbul. During his term he solved many of the chronic problems of the city. Water shortage, garbage disposal, traffic, air pollution, debt and corruption were effectively tackled and sorted. He set an example and won the confidence of the people.

In 1997 Turkey's secular military leaders forced the country's first Islamist prime minister, Necmettin Erbakan, to step down. Soon after Erdogan, as mayor of Istanbul, at a rally in the city of Siirt referenced a poem by the Turkish nationalist Ziya Gokalp:

The mosques are our barracks,

the domes our helmets,

the minaret our bayonets,

and the believers our soldiers.

This Islamist-leaning mayor was then seen as a threat. He was dismissed and jailed for four months for inciting religious hatred.

Erdogan emerged from prison as a different man, committed more to Western-style democracy than Islamism. With hindsight this turned out to be more a pragmatic and opportunistic approach than a change of view. Erdogan learned that it is better to be the prosecutor of the poet than the poet himself.

In 2001 Erdogan established the Justice and Development Party (AK Party) that in 2002 became the sole ruling party, winning two third of votes at the political elections.

As prime minister Erdogan implemented a number of crucial reforms. Most of those launched under the IMF umbrella, following the 2001 country crisis. Inflation, a turkey endemic malaise, was curbed. An

unprecedented number of dams, residential units, schools, roads, hospitals and power plants were constructed. These achievements were known as the "silent revolution".

Tensions between Turkey's secularist parties and Erdogan's AKP were highlighted in 2007, when attempts to elect an AKP candidate with Islamist roots to the country's presidency were blocked in parliament by an opposition boycott. Erdogan called for early parliamentary elections, and his party won a decisive victory at the polls in July.

In early 2008 parliament passed an amendment that lifted a ban on the wearing of head scarves on university campuses. Opponents of AKP renewed their charges that the party posed a threat to Turkish secular order, and Erdogan position came under scrutiny. In March the constitutional court voted by a narrow majority not to dismantle the AKP and banning Erdogan and other AKP Islamist members from political life.

In September 2010 a package of constitutional amendments championed by Erdogan was approved by a national referendum.

The package included measures to make the military more accountable to civilian courts and to increase the legislature's power to appoint judges. The Erdogan power was gradually extending, and the secular system set by Mustafa Kemal Ataturk put in jeopardy.

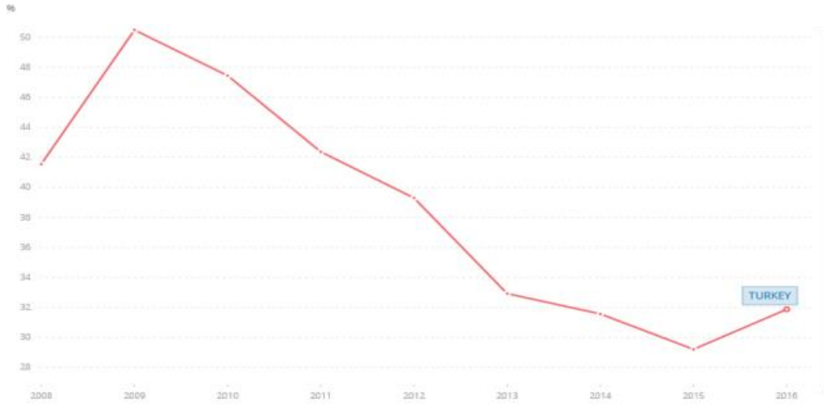
Erdogan gradually became an authoritarian leader, increasing his grip on the country. In 2013 his fraternal political ally, Egypt President Mohamed Morsi, leader of Muslim Brotherhood and a known Islamist, was overthrown by General Abdel Fattah el-Sisi. Erdogan then feared something similar could happen in Turkey. He accused the West of masterminding Morsi's removal. That year he jailed for life a numbers of senior army officials, causing a mass resignation. He also ordered the army to crash peaceful student demonstrations at Istanbul Gezi park. He also temporarily blocked the access to Twitter and YouTube. This led many acolytes to part way from Erdogan, including Fethullah Gullen, his closest and most influential ally.

Barred from being re-elected for the fourth time as prime minister by AKP internal rules, Erdogan became president in 2014. He then started to seek to expand the power of presidency.

From 2014 to May 2016, the governments prosecutors had opened 2000 cases against Turks for insulting Erdogan. Many journalists were fined or detained. From 2002 to 2016 Turkey dropped from 99th to 151th in annual ranking of freedom of press. The oppression was very much ongoing well before the coup.

These facts were nonetheless overlooked by most of the population as the economy continued to grow, the public finances improved (look at the histogram at the left-hand side) and Turkey was gaining a status as local leader.

Central government debt as a % of GDP



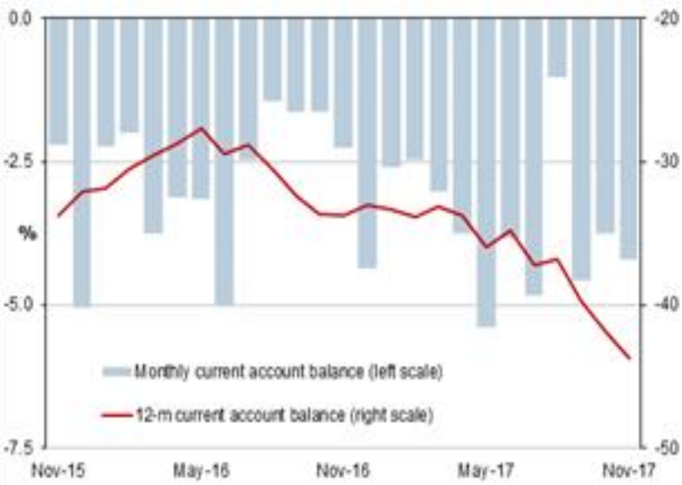
Source: Wolrd Bank Development Indicators 2017

On July 15th 2016 Erdogan was vacationing with his family while a coup was staged. He managed to escape and broadcasted a video over skype urging the people to raise against the plotters. Within few hours the coup had failed and the alleged conspirators surrendered. A massive purge ensued. Tens of thousands were arrested or dismissed from public service. Military, media, education and law were in particularly targeted, as well as Erdogan rivals and critics. Erdogan accused his on- time allied, Fethullah Gullen, to be the man behind the coup, something he denied strongly.

Many allege that Erdogan could have staged his coup himself, to gain a pretext to exterminate all opponents without mercy. The coup was in fact extremely ill-organised. Erdogan mysteriously managed to escape. The coup was staged in the late afternoon while coups are notoriously staged late in the night in order to meet less resistance from the police and the population and limit the casualties. Also, the speed and the efficiency of the purge that followed has been sided as evidence that Erdogan had prepared for the coup.

Erdogan's desire to expand the presidential powers came to fruition in April 2017 when he won a popular referendum. However, the referendum passed by a narrow majority, despite the government almost total control of the media, a great and unfair advantage granted by post-coup emergency powers.

The changes were set to be implemented after the next election cycle. Early elections were called and on June 24, 2018, Erdogan won a majority of the vote for the office of president. The early elections allowed Erdogan to benefit again of the almost complete control of the media during the political campaign and to reap the reward for the massive expansionary economic policies implemented after the coup.



Apart from limiting the democracy and gradually reinstating the Islamic country that Ataturk abolished, Erdogan has led a conflictual foreign policy versus the EU and the USA, siding with Russia and the Islam. Erdogan sees himself as the reference point for the modern Islam, stretching his power in uncharted waters.

In total disrespect of investors he flew to London before the elections and told international investor, against the basic rules of finance, that high interest rates are the cause and not the effect of high inflation. This hit the Turkish Lira. Then, after the elections, he named Minister of Finance his son-in-law, Berat Albayrat, dismissing Mehmat Simsek, the internationally well-regarded deputy PM who many times managed to keep the investors in Turkey despite Erdogan vagaries.

Turkey is now on a collision course with USA, following a spat over the release of an American pastor, Andrew Brunson, charged to be a Gullen man, and over a contested order for Russian missiles. This could lead to sanctions able to weaken further the dollar flow into the country. The more Erdogan position hardens the more the investors become skittish, leaving the currency drop and inflation accelerate.

Mehmat Simsek

Turkey current account deficit is significant as well as the corporate hard currency debt. The banking sector is solid, however a full-blown currency crisis could seriously harm it.

The USA are tired of Erdogan and his aggressive posture in dealing with neighbours and NATO allies. Turkey has become expendable for USA and NATO.

Let's now take a look at Turkey's strengths:

- Turkey is the 18th economy in the world (before Netherland and Swiss)
- It grew by 7.4% in 2017, the highest among G20 countries
- It is the 16th manufacturers in the world, before Poland, Switzerland and Netherland. In terms of manufacture per capita is ahead of China, 8 times India e two times Brasil.
- The currency has lost 2/3 in about two years, leaving it undervalued by more than 50% on PPP
- The trade deficit (5.5%) is the result of the expansionary fiscal policies adopted after the failed coup and the inflation (16%) depends greatly by the currency big drop caused by Central Bank lack of independence and Erdogan monetary and foreign policy stance
- Growth will collapse this year and with it the inflation if the currency stabilises
- Public debt to GDP is 30% and the public deficit is 1.5%

Despite Turkey many strengths, a currency crisis can be lethal for a country with significant hard currency debt. This should have been well understood by the top brass in the country. The Turkish government economic team has been for long considered the best among the emerging markets.

A full-blown currency crisis is what the market has now delivered, following the total incapacity of the Turkish Central Bank to raise interest rates, compounded by the defiance of Erdogan in front of the American ultimatum related to the release of the pastor. This led the dollar trading well above 7 Turkish liras, a level unbearable for the banks and many of the Turkish companies.

It is surprising that Erdogan is letting this happen. This scenario, if played till the end, will humiliate and deadly weaken Erdogan political position or could turn a strong and highly westernised country into a poor country, reminiscent of Pakistan. Erdogan pragmatism and experience could still help

Korean Doi-Moi

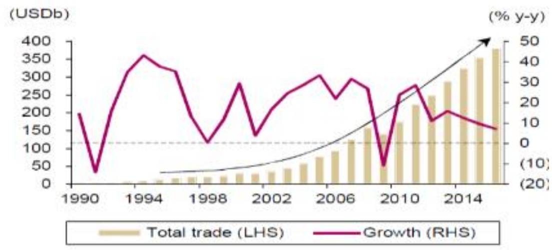
The US has urged North Korea to follow the Vietnam model of economic reform. While in Vietnam for a visit, US secretary of State Mike Pompeo said that the country can replicate the Vietnam transformation miracle: “In light of the once-unimaginable prosperity and partnership we have with Vietnam today, I have a message for Chairman Kim Jong Un: President Trump believes your country can replicate this path”.

Vietnam, like China, has embraced international investment and economic liberalisation without abandoning its one-party Communist political system and for months has been flagged as a potential model for North Korea.

The Vietnam experience, known as the Doi Moi revolution, after the leader who initiated it, is divided into three phases: the promotion of a multi-sector economic system (phase 1: 1986-1991); laying the foundations for market economy (phase 2: 1992-2005); establishing the market economy (phase 3: 2006-2010). The economic results of this reform route are remarkable: Vietnam’s GDP (Gross Domestic Product) expanded at a CAGR of 7.2% over 1990-2007; its nominal GDP hit 205.3 billion $ in 2016, 32 times larger than the 1990 figure of 6.5 billion $. The manufacturing and construction sectors climbed from 23% to 33% of GDP during the period between 1990 and 2016; an important part was played by foreign direct investment that surged 70 times.

While many are the similarities of Vietnam with North Korea there are also some differences. After 65 years of the so-called “juche” (North Korea self-

Total trade growth in Vietnam



Source: CEIC

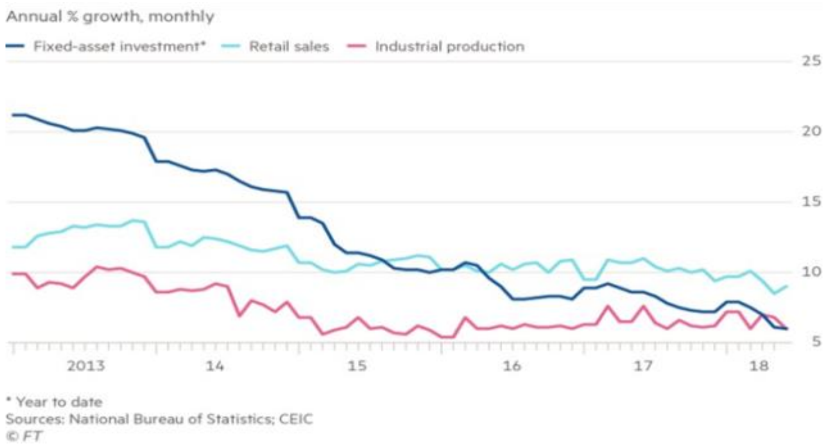
reliance ideology) the entrepreneurship in North Korea is much less than it was in Vietnam in the 80s, where collectivisation lasted just ten years. Urbanization is a further factor which must be considered: it was a powerful factor in the development of Vietnam but in North Korea 60% of the population already live in the cities. Indeed, more than 70% of the Vietnam’s workforce was in agriculture when the reform started, and this created a pool of cheap labour for the country infant industry. There exists another difference in the potential foreign investments, that represented one of the Vietnam’s boost. In fact, North Korea has in the past attracted foreign investments that were later seized. This could hamper international investors’ trust in the government and, hence, the new investments flow. Finally, North Korea population median age is already 34 while in Vietnam and China it was about 20 when the process started, and this can limit the growth trajectory.

These differences make the task tougher and all the more reason for Mr Kim to get cracking on economic reform as soon as possible.

China is getting ready for 

China's economy expanded by 6.7 per cent in the second quarter, and this was highlighted negatively by the press as its slowest pace since 2016. In reality this figure is slightly below the last 3 quarters growth rate (6.8%) and well above the government's target of "about 6.5 per cent" growth for the year, despite the impact of the (much needed) aggressive deleveraging that heavily reduced investments in infrastructures. In fact, a campaign to tackle excessive debt that began early last year, following almost a decade of heavy credit stimulus, has weighed on fixed-asset investments, a pillar of overall growth. Such spending grew only 5.5% per cent in July, a record low.

China key economic indicators



China is gradually reducing its dependency to capital formation while increasing the consumption, moving towards a developed market structure. Increases in wages as well as in resources for public health, education and welfare will support consumption growth. There is still a significant difference between China and Usa in terms of capital formation (43.5% vs 19.8% of GDP) and personal consumption (38.1% vs 68.1% of GDP).

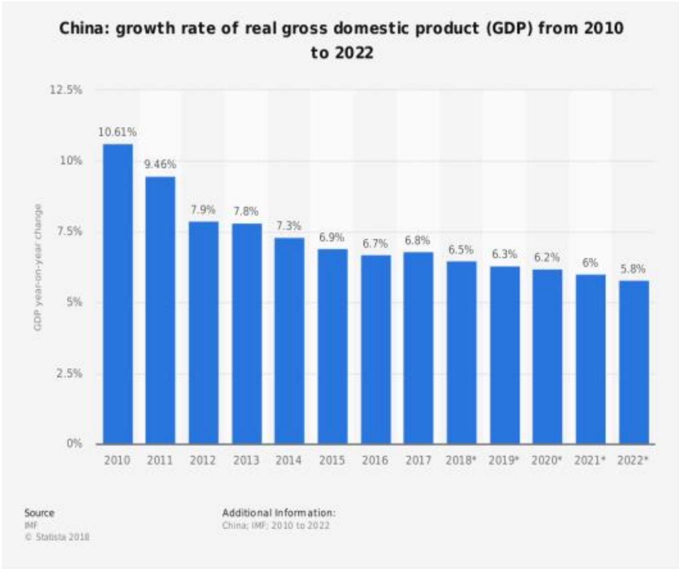
Data released at the end of the month showed that M2 money supply and overall credit growth — including bank lending and off-balance-sheet lending — both progressed at their slowest pace ever in June. The impact of new rules aimed at curbing risks from shadow banking has led to a sharp contraction in lending by non-bank institutions. Now Beijing's trade war with the US represents an additional drag to growth for 2018.

However, the politburo has released in the past few weeks a series of communiques announcing measures to support growth, from tax cuts and new infrastructures spending to actions to loose back the monetary policy and the financial regulation designed to curb shadow banking.

All in all, China is well equipped to withstand this trade spat and to continue to rebalance its economy.

In case of a rapid solution of the trade war, the expansive actions put in place by the Chinese authorities could lead to an acceleration of the economy during the last quarter and a rebound of the market.

That said, we have to remind that China gross debt is almost 3 times the GDP, doubling over the past 10 years. Most of it it is owed by corporations through the banking system. High household savings and the trust in the government help to cushion the system. However is capital control that protects China from a financial crisis. This is why it is important that China, in the medium to long term, continues to restructure its economy, reducing the gross debt and reining in the unprofitable capital investments.



Pakistan sports a former play-boy cricketer as PM

Imran Khan, a former captain of Pakistan's cricket team, and his party, Pakistan Tehreek-e-Insaf (PTI), won the political elections. Mr Khan controls now 115 seats in the National Assembly and still needs some allies in order to govern. During his life he has often surprised his detractors, showing a great capacity to adapt. In 1970 he was a mediocre cricketer who turned out to be a champion after having spent few years in Oxford. When he founded his own party, he was depicted as irrational and arrogant to go solo. He was then decried as a play-boy while he subsequently converted to conservative Islam, helping to gain the decisive rural votes.

However, the incoming government has to face a severe balance-of-payments crisis. The current-account deficit has widened and the currency is sliding. Pakistan imports three-quarters of all its energy needs. Foreign-exchange reserves cover just two months of imports. The country is now negotiating a 12bln usd IMF bailout. Previous borrowing from China to build a modern infrastructure network won't make things easier. The would-be finance minister, Mr Umar, a reform-minded and admired manager, is in charge of the negotiations. The terms of the deal will bring a populist party down to earth and will shrink the electoral promise of "Islamic welfare state".

Also in foreign policy won't be easy. Mr Khan has been critical of America and speaks of opening borders with Afghanistan. And he will have to face the generals to cut the army budget in order to finance education and health. Finally, he made irresponsible electoral promises, like to cut corruption in 90 days, that will backlash.

Radical changes in Pakistan won't come easy. Don't hold your breath.

The 3 wives of Khan indicate a gradual steer towards more conservative roots...

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Niche Asset Management Ltd

2nd floor,
17 Lennox Gardens,
London SW1X 0DB

F: +44 (0) 2074601687

info@nicheam.com

www.nicheam.com

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