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Sevens Report Alpha Webinar Transcript 8.31.17.

Good afternoon everyone, and welcome. It is 1:30, so, it is time to get started.

First of all, thank you for joining us, and thank you for your interest in *Sevens Report Alpha*. I am very excited to start these webinars.

For a guy who writes for a living, I have very consistently been told that I actually do a better job of explaining and communicating by talking than I do by writing. So, getting these webinars going is something I have long wanted to do with *Sevens Report*, and I think that combined with the additional research we are going to be producing, this is all going to provide a tremendous additional value.

I want to get started because we only have 30 minutes, which really is not that long for these things, especially with everything we are going to cover today. So, here is our typical disclaimer, the same ones we had on the previous webinar. You know, give it a read, but basically it can be summed up by saying everybody is responsible for their own decisions.

As far as goals for today's webinar, there are a couple of key things we want to touch on. At the beginning of every webinar we do going forward, I am always going to address this question, **"What do you think about markets?",** and the reason I want to address this consistently in these webinars is because this is a question I am asked all the time by not just subscribers but by people who do not subscribe to our research, just regular investors.

And I always think to myself, boy, if I were an advisor and I had a really strong answer, a succinct confident answer, that would lead to hopefully a relationship down the line that might lead to a client, or if it was a client, then it might lead to greater assets. So, that is something I am going to cover directly in these webinars going forward.

Then, obviously, the focus on the remainder of the webinar once we get past that macro portion is going to be on China and then index rebalancing, because we are lucky enough to have Brendan Ahern on with us who is the CIO of KraneShares. The KWEB name that we sent out about two weeks ago that has gotten very positive response so we reached out to Brendan. He graciously agreed to join us and talk about it and talk about China. So, we are going to use a lot of our time to get his expertise there, and then finally we are going to do Q&A because that is an important part of these webinars – being interactive and answering questions.

Looking at China specifically, we want to touch on three things:

#1 – Perceptions and reality of risks. Brendan spends a lot of time in China. It is one of those countries where I think you can only really get sort of great insight by being there. You can read as much research as you want, but being there makes the difference. So, we want to talk a little bit about that.

#2: Is China structurally under owned by investors? Some people would say no, but my research implies yes, and I have a personal story about that that surprised me in my preparation for this webinar.

#3: Finally, getting back to the index rebalance which is really at the heart of the story of KWEB. I mean, yes, it is about China, but really the catalyst for this, the reason we brought you this idea was index rebalancing, and just revisiting that indeed the numbers do not lie as far as the opportunity there.

Section One: Macro Analysis

What Do You Think About Markets?

So, we are going to start with the macro. What do you think about the market?

Well, the first thing is that it is not cheap. Even after the August volatility. If you look around at sentiment around the market, you would think that stocks pulled back 3-5%, but now especially after the rally of the last few days, we are barely down 1% off the highs. So, the market is still expensive at 17.5X 2018 S&P 500 EPS (estimated at $140/share). I got that from FactSet, but all the firms are basically around that number.

But, as we know, a market being expensive alone is not a death sentence. This market has been expensive since November of last year, frankly, and it has just kept going up.

But, that said and as you have gotten from the reports, I hope, I do believe we are near a tipping point.

I have said consistently that strong earnings growth and decent economic activity have powered stocks higher in 2017, and if you look at the earnings growth, the $131 number is the 2017 estimated EPS for the S&P 500, the $140 number is the 2018 S&P 500 EPS for 2018.

That is a $9 gap.

That equates to about 8% earnings growth year over year. Well, the S&P 500 is up a little bit more than 9%. So, that is a pretty direct representation that a lot of this rally has been driven by higher earnings.

But, as we have been talking about in the report, we are now in need of a positive catalyst to spark further earnings growth **because the marginal rate of change is starting to slow for both earnings growth and economic activity.**

So, we know the earnings growth is positive, but is it getting more positive or less positive? In the near term the market really only cares about marginal rate of change. So, even though earnings growth is still positive, if we see numbers come out in Q3 that are showing that the growth is starting to slow, then that is going to be a problem for stocks.

Looking at what could be a positive catalyst, two things, and I have been talking about it in the report.

The first is tax cuts. Tax cuts are an immediate positive if it looks like they are going to go through because by most estimates, conservative estimates frankly, that pops the 2018 EPS to $145 a share which allows the market to move higher to get to that 17.5X valuation again. That would be an immediate, you know, 3-5% rally, most likely, in the markets.

The other is economic acceleration. That rising tide, that reflation that we are looking for. Still no conclusive signs of it, but we are hoping, and we are looking for it.

The Horizon: Upcoming Events to Watch

Now, shifting gears, we now want to focus on upcoming events, or the market horizon. This is is what I call it internally.

Specifically, what is coming down the line that could cause a pullback or a breakout that could help be that tipping point that we are talking about?

I list these candidates in order of importance, not chronically.

Tax cuts. I have been consistent on this. I am going to continue to be consistent on it. There need to be signs of material progress on the framework for tax reform by mid-October. If there is not, then the chances of getting something done by the end of the year are very slim. At that point, people are going to start to worry about Q1 2018, and after Q1 2018, if it is not done by then, the chances of it getting done are low because now, as crazy as it sounds, you are into reelection season. As far as indicators to watch on taxes, it is the “Big 6,” OK. These people I talked about them in the report about 10 days ago. Treasury Secretary Mnuchin, White House Economic Advisor Gary Cohn, Paul Ryan, Mitch McConnell, Kevin Brady who is the head of the House Ways and Means Committee, and then Orrin Hatch, who is the chairman of the Senate Finance Committee.

If I see headlines where more than two of these people are mentioned in the same article, I am going to be reading that article in case it pertains to taxes and gives me some color as to whether or not they are actually making progress or there is just sort of more stagnation.

Q3 earning season: October 9th is the important date here. That is when most of the big banks report their earnings. It signals the kickoff to the Q3 earnings season. There were signs of fatigue, and we talked about them with earnings growth and positive stock reactions to earnings in Q2. Anecdotally, that implies that good earnings have already been baked into where the market is. If earnings growth loses more momentum, than this could be another October surprise, and I mean a negative one. Economic data, this is all important because of the Fed to be honest. I do not think there is going to be any great chance in the growth data over the next couple of months. You know, 2.5-3%, 2-3% GDP is probably a reasonable expectation regardless of what happens, but they key is inflation. If we see inflation numbers start to move higher and that begins tomorrow with the Jobs Report, then all of a sudden, we are going to start pricing in another December rate hike. That is not priced into stocks right now. So, that is a potential head wind that we are looking for.

Wild Card to Watch: These are what we used to call on the floor "tape bombs". If they show up out of nowhere and as we have seen a little bit here in August, they are just going to cause knee-jerk selling. Whether that is a game changer depends on what happens, but nonetheless, these are things we are sort of keeping an eye on to see if they flare up.

Government shut down/Debt ceiling. Key Dates: Government Shutdown on 9/30, Debt Ceiling 9/30 – mid-October. OK, technically I think that that ceiling is reached on 9/30, but they can do accounting trickery to push it to mid October.

North Korea, and the key here is Guam, as we have discussed. If North Korea shoots a missile at Guam, regardless of whether that missile actually hits the island, stocks will drop because that will be a significant and a severe escalation of the tensions, and then at that point we really need to pay attention. So, those are the key events in the horizon we are watching as we make this turn towards the stretcher on into the end of the year.

<u>Section 2: Guest Interview: Brendan Ahern, CIO of Krane Shares.</u>

Now I would like to bring in our guest now that we have covered the macro and introduce Brendan Ahern, CIO of KraneShares. We are very lucky to have him. I am very excited that he is here so we can get sort of from the horse's mouth some more intel on what is going on with China and this rebalance. So, Brendan, thank you very much for joining us.

Brendan Ahern (BA): Oh, no. Thank you very much for the opportunity, Tom.

Tom Essaye (TE): Absolutely. Just to give a little bit of background on you real quickly. As people can see on the slide, you have been in the ETF industry for almost 20 years with KraneShares since 2012. We had a little previous conversation in prepping for this webinar, and you told me about your travels to China and specifically with you today, Brendan, what I want to discuss is:

- The China macro worries and get really someone who has been there and their take on those risks,
- General allocation levels to China amongst investors and
- The story of index rebalancing.

So, are you ready to tackle those three?

BA: Yeah, let's have at it!

<u>China Risks: Perception Vs. Reality</u>

TE: Alright, sounds good. So, talk to me a little bit about, you know, sort of the general peripheral worries about China, and I can list things, you know, the shadow banking system, the political risks, the ghost cities, things that we see as we read them, the media, you know, the financial media, but I doubt very many people on this [webinar] have gone, and I have not been to China specifically either. Talk to me a bit about the macro outlook for China, and what is the perception versus reality?

BA: Yea, I think there are two factors, and one we have to think, Tom, one of the greatest values that you bring to your subscribers is you are not biased in any way. I am not paying you for this opportunity. You are not paying me. There is no monetary exchange.

TE: Yes.

BA: The financial media, due to the death of classified ads and paid subscriptions, has become very very dependent upon either advertisers or, as a journalist, getting paid on clicks.

When you write an article online, you literally as a journalist you get paid on how many people click it, and so you have the sensationalistic headlines.

For the financial media as a whole, they are very beholding to your advertisers, and if those advertisers care about something we are going to read about it a lot. And, if they don't, then we are not going to.

So, China has been an area where it can be hard to understand, and I think that is **where journalists sometimes very much focus on these sensationalistic headlines that are very much liability driven**.

So, you know, we read a lot about of say China's debts and GDP, and China's debts and GDP have grown over the last several years.

At the same time, I am going to introduce a new financial ratio.

It is called **bank deposit to GDP ratio**.

China's bank deposit to GDP ratio is almost as equal to its debt to GDP ratio. That means assets largely match liabilities.

<u>**So, a better measure of where China is in terms of credit is actually debt minus assets divided by GDP, and low and behold, that ratio is exactly the same as the United States of America.**</u>

So, you know, I think one, there is that overemphasis on the liabilities, and secondarily, as China grows as a part of some of these index inclusions we are going to discuss, the media views of China are going to change because their biggest advertisers are going to be owning a lot more China in the very near future.

TE: Well, yea, and to make that, I guess, sort of more concrete, if I am Vanguard, my China funds are not a huge revenue driver= but a lot of these other funds are. So, as I exert my will on, *Barron's* or the *Wall Street Journal* or the FT or CNBC through my advertising dollars, I obviously want to feature those high margin funds.

I mean you cannot blame them. It makes business sense, but it raises a good point. Is the true story being told??

You gave me this slide, and it looks at the top 10 KWEB holdings versus their US equivalents, and it is a very interesting **slide because if you look at the average growth rates, 1 year, 5 year, you know, the Chinese stocks are significantly higher than their US counterparts.** I mean, part of that is obviously because of the age of the companies to a point but also because it is of demographics. Their market is so much larger.

BA: Very, very much so, and I think, you know, today China overnight reported their PMIs. For manufacturing PMI, you had 33 economists globally gave an estimate on what they felt China's manufacturing PMI would be. Exactly 0 gave an estimate for non-manufacturing. The service PMI, despite the service sector is now 50% of China's GDP. **China is much more than just an export driven manufacturer.** Domestic consumption is alive and well, and the companies we capture in KWEB are literally the transmission engine for domestic consumption which in China when you know the Amazon model exists, you are leapfrogging over that big box retailer stage, and it is happening online.

TE: Absolutely, and it is interesting. One of the things, you know, you look at China, and you look back in history. The last few major economies to really come of age and over the last say 150 years, you can look at the English economy, the US economy, the Japanese economy, and now the Chinese economy. All of them began as export-based economies where you could buy stuff cheaply or make stuff cheaply and then sell it, but as that grew the economy, it transformed into a consumer-based economy, and we saw that in the United States in the 1900s.

You saw it in England in the 1800s and then early 1900s.

You saw it in Japan from the 50s, 60s, 70, and into the 80s and 90s, and now we are seeing the same thing happen with China.

Obviously because of some of the political structure there, it is sort of shrouded in mystery, and I think that makes people nervous, but if you look at these companies, I mean, I think it is important for people to break out a Chinese company versus China in general too.

The stocks we have on the screen right now, these top 10 KWEB holdings, these are major corporations, huge corporations, multibillion dollar corporations that are doing tons of business in China, and so it is important to make that distinction, would you agree?

BA: Oh, for sure, for sure. I mean, and these numbers were from the second quarter.

So, third quarter numbers were even better than what we are showing here, and that is #1 holding Tencent. They are famous for providing WeChat. WeChat is the facebook of the China. In Q2 they actually grew earnings 58%. It is the largest company in emerging markets today, almost $400 billion in terms of market cap.

One of the things that I love to do is show people photos of when I travel to China because of going to the Tesla dealership next to my hotel or the Apple store. I have been asked to show people. So, this is WeChat. So, WeChat, like Facebook, is social media so you can have photos of, you know, photos of you with your friends, but WeChat Wallet.

I can view more on my phone in China today than I could ever do here in the United States.

- From my phone, I can transfer money to other WeChat users.
- I can buy mutual funds. I can pay my utility bills.
- I can go dutch as to pay at a restaurant.
- I can pay my credit cards.
- That lower left, that little heart is to donate to charity.

So, in China, people do not carry around wallets anymore because you do not need a wallet or a purse when you have got a smartphone.

Are Investors Under-Allocated to China?

TE: Are investors under allocated to China?

Once I started reading into KWEB and the index rebalance, I actually looked on my IRA. I have an IRA with Schwab, and I own an emerging market ETF. **I had always assumed that I had exposure to the largest Chinese companies through this ETF, and I was wrong.**

This Schwab ETF follows the FTSE Emerging Market indices. So, when I read that I realized that my Schwab ETF does not own BABA, BIDU, WB, etc. Shame on me for not paying more attention, but I have owned this emerging market ETF for a couple of years and always just operated on the assumption that the China allocation included a lot of these ADRs, but it did not.

And, I think that raises a bigger point.

If I were to tell somebody that the second-largest economy in the world, represents just 3.3% of an all-country world index, they would look at me and be like, What?

But, that is actually accurate.

And, speaking to the opportunity, you said something to me on the pre-interview call that really caught my attention. **You said you believed there is potential here for a 1980s-like Japan equity market move where, all of a sudden all of these mutual funds had to include Japan because it had arrived, and it created this tremendous demand.**

Index Rebalance: A Powerful Tailwind.

BA: I quit another job to help be part of building this company **because I know the power of these flows**.

As much as ETFs have grown, I always say, well, how many people have read, say MSCIs global investable market indices methodology?

It is 172 pages, but it dictates how $10 trillion gets invested, and today is actually a great day to have this call, Tom, because today is a sleepy day in the summer. You and I and your fellow listeners are the only people working, I think, but today is an MSCI quarterly rebalance.

This is a minor. There are two big semiannual rebalancing.

To see how influential rebalancing can be on stocks, today at the close (*Ed Note: this was last Thursday*) look at two stocks. In the last 10 minutes of trading, just pull up on your screen DD and DOW. DD is being deleted from MSCI indices, and DOW is going in. Those two stocks. I am not saying I know if they are going up or down, but they will trade like crazy.

Another example is a South Korean company LG.

TE: The appliance maker, yea.

BA: Yep. So, they are part of this rebalance where they were deleted. LG traded in South Korea a million shares yesterday. Today, it traded 16 million shares. Symbol 032640 – check it out.

As index funds and ETFs get bigger, the flows and the effect it has, it just cannot be denied, and with China where you have this massive underinvestment, people are going to literally be forced to say, be forced to buy Schwab and Vanguard which are benchmarks, but you also mechanically are going to have to buy US-listed Chinese companies that we hold in KWEB.

TE: Hundreds of billions in capital that needs to be allocated to these shares. It is just consistent demand, and we have talked about this with subscribers on the previous webinar.

Anytime you can find an investment or a strategy that reduces or minimizes general macro risk, that is a good place to start because, you know, I sit here and do this all day and do our best, you know, to help our subscribers, but getting the macro right on a short term, you know, period is very difficult because all of a sudden North Korea wants to do something crazy or something wacky happens.

So, anytime you can minimize or reduce that macro influence, it is very positive.

We had three ways to play this.

Short Term Hedged Trade: You can buy KWEB and short VWO. I image this would be a lot of the hedge fund trades that are going on right now because you can single in on those names. You are just going to get a bigger bang from your bucks because the name is being allocated to the end shares and are just a bigger percentage of KWEB than they are of VWO.

Medium term: Buy KWEB and hold it through the transition period which lasts through June 2018. and

Longer term: Buy KWEB because there is just going to be continued allocation to these names, but then there is also a domestic growth story. I mean, imagine if you could get in at the beginning of what we saw in Japan in the 70s and 80s as far as allocations. You know, or even to the US in the 90s. I am not saying it is going to be the same thing. I am not saying it is going to be a completely smooth ride either, but the growth story is compelling, and I do not think that has been adequately explained so people can make the right decision for themselves.

BA: Thank you very much for the opportunity, Tom. Thanks again.

TE: Absolutely, and thank you everybody. The recording of this will go out here very shortly, as well as the transcript will follow and some more Q&A, and then also you can be on the outlook for your next written issue of *Sevens Report Alpha*, which will come out on Thursday.

So, a week from Thursday the 31st, and that will include two new ideas that we are very excited about to share with you. So, thank you everybody. Have a great day and have a great Labor Day weekend, and we will talk to you soon.