SANNING CAPITAL
EFFICIENCY FUND

2015 August – will the fiscal dragon stop now or blow up later?

China's centrally orchestrated credit boom of last 15 years has no parallel in the world. Total-debt-to-GDP ratio exploded from 158% in 2007 to 282% in 2014. This explosion of debt manifested itself in approximately $ 17 trillion new banking assets in contrast with only $ 4 trillion growth of nominal GDP (increase from ca. 240% to some 300% of GDP). The main consequence of the speed of growth in favor of state-favored firms is huge risk of misallocation of capital with two main consequences: 1. directing capital into politically motivated projects with low return (ghost cities), and 2. Crowding out of private investment into shadow banking with much higher interest rates.

These in turn increase the risk of borrower defaults heavily. Although exact percentage of nonperforming loans (NPLs) is unknown (official report of 1.54% cannot be realistic), estimates range from conservative 11% to more aggressive 30% (as was the case during 1997 Asian financial crisis) of all loans. This means that about 3 to 10 trillion or 30% to 100% of China's GDP is in bad debt. In relation to the stock market capitalization of $ 3.87 trillion; this is roughly 100% to 300% (in Subprime crisis the amount of bad loans was only some 7% of market capitalization). In either case, the relative size of debt, when combined with the central dilemma in the title can be catastrophic now or lead to a bigger catastrophe later.

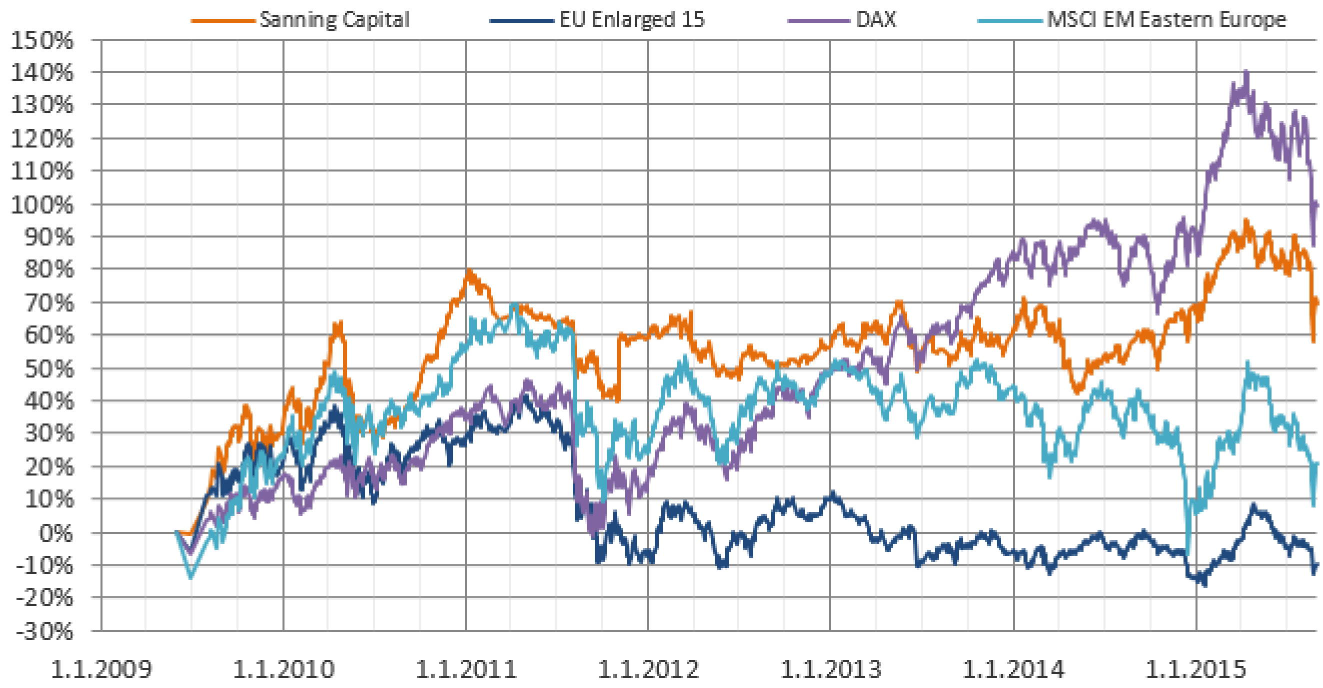
One day, China will face this impending debt burden. It cannot grow out of its debt hole as the so called "credit multiplier" tends to decrease due to growing debt. 2013 estimate puts this figure around 0.3, therefore in order to grow 7%, as stubbornly declared by Chinese government, 20% growth of credit would be necessary. In that case total debt would grow to $35 trillion by 2018 (350% of GDP). The country has two ways of dealing with situation: It either restrains its lending policy and severely undercuts its growth target (few percentage points p.a.) or continues to kick the can down the road by issuing new debt thus increasing magnitude of necessary blow-up later. In the short run, economy can be propped by variety of state policies such as lowering required reserve ratio (currently at 18.5%) or benchmark interest rate (currently at 4.85), however if core problems such as top-down hierarchical approach in credit transmission system and lack of market forces are not addressed, China cannot avoid the real ''hard landing''.

According to current Chinese stock market valuation the implicit earnings growth rate for Shanghai Composite Index is around 6.4% (assuming 13.5% required rate of return) - not consistent with inevitable slowdown of debt-fueled economy.

Possible trading strategy: at this price level, i.e. approximately 38.8% from the top, we choose to stay out of the Chinese market (as we always did), but will consider shorting after a possible rebound.

This month we performed **-8.1%**. Since substantial part of our portfolio is dollar denominated we were negatively affected by EUR/USD strengthening by 1.94%. Here is the performance of the watched indices in December: **EU Enlarged** (-7.5%), **MSCI EM Eastern Europe** (-6.2%), **DAX**(-9.3%), **S&P 500**(-6.3%) and **NASDAQ** (-6.9%).

Fund vs. Indices



Fund Manager

Jan Pravda

Launch Date

2.6.09

Location

Prague

Fund Currency

EUR

Share Price

€ 1,696.86

Performance Fee

20 % HWM

Management Fee

2% p.a.

Cumulative Performance

Period	Sanning[1]	EU Enlarged[2]	MSCI EM EU[2]	DAX	S&P 500	Nasdaq
1 month	-8.1%	-7.5%	-6.2%	-9.3%	-6.3%	-6.9%
3 months	-9.6%	-12.8%	-13.3%	-10.1%	-6.4%	-5.8%
12 months	7.2%	-5.8%	-10.3%	8.3%	-1.6%	4.3%
3 years	11.8%	-11.5%	-13.3%	47.2%	40.2%	55.7%
5 years	25.1%	-24.6%	-10.3%	73.1%	87.9%	125.9%
Since inception (2.6.2009)	**69.7%**	-9.9%	20.6%	99.4%	108.8%	160.0%

Further Characteristics

Beta relative to:		Volatility [3]	**18.6%**
EU Enlarged 15	**0.28**	Alpha (vs EU15)	**0.10**
DAX	**0.24**	Sharpe ratio	**0.45**

(1) Net off management fees, gross off performance fees

(2) These two indeces presented only to illustrate performance in 2009-2014, when focused on Central Eastern Europe

(3) Annualized standard deviation since inception

SANNING CAPITAL LIMITED is an opportunity fund based on fundamental research focused on investments into publicly traded companies providing global improvements of eifficiency and/or reduction of consumption of energy, capital and time. It is funded by the managers' own capital and several private investors.

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