AS AT 30.09.2024

Market Review

Chinese equities strongly rebounded in September on the back of waves of policy announcements and positive read-outs from the Politburo meeting: onshore and offshore equities rallied by 23.1% and 23.9%, respectively. Consumer staples and consumer discretionary led the rally amid a short squeeze and retail investors' excitement, while policies relaxing home purchase restrictions in Tier 1 cities further fuelled the real estate sector's performance.

On the macroeconomic front, activity and spending data for August disappointed to varying degrees across the board: retail sales growth slowed to 2.1% YoY from 2.7% in July, and industrial production moderated to 4.5% YoY from 5.1% in July. Investment rose only slightly (thanks solely to the manufacturing sector) and investment in construction (residential and infrastructure) contracted between July and August.

The September purchasing managers' index (PMI) surveys suggest that momentum probably slowed further in September. The two manufacturing PMIs diverged again in September: the official PMI rising to 49.8 from 49.1, while the more export-oriented Caixin index dropped to 49.3 from 50.4. Notably, the breakdown of the official survey showed a pick-up in both output and new domestic orders, while the new export orders sub-index fell. The official non-manufacturing PMI edged down further to 50.0 from 50.3, driven by the decline in transport services sector.

Export growth in US dollar terms picked up to 8.7% YoY in August, with broad-based growth across major developed and emerging markets. Shipments of motor vehicles and electrical products contributed the most to export growth among the different categories. Meanwhile, imports slowed to 0.5% YoY from 7.2% in July amid sluggish domestic demand.

Broad credit growth slowed in August to 8.1%, reversing the pick-up in the previous month. The breakdown of the data showed a slowdown in bank lending growth on the back of a further moderation in both business and household borrowing.

Labour market data showed a deterioration in August. The national surveyed unemployment rate edged up further to 5.3% from 5.2% and the 31-major cities rate rose to 5.4% from 5.3%. That said, the recent pick-up may be in large part due to an influx of graduates.

Consumer price index (CPI) inflation edged up to 0.6% YoY in August due to higher food costs due to high temperatures and rainy weather, while the producer price index (PPI) slipped by 1.8% YoY.

It was probably these results that convinced the authorities to announce a new series of monetary and fiscal support measures: after a 10bp cut in the 14-day reverse repo rate, the People's Bank of China (PBoC) announced a 20bp cut in the 7-day reverse repo rate as well as a 50bp cut in the Reserve Requirement Ratio (RRR), and gave guidance on further RRR cuts in the fourth quarter and probably early next year. Following the

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financial regulators' package and the direct cash hand-outs (25 Sep) to extremely poor people ahead of the National Holiday, the Politburo also called for more support for the economy (26 Sep). The market gave this announcement credence as the latest Politburo meeting in September was unusual (normally, the Politburo discusses economic matters only at its April, July, October and December meetings) and it was headed by President Xi. In our view, the fact that the September meeting was re-purposed to focus on the economy highlighted the increasing worries among the top leadership and the urgency behind the latest stimulus push. The latest stimulus package announced by Beijing is more aggressive than the market anticipated, showing officials' determination to hit the growth target this year (5% GDP growth).

Fund Performance & Portfolio Activity

Fund Performance

The fund BNP Paribas China Equity returned +21.37% in September underperformed the benchmark by 321bps (Classic, Capitalisation share class, net of fees, NAV-to-NAV with dividends reinvested, in USD).

Main Contributors

Stock selection in industrials and financials contributed to the relative performance, along with our underweight allocation in energy and financials.

Contemporary Amperex Technology (CATL), China's largest EV battery manufacturer, ended the month as a top contributor. Despite slowing EV demand overseas, the company's utilization bottomed in H1 and Q2 results demonstrated robust and stable unit profits and improving product mix. We continue to like the name as a high-quality player in global EV battery supply chain, with competitive advantages on its technology leadership and dominant market share.

Overall consumption discretionary sector recorded good performance along with the market rally. The latest stimulus package announced by the PBoC and the positive tone from Politburo have supported the market sentiment. Although the exact target of the next stimulus remains unknown, consumption sector is likely to be the first batch of beneficiaries given its importance to the market confidence and to the economy growth. Among our holdings, Meituan, PDD, and Trip.com all recorded good performance in September.

Main Detractors

At portfolio level, stock selection in information technology and consumer discretionary mainly detracted from the relative performance.

What we see in China between 24-30 September is a short squeeze on the whole China asset class, by nature of which every sector is up especially the weaker ones (e.g consumer durables, food and beverage, property and areas where China is getting paramount pressure). Where we gained previously by holding less of the deteriorating companies become a drag over the last week, whereas our steady winners and non- internet

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related technology positions are less sensitive in this bounce as they have been relatively immune to the cyclical downturn and have been performing. Within our holdings, ICBC Bank, China Yangtze Power and China Petroleum & Chemical were amongst the top detractors.

Taiwanese equities posted limited gains in September amid foreign outflows and global investors switching back to add China exposure. Taiwan Semiconductor Manufacturing Company (TSMC), our active bet in Taiwan semis, was the top detractor in September. TSMC is the largest Integrated Circuit foundry in the world with over 50% market share and it is the only company that can fabricate chips using the most advanced technology at high volume production. As the only foundry that can manufacture leading edge nodes (such as 3nm and 5nm) at scale, TSMC is set to consolidate its market share further with customers migrating upward to newer technologies. The boom in Generative AI is pushing Cloud Service Providers to spend more on data centre infrastructure (e.g. GPU). TSMC, a key enabler, is well positioned to gain from this structural growth. What's more, cyclical growth drivers will also contribute given a bottoming of inventory levels. Despite near-term underperformance versus the onshore Chinese players, we remain confident in the name as the investment thesis of solid revenue growth combined with margin expansion is gaining increasing visibility, while valuation is yet attractive at current price level.

Portfolio Activity

We fully exited from Kweichow Moutai over the month.

Fund Outlook and Positioning

Overall, the latest stimulus package announced by Beijing is more aggressive than anticipated, showing officials' determination to hit their 5% GDP growth target this year. Going forward, additional monetary, fiscal, and structural reform policy supports will be key to turning the market rebound from a short-term pop-up to a more sustainable rally. While the economic recovery is likely to remain patchy and uneven, high- quality development and market-based reforms are key for China to maintain sustainable growth in the longer run. Chinese equities, with undemanding valuations, may also benefit from a global re-allocation of fund flows and its low correlation with the rest of the Asian and DM indices.

For the key areas where we think policy is urgently needed to lift economic growth – property and fiscal – the announcements at the end of September slightly underwhelmed. Monetary easing by itself may not be sufficient to resolve the fundamental issues faced by Chinese economy. The market needs a '1-2-3 punch' (with current monetary easing as the first action) followed up by big fiscal stimulus, and more importantly structural reform to sustain the rally rather than it being a short-term trade. The takeaway from the September Politburo meeting gives some hope of the second punch in terms of stronger fiscal stimulus. We believe additional fiscal stimulus is likely, i.e. a mid-year budget adjustment and/or additional government bond issuance. However, timing-wise, the policymaker may save some ammunition until after the US election just in case the worst case scenario emerges.

China is going through a structural transformation. To boost future economic growth, officials have called for

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state-led investment to stimulate private investment and to support the new initiatives such as 'new quality productive forces'. Structural transformation is renewing investment growth in innovation and upgrades in the industry value chain. The new infrastructure sector (e.g., IT, artificial intelligence, data hub, hard tech development, environmental projects, electric vehicles, transport, etc.) are likely to benefit more than traditional infrastructure from future investment growth. We expect to see increasing opportunities to pick up fundamentally solid long-term market winners at more reasonable valuations.

Risk prevention remains near the top of the policy agenda, with a particular focus on stabilising the property sector. Insufficient domestic demand, pressures on private firms and a more complex external environment are hidden risks in key areas. Local government spending and property inventory purchases have been held back in 2024 mainly by overly stringent rules rather than a lack of funding. It's important for Beijing to provide a pathway forward with better execution plans (e.g. more and cheaper financing support from central government, lower returns requirement etc). Resolving these structural issues requires decisive, forceful and predictable policies. Looking ahead, the regulatory environment is stabilising in China (compared to 2020-2021), with Beijing reiterating its focus on taking a pro-growth and pro-business policy stance.

We believe China's relationship with the US will remain challenging in 2024 and beyond, with geopolitical risks remaining high as both economies increasingly see each other as competitors. In some areas where both parties have common interests worth compromising on, we are seeing progress. However, risks remain, especially in specific areas such as semiconductors, AI development and sectors chosen as China's new growth engines. Over recent years, western multinational companies have been diversifying their supply chain to southeast Asia and India to mitigate Sino-US trade tensions. That said, the diversification and/or relocation of supply chains is a slow process, given China's scale, capacity and efficiency as well as its strong manufacturing ecosystem. This can be seen from the increased market share of China's global exports in the past few years despite tariffs, as well as from the increased intra-regional trade between China and other Asian countries.

From an investment perspective, the stimulus (and the expectation of more of it) will support valuations, but the economy and corporate earnings could remain weak for some time. The government's support clearly reduces the chance of the downside risk scenario and is setting the ground for a tactical recovery. The extent of a sustainable recovery will hinge on many factors, notably earnings delivery. We believe the risk-reward is turning more positive even though China is not fully out of the woods yet. Re-rating prompts a shift in investor focus towards individual company fundamentals. This may result in a greater divergence in stock performance. Year-to-date at the portfolio level, we have taken macroeconomic top-down and cyclical factors into greater account to select steady growth companies with an attractive dividend. We have also reduced our exposure to companies which are more sensitive to geopolitical risks while increasing the number of holdings in sectors/themes in which we still see long-term growth potential for the purpose of diversification. We continue to focus on our bottom-up stock-picking process, identifying the highest-quality growth companies with sound or improving environmental, social and governance (ESG) profiles.

Modest valuations, light investor positioning, good fundamentals and structural long-term growth opportunities should help Chinese assets withstand near-term volatility. We believe China's equity markets are increasingly led more by structural growth factors than cyclical factors. The loss of public confidence is a

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key issue which has been dragging the recovery of domestic economy in China over the last two years. The market needs to see the leadership's determination to priorities growth again ahead of other priorities to gain confidence for future and to revive the 'animal spirit'. Long-term recovery depends on the extent of government support and reform. Looking ahead, privately-owned enterprises (POEs), innovation and industrial upgrading companies are favoured under Beijing's structural reform tactics. Our China equities team identifies investment opportunities in the themes that are well positioned to benefit from structural changes: 1) innovation; 2) industrial upgrade; and 3) lifestyle change. These themes are the guiding stars in our long-term portfolio strategy.

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DISCLAIMER

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