AS AT 28.06.2024

Market Review

Chinese equities underperformed their Emerging Markets (EM) Asia peers post the April-May rally, with offshore and onshore equities ending the month down, at - 1.9% and -3.6%, respectively. Year-to-date, offshore equities (+4.7%) have held up better than their onshore peers (-3.3%). From a sector perspective, utilities and telecommunications held up relatively well in June amid continued strength of yield plays given declining yield-to- maturity of long-term central government bonds. On the macroeconomic front, hard data showed a slight slowdown in economic growth in May with clear divergences across the economy. The rebound in retail sales (which accelerated to 3.7% YoY in May from 2.3%) was the bright spot, but the rest of the economy appeared to weaken. Industrial production (IP) slowed to 5.6% in May from 6.7% in April as infrastructure growth moderated and the property contraction deepened. The Governor of the People's Bank of China (PBoC) reiterated in June his commitment to supportive monetary policies. While June may have appeared to be a transition month, additional fiscal and monetary measures could follow the Politburo meeting or the third Plenum, both scheduled for July. China announced late in June negotiations with the European Union over the EU's proposed additional tariffs on Chinese electric vehicles due to enter into force on 4 July.

Purchasing Managers Index (PMI) surveys were mixed in June: The official manufacturing index stayed at 49.5 in June while the Caixin manufacturing PMI edged up to 51.8 from 51.7. The breakdown of the official index showed a deterioration in production and new domestic orders that was offset by a rise in the inventories and expectations components. The official non-manufacturing PMI fell to 50.5 from 51.1, with easing in both construction and service activity. However, some of the deterioration in these surveys may be associated with temporary disruptions caused by heavy rain in parts of China last month and the manufacturing surveys could also be weighed down by sentiment effects caused by rising trade frictions.

Exports in US dollar terms surprised to the upside in May, accelerating to 7.6% YoY. In product terms, the pick-up was broad based, with exports of furniture, toys and plastic goods being the exceptions. By contrast, import growth slowed to 1.8% YoY in May, underperforming expectations. The breakdown of the data in volume terms showed the latest decline was driven mainly by a slowdown in energy imports. Other categories, in particular industrial metals, performed better.

Consumer price index (CPI) inflation eased modestly to 0.2% YoY in June driven by a slight deepening in food price decline, while producer price index (PPI) deflation improved to -0.8% from -1.4% in May.

Labour market conditions remained strong, with the national surveyed unemployment rate stable at 5.0% and the 31-major cities rate falling to 4.9% from 5.0%. Labour market conditions remained strong, with the national surveyed unemployment rate stable at 5.0% and the 31-major cities rate falling to 4.9% from 5.0%.

Fund Performance & Portfolio Activity

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Fund Performance

The fund BNP Paribas China Equity detracted by -1.83% in June outperformed the benchmark by 53bps (Classic, Capitalisation share class, net of fees, NAV-to-NAV with dividends reinvested, in USD).

Main Contributors

Stock selection in information technology, consumer discretionary and communication services mainly contributed to the relative performance. Our underweight in consumer staples and real estate also paid off.

Within our holdings, China Yangtze Power, the largest hydropower generation company in China, was among the top contributors in June. The stock recorded good performance amid continued strength of yield plays given declining yield-to-maturity of long-term central government bonds. China Yangtze Power is a defensive name in our portfolio to navigate near-term volatility within Chinese equities while remain positioned in China's long-term structural growth drivers. Fundamentally, we like Yangtze Power for its attractive dividend yield and expect it to benefit from SOE reforms and deliver steady growth in the long term.

AI infrastructure names continued to be the bright spot within the information technology space. Within our portfolio, Taiwan Semiconductor Manufacturing Company (TSMC), Yageo Corporation, Delta Electronics and Zhongji Innolight (Innolight) were all the top contributors to excess return over the month.

Innolight, listed in China onshore market, is mainly engaged in producing high-end optical communication transceiver module. It is one of the earliest suppliers to ramp up 800G optical transceiver shipments and has become a major supplier of 800G transceivers to Nvidia and Google. The stock had a nice rally over the month amid optimism around Artificial Intelligence (AI). Within the AI-related supply chain, we believe Innolight is well positioned to capture the global AI demand from both volume and ASP uplift. Going forward, we expect Innolight to be the key networking equipment enabler to the growing AI training and inference demand with early mover advantage.

Main Detractors

Stock selection in financials, industrials and consumer staples slightly detracted from the relative performance.

Yifeng Pharmacy Chain (Yifeng), a leading pharmacy chain in China, was the top detractor in June. The bio-pharma sector got beaten down on the news that National Healthcare Security Administration recently launched an online price comparison system across designated retail pharmacies, which triggered concerns around the sector's margin pressure. In our view, the pullback provided a good entry point as the policy will bring limited impacts on Yifeng's revenue whilst its investment thesis remains on track with recent policy drivers further accelerating industry consolidation. In our opinion, Yifeng, as an industry leader, is well positioned to outperform the broader retail pharmacy space with scale and quality advantages and has indeed continuously growing its market share over the past a few years. We took the chance to slightly top up our position in June and will continue monitoring the sector.

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Portfolio Activity

We did not make any major changes to the portfolio over the month. In terms of portfolio activities, we trimmed our positions in Kweichow Moutai and topped up in steady growth names including Yifeng Pharmacy Chain and Industrial and Commercial Bank of China.

Fund Outlook and Positioning

Market sentiment towards Chinese equities has started to recover, backed by a more encouraging outlook and more supportive economic policies. In the near term, the authorities' policy focus is shifting to the implementation of existing easing measures to tackle the cyclical issue of an uneven and patchy recovery. In terms of a long-term growth strategy, policymakers are emphasising a commitment to the importance of reforms to boost productivity, economic growth and China's path to modernisation. While the structural issues (i.e. local government debt, property sector woes) are still works in progress, China has the tools to manoeuvre and be more proactive in managing the risk. Chinese equities, deeply discounted, may also benefit from a global re-allocation of fund flows.

Policy support is likely to be stepped up in the coming months, with front-loaded fiscal support doing much of the heavy lifting, backed by monetary easing. On the fiscal policy side, the main tools include front-loading support via early issuance of special CGBs (central government bonds) and accelerating the issuance of special LGBs (local government bonds). On the monetary policy front, China's central bank also has more leeway for further liquidity stimulus, such as further policy rate and RRR (reserve requirement ratio) cuts, compared to developed markets and the other emerging economies.

To boost future economic growth, officials have called for 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 high-value-added manufacturing 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. Resolving these structural issues requires decisive, forceful and predictable policies. Looking ahead, in our view, 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 other new technology. Over recent

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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.

For 2024, we believe the risk-reward is turning more positive even though China is not fully out of the woods yet. Re-rating prompts investor focus to shift towards individual company fundamentals. This shift may result in a greater divergence in stock performance. At the portfolio level, while 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, we are also taking macroeconomic top-down and cyclical factors into greater account to help us select the better-performing companies in relative terms. We prefer companies that are likely to benefit from policy moves and domestically focused names and avoid those that are subject to higher geopolitical risk.

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. Our China equities team identifies investment opportunities in the themes that are well positioned to benefit from structural changes: 1) technology & green innovation; 2) consumption; and 3) industry consolidation. These themes are the guiding stars in our long-term portfolio strategy.

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