China Allocation Opportunity

As of July 31, 2024, monthly performance commentary and review

Performance Review

The strategy performance was negative for the month of July. MSCI China slipped 1.3% while MSCI China A onshore (in USD terms) rose 0.6%. JACI China investment grade bonds ticked up 1.2% and JACI China high yield bonds rose by 1.8%. Barclays China Agg (in USD terms) was up 1.3%.

Fixed income contributed to performance this month and equity was the main detractor. Tactical asset allocation was slightly negative, driven by our offshore equities allocation and tactical equity allocation in Taiwan while our overall credit exposure, the stepped up allocation to high yield and long duration position, contributed positively. Our underlying equity manager underperformed its own benchmark in July, driven by detractions from stock selection in healthcare and overweight in consumer staples, which was partly offset by contributions from overweight in healthcare. Our underlying fixed income manager outperformed in both high yield and investment grade sleeves against their own respective benchmarks. Positive attributions in the high yield bucket were driven by issue selection in real estate and overweight in consumer, slightly offset by underweight in financials. Within the investment grade sleeve, overweight in financial and real estate contributed, slightly offset by underweight in quasi-sovereign. In terms of onshore rates selection, our underlying manager marginally underperformed its own benchmark, driven by duration management and underweight in China government bonds (CGBs).

Market Review

Global equities managed to end the month of July higher yet again, making it eight of the last nine calendar months that equities have provided positive returns. That said, there was considerable volatility with a drawdown of almost 5% in the S&P 500 in the middle of the month, and a marked change of sectoral leadership away from expensive tech stocks to some of the cheaper parts of the equity complex. Lower U.S. inflation readings and some slowing labor market data generated optimism regarding a soft landing, and pushed bond yields to move considerably lower as fixed incomes returns were also positive globally.

While Chinese equities gave back some of this year's gains, credit rose in July. Chinese policymakers continued to take modest steps to address stubbornly sluggish growth. In response to the Q2 gross domestic production (GDP) miss (0.7% quarter-on-quarter (q/q) vs expectations of 0.9%), the People's Bank of China (PBOC) unexpectedly lowered the 1-year medium-term lending facility (MLF) rate by 20 basis points (bps) – a dovish surprise to the market. The Third Plenum focused on the authorities' goals of high-quality development through investments in technology, the green transition and education. To contain the left-tail risks, the leadership pledged to control risks in the property and committed themselves to achieve the full-year 5% GDP target. In the meantime, Chinese purchasing managers' index (PMIs) remained soft through July as the national composite PMI marked a new low for the year, showing little signs of an imminent pickup in growth.

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Outlook & Strategy

The 2Q2024 GDP growth for China came in at 4.7% year-on-year (yoy), softer than expectations. A sharp deceleration of consumption was the main culprit as June retail sales growth missed estimates, clocking in at 2.0%, a significant slowdown from the 3.7% increase in May. The supply side held up better, with strong export growth being up 8.6% YoY, as escalating geopolitical tensions with the US and Europe resulted in front-loading orders ahead of expected tariffs. China saw a poor start in the third quarter due to weak domestic demand, with National Bureau of Statistics (NBS) Manufacturing PMI and Caixin manufacturing PMI both falling in July. Mixed data is keeping alive calls for further government stimulus.

The Third Plenum of the 20th Chinese Communist Party (CCP) Central Committee concluded July 18. Expectations were downplayed going into the Third Plenum and the post-Plenum document has not surprised, being generally in line with the market's muted expectations. While no major policy initiatives to address the country's near-term growth challenges were announced, leadership has pledged to "unswervingly achieve the full-year growth target" and "proactively expand domestic demand".

After keeping its MLF unchanged earlier in July, the PBOC surprised market just days later with an unscheduled cut by 20 basis points. The MLF cut came on the heels of unexpected reductions in other PBOC rates, including the 7-day reverse repo rate and loan prime rates. These rate cuts are signaling intent to boost growth amid the Third Plenum's call for achieving this year's growth target of 5%.

In terms of cross-asset positioning, we are shifting more risk towards credit, in particular high yield (HY), for diversification at the expense of equity. We have moderated active and total risk in anticipation of higher volatility amid policy and geopolitical uncertainty as we move closer to the US election. Within equities, we have adjusted our exposures by trimming equity risk, particularly in the semi & Information Technology (IT) sectors, and consolidating our high dividend holdings. We continued to have conviction in Artificial Intelligence (AI) and high income themes. Over the month of July, we took profit in Taiwan and trimmed our equity allocation amid recent market volatility.

To evolve the AI thematic play, we dived deeper into the concept and decided to focus on and added to our position in AI-beneficiaries across up-, mid-, and downstream, particularly industry players powering the whole AI supply chain to broaden our existing AI thematic exposures. Within fixed income, we remain more constructive on and further added to China HY in July, recognizing that sharp and broad-based market rallies hereon are likely led by property, and see HY as a better way to capture this relative to property equities. We had a reasonable exposure to government bonds for diversification benefits. In foreign exchange, we retain our short CNHUSD position, fully hedging onshore government bonds exposure.

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