China Allocation Opportunity

As of June 28, 2024, monthly performance commentary and review

Performance Review

The strategy performance was positive for the month of June. MSCI China slipped 1.9% while MSCI China A onshore (in USD terms) fell 3.6%. JACI China investment grade bonds ticked up 1% and JACI China high yield bonds rose by 1.4%. Barclays China Agg (in USD terms) ticked up 0.6%.

Fixed income contributed the most to performance this month, slightly offset by detractions from equity. Tactical asset allocation was positive this month, driven by our tactical equity allocation in Taiwan, preference for offshore equities, and defensive equity income theme. Contributions were slightly offset by our absolute exposure to equities. Our underlying equity manager outperformed its own benchmark in June, driven by stock selection and overweight in communication services, which was slightly offset by overweight in consumer staples. Our underlying fixed income manager outperformed in the high yield sleeve but underperformed in the investment grade sleeve, both against their own respective benchmarks. Positive attributions in the high yield bucket were driven by issue selection in real estate and overweight in consumer, though slightly offset by underweight in financial. Within the investment grade sleeve, underweight in quasi-sovereign and oil & gas detracted, offset slightly by overweight in financial. In terms of onshore rates selection, our underlying manager marginally outperformed its own benchmark, driven by duration management and underweight in Chinese Government Bonds (CGBs).

Market Review

Macro data published in May generally supported the outlook for a US soft landing and has lifted both global Encouraging inflation prints in the US and the ongoing AI theme lifted up global stocks in June. The SPX made new all-time highs before pulling back slightly to end the month up 3.6%. Technology stocks continued to lead the market higher. Nasdaq was up strongly by 6%. European stocks underperformed driven by the ongoing uncertainties around the French election. US Treasury yields ended the month with 10 bps lower vs last month, depressed by the lower inflation readings and relatively disappointing economic data.

While Chinese equities gave back some of this year's gains, credit rose in June. Chinese growth data showed slightly stronger industrial growth, with IP growth at 6% year on year, but activity continues to look unbalanced as retail sales growth still looked anemic at 3% year on year. Deflationary pressures persisted. Excess supply plus higher tariffs continued to pressure margins for Chinese manufacturers. In June, it was reported that prime minister Li Qiang presided over a State Council meeting regarding a report on the property market and the efficacy of implementation of recent measures, such as the destocking of existing inventories. While this highlights the high-profile attention on the ongoing challenges in the sector, there were few new take-aways on potential policy measures going forward. The Third Plenum of the 20th Party Congress will be held from 15-18 July and it set to lay out the vision for policy-direction over the next 5-10 year period. The Third Plenum usually provides longer-term directionality on economic issues, and are less likely to provide short-term solutions, i.e. to the ailing real estate sector.

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UBS

Outlook & Strategy

The May activity data showed a reversal of the April trend, confirming the distortions from the shifting Labor Day holiday timing. May retail sales increased by 3.7% year-on-year (YoY), showing some improvement after prior months' setbacks, while industrial production and FAI missed estimates. But taking the averages of April and May data, industrial production was growing steadily at a ~6% YoY pace while retail sales was soft at ~3% YoY growth, pointing to an unbalanced growth outlook between upstream manufacturing and downstream demand.

The European Council hiked tariffs of Chinese-made electric vehicles (EVs) to between 17.4% to 38.1%, depending on the car makers' cooperation. On average, the new all-in tariffs ended up being around 33%, slightly higher than the market expectation of 20-30%. Shipping fees subsequently spiked and exports beat expectations (7.6% vs 5.7% estimate), likely partially driven by the front-loading of demand ahead of the tariff increases.

The Third Plenum of the 20th Communist Party of China Central Committee, held every five years, will take place in mid-July. Key structural reforms are usually announced and this time, the focus is likely on encouraging technology innovation and improving social welfare programs. A major investor concern is if the meeting would hike consumption tax to improve local governments' fiscal conditions. We think such likelihood is low given the soft domestic consumption sentiment.

In terms of cross-asset positioning, the positive earnings revision trend alongside evidence of continued active policy kept us engaged with risk in June despite a challenging macro backdrop. Considering the relative attractiveness, we have slightly added to Credit, high yield (HY) in particular, at the expense of equity as we expect the market to be more volatile as we move closer to the US election in 2H 2024 while maintaining overall portfolio risk. Within equities, we continued to have conviction in artificial intelligence (AI) and high income themes. While broadly maintaining our overall equity exposures, we sharpened our barbell approach through adding to high beta AI and tech thematic play on growth potential and high income and state-owned enterprise equities for defensiveness. Our AI thematic equity exposures contributed positively year-to-date. To evolve the AI thematic play, we dived deeper into the concept and decided to focus on and initiated a modest 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, while we maintained the overall exposures to investment grade, we turned more constructive on and added to China HY, 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 retained a reasonable exposure to government bonds for diversification benefits. In foreign exchange, we retain our short Chinese yuan against US dollar (CNHUSD) position, fully hedging onshore government bonds exposure.

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