China Allocation Opportunity

As of September 30, 2024, monthly performance commentary and review

Performance Review

The strategy returned positively for the month of September. MSCI China gained 23.9% while MSCI China A onshore (in United States Dollar (USD) terms) was up 23.1%. Hang Seng Tech returned 33.5%. JACI China investment grade bonds ticked up 1.0% and JACI China high yield bonds slipped 2.2%. Barclays China Agg (in USD terms) was up 1.3%.

Equities contributed the most to performance this month followed by fixed income. Tactical asset allocation was positive this month, with top contributors being our absolute overweight in equities and our conviction in offshore technology. This was slightly offset by allocation in Taiwan, together with the onshore tilted, high income theme and power Artificial Intelligence (AI) theme across Asia.

Our underlying equity manager underperformed its own benchmark in September, driven by detractions from stock selection in communication services and underweight in consumer discretionary. This were partially offset by contributions from overweight in consumer staples, along with underweight in energy and financials.

Our underlying fixed income manager outperformed in both high yield and investment grade sleeves against their own respective benchmarks. Key contributions in the high yield bucket were driven by the issue selection in real estate, overweight in consumer and Technology, Media, and Telecom (TMT), partially offset by the underweight in financial. Within the investment grade sleeve, the overweight in real estate, TMT and financial contributed to overall performance, which was slightly offset by detraction from underweight in quasi-sovereign. In terms of onshore rates selection, our underlying manager outperformed its own benchmark in September as well.

Market Review

The market's narrative shifted back to "soft landing" in September as a substantial shift in the Fed's reaction function and a 50bps rate cut cleared the way for easier financial conditions to stabilize the labor market. Global stocks rose to a new all-time high, with United States (US) tech and cyclical sectors in the lead. Meanwhile, fixed income generally benefited from the unfolding global monetary easing cycle. The US dollar depreciated against almost all other major currencies, driven by Fed cuts and China stimulus.

In contrast with sluggish fundamentals, Chinese equities strongly rebounded following recent policy announcement. China's Consumer Price Index (CPI) and Producer Price Index (PPI) both surprised to the downside. Non-food CPI rose only 0.2% Year-on-Year (YoY) and was down 0.2% (Month-on-Month) MoM, while producer prices fell 1.8% YoY. Imports also showed no growth. Data generally reflected a broad-based weakening in industrial and consumer demand. A former People's Bank of China (PBoC) Governor acknowledged China's deflationary pressure, saying that the Gross Domestic Product (GDP) deflator has been negative for the past five quarters.

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UBS

Just a week after the Fed opened the door, the PBoC walked through by easing its own policy stance, reaffirming the 'put' on the stock market and economy. It introduced a Rmb 300 billion re-lending program to support corporate buybacks. With the dividend payout ratio of CSI 300 companies around 3%, this gives enough financial incentives for firms to buy back shares and for major shareholders to increase their holdings. The government also announced a Rmb 500 billion asset swap facility that can be tapped by funds, asset managers and insurance companies to invest in Chinese equities. Policymakers are willing to increase central government's leverage, offering economic incentives for different market participants to participate in the stock market. This commitment mitigates some tail risks in the equity market.

The Chinese government held its first unscheduled Politburo meeting since COVID. Their urgency underscores the need to revive the economy. Compared to the last Politburo communication, the most recent statement is much more condensed with a specific focus on achieving the GDP growth target, stopping further property market declines, enhancing employment and consumption, as well as boosting capital markets. There was no discussion of moral hazard, deleveraging and local government debt concerns. This reads as the government recognizing the potential for growing social instability and a break the glass moment to do what they've needed to do—which is to directly boost private sector confidence. Reuters reported that there will be 2 trillion Chinese Yuan (CNY) of special sovereign bonds this year split between consumption and local governments. This is the first time the Chinese government is directly targeting consumer spending in a serious way.

Outlook & Strategy

Chinese equities, both onshore (CSI 300) and offshore (MSCI China), saw a strong rebound of 20%+, marking the best weekly return since the Global Financial Crisis. The year-to-date rally in Chinese offshore equities now even surpassed stellar US stock performance. Sectors dependent on Chinese growth, such as European luxury, mining and China-exposed US stocks also saw large gains in the last week of September. We think spillover to global assets beyond Chinese equities are limited. While we expect some modestly positive sentiment in commodities and commodity currencies, but more China stimulus is necessary for this to be a sustainable driver. We express China stimulus optimism via long onshore and offshore Chinese equities, and we think the spillover trades may only meaningfully work if stimulus announcements are significantly larger than the reported amount.

The government's intention to supporting the stimulus remains strong. The coordinated approach to distributing the stimulus across various sectors, including fiscal, monetary, equity market, property and banks, underscores the government's determination to uphold market confidence. There is no intention to diminish the confidence at this time and the market is expected to remain on its current trajectory.

There are questions of implementation, effectiveness, and 'will it be enough' to improve confidence and shake the deflationary mindset. We likely won't know the full effects for months, but the market doesn't necessarily need to see an ultimate solution at this stage. Despite the sharp and quick rebound in Chinese equities, we believe Chinese equities and Emerging Market Equites should have legs, given how under allocated the market is.

The recent eruption represents the initial phase of rallies, driven by beta influence. The era of widespread investor interest in China appears to be behind us. Looking ahead, we foresee a market environment that is likely to be more volatile and discerning in its investment strategies.

In terms of cross-asset positioning, in response to the China rallies triggered by encouraging stimulus measure, we adopted quickly to dial up our risk appetite. We are cautious on how we express our risk-on stance and piling up risk in themes where we have conviction instead of adding exposures indiscriminately. We added equity exposure funded out of fixed income. Within equities, we have been favoring offshore shares over onshore since the start of the year, given the former is more linked to global investment sentiment, until recent stimulus announcement where we turned more positive towards latter as the announcement is likely to provide more tailwind to domestic shares. In terms of thematic strategy, one observation we have made recently is that there seems to be some sense of rationality returning to the market with investors being more willing to differentiate between companies with resilient and even improving fundamentals and those that continue to struggle in the challenging macro backdrop. To this end, we saw some green shoots in the China Internet sector where earnings revision and price momentum has

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turned more positive. On the back of this incremental market development, we rotated more to China Internet ahead of and after the stimulus release.

Apart from our offshore internet theme, we recalibrated expression of our high income theme, partially allocated to a Hong Kong Shareholder Return basket, which is the key benefactor to State Owned Enterprise reform and policy maker focus on enhancing shareholder return. We continued to have conviction in high income theme though prefer to have a more diversified approach. We took profit from Taiwan to fund the addition Chinese equity exposure as well. Within fixed income, we trimmed overall fixed income exposure across credits and rates to fund the equity exposure. We maintained a decent exposure to onshore government bond for portfolio construction purpose. In Foreign Exchange, we retain our short CNHUSD position, fully hedging onshore government bonds exposure. Additionally, we initiated a small position in gold as part of the hedge bucket alongside duration.

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