China Equity Opportunity

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

Global economy

Market performance through August has been solid across most asset classes. But that's masking significant intra-month volatility. A weaker-than-expected US labor market report for July caused investors to quickly price in additional Fed easing at the start of August. Falling US yields weighed on the US dollar and triggered an unwind of popular carry trades. In particular short positions in the Japanese yen were reduced, driving USDJPY below 145 for the first time since January. As a consequence, Japanese stocks experienced one of their worst days in history. Ripple effects were felt across the globe and - amid seasonally weak liquidity - the VIX temporarily spiked above 60. But the market turmoil ultimately was short lived. As more solid US data dispelled fears of an imminent recession, a swift recovery unfolded, taking global stocks back to their prior all-time high. Meanwhile, interest rates stayed around year-to-date lows as falling inflation and slowing growth suggest faster policy rate cuts than previously anticipated, especially in the US. The US dollar depreciated against all other G-10 currencies and dropped towards a 12-month low in August, but stabilized somewhat at month-end. The gold price - rising for the 7th consecutive month - reached a new all-time high above USD 2'500.

Market review

MSCI Asia ex Japan ended the month up 2% in USD terms, with Southeast Asia rising most as investor interest returned on expectations of a Fed rate cut in September. Markets took a temporary sharp dip at the beginning of August on Artificial Intelligence (AI) cautiousness partially sparked by rumours about Nvidia's product delay, and concerns about a US recession, with investors rotating from stocks that had done well. Other reasons for global market volatility was a rising tensions in the Middle East, and the Japan carry trade unwind after the Bank of Japan raised rates. Chinese equities outperformed during that period of elevated volatility but ended the month underperforming the region, as mixed economic activity data and diminished expectations for strong policy stimulus further pressured the market. By month end, all markets managed positive returns except Korea. At a sector level, Healthcare, Real Estate and Communication Services were the strongest sectors and only Materials saw negative returns.

China Market review

Chinese equities ended positively in August. Higher yields, stronger Q2 results, and a weaker DXY contributed to the better performance of offshore equities compared to onshore. Mixed economic activity data and diminished expectations for strong policy stimulus further pressured the onshore market until the last trading day when speculation about China potentially allowing homeowners to refinance US$5.4 trillion in mortgages to reduce borrowing cost provided some relief. On the economic front, macro data sent mixed signals. China's trade surplus came down from the historical high due to a slowdown in export. Fixed Asset Investment (FAI) growth slowing to 3.6% year-on-year (yoy) from January to July due to continued contraction in real estate investment and further moderation in infrastructure. Meanwhile, retail sales showed a moderate uptick compared to the previous month. From a sector perspective, Financials was the key contributor for the offshore index, while Utilities pulled back over the month.

Performance summary

August 2024

The China Opp strategy underperformed the benchmark in Aug. Stock selection in Health Care was the main drag. Stock selection in Consumer Staples was positive. On a stock level, underweight in PDD was a key contributor. Meanwhile, overweight in Kweichow Moutai and Hansoh Pharma also added value. On the other hand, Netease and TAL Education gave back some previous gains, together with CSPC Pharma were major detractors. While Netease's Q2 result slightly missed expectation and reported a decline in deferred gaming revenue, we noted that market expectation was high. We believe that the company's rich game portfolio would sustain long term growth in the future.

Key stock comments

Key contributor:

PDD <UW> (Consumer Discretionary):
Underweight in PDD added value. Share price tumbled due to the management's cautious business outlook amid intensifying competition. In addition, it said it would not be increasing shareholder returns in the next few years as the company is still in an investment phase, amid external environment challenges. Meanwhile the company's 2Q revenues growing 86% year-on-year (yoy) (slightly below expectations) while bottom line grew 125% (above expectations).

Kweichow Moutai (Consumer Staples):
Moutai fell recently alongside a fall in its wholesale price, amid weak consumer demand environment in China. E-commerce platforms looking to clear their inventory pushed prices down. Prices have stabilized as Moutai has taken measures such as ceasing supply of 12-bottle cases, direct sales through enterprise group-buy channels and squeezing speculative demand. We are reconsidering the thesis as we believe economic growth will take longer to recover and weigh on high-end consumption.

Hansoh Pharmaceutical (Health Care):
Hansoh Pharmaceutical outperformed on back of strong 1H24 results, delivering more than 20% earnings growth in 1H24, among the best within the industry. On top of it, Hansoh are positive on sales growth and sound prudently optimistic towards government policy support on drug innovation.

Key detractors:

NetEase (Communication Services):
Netease's stock fell due to Q2 results slightly missing expectations. The company reported an 11% decrease in deferred gaming revenue, with revenue from mobile games up 16%, and revenue from PC games being flat year-on-year (yoy). We believe the company's rich game portfolio should continue to grow long term with its best-in-class development capabilities. The company has been gaining market share and is expanding globally by partnering with international game studios.

CSPC Pharmaceutical (Health Care):
CSPC's stock fell on concerns about the impact of volume-based procurement (VBP) on CSPC's revenues, with weak Q2 sales from several of its oncology products. The company also expects certain delays for in-hospital sales of its new products, due to the regulatory environment in China and the anti-corruption campaign, and thus revised down its FY24 sales target for innovative products.

TAL Education (Consumer Discretionary):
TAL Education underperformed as investors took profit. The stock had risen the previous month as concerns about regulations eased after the Ministry of Education released a draft consultation opinion and did not mention rules on high school tutoring and non-academic tutoring, which appears to offer an olive branch for after-school tutoring companies. The company's hardware business has been gaining tractions and is expected to reach a threshold in the next fiscal year. With the industry led content and Artificial Intelligence (AI) enabled function, such hardware is believed to be a lucrative business with strong stickiness to end users.

Investment thesis for top holdings

Tencent
Tencent is the leading company in China's PC/mobile internet market, engaged in the provision of services such as instant messaging, online gaming, social community, news and online music. Tencent has established several powerful online service platforms and accumulated huge number of loyal customers. We believe the company is well-positioned in China Internet and will benefit from "2B" (services to businesses) business growth and game expansion to overseas markets.

Kweichow Moutai
Kweichow Moutai is the market leader in ultra-premium Baijiu (local spirit) in China. Its key drivers are its strong brand, distribution, and pricing. It enjoys double-digit growth for premium Baijiu demand in China, aided by favorable demographics for their segment and rising incomes. Moutai also has high barriers to entry, given deep linkages to local "heritage", local sourcing requirements and long maturity period for premium spirit.

NetEase
NetEase is a leading online game company in China. It has a good track record for delivering blockbuster games and has had healthy growth for more than ten years. We believe that the company continues to have a strong moat in the China gaming industry, supported by its large research and development (R&D) development capacity, streamlined process, as well as shared supporting platforms.

China Merchants Bank
China Merchants Bank has the leading retail banking franchise in China. This was built up over many years due to an early focus on the segment while large state-owned enterprise (SOE) banks were focusing on corporates. China Merchants Bank is also well positioned to benefit from China's growing wealth which would drive demand for wealth management products and financial advice could rise to become a significant contributor as the industry matures.

Alibaba
We invest in Alibaba on the back of attractive valuations, normalization of sector regulations, and an stablizing outlook on discretionary spending. We believe Alibaba's core commerce could see some stabilization with ecommerce industry recovery. On top of that, Alibaba is restructuring into six units and some are scheduled to be spun off in initial public offerings (IPOs).

Outlook and strategy

The China market has been challenging for the past few years. As China's growth normalizes, investors' confidence dents and valuations remain well below historical average. While we recognized economic recovery will take a longer time amidst structural and geopolitical concerns, lower valuations, oftentimes, sow the seeds for long-term alpha generation within Emerging Markets. In the long run, we note that China is in a different growth stage and economic environment, facing considerable challenges, but it remains on a growth trajectory with sizeable investment potential.

Put another way, slower economic growth does not mean lower stock returns. The lack of correlation can be somewhat perplexing but well-illustrated among Chinese companies. In the lower growth environment of the past few years, few companies are still able to thrive and deliver healthy gains, supported by attractive dividend yields.

China is still home to a large number of high-quality companies and remains a fertile ground for active management. Some of them have made breakthroughs in expanding their businesses overseas. These companies are no longer producing low end processing trade products or primary processed goods, but successfully competing with well-established global brands in international markets. They are adapting to the various external challenges in this volatile environment, and continue to invest in technology and R&D (research and development), control costs and grow their market share. As bottom-up investors, we continue to believe that extensive boots on the ground research is required to identify best opportunities.

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