China Equity Opportunity

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

Global economy

Encouraging inflation prints in the United States (US) and the ongoing Artificial Intelligence (AI) theme lifted up global stocks in June. The S&P 500 Index (SPX) made new all-time highs, topping 5'500 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 basis points (bps) lower vs last month, depressed by the lower inflation readings and relatively disappointing economic data.

Market review

MSCI Asia ex Japan rose 4.3% in June in US dollars (USD) terms, boosting the quarter's returns to +7.2%. Taiwan and Korea rose most in June as the tech sectors in both markets were buoyed by continued AI expectations. India also rose as investors expect policy continuity after the recent elections. Hong Kong was the weakest market with real estate sales cooling after an initial boost from removal of property curbs, coupled with lacklustre economic situation domestically and in China. Chinese equities ended negatively in June while posted positive gains in 2Q24. Mixed economic activity data and lowered expectation for strong policy stimulus sent Chinese equities lower in June. Over the quarter, Taiwan and India rose most while Indonesia fell as transition to the new government raised some uncertainties. At the sector level, Information Technology (IT) and Energy rose most in June. Over the quarter, Utilities, IT and Communication Services outperformed while Healthcare lagged most.

China Market review

Chinese equities ended negatively in June while overall posted positive gains in 2Q24. Mixed economic activity data and lowered expectation for strong policy stimulus sent Chinese equities lower in June. Defensive yield stocks were preferred amid declining yield-to-maturity of long-term China Government Bonds (CGBs). On the economic front, macro data sent mixed signals. Sluggish growth in new bank loans indicated a relatively weak private business confidence. Fixed Asset Investment (FAI) expanded by 4.2% year-on-year (yoy) from January to April, missing the market expectation as real estate investment remained weak. China National Bureau of Statistics Manufacturing Purchasing Managers Index in June stayed flat compared to May. Meanwhile, retail sales grew in May, reverting the decline trend in previous months. From a sector perspective, Utilities led gains in Q2, while Consumer Staples was the key detractor. In June, Communication Services was the best performing sector for the offshore market. Consumer Discretionary was the biggest drag on the MSCI China index, while Consumer Staples stock performance weighed on the onshore index.

Performance summary

June 2024

The China Opp strategy underperformed the benchmark in June. Stock selection was positive in Communication Services and Real Estate. However, overweight in Consumer Staple detracted value. On a stock level, Netease and China Merchants Bank, along with underweight in PDD Holdings, were key stock contributors. However, Kweichow Moutai and AIA Group were among the key detractors.

Q2 2024

The strategy was behind the benchmark in Q2 2024, mainly due to overweight in Consumer Staples and negative stock selection in Financials. Meanwhile, underweight and positive stock selection in Consumer Discretionary added value. On a stock level, underweight in Li Auto and Baidu, and also overweight in China Merchants Bank contributed positively. However, Kweichow Moutai, NetEase and SSY Group pulled back in Q2 and were key detractors.

Key stock comments (Q2 2024)

Contributors:

Li Auto (Underweight) (Consumer Discretionary):
Not holding Li Auto contributed. Li Auto's new model sale was not up to management's expectations, and the company revised down its annual sales target on the disappointing launch.

Baidu <Underweight> (Communication Services):
Not holding Baidu contributed as the stock fell on concerns over a weak outlook and lack of significant progress on AI development.

China Merchants Bank (Financials):
China Merchants Bank (CMB) outperformed as profit beats expectation for 4Q23 preliminary result. Its high dividend yield also attracted investors for defensive play during the downturn of the broad market. CMB is one of the best quality banks in China and it should be relatively resilient due to its higher-than-peers' fee income contribution to revenue.

Detractors:

Kweichow Moutai (Consumer Staples):
Kweichow Moutai fell recently alongside a fall in its wholesale price, due to weaker demand amid the lackluster economic situation. However, this does not impact Moutai's ex-factory price and there continues to be a widespread between ex-factory price and wholesale/retail price. We believe Moutai's growth outlook remains healthy, and the stock is trading at reasonable valuations.

NetEase (Communication Services):
Netease pulled back after a period of outperformance. Recent performance was dragged by lukewarm reception to its latest releases and a less certain outlook. Meanwhile, it is scheduled to launch its much-anticipated new game title this year.

SSY Group (Health Care):
SSY's share price consolidated among other Health Care companies. We do not see fundamental changes in the name. 1Q24 results saw strong revenue and profit growth with robust intravenous (IV) infusion growth

Key trades (Q2 2024)

Purchases

PDD Holdings:
Valuation is compelling despite concerns on geopolitical risks. PDD's overseas expansion efforts continue to gain traction, and the robust momentum behind their shopping app, Temu, remains sustainable.

NetEase:
We added to Netease as we believe the company will continue to be a leader in game development with a promising pipeline of new games.

Sales

Hong Kong Exchanges & Clearing (HKEx):
We took profit from HKEx amidst recent market rally. While it remains a gateway for China inbound and outbound funds, we believe that valuation looks full in the near term.

AIA Group:
While AIA Group's results showed growth in value of new business, the investigation by Insurance Authority (IA) and the Independent Commission Against Corruption (ICAC) against suspected unlicensed selling to Mainland visitors remains an overhang.

Tencent:
We decided to top slice our bet in Tencent as the stock has outperformed recently on a successful launch of its Dungeon & Fighter mobile game. It remains as a core position in the fund. Fundamentally, the company reported strong 1Q24 results with international gaming and online advertising business growth.

Investment thesis for top holdings

Tencent
Tencent is the leading company in China's personal computer/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 & 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

2024 kicked off with the China market sharply undershooting expectations and we believe that market was overly pessimistic on Chinese equities, which has played out well for our strategies. Since then, Chinese equities have rerated significantly. At this juncture, China's economic recovery is still a patchy one. As the property sector still plays an outsized role and a stabilization of new home sales is key to watch, consumption and manufacturing are also strong growth engines for the country. We believe that China is at a different growth stage, and we maintain our focus on identifying industry leaders in different industries. Furthermore, even when policy intensity has picked up, we still think that there is room for further policy support when the US economy showed signs of weaknesses and the presidential elections is looming nearer.

China is home to a large number of high-quality companies which are still under appreciated by the market. They offer attractive opportunities in light of improving shareholder returns, earnings quality and undemanding valuation. We invest in fundamentally solid companies with strong cash flow and emphasize on investor returns, including decent dividend payout and share buybacks. Some companies 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, control costs and grow their market share. As bottom-up investors, we continue to believe that Chinese equity markets hold significant opportunities for active investing.

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