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China Equity Opportunity

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

Global economy

Capital markets generally struggled in October. Investors increasingly looked forward to the US election at the beginning of November. Polls and betting odds moved in favor of a Trump victory throughout the month, increasing the prospect of a "red sweep" which was associated with tax cuts and additional trade tariffs. Implied equity market volatility rose substantially above realized volatility, indicating heightened awareness of the event risk ahead to finish the month. The S&P 500 did hit fresh all-time highs on solid earnings and economic data earlier in the month, but then reversed to finish the month down almost a percent. Global rates, led by US Treasuries, sold off amid the perceived increasing likelihood of US fiscal stimulus. In sympathy, the US dollar rose against most currencies.

Market review

MSCI Asia ex Japan index fell 4.6% over October, in USD terms. This was driven by concerns of higher-for-longer Federal Reserve (Fed) funds rates amid robust US economic data, including retail sales and employment numbers, which increased the odds of a soft landing. In addition, the possibility of a Trump election win and higher inflation looked more likely. Taiwan was the only market that saw positive returns, pulled up by a recovery of some tech names that had been oversold and amid encouraging outlook from Nvidia and AI-related demand. India fell most as earnings continued to disappoint the lofty expectations that were reflected in elevated valuations. China underperformed the region as the stimulus-induced rally faded, with focus moving from outsized expectations of the policy pivot to a wait-and-watch mode going into the Chinese National People's Congress (NPC) Standing Committee meeting, the US presidential election, and the next Federal Reserve meeting - all happening in early November. Korea also underperformed as its Information Technology (IT) sector weighed on performance, especially index heavyweight Samsung Electronics. Sector-wise, IT was the only sector with positive returns while Energy, Consumer Staples and Materials detracted most.

China Market review

China equities consolidated in range-bounded market after strong rebound earlier in the month and macro events remained the dominant market drivers. The market has been in a wait and watch mode into the Chinese NPC Standing Committee meeting, the US presidential election, as well as the next Federal Reserve meeting, which are all happening in early November. Domestically, activities indicators showed a moderate uptick. Nominal retail sales came in largely above expectations likely driven by recent trade-in subsidy policy to support consumption. Fixed investment and Industrial Production also beat market expectation. For the offshore market, Consumer Staples, Communication Services and Health Care pulled back meaningfully over the month, while Information Technology was the key contributor to index. Meanwhile, Q3 result season kicked off for A-shares equites. Generally, earnings were in line with expectations with spot of weaknesses among the consumer names. In China A market, Information Technology outperformed driven by higher hope on local government financial aids and debt restructuring. On the other hand, Consumer Staples was the key detractor giving back some gains from previous rally.

Performance summary

October 2024

The portfolio underperformed the benchmark in October. Overweight in Consumer Staples and underweight in Information Technology were the main drags on performance. Stock selection was positive in Health Care and Consumer Discretionary but was offset by negative stock selection in Financials, mainly due to underweight in large banks such as ICBC and CCB. On a stock level, overweight in Chinasoft, and underweight in Alibaba Group and Baidu were among the contributors, while major stock detractors were Kweichow Moutai, NetEase and underweight in Xiaomi Corp.

Key stock comments

Key contributor:

Alibaba <Underweight> (Consumer Discretionary):
Our underweight in Alibaba contributed as the stock corrected after the stimulus-induced rally faded. The company is raising payment and service fees, and market share appears to be stabilizing after declining for the past year and more.

Chinasoft (Information Technology):
Chinasoft saw a rebound on the back of the software localization drive and it was trading at attractive valuations.

Baidu (UW> (Communication Services):
Not holding Baidu contributed as the stock corrected after the stimulus-induced rally faded and fell on concerns over a weak outlook for advertising revenue growth.

Key detractors:

Kweichow Moutai (Consumer Staples):
Moutai fell as the stimulus-induced rally faded. Market focus remains on declining wholesale prices in the short term while Moutai looks on track for its full-year target.

Xiaomi <Underweight> (Information Technology):
Not holding Xiaomi detracted as the stock rose on its release of the new Mi 15 Series and SU7 Ultra, which are priced competitively and expected to be well received. We are not invested in Xiaomi as we are cautious about their expansion into manufacturing electric vehicles which seems beyond their core businesses of smartphones and increasingly Internet of Things (IoT) and internet services.

NetEase (Communication Services):
The stock fell as the stimulus-induced rally faded. While it has ended slightly above pre-stimulus levels, its return for the month is negative. 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.

Investment thesis for top holdings

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.

Tencent

Tencent is the leading company in China's Personal Computer (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.

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.

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).

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.

Outlook and strategy

Policymakers in Beijing has rolled out a strong and broad set of policy support measures in September, following the 50 basis points (bps) US rate cut. The comprehensive policy response beat market expectations and this policy pivot urged international investors to take a second look at investing in China. We saw health correction ahead of the few important macro events in November, including the Chinese NPC Standing Committee meeting, the US presidential election, as well as the next Federal Reserve meeting. We believe that government is putting in a backstop for the economy and set the tone for the market without creating another stock market bubble like the one from 2015.

While it is positive that the government put in a backstop for the economy and set the tone for the market, policymakers are not interested in creating another stock market bubble like the one from 2015. We expect to see a more measured and gradual approach to follow. In the long term, we are still looking forward to measures that target households, whether through social welfare spending or direct consumption support, in the country's push for a more sustainable, high-quality development focused on consumption. We would also like to see policies that target businesses and help reestablish confidence among entrepreneurs. We believe they can be more effective to put an end to the downward spiral of consumer and business sentiment than those targeting investment and infrastructure. It will inevitably take time for the various support measures to work, but at the same time we are hopeful as the policy direction is clearer now.

We had turned more constructive on Chinese equities earlier this year. When stocks were extremely undervalued, the fears among investors were not based on market fundamentals. Among our strategies, we are almost fully invested and focus on high quality companies, especially in the consumer sector and some consumer-related industries, the rally has been beneficial to our performance.

All in all, we are bottom-up investors and take a long-term view. The industry leaders we invest in are well positioned to continue to outperform their peers. 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, control costs and grow their market share. We will continue to stay discipline and invest in names that present good long-term opportunities and trade at a reasonable valuation, at the same time, we pay close attention to the ongoing policy developments for active positioning.

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