China Equity Opportunity

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

Global economy

The market's narrative shifted back to "soft landing" in September as a substantial shift in the Federal Reserve (Fed)'s reaction function and a 50 basis points (bps) rate cut cleared the way for easier financial conditions to stabilize the labor market. Global stocks rose to a new all-time high, with US tech and cyclical sectors in the lead. Meanwhile, fixed income generally benefited from the unfolding global monetary easing cycle. The big outperformer over the past month has been Chinese equities. The announcement of significant monetary and potentially fiscal stimulus measures sparked an impressive rally. Metal prices also benefited from the hope for a better Chinese growth outlook. But the oil price dropped significantly through September due to higher expected supply on the horizon. The US dollar depreciated against almost all other major currencies, driven by Fed cuts and China stimulus.

Market review

MSCI Asia ex Japan ended the month up 8.4% in USD terms, lifting the quarter to close up 10.4%, as the Fed cut rates by 50bps, more than what some market watchers had anticipated. In addition, the China government's policy pivot sparked a rally in China and Hong Kong markets. The urgency with which the broad set of supportive measures were announced starting from 24 September with follow-on announcements the following days, lifted investor sentiments. The financial authorities jointly rolled out a slew of policy measures including rate cuts to encourage more lending activities. While the cuts were in line with market expectation, the regulators introduce new lending facilities for financial institutions and company owners to fund equity purchases. Further, at an off-schedule Politburo meeting on 26 Sep, led by President Xi Jinping, the policymakers called for support to stop the housing price slump, as well as potential fiscal stimulus boosted investor confidence. Almost all markets rose in September except Korea which saw profit taking in its Information Technology sector.

At a sector level, Consumer Discretionary and Communication Services rose most in September while Energy and Information Technology fell slightly. Over the quarter, Southeast Asian names outperformed, alongside China and Hong Kong, as the Fed rate cut prompted risk-taking. The region's medium term growth outlook remains strong and Southeast Asia is viewed as a favourable investment destination for Foreign Direct Investment (FDI) flows, benefitting from the China-plus-one strategy. Meanwhile Taiwan and Korea underperformed most, as investors rotated out of the Information Technology sector on Artificial Intelligence (AI) cautiousness over AI concerns of peak pricing and the Information Technology sector recovery staying narrow and not broadening out yet to other areas such as to consumer electronics. At a sector level, Health Care, Consumer Discretionary and Real Estate rose most over the quarter while Information Technology fell.

China Market review

China equities recorded a sharp rebound in September, lifting both China A and China offshore indices to the positive territory with more than 20% gains in Q3. The financial authorities jointly rolled out a slew of policy measures including rate cuts to encourage more lending activities. While the cuts were in line with market expectation, the regulators introduce new lending facilities for financial institutions and company owners to fund equity purchases. Further, at an unexpected Politburo meeting on Sep 26 led by President Xi Jinping, the policymakers called for supports to stop the housing price slump, as well as potential fiscal stimulus boosted investor confidence. Almost all sectors recorded positive returns over the quarter, Consumer Discretionary and Health Care were the key outperforming sectors for the offshore market, while Energy underperformed.

Performance summary

September 2024

The portfolio benefited from the market optimisum but underperformed the benchmark in September. Underweight in Consumer Discretionary and stock selection in Communication Services detracted value. On the other hand, underweight in Energy contributed positively. From a stock perspective, stock contributors were not holding China Construction Bank and Bank of China and our overweight in China Jinmao. Key stock detractors were our underweight position in Alibaba Group, not holding JD.com and overweight in China Mobile.

Q3 2024

The portfolio underperformed the benchmark in Q3. Underweight in Energy and stock selection in Financials contributed positively. On the other hand, stock selection in Health Care, Communication Services and Consumer Discretionary detracted value. Key stock detractors in relative terms were our underweight in Alibaba Group and overweight in Netease and CSPC Pharmaceutical. Key stock contributors were our overweight in China Jinmao and not holding China Construction Bank and PetroChina.

Key stock comments (Q3 2024)

Contributors:

China Jinmao (Real Estate):
China Jinmao rose along with Chinese equities' rallying after the government announced a package of supportive policy measures including rate cuts, potential fiscal stimulus and a call to stem the decline of the real estate market. After opting to "kitchen-sink" last year, China Jinmao saw recovery in core profit and dividend payout.

China Construction Bank <Underweight (UW)> (Financials):
China Construction Bank lagged the overall market rally this month. Our underweight position helped relative performance. Our preferred exposure in China's banking sector is China Merchants Bank.

PetroChina <UW> (Energy):
PetroChina lagged the overall market rally this month as oil price showed weakness. Our underweight position helped relative performance.

Detractors:

NetEase (Communication Services):
Netease's stock underperformed 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 Personal Computer games being flat year-on-year. 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. The stock rallied post the Chinese government's policy pivot but underperformed in the rally.

Alibaba Group <UW> (Consumer Discretionary):
Our underweight in Alibaba detracted as the stock rallied alongside Chinese equities due to a basket of policy stimulus measures. The company is raising payment and service fees and market share appears to be stabilizing after declining for the past year and more.

CSPC Pharmaceutical Group (Health Care):
We had held CSPC Pharmaceutical for a long time as we believed valuations was attractive, and fundamentals would see potential upside. Meanwhile, we are reviewing our investment thesis on the name.

Key trades (Q3 2024)

Purchases

Midea <Hong Kong Initial Public Offering (IPO)>: Midea Group is well positioned in the China appliances market, with ability to gain market share via its strong product portfolio, leading Research & Development and development capabilities, strong distribution, and efficient supply chain. We also believe that it can continue to expand its footprint in the global appliance markt. The IPO is priced at a discount to its listing in the A-share which we think that the valuation is attractive.

PDD Holdings:
PDD delivers the highest growth among all e-commerce players in China, continues to see strong operating cash flows, and is sitting on a strong balance sheet with billions of net cash balance. We expect to PDD to execute well and grow domestically and also via its strong cross-border e-commerce marketplace, TEMU.

Sales

Ping An Insurance:
We have reduced Ping An Insurance as share price rose when government policies are aimed towards stabilizing the economy and stemming the real estate market's decline. We look to invest in other strong long term opportunities.

Meituan:
We trimmed our position in Meituan as we are assessing the potential impact to the delivery platform when restaurant owners and operators are facing challenges to remain profitable. Many restaurants were forced to cut prices and entered into a price war. We believe that this can be challenging for Meituan to sustain the take rate if the marco situation continue to deteriorate.

Kanzhun:
We reduced our exposure to Kanzhun as the recruitment market in China has cooled marginally into the second half of 2024. The job seeker to job recuiter ratio maintains at a high level which may imply a lower monetization rate going forward. Meanwhile, the Monthly Active Users (MAU) of the recruitment platform still showed healthy trend.

Additional comments

Performance summary – Year-to-Date (YTD) 2024

The portfolio underperformed the benchmark year to date ending September. Stock selection was negative in Financials, while overweight in Consumer Staples also dragged on the performance. However, stock selection was positive in Consumer Staples. Underweight in Information Technology also boosted the performance. On the stock level, CSPC Pharmaceutical, Kweichow Moutai and Netease were the main detractors, while overweight in China Merchants Bank, underweight in PDD and not holding Baidu were the main contributors. In particular, we maintain a meaningful overweight in Kweichow Moutai and Netease.

We maintain a long-term positive view of Kweichow Moutai, a Chinese premium liquor brand with strong pricing power and growth visibility. 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. While market has the concern that economic growth will take longer to recover and weigh on high-end consumption, we believe that the demand of Moutai should be stable and we expect wholesale price to find strong support. Meanwhile, Moutai is commited to raise cash return to shareholders. In September, the company announced it first share repurchase plan (with Rmb 3bn-6bn in next 12 months), after it has lifted the dividend payout (to 75%+) in 24E-26E in early Aug. These acts are positive to long-term investors amid a volatile equity market.

Even though Netease lagged performance YTD, it was a key performer in the long term. We believe that domestic regulatory environment on gaming industry has been stable as evident by the deletion of the draft regulations posted last December, and high volume of new game approvals so far this year. On top of that, management has been very focused on investor's return, with a US$5bn buyback program over 2023-25 in place and a very decent 40% dividend payout ratio. Both implied superior corporate governance. NetEase has been gaining market share via its best-in-class development capabilities. It is expanding globally by partnering with international game studios. We believe that the company's rich game portfolio would sustain long term growth in the future.

Team and process update

We continue to invest in our China franchise as one of the leading active managers in China and are committed to hiring and retaining the best talent. We are in the advanced stages of hiring experienced analysts hires in areas where we perceive we need to enhance our coverage.

With high volitility in the market, we have further improve the overall team capabilty. In Q3, Elise Ying joined the team. She is responsible for investment analysis of China/Hong Kong Health care, Financials and Chemical sectors. She is based in Shanghai. Before joining UBS, she worked at CIB Fund (China) since 2015 as an Equity Research Analyst covering both Chinese Health care and Financials stocks.

We are confident performance will recover notably. In our almost 30-year track record of managing portfolios to our process, past experience has shown that in periods where alpha spreads narrow, performance has rebounded significantly.

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/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 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 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 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 the last week of Q3, following the 50bps US rate cut. The comprehensive policy response beat market expectations. Meanwhile, investors are reacting euphorically in the short term to the stronger set of policies amid overly bearish market sentiment. We believe that part of the reason for the rally's magnitude is the significant underweighting in China by global investors in the past three years. This policy pivot has urged international investors to take a second look at investing in China.

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 (research and development), 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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