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Rosefinch Research | Winning at the End Game

World is entering into a new period of turbulent change

September saw all three major US equity indices ratcheting lower with VIX back to highs, USD rebounded, and both China & US long-term yields trading in low range. With US poised to Taper and supply-demand being imbalanced, commodities had divergent performances: precious metal and global commodities like copper fell, while those with limited supplies like coal or steel rose. Oil also rose as US built back up its strategic inventory. A-share markets saw rangebound trading with record high volumes. Coal and steel sectors rose early then retraced, while photovoltaic and Lithium stayed strong. Food & Beverages and consumer electronics lacked strong end-demand, though seem to hold now after a weak September. Following concerns about Macau gambling license revisions, talks about HK Real Estate sector under scrutiny caused HSI to make new lows for the year. **Worries about major Chinese real estate company are taken by domestic investors as less of a Lehman-moment, and more like a Hainan Airline debt restructuring.** Global investors though seemed more concerned, and net sold during the Mid-Autumn festival period in late Sep.

The ongoing pandemic has already changed the global social dynamic. The world is entering into a period of turbulent change. The major central banks are communicating tightening expectations: RBA added Taper, ECB slowed PEPP, and US Taper is just a matter of time. As of Sep 28th, S&P500 has made 53 new record highs in 2021, which is already the 5th best annual performance in the past 100 years. In the best year of 1995, S&P rose 34.11%, then +20.26% in 1996; in the 2nd best year of 2017, S&P rose 19.42% but dropped -6.24% in 2018. Remember back in 1928, S&P rose +37.88% and kept up another +30.23% for the first 8 months in 1928 before collapsing. How the US Stock will play out in 2022 remains to be seen.

Currently there's a mismatch in economic cycles between China and US, with the road to recovery full of twist and turns. Given the demand is recovering faster than supply, the prices are increasing faster than economic recovery. With shifts in US fiscal policy, China's Common Prosperity drive, and global push for fair pay, more resources are being put towards labor inputs with labor costs increasing across the board. Increase in personal income does help consumption, but not necessarily investment or financial markets where stagflation risks remain. While there's a lot of discussion around China's debt problem, aging demographics, or trade wars, there's an underestimation of US inflationary risk in terms of its duration and intensity. We should also be vigilant against negative shocks to capital market prices, especially given shifts in underlying business cycles.

Recently, China's Central Committee for Financial and Economic Affairs highlighted the risk of overzealous implementation of carbon-reduction targets. NDRC also published guidelines to "Create First (Green energy) Before Break (Carbon)". Some investors are worried that the recent policies are restricting Chinese people's pursuit of wealth. We hold the view that call for common prosperity is not call for common poverty. In fact, for most successful entrepreneurs, the success lies not solely in how much wealth they accumulate, but also in experiences of competing in areas of their core expertise and promoting greater industry development and social advancement. On political front, the return of Huawei CFO Meng to China on Sep 25th was a timely gift for the Chinese National holidays. There are renewed engagements among China, US, and Canada, especially for the Oct G20 meetings. While the market looks favorably at China's economic outlook, the US mid-term elections next year may slow potential investments or cooperation. General Secretary Xi announced the creation of Beijing Stock Exchange as a main platform to promote innovative SME's. The capital market is actively supporting the real economy, driving efficient allocation of resources to promote structural transformation of the economy. The increase of personal wealth investment towards equity products also increased the overall activities of the equity markets. **Looking forward, we see 2022 as a neutral year for Fixed Income, a cautious year for commodities, and a slow bull market for equity market.**

The Green Transformation has moved from scientific consensus to a political and social consensus. It's now a major driver for global technological innovation. The era of "3060" encourages technological innovation and upgrade, as well as improve earnings of lower-income labor force via steady "dual-circulation" economic growth. The A-share's cyclical tendencies are weakening as traditional industries become more concentrated and capital market is shifting towards new economy. 3060's goal is not only an "ecological revolution", but also a path full of challenges, unknowns, and opportunities. Those nations that can build zero-Carbon companies or zero-Carbon industries will be the ones leading the world for the decades to come. To make the right investment decisions, we must have superior knowledge and clarity. We will focus on our core competencies and eco-systems, analyze company management teams closely, study the industries' fundamental logic and predictability, and make the best forecasts. We expect our analysts to chase long-term absolute return and match their career aspirations with the life cycles of their best companies. **The current market's large swings and emotion-induced retracements are creating opportunities for next year.**

Carbon-reduction is not meant to disrupt orderly supply

While July data already showed signs of slowdown, the August number showed even more weakness as both long-term trends and short-term factors impacted the data. Even with short-term factors weakening, the long-term pressures still call for more active and forceful policy adjustments. In the recent conference for SME, Vice President Liu He highlighted China's SME as the important creator of national wealth, the main employer for the people, the leading force of innovation, and the repertoire for future large companies. He called for all government agencies to create good environments for SME, including reducing the pressure from increasing raw material costs. During the Sep 22nd China State Council Standing Committee meeting, all departments are asked to maintain continuity and effectiveness of macro policies, be prepared to micro-manage, to minor-adjust, to engage across cycles in order to achieve stable markets. Greater cooperation amongst fiscal, monetary, and employment policies are required to stabilize commodity pricing, stimulate consumer spending, increase effective investments, maintain export growth, and ensure economic stability. Economically, the restriction in production capacity causes inflation, while downstream short term demand weakness causes stagnation. This "stagflation" risk can be seen in both equity and fixed income market. Recent government meetings have clarified the need to reduce overzealous implementation of carbon-reduction targets, and to create Green energy capacity first before cutting carbon energy capacity. In the NDRC guidelines published in September, once local government exceed the minimal renewable energy target, the extra portion can be exempted from the quota on overall energy consumption in the current 5-year plan. In addition, some national energy consumption quota was set aside to accommodate key national renewable energy projects. These policy adjustments will motivate local governments to promote new energy, encourage transition away from traditional carbon-complex consumption.

In the 2021 China's World Economic Forum, State Council Economist Mr Liu Shijin said carbon-reduction should be done via coordinated efforts across carbon-reduction, pollution-reduction, green-increase, and economic growth. **To be clear, the key to achieve 3060 is to use Green technology to replace traditional technology; to reduce carbon, not to reduce productivity or growth, and certainly not to disrupt normal carbon-energy supply chain when the Green energy supply chain isn't ready.** He suggested using carbon control targets instead of energy control targets. From Rosefinch's perspective, it's normal to see extreme policy stance at the beginning. We hope it's a trial-and-error phase that will correct itself into an executable roadmap. We had similar overshoots before during period of supply-side reform, and carbon-neutrality policies may need a similar correction process.

As economic enters high quality development phase, it must move beyond the "(sell) land for growth" model. But the real estate sector is huge in China, has long industry value chain, and highly influential in the macro-economy. The recent issues with a major real estate company is the first large liquidity issue, and has crossed over into the entire real estate value chain as well as financial industry. Hang Lung Property Chairman Chen said: I don't dare to embrace this bear market (in real estate) because it's related to law, to the industry regulations, and to government control. This change in real estate is then more systematic than cyclical. Rosefinch Fixed Income team sees popular acceptance of the view that housing is for living, not speculating. There are still some hard demands for housing in key cities' popular neighborhoods. The government has also been carefully monitoring the high-leverage real estate companies' liquidity, and unlikely will allow large systematic risks to materialize. Having said that, the sheer size of the real estate sector and repercussions to future housing price expectations make this a larger risk than inflation.

With the global consensus on Green, it's becoming the new driver for global technological innovation. High quality growth has two major components: technological innovation and common prosperity. The key to implement 14th 5-year plan or achieving 2035 goals is the balance between efficiency and fairness. In Dr Peng Wensheng's paper "Welcoming China's Innovation Economy", he mentioned: a key characteristic of knowledge is its non-competitiveness, which means private sector investment will be insufficient. Furthermore, the life cycle of innovation from investment to output is a long and non-linear process with tremendous uncertainty. Private sector is ill-suited for the patience and resilience needed to withstand failures. Public sector however is better suited. The government's role in innovation is therefore not just counter-cyclical stabilizing macro-policies, but also medium to micro level public policy to promote innovation. The State Council recently published guideline on intellectual property policy for 2021-2035. Chairman Xi addressed Zhongguancun forum on Sep 24th to promote IP protection, create top innovation eco-system, formulate concept of good technology, perfect technological management, and better benefiting mankind. In the long term, innovation is the main source of increasing consumer welfare. Therefore, the best indicator of monopoly is the absence of innovation. Platform enterprises jump started from innovation, the key is do they prevent other companies' innovations, or do they have exclusivity clauses to prohibits new competition? The key consideration by central government will be to construct new development framework, push for high quality development, encourage common prosperity, create fair competitive landscape for SME's and protect consumer rights. Because some platform enterprises had aggressive growth and chaotic expansions, it's the role of government to increase regulatory presence, counter monopolistic or other anti-competition behaviors. We are seeing effective preliminary results with market competition now steadily improving.

Under "Loose Credit, Steady Growth" Policy, "stagnation" issue may be slowly mitigated

From March 2020 to July 2021, US FED's balance sheet expanded from $4 trillion to $8.2 trillion. In 2021, there's a clear increase in US inflation, while employment situation also improved. PBOC vice governor Pan Gongsheng mentioned in July State Council meeting that China's monetary policy is still within the normal range and therefore retains more policy flexibility. This flexibility is the major difference between China and other major economies. Next, PBOC will implement stable monetary policy, maintain reasonable liquidity, keep basic alignment between growth rates in monetary supply, aggregate financing for real economy, and nominal economy. China's monetary policy will prioritize domestic situation, increase independency. Structural policies will be implemented to support major sectors and weak links. Medium- or short-term inflation are triggered by volatilities in macro cycles, while long term inflation comes more from demographic trends or turning points. In the short-term, upstream supply constraints will likely remain tight, so the structural inflationary pressure won't easily recede. As pandemic situation normalizes, the macro policy will shift towards loose credit, steady growth, which will slowly mitigate the "stagnation" issue.

In the Sep FOMC meeting, Powell gave the signal to reduce QE as early as November. His comment of mid-2022 termination of QE, subject to continued economic recovery, is largely in line with market expectations. It's likely that US fiscal stimulus and loose monetary conditions will remain in place ahead of US mid-term elections. FED did raise its 2021 core PCE inflation expectation from 0.7% to 3.7%, reflecting strong real inflation and supply chain bottleneck. The 2022 and 2023 PCE inflation expectations were also raised to 2.3% and 2.2%, both higher than the stated 2% target. It remains to be seen if the massive QE will have negative consequences – we are all living witness of this major global macro-economic phenomenon.

New tests for capital market pricing – must have the endgame in mind first

In the past 40 years, China has developed market economy, supported international cooperation, built capital market, and encouraged entrepreneur spirits. Some investors are actively participating these trends. As of end of June 2021, foreign entities held a total of 10.26 trillion RMB of onshore stock, bond, loan, deposit, or other financial assets. This represents a +42.8% increase YoY. The leader in global capital market is US, where its stock markets are deeper and broader than other nations. NASDAQ is widely recognized as a main driver for innovative economy such as global digital economy and biopharmaceutical industries. In China, Shanghai stock exchange created STAR (Sci-Tech Innovation Board) market in 2019 and tested registration-based system for IPO; Shenzhen stock exchange also tested registration-based IPO in 2020 for its GEM (Growth Enterprise Market); and Beijing Stock Exchange creation is announced in 2021 to better support SME and develop a multi-layer capital market system for better technological innovation and common prosperity. CSRC Chairman Mr Yi Huiman said in his opening remarks of the 60th WFE (World Federations of Exchange) annual meeting: capital markets play a major role in the steady recovery of global economies. Serving real economy and protecting investors' legal rights are the body and soul of capital market developments.

Innovation's long period of uncertainty and high risks make it more suitable for equity capital markets than debt capital markets. Taikang Capital CEO Mr Duan Guosheng believes insurance asset managers should increase strategic allocation for equity assets in order to fundamentally decrease risks of asset liability mismatch. It's important to research deeply, through the sector, down to the industry, and even into the specific links of the supply chain. The current transformations will create historical differentiations amongst various sectors or industries. How to valuate capital market assets will therefore face many new challenges. For the 3060 themed opportunities, we must persistently conduct deep research, be open-minded to innovative perspectives, and dive deeply into various sectors. If investors don't have the foresights or the endgame in mind, chasing the market or fading the trends will just become a gamble. On the investor side, we must also gain deep understanding of investors' long-term needs, and only then can we find true partners to create value and grow together.