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The Animal Spirit

Stick with core capabilities, and respect the market patterns

The biggest risk in investment is running into unexpected risk. With high inflation and tightening FED as the macro backdrop, the Ukraine conflict further exacerbated global stagflation risk as global yield curves rose. Compared to US's economy's overheating risk, China is facing the downward pressure from real estate cycle. The last two months' pandemic further increased the recovery uncertainties, while the domestic monetary policy has broadly maintained sufficient liquidity under the "steady growth" principle. Looking ahead, the short-term market shocks from conflict and pandemic may subside soon, but the medium to long term market outlook must be analyzed with a historical perspective.

Social stability is the most important rationale. The Ukraine conflict reflected the tremendous influence of the Western democracies and will have lasting impacts. On one hand, the Western world will emphasize economic and military alliances, such as shifting core industrial supply chains inwards or continuing trade tensions with China. China will also prioritize national independence and safety in food, energy, defense, and core technologies. On the other hand, last year China had over 3.6 trillion USD of bilateral trade with US and other Western nations. As the two largest economic entities, US and China have a lot of mutually beneficial relationships. From the development of humanity perspective, the two nations should have the wisdom to find win-win situations and find a sustainable growth path rather than end of globalization.

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Economics is another key rationale. Xi Jinping said: *we must bear one rule in mind, and that is economic development and social security is like water and boat – if water is shallow, then boat must be small; if water is deep, then boat can be large. Break this pattern then you may ground the boat or have it capsized.* At the end of day, pandemic prevention is tactical while social stability and people's welfare are strategical. We expect the pandemic's short-term shock to economy will wane in 2H22, while infrastructural investment will be effectively implemented by then. Global inventory restocking can provide further support to exports. Even if real estate sector remains soft, we can still see the economy basing off a low level in 2H22.

Adversity may be a gift. Even though US stocks have corrected since Jan, since the large rise in the risk-free rates, the S&P dividend yield is still over 1% lower than the 10y UST yield, making US stocks even more expensive in valuation. As Ukraine conflict erupted, US stock became a safety harbor for global assets, and the major equity markets in India, Japan, England, France, Germany, and Canada have all recovered their losses since Feb 24th. China's A-share sees the inverse P/E ratio and CGB yield spread at recent highs, while market risk appetite is at low end of the range.

Self-confidence or belief is the best hope while in the dark. In peaceful and normal times, stock market prices mostly reflect the fundamentals. But in war or pandemic times, stock market prices tend to reflect future expectations or "thermometer of hope." Looking back at the stock market performance during major historical episodes since World War II, during periods of high uncertainty, the ***animal spirit*** is a necessary quality for successful investors, and indeed is a core driving force for humanity's advancement. John Keynes said in his 1936 classic The General Theory of Employment, Interest and Money: "Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as **the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.**" Capability determines confidence, and domestic capital investors' long-term confidence is a key factor in the trend of the A-share market. Due to its relatively short history and developing structure, A-shares haven't yet seen the type of multi-cycle legendary investors like Buffett, Soros, or companies like Baillie Gifford.

In the history of Rosefinch Fund Management, be it 2008, 2012, or 2016, we've learned to reflect, learn, and embrace the market changes each time to stand on top of the new stages**. Today Rosefinch has stronger team and higher capabilities, and is more confident to advance in the correct direction.** Our investments must stay within our core capabilities: we will search for high-quality development themes, identify globally competitive companies especially those who may lead the next round of innovation for the industry. We will follow those leaders of domestic economy's key industries, and stay with long exposures when the market becomes pessimistic. At the same time, we must be vigilant on Black Swan event that may fundamentally alter the market dynamics.

The Ukraine conflict will further push European shifts in energy dependency towards less Russian imports, and more photovoltaic, wind, hydrogen, nuclear energy. **These new energy build outs and associated infrastructural equipment needs can further strengthen the Euro-China links.** During the 23rd Sino-Europe leader summit, the leaders discussed the impact of Ukraine conflict on food and energy security. Both sides agreed to continue cooperation on climate change and energy transition.

The US-China relationship is a critical relationship in the international network. Whether or not we can prevent further systematic decoupling is largely dependent on whether we can adapt the approach of: even if US sees China as the enemy, China should not see US as the enemy. Back in Aug 1982, Chinese foreign minister Huang Hua said to UN Secretary General Javier Cuellar that China will not be subservient to any superpower, it will not play the US card against the USSR, nor play the USSR card against the US, nor will it allow any country to play the China card in their games. The opening of China to the US led to widespread cooperation across economic and technical fronts, as well as the dynamics among the Asian countries. **On April 21st, Chairman Xi remarked on the opening of 2022 Boao Forum for Asia that international community's development has become a sophisticated and organic machine, where a removal of a single part may create difficulty for the whole machine. Both the owner of the part and the remover of the part will be damaged as the result.** In the last few decades, Asia region has created the "Asian miracle" through overall stability and fast economic growth. A better Asia can lead to a better world.

Energy Crisis is actually an Energy Revolution

China's 1Q22 GDP growth was 4.8% YoY, which was better than 4Q21's 4% but still noticeably weaker than the annual growth target of 5.5%. In order to achieve the 5.5% target, the subsequent 3 quarters must achieve 5.7% to 5.8%, which means the policies must be adjusted and implemented. The March pandemic had bigger impact than expected, the key now is to raise people's future expectations and consumer confidence. Vice Premier LIU He called for an urgent meeting to ensure supply chain stability and smooth logistical operations. Announced measures including recognition of nation-wide PCR test results over 48 hours and other monitoring guidelines to tackle key issues. The aim is to create conditions for total resumptions in production and manufacturing.

The Chinese State Council also announced initiative to create a nation-wide unified market. The goal includes having a uniform basic market regulation, uniform market regulation, uniform resource and key material market, uniform commodity and service provision. **The goal of the nation-wide market is not to go back to planned economy, but to remove impediments to free-market competition so we have more fluid goods circulation and resource allocation market.**

Henry Ford once said: if I asked my clients what they wanted, they would have said "faster horses." The sustainable growth of modern economy must have the combination of science, innovation, and enterprise. The key for our society to move beyond agricultural economy, or for nations to escape middle-income trap, is to leverage on science, innovation and technology revolution to increase productivity. This process will require large amount of research and development, visionary

entrepreneurs, supportive government, and the interdependency of political and economic developments.
A new revolution is coming. As an example of European energy structural transformation, the German economic minister called for accelerated renewable energy development including having 80% of energy generation from Green energy sources by 2030 and 100% renewable energy source by 2035. UK also targeted its solar generation capacity from current 14GW to 50GW by 2030, oceanic wind generation capacity from current 11GW to 50GW, land wind generation capacity from 15GW to 30GW, and nuclear generation capacity from 7GW to 16GW. Biden administration in the US plan to use Defense Production Act to secure key mineral mining and extraction to support renewable energy and car batteries. While India is delaying its ALMM policy by 6 months since local production of photovoltaic assembly can't keep up with demand. In China, NDRC published industry white paper on Hydrogen energy planning till 2035. Hydrogen will become a key component of national energy complex. It also means hydrogen will play major role in long-cycle energy storage, and in other industrial applications. The current energy price rally is mostly caused by short term supply & demand mismatch. **As the global markets go through structural upgrade in the energy complex, the current "energy crisis" is actually an "energy revolution", which will be the background theme song as the world increases the productivity.**

Globally, the ratio of grain for food, industrial usage, and animal feed is roughly 40%, 20%, and 40% respectively. Currently, China's food production rate is 100%, but there's a large gap in animal feed, which accounts for 80% of China's grain inputs. 2020 was the first year that soybean important rose through 100 million tons. It's imperative that China diversity the sources to include ocean farm, artificial synthesis, and biological advances. Similar to the advancement in genetic research, these investments in biological research and associated intellectual property protection has signaled long-term growth trend for the coming 10 to 20 years.

Another sector worth monitoring is the game sector which has annual revenue of 350 billion RMB. Each game license is a small supply side revolution. In last 20 years, internet has seen tremendous growth in China with over 1 billion internet users and over 71% penetration rate. Tencent's Ma said: social value is like the fertile ground, it's the foundation of the whole enterprise's growth. The deep root system creates more user values and higher enterprise valuation. The three values are intertwined and grow together.

Focus on the Great Companies of Tomorrow

The Ukraine conflict and Shanghai pandemic threw a spanner in the market tracks. The world is changing, will it continue? Will US-China financial market decouple? And if we decide this is a crisis, how do we not waste the opportunity?

Historically, after each major market correction, to pinpoint the exact bottom during the consolidation period is pure chance. But market bottom is formed by many individual stocks. Recently we saw positive sign from the significant increase in both amount and frequency of stock buy-back by listed companies. The energy transformation revolution, digital economy, agricultural technology, and aerospace sectors are not the flagbearer of our time, but also key engines for our future growth.

When we evaluate a company, the key question is how far and how long can the company grow? How big a valuation can the company's industry or its management team support? In the US, there were 7,300 public companies in 1996 and now only 4,800 remain. On the other hand, the number of enterprises invested by PE funds rose from 1,600 to over 10,000. More and more companies rather to be privatized than public companies. If this trend of decreasing public companies continue, it will have large impact to the US capital market.

Whether its more volatile trading or the disappearing IPO premium, there will be more micro level differentiation. The industry leaders have accumulated advantages, high certainty, strong pricing power, steady cash flow, while those sub-industry leaders face a more uncertain future. The former can more easily attract and retain excellent team, and the latter will suffer lower valuation unless it can bind closely with those market leaders.

In the A-share market, those active manager's diversified investment approach will have more challenges ahead. Those active managers will more trading tendencies will be challenged by the quantitative CTA funds. While those with sector or thematic investing may be replaced by passive index funds. If the active managers do not have the capability to dig deep and uncover those companies with long-term growth potential, can they still make sizeable bets? We believe the successful long-term fund manager must have the foresight, courage, and finances to invest in the great companies of tomorrow. For small companies, it's the people that make things happen. For the larger companies, the management team had proven track record, but even them must have the right people doing the right things in order to continue their success. **At Rosefinch, we will firmly focus on the high-quality market leaders so we can grow with them. Our most important resources are our investment philosophy, our talents, our ability to grow with the times, our confidence in our path, and our experiences accumulated over the last 15 years.**