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# Time Does Not Wait

## Policy is currently the core driver for the market rally

In the first half of 2022, S&P and DOW fell -20.6% and -15.3%, the worst performances in the last 70 and 62 years respectively. NASDAQ was down -29.5%, the worst first half return on record. USD index broke above 109 for a 20-year high with EURUSD exchange rate below parity. US yield curve remains inverted with 2y over 10y spread. Commodity prices are reflecting recession expectations, though the energy complex is more resilient than metals given its higher supply-side pressure. US is releasing 2Q GDP data this week, with looming risk of another contraction after 1Q22's -1.4%. Inflationary picture remains tough as Jun US CPI broke 9%. The inflationary drivers are shifting from commodity to services, as salary and rental costs are sticky. FED Chair Powell indicated that rate cycle won't ease until inflation shows a credible and clear retracement. US will likely reach peak inflationary pressure in 3Q, with FED remain its vigilant tightening stance. For the US stocks, even though the worst of risk-off sales are over, there may be more challenging profitability questions ahead in 3Q and 4Q.

For China, the 1H GDP grew +2.5%, which means 2H GDP has to grow at above 7.5% if China is to achieve the annual target of 5.5%. **This lofty 2H growth target would be near impossible even without pandemic.** Recently, we saw real estate sales resuming its weakening trend, while household and enterprise balance sheets & cash flow problems remain. Externally, the negative impacts from Ukraine conflict, FED hike, and softened demand will likely extend into next year.

Compared to the US stocks' drops in last couple of months, China A-shares have staged the comeback since late April. The A-share valuation is less attractive now, and the capital flow indicators are showing signs of overbuying. Once high-frequency economic data turns softer, we'll likely see some quant driven investors leaving the market. Historically, we've seen some retracements after first rallies: SSE usually falls about 50 days, during which time main indices like SSE, CSI300, Wind-A, and Chi-Next retraced about 13% or roughly 50% to 70% of the rally.

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In order for the market to continue its upward momentum, it'll want to see clear improvements on the capital front, more certain adjustments in pandemic policy, firmer future growth expectations, steadier global markets, and resolution of key political meetings in both domestic and international arenas. **In our recent meetings with entrepreneurs and listed company management teams, we noticed people are looking for key long-term policy clarity and stability to support the market rally.** We may see more market price retracements to test the strength and resilience of key industry value chains, including the carbon-reduction sectors. Hopefully this process will provide a firmer foundation for future long-term growth next year and beyond.

## Carbon-reduction Theme Key in China's Stagflation Fight

Recently, the Chinese USD-bond index Markit iBoxx made new 12-year low with a YTD return of -53.5%. This is a part of a vicious liquidity cycle for real estate developers, housing prices, and local banks. The long-term downtrend in real estate prices is evident from aging demographics and slowing urbanization rates. While short-term policy stimulus can help, it's only impacting limited number of cities and not sustainable in the long term. As the issues in both demand and supply side compound, the real estate development cycle will extend even longer, making real estate sector a clear drag on the economy. Government official Mr. Yang Weimin recently pointed out that while Chinese economy realized V-shaped recovery in 2020, it was due to a combination of 2 trillion RMB fiscal stimulus, real estate, information service, and export sectors. Currently, real estate, information service, and export sectors are all under heavy pressure. It is therefore highly unlikely for us to see a similar V-shaped recovery in the 2H22.

In the history of Chinese economic reform, the most successful episodes dealt effectively with the balance between additional capacity and existing capacity**. In the current global stagflation background, "3060" Carbon-reduction theme will be the key in driving China out of stagflation trap.** Carbon-neutral represents new investment as well as new growth; it's built on China's technological advances as well as global cooperation; it's both energy revolution and energy security. The Carbon-reduction theme will push for entire manufacturing chain upgrade, including digitalization. It will also make consumer surpluses and further transform economic and financial systems.

European Parliament recently passed the amendment on Carbon Border Adjustment Mechanism (CBAM) which will require importers of certain carbon-intensive goods to pay a fee on the emissions. BP also published Statistical Review of World Energy which showed that in 2021, Solar and Wind energy generation has exceeded 10% of total global energy generation for the first time. Early in 2022, market forecasted annual capacity increase of 210-220GW, and now, this figure has been revised up to 280-300GW.

In the 7th Annual China Energy Development and Innovation Forum, speakers expect three major industry chains evolving in the coming 30-40 years of energy transformation: first is the clean energy represented by solar and wind energy. It's estimated that by 2030, the global solar generation capacity will increase by 1500GW a year. Second is the energy storage and intelligent management of these intermittent and non-continuous energy inputs. Third is hydrogen, which will be active in battery, chemical, steel, construction sectors. It's estimated that by 2050-2060, annual global hydrogen consumption will reach 600-800 million tons.

New energy autonomous vehicle is another interesting scalable opportunity. China has adapted a more tolerant regulatory framework on new energy autonomous vehicle, which provides a great testing ground for such innovative technology. Shenzhen government has already announced regulatory framework for such autonomous vehicles, providing a good reference point for national rollout. In Shanghai, it has created a dedicated road lane for autonomous drive testing on the Donghai bridge. The Central Government has also published consultation papers on building digital infrastructure. All these existing and upcoming measures will support the future commercialization of domestic autonomous vehicles. This will add impetus to a positive feedback loop: the fast industry commercialization will increase innovation in laser radar, camera, navigation, field control, high-accuracy map. On the software development side, the


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increased autonomous vehicle traffic will capture massive amount of real data, which in turn will improve data identification, processing, and other industrial needs.

From China's perspective, if global economy, especially US were to have recession, it'll damage external demand and global financial market risk appetite. On the other hand, China will likely still grow faster than US, while commodity prices should retrace lower, and trade tensions such as tariffs will decrease. In the short term, the key is to avoid China growth decrease in 4Q in a weak global environment. In the medium to long term, China needs to carefully cushion long-term economic growth given current backlash on investment and innovation**. We need to stimulate market force and promote the entrepreneur spirits, so we can have a regulated, transparent, open, lively, and resilient capital market. To ensure Chinese economy avoids stagflation and inflation, we'll channel investments towards the spirited and innovative enterprises.** Back in early July, Chinese premier has said in government working meeting that the 160 million market entities are the sources of Chinese economy's resilience. If we protect these entities, we can protect employment and steady the economy. We must work to solve challenging and complex problems, and avoid silo-minded over-simplified blind implementations.




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