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Where the Earth Ends and Sea Begins

History is not the future; “frozen” is not China’s whole picture

“Where the earth ends, and sea begins” is the famous line from Portuguese poet Luis de Camoes that portrayed his country’s great achievements in the Age of Exploration. We too may be embarking on a new great age, where the old historical trends no longer apply. Facing this great transformation, we remember the quote from Leo Tolstoy from War and Peace: “We can know only that we know nothing. And that is the highest degree of human wisdom.” Indeed, we must acknowledge and face our own ignorance in this age of change. Since the WWII, there were two pivotal moments in the global geopolitical arena: 1978’s start of Chinese economic reform, and 1989’s collapse of the Berlin wall. In a way, these two events broke down traditional barriers and united the world. How will the 2019 Covid pandemic and the 2022 Ukraine War be remembered in the world history? Will they be the signposts of deglobalization or even the start of the breaking up of global order?

In China, 2022 saw three surprises of Real Estate, Ukraine, and Covid that held back the economic goals. Domestic economy is still in recovery mode and remains soft. The national policy environment is still in execution phase of the “steady growth” plan, with responsive adjustments to the economic and social challenges. There is a clear divergence in the monetary policies of China and US, which indicates the differences in the respective economic cycles. As we enter into the post-Pandemic age, the government has emphasized a few ideas: employment is pillar of social well-being; supply-demand mismatch is the main conflict now; and enterprises are the driver of innovation. The “frozen” real estate sector is therefore only part of China’s situation and by no means the complete picture. Apart from real estate, we also have a group of increasingly competitive advanced manufacturing and domestic demand driven companies in the dual-circulation model. It’s during period of stress that we know who remains strong. In the half-year reports released so far, we notice the chills from real estate companies, but we also notice the strong progress by those related to Carbon-Peak and Carbon-Neutrality fields and the leading domestic consumption brands. **The different performances of the different companies are impacted by the macro environment, and more so from the differentiating factors like the companies’ respective capabilities and efforts, especially their passionate persistence and grit in the face of challenges.**

Behind every crisis there is an opportunity. Global recovery from stagnation will require time. For a developing manufacturing powerhouse like China, this is not all bad news: the digital economy grew from pandemic, new energy benefited from geopolitical turmoil, and social media reflected more thoughtful insights. Even though domestic economy hasn't completely transformed, its innovative capability has vastly improved from just a decade ago. There is strong emphasis in R&D, especially amongst large corporations and national levels. Privately-Owned-Enterprises and active capital market have become pillars of social development. We need to have active participation across all social sources to avoid "lie flat" of the domestic capital.

For the capital market, China's stock market can serve as the barometer for the economy. After 2000, China entered into fast growing urbanization and industrialization phase. The bull market of 2006-2007 saw cyclical companies like the real estate, commodity, and transport pushing Shanghai index over 6000. After GFC of 2008, Chinese economy shifted from investment towards consumption. The drivers in Chi-Next rally of 2012 were consumers and electronics stocks. After 2018, it's the advanced manufacturing companies in new energy vehicles, photovoltaic, and semiconductor that led the charge. As more capital enter into emerging industries and accelerate economic transformations, it creates a virtuous circle between the capital market and the real economy. High quality development requires direct funding, and the structural Chinese household investment shift from real estate to equity market provide the source of funding. In 2019-21 period, China A-share is in the slow bull market. China's overall economic development is better than Japan during 1990s and is more like the US of the 1980s. **In the next 5-10 years, slowdown in real estate and infrastructural investment will reduce market cost of land and labor, which when combined with improvements in corporate profitability may bring about long-term bull market for A-shares.**

We saw some stock market corrections in Jan and July this year due to concerns on fundamentals. It's normal to have cycles in economies. These two years, there's a noticeable drop in demand due to real estate and pandemic factors. With a more relaxed real estate sales policy, lower mortgage rates, and more proactive fiscal stimulus, real estate sector will gradually improve. The pandemic controls remain a drag on the economy, so it's worth following any policy shifts there. Export sector was the main driver in the last two years for Chinese economy. Its future development may see negative impacts from the recessionary US market. We may see the bottom of global economic cycles towards the end of 2023. In the near term, we see the A-shares are back down near April levels.

In our view, when capital market has fully priced in negative expectations, it'll gradually start to price in recovery expectations. **Our overall view on the stock market has turned from cautious to more constructive.** The market contraction has laid the foundation for future rally. We do not expect to precisely capture the market bottom. But we do intend to position here with the confidence to accumulate on dips, and even to increase shareholding on excellent companies at discounted prices. It's worth noting that investment not only requires framework and insight, but also on-the-ground intelligence and feel.

Time is first ingredient of success; Effort is the only path.

China's core issue is one of economic transformation. Some main focus areas are: develop domestic demand system; accelerate technological independence; improve industrial supply chain upgrade; modernize agricultural activities; raise living standards and quality; maintain safe developmental path.

When we look at important ingredients to success, time always comes first. The new energy smart cars are at such a time. Recently California, the biggest state for automobile in US, announced it will ban fossil fuel vehicles by 2035. This reflects the trend of our times as US continues encouraging new energy vehicle purchases. Shanghai also just announced its blueprint to accelerate development of intelligent vehicle networks. It published clear and comprehensive requirements for key technology, intelligent cars, and transportation infrastructures. We are seeing clear policy support and guidance on driver-less cars in the major metropolises of Beijing, Shanghai, Guangzhou, and Shenzhen, which will serve as guiding posts for other cities' commercial trials of commercial driver-less businesses.

Another topic on our mind is the shortage of electricity, which already started in winter of 2020 and exploded into the national scene in Sep 2021. There were four major reasons for this: 1) steep climb of thermal coal prices and associated tight supply; 2) drop of hydro-electricity; 3) increase in electricity demand; and 4) stringent local energy control policies. We'd expect a further tightening of electricity supply in southern areas during turn of the year. According to southern electricity grid experts, local supply will remain tight in the 2023-25 period. It's facing pressure on both consumer end and supply end, so is between a rock and hard place. It's been 20 years since China embarked on electricity reforms. After the latest round of reform in 2015, domestic electricity infrastructure and market-pricing have improved drastically. The future 10 years will be the key period to establish national energy infrastructure and make technological breakthroughs. Ideally, we can see both drivers of new energy and energy infrastructure making strong strides.

Even if we come in at the right time, effort is the only path to success. Earlier this year, founder of Li Auto Xiang Li shared his perspectives. In 2021, the new car makers have survived the proof-of-concept phase that went from “0 to 1”, with many taking some market shares of around 3%. The next stage will be the accelerated growth phase to go from “1 to 10”. This phase is a comprehensive competitive phase, where the carmakers should realize annual revenue of trillion-RMB in order to be seated in the final round. Being in the race is only half the battle, only one in a thousand can truly excel through their relentless efforts.

On the domestic consumption brand front, the overall 1H22 retail sales dropped 0.7% YoY, with clothing, shoes, etc. taking a -6.5% hit. But the domestic leading brands are doing well with one company reporting an increase of 14% to over 26 billion RMB to replace Nike as top shoemaker in China. Another domestic company also reported almost 50% of Nike's sales, thus stepping over Adidas in China market. As domestic brands make waves, they have finally exceeded global brands in China. Their acceptance by domestic consumers is reflected in similar pricing points as global leading brands.

We are focused on new energy, where global demand for clean and cheap energy is the fundamental driver for the industry. As traditional fossil energy costs rise and photovoltaic costs drop, the new energy story is more compelling than ever. In 2022 we saw the increasing demand for energy independence and security. European demand for photovoltaic capacity has continually exceeded original forecasts due to Ukraine war. US tariffs also remains marginally supportive of photovoltaic imports, while emerging markets like Brazil, ASEAN, and Middle-East are rushing in. During the latest Hurricane Ian, the town of Babcock Ranch survived intact despite being near the center of destruction thanks to its 700,000 solar panels that kept its electricity on the whole time.

In the last three years, the total investments in various phases of photovoltaic capacity have exceeded 2 trillion RMB. The industrial chain is expanding rapidly thanks to friendly government policy, ambitious enterprises, and enthusiastic investors. In future, there's bound to be severe over-capacity which in turn will lead to vicious competition and market upheavals. The leading companies must not only rely on their technological innovation, but also zoom in on client needs, improve product experience, and build solid system infrastructure. In the global arena, the “China-plus-1” strategy has become common place. Unlike the previous globalization logic of efficient investment and global connectivity, the emphasis is now on economic and supply chain resilience. Global companies are positioning for co-existence of offshore and onshore capacities. But at the same time, take photovoltaic industry as an example, US lacks the complete industry supply chain and faces issue of high costs in its labor and environmental factors. It will be difficult to completely decouple from China.

Taking a step back and looking at history, global economic growth really accelerated only in the last 200-300 years. In this most dynamic 200-300 years, every country's growth is bookmarked by the stories of entrepreneurs' innovations. The economist and author Weiyin Zhang wrote “Re-understanding the Entrepreneurial Spirit”, where he shared 3 main drivers for human history: logic of market; logic of bandits; and logic of belief. The entrepreneurs follow the logic of market – wherever there's sustainable value-add, there will be entrepreneurs to capture that. Even if we see an increase in geopolitical tension, the logic of market will not disappear. Any decoupling will be a long and drawn-out affair.

Building the Research Team; Rather Miss than Rush.

October will bring about key political meeting in China which will increase policy certainty, clarify future expectations, and strengthen government implementations. Real estate sector has been through a washout, which may see a reversion to more normal footing after government policy support. With US going through deep recession, China and US may recover from the bottom together. For the China market, we see increasing likelihood of long-term bull market in 2023 as manufacturing sector kicks in.

For us, it's easier to find the best-value companies instead of predicting the market top or bottom. When it comes to investing in hot sectors, there are plenty of ambitions in the market, but not enough patience. It's only when there's disagreement in the market can we notice the different managers' value-add. In our view, the beta of the times, the alpha of the company, the predictive insights of the manager are all necessary ingredients for a successful long-term investment. That's why we continue building the research team to expand our capabilities; that's why we're rather miss an investment than rush into it without thorough vetting and understanding. Of course, investment is still often an imperfect decision. **It's important to recognize that during the time of transformation, extreme uncertainty is part of the environment that launches social, technological, and economic advancements. This uncertainty is the source of growth opportunities.**

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