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Don't Cut Your Tree In Winter

In the last few days, there's a rumor that a major bank had a huge redemption in its bond fund. This is similar to the rumor in the beginning of year of a major equity mutual fund facing huge redemption. Even the amount of redemption was rumored to be the same. Whether these are true or not, such stories reflect the challenges that market faces this year across bond, equity, and commodity. Capital market's hot topics spin faster than the ceiling fans! Even for the same security, it must have felt like getting on a rollercoaster ride. Nobody feels comfortable in this market, and we should just feel lucky if we are not getting whiplashed. Looking back at the beginning of Nov, everyone was talking about how the CSI300 to 10Y CGB yield was at a historical extreme level, favoring the equity market. People focused on whether it's time to pick the bottom in equities, or whether there's still another 10-20% to go. Nobody talked about the possibility that the extreme relative valuation doesn't only mean equity is cheap, but can mean bond is expensive. While the equity market is keenly followed by the 200 million Chinese retail investors, there's much less chatter about the bond market, which is dominated by institutional investors. Most retail investors' exposure to bond market is indirect via bond fund or allocated exposure in other funds. In fact, the bond market has become very crowded: in the last two quarters, the bond mutual fund launches contributed to more than half of new fund launches, which hasn't happened since 4Q 2018.

On Monday, some experienced bond traders highlighted the market risk since the case for further rate cut is decreasing. As the investment thesis changes, major market sell-off may trigger year-end stop-losses as institutions protect their 2022 profits and as bond products trigger redemption levels. Indeed, this is exactly what happened as market lost all its gains in the previous three months in a single day. The sudden collapse caused panic as market was routed in the vicious cycle of selling => more redemption => more

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selling. Bond market is no different than the equity market when it comes to the logic of market correction when a security is overcrowded and is too expensive. It was just a matter of time.

This week, PBOC released the 3Q22 report on China's monetary policy yesterday, where it highlighted that "domestic economy is showing clear recovery, (PBOC) shall strengthen implementation of stable monetary policy, and be cautious about future inflationary pressure." **This increased future tightening expectations and may cause more bond market volatility.** Of course, bond yield comes from both the coupon and the capital gain. In the long-term it's the former that's the main driver and we shouldn't be overly stressed over short-term rate volatility. For investors that take a more balanced asset allocation approach, their "FI+" products with equity allocations would have done better in this period.

For the equity market, the long-only funds are actively adjusting asset structure, while macro hedge funds are calling now the "start of the bull market." The supportive government policies and attractive low valuations are putting in conditions for a new round of rebound for A-shares. China Merchant securities did a quadrant analysis of how 10Y UST yield and USD index affect A-share performance. They noticed that when the 10Y UST yield goes down and USD index goes down simultaneously, it's a sign for improved liquidity and increased valuation. It coincides with periods of A-share rallies, so those industries with relative high future growth certainty and significant room for further development will benefit the most. **For the A-shares market today, the key industries to watch are new energy, consumer staples, and information technology.**

Source: China Merchant Securities. Y-axis is 10Y UST real yield; X-axis is USD-index.

We're seeing some famous investor gurus turning their views to semi-conductors and new energy. Even Charlie Munger, who famously said Tesla is doomed to fail, is now saying "Tesla has done some good things that others couldn't do. Tesla has made some real contributions to this civilization." The last time

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Munger publicly acknowledged his mistaken view was for missing Google. As for his partner Warren Buffett, he just spent $4.1 billion to buy into TSMC. **What the investor holds is the clearest expression of the investor's views.**

In the start of every bull market, the investor sentiments are at best ambivalent and often downright depressed. Just as John Templeton said: "Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria." Investors who can capture the emotional pivot from extreme pessimism to optimism will capture significant returns. Even those who can't pinpoint the exact turn, so long as they can stay at the table, can still get the market returns. It's only those who jump in on the highs and liquidate at the lows will lose their shirt and leave empty-handed.

One investor once said: bull market and bear market are just two handles of the saw that chops up the inexperienced investors. This analogy aptly described the challenges many investors face. They don't dare jumping on the train at the early stage of the bull market; they cautiously add drips and drabs as market rallies; they boldly go all-in near the highs, and then feel the chill as they stand at the windy edge of precipice. **What resolves difficult challenges are not fancy tools but basic principles.** The most powerful principles are Howard Marks' Market Pendulum, Ben Graham's Margin of Safety, Warren Buffett's Circle of Competence, Charlie Munger's Investment Checklist.

Buy on the cheap is a key component of capturing investment returns. For equity investors, now may be the good time. **Winter is always tough, but no matter how tough, please don't cut your tree in winter.**

We hope that by sharing Rosefinch's views, in a small way, we add value to your day.