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Rosefinch Research | 2023 Series # 6

Time to Fly With the Wind

The theme of "strong expectation vs weak reality" continues in the market. This week's Jan financial data saw household savings making historical highs, while medium to long term loans drop, showing a risk-reduction sentiment amongst the retail investors. As economic growth slows, retail investors tend to embrace bank savings accounts. Since 2006, there were only three episodes where new quarterly deposits went above 1 trillion RMB for more than two quarters in a row: 2Q08-1Q09, 3Q18-2Q19, and the current 1Q22 to now. When the investors avoid risk and embrace certainty, that means the risky assets are less crowded. Even when the Northbound Stock-Connect flows made historical highs in Jan '23, the daily transaction volumes and mutual fund issuance levels still remain below 2022 average. More capital are waiting on the sidelines for the annual reports in the upcoming earnings season.

While the capital flow has been quiet, the industry rotations kept spinning. The various sectors like consumer, financial, real estate, new energy, and now AI all have sound logic behind their popularity. The following A-share industry rotation chart showed that the speed of the rotation is at historical high.

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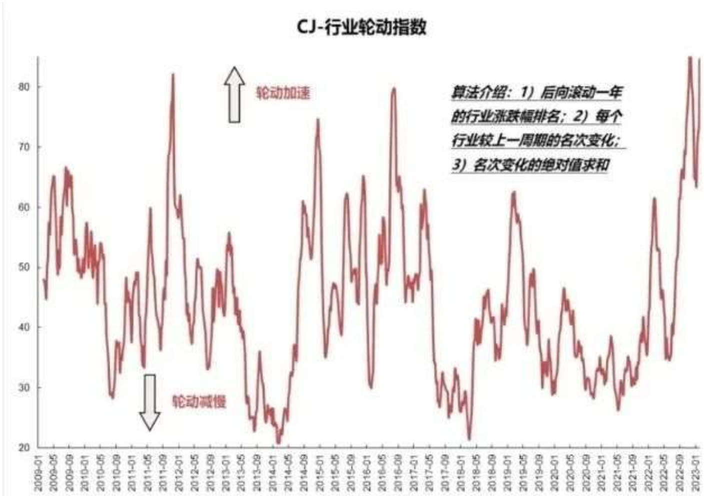

Source: Changjiang Securities. The chart graphs the sum of absolute differences between the industries rankings between now and a year ago.

In the last few economic cycles, the industry rotation tends to start from investments that push up upstream commodities, then move down to midstream industry, and last to downstream consumers. Looking back, this rotation mechanism reflects China's high-speed growth phase, and demonstrated the historical significance of real estate investments. Right now, there are also some supportive measures for real estate sector. But due to the "housing is to live not to speculate" mantra, it's hard for real estate to lead the economy out of the trough and impact consumers like before. The overall weaker macro demand means the rotation may not work the same way as before. It's becoming more critical to choose the right industries and the right stocks.

Munger used to explain the first rule of fishing is: "fish where the fish are", and the second rule of fishing is: "don't forget rule number one." In the 21st century, finance and real estate accelerated urbanization. Since 2010, consumer electronics and internet technology lead the mobile internet wave. As we enter the 2020's, energy revolution and domestic substitution are becoming the main drivers of this rotation. Since 2020, the Chi-Next has been highly correlated with the NASDAQ, while outperforming in the last three years. **From industry classification perspective, the driving force of Chi-Next has been advanced manufacturing, with about 70% coming from electric equipment and new energy.**

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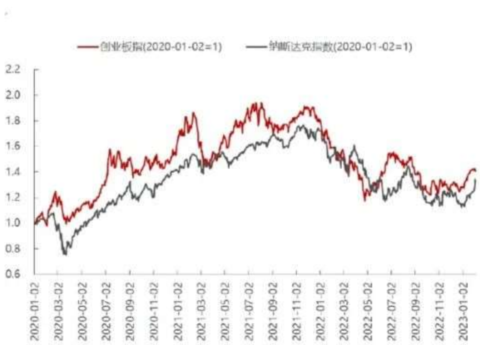
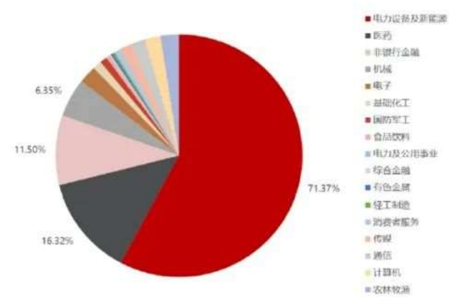
2020 年以来创业板指跑赢纳斯达克指数



2020 年以来创业板指行业涨幅贡献



Source: Wind, Minsheng Security Research. Left is performance of Chi-Next (red) vs NASDAQ (blue) based on Jan 2nd, 2020; right is contribution by industry, led by electric equipment and new energy.

As the new energy revolution changes the world, China is currently leading the race. In 2022, China's New Energy vehicle production totaled more than 7 million, almost doubling from 2021, and accounting for about 65% of total global production. In terms of solar power, China added 85GW of new installed photovoltaic capacity, +60% YoY. China also saw a +70% increase in photovoltaic equipment export, reflecting the 70+% global capacity that China has across the photovoltaic industry supply chain.

But in the intense market competition, even winners can't stay on cruise control. The pricing competition saw the first domino fall via Tesla. We see the same dynamics across photovoltaic silicon material, price competition, excess production capacity, ever-more efficient assemblies, etc. When the industry development focuses on quality and not quantity, then it's time to challenge the true competencies of these companies.

Stock market is the same. The most popular investment method is to cast a wide net and capture all the hot themes, which unfortunately reduces the excess returns the wider the net is cast. **The repeatable success though must come from deep insights and understanding of the industrial chain fundamentals, so you can dig out the most advantageous links and the most valuable companies.**

When investors have been in a bear market too long, they tend to stuck with the bear-market mindset. Some may become fixated at their cost and quickly liquidate their position on any rally, in the process losing the chips they held onto over the bear market. Some may try to chase the hot them of the day, buy high or sell low, thus either losing their exposure or increasing their cost.

Data has shown that among China mutual fund investors, there's a "U"-shaped relationship between mutual fund investors' returns and the net subscription ratio. The highest ratio of net-subscription occurs when the return is above 10%, while the lowest ratio occurs when the return is 0-2%.

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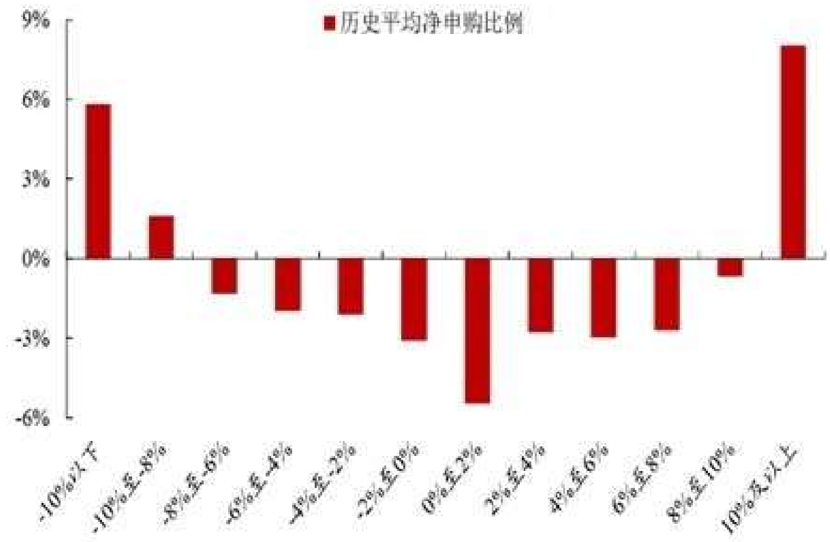

Source: Wind, Minsheng Securities Research

The capital market returns are rarely linear. Human emotions will drive investors to be more optimistic when stock rallies, and just when the market retraces to a more favorable potential return profile, many investors have already revised their future expectations and redeem on the lows. In the tug of war between expectation and reality, there's a growing gap between the mutual fund's actual returns and the investors' realized returns.

The Economics Nobel laureate Richard Thaler did a case study on taxi drivers: most drivers work for taxi companies and rent the cars for 12 hours a day. They pay rental fees and fuel, so most drivers targets a monetary amount above the cost and go home when that's done. Some days it takes a long time to reach their daily profit target, on rainy days it's shorter. So the question Thaler asked was this: what if the taxi drivers change their strategy? Strategy A: work a fixed amount of hours a day, rain or shine; Strategy B: keep overall hours the same over the week, but work longer on days with good business, shorter on days with little business. Compared to the status quo, those who adapted strategy A made 5% more income on average, and those who adapted strategy B made 10% more income on average. **Why does the taxi driver stick with their current sub-optimal strategy then?** Thaler explains that most people hate losses and prefer to capture certain gains. People also tends to think short-term, focusing on the day's income rather than optimizing over a longer horizon. Instantaneous satisfaction seems to be a dominator behavior driver for the taxi drivers, no pun intended…

If we think about it, how the taxi drivers allocate working time is like how the investors allocate capital in the market cycle. Most people will make the same mistakes that the taxi drivers do: feel happy with small gains when the trend is good, while work harder and longer when the going gets tough. **Now that you see the pattern, what can you learn from your advice to the taxi drivers?**

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So when will the market rally? The timing is impossible to predict, but we do know that with China's economy recovering and US hiking cycle nears its peak, A-share is coming around to its slow bull track. **Tis time to fly with the wind.**

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