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Rosefinch Research | 2023 Series # 13

Monthly Commentary 2023 July

Put Our Heart Into It

"I just think there have to be reasons that you get up in the morning and you want to live. Like, why do you want to live? What's the point? What inspires you? The value of inspiration is very much underrated." – Elon Musk

1. Macroeconomic pressures remain, but A-share is not pessimistic.

U.S stocks are approaching bull market territory. Over the past year, those optimistic that inflation would cool, and the Fed would soon pivot won the tug of war. The S&P 500's price-to-earnings ratio is about 19 times. Technology, communication services and non-durable consumption contributed most of the returns this year. Domestically, commodities fell overall. Data from the National Bureau of Statistics shows that in May CPI rose 0.2% year-on-year and fell 0.2% month-on-month, while PPI fell 4.6% year-on-year and 0.9% month-on-month. The fall in upstream energy and raw material prices drove the overall price of industrial goods down, showing insufficient end-demand. The May manufacturing PMI fell for the 3rd month in a row to 48.8 month-on-month, down 0.4. After exiting pandemic policy at the end of last year,

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there was a brief jump in revenge-spending in travels and services, but since April the economic recovery has slowed down, price rises have fallen back, and credit growth has been sluggish. In May, both imports and exports both declined in USD terms.

The oversupply of real estate and overleveraging of local government urgently need to shift gears. Meanwhile, there's temporary oversupply in photovoltaic and EV industries, which will need time to digest and upgrade. The intensifying de-globalization trend continues to increase uncertainty in global demand and capacity buildout. Private economy, digital economy and service industry encountered setbacks; post-epidemic structural problems, along with population decline and other socio-economic factors added to macro pressures on the Chinese economy.

The stock market has not found a new growth engine, which has led to lower trading volumes as RMB weakens against the USD. June is an important window for stable growth in the second half of the year. PBOC Governor Yi pointed out that the GDP growth rate in the second quarter should be relatively high, and CPI is expected to gradually recover in the second half of the year. Before tangible weak social and credit data, reverse repos rates have already dropped as PBOC guides market expectations on monetary policy. Despite the current weak sentiments, the market is seeing a glimmer of hope.

Whether it is world-class enterprises or Chinese industry leaders, when they went through painful hardships in history, they relied on their inspirational visions and dreams to pull them through. Once the commitment is made, the path becomes challenging but possible. And as Musk put eloquently: "The first step is to establish that something is possible: then probability will occur." As we face headwinds, it's important to plan for the worst and be confident of achieving solid results.

China's technological revolution includes the transformation of energy, information technology and life science, which promote each other in the long cycle. New technologies in the new energy sector such as photovoltaics, offshore wind, carbon capture, energy storage and hydrogen energy still have huge development space, some entrepreneurial leaders have enough resilience, endurance, and ambition to drive at the forefront of the global energy transformation. In addition, there are also exciting opportunities brought by AI, which are expected to be comparable to that of new energies opportunities after the end of 2018 and EV opportunities after the second half of 2019.

Macroeconomic pressures remain, but the A-share market is not pessimistic. According to various sell-side analysis, the market sentiment has now fallen to around recent lows like 2018/12, 2020/03, 2022/04, and 2022/10. CSI300 has negative returns for three consecutive years, Hang Seng Index has negative returns for four years in a row, and Chinese mutual fund issuances hit a new low in 8 years. But these pressures are part of our research and investment work. To be successful, we must handle tough losses and remain thoughtful and even courageous when facing fear. On one hand, it's useful to take a long-term perspective on the companies and industries as we evaluate industry cycles and risks. On the other hand, we need to think about why market sentiment "bottom" seems to occur more frequently. We see the mutual fund issuances of equity products was 400 billion RMB in 2022, but only about 150 billion RMB in 1H23; similarly, IPO was about 1.3 trillion RMB in 2022, and only 500 billion RMB in 1H23. Could it be excessive industry rotation? Short-term trading? Structurally high valuations? Poor risk management?

From Rosefinch's perspective, to reach something, we must put our heart into it! For Rosefinch to achieve long-term success, the most important factor is our core team's heart! When we find the right people and brave through the market cycles' trials and tribulations together, we will succeed. There are companies whose teams fall apart when the storm hits, and then there are companies whose team gel together even stronger and emerge from the high pressure like diamonds, full of passion and energy!

2. From Exporting Products to Exporting Capacity.

Looking back at the past 50 years, the China-U.S. relations have been a history of overcoming difficulties while moving forward through winds and rains. Today's China-U.S. relations have grown too big to reverse; if they cooperate, both sides benefit, but if they fight, both sides will suffer. Today, China-U.S. relations are once again standing at a crossroads in history.

Blinken's visit helped to ease some tensions in the short-term, but how the China-US relationship evolves in the medium and long term has a more profound impact on multiple industries. The globalization trend has shifted from exporting products to exporting manufacturing capacities. According to the latest global semiconductor equipment market statistics from SEMI, global semiconductor equipment sales in the first quarter of 2023 increased by 9% to $26.8 billion year-on-year, while semiconductor equipment sales in mainland China in Q1 were $5.86 billion, down 23% year-on-year, clearly affected by the U.S. semiconductor equipment restriction order.

Rosefinch believes that as a mature industry, the global semiconductor cycle has gone through nearly 20 rounds, each time getting through the crisis of excess capacity by clearing out uncompetitive enterprises, and then in the new cycle, allowing the leading enterprises to grow. Each product track has only two or three dominating companies. At this time, trying to compete in this space without innovation is simply value destruction from a global perspective. In recent years, Chinese semiconductor enterprises have developed rapidly and for the first time really participated in this global semiconductor mega cycle.

The visits to China by Cook, Musk, Jamie Dimon and Bill Gates are neither the beginning nor the end of the "politically cold but economically warm" pattern between China and the U.S. The question is, after these multinational CEOs return to the United States, how will they formulate their views on the Chinese market, business opportunities, and supply chains?

3. More Pressure to Achieve Economic Growth.

In May, economic data was generally below expectations with little bright spots. In 2022, the average assets of customers in major private bank declined year on year. Social finance credit data showed obvious weakness. Enterprises lack the willingness to expand, production is weak, motivation for capital expansion is mediocre, and households are taking a more conservative approach with weak outlooks.

In the beginning of the year, most forecasters expect the lifting of pandemic controls to bring a sharp pickup in "revenge spending", where the annual economic growth rate in 2023 can easily reach 5%. However, the industrial value-added growth in May was only 3.5% year-on-year. With the increase of base effect in the third and fourth quarters, the economic growth rate may be lower than the second quarter, meaning that the pressure on achieving the 5% annual economic growth target has suddenly increased.

Employment is the barometer of economic development. Currently, the unemployment rate of young people is still around 20%. By 2025, the number of annual college graduates in China will further increase by 3 million to nearly 20 million. In the coming years, we need to digest the accumulated unemployment in the past three years and recognize that the demand for urban employment will reach the highest point in history. The employment situation will become more serious.

New energy is a globally recognized area of strategic development, with a group of dynamic and visionary entrepreneurs actively involved. But there is no straight path to the mountain top, and the development of the photovoltaic industry is no different. After the bankruptcy of the leading enterprises in 2012, and government policy changes in 2018, the photovoltaic industry faced three pressures: overcapacity, consumption, and geopolitics. However, Rosefinch believes that overcapacity is just an opportunity for prudent companies with core competitiveness to drive industry progress through technological innovation, and only through technological iteration can the industry break existing integrated-barriers for the specialized companies emerge. Government subsidies can help to promote the creation of a more unified market. Consumption is an obstacle but also can be a driving force: the inherently intermittent sunshine will inevitably improve the energy-storage ratio and the management of off-grid power supply, further promoting the progress of power grid reform.

On June 2, the National Energy Administration organized the release of the "New Blue Book on the Development of New Power Systems." The incentive mechanism for green power consumption is gradually improving and the scale of green power and green certificate transactions continues to expand. The International Hydrogen Council estimates that hydrogen energy will account for 18% of global end-use energy demand by 2050, and clearly states that "building an end-use energy structure based on synergies between electricity and hydrogen will help the whole society achieve deep decarbonization."

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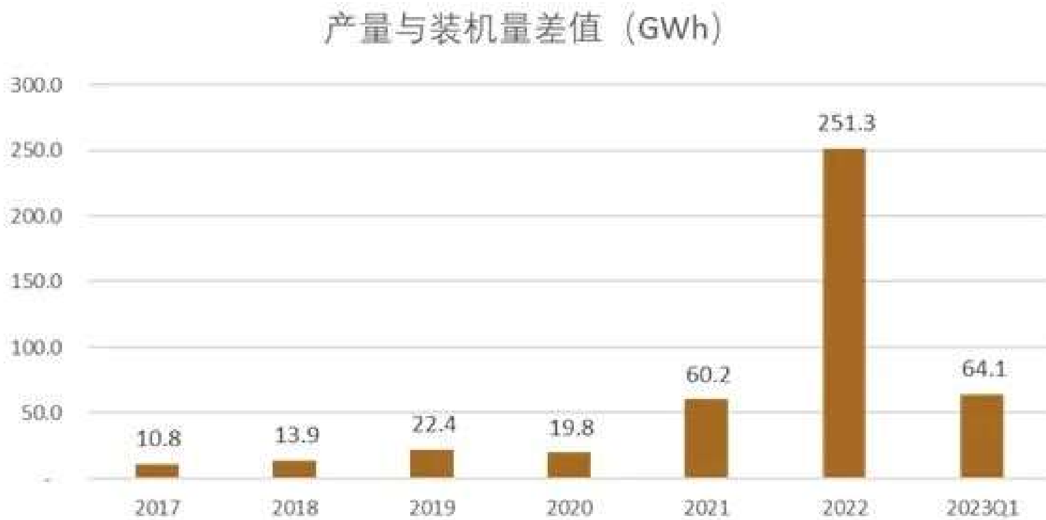

Source: Wind, Rosefinch. The difference between production and installed capacity.

According to Wind, in 2022, China's production and sales of new energy vehicles were 6.337 million and 5.545 million, respectively, up 93.3% and 83% year-on-year. Driven by the rapid development of the new energy vehicle industry, China's power battery production in 2022 was 545.9 GWh, up 148.5% year-on-year; shipments of 465.5 GWh, up 150.3% year-on-year, of which exports were 68.1 GWh; installation volume of 294.6GWh, up 90.7% year-on-year. In the first quarter of 2023, China's new energy vehicle production and sales were 16.5 million vehicles and 15.86 million vehicles respectively, up 27.7% and 26.2% year-on-year; domestic power battery production was about 130.0 GWh, up 26.3% year-on-year; shipments of about 108.5 GWh, up 66.8% year-on-year, of which exports were 25.8 GWh; installation volume was about 65.9 GWh, up 28.4% year-on-year.

The global power battery installation rate CR10 increased from 90.3% in 2021 to 95.6% in Q1 2023. Behind the high growth is the widening difference between production and installation volumes, highlighting the supply and demand mismatches in the power battery industry. In 2022, the difference was as high as 251.3 GWh, excluding 68.1 GWh of exports, about 180 GWh of power batteries were in inventory. The difference between power battery production and installation in the first quarter of 2023 remains high, and battery plants and automakers are expected to face considerable inventory pressure.

BYD CEO Wang Chuanfu said that the automotive industry has entered the “elimination stage”. Competition leads to the survival of the fittest and a more prosperous industry. For enterprises to win, they must first have core technologies. The transformation of new energy vehicles is a technological revolution. Second, they must have a good strategic direction, and vehicle models and technology choices are very important. Battery companies' competition in the second half has also shifted from scale competition to technology competition, with new forces entering from semi-solid/solid battery technologies, dedicated to improving safety and battery energy density.

4. Rate Cut to Support Real Economy.

Over the past year, the growth of China's broad money supply has accelerated, but its effect in promoting total demand and asset prices seems limited, with recent data showing economic growth below potential level, especially in light of inflation and unemployment indicators. M2 balance exceeded 100 trillion RMB in March 2013, while M2 at Jan 2020 exceeded 200 trillion RMB, and M2 increased by an average of 12.65% in April-May this year, reaching 282.05 trillion RMB. But the growth of social financing in the first four months was the lowest in the past five years. Social financing growth was 9.5% in May, an increase of 1.56 trillion RMB, 1.31 trillion RMB less than the same period last year. From January to May, real estate development investment in China amounted to 4.57 trillion RMB, down 7.2% year-on-year; saleable floor area of commercial housing reached 464 million square meters, down 0.9% year-on-year, and sales revenue of commercial housing reached 4.978 trillion RMB, up 8.4%.

In May, CPI rose year-on-year but fell month-on-month, while PPI continued to grow negatively month-on-month, with the PPI-CPI gap widening further. Looking ahead, we'll probably continue the low inflation environment due to weak demand for pork, low consumption willingness of residents, and growing risks of external downturn in the context of weak domestic and foreign demand. On June 13th, the PBOC conducted a 200 billion RMB 7-day reverse repo operation, with the benchmark interest rate at 1.90%. On the 15th, it continued the small-scale MLF increment operations and lowered the interest rate by 10bp following the OMO rate cut. In terms of scale, the market's liquidity is relatively ample at this stage. In terms of price, the PBOC has built a dual-core policy interest rate system of "7-day reverse repo rate + 1-year MLF rate", and the pace of rate cuts has basically remained consistent. It is expected that the transmission path of MLF-LPR will guide banks to lower actual loan rates to support the real economy. Meanwhile, if the 5-year mortgage rate linkage is also adjusted downwards, it will provide some support for stabilizing the liabilities of residents. Rosefinch believes that the significant weakness in social financing data means that the PBOC's adjustment of OMO rates ahead of MLF rates may imply an urgency to cut rates.

On the other hand of land finance is local government debt. This month, the Standing Committee of the Liaoning Provincial People's Congress emphasized the need to pay attention to debt risks and prevent market and county-level debt risks from spreading to the provincial level. The Hunan Provincial Party Committee and Provincial Government held a training session focusing on strictly prohibiting statistical fraud and strictly controlling local government debt risks. Against the backdrop of macroeconomic situation, the central government has given very clear signals to strengthen local debt management and urge governments at all levels to gradually reduce debt risk levels and resolve implicit debts in a stable manner. The message is simple: maintain the basic operation at the grassroots level, and assume responsibilities locally.

The scale of local government debt is huge but at the end of day, it is not commercial debt. Of course, if there are large-scale defaults, it will still impact the economy significantly. Urgent measures are therefore needed to build new mechanisms that support the economy while constraining the growth of new debt. According to relevant officials from the Ministry of Finance, currently, local government debt is unevenly distributed, with some places having higher debt risks and therefore greater payment pressure. MOF has urged the relevant local governments to take responsibility and avoid systematic risks.

The Fed's June interest rate meeting conformed to expectations and maintained its policy rate at 5.0% to 5.25%. Powell indicated that further rate hikes may be reasonable, and if the impact of credit tightening becomes more severe, it will be taken into consideration in interest rate decisions. In the short term, in the next 1 to 3 months, inflation may still show some inertia and continue to come down, but the pace may be slower than what the market expects. In the medium term, in the next 6 months or so, it mainly depends on the situation of economic vigor, whether total demand can be brought down. In the next one to two years, the trend of inflation depends on monetary supply conditions. If US monetary policy continues to maintain a tightening stance, inflation will eventually come down, and the economy may also enter a recession.

Dr. Peng Wensheng believes that from a longer-term perspective, the global macro environment has undergone fundamental changes. In the future, if we want higher economic growth, we have to accept higher inflation; and in order to control inflation, we have to accept lower economic growth. In the face of this trade-off, what will the government do? There are two factors worth considering. First, over the past few decades, income gaps have widened significantly in many countries. Recently many countries are moving to reduce income gaps and promote inclusive growth, meaning rising consumption rates and falling saving rates, which may lead to higher political tolerance for inflation. Second, the government debt of countries like the US and Europe is relatively high, and higher interest rates will have a negative impact on the sustainability of government debt. Overall, governments may choose to tolerate higher inflation rates to maintain economic growth.

5. Put Our Heart Into a Career that “Sustainably Create Value.”

The financial future of a country is closely related to its economic nature and development model. The Standing Committee of the National People's Congress emphasized that supporting start-up technology enterprises should be the top priority, and that government should accelerate the formation of an equity investment-based financial service support system that integrates "credit, debt, securities and insurance".

At the Shanghai Lujiazui Forum, Chairman Yi made a speech focusing on providing more precise and efficient support for science and technology innovation, helping the construction of the modern industrial system, and adhering to the coordinated development of investment and financing to better serve the diversified financial needs of residents. He further pointed out that we need to constantly improve the foundations of the capital market, improve the information disclosure quality of various market entities, play a better role of the capital market, create a coordinated market environment and ecology for residents' asset allocation, and better meet the needs of residents' wealth management.

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In the world of Three Bodies, its trajectories are mostly non-linear. "Heart" is the architect of our lives' meaning. Since Rosefinch's inception, we have embraced "sustainable value creation" into our heart. In the past, our business development has benefited from innovation and focus. In the future, Rosefinch will continue to take "3060+" as key theme to support innovative, competitive, and visionary enterprises to promote energy transformation, digital transformation, and consumption upgrade of human society.

In terms of Rosefinch's operation and management, we use partnership structure to align our personal interests and aspirations with those of Rosefinch. We are making Rosefinch the natural ladder for our team members' career progression. Of course, knowing is not enough, one must do. We will overcome challenges, seek out excellence, protect investors, and always strive to improve.

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

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