Rosefinch Research | 2023 Series # 20

Seeking Opportunities Amidst Pessimistic Market

"Those scars we have make us who we are." Batman in the movie "Flash."

1. With firm conviction and patient mindset, invest in the drivers of change

Since September, the economic data released shows that the US economy has high resilience, yet many other indicators such as industrial production, residential loan growth rate, existing home sales, etc. have shown a downward trend. Meanwhile the Federal Reserve significantly raised its economic forecasts for 2022 and 2023, lowered its unemployment rate forecasts for the next 3 years, and kept interest rates unchanged at 5.25%-5.5%. The yield on the 10-year Treasury bond rose significantly, bringing about a decline in global risk appetite, and commodity metals (oil, copper) and global stock indices started adjustments, with US stocks fluctuating more widely, amplifying risks across various asset classes.

During the pandemic, US fiscal stimulus from the government was extremely strong, with the deficit ratio exceeding the 15% level last seen in the 2008 financial crisis and reaching a historical high. As of July 2023, the 12-month fiscal deficit/GDP has already reached 8.4%. The Federal Reserve may be too optimistic. They may be surprised by rising inflation or weakening economic activity, or both in the form of stagflation.

The divergence between US and non-US economic and monetary policies has intensified to some extent, leading the US dollar index to rise again. As the RMB exchange rate itself is under strong PBOC guidance, RMB-denominated gold, oil and iron ore are becoming the preferred instruments for currency devaluation plays. Looking at the price trends of major agricultural commodities, they have also been affected to varying degrees by currency depreciation. For exchange rate pressure to truly ease in the future, we still need to wait for the Fed's rate hike cycle to end. Ideally, we can also see the continued ramping up and implementation of various domestic policies, with economic data gradually validating recovery trends of various fundamentals.

After August's record monthly net outflow of Stock Connect, September continues to see net outflows. Market funds' positions were generally reduced with trading becoming more cautious. The CSI300 index trading volume, adjusted after quantitative trading volumes, has not yet reached the extreme low position in 2018. The forward P/E of the MSCI China Index and the CSI300 Index is around 10 times and 11 times respectively, about 18% and 11% lower than their five-year averages. They are also 40% and 30% lower than developed markets average and emerging markets excluding China, which puts China's valuation at historical low levels. **In the industries that we focus on, most companies have fallen below their long-term value levels.**

August China data showed signs of bottoming out in the domestic economy. Total retail bottomed out and rebounded, industrial added value increased from 3.7% year-on-year in July to 5.5% in August. This data showed welcoming signs of recovery for both consumers and businesses. The August social financing increased by RMB 3.12 trillion, with RMB loans increasing by 1.36 trillion YoY. CPI also turned positive to 0.1% from -0.3%. The manufacturing PMI for September rose for the first time since April to the expansion range.

Under the government goal of "ensuring the completion of the full-year economic growth target", the debt-reduction policies are expected to be rolled out gradually, thus eliminating the risk of disorderly unwinding of local government debts. But the growth rate of nationwide real estate development, sales area and sales of commercial housing continued to slide. Given the supply and demand imbalance in the housing market, we'll like see adjustments or reversals of some previous restrictive policies on home purchases. There may also be more easing measures ahead in monetary policy and in RRR. Improvements to long-term household expectations though still need to come from the income side. Entrepreneurship and innovation still favor the brave: to be successful, we'll need both the "animal spirit" and the nurturing environment.

Given government policy impacts, Chinese economy is expected to stabilize in the fourth quarter domestically amid low interest rate levels. Before the APEC meeting in November, China and the US set up three working groups focusing on trade, economics, and finance. A rebound from extreme oversold conditions is worth waiting for! But in the long run, what determines the fate of the stock market is investment returns and the rule of law. From this perspective, pessimism can also be a source of power. Forces of digitalization, globalization and energy transformation are irreversible forces that shape our world today. From the perspective of outstanding enterprises, they have fully prepared for the uncertainties in the market environment, maintaining prudence in financial and domestic and foreign production capacity investment, taking roots for the long term by building their core competitiveness. Efforts to strengthen technological innovation, coupled with overcapacity pressure from a weak market and financing constraints, are also a form of supply-side reform that can help photovoltaic, new energy vehicles and semiconductors industries clear excess capacity and change investors' expectations.

With confidence and patience, we hope to better grasp opportunities within our capabilities amidst the market pessimism. We are closely tracking companies that continuously build core competitive strengths, and increase market share and profitability. After nearly 2 years of declines, the systemic risks are already reduced as reflected in attractive valuations. Although there seems to be no clear signs of a near-term turnaround, industries with their unique inflection point have the potential to set new highs during rebounds, and weak industries will also see alpha from companies with strongly positioned products.

In the long run, we believe growth and innovation will determine the direction of macroeconomic development rather than vice versa. "Investing in the driver of change" has always been the dream and practice of generations of Rosefinch research teams! Times create heroes, heroes lead the times. There are no shortcuts in investment. Making money takes work, and all towering trees have a growth process.

The good thing is that Rosefinch's coverage capabilities in 3060, digital economy, agriculture, healthcare and key consumption sectors have grown significantly over the past 5 years. On the one hand, we must be vigilant to align with industry direction; on the other hand, in security investments, we must follow the big trend and selectively take advantage of short-term market corrections.

2. Entrepreneur Spirit and Technological Innovation are the backbones of A-share

In August, there were changes in the operating data of industrial enterprises in terms of total volume, showing active inventory replenishment for the first time, with increasing quantity and price as well as recovery of profit rate. Factors such as releasing demand due to summer vacation period, marginal improvement of price factors and continuous positive impact from policy assurances brought incremental profits. In September, the manufacturing PMI data continued the characteristics of "recovery of production and demand + price rebound", with improvement in production still better than demand, and increased purchases; production and operation expectations were relatively strong, with the key point of observation still on the continuity of demand going forward. In real estate, the seasonal characteristics of "Golden September and Silver October" transactions continued, but the sentiment in the secondary market softened somewhat, with investment side continuing weak fluctuations at the bottom, and recovery of developers' confidence intermittent.

The 10th National New Industrialization Promotion Conference was held in Beijing from September 22 to 23. It called for continued efforts in strengthening technological innovation and ensuring industrial security, continuing efforts in optimizing industrial structure and promoting system upgrades, continuing

朱雀基金 Rosefinch Fund
[021]2030 5888 [021]2030 5999
58 Floor, New Bund Center, NO.555 West Haiyang Road/588 Dongyu Road, Pudong New Area, Shanghai
上海市浦东新区海阳西路 555 号/东育路 588 号前滩中心第 58 层，邮编：200126

efforts in promoting industrial digitization and green transformation, and continuing efforts in deepening reform and opening up and adding impetus and vitality.

The Ministry of Finance issued the "Interim Provisions on Accounting Treatment of Data Resources." Huawei's continuous and unceasing huge R&D investment has led to numerous technological breakthroughs represented by the Mate60 with Kirin chips, new AI, satellite communications and other technological applications, which have stimulated Huawei's industrial chain. Not only does it enhance the stability of the domestic supply chain, but it will also promote extensions to higher quality segments, the upgrading and evolution of the industrial chain. This example demonstrates that external pressure will counterintuitively promote independence, and technological blockades are not the best choices and only bring tremendous costs to the global economy.

The essence of planned economy thinking is that the government leads the economy, while the essence of market economy thinking is that the market allocates resources and entrepreneurs lead the economy. Government-leadership relies on calculation and top-down commands, while entrepreneur-leadership relies on imagination, judgment and integrated ability to deal with uncertainties, which spawns and drives market expansion and technological iteration.

As described in "The History of the Theory of Entrepreneurship," "Throughout history, the entrepreneurial spirit has always been the driving force behind economic activity and national prosperity. In ancient times, it manifested in military leadership and strategy, often involving life and death. However, it fully blossomed with the development of the market economy. Today, the entrepreneurial spirit inspires another force of progress - technology, thus producing a variety of consumer products such as fingernail clippers and smartphones. Artificial intelligence (AI) may be the current frenzy of technology, but its ultimate uses and directions will be determined by the minds of entrepreneurs and those willing to bet on its utility to consumers."

Driven by new energy, the energy eco-system has taken on manufacturing characteristics. China's PV, lithium battery and other technologies are at the world's advanced level. Innovation is lively in areas such as hydrogen energy, fuel cells, new energy storage, carbon capture, utilization, and storage, etc. It is expected that the share of green electricity in power generation will reach the key threshold of 20% within 2 years. From the perspectives of equipment cost proportion, R&D expenditure proportion, and reliance on public infrastructure, China's green power economy has demonstrated global scale advantages, cost advantages and manufacturing advantages.

To accelerate the growth of its domestic PV manufacturing industry last year, Europe began carrying out large-scale fiscal subsidies and incentive policies. However, despite strong PV demand in Europe, excessive new investment and fierce competition with Chinese suppliers have led to overcapacity in the market, continuous declines in PV prices. The SolarPower Europe Association indicated that European solar companies are at risk of bankruptcy, undermining the EU's goal of rebuilding a 30GW solar supply chain.

Email ir@rosefinch.cn

From the perspective of the US market, given its relatively independent industrial chain and disengagement from China's PV industry chain, it has been less significantly affected by declines in industrial chain prices to a certain extent. But due to its current reliance on imports of PV products from Southeast Asia, its plans to rebuild domestic PV manufacturing may also be difficult to achieve in the short term amid competition from low-cost imported PV products.

It is worth noting that by the end of 2023, annual production capacities for the four main links in the PV industry chain will all exceed 800GW, whereas there's an installation demand of 400GW and component demand of 475GW in 2024. The PV industry, which has come of age, is facing difficult times again. Recently, a leading company has suspended a proposed share issuance of RMB16 billion, and another leading company has applied to withdraw its filing for an initial public offering. Yet another leading company has publicly announced investment on the BC technology.

Although it is difficult to change the fact that there will be overcapacity in the industry in 2024, it is already affecting expectations for the supply-demand situation and competitive landscape in 2025. Tightening financing and technological upgrades are working together to push supply-side reforms in the PV industry and thus promote industry progress. Under the leadership of ambitious entrepreneurial companies, industry share and profitability will once again concentrate in companies that uphold the correct visions and have continuous innovation capabilities.

Recently, European Commission President Ursula von der Leyen announced that it will launch an anti-subsidy investigation against electric vehicles from China. The implementation guidelines for the EU's Carbon Border Adjustment Mechanism (CBAM) transition period will also formally take effect on October 1 this year. Together with the US "Inflation Reduction Act" in 2022 and the EU's draft "Net Zero Industry Act", the goal is to promote local clean technology capabilities through industrial policies while balancing carbon neutrality and economic development, integrating green transformation with industrial development.

In recent years, the market share of Chinese branded new energy vehicles in Europe has increased rapidly, posing some impact to the development of local electric vehicles in Europe. The penetration rate of Chinese auto brands in Europe rose from 3% in 2020 to 8% currently, with Canalys forecasting it will increase to 16.5% by 2025. Chinese auto exports, which long stayed below 5% of total production, surged over the past three pandemic years, with total volume approaching 5 million vehicles this year, making China the world's largest exporter, with an export ratio nearing the 20% level of major automotive exporting countries.

It is estimated that the market share of Chinese new energy vehicles in European exports accounts for over 30% (including Tesla China). If trade protection policies such as tariffs are substantively implemented in the future, it may force local automakers to accelerate overseas deployment in Europe. At the same time, there are inherent differences between trade protectionism in Europe and the US: automobiles are a pillar industry closely linked to local employment and livelihoods in European countries.

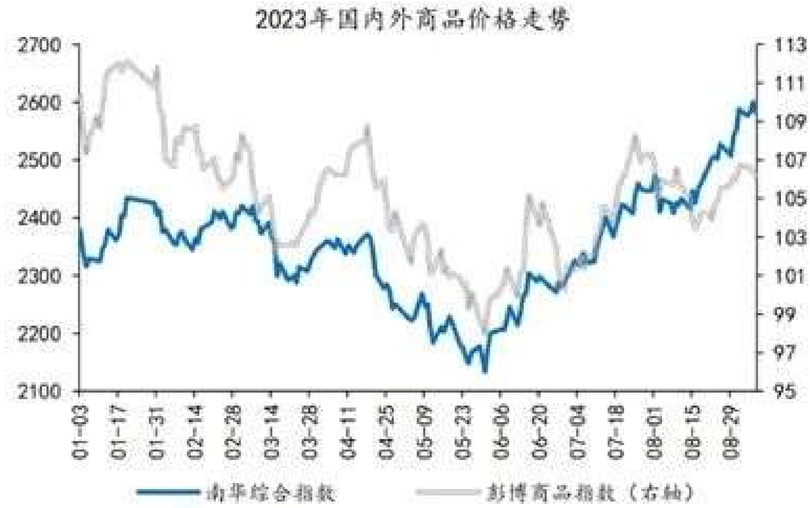
The 10th China-EU Economic and Trade High-Level Dialogue was recently held in Beijing. Both sides pledged to maintain two-way opening and provide a fair and non-discriminatory business environment for each other's enterprises. The two sides agreed to jointly maintain and strengthen the multilateral trading system centered on the WTO and based on rules, and oppose unilateralism and protectionism. The two sides agreed to build a stable and trusted industrial and supply chain, jointly maintain the resilience and stability of global industrial and supply chains, and oppose "decoupling and dismantling." The third Sino-German High-Level Financial Dialogue reached 25 consensus points in Frankfurt.

In his Jackson Hole speech, Powell reaffirmed that the target of 2% inflation does not change, and future data will determine the policy path, which may involve further rate hikes. Overall, given that the supply of medium- and long-term US treasury bonds has not increased significantly in the second half of the year, interest rate hikes are only stage adjustments. Meanwhile, signs of declining inflation and employment data imply that the current round of Fed rate hikes is likely to end. At the same time, high interest rates are starting to put obvious pressure on the US fiscal burden and thereby drag on the economy. Although persistent high inflation is still not seen, maintaining the 2% target.

Historically, actual interest rate trends in the US rose in 1919, 1946 and 1979. The first two periods corresponded to the end of the two world wars, when explosive global population growth was the main driver of rising actual interest rates. 1979 saw the information revolution brought about by computer technology, which significantly improved labor productivity. Current artificial intelligence cannot yet significantly improve the overall labor productivity of society in a short period of time, like computer technology did back then. Moreover, the world is undergoing structural changes - geopolitical risks and even wars have decreased due to deglobalization, lowering the efficiency of global supply chains. At the same time, carbon neutralization is raising energy costs, as are US tax increases on investment and social welfare. While hyper-inflation is still not visible, the 2% target may also need adjustments as the world environment evolves.

The strengthening of the US dollar is conducive to controlling inflation in the US, but for other countries and regions, it means currency depreciation and inflationary pressure, exacerbating the risk of stagflation. The People's Bank of China said that "financial regulators have the capability, confidence and conditions to keep the Renminbi exchange rate basically stable" and "resolutely guard against exchange rate over-adjustment risks." It decided to lower the reserve requirement ratio for foreign exchange deposits of financial institutions from the current 6% to 4%, effective from September 15, effectively increasing supply of USD in onshore market.

Since May 31, both domestic and international bulk commodities have strengthened, with domestic commodities performing particularly well.



Recently Bloomberg reported that mainstream economic narratives that have dominated global capital flows for decades are rapidly reversing. The US, Japan and Europe also face their own challenges and worry about the impact of weaker Chinese demand on the global economy and their domestic companies. The opportunities of reform and opening-up, obtaining resources through marketization, making a living with one's own abilities - history has bestowed tremendous, good fortune on this generation of entrepreneurs. Coupled with their own aspirations, within just 30-40 short years, they have repeatedly proven that in a benign social, political and economic environment, the entrepreneurial spirit has the ability to overcome challenges. Entrepreneurial spirit and technological innovation are the backbone that is crucial for the A-share market.

3. Beware of “pick the bottom” mentality, and focus on the turning points in the industry and the company

After the shareholding reform, the registration system further promoted the development of the A-share market towards legalization, marketization and internationalization, which is also the direction with the least resistance and the largest space for the whole society. It is hoped that raising the IPO threshold and the new policy on reducing holdings can force enterprises to effectively utilize the functions of capital market mergers and acquisitions. This is profoundly significant for improving the supply-demand of A shares and creating a long-term healthy capital market.

For the asset allocation of residents and enterprises, at the current historical low valuation levels, as long as the social and economic expectations are stable and clear, the fundamentals are likely to recover and move up, the price-performance ratio of stock assets will then be highlighted.

We have observed that the main shareholders' willingness to increase their holdings has increased recently, because they feel the company is worth the investment, and they genuinely look forward to the company's medium and long-term development. Market insiders feel it can't fall anymore, while market outsiders hope to wait for another 10-20% decline and are reluctant to make a move but start to worry about missing out.

We judge that at this time and place, some high-quality companies have already turned profitable, and a few companies whose fundamentals have shown signs of improvement should have already left the bottom: after all, stock prices follow earnings expectations. We need to beware of the mentality of perfect bottom fishing and focus instead on industry and company inflection points, especially pay attention to selecting tomorrow's stars. **Excellent companies with large industry growth space, good competitive landscape, and focused entrepreneurs are very rare in any market, and those stars of tomorrow who can drive progress and become future giants are even fewer. And these stars of tomorrow are what Rosefinch team are identifying for our investors today.**

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

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