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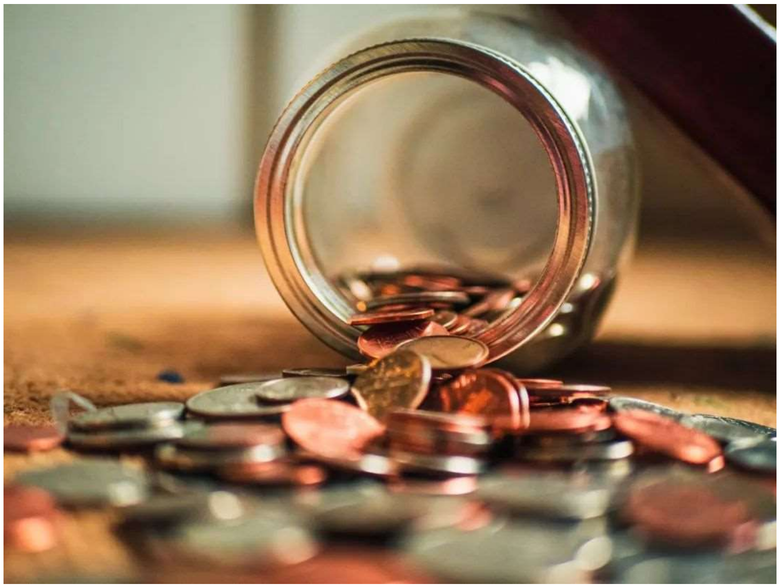
Rosefinch Research | 2024 Series # 12

Overshooting Leads to Underperformance



"We need finance, but now we have too much of a good thing." John Kay

1. Valuation More Important Than Timing

Since the beginning of the year, the overall US stock market has seen stocks rising and bonds falling, and the market believes that the probability of a soft landing for the US economy has increased significantly. Driven by the AI wave, the Nasdaq, S&P 500, and Dow Jones have rebounded for four consecutive months since last October, setting new historical highs. Although the economies of the UK, Japan and Germany are technically in recession, European and Japanese stock markets have also hit historical highs. Since the beginning of the year, the Nikkei 225 index has risen more than 18%, breaking its 1989 high and the 40,000 level, the Taiwan Index has risen over 10%, setting new highs by breaking through 20,000 points, and the Indian SENSEX index has started its 9th consecutive year of gains.

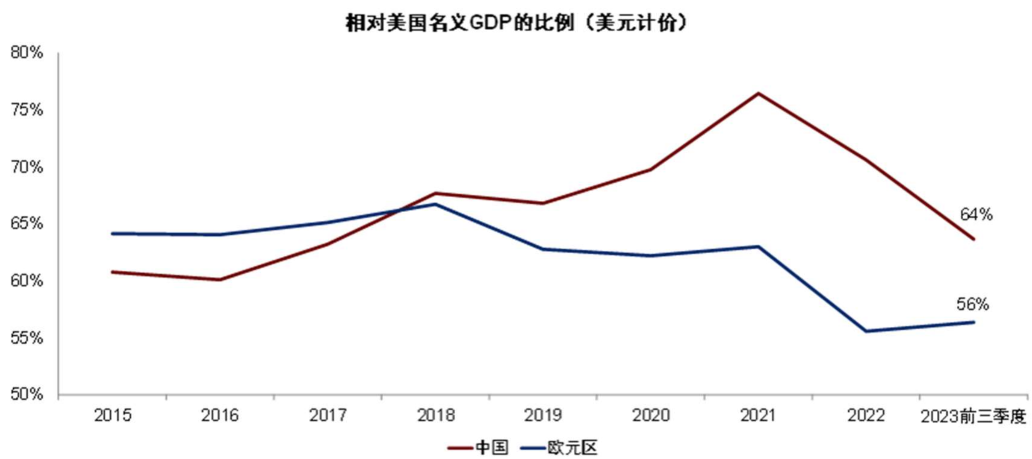
Nvidia, AMD, TSMC, Microsoft, Meta and others have all set historical highs, with Nvidia rising nearly 10 times in the past 16 months, up over 76% this year. After surpassing Google's parent company Alphabet and Amazon in market value (US$2.3 trillion), it has now surpassed Saudi Aramco to become the world's third largest company, just behind Microsoft and Apple.

The US dollar and US bonds have basically returned to the level before Fed Chairman Powell's unexpected "dovish" shift in mid-December 2023. But gold has hit a historical high as it is a decentralized carrier of intrinsic value, enjoying similar logic as a non-sovereign currency. From the gold-dollar to the oil-dollar and now the computer-dollar, Nvidia's underlying logic is the AI era.

Driven by AI, the earnings of large US tech companies are in a period of rapid growth, and the valuations of some companies in the market still do not seem to show signs of a bubble. But the S&P 500 rose 24% in 2023, with current US stock gains concentrated in a handful of heavyweight stocks, pushing market concentration to its highest level since 1972.

China Securities Regulatory Commission Chairman Wu Qing said that "once the market seriously deviates from fundamentals and sees extreme fluctuations, liquidity drying up, market panic, and severe lack of confidence, we will resolutely intervene to correct market failures." On February 6, the government owned Central Huijin Investment issued a notice that it will continue to increase the scale and intensity of ETF purchases to resolutely maintain the stable operation of the capital market.

After the Chinese New Year holiday, the Shanghai Composite recovered the 20-year line, while the CSI300 and the ChiNext Index have both turned positive for the year. As of March 12, the CSI 500 and SSE 50 fell 5% and 17.5%, respectively. **The market is starting to see a de-emphasis of overall liquidity supply factors and instead paying more attention to micro-logic and industry trends.** Some ETFs and foreign capital outflows have slowed, while newly launched equity mutual funds raised over RMB17 billion.



Source: Wind. Relative nominal GDP percentage for China (red) and Eurozone (blue.)

After the outbreak of the COVID-19 pandemic in 2020, the relative scale of China, the United States, and the eurozone - the three largest global economies - has changed, with the US economy rising relative to China and the eurozone. In terms of GDP denominated in US dollars, from 2020 to 2023, the ratio of the eurozone to the US economy declined by about 7%. In the early days of the pandemic, the relative scale of the Chinese economy to the US rose. Over decades of decline, Japan's ratio to the US GDP fell from nearly 80% to around 15% last year. In the 1990s, the market value of Japanese stocks accounted for about 45% of the global stock market, leading the US' 33%. By 2024, the total market value of US stocks has exceeded 50 trillion US dollars, accounting for about 50% of the total market value of all global stock markets.

Over the past year, China has maintained strategic composure. Macroeconomic performance was relatively modestly weak, with "the decline of external demand and insufficient domestic demand intersecting, along with the coexistence of cyclical and structural problems, and some local risks such as real estate, local government debt, and small and medium-sized financial institutions becoming more prominent." Based on the historical experiences of other countries, the adjustment of real estate and debt may last for a relatively long time.

The insufficient effective demand currently facing the economy is highly likely to have cross-cycle characteristics. The lack of total demand is reflected in savings surplus in real terms, meaning the equilibrium level of the actual interest rate required for economic supply and demand balance has fallen. At the same time, weak expectations are reflected in the financial sector as an increase in demand for safe assets, leading to real interest rates rising including risk premiums. China's "Clearing monetary policy transmission mechanisms and avoiding idling capital" differs from US, who has more domestic resilience. Domestic monetary policy pays more attention to external factors and "in 2024, the RMB exchange rate will continue to remain basically stable at a reasonable equilibrium level."

Dr. Peng Wenshan believes that "fiscal expansion and expansion of central bank balance sheets" will be effective means to promote sustainable economic recovery for a considerable period of time in the future. It is conducive to raising the equilibrium interest rate level and reducing risk premiums to support the strong currency required for a financial superpower. The combination of GDP target of 5% + narrow budget deficit of 3% + special national bonds of 1 trillion yuan are consistent with conservative expectations. The small increase in the broad deficit rate comes from special national bonds, with fiscal stimulus primarily in the form of increased leverage by the central government in a mild expansionary manner. Xinhua noted that "further comprehensive deepening of reforms to resolve deep-seated institutional and structural barriers and contradictions, fully stimulate creativity, innovation and vitality throughout society, enabling Chinese modernization to overcome obstacles and move forward steadily."

For investors, declines are risks but also reminders. **Good strategies foresee the future; good research makes forward-looking judgments.** Investors focus on fundamentals; traders focus on each other; quantitative analysts focus on data. 80/20 differentiation is a trend - it's better to be diligent, persistent, and wise than trying to outsmart the market. Research focus should be on big opportunities within one's circle of competence, judging industry development space and profitability as well as consistency. Picking the right price is better than timing; invest carefully without rashness in adversity and make good use of opportunities. Today's difficulties will make one stronger; tomorrow one need not force progress against the current.

2. Advanced Semiconductor may be basic infrastructure for Sovereign AI

In the past, the global economy was generally characterized as "China produces, America consumes." In 2018, the trade war initiated by the Trump administration increased tensions of "decoupling" between

China and the US, making China's domestic demand deficiencies and US domestic supply deficiencies more prominent. The Biden administration focuses on industrial policy with the "Inflation Reduction Act" and the "CHIPS and Science Act" effectively driving up manufacturing spending in the United States.

AI technology is different from all past technologies in terms of its revolutionary changes, a new form of cognition, progress, and improvement of life, complementing human capabilities, and may become an ecological system on which the world depends for survival. In an interview, Jensen Huang, CEO of Nvidia, said that the understanding of the importance of "sovereign AI capabilities" is quite globalized, and every country hopes to build this important infrastructure. The European Parliament passed the "AI Act" by a large majority to make Europe "a leader in this field." Premier Li emphasized during his inspection in Beijing that artificial intelligence is an important engine for developing new productive forces. It is necessary to accelerate the improvement of computing power, promote algorithm breakthroughs and data development and utilization. The surging national-level AI hardware demand drives huge demand for cutting-edge chips. In response to the "$7 trillion AI chip project", OpenAI CEO Altman said, "The core fact is that we believe the world will need more artificial intelligence computing chips."

Regarding sanctions on semiconductor exports to China, the Biden administration has asked Japan, the Netherlands, Germany, and South Korea to expand the scope and strengthen supervision, and initiated an investigation into intelligent networked electric vehicles from China citing "national security." Following X and TikTok, the EU Commission has formally launched an investigation into whether AliExpress of Alibaba violates the EU's Digital Services Act (DSA). Isaac Asimov once said: The greatest tragedy in life is that scientific knowledge accumulates faster than society's ability to absorb wisdom.

"I hope to compete, not conflict with China," and there are common interests between the US and China. China's stable economic development needs policy support and still needs reform and opening up as a new impetus. Globalization is accelerating again, and the external environment provides many opportunities. In the face of challenges from those trying to exclude us from the globalization process and "kick us off the train", we must not jump off the train ourselves. We should strive to participate in the global division of labor system and continuously improve our level. The differences between consumer-level chips and HPC are now clearer globally. The former can continue globalization, while HPC is a very important strategic resource in each country that must ensure sovereignty.

Computing power is the foundation for AI. It is highly unlikely that we will lead in AI without leading the field of advanced semiconductors. Domestic semiconductor manufacturing currently has low yields, which is due to limitations in processes, equipment, and materials. Even under such difficult production conditions, Chinese enterprises must maintain the development of AI chip computing power, with the goal of striving to compete at the same stage as international advanced levels, until AI can be applied to real productivity.

3. Increasing Productivity via Digital and Green Technology

China's economy is in a transition phase, shifting from past high-speed growth to high-quality development. In recent years, China has actually been in a period of mid-speed growth. In the past few years, the pandemic has disrupted the transition process to some extent. But starting last year, China has basically shaken off the interference of the pandemic and gradually returned to the normal growth track. In 2023, China's GDP grew by 5.2%. But it needs to be noted that the base in 2022 is relatively low. The actual average growth rate between 2022 and 2023 is 4.1%.

The Premier said in the government work report that "the impetus for world economic growth is insufficient, regional hotspot issues occur frequently, and the complexity, severity and uncertainty of the external environment have increased. The foundation for China's economic recovery and improvement is still not solid, effective demand is insufficient, some industries have excess capacity, social expectations are weak, risks and hidden dangers still exist in many areas, there are bottlenecks in the domestic large circulation, and interference in international circulation."

Source: Wind. Retail sales figures and growth rates.

In response to the two rounds of crises in 1997 and 2008, China mainly relied on exports, infrastructure, and housing investment. Today, improving domestic demand, especially promoting consumption growth, is key to solving current economic and financial challenges, easing deflationary pressures, and restoring financial balance. In terms of residents' consumption structure, subsistence consumption such as clothing, food, shelter, and transportation has basically been met, so the focus of expanding consumption should be placed on development consumption, such as residents' demands for housing, medical care, education, and social security, in which area the government's basic public services are very important. **Both subsistence consumption and development consumption ultimately need to be boosted by increasing income.**

In the mid-to-long term, China must further promote reform, open up, and improve the urbanization level and quality. Our current per capita GDP is around $13,000. The country has proposed mid-to-long term development goals of basically realizing socialist modernization by 2035 and reaching the per capita GDP level of middle-income developed countries, which is around $30,000 to $40,000. Compared with the present, there is a catching-up potential of about $20,000, which is mainly expected to rely on the growth of the services sector and the transformation and upgrading of agriculture and industry.

In addition, in recent years, with new technological revolutions driven by digital technology and green transformation, new growth potential has also been provided to us (40% of China's GDP growth last year came from clean energy). Professor Liu Shijin pointed out that by integrating catching-up potential and new technological potential, it will form our new competitive advantages in the international arena. We need to make good use of these potentials, lift the income level of the current 900 million people with low and middle incomes horizontally, and promote industrial transformation and upgrading vertically.

The government's work priorities for 2024 will put "vigorously advancing the construction of a modern industrial system and accelerating the development of new productivity" in the first place. It will fully leverage the dominant role of innovation, accelerate the advancement of new industrialization, improve total factor productivity, and promote new leaps in social productivity. After "deeply implementing the strategy of strengthening the country through human resource development and science and technology and strengthening the fundamental support for high-quality development", it will propose "making efforts to expand domestic demand and promote a virtuous cycle of the economy". It aims to better coordinate consumption and investment by organically combining the implementation of expanding domestic demand strategy with deepening the structural reform of the supply side, thereby enhancing the driving role for economic growth. It also requires "resolutely deepening reforms and enhancing endogenous impetus for development", and "expanding high-level opening-up and promoting win-win cooperation."

The Political Bureau of the CPC Central Committee held its twelfth collective study session on new energy technologies and China's energy security on February 29th. The General Secretary pointed out that in the face of a series of challenges in China's energy development, the way forward is to vigorously develop new energies. He emphasized that new energy development has already had a good foundation, and China has become an important promoter of the world's energy development transition and response to climate change. We must cultivate energy technologies and related industries to become new drivers of industrial upgrading in China and promote the development of new productive forces.

Simply put, new productive forces refer to comprehensively improving total factor productivity by utilizing new technologies. In this sense, AI may be the most important new productive force. Digital technologies and new green technologies have opened up increasingly new avenues for improving our total factor productivity. The relationship between new productive forces and economic growth is mutually reinforcing.

The recent rebound in performance in the new energy industry has to a large extent clearly manifested the inflection point of the cyclical nature under expectations. However, from the perspective of actual survival status, the photovoltaic industry is still experiencing a phase of difficulties, and price declines have led many companies to already operate at a loss of cash; but from the perspective of development cycles, the

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industry should be at the bottom; and from the perspective of technological development, the photovoltaic industry is improving.

In terms of policies, Shaanxi regards building the Yulin Energy Revolution Innovation Pilot Zone as a concrete action to implement the new energy security strategy. Inner Mongolia becomes a region after Guangdong, Hebei, and others to cancel the hazardous chemical attribute of green hydrogen. Shandong and Sichuan have introduced policies exempting hydrogen fuel vehicles from expressway tolls. The National Energy Administration is accelerating the construction of new energy mega-bases, actively developing distributed new energy, strengthening the construction and implementation of renewable substitutes, and cultivating new energy industries.

The variability of wind power and photovoltaic output is difficult to completely eliminate. In the future, the consumption patterns of wind power and photovoltaics may no longer be simply large-scale grid connection, but need to be deeply integrated with other industries to realize on-site direct supply and consumption. This trend will help improve energy utilization efficiency, reduce energy costs, and ensure energy security, while also providing new opportunities and challenges for the sustainable development of the wind power and photovoltaic industries. In the long run, the construction of new power systems is key to realizing multi-directional energy flows between new energy, storage, hydrogen, heating and cooling, and gas.

4. The Need for Safe Assets

Source: Wind. Real effective exchange rate for RMB (red) and USD (grey).

In February, China's CPI increased by 0.7% year-on-year and 1.0% month-on-month, better than market expectations. The year-on-year CPI growth also turned positive for the first time in five months, but PPI declined year-on-year. It is generally believed that if the consumer price index (CPI) falls for two consecutive quarters, it indicates deflation in the economy. In addition to narrow deflation, broad deflation should also include deflation in economic factors other than consumer goods, especially assets, including real estate and financial assets such as stocks. In recent years, the supply of money in China has maintained

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a relatively high growth rate, but judging the adequacy of money supply also needs to consider money demand during the same period. From this perspective, in addition to commodity prices, risk premiums should also be considered in judging whether there is deflationary pressure on the economy.

Dr. Peng Wensheng pointed out that one phenomenon worth noting is that monetary expansion in response to the epidemic led to inflation in the United States, but the U.S. dollar exchange rate appreciated, thereby increasing the nominal GDP of the United States relative to other economies. Monetary easing domestically but appreciation externally reflects investors' simultaneous increase in demand for safe U.S. assets and risky assets. This led to the combination of U.S. stock markets rising across the board and the U.S. dollar appreciating in 2023.

The central government has proposed that building a financial power requires a strong currency. A strong currency means investors have strong demand for both safe assets and risky assets denominated in it, that is, demand for safe assets is not driven by a decline in risk preference but by higher equilibrium interest rates. It is obvious that downward demand pressure on the economy does not support the combination of strong safe and risky asset demand.

Source: Wind. Real interest rates for 10yr CGB (red) and UST (grey).

Measured by nominal interest rates minus inflation rates, China's actual interest rate levels have been at a relatively high level over the past decade or more. Although China's nominal interest rates are lower than US rates, China's real interest rates are higher than the United States. One way to deal with actual interest rates higher than equilibrium levels is monetary easing. Another way is fiscal expansion to directly stimulate demand, reduce excess savings, and play a role in raising equilibrium interest rate levels.

Dr. Peng believes that in the second half of the financial cycle, resolving debt problems requires systematic measures, especially the coordination of fiscal and monetary policies. Raising equilibrium interest rate levels while lowering risk premiums and raising inflation expectations would have a more stimulating effect on expanding aggregate demand through comprehensive effects. "Looking ahead to 2024, on the one hand we need to observe the progress and strength of fiscal expansion, including the 'three major projects', and on the other hand we need to pay attention to changes in the central bank's balance sheet."

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During the two sessions, Governor Pan indicated that maintaining price stability and promoting moderate price increases will be an important consideration in monetary policy, coordinating the health of the banking industry's balance sheet, and continuing to promote a steady decline in the overall cost of social financing. Yi Gang pointed out that it is currently necessary to strengthen the coordination and cooperation between financial policies and other policies such as fiscal policies. Strengthening provinces' efforts and turning weak provinces' debts, will further shrivel local governments' available investment capacity.

On February 2, Premier Li Qiang chaired and convened a State Council executive meeting, pointing out that building a world-class business environment that is market-oriented, rule of law-based and international is an important measure to address downward pressure on the economy and boost the confidence of business entities in operation. It is necessary to pay more attention to responding to the outstanding concerns of business entities, speed up the building of a unified national market, strengthen the consistency assessment of macro policies, and create a stable, transparent, and predictable policy environment.

On February 19, General Secretary Xi Jinping chaired and convened the fourth meeting of the Central Committee for Comprehensively Deepening Reform, emphasizing that this year is another important year for comprehensively deepening reform. We must stick to using reform and opening up as the key tactic to solve problems in development, address risks and challenges on the path ahead. Reform measures should have clear direction and charge of solving the most prominent problems. Reform should be thick in flavor and rich in substance.

5. The 80/20 Trend in Mature Markets

A well-functioning capital market allows capable entrepreneurs to obtain more financing, create job opportunities, and contribute tax revenues and create value for society; it allows investors to obtain returns through the stock market and effectively connect savings with financing, forming a virtuous cycle.

In history, bull markets can generally be divided into three stages: from when only a few people began to realize that conditions were improving, to when most people believed that improvements were actually happening, to when everyone believed that conditions could only get better. We should pay attention to how to establish a sound financial market order from the perspective of rules and institutions, how to effectively protect the interests of small shareholders in practice from an administrative and judicial perspective, and the large changes in fiscal, monetary, and other policies.

Rosefinch believes that the concentration of market value of the top A-share companies is lower than the relatively mature US and Hong Kong stock markets, with a serious "fat tail" in the distribution of PE ratios, which is mainly due to the relatively high valuation of downstream mid-small companies, and was

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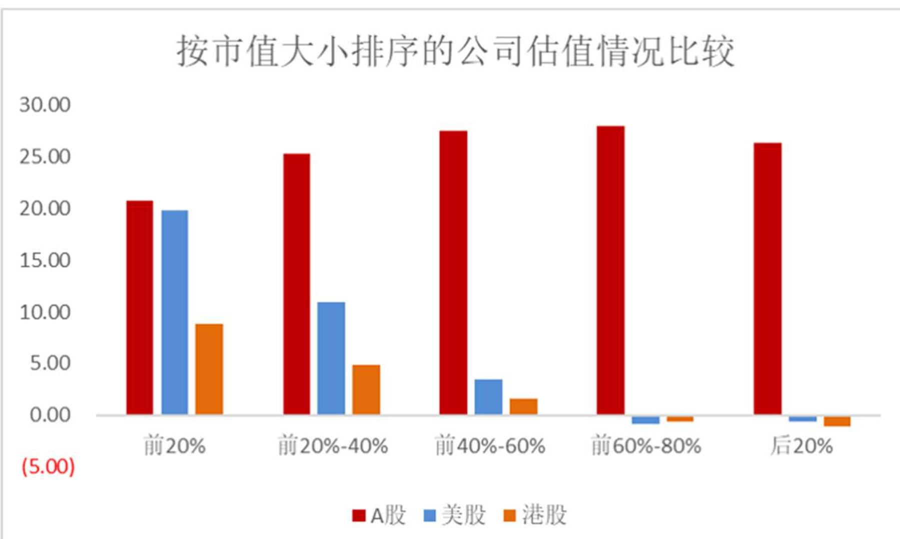
influenced for a fairly long period in the past by the mainstream investment style of growth investment, and A shares were in short supply in the early days.

The median market value grouped by market value size (in 100 million RMB, as of the end of 2023)

	A 股	美股	港股
前 20%	258.13	1215.66	216.15
前 20%-40%	93.28	185.21	22.92
前 40%-60%	53.66	42.84	5.60
前 60%-80%	35.52	9.72	1.89
后 20%	22.72	1.34	0.57

Source: Wind, ifind.

The median PE grouped by market value size (as of the end of 2023)



Source: Wind, ifind.

The median 2023 return grouped by market value size

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	A股	美股	港股
前20%	-1.7	17.8	-7.4
前20%-40%	-1.9	14.4	-15.8
前40%-60%	1.6	5.0	-12.7
前60%-80%	3.3	-1.9	-22.0
后20%	12.3	-49.4	-32.0

The macro environment, financial ecology and capital market itself are undergoing changes: From the perspective of corporate development, compared with the past 20 years, the slowdown of quantitative economic growth has made it more difficult for industries and companies to seek high growth; for entrepreneurs, the requirements for companies to grow are higher; from the perspective of investors, uncertainties increase, risk premiums rise, the high premiums given to small companies for growth in the past may not be sustainable; from the perspective of market liquidity, the future liquidity environment will also tend to shift existing assets; with the continuous promotion of registration system reform, the shell resource value of small cap companies will probably not be sustainable, and mergers and acquisitions will only have value when valuations are reasonably low, achieving secondary market resource optimization and reconfiguration through delisting will become the norm.

Under the differentiation of 80/20, the challenges of investment have evolved from guessing the other's mind in a game of wits to having to judge the development space and certainty of industries, the competitive landscape and return capabilities of companies, and the entrepreneurial spirit.

"The path of financial development with Chinese characteristics not only follows the objective laws of modern financial development but also has distinct Chinese features that are suitable for China's national conditions, with fundamental differences from Western financial models." Chairman Wu Qing said at the second session of the 14th National People's Congress economic theme press conference: From a regulatory perspective, the focus is on two key words, one is "strong”, and the other is "strict". Improve the quality of listed companies from the regulatory side with four major aspects: tightening entry standards, strictly conducting day-to-day oversight, facilitating exits, and making responsibilities crystal clear.

In strict day-to-day oversight and strengthened post-IPO monitoring, currently three key tasks are emphasized: cracking down on fraud, regulating stakes reduction, and promoting cash dividends. Facilitating exits will primarily step-up delisting efforts, with both mandatory delisting and voluntary delisting to be implemented. On one hand, more stringent mandatory delisting criteria will be implemented to ensure thorough delisting as required. On the other hand, absorption and acquisition policies will be improved further to broaden diversified exit channels, also encouraging some companies to voluntarily delist. On March 15, the China Securities Regulatory Commission issued the "Opinions on Strictly Controlling Issuance and Listing Access to Continuously Improve the Quality of Listed Companies from the Source (Trial Implementation)" and the "Opinions on Strengthening the Supervision of Listed Companies (Trial Implementation)". It is clearly stated to adhere to the functional positioning of different sectors, comprehensively improve the stake reduction rule system, establish a "1+2" rule system with stake reduction management measures at the core and supplementary provisions for stake reductions by directors, senior executives, and venture capital funds. It is proposed to strengthen cash dividend supervision and enhance returns for investors. Listed companies are encouraged to strengthen market value management and improve investment value. Oversight over restructuring listings will be further strengthened to further reduce "shell" values.

"Protecting the legitimate rights and interests of investors, especially individual investors, is the CSRC's most important core task, which also reflects the political and people-oriented nature of capital market regulation." The "Opinions on Strengthening the Supervision of Securities Companies and Public Funds to Accelerate the Development of First-Class Investment Banks and Investment Institutions (Trial Implementation)" adjusts the positioning of industry organizations: Functionality should take precedence, properly handling the relationship between functionality and profitability. Industry stability through ups and downs should become a thing of the past. The industries should be guided to develop in the direction of functionality, intensiveness, specialization, and characterization.

Rosefinch will be rooted in "differentiated development, specialized operations, combining shareholder characteristics, regional advantages, talent reserves and professional capabilities", focusing on the long term from investor's perspective.

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

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