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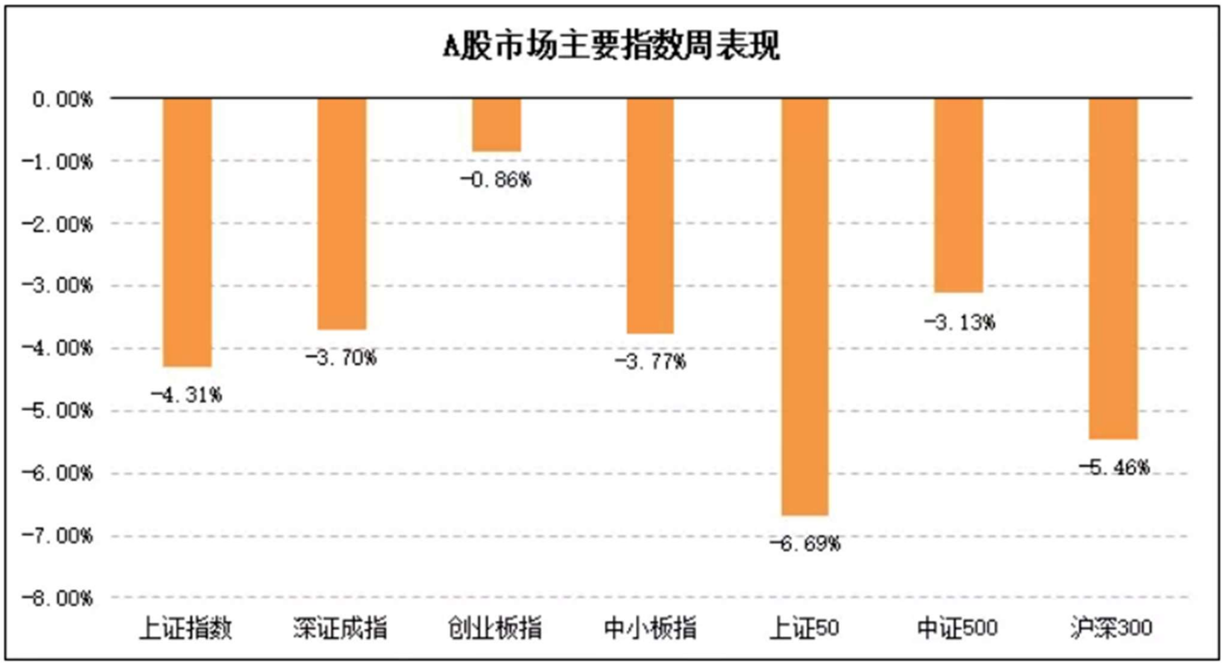
Rosefinch Weekly | Drawdown is key source of excess return
Liquidity easing bias is more likely towards year end

1. Market Review

Last week saw A-share dropping as structural differentiation continues. The small to medium stock indices like CSI500 and CSI1000 continue to lead major indices like SSE50 or CSI300. SSE was -4.31%, SZI was -3.7%, GEI was -0.86%, while SSE50 was -6.69%, CSI300 was -5.46%, CSI500 was -3.13%.



数据来源：Wind，朱雀基金整理

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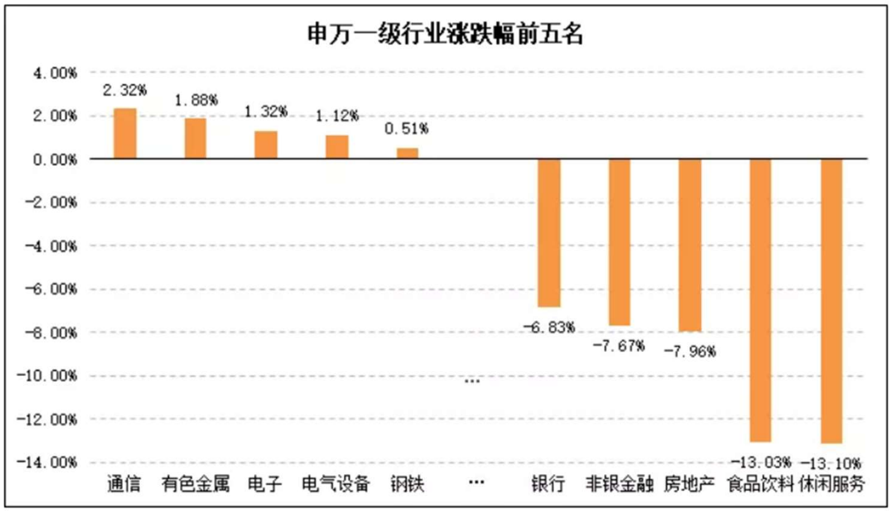
Amongst the ShenWan Primary industries, only 5 out of 28 rose last week: telecommunications, non-ferrous metal, electronics, electrical equipment, and steel.



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There was heavy volume last week, with both northbound and southbound net selling interests.

Source： Wind， Rosefinch. Graph of cumulative positions in Northbound (blue) and Southbound (red) stock connect flows.

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2. Market Outlook

Last week's China Politburo meeting concluded that global pandemic is still evolving. This made the external situation more complex and difficult, while the domestic economic recovery is still uneven and unsteady. There was also further deceleration in economic activity as the July manufacturing PMI was 50.4, which was 0.5 lower than June and lowest since the pandemic. Therefore, the macro policies will continue their multi-cycle adjustment approach; the fiscal policy will be more active and more effective; the exchange rate will also be more flexible to respond to external changes. In the new development framework, the domestic circulation remains a key theme with specific highlight on new energy automobiles. The global circulation will lean on One Belt One Road. Technological innovation and supply chain chokeholds will be key areas to strengthen. The carbon-related policies are likely to focus on developing carbon-correction capabilities first before drastic cut back in emission. This may lead to softening of production caps or policy restrictions, thus soften pricing pressure on main commodities. We see clear policy guidance on address key risk areas. The real estate policy is further clarified, and more promotions on 3rd-child will be announced in due course.

This Tuesday, rumors of SEC forbidding US capital from investing in Chinese asset caused heavy selloff across Chinese equity, fixed income and foreign exchange markets. These kind of market rumors about foreign investors' restrictions will indeed bring investor angst and cause market correction. But from long-term perspective, be it stocks or bonds, the foreign investors' holding percentages of Chinese assets are still very low. As RMB market opens up, more Chinese assets are added to global indices and the RMB assets are still attractive vs other emerging markets. There's still plenty of room for increasing foreign participation.

In the past five years, there were several rounds of high volatility in domestic equity and bond market and US-China relationship experienced tough trade-war since 2018. Despite the sporadic rumors of US investment restrictions, the foreign investors have steadily increased their holdings of Chinese stocks and bonds. The short term adjustments do not change the long term trend.

Looking back in history, the drawback is actually the key source of excess return for active equity managers. We expect a high chance of looser macro policies around the end of 2021. There's always Spring after Winter.

Special Topic: Main points of the July 30th Chinese Politburo meeting.

In general, the July 30th Chinese Politburo meeting headed by Xi had a positive and market friendly tone: the monetary policy should be consistent with an easing bias; fiscal policy to be more active, stressing long-term adjustment and alignment with the macro policies across 2021-22. We looked closely at the statement released after the Politburo meeting, and have the following observations:

1. The statement viewed the external situation as more complex and difficult. The 2H economic pressure is clearly higher due to uncertainty in export demand as foreign supply chains resume and US pandemic financial assistance terminates. There's also further pressure on the domestic SME's operating pressure and structural challenges. (Note the July Small Enterprise PMI was 47.8.)

2. Stress the need for cross-cycle macro policy adjustments to maintain policy continuity and sustainability. Prepare for smooth transition from 2021 to 2022, which is a key year in China's political calendar. 2022 will be a major election year where the new Politburo members will be elected. The major policy focus will be to prepare 2H21 for robust economic growth in start of 2022. It's important for the macro policies to support a steady and growing economic backdrop in the 1H22.

3. Monetary policy should remain reasonable and ample. The current relatively loose conditions won't change, with further 2H21 RRR cut still in "wait-and-see" mode. The recent RRR cut had a clear structural aim, which was to keep liquidity at reasonable level for SME and other challenged sectors. The Politburo meeting also highlighted the need to "increase macro policy independence", which means Chinese policy won't simply follow FED on the tightening path. China is keen for the market to establish a stable local monetary policy outlook, one that is separate from the US and more responsive to local economic conditions.

4. Fiscal policy will be the key lever for 2H21 and 1H22. Other than recent government guidance on ensuring effectiveness for project-debts, the statement added "reasonably handle progress of budgeted investment and local government debt issuance". Even though it didn't explicitly say whether "reasonably handle" means increasing or maintaining current pace, but it probably means this year's fiscal expenditure will slowdown slightly to reserve some resource for 1H22 implementation. From revenue collection side, the 1H21 was 59.3%, which was higher than last few years' pace. But the expenditure side for 1H21 was only 48.6%, lower than 2019's 52.5% and 2018's 53.2%. The minutes also said "substantiate impact in end of this year to start of next year", which indicates preference of fiscal impacts to start from 4Q21. Recently NDRC also sent notice for local committees to prepare 2022 projects. We'd expect 2022 fiscal plan to be more front-loaded, whereas 2021 is so far more back-loaded.

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5. On the Carbon policy, will adjust the implementation style to be less aggressive. When the Carbo-peak in 2030 and Carbon-neutral in 2060 goals were initially announced, there were very aggressive implementation in China. This caused clear upward pressure in commodities, with some areas cutting electricity supply to meet carbon-emission-reduction quota. This strengthened inflationary expectations and increased price and inflation pressures. For example, on the back of carbon-emission policy rollout, many provinces instigated policies on crude steel production. If the YoY production is flat to 2020, the 2H21 production must be reduced by 11%. Some provinces actually targeted negative YoY growth, which translated to a bigger production reduction. Such strong-arm policy caused expectation of supply shortfall. There should be more balance between developing new energy industries and phasing out old capacity, thus hopefully reducing inflationary pressure and energy shortfall.

6. Other key industry policies include a) housing is for living, not speculating; b) support new energy cars; c) encourage 3rd Child, reduce costs for child bearing, raising and education; d) repair and strengthen supply chain, focus on "bottleneck" problems.