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Rosefinch Research | 2023 Series # 4

Monthly View - February

The A-share may ascend gradually with high gyrations.

The pain of 2022 is leading to profits in 2023. Both the inflation and economic data had a strong showing in 2023, as global equity and bond markets rallied with a vengeance. The total amount of global bond market with negative yields zeroed out by Jan 4th, 2023, from a high of 18 trillion USD. As of end of Jan, S&P rose 5.9%, NASDAQ +10.7%, CS300 +7.4%, Chi-Next +10%, HSI +10.4%. USDCNH went back down to 6.7, reaching the low from Aug 2022. 2022 marked the end of an era as global inflation peaked. It's however unlikely for the world to return to the same low-inflation period since the 2008, nor will it likely go back to the low, zero, or even negative rate environment. This is a fundamental shift in investment framework as we bid farewell to the negative-rate environment and its associated pains.

After the painful 2022, there are now more opportunities in 2023. A-share, HK-shares, and China-themed stocks staged strong rallies so far. Stock Connect's Northbound flow showed record net inflow of 141.3 billion RMB. Overall the post-pandemic rally favored consumer, financial, real estate, and new energy stocks, each with its own compelling industry logic. Given the background of strong government support, and a lag in real time economic data, it's easy for market to re-rate aggressively. The long-missed series of up-days seem to be piercing through the overcast from 2022.

The A-share market has a good chance of returning to the slow bull trend that started back in late 2018. The first step is to recover the risk appetite, and the second step is the recovery of both economic data and corporate profits. The offshore capital is at high risk sentiment already, fairly confident about China's reopening. It's worth reminding ourselves though that China is different from global markets: its household leverage, real estate sector impact, household debt, unemployment, and fiscal stimulus may be at different stages from global markets. Since the change in China's pandemic policy in December and the wave of "revenge spending" over Chinese New Year holiday period, we may see some short-term pick up in consumption. But given the three long years of pandemic controls, it will take more than a few months for the economy to recover. Furthermore, both the household and the government had suffered through lower income and higher debt as a result of the pandemic, which means the consumption recovery lacks legs. The real estate companies will need 1-2 years before they can repair their balance sheet and expand again. Infrastructure spending was already at high end from last year, so this year's upside is limited. Export may also see some mild contraction. All this point to a benign rate environment in China, at least for 1H23.

Given the market's high expectation and the economy's weak reality, A-share may see more volatile trading albeit with a general upward bias. It won't be a one-side straight rally to new highs – currently the sectors rallying the most are those the fell the most before, but the sectors that will rally most sustainably will definitely be those most dynamic entities. In 2022, China's GDP growth likely fell behind the Asia GDP growth for the first time since 1990. Looking back in history, weather it's the US recessions or Japan's lost decades, China will require a few years to recover from the loss of power from its real estate and infrastructure engines. China needs sizable new growth engines like New Energy or EV to re-establish the new pillars of growth. As Chinese economy transforms into a high-quality economy, it'll require the investors to establish core positions in the early stages. Investors must be aware of the new framework, get deep insights on the industry developments, and stable long-term partners who are prepared to grow with the new economy.

In the Ever-Changing World

The world is changing rapidly around us. The key risk is to avoid wide-spread open conflicts between the major powers. In the last century, despite intense competition, Soviet Union and US avoided open war. Similarly in this century's geopolitical arena, US and China may compete, but as long as reason prevail, they should be able to avoid open warfare since the losses will be unimaginable. In the following chart by Max Roser, which shows the ratio of times that great powers are in active conflict from 1500 to 2015. In the period 1500-1800, the Great Powers of the time were at war at least 70% of the time. This ratio has dropped steadily since then, with very infrequent occurrences lately. The world has become more peaceful, living standards have improved, and culture is advancing. We hope that the global governments can find a smarter wars to address conflicts than open warfare.

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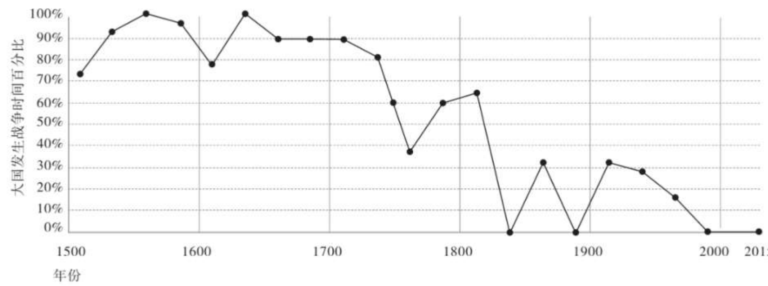
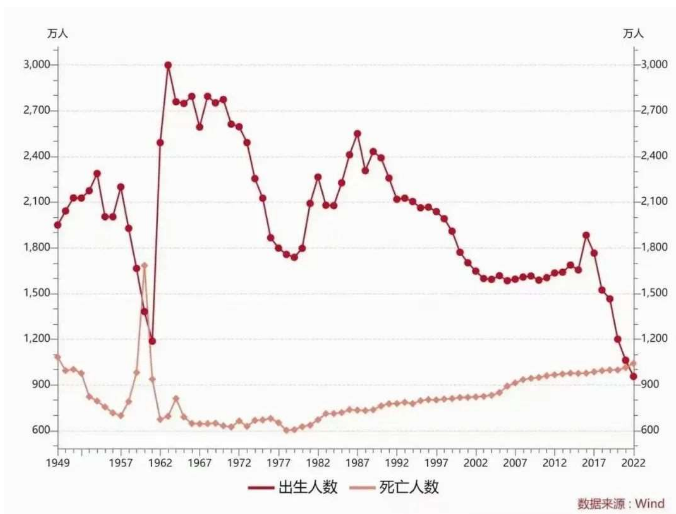


China is seeking globalization of economic activities, while US is seeking globalization of its military security. Most nations choose to be neutral in their conflicts. This bipolar situation is a very regrettable and unfortunate choice. In this year's Devos forum, China's vice president Liu He said China is working hard to building up domestic circulation while actively engaging dual circulation with global partners. China's national situation calls for an open economy, improving global exchanges both in quality and in quantity. Vice President Liu also called for global macro-policy coordination to balance need to control inflation and stabilize growth.

The Key is to Change Expectations and Consolidate Long-term Confidence

To the Chinese economy, 2022 wasn't a good year with only 3% growth for the full year. This is the 2nd slowest annual growth since 1978 (2020 was lowest at +2.2%), and barely over half of the original target of +5.5%. In addition, the birth rate continues to drop to 6.77%, finally falling below the death rate of 7.37% for the first time since 1960. China finished 2022 with 1.412 billion people, or about 850,000 less than 2021. As the population enters into negative growth rate, the urbanization rate also slowed to only +0.5%, and the real estate sales dropped -26%. In 2023, India will likely replace China as the most populous country in the world, while China will add another 30 million senior citizens.



In addition to tracking the population number, we must also look at the quality of the labor force of those between 15-59 years old. The ratio of such working population peaked 10 years ago, but the education

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level of this population continued to improve. From Rosefinch research team, we believe in the mid- to long-term, Chinese economy still has some resilient basis for further growth. The benefit from a highly educated population will bring dividends for years to come, including higher productivity which may counter the drop in absolute population level. In addition, globally those economies with per-capita GDP below 20,000 USD can maintain growth rates of about 6%. **Therefore, in the next ten years, Chinese economy still has the foundation for a relatively stable growth of between 5% to 6%.**

After end of pandemic, we may see China's recovery to the new normal within 1Q23. Economy is still near the bottom, as many households' balance sheet worsened during the pandemic. Currently, Chinese economy is still undergoing the transformation away from over-reliance on real estate sector. So even with the change in pandemic policy and overall economy-friendly policies, there's still a lot of pressure on the China economy. **The core issue will be how to change people's expectations and consolidate long-term confidence, so that the economic entities can reinvigorate.**

In the last ten years, Chinese economy grew from 54 trillion RMB to 121 trillion RMB; life expectation rose from 74.8 to 78.2; contributed about 36% of global economic growth. Vice President Liu said there are five major themes from last decades' experience: 1) keep developing economy; 2) keep socialist economic reform; 3) keep opening up externally; 4) keep ruling by law; and 5) keep developing by innovation. Mr. Liu also said that we must follow these major themes resolutely going forward.

For Chinese enterprises, they are like seeds that grow in the soil of market. The bigger the market, the bigger the enterprises. This is why US has so many of the Global Fortune 500 companies. In the last few decades, the global innovations are basically following the G2 model: US-led developed countries are leading the technological innovation, while China is using its highly educated workforce and large markets to commercialize the innovations. In this model, US companies can monetize their innovations quickly through Chinese manufacturing and markets, while the new profits can be reinvested into future innovations. China is learning from this process as well, and rapidly improving its technological expertise. As a result of the G2 model, globally consumers are benefiting via low-cost high-productivity innovations. When this model is being challenged, it'll be important to invigorate private sector and improve its resilience. China must build up its expertise, repair its weakness, and strengthen its infrastructure.

In terms of industry and enterprise level, Rosefinch are noticing very proactive engagements by the companies we follow. Take EV for example, Elon Musk noted recently that his most likely competitor will be a Chinese car company. As Tesla announced its cost-cuts in 2023, the industry competition is heating up quickly. Rosefinch Advanced-Manufacturing Research team #2 believes that cutting cost is the most viable way to improve EV's Cost-Value Ratio and accelerate the replacement of traditional fossil fuel cars. Back in the days of Ford Model T, it was sold for 950 USD in 1910 and the cost steadily decreased to 269 USD by 1923. Tesla is doing the same cost-cutting, which is driven by its economy-of-scale manufacturing and supply chain efficiency. This will create powerful pressure on other entrants, and force the industry to continuously optimize product strategy, improve manufacturing, increase efficiency, invest in R&D.

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The Biggest Profit Comes from a Few "Super"-Companies

When we read about Warren Buffett, his core approach is to find great companies. We must diligently analyze industries, companies, and management teams. Once we formulate a robust valuation framework, we must act upon the results, and act boldly for it to matter. In Rosefinch's history, even the most successful investments were not a straight line to the top. For the reflective investors, a challenging investment journey will help us to improve our skills. Each time there's a large change in stock price, it's the market's reminder for us to seize the opportunity.

It's worth noting that stock price is driven not only from it's fundamentals, but also from the top-down liquidity, market risk appetite, etc. So we must be cognizant of both the bottom-up analysis and the top-down environment and invest decisively. Even in the most successful stock market: the US market, most companies will underperform US Treasuries and disappear in the river of time. The biggest profits come from a few "super"-companies.

The investments that generate the most profits are those that profit from the future industry leaders' corporate life cycle, and not from market timing. The confidence of such investments comes from the sustainable business model and the overall capability of the management team. Rosefinch always seeks out the companies that can continuously create value and generate profits. In 2023, global economies are facing a challenging year, and China-US relationship is also in adjustment period. While there was market consensus about bullish A-share views in late last year, there's still some question marks due to the uncertainties about domestic economic recovery and the external environments.

In 2022, China saw new deposit increase of a record 17.8 trillion RMB, almost 80% higher than the roughly 10 trillion RMB annual increases in the previous 3 years. These deposits may very well become the source of growth for future markets. After all, real estate is localized asset, so only through diversified capital market can the domestic households deploy their wealth effectively. China is the 2nd largest economic entity in the world with huge domestic capacity where its manufacturing GDP is more than combined manufacturing GDP from US, Japan, and Germany. China is already a world leader in some EV and New Energy areas.

Value investing is based on real world's basic commercial logic, which is a much bigger system than the stock market. But the volatility in the market will be much bigger than the volatility in the fundamentals. For Rosefinch, we rely on the industry logic and a stable investment system and process. First, we focus on building and refining our expertise in specific industries. Second, we realize that the excellent companies are often the best partners to learn from and grow with. Each time we gain new insights will bring new opportunities as well. As Rosefinch research team expands to over 40 people now, we believe there will be more insights and more opportunities to come.

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