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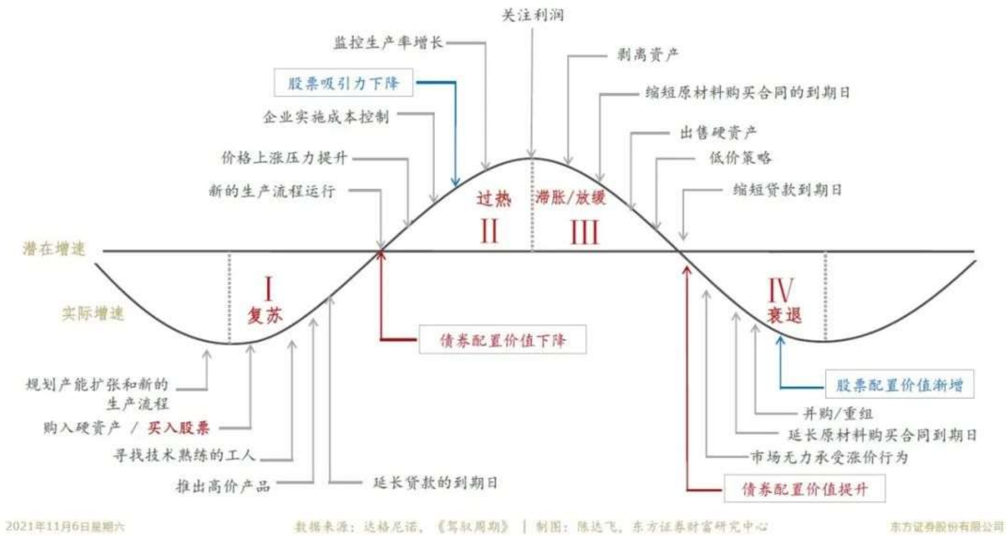
Rosefinch Research | 2023 Series # 5

Tis the End of an Era, and the Start of Another

In the past year, the reverberations of our times echoed through market. The Russia-Ukraine War, raging pandemic, flying interest rates, sky high commodities, rollercoaster equity markets, all these themes worked their way through the financial markets and gradually dampened as we finally welcome the bull markets in 2023. Since the start of the year, vast majority of China stock subindices rallied in almost a mirror reversal of 2022's start of year. The main theme in the market is an optimistic one, with most people believing the 2023 policy support, currency stability, and fundamental improvements should bring about a bullish A-share market. The first wave should be riding on government policy, second wave on corporate profits, and the third wave on fundamental bullish trend. In other words, the time to invest in stocks has arrived.



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The equity investors who were burned in 2022 are hearing the calls of the market again. Yet, as we head into February, both Hong Kong and Mainland shares are seeing retracements. A few consecutive down-days and a long ponder over the weekend saw the investor sentiment wavering from imminent investment to a holding pattern. Some macro fund managers have already cautioned against a one-side equity bull market and reduced their equity exposure.

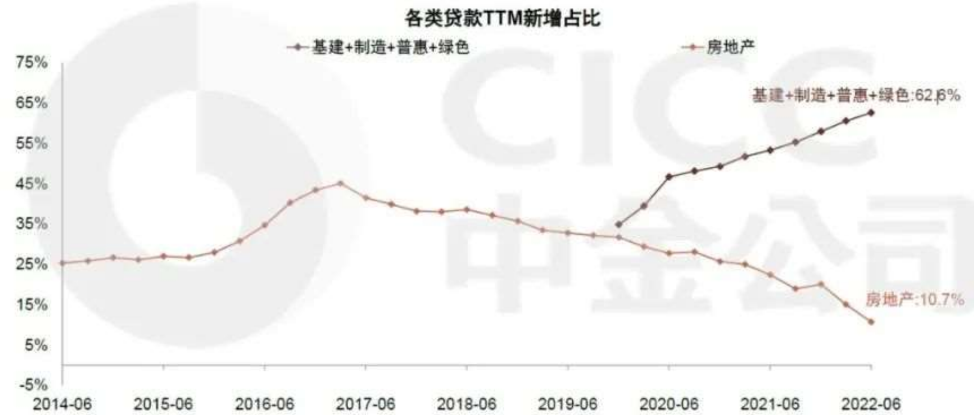
Northeast Securities chief economist Teng Fu said: don't only view things as great or horrible, there are still many situations that are in between. Most of the US equity market excess returns in the last 40 years come from rerating due to lower interest rate, but as future rates climb higher, the investment framework must change. While many people believe 2022 was a one-off macro year, but 2022 may actually be signaling the end of an era, and the start of another.

The liquidity-driven bull market may be over, where the future equity returns depend on corporate profits. But this doesn't mean value is better than growth. **For the institutional investors that hold growth stocks for the long term, the future may be great.** Without the mad liquidity rush of the markets, you can more quietly and patiently search for the future leaders and wait for them to grow and capture the profits.

Corporate growth needs innovation, market needs, and capital. Just like how investing environment is changing, these factors will also change. In the last few decades, the global innovation took on the G2 model, where US-led developed countries innovated, and Chinese engineers and its vast consumer market commercialized. But now, the G2 model is being challenged. Last March, Zoltan presented the USD-centric global economic framework. Cheap Chinese products and Russian gas kept the global inflation low, and their export income were used to purchase G7 government debts. This cycle historically reinforced the stability of global monetary system based on USD. This system though is being weakened. There are break up and decoupling wherever we see: innovation, production, consumption… new systems are being developed right now. Those who can wean off their deep dependency on others, completes its innovative push, provide its own energy, creates its supply to demand circulation, and find its growth engine will be able to get a head start in the new arena of the deglobalized world.

In this process, energy independence, innovative technology, large market, and national security become very important factors. As China's real estate sector fades in importance, a diverse portfolio of new energy, intelligent vehicles, AI will gradually become the new growth engine for the economy. In fact, in the last few years, we've seen the Green Economy and Digital Economy taking on growing shares of China's economy, as evident from the increase of relevant loans that replaces real estate lending.

图表13：房地产贷款下降，政策性金融成为主力

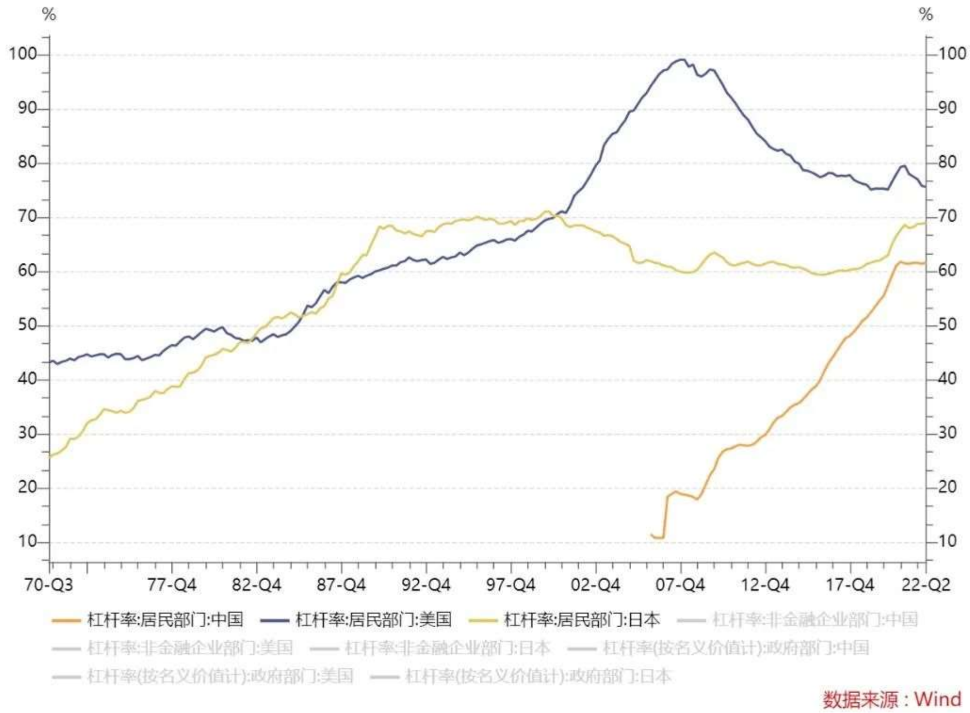


资料来源：Wind，中金公司研究部；注：基建、制造、普惠、绿色贷款官方口径存在一定重复计算，已剔除重复部分。基建包括交通运输、仓储和邮政业，电力、热力生产和供应业，水利、环境和公共设施管理业，建筑业，租赁和商务服务业。

Source: Wind, CICC. Red line is pct of real estate new loans; grey is manufacturing, green, etc.

This massive trend shift was reflected in the 2019-21 new energy bull market, or the recent AI rush. When you look at it, you can find signals of these explosive moves from extended harvesting by the industry players and the relevant industrial policies.

When it comes to industrial policy and how to get a head start, we must also grasp the importance of debt cycle. If the capital return from the growth can't pay off the debt servicing charges, it'll lead to debt crisis. Another issue may come from rapid depreciation of the capital, while the debt obligation remains constant, which also leads to a balance sheet recession. One of the key indicators of debt cycle is the macro leverage ratio, which can be monitored for households, non-financial corporates, and governments. We can actually see some interesting comparisons among China, US, and Japan leverage ratios.



Source: Wind. Orange: China household; yellow: Japan household; blue: US household.

In the past 15 years or so, China’s household leverage ratio has almost caught up with US and Japan, with a similar slope as Japan’s increase back in 1970-90. The household leverage mainly takes the form of housing loans, where the current levels may signal less room for significant growth. US did push the leverage further to 100%, but that triggered the sub-prime crisis in 2008.

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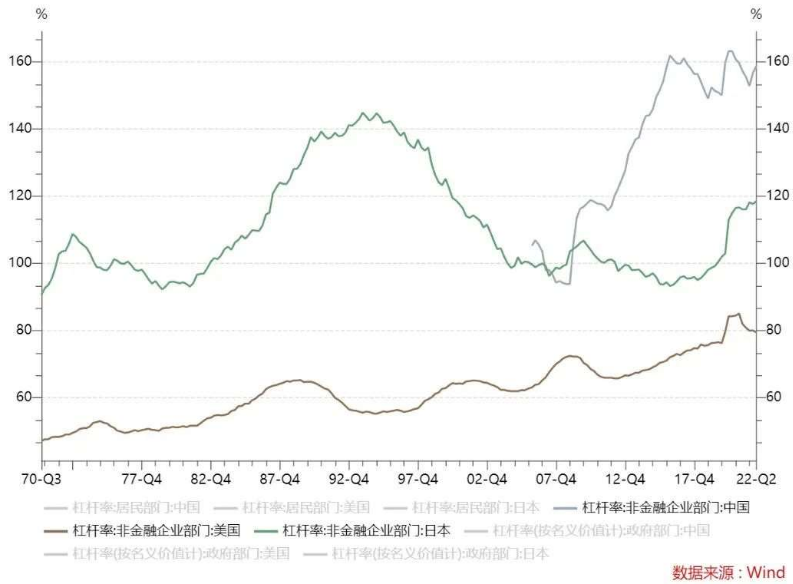
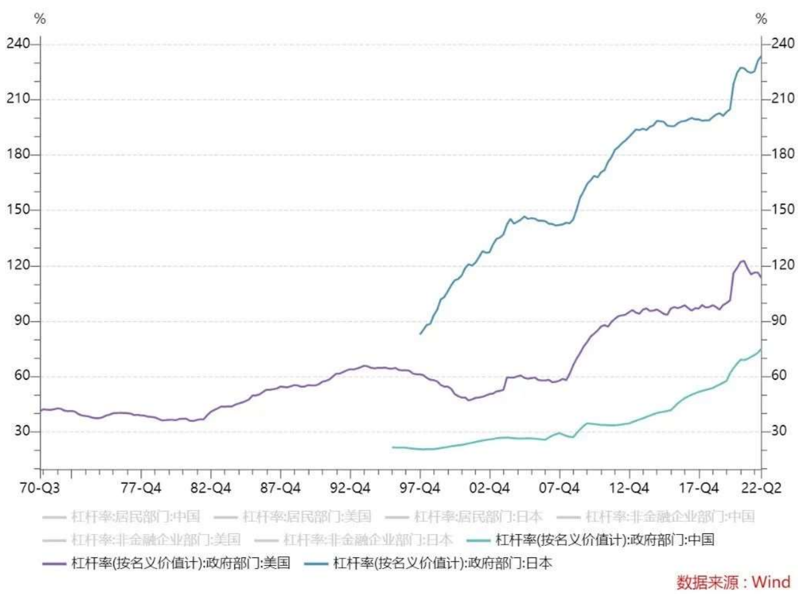
When we look at the corporate leverage, China has the highest ratio at around 160%, thus with limited room for higher ratio. What's left is the government leverage, where China's current leverage ratio is only about 1/3 of Japan, and 70% of US.



Source: Wind. Green is Japan corporate leverage, brown is US, grey is China.



Source: blue is Japan government leverage, purple is US, green is China.

US is now facing debt crisis as Secretary Yellen said a failure to lift the 31.4 trillion USD debt ceiling will trigger economic and financial crisis that may even lead to global financial crisis. So given China's household and corporate leverages are already at high levels, only the government leverage may be a candidate for further increase. We're already seeing household deleveraging through early repayments, and corporate deleveraging through headcount reductions. So does Chinese government have to be the borrower of last-resort to increase the leverage ratio at national level? While no one knows the answer for sure, we do know this will lead to market volatility, which in turn will lead to risk and opportunity.

If the government take on additional debt to stabilize real estate market and support Green & Digital economies, this may be a major investment direction. Wealth can only be created by the asset increase from economic growth, while purely taking on more leverage can at best delay the crisis. Looking ahead, high-tech industries like new energy, intelligent vehicle, AI may very well become the long-term drivers. There will be shifts in industrial cycles and valuation changes, and different market segment valuations, which may bring some structural shifts in investment.

When it comes to investment, people may say: alpha is important, beta is not. This may be a misunderstanding, since the ability to consistently choose the correct beta is a source of alpha. The ability to evaluate macro factors will become more and more important in a volatile market. The first rule of fishing is to know where the fish are. So we must have alpha, beta, and a forward-looking mindset in order to be successful in a volatile market.

For the dedicated investors, to truly understand investment, you must consider long term, medium term, and short term; you must see the macro, local, and micro perspectives too. You must see the biggest macro shifts as well as the smallest economic veins that flow through the companies. This is of course exceedingly challenging to achieve, and will take more than just 2 or 3 years to validate. Finding such managers will take time, and it will take trust. You can argue that having that trust is more important than the historical return chart.

For many organizations and individuals, 2023 is a turning year. The spring is finally here, we can throw away the pessimist-hat, make asset allocation decisions, and rationally search for the right manager and get to know them better. And then, wait for the flower to bloom.

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