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

Rosefinch Research | 2023 Series # 23

Onwards and Outwards

"If the macroeconomic conditions are stormy, even the best ship is still going to have tough times." Elon Musk

1. Reform and opening up are the foundation for high-quality development.

U.S. October CPI increased 3.2% year-on-year, remained flat month-on-month, lower than expected and previous values. Core CPI rose 4%, the lowest in over 2 years. The ISM manufacturing PMI for October was 46.7%, the lowest in 5 months. Meanwhile, non-farm data further confirmed the weakening trend in U.S. employment, and the labor market started cooling down, reinforcing market expectations that the Fed has completed interest rate hikes. The U.S. dollar index and U.S. bond yields both saw large declines. Compared with U.S. bond yields, the U.S. dollar index better represents the flow of funds in global markets.

The Nasdaq rebounded more than 10% in the short term and rose 36% for the whole year. In terms of commodities, both domestic and foreign demand are facing a period of slow recovery. Oil prices have shifted downward somewhat overseas as economic momentum remains insufficient for continued upward movement and the Palestinian-Israeli conflict remains under control. Gold prices have reacted to safe-haven sentiment returning to $2000/ounce, completely reversing the impact of rising USD interest rates.

 Email ir@rosefinch.cn

The offshore renminbi has appreciated nearly 2,200 pips. Coupled with the direct subscription of gold ETFs in late October and the approval of the NPC Standing Committee to issue more government bonds, it confirms the government's determination to increase liquidity through fiscal policy. Against the backdrop of events such as the APEC meeting and a successful meeting between Chinese and US leaders in San Francisco, China's GEM board initially rebounded from its low point of 1840, only to retrace nearly half just as quickly.

Market's bottom-hunting dynamic driven by greed over fear was brief and weak. Compared with the Nasdaq and Dow, which rose 36% and 6.7% respectively this year, the Shanghai Composite has fallen from 3100 points at the beginning of the year to around 3000 points now. The Hang Seng, Sci-Tech 50 and Hang Seng Tech indexes have fallen for three consecutive years, with the Hang Seng down for the fourth straight year. From the initial hype around China concept stocks and AI, to the current focus on the SSE 50, there have been plenty of hot topics, but market confidence is still lacking.

Before the COVID-19 pandemic, the euro area's GDP accounted for about 63% of that of the United States; it is now 55%. Apart from the impact of the pandemic, the European economy was also greatly affected by the Russia-Ukraine conflict. Benefiting from relatively effective epidemic control measures, China's GDP growth relative to that of the United States continued the previous upward trend during 2020-2021, once reaching 76%. However, since 2022, this ratio has declined significantly and is basically back to its pre-pandemic level.

In October, signs of national economic recovery continued to improve, but domestic demand remained notably insufficient. Cyclical problems may see temporary improvement with policy support, but solving structural issues will require longer-term time and the power of reform and opening up. The great resilience, potential and vitality of the Chinese economy ultimately stems from reform and opening up, which remains the absolute fundamental pillar to promote high-quality development in the Chinese economy.

Establishing historical patience and strategic determination requires stabilizing and improving expectations through rule of law construction and institutional mechanisms, restoring confidence, especially that of entrepreneurs, and fully leveraging the role of market entities in a market economy. Only by "Taking Responsibility and Executing Well" can we stop the continued declines in asset prices driven by risk-aversion, unclear future expectation, and low confidence.

The Chinese Government's Central Financial Work Conference also mentioned for the first time the idea of "financial power." In terms of "effectively preventing and resolving financial risks," it proposed "establishing a long-term mechanism for preventing and resolving local government debt risks that is compatible with high-quality development, and establishing a government debt management mechanism that is compatible with high-quality development" regarding local government debt, and proposed "promoting the virtuous interaction between finance and real estate, improving the regulation system for real estate enterprises and capital regulation, perfecting macroprudential management of real estate finance, and meeting the reasonable financing needs of real estate enterprises regardless of ownership" regarding real estate.

On the international stage, China and US leaders at the APEC meeting emphasized the importance of joint efforts in the next crucial decade to accelerate response to the climate crisis. They expressed welcome for the resumption of high-level military exchanges, US-China defense policy coordination dialogues and agreements on US-China military maritime consultations. President Biden reiterated that the US policy on one China has not changed, and that past and present administrations have been consistent on this issue. He reaffirmed the world's expectation that the US and China will responsibly manage competition to prevent it from escalating into conflict, confrontation, or a new Cold War.

"Leveling, bifurcation and exorcism" are the results of the "dual revolution" the French sociologist Fernand Braudel reviewed from the "long 19th century." On the one hand, as China's economic growth slows from high speed to moderate speed and returns to normalcy and prudence, policies should quickly move out of risk response mode to put China's economy back on the path of high-quality sustainable development. On the other hand, based on current domestic and international trends, we look forward to high-level opening-up becoming a more powerful driver of strong growth in the Chinese economy to achieve development that unifies increases in quality and quantity.

Under today's context of global technological and industrial integration, an all-round industrial structure cannot enjoy the scale economics, rapid technological iteration, utilization of global resources and sharing of global markets brought by division of labor. Participation in global industrial and value chains is also highly meaningful. Overseas customers also require Chinese supply chains to have global backups within a certain period of time. Currently, there are very few Chinese enterprises who are globally competitive and successfully expanded in Europe and the US. **In the process of globalization, Chinese enterprises will inevitably face geopolitical uncertainties, but still must continue “onwards and outwards” while leveraging in the global energy transition and digital economy development.**

It is worth noting that horizontal division of labor as the main form of opening-up is fundamentally different from traditional cooperation based on vertical division of labor and manufacturing of complementary products. Cooperation has changed from mutual promotion to competition. In the digital and intelligent era, open source and open collaboration are inevitable trends for promoting global technological progress through cooperation.

In late 2022, three major tailwinds strongly reinforced each other: topped US inflation, China's pandemic recovery and escape from Europe's energy crisis, leading to a rapid weakening of the US dollar and US treasuries while boosting global stock markets. This year, US inflation has declined for half a year, China's momentum needs to be repaired, and Europe's fundamentals continue to deteriorate. It is hoped that the US-China yield gap can narrow from current levels to ease renminbi depreciation pressures and indirectly ease pressure on renminbi assets while expanding monetary policy space.

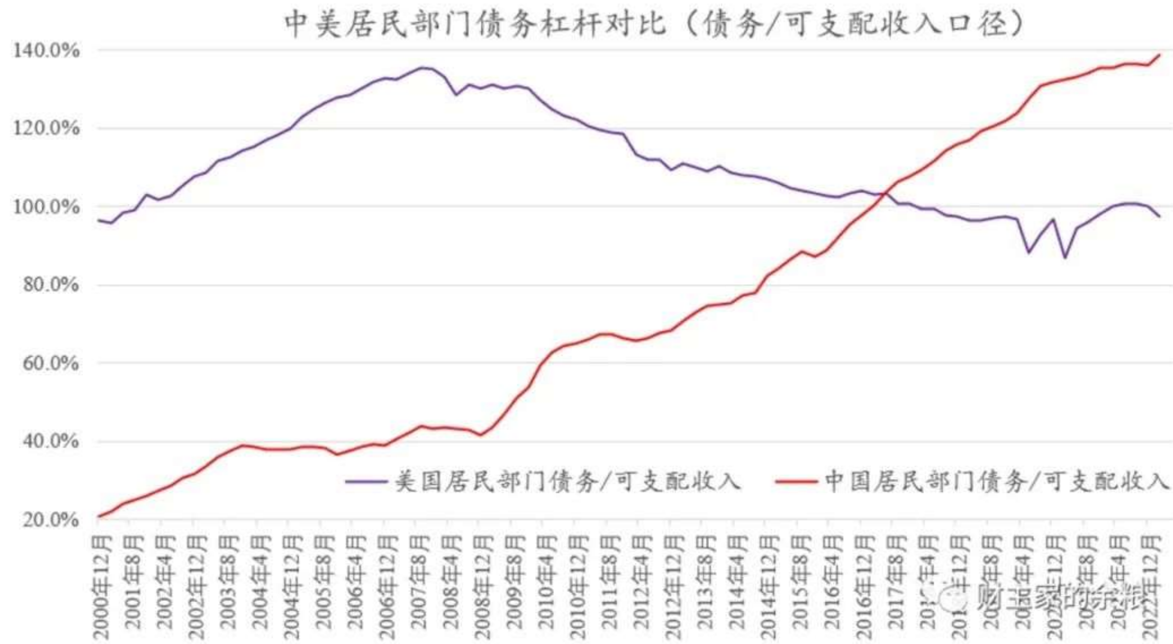
However, structural contradictions continue to weigh on economic cycles. China's stock market has fallen for two consecutive years, but relying on relatively low valuation levels alone may not bring systematic opportunities. Without being a financial powerhouse, can China truly become a technology powerhouse? Simply comparing real estate, bonds and conventional wealth management products, China's A-shares have a certain overall cost-benefit advantage, with risks stemming from potential future declines in profits or low visibility. **We see the best 2024 investment opportunities in identifying future pivot points in fundamentals for specific industries or companies, or when valuations for high-growth companies with robust trajectory return to reasonable levels.** Given the backdrop of potential slowdown in growth rates, companies still capable of sustained growth are becoming increasingly scarce.

Focusing on our own expertise, we are optimistic about opportunities in the next 1-2 years in carbon peak and carbon neutral fields driven by innovation, demand growth and capacity clearing. Other industries of interest include hydrogen energy, intelligent driving, robotics, civilian aerospace, 3D printing, and structural upgrades in digital economy, medical services, and consumer goods. Industry supply and demand relationships and different companies' fundamentals within industries will evolve dynamically based on expected changes in policies, technologies, and industrial participation.

2. The widening M2/M1 Gap; where is the new energy for steady growth?

In October, CPI was down 0.2% year-on-year and down 0.1% month-on-month, while core CPI was up 0.6% with no change month-on-month. The weakness in core CPI better reflects the state of the economy. Demand in October showed significant fluctuations after warming up in July-September, reflected not only in durable goods but also in services, as residents' income and expectations saw no fundamental improvement. The improvement in CPI mostly reflects temporary stage effects without further declines, but the rebound lacked obvious strength. PPI was down 2.6% year-on-year with no change month-on-month, driven more noticeably by oil prices but with significant weakness in building materials. The impact of weakening real estate investment was also quite significant.

Different from neighboring economies, the post-epidemic recovery in China's consumption tendencies was relatively weak. Historically, when prices are generally low or even negatively growing, ordinary people tend to delay or reduce consumption. In addition, over the past 20+ years, China's household sector debt burden has been relatively heavy, and the degree of damage to household balance sheets also differs significantly from overseas. The main reasons for declining disposable income of residents were the slowdown in broad credit expansion, while the decline in consumption tendencies was mainly due to epidemic factors, falling income expectations and changes in income distribution. The "Opinions and Suggestions on the Report on Financial Work" mentioned at the National People's Congress brought up the importance of avoiding idling funds.



Source: BIS, Fed, China National Bureau of Statistics

This year, Rosefinch observed several major changes in macroeconomic trends compared with pre-epidemic periods: 1) The average 4-year growth of total retail sales of social consumer goods (3.8%) remained lower than pre-epidemic growth (7-8%). 2) Downward pressure on the pace of real estate investment. 3) Risks of declining export growth due to high bases over the past two years and falling external demand.

From October's economic data, China's economic recovery showed some improvement, but the widening M2-M1 scissors difference and low inflation reflected ongoing demand weakness. In fact, M2 is an indicator of credit expansion, M1 an indicator of private investment, measuring the results rather than causes of economic activity. **This year saw "increase idling" in the deviation between M2 and M1, and even a lack of "engagement," as shown by rising household savings tendencies.**

In practice, against the backdrop of real estate and infrastructure contraction this year compounded by severe consumption downgrades, overall sales volumes declined across the aquatic products and feed industries mainly due to downstream demand impacts. Current assessments indicate its highly likely overall demand for the feed industry over the next two years will decline. Many other consumer goods have also revised down full-year expectations in Q3 reports, with one liquor company lowering growth forecast to 15% and one food supply chain company from 30% to 25%; one cosmetics and skincare company sees Q3 revenue of +20% with profit growth just slightly over 10%; one apparel brand company didn't revise expectations downward, but market is already pricing in lower expectations.

The core of the property market is population and income expectations. As population ages rapidly with falling birthrates and slower urbanization in China, real estate demand is declining steadily. This year's sales volume of 700 million square meters is already very close to latent urbanization demand. In the past decade, previously high-growth drivers like infrastructure, real estate and exports have gradually slowed, but their momentum persists, providing some support during economic downturns. However, this time, accelerating population aging, negative real estate growth, declining investment capacity of local governments, and questions around sustainability for continued infrastructure investment are posing new difficulties.

Structural issues were bound to be exposed as economic transformation and high-quality development encountered growing pains, exacerbated by external imbalances and epidemics. **To address the current cross-cycle demand gap facing the Chinese economy, macro policy focus needs to shift from investment to consumption, and policy tools from financial to fiscal.** Fiscal expansion can empower and build confidence in consumer spending, achieving internal circulation from production to consumption to unleash endogenous growth momentum. Comprehensive market-oriented structural reforms should also be implemented to boost productivity, support rebalancing and decarbonization goals, alleviating headwinds from population aging, declining investment returns and geopolitical divisions.

China's economy remains in the transition from high-speed to medium-high-speed growth or high-quality development. With old drivers of basic infrastructure, real estate and exports no longer effective, new sources of stable growth are urgently needed. The Party's 20th National Congress report proposed building a "modern industrial system" encompassing modern agriculture, industry, services, and infrastructure.

Among these, modernized industry represents the most essential foundation and core, providing material and technological support for other areas' modernization. Building a modern industrial system is a common development rule followed by world powers. On October 12th, President Xi emphasized during an inspection tour in Jiangxi's Nanchang to promote high-quality development of the Yangtze River Economic Belt that efforts must be made to modernize industrial and supply chains, continue implementing actions to enhance core manufacturing competitiveness, cultivate and strengthen advanced manufacturing, accelerate strategic emerging and future industries, and deepen integration of the digital and real economy. It's important to achieve complementary and in-depth integration of traditional energy like hydro and wind power, photovoltaics, and hydrogen energy with new sources, accelerate building a new energy system and promote integrated development of sources, grids, loads and storage.

On October 13th, President Xi stressed the importance to strategically deploy innovation chains and actively connect to national strategic science and technology resources to breakthrough a number of key core technologies and build several high-tech industrial clusters with nationwide influence. Market access of private investment should be expanded in an orderly way, promoting fair competition through supportive policies to establish harmonious and unified new types of government-business relations facilitating healthy development of private sector economy.

3. ASEAN export growth exceeds US export growth.

On November 16th, President Xi spoke at a welcoming banquet hosted by friendly American organizations, noting that China is the largest developing country in the world. For over 1.4 billion Chinese people, working better, living better, and growing children up better are their dearest wishes. The Communist Party of China is here to serve the people, and the people's longing for a better life is our struggle and something we must hold dear to the people's hearts. Through a century of exploration and continued struggle, we have found a development path that suits China's national conditions and are advancing national rejuvenation through Chinese-style modernization.

We are committed to sustainable development and harmonious coexistence between humanity and nature. Now, nearly half of global PV power generation equipment is installed in China, over half of new energy vehicles worldwide operate in China, and a quarter of new green forest globally comes from China. We aim to achieve peak carbon emissions by 2030 and achieve carbon neutrality by 2060. We do what we say.

On October 26th, NDRC convened a seminar on the real economic situation in some localities. Shanxi, Shaanxi, and Inner Mongolia—traditionally major energy provinces accounting for over 70% of China's coal production—were discussed. In the previous two years affected by geopolitics, sharp rises in international energy prices boosted the actual GDP growth rates of these provinces above national averages. This year as coal, oil and natural gas prices declined, energy industry value-added growth has slowed. However, differences emerged between the provinces: Inner Mongolia's GDP grew 7.2% in the first three quarters, while Shaanxi and Shanxi grew only 2.4% and 4.5%, respectively.

In terms of investment, Inner Mongolia's fixed asset investment rose an impressive 26.2% year-on-year in the first three quarters, while Shaanxi and Shanxi saw negative growth. For consumption, Inner Mongolia's total retail sales of consumer goods grew 5.1%, versus 3.1% and 3.7% respectively in Shaanxi and Shanxi. For imports and exports, Inner Mongolia's total trade value grew 29.2%, Shanxi only 2.5% while Shaanxi declined 17.3%. The "ballast industry" of industry also differed - Inner Mongolia's above-scale industrial value-added grew 7.6%, 3.6 percentage points above the national average, while Shanxi grew only 3.5% and Shaanxi declined 1.5%.

Analysis shows Inner Mongolia benefited from manufacturing demand increases driving CAPEX growth, underpinned fundamentally by new energy industry development. Under the 13th Five-Year Plan, Inner Mongolia's UHV grid construction started earlier, now boasting three completed DC trunk lines, versus one each for Shanxi and Shaanxi. Strengthening local consumption and emphasizing coordinated construction of sources, grids, loads and storage, plans exist by 2025 in Shaanxi/Shanxi to build 7.4GW of pumping storage and 5GW of new-type energy storage; Shaanxi aims to build 2GW of new-type storage in the 14th Five-Year Plan period and Shanxi 6GW.

Looking ahead, Inner Mongolia's installed new energy capacity will surpass thermal power by 2025 and total new energy generation will overtake thermal power by 2030. By transforming and upgrading based on its industry endowments and resource advantages, Inner Mongolia has essentially improved local economic resilience. While facing overall pressure, Shaanxi is also working hard toward structural optimization, improved quality, and accumulating momentum through initiatives like building a modern industry system.

On November 6th, NDRC released the "Pilot Program for Peak Carbon." On November 15th, the US-China statement on strengthened climate cooperation was issued. Joint efforts are aimed at tripling global renewable capacity additions by 2030 and fully accelerating renewable deployment in both countries from now through 2030 based on 2020 levels to expedite coal-oil-gas power replacement, enabling expected meaningful absolute reductions in the power sector after peaking.

The IEA's World Energy Outlook 2023 report found that US legislation will drive electric vehicles to 50% of new car sales by 2030; the EU's 2030 heat pump installation target will reach 2/3 of that needed for net zero scenarios; China's additional PV and offshore wind capacity through 2030 will triple WEO2021 forecasts; and nuclear prospects will also improve. Solar power has become a major global industry and considering manufacturing plans and competitiveness prospects exceed any other clean technology, significant growth potential remains. Global solar PV production capacity could surpass 1200 GW by 2030.

Measures are needed to boost solar PV installations, particularly grid expansions and storage additions. PV manufacturing also faces high concentration issues—China is already the largest producer with much larger expansion plans than other nations. Global trade is crucially important for supporting solar deployment.

The key features of China's latest 2Q23 Balance of Payment data were: FDI equity inflows remained historically low; the widening US-China rate differential turned foreign debt trends; and exports became more reliant on trade surplus. China's external balance levers remain in goods trade. But from a long-term perspective, China's external structure may require a transformative upgrade - from solely relying on goods trade surplus to a "two-legged" model of goods trade surplus and investment income inflows providing firmer currency support and greater leeway for future fiscal and monetary policy coordination.

Developing countries are more greatly affected by economic factors, while also being impacted by US Treasury rates. Developed countries can be divided into Five Eyes alliance countries and other developed countries - the latter being most impacted by economics, while Five Eyes countries see greater political impact. In 2020, ASEAN overtook the US to become China's largest trading partner. Since the China-US trade war broke out, ASEAN exports to the US rose sharply while imports from China grew even faster - ASEAN imports of intermediate goods from China far exceeded its exports of final products to the US, and a similar situation emerged in India. Chinese enterprises invest in factory construction and talent recruitment across Southeast Asia and neighboring countries of the US, rapidly entering Japan-US allied countries for outsourcing.

From another perspective, comparing domestic joint venture auto plants of that time - after Volkswagen Group, Europe's largest automaker invested in Xiaopeng Motors, Stellantis, Europe's second largest automaker, also announced investment in Leapmotor, with a leading global automaker cooperating with a new Chinese EV company on global electric vehicle projects in a reverse joint venture. This represents a new approach of globalization, lowering domestic automakers' barriers to going abroad while opening international markets.

In fact, regardless of whether it is the development of photovoltaic, energy storage batteries or electric vehicles, the original technical principles and industrialization were not conceived in China. After these industries entered China, **it was China's enormous industrial scale, diligent and intelligent R&D personnel, and industrial workforce who through continuous, astonishing cost reductions brought originally costly non-commercially viable photovoltaic and energy storage products quickly into price affordability and technical practicality, kickstarting these industries' spontaneous explosive growth.**

The global new energy industry should thank the large group of enterprising, competitive-spirited Chinese entrepreneurs, engineers and industrial workers who have enabled the world to truly realize carbon peaking and carbon neutrality to achieve sustainable development. After difficulties in refinancing of photovoltaics, readjustment may come quickly by year's end or early next year as government and banks also pull back slopes - compared to the short adjustment of 2018, industry size is now much larger and company strength is stronger, so 2023's readjustment period will be longer. Ultimately, the decline or failure of some leading companies due to their own circumstances may signal the start, while companies with integrated strengths in technology, operations management and finance take the lead in developing industries and increasing market share.

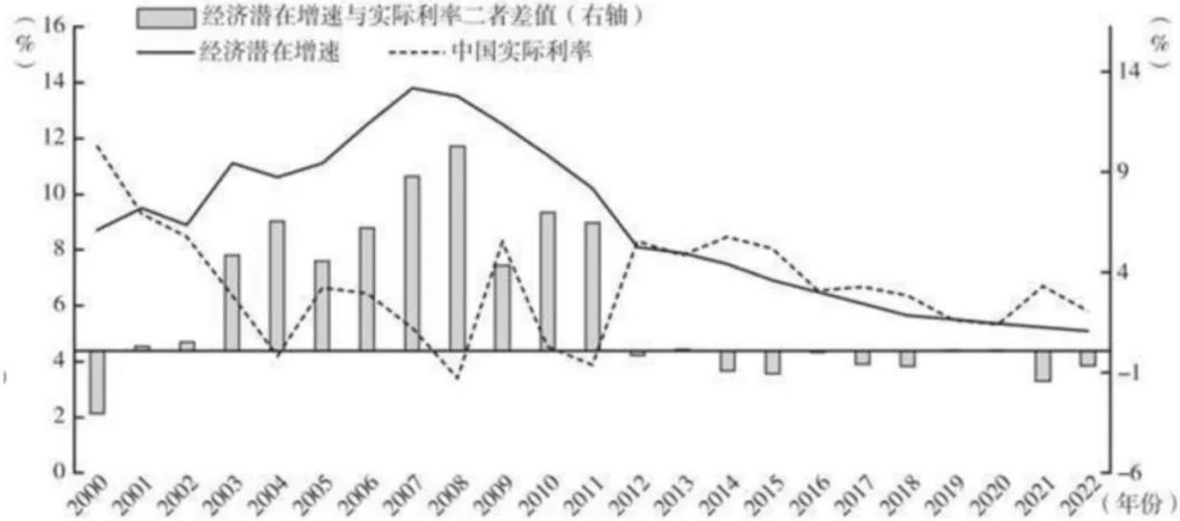
Rosefinch believes that as photovoltaic capacity develops to 500-1000GW in scale, homogenous competition over capacity scales has lost meaning. What's still needed includes: 1) Breaking through bottlenecks with technological breakthroughs to effectively create new demand through supply. 2) More complete supporting facilities and policies, especially relaxing various limitations involving land, grids, storage facilities. 3) Overseas expansion and capacity construction.

One new energy vehicle enterprise plans a 10% staff cuts in November, believing the next two years will be the most fiercely competitive period of change for the auto industry...A reshuffle has begun in the new energy vehicle industry, with the first to fall being new forces losing financing ability - enterprises without innovative capacity will face greater risks going forward.

4. Market rates like to fall as fiscal stimulus providing strong growth signals

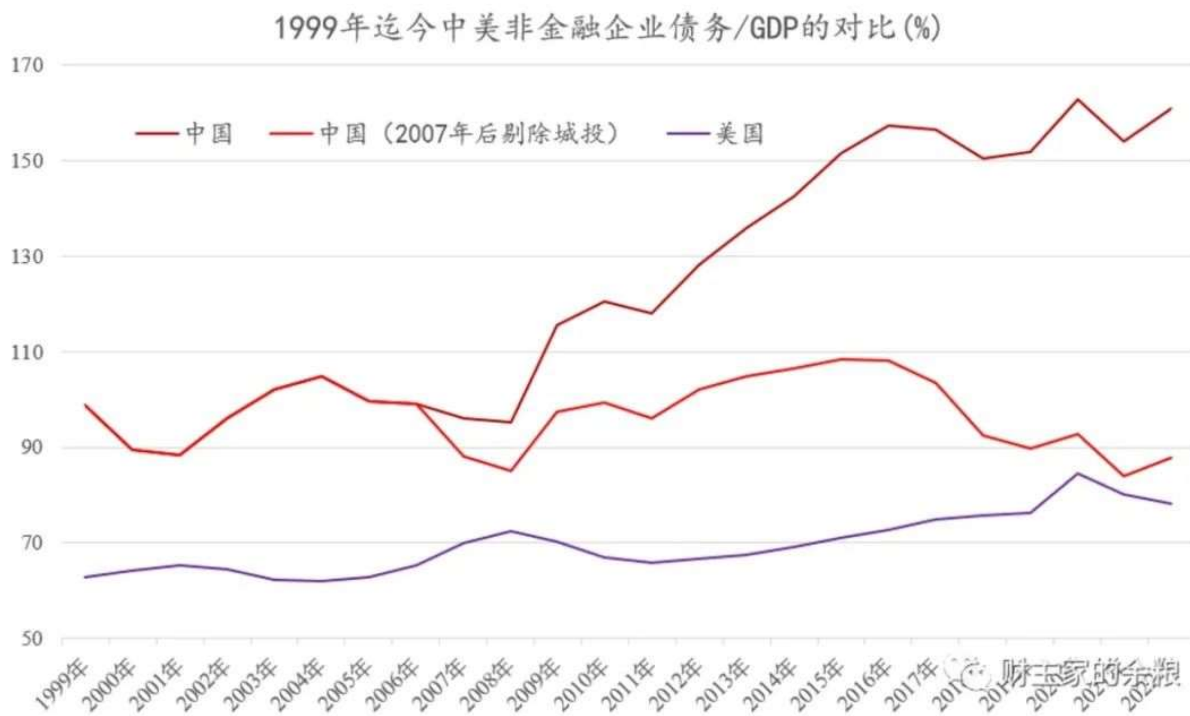
From PBOC's perspective, keeping actual interest rates appropriately matched to potential economic growth requirements, without overly tight or excessively stimulative monetary policy, should be an ideal state. We can use this perspective to examine the interest rate level and trends over the next 3 years.

According to estimates and analysis by the Chinese Academy of Social Sciences, three factors - pandemic impact, China-US decoupling, and population aging - are expected to reduce China's potential growth rate by 1 percentage point during the 14th Five-Year Plan period. In the baseline scenario, the potential growth rate will decline to 4.27%. Looking at a potential inflation rate of 2%, the estimated actual interest rate range remains around 4.8%, leaving some room for nominal rates to reduce further.



As risks are addressed and financial support facilitates high-quality real economic development, local government debt risks have eased somewhat while declining credit spreads correspond to falling corporate financing costs. Low interest, low spread rates may become the norm in the future, providing lower static returns from bonds. From the perspective of monetary policy objectives, there remains some room for risk-free rates to downtrend absolutely, though the space is gradually narrowing - market rates will likely slowly adjust downward. Inflation has likely bottomed out, with upside risks greater than downside going forward, though the magnitude will depend on overall demand itself.

Recent policy signals have been increasingly positive fiscally, with continued optimization of property measures. A supplementary RMB10 trillion in national bonds for 2023 will be issued in Q4 this year as special national debt, expected to raise the deficit ratio to around 3.8% from 3%. All bonds will be arranged for local transfer payments to concentrate support on post-disaster recovery and reconstruction and fill gaps in prevention and mitigation. Near year-end expansion of the budget and deficit will strongly signal stabilization of initial 2023-24 fiscal spending.



China's new minister of finance Lan emphasized balanced expenditures, effects of fiscal spending, as well as local cooperation on debt swap projects. Overall his thinking seems more positive and proactive than the past, with a focus on bundled debt solution implementation to address local government debt risks actively and prudently.

Government's policy document No. 35 measures have begun gradual implementation, with emerging impacts - city-level debt especially lower-rated issuers have been market favorites, assets maturing pre-2025 now seen as basically safe, rates on some earlier "internet celebrity" regions declining sharply; city-level debt approval has tightened, heavily indebted areas generally only allowed for refinancing while others must pledge no new implicit debt, keeping incremental risks under control. In unconventional areas some Western provinces reportedly entered debt restructuring with capital not fully repaid, debt classification and disposal reflecting clear thinking. Selected bank consortium loans have landed, focused on non-implicit debts to lower debt costs through extension.

Ministry of Finance has identified 8 cases of illegal implicit debt issuance by financing platforms, showing accountability is being implemented. But fundamentally local government investment-driven growth model dependence must change, the key is about changing government behavior patterns and fiscal systems. Overall on market speculation, thinking remains slower adjustment over time, and hopefully while government retains the will and the capability to sustain the process.

5. To grow sapling into towering trees

T [021]2030 5888 F [021]2030 5999
A 58 Floor, New Bund Center, NO.555 West Haiyang Road/588 Dongyu Road, Pudong New Area, Shanghai
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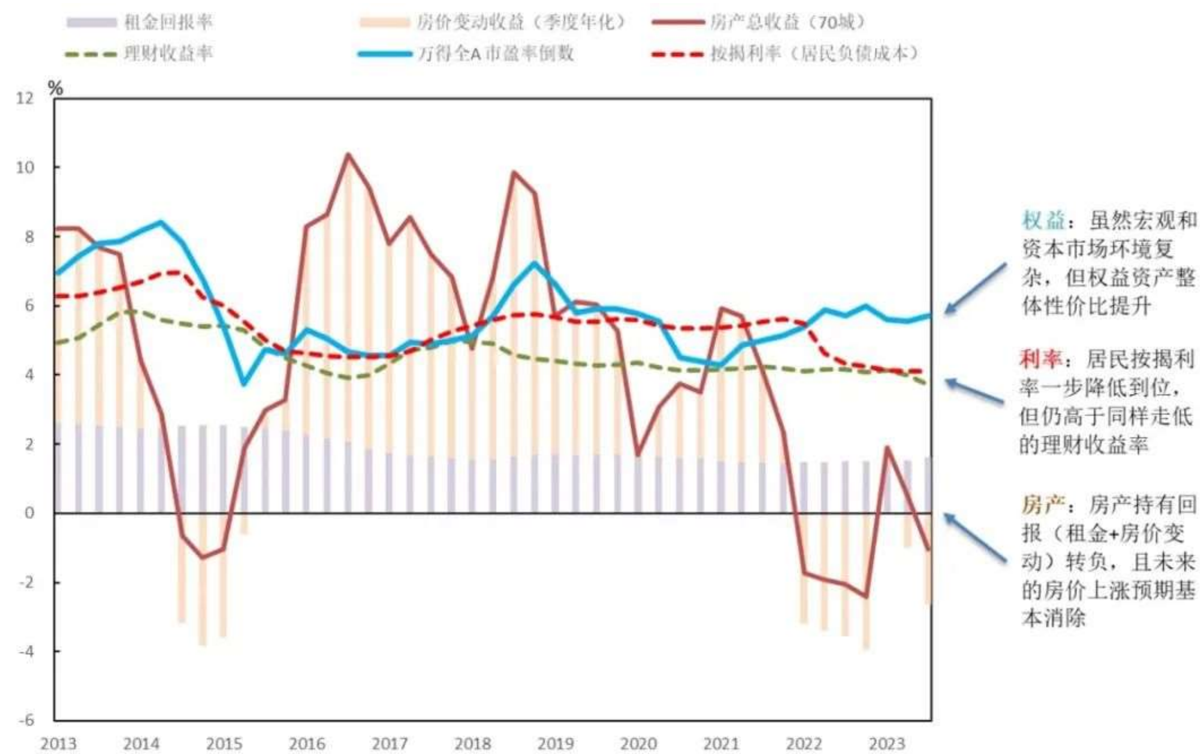

Source: Wind, Rosefinch.

In 2015, amid expectations of US rate hikes and domestic deleveraging policies, consecutive stock, currency, and bond market crashes occurred. Facing today's more complex domestic and foreign challenges, internal circulation's core drivers - real estate and urbanization (local government debts) - cannot temporarily act as a counter-cyclical adjustment tool during economic downturns. External circulation's core element, China-US relations, has also undergone qualitative changes.

"In the next stage, the People's Bank of China and State Administration of Foreign Exchange will comprehensively deploy policies to stabilize expectations, resolutely prevent self-fulfilling unilateral expectations, resolutely correct pro-cyclical market behaviors, resolutely dispose of disorderly market conduct, and resolutely forestall exchange rate over-correction risks." Since 1978, following the approach of "inflows before outflows, long-term before short-term, direct before indirect, institutional before individual", the People's Bank of China steadily increased the convertibility of capital items. But currently within a global scope, China's degree of capital account opening remains relatively low, with global asset allocation posing difficulties - currently there are over $25 trillion worth of various types of RMB deposits.

"Optimizing financing structures to better give play to capital markets' nodal functions." For domestic investors, there is a certain degree of "asset famine", with high-certainty assets having low returns while assets with high potential returns also having high uncertainty. Breaking through the "asset famine" depends on how growth potential is recovered.

Email ir@rosefinch.cn

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Rosefinch embraces our original vision to sustainably create value by adhering to a culture of "prudence, focus, innovation, analysis" and always putting research as first priority. In focusing on our expert fields, we seek to replicate the practice of "growing with saplings into towering trees", which first requires identifying the best management team, learning business models, and tracking with patience and perseverance.

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

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