Prescient
CHINA

PRESCIENT CHINA QUARTERLY COMMENTARY

2024 Q1

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THE END OF CHINA'S BLACK FRIDAY SALE

In our last quarterly commentary reviewing a difficult 2023, we made the argument that economic fundamentals will always matter in the long run. Afterall, fundamentals should drive corporate earnings which should then translate into stock market valuations. January 2024 attempted to prove our argument wrong when Chinese equity markets significantly corrected downwards even as economic data releases continued to improve. In USD terms, the onshore CSI300 Total Return Index dropped -7.5% and the offshore Hang Seng China Enterprises (HSCE) Total Return Index gave up -10.0% for the first month of the year. To our relief, the irrationality was short lived and markets sharply rebounded as we approached Chinese New Year. By the end of February, all of January's losses were recovered. For the quarter, the CSI300 Total Return and HSCE Total Return Indices delivered USD returns of +1.2% and +0.5% respectively.

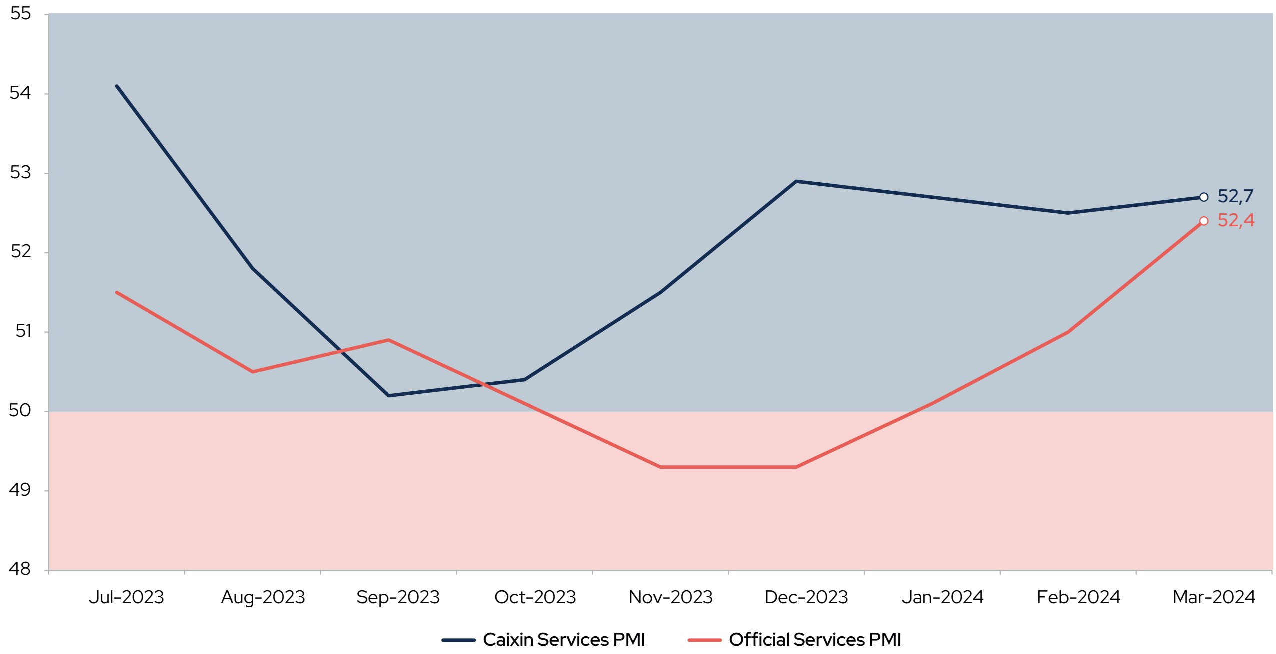
Our Prescient China Balanced Fund had a flat quarter while our Prescient China Equity Fund beat its benchmark CSI300 Total Return Index slightly, by 0.3% over the quarter, to deliver a USD net return of +1.5%. Chinese equity markets continue to be valued at decade low multiples and with the recent observed shift in market sentiment along with strong and improving economic data, we believe current valuations will not be around for long. For our Prescient China Balanced Fund, we continue to hold aggressive positions to maximise upside market exposure while holding downside protection for specific more volatile parts of our holdings..

FUNDAMENTALS KEEP IMPROVING

PMI

PMI data are some of the earliest monthly economic indicators we keep track of. March's figures certainly did not disappoint as both services and manufacturing PMI improved to be solidly in expansion territory above 50. Since last quarter, China's official Services PMI published by the National Bureau of Statistics (NBS) has converged upwards toward the Caixin China Service PMI. This is very encouraging as it indicates confidence levels are not only high in the private sector, they are also returning to the larger SOE sectors. We need to also keep in mind that the services sector represents over half of China's GDP.

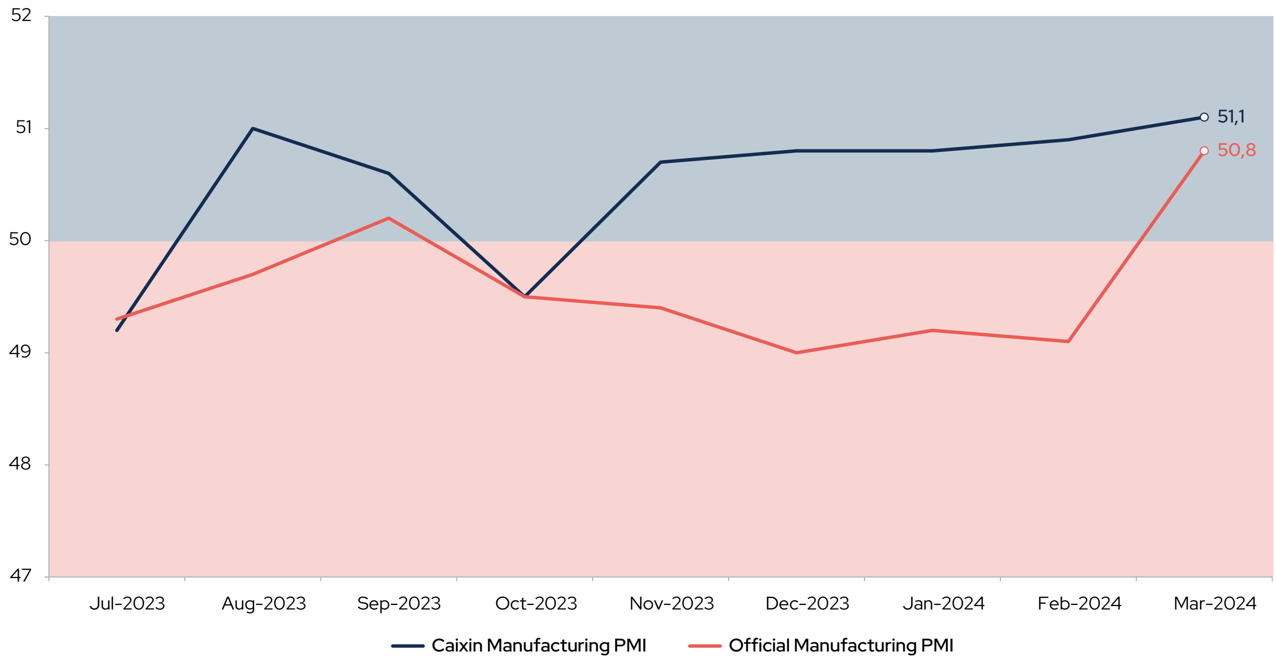
China Services PMIs



Sources: Prescient, Caixin, NBS (as at 31 March 2024)

To our surprise, the manufacturing sector, impacted by weak global demand and a struggling property sector, continued to produce higher PMI numbers for 2024. The Caixin China Manufacturing PMI figure stood at 51.1 for March 2024, its fifth straight month above 50. Even the NBS's official China Manufacturing PMI jumped in March to 50.8, moving into expansion territory for the first time in 6 months. While the economic recovery is still not perfect, data releases appear to be heading in that direction for now.

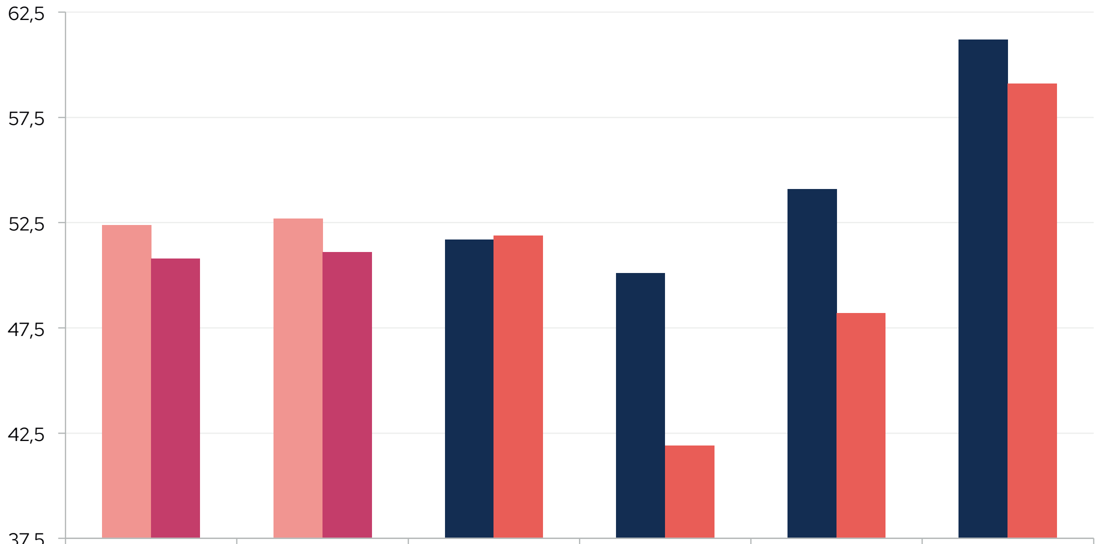
China's Manufacturing PMIs



Sources: Prescient, Caixin, NBS (as at 31 March 2024)

China's PMI figures also stack up solidly relative to major global peers, with India being the only country significantly outperforming all peers as at March 2024.

PMI - China vs Peers



	China NBS	China Caixin	US	Germany	Japan	India
Services PMI	52,4	52,7	51,7	50,1	54,1	61,2
Manufacturing PMI	50,8	51,1	51,9	41,9	48,2	59,1

Sources: Prescient, Caixin, NBS (as at 31 March 2024)

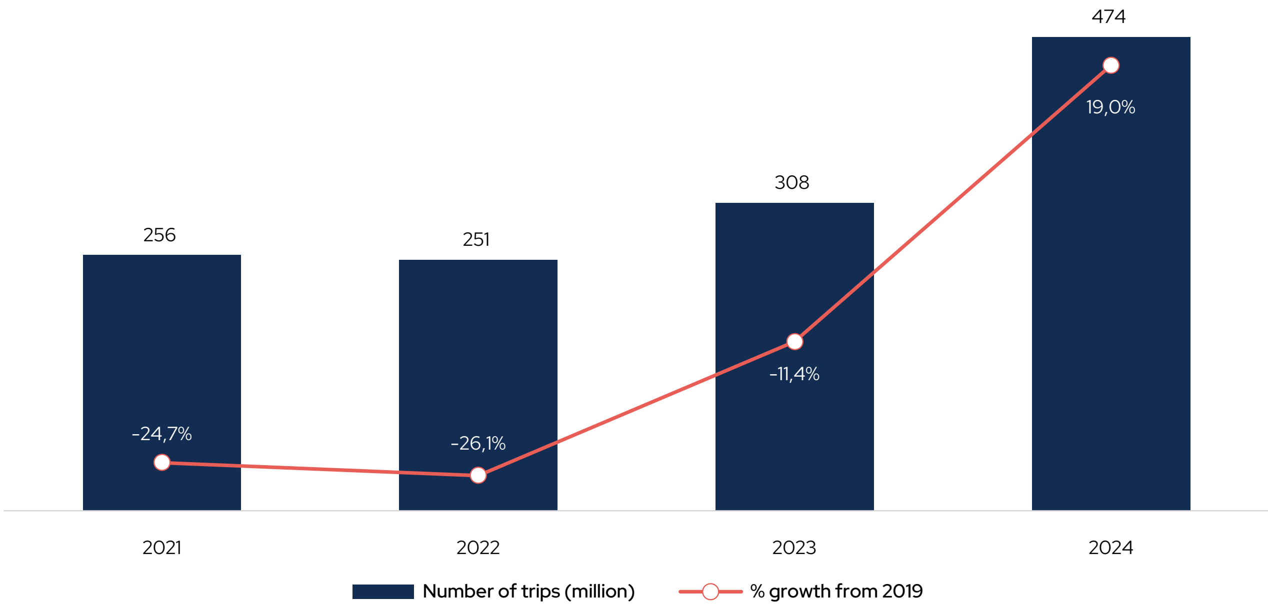
CONSUMER CONFIDENCE

One set of data we have been paying more attention to recently is Chinese tourism revenue over major national holidays. We view the data as a reasonable balance between essential and discretionary spending, a good indicator of overall consumer confidence.

After a slow start to 2023, we started to see significant increases in tourism spending during the May Worker's Day and October National Day holidays last year, with total revenues surpassing pre-pandemic 2019 levels. The positive momentum has continued in 2024 and we have seen further improvements for the first 2 national holiday breaks this year.

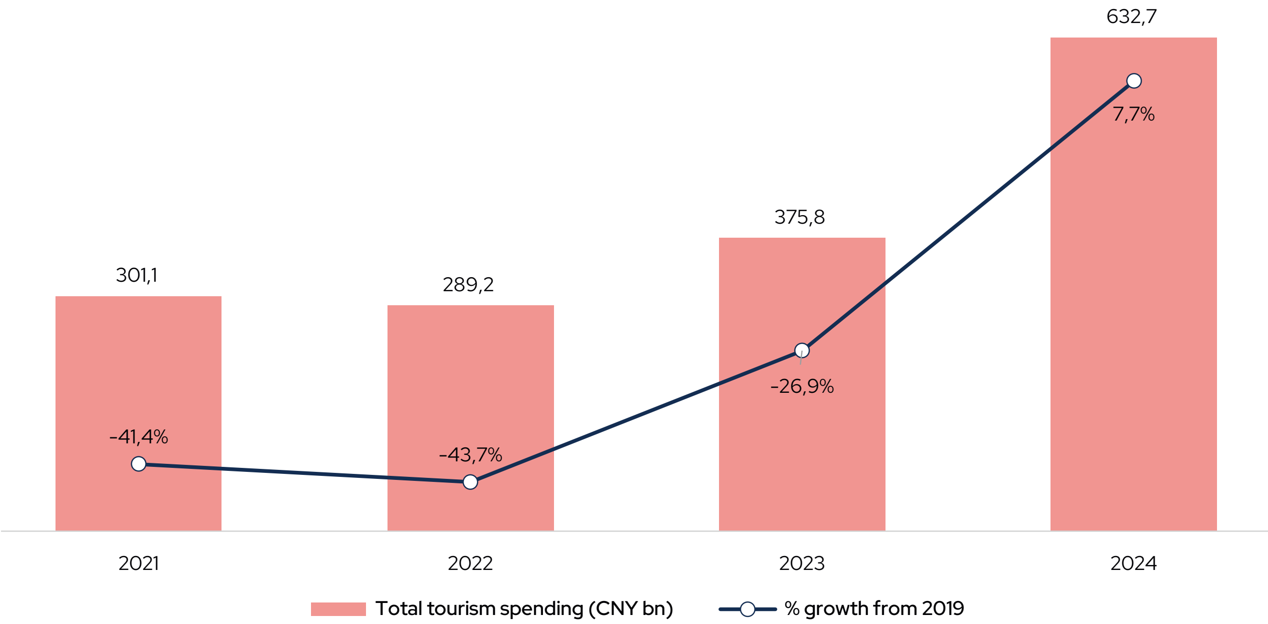
For Chinese Lunar New Year holidays in February, we saw massive increases in both number of trips taken and total tourism spend. In total, 474 million trips were made over the most important Chinese holiday period contributing to total tourism spend of CNY 633 billion (USD 88 billion). The number of trips and total tourism spend were 54% and 68% higher than 2023 respectively, but more importantly 19% and 8% higher than pre-pandemic 2019 levels.

China Lunar New Year Tourism – Number of Trips



Sources: Prescient, Ministry of Culture and Tourism (as at 31 March 2024)

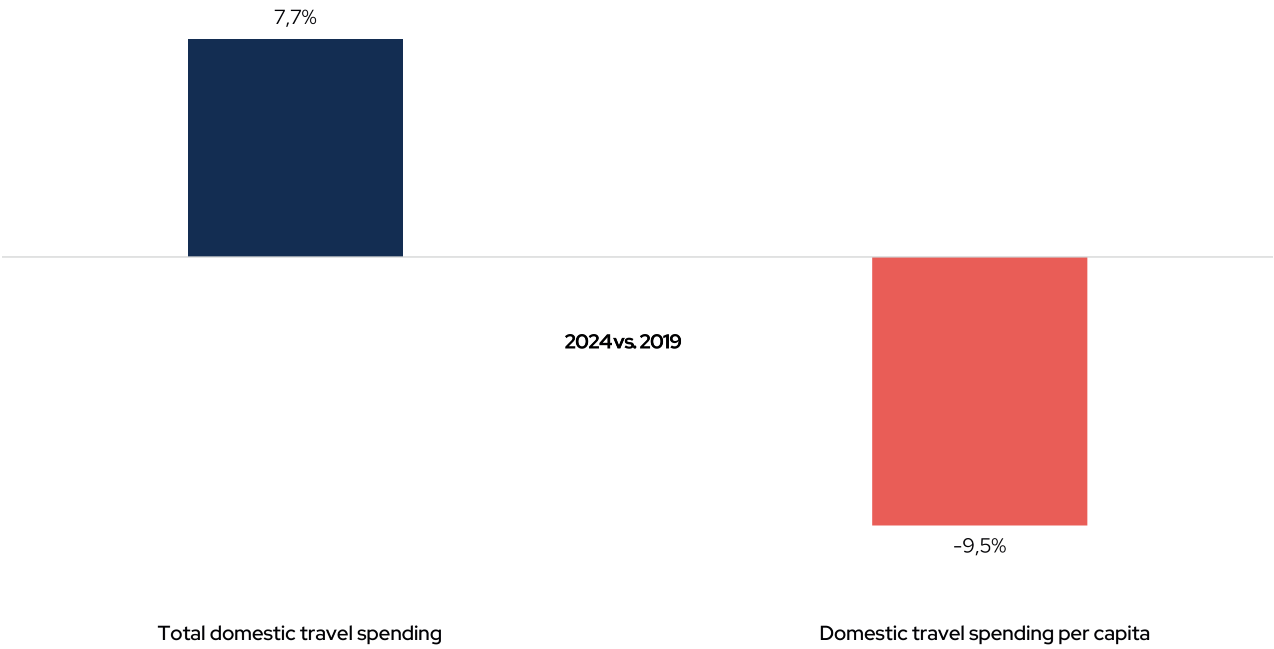
China Lunar New Year Tourism – Total Spending



Sources: Prescient, Ministry of Culture and Tourism (as at 31 March 2024)

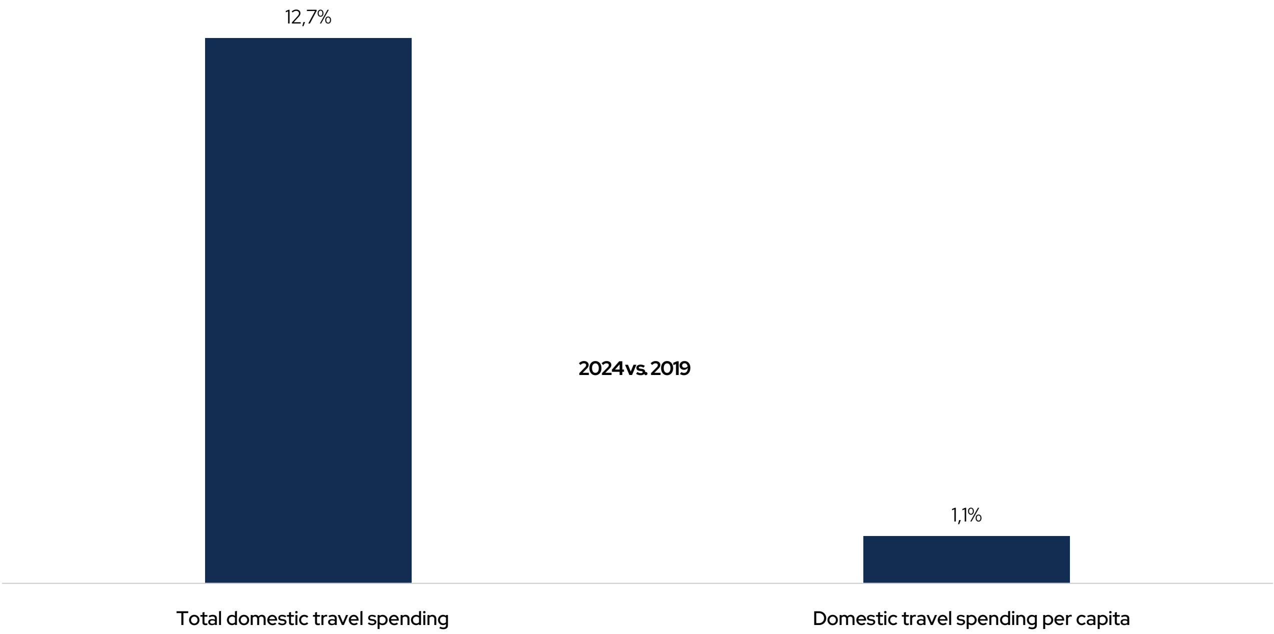
There are however still imperfections in the data. Per capita spend for Chinese New Year was only a little over 90% of 2019 levels and for Qingming Festival in early April, per capita spend marginally surpassed 2019 levels by 1.1%. As the economic recovery continues to gather momentum, we expect continued improvements in related data for the remainder of 2024.

China Lunar New Year – Tourism Spending



Sources: Prescient, Ministry of Culture and Tourism (as at 31 March 2024)

Qingming Festival – Tourism Spending



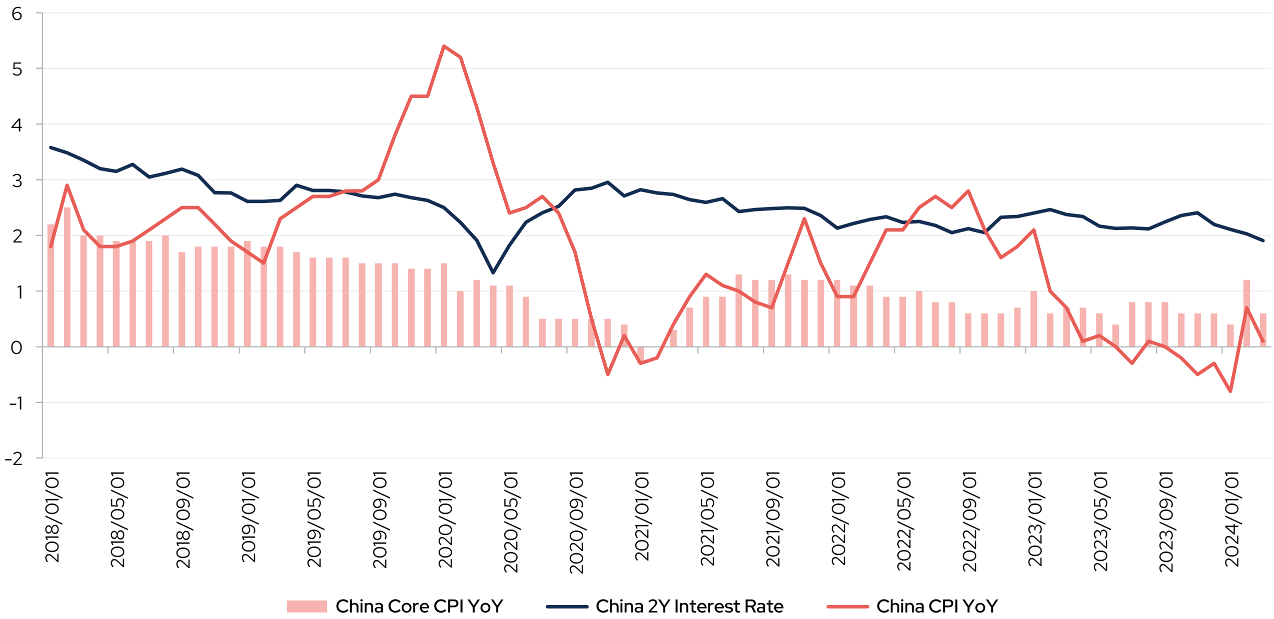
Sources: Prescient, Ministry of Culture and Tourism (as at 31 March 2024)

INFLATION & INTEREST RATES

CPI releases for Q1 of 2024 had a lot of similarities to equity market performance. January produced a concerning CPI figure of -0.8% YoY, the fourth consecutive monthly negative YoY reading. February and March both showed positive readings of 0.7% and 0.1% respectively, officially leaving deflation territory.

There was a lot of media hype on China moving into a Japanese style persistent deflationary environment late last year. We continue to believe there is no data backing up those concerns as Chinese Core CPI remains consistently above zero and PPI steadily above the lows of June 2023. As consumer sentiment continues to improve along with overall consumption in the domestic economy, it will be unlikely that we will see major risks of persistent deflation in the near future.

China Inflation vs Interest Rates



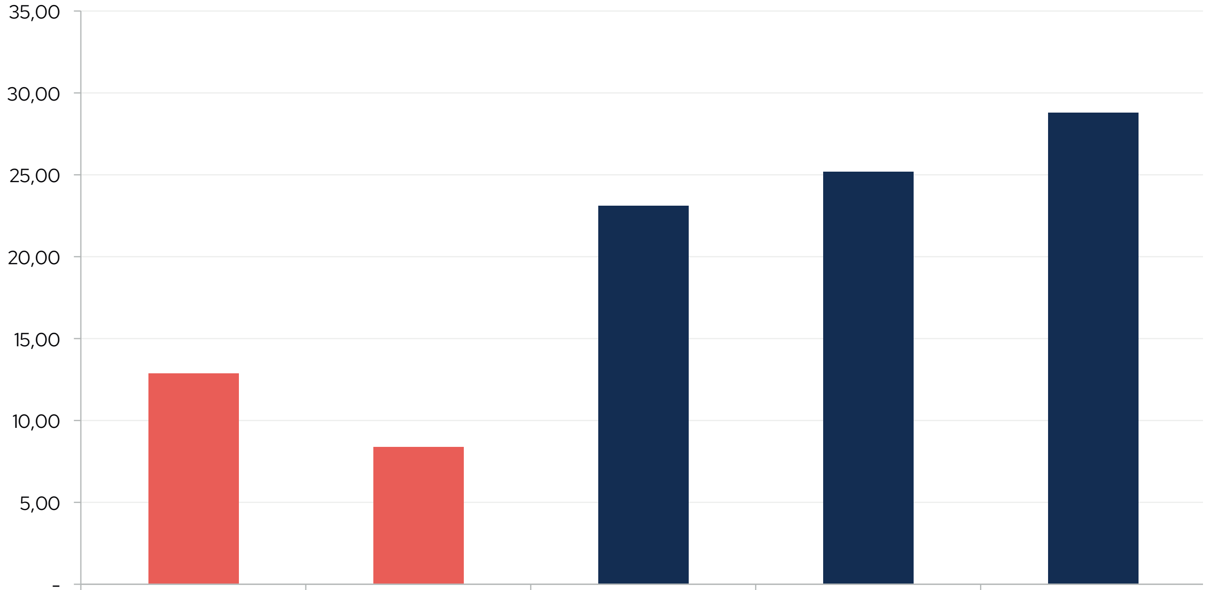
Sources: Prescient, Bloomberg (as at 31 March 2024)

The real rate environment in China also remains stable at around 2% with expectations of minor cuts in interest rates in an attempt to boost economic growth. Policymakers are currently having a very tough job managing monetary policy as high US rates and continued delays in the Fed cutting USD rates mean there is limited room for the PBOC to significantly reduce Chinese interest rates. Having said that, the current 1.8% 2 year real yield on CNY is marginally better than the USD equivalent of around 1.5%, even if nominal yields appear low.

CHINA'S BLACK FRIDAY SALE

With earnings largely flat for the CSI300 over the last 2 years and valuation multiples sharply decreasing, we are now in a once in a decade opportunity to pick up Chinese equities at record low valuations. Chinese stocks are priced as if the country and economy will disappear in the near future but that cannot be further from the truth. Just as economic data releases now clearly demonstrate a consistent recovery in the country, we believe it will only be a matter of time before earnings follow. Unlike many companies listed in the US or South Africa, Chinese companies still on average derive earnings domestically. A simple comparison of PE multiples between China and its peer markets as at the end of March show colossal differences.

Index PE ratios – March 2024



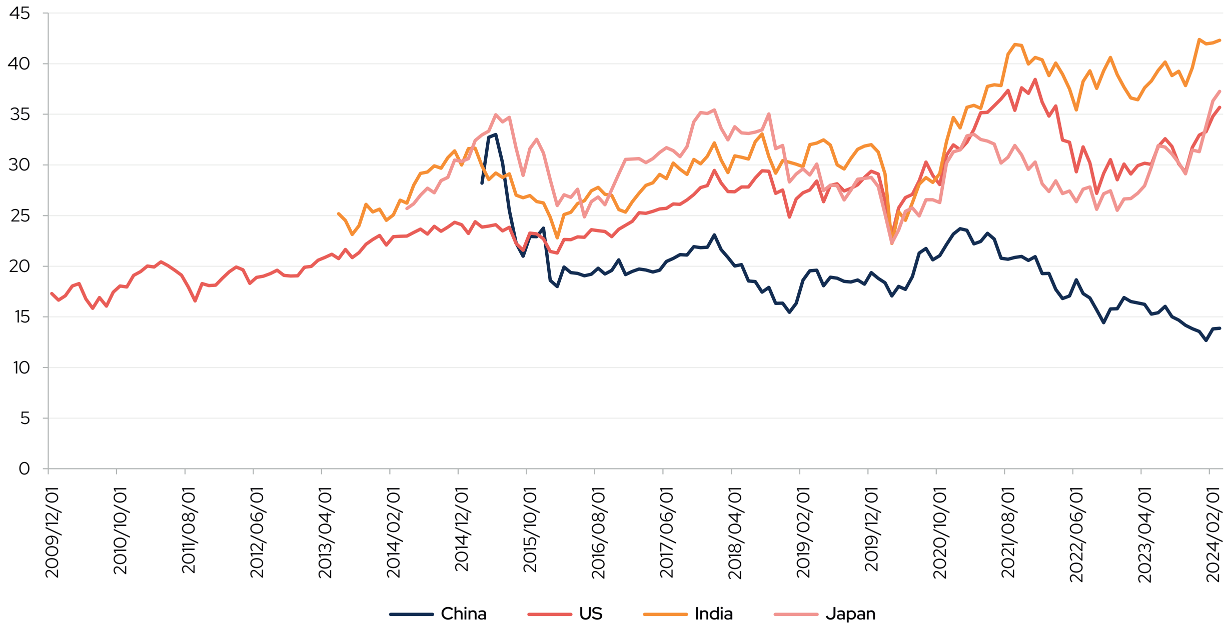
	CSI300 (China A)	HSCEI (China H)	India NIFTY	US SP 500	Japan NIKKEI 225
■ 2024-03-31	12,87	8,40	23,11	25,18	28,81

Sources: Prescient, Bloomberg (as at 31 March 2024)

If we consider Chinese shares listed in Hong Kong, the HSCE Index is currently almost 70% cheaper than Japanese, Indian and US equities. If we consider the consistently improving fundamentals and the expectations of earnings increases this year and beyond, Chinese equities are pretty much on a massive “Black Friday Sale” with no reduced quality on the SALE items. Onshore A shares going for major discounts and offshore H shares probably on a “GOOB – GOING OUT OF BUSINESS” type of SALE.

Of course, a point-in-time PE multiple comparison is probably too simple. Which is why our comparison goes beyond to look at long-term Cyclically Adjusted PE (CAPE) Ratios. The results are not surprising and show Chinese equities, as represented by the **more expensive** onshore CSI300 Index, at historical lows both relative to peers and relative to its history.

CAPE Ratio China vs Peers



Sources: Prescient, Bloomberg (as at 31 March 2024)

OPPORTUNITIES VS RISKS?

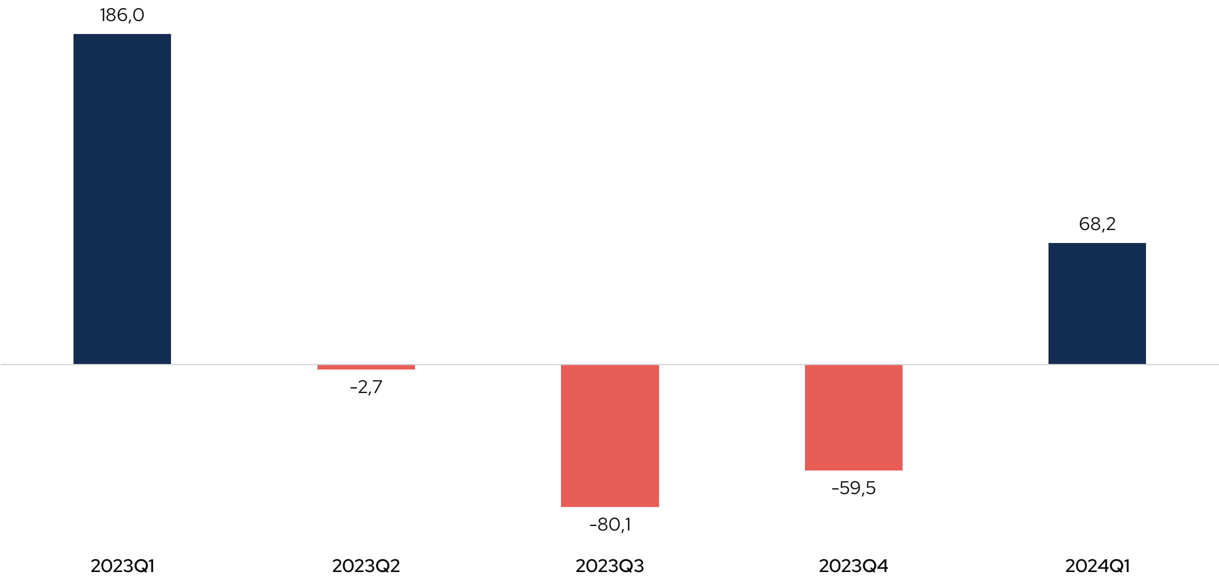
At current valuation levels, we believe it is a once-in-a-decade (if not once-in-a-lifetime) opportunity to invest into Chinese equities. Chinese equities are currently priced for an outcome far worse than the Japanese crash of the 1990s. As an example, at the bottom of Japan's crash during 1991-1992, the market had an average PB ratio of around 1.5. Currently China H shares has an average PB ratio of around 1. Depending on the denominator one uses, China is currently 33% or 50% cheaper than Japan right at the bottom of the crash.

At these "Black Friday" valuations, markets are suggesting China's risks are large enough to warrant it to disintegrate from the global economy and turn out to be worse than Japan and the Soviet Union in the 1990s. We believe China's biggest issues currently are probably tense relations with the US and its struggling property sector. We certainly don't believe current tech and trade sanctions on China imposed by the US will do anything more than temporarily slow down development of select domestic sectors. Having been on the ground throughout the Covid years in Shanghai, we can assure you that the opportunities currently, in all likelihood, outweigh the risks.

SENTIMENT INDICATORS?

We've said enough about China being cheap and cheapest in decades. The counterargument is that China has been priced similarly for over a year now. So, the key question is: when will the Chinese market rally come? Historically, it has always been a random trigger to major market rallies in China. When market rallies occur here, they occur with speed. Which is why we believe it is critical to maintain exposure to China, so one is always ready for when the rally occurs.

Foreign Fund Flows into Onshore A Shares - North Bound CNY bn



Sources: Prescient, Wind (as at 31 March 2024)

Looking at foreign funds flow data for the China onshore Northbound stock connect, it is clear that we are not alone in seeing a great investment opportunity in China. The first quarter of 2024 was the first time in a year where we saw net inflows of funds into China's onshore A share market from foreign investors. An extremely encouraging sign that sentiment is increasing even amongst foreign investors.

PRESCIENT POSITIONING

CHINA EQUITY FUND

After a couple of forgettable years for Chinese equity market performance, we have seen sentiment indicators improve in February and March this year. Despite all the challenges, the Fund still delivered 1.01% alpha over the CSI300 Total Return Index for investors over the last 12 months, and 0.28% alpha over the quarter. Compared to China onshore equity ETFs, our Prescient China Equity Fund continues to dominate after fees. An annualised outperformance of 2.49% net of all fees has been achieved since inception compared to the largest listed USD CSI300 ETF.

Prescient vs Largest USD CSI300 ETF - Net of Fees

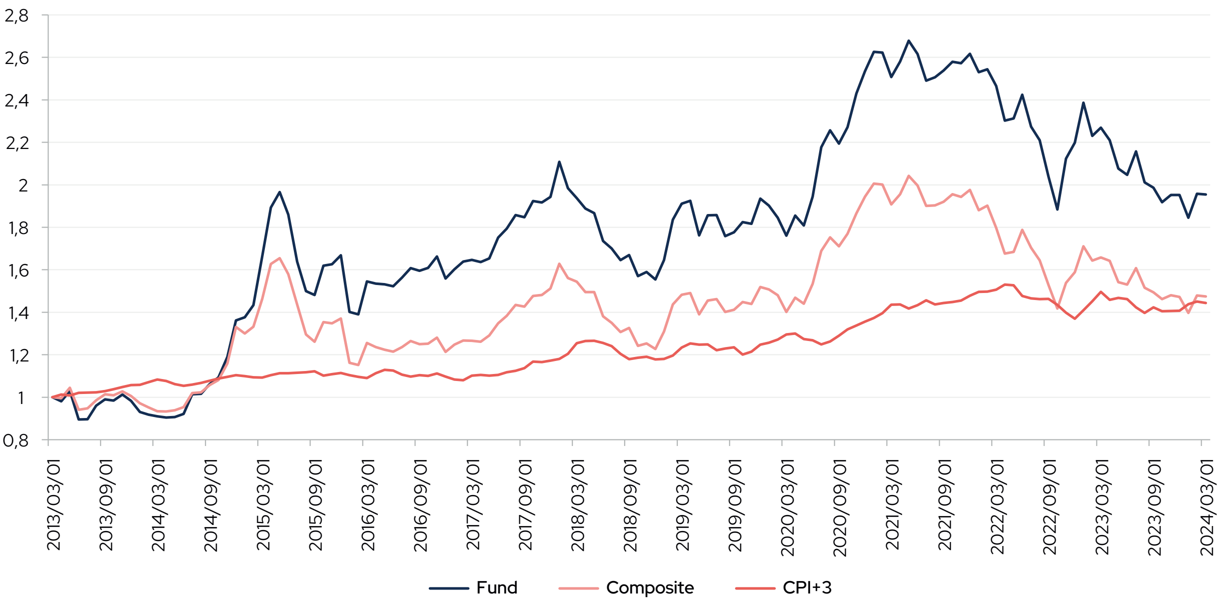
Sources: Prescient, Bloomberg (as at 31 March 2024)

Our Prescient China Equity Fund continues to consistently provide index level risk while significantly enhancing returns over the index and passive China strategies over the cycle. This, along with passive level fees are some of the main reasons why the fund continues to be rated 5 stars by Morningstar over all rated periods.

CHINA BALANCED FUND

With consistent policy support in addition to record low valuations, the last piece of the puzzle for an extended market rally will be fully positive investor sentiment. We anticipate sentiment to come through as more consistent economic and earnings improvements are announced, maybe as early as Q2 and Q3 of 2024. We are already seeing signs of improvement late in Q1 and also in April 2024. Our Prescient China Balanced Fund continues to be positioned close to full equity upside exposure, with adjustments for sentiment swings.

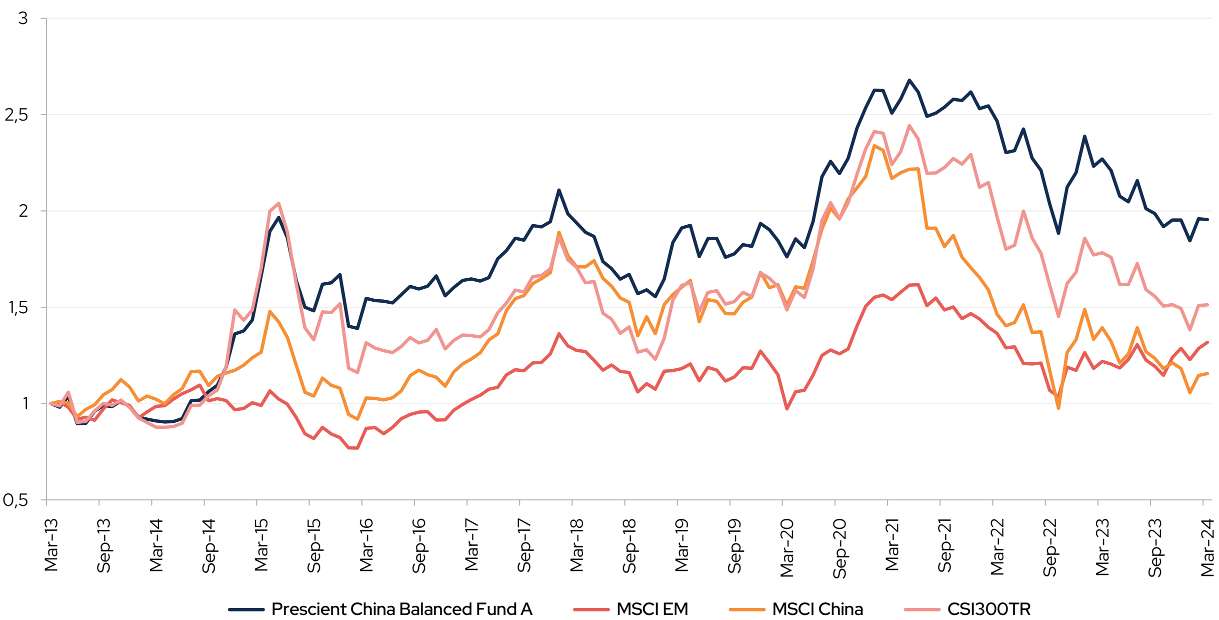
Prescient China Balanced Fund - USD A Class net



Sources: Prescient, Bloomberg (as at 31 March 2024)

Composite: 65% CSI300 and 35% CSI1Bond. Inception Date: 30 April 2013

Prescient China Balanced Fund Performance Since Inception - USD A Class Net



Sources: Prescient, Wind (as at 31 March 2024)

Even with the aggressive positioning within our China Balanced strategy, we managed to outperform pure equity markets over the past 12 months. Over the long-term the fund has comfortably outperformed all pure equity indices that are China related. An added benefit of our Prescient China Balanced Fund compared to our Prescient China Equity Fund is that we have full flexibility of allocating to Hong Kong equities. With Hong Kong equities extremely attractive, we currently have over a quarter of the fund's exposure in Hong Kong, much of that exposure having additional downside protection. With the extreme volatility we have seen in the Hong Kong equity markets, the downside protection is an additional feature we decided to include within our strict risk management framework. Over the medium to long-term, we continue to aim for full equity market upside while limiting downside to around 65%.

IF NOT NOW, THEN WHEN?

When we were in South Africa during the first quarter we noticed overwhelming interest in allocations to China. Afterall, who doesn't like a bargain? The concern however was the same old question of: Is China still investable? Having been bombarded with negative headlines on China over the past years, it's natural to have fears of a direct allocation to China losing money, resulting in a "I told you so" scenario. The good news is that, with such good economic data coming out of China, the markets have reacted with some very strong performance from February to April 2024.

Most South African investors have little to no direct exposure to Chinese assets, especially in the onshore A share market. Our recommendation has always been to begin with a small 1-2% allocation at a portfolio level. It gives one skin in the game but also small enough to make even major losses insignificant. Current valuations combined with the diversification benefits of Chinese assets for South African investors make this an easy decision to make, with very limited downside risk. Like with all SALE events, this BLACK FRIDAY SALE on Chinese equities will end, when it does, it will end very quickly.

We will be in South Africa during June for the annual Meet the Managers events in Cape Town and Johannesburg. We look forward to seeing many of you back home.

Prescient