Prescient
CHINA

PRESCIENT CHINA QUARTERLY COMMENTARY

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REVIEWING A DIFFICULT YEAR

Any investor in the Chinese stock markets will probably agree that 2023 was one of the toughest years in recent times. The year started off with immense optimism as China officially abandoned its strict zero-Covid policies to open up to the rest of the world. Markets rallied in January but then began their slow decline for the remainder of the year. The CSI300 total return index ended the year down -11.1% in US dollar terms, marking its third consecutive year of losses since 2021.

At the beginning of the year, we were optimistic about the post-Covid economic recovery in China, believing that improvements in the real economy would lead to increased financial market confidence. In reality, both the onshore A share and Hong Kong Chinese stock markets consistently declined over the year even as the economy recovered, albeit at a slower rate than market participants had initially hoped for. However, the last quarter of 2023 continued to show promising signs of economic recovery and policy support.

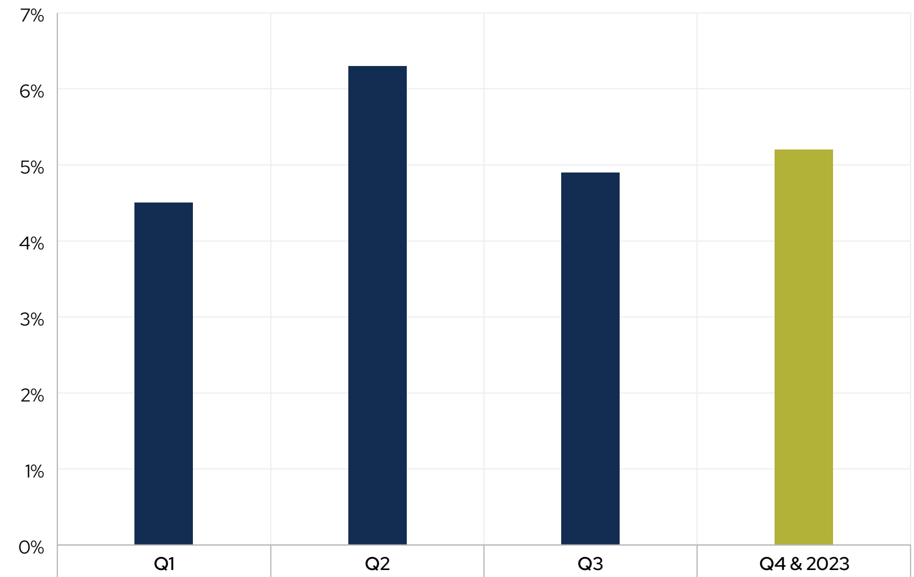
Our Prescient China Balanced Fund struggled in 2023 along with the market. Our Hong Kong exposure detracted from performance earlier in the year, before protection from our downside protection levels kicked in. Overall, the Fund produced similar returns to equity total return indices for 2023. With the market at the cheapest valuations in a decade and sentiment indicators at extreme lows, we aim to position the Fund to maximise our upside offered by this once-in-a-decade investment opportunity. A key component of investing for the long term is to maximise the risk when the expected payoff is extremely large. Given decade-low valuations, we will be positioning the Fund to maximise the upside while keeping downside risk in line with the equity market.

FUNDAMENTALS WILL MATTER IN TIME

GDP & INFLATION

The official GDP growth target for 2023 was “around 5%”. That was achieved when the annual GDP growth rate of 5.2% was announced in January 2024. While this growth rate is an enviable number for most countries in this world, it fell short of China’s historical performance. With a slowing property market, the economic recovery was less robust than the historical norms of China, but given the limited stimulus implemented by government, the result is still solid.

China YoY GDP growth 2023



	Q1	Q2	Q3	Q4 & 2023
■ China YoY GDP Growth 2023	4,5%	6,3%	4,9%	5,2%

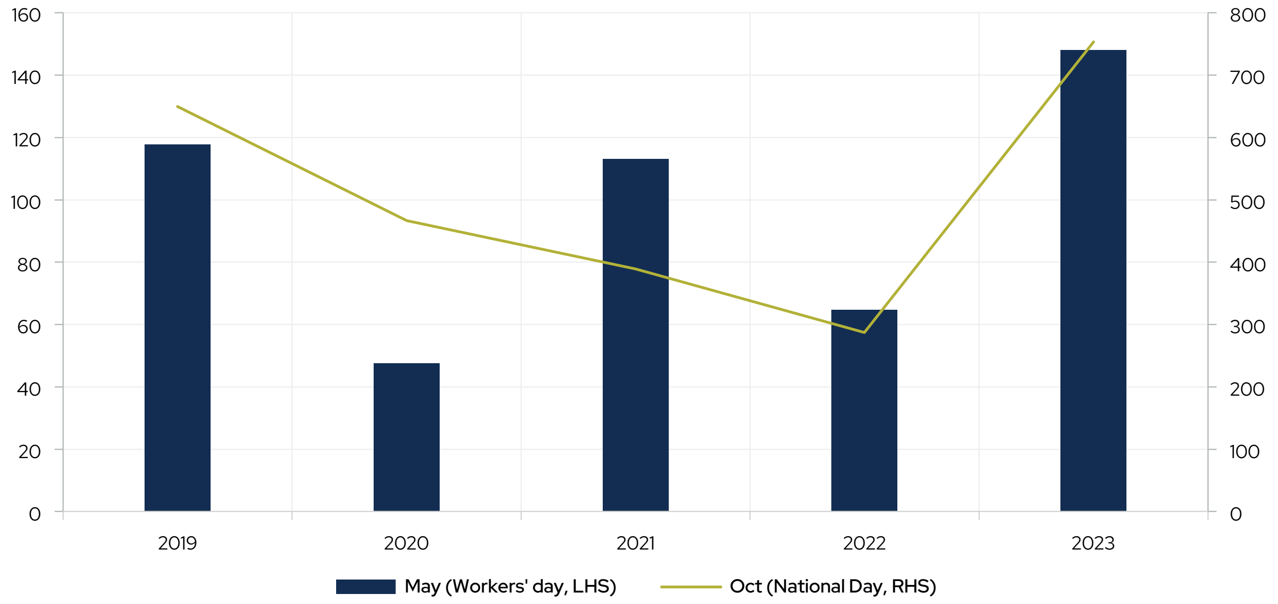
Sources: Prescient, China National Bureau of Statistics (as at 31 December 2023)

China is experiencing mild deflation of -0.3% year-on-year, but we believe this is preferable to high inflation. If required, the current low inflation/deflationary environment allows for massive Japanese-style stimulus. Given that both consumer confidence and retail sales data improved over the last quarter of 2023, we don’t expect to get to that type of scenario soon.

CONFIDENCE RETURNING

Retail consumer sentiment improved throughout 2023, as evident during China's two largest holiday periods. For both the May Worker's Day and the October National Day Golden Week holidays, tourism spending crept above 2019 levels again. We expect further solid numbers to be published for the upcoming Chinese New Year holidays in February 2024. Overall, consumer confidence significantly dropped in April last year but has since been steady and on a path of recovery.

China tourism revenue (CNY bn)

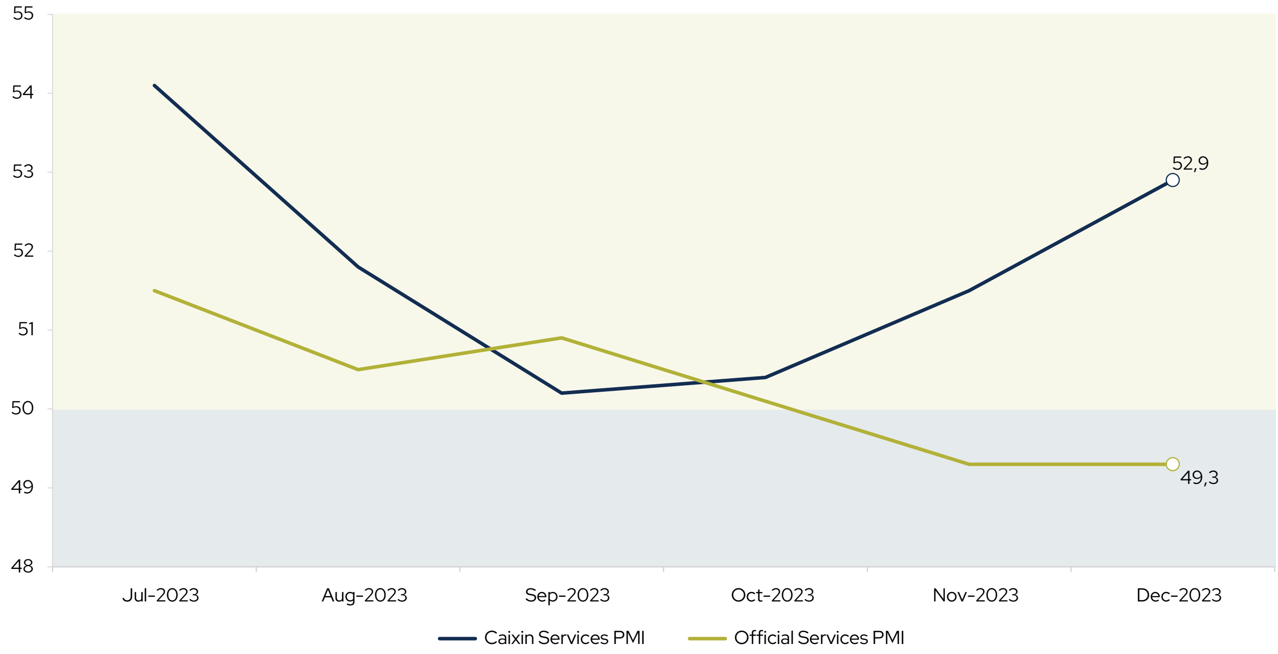


Sources: Prescient, Wind (as at 31 December 2023)

IN-DEPTH LOOK AT PMI

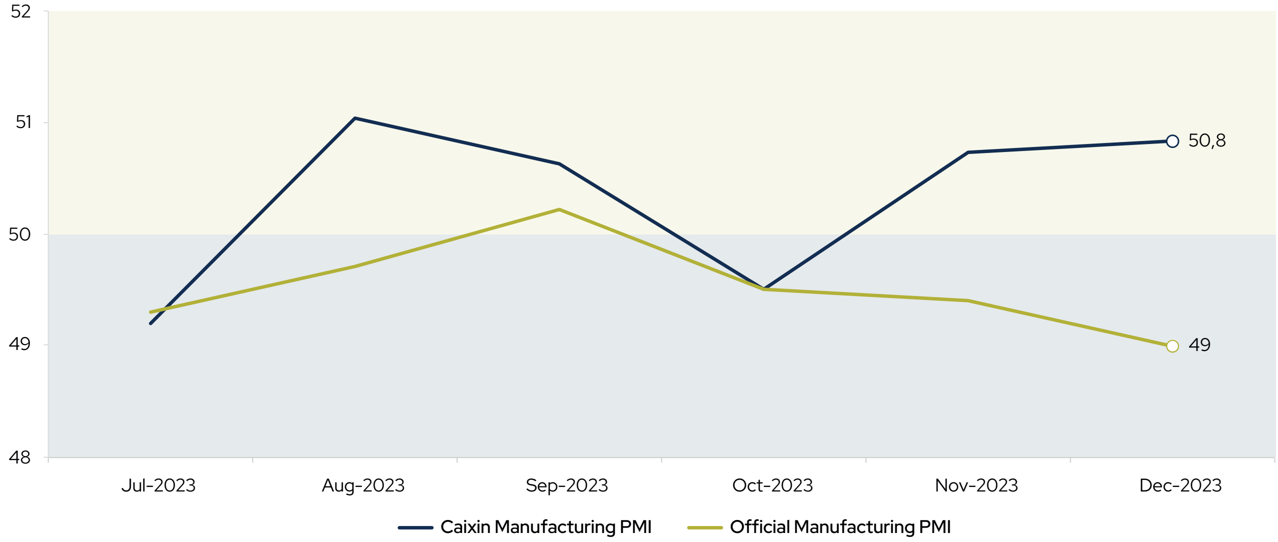
China's PMI numbers produced interesting readings in December 2023, with the two main publishers, the National Bureau of Statistics (NBS) and Caixin, still producing diverging numbers for both the services and manufacturing PMI. Both the Caixin Services and Manufacturing PMI readings were in expansionary territory at 52.9 and 50.8, respectively. In contrast, NBS published weaker numbers, with a Manufacturing PMI of 49 and a Services PMI reading of 49.3 for December, both in contractionary territory. Why the difference? The NBS surveys are more heavily weighted towards large and state-owned enterprises, whereas the Caixin figures are weighted towards mid- and small private enterprises. While the overall business environment remains tough for large and state-owned enterprises, we are very encouraged by the consistent improvements in the private sector.

China services PIMs diverge



Sources: Prescient, Caixin, NBS (as at 31 December 2023)

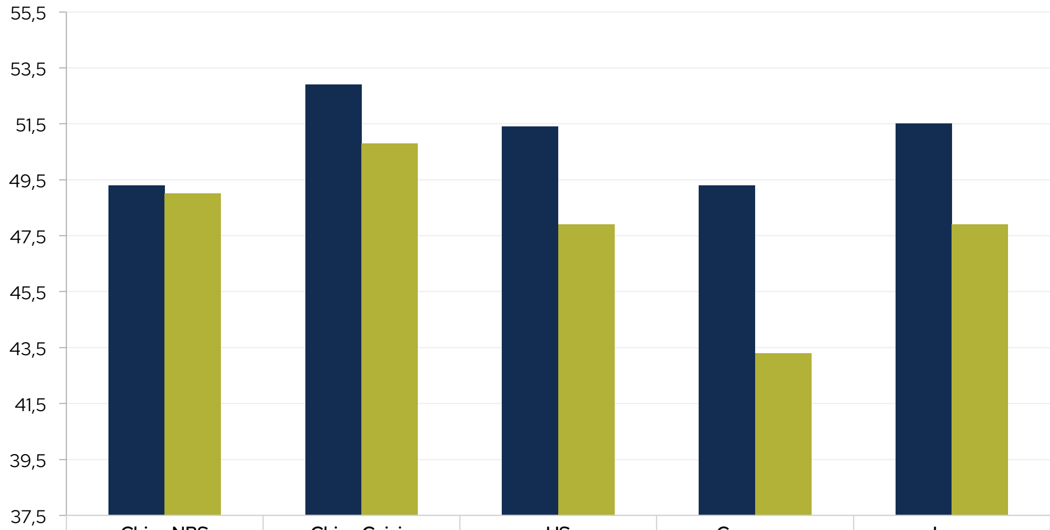
China's manufacturing PMIs diverge



Sources: Prescient, Caixin, NBS (as at 31 December 2023)

Chinese PMI numbers have often been the scapegoat of negative performance on the Chinese stock markets. They tend to be the most convenient number to blame when there's no clear fundamental reason for volatility in the stock market. But, while they have often fallen below the 50 mark, the NBS and Caixin figures have hovered around 50 for 2023, meaning no significant contraction or expansion has taken place. It's also worth comparing where China stands relative to other major economies, as per the below comparison.

PMI - China vs peers



	China NBS	China Caixin	US	Germany	Japan
Services PMI	49,3	52,9	51,4	49,3	51,5
Manufacturing PMI	49	50,8	47,9	43,3	47,9

Sources: Prescient, Caixin, NBS, Bloomberg (as at 31 December 2023)

As much as China's manufacturing has struggled within the current high inflation and low global demand environment, both the NBS and Caixin manufacturing PMIs are beating their peers, including other major exporters like Japan and Germany.

SENTIMENT DEEP IN THE BASEMENT

CAUTIOUS INVESTORS TURNED SAVERS

Chinese investors have been extremely cautious for the past three years, and, with Chinese equity markets performing poorly both onshore and offshore, one can fully understand the current lack of risk appetite. Ironically, investor caution has added to the woes of the stock market. Our recent research showed new household deposits in China reached all-time highs as investors grappled with loss aversion, even as deposit rates continued dropping on the back of central bank interest rate cuts.

Chinese household deposits (new) - CNY bn (LHS) vs. CSI300 Index (RHS)

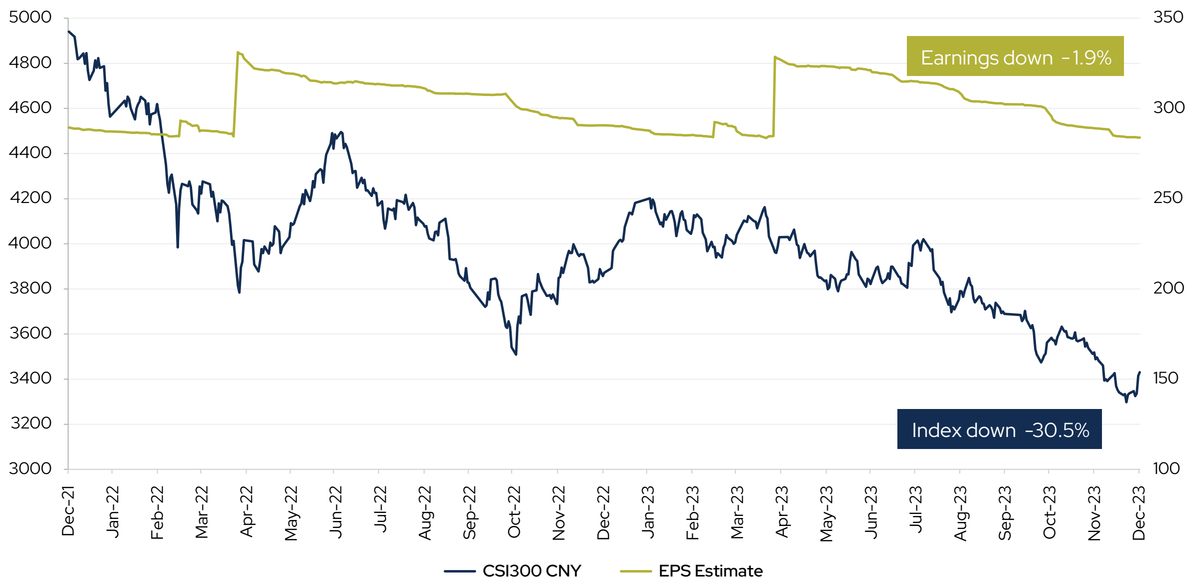
Sources: Prescient, Bloomberg (as at 30 November 2023)

New household deposits have increased almost four-fold since a decade ago, almost doubling 2019-2021 levels when investor sentiment was positive on the Chinese stock markets. With inflation hovering around zero, real returns offered by deposits and investment-grade bonds remain appealing to the general public. If history is an indication, Chinese investor sentiment can turn very quickly. We believe a positive turn in investor sentiment will bring that cash back into the stock markets very quickly, and by the looks of it, there's certainly no shortage of cash.

SENTIMENT KICKER?

Our historical research suggests that sharp turns in sentiment are almost always random and extremely difficult to identify quantitatively. The actual event trigger for market-wide sentiment changes may be difficult to identify ahead of time, but as the economy recovers with more solid economic data releases, we believe the market will eventually be forced to revalue upwards. Chinese equity markets have continued to drop in the first few weeks of January, with no strong fundamental driver. If we look at market valuations relative to factors such as inflation, interest rates, economic growth and average earnings changes over the past decade, there is a clear disconnect between Chinese equity markets and peer markets in developed and emerging markets. Through 2022 and 2023, the average best estimate earnings of listed Chinese companies dropped marginally in local currency terms, -1.9% over two years to be exact. The benchmark stock index, however, dropped by a whopping -30.5% over the same period, largely a function of diminished earnings multiples. The visual impact is shown in the chart below.

CSI300 Index (LHS) vs. Earnings (RHS) - CNY since 2022



Sources: Prescient, Bloomberg (as at 31 December 2023)

As the economy continues to recover and corporate earnings catch up with GDP growth rates, market valuations will need to be revised to account for updated earnings reports. With the widely reported property sector a negligible portion of China's listed stock market, the turning point in investor sentiment may be when the market realises the true resilience of the physical economy.

THE TAIWAN CONNECTION

In early January 2024, the island of Taiwan, formally known as the "Republic of China", elected "Taiwan independence worker" Lai Ching-te as its new president. This result was widely expected as Lai consistently led in opinion polls running up to the elections, eventually winning 40% of the votes in a three-way race. There are, however, some key changes that will help manage political risk:

- Lai won a minority victory with only 40% of the votes, 17% less than predecessor Tsai Ing-wen on lower voter turnout.
- The DPP also lost its Legislative Yuan (parliament equivalent) majority, and the Mainland China-friendly KMT now has the most seats.

These changes, we believe, continue to show a preference for the status quo within Taiwan, and the major risk of irrational political policies should be limited, given no single party now holds a majority in the Legislative Yuan. As such, we continue to view the likelihood of Taiwan being the next "Ukraine" as zero to minimal.

Lai's victory did not help improve Chinese equity investor sentiment, but fundamentally, it is more detrimental to the outlook of Taiwanese equities within the Greater China category. More than 40% of the Taiwanese equity market weight is TSMC, the world's largest and most advanced chip foundry. Given its relatively high valuations and trading restraints with Mainland Chinese customers such as Huawei, it is a risky company in our view. We do not have any exposure to Taiwanese equities within our funds.

PRESCIENT PERFORMANCE

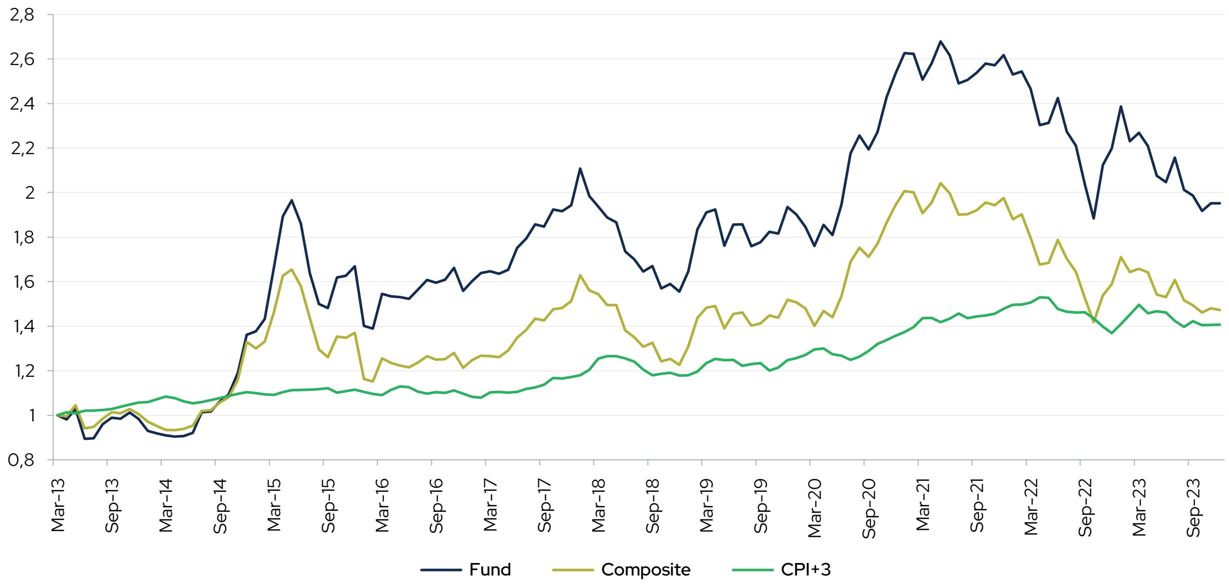
CHINA BALANCED FUND

The year 2023 was extremely challenging for the Chinese equity markets. Our Prescient China Balanced Fund was down -11.2% for the year and -1.7% for the last quarter, both in US dollar terms, net of fees, in line with the equity market.

At current valuations, the forward-looking expected return is exceedingly high, and we will continue to position the Fund for close to full equity exposure. There are a limited number of opportunities in a decade to produce very high real returns. They typically occur when sentiment is extremely negative while fundamentals are not nearly as bad. Like the great global financial crisis in 2007-2008 and the more recent COVID pandemic, investors can only see the negatives when fear takes hold. Whether it's demographics, the property sector woes or the geopolitical environment, most investors are currently only seeing the negatives in China. However, given the attractive valuations in the market and positive policy support from the authorities, we anticipate strong growth to reflect in the equity market eventually.

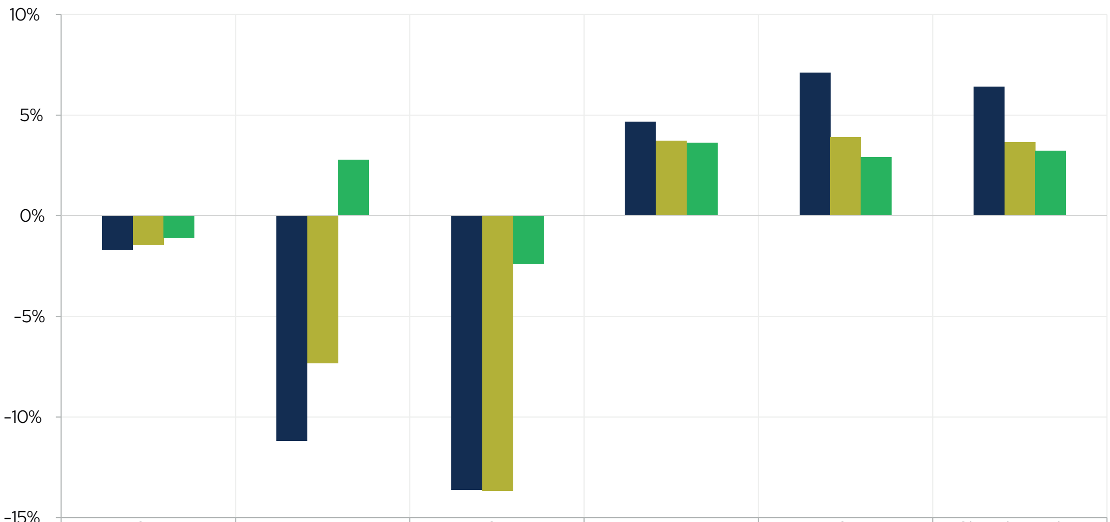
Having said that, we will also always be guided by our strict risk management framework, which is why we still performed in line with equity. Both the onshore CSI300 Total Return Index and Hong Kong's Hang Seng China Enterprises Total Return Index (HSCEI TR) lost -11.1% in USD terms for 2023.

Prescient China Balanced Fund - USD A Class net



Sources: Prescient, Bloomberg (as at 31 December 2023)
Composite: 65% CSI300 and 35% CSI1Bond. Inception Date: 31 March 2013

Prescient China Balanced Fund - USD A Class net



	3M	1Y	2Y	5Y	10Y	Since inception
Fund	-1,70%	-11,18%	-13,63%	4,66%	7,10%	6,42%
Composite 65/35	-1,45%	-7,33%	-13,67%	3,72%	3,88%	3,66%
CPI+3	-1,10%	2,79%	-2,41%	3,62%	2,91%	3,23%

	Fund	Benchmark
Highest rolling 1 year	116.81	17.08
Lowest rolling 1 year	-26.97	-7.82

Sources: Prescient, Bloomberg (as at 31 December 2023)
Composite: 65% CSI300 and 35% CSI1Bond. Inception Date: 31 March 2013
Note: Returns for longer than 1 year have been annualised

Our current positioning remains aggressive as we aim to capture, on average, close to full equity market upside while limiting downside to around 65% over the medium- to long term. Our positioning will remain the same with consistently improving economic data and extremely attractive valuations. The current market slump is now the longest bear market over the past decade. Forward-looking expected returns at current valuations are some of the highest in China's history.

KEEPING OUR NOSES TO THE GRINDSTONE

With Chinese markets moving the way they have over the past three years, it's easy to question the relevance of economic fundamentals when they typically have not translated into stock market valuations. We expected volatile foreign investor sentiment in Chinese equities, especially in the Hong Kong market, less so for domestic investors in the onshore A shares market. In the final quarter of 2023 and early 2024, extremely negative sentiment predominated on both the onshore and offshore equity markets. As frustrating as it is to endure during periods like this, it is very typical in the financial markets. Investors often move from extreme euphoria (IT, subprime mortgage, crypto bubbles) to extreme pessimism (September 11th, subprime crisis, COVID). The current pessimism has also been exacerbated by Chinese investors themselves, who are highly sentiment-driven, contributing to very weak equity markets.

For months, the most respected financial media outlets have complained that the Chinese authorities are not pushing through enough stimulus. As much as a blanket bailout of the property and shadow banking sectors would help trigger a quick market revival, it would merely introduce future financial risk to the market. Stimulus should be used sparingly and allocated to more productive economic sectors. With debt ratios no longer low, it is understandable that the government is focused only on efficient and necessary stimulus rather than blanket stimulus. We respect the patient and prudent policymaking we have seen. When markets tumbled after the new draft gaming regulations were published for comment in December, the key government official responsible for the publication stepped down merely a week later. This indicates that the Chinese government will continue to steer the country on a balanced path and remain business-friendly to the rest of the world.

We learned tough lessons in 2023 and continue to enhance our investment processes to better generate alpha. As with the patience of policymakers here holding a long-term view, we are grateful for the patience and resilience of our clients. For 2024, the year of the dragon, we will continue to keep our noses to the grindstone to ensure we are best positioned to capture market upside beta and alpha for our clients.

We will be in South Africa in the first quarter of 2024 in both February and March. Please get in touch should you want to attend one of our events or schedule a meeting.