Prescient
CHINA

PRESCIENT CHINA QUARTERLY COMMENTARY

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LIANG DU
Chief Investment Officer
Prescient China
BBusSci & MBA (UCT), CFA, CQF

TIAN PAN
Head of Strategy & Product
Prescient China
BBusSci (UCT), FIA, CERA

CHINA'S RISING TECH SELF-SUFFICIENCY

The second quarter of 2024 was quite a rollercoaster ride for the Chinese financial markets. We started with a very strong rally in April, followed by slow declines throughout May and June for both the onshore and offshore equity markets. We ended the quarter with the onshore CSI300 Total Return index slightly down -1.7% in US dollar terms, while the offshore Hang Seng China Enterprises (HSCE) Total Return index performed strongly, delivering a 10.7% US dollar return.

Our Prescient China strategies all performed strongly for the quarter, with the Prescient China Equity Fund beating its benchmark CSI300 Total Return index by 1.5% and the Prescient China Balanced Fund beating the same 100% equity index by 2.1% over the quarter.

During our conversations with investors in Cape Town, Durban and Johannesburg in June, we covered the continued improvements of Chinese economic data, consumer and investor sentiment, along with "Black Friday" valuations of Chinese stocks. The situation remains similar, with the economic recovery on track even if valuations are slightly higher than the lows of January and February. For this quarter's commentary, we thought we'd follow a slightly different format and cover China's progress in achieving tech self-reliance, a subject that has been topical recently. More importantly, we feel such self-sufficiency is essential for China's long-term sustainable economic growth prospects, inevitably affecting the long-term growth prospects of Chinese equity markets.

TECH ADVANCEMENTS

HUAWEI'S QUIET RESURGENCE

Widely regarded as China's technology champion, privately-held Huawei has kept a low profile since being targeted by US sanctions over five years ago. For those that may not be familiar with Huawei, it was not too long ago, in Q2 2020 to be exact, when Huawei smartphones were the best-selling smartphones in the world, commanding a 20% market share. Around the same time, the company was also deemed a national security risk to the US after having already been placed on the US Entity List in 2019. Additional sanctions over the years meant Huawei could not sell anything to US clients nor use anything made with any US technology or involvement unless specifically approved by the US government.

Items ranging from advanced semiconductors to software such as Google's Android OS could no longer be used by Huawei. As a result, Huawei's smartphone and chip design businesses collapsed. Few, except Huawei themselves, probably believed the collapse would be temporary.

Fast forward to 2024, Huawei launched the Pura 70 series of 5G smartphones to much fanfare, with pre-orders sold out within minutes of launch. The Pura 70 series is the second self-developed sanction-proof model of smartphones after the Mate 60 series was launched in late 2023. These phones are powered by the in-house designed and produced Kirin 9000S1 and Kirin 9010 advanced processors running on the in-house developed HarmonyOS. Why is this significant? Huawei achieved all this despite being, arguably, the most sanctioned tech company in the world. For example, they had to:

- Design the semiconductors without being able to use any US-linked electronic design automation (EDA) software, critical for the semiconductor design and production process.
- Produce the Kirin chips without being able to work with leading semiconductor foundries, such as TSMC and Samsung.
    - One of the main reasons Huawei could not produce its own 5G chips for several years even though it pioneered 5G technology and is the leading patent holder.
- Work with domestic Chinese foundries that are also sanctioned and barred from using any US-related technologies in their lithography machines. This effectively rules out being able to use extreme ultra violet (EUV) lithography systems that are used to produce the world's most advanced semiconductors.
- Build Huawei's own mobile operating system – HarmonyOS from ground zero, given US government restrictions on working with Google's Android ecosystem.

As of Q1 2024, Huawei's smartphone market share within China has almost doubled since the end of 2022, making it once again the best-selling smartphone brand in China. Huawei's homegrown HarmonyOS also unseated Apple's iOS in China over the same period, becoming the second most popular mobile operating system behind Android. The platform boasts over 900 million users and 2.5 million developers creating apps.

In addition to success in the smartphone business, Huawei has made massive strides in AI chips, giving Nvidia a run for its money in the Chinese market. How can any company challenge Nvidia on AI chips in its current form, you may ask? This is because Nvidia cannot sell its latest and most advanced technology, such as its A100 and H100 chips, to Chinese clients. As a workaround, Nvidia originally produced "dumbed down" versions specifically for the Chinese markets, such as their A800 and H800 chips, before those were also banned last October for being too "advanced". A further "dumbed down" H20 version of their offering is now being sold in China.

All the chip model numbers mentioned probably don't mean much to most readers, so let us use the "bakkie analogy" to explain. Imagine Toyota was told by Japanese authorities that they could no longer sell Hilux bakkies to South African farmers, in fear that they would become too competitive and that Japanese farmers would suffer in the international market. As a workaround, Toyota tries to maintain business ties by selling the Corolla instead. After a while, the South African farmers continue to do well with the help of their Corollas, even though they would prefer Hilux bakkies. After all, the Corollas are very reliable too; they just aren't able to handle as much heavy lifting as the Hilux bakkie. The Japanese authorities then steps up the sanction pressure again and bans selling Corollas too, telling Toyota they can only sell the Tazz instead (who still remembers the Tazz?).

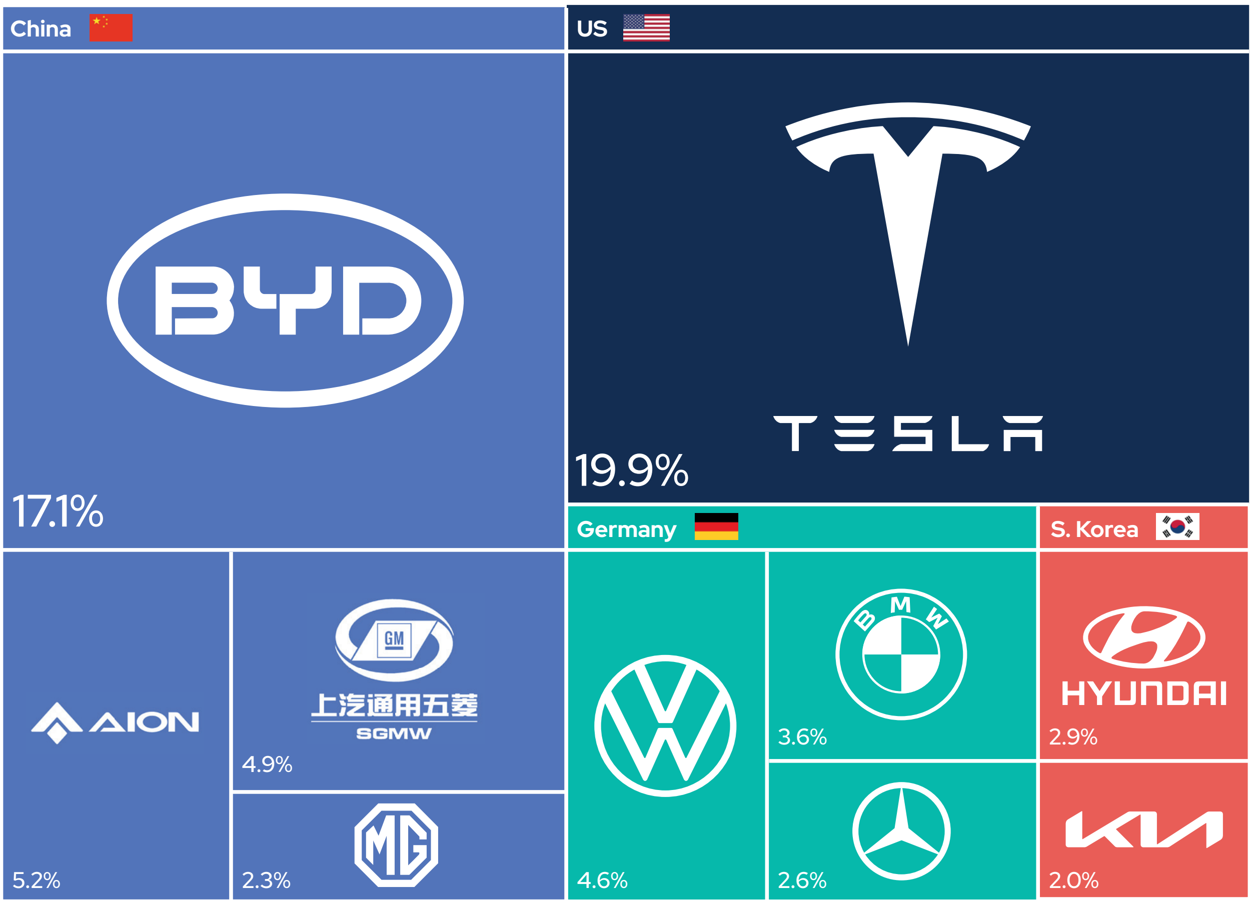
These sanctions may reduce the competitiveness of South African farmers in the short term, but they will hurt Toyota's revenues and, at the same time, create opportunities for others. The Ford Ranger and GWM P Series bakkies will suddenly only have to compete against the Tazz. In this case, Huawei has grasped this opportunity in the AI chips space with both hands.

While Huawei's AI chip market share in China is still low, their latest Ascend 910B chip is widely regarded to be superior to Nvidia's H20 and on par with Nvidia's 800 series in terms of performance, even beating the A100 models in certain tests. As restrictions on Nvidia to sell advanced chips in China remain, we expect Huawei to gain market share from Nvidia gradually. Technology-wise, we would probably not bet against Huawei catching up to and surpassing Nvidia over time. We are not tech experts, but we certainly believe it when many tech sector insiders call Huawei's achievements since 2019 nothing short of a miracle. The good news (and perhaps bad news for the US government) is that Huawei appears to be only getting started.

GROWING EV DOMINANCE

Tesla is the first brand that comes to mind when one mentions electric vehicles (EV). While Tesla remains the leading EV brand globally with a 19.9% market share, Chinese brands have caught up. BYD is expected to overtake Tesla in 2024 to become the best-selling EV brand globally. In total, Chinese brands combined had around 30% of the global EV market share in 2023.

Global EV Market Shares in 2023 - Top 10 Companies



Sources: Prescient, TrendForce (as at July 2024)

For anyone who has been to China in recent years, EVs are something one cannot miss. From electric buses to the various EV models available on car-hailing platforms, such as DiDi, it is easy to experience both budget and luxury EVs. Needless to say, domestic competition in the EV sector is exceptionally intense, with many lesser-known domestic brands having already disappeared. Market leaders like Tesla have had to lower prices multiple times to remain competitive. Chinese EV leaders such as BYD, Nio, Xpeng, SAIC, and Zeekr compete in price and the full spectrum of their EV product offerings. Luxury interiors, AI infotainment systems, and assisted driving are just some of the basics that come with all-new EVs in China. Gone are the days when we had to wait three years for a model facelift and five years for a slightly improved new car model. New EV models are being launched at a rate similar to smartphone releases, with better prices every year.

As good as these EV developments are for the end consumer and global climate change, a significant negative side effect of the rise in China's EV industry is the trade tensions with the developed world. US President Joe Biden announced in May this year that tariffs on Chinese EV imports would be adjusted from 25% to 100%, effective 1 August 2024. The EU also plans to impose additional tariffs on Chinese EV imports, increasing these from 10% to 48%. We mentioned in our prior webinars that the 100% tariff imposed by the US is largely symbolic and "election noise" as there are hardly any meaningful Chinese EV exports to the US. The EU tariffs are a much bigger deal. As Chinese firms commit to investing in EV and battery production plants within the EU, we are optimistic tariffs will be toned down by the time we reach the November deadline.

In the meantime, EU authorities have a tough job of balancing protecting their existing domestic car industry from Chinese competition without hurting that very same industry. This may sound confusing, but in addition to the expected retaliatory tariffs imposed by China on EU exports, these EV tariffs on Chinese imports will also directly hurt European car companies. Why? Because "Made in China" does not necessarily mean it is a Chinese-branded car. In fact, in 2023, there were more imports into the EU from China for non-Chinese brands, such as Tesla, BMW, Renault, Mercedes-Benz, etc, than Chinese brands themselves. This is because many foreign brands, like those mentioned, choose to manufacture EVs in China, given the efficiency of the production chain there. The current proposed tariffs vary widely, with Chinese companies BYD and SAIC expected to pay an additional 17.4% and 37.6%, respectively. In comparison, European companies Mercedes-Benz and Renault are expected to pay an additional 20.8%.

We did a simple exercise to compare car prices across Germany, China and the US, with South Africa also included as a reference point.

	Germany	China	USA	South Africa
BYD Dolphin base model	EUR 32,990	EUR 12,676	n/a	EUR 27,422
Tesla Model 3 base model	EUR 40,990	EUR 29,455	EUR 35,992	n/a
BMW i5	EUR 70,200	EUR 43,172	EUR 61,663	EUR 111,232

Source: BMW, BYD, Tesla official regional websites as of July 2024.
South Africa pricing for BMW i5 is for the M60 model as base model not officially available.
Exchange rates as of 7 July 2024

One can immediately notice the pricing of EVs in Germany is the highest while China's retail prices are the lowest. What was most striking to us was the domestic versus international pricing for the BYD Dolphin; this ratio is consistent across BYD models sold domestically and internationally. This shows the global dominance of BYD in terms of its EV product offering, even when faced with higher-than-expected tariffs. Theoretically, the BYD Dolphin can be sold cheaper than the Tesla Model 3 in the US, even with a 100% tariff. The Dolphin is certainly not the best of BYD's cars, and we would probably not buy it over a Tesla Model 3 at a 20% price differential, even though we feel it has a superior interior over the Model 3.

In China, however, the Dolphin is sold at almost a 60% discount, making it an easy decision for the average car consumer.

BYD is not alone; Chinese EV makers are offering the best products at the best prices, and legacy car makers are having a hard time surviving in the world's second-largest economy. We expect BYD and its Chinese EV peers to continue to dominate the EV market globally, even in the face of potentially higher tariffs.

WHY DO THESE TECH ADVANCEMENTS MATTER?

We have often been asked about the catalyst for the Chinese equity market recovery. We cannot always accurately explain short-term market swings, but Huawei and BYD are two great examples of companies we believe will be long-term drivers of economic and market performance in China. It is a pity that Huawei is not listed. We believe technological advancements, along with tech self-reliance, are absolutely critical for China in 2024 and beyond, especially given the ever more complex global geopolitical landscape. Chinese companies are innovating and competing on a global scale like never before. Sanctions and tariffs may temporarily slow their growth, but the core competitiveness of Chinese firms will form an exceptionally strong foundation for Chinese economic growth in the decades to come.

RECOVERY ON TRACK

CONSUMER CONFIDENCE CONTINUES TO IMPROVE

China had two national holidays during the second quarter: the May 1st Labour Day Golden Week and the shorter Dragon Boat Festival in June. Both holiday periods showed upbeat consumer data, with improvements on 2023 figures and greater improvements compared to pre-Covid 2019 levels.

	No. of Trips vs 2019	Spending vs 2019
Labour Day Golden Week	28.20%	13.50%
Dragon Boat Festival	14.60%	2.60%

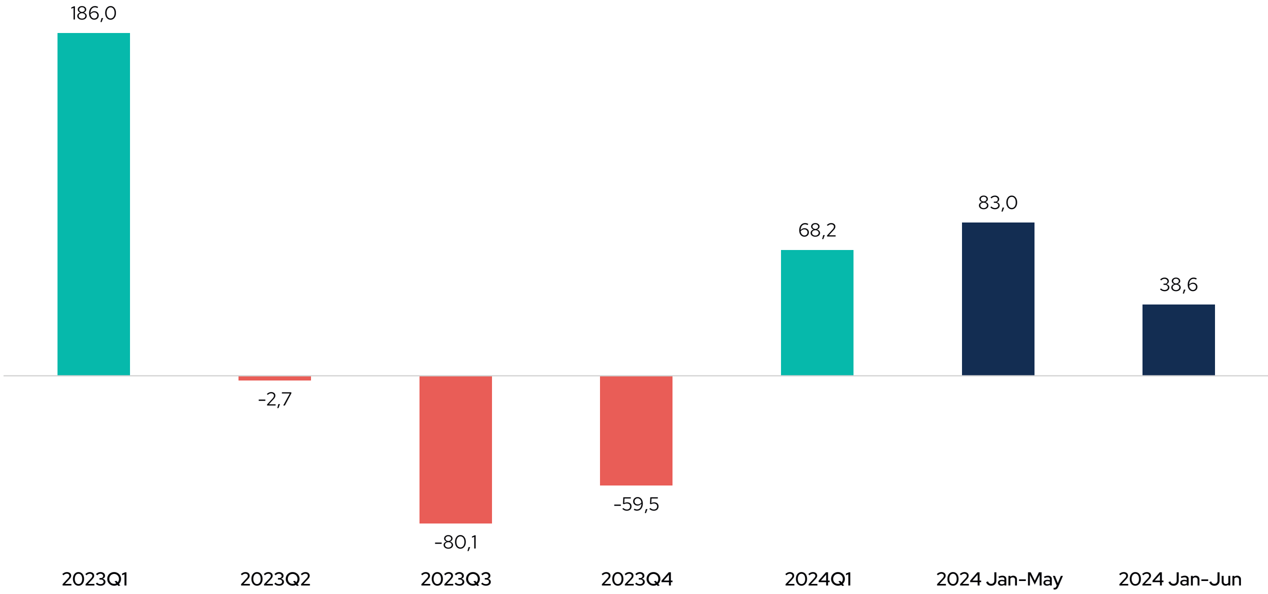
Source: Ministry of Culture and Tourism, Prescient, July 2024

It's clear that consumer confidence is recovering, and we expect solid numbers for the next big holidays in China, the Mid-Autumn Festival and National Day Golden Week coming up in the next few months. There is still significant room for improvement in the data. We are currently seeing lower per capita spend even though more people are travelling for leisure during national holidays.

INVESTOR SENTIMENT IS MIXED

When we were in South Africa in June, we showed statistics of how foreign investors have once again started to be net buyers of onshore Chinese equities this year after three consecutive quarters of net outflows since Q2 2023. By the end of May 2024, year-to-date net buying of onshore equities from foreign investors via the Stock Connect program had already doubled total net flows for 2023. However, sentiment took a negative turn in June with a big net outflow of CNY44.4 billion, showing how quickly sentiment can change. Although foreign ownership of Chinese equities in the onshore market is only between 2% to 3%, these flows still indicate overall investor appetite for Chinese equities.

Foreign Fund Flows into onshore A shares - CNY bn



Sources: Prescient, Wind (as at 30 June 2024)

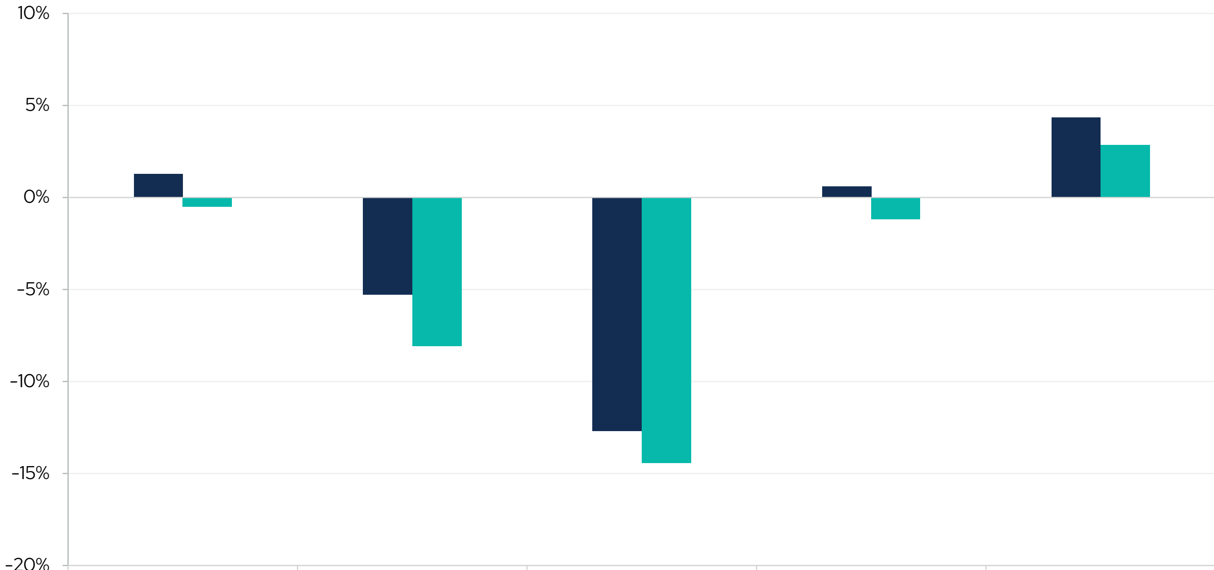
Sentiment in both the onshore A share and offshore H share markets has been volatile since May. We expect to get more direction after the central government's twice-a-decade third plenum meetings between July 15 and 18. Once again, we don't expect announcements of blanket stimulus policies but rather positive long-term tangible economic policies that should bring additional confidence to investors in Chinese markets.

PRESCIENT POSITIONING & PERFORMANCE

PRESCIENT CHINA EQUITY FUND

The onshore equity market has had quite a ride this year, with the CSI300 Total Return Index having a terrible January before going on a three-month rally from February to April, only to give up all the gains again by the end of June. Our Prescient China Equity Fund performed strongly over the second quarter, producing an alpha of 1.49% over the CSI300 Total Return Index with a net-of-fees return of -0.22%. Year-to-date, the Fund has a positive net-of-fees return of 1.27%, 1.79% ahead of the -0.52% loss produced by the index.

Prescient China Equity Fund - USD A Class net

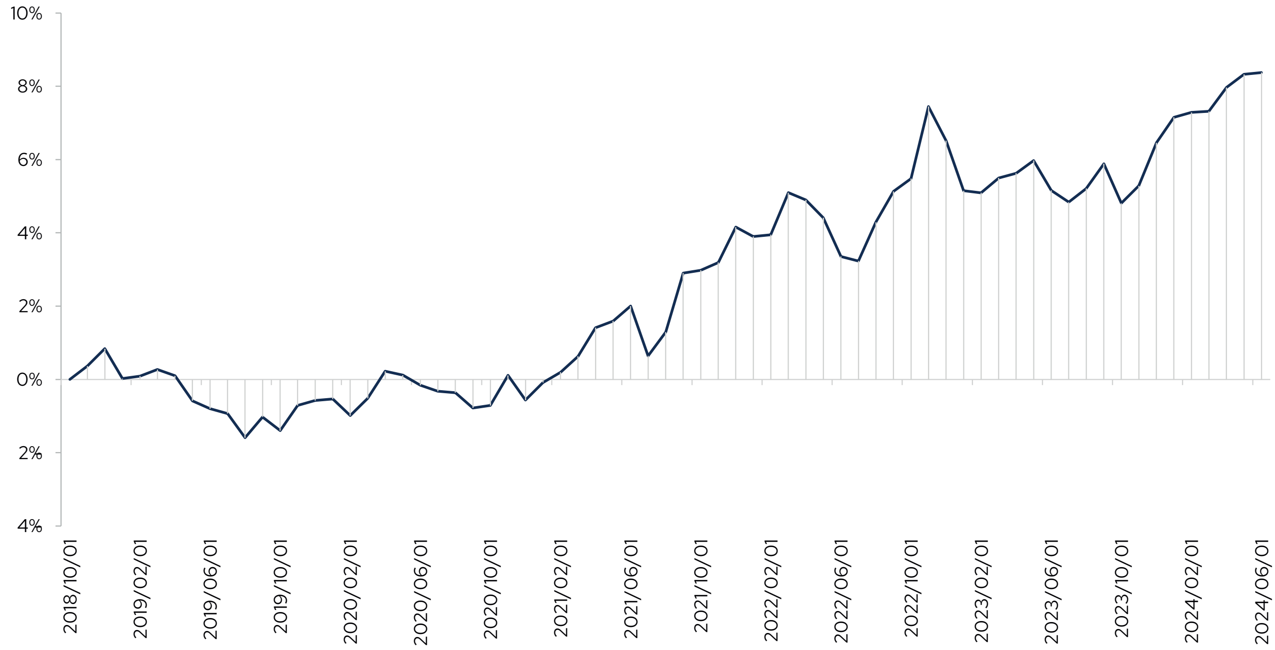


	YTD	1Y	3Y	5Y	Since inception
Fund	1,27%	-5,27%	-12,69%	0,59%	4,33%
CSI300TR	-0,52%	-8,08%	-14,44%	-1,18%	2,86%

Sources: Prescient, Bloomberg (as at 30 June 2024)
Inception date: 31 October 2018
Note: Returns longer than one year have been annualised.

	Fund	Benchmark
Highest rolling 1 year	59.95	58.23
Lowest rolling 1 year	-33.50	-36.09

Cumulative Alpha - Since Inception of Prescient China Equity Fund



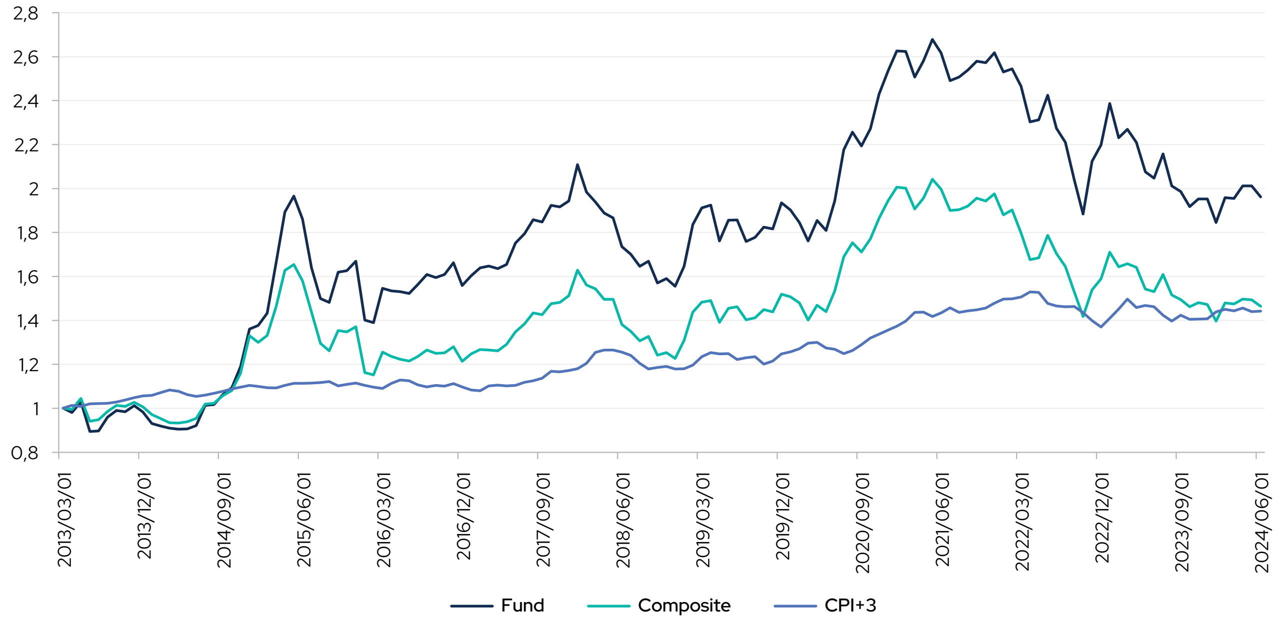
Sources: Prescient, Bloomberg (as at 30 June 2024)

Our multi-factor models continue to generate alpha consistently for our clients. This ensures a consistent alpha experience irrespective of when they enter or exit our Fund. The Prescient China Equity Fund aims to provide index-level risk while significantly enhancing returns over the index and passive China strategies over the cycle.

PRESCIENT CHINA BALANCED FUND

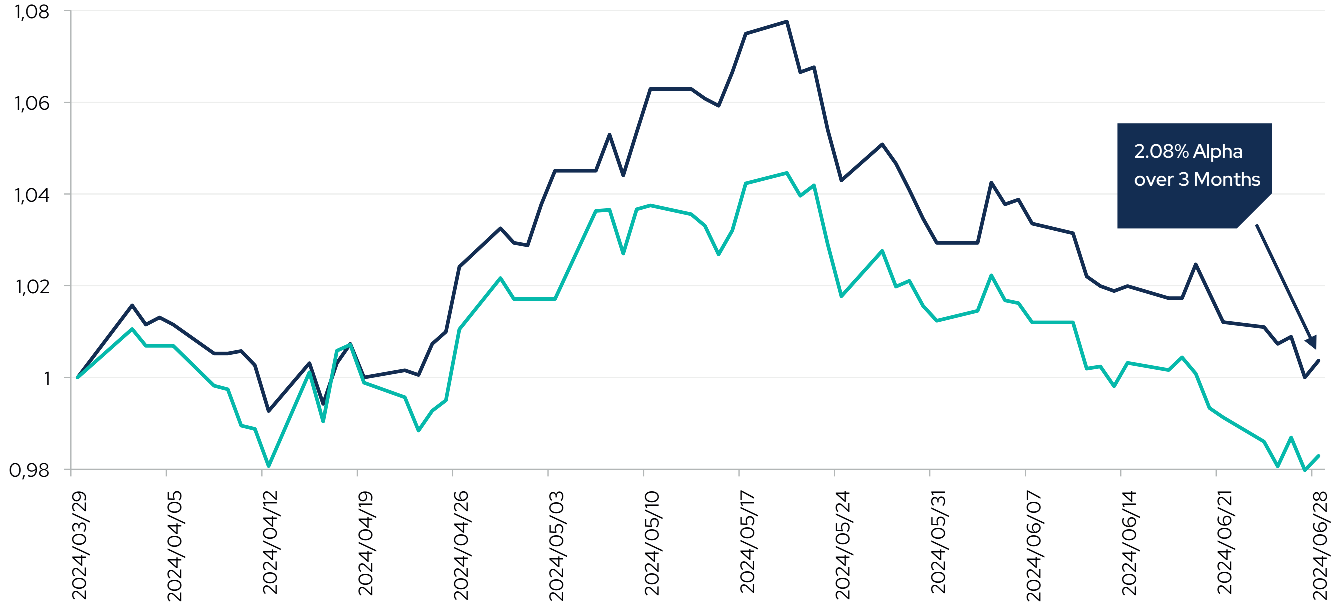
Our Prescient China Balanced Fund continues to provide close to full equity upside exposure, with adjustments for sentiment swings. Over the second quarter, we averaged above 90% total equity exposure in the fund and, at the same time, outperformed the CSI300 Total Return Index by 2.08% net of fees, an annualised outperformance of 8.58%. In absolute terms, the Prescient China Balanced Fund returned 0.37% net of fees for the quarter, also slightly beating our pure China equity strategy.

Prescient China Balanced Fund - USD A Class net



Sources: Prescient, Bloomberg (as at 30 June 2024)
Composite: 65% CSI300 and 35% CSI1Bond
Inception date: 31 March 2013

Prescient China Balanced Fund - USD A Class net - 2024 Q2



Sources: Prescient, Bloomberg (as at 30 June 2024)

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

Given current valuations and positive economic outlook, we remain aggressively positioned in our Prescient China Balanced Fund. We expect sentiment to continue to be volatile, so we continue to hold derivative structures in the fund to reduce downside volatility. Over the long term, in a market with major bull and bear market cycles like China, we expect our Prescient China Balanced Fund to produce extremely competitive risk-adjusted returns relative to peers and pure China equity indices. Our track record of beating pure China and EM equity indices net of fees since inception demonstrates the robustness of our asset selection and dynamic asset allocation processes.

BEWARE OF NOISE

With US elections coming up later in the year, we've been warning clients about a lot of potential "China bashing" by both Joe Biden and Donald Trump. We have already seen the additional tariffs Biden's administration announced back in May. With Donald Trump now looking more likely to win after their recent debate and what appears to be an assassination attempt, some are beginning to get worried about his comments on imposing 60% tariffs on "all Chinese goods". We believe this is highly unlikely, nor do we expect a Trump presidency to improve China-US relations significantly. What will be positive, as evident from the recent presidential debate, is that a Trump White House will likely provide more policy clarity and better decision-making capabilities compared to the current administration. Nevertheless, we need to understand that China-US bilateral trade now only accounts for around 10% of China's overall trade with the world, which is not nearly as important as it was 20 years ago.

In the Chinese equity markets, all of the noise, potential noise and bad news have been priced in. In fact, China is trading at valuations cheaper than Japan's at the bottom of its crash back in 1991/1992, and it is trading at the cheapest levels relative to its own history on a cyclically adjusted basis. We continue to believe it is a once-in-a-decade opportunity to allocate to, or increase, investment allocations to China. With economic fundamentals only improving, China is not going anywhere. It will only be a matter of time before investor sentiment turns and valuations in China normalise. In the meantime, we will continue to monitor developments in Shanghai and ensure our clients are getting the best possible China investment experience.

A sincere thank you to our clients for your continued trust and support; we are grateful to have all of you on this journey with us.