Prescient
CHINA

PRESCIENT CHINA QUARTERLY COMMENTARY

October 2023

Liang Du

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

Tian Pan

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

PERSISTENT RECOVERY GAINING MOMENTUM

TOURISM SPENDING SURPASSES PRE-COVID LEVELS

The third quarter ended with a week-long combination of national holidays in China during which families reunited for the traditional Chinese Mid-Autumn Festival and the National Day Golden Week. While media headlines continued to downplay improvements in tourism data, the underlying data turned out to be very encouraging.

Highlights were:

- 826 million domestic trips were made during Golden Week.
  - It was an increase of 71.3% on 2022 levels but, more importantly, a 4.1% increase on 2019 pre-COVID figures.
- Tourism spend amounted to CNY 753.4 billion during the same period.
  - That was a 129.5% increase on 2022 and a 1.5% increase on 2019 figures.

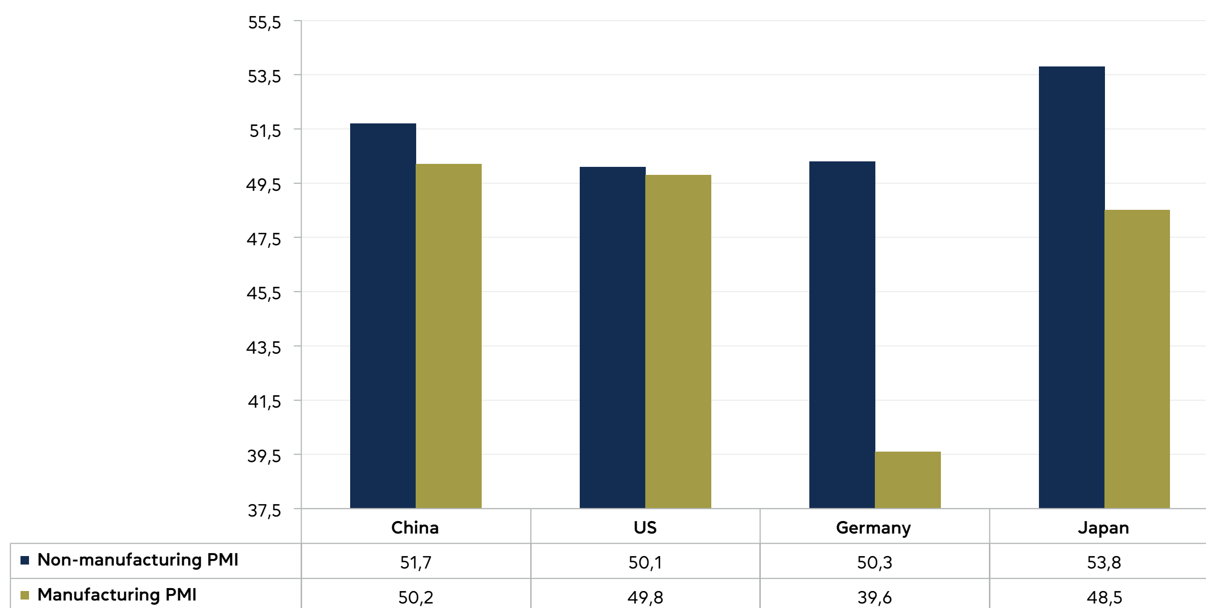
These figures are vast improvements on the tourism spend numbers in June during the Dragon Boat Festival. During that holiday period, tourism revenues did improve but were still 5% down on 2019 levels. If we rewind further back to May this year to when tourism spend improvements during the May Labour Day holidays were praised by the media, overall tourism spend was only 0.7% higher than 2019 levels. While these improvements appear modest, the progress is an important sign of improving domestic consumer confidence.

PERSISTENT ECONOMIC IMPROVEMENTS

China's official manufacturing PMI at the end of September moved into expansion territory (50.2) for the first time in six months. This change is consistent with the Caixin China Manufacturing PMI figures, which are more weighted towards private enterprises and which moved above 50 last month. Its end of September reading was 50.6. While exports remain under pressure due to a poor global economic environment, improvements in domestic manufacturing demand helped push up manufacturing PMI numbers, another encouraging sign of a persistent domestic economic recovery.

Official services PMI also improved, reaching 51.7 for September, the highest reading for the entire third quarter of 2023 and above economist forecasts. While we cannot be certain that all economic data will be directionally positive from here, there are obvious signs that China's post-COVID growth and confidence slump has "bottomed out". Comparing China to other significant economic peers paints a similar picture. While China's current growth is slower than its historical growth numbers, the economy is still looking strong compared to global peers. We compare China's PMI numbers to the US as well as two other major economies highly dependent on exports in the chart *PMI – China vs peers*.

PMI - China vs peers

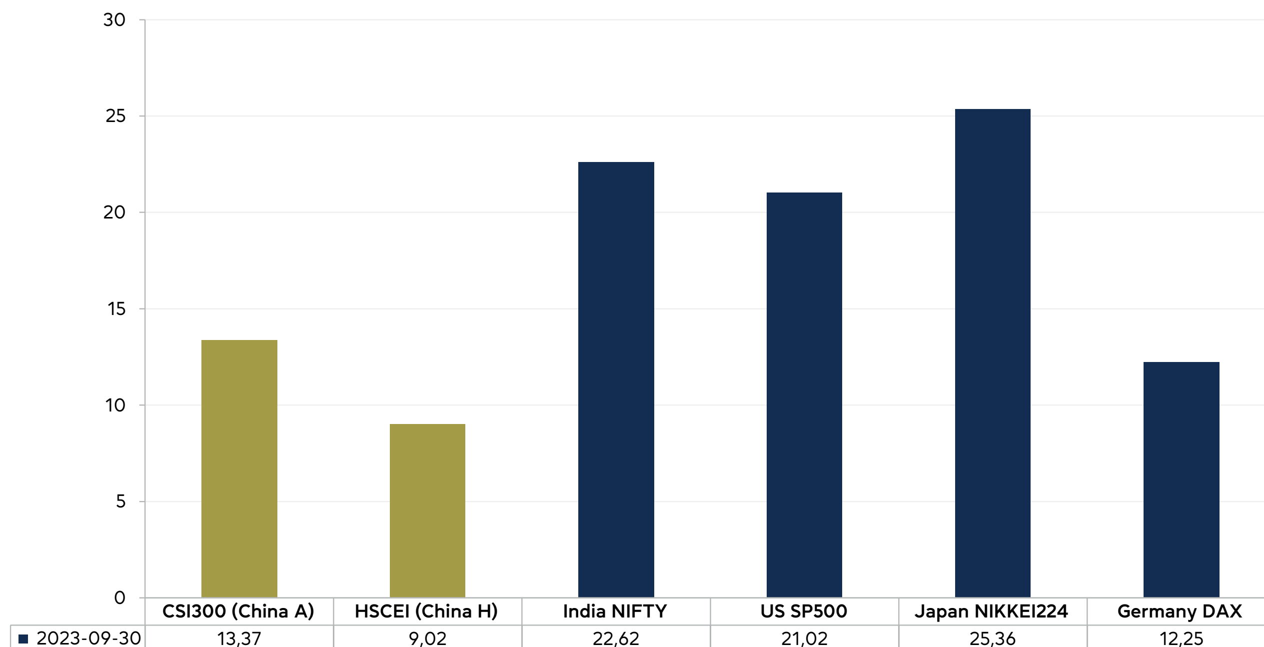


	China	US	Germany	Japan
Non-manufacturing PMI	51,7	50,1	50,3	53,8
Manufacturing PMI	50,2	49,8	39,6	48,5

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

Over the past 12 to 18 months, we have frequently been asked: "Is China still investable". While financial market performance in China has disappointed so far this year, economic fundamentals remain solid. As a result, our views are unchanged. We believe that it will only be a matter of time before financial market performance "mean reverts" towards the country's strong underlying economic fundamentals. Valuations in Chinese equity markets remain low compared to global peers, which, on average, have worse economic fundamentals. Current equity market valuations are also cheap when compared to China's own history. As average earnings recover from the 2022 COVID-induced lows, we believe there is significant upside potential in Chinese equities in the short to medium term.

Index PE ratios



	CSI300 (China A)	HSCEI (China H)	India NIFTY	US SP500	Japan NIKKEI224	Germany DAX
■ 2023-09-30	13,37	9,02	22,62	21,02	25,36	12,25

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

STABILISING PROPERTY SECTOR

China's property sector has been in trouble since at least 2020 and the current activity in the sector will probably be the new normal. Property cycles are long, given the nature of the asset class, and we believe the excessive property growth in terms of price and construction activity is likely to be a relic of the past. The shock to investors in the sector will be painful. From suppliers to financiers dealing with the fallout after a decades'-long boom, this "end" was inevitable in our view. As we move into 2023's final quarter, we expect government to continue with policies intended to stabilise the sector, including plenty of policy support to help the property bubble deflate in an orderly manner. Recent policy support includes:

- Multiple central bank interest rate cuts:
  - 10 basis points (bps) in June
  - 15 bps in August
- A move to push commercial banks to pass on interest rate savings to existing mortgage holders, something that is not automatically applied in China.
- Easing of purchasing restrictions across multiple major cities, including Tier 1 cities, such as Guangzhou, and Shanghai, where we are based.

The support policies are measured and aim at promoting organic market demand to stabilise the property sector. The authorities have made it clear they will not provide the sector with a blanket bailout and are focusing on completing already sold property and paying contractors to protect the most vulnerable stakeholders. Prescient's China strategies have avoided related assets since about 2018, when the sector's issues were already clear.

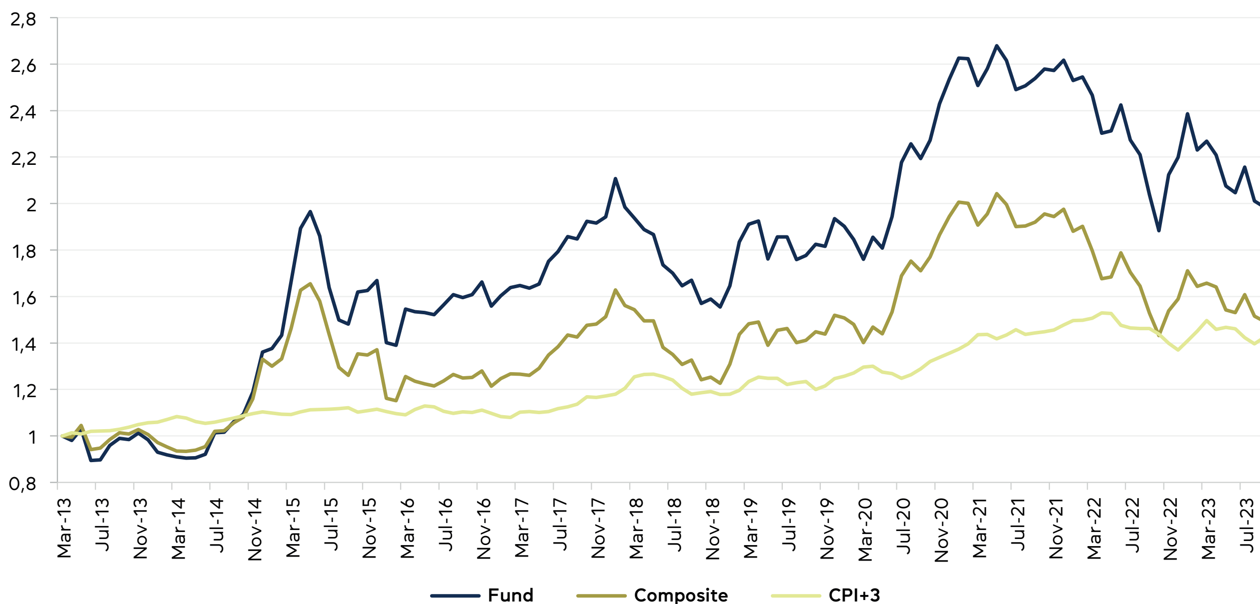
Our investment thesis has always counted on the property sector shrinking as a proportion of total household wealth over the long-term. We expect other assets, such as equities and bonds, to eventually become a significant part of household wealth. The primary savings vehicle for Chinese people will change over the next decade, and this structural change will once again result in a more sustainable growth path for the country.

Having said all the above, we continue to see signs of stabilisation. China Real Estate Information Corp. (CRIC) data at the end of the quarter showed the following:

- New property sales by China's top 100 developers grew 17.9% in September from a month earlier.
- More than 60% of developers reported month-on-month sales increases in September.
- Tier 1 city sales increased by 16% month-on-month as measured by square meterage.

The property market is finding a new equilibrium in China; a market based more on actual demand than speculation. This transition is inevitable, and some can argue that the transition is coming too late. In our view, this transition is healthy for the longer term. Our China funds have avoided most of the direct impact on the property sector. Both bonds and equity within the sector have fallen to such an extent that neither is now a significant portion of the listed market. The entire property sector is now less than 1.5% of the stock market.

Prescient China Balanced Fund - USD A Class net



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

GEOPOLITICS REMAINS AS IS

Following US Secretary of State Anthony Blinken's visit to China in June, several high profile US officials visited China in the third quarter. Treasury Secretary Janet Yellen visited the country in early July, followed by John Kerry's special climate envoy later in the same month. Even veteran diplomat, and former Secretary of State, Henry Kissinger visited Xi Jinping in Beijing in an attempt to improve ties between the world's largest economies. The overwhelming outcome of the visits and talks? In plain English: we tried, couldn't agree on much, but we'll try again in the future.

When Huawei's Mate 60 range of 5G smartphones, apparently produced without using any US technology, launched during US Commerce Secretary Gina Raimondo's tour of China in August, it was a clear sign that the Chinese are not pinning their future hopes on improved US relations and trade. This is not unexpected, and we believe dialogue and channels of communication are important at least to prevent further deterioration of bilateral relations. After all, any improved China-US relations driven by the current Biden administration will be attacked by the opposition in the US. For now, we are comfortable that bilateral relations are not deteriorating.

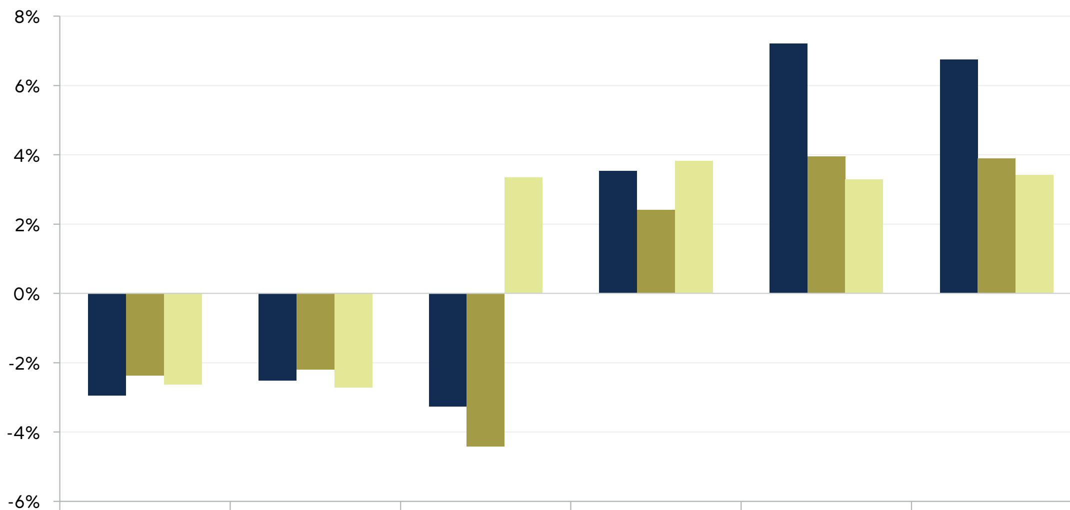
The other significant development over the quarter was the EU launching anti-subsidy investigations on Chinese electric vehicle (EV) makers. This could result in an increase in the standard 10% tariff on Chinese EVs imported into the EU currently. The investigation is still in its early stages and, with only about 5% of Chinese exports currently heading to the EU, the impact of additional tariffs will be limited. China is currently the primary market for luxury German cars, we expect the EU to tackle this issue in a more balanced manner than the US's unilateral tariffs and sanctions.

PRESCIENT PERFORMANCE

PRESCIENT CHINA BALANCED FUND

The third quarter of 2023 continued to be tough for Chinese financial markets, with the onshore CSI 300 Total Return Index losing -3.7% and the offshore HSCEI Total Return index losing -2.2%, both in US dollar terms. The quarter started off on a very strong note as markets rallied in July, before giving up all of these gains in August and September.

Prescient China Balanced Fund - USD A Class net



	3M	1Y	3Y	5Y	10Y	Since inception
Fund	-2,95%	-2,51%	-3,26%	3,53%	7,22%	6,75%
Composite 65/35	-2,38%	-2,20%	-4,41%	2,41%	3,96%	3,90%
CPI+3	-2,64%	-2,72%	3,35%	3,83%	3,30%	3,42%

	Fund	Benchmark
Highest rolling 1 year	116.82	17.08
Lowest rolling 1 year	-26.97	-7.82

Sources: Prescient, Bloomberg (as at 30 September 2023)
Composite: 65% CSI300 and 35% CSI1Bond. Inception Date: 31 March 2023
Note: Returns for longer than 1 year have been annualised

In terms of performance, the Fund lost -2.95% in dollar terms, slightly more than the benchmark 65/35 composite index, given our higher average equity weighting over the quarter.

With valuations approaching decade lows and policy supportive, we are targeting the Fund to have around 90% to100% of market upside while only around 65% of the downside. To achieve this asymmetrical return profile, we are willing to risk approximately 3% per annum in terms of risk budget. During the market rally in the fourth quarter of 2022 and first quarter of 2023 we achieved this goal, but unfortunately lost the alpha when markets corrected over the subsequent quarters. We will continue to follow our tried and tested investment model, continually enhancing it for market changes over time. This does not mean the model will deliver every quarter, but we are confident it will work well over the investment cycle.

Our current positioning remains the same, both economic data and market valuations are attractive. We have positioned the portfolio to have maximum upside should the market rally but with downside closer to 65%. The current market slump has been one of the longest bear markets in China's history and longest over the past decade. This also brings with it the best opportunities for investment. From this point forward, the Fund will either be neutral in our strategic allocation or maximum long. The current expected returns of the Chinese markets are some of the most attractive in over a decade.

IT IS DARKEST BEFORE DAWN

There is no doubt that it has been extremely tough in the Chinese markets over the past two to three years. However, as we mentioned during our second quarter trip to South Africa, we believe it will be a matter of time before the economy and financial markets recover. The second quarter was an improvement on first and third quarter data has shown further consistent improvement. With solid economic fundamentals, supportive policies and low inflation, confidence appears to be the last hurdle in the way of unfettered economic growth. When that improves, corporate earnings and financial markets will follow suit. We are excited for the last quarter of 2023.

There is a lot of fear given the nature of reporting by the English-speaking world on developments in China. One of the primary fears is the "collapse" of China. We believe on-the-ground exposure to China can help us determine whether this fear is valid. Direct access to the market, businesses and regulators is critical to a successful China investment strategy. This is why we insist on having our core decision making investment team located in Mainland China.

We hosted our first Prescient China Investor Tour in four years this October, where we welcomed a group of investors for an on-the-ground experience in China. As we often say to clients, once you see the physical economic activity on the ground, it will be difficult to exclude China from any global portfolio.

In the coming weeks, we will provide updates on the trip and look forward to welcoming new clients to our investor tour in the future. As with any bear market, one needs immense patience. We expect the financial markets to eventually catch up to strong economic fundamentals. As the age-old proverb says: It is always darkest before the dawn. We certainly believe the dawn is near.

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