Prescient
CHINA

PRESCIENT CHINA QUARTERLY COMMENTARY

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FILTERING THROUGH MEDIA PESSIMISM

POOR SENTIMENT

When we were in South Africa during the second quarter, one of our main messages to clients and investors was to "cut through the noise", especially stripping out the sensational media headline noise to get a clearer picture of what is really happening on the ground in China. We are reminded of the difficulty of this task daily, as our news feed and data analysts are bombarded with pessimistic media headlines. Being systematic investment managers, we are fortunate to be able to find sanity in the form of concrete Chinese economic numbers that are consistently being released as we head into the third quarter of 2023.

As the title of this quarterly commentary suggests, we attempt to find out just how "terrible" the Chinese economy and financial markets are, both in absolute and relative terms.

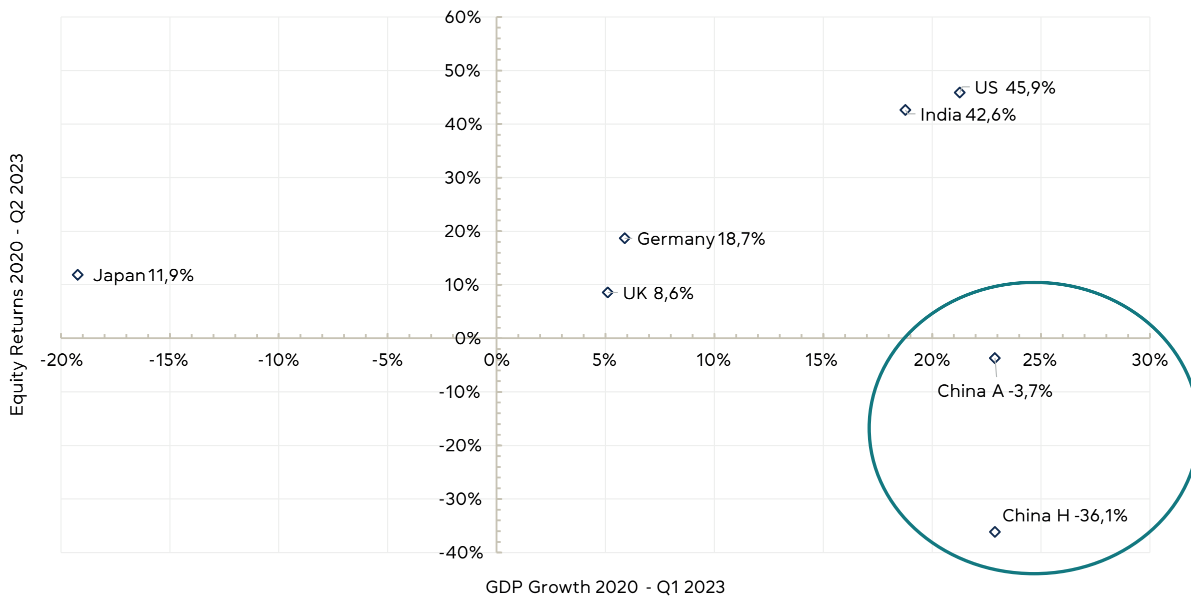
ECONOMIC REALITY NOT REFLECTED IN FINANCIAL MARKETS

China has been the fastest-growing major economy in the world for the past four decades, but as with most things, amazing growth cannot go on forever. With an USD18 trillion economy, there are no longer expectations of rapid double-digit GDP growth figures year-on-year. Having said that, it certainly feels like financial media outlets continue to have high expectations for Chinese economic growth, especially with headlines focusing on the "slowing" part of slowing growth.

We'd like to argue that growth is growth, and by the looks of it, Chinese growth is still top notch when compared to global peers. If we compare China to its major global peers from developed and emerging markets since the onset of COVID-19 back in 2020, there is no doubt that it has been the best and most consistent contributor to global economic growth. China's GDP (in USD) on a rolling basis is now 23% larger than it was pre-COVID-19. The same measure in domestic currency terms is even better as recent US dollar strength against all major currencies affected the latest GDP figures.

John Maynard Keynes's age-old quote, "Markets can remain irrational longer than you can remain solvent", seems quite appropriate in describing the Chinese financial markets of recent times. Since the peaks of early 2021, Chinese equity markets, both the onshore A and offshore H share markets have experienced consistent declines. Combined with the negative impacts of a strong dollar, the Chinese benchmark stock indices have underperformed their peers, ranking last (H shares) and second last (A shares), as can be seen in the chart *Equities vs GDP growth since 2020 – USD* below. There is a complete disconnect from its GDP growth performance.

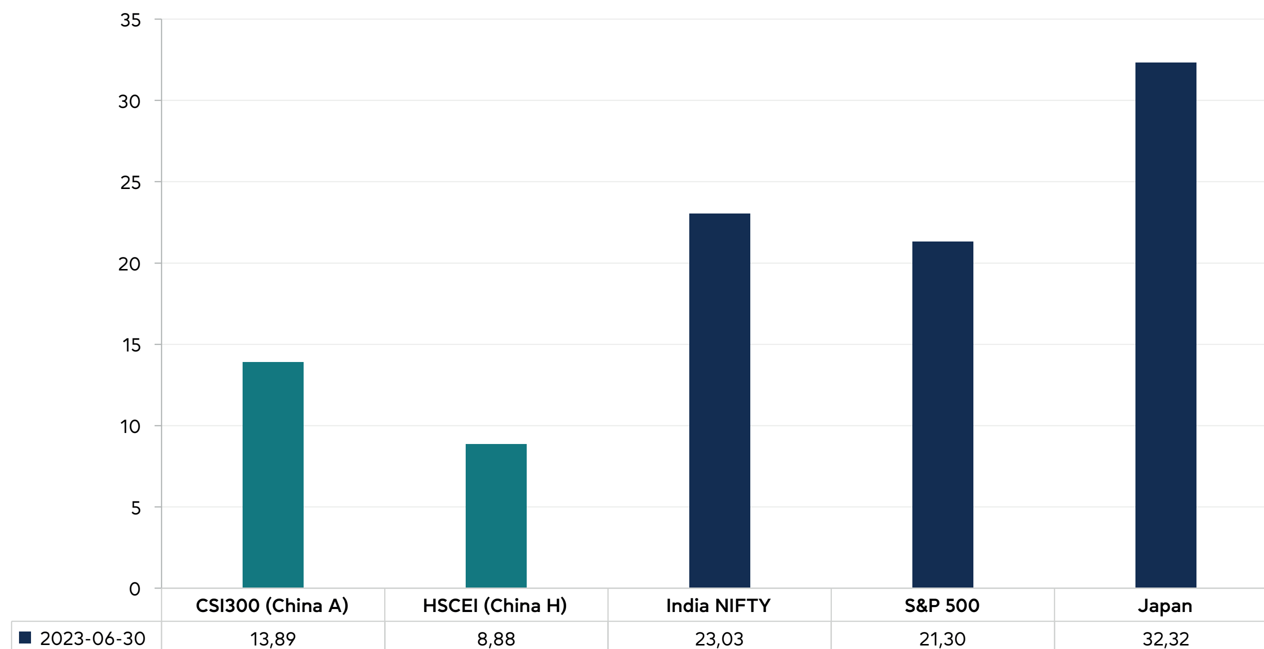
Equities vs GDP growth since 2020 - USD



Sources: Prescient, Bloomberg (as at 30 June 2023)
GDP growth data as at Q1 2023 - rolling four quarters.

Countries with similar cumulative economic growth to China since 2020, the US and India, both posted cumulative stock markets returns of over 40% in US dollar terms. When measuring the relationship between benchmark equity index performance and average earnings growth, China consistently diverges from markets like the US and India. This is reflected in the significantly higher earnings multiples for those markets. As at the end of June 2023, China's HSCEI had an index price:earnings (PE) ratio of 8.9 times whereas India's NIFTY (PE 23) and US's S&P500 (PE 21) were valued at more than double the earnings multiple. Japan is the other anomaly on the XY plot above, with its GDP shrinking but equity markets performing solidly. This is also reflected in Japan's very high PE valuation multiples.

Index PE ratio

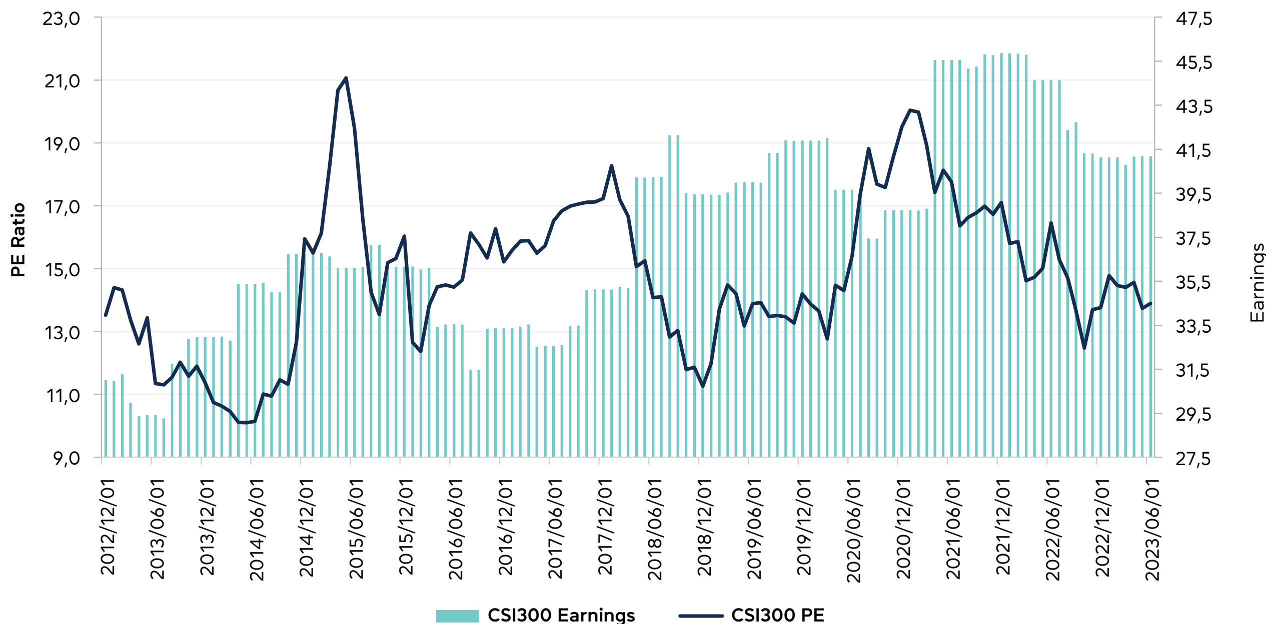


	CSI300 (China A)	HSCEI (China H)	India NIFTY	S&P 500	Japan
2023-06-30	13,89	8,88	23,03	21,30	32,32

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

One contributor to the negative performance of Chinese equity markets is depressed corporate earnings on the back of strict COVID-19-related lockdowns last year. We certainly believe the earnings dips are temporary as COVID-19-related restrictions on the economy are behind us. Depressed earnings, in addition to low earnings multiples, translates into a “double down” cycle for Chinese markets currently. The good news, as we communicated on our recent trip to South Africa, is that earnings should start to recover in the next few quarters as the fruits of a fully functioning economy emerge.

CSI200 earnings and PE ratio multiples



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

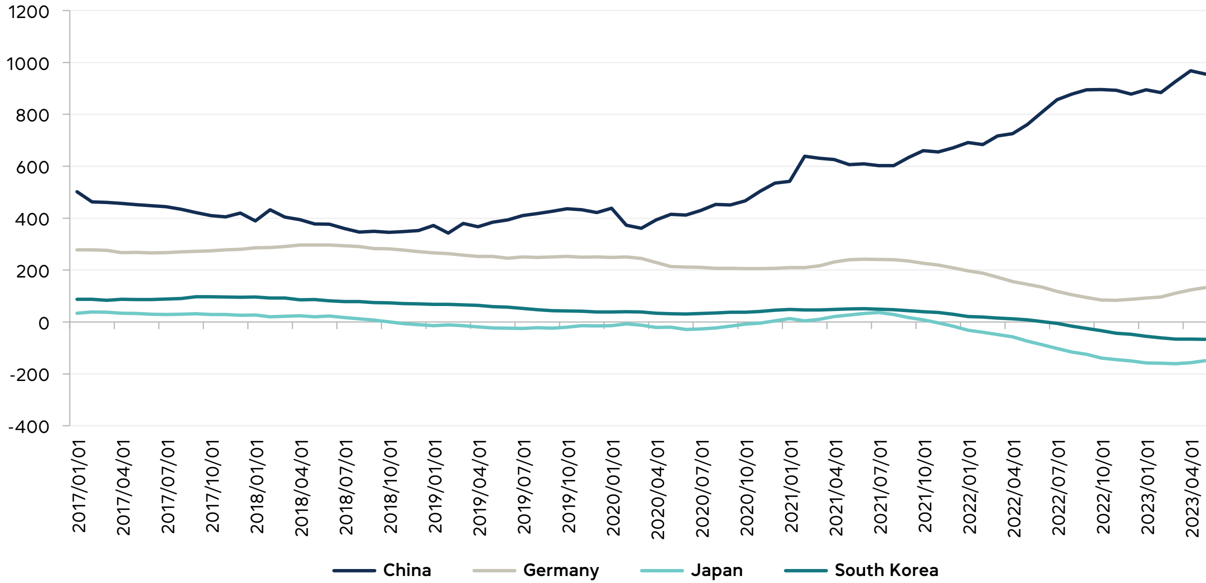
We need to remember that it was only about a year ago when Shanghai experienced a gruelling COVID-19 lockdown and the rest of the country experienced periodic lockdowns throughout 2022. With earnings temporarily low and earnings multiples also at historically low levels, we believe both China A and H share markets are currently very attractive.

FUNDAMENTALLY SOLID

RESILIENT ECONOMY

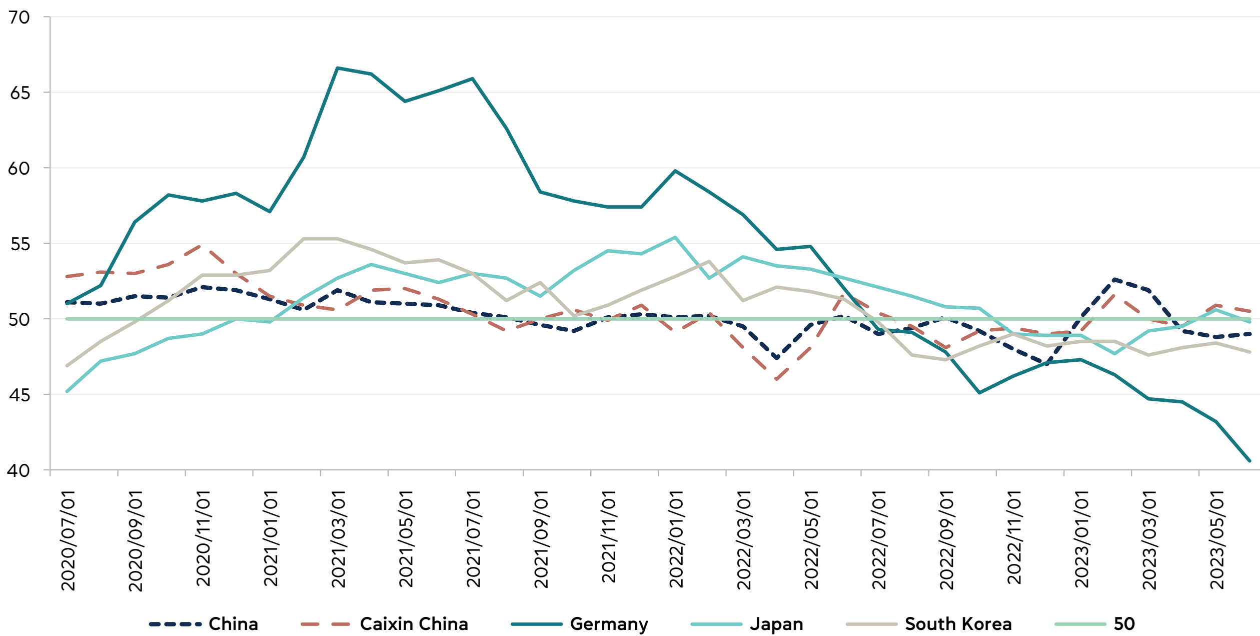
Sentiment towards China has been poor globally, including a lot of pessimism from domestic Chinese media outlets. Slowing export growth and poor manufacturing Purchasing Managers' Index (PMI) data have been the focus recently. While we do agree that China's current trade and manufacturing data looks poor when compared to Chinese trade and manufacturing data five years ago, it is also encouraging to see that only China can beat China. What do we mean? The charts *Trade surplus/deficit USD billions – rolling 12 months* and *Manufacturing PMI* on the following page, show how China compares to major export and manufacturing-focused peers.

Trade surplus/deficit USD billions - rolling 12 months



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

Manufacturing PMI



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

All major export-focused economies are struggling in the current global economic environment. Poor economic conditions lead to poor confidence and lower consumption globally, meaning all exporters suffer to a certain degree. While media outlets have focused on China's manufacturing PMI numbers remaining below 50 and slowing export growth, we can see that China is once again doing quite well relative to global peers.

The only PMI reading above 50 for June 2023 is the Caixin China Manufacturing PMI, more weighted towards small and private enterprises in China. This is very positive as we now see more confidence in the Chinese private sector. China is also the only major exporter with a rolling trade surplus that is consistently increasing, Japan and South Korea are worryingly already in trade deficit territory. Yes, the current Chinese growth is not as attractive as a decade ago, that had amazing growth numbers, but, as we stand, there is no other major economy doing better in the current economic environment.

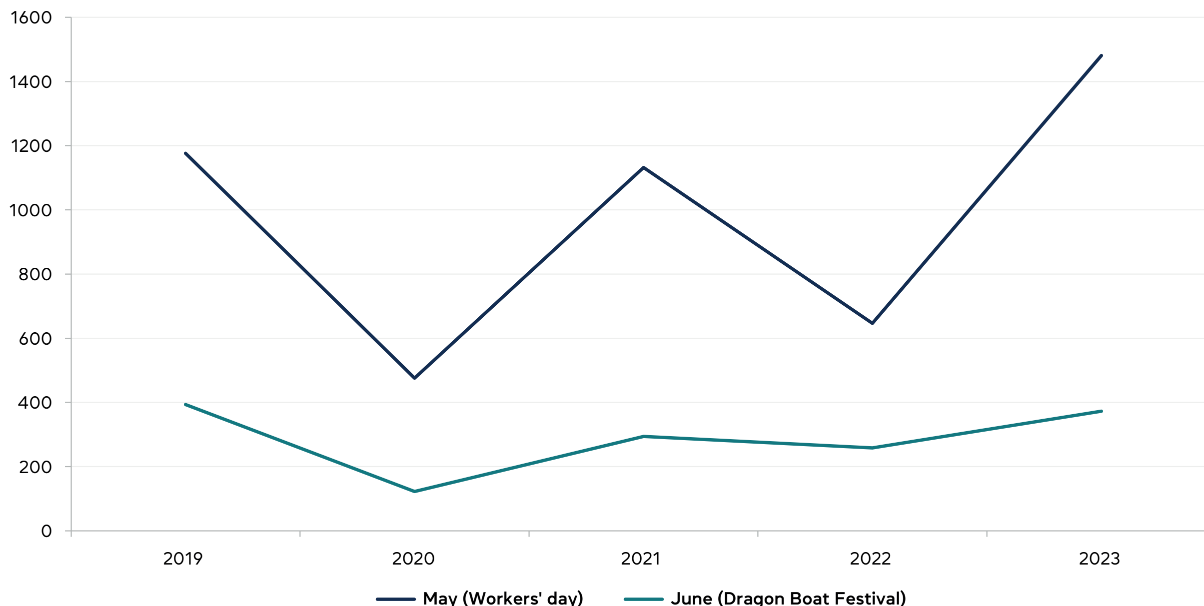
A decade ago, we made the call that China's growth will inevitably slow, yet the market will still be attractive against the backdrop of these lower growth rates. Today is the same, we expect growth rates to continue to slow down over time. If the next decade's average economic growth for China is in the 3% to 4% range, very achievable in our view given higher targets, we think the country will still be in a good place because it will likely be the biggest economy in the world by then. The equity markets seem to believe otherwise, just as they were when we launched the fund in 2013. The markets appear to have priced in a serious recession, an improbable event in China given that all measures currently point to Chinese GDP growth coming in above 5% for 2023.

IMPROVEMENTS SHOULD BE ACKNOWLEDGED

A recent article published by Caixin[1] covering domestic tourism revenue for the recent Dragon Boat Festival focused on the 2023 figure being below pre-COVID-19 levels. While factually correct, we believe it was unbalanced, with a focus on the negative part of the data. We want to show the data as is and explain why headlines are often overly sensational.

[1] https://www.caixinglobal.com/2023-06-26/chinas-holiday-spending-trails-pre-pandemic-levels-102069323.html

Tourism revenue - CNY 100m's



Sources: Prescient, Wind, Ministry of Culture and Tourism (as at 30 June 2023)

The Chinese Dragon Boat Festival is a minor national holiday that effectively results in a three-day long weekend. While total domestic tourism revenue was down -5% compared to 2019, it was up +45% compared to 2022 and up +27% compared to 2021 when there were no nationwide COVID-19 lockdowns. We believe the level of growth is encouraging to say the least. The May Worker's Day data was even more encouraging, especially because it is a longer break, with traditionally significantly more spending. Domestic tourism revenue for the 2023 May Workers' Day holidays were +129% higher than 2022, +31% higher than 2021 and +26% higher than before COVID-19 in 2019.

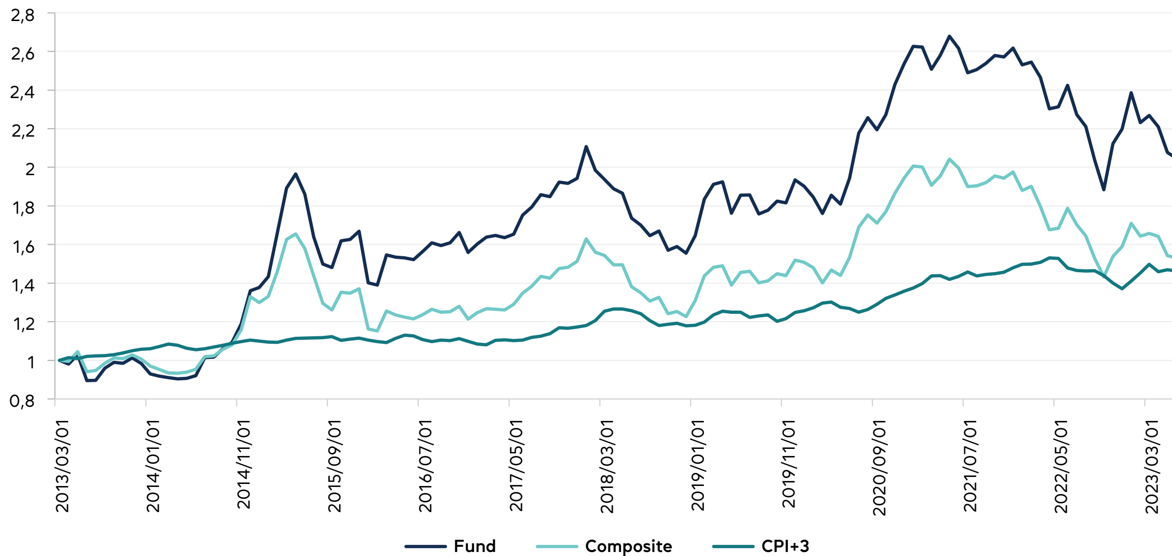
We feel these numbers are not amazing but certainly encouraging. Like our economic model, it shows that the Chinese economy is not doing anything spectacular but it is recovering back to normality. Coming from COVID-19- dominated 2022, we believe normal is good. As the economy continues to fully function, we can expect earnings to follow. When will that begin to reflect in equity market performance? We don't know. Our sentiment models have once again moved to very negative. Right now, we can only wait for market sentiment to turn positive again once it realises earnings growth is back for good.

PRESCIENT PERFORMANCE

CHINA BALANCED FUND

The second quarter of 2023 continued to be tough for Chinese financial markets, with the onshore CSI 300 Total Return index losing -9.3% and the offshore HSCEI Total Return index losing -6.6%, both in US dollar terms. The losses were largely affected by a strong dollar, as the USDCNY exchange rate depreciated by almost 6%. The Fund was overweight equities at the beginning of the quarter and quickly adjusted when sentiment turned extremely negative.

Prescient China Balanced Fund Class A - Returns in USD net of fees



Sources: Prescient, Bloomberg (as at 30 June 2023)
Composite: 65% CSI300 and 35% CS1Bond. Inception date: 31 March 2013

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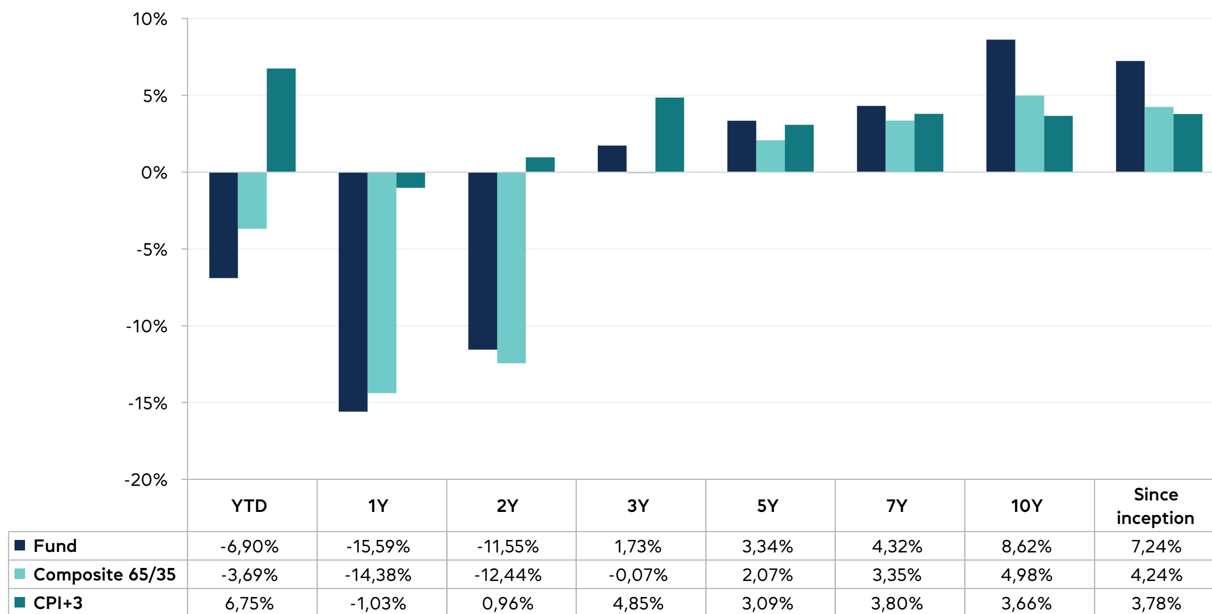

	YTD	1Y	2Y	3Y	5Y	7Y	10Y	Since inception
Fund	-6,90%	-15,59%	-11,55%	1,73%	3,34%	4,32%	8,62%	7,24%
Composite 65/35	-3,69%	-14,38%	-12,44%	-0,07%	2,07%	3,35%	4,98%	4,24%
CPI+3	6,75%	-1,03%	0,96%	4,85%	3,09%	3,80%	3,66%	3,78%

	Fund	Benchmark
Highest rolling 1 year	116.82	58.23
Lowest rolling 1 year	-26.97	-7.93

Sources: Prescient, Bloomberg (as at 30 June 2023)
Composite: 65% CSI300 and 35% CS1Bond. Inception date: 31 March 2013
Annualised figures are used for periods longer than 12 months.

In terms of performance, the second quarter of 2023 was a tough quarter as the Fund lost -9.8% in dollar terms, effectively giving back the alpha generated in the past three quarters. All models have periods where they don't work, the events of this year were precisely where our model struggled the most, with valuation, policy and sentiment all positive in the first quarter before turning negative in the second quarter. Combined with the gains made in Hong Kong in quarter one sharply reversing in quarter two, the Fund underperformed our 65/35 reference index over the quarter.

With valuations so attractive and policy supportive, we targeted the Fund to have around 90% to100% of market upside while only around 65% of the downside. Over the past year, we almost achieved this goal, with high upside exposure and around 68% of the downside. We will continue to follow our tried and tested model, continually enhancing it for market changes over time. This does not mean the model works perfectly 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. Though there may have been bouts of false bull rallies, we will look to add positions when sentiment improves in the future. The current market slump has been one of the longest bear markets in China over the past decade, yet fundamentals have been solid and reasonable. We think this is as good an opportunity to invest in China as ever.

BE GREEDY WHEN OTHERS ARE FEARFUL

This quarter's commentary is one of the rare ones in recent years where we have not covered anything in terms of geopolitics but have rather focused on hard data. As much as geopolitics dominate the headlines, we believe it was actually a quiet quarter in terms of market-impacting geopolitical events, at least relative to those we've seen in the past few years. Anthony Blinken's trip to Beijing expectedly yielded no visible progress and we don't expect too much from Janet Yellen's trip either, only time will tell. What we are encouraged by is that China continues to pursue its foreign policy of active global co-operation, even if co-operation is more difficult with the US and its close allies. Warming relations with Europe, progress with a growing BRICS and Shanghai Co-operation Organisation (SCO), along with a formal application to join the CPTPP free trade pact all shows us the policy intention and direction is very positive for China.

There is no doubt that, even with everything going in the right direction, investors continue to be very negative on China's markets. Investor sentiment globally and domestically remains poor, yet we have seen many times how sentiment can change quickly and drastically in China. Warren Buffet's age-old quote, to be "fearful when others are greedy, and greedy when others are fearful", comes to mind. The market is certainly extremely fearful at this point in time.

To all our clients, we are grateful for your continued support. Perhaps it's time to get a bit greedy on China, we certainly are!

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Annualised performance shows longer-term performance rescaled to a one-year period. Annualised performance is the average return per year over the period. Actual annual figures are available to the investor on request. Highest and lowest is returns for any one year over the period since inception have been shown. NAV is the net asset value represents the assets of a Fund less its liabilities.

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