RISCURA

January 2023: China Newsletter

Recap of 2022 and 2023 Outlook

China update

We wish everyone a happy Chinese New Year as we kick off the Year of the Rabbit.

In December, Chinese equities continued their uptrend, with the MSCI China and MSCI China A Onshore rising by 5.2% and 1.8%, respectively, over the month.

Investor sentiment further improved due to an earlier-than-expected reopening of the country's economy and supportive government policies put in place for the property sector, as discussed in our last letter. As a result, beneficiaries of the reopening and stimulus measures led gains in the market.

On the macro side, December PMI numbers fell to new lows as both supply and demand were hit by a Covid wave. However, we expect the impact to be temporary as China has largely reached herd immunity. Some experts estimate that around 80% of the Chinese population has already been infected, with more than 35 million new cases a day at one point. While it's very unfortunate to see a surge in Covid-related deaths, there isn't as much anger in society as some had speculated. Most Chinese people are tired of lockdowns and want to return to their normal lives as soon as possible.

Another challenging year for fund managers

2022 was an eventful and volatile year for everyone, and this was equally true for investors into China. Russia's invasion of Ukraine, global rate hikes and recession fears provided a challenging external environment. Domestically, China experienced a stringent zero-Covid policy, an extended property market slowdown and a large leadership reshuffle within the Politburo, all of which resulted in broad sell-offs across Chinese markets at different times, often exacerbated by foreign outflows. The MSCI China and MSCI China A Onshore indices lost 42.7% and 35.5%, respectively, in the first 10 months, making it one of the worst equity performance periods in history. This was then followed by a great rebound in the last two months as perceived risks reduced on all fronts and foreign investor flows increased.

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Diversification across styles and managers is so important

It was truly remarkable to see how market sentiment went from panic to optimism in just a few weeks.

For Chinese fund managers, it was another challenging year as over half of the universe underperformed market benchmarks. A peer group of 107 Greater China and All China products delivered a median return of -24.0% versus the MSCI China All Shares' return of -23.5%. For onshore-focused China A-Share managers, a peer group of 51 products delivered -27.8% versus the MSCI China A Onshore's return of -27.0%. Many of the best of the best managers and hedge funds suffered in this sentiment-driven market with frequent style changes.

Perhaps most importantly, the last two years have demonstrated that no single manager, regardless of talent, can fully mitigate the unique risks in China. That is why diversification across styles and managers is so important.

A brighter year ahead

On the back of strong policy support, faster economic growth and attractive valuations, we expect a brighter year ahead for Chinese equities, which have already started off well in January. We have seen strong passive and active flows into China in the past few months. This will likely continue as global managers are still significantly underweight to Chinese shares. Among those, A-Shares have trailed the gains seen in the offshore markets in the latest rebound. As the valuation spread between these markets narrows and onshore investors increase confidence, we may see onshore indices catching up in the next market phase.

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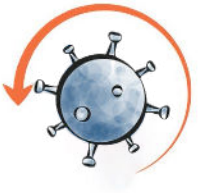
The regulation of technology companies is also progressing. We have seen government-owned entities take or plan to take small stakes (like 1%) in large technology companies' subsidiaries in exchange for a board seat. While neither the shareholding nor the board seat necessarily allows the state to interfere with day-to-day decision-making, they are expected to increase control over content. For example, ByteDance has introduced a "content safety committee" and it is to be chaired by a government-sponsored board member. Greater supervision was perhaps inevitable, but the way the state implemented this was very important in regaining shareholder confidence. By using board representation, the state can monitor internal decisions and give early guidance on practices that may be considered inappropriate. That potentially reduces the need for formal regulation later. The state-appointed board member also becomes a useful conduit for understanding and even providing feedback on anticipated state policies. Reduced regulatory uncertainty allows the companies to move forward and plan for the future. Share prices of many of these companies, such as Alibaba and Pinduoduo, have nearly doubled from their lows.

When market volatility subsides and investors' focus shifts back to fundamentals, stock selection will be a key driver for returns.



Companies that have become stronger during the pandemic and those that continue to innovate will likely win out

From a fundamental perspective, the best companies in the next five years will be different from the past. Companies that have become stronger during the pandemic and those that continue to innovate will likely win out. As an example, New Oriental, once a leading after-school tutoring company before the government's crackdown on the sector in 2021, has reinvented itself and found success in livestreaming e-commerce. Its share price has gone up by over 400% from the bottom.

As we said in **our October 2022 letter**, the changed market sentiment demonstrates that China is irreplaceable in global supply chains despite increased geopolitical risks. These tensions will continue and China's long-term goal of becoming independent in science and technology will see certain sectors grow exponentially, providing even more opportunities for investors.

About RisCura

RisCura is a global firm of investment experts that offers a range of services across the investment industry. With a focus on emerging and frontier markets, RisCura has pioneered research of investment managers in mainland China for over 10 years and has helped clients allocate over USD1bn into the region.

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