Notes from our recent trip to China

China update

In September 2024 the Chinese equity markets experienced a substantial rebound. Driven by favourable policy measures, market sentiment was notably boosted. Among sectors, real estate, internet, and financials were the top performers, rising by 25.1%, 22.1% and 15.6%, respectively.

The real estate sector led the gains, largely benefiting from various government measures aimed at stabilising the property market.

- **The MSCI China, MSCI China All Shares, and MSCI China A Onshore Indices all surged by 23.6%, 23.0% and 23.0% respectively.**
- **The People's Bank of China introduced key monetary policies, which injected approximately 800 billion RMB into market liquidity, enhancing market confidence and driving a strong rally.**
- **The US Federal Reserve's rate cut played a role in supporting the Chinese market, further boosting optimism toward Chinese stocks.**

Policy boosts and global tailwinds

On 24 September the People's Bank of China announced a series of monetary policy measures, including cuts to the reserve requirement ratio (RRR) and interest rates, to support economic and market stability. Additionally, the central bank introduced two new monetary policy tools: a swap facility to support the stability of securities, funds, and insurance companies, as well as a special re-lending program to facilitate share buybacks and increased holdings by listed companies. Together, these measures are expected to inject approximately 800 billion RMB into market liquidity. These measures effectively enhanced market confidence and led to a significant rally in the stock market.

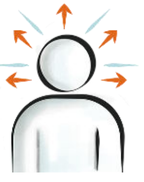
The rally was also influenced by the global economic environment. In September, the Federal Reserve announced a 50-basis-point rate cut, which exceeded market expectations and formally initiated the rate-cutting cycle in the US. This move helped reduce global financing costs and had a positive impact on Chinese assets. As a result, foreign institutions became more optimistic about the outlook for Chinese stocks.

Regarding market sentiment, the sharp rally in the onshore A-share market attracted substantial capital inflows. Reports indicate that the total market capitalisation of A-shares surged by 9.6 trillion RMB in just one week, reflecting highly bullish sentiment. With the 7-day National Day holiday taking place over the month end, investors remain cautiously optimistic about the post-holiday market, expecting the upward trend to continue, even if there is likely to be some short-term volatility

Some challenges persist

The recent share price recovery may well be the beginning of a recovery in the Chinese equity market, but there is no doubt that domestic consumer sentiment is stretched. Much of their wealth is tied up in their homes that are depreciating in value.

The U.S. Federal Reserve's rate cut positively impacts Chinese stock market outlook.



Consumers are strained and downgrading from premium brands to affordable choices.

Government-sponsored discount vouchers motivate consumers to purchase TVs and cars.

Companies like Tencent and Alibaba are enhancing efficiency and returning capital to shareholders.

People are also concerned about job security as the Chinese economy transitions from being one that was led by real estate and infrastructure to a technology and consumption led economy. It is no surprise that consumers are reluctant to spend on big-ticket items, making it tough for most consumer companies.

Still, there are exceptions. For example, consumers are downgrading from premium options like Starbucks to more affordable alternatives such as Luckin Coffee or switching to discount e-commerce platforms like Pinduoduo.

Stimulus is coming but more is needed

The government is beginning to realise that concrete action is needed, prompting various types of monetary and fiscal stimulus initiatives. However, for now these efforts fall well short of the bazooka stimulus required to stabilise the economy and reassure consumers – in particular, more significant fiscal stimulus is needed.

While in China, we met people who mentioned purchasing televisions and cars on the back of government-sponsored discount vouchers. This is just the beginning of such measures, and more is necessary to encourage consumers, who have built up a record amount of excess savings.

September's stock market return is only the start with consumer confidence beginning to return as house prices stabilise.

High quality businesses have cut their fat

In recent years, companies have shifted their focus from growth to improving efficiency. They have shed thousands of jobs, closed non-core or loss-making divisions, increased their earnings substantially, and are returning capital to shareholders through dividends and share buybacks. Internet giants like Tencent and Alibaba are prime examples of this trend.

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Manufacturing processes are incredibly efficient

Wage inflation has increased as Chinese workers have become wealthier and older, and manufacturing processes are adapting to this new reality. For example, we visited Xiaomi's famous "dark factory", which is fully automated, requiring no human intervention, hence no need for lights, boasts of churning out one phone per second. At this facility, engineers can examine a live 3D virtual images of factory machinery to identify the exact problem should one occur. We also visited BYD (the electric car manufacturer), which has moved production from its legacy site in Shenzhen to a new, fully automated manufacturing line that produces a car every 51 seconds.

These technological upgrades are happening across the country. This is only the start: today China can produce high-quality volumes faster than anyone else. The next step is for factories to manufacture customised products. Imagine every car, shoe, or piece of furniture coming out tailored to your unique needs. Americans may be leading in artificial intelligence research but the Chinese may well be ahead in the practical application of artificial intelligence.

Chinese companies are going global

Hard times have accelerated the pace of Chinese companies globalising. Larger companies are rapidly taking market share from their global competitors, whilst start-ups are adopting a global mindset from day one.

There are many examples of this trend that we have discussed in recent newsletters such as Temu, for instance. We also received communication from Tencent about plans to increase their global market share in the gaming sector (where their share is in low single-digits compared with holding almost half of the Chinese market).

Fully automated factories like Xiaomi's "dark factory" are boosting manufacturing efficiency.

China's manufacturing is practically adapting with AI, enabling customised production.

High-quality start-ups with global mindsets are emerging, raising venture capital interest.

China's stock market may rebound quickly, which will attract eager investors.

Amer Sports, a subsidiary of Anta, has completely restructured Salomon, Arc'teryx, and Wilson, and is now growing rapidly internationally. Hangcha Group is a global market leader in the manufacturing of forklifts with a 27% market share in China but only 7% internationally. There are many examples of multi-billion-dollar licences of Chinese-developed molecules to American pharmaceutical companies hence our excitement for healthcare venture capital.

In the venture capital space, we met with leaders in the industry who are behind the Chinese tech giants of today. Whilst there is no doubt that the supply of capital has reduced, the quality of start-ups is much higher, and valuations have come down. One company we met operates in the field of data analytics and within just a few years has proven that their services are far better than Snowflake and Databricks, the US leaders in this space. The company already boasts of working with the largest companies in the USA including Apple, Microsoft and Expedia.

When the Chinese market moves, it moves quickly

The depressed valuations of high-quality companies are largely due to poor sentiment. There will likely be a top-down catalyst that brings momentum back to this forgotten market. However, history has shown that once this happens, things can move fast making it too late for investors waiting on the sidelines. In 2015, the China A share market went up by 150% in just 11 months and the market has already gone up by 20% in the last week of September. While we can't say for sure whether this is yet another false start, we can say that there are extremely undervalued Chinese companies that are global market leaders who continue to grow rapidly.

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