China Mid-Year Market Outlook

A more broad-based recovery after initial reopening, though some bumpiness is expected.

June 2023

KEY INSIGHTS

- Despite some softer macro data recently, the initial stage of economic reopening largely met our expectations, with the services sector leading the way.
- We expect the recovery to broaden with some bumpiness due to the volatile base, uncertainties in the external economy, and geopolitical tensions.
- The regulatory environment should normalize, with more support for the private sector. Valuations are attractive versus growth for China equities.

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China's economic reopening has largely played out as we had expected in December 2022. Initially, there were a string of positive economic surprises that boosted investor confidence. China's 1Q GDP growth number, for example, came in at 4.5%, much better than the consensus forecast of 4%. The consumption rebound was also strong, led by strong service sector recovery.

- Travel-related consumption services rebounded very strongly.
- Catering notched above 20% growth in March and overall around 14% in the first quarter.
- Industrial production was a little weak as was exports prior to the rebound in March but both were within expectations.

Residential property remains a key uncertainty after the sharp contraction last year. The property market in Q1 appears bifurcated. We have seen a healthy rebound in higher-tier cities where policy restrictions on home purchase at the city level have eased. Sales numbers in lower-tier provincial cities remained weak, however, which may be partly due to net migration to larger cities. Property sales by value rose 4.1% in the first quarter while new home prices increased for a third consecutive month in March. Q1 national new home starts remained in contraction territory, though the magnitude narrowed.

Outlook for the Second Half of 2023: Recent Softness in Macro Data Unlikely to Derail 2023 Economic Recovery Trajectory

We believe the recent weakness in China's macro data is more likely to be a temporary hiccup rather than a major trend that could derail 2023's recovery trajectory. We anticipate a gradual but more broad-based economic recovery for the rest of the year and into 2024, with some bumpiness expected due to the volatile base, uncertainties in the external economy, and geopolitical tensions. In

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such an environment, stock picking is our focus in navigating the uncertainties.

Annual growth rates for retail sales, fixed investment and industrial output surged in April but this was due to the base effects arising from Shanghai's lockdown in April 2022. Base effects are likely to distort year-on-year data comparisons throughout 2023, adding considerable 'noise' to the monthly data releases. If we focus on 4-year CAGRs (compound annual growth rates) from 2019, it shows that the Chinese economy lost some momentum after the first phase of reopening ended.

Following softer economic data in April, investors have recently become concerned about the sustainability of economic recovery. As a result, the rally in Chinese stocks that began last October has stalled recently, leaving the market on attractive valuations, especially in sectors such as communication services and IT (Figure 1).

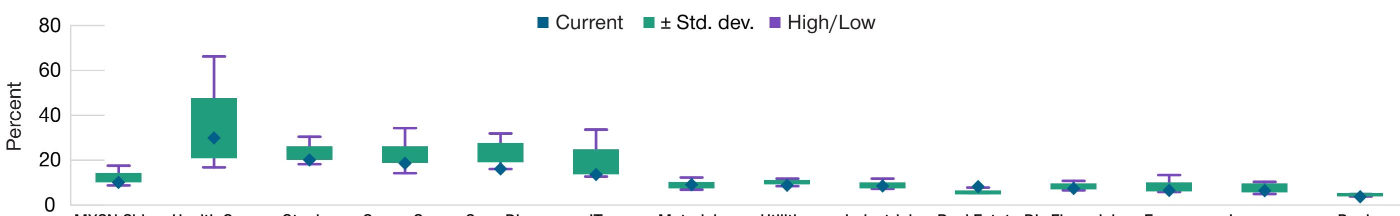
We believe the initial phase of China's reopening – benefitting consumer services in areas such as travel, entertainment, hotels and restaurants has largely played out. However, the economic recovery should have legs. Because of COVID, it is estimated that the services sector failed to create as many as 30 million jobs cumulatively in the past 3 years (source: Morgan Stanley Research). As "experience" types of consumption recovered in the first phase, we expect employment in these areas to improve and the recovery to broaden out in the second phase to include job recruitment agencies and the broader consumer space including goods consumption. Later in 2023 or early in 2024 we should see the third recovery phase begin as late-cycle themes start to gain traction with improved business confidence, such as advertising companies and private investment.

Given the recent softness in macro data, the possibility of selective fiscal

China Valuations Are Attractive

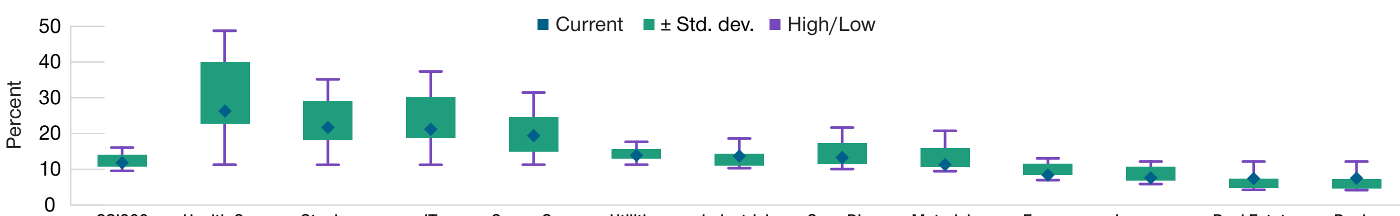
(Fig. 1) 12-month forward price/earnings ratio. 5-years historical data.

MXCN China 12M Forward P/E (X)
5 Years Historical Data



	MXCN China	Health Care	Staples	Comm Svcs	Cons Disc	IT	Materials	Utilities	Industrials	Real Estate	Div Financials	Energy	Insurance	Banks
Current	10.1	29.9	20.1	18.6	16.1	13.6	9.1	8.8	8.5	8.2	7.4	6.5	6.4	3.7

CSI300 12M Forward P/E (X)
5 Years Historical Data

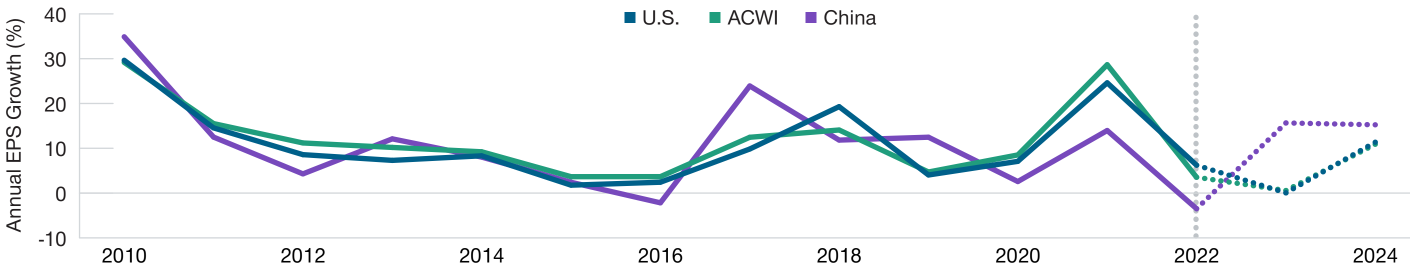


	CSI300	Health Care	Staples	IT	Comm Svcs	Utilities	Industrials	Cons Disc	Materials	Energy	Insurance	Real Estate	Banks
Current	11.8	26.3	21.7	21.2	19.4	13.9	13.7	13.3	11.3	8.4	7.6	7.4	4.5

As of April 30, 2023.
[1] Tagged footnote.
Source: FactSet, I/B/E/S, MSCI, Wind, Goldman Sachs Global Investment Research. Financial data and analytics provider FactSet: Copyright 2022 FactSet. All rights reserved.Please see Additional Disclosures page for information about this MSCI information.

Earnings Forecast: China Versus Rest of The World

(Fig. 2) Annual EPS growth forecasts (%) for 2023 and 2024



As of April 30, 2023.
EPS = Earnings per Share. ACWI = MSCI All Country World Index; US = S&P 500 Index; China = MSCI China Index.
Source: MSCI, Goldman Sachs Global Investment Research. Please see Additional Disclosures page for information about this MSCI information.

> We look for more stabilization-type policies to reassure the private sector and boost business confidence.

measures to support growth is increasing, although it is difficult to forecast their timing and magnitude. Monetary policy in China should remain supportive throughout 2023. The People's Bank of China (PBoC) cut to its reserve requirement ratio for banks in March. Credit growth, like other economic data, showed some volatility in recent months and most China economists now expect one or more interest rate cuts this year. This may be facilitated if the Federal Reserve is currently close to peak monetary tightening in the U.S. In addition, should there be external demand uncertainty to weaken China's export growth, we believe regulators have fiscal tools or easing housing policies, such as second home restrictions, to support better growth.

Overall, the government's full-year GDP growth target of "around 5%" is not demanding. We think the volatile base will lead to bumpiness in monthly macro data, but the recovery trajectory is unlikely to be derailed.

Consensus earnings forecasts for MSCI China in 2023 showed an initial upward revision after reopening which has since been trending down. A key factor is that the impact of the COVID-19 outbreak in the fourth quarter of 2022 and early in 2023 has made near-term forecasting difficult. Following the wave of COVID cases in January, around half of Chinese companies missed their earnings expectations in Q1 2023. We expect this to turn around in the coming months as the second and third legs of the recovery play out. As Chinese companies emerge from 2022's negative impact from COVID lockdowns and weakness in residential property, they may reveal more confidence about demand recovery (Figure 2).

More Support For The Private Sector

A feature of the new leadership since the National People's Congress (NPC) in March has been the stream of government statements supporting the private sector. After the regulatory crackdowns in 2021 and last year, many foreign investors remain unconvinced. Investors may also have been disappointed by no big fiscal stimulus measures since the NPC. The government's economic policy changes in 2023 have until now been more micro than macro in nature. What is important to us, however, is that we find Premier, Li Qiang, to be pro-business. Under him we expect a greater degree of policy consistency over the next couple of years. **We look for more stabilization-type policies to reassure the private sector and policy normalization in expectation setting.**

Anecdotally, Alibaba's proposed restructuring into six business units shows that China's private sector companies may sense more freedom for self-help and flexibility in the current environment. In addition, online game approval is normalizing and recently some of the foreign game titles were also approved. These positive signals will bring more vibrant energy and innovation to the private sector, a contrarian view we take that stands in contrast to the negativity commonly encountered.

As another example, China recently released a regulatory policy for artificial intelligence (AI) companies. Some commentators viewed this negatively given that it came so quickly when the AI industry was in its early stages to develop. But we view the government as learning from the past. Historically, Beijing often let new industries grow in size for a number of years before bringing in government regulations. This risked creating negative investor sentiment as the businesses involved were already big and the impact of the new regulations was uncertain. This time, Beijing has stepped in early to guide the industry and provide regulatory direction. This should help companies to adjust their products and business models at an early stage in order to comply with the new regulations.

Easing Geopolitical Tensions

China remains an essential part of the global economy. Despite the potential decoupling in selected high-tech areas such as leading-edge semiconductors and biotech, we believe that China can be a key contributing factor to counter global inflation.

The Chinese government has shown its willingness to cooperate with the U.S., as evidenced by the solution reached on audit inspections of U.S.-listed Chinese companies. The resumption of high-level talks between the U.S. and Chinese government and the more constructive comments on China in the recent G7 Summit Statement suggest that geopolitical tensions are easing.

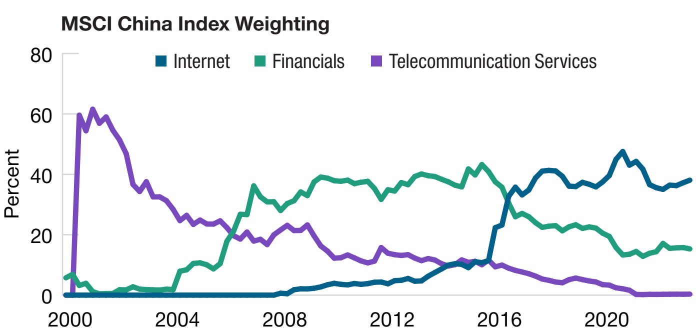
We see the strategic competition between China and the U.S. as structural. The two countries and the rest of the world are adjusting to the new environment and will have to find a balance. During this process, we as investors must focus on finding areas that are unlikely to be adversely impacted by policy change, or which stand to benefit from the reshaping of supply chains.

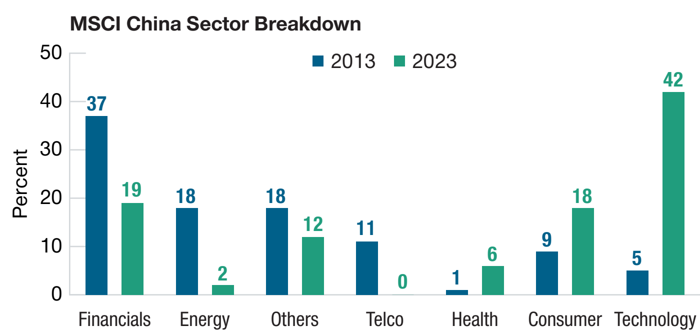
Investment Opportunities

The structure of China's equity market has evolved dramatically over the past two decades and we expect this to continue

China's Rapidly Evolving Equity Market Structure

(Fig. 3) Consumer, health care & technology have grown in importance; financials, energy and telecoms have shrunk





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Information Technology: Information Technology, Media & Entertainment, and Internet & Direct Marketing Retail.
Consumer: Consumer Staples and Consumer Discretionary ex Internet & Direct Marketing Retail.
Financials: Financials and Real Estate.
Telecommunication Services: Communication Services ex Media & Entertainment
Other: Industrials, Utilities, Materials
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We continue to find interesting investment ideas in the domestically-listed A-share space....

(Figure 3). Dynamic industry and sector trends are the norm for China. Investors therefore need to anticipate each key trend if they are to stay ahead of the game. Figure 3 shows that since 2012 the consumer, health care and technology sectors have grown significantly in importance while financials, energy and telecoms have all shrunk.

For a good example, consider how rapidly electric vehicles (EVs) are currently disrupting China's auto industry. Our industry analysts attended the Shanghai Auto Show in April and confirmed our belief that EVs have become the mainstream in the Chinese auto industry. Out of over 100 new models launched during the show, more than 70% were EVs, heavily outnumbering traditional ICE (internal combustion engine). Local brands continue to lead the way, with over 80% market share in the EV market (Figure 4).

The EV ecosystem offers exciting investment opportunities in many areas, including Chinese companies with leading-edge technology in powertrains, fast charging, autonomous driving, auto component supply chains and industrial equipment manufacturer, particularly those that benefit from volume growth and content gain stories. China is not only the largest EV market in the world, it has also become the largest auto exporter globally. In the first quarter of 2023 alone, over 800,000 units were shipped, driven by demand from emerging markets. Under such rapid industry disruption, we believe that stock selection will be crucial in picking the future winners in this space.

We continue to find interesting investment ideas in the domestically-listed A-share space, especially in industrial areas where we find structural market share gainers with strong product offerings. Since 2018, several factors have happened simultaneously that structurally drove the domestic players gaining more market share, the combined power of which is likely to be underappreciated by market. These factors include:

1) an accelerated pace of domestic substitution since the 2018 trade war with the U.S.;

2) the EV and renewable energy trends have accelerated since 2020, driving demand growth for key industrial components;

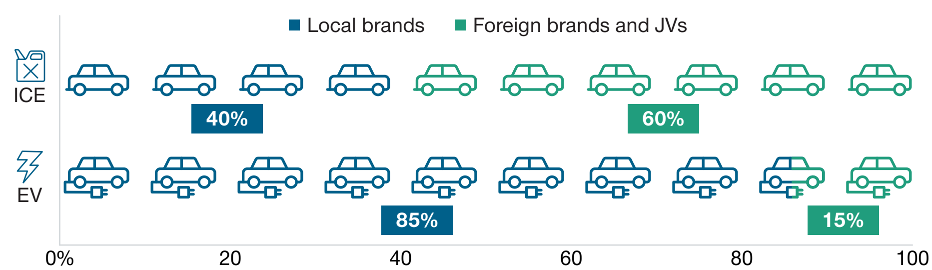
3) COVID-related supply chain disruption to foreign suppliers provided an opportunity for Chinese players to enter the market.

The China Growth Opportunities strategy is currently overweight A-shares by around 5%, and this is likely to increase over time.

We are also spending more time than before looking at some of the listed state-owned enterprises (SOEs). China's SOE reforms have encouraged them

In EV, Local Brands Dominate China's Auto Market

(Fig. 4) Share of local makers versus foreign and joint venture brands



As of April 30, 2023.
ICE=Internal Combustion Engine; ICE vehicles are conventional vehicles powered solely by an Internal Combustion Engine. EV = electric vehicle.
Sources: Goldman Sachs Global Investment Research, TRP analysis.

to switch from being revenue-driven to being more return-driven with a greater focus on profitability, cash flow and dividend distribution. Overseas investors are often biased against SOEs simply because they fall within the public sector, even those with a good management team and a strong track record. We search for SOEs with the right incentive scheme, improving return profile, strong cash flow generation capability, solid growth outlook, and attractive valuations that fit into our growth investment framework.

In view of a gradual and more broad-based recovery with volatility, investors can position their portfolio with a balance along the growth spectrum, including fast-growing disruptors with unique technology or business models and high-quality compounders that can sustainably grow their earnings and cash flow.

Conclusion: The Return of Confidence

As consumer confidence gradually returns, the recovery in consumption from services to goods (within goods from small ticket items to large ticket products) should in turn pave the way for a pick-up in corporate confidence and eventually a rebound in private investment in 2024. Compared to other major economies, China is at a different stage of its business cycle. Benign inflation in contrast to the decades-high readings seen in other economies gives China the leeway to maintain an accommodative monetary policy and also to introduce selective fiscal support should that prove necessary.

We believe the new leadership's focus on promoting business is a force to be reckoned with. As the economy stabilizes, the breadth and depth of China's market should provide ample opportunities for bottom-up investors. The undemanding valuations of Chinese equities have created an attractive investment case for long-term investors, in our view.

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