China: Embracing Uncertainty

And Identifying Good Opportunities

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The China Evolution Equity Strategy that I manage has what we believe is a unique design among China equity strategies. We invest in the whole of the China equity universe, excluding the top 100 largest listed companies.[1] The Chinese stock market has around 6,000 public companies, with fewer than 100 having a market cap above USD 30 billion. However, among mainstream China strategies, many invest around 60% of their portfolio in these mega-cap stocks. So around 60% of assets appear to be invested in less than 2% of the investment universe.[2] We regard this as a major disconnect in terms of diversification and breadth of opportunity.

The first objective of the China Evolution Equity Strategy is to offer a unique exposure to the approximate 98% of the opportunities that are under-explored. As a key design feature, we do not aim to invest in the top 100 Chinese mega-cap stocks. A second element of portfolio design is that we take a holistic, style-agnostic investment approach. We are not constrained by growth or value. Rather, we look for stocks that have a combination of fundamental strength and mispricing opportunities. We do this through the process of discovery, deep research, and pattern recognition.

A third feature of portfolio design is a strong focus on alpha generation. We believe that the approximate 98% of the universe that we operate in has more mispricing opportunities and aim to identify these with a flexible investment approach.

Q1: Chinese equities appear to have stabilized since May. Has investor sentiment toward China turned the corner?

Looking back over recent quarters it is clear with hindsight that Chinese equities encountered a "perfect storm." Beijing started to tighten liquidity as far back as the second half of 2020, much earlier than the rest of the world. On top of that tighter macro policy stance, you had all the regulatory actions that took investors by surprise and that lasted throughout 2021.

At the beginning of this year, the new omicron variant of COVID-19 posed a major threat to China's strict zero-COVID policy, plus a new round of geopolitical concerns triggered by the Russia-Ukraine conflict.

Over the past one to two months, we have started to see improvement in many aspects. The policy priority has shifted from tightening to supporting growth. We would expect a more favorable liquidity and regulatory environment for the coming quarters.

[1] By market cap.
[2] The 100 largest listed companies in China by market cap represent around 2% of the opportunity set in terms of the total number of companies.
As of June 30, 2022. Sources: Bloomberg Finance L.P., FactSet. Financial data and analytics provider FactSet. Copyright 2022 FactSet. All Rights Reserved.

> Since the low in mid-March, Chinese equities have clawed back some of their earlier losses.

The COVID situation has improved, and the supply chain is largely back to normal. We still see small-scale outbreaks in a few cities, which inevitably impact local service businesses. However, we think another major supply chain disruption can hopefully be avoided.

Last, rising raw material prices, which hurt the margins for many Chinese industrial companies, have started to come down. This should help the earnings growth for mid-/downstream companies in China.

Since the low in mid-March, Chinese equities have clawed back some of their earlier losses. The MSCI China Index gained 9.2% while the MSCI AC World Index fell 2.2% from March 15, 2022 to August 10, 2022.[3] Despite this partial recovery in relative performance, I don't get the sense that sentiment has suddenly turned overly bullish. The sense I get is that investors feel that the worst is probably behind us, and the economy should improve in the second half of the year.

Q2: With some light at the end of the tunnel, in China's case, has the bad news largely been discounted?

I think the Chinese economy has passed the phase of sharp deceleration seen in the first half of 2022. We do not expect large-scale stimulus, but we believe things will be improving in the coming quarters. The question is about what the slope of the improvement would look like.

One thing I want to highlight is that I think China is in a unique position when it comes to its business cycle. With inflation remaining muted at around 2.5% in June, according to government data, the central bank has enough leeway to loosen, while most other major economies are on a tightening cycle to contain high inflation rates that have not been seen in decades. This could put China's market in a relatively better position.

The result of the different economic picture can be traced back to COVID response. In the first COVID wave, most countries responded to what was essentially a supply issue by stimulating aggregate demand. With hindsight, that's a recipe for high inflation. China, on the other hand, focused on cutting taxes for enterprises and protecting employment. The result is that supply chains and productivity are maintained, but demand has been relatively weak.

I think what's important for investors is not whether China will meet a specific gross domestic product growth target of 5.5%. Rather, it's about whether the economic situation in a broad sense is improving or deteriorating. China's equity market is broad and deep. As long as the economy stabilizes, there are ample bottom-up opportunities for investors.

Q3: Turning to your portfolio, what changes have you made in 2022?

We are bottom-up investors, and we don't construct the portfolio based on our macro views. We go through the whole opportunity set and try to identify stocks with the most attractive risk/reward profiles. There are three buckets where we find interesting opportunities.

The first bucket is a group of unique businesses that we believe can compound at 20%+ for the next three to five years. The sharp sell-off earlier this year offered us the opportunity to acquire some of them at an attractive price. That includes a leading EV (electric vehicle) startup, an online recruiting platform, and a shopping mall operator.

The second bucket is what we call "nonlinear growers." These are companies that we think will go through meaningful earnings acceleration driven by product cycle or operation improvement. Examples include an automotive display company and a pharmaceutical packaging company. We expect both to benefit from a sharp increase in average selling price (ASP) driven by product upgrades.

[3] **Past performance is not a reliable indicator of future performance.** Source: Bloomberg Finance L.P. and MSCI (see Additional Disclosure).

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In the third bucket are companies facing short-term margin pressures because of rising raw material prices. They are proven businesses, and we think margin pressures are likely to reverse over the next one to two years. This category includes a leading gas distributor in China as well as an instant noodle manufacturer.

On the flip side, we have also been making some disposals, including stocks that benefited from the pandemic and supply chain disruption. Their margins are at multiyear highs and could be difficult to sustain. Examples include some integrated circuit design companies, container shipping businesses, and small appliances manufacturers.

In some other cases, we are making the changes to adapt to evolving trends. For example, the structural shift in the property market and demographic change (low birth rate) could have long-term consequences for some of our holdings, and we have made some adjustments accordingly.

Q4: Do you see electric vehicles as a big opportunity for investors in Chinese equities?

I think EV could be a major driver for China's industrial upgrade over the next five to 10 years. China's auto market is seven to eight times larger than the smartphone market, [4] and we see similar dynamics between the two industries. China is the largest auto market globally but local original equipment manufacturers (OEMs) had a relatively weak position in internal combustion engine (ICE) cars with less than 40% market share. However, Chinese companies' position in EV is much stronger with a share in the local market of more than 80%.[5] Over time, we believe China auto makers could potentially play a meaningful role in global EV markets as well.

That potentially could bring huge opportunities across the whole supply chain. Including battery makers, auto parts companies, equipment suppliers, and automation/software vendors.

Our focus in EV, besides select EV OEMs, is mainly on auto parts companies with strong competitive positioning and content gain opportunities. For example, we think there is potential for auto glass's value per car to go up two to three times over the next several years, driven by EV and innovations. Similarly for auto display, we see both rapid content gain as well as market consolidation as auto screens become larger with high specifications. Another area of content gain is auto relays, where high voltage from EVs can drive ASP two to three times higher.

The EV transition is expected to lead to rapid change in competitive landscape as well. For example, one of China's leading gearbox manufacturers has only an 8% market share in the traditional ICE market. However, for the EV market, the manufacturing process requires far greater precision, and this added complexity creates higher barriers to entry. As such, this company has achieved a 50% market share and gained a dominant market position.[6]

Q5: Finally, what happens if a portfolio holding were to break into the ranks of the top 100 Chinese mega-cap stocks?

The China Evolution Equity Strategy seeks to invest in potential future winners at an early stage of their life cycle. Compounders are rare, and once we find them, we hope to stay invested and let them compound value for our clients. So, we don't have to sell when our portfolio companies become mega-cap stocks. However, we constantly evaluate each position in our portfolio. There should be good reasons for the mega-cap to remain in the portfolio. They'll have to continue to meet our expected return target and still have strong growth prospects.

[4] T. Rowe Price ballpark estimate for illustrative purposes only, as of June 2022. Actual outcomes may differ materially from estimates. Estimates are subject to change.
[5] Source: T. Rowe Price analysis of industry data, as of June 2022.
[6] Sources: T. Rowe Price analysis, company disclosure FY2022.

Risks—the following risks are materially relevant to the portfolio:

Country (China)—Chinese investments may be subject to higher levels of risks such as liquidity, currency, regulatory and legal risks due to the structure of the local market.

Currency—Currency exchange rate movements could reduce investment gains or increase investment losses.

Emerging markets—Emerging markets are less established than developed markets and therefore involve higher risks.

Small and mid-cap—Small and mid-size company stock prices can be more volatile than stock prices of larger companies.

Stock Connect—Stock Connect is subject to higher regulatory, custody, and default risks as well as liquidity risk and quota limitations.

Volatility—the performance of the portfolio has a risk of high volatility.

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