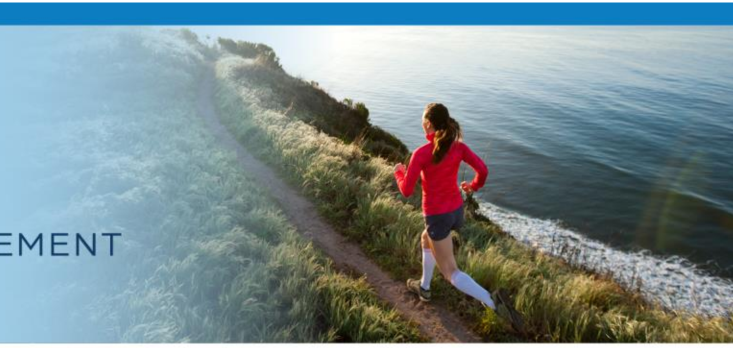
On the Road

WITH ALPHINITY INVESTMENT MANAGEMENT



Who	Where	When
Johan Carlberg	**China**	**September 2023**

Location

What were you looking for?

China's economic recovery since the Central Government's Covid lockdown pivot in November last year has been patchy. Expectations of a strong rebound were initially running high but after a decent March quarter concerns resurfaced as the economy, and especially the property sector, slowed again. Following a particularly weak July, the Central Government announced a number of policy easings to support credit growth and the property sector. Commodity prices and share prices have reacted favourably to the announcements.

Alphinity travelled to Hong Kong and mainland China in September to find out to what extent the stimulus measures were having or could soon be having a real impact on economic activity and consumer confidence. This was our third trip to China in 2023 and since the travel restrictions were lifted.

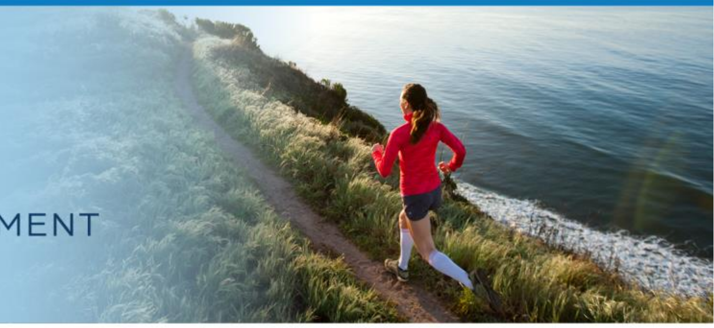
We also wanted to better understand the Chinese auto market and its rapid transition to EVs which will have important implications for participants along the supply chain to the Chinese auto industry but also globally as China advances its competitive position.

What did you discover?

Our travels took us to Beijing in the north, Nanjing east-central China, Fuzhou across the strait from Taiwan as well as Shanghai. Despite only covering a small part of the country this still required close to 20 hours of domestic travelling on airplanes, high speed rail and minibuses, reminding us of the size of China.

We came away thinking that those expecting a sharp rebound in property construction activity over the next 6-9 months are likely to be disappointed. While the stimulus measures have been welcomed by most, an initial flurry of activity with increased property sales in key cities as well as stronger loan growth appears to have lost momentum in more recent weeks. Most observers on the ground acknowledge that after years of overbuild it will take a lot more for the sector to recover to the degree that construction activity will rebound meaningfully. Such expectations also appear off the mark in terms of the intent of the Central Government. The stimulus is more targeted at restoring confidence in the property market, the main store of wealth for Chinese citizens, rather than set off another building boom. Stable or gently rising prices after a couple of years of declining property values that were at risk of accelerating to the downside is likely to be what the Government would like to see. On the positive side, we would expect more stimulus to be forthcoming until this has been achieved.

And for the overall economy the outlook is probably not as bad as some of the commentary would suggest. Firstly, while still an important driver of the Chinese economy, property is no longer as dominant as it once was. Other sectors are showing better prospects including manufacturing and infrastructure where some projects that got slowed down before credit restrictions were eased are now underway again. In addition, like we have seen in other parts of the world post covid lockdowns, the Services sector has recovered strongly with growth of around 20% year to date. So all up, we don't see a significant reacceleration in economic growth in the near term but equally a further stalling of growth looks overly pessimistic.



Medium term the challenge for China to transition to a consumer led economy from one relying on fixed asset investments (FAI), such as Property and Infrastructure, is building as new FAI becomes increasingly unproductive.

On the Electric Vehicle front the world leading growth rates are becoming visible on the streets in the main cities of China, especially in the south. With the multitude of Chinese auto brands (some estimates put them well into the hundreds) an innovative system where EVs (including hybrids that are also gaining popularity) have green license plates and traditional combustion engine cars, or ICE as they are increasingly becoming known as, have blue license plates it is easy to get an idea of how common EVs are becoming. With sales estimates as high as 35% of total auto sales EVs now represent just under 5% of the total car fleet in China. However, in cities like Shanghai this number appears to be quickly approaching 50% i.e. every second license plate is green.

Despite the strong growth rates, or perhaps due to, the Chinese EV market is fiercely competitive, and most EV makers are loss making. However, it appears clear already that some national champions will emerge as winners. Already at scale producers such as BYD are solidly in profits and likely to become a badge that we will see in most global markets where geopolitics don't keep them locked out of in the decades ahead. From an Australian company perspective where interests are mainly a long way down the value chain in lithium mining and lithium hydroxide and carbonates, the supply demand tightness from a year ago has evaporated. Despite strong long term demand for EVs, the overbuild of battery capacity in China as well as the rapid expansion of lithium production globally appears to not yet have found an equilibrium. EV sales growth has also somewhat disappointed high expectations this year in Europe. However, they remain solid in the US where increased subsidies are supporting demand. Separating underlying apparent consumption trends from shorter term inventory cycles is always inherently difficult but a stronger pricing cycle appears some time off with several industry players mentioning 2025 as the first year with a more balanced demand/supply outlook.

What does this mean for the Alphinity portfolio?

Alphinity's Australian portfolios are underweight in the Resources sector. The actual impact of recent months' stimulus announcements is likely to be more muted than commodity and share price reactions appear to be factoring in, in our view. We exited Iluka during the September quarter as zircon and rutile prices are likely to be negatively impacted by the subdued Chinese property market. Iron ore and met coal prices have been resilient as steel production has surprised positively year to date. Slower seasonal demand and the risk of some steel production caps (though likely to be less strictly implemented compared to the last two years) may impact prices in the December quarter. We will be monitoring this development closely as price expectations for next year look comfortably achievable and provide upside to earnings expectations.