QUARTERLY COMMENTARY

30 September 2024

Manager Update: October 2024

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The announcement of a wide range of monetary policy measures by China's central bank on September 24th triggered an impressive jump in Chinese equities. The announced measures included:

- -0.5% cut in bank reserves (injects ~RMB1trillion long term liquidity)
- -0.5% reduction in mortgage rate (reducing household interest expense by ~RMB150bn pa)
- RMB500bn swap program to fund stock purchases by securities firms, funds and insurance companies
- RMB300bn lending facility to fund stock purchases by major shareholders and stock buyback programs

The central bank also said there could be further liquidity injections before the end of 2024 and multiple expansions of the stock market support programs. The message was clear that China would do whatever it takes to achieve near-term economic goals and support the stock market.

Following a two-week epic rise, equity prices have since retraced a lot of their prior gains. The question remains: have Chinese equities turned the corner? We think yes, and refer readers to previous comments in our 2024Q1 and 2024Q2 quarterly reports. The latest measures are further evidence backing our assertion that the rules of the game have changed, and **reinvigorating equity valuations is one of two crucial policy directives** of the Chinese government.

To understand the importance of this policy, the characteristics of the average Chinese household needs to be understood. Compare the extreme difference in savings rate of the average Chinese household to developed market peers and then note the similarity of this savings behaviour to the top 1% wealth class in the U.S. (see Appendix). Consumption behaviour is likely similar where the wealth effect plays an outsized role. Given majority of Chinese household wealth was previously invested in residential real estate, this could mean changing house prices alone was a primary factor in reducing consumer confidence and spending.

Of course, the government has no desire to revive the housing bubble and the current suite of property easing measures was slowly and incrementally put forward only to stabilise the situation. In contrast, the government wants stock prices to rise, and the policy support is clearly targeted at raising equity's share of household savings. Why? Because solving for the wealth effect by supporting the stock market substitution of real estate could be a key part in restoring consumer confidence.

Additionally, the scoreboard nature of the market may help reignite a positive confidence cycle across risky assets and the real economy. Over the long-term, a healthy stock market is the best solution to absorbing China's large household savings and efficiently funding productive assets. Significant stock market reforms earlier this year[1] aimed at improving listed company quality and shareholder treatment were part of this policy planning.

Many economists and industry experts may disagree with this line of reasoning, and many believe only a big bang fiscal stimulus can save China. Fiscal stimulus will happen, but it is unlikely to be the massive infrastructure projects of the past or mass helicopter money type spending. Both are seen (rightly so in our opinion) as wasteful and unsustainable. China's Minister of Finance gave indications how this would play out in a press conference on October 12, 2024 when he said that the central government has significant room to increase debt and the deficit, and announced a host of measures which effectively translated to recapitalising local governments. This, we think is the **second crucial policy directive – the central government uses its balance sheet to bail out local governments**. Resolving local government budgets would immediately unblock a large part of the real economy and will be the primary way in which future tailored fiscal programs (e.g. affordable housing) get implemented.

The central government's capacity to fund its policies is high and timing, in terms of FX and debt market conditions, is good. We've seen increasing urgency at the top levels of the government to address the economic problems while China's track record for policy co-ordination and implementation is excellent. This gives us confidence that China can successfully restructure and move onto the next phase of growth quickly. Also, importantly, the lessons of moral hazard and accountability have clearly been seared into the minds of the current generation. Perhaps the current crisis was inevitable in China's economic development pathway. Whatever the case, we think the way it's being handled is both fiscally responsible and appropriate. Within the current policies, we can see echoes of Ray Dalio's 'beautiful deleveraging' and Soro's 'theory of reflexivity' being put to practice. The Chinese are pragmatic above all else.

[1] Good summary in the April 18, 2024 Bloomberg article: "China Aims to End Age of Froth with New Stock Market Reforms"

Moving back to the equity value recovery question, lastly consider that Chinese household bank deposits is now ~US$20trillion (U.S. households ~$4trillion) while the entire A-share stock market capitalisation is ~US$11trillion (SHSE $6.6trillion + SZSE $4.4trillion) and HK stock market ~$4.7trillion. The immense size of household bank deposits to local stock market capitalisation relationship is not found anywhere else in the world (and Chinese households have no alternatives but domestic assets). With government policy simultaneously reducing bank deposit rates and pushing money into supporting the stock market, it seems inevitable that prices will rise. Longer term, a stock market bubble might even be unavoidable (closed capital account with high savings rate – capital must pool somewhere).

Short term, volatility could remain high as the market debates and comes to terms with the Chinese government policy measures. We aren't too worried about this and see bigger immediate risks hiding elsewhere such as the U.S. elections in November (and the aftermath). Government sponsored buying will eventually sustain a bigger capital participation cycle which will flow from the domestic A-share market into offshore Chinese equities via sentiment and the stock connect programs. Prices inevitably follow capital, and investors inevitably follow returns.

We admit to moving away from our primary field of competence in evaluating these macro issues. However, having firm conviction and perspective on the bigger picture is necessary in extreme markets such as this. Furthermore, this is one of the rare occasions where we hold a strong minority top-down view that is as important, if not more, to immediate investment actions and returns as our bottom-up fundamental analysis. Regardless of top-down conditions or bottom-up valuations, we believe both are aligned in favour of Chinese stocks rising from here.

Fund Update

Our net fund performance this quarter was 3 months: 29.8% and YTD: 6.9%. Performance is still nowhere near our long-term expectations but we're optimistic the turning point is near.

During the initial two-week equities boom, we focused on managing risk by adjusting our portfolio composition and accumulating dry powder. We were well positioned entering this period of volatility and market pullback.

Our portfolio remains predominantly offshore listed Chinese technology and consumer goods companies. Their fundamentals are good and we're confident they will continue to grow their cash profits and market share. Capital returns should also meaningfully step up over the next year.

Finally, we welcome our first batch of new investors into the Fund and thank our existing investors for further expanding their support. We will work hard to deliver on your trust.

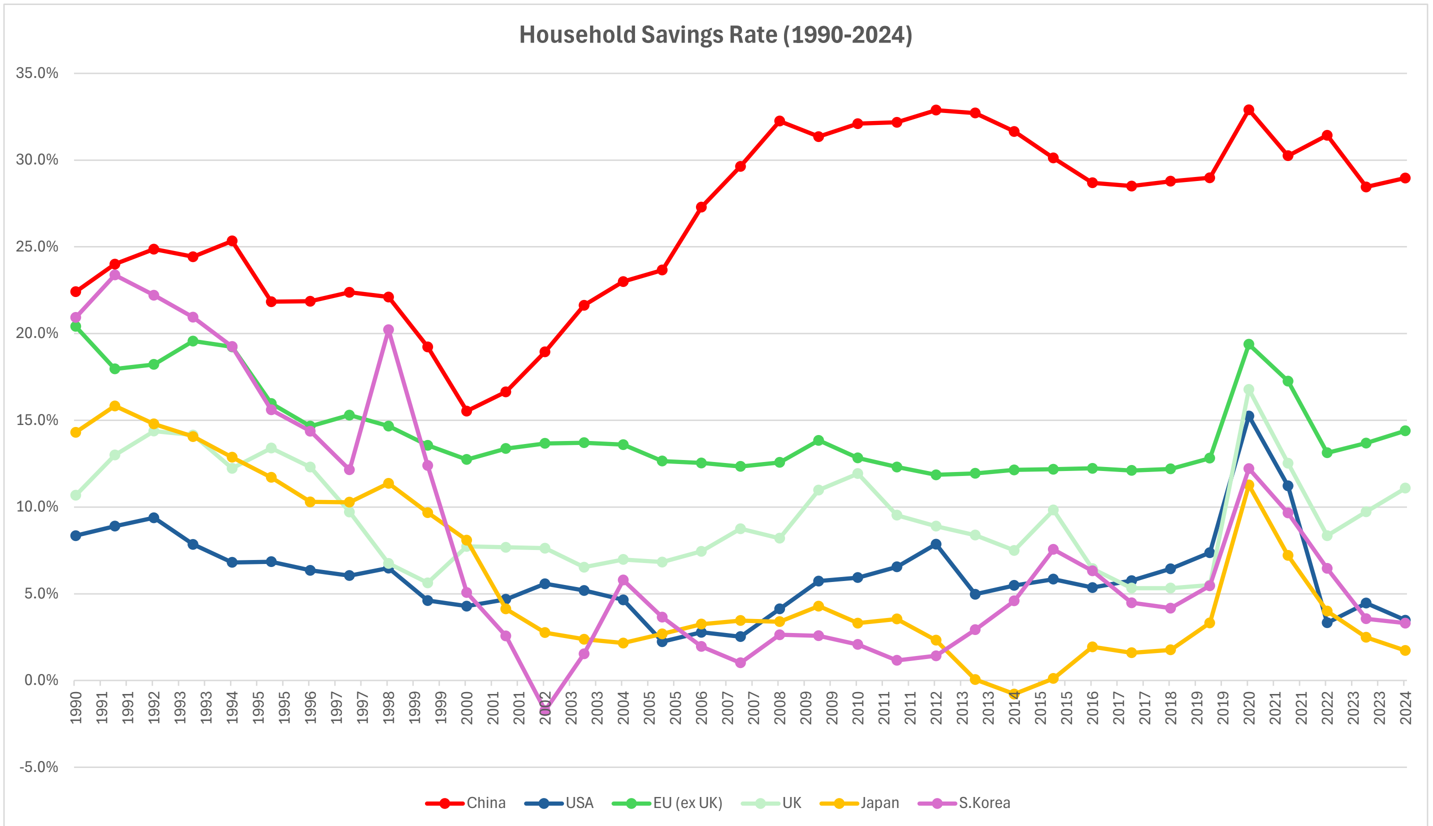
Portfolio Overview

ORLOG CAPITAL

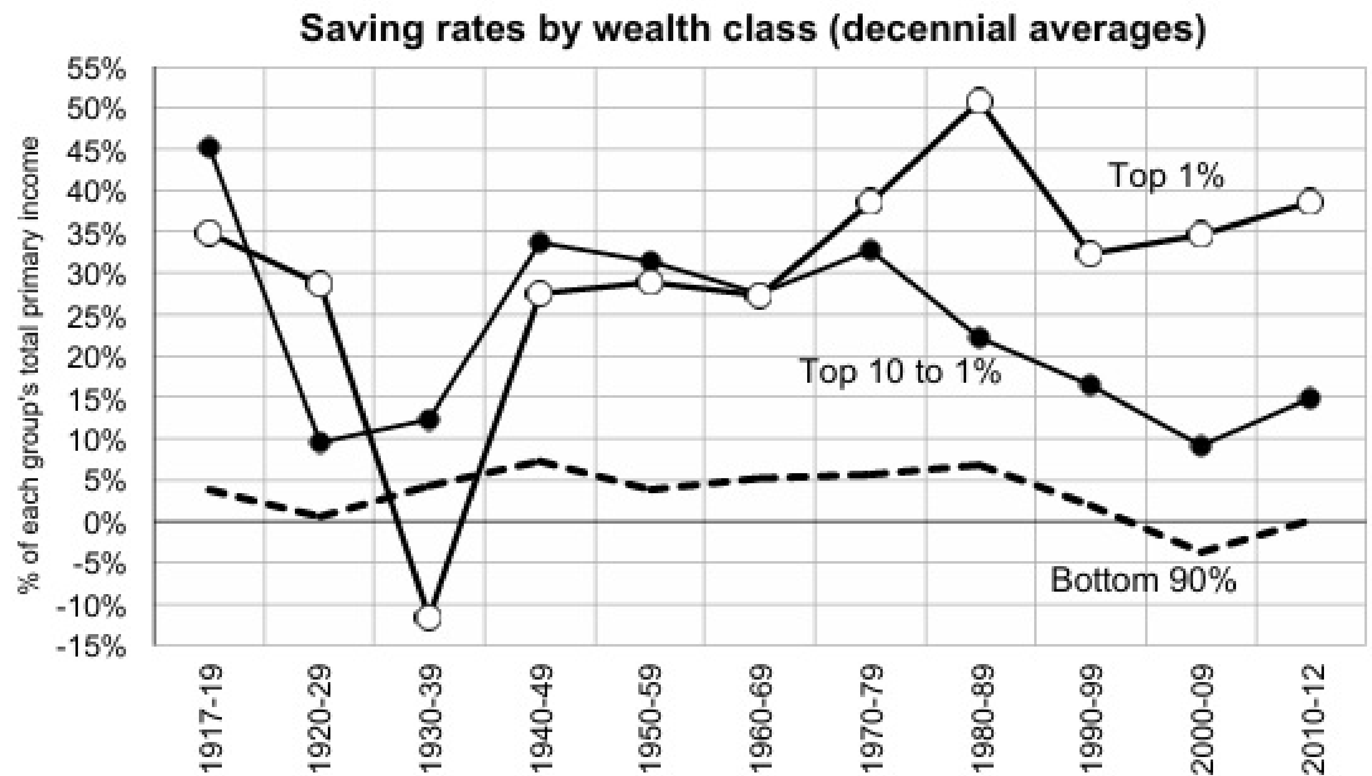
Top Five Major Holdings (in alphabetical order)	
Alibaba	E-Commerce
Dada Nexus	E-Commerce
Full Truck Alliance	Logistics
JD.com	E-Commerce
Sands China	Casino

Performance	
Annualised Net Returns in US$[1]	
Since Inception (Jan 3, 2022)	1.1%
1 Year	4.3%
Non Annualised Net Returns in US$[1]	
Year to date	6.9%
3 months	29.8%
6 months	14.5%
Net Returns By Year in US$[1]	
2023	-27.8%
2022	33.4%

1. Net of 1.5% annual management fee and 20% performance fee (excess return above 5% hurdle rate and subject to HWM)



Source: Oxford Economics



Source: Emmauel Saez and Gabriel Zucman (2014). Wealth Inequality in the United States since 1913

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