

CHINA MONTHLY

AUGUST 2023

The Briefing 1

The Essay 2

China's Uneven Consumer Recovery

The Big Picture



China's first home-grown large cruise liner, the Adora Magic City, completed its first sea trial in July. It represents a significant technological advancement for China, being the last type of high-end ship that the country had yet to produce.

THE BRIEFING

Top Echelon Support for China's Entrepreneurs

China's Central Committee and the State Council, the country's Cabinet, issued a rare joint communique in July, detailing 31 measures to drive the development of private enterprises. They range from market entry, fair competition, legal protection, financing support, and fundraising, to the protection of intellectual property rights and innovation input.

China Regulators Meet Global Investors

China Securities Regulatory Commission vice-chairman Fang Xinghai, accompanied by regulators from the securities watchdog and the Asset Management Association of China, met global investors in July. They discussed topics like steps to ensure global funds can continue to invest in China, procedures for overseas initial public offering registrations, accelerating listings in mainland China, as well as relaxing mergers and acquisitions rules, sources said.

Slower than Expected Growth

China's 6.3% YoY 2Q GDP growth missed expectations, with the 0.8% QoQ pace of growth slowing from 1Q's 2.2% QoQ pace. Analysts polled by Reuters had predicted a 7.3% increase in the 2Q GDP.

Digital Yuan Transactions Hit Milestone

Nearly USD250 billion of transactions have taken place using China's digital yuan in the one-and-a-half years since the start of its pilot, People's Bank of China governor Yi Gang told a conference in Singapore in July. This is an increase of over 70% from the value of central bank digital currency transactions in August 2022.

Cooperation on Climate Change

US climate envoy John Kerry and his Chinese counterpart, Xie Zhenhua, who have known each other for over 20 years, spent over 20 hours in days of talks in China, deliberating ways to more rapidly reduce reliance on coal-fired electricity, pare methane emissions, and deploy renewable power. Both sides have committed to more negotiations and to "work intensively" to make progress, Kerry said.

We Never Forget Our Old Friends

Chinese leader Xi Jinping told Henry Kissinger "We never forget our old friends," during a meeting with the 100-year-old former US Secretary of State who was in Beijing for a surprise visit. "China and the United States are once again at the crossroads of where to go, and the two sides need to make a choice again," he said, urging Kissinger and like-minded Americans to "continue to play a constructive role in bringing China-US relations back to the right track."

CHINA'S UNEVEN CONSUMER RECOVERY

By Wang Jiayuan

China's post-Covid consumption recovery has fallen short of many investors' expectations. The recent 618 sales event, for example, was much weaker than expected and outbound travel has remained well below pre-Covid levels. However, we would describe the recovery as uneven and not an indication that the long-term trend in consumption upgrading has ended. In this note, we will explore the drivers behind the divergent trends and their investment implications.

There are a few notable features in the uneven consumption patterns. The first is the economy transitioning to being primarily driven by innovation, away from traditional sectors such as real estate. Although innovative companies are growing much faster, it will take time for this group to collectively offset weakness in the old economy, which currently accounts for a larger portion of GDP. This leads to the issue of youth unemployment, which is currently running at historical highs. We believe this is transitory as there is a mismatch of demand and supply, with manufacturers unable to find enough workers as university graduates no longer wish to take on these manual, labour-intensive jobs. The increasing automation of manufacturing will transition workers to higher value-add functions such as systems controllers, but this process will continue for many, many years. Lastly, the Covid period has severely weakened the balance sheets of small-to-medium-sized enterprises. Because China was relatively conservative in fiscal and monetary support during the Covid period, these companies will need time to recover, after which consumer confidence will follow suit.

These factors have led to what we characterize as an "M-shaped" recovery – with high-end and low-end consumption faring better than mid-range segments. Spending by businesses has also performed relatively well, while there are idiosyncratic factors that are hobbling the e-commerce players.

China E-Commerce June 2023 – No Bang for Big Bucks

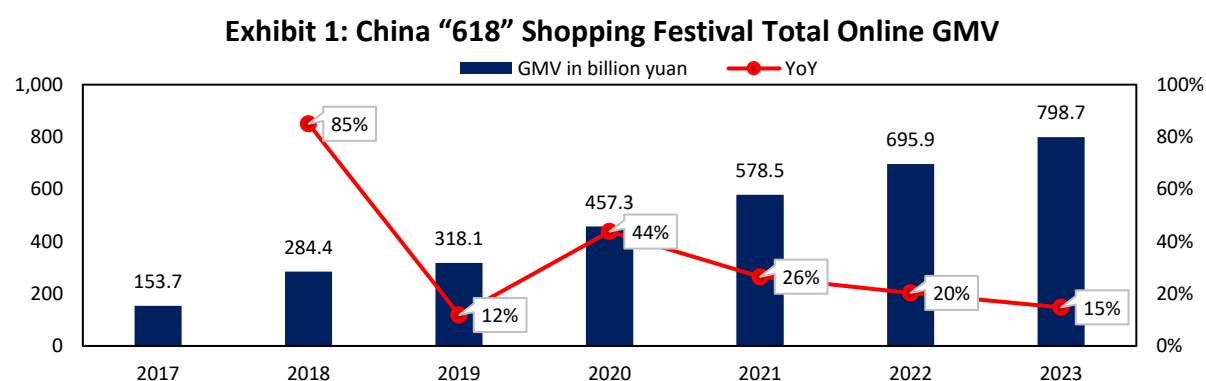
The "618 Shopping Festival" is one of China's two biggest annual e-commerce festivals. In 2023, while China's major e-commerce companies supposedly spent the most on promotions, they garnered the poorest returns. Almost no e-commerce platforms or merchants/brands released after-action "battlefield reports", in stark contrast from the past three years. This e-commerce festival is widely regarded as a window into Chinese consumption. What happened?

Race to the Bottom – China’s 2023 618 E-Commerce Festival

As the first major sales promotion after three years of Covid, this year's “618” bore the weight of great expectations: it was not only seen as a starting point for consumption recovery in the post-Covid era, but also a test balloon for the strength of recovery.

Both Alibaba and JD.com claimed 2023 to be their largest 618 investment in history, and they had hoped to make this 618 the springboard promotion of their turnaround. However, in a departure from past years, none of the “Big Three” of Alibaba, JD.com and Pinduoduo (PDD) announced their GMV, unlike the emerging live streaming e-commerce companies Kuaishou and Douyin.

According to retail data provider Syntun, during this year’s 618 (from May 31 to June 18, 2023), the three traditional e-commerce platforms had sales of CNY614.3 billion, up 5.4% Year-on-Year. Sales by live streaming e-commerce firms reached CNY184.4 bn, up 28% YoY but massively trailing 2022’s explosive 124% YoY growth. The combined 618 sales from all online platforms totaled CNY798.7 bn in 2023, up 14.7% YoY to pip 2022’s 13.5% YoY growth, signposting a moderate rebound in consumption growth.



Source: Syntun

However, we must note the low base last June, with Shanghai only fully reopened from June 1, 2022 and with affluent cities in the region similarly affected. Logistics were just recovering while consumers were still finding their feet. Against this backdrop, this year's 618 recovery should be considered as tepid at best.

Furthermore, the e-commerce price wars are heating up. Taobao has added a growing number of low-priced products in the "3 yuan for 3 pieces" and "9.9 yuan for 3 pieces" pricing formats. JD.com has started offering more support to small and medium-sized merchants, cancelling platform usage fees for JD.com’s smaller merchants, and it is helping more merchants selling low-priced unbranded goods to quickly open stores on JD.com.

Exhibit 2: E-commerce Platforms' 618 Price War (Taobao, JD.com, PDD, and Douyin, from Left to Right)



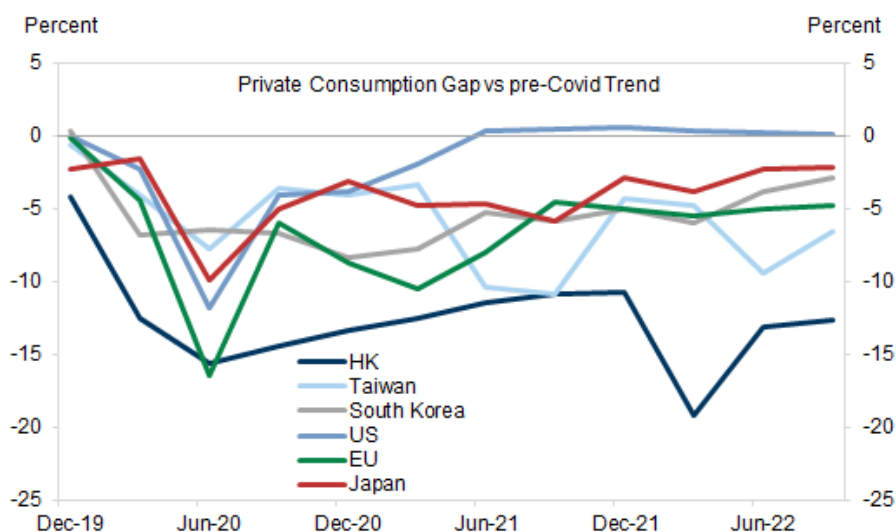
Source: Taobao, JD.com, PDD, Douyin

China's Comparatively Quick Post-Reopening Consumption Rebound

While the world's developed economies exited Covid lockdowns earlier than China, the pace of recovery varies between economies as well as segments. The United States government offered subsidies to boost goods and services demand, and has recovered to pre-Covid levels by now. America's services sector took a year to return to normal after mask mandates were eased from July 2021.

However, consumption in other major economies such as the European Union, Japan, and South Korea had not recovered to pre-Covid trend levels after one year's reopening.

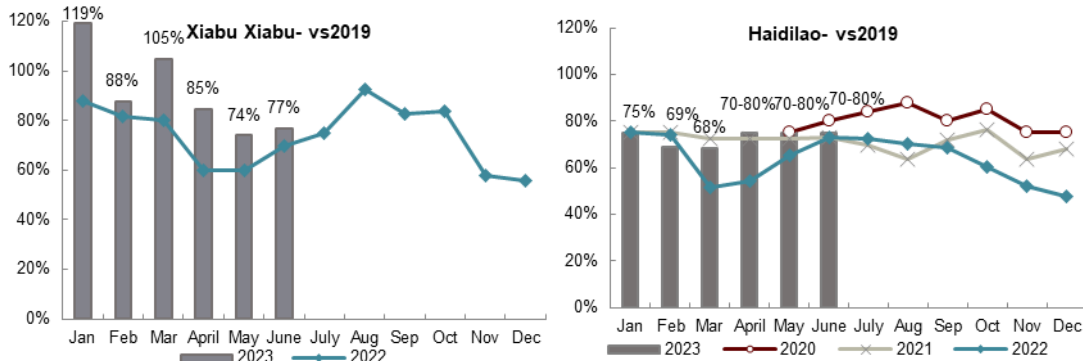
Exhibit 3: Select Developed Economies' Consumption Recovery Paths



Source: Goldman Sachs

China has had a quick rebound in certain areas while other segments lagged. After reopening across the nation from the end of November 2022, restrictions on mobility were eased. The pent-up demand for domestic tourism kept rising for six straight months.

Exhibit 4: China Hotpot Chain Restaurants Recover to 70%-80% of Pre-Covid Levels in June 2023

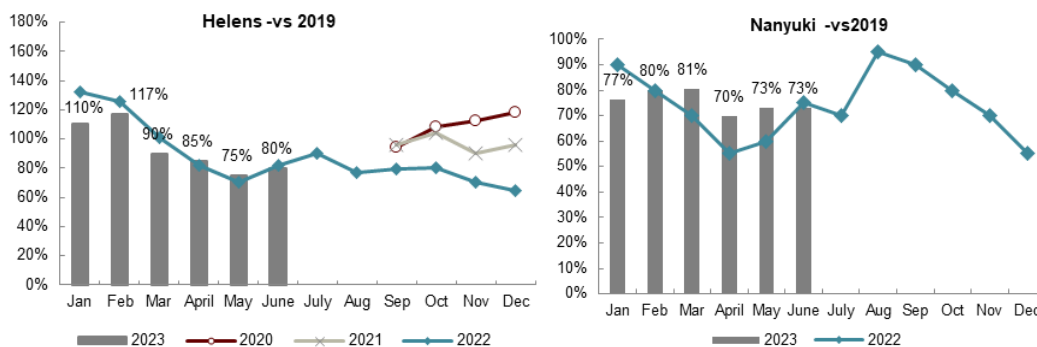


Source: CICC, Company Data

Restaurants, however, are a window to discern ordinary consumers’ basic needs. Both high-ASP (average selling price) Haidilao and low-ASP Xiabu Xiabu are still 20%-30% below pre-Covid levels. Xiabu Xiabu's pent-up demand fizzled out by 2Q2023.

On top of that, both high-ASP milk tea Nanyuki and Helens, a chain of bars, lost steam in the second quarter. This pent-up demand quickly ebbed, especially for highly discretionary consumption where the customers are mainly young people, a demographic facing challenges in securing employment.

Exhibit 5: Milk Tea Nanyuki and Bar Helens Fizzle Out in 2Q2023



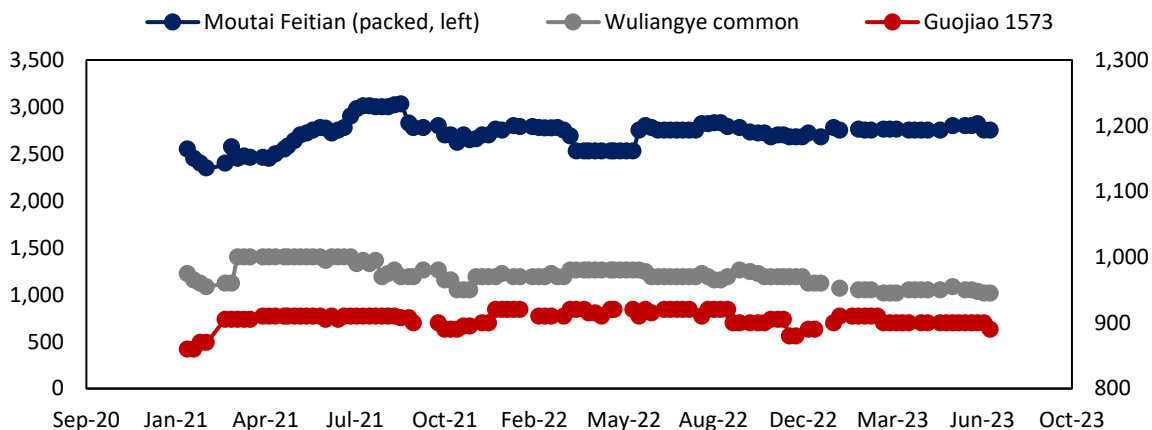
Source: CICC, Company data

M-Shaped Recovery in Liquor: High-End and Low-End are Strong While the Middle Sags

Liquor is the largest consumption sub-sector by market value in China’s stock market.

Sales for top-of-the-line premium liquors, such as Moutai and Wuliangye, have not been affected by the weak economic recovery, supported by solid demand for gifts and business banquets. Strong brands have gained market share from weaker brands.

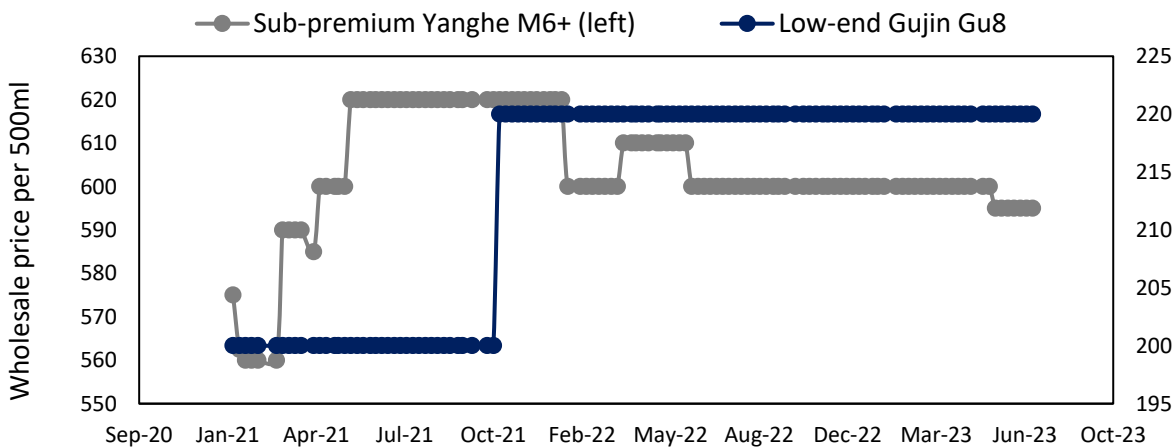
Exhibit 6: Moutai is Most Robust in Its Price While Two Other High Premiums Slightly Weaken in Price



Source: Changjiang Securities

Mid-range liquor, such as Shede Liquor, Jiugui Liquor, Gujing Gongjiu Gu20, and Yanghe M6+, experienced comparatively weak sales. Taking Shede as an example, 60% of its demand comes from businesses while 30% comes from banquets related with weddings and social gatherings. In the past, demand was driven by the real estate sector.

Exhibit 7: Sub-Premium Liquor Dropped Its Wholesale Price While Low-End Held Its Price



Source: Changjiang Securities

Consumption patterns have shifted away from drinking lots of mid-range liquor such as Shede, to drinking top-end liquor like Wuliangye, but in smaller amounts. In a weaker economic environment, brand equity has become more important than ever.

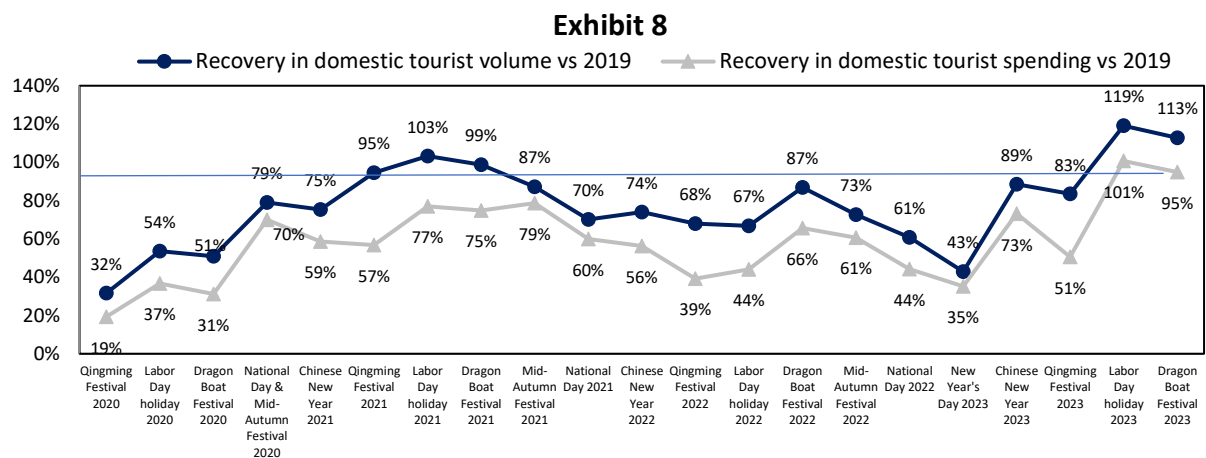
Mid-range liquors have also lost out to low-end offerings priced at CNY200 to CNY300 a bottle, such as Gujing Gongjiu Gu8 and the Yanghe Haitian series. Business banquets for less lucrative industries or clients have been downgrading in this regard.

This is a typical M-shape differentiation in consumption, with the high-end and low-end simultaneously taking bites out of the mid-range segment.

M-Shaped Recovery in Tourism

In prosperous times, the middle-class upgraded to outbound travel, but in tough times, they downgraded to domestic trips. This is what is taking place in China.

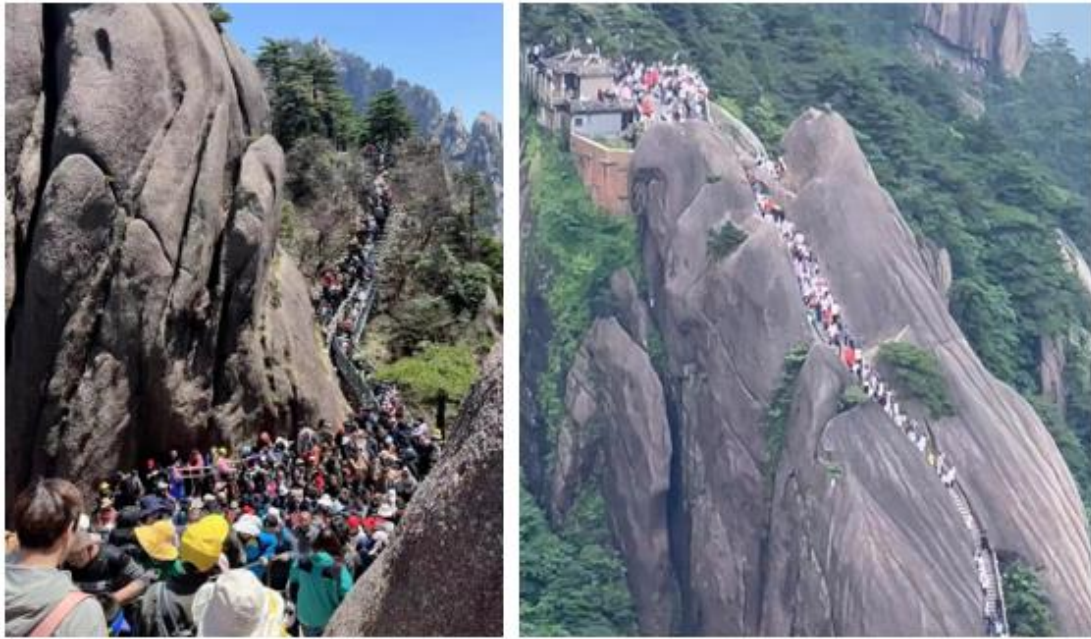
After China’s economy reopened in late 2022, domestic tourism rebounded to pre-Covid levels as mobility restrictions were scrapped, while international travel has remained a fraction of its prior peak. Six months into the recovery, domestic tourist volume had exceeded the pre-Covid level, but expenditure is not robust yet as travellers are spending prudently.



Source: Ministry of Culture and Tourism of the People's Republic of China

At the low end, tourists crowd destinations like mountains that only charge a bit over CNY100 per visitor. Take the 2023 Dragon Boat Festival holiday period as an example. The Yellow Mountain received 123% more visitors than in 2019, accelerating from 119% more during the May Day Holiday a month prior. For the Zhangjiajie Scenic Area featuring karst landforms and caves in the middle of China, the corresponding figures were 133% and 110% respectively, also an acceleration. Low-end domestic tourism is enjoying explosive growth.

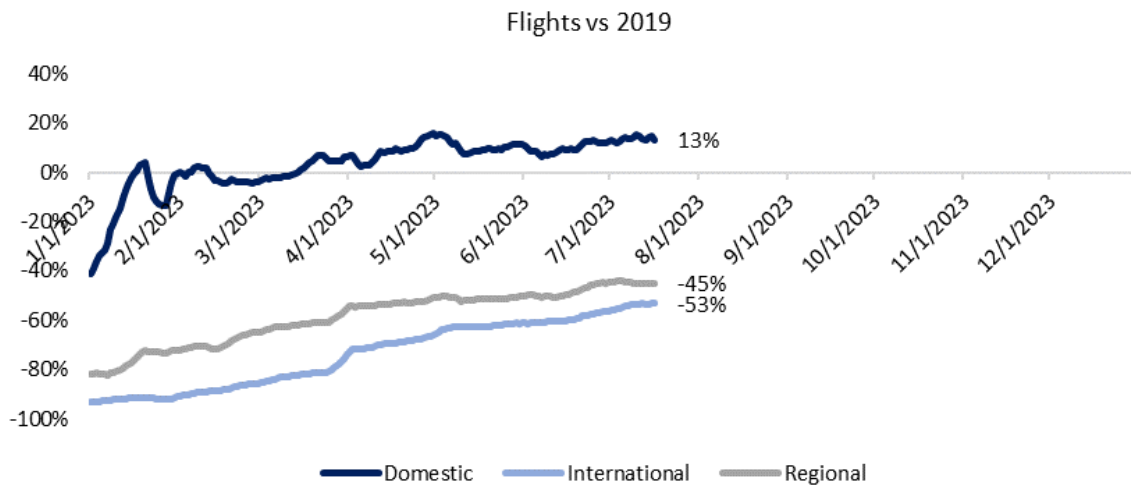
Exhibit 9: Tourists Queuing on the 1,864-metre Yellow Mountain



Source: RED

Domestic flights have been strong, climbing 13% from 2019. Meanwhile, international flights are only 50% of the pre-epidemic level, albeit improving from only 33% in May 2023. We think a great number of consumers are downgrading to domestic travel.

Exhibit 10: Domestic and International Flights Have Divergent Recovery

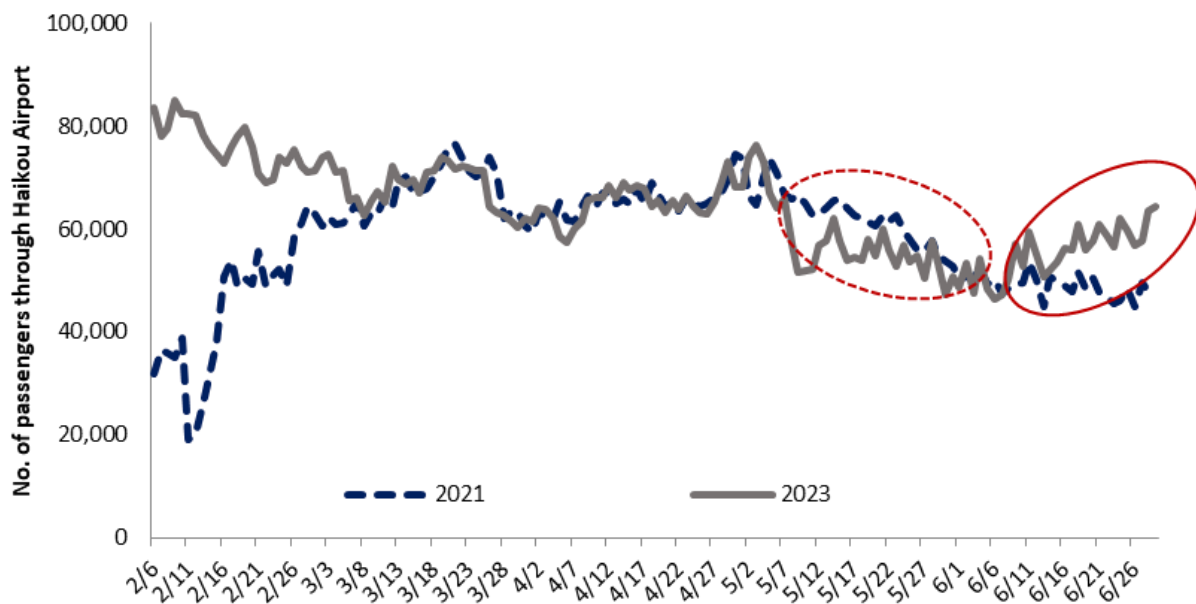


Source: Goldman Sachs, Flight Master

Duty-Free and Value-for-money

In China, the duty-free industry met the newly affluent middle class' demand for the consumption of entry-level luxury goods, mainly selling brand-name cosmetics and high-end leather goods. During the Covid outbreak, Hainan Island was practically the only major island destination available to Chinese citizens, and the island's duty-free industry has seen an explosive growth. Contrary to expectations, after last year's reopening, visitors across the country flocked to Hainan. Recently, the number of passengers received by Hainan's Haikou Airport has recovered to 100%-110% of the pre-Covid level.

Exhibit 11: Tourists to Hainan Slipped in May but in June Surpassed 2021 Numbers



Source: CICC

In 2Q2023, the categories of “Grain and food” as well as “Tobacco and alcohol” were the bright spots in the recovery of consumption, rising 6.1% and 5.6% respectively in terms of a two-year CAGR. It is interesting that the Chinese spent more on food, tobacco, and alcohol no matter the economic environment. Categories that fared comparatively worse were apparel, cosmetics, home appliances and furniture, beverages, and cars.

Exhibit 12: Retail Sales in 2Q2023: Food, Tobacco, and Alcohol are Core Needs

Retail sales (100 million)	2yr CAGR (2021-2023)				2023-06	2023-05	2023-04	2023-03	2023-01&02	2019
	Avg 04-06	2023-06	2023-05	2023-04						
Total					39,951	37,803	34,910	37,855	77,067	411,649
YoY	2.7%	3.1%	2.5%	2.6%	3.1%	12.7%	18.4%	10.6%	3.5%	8.0%
Cumulative online retail sales (YoY)	8.0%	8.0%	8.2%	7.7%	13.1%	13.8%	12.3%	8.6%	6.2%	16.5%
Clothing, shoes and hats, knitted textiles	1.5%	4.0%	-0.7%	1.1%	6.9%	17.6%	32.4%	17.7%	5.4%	2.9%
Furniture	-4.2%	-2.8%	-4.0%	-5.7%	1.2%	5.0%	3.4%	3.5%	5.2%	5.1%
Cultural office supplies	-2.7%	-0.9%	-2.3%	-4.9%	-9.9%	-1.2%	-4.9%	-1.9%	-1.1%	3.3%
Gold and Silver Jewelry	4.5%	7.9%	2.5%	3.0%	7.8%	24.4%	44.7%	37.4%	5.9%	0.4%
Grain and food	6.1%	7.2%	5.6%	5.4%	5.4%	-0.7%	1.0%	4.4%	9.0%	10.2%
Beverages	2.5%	2.7%	3.4%	1.2%	3.6%	-0.7%	-3.4%	-5.1%	5.2%	10.4%
Tobacco and alcohol	5.6%	7.3%	6.2%	3.4%	9.6%	8.6%	14.9%	9.0%	6.1%	7.4%
Cosmetics	1.5%	6.4%	-0.3%	-1.7%	4.8%	11.7%	24.3%	9.6%	3.8%	12.6%
Daily necessities	0.5%	1.0%	1.0%	-0.6%	-2.2%	9.4%	10.1%	7.7%	3.9%	13.9%
Home appliances and audio-visual equipment	-1.2%	3.8%	-5.4%	-1.9%	4.5%	0.1%	4.7%	-1.4%	-1.9%	5.6%
Chinese and Western medicines	8.0%	9.2%	8.9%	5.8%	6.6%	7.1%	3.7%	11.7%	19.3%	9.0%
Communication equipment	3.2%	6.6%	8.4%	-5.3%	6.6%	27.4%	14.6%	1.8%	-8.2%	8.5%
Petroleum and products	7.0%	5.9%	6.2%	9.0%	-2.2%	4.1%	13.5%	9.2%	10.9%	1.2%
Cars	1.8%	6.1%	2.1%	-2.8%	-1.1%	24.2%	38.0%	11.5%	-9.4%	2.8%
Construction and decoration materials	-9.5%	-5.9%	-11.3%	-11.5%	-6.8%	-14.6%	-11.2%	-4.7%	-0.9%	-0.8%

Source: China Bureau of Statistics

We are upbeat about value-for-money products, such as low-to-medium-priced sportswear, low-to-medium-priced brands in household appliances, and low-to-medium-priced products in snacks. Clothes, food, and domestic travel are life's little affordable luxuries that the average Chinese citizen will not forgo. Products meeting consumers' basic needs will prosper, like Uniqlo becoming the world's largest clothing company by market value after surviving the business environment of 1990s Japan.

For young Chinese people, the consumption of "little luxuries" for "little happiness" is still sought after. For the youth in first-tier and second-tier cities, there is still strong demand for leisure activities, but their tastes have changed. Investment opportunities primed to profit from this shift are not easy to find, because companies in the past were accustomed to expanding their margins by raising prices. Their product prices need to make a U-turn to catch the typical young Chinese consumer.

Business Spending May Recover Quicker than Consumer Demand

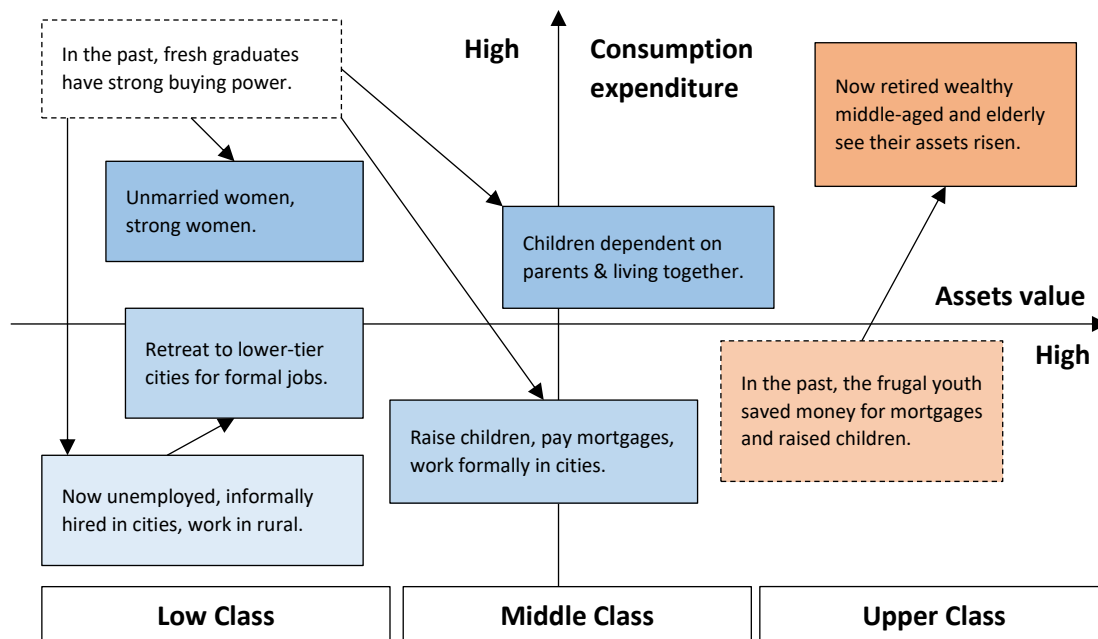
Expectations for fiscal stimulus from the central government are gradually increasing, after Premier Li Qiang recently called for a package of economic stimulus plans to boost the economy.

The industries that are directly stimulated by fiscal policies will likely be the first to usher in a recovery. Large enterprises firstly obtain orders from the government, and small enterprises then obtain subcontract orders from those large enterprises. This process is accompanied by business needs and gift-giving needs, so both high-end liquor and sub-high-end liquor will benefit. Therefore, we are positive on consumption derived from increased business activity.

Rise of the Silver-Haired Consumer

Chinese citizens born in the 1950s, 60s, and 70s, aged between 50 and 75, enjoy the Chinese economy’s speedy growth over the past 50 years. Now they are asset-rich, with empty nests as their children have formed their own family units. This silver-haired generation now have both time and money. They are likely to become a major force for Chinese consumption.

Exhibit 13: Wealth Redistribution is Behind the Change of Consumption



Source: APS

For the middle-aged consumer, quality of life is the priority. They would be willing to upgrade from low-to-mid-range liquor to sub-premium or even premium bottles. Air conditioners could be upgraded to premium brands. Healthcare products showed a year-on-year growth of 38% in this year’s 618 e-commerce festival. There is strong resonance with slogans like “You had worked hard, and it is now time to enjoy”.

Temporal Down Shift

Despite the mixed short-term consumption landscape, our long-term thesis on consumption upgrading remains intact. China’s middle class will continue to grow but will be increasingly driven by innovation rather than traditional sectors such as real estate. We believe much of the negative cyclical and transitory issues have already been factored into current stock prices. Therefore, we remain positive on the Consumption Upgrading alpha cluster but will be discerning and focus on companies with attractive fundamentals.

Wang Jiayuan joined APS in February 2023. He has nine years of research and investment experience covering the consumer sector. Previously, he was at Industrial Securities and FengHe Fund Management. He graduated from the Hong Kong University of Science and Technology with a Master's degree in Economics, and from Nankai University in Tianjin with a Bachelor's degree in Economics.

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