



## CHINA OPPORTUNITIES MARKET COMMENTARY

2Q 2023

### The Quarter in Review

For the quarter ending June 30, 2023, the China Opportunities Composite returned -6.41% (-6.75% net of fees) compared to -9.71% for the MSCI China Index, an outperformance of 330 bps (296 bps net of fees). Year-to-date, the Composite returned -7.95% (-8.57% net of fees) versus -5.46% for the MSCI China Index.

Amid an economic recovery that has so far been significantly lighter than expected, Chinese equities declined in the second quarter, in contrast to the rebound seen in most other countries. China's manufacturing PMI in June was a disappointing 49, marking the third consecutive month of readings below 50. PMI readings under 50 are indicative of contraction. Profits of industrial enterprises fell 18.8% in the first five months of 2023. With continued slowness in Europe and the United States, exports were also a drag. Exports fell 7.5% in May in U.S. dollar terms. The macroeconomic slowdown has also led to a sluggish change in private investment of -0.1% in the first five months. Retail consumption was one of the few bright spots, with retail sales increasing 9.3% from January to May, driven primarily by offline services. While the Chinese economy has made some progress since its reopening six months ago, the recovery has not been robust and recovery to a healthy economy remains elusive thus far.

Muted policy response to the slow economic recovery has also frustrated investors. Chinese policymakers are clearly aware of the recent slowdown. Economic growth was re-emphasized as a priority at the Politburo meeting in April. There have been some policy changes: The Chinese government reduced its loan prime rate (LPR) interest rate by another 10 basis points and extended tax benefits for new energy vehicles. Premier Li Qiang also vowed at the Summer Davos Forum in Tianjin to launch new monetary and fiscal measures to shore up the economy when necessary. However, the introduction of more aggressive stimulus policies have been constrained by structural problems, such as high macro leverage and a shrinking labor force. Economic weakness combined with the lack of effective stimulus has put pressure on highly leveraged sectors. Local government debt has become the latest market focus. During the epidemic, in order to cope with the impact of the COVID-zero policy, local governments carried out aggressive stimulus packages to stabilize the economy. Land revenues have fallen sharply due to the decline of the real estate market over the past two years. As a result, local governments in some economically underdeveloped areas have experienced severe liquidity pressures. While we believe local government debt is unlikely to pose a systemic risk in the near term, it has further reduced investor risk appetite for Chinese equities.

In addition, geopolitical risk continues to weigh on global investors' allocation to Chinese equities. Although U.S. Secretary of State Antony Blinken resumed plans for a visit to China that was previously cancelled after the balloon incident, such a visit seems unlikely to lead to any substantial progress under the current circumstances. The fund flow into Chinese mainland equities through the Connect Programs was muted in the second quarter. Inflows were only RMB3.8bn vs. 180bn in the first quarter. In any case, the resumption of high-level communication between China and the United States should be a decent first step toward stabilizing bilateral relations and preventing further deterioration of the relationship.

Although the overall market economy was rough this past quarter, our portfolio performed better than the benchmark because we still found pockets of growth. For example, Generative AI has been the hottest investment theme this year after Microsoft launched ChatGPT. As first glance, this might not seem to benefit Chinese companies. While they are actively deploying generative AI big models, Chinese companies have difficulty procuring the most advanced processing chips due to U.S. sanctions. On the other hand, Chinese and Taiwanese companies occupy a pivotal position in the AI server and chip supply chain. These companies will continue to benefit from the emerging wave of technology. Such companies were also the main source of our outperformance in the quarter.

#### AVERAGE ANNUAL TOTAL RETURNS (as of June 30, 2023)

	QTD	YTD	1 Yr	3 Yr	5 Yr	10 Yr	Since Inception 10/1/2005
<b>China Opportunities (gross of fees)</b>	<b>-6.41%</b>	<b>-7.95%</b>	<b>-24.76%</b>	<b>-8.79%</b>	<b>-1.35%</b>	<b>6.08%</b>	<b>10.57%</b>
<b>China Opportunities (net of fees)</b>	<b>-6.75%</b>	<b>-8.57%</b>	<b>-26.13%</b>	<b>-10.06%</b>	<b>-2.66%</b>	<b>4.79%</b>	<b>9.18%</b>
MSCI China Index	-9.71%	-5.46%	-16.82%	-10.26%	-5.27%	3.05%	6.47%

**Past performance is not necessarily indicative of future results. Performance is historical and includes the reinvestment of dividends and other income. Unusually high returns may not be sustainable. The strategy invests in rapidly growing smaller and medium-sized companies that may offer greater return potential. However, these investments often involve greater risks and volatility. Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations. Net-of-fee composite returns are calculated using the highest model investment advisory fees applicable to portfolios within the composite. Advisory fees are disclosed in Part II of Form ADV.**

*Oberweis Asset Management, Inc. ("OAM") is an independent investment management firm that is not affiliated with any parent organization. The composite returns are comprised of all fully discretionary accounts with a minimum value of \$5 million. Performance results, from 10-1-05 until 10-1-06 as well as 5-1-08 to present, are derived solely from the performance of the Oberweis China Opportunities Fund, a registered, open-end mutual fund, for which OAM serves as investment adviser. Accounts are dollar-weighted within the composite and reported in U.S. dollars.*

*The MSCI China Net Index is a free float-adjusted market capitalization-weighted Index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong Exchange, and B shares listed on the Shanghai and Shenzhen exchanges and P chips and foreign listings with minimum dividends reinvested net of withholding tax. It is not possible to invest directly in an index.*

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### Outlook

It's hard to find optimists on China these days, but from our vantage point, we find it easier to find opportunities when few others are looking. We don't have to bet on the broad Chinese economy. We just need to find 50-100 companies whose fundamentals are not appropriately reflected in their stock prices. When pessimism rules and valuation multiples contract, this exercise becomes significantly easier.

Also, if there is one sure thing, it is that the Chinese government can pivot and pivot quickly when times require. While we recognize that policymakers prefer austerity over stimulus right now, we believe their hand will be forced in the second half. We expect that the Chinese economy will continue to gradually recover, against a backdrop of very low investor expectations, but not enough to hit the new administration's 2023 growth targets.

Above all, the government seeks social stability and the current conditions left unchecked could pose a threat. Over 20% of China's youth remain unemployed. At the current rate of economic growth, it will be difficult for the government to achieve the growth targets they set at the beginning of the year. Falling short of growth targets in the first year of a new administration would yield a loss of face, and we expect the government will pull out all the stops to prevent this. This means that we expect to see significant stimulus in the balance of year, which we believe will put upward pressure on economic growth and eventually corporate earnings.

China's economy is undergoing a major transformation. The ongoing upstream transition to an economy driven by consumption and technological innovation will make it even more competitive globally. This process comes with significant uncertainty, but also with many new investment opportunities. Despite the short-term pressure, we are still positive on China's long-term growth outlook and most importantly in our ability to find undervalued opportunities, particularly at today's equity valuations. Chinese stock valuations are compelling, both in absolute terms and relative to those in other geographies. The MSCI China Index is trading at a P/E ratio of 10x forward 12 month estimates with 17% estimated earnings growth in 2023 and 14% growth in 2024.

Our strategy will continue to focus on misunderstood companies undergoing positive fundamental changes when we believe such changes have not been fully understood by the market yet. It's rare that GDP is the primary determining factor in the success of most of our holdings. Instead, we look for niche-oriented companies whose success is more predicted on product success, market consolidation, regulatory changes, and the evolution of new markets in China. In the quarter, we found new ideas in information technology, renewable industrials and consumer discretionary. Generally, these companies are leading players in niche markets whose growth is more predicated on product acceptance than on overall GDP growth. Many such ideas are beneficiaries of the ongoing structural economic and social changes occurring in China.

### Portfolio Highlights

During the quarter, the portfolio was 98.1% invested in 67 companies. The biggest performance contributors were information technology, industrials and consumer discretionary. On the contrary, our biggest performance detractors were financials, consumer staples and health care.

### Organization Update

There was no change to the team during the quarter.

### Oberweis Asset Management's Investment Philosophy

We believe that investing in smaller companies driving revenue and earnings growth in excess of expectations results in superior investment performance over long periods of time. We believe that innovation is the key to economic growth and wealth creation and are committed to investing in companies at the forefront of innovation – smaller company stocks that offer the potential for extraordinary revenue and earnings growth.

The entrepreneurial spirit is alive and well at these companies. Many are nimble and uniquely address the needs of their customers with patented new products and services. Successful investing, however, demands more than finding companies with good growth prospects. We must also buy these stocks for our clients at prices that make sense. By paying careful attention to companies' valuations in relation to expected earnings growth rates, we seek to purchase stocks when they still have considerable appreciation potential.

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