Larry Cheung, CFA: Patreon Investment Community Research Updates
September 1st Half Strategy Report (9.1.22-9.15.22)

Title & Thesis: Jackson Hole has reminded investors that inflation must come down, and the Fed will not stop their mandate in accomplishing this goal. Now, after proper risk-reduction discussed previously, we are in the position to hunt for the proper time to partially re-enter positions. Prior bearish opinions were shared with high conviction. With the markets approaching equilibrium near-term, I expect whiplash at the index level more than a clear directional trend. I am putting a few companies on my watchlist and eyeing entries. Stock-Selection opportunities are discussed in this report.

For context, please make sure to read my previous updates leading up to this one so that you understand my thought process.

Important Note: Make sure you're in our Discord Channel where I provide timely updates in between formal updates like these ones here. If you enjoy my research, please share your experience with friends/family who could benefit from my work. TY as always.

Dear Friends, Members, and Patreon Investment Community,

Over the past several weeks, in my public content on Youtube, Twitter, Email List, and our Research Notes here, I've taken this opportunity of elevated equity prices to go all- out to share my opinion that this price range has been a critical level to reduce risk (translation: reduce equity exposure). In August I turned particularly bearish on Semiconductors as the sector had made a tremendous rally that was completely out of sync with its current fundamental outlook. I also discussed that the 4200-4400 region for the S&P 500 was met with incredible risks. All these opinions were shared numerous times in my Patreon posts as well as my previous Bi-Weekly reports, Monthly Slide Decks, and Research Dashboard. If you review my August Slide Decks, you will see that I cut a majority of my exposure in key names such as AMD, NVDA, and LRCX along with other names as well.

This latest wave of volatility in Semiconductors and Technology is of course unpleasant, but its effects are greatly minimized for you and me (I would hope).

While my research opinions have materialized in my favor, I want to remind our friends here that my research is intended to aid your thinking and your strategy. Please treat my investment strategy as just one more data point in your overall investment journey. I do not want members blindly following my guidance - I want to teach you how to think. I want to be your mentor and Strategist.

This way, just like a mentor and mentee relationship, even when I do not comment on markets on a specific day, you may be familiar with my thinking and can surmise "this is what Larry may do based on his research process."

You will notice that I do not comment every day on Discord. I comment only when I feel I have an important strategy update. This is by design. If I were to comment too frequently, my village will start shortening their investment timeline, and think shorter term in terms of strategy. IMO, that is a dangerous path to go down. Action should be taken when appropriate. But action does not need to be taken every day. My pacing of commentary is designed to condition the mind to be more patient, and think more long-term.

Long-time members enter September hopefully in a position of strength based on our guidance provided. New members & friends are now here seeking clarity on the road ahead. If you are new, welcome - make sure to review my previous research pieces before reading this one. For all of us, I will continue to do my best to guide. There are no guarantees ever in this market, but I will do my best to share with you a strong process from which to make decisions.

In addition to investment strategy, once volatility cools down, I'll also discuss aspects related to personal growth and perspectives that will take your career to the next level. Within the context of being an Investment Strategist, I also wish to serve as a role model inside our Community. For now, markets are top of mind - so let's get started.

I want to take the first couple minutes to share with you a technique I use to complement my fundamental, macro, and technical analysis: sentiment analysis. In each of my reports, when timely, I like to blend in some investor education to sharpen your skills in this dangerous market.

As a Content Creator on various social media platforms, I am in a unique position of receiving many different comments throughout the ongoing market environment. The language in the comments section gives me hints at general sentiment. Every voice is independent, but added up together, they begin forming a crowd view. On top of this, based on the CPM (cost per mille) data that I receive on each Youtube video I produce, I also understand what the general search term volume is heading. Because of this, I have a pulse on where the crowd is leaning because of all the data that comes through my channels.

And in the past several weeks, I particularly noticed that Bullish retail investors were shaming Bearish twitter accounts for their views while the market approached its 200 Day Moving Average. This type of commentary was more emotional than rational.

You might have noticed in my videos that I purposely ask my audience on Youtube to follow me on Instagram, Twitter, or my email list. The first reason is obvious - to ensure that everyone can follow my up to date thoughts.

The second is more strategic, related to investment strategy. By having a larger audience pool, this allows me to increase my sample size to measure sentiment. During days of intense market volatility or extreme euphoria, I get multiple DMs across Instagram asking me for my thoughts.

For example, when Alibaba falls 5 or 7% in a day, I can almost always expect at least 10 people DM-ing me about this on Instagram. You think I'm kidding about this, but I am not.

In general, the more toxic the comments and the greater the volume of such commentary, the closer we are to a vicious turnaround towards the other direction. Timeline is of course uncertain, but a turnaround is brewing. As a prime example, you can observe the number of "opinionated" comments in my Michael Burry video where many of my viewers attacked Burry on his views of being bearish.

If you read the nature of these comments, they were not constructive criticisms towards his "approach." They were primarily personal comments that were directed towards Michael Burry himself.

In linguistics, this type of language is typically categorized as emotional. Emotional language often means the mind isn't using complete logic in its decision-making.

So what do we make of all this?

As we've seen, using emotions to approach investment strategy is no sustainable approach. Regardless of your timeframe (near-term, intermediate-term, and long-term), it's very important to separate emotions (influenced by prices) from your decision-making (which should be influenced by research).

This is perhaps one of the most important guiding principles that allows investors to stay true to their research findings and stick with a strong process, even when the market's emotions make prices temporarily disconnected from where they should be.

I'd rather use a good process and be periodically wrong, than to have the wrong process and be on a hot streak and be "right".

Always remember this. With this blurb on sentiment analysis finished, let's talk strategy.

Quick Conclusions, Followed By Research and Actionable Guidance

If you've been following me for a while now, you would know that I approach the market from the perspective of active research using macro and fundamentals. I then use technical analysis to identify local potential entries and exits.

In previous Bi-Weekly notes, I've focused very heavily on Macro. This report will focus a bit more on my thinking related to company-specific considerations and general themes that I think may work better from here. Macro is incredibly helpful to understand where the general indexes are going (SPY, DIA, QQQ). In previous reports, I could afford to be bold and let everyone know that markets would make a large retracement. I had ample evidence to support my thesis (valuation, macro, technicals, positioning).

However, with the indexes now reaching more of an equilibrium, it is objectively more likely that the indexes face more of a whiplash action than a clear trend. In other words, from here, if I were a short-seller, I would find shorting S&P 500 at 3900 to be a gamble. It was a clear winner at 4300. But at 3900? It's a gamble.

What about on the long side? At 3900, starting a new long S&P 500 position is ALSO a gamble.

Previously, when the counter-trend rally produced an 18X forward multiple and 73 RSI on S&P 500, I was nearly sure that a big retracement was coming. Today, with the S&P 500 back at a 34 RSI and ~16X forward, I believe we face more choppiness than a clear directional trend over the next 2 weeks. Over the intermediate-term? Most likely we still face incredible challenges ahead.

Let's do a quick recap of what has happened to refresh your memory.

Over the past 4-6 weeks, we witnessed the following situations (a very brief overview):

- In July we got an uncomfortably high June CPI reading north of 9%. U.S Markets started bottoming on this fact on the premise that 9% may have been a local high.
- At July FOMC, the Fed said that they may be slowing rate hikes at a future point down the road. Markets rallied strongly on this interpretation of a dovish pivot
- Around the same timeline, the markets received significant support from Apple, Microsoft, Google, and Amazon earnings to support the goldilocks narrative.
- In mid August, we witnessed July CPI coming in at 8.5%, lower than expectations. Markets used this as an opportunity to push the narrative that inflation is finished. S&P 500 approaches its 200-Day Moving Average (18X Forward Earnings)
- At Jackson Hole, the Fed reiterates their stance to bring down inflation and that one-month of data falls far short of what they need to see. Equities reprice. And here we are back at S&P 500 around 4000 (+/-1.5%).

- In the meantime, to bolster China's economy, Chinese officials and PBOC unleash new monetary stimulus and fiscal stimulus measures.

In other words, from S&P 500 3636 to 4320 (a move of nearly 700 points) the market had digested 2 CPI reports with falling YoY inflation, 2 Job Reports that indicated economic strength, and FAANG Earnings that all nearly beat expectations.

These ingredients made the goldilocks scenario (economic growth is good, but not hot enough to get Fed more hawkish) appear increasingly plausible.

In fact, IF (big if) we do somehow get a goldilocks scenario to play out, the S&P 500 can indeed recover materially from here.

The problem is, I don't see how we will get a goldilock scenario.

Here's why. After reviewing the most updated earnings call transcripts available, here is what I found

- Last quarter, Apple reported that their business experienced next to no macro weakness. They discussed their iPhone segment and saw no signs of slowing down and that the consumer was still really strong (excuse me?)
- Last quarter, Microsoft discussed another record quarter where their deals and pipeline of large billion dollar contracts exceeded investor expectations.
- Visa discussed no consumer spending slowdown and said that consumption remains very healthy
- And Home Depot says that there are no cracks in the housing market, yet discussed that it is their Pro client base that is the strongest.
- NVDA earnings was one of the most bearish fundamental events I've seen in Semiconductors for a long time. Their average selling prices (ASPs) dropped significantly, and their gross margin profile went from 65% to low 40% range. Their forward guidance was also very soft. Needless to say, at NVDA's valuation, this type of gross margin profile is nearly unacceptable for value investors. Growth investors might entertain this, but value investors will not enter or keep NVDA at these valuations. There will be a time to re-enter NVDA. I believe we will have our chance soon. Keep NVDA on your watchlist, but no position should be taken until the QQQ and SOXX ETF can stabilize.

Look, I trust the management teams at the Fortune 500 to be as honest as they can when it comes to their guidance when they speak with the sell-side. But this type of commentary from Apple, Home Depot, and Visa is incongruent with the economic reality that the U.S. has been in over the past 9-12 months. And it will be even more clear that this type of optimistic commentary will have to be revised in coming quarters.

This leads me to my biggest concern: that this past quarter, or perhaps this upcoming immediate quarter will represent "peak earnings."

What this means is that the set of earnings results that we just saw from the FAANG companies is nearing its peak in terms of EPS strength, gross margin strength, and sales growth outlook. And from here, the guidance becomes a bit more challenging. Management discusses cracks in their customer base, and they see growth slowing.

When the S&P 500's most important component - Apple (7% weight of S&P 500 index) - reported its "blockbuster" earnings on July 28th, the S&P 500 traded at 4080. Apple at the time traded at 157. Now AAPL is back near 155 (always treat +/-1.5% Margin of Error) around the date of this report.

While the market advanced after Apple earnings, it subsequently retraced all of those gains and more. What this tells us is that the Buyside is just as skeptical as I am about the optimism that these companies are conveying, and that the coming quarter or two will be the biggest test for this market.

As of right now, the market is now ironically a bit too focused on inflation data and CPI. Of course, inflation remains extremely important, but in the coming weeks, I expect Apple's iPhone launch on September 7th to be a more important fundamental event than the flurry of economic data that we receive.

Why is this you may ask?

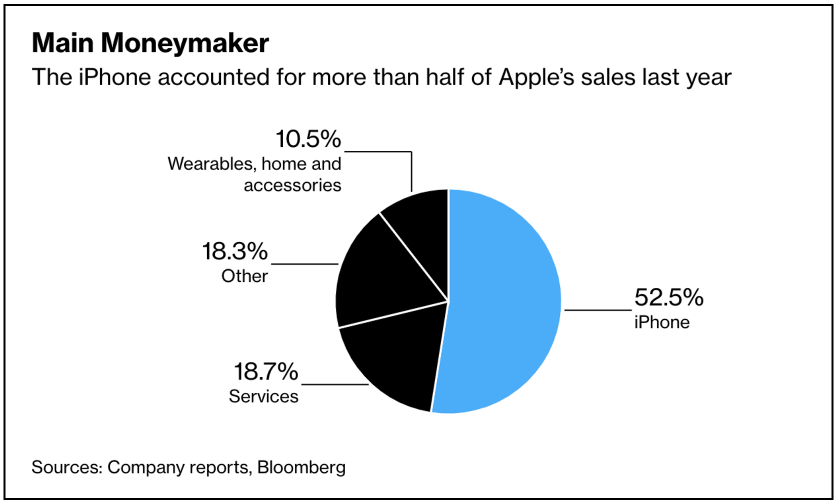
Follow my logic.

We know Apple is 7% of the S&P 500, and also a top component in the Nasdaq and the Dow.

Apple is represented in almost every major growth fund and mutual fund.

There is an entire ecosystem of companies that depend on Apple's strength - namely semiconductors (SOXX names).

And the iPhone is approximately 50% of Apple's business revenue.



The current cash cow profit driver of Apple's business is their Services segment, which includes their App Store, iCloud Storage, and Apple music. Their services segment accounts for nearly one-third of Apple's gross profit. In order for Apple to continually get more users to participate in their Services segment, they need to continue penetrating deeper and deeper into the smartphone market with their iPhone upgrade cycles.

In other words, the iPhone is the top of funnel business product (which is already very profitable), but the Services segment serves to be a long-tail RECURRING revenue stream for the company as users use their phones to use more apps and store more photos/videos (hence requiring more "services" via App Store and iCloud).

On top of the iPhone being essential to Apple's core hardware business model, the iPhone launch is perhaps one of the cleanest data points to understand consumer confidence in the coming weeks and months.

There is a significant amount of complexity in how economic data is reported and measured. But understanding consumer sentiment will become a lot easier if you know where to focus.

And for me, I'll be focusing on Apple's highly anticipated iPhone 14 launch.

Apple has not yet released official pricing for its iPhone 14. There are multiple camps that are greatly debating whether the iPhone 14 will be more or less expensive than the iPhone 13 (pricing table below).

I personally believe if Apple prices the iPhone 14 too high, they risk alienating a large consumer base in this macro environment.

Yet if they price lower than last year, they will see near-term headwinds in their gross margin profile since supply chains have made their input costs go up, which will give Wall Street a reason to compress AAPL's multiple.

Either way, while Apple has fallen 10% from my previous report, I still believe the company is trading with a valuation too expensive that offers investors little margin of safety.

At least for the next 2 weeks, the market knows that the Fed's intention is now firm, regardless of what happens in the next CPI or jobs report.

So while other analysts are going to keep talking about inflation, I'm going to revisit inflation analysis in my 2nd Half September report, and focus on fundamental catalysts that could be driving the market's action in the coming weeks.

That catalyst is Apple's iPhone launch on September 7th.

In my opinion, should AAPL fall under 150/share, the S&P 500 will have a very difficult time defending 3900. If Apple remains under 150, the S&P 500 is likely to remain under 3900. I'm personally bearish on Apple. But for the sake of bulls, I hope they stabilize so that the market can recover.

There is a lot to learn from this launch event, and offers aspiring fundamental equity analysts a powerful opportunity to understand their business strategy (besides from just an investment perspective)

iPhone 13 specs: All models compared

	iPhone 13 mini	iPhone 13	iPhone 13 Pro	iPhone 13 Pro Max
Starting price	$699	$799	$999	$1,099
Storage	128, 256, 512GB	128, 256, 512 GB	128, 256, 512, 1TB	128, 256, 512, 1TB
Screen size	5.4 inches	6.1 inches	6.1 inches	6.7 inches
Resolution/ppi	2340 x 1080/476	2532 x 1170/460	2532 x 1170/460	2778 x 1284/458
Adaptive refresh	No	No	Up to 120Hz	Up to 120Hz
Processor	A15 Bionic	A15 Bionic	A15 Bionic	A15 Bionic
Rear cameras	Dual 12MP (Wide,	Dual 12MP (Wide,	Pro 12MP (Telephoto,	Pro 12MP (Telephoto,

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Potential Investment Themes / Companies that we can put on our Radar

Here's what we can all agree on: if the Fed continues on their current path of raising rates beyond the neutral rate into restrictive territory and rolling its Balance Sheet off with its planned 95B reduction, the economy will only continue to soften from here.

What can be **nearly sure** of is the following: rising unemployment, continued weakness in consumer confidence, and slower business confidence.

If these are the expected (and nearly guaranteed facts), how should we position ourselves in the coming 6 months?

If I could buy a call option on rising unemployment, I would 100% do so because that is a macro trend virtually guaranteed to open.

Unfortunately, we aren't able to do that.

So to answer this question, we need to understand what are the asset classes or sectors that can potentially rise in a weakening economy. **As a very important reminder, the guidance provided here is not yet a call to action to buy today. Never catch a falling knife.** You have plenty of time to scale into these positions as the landscape changes. The purpose of this guidance is to get you to start studying/familiarizing with these sectors so that upon great pricing, you begin to **leg** into these positions carefully.

Here are some investment themes that I believe should be on our radar as we enter the next stage of markets, in no particular order. These are opportunities that I believe will start to appear in the coming weeks and months, which I will continue to provide guidance on.

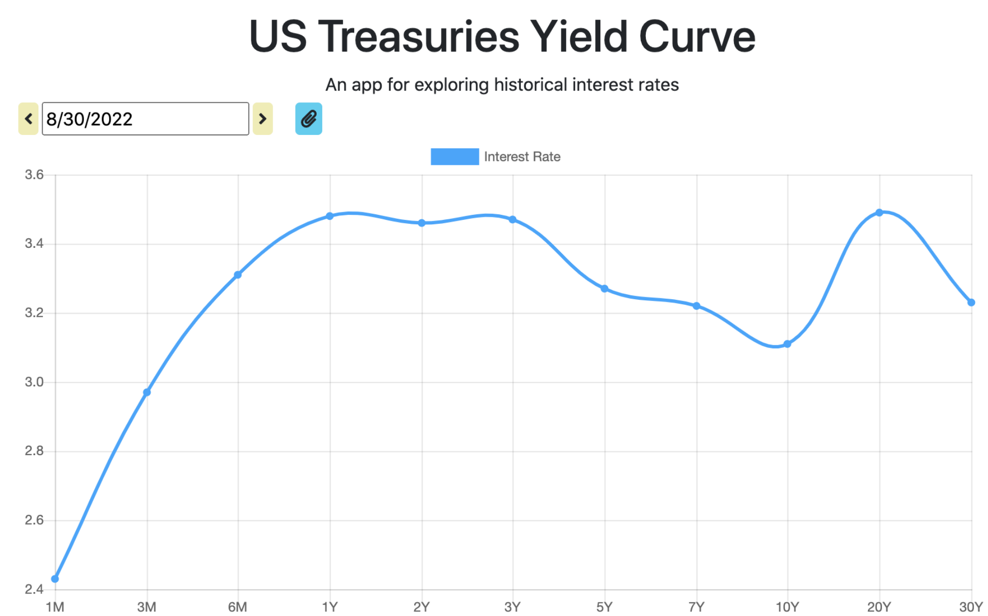
On the Yield Curve

If you are an intermediate-level investor, you should understand how the yield curve works. However, just as a refresher, here's a reminder. The Yield Curve is a representation of the Bond Market's view on the strength of the economy.

<u>In general, here are some principles:</u>

- Upward sloping yield curve: Economic outlook is strong
- Inverted sloping yield curve: Economic outlook is weak
- Humped yield curve: Investors are debating whether monetary policy will influence long-run economic expectations

This is the U.S. yield curve we have as of this report.



Now the short-end of the yield curve (2Y yield) reacts based on the Fed's monetary policy. The intermediate-term and long end of the curve (20Y and 30Y) move based on fixed income investors expectations of the economic outlook.

When the economic outlook is weak, the yield curve will invert, causing the 20Y and 30Y part of the curve to be materially lower than the front end of the curve.

My view is that the economic outlook will weaken further. This means that the long-end of the yield curve should invert further from where it is today. In other words, investors may buy the 20Y or 30Y Treasury bond to lock in higher yields before investors sell other asset classes and buy Treasuries to hide during market volatility.

While the narrative is currently hyper focused on Inflation, I do believe as prices make a fast descent, the narrative of "Deflation" may emerge within 6-9 months. I believe this may happen because the Fed's QT program is going to cause demand destruction, and this will have a more forceful effect on today's prices across our economy.

In an environment where deflation is starting to take hold, Bonds are more attractive than equities because they offer fixed payments.

The way for retail investors to participate in an inverting yield curve (aka weakening economy or deflation) at the long end is through the TLT ETF (proxy for long-end bonds, 20Y maturity or longer).

In terms of levels where I think the TLT ETF is likely to be attractive, here's what we should put on our radar.

- If we see the **20Y go north of 3.8% (currently 3.6%)**, I do think a moderate position (2-3%) in TLT can add alpha/diversification benefits
    - **Going for TLT in the 98-103/share range would be ideal for a starter light position**
- If we see the 20Y go north of 4%, I would say that a 5%+ position in a diversified portfolio in TLT will add alpha.
    - **Going for TLT in the 85-95/share range may reward investors who are positioned in this risk-off theme before everyone else.**

The reasoning behind being long TLT is the same reasoning as locking in bond prices when yields are high. When buyside investors are in risk-off mode, where do they park their cash? They will park them in treasuries, which will drive yields lower and therefore bond prices higher - making the TLT ETF appreciate.

This year, as inflation has soared, investors have dumped fixed income securities and repositioned into asset classes that can be a shield during high inflation.

This trend may not yet immediately reverse, but once the economy begins to falter, investors will be forced to park their capital in risk-off asset classes.

I will alert you when I personally buy the TLT ETF. Right now, I have a 1-2% starter position in the TLT ETF in my 401K.

On Counter-Cyclical Companies

There are a number of companies in my coverage universe that perform better as consumers get more skittish about spending. If the economy weakens substantially, certain companies will actually attract more consumers due to the nature of their business model.

Such companies include Dollar Tree (and its largest competitor Dollar General), Johnson & Johnson, and Kroger.

On Dollar Tree (DLTR) & Dollar General (DG)

Just a quick note: the big difference between Dollar Tree and Dollar General is that Dollar Tree has products sold at $1.25 in its stores while Dollar General sells low priced products but most of them are actually above $1. Dollar Tree also has the Family Dollar brand under its business, and that segment sells products at low-prices (above $1) and that competes with Dollar General.

In the latest earnings call, Dollar Tree discussed closing the gap on competitive pricing in its Family Dollar brand to compete with Dollar General. Obviously, this will pressure margins and impact valuation.

This explains the gap down we saw in Dollar Tree post earnings, whereas Dollar General's decline is less pronounced.

In terms of its risk/reward setup, Dollar Tree's forward multiple is at 18X earnings and its Daily RSI is at 20 (indicating that it's very oversold).

I've started a very small position in DLTR (2-3% of portfolio) in the 135-138 region because of its counter-cyclical business model along with its current valuation and technical setup. I'm also looking to start a position in Dollar General upon further weakness.

If DLTR hits horizontal support at 126, I'm most likely going to add to my position as that represents an objective entry. If DLTR gets to that level, I would most likely raise my stake to 3-4% of my portfolio. I will know I'm wrong about the company if DLTR gets under 110/share, and would set a stop loss at that level. If DLTR is under 110, then unemployment is likely past 3.7-4%. In that case, the entire market would be soft.

In terms of timeline, I believe DLTR is an intermediate-term investment of 6-12 months. The largest swings in these names (both DLTR and DG) take place within a 6-12 month period based on my analysis. The macro environment that benefits Dollar Tree the most is one where the economy is softening and people look for alternatives for their consumer staples, but not an economic downturn that is so disturbing where even the Dollar shops appear expensive (that's what happened in 2008).

While we are currently in an economic downturn, a recovery may take place in the 2H of 2023. An economic recovery would make Dollar Tree and Dollar General less attractive to consumers.

This is why I view Dollar Tree/Dollar General as intermediate-term investments. Any returns north of 10-20% should be capitalized upon, depending on what profit target works for you.

On Johnson & Johnson (JNJ)

JNJ is a premier name in the consumer staples/healthcare space that also has a counter-cyclical nature to its business model. Its products are generally considered to be staples rather than discretionary, and this theme is likely to remain resilient during economic downturns.

JNJ is approaching an objective entry at 155/share at horizontal support. I recently started a new JNJ position at 165 just so that I can track the sentiment. 165/share may not be the best entry, but I needed to get skin in the game so that I can “feel” what other investors are feeling who own JNJ.

Part of the reason my guidance is unique is that I purposely get into the same positions I discuss, which exposes me to the same emotions that investors have in these names.

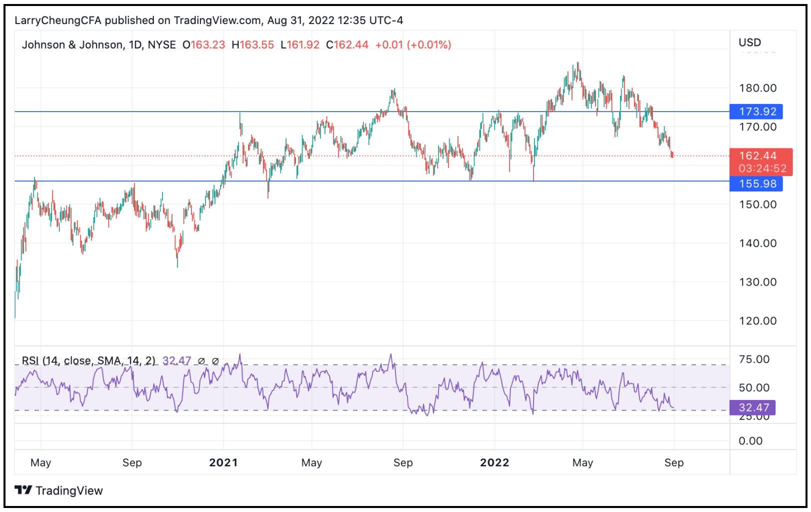
Now obviously, the closer the RSI is to 30, the better for a longer term risk/reward profile. RSI currently 41 as of this writing.

The name trades at 16X forward, which is the lower part of the range in its historical valuation band (see below).

Investors who are able to patiently wait for JNJ to re-enter the 150-155 region may have an opportunity to pick up approximately 8-15% upside from that 150-155 level over a 6-9 month period in a safe manner. Any position started at 165/share has perhaps 6-8% upside. In this environment, those return profiles are considered to be excellent when you adjust for the risk involved. Best we can do is help to identify the best valuation and technical junctures to stack the edge in your favor based on objective data. JNJ sports a 2.7% dividend yield. So you get paid to wait for capital appreciation to work out.

Stop-losses can be set at 140/share. If JNJ falls under 140/share, the entire broad market is likely to be in poor condition. JNJ at 140 most likely means that the Dow is under 30,000.

Remember that in markets, anything can and will happen.



<u>On cyclical companies with relatively lower P/E ratios / safer valuation</u>

I do have a few cyclical companies that I do believe have strong fundamentals. But those are much more tactical and sensitive in nature, and I'll update everyone on Discord when those opportunities come up. This list is obviously higher risk in nature, but in a bounce scenario, you could see 5-7%+ within 2-5 trading sessions. If you want guaranteed gains, book the profits, and do not overstay your welcome. Of course, these are long-term levels as well, but I know that not everyone wants to play the long game so my guidance is prioritized to "win first, hold second."

For now place the following companies on your watchlist for a tactical bounce that may come soon:

- If Adobe reaches 350-355 (RSI currently 28)
- If AMD reaches 70-75 (RSI currently 31)
- If Micron reaches 48-52 (RSI currently 37)

Any position taken in cyclical companies must be carefully positioned, and treated as a bounce idea rather than a long-term investment if you want guaranteed gains. The volatility in cyclical companies right now is not suitable for beginner investors.

Chinese Internet Strategy: China expands their QE program, while the rest of the world continues to tighten their monetary policy. However, the Chinese Internet sector is not immune to a global selloff led by the U.S. I continue to find the sector attractive today, and even more so upon a 10-15% selloff based on systemic selling, contagion, and fear.

Be sure to understand the context of this update on China [by reading my previous update first if you are a new friend in our Community.]()

Chinese Internet Sector KWEB ETF

Over the past two weeks, the macro setup narrative of the U.S. accelerating their QT plans while China accelerating their plan to rescue their economy via QE is especially pronounced. My opinion of China's valuations looking attractive (relative to U.S.) in my last note has continued to materialize in my favor.

However, rising stock prices and the real economy must eventually meet some level of consensus.

Without a doubt, the real economy in China faces formidable challenges. While most China equity analysts are glued to the health of the real estate sector (I am too as well), I'm also focusing on the structural areas of the economy that can actually improve the real fundamentals of the economy.

That structural area I'm talking about is the unemployment rate among Youth (people aged between 18 and 24). The unemployment rate for this age group is around 20%, which is astonishingly high for a developed economy.

The reason this metric is so important is that a healthy job market for college graduates is essential for the economy to function normally. In the cycle of a person's career trajectory, a person attends college to specialize in an area (via what they major in), and then work in the public or private sector after they graduate. Typically after 2-3 years in their first role, people either get promoted to the next level of their organization or they land another external opportunity outside of their company. People in this age cohort sometimes also choose to attend graduate school as well.

The cohort of college graduates that land their first job post-graduation is a very important cohort for several reasons.

This cohort serves as an important potential customer base for apartments and housing in the city where they live. If their job outlook is bleak, their ability to live on their own by renting out an apartment (buying a home becomes out of the question) becomes greatly compromised. For such people, they may be forced to live with their families until their job prospects improve.

This cycle of a weak job market will push out the timeline for a recovery in the real estate sector. We also need to assess the real estate market via the City Tiers in China. For my members who follow China closely, they would know that China has 4 tiers of cities: Tier 1, Tier 2, Tier 3, and Tier 4.

Tier 1 cities are the mega cities such as Beijing, Shanghai, Shenzhen, and Hangzhou and so forth. Meanwhile Tier 4 cities are the smaller cities in China where the population is a fraction of the population in Tier 1 cities.

Generally speaking, the health of Tier 1 cities real estate is still relatively stable and healthy. The problem lies in Tier 3 and 4 cities where real estate developers overbuilt, and overextended their use of credit in the years leading up to today.

Now the key to recovery in China real estate is going to be the policies enacted to help people across these 4 tiers of cities improve their job prospects, where Tier 3 and Tier 4 cities need the most help.

In China, you may be surprised to know that 99.8% of businesses are classified as Small-Medium Enterprises (SMEs). And among this percentage, about 85% of companies are considered to be micro enterprises. Structurally speaking, this means that the best kind of policy that will help SMEs are the following:

- A rollback of Zero Covid policies
- Targeted incentives for SMEs to hire more college graduates
- Potential Tax breaks for hiring youth

- Increased infrastructure spending that could create employment opportunities.
- Any measure that can improve the consumer confidence of local citizens

Over the past 2 weeks, we witnessed the PBOC come out with new rate cuts on its Medium Term Lending Facility Rate (short for MLF). On top of this the PBOC also has cut mortgage rates in an attempt to stimulate the Real Estate sector.

In addition to monetary policy, we saw news of a new Fiscal Stimulus effort designed to also bolster the economy. The fiscal stimulus package will mostly focus on infrastructure spending. This was outlined in a 19-point policy package on Wednesday August 24th.

In my opinion, these policies will have a powerful impact in terms of long-term confidence being restored as the capital makes its way into the Chinese economy. However, these initiatives are longer-term in nature, and are not as concrete towards helping SMEs as the policies I laid out above.

The combination of monetary policy from the PBOC and the fiscal stimulus from China merits the Chinese Internet Sector to modestly expand their valuation multiples in the intermediate term. In simple language, this means that there should be a higher floor on valuations even if the sector retraces again.

Once we see policies designed to target SMEs and spur job creation with concrete plans, that will be a very clear signal that the landscape is truly on the path to structural and meaningful improvement.

I want to lay out some conclusions based on the most recent macro and fundamental landscape I am seeing:

On E-commerce names JD/Pinduoduo/Alibaba

If the Chinese consumer economy improves, the first place you will see the market reward is the Ecom space in China - namely Alibaba/JD/Pinduoduo. We witnessed JD and Pinduoduo soar after earnings and beating estimates. In my view, the bar right now is set relatively low and this makes risk/reward attractive. This expectation that the Buy Side currently has will not last forever.

In other words, the window of opportunity to get in at the best prices for Chinese Internet typically closes very quickly. You can remind yourself of this by reviewing how long Alibaba stayed under 90 or JD under 55. The answer is not for very long. For this reason, when there is panic in the market that causes dislocations that I've laid out, if it is appropriate to do so, those are moments when true alpha is found.

When monthly retail sales data comes out, the Ecom sector immediately responds to this macro data. The pure-play Internet names move as well, but at a lower degree of volatility.

<u>On Pure-play internet names Tencent/Baidu</u>

Tencent noted in the latest quarter that the regulation landscape has been more stable and that the forward outlook looks to be more predictable for the platform economy. However, this type of optimism needs to be closely balanced.

We see evidence of this with Baidu securing new rights to launch their autonomous driving vehicles in several select cities. That is a win for this argument. However, we are not yet seeing major gaming companies such as Netease and Tencent getting gaming approvals again.

So while the regulation landscape hasn't gotten worse, <u>it hasn't gotten materially better.</u>

I believe a more dovish stance on Zero Covid and Regulation would result in the valuation of the sector expanding (and therefore the stock prices) by a minimum of 15-25%+. Such changes (if they happen) may have to wait until Xi Jinping's 3rd term re-election in the coming months.

On the US-Audit SEC Delisting Issue

I personally believe that the news flow surrounding the first-stage agreement that US and China regulators have on the US ADRs is a promising first step. However, the way I view Chinese ADRs is that they are a bargaining chip that the U.S. will use in order to prevent China from taking drastic actions on Taiwan.

We can see from Nvidia's latest announcement that the U.S. will ban NVDA chips to China that the US-SINO relationship is still extremely competitive. It's borderline hostile, even if both sides seem to play down the tone.

I do believe that if there is a military flareup in Taiwan, then Chinese ADRs will almost certainly be delisted. Even if an SEC deal is reached, it may be walked back upon.

Delisting or no-Delisting is a political show that attempts to balance the economic interests of both the U.S. and China while the two countries' ideologies continue to diverge.

If Biden and Xi meet this Fall, and there are no abrupt surprises to damage their relationship further, then I do not believe the SEC will do anything to jeopardize that relationship.

However, the SEC will receive a call from Biden to "take action" on the Chinese ADRs if the Biden-Xi talks do not go well.

You may think my conclusion here is extreme, but I can assure you that this is the way this sector evaluates risks/reward. I've been following this sector long enough to know that at least a meaningful percentage of the risk premium (suppresses valuations) placed on this sector is due to geopolitical factors.

My net conclusion is that I still find the Chinese Internet Sector to be attractive for long-term (12-month) investment, if these tail risks don't materialize.

Any return to Alibaba 80-85, Tencent 33-36, KWEB 24-26, JD 52-57, BIDU 127-132 should be treated as long-term opportunities for accumulation based on your risk tolerance and understanding of the sector.

Note to Members & Friends

If/When I approach 100K friends on Youtube, I will be sharing a really motivational and powerful story with everyone.

It is a story that will inspire you to become the best version of yourself, and I believe you'll enjoy it very much.

Until then, you can expect me to keep doing my best work.

Tell friends and family if you enjoy what we do here. Like this post if you enjoyed the read.

-Larry
