CHINA MUSINGS

# Rotation Temptation

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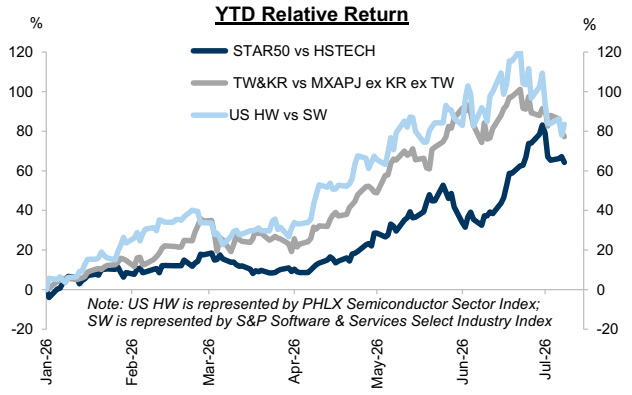
1. We recently held extensive investor meetings in Asia and the Americas, with client conversations centering on: a) the substantial underperformance of H vs. A shares and other regional peers ytd; b) the potential and possible timing for a leadership shift from A to H shares, or from Hard to Soft Tech; c) the reasons for disappointing earnings by listed Chinese companies and the drivers for a profit turnaround; d) are A-share AI stocks overheated? e) investor flows and positioning in Chinese stocks vis-a-vis other North Asian markets; f) the impacts of an active IPO pipeline on market returns and liquidity; g) AI developments in China, and the investment strategy within the Chinese AI ecosystem; and; h) how to make generate returns in 2H26, especially in the non-AI universe?

In this China Musings, we summarize investor feedback/FAQs and our refreshed views on these subjects, **reiterate our broad A over H** (Hard vs. Soft Tech) tactical preference, emphasize our **high-conviction thematic ideas such as GS Select AI Portfolio and GS 15FYP Portfolio**, but would start **scaling into select Soft Tech/Internet proxies** in H shares post their de-rating and in anticipation of their earnings recovery in the months ahead.

**2. Extraordinary gains and dispersion of Asian equities.** The return dispersion across the region and within the Chinese equity universe has been a subject featured in all of our client conversations. The impressive ytd gains in Korea and Taiwan, propelled by memory, foundry, and AI infrastructure plays, are well recognized and appreciated by international investors, but the equally significant divergence between A and H shares, and in similar vein, the wide relative return gaps between Hard and Soft Tech seem less well-telegraphed among investors outside of Asia. For instance, STAR50 (a proxy for onshore AI Hard Tech) has outpaced HSTECH (dominated by offshore Internet/platform companies) by 68pp ytd, while ChiNext has led SHCOMP/CSI300 by 19pp/17pp so far this year, both reaching unprecedented or extreme levels in the history of Chinese equities. **This great divergence suggests to us that the AI bottleneck, Hard vs. Software, or AI infrastructure supplier vs. AI capex spender trade is also at play in China**, although manifesting in pockets of the equity universe that are less well followed and positioned by foreign investors.

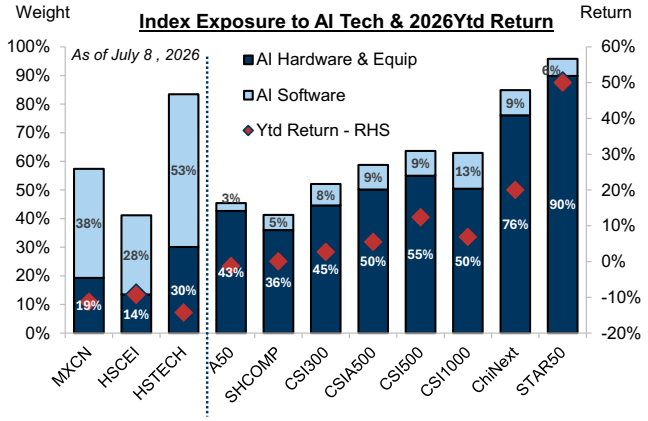
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**Exhibit 1: The AI bottleneck, Hard vs. Software, or AI supplier vs. AI capex spender trade has been a dominant equity theme globally**




Source: Wind, FactSet, Goldman Sachs Global Investment Research

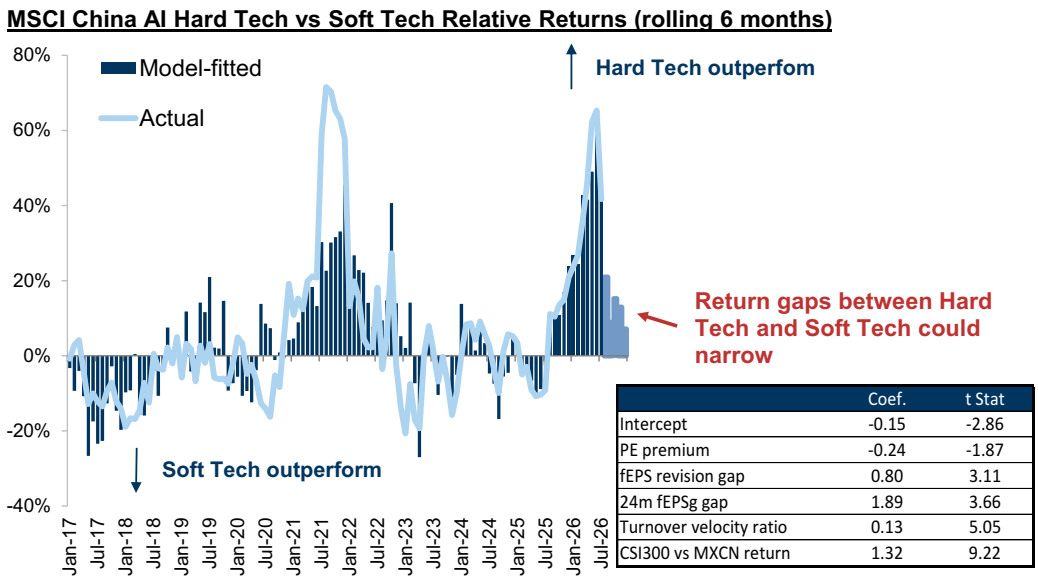
**Exhibit 2: Indexes with higher AI Hardware exposures have outperformed ytd in the Chinese equity universe**




Source: FactSet, MSCI, HSI, CSI, Goldman Sachs Global Investment Research

**3. Rotation temptation.** The significant return disparity and index return concentration has prompted investor questions about **the likelihood, necessary conditions, and timing of a potential rotation from A to H, or from Hard to Soft Tech**. Indeed, HSTECH has rebounded 11% in the past two weeks (still down 14% ytd), led by a few Internet incumbents on better newsflows, suppressed starting valuations, and continued AI application/monetization developments. Our top-down Hard vs. Soft Tech rotation model, an extension of our A-H Market Rotation Model, also points to the direction that **H-share Soft Tech equities may start to trade better in the coming months**, potentially narrowing their underperformance gaps vis-a-vis their A-share Hard Tech counterparts on various fundamental, valuation, and liquidity factors. That said, while recognizing that prevailing valuations of leading Internet names may have already factored in further de-rating in their core businesses and/or negative NPV/ROIs on their AI investments, which seem overly bearish to us, we believe **a sustained price rally would require a visible recovery in underlying profits**, which could be still a couple of months or quarters away as we elaborate below.

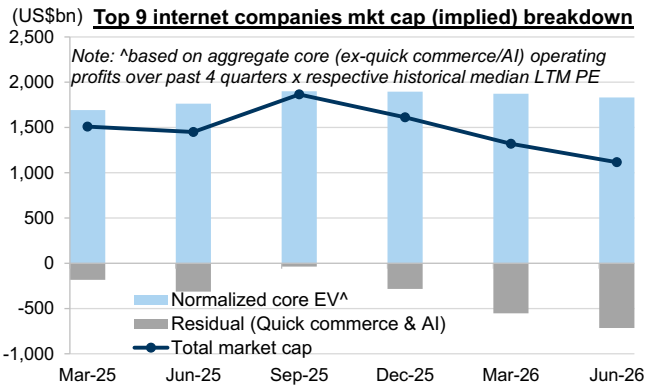
**Exhibit 3: H-share Soft Tech may start to close its underperformance gaps vis-a-vis Hard Tech in A shares in the months ahead**




| | Coef. | t Stat |
|---|---|---|
| Intercept | -0.15 | -2.86 |
| PE premium | -0.24 | -1.87 |
| fEPS revision gap | 0.80 | 3.11 |
| 24m fEPSg gap | 1.89 | 3.66 |
| Turnover velocity ratio | 0.13 | 5.05 |
| CSI300 vs MXCN return | 1.32 | 9.22 |

Source: Wind, FactSet, Goldman Sachs Global Investment Research

**Exhibit 4: A bearish scenario in terms of Chinese Internet companies' AI investments could be already in the price**



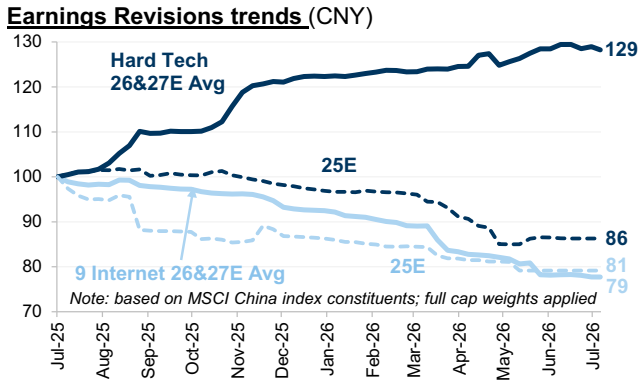

Top 9 internet companies include: Tencent, Alibaba, PDD, Xiaomi, Meituan, NetEase, Baidu, JD, and Trip.com.

Source: Company data, Goldman Sachs Global Investment Research

**4. No earnings, no gains.** Subdued earnings delivery has weighed on returns of offshore indexes, and was a key input to our downgrade of MSCI China from Overweight to Market-weight 6 weeks ago. 1Q26 profits were down 8% for MSCI China, dragged primarily by the Internet sector (35% of earnings weight), which has incurred more than Rmb180bn of subsidy losses cumulatively since 2Q25, and has been a major sponsor for AI capex domestically that could top US$100bn/US$120bn this year and next on GS estimates. The weak 1Q results follow a lackluster year in 2025 when index earnings grew merely 7%, trailing below consensus expectations for 6 consecutive years. Looking ahead, we are still of the view that narrowing subsidy losses, fast-growing AI-related new opportunities (e.g. Cloud, agentic AI, and AI tokens), and stable, cash-generating

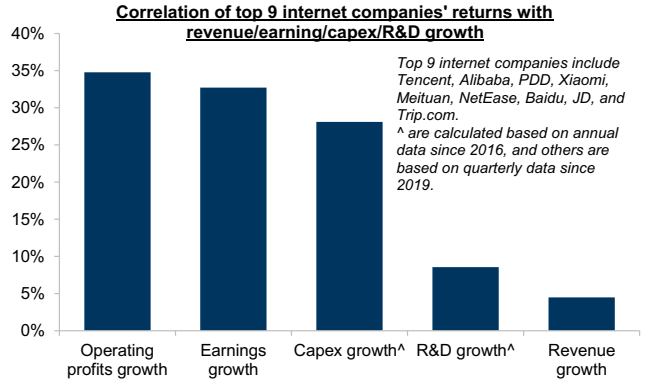
e-commerce businesses could help drive **a (operating) profit turnaround for Internet heavyweights in their 2Q or 3Q results season**, at which point investors may be better placed to quantify these companies' AI upside optionality, and could be more incentivized to value these stocks on a sum-of-the-parts basis as opposed to a likely blended (earnings) approach now, in our view.

**Exhibit 5: Chinese Internet/Soft Tech stocks have seen persistent downward earnings pressures in the past year**



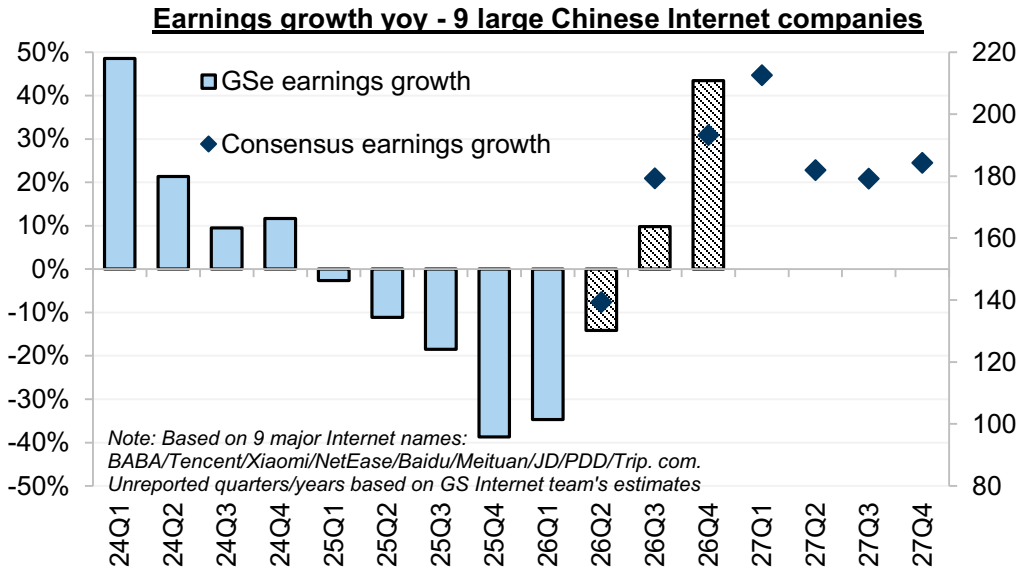

Source: MSCI, FactSet, IBES, Goldman Sachs Global Investment Research

**Exhibit 6: Chinese big tech companies' returns are most sensitive to realized profit growth**




Source: Wind, FactSet, Goldman Sachs Global Investment Research

**Exhibit 7: Profit growth momentum for offshore tech could improve in 2H26 per GS and consensus expectations**

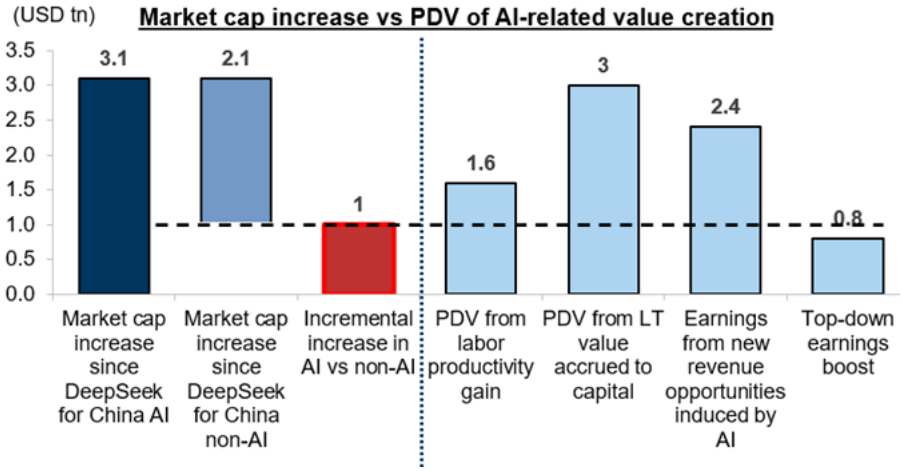



Source: MSCI, FactSet, Goldman Sachs Global Investment Research

**5. Are China AI stocks overheated?** This is a popular question from investors, probably a derivative of the AI bubble debate that has dominated investors' mind-share globally in recent months. In sum, we push back to the notion that the aggregate Chinese AI equity bloc is a bubble as our top-down analysis shows that the potential economic benefits via efficiency gains and new profit/TAM creation could be 50% to 100% higher than what is currently discounted in AI equity prices. That said, **we see emerging signs of overheating in certain pockets of the AI universe**, namely the semi cohort and select A-share Hard Tech proxies where valuations are at rich premiums vs. historical

norms and global comparables, and concentration and leverage risks are rising at somewhat concerning paces. This warrants heightened focus from investors on controlling risks, diversifying exposures, and leaning into earnings-powered strategies to strike better risk/reward. See #10 for details.

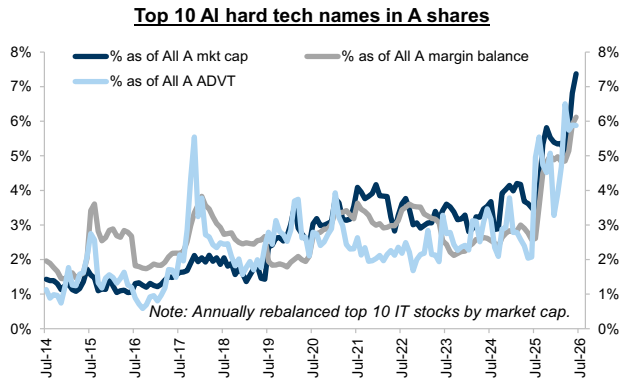
**Exhibit 8: The (net) appreciation in Chinese AI market cap since the DeepSeek moment looks moderate compared with the potential growth and earnings upside that AI could generate in the future**




Please refer to AI changes the game (Part 2) for the definition of China AI and non-AI universe.

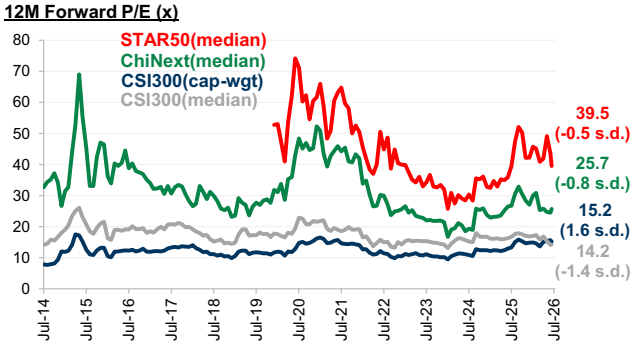
Source: Bloomberg, FactSet, Goldman Sachs Global Investment Research

**Exhibit 9: Valuations have risen, but not at extreme levels**




Source: Wind, Goldman Sachs Global Investment Research

**Exhibit 10: Valuations for A-share Hard Tech equities are still slightly below their historical norms**




Note: Based on latest constituents; z-score over past 12 years (monthly)

Source: FactSet, I/B/E/S, CSI, Goldman Sachs Global Investment Research

**6. Are Korea and Taiwan stealing thunder from China?** Empirically, the directional return correlations between China and the two North Asian markets are near their respective historical troughs. Per GS Prime Brokerage statistics, hedge funds' net risk exposures in EM Asia (ex-China) are at all-time highs while those in Chinese stocks are at the bottom of the range. However, allocations from mutual funds, especially for EM mandates, have edged up to multi-year highs (modest Overweight by EM funds for the first time on record dating back to 2011, likely due to China's reduced index weights in the EM benchmark), gross exposures from hedge funds are near cycle peaks, and participation from foreign cornerstone investors in HK IPOs ytd are comparable to the historical highs in 2021, all suggesting that foreign investors are still active and engaged, but prioritizing market-neutral strategies and **alpha opportunities over beta risks in**

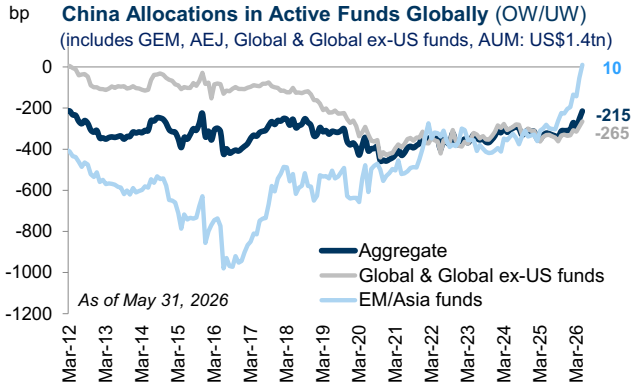
**Chinese equities.**

**Exhibit 11: Chinese equities' return correlations with Korea and Taiwan are close to historical lows**



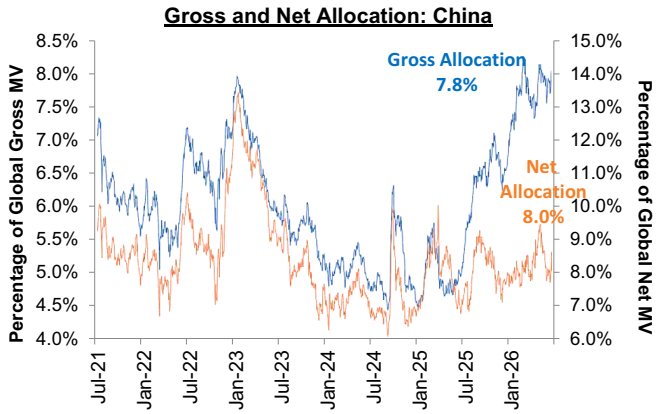

Source: FactSet, Goldman Sachs Global Investment Research

**Exhibit 12: EM funds are now Overweight China for the first time in history**




Source: EPFR, Goldman Sachs Global Investment Research

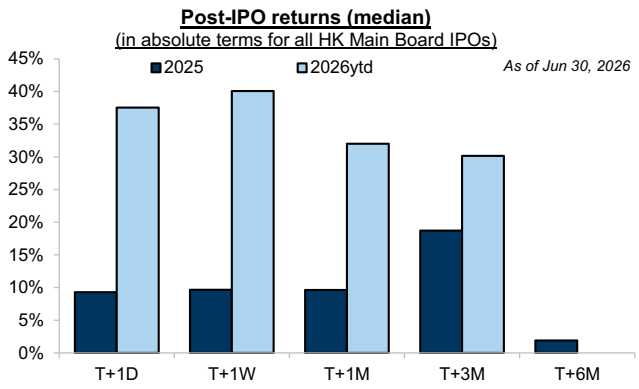
**Exhibit 13: Global hedge funds' gross allocation to China has risen faster than their net exposures, suggesting stronger bias for alpha trading**




Source: Goldman Sachs FICC and Equities and Prime Services data as of July 3, 2026.

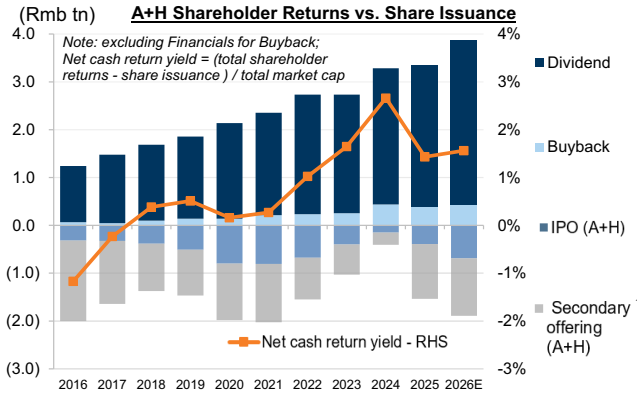
**7. Excitements and worries about IPOs.** IPOs have become a popular avenue for investors to extract alpha in a challenging beta environment. Our study shows that 100 companies have made their debuts on the HK bourse ytd, raising US$35bn in total and generating a median stock return of 32% and 30% in the first 1 and 3 months post-listing. Factors such as (large) issuance size, standalone H-share listing, and moderate cornerstone ownership (30%-50%) have explained a large extent of the outperformance among the new listings. The active and long IPO pipeline in HK has nevertheless raised **investor concerns about liquidity drain, which appears overdone to us** considering the expected issuance size in the remainder of this year (US$25bn for IPOs and US$45bn including follow-ons on GS estimates) and the record-high cash returned to shareholders by listed companies via dividends and buybacks (US$500bn/FU$560bn for FY2025/FY2026). A-share IPO activity is also picking up pace with CXMT, a Chinese DRAM maker, reportedly aiming for STAR board listing and looking to raise US$4.3bn in its primary issuance, which would be the largest A-share IPO since May 2022.

**Exhibit 14: Investors participating in IPOs over the past two years could have achieved approximately 20-30% returns in the first three months post-listing**




Source: Wind, FactSet, Goldman Sachs Global Investment Research

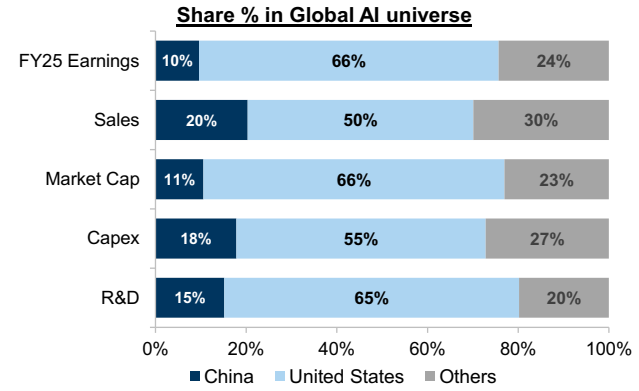
**Exhibit 15: The amount of new issuance supply looks manageable compared with the record-high cash returns to shareholders from listed corporates**




Source: Wind, Bloomberg, Goldman Sachs Global Investment Research

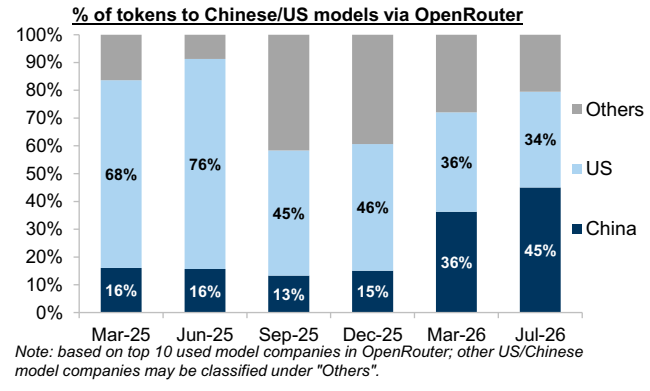
**8. AI has indeed changed the game and has dominated our client conversations,** which have revolved mainly around: a) the progress of the self-reliant AI ecosystem build-out in China; b) the technological breakthroughs in certain choke points in the supply chain, namely EDA, lithography, advanced packaging, and High-Bandwidth Memory (HBM); c) the cost and efficiency differentials between AI capex spent in the US and China; d) China's competitive threats to global incumbents in areas such as LLMs, robotics, and AI tokens, with the latter already representing almost half of the global consumption; e) AI use cases, monetization, and economics of AI investment; and, f) the role of the Chinese government in AI regulation and infrastructure build-out. Overall, **China is an integral part of the global AI equity universe**, accounting for 11%/18% of AI-related market cap/revenue worldwide, but China AI equities are significantly under-owned by international investors, especially in the **Power, Infra, and Physical AI layers where Chinese companies arguably have comparative and competitive advantages** on a global basis. We'd continue to recommend our China Select AI Portfolio which comprises 50 names from 22 specific AI industries, aiming to provide investors with balanced and comprehensive exposures across the whole AI value chain. See Part 1, 2, 3, and 4 of our AI changes the game series for details.

**Exhibit 16: China is an integral part of the global AI equity universe**




Source: FactSet, MSCI, Goldman Sachs Global Investment Research

**Exhibit 17: Chinese AI models account for almost half of the world's token usage**




Source: OpenRouter

**9. Macro taking a backseat, for now.** The topicality of AI has overshadowed investors'

interest in macro-related subjects. That said, important economic subjects such as the China's potential housing market stabilization in 2027, China's resiliency in the latest global oil shock, the continued weakness in domestic consumption, the strength of the Rmb (vs. the USD) and Chinese exports, and potential policy responses (stimulus) in the July Politburo meeting have come up in our meetings with macro-focused investors and asset allocators. This orientation is partly reflected in and consistent with (the readings) our US-China Relations Barometer, which is currently at the lowest levels since 2022 (i.e. low bilateral tensions implied by market prices), indicating that prevailing **equity market pricing could be more driven by the AI theme and other idiosyncratic micro factors** as opposed to general macro forces and geopolitical issues, at least tactically.

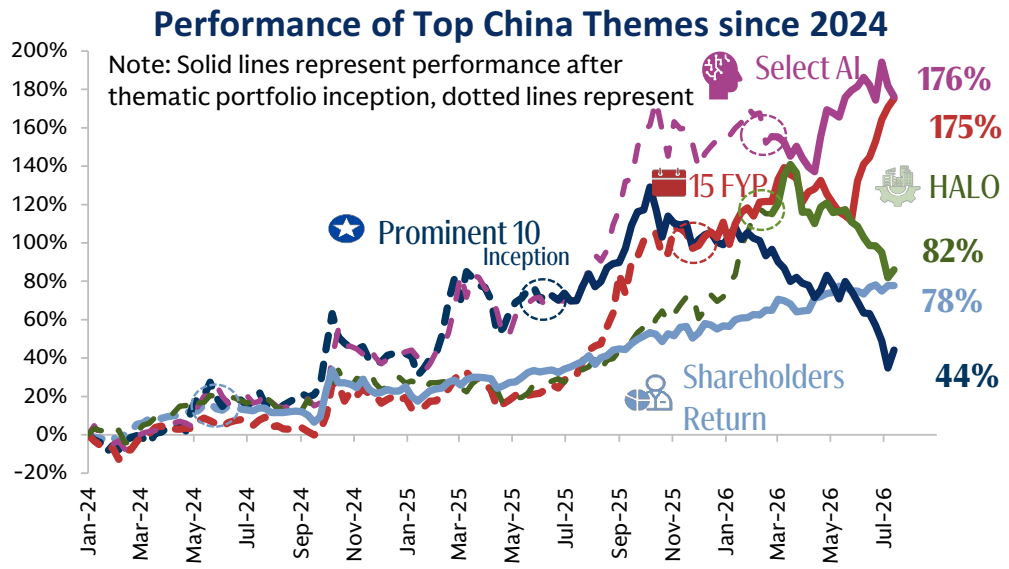
**Exhibit 18: US-China Relations Barometer (GSSRUSCN) is at 39, around the lowest level since April 2022**




Source: Goldman Sachs Global Investment Research

**10. Ways to generate returns in 2H26.** By market, our **tactical preference still resides with China A (maintain OW)** given its more favorable earnings momentum cyclically and underappreciated diversification benefits (to international investors), although we'd **begin to scale into certain large-cap H-share Internet stocks** considering their meaningful de-rating ytd and our envisaged profit recovery in the quarters ahead. Sectorally, our **overweights in Materials, Cap Goods, and Insurance** may offer investors alpha opportunities beyond the AI universe, in addition to other non-AI micro ideas in ship-building, (new) consumption, healthcare/biotech, the extended housing value chain, brokers, and hog cycle that our sector analysts have recently highlighted. Thematically, our **Select China AI Portfolio and GS 15FYP Portfolio** remain our high-conviction ideas, and together with our HALO screen, our China Prominent 10 Portfolio, GS China Growth Portfolio, and our Shareholder Returns list, they should render investors exposures to what we view as alpha-generating themes and vectors within the Chinese equity universe.

**Exhibit 19: Policy (support) and AI are the two factors underpinning our preferred investment themes in the China equity universe**




Source: FactSet, Goldman Sachs Global Investment Research

# Disclosure Appendix

## Reg AC

We, Kinger Lau, CFA, Timothy Moe, CFA, Si Fu, Ph.D. and Kevin Wang, CFA, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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