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A little trouble in big China?

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"*There is no fundamental contradiction between socialism and a market economy. The problem is how to develop the productive forces more effectively….If we combine a planned economy with a market economy, we shall be in a better position to liberate the productive forces and speed up economic growth*"

Deng Xiaoping, second leader of People's Republic of China, October 1985

Not quite a quiet summer

Earlier this year, we advocated dedicated China equity allocations within portfolios given their potential to enhance prospective risk-adjusted returns. Since then, there have been a number of regulatory actions in areas of antitrust, data security and private education:

- Ride-hailing company DiDi Global Inc. saw business activities severely curtailed after it went ahead with an overseas listing without full regulatory approval.
- Education sector reforms that will force after-school tutoring companies to transform into non-profit entities, which could be seen as a confiscation of an entire sector by depriving investors of future profits they would have derived.
- Tech giant Tencent faced antitrust actions against its music streaming business and was subsequently rocked further by a strongly worded article in the state media that suggested there was potential for regulatory action against its video gaming business.
- Meituan, an e-commerce platform, faced antitrust action and was also impacted by the introduction of government guidelines to improve the wages and benefits of food delivery riders.

Chinese equity markets went into a tailspin during July 2021 partly as a consequence of the aforementioned events[i]. China's offshore equities exhibited the largest drawdown, while the onshore market experienced a less severe decline, as illustrated in **Figure 1**. This led to the worst monthly performance for Chinese equities as a whole since last year's COVID-19 sell-off, with companies in sectors impacted by the regulatory actions such as tech, private education and food delivery leading the decline. On the other hand, some companies in sectors believed to be seen more favorably by Beijing, such as high-tech manufacturing or electric vehicles, held up well, as illustrated in **Figure 2**.

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At the same time, China's relations with the US and other western countries took a turn for the worse as more Chinese companies were blacklisted by the US, the US and western allies accused China of malicious cyber activities, and both sides imposed more limitations on listings by Chinese companies overseas. The US withdrawal from Afghanistan and subsequent collapse of its government may also embolden China in its determination to reintegrate Taiwan if the withdrawal is interpreted as a sign of the US's decreasing willingness to fight wars on behalf of allies in far-flung places.

Taken together, these events have led to some nervousness from investors about the dangers of investing in China. Geopolitics remain a morass of tail risks that will not be going anywhere anytime soon. Greater regulatory involvement in some of the affected sectors may have been foreshadowed through official communications and actions in the recent past, but messaging had been ambiguous at best. The heavy-handed regulatory clampdown was therefore a stark reminder of China's top–down influence, the risk this poses to long-term earnings in sectors that could be affected by future crackdowns (such as healthcare) and, therefore, the need to engage specialist managers to navigate these complexities when investing in this market.

Equally, the fact that the drawdown hit tech-heavier offshore shares by a far greater magnitude than onshore shares underlines the importance of building the broadest possible exposure to China's equity market.

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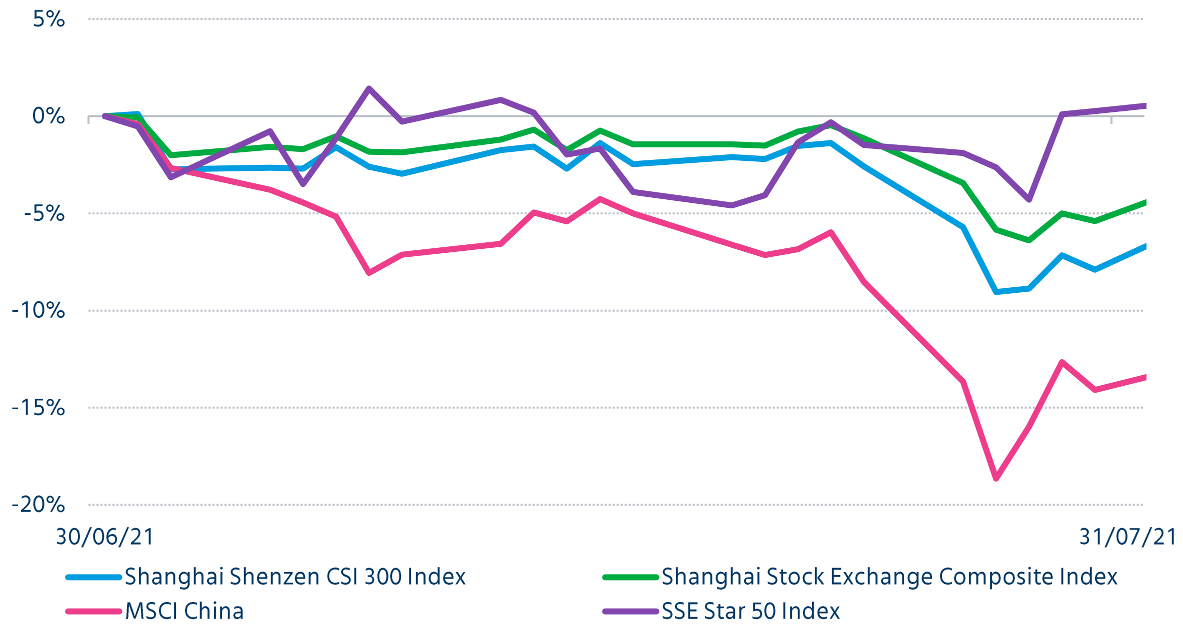
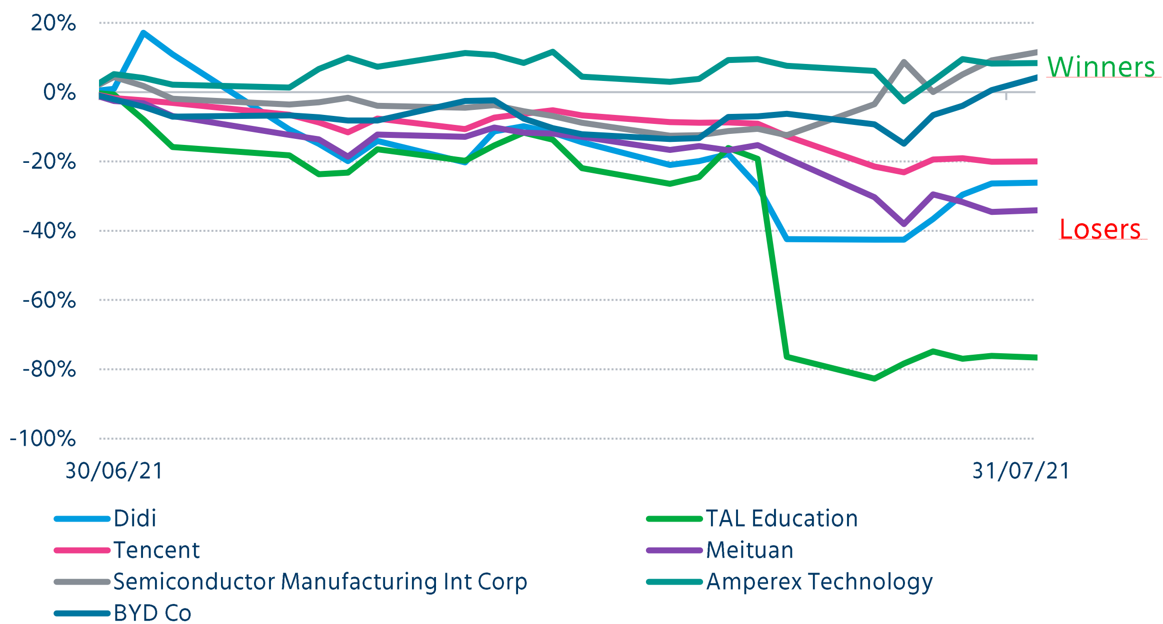
Figure 1: Performance of select Chinese indices



Source: Bloomberg; as of 31 July 21.

Figure 2: Performance of selected companies



Source: Bloomberg; as of 31 July 21.

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More picky but still open for business

One could interpret the regulatory actions as a sign that the tide of market liberalization has shifted. From day one, Xi Jinping has been consolidating power by purging potential challengers, making himself the head of all essential committees and extending his presidential term for life, contrasting with the “collective” leadership style of his predecessor, Hu Jintao. It was just a matter of time before free enterprise clashed with Xi’s top–down leadership style, and something had to give.

However, we view the primary motivation for these regulations as enabling China’s next phase of economic development. Chinese policymakers have made clear their intentions to double per capita GDP by 2035. This economic pivot will focus on improving four strategic priorities, including (1) dual circulation,[ii] (2) domestic innovation, (3) productivity and (4) population growth.

To achieve these goals, China’s government is actively trying to divert capital and labor resources away from sectors it believes are fuelling less essential consumption and toward areas conducive to becoming more self-reliant. While this has been hurting internet stocks, for example, it has been benefiting those companies that are more aligned with these goals, including advanced manufacturing, brands serving the essential needs of domestic consumers and innovative biotechnology companies.

China’s rapid economic growth over the past two decades has also brought about some imbalances the government believes must be addressed to facilitate the economy’s ongoing transformation. The government’s latest regulatory initiatives aimed to deal with major concerns, including (1) housing affordability, (2) the rising expenses of educating a child and (3) anti-competitive market practices. Therefore, the areas targeted were real estate, private education and technology.

China’s policy approach to dealing with these issues differs greatly from that typical in the West, as it reflects the Chinese state-directed model. On numerous occasions in the past, the government has introduced regulations of similar magnitude to set the direction of private-sector activities, and has also undertaken large-scale restructuring in state-controlled sectors. The most prominent of these reforms took place in the early 1990s, when the Chinese stock market was too small to elicit significant international attention. From there, we have seen the private sector continuing to flourish, with businesses adapting to the new framework and an evolving regulatory landscape. We believe that after a period of readjustment, the private sector will continue to play a leading role in China’s economic transformation this time as well. In the case of private education, for example, companies will have to focus on opportunities in the vocational training market, which is larger but less developed than K-12 tutoring. Over the longer term, this should contribute more to productivity growth by cultivating marketable skills rather than cementing an outdated rote-learning model.[iii]

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Nevertheless, investors need to be mindful that policy priorities will not always be aligned with shareholder interests in the short term, which also holds true to varying degrees in other markets. In some respects, China's government is asking its private companies to change what they produce and how they produce it, similar in impact to a sudden shift in consumer preferences: Companies have to adapt and deliver what consumers want to buy, and in the case of China, its government has a major say in this. However, this is no different in principle from western countries' attempts to tackle obesity, alcoholism or gambling by curbing business activities in these sectors, while antitrust actions go back more than a century. No matter where a company operates, it will always be subject to changing consumer preferences and government actions, and these are often interlinked. Well-managed companies with forward-looking leadership can typically adapt to changing circumstances — COVID-19 restrictions, the shift to digital commerce, consumer demand for higher sustainability credentials in retail products or a crackdown on tech.

One may disagree in principle with governments meddling with the free market and individual choice, but in our view these targeted regulatory actions do not imply that China's government is curtailing private business as a whole. China's policymakers are fully aware that private enterprise will be a critical engine driving innovation, productivity, wealth creation and job creation over the coming decades. A full-scale crackdown on private enterprise is unlikely to be consistent with China's longer-term policy goals.

Following the negative public equity market reaction in early July 2021, the Chinese Securities Regulatory Commission held a meeting with major international banks to provide assurances about the intent and scope of regulatory actions.[iv] Similar messaging has been conveyed via China's official Xinhua News Agency. Official communication, of course, should not be treated as gospel, but these statements give us reason to be cautiously optimistic that China's intentions are indeed not to fundamentally alter the role of private business in its economy. The country's regulatory landscape will continue to evolve, particularly in relatively new areas of the economy where regulatory frameworks are still taking shape, but we believe that China remains open for business.

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Financial decoupling now

As geopolitics have taken a turn for the worse, both sides have also accelerated the pace of financial decoupling.[v] The US Securities and Exchange Commission tightened disclosure requirements for Chinese firms listing in the US,[vi] and Chinese regulators raised the bar for companies seeking to list overseas. US disclosure requirements contradict Chinese law, which prohibits companies from sharing the required information. In the light of recent US accusations against China relating to alleged malicious cyber activities and the tense Taiwan situation, a rapprochement is unlikely. Congress is actually trying to accelerate the pace of delisting of Chinese companies.[vii] The accelerating pace of financial decoupling makes a direct portfolio allocation to the world's second-largest economy therefore more important than ever because opportunities to gain China exposure from overseas listings are disappearing.

Strategic case still sound, valuations now more attractive

In the past, Chinese policymakers have emphasized their resolve regarding healthcare reform, regulation across the fintech industry, containing the overheating real estate market and regulating the private tutoring sector. Policymakers could have been more effective in communicating this, though. As the severity of the regulatory actions — especially the heavy-handed clampdown on, if not outright confiscation of, private education — came as somewhat of a shock, we have seen investors repricing for higher regulatory risk in the Chinese equity market.

Over the long run, recent actions have raised concerns about the role China's government envisions for the private sector as a whole. We do not expect Chinese policymakers to completely favor prioritizing politically desirable outcomes at the expense of investors after previous liberalization measures led to the creation of some of the largest and most successful firms in the world, including Alibaba, Tencent, Xiaomi and Huawei. At the same time, it would be difficult to see unabated growth in the private sector such as throughout the 1980s and 1990s since China's economic foundations are no longer the same. Going forward, Chinese policymakers are likely to keep a tighter grip on the direction of the country rather than letting it grow first and regulate later. China is no exception here — regulatory action is taken routinely in most countries, including the most developed — the ranks of which China is about to join.[viii] What remains clear, though, is the continued role of the private sector in fostering innovation and productivity. And for investors in companies who understand the importance of working with China's ruling political party, we see this as an opportunity to translate the country's ongoing transformation into portfolio returns. Navigating the evolving regulatory framework presents alpha opportunities for active managers with local knowledge and the ability to judge the potential opportunities and risks emanating from the constantly evolving regulatory regime.

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This is why **earlier in the year, we advised investors to build a dedicated China allocation into their public equity portfolios in addition to existing broad emerging market allocations. This dedicated China allocation facilitates a strategic overweight to China onshore equities relative to standard global benchmarks**[ix] to achieve broad exposure to a promising opportunity set and compensate for low representation of Chinese onshore equities in typical global benchmarks and portfolios.[x] **Our strategic recommendation is not undermined by recent events,** even though they have further highlighted the importance of choosing an active mandate for this allocation.

From a tactical standpoint, we note that the decline in equity markets has reduced valuations, presenting a cheaper entry point. However, we would not go all gung-ho yet to allow more time for the current regulatory dust to settle.[xi] **Therefore, our tactical (one– to three-year) view on Chinese onshore and offshore equities is to be invested in line with the long-term strategic allocation explained above**.

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[i] The ongoing credit tightening and a fear of a slowdown in Chinese economic growth driven by renewed COVID-19 related restrictions are other factors that contributed to negative market sentiment.

[ii] Expanding domestic demand and innovative capacity, and reducing reliance on imports to produce goods and services critical for long-term economic development — semi-conductors being an obvious example. Beyond the most critical key sectors, the economy remains open for trade and foreign investment.

[iii] CNBC. "China's Education Crackdown Will Be Beneficial in the Long Run, Says Consultancy Oliver Wyman," August 1, 2021. Available at https://www.cnbc.com/video/2021/08/02/china-education-crackdown-will-be-beneficial-in-long-run-oliver-wyman.html.

[iv] Bloomberg. "China Convenes Banks in Bid to Restore Calm After Stock Rout," July 28, 2021. Available at https://www.bloomberg.com/news/articles/2021-07-28/china-convenes-banks-in-bid-to-restore-market-calm-after-rout?sref=69A1tQL7.

[v] This is not the same as economic decoupling — that is, trade and integrated supply chains. Although economic integration has also been stalling, interdependence between the two countries is too great for a full decoupling. However, *financial* decoupling means that to benefit from the continued mutually beneficial economic relationship between both countries on a portfolio level, direct exposure to both countries is needed.

[vi] US Securities and Exchange Commission. "Statement on Investor Protection Related to Recent Developments in China," July 30, 2021. Available at https://www.sec.gov/news/public-statement/gensler-2021-07-30.

[vii] John Kennedy, US Senator for Louisiana, Press Release. "Senate Passes Kennedy Bill to Strengthen America's Protection Against Fraudulent Foreign Companies," June 22, 2021. Available at https://www.kennedy.senate.gov/public/press-releases?id=0B06BCEF-0558-4092-8837-6BE4D41B2925.

[viii] Political risk in developed countries can also be high at times, such as the perceived risk of Jeremy Corbyn winning a majority in the 2019 general election in the UK. Nationalizing key industries and forcing companies to transfer up to 10% of their equity into a "workers' fund" were among the many punitive measures the hard-left manifesto promised. This was also widely regarded as a very worrying prospect for UK equity holders at the time.

[ix] Such as the MSCI AC World Index.

[x] Mercer. "Investing in China." Available at https://www.mercer.com/our-thinking/wealth/investing-in-china.html.

[xi] Our more detailed dynamic asset allocation view on China relative to the rest of emerging markets and developed markets is available upon request.

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