

Experts' view on China

Global Matters Weekly

23 August 2021

– Lorenzo La Posta, CFA

When you invest with so many high-quality fund managers, it's only natural to pick their brains every now and then. We have spoken to a few of them and collected their thoughts on the current situation in China.

As a background, around nine months ago, in November 2020, Ant Financial (Alibaba's fintech business) was ready to break records with a \$37 billion IPO and an estimated valuation close to \$300 billion. However, the Chinese regulators pulled the plug on it, officially because of risks around financial security. Since then, the clampdown has extended more broadly, reaching the wider internet and e-commerce sector, property developers, the ride-sharing company Didi Chuxing and the entire private education sector. Markets and more broadly investor sentiment has been under pressure and Chinese stocks are now trading at around 30% below their February peak¹.

Most of the managers we spoke to have a constructive view and, on average, their thoughts can be summarised in the following points.

Regulatory tightening cycles are not that unusual in China. In 2015, the coal and steel industries underwent a period of reform with China aiming to clean up those sectors. In 2018, younger industries such as peer-to-peer lending and online gaming were heavily regulated to align strategically important areas to existing social and economic plans. The entire healthcare industry has been an ongoing priority of the Chinese government for the past few years. So, in hindsight, a regulatory clampdown of the internet sector was just a matter of time and the only difference with the past is that such changes have affected the largest and widely held Chinese companies, such as Alibaba, Tencent, Meituan etc.

The recent changes are in part an overdue catch-up with matters such as privacy, data protection and anti-competitive behaviours, but also a part of the wider government plan of reducing reliance on western economies. China's geopolitical and social agenda necessitates directing more capital towards sectors seen as core for the country's industrial autonomy, such as semiconductors, robotics, energy storage and artificial intelligence so, perhaps, regulating (and making less appealing from an investor's perspective) consumer internet services could

China needs and wants foreign capital

contribute to that.

Looking forward, the expectation is that the intensity and the severity of the internet regulatory crackdown will decrease but today is too soon to assume this tightening cycle is over. Clearly, rules put in place so far will not be rolled back and their impact on companies and business models still needs to be fully understood, but as uncertainty dissipates this could prove to be a very interesting entry point (from a valuation perspective) in a part of the Chinese equity market that for many years has offered outstanding growth.

The private education sector is in a worse place. Recent regulations are similar in nature to previous ones in that they come from a social need, but the consequences are a lot more severe. The government's objectives are both to reduce the cost of having children and to even out the education system across different regions and wealth levels. In March 2021 President Xi called the private tutoring sector "a chronic disease" and since then has put rules in place to essentially force companies out of mandatory school years. From their peak, the main private education companies lost more than 90% of their market value².

Overall, **this was not an attack on the private sector.** China needs and wants foreign capital, as proven for instance by the extensive growth of the Stock and Bond Connect programs. Some structures, such as US ADRs, might change or even disappear, but ultimately a strong, advanced private sector is vital for China's future as a technologically advanced economy. Regulation is often a short-term negative for equity prices and investor sentiment tends to fall under a lot of pressure, as it is the case today, when such large changes happen almost without anticipation. China's way of communicating has perhaps been opaque and sudden, but ultimately the country's long term investment case is little impacted: the equity market remains wide, deep and full of attractive investment opportunities for those investors who can actively select the best stocks. The fact that the market is now one third cheaper than it was six months ago is an obvious plus.

¹ As measured by the MSCI China Index in HKD terms, source Bloomberg Finance L.P.

² TAL Education and New Oriental Education, source Bloomberg Finance L.P.

The Marketplace

- Global equities fell -1.4% last week
- The delta variant of coronavirus continues to weigh on investor sentiment, not helped by reports of weakening vaccine efficacy
- Brent crude fell -7.7% over the week to \$65.2 a barrel
- Gold rose 0.1% to \$1781 per ounce

Market Focus

US

- US equities fell -0.6% last week
- Retail sales fell by -1.1% in July vs -0.3% expected with industrial production more robust with growth of +0.9% against expectations of +0.5%
- Weekly initial jobless claims for the week through August 14th fell to a post-pandemic low of 348k (vs 364k expected), with the 4-week moving average also at a post-pandemic low
- Housing starts fell to an annualised rate of 1.534m (vs expectations of 1.6m), hitting a three-month low. However, building permits rose after three consecutive declines to an annualised 1.635m, slightly ahead of expectations of 1.61m
- The University of Michigan's preliminary consumer sentiment index for August fell to its lowest level in nearly a decade
- The Empire State manufacturing survey fell sharply to 18.3 in August from 43 in July, missing the market expectations of 28.5
- The Philadelphia Fed's manufacturing business outlook survey saw the diffusion index for current activity drop to 19.4 in August (vs 23.1 expected), marking its fourth consecutive decline. Moreover, the current prices received index rose to 53.9, its highest level since May 1974
- Covid booster shots will begin from next month with a plan to begin offering them from September 20th subject to an FDA evaluation and CDC recommendation

Europe

- European equities fell -1.3% last week
- There are now less than 5 weeks to go until the federal election in Germany which will come into increasing focus over the next month ahead given the implications for the EU as well as domestic policy
- The Eurozone July CPI reading came in at 2.2% year-on-year, meeting the flash expectations

UK

- UK equities fell -1.6% last week
- July CPI came in at 2.0% year-on-year, below expectations of 2.3%. Core CPI similarly came in weaker than expectations at 1.8% falling short of expectations of 2.0%. One area of buoyancy was house prices, which advanced 13.2% year-on-year in June, its fastest annual rise since 2004
- The unemployment rate in the 3 months to June fell to 4.7% vs expectations of 4.8%
- The number of payrolled employees was up +182k in July, marking the eighth consecutive increase but job vacancies in July rose to a record high of 953k

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned -4.6% last week
- Japanese equities fell -3.9% over the week
- Chinese equities fell -7.8% last week with continued concerns around regulatory interventions
- Japan's flash composite PMI reading fell to 45.9 from 48.8 last month as Covid restrictions extended to more regions. Much of that decline came from a drop in the services PMI (43.5 vs 47.4 last month) whereas manufacturing remained relatively stable (52.4 vs 53.0 last month)
- Australia's flash composite PMI reading was 43.3 vs 44.2 last month, remaining in contractionary territory amidst a worsening Covid situation there as well

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Asset Class/Region	Currency	Currency returns			
		Week ending 20 Aug. 2021	Month to date	YTD 2021	12 months
Developed Market Equities					
United States	USD	-0.6%	1.1%	19.0%	32.6%
United Kingdom	GBP	-1.6%	1.4%	13.2%	22.1%
Continental Europe	EUR	-1.3%	1.8%	19.7%	31.2%
Japan	JPY	-3.9%	-1.1%	5.4%	20.1%
Asia Pacific (ex Japan)	USD	-4.7%	-4.1%	-4.3%	14.3%
Australia	AUD	-2.0%	1.3%	15.6%	25.9%
Global	USD	-1.4%	0.5%	15.6%	30.8%
Emerging markets equities					
Emerging Europe	USD	-2.2%	0.3%	15.0%	27.7%
Emerging Asia	USD	-4.9%	-4.8%	-7.3%	11.7%
Emerging Latin America	USD	-4.7%	-5.2%	-1.0%	25.9%
BRICs	USD	-5.7%	-4.9%	-9.6%	4.1%
China	USD	-7.8%	-7.6%	-19.0%	-9.0%
MENA countries	USD	-0.4%	2.3%	24.3%	35.5%
South Africa	USD	-8.4%	-8.8%	-1.0%	23.6%
India	USD	-0.6%	4.5%	16.8%	48.6%
Global emerging markets	USD	-4.6%	-4.3%	-4.1%	15.2%
Bonds					
US Treasuries	USD	0.3%	0.0%	-1.5%	-2.6%
US Treasuries (inflation protected)	USD	-0.4%	-0.8%	3.6%	6.1%
US Corporate (investment grade)	USD	0.2%	-0.3%	-0.2%	2.1%
US High Yield	USD	-0.1%	-0.4%	3.6%	10.0%
UK Gilts	GBP	0.4%	0.6%	-2.6%	-1.5%
UK Corporate (investment grade)	GBP	0.3%	0.5%	-0.7%	3.5%
Euro Government Bonds	EUR	0.2%	0.5%	-0.7%	0.9%
Euro Corporate (investment grade)	EUR	0.1%	0.0%	0.8%	2.8%
Euro High Yield	EUR	0.0%	0.2%	3.7%	8.8%
Japanese Government	JPY	0.1%	0.0%	0.4%	0.6%
Australian Government	AUD	0.9%	0.7%	0.4%	0.4%
Global Government Bonds	USD	-0.2%	-0.5%	-3.6%	-1.6%
Global Bonds	USD	-0.3%	-0.6%	-2.8%	-0.4%
Global Convertible Bonds	USD	-1.3%	-1.5%	-1.3%	11.2%
Emerging Market Bonds	USD	0.1%	0.3%	-2.2%	1.2%

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Asset Class/Region	Currency	Currency returns			
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Property					
US Property Securities	USD	-0.4%	-0.3%	26.8%	37.6%
Australian Property Securities	AUD	1.3%	3.1%	11.3%	27.8%
Asia Property Securities	USD	-1.9%	-0.8%	2.1%	8.6%
Global Property Securities	USD	-1.0%	-0.1%	16.5%	29.0%
Currencies					
Euro	USD	-0.8%	-1.3%	-4.3%	-1.3%
UK Pound Sterling	USD	-1.7%	-1.9%	-0.2%	3.3%
Japanese Yen	USD	-0.1%	0.0%	-5.9%	-3.6%
Australian Dollar	USD	-3.2%	-2.8%	-7.2%	-0.5%
South African Rand	USD	-4.1%	-4.9%	-4.5%	12.9%
Swiss Franc	USD	-0.1%	-1.1%	-3.5%	-0.9%
Chinese Yuan	USD	-0.4%	-0.6%	0.4%	6.4%
Commodities & Alternatives					
Commodities	USD	-4.8%	-6.0%	22.7%	37.4%
Agricultural Commodities	USD	-3.5%	0.5%	20.2%	48.1%
Oil	USD	-7.7%	-14.6%	25.8%	45.2%
Gold	USD	0.1%	-1.8%	-6.0%	-8.4%
Hedge funds	USD	-0.5%	-0.3%	3.2%	8.7%

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