China: Game Over? September 2021

OVERVIEW

- **Chinese equities have lagged both emerging market and global equity indices year to date.**
- **Recent regulations directed toward education and technology companies have caused Chinese equities to come under pressure.**
- **As further regulatory actions appear likely, should investors continue to allocate to Chinese equities?**

Background

Looking back to 2020, China seemed impenetrable. As COVID-19 emerged in early 2020, Global Equities (MSCI All Country World Index, ACWI) fell 21% in the first quarter, while the MSCI China Index fell only about 11%. At the end of 2020, the MSCI ACWI was up nearly 17%, and the MSCI China Index was up nearly 29%. Fast-forward to 2021, the story is quite different. Year-to-date through August, the MSCI China Index is down about 12%, compared to EM equities which are up just over 3%, and global equities (ACWI) which are up over 16%. Much of China's weakness occurred in the month of July.

	2020	YTD Aug 2021	Jul 2021	Aug 2021
MSCI ACWI	16.8%	16.2%	0.7%	2.5%
MSCI EM	18.7%	3.1%	-6.7%	2.7%
MSCI China	29.0%	-11.9%	-13.7%	0.1%
MSCI China A	43.2%	-1.2%	-6.6%	1.1%

Source: ACG Research

Following the Chinese equity sell off in July, ACG surveyed over 15 investment managers around the world, including teams in Singapore, Hong Kong and mainland China, to gain broad and diverse perspectives on how China's regulatory actions might play out.

Economic Softness and Increased Regulation

While most of the recent equity market weakness in China occurred in July, Chinese equities had lagged the broader EM Index earlier in the year. This could be attributed to China's moderating economic growth trajectory in 2021, while other global economies accelerated off more depressed 2020 bases.

What surprised investors in late July was the swift overhaul of the education sector, specifically the after school tutoring (AST) industry. The Chinese government mandated that AST for grades K-9 be run as not-for-profit organizations. As opposed to prior regulatory actions where the penalty was a fine or mandated change in how business is conducted, this decision significantly reduced profit opportunity for education companies.

Regulatory Timeline

Since President Xi Jingping came to power in 2013, he has emphasized the long-term nature of his vision for China. Regulatory cycles have been consistent with his plan to achieve long-term goals. In light of this, investors have had to discount any near-term economic/market disruptions caused by regulatory actions.

A recent string of regulatory changes has been a stark reminder of such risks. In 2020, regulators halted the IPO of Ant Financial causing affiliate Alibaba to lose 8% (or $60 billion dollars of market value) in one day. Other actions in 2021 include crackdowns on anti-competitive practices (Tencent Music & Meituan), data privacy/national security (Alibaba & Didi), the aforementioned education sector (New Oriental Education & TAL Education) and most recently restrictions on online gaming.

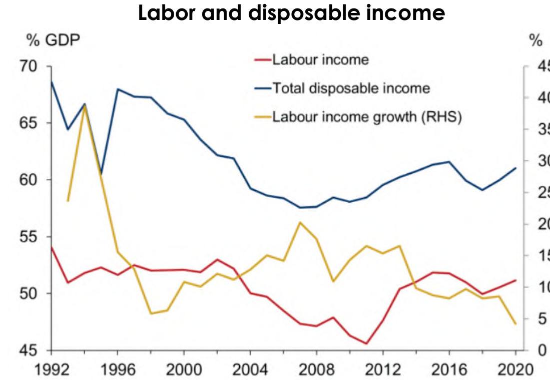
Striking a Balance

China is trying to strike a balance between fostering "common prosperity" for all of its citizens while maintaining social harmony and control over the country. The basic tenets of common prosperity include equal access to public services, a "reasonable distribution system" of taxes and transfer payments, equal educational opportunities, and giving back to society for high income groups. China's current Five-Year Plan includes nineteen key initiatives, but many of these have common linkages to both economic and socially oriented outcomes which recent regulatory actions are designed to address.

What's Next?

China's economic growth and developing financial system have created significant wealth in the country and increased income inequality:

Labor and disposable income



Source: Oxford Economics/Haver Analytics

The gap between labor income and total disposable income in China remains quite large and labor income growth has decreased significantly since 2007. As a result, companies using unfair practices that are anti-competitive or otherwise seen as contributing to China's widening income inequality could potentially be targeted by regulators. In contrast, those companies who "play by the rules" and are perceived as positively contributing to reducing inequality could see material upside.

Conclusion

China's growing income disparity threatens its "common prosperity" goals and will likely lead to more regulation down the road. Additional impacts of the government's wealth redistribution efforts are likely to include higher taxes, higher business costs, decreased foreign investment, and potentially slower economic growth. Given these uncertainties, a macro/top-down approach to investing in China could remain challenging. As such, ACG continues to favor active emerging market equity strategies where managers can weigh the risk/return tradeoffs at the company level within China and at the country level when opportunistically allocating between China and other regions.

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