China – Healing Self-Inflicted Wounds?

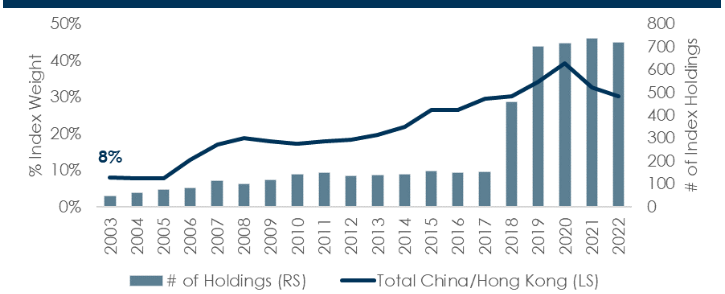
January 2023

- **Through rapid growth in fixed investment and trade, China has become interwoven into the global economic landscape**
- **In recent years, hard line policy stances have stifled economic growth**
- **A pivot in late 2022 toward easing of policy stances may prove to be a catalyst for future growth**

China's Role in the Global Landscape

As the driver of global real gross domestic product "GDP" growth over the past decade, China is now the second largest economy in the world and the largest trading partner with the United States. Within the MSCI Emerging Markets Index, China has grown from an 8% to 30% weight and 50% of holdings.

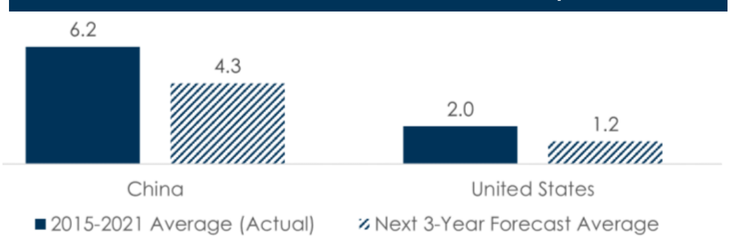
China's Increasing Importance in Emerging Markets



Source: ACG Research, Bloomberg

Despite its growth and expanding role in the global landscape, China has acknowledged the need to transition its economy from a focus on fixed investment and exports to consumer spending, services, and innovation. In doing so, China has embraced slower forward-looking economic growth (albeit higher than most developed countries) as its economy continues to evolve.

China's Slower Real GDP Growth Still 4x US Expectations



Source: ACG Research, Bloomberg

Self-Inflicted Wounds

A Zero Covid policy, stringent big-tech regulations, and accounting transparency issues are key factors that have impacted growth, equity valuations, and investor sentiment toward the Chinese market.

Its Zero Covid policy has stifled approximately 20% of the world population's ability to spend, constrained the global supply chain, and increased inflationary pressures. On the technology front, new laws limiting the screen time of individuals under 18, record setting anti-monopoly fines, and increased scrutiny of e-commerce platforms have stifled growth, investment, and innovation in big-tech (four stocks represent 28% of the China Index). According to the US, China has historically imposed laws and regulations that impeded the US Public Company Accounting Oversight Board ("PCAOB") from obtaining audit-related documentation of the approximately 260+ Chinese-domiciled companies listed on US exchanges.

Potential Catalysts for China

In October, President Xi won an unprecedented third term as the leader of the ruling Communist Party and filled his cabinet with close political allies. The initial market reaction was negative on fears that the consolidation of political power would provide the ability to maintain hardline policies. However, since Xi's reelection, China has announced waves of policy easing measures.

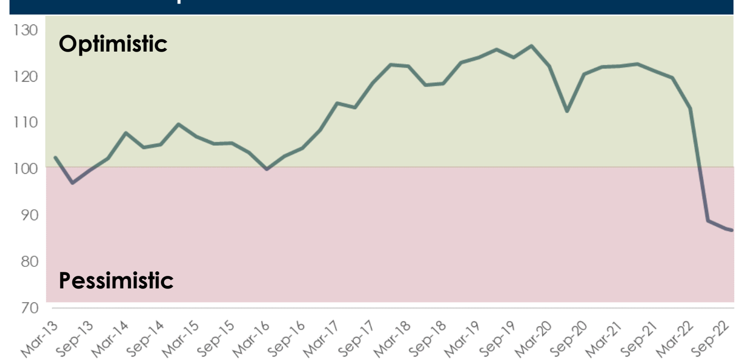
In early December, Xi announced a policy shift from "Zero Covid" to "20 measures for optimizing Covid control" by reducing quarantine periods, reopening major cities, allowing citizens to quarantine at home vs. at a state facility, and removing tracking of close contacts. In late December, China announced it would drop the quarantine requirements for international travel in early January 2023, reopening travel to/from the rest of the world after approximately three-years of severely constrained travel.

Regulations on tech companies are likely to remain, however the government has indicated it will modify policies to support the economy, including its internet platforms and online marketplaces. Since June, China has approved over 60 online games, eased restrictions on the tech IPO market, and allowed previously restricted companies to resume new user registrations.

From a transparency perspective, the US PCAOB announced in December that they have gained full access to inspect and investigate Chinese-domiciled companies listed in the US for the first time.

Chinese consumer confidence was at 10-year highs prior to the Zero Covid policy in 2020. Recent steps to reopen the economy have slowed the pace of declining consumer confidence.

Massive Drop in Chinese Consumer Confidence has Slowed



Source: ACG Research, National Bureau of Statistics of China

ACG's Position

Despite the recent slowdown, China remains a key driver of the global economy and the emerging markets index. Short-term risks remain around reopening the economy, but recent shifts in policy may prove to be a catalyst for future growth. For investors who are underweight emerging markets, we believe it may be an opportunity to rebalance back to a neutral stance relative to their respective policy.

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