INVESTMENT BRIEF

Q3 2021

Strategic Investment Group®

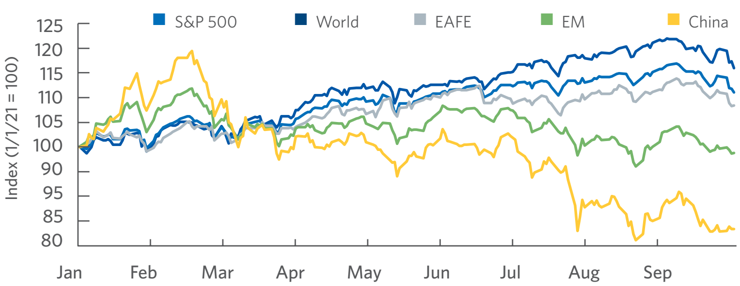
China Equity Market Dynamics

Like the Chinese economy, Chinese capital markets have grown rapidly, deepened, and opened to the rest of the world. In contrast to other major equity markets, the Chinese market has declined so far this year while others have enjoyed strong gains (Exhibit 1). Uncertainty generated by a regulatory crackdown, slowing economic growth, and concerns of froth and debt levels in the real estate market have contributed to the divergence between equity returns in China and the rest of the world. This quarter's Investment Brief considers the causes and implications of recent Chinese equity market dynamics.

EXHIBIT 1:

China Lags other Equity Markets

Sources: MSCI, Bloomberg. Data through September 30, 2021.



Regulatory Screws Tighten

The Chinese government has historically championed domestic technology firms for their strategic value and as agents of growth. These efforts have fostered the successful development of large tech companies that have attracted foreign investment, and in some cases become dominant players. Since Q4-2020, however, the government has cracked down on monopolistic business practices and increased its regulatory scrutiny across the tech sector. Sweeping actions ranging from large fines to outright bans contributed to selloffs for many prominent Chinese firms, including Alibaba, Tencent, and Meituan – the country's three largest companies. While uncertainty about future regulations remain, many of the new regulations mirror those that are already commonplace in advanced markets.

Growth through Common Prosperity

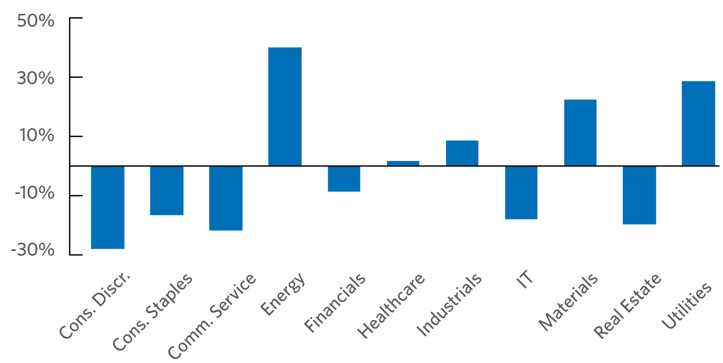
Crackdowns have also sought to rein in market segments that are misaligned with President Xi's new "common prosperity" agenda aimed at balancing economic growth, social cohesion, and financial stability. The government has focused on reducing the three largest costs for families: education, housing, and healthcare. Recent regulatory actions include tightening controls on ubiquitous afterschool tutoring companies, reducing real estate speculation by imposing mandatory minimum holding periods, and instructing digital platform companies to improve the pay and conditions for tens of millions of "gig economy" contract workers.

Many of our managers expect additional regulatory announcements in the future, particularly around housing and healthcare, sectors that have underperformed recently. Sectors that align with China's national development objectives, including green/renewable energy and infrastructure, have in contrast outperformed (Exhibit 2).

EXHIBIT 2:

Chinese Equity Returns by Sector

Sources: MSCI. YTD through September 30, 2021.



Separately, overseas stock listings used by many of the largest Chinese firms to access international capital have also come under scrutiny. Regulators halted the IPO for financial giant Ant Group in November 2020 and, this year, banned ride-hailing company DiDi from enlisting new users two days after the company's U.S. IPO. Questions surrounding the continued viability of "variable interest entity" (VIE) structures used by offshore investors to gain access to Chinese firms precipitated the decline. VIEs are designed to circumvent rules forbidding foreign ownership in firms operating in key sectors of the Chinese economy. A complete ban against these structures appears unlikely, as it would largely cut China off from most foreign capital permanently. Moreover, several large companies have started looking into Hong Kong listings to mitigate some of the potential future regulatory risk while retaining access to international investors.

Credit-Fueled Property Market Speculation

The recent default to bondholders by the country's largest property developer, China Evergrande Group, has also underscored risks posed by rapid credit-fueled speculation in the property market. While the risks are real, Evergrande's collapse was triggered by a deliberate policy decision by the central government to cool an overheating market, not a market crisis with systemic consequences. By its action, the government has signaled that it is willing to enforce financial discipline rather than wait for the market to do so. The ultimate result of these steps may well be a sounder property sector.

Looking Ahead

Although recent Chinese market dynamics highlight the inherent risks of abrupt changes in policy and the perils of credit-fueled speculation, the Chinese authorities have powerful tools and the political will to preserve market stability. Moreover, the Chinese market is likely to continue to grow, deepen, and open, making it an attractive investment destination offering opportunities for adding value. We plan to continue to exploit this opportunity.

Note: Opinions expressed herein are current as of the date appearing in this material and are subject to change at the sole discretion of Strategic. This document is not intended as a source of any specific investment recommendations.

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