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Making Sense of China

- **The reasons for China's equity market wobble were some years in coming**
- **President Xi Jinping has been very consistent in promoting a more socialist agenda for economic reform**
- **Investors will have to re-adjust their expectations for the future of previous growth industries in Edu-tech and internet related.**
- **Good investment opportunities remain in sectors that will benefit from ongoing good GDP growth and those promoting the domestic development of technology**
- **The equity market is good value but warrants a higher risk premium after the recent setback**

It would be a mistake to explain the developments in the Chinese equity markets in the past few weeks with some trite comments on politics. These issues have manifested in some high-profile near-term losses for investors in equity markets; however, the backdrop is far more complex and calls for a deeper analysis.

China's evolving socio-political landscape. Ever since the appointment of Xi Jinping as the CCP general secretary in 2012, China has been on an 'adjusted' path, different from the one seen during the times of Deng Xiaoping. Economic reforms and opening-up have been more nuanced, with a strong focus on further structural reforms. Still, the state appears less certain about a full-fledged "socialist market economy", and by implication, the CCP is taking a far more central role in policymaking. When President Jinping came to power, he spoke of a Chinese dream – strong GDP growth, a more formidable military, and the state meeting the social welfare needs of the people. Unfortunately, the markets had got into a frame of mind that despite the 'dream', China would ultimately remain on a capitalist path where profit was omnipotent – that has clearly not been the case.

In the past few weeks, part of what we have seen is a rather heavy-handed rolling back of liberalisation of industries where the centre believes that the social goals are not being achieved. In the early 1990s, China's government retreated from its monopoly on social welfare provisions. Consequently, the private sector grew rapidly in areas such as education, medical care, and environmental protection industries. It's also worth noting that the internet became a vibrant (private sector) contributor to a more open economy during this period.

The tightening of central control has had its roots in the decision in late October 2016 at the Fifth Plenum of the 18th Party Congress to designate Xi Jinping as the core of the political leadership. Subsequently, in March 2018, the CCP amended its policies to allow a leader to stay indefinitely, i.e., beyond 2022. I remember being in Beijing at a conference shortly after the decision. One of the government speakers alluded to the clarity in the country that gives a clear path for the economy in years to come.

With time, Xi Jinping is adjusting the economy to the agenda he has set. The growth forecasts were achieved, military spending is higher, and the country is far more active in overseas diplomacy. The final element, which is a more socialist model of governance, is starting to be more evident in policymaking. The policy shifts may appear heavy-handed, but in truth, there have been some runaway trains of reform that the centre has not been happy with. Even people in the West might sympathise with the recent controls imposed on the education system. People's social mobility was heavily compromised by a vibrant private sector that 'guaranteed' good school grades and university attainment... as long as you had money. Given that the median income in China is \$4,300, the sector was not carrying out a good socialist agenda.

The question, of course, is, why is China making these changes now? Xi Jinping was always seen as a politician who plays the long game. Still, the opportunity to push back was created by a combination of his increasing control over the CCP and the antagonism from the previous Trump administration.

The internet space has been another point of contention. The data collection troubles in the internet sector are not just a China problem. Congress in the US is already investigating many internet companies for market abuse. While capitalist countries, particularly the United States, are loathed to undermine their national champions, things are different in China. At the core of the investigations is the abuse of customer data, a topic of debate in both the East and the West. As an Asia Times [article](#) pointed out, China's state media stated that "the government will not allow internet giants to become rule-makers of data collection and usage. The standards must be in the hands of the government to ensure that giant companies are restrained".

The knee-jerk reaction of foreign investors appeared to suggest that China has become un-investable. While we can contextualise the demolition of specific company share prices going back to the Ant Group IPO last year, it simply doesn't help sentiments, at least in the near term. Investors are likely to remain circumspect about investing in the Chinese equity markets for some months to come until there is a clearer understanding of the scope of the Chinese government's intervention.

Chart 1: MSCI China Index falls sharply after a three-month consolidation



Source: Bloomberg

So, in trying to make sense of the past few weeks, we would provide some guidance points.

China is a socialist state that has a leadership committed to balancing economic growth with socialist

ideals. The authorities will at times be at odds with capitalist thinking. Investors should be wary of investing in companies that challenge the ideals of the state. Competitive markets, and not monopolistic markets, should be investors' focus, unless, of course, the state is strategically involved.

Tech will come back, but the emphasis is on the tech that replaces international supply challenges, and not the tech that exploits household data. Beijing wants to see "hardtech" such as semiconductors, renewable energy, agritech, and biotech. Also, China is making a huge effort in the robotics industry to improve productivity and make up for slow population growth.

Global investors cannot ignore China. The scope for robust economic growth and further development of its economy will remain. The huge underdeveloped domestic market will remain attractive to many companies. China has not shut the door to international investors, and the authorities were keen to calm things down after the market turmoil.

For the near term, (i) active, not passive management at the broader market level and (ii) focus on the domestic market, and not the international giants, should be the criteria. The A-share domestic market will look relatively attractive given the heightened level of regulations and oversight on international quoted stocks. However, the regulators highlighted last week that even in the local markets they were tightening restrictions on "illegal activities" such as insider trading and financial fraud.

Bottom line is, we are left with a sense that we could have seen some of this coming. China's leadership has been articulating a socialist agenda for some years now. Its capital markets are still work-in-progress and hence there is always the risk of hiccups along the way. However, the step changes are not welcome in the sense of market volatility. Chinese equities are cheap in a global context but will warrant a high risk premium until investors are sure of the scope of the government's crackdown.

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