China Update: Common Prosperity in China

Market Insight

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October 13, 2021

The Chinese government and regulation have long played a key role for investors who venture into Chinese equity investments. However, in recent months, this protagonism has taken a new dimension as sweeping regulations from Chinese policymakers have alarmed investors with the speed, scope and scale of its moves. As the MSCI China Index fell -30% since its February peak through the end of September[i], even the most experienced investors were left wondering whether China has had gone from too big to ignore, to un-investable.

FROM GROWTH AT ALL COSTS TO COMMON PROSPERITY

To better understand China today, we must place it in the context of the extraordinary economic leap it has experienced over the last 43 years. When China opened its door to foreign businesses in 1978, its economy represented only 1.7% of global GDP and 84% of the population lived below the poverty line[ii]. Since that point, China's economic output has expanded 98 times to become the world's second largest economy[iii]. Its annual output represents nearly 17% of global GDP, and as of 2019, only 0.6% of the population live below the poverty line[iv].

> "We believe that China is prioritizing long-term sustainability over growth after four decades of unfettered economic expansion unleashed by the "reform and opening up" policy from 1978. Viewed from this prism, recent developments in China have been years in the making and should lead to a more sustainable future if executed well."
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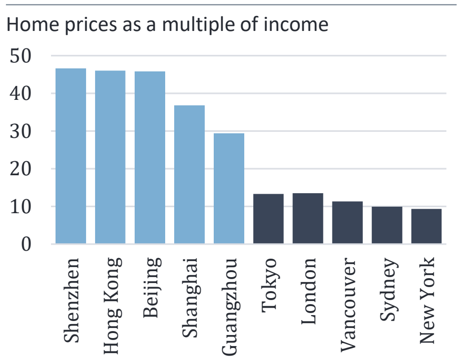
> *-Specialist with Hong Kong investment team*

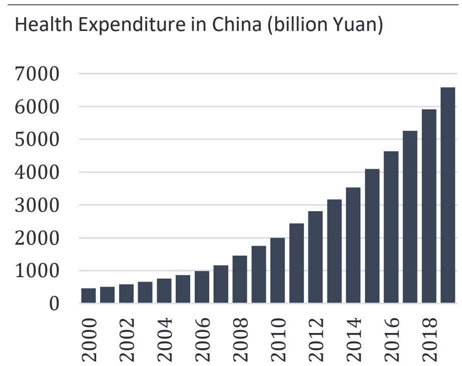
This period of sustained high growth was made possible by policies that prioritized growth and market efficiency over legal and regulatory protection. With little regulation to govern new sectors such as internet, e-commerce and education, private companies grew at a rapid pace, taking an increasingly important and influential role in China. Today, the private sector accounts for 70% of GDP, 80% of employment and 95% of new jobs created[v].

One of the key consequences of pursing a policy focused on promoting growth at all costs is the inevitable widening of the wealth gap of the population. During this period, the government let a small group of people (i.e. entrepreneurs) to get rich first with the goal of spreading the wealth later. Last year, China's richest 20% had 10 times more disposable income than the bottom 20%[vi]. At the same time, the burden of property, education, and healthcare costs, known as the "three big mountains" that Chinese families must climb, started to become insurmountable. Indeed, parts of the younger population started to think twice about starting families and tackling these mountains. This environment has further contributed to one of China's greatest challenges: demographics. With an ageing population and declining birth rate, China's working age population is projected to decline while the elderly population will continue to climb.

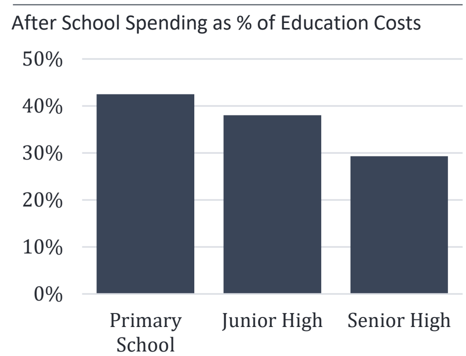
Property



Health Care



Education



Source: Bloomberg and Statista. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision

Having largely achieved its goal of strengthening the nation's economic potential and lifting the country out of poverty policymakers have shifted their focus on fixing some of the imbalances created by the growth-focused policy of the last 40 years. Afterall, while less emphasized at certain moments in history, socialism remains the core principle of the governing party. The policy of growth at all costs, has been replaced with an inclusive and sustainable growth model. The focus now is on "**Common Prosperity**". Although the new regulations of 2021 may seem sudden, investors closely watching China suggest that these polices are part of a continuum of reforms that have been in motion for several years. China has been pushing for greater regulation since the mid-2010s. The cadence has simply accelerated in 2021.

IMPLEMENTING THE CONCEPT OF COMMON PROSPERITY

The concept of common prosperity is expected to impact policies across multiple aspects of Chinese life and economy. Areas where we have already seen shifts include:

- **Reforming Income Distribution**
  The government has set out a goal to reshape the pyramid wealth structure to an olive shape. Policymakers have pursued reforms against labor abuses and an excessive work culture. Private philanthropy has been strongly encouraged. Scrutiny and enforcement of taxes of well-known public figures have increased.

- **Providing More Equal Opportunities Across the "Three Big Mountains": Education, Healthcare and Housing**
  In July, China issued major changes to education policy, including strict regulations on the private education industry that seek to decrease the cost and prevalence of tutoring. These policies have all but wiped out the for-profit education business model. In June, policymakers announced a plan to reform the healthcare system further. While details have yet to surface the goal will be to expand availability of healthcare resources and distribute them more equally. Meanwhile, the excessive use of leverage by property developers has been a long-time concern as it risks increasing not only financial risk but also property prices. The government has been warning about property speculation for years and finally introduced the three red-line policy which sets leverage ratios for property developers.

- **Addressing Monopolistic Behaviors**
  Throughout 2021, regulators have tightened screws on large companies deemed to be monopolistic, too wealthy, and/or too influential. In February, China issued revised antitrust rules for internet firms. In April, Alibaba was fined 18.2B yuan in China's anti-monopoly investigation after its ANT Financial IPO was cancelled two days before listing last October. Later that same month, China opened an anti-monopoly investigation into Meituan which resulted in a fine of 3% sales earlier this month. In July, regulators ordered local app stores to remove Didi's app, days after its IPO in the US on concern of consumer data privacy

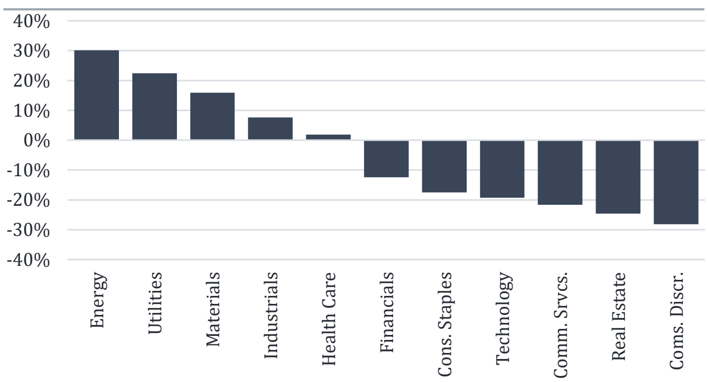
- **Spiritual Opium**
  More recently, online gaming, described by the state media as spiritual opium, has been the target of regulatory campaign towards a common prosperity. China has forbidden children under the age of 18 of playing video games for more than 3 hours per week. Policymakers suggested that Macau's Casino companies are next in line as plans to tighten regulation were announced in September.

> "Obviously 2021 is big year in terms of regulation rollout. All the policies and regulations on internet platforms, off-campus tutoring, healthcare, and property sectors are part of China's holistic social governance. These policy directions had been set in as early as 2018, but still came as a shock in 2021, showing that the market had underestimated the government's political will to implement these strategic decisions."
>
> *- Local specialist based in Beijing*

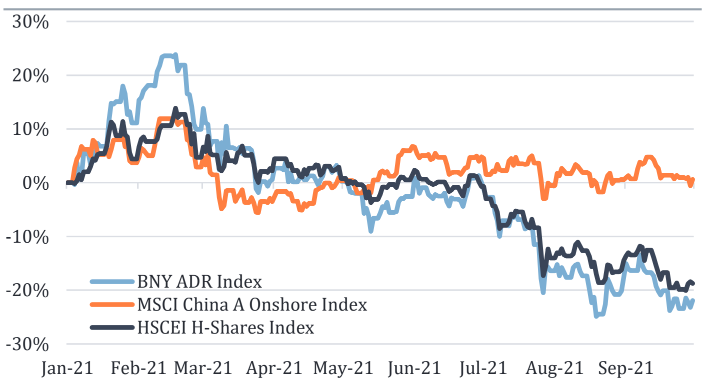
THE ROLLERCOASTER FOR THE CHINA INVESTOR

The combination of the volume of regulatory changes and the sudden nature with which China implements new policies have created what felt like a rollercoaster from China and Emerging Markets investors in 2021. The MSCI China Index is down -16.5% unperforming the broader MSCI Emerging Markets index by over 15%[vii]. While the Chinese market as a whole has struggled, losses have not been even. Targets of China's regulatory paradigm shift have suffered the greatest losses. From a sector standpoint the worst performers included real estate along with new economy sectors like education, technology and e-commerce. Meanwhile, sectors such as utilities, industrials and energy were more resilient.

2021 Performance Dispersion by Sector



2021 Performance Dispersion by Listing Type



Source: Bloomberg as of September 30, 2021. Graphs are presented for illustration purposes only and should not be relied on to make an investment decision

US listed Chinese ADRs faced the greatest headwinds. Their larger weight towards new economy stocks such as technology and education has been a drag on performance. The hurdles for these stocks are greater than those of other listings as they have come under pressure not only from Chinese regulators but also US regulators. Meanwhile China A shares endured relatively better, up +0.6% for the year[viii]. This listing type tends to be more diversified and also has more exposure to small and mid-cap stocks in industries that could be beneficiaries from China's policy direction change (example: electric vehicles and renewables). More importantly, however, reforms not only affected sectors and listing types differently, but they produced outsized winners and losers within these subgroups. Stock picking is as important as ever in the current environment.

WHAT NEXT? OPPORTUNITY OR UN-INVESTABLE

Most policies and regulations start with good intentions but whether they will achieve the goal will come down to execution. As policies in China can rotate from extreme to extreme, it can be difficult for people and corporates to adjust. The stock market has been very volatile due to these uncertainties, but it is likely investors will have more clarity going into 2022.

With regards to equity investments, the ability to generate alpha in these markets will be highly dependent on a deep understanding of the markets that is typically only obtainable by being an experienced specialist with deep networks and knowledge from being locally based. This knowledge allows local specialists to see through the uncertainty and find attractive opportunities as the environment in China changes and evolves.

> "Should investors run with George Soros, who has argued that the Common Prosperity Plan spells the end of capitalism, the death of entrepreneurship, and a return to the era of Maoism? As far as we can tell, there isn't a lot of evidence of those intentions in the Grand Plan. In addition, President Xi personally announced the setting up of the Beijing Stock Exchange for small- and medium-sized companies as recently as September 3rd. Which entrepreneur would want to list his or her company if Xi and his team are targeting them in their Common Prosperity Plan? It makes no sense whatsoever."
>
> *- Local specialist based in Shanghai*

> "The opportunity to generate alpha in China is as great as ever, however, the investment framework under the new regime requires a different skillset from what worked during the last two decades."
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> *-Specialist with Hong Kong investment team*

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[i] Source: Bloomberg as of September 30, 2021

[ii] Source: World Bank as of 2020.

[iii] Source: World Bank as of 2020.

[iv] Source: World Bank as of 2020.

[v] Source: The Straits Times as of September 2, 2021. https://www.straitstimes.com/opinion/china-the-search-for-a-new-destiny

[vi] Source: Bloomberg as of January 18, 2021. China's Wide Income Gap Undercut Spending as Growth Recovers.
https://www.bloomberg.com/news/articles/2021-01-18/china-s-strong-growth-masks-unbalanced-recovery-as-incomes-lag?sref=P6xXtEaF

[vii] Source: Bloomberg as of September 30, 2021

[viii] Source: Bloomberg as of September 30, 2021