

China: How to ride the new wave?

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China's drive towards 'common prosperity', aligned to strengthening both national security and social welfare, has resulted in a new wave of regulation which may have a ripple effect that spreads far and wide. This new wave may not have reached its peak and investors should consider how best to ride this wave as it ultimately affects investments in risky assets.

The US Vice President, Kamala Harris, recently emphasised China's threat to the Asian region while reassuring nations in the region that the US will not force countries to choose between the world's biggest economies. Looking beyond Asia, the impact of China's policies cannot be ignored.

China is one of the largest contributors to global economic growth and has been a driving force for the past 13 years. As a major trading power, China's substantial demand for imports such as energy and agricultural products helps boost corresponding exports from its trading partners. The world's most populous country, China is also the second-largest economy in the world. China's Gross Domestic Product (GDP) was worth over \$15 trillion in 2020, according to official data from the World Bank, representing more than 13% of the global economy. The country currently has the highest global ecommerce market share, including the highest number of tech unicorns, and holds the largest foreign exchange reserves.

It is also worth highlighting that China is quite different from other large economies like the US and Europe in terms of how its economic conditions ripple across the world. The linkages through its direct demand for goods and commodities are significant, primarily due to its high population. Compared to other large economies, China typically exports much less capital, and few global reserves are held in Renminbi (RMB), its official currency. As a result, it is not significantly impacted by changes in capital flows as experienced in Europe during the Euro-zone slowdown. The larger foreign reserves also insulate China from US monetary policy changes due to the lesser need to borrow or repay in foreign currency. Despite this distinctive difference, there are idiosyncratic pockets around the world where China's slowdown can have significant impacts, especially in some developing countries which are dependent on its products, some of which are very sensitive to their economies. Those countries might be in serious trouble, if for instance, China decides to cut exports to them.

The common prosperity agenda calls for a more equal distribution of wealth which would be achieved in part through more government intervention in the economy and more steps to get the rich to share the fruits of their success. The Chinese Government wants to establish a society in which all property is publicly owned, and each person works and is paid according to their abilities and needs. President Xi Jinping has given his



party a new development model to implement, one that prioritises social fairness and national security, though implicit is the aim of strengthening the party's control over an increasingly technology-driven economy.

While the success of this policy is uncertain, we are witnessing an inflection point in the Chinese economic life. The Chinese economy is facing structural reforms which will see a prolonged period of regulatory uncertainty and state-market intervention. The government will have a level of control that would allow it to steer the economy and industry along a path of its choosing, and channel private resources into strengthening power of state. This will likely damage business sentiment and market efficiency. The Chinese Government insists that these policies are targeted at increasing the size and income of the middle class and boosting social welfare. This political-economic shift has the potential to catalyse rebalancing growth in China, thereby affecting long-term growth prospects.

The timing of pushing the common prosperity agenda is not a coincidence. It is happening when the ruling Communist Party, which has been in power for over 100 years, is expected to host its once in a decade leadership transition at the 20th Party Congress due in late 2022. President Xi Jinping, regarded by some as the most powerful Chinese leader, is expected to break the established system of succession to stay in power at that Congress. The party's standing among its original base, the working class, and the rural underprivileged is growing strong, hence the justification of President Xi's continued stay in power. China used its unique economic system to compete with the West when it opened up some areas of its economy to the private sector, but the time might have come for large private business owners to be reminded of the country's social and economic agenda. Sectors targeted to date include technology, after-school tutoring, digital gaming and entertainment.

Chinese policymakers have been cracking down on sectors whose business practices are believed to harm the country's social standings. Rules providing guidance on anti-competitive behaviour, including abuse of dominant market positions, and use of concentration and market power to restrict competition have been enacted. Digital gaming stocks have been criticised for the social consequences of video games. Home-schooling education companies have been pressured to register for non-profit status. Manufacturing hubs were ordered to limit power usage, a blow to electricity-intensive businesses largely in the materials industry. China also banned all crypto transactions and undertook to root out the mining of digital assets, delivering the toughest blow yet to the crypto industry. The local casino industry has not been spared and was hit by potential reforms including increased equity ownership requirements for directors and an end to future sub-concessions. In the real estate development industry, China has been tackling unbridled borrowing with caps for debt ratios. This has been dubbed the 'three red lines', which outlines caps for debt-to-cash, debt-to-



assets and debt-to-equity ratios. These red lines have resulted in the fall out of China's second largest developer, Evergrande.

While European Central Bank President Christine Lagarde has reiterated, for instance, that Europe's direct exposure to Evergrande is limited, investors should holistically consider this Chinese new wave. The US and European equity markets have so far brushed aside China risks largely due to solid seasons of corporate earnings. It is unclear how long that will last though, as the world's second largest economy is faltering and likely set to weigh on global profits which would affect the US and European markets. As the Chinese political calendar remains charged and with those in authority very keen to bolster populist agendas in pursuit of retaining power, political scrutiny of markets is likely to remain elevated, rather than recede in the foreseeable future.

The challenge is to assess which industries or sectors are likely to be winners or losers in this wave. The starting point of such an assessment is to establish why the regulatory offensive is taking place now instead of later. Second in the assessment is understanding the overall objectives of the new regulatory wave which is aimed to address areas such as education, healthcare and property development. Consequently, companies in these sectors may face the wrath of the regulation blitz while winners will be from sectors and businesses aligned with the core national objectives of technological self-sufficiency, advanced manufacturing prowess and green development.

Opportunities appear to be out of those industries that align with national objectives such as technology hardware and semiconductor companies. These are likely to continue to benefit from an exceptionally strong policy tailwind. However, because the execution of the crackdown on firms is both unpredictable and inconsistent, the broader market is likely to remain volatile as it seeks to determine how much of a discount is appropriate for individual names. Outside of the education and property development sectors, consumer discretionary and health care sectors are the most susceptible sectors at the moment. The Chinese Government's objectives of common prosperity include reducing inequality, improving social welfare and encouraging the ultra-high net worth individuals and mega companies to contribute more to the society. These objectives have been the driving force behind recent regulatory actions aimed at highly profitable consumer facing online platforms. The still relatively high valuations in the consumer discretionary and health care sectors suggest that further measures are likely, and investors may want to avoid these sectors. Outside of equities, government bonds will likely continue to be a favoured safe haven for local and other emerging market investors. Commodities are likely to continue to be under pressure given the recent slowdown in the property, which have negatively affected the demand for construction commodities such as iron ore. Investors should therefore approach the commodities market with caution given this new wave.



Overall, the common prosperity drive might slow GDP growth, raising an additional concern for Chinese equities. However, China is among the fastest growing markets and has the scale, economic complexity and income level to support equity valuations above global average levels. Chinese equities now equate to just over a third of the MSCI Emerging Markets index, signalling the significance of the Chinese market in the global landscape. Investors will have to get both valuations and politics right as they pick up investments with exposure to China, a decision that is not going to be easy.

Sources

World Economic Forum, www.worldbank.org

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