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Amundi ASSET MANAGEMENT

INVESTMENT TALKS

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Main themes for investing in Chinese equity over the summer and beyond

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- ***Regulatory storm:*** *All eyes are on the recent tightening of regulations for tech and education companies by Beijing and on possible new measures that could affect other sectors. Under this regulatory pressure, the Chinese market has underperformed both MSCI DM and MSCI EM indices following a strong performance in 2020. In the short term, China's regulatory tightening could be challenging and may include restrictions on companies listing overseas using the Variable Interest Entity (VIE) structure. Furthermore, in autumn 2022, the Chinese Communist Party (CCP) will hold its 20th National Party Congress, adding uncertainty over new policies. This could keep volatility high. However, this short-term correction coupled with possible further weakness should prove healthy for the market in the medium term and could be seen as an opportunity for investors looking for sustainable returns.*
- ***Political rationale:*** *With its move, the Chinese government aims to address inequalities and promote common prosperity. On a long-term perspective, this policy could boost competition and reduce systemic risks.*
- **Economic outlook**: *From a macroeconomic standpoint, with China's growth decelerating somewhat in Q2 and overall inflation contained, the dovish policy stance should continue for the rest of the year. We cannot rule out downside risks from new wave of Covid-19 but the government and the PBoC have ample resources to deal with it.*
- ***Investment implications:*** *Despite recent turbulence, we remain constructive on the Chinese equity market over the long term. We think that recent weakness has opened up interesting opportunities. Investors could take advantage of the sell-off to increase their allocation to Chinese equity in global portfolios, with better entry points that could deliver positive returns over the medium term. We see compelling opportunities in China for selective investors, supported by the increasing geopolitical relevance of China globally, its economic power, its emerging middle class and the rising share of China in EM indices.*

Chinese tech crackdown and how far the regulatory move could go

Over the past year, the Chinese government has instituted a variety of regulatory measures that have unnerved investors. There have been anti-trust measures against e-commerce giants, new data security laws to prevent companies from transferring information abroad, new capital requirements in the fintech sector, and greater scrutiny of companies' plans for foreign listings. The latest move to limit the for-profit status of education companies has sent their share prices plummeting to multi-year lows. The key question investors are now grappling with is how much further this regulatory campaign will have to run and the implications for investing in China going forward.

Regulation in an historical context: we have been here before

While the current spate of regulation changes looks heavy-handed, it may be helpful to view them in an historical context. This is not the first time the government has tightened regulation sharply over a short period of time. Over the last decade there have been several similar episodes:

- In 2012 the government clamped down on the foreign holding structures of Chinese companies listing abroad;

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- In 2015 the government conducted a far-reaching campaign against corruption in public life that impacted the luxury goods and Macau gaming sectors among others;
- In 2017 regulators placed restrictions on companies' outbound M&A and investments abroad; and
- In 2018 there was increased scrutiny of the online gaming and after-school-tutoring markets as well as reforms to collect social insurance premiums from businesses.

While these episodes weighed on market sentiment in the short term, ultimately they helped market returns over the longer term by plugging loopholes in the regulatory system, boosting competition and reducing systemic risk. Indeed, China experienced the highest productivity growth of any major economy during the period of its most intense regulatory activity: in 2013-19, total factor productivity grew steadily at 2.1% per annum compared to a deceleration experienced in the 2008-13 period.

Current regulation wave

We see a similar logic to the current wave of regulation. While the moves against education and internet companies seem drastic, they are responding to social pressures which have built up regarding a perceived lack of social mobility, particularly among the younger generation. The 'nei juan' (内卷) or 'tang ping' (躺平) movements on social media decry tech companies' employment practices, which they see as exploitative (the '9-9-6' work culture of working from 9 am to 9 pm six days a week), as well as the inequity of families having to pay extra for private tutoring if their children are to be competitive in the 'gaokao' (高考) standardised college entrance exam. The government has been particularly sensitive to such criticism this year, which marks the 100th anniversary of the founding of the Communist Party.

"The growing influence of the tech giants in sensitive areas, such as financial intermediation and digital data collection, has posed a challenge for the government's national development goals."

Xi's political agenda has a grand goal of addressing inequality and promoting common prosperity, as he pointed out in January 2021: *"Realising common prosperity is more than an economic goal. It is a major political issue that bears on our Party's governance foundation… We cannot permit the wealth gap to become an unbridgeable gulf. Of course, common prosperity should be realised in a gradual way that gives full consideration to what is necessary and what is possible and adheres to the laws governing social and economic development. At the same time, however, we cannot afford to just sit around and wait."*

Similarly, **the growing influence of the tech giants in sensitive areas, such as financial intermediation and digital data collection, has posed a challenge for the government's national development goals**. The government is only too aware of the financial stability risks caused by not sufficiently regulating the shadow banking sector following the 2008 Great Financial Crisis. This would explain why it has taken pre-emptive steps to reign in consumer lending practices at fintechs last year. Also, with the rising importance of digital information for governments around the world, China's new data security law seeks to ensure that the growth of the digital economy is in line with its national security goals, an aim not too dissimilar to that of the US law enacted under the Trump administration in 2020.

How further could the tightening go?

The bad news for investors is that, in the short term, the current wave of regulation is likely to continue and could intensify. Recent regulatory changes have emphasised a layer of risk that could impact the investment framework beyond traditional policy drivers such as credit and liquidity/rates. As the recent tightening of restrictions in the education sector illustrates, the government appears resolute in reaching its national development goals and focused on keeping the broader population happy.

The crackdown on housing and anti-monopoly also fits this agenda. The source of market panic is more than that: what next?

It is hard to discern which sectors could be next in line for tighter restrictions. However, we know that cyber security and data protection remain a firm focus for regulators in the short term. This could mean the internet sector – particularly with regards to digital advertising and data sharing – should remain a target. The equitable treatment of contract workers, especially those working in the gig economy, could also see further support, in line with the recent calls for internet platforms to provide minimum wage protection for drivers. Lastly, national regulators are likely to continue to restrict companies from listing overseas using the Variable Interest Entity (VIE) structure.

For both **housing and education**, the warnings are years ahead, followed by increased tightening. However, unlike housing, which is always in the spotlight, the policy stance on education is easily forgotten. In September 2018, Xi addressed the National Education Conference, mentioning *"some off-campus training organisations offer examination-oriented courses, which goes against good practice in education and the healthy growth of students… An industry calling for conscience should not become profit-driven."* In this respect, the new education regulation is limited to K-12[1], it is very specific and makes sense as K-12 services evolved de facto in a system where too much stress is put on children and also on parents' spending. We do not think the decision is purposely directed against foreign investors; rather, it is about establishing equality for education.

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On **healthcare**, the regulations are more granular and sensitive. The push to reduce medicine prices has been underway for over three years with the launch of the provincial tendering process. In May 2021, the Politburo released guidelines to reform health service prices. The rationale warrants that overall healthcare services costs are bearable and transparent, but pricing can be flexible and differentiated, taking into account the doctors' preference. This means that – while making basic healthcare accessible to everyone – differentiated services will be allowed.

We believe the concerns regarding **consumption** are overdone. **The government has a goal of increasing the size of the middle class** and has shown a relaxed attitude for the sector, albeit enhancing the protection of consumer privacy and preventing differentiated pricing for daily household goods, in line with the anti-monopoly move in the e-commerce space. Meanwhile, **consumer upgrade is still a desirable goal**. In the same speech in January, Xi mentioned: "*Expanding domestic demand is not a temporary policy to cope with financial risks and external shocks, nor it is about unleashing a deluge of strong stimulus policies or increasing government investment. Rather, it is about **expanding consumer spending while also upgrading the level of consumption**, so that the development of our vast domestic market becomes a sustainable historical process."*

The impact of such a policy could be two-dimensional going forward:

- **Sector preference:** governments have a clear goal of directing money into preferred sectors (e.g., advanced manufacturing, green transformation, semiconductors[2], and infrastructure[3]), and regulating those sectors with negative externalities or hurting the goal of common prosperity if privates are significantly involved (e.g., housing, education, basic healthcare and elderly care).
- **Company scale:** within the same sector, when private companies grow too big and powerful, the struggle between state intervention and private power will come into play. Regulation will kick in to limit monopolistic power and companies are likely to become more socially responsible, focusing more on all stakeholders rather than exclusively equity holders, a similar approach taken by Japanese companies. Tencent and Alibaba are clear examples of this.

The implication is that investors have to price in a more realistic earnings growth outlook for large private companies. However, in a sector's early cycle, companies may grow in a lightly regulated environment and still enjoy high growth.

[1] K-12 system is a term used in education and educational technology and includes education starting with kindergarten up to 12th grade.
[2] Semiconductors are mixed, some local governments are receiving new guidelines not to over-invest.
[3] Infrastructure is selective, city sewage/pipeline, rural revitalisation, and the new infrastructure (digitalisation, data centres, 5G).

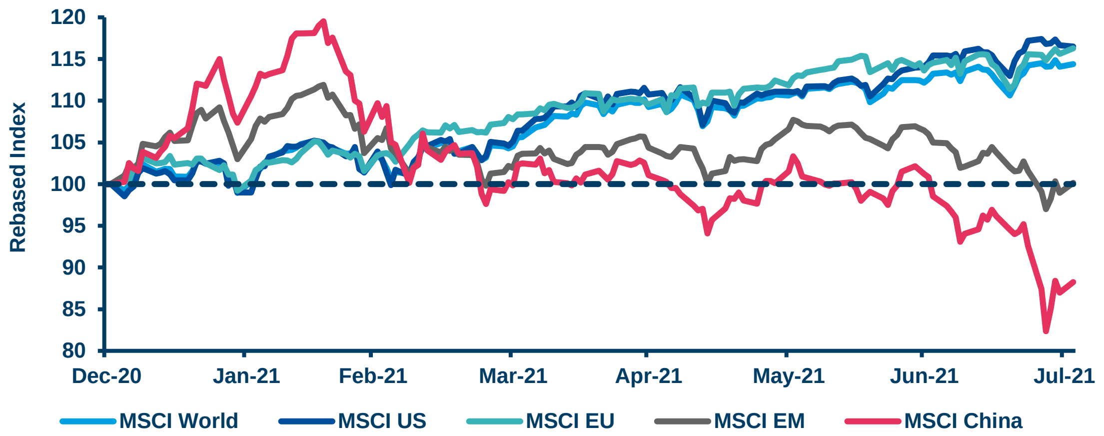
Equity market: appealing opportunities in the long run

We believe uncertainty will remain high in the internet and other related sectors and, by extension, towards Chinese equity in general. The anti-trust and social welfare regulations are likely to temporarily disrupt both revenues and cost structures, while uncertainty over the magnitude of future regulations and business models will keep risk premiums elevated.

"This phase of market correction could create some interesting entry points in structurally growing companies which could generate appealing returns over the longer term."

Ultimately, the government's national development goals require a vibrant private sector. We believe the government is aware that, especially with current trade tensions, it is self-defeating to impair the competitive advantage of the nation's most innovative companies. As such, we do not expect a 'Yukos'-type[4] moment any time soon. Regulatory episodes have ultimately benefited the economy, as well as investors over the longer term. **We do think this phase of market correction could create some interesting entry points in structurally growing companies which could generate appealing returns over the longer term.** We think the time to re-deploy capital is not far away, as names reprice to more compelling valuations and the market eventually becomes more comfortable with the Chinese regulatory regime.

Equity market performance, MSCI China has underperformed YTD



Source: Amundi, Bloomberg. Data is as of 3 August 2021. Indices are rebased as of 31 December 2020 = 100 and refer to local-currency MSCI indices. The MSCI World and EM indexes are measured in dollars.

Chinese equities had an impressive performance in 2020: the CSI 300 large-cap index rose 27.0% in 2020 compared to 16.3% for the S&P 500 and had a good start in early 2021 as well**.** However, weaker-than-expected growth from the world's second-largest economy, plus **the recent regulatory changes and the lack of policy clarity over the medium term, have weighed on Chinese equities.** Some off-shore Chinese companies lost billions of dollars over a few trading sessions at the end of July, and volatility has resurfaced in the Chinese market at a juncture where other equity indices have recorded new all-time highs.

The ADRs and VIEs scheme have been working in the interest of China to get financing from abroad. However, the future of those 'corporate structures' in a possible future regulatory framework **could lose popularity among global investors**, especially when a Hong Kong listing is available. In one-two years, de-listing looks inevitable, as there is now a chance that

[4]**Yukos oil company** was an oil and gas company based in Moscow, Russia. Yukos was acquired from the Russian government by Russian oligarch Mikhail Khodorkovsky's Bank Menatep during the controversial 'loans for shares' auctions of the mid-1990s.

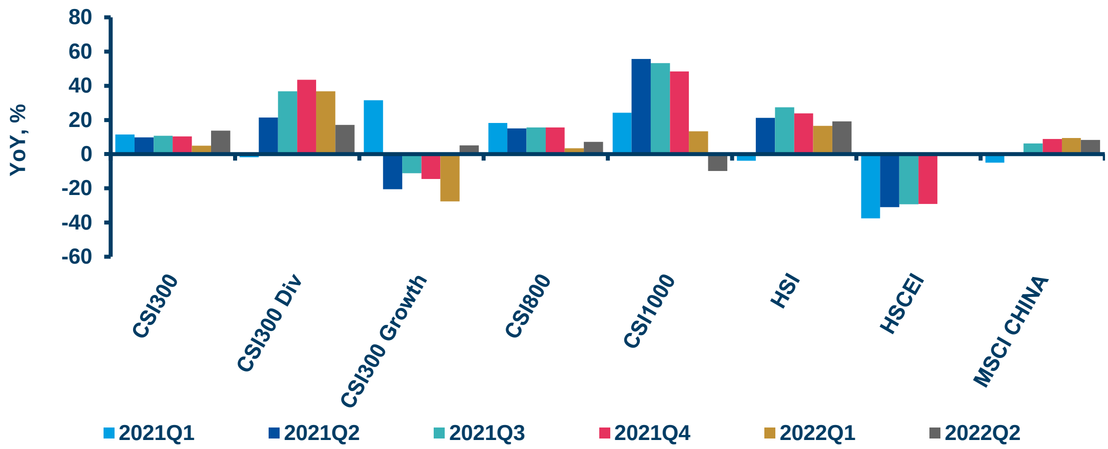
the US Securities and Exchange Commission (SEC) will be granted access to the reports of the Chinese auditors on the companies listed in the United States. Furthermore, in the context of Chinese policy risk and lack of transparency, the VIEs problem, a long-standing one, makes things even worse, as the VIEs structure offers little protection to global investors. It would not be a surprise if the US administration applies new measures to limit access to US capital for Chinese companies, for instance through the Rubio bill. **All in all, the trade war started by Trump is likely to evolve into a financial war under the Biden administration.**

"Investing in emerging markets involves risks, including regulatory constraints, but we believe that opportunities outweigh risks and solid fundamentals will support China's stock market."

Against this uncertain backdrop, we have become more cautious on Chinese equity compared to early 2021, due to tightening regulation and valuation concerns. Earnings and multiples could still be at risk, due to some potential new regulatory changes. **High scrutiny and sector selection remain crucial in China** to avoid possible new regulations or bubbles. In this respect, **we are focusing on strategic sectors where government policy is a clear tail wind rather than a headwind. Clean energy and biotech are two examples**: the former could benefit from China's plans to become carbon neutral by 2060, while the latter is a cornerstone industry for the Chinese government. China's transition to a green economy has immense implications and opportunities for investors. This is one of the reasons why we are constructive on the green economy and the new advanced materials industry. To this respect, the CSI500 Index – which includes 500 mid- and small-cap companies listed in Shanghai and Shenzhen -- is one of the indices which represents best those new trends.

The Chinese market has suffered from the growth slowdown and tightening regulation and still faces regulatory uncertainties. However, the long-term story for China investing is intact and possibly could be enhanced further, because what is painful today could help stabilise growth and the pursuit of the long-term goals of equality and the protection of strategic sectors. **Investing in emerging markets involves risks, including regulatory constraints, but we believe that opportunities outweigh risks and solid fundamentals will support China's stock market. This short-term pain could unveil its benefits over the long run and provide good entry points to long-term investors.**

Earnings growth and forecasts



Source: Amundi Research, data as of July 2021. EPS: earnings per share.

Macro outlook: most tightening behind us to balance growth

"The combination of the dovish policy tilt and selective sector tightening looks set to stay for the remainder of the year."

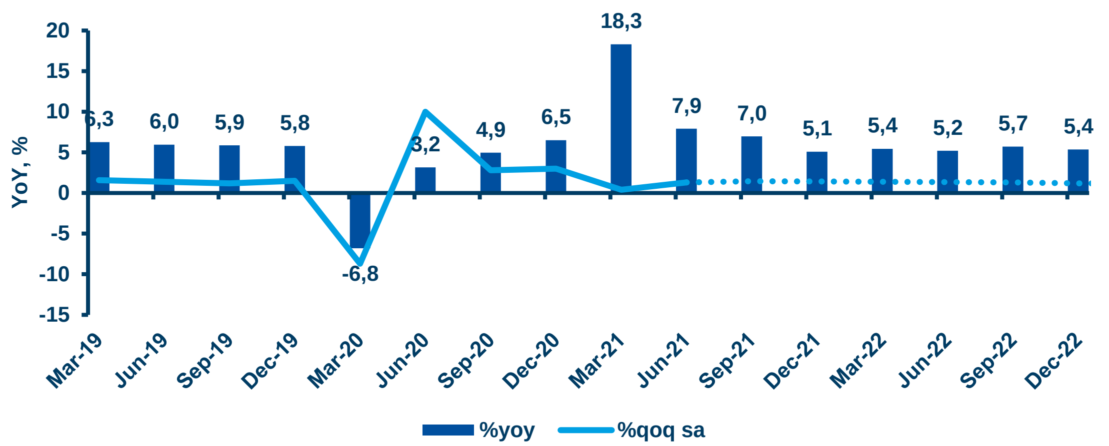
China's real GDP growth slid to 7.9% YoY in Q2 from 18.3% in Q1, mainly reflecting the distortion of base effects. In sequential terms, growth improved to 1.3% QoQ from 0.6% after a seasonal adjustment, underpinned by a rebound in services consumption after the relaxation of pandemic controls. Despite a recovery in Q2, the services sector and consumer spending growth remained softer than their pre-Covid-19 pace, both of which have room to pick up.

However, China's handling of the new waves of Covid-19 outbreaks remains stringent despite the fast-climbing vaccination rate. With a policy goal of "zero infections", this approach of strict pandemic controls is unlikely to alter in the near term. Household mobility and services consumption will be under pressure again in Q3.

Meanwhile, export growth will continue to normalise given the reopening of other economies. With softer external demand growth and uncertainties clouding consumption, China's growth should drift down towards its long-term trend. **We expect annual growth to soften to around 7.0% in Q3 and 5.0% in Q4, before rebounding to 5.5% in 2022.** Investments would become a growth stabilizer again, in light of an acceleration of on-budget fiscal spending.

While fiscal policy is set to loosen on the margin, monetary policy has started to adjust and was tilted towards the dovish side in July following a fast tapering in H1. The PBoC cut the reserve requirement ratio (RRR) by 50bp. Total social financing growth stabilised in June, indicating the credit impulse is bottoming out. On the other hand, regulatory tightening has expanded from the tech and housing sectors to the education one. In addition, Circular No.15 confirms that contingent local government debt will be contained tightly. Overall, **the combination of the dovish tilt in macro policy and selective tightening in sectors looks set to stay for the remainder of the year.**

China's real GDP growth and forecasts



Source: Amundi Research. Data is as of July 2021. Forecasts are by Amundi Research and start from September 2021.

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Definitions

- **Liquidity:** Capacity to buy or sell assets quickly enough to prevent or minimize a loss.
- **S&P 500 index:** It is a commonly used measure of the broad US stock market.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market

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