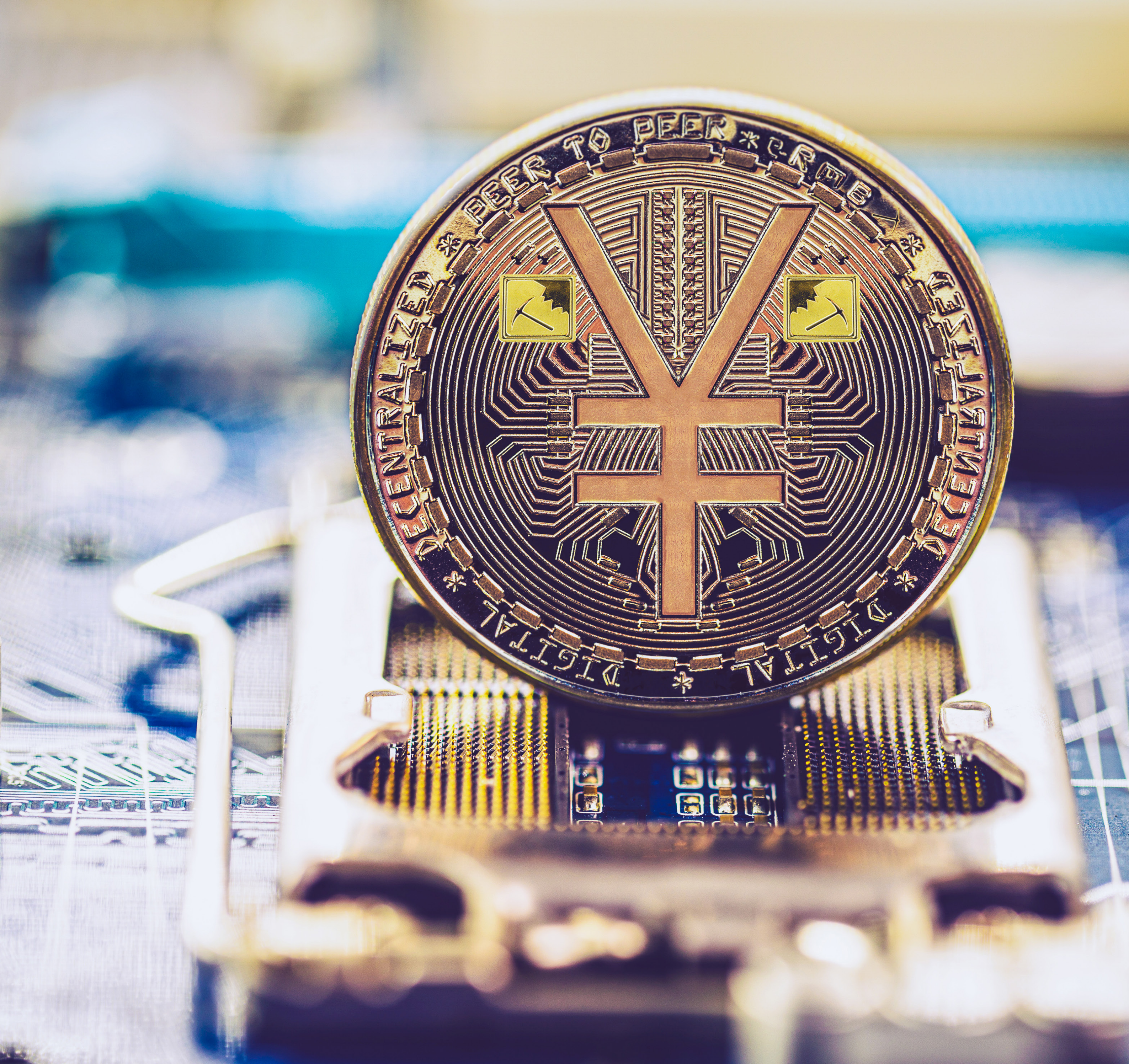

China’s regulatory shifts: Where do we go from here?

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Executive Summary

China's recent regulatory actions, predominantly targeting technology and education companies, has triggered sharp falls in domestic markets. These policy actions appear to be driven by the government's larger social and economic agenda, and the desire to achieve more equitable outcomes for people. They are likely to have far reaching consequences on the competitive landscape in China, as they impact companies in affected sectors.

With the situation continuing to evolve and the possibility of further regulatory changes, it may be too early to draw precise conclusions on what will happen next and how it will play out. However, we believe that over the next 1-2 years as Chinese firms adapt to the new policy regime, there are likely to be winners and losers.

In this paper, we provide a qualitative assessment on the impact and implications of the recent policy changes. We look at the trends and possible scenarios that investors may wish to keep in mind, especially as they consider their longer term investment allocations to China.

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Cyclical sector level winners and losers may unfold

We expect sector leadership across China's equity markets to churn significantly in the years ahead. From a cyclical perspective, the following industries are more likely to prove resilient and provide attractive sources of alpha for investors:

- 'new-economy' high-value added manufacturing
- industries embracing decarbonisation and renewable energy
- firms serving households and benefiting from greater consumer spending

In contrast, firms that may struggle and deal with ongoing regulatory scrutiny, are likely to be making 'monopoly like' profits across the technology and e-commerce sectors, or with business models driven by excessive leverage.

When facing significant uncertainties that are difficult to 'price in', investors should stay focused on core fundamentals, and avoid stocks with rich valuations and excessive earnings growth expectations. For these reasons, investors should remain active, nimble, and selective, when navigating the investment landscape.

Real estate sector carries risks, but also opportunities

The real estate sector is debt dependent and likely to face significant headwinds as deleveraging continues. This will prove very painful for players like Evergrande. Ultimately Evergrande may need financial restructuring, but much of its default risk appears to have been priced in by markets.

More importantly, China's policymakers have enough resources to contain any significant adverse spillovers from Evergrande, and we do not expect the situation will become China's 'Lehman moment' (refer to box story *"Default risk from China's real estate developers: Could Evergrande become China's 'Lehman moment'?"*). Investors still need to be discerning, but there are likely to be alpha opportunities over time with developers that can maintain strong balance sheets and build market share.

Positive outlook for Chinese fixed income

We have a positive outlook for China's government bonds. For investors seeking carry, real yields are likely to remain attractive compared to other key markets. For investors seeking longer term capital gains, the decline in China's nominal yields may continue, albeit at a slower pace than the past.

An important long-term strength of China's corporate credits is that default rates are most likely to remain idiosyncratic, as the policy backstop from the government is significant. Stronger per capita incomes over time also create a favourable operating environment for Chinese firms. Under these conditions, corporate balance sheets can draw strength from solid domestic demand.

Bullish and bearish scenarios with signposts

As active fundamental managers, we tap our bottom-up sector analysis to present two scenarios - bullish and bearish - for the long-term performance of Chinese equities.

- **Bullish scenario**

  In our bullish scenario, weaker growth resulting from the regulatory crackdown does not translate into poor equity returns. Instead, other factors support equity returns over time such as R&D spending (especially into high value-added areas), higher per capita incomes, consumer demand, and financial sector development. China's 'common prosperity' drive ultimately creates 'a bigger cake with more pieces', with robust domestic demand and corporate revenue expansion. As a result, a structural derating of Chinese equities is avoided, and returns can remain around historic averages.

- **Bearish scenario**

  In a bearish scenario, China's regulatory crackdown causes corporate profits to decline. At the same time, the risk premium associated with political uncertainty rises and investment sentiment deteriorates significantly. Exacerbated by lower corporate profits, the decline in China's real GDP growth continues, and as a result, Chinese equities face a significant derating. In such a scenario, investors would need to adjust their return expectations significantly lower than the double digit returns that on average, have been the norm since 2005.

Introduction

China's recent regulatory actions are part of its pursuit of 'common prosperity' that aims to improve the quality and equality of growth outcomes. A key objective is to give additional support to consumers, especially low wage workers, and to make large firms that have been making monopoly like profits more economical, notably across the IT sector.

These policies also focus on more inclusive growth, social stability, and self-sufficiency. To achieve such outcomes means continuing to grow per capita incomes, and reducing the high cost of housing, education, and healthcare. The latter implies that the firms operating across these sectors could face downward pressure on profitability, as policymakers demand greater price competition and affordability for households.

Over time, China is likely to strengthen its social services, but that doesn't mean shifting towards a European style welfare economy or high tax regime. Focus will be on more equal opportunities and access to social services. Authorities will attempt to 'share the pie more evenly', while also being committed to 'making the pie bigger'.

To achieve this objective, the 'common prosperity' goal doubles down on China's already successful model of urbanisation. This includes upgrading its manufacturing capabilities, with continued strong R&D spending into higher value-added areas.

These policy shifts in China have certainly disrupted markets, and are being vigorously pursued at a time when China is already such a key player in the global economy (i.e. the world's largest consumer market and the second largest equity market).

Why the urgency to achieve 'common prosperity'?

COVID pandemic

While rising inequality is a global phenomenon, the COVID pandemic has compounded this problem. The pandemic has favoured asset owners while the lower wage sectors have suffered the most. The pandemic has also favoured large companies that have been able to accumulate even more market power.

Geopolitical headwinds

The Chinese government is acutely aware of the need to be more self-sufficient. In May, the Ministry of Finance (MOF) and the Ministry of Industry and Information Technology (MIIT) increased its 'buy locally made' targets for all its state owned enterprises (SOEs). Ongoing consumerism, and the need to raise per capita incomes over time, will strengthen domestic demand with less reliance on imports.

Cyclical sector level winners and losers may unfold

The prospect of lower profits and lower returns to shareholders, sparked a 22% fall in China's equity market[1]. At this juncture, it is difficult to predict the regulatory changes ahead, and accurately gauge the impact of regulations that have been announced.

That said, over the next 1-2 years, it is likely that as Chinese firms adapt to the new policy regime, there will be some sector winners and some losers. However, for investors to pick the potential winners and avoid the losers is very difficult. From a cyclical perspective, certain industries are likely to prove more resilient and provide attractive sources of alpha for investors. These include high value-added manufacturing, industries embracing decarbonisation, as well as firms serving households and benefiting from greater consumer spending.

In contrast, firms that may struggle and deal with ongoing regulatory scrutiny, are likely to be those making monopoly like profits across the Information Technology (IT) and e-commerce sector, or with business models driven by excessive leverage.

In making our sector assessments below, we have given more weight to qualitative arguments and judgments and considered regulatory objectives and how specific sectors may adapt.

Manufacturing

We foresee alpha opportunities across manufacturing, especially in the 'new-economy' industries that favour spending on R&D. We believe these firms are unlikely to be adversely impacted by regulatory changes, as they are key drivers of China's economic development and per capita income growth. We expect investors to benefit, as China's global market share rises, especially across capital intensive industries such as paper products, chemicals, electrical equipment, machinery, and pharmaceuticals.

Companies aiding automation and concentrated on advanced manufacturing are also likely to benefit from shifts up the value-added chain, especially across areas like robotics and machine vision. Reflecting similar dynamics, we also expect strong growth for software companies, cybersecurity, operating system (OS), internet of things (IOT), and software as a service (SAAS).

With China's difficult relationship with the US, and associated trade restrictions, priority has been given to greater localised development of key industries. These sectors will likely continue to see strong policy support (especially across semi-conductors and other strategically important industries within electronics). To add to the positive outlook for domestic demand, China's policymakers have also reiterated the importance of state owned enterprises (SOEs) continuing to buy locally made goods. Furthermore, China's manufacturing sector continues to benefit from the broader 'made in China 2025 plan', as well as from stronger trade growth across the Asian region.

Decarbonisation

China's net zero carbon emissions target by 2060 (with ongoing decarbonisation initiatives to make sure emissions peak by 2030) is creating investment opportunities across multiple sectors. We remain the most positive on renewable energy (solar and battery electric vehicles), hydrogen propulsion technologies, and innovative firms involved in energy intensive metals manufacturing (steel and aluminium). On the latter, companies helping China's steel industry to move from blast furnaces to electric arc furnaces (EAF) are likely to be growth beneficiaries.

[1] MSCI China index from 28 June, as the regulatory crackdown widened, until its 20 August trough (as at 28 September the MSCI China index remains 20% down from 28 June).

Consumerism and discretionary spending

We believe that stronger discretionary consumption spending remains a key structural trend as household disposable income growth continues. Leading domestic consumer brands with significant market share will likely remain the key beneficiaries of this growth trend (e.g. firms across leisure, clothing, sportswear, travel, home improvement, restaurants, food and beverage). At the same time, there may be less spending on products like online gaming as policymakers’ interventions could increase the real cost of such products.

Financial services and wealth management

Rising middle class incomes should continue to create investment opportunities across financials and wealth management. Investment portfolios across China’s households are likely to become more diversified over time, away from real estate. Other initiatives from policymakers should also encourage more widespread ESOPs (Employee Stock Option Plans) and incentives for households to buy equities. China’s leading banks, brokerages and fintech players are likely to be beneficiaries of stronger demand growth, but the sector will also have to navigate tighter regulations which may limit profitability.

Healthcare

We believe that in the longer term, innovative biotech and medical technology companies are likely to continue to benefit from China’s push towards more innovative therapies and drug development. The importance of healthcare under common prosperity, and China’s aging demographics, will remain supportive of growth. However, over the near term, profitability headwinds could increase as policymakers strive for greater healthcare affordability for low income households.

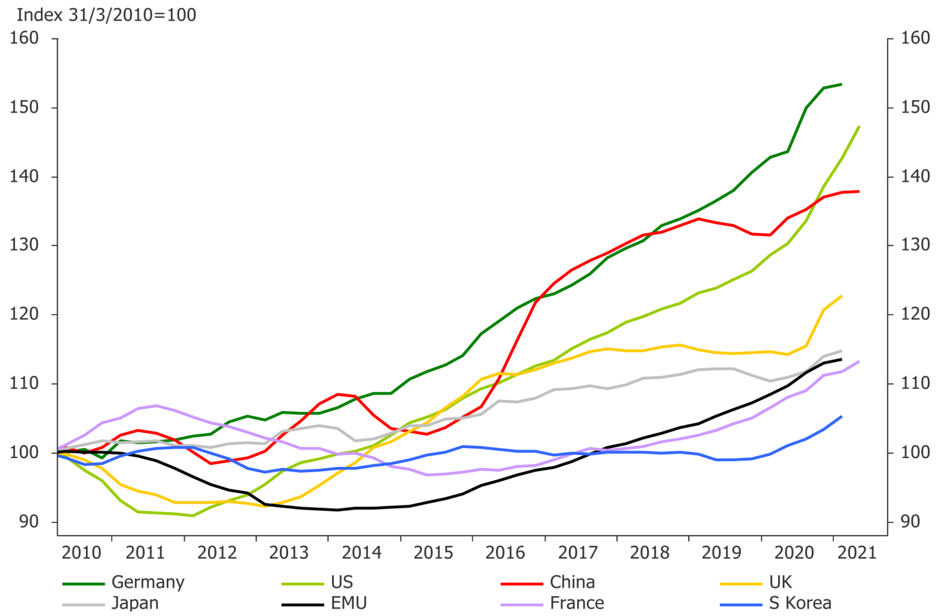
Information Technology (IT) and e-commerce

The sector represents ‘ground zero’ for China’s regulatory crackdown, which has targeted fintech’s lending businesses, anti-trust/monopolies, variable interest entity business structures, data privacy, and cyber security. As such the sector is likely to struggle and is unlikely to sustain its previously high profitability. Over time, there is likely to be greater pressure from policymakers for such companies to invest and support social goals. For example, Alibaba has already pledged to donate roughly two-thirds of its 2020 net income to support social objectives over time.

Real estate sector carries risks, but also opportunities

A key motivation of China's regulatory crackdown is the need to lower the high cost of housing. China's real house prices have already increased significantly (refer to Figure 1), and China's policymakers have seen the damage house price bubbles can cause in foreign markets.

Figure 1: Real house prices across key countries



Source: Refinitiv Datastream, 3 Oct 2021

As a result, China's regulatory reforms across real estate will continue to try and increase affordability. The common prosperity drive could result in shifts toward more property taxes and measures to encourage more construction, including building more government subsidised rental apartments. That said, discussion on higher property taxes have been in the works for almost a decade and are thus unlikely to be implemented quickly. If tighter property taxes are eventually implemented, they are more likely to be regional rather than national and include significant exemptions.

It remains our view that tighter regulations across real estate are unlikely to derail the industry because it is too systemically important. China has one of the highest home ownership rates in the world, and real estate accounts for around 25% of GDP[2] and about 60% of household wealth[3]. Rather, over time, changes in real estate policy measures are likely to focus on ensuring affordability without threatening stable growth.

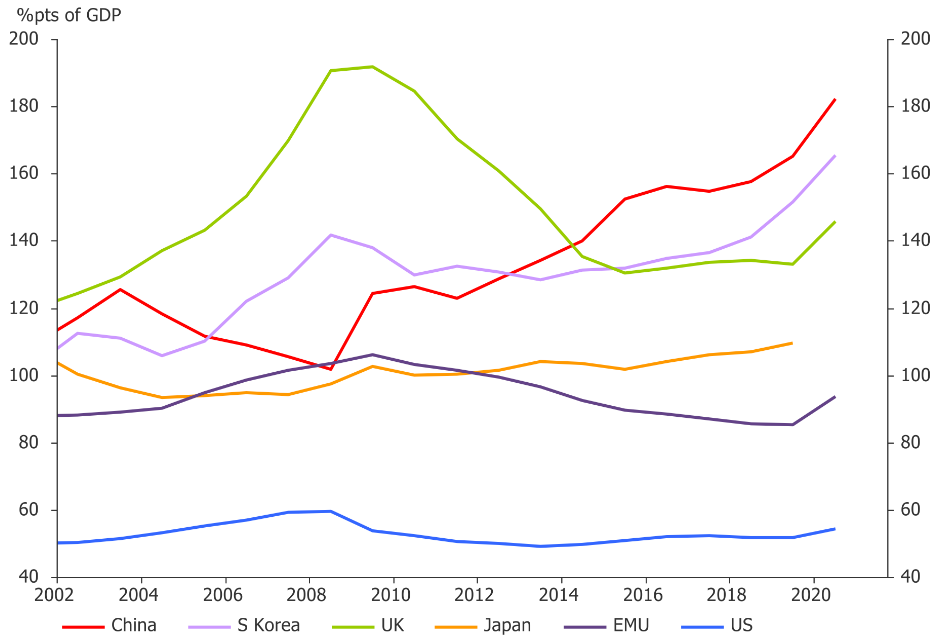
Aside from regulatory changes and the drive to common prosperity, another key concern for China's policymakers is preserving financial stability and the need to ensure that leverage, especially across real estate developers, is contained. We outlined in a previous paper on China's real estate sector[4] that policymakers are likely to maintain a tight grip on credit, especially given how strong the growth in economy wide credit has been (refer to Figure 2).

[2] Source: 29% was the estimated share by Rogoff and Yang, NBER Working Paper, August 2020. While Eftimoski and McLoughlin, RBA, March 2019, estimated 20%

[3] Source: JP Morgan, September 2021

[4] See https://www.fullertonfund.com/update-on-chinas-property-sector/

Figure 2: Bank credit to the private sector across key countries (% of GDP)



Source: Refinitiv Datastream, 3 Oct 2021

Investors should remain cautious, with active equity and credit selections, especially across real estate and China's high yield corporates. Spreads have widened and still offer significant payoffs to bond investors over time. However, downside risks are also greater, as default risks have increased significantly. The real estate sector is likely to face significant headwinds as its debt deleveraging continues and proves very painful for some key players like Evergrande (refer to story on *"Default risk from China's real estate developers: Could Evergrande become China's 'Lehman moment'?"*).

Furthermore, as real estate sales growth continues to slow sharply, other heavily leveraged developers may drive further rationalisation and downsizing across the industry. However, we believe that China's policymakers will provide more targeted stimulus if economy wide growth becomes threatened.

Attractive alpha opportunities for equity investors are likely to unfold over time with developers that can maintain strong balance sheets and build market share. As more firms progress towards compliance with regulatory guidelines, such as the 'three red lines' policy[5], then the environment should strengthen credit quality metrics over time, which will prove positive for both equity and bond investors in the long term.

[5] A micro-prudential policy guideline (from August 2020) that sets accounting limits on select real estate developers: comprising a liability-to-asset ratio (excluding advance receipts) of less than 70%, a net gearing ratio of less than 100%, and a cash-to-short-term debt ratio of more than 100%.

Default risk from China’s real estate developers: Could Evergrande become China’s ‘Lehman moment’?

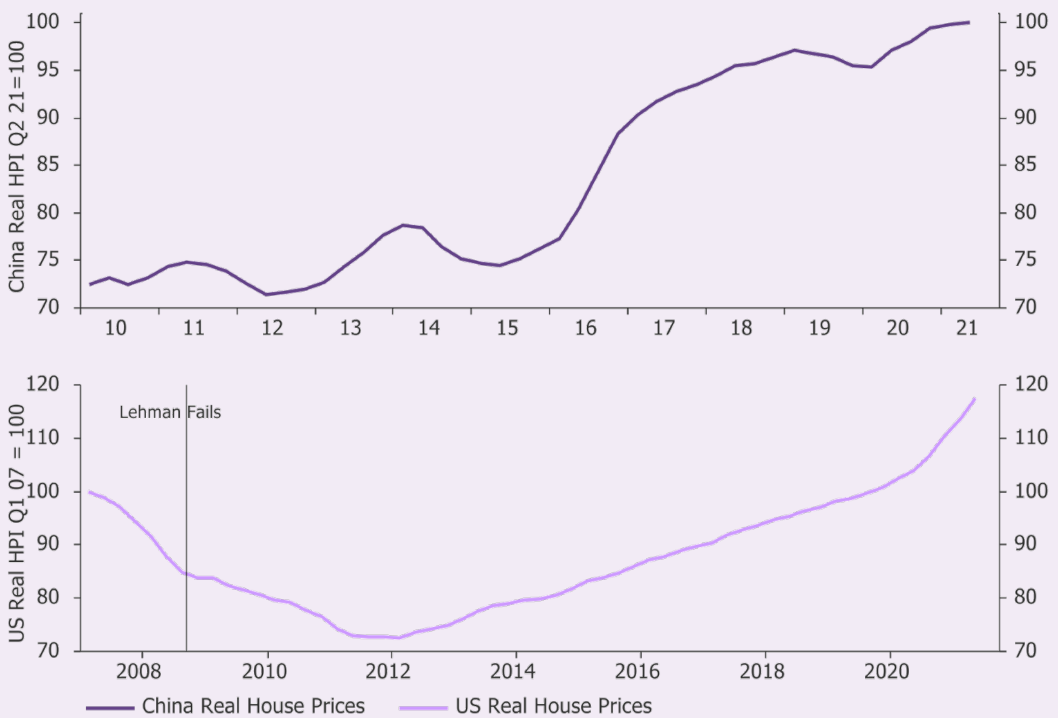
Evergrande, one of China’s most heavily indebted property developers, has a greater chance of default and subsequent restructuring given its credit rating downgrades by major global agencies.

- Direct bank loan exposures to Evergrande are less than 1% of total Chinese bank loans. However, spillover stress from Evergrande could be significant as its liabilities are estimated to involve more than 120 banks and over 120 non-bank institutions. For example, any late payments from Evergrande could trigger other defaults across multiple entities, with either direct loans or indirect claims. Across the dollar bond market, Evergrande accounts for around 15% of Chinese real estate high yield credits[6], which could be significant enough to trigger selloffs across multiple firms.
- That said, the passage of time since the second quarter of 2021, has enabled many investors to reposition their China high yield exposures across many key corporates. With Evergrande dollar bonds sliding below 30 cents on the dollar[7], it seems the heightened risk of default is mostly priced in.
- More importantly, China’s financial regulators have ample resources to intervene and keep liquidity flowing if there are any signs of systemic credit risks surrounding Evergrande.

It is likely that Evergrande will need financial restructuring, but it seems that much of its market risk has been priced in. Against this backdrop, it remains very important for China’s policymakers to make sure that economy-wide property prices stabilise and don’t fall dramatically. In the US, real property prices fell significantly and were a key defining feature of the macro stress at the time, and the subsequent failure of Lehman Brothers (refer to Figure 3).

At this juncture, Evergrande is not creating the systemic spillover stress like the US experienced in the run-up to Lehman, because China’s real house prices are not falling significantly (refer to Figure 3). Mortgage loan-to-value-ratio requirements are also more conservative. That is why China’s policymakers will be very careful in ringfencing potential risks from Evergrande and ensuring economy-wide real estate demand does not collapse.

Figure 3: Real house prices in China (2010-2021) and the US (2007-2021)



Source: Refinitiv Datastream, 3 Oct 2021

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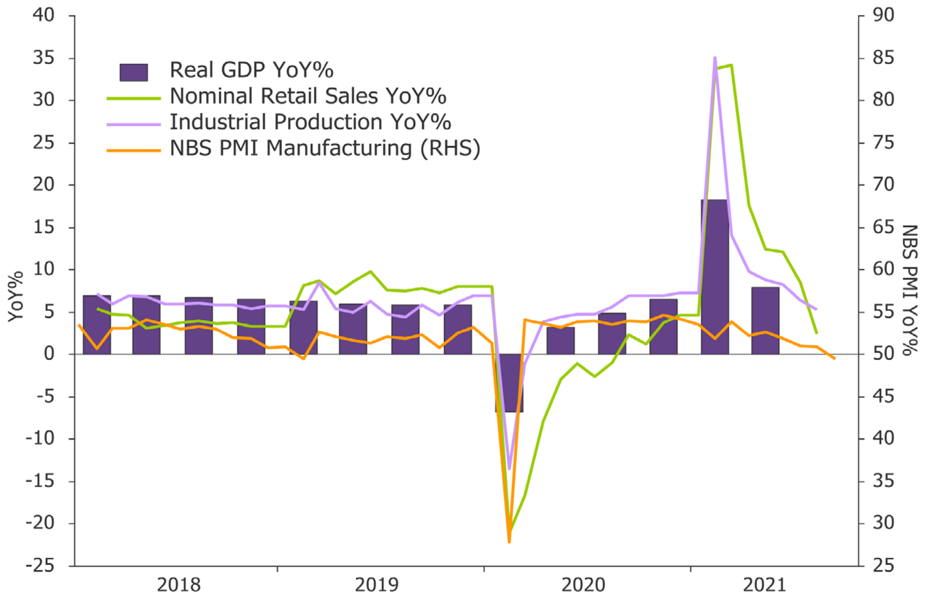
[6] i.e Evergrande’s offshore bond weight in EM Asia USD China HY property index, as of 22 July 2021.
[7] Source: Bloomberg, October 2021.

Policymakers ready to act if growth falls too sharply

We expect China's monetary policy will remain accommodative during this cyclical adjustment phase, in part to counterbalance any potential drag from the regulatory crackdown. Liquidity provision will remain critical, with additional reserve-ratio cuts being likely for the banking sector to encourage lending. We also expect fiscal policy to remain supportive, with public investment growth, particularly on infrastructure spending, picking up.

Retail sales, and industrial production growth have slowed significantly (refer to Figure 4), and we believe that China's policymakers will provide more stimulus if GDP growth falls sharply below average.

Figure 4: Key indicators of activity in China

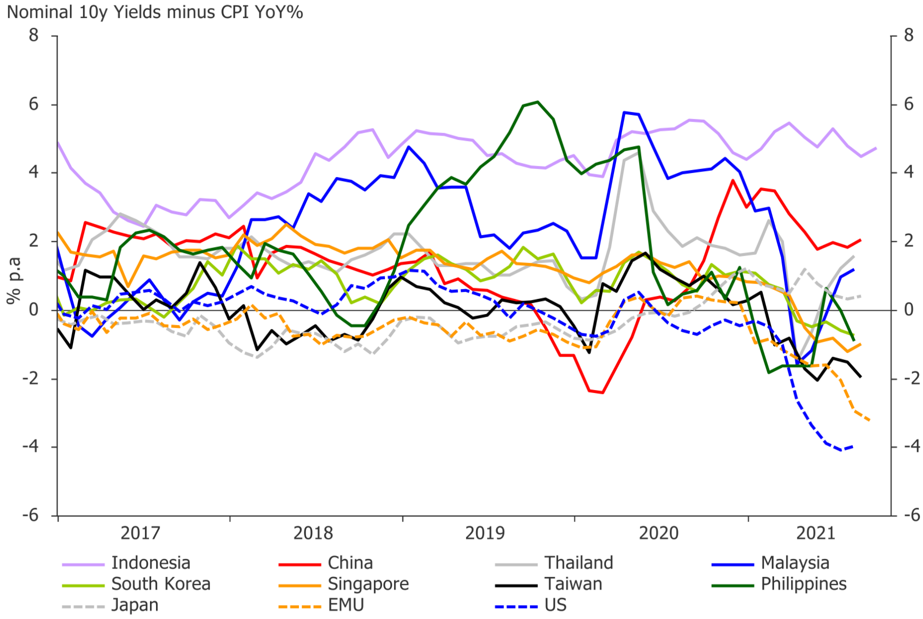


Source: Refinitiv Datastream, 3 Oct 2021

A positive outlook for Chinese fixed income

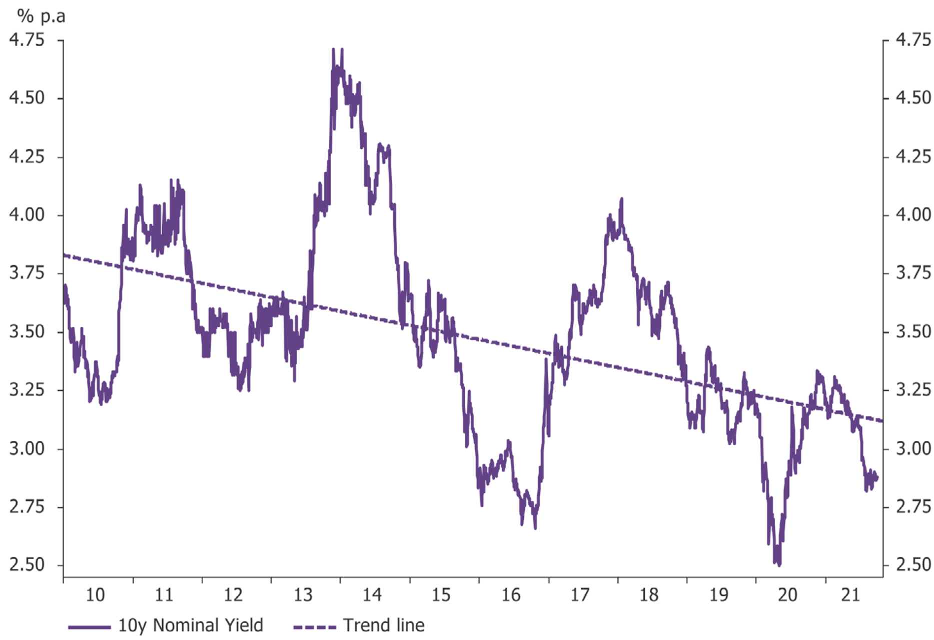
We have a positive outlook for Chinese fixed income markets. For investors seeking carry, real yields in China are likely to remain attractive especially compared to other key markets (Figure 5). For investors seeking longer term capital gains, the trend decline in China's nominal yields may continue (refer to Figure 6), albeit at a slower pace than in the past.

Figure 5: Real 10-year yields across key markets



Source: Refinitiv Datastream, 3 Oct 2021

Figure 6: China 10-year Government Bond Yields



Source: Refinitiv Datastream, 3 Oct 2021

Investors need to remain selective in choosing corporate credit opportunities across China. Firms with the strongest balance sheets should continue to gain from further spread compression over time.

An important long-term strength of China's corporate credits is that default rates are most likely to remain idiosyncratic because the policy backstop from the government is so significant. Similar factors driving stronger per capita incomes over time also create a favourable operating environment for Chinese firms, where balance sheets can draw significant strength from solid growth in domestic demand.

The International Monetary Fund (IMF), in its Global Financial Stability Report, April 2021, also noted China's very large policy resources that implicitly backstop the financial system and minimise systemic risks. The IMF indicates that China's biggest challenge in the longer term is less about its debt risks and avoiding significant jumps in defaults, and more about unwinding 'implicit government guarantees' that can distort market pricing of fundamentals. What these observations suggest is that long-term bond investors in China should be prepared for greater return volatility but should be less worried about systemic default stress.

Bullish and bearish scenarios with signposts

It is too early to conclude that the recent regulatory shifts will drive a structural change in China's long-term equity market performance. We therefore highlight a bullish and bearish scenario. From this scenario analysis, a key takeaway for investors to help prepare for potentially bifurcated outcomes, is to have a better understanding of the factors that will drive returns, as well as the signposts to monitor.

Some key signposts that may provide an early warning signal as to the scenario that is unfolding include further changes in market sentiment, shifts in capital flows to China, and any adjustments in China's policy rhetoric. These signposts have tended to be positive so far, which is encouraging, but it is still far too early for investors to take comfort.

- **Bullish scenario: Chinese equity prices continue to trend upwards**

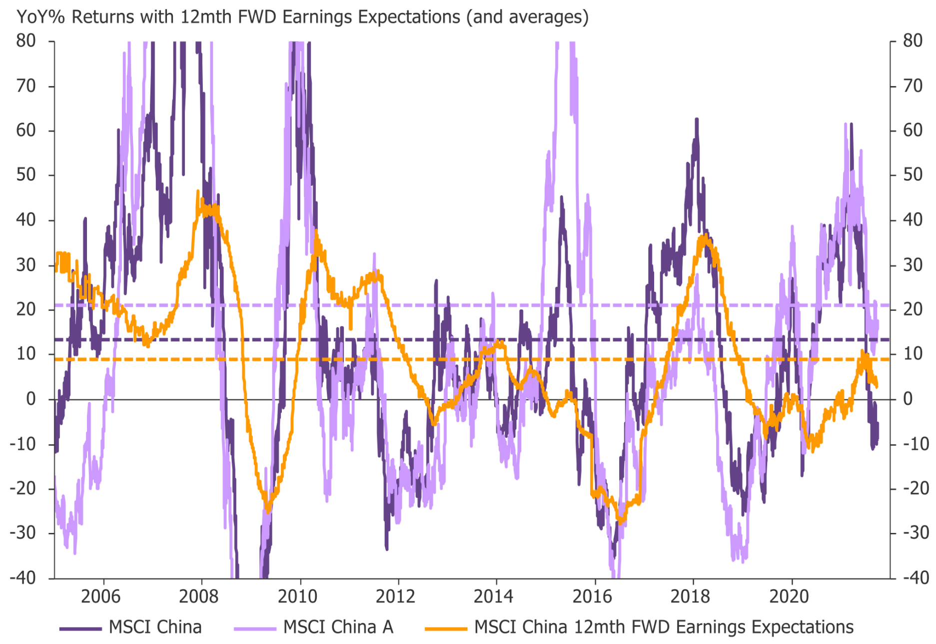
  In our bullish scenario, the weaker growth that may arise from the regulatory crackdown does not translate to poor equity returns. As we have seen over history, even with the trend decline in GDP, market expectations of China's earnings growth have been reasonable and annual returns from Chinese equities have averaged double digits (refer to Figure 7).

  Many other factors that are supportive of equity returns over time[8] such as R&D spending (especially into high value-added areas), higher per capita incomes and consumerism, liquidity, and financial sector development, are unlikely to be threatened by the regulatory crackdown.

  In a bullish scenario, China's 'common prosperity' drive causes 'a bigger cake with more pieces' – continued solid growth in per capita incomes, fuels domestic demand growth, and drives solid revenue expansion for industries. As a result, a structural derating of Chinese equities is avoided, and returns hold up around historic averages.

[8] For a more complete discussion of all the factors that can drive China's equity returns over time, beyond GDP and regulations, see https://www.fullertonfund.com/when-opportunity-knocks-the-case-for-investing-in-chinese-equities/

Figure 7: China equity returns with earnings growth expectations



Source: Refinitiv Datastream, 3 Oct 2021

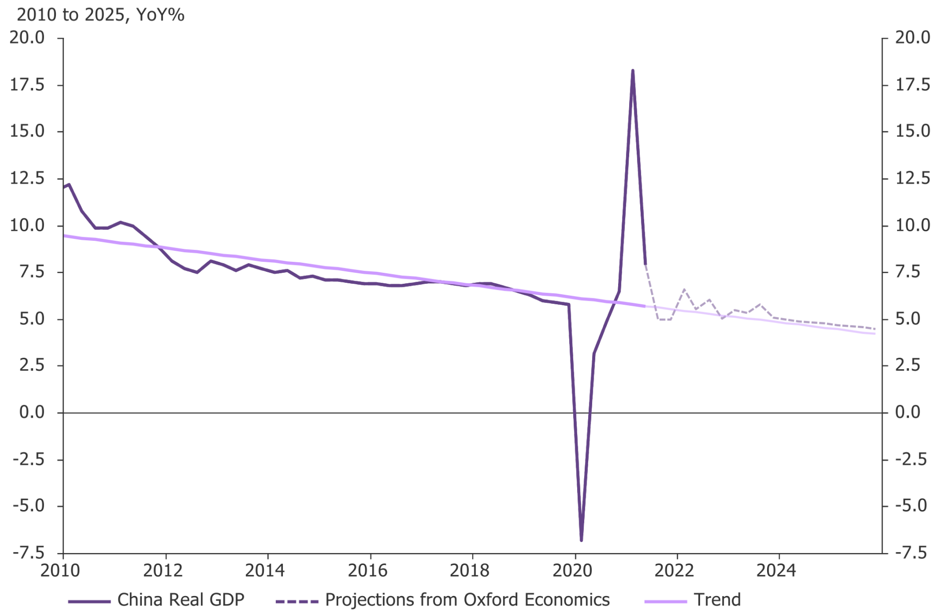
- **Bearish scenario: Chinese equities experience a structural derating**

  In a bearish scenario, a key concern for investors is that the regulatory crackdown could ultimately be deflationary. It could erode China’s trend growth which would be bad for all growth assets, especially equities.

  The regulatory crackdown could cause China’s corporate profits to be significantly lower, and firms may not be able to adapt over time with stronger revenues or better cost controls. At the same time, the risk premium associated with political uncertainty would rise and investment sentiment could deteriorate significantly.

  Exacerbated by lower corporate profits, the trend decline in China’s real GDP growth would continue (refer to Figure 8), and as a result, Chinese equities would face a significant derating. Under this scenario, investors in China would need to adjust their return expectations significantly lower than the double digit returns that have, on average, been the norm since 2005.

Figure 8: China real GDP growth



Source: Refinitiv Datastream, 3 Oct 2021

Key signposts to watch:

Policy moderations or reversals in rhetoric

This may occur because the policy pendulum can’t swing too far for too long. China’s policymakers will likely need to balance their regulatory agenda, of ‘sharing the pie more evenly’, with the need for economic stability i.e. ‘making the pie bigger’.

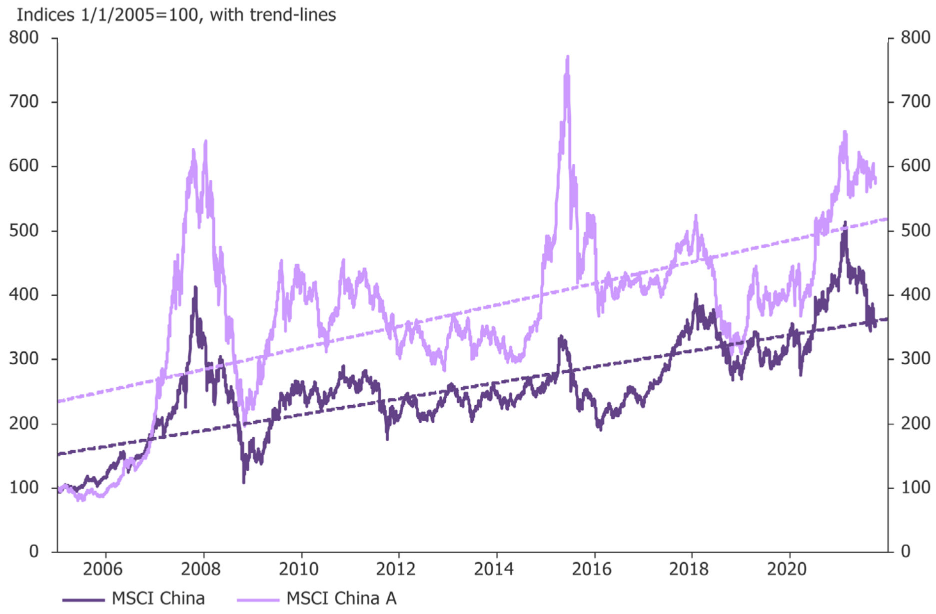
- A great example is that China’s policymakers have shown they are still very much committed to growing and deepening onshore capital markets. Just as the regulatory crackdown widened, China also revealed plans in early September, to set up a third stock exchange as the primary platform for serving innovation orientated Small and Medium Sized Enterprises (SME).

Market shifts and capital flows

What is encouraging so far is that the sell-off in Chinese equities has not been as harsh as some investors may have feared, and investment inflows rebounded over August.

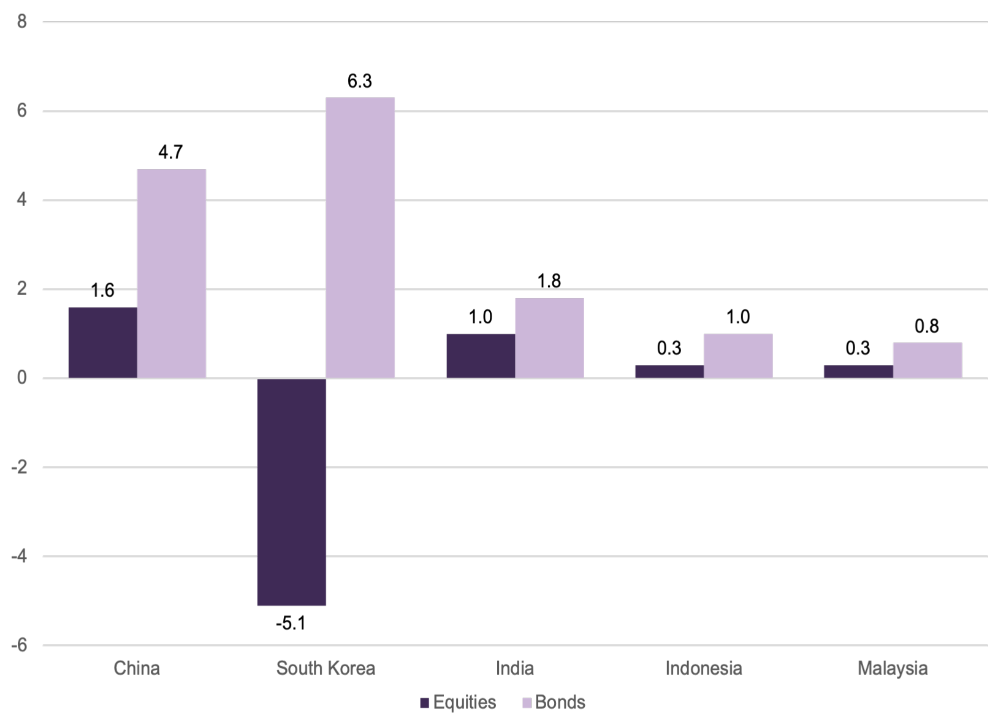
- China’s broad MSCI index, which has suffered because of the regulatory crackdown on technology, has reverted to its historic long-term positive price trend (refer to Figure 9).
- China A shares, supported by robust ongoing domestic demand growth, are still above their historical price trend (refer to Figure 9).
- China’s net investment inflows, across equities and bonds, rebounded solidly over August (refer to Figure 10). We also expect a further boost to capital inflows from the fourth quarter of this year with Chinese government bond (CGB) inclusion in the FTSE World Government Bond index (commencing in October 2021 and lasting for 36 months).

Figure 9: China equity prices with long-term trends



Source: Refinitiv Datastream, 3 Oct 2021

Figure 10: Equity and local bond net investment inflows for August (USD bn)



Source: Bloomberg, as at 14 Sept 2021