Investment Views

August 2021

Made in China?

Is corporate China under attack from within? In November 2020, local regulators forced Alibaba to pull the IPO of Ant Financial, its fintech subsidiary. Rumoured to be valued at over $300bn, it would have been the most valuable flotation ever. Fast forward to April of this year and 34 of the largest internet firms were told by regulators to rectify anti-competitive practices; another 25 got the same treatment four months later. More recently, just days after raising $4.4bn via a US listing, the ride hailing service Didi Chuxing had its app delisted from online stores due to concerns about its handling of customer data.

And finally, August saw both the gaming and private education sectors battered by government intervention. Having described the need for (and cost of) after-school tuition as a “chronic disease”, President Xi mandated that these quoted businesses become ‘not-for-profit’. In the online gaming world, a government-linked editorial described computer games as “spiritual opium”, questioning their impact on young minds and the value to society of this RMB279bn industry.

Related stocks have been crushed. Alibaba and Tencent are nearly 40% below their recent peaks, Didi has lost a third since its July IPO and US/HK listed education companies have shed over 75%.

Why has China aggressively clamped down on these industries? Has it rejected “capitalism with Chinese characteristics”? And does this rolling uncertainty make Chinese stocks un-investable?

The reasons for the crackdown are several. Firstly, the Authorities seek to face down the growing economic influence of the dominant tech platforms and the entrepreneurs behind them. They see them as a threat to one party rule, akin to Putin’s challenge from the Oligarchs. Whilst the failed Ant IPO was ostensibly due to new regulations that undermined its lending business, the willingness of billionaire owner Jack Ma to question the regulators and his failure to show economic and political fealty to Beijing was the real undoing.

The Chinese government's worries run wider though, extending from the political into the social. It is increasingly concerned that the lightly regulated tech firms are poor stewards of the monopoly power that they have achieved, in part, by anti-competitive practices and abuse of consumer data.

Furthermore, many of their business practices and services are seen as a source of societal friction. In this respect, the demolition of Didi had as much to do with their drivers openly protesting about pay and conditions, as any data security concerns, whilst the effective closure of the private tuition sector speaks to troubled Chinese demographics. According to a Government census, there were 12m babies born in 2020; a multi-decade low and 2.7m less than 2019. With many families spending over 25% of their disposable income on after school tuition, such costs are cited as a barrier to bigger families.

Many of these ills find echoes further afield. The EU has repeatedly penalised big tech for data violations and anti-competitive practices, most recently slapping Amazon with an $888m fine for data protection violations and GDPR misdemeanours. In the UK, the autumn will see the new Online Safety Bill come into force, obliging web platforms to share information about content and to protect users from harmful and illegal speech; fines of up to 10% of global revenues can be levied for any transgression.

Finally, US President Biden has appointed two tech 'hawks' to key positions. The anti-trust scholar Lina Khan will chair the Federal Trade Commission whilst Tim Wu, author of "The curse of bigness: Anti-trust in the new gilded age", joins the National Economic Council as special assistant to the President for technology and competition policy. He is an outspoken critic of the size and influence of companies like Amazon, Apple, Facebook and Google.

Biden has also acknowledged the national security aspects of US-listed Chinese stocks, passing an executive order "protecting Americans' sensitive data from foreign adversaries". It forces Chinese companies to disclose more information as a condition of a US listing. Along with new domestic regulation, it suggests that most mainland firms will delist from the US; a likely boon for the Hong Kong exchange as many seek a primary quote in the SAR. Indeed, assuming corporate law and the currency peg remain largely untouched, Hong Kong's role as a foreign capital gateway to China will surely grow.

Globally, tech firms have expanded rapidly by delivering amazing innovation, functionality and efficiency. However the cost of such rapid progress has been a variety of social ills; a Netflix documentary, "The social dilemma", explores some of these issues. To us, the Chinese crackdown is an authoritarian way to address these challenges, untroubled by democratic niceties.

So does this regulatory purge presage a rejection of every capitalist tenet? We doubt it. China has profited handsomely by embracing capitalism since it acceded to the WTO in 2001. The private sector has fuelled rapid growth, accounting for 80% of all new jobs. To deliver continued progress, a key promise of the Communist incumbents, Xi needs a vibrant domestic economy. Indeed, we note that small and mid-cap companies may well benefit as the anti-competitive practices of their larger peers are reined in. Xi also needs motivated, well capitalised national champions to help him deliver "Made in China 2025", expanding the high-tech and advanced manufacturing sectors. The President urgently wants to reduce China's reliance on overseas tech and intellectual property.

That said, we expect investors to shy away from any entrepreneur, company or sector that fails to marry social stability and national security to investor interests. It also seems likely that we see a period of readjustment as Xi reaches into others aspects of private life, with investors pricing in lower returns from 'in scope' industries that are forced to evolve and adapt.

Turning to equity investment, having enjoyed near 40% returns in 2020, our China A share positions are showing a 2% loss for the year-to-date; given their domestic focus and limited big tech exposure, they have largely side-stepped the turmoil. On the various valuation metrics we follow they remain cheap, startling so when compared to the S&P500. At 4.7 times price-to-book and a P/E of 24x 2022 earnings, US stocks are about twice as expensive as the China A index. We also note that the People's Bank of China has started to push additional funds into the economy after a period of post-covid parsimony. It cut the bank reserve requirement ratio by 0.5% (to 5%) in July, enabling banks to lend an additional $150bn. Historically, the stock market has responded well to rising liquidity.

Whilst the confused regulatory backdrop and nerves about the economic impact of delta-covid remain, our sense is that opportunity knocks for brave investors as volatility endures beyond the summer; there is every chance that sentiment causes a negative over-reaction. As such, we remain committed to our Chinese equity allocation but are looking to switch from a passive ETF exposure to active managers who can take advantage of this new normal.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

6-12 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan Value ESG & Impact funds FinTech & Blockchain	Inflation-linked, Emerging Market, China	Gold, Volatility Strategies
—	Bonds	European US	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	31- Jul 21	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3904	0.5%	0.6%	6.3%
CHF	1.1045	2.2%	0.9%	0.9%
AUD	0.7344	-2.1%	-4.8%	2.8%
JPY	109.7200	-1.3%	0.4%	3.7%
EUR	1.1870	0.1%	-1.2%	0.8%
BOND YIELDS (10 yr)				
UK	0.56	-0.15	-0.28	0.46
US	1.22	-0.25	-0.40	0.70
Germany	-0.46	-0.25	-0.26	0.06
Australia	1.18	-0.35	-0.56	0.37
Japan	0.02	-0.04	-0.08	0.00
EQUITIES				
US. S&P 500 (USD)	4,395.26	2.3%	5.1%	34.4%
UK. FTSE 100 (GBP)	7,032.30	-0.1%	0.9%	19.2%
FTSE Europe Ex UK (local)	333.41	2.1%	6.5%	30.7%
Japan. Topix (JPY)	1,901.08	-2.2%	0.1%	27.1%
China. Shanghai Comp (RMB)	3,397.36	-5.4%	-1.4%	2.6%
HK. Hang Seng (HKD)	25,961.03	-9.9%	-9.6%	5.6%
Australia. All Ords (AUD)	7,664.19	1.0%	5.1%	26.5%
FTSE Asia Pac ex Japan	679.77	-6.5%	-5.8%	20.0%
FTSE World (USD)	858.04	1.3%	3.9%	33.0%
FTSE World (GBP)	914.95	0.6%	3.4%	25.6%
COMMODITIES				
Oil (WTI)	73.95	1.6%	18.0%	71.8%
Gold	1814.19	2.5%	2.5%	-8.2%

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Authorized and regulated by the Financial Conduct Authority, registered office 29 Queen Anne's Gate, London SW1H 9BU. Registered Number 07602886

Published and distributed outside the UK by **Bentley Reid & Co Limited**
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