CIO View
CIO Flash

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DWS

Marketing Material

CHINA HAS A (REGULATORY) PLAN

CASUALTIES OF CHINA'S ECONOMIC RECALIBRATION

IN A NUTSHELL

_ On various occasions this year Beijing has taken aim at specific sectors and companies.

_ This is part of a recalibration of its economic policies that aims for more balanced growth and more social equality. We expect regulatory measures to persist well into 2022.

_ While we believe investors should take a very selective approach to China, the rest of Asia remains a favorite region of ours.

China increases regulatory pressure as part of its new five-year plan

By tightening the regulation of education providers on July 23, the Chinese government dealt another blow to investors. Individual stocks in the sector lost over two-thirds of their market capitalization[1]. This was not the first regulatory offensive. Previous targets were mainly large technology and financial-services providers, as well as real estate. Companies that are listed abroad (especially in the U.S.) or have been judged by the government to have abused their market power have not been well viewed by Beijing for some time. A joint statement from China's State Council and the Communist Party's Central Committee from August 11 shows how far reaching the reforms are meant to be. It lays out that authorities would "actively" work on legislation in areas including national security, technology and monopolies while adding that law enforcement will be strengthened in sectors ranging from food and drugs to big data and artificial intelligence. The agency said that it is encouraging for companies to address these issues voluntarily and said those that failed to comply would face "severe punishment."Even though individual companies came under pressure a year ago, the speed and scope of the latest offensive came as a surprise, as the market reaction showed. The MSCI China Technology Index, for example, lost around 10% within three days. The timing of the offensive, however, was probably no accident. With the centenary celebrations of the Chinese Communist Party coming to an end and the unveiling of the new five-year plan, Beijing's leadership has recalibrated its economic policy. The goal of achieving pure quantitative growth has given way to a focus on economical more sustainable, balanced growth. That has been said in the past but there are some signs that the current government initiatives, which are also a reaction to external pressure, are a high priority. For example, Beijing feels compelled by U.S. foreign policy to increase its autonomy, including and especially in the high-tech segment. But the political realignment is much broader. It essentially rests on four pillars:[2]

_ **Social security:** Beijing wants to strengthen the social safety net for private households and provide price stability. The core aim is to make education, housing and health care affordable and to expand the pension system. But there are also measures to reduce social inequality and to prevent the abuse of market power (here again, especially by large technology corporations).

_ **National security:** This includes stricter handling of IPOs abroad and accelerated expansion of key technologies such as semiconductors to ensure technological independence. The goal of having as many parts of individual value chains as possible in one's own country also falls under this.

_ **Financial markets:** Reduction of regulatory arbitrage and reducing risks to financial stability.

_ **Sustainability:** Achieve CO2 neutrality by 2060.

[1] Bloomberg Finance L.P. as of 8/11/21
[2] Morgan Stanley, China's Regulatory Reset, August 1, 2021

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As they pursue these goals, leaders in Beijing seem to be willing to sacrifice stock-market stability in the short term. China is even willing to suffer setbacks in the race with major U.S. internet companies – for which Chinese companies seem to be the only competitors.

Regulation is currently not the only headwind

The Chinese government's resolute actions may have spooked many, especially those who have suffered direct financial losses as a result. It fuels the view that investments in developing countries deserve a valuation discount. However, one can also see some positives in the recent regulatory pushes.

In a sense, China enjoys the benefit of coming late to the game when it comes to economic policy. It can study what economic policy mistakes other countries have made and therefore avoid them. While in the West the dominant position (and low tax contribution) of the technology giants has been denounced for years but not really addressed, China has acted. However, only after its own tech giants have made a big contribution to growth in recent years.

One of Beijing's challenges will set limits on the private sector's activities without suppressing its dynamism. A bigger problem, in our view, would be if China curbs the private sector in order to favor large state-owned enterprises (SOEs).

We are not assuming that the new wave of regulation has already reached its peak. In our view, the initiatives, and thus the uncertainty for the corporate sector, might well continue into 2022. Whether the market has overdone it with its reaction so far will also depend on what follows now. Especially as Beijing's regulatory offensive is not the only headwind for Chinese assets. The others are:

- The further decoupling of the two great powers under Joe Biden and the prospect that Biden could attract more international allies than his predecessor to help his efforts.
- The tightrope walk in the (real estate) credit market, where Beijing does not want to further fuel leverage, and thus speculative bubbles, but at the same time cannot allow prices to collapse.
- Covid-19: New infection figures in the hundreds have been reported by China for the first time in a long time. This may be completely negligible by international standards, but, given the rigor with which Beijing is pursuing its zero Covid-19 policy, growth-reducing lockdowns should also be expected if new cases continue to spread.

Investors may have to readjust sector favorites and time horizons

From a capital-markets perspective, China has had to contend with other disadvantages this year in addition to the challenges mentioned above, especially compared to other markets:

- While, especially in the West, government support measures continue to be generous this year, Beijing is providing little fiscal or monetary support to its economy.
- While China has come through the crisis best so far, the positive surprise element has been much higher this year in Europe and the United States. For example, consensus estimates[3] for 2021 gross-domestic-product (GDP) growth rates in the U.S. have been raised since the beginning of the year from 3.9 to now 6.5%, but in China only from 8.2 to 8.5%. For 2022, the growth estimates are now only 140 basis points apart.

In addition, in the case of China, market timing has been made all the more difficult when regular reports of regulatory measures can cause large moves overnight in the shares of entire sectors.

For longer-term investors, on the other hand, we believe that economic policy measures which put growth on more stable foundations, as painful as they may be for individual companies, should also be beneficial to the stock market as a whole in the longer term.

[3] Bloomberg Finance L.P. as of 8/11/21

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Equities: selective in China, still positive for the rest of Asia

Despite the market correction in recent weeks and the relative underperformance of Chinese equities vs. the rest of the world since the beginning of the year, we prefer a differentiated approach. Regulation should move forward and skepticism from foreign investors may still increase. In our opinion, the following points should be taken into account when considering Chinese equities:

_ After the recent selloff, the market seems oversold, which might suggest it has potential over the medium term. Positioning surveys point out that many global investors have cut their exposure to emerging markets, and might actually be underweight in this asset class right now.[4]

_ The challenging point with Beijings reforms is the fact that they not only affect different sectors to a diffierent extent, but that they are likely to produce winners and losers within one sector. This puts a lot of emphasis on stock picking. Otherwise, one has to look at how the various indices are affected by the regulatory push, on a relative basis.

_ Caution seems to be warranted, in our view, in regard to those companies which are a particular focus for Beijing, such as large technology, real estate, or education companies. The regulatory screws could also be tightened even further for healthcare providers. In general, companies with market power that translates into pricing power are likely to remain in the government's sights.

_ In terms of market segments, the least preferred are foreign listed shares, foremost U.S. listed ADRs (American depositary receipt)[5], which are likely to remain under pressure from two sides (China and the U.S.).This translates into a cautious view of the MSCI China Index, as it has over 30% weight in ADRs (VIE structure) and internet stocks, which are subject to high regulatory risk.

_ We prefer Shanghai Stock Exchange A-Share Index as it is subject to least liquidity outflow and as it is least owned by foreign investors. It also has more small/mid caps that should benefit from policies, such as electric vehicles, renewables, semiconductor, software, industrial automation, etc.

_ We also prefer the Hang Seng Index (HSI) to the MSCI China, as we believe that major sectors of the HSI such as properties and utilities have historically been immune from China policy risk, and continue to exhibit steady earnings recovery post Covid-19.

Regionally, we still see Asia as particularly attractive, even if we take a more differentiated approach to the Chinese market. While individual segments may be oversold here in the short term, the upside is likely to remain limited as long as regulatory uncertainty remains.

We believe Chinese bonds are still too expensive

Beijing's reform push did not leave the bond market unscathed either, especially as bonds had already been battered by some shake-ups in larger real estate companies. The J.P. Morgan Asia Credit Index (JACI), for example, in which Chinese bonds account for almost half of the value, has lost 0.5% since the beginning of the year. The J.P. Morgan JACI China Index has lost 2%, and 1.3% in the last week of July alone.[6] The high-yield segment, dominated by real-estate stocks, has recorded losses since May, when Beijing tightened regulation of the property market.

We think Beijing's regulatory push is likely to leave a longer-term mark on the bond market as well. The way in which entire business models were shaken up in the blink of an eye is likely to make investors nervous in the long term, resulting in higher risk premiums for some sectors, especially in the high-yield segment. Already, since the beginning of June, the risk premium (vs. U.S. government bonds) has risen from 340 to almost 400 basis points as of end-July. As of now, August 11, they have fallen a bit to 378 basis points[7], which in our opinion reflects the fact that investors are re-entering the market on a selective basis. Higher high-yield spreads have affected other Asian markets as well, but not homogenously. In fact, investors initially re-allocated some money in bonds of better-liked Asian companies. This underpins our opinion of the importance of diverseification and its potential to work well within Asia. In our view, Chinese bonds are still expensive. Nonetheless, we believe demand for this asset class is likely to remain high. Thus, we think for the investment-grade segment, risk spreads will stabilize on current levels. The divergence between sectors disliked by Beijing and state-owned corporations is likely to continue.

[4] BofA Fund Manager Survey, BofA Global Research, July 13, 2021
[5] American depositary receipt is a security that represents indirect ownership of shares of a foreign company that isn't directly traded on U.S. exchanges.
[6] Bloomberg Finance L.P. as of 8/11/21
[7] Bloomberg Finance L.P. as of 8/11/21

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Glossary

China A-shares are the stock shares of mainland-China-based companies that trade on the two Chinese stock exchanges, the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE). Chinese A-shares are only quoted in RMB and it may be difficult for foreign investors to buy them due to Chinese government regulations.

One basis point equals 1/100 of a percentage point.

With China's five-year plan the Chinese Communist Party sets out growth and other economic and social targets, helping define government policy priorities.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

The Hang Seng Index (HSI) is a freefloat-adjusted market-capitalization-weighted stock-market index in Hong Kong. It tracks the 50 biggest and most traded companies on the Hong Kong stick exchange.

Initial public offering (IPO) is a type of public offering in which shares of stock in a company usually are sold to institutional investors that may in turn sell them to the general public, on a securities exchange, for the first time.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The J.P. Morgan Asia Credit Index (JACI) provides investors the opportunity to track total return performance of the Asia fixed-rate dollar bond market. The index is a market cap-weighted index comprising sovereign, quasi-sovereign and corporate bonds and it is partitioned by country, sector and credit rating.

The J.P. Morgan Asia Credit China Index (JACI) tracks total returns for actively traded US-dollar denominated debt instruments in China

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

The MSCI China Index captures large- and mid-cap representation across China H shares, B shares, Red chips, P chips and foreign listings.

The MSCI China Information Technology Index captures large and mid cap representation across China H shares, B shares, Red chips and P chips. All securities in the index are classified in the Information Technology sector as per the Global Industry Classification Standard

Regulatory capital arbitrage is a practice whereby firms capitalize on loopholes in regulatory systems in order to circumvent unfavorable regulation.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The Shanghai Stock Exchange A-Share Index is a market-capitalization-weighted equity index comprising all A-shares listed on the Shanghai Stock Exchange.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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