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The changing face of China

Market Comment, September 2021

China has changed. Whereas in 2020 the country was still clearly an engine driving economic activity and attracting investors, it has now become a negative factor for the stock markets. What lies behind this? What is the intention of the Communist government? No one knows for sure, but underlying all the visible changes there appears to be a definite change of policy. This could lead to increased volatility not only in Chinese equities but also in the global economy. Investors will now have to live with greater uncertainty. A higher risk premium for China therefore seems appropriate.

Not long ago the general view was that China was the growth engine of the global economy. As a result, Chinese equities were very much in favour with investors and this was reflected in their particularly strong performance last year: in 2020, the MSCI China equity index delivered a total return of 28% compared to 17% for the MSCI World equity index. By contrast, this year Chinese equities have been a disappointment, underperforming the World equity index by around 25%. So what is behind this?

When share prices notch up double-digit losses, it is down to a combination of factors undermining investor confidence. This year, Beijing failed to contain the spread of coronavirus as well as it did in 2020. This not only led to more restrictions on movement in key provinces and cities, but also affected important export ports. At the same time, the public is becoming increasingly cautious. This has led to a decline in consumer spending, as was reflected in the drop in retail sales growth in July. Nevertheless, it was not just this key economic indicator that disappointed the market consensus: business surveys in the manufacturing and service sectors have also been deteriorating for several months.

Moreover, so far – unlike its counterparts in other countries – the Chinese government does not seem to be willing to provide any significant economic stimulus. While the US and Europe are backing expansionary monetary and fiscal policies and supporting their economies with government spending, Beijing is deliberately slowing down economic growth. This is probably aimed partly at reducing debt in the real estate sector and among companies. The price being paid for this is increasingly disappointing economic and equity growth.

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What’s more, the focus of the communist leadership has clearly shifted. In the past, the aim was more growth and cheap financing, particularly for companies in the internet sector, including financing by foreign, especially American, investors via listings on US stock exchanges. Now it’s about reducing rampant social inequality in an ever less homogeneous Chinese population that now includes numerous “internet billionaires”. The Communist Party wants to curb their influence, either by means of new taxes or through regulations. The public are being told that the change of direction is urgently needed in order to boost “general” incomes and distribute internet profits. In addition, the quasi-monopolistic structures of the few platform companies are to be broken up, potentially reducing their earnings growth. IT companies are also being directed to increase wages and benefits, which could mean higher costs.

In addition, China’s communist leadership wants to reduce US influence, partly in the name of national security. Data security in China is also to be improved. On the other hand, the US too has stepped up its efforts to limit US equity investors’ funding of Chinese technology firms that serve China’s military power. The listing of Chinese companies is currently under discussion, for example. Contrary to general market expectations, political ten-

sions between the US and China have not eased under US President Joe Biden. In our December market commentary ("Major change in geopolitics?"), we pointed out that geopolitical hopes would lead to disappointments. China is showing a deceleration in its companies' earnings growth and a clearly visible slowing of economic growth. This is not only related to the more contagious variant of coronavirus, but should also be seen in the context of the new regulations now being rolled out. It should never be forgotten that China's Communist leadership is more concerned with political control than with corporate earnings. This should not come as a surprise: China has a Communist political leadership and not one which is geared to capitalism or shareholders. The regulations imposed on various sectors were introduced surprisingly swiftly and were on an unexpectedly massive scale. Given the lack of clarity over the future direction of travel, China can now be expected to trade at a higher risk premium than in previous years.

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