September 2021

China - An opportunity among growing uncertainty?

Over the last year, Chinese equities have been battered after the Chinese government, directed by the Chinese Communist Party (CCP), stepped up regulatory interventions across the technology sector and wealthy individuals. These actions have sent the share prices of the most beloved Chinese tech companies crashing. The first such move came in November 2020 when Alibaba was blocked from listing its fintech arm, Ant Group. Following on that, in July this year, the Cyberspace Administration suspended ride hailing app Didi for violating data security regulations – only days after the company listed on the New York Stock Exchange. Investors who bought into Didi at the IPO have lost about 50% of their investment since then.

Just a few months later, the decades long Chinese property boom seems to be coming to a sudden halt. The collapse of one of China's largest property developers, China Evergrande Group, seems inevitable. The shear size of the Evergrande problem, owing $300 billion to lenders and customers, has the market worried about contagion across the property sector and the broader financial system. It is unknown if the Chinese government will be willing to assist Evergrande or bail out investors but without help it will surely be the most significant corporate collapse in China's history.

Figure 1: iShares MSCI China ETF & iShares MSCI ACWI - 1-year performance



Source: Tradingview

The combination of these two shocks has seen the Chinese equity market suffer a severe decline this year. Now down more than 35% after reaching an all-time high in February. Meanwhile, global equity markets – driven by record low interest rates and positive news from re-opening economies – have continued their march higher and onto new all-time highs.

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China's outwardly hostile treatment of tech companies and the economic impacts of an Evergrande collapse will have a lasting impact on investors. We assess what these developments mean for our portfolios and the global investment outlook.

A new regulatory regime

The Chinese government has a long history of tightly controlling and regulating industries – before the internet was available in China, all news and most media publications were state controlled. So, the question remains, why are investors surprised by this latest wave of regulatory crackdowns from Beijing? To answer this, it may be better to start at the beginning – to ask what is China and what does it want to be?

China is a socialist nation still transitioning into the 21st century. Governed by single party rule and led by President Xi Jinping with an aspirational vision for the future – a "great modern socialist country" by 2049. This should warn one to not expect China to conform to Western norms and standards.

The Chinese internet sector has flourished in the last decade and in many regards, it has leapfrogged the West. Internet connectivity rates and mobile phone penetration are among the highest in the world. Its citizens are some of the most tech savvy globally with most ordinary people using their smartphones for just about everything from jumping on the subway to paying for a basket of groceries at the local street market.

This success has brought untold wealth to the social elites and technology workers running the countries internet giants. The widening wealth gap is highly visible when moving across China. With more than 600 million workers living off a monthly income of $154 or less, the concept of common prosperity has been reawakened. The party wants a rebalancing of wealth across classes and a more equal sharing of the nation's prosperity. How this will play out is still to be seen but for now it looks as though a policy shift is inevitable.

The uneasy truce between the innovative technology sector and the government has always been front of mind when investors think about China. Despite often growing faster, having better business economics, and state sanctioned monopolies, investors often valued Chinese tech companies lowly compared to their Western peers. This was to account for the perceived additional risk. The most recent performance of the Chinese tech sector would indicate that investors are now expecting the worst.

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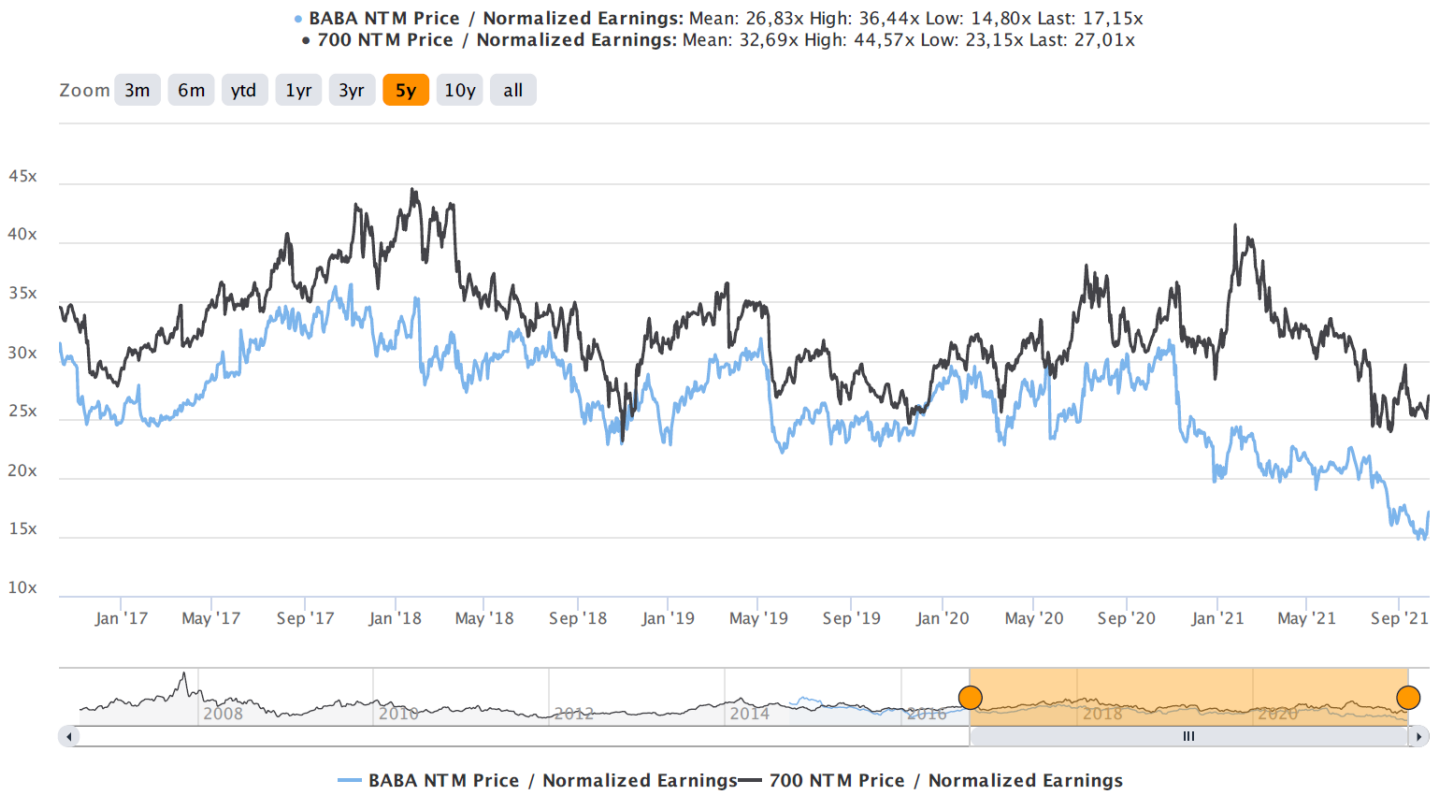
Figure 2: Alibaba and Tencent Normalised P/E Ratios - 5-year history



Source: Tikr.com

The market mood can be seen in the share prices of some of the biggest and most favoured tech stocks. Alibaba, China's largest e-commerce, cloud computing and fintech operator is trading at a 40% discount to its average valuation over five years. The lower valuation multiple reflects how the market perceives Alibaba's future – greater uncertainty and higher risks. Tencent on the other hand, having always been more conservative and diplomatic in its public engagements, has fared relatively better. After the initial sell off from the February highs, Tencent's share price has stabalised while Alibaba shares have continued to slide.

There is no doubt that many of the new rules governing the tech industry are about more than just balancing the economic scales. Stricter data privacy rules and new artificial intelligence limits would suggest the government has concerns about the industry being able to self-regulate potentially dangerous technology. They have seen the outcome of failing to do so in the US, where social media was used to amass thousands to descend on the US Capitol in the January 6th riots. The moves by Beijing seem designed to set the rules of engagement more so than to wipe out the industry entirely. Perhaps the intention is to prevent the enormously powerful trove of data ever being used against it.

While the jury is still out on what this means for Chinese tech companies, it seems likely that the journey of limitless growth has come to an end. The message from Beijing is that in order to survive, companies must realign their priorities with China's. Given the sheer size of the Chinese economy and the low base it is coming off, this could mean there are still opportunities to create enormous value. The 600 million people Beijing hopes to move into the middle class will become stronger consumers as they become wealthier. Digital services like banking, online shopping and entertainment will be beneficiaries of this change and the tech companies that build these products will reap the benefits.

For investors with exposure to China, a real concern is if the political dispensation remains as kind to foreigner investors as it has over the last 20 or so years. Experience would tell you that these things tend to blow over and in a short while it will be back to business as

usual. That's not to say the future won't be different though. Deeper insights and an increasingly detailed stock picking approach will be more important than ever before. Picking winners and understanding the long-term sustainability of the business model will be a more nuanced exercise than riding the mega trends like internet adoption. Some of the fund managers we watch recognise this change – Baillie Gifford and Fidelity continue to put roots down in the country, investing resources in people and process.

The Evergrande bubble

The China Evergrande Group has been at the forefront of China's decades long property boom. Today, it may be nearing total collapse. When the group missed payments to lenders in late September, global markets reacted negatively. Fearing that the contagion would rip across the global financial system.

While some are likening Evergrande to the Lehman Brothers collapse – which in part triggered the Great Financial Crisis in 2008 – it seems an unlikely outcome. It has been known for quite some time that the group was struggling to pay back its lenders and suppliers. That it has happened now is in fact a consequence of the borrowing restrictions that the government put in place in August 2020. These rules restricted how much debt property developers could take on and forced them to hold more cash than they would like to. The cash crunch at Evergrande would have been foreseen by the policy makers who put these limits in place.

The market knew this too, the share price of Evergrande has been on a slide since the beginning of the year. It was down almost 75% before the news of its demise started to dominate headlines at the end of August.

Figure 3: China Evergrande Share Price - Year to Date Performance



Source: Tradingview

Knowing that the new borrowing limits would starve the property sector of the debt so critical to its business model, the question is what the new rules were intended to achieve.

At an estimated $58 trillion, Chinese property might be the world's largest asset class. Between 15% to 30% of economic activity is linked to property and related services. Property sales by local governments are used to fund budgets and finance massive infrastructure projects. The sector has grown at rates considered unsustainable. Speculators have entered the market, driving up prices which in turn incentivises developers to build more.

The government is well aware of this and has pushed to delink China's economy from the property market and to subdue speculation. This is difficult to do without causing harm to Chinese households who have 70% of their wealth tied up in property.

With debt of more than $5.0 trillion it is certainly big enough that it could trigger a much bigger crisis. This seems unlikely though. The negative social impacts from a property recession would be too great for the CCP to bear. Instead, it looks like an orderly restructuring of the sector is on the cards. No doubt there will be casualties though.

Over the Chinese summer President Xi Jinping began messaging about common prosperity. Some have interpreted this to mean a more balanced China with the equalization of wealth across classes. Might this mean that some former darlings, such as Evergrande, are allowed to fail? Very possibly but probably not in a manner that creates risk to the sector. In the last few days, news has emerged of potential buyers for some of Evergrande's business. We will have to wait and see how this develops but for the time being it seems that a chaotic collapse is off the cards.

A crisis is an opportunity riding a dangerous wind.

– Chinese Proverb

China seems to be at an important crossroads. On the one hand it is still the engine of global economic growth. If it stumbles, the ripples will be felt around the world. On the other hand, important policy changes are being made. The outlook for business is more uncertain than at any point in the last decade.

China is entering a phase of normalised economic growth – slower and with a larger contribution from consumption. This maturing of the economy will have large ramifications. As investors, we are unsure where we stack up in the hierarchy of Chinese government priorities. The actions of the last year would suggest an attitude of ambivalence toward foreign investors. While this may be true, what it means and whether this new paradigm is good or bad for investors, is as yet unknown.

By allowing a large privately owned property developer to go under, the government is sending an important signal to the market. The one you may read about is that they are allowing the wealthiest Chinese citizens to fail but the more important signal is that they are moving toward more of a free market model.

The tightening of regulations in the tech sector could be read as a government overreaching or rather, perhaps they are leaders in this regard. We have seen increasing regulatory scrutiny in the EU and although nothing has come of it, there has been a large focus in the US on tech companies' responsibilities to society with the data and resources they control.

Only with time will the world know what these conflicting signals mean. For the foreseeable future though, the government in China must do what it can to shore up the confidence of consumers and business. As outsiders looking in and investors deciding whether to allocate capital into the country – should we be making these decisions using the same framework that we use in the West? Should we expect the same from China that we do of our policy makers and companies? In fact, it's possible being diversified across political regimes is as important as geographical or industry diversification? If China achieves its 2049 ambitions, wouldn't we want to participate in it?

The key is understanding the guiding principles that drive China and how it impacts investments differently from the West. We know that some of the best opportunities are picked up by looking through the noise. In this time of great uncertainty, perhaps those opportunities are there now.

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data provided by Refinitiv

MARKET REPORT

31/08/2021

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.1%	10.1%	25.2%	8.2%	8.3%	11.4%	15.3%	13.4%
FTSE/JSE SA Listed Property	ZAR	10.4%	31.6%	51.0%	-7.3%	-5.3%	5.3%	26.0%	21.1%
SA All Bond Index (ALBI)	ZAR	3.7%	6.9%	14.8%	7.6%	8.2%	7.6%	8.0%	7.9%
SA Cash Index (SteFI)	ZAR	0.9%	2.2%	3.8%	5.9%	6.5%	6.2%	0.4%	0.3%
Balanced Benchmark	ZAR	2.9%	9.4%	18.1%	8.3%	8.3%	11.5%	10.3%	8.8%
SA Inflation (1 month lag)	ZAR	1.4%	3.5%	4.6%	4.2%	4.3%	5.0%	1.2%	1.3%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	6.0%	19.4%	30.3%	15.6%	15.4%	12.8%	14.6%	13.7%
Emerging Markets Equity (Datastream EM)	USD	-4.0%	0.0%	21.5%	10.2%	10.8%	5.2%	16.5%	17.6%
Global Property	USD	7.7%	24.3%	30.8%	11.1%	8.5%	9.4%	14.2%	14.6%
Global Bonds (Barclays Global Bond Index)	USD	0.0%	-2.5%	-1.3%	4.2%	1.9%	1.1%	5.2%	5.0%
Global Cash	USD	0.0%	0.1%	0.2%	1.3%	1.4%	0.9%	0.3%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-0.1%	10.1%	25.2%	8.2%	8.3%	11.4%	15.3%	13.4%
Global Equity (Datastream World)	ZAR	11.7%	14.8%	11.3%	15.1%	15.0%	21.2%	15.8%	14.5%
Emerging Markets Equity (Datastream EM)	ZAR	1.2%	-3.9%	3.7%	9.8%	10.4%	13.1%	13.9%	13.4%
Global Property	ZAR	13.6%	19.5%	11.6%	10.6%	8.1%	17.6%	16.4%	14.5%
SA All Bond Index (ALBI)	ZAR	3.7%	6.9%	14.8%	7.6%	8.2%	7.6%	8.0%	7.9%
Global Bonds (Citigroup)	ZAR	5.4%	-6.3%	-15.7%	3.7%	1.6%	8.7%	15.7%	14.5%
COMMODITIES									
Gold (US Dollars)	USD	-5.2%	-2.8%	-8.2%	14.5%	6.7%	-0.1%	13.2%	15.7%
Gold (Rands)	ZAR	-0.1%	-6.6%	-21.6%	14.0%	6.3%	7.4%		
CURRENCIES									
Rand / Dollar	ZAR	-5.4%	3.9%	14.6%	0.4%	0.3%	-7.5%	15.6%	15.6%
Rand / GBP Pound	ZAR	-2.1%	3.7%	12.2%	-1.5%	-0.7%	-5.7%	15.5%	14.7%
Rand / Euro	ZAR	-1.8%	6.6%	15.7%	-0.1%	-0.8%	-5.4%	14.5%	13.7%

Spot Rates		31-Aug-21	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	14.47	14.28	16.94	14.41	7.03	8.43
Rand/GBP	Rand	19.92	19.71	22.43	18.56	11.66	12.22
Rand/EUR	Rand	17.08	16.93	20.26	16.09	10.21	7.66
RATES							
Libor 6m $	US$	0.15	0.16	0.31	1.23	0.48	3.45
Repo Rate	Rand	3.50	3.50	3.50	7.00	5.50	11.00
Prime	Rand	7.00	7.00	7.00	10.50	9.00	13.50
All Bond Index Yield	Rand	9.55	9.66	11.64	9.40	7.74	9.74
COMMODITIES							
Gold ($/oz)	US$	1 806.30	1 765.43	1 967.93	1 322.42	1 778.90	273.10
Platinum	US$	1 001.00	1 059.00	930.00	1 077.00	1 812.00	446.00
Oil (Brent Crude) $	US$	73.02	75.25	45.12	49.27	112.60	26.64
INFLATION							
SA Inflation	%	4.6	4.9	3.1	5.9	5.3	9.4

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