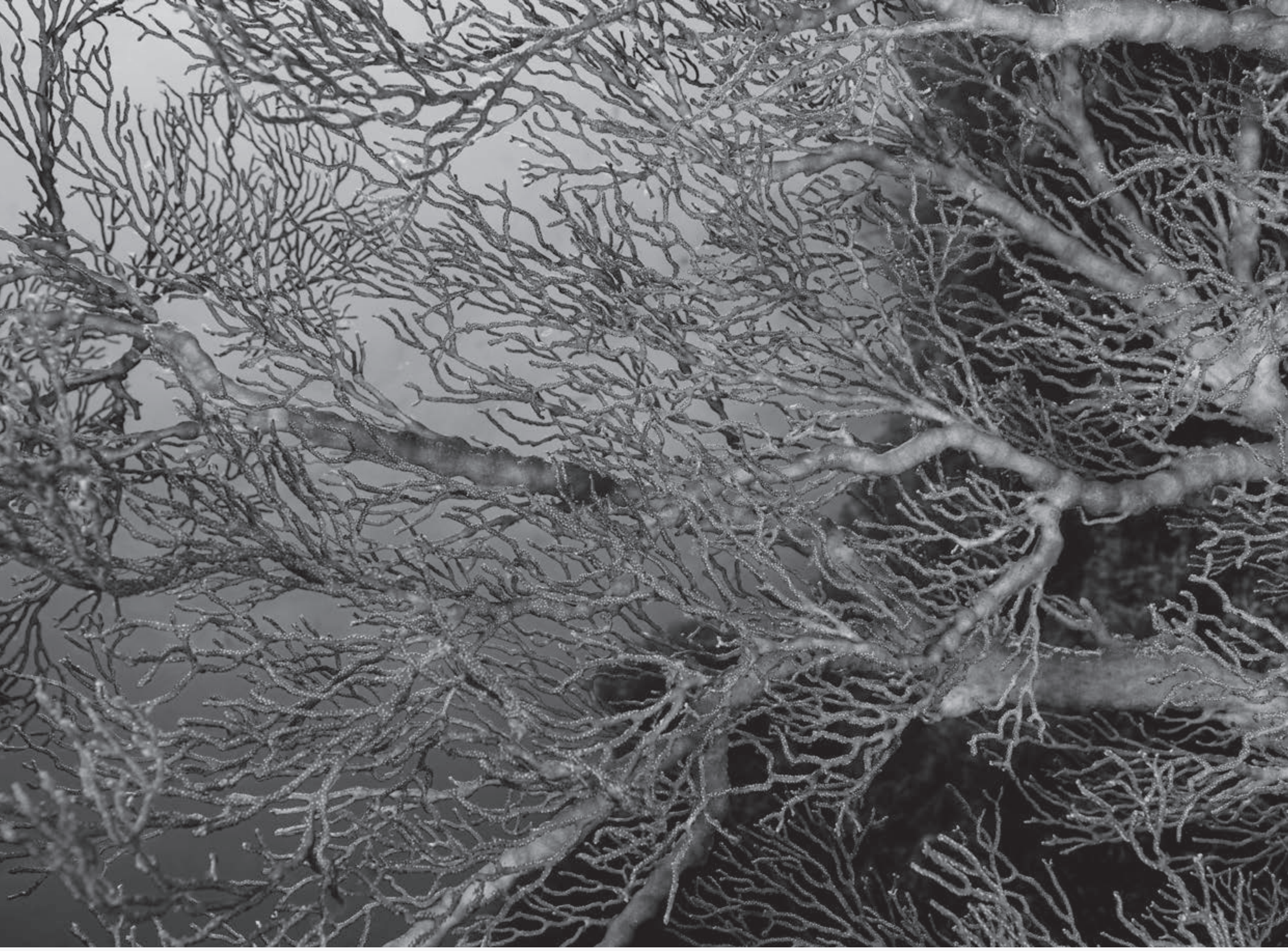


WILSONS

Emerging Markets and the China Regulatory Crackdown

Our weekly view on asset allocation.

13 August 2021

China: Opportunity or Threat?

In May 2020 our research spoke to a number of significant medium to longer term positives supporting the Emerging Market (EM) investment case.

Read our May Investment case for Emerging Market Equities

While the second half of 2020 saw very strong performance from EM equities, the past 6 months have been more challenging - although we note our preferred active manager (Fidelity) continues to outperform the benchmark by a considerable margin.

Read our Quarterly Managed Funds Report

The Chinese equity market in particular (36% of the MSCI EM index) has hit the headlines in recent weeks in respect of a broadening regulatory crackdown impacting a range of companies and sectors.

This has led to weakness in the Chinese equity market and underperformance from the EM benchmark index relative to the very strong performance from developed markets. The selldown looks to have stabilised over the last week or so with some sharp bounces in some of the impacted companies.

Is the regulatory crackdown a warning of a structural shift in the attractiveness of Chinese equities, or is it just reflecting the reality of EM/China investing and therefore an opportunity to accumulate further exposure for investors with a multi-year time horizon?

We analyse the situation and put forward our current investment views.

Exhibit 1: Over the long term emerging markets have outperformed developed, albeit with volatility

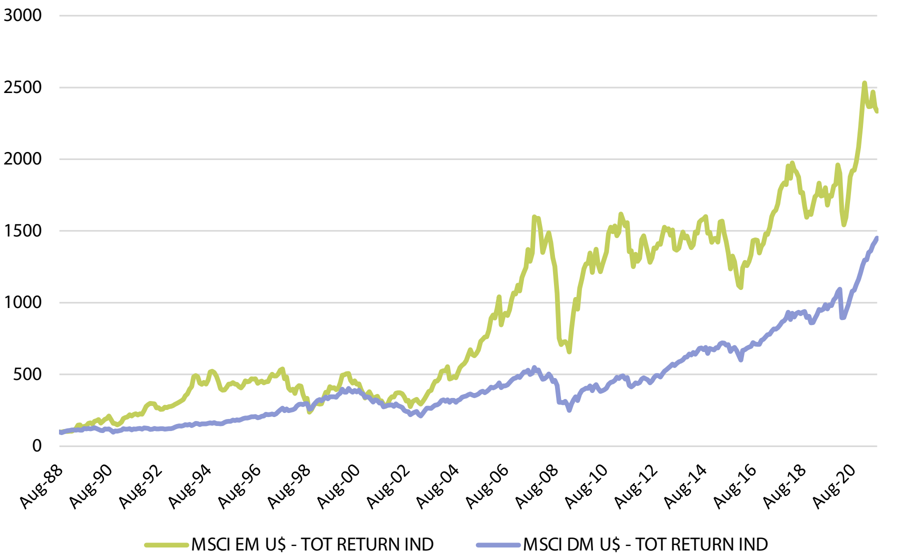


Exhibit 2: Emerging markets have underperformed in recent months

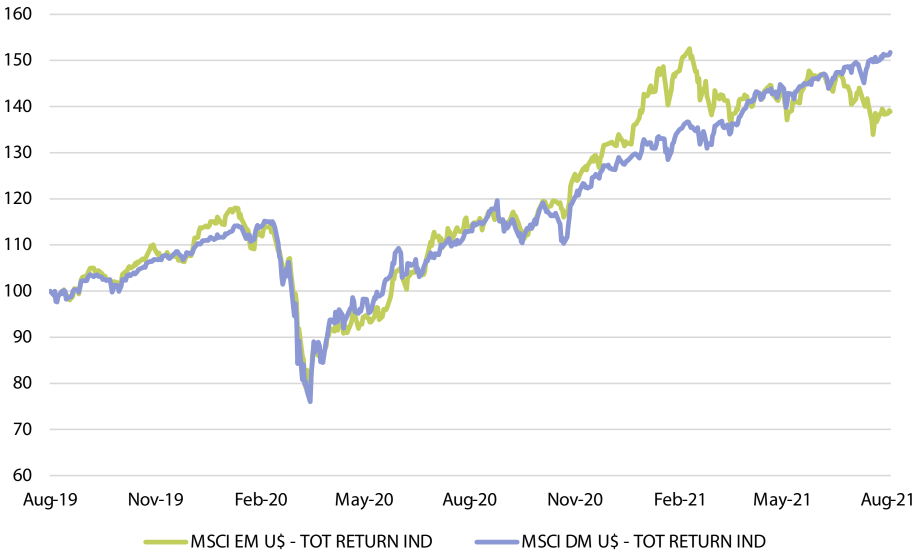
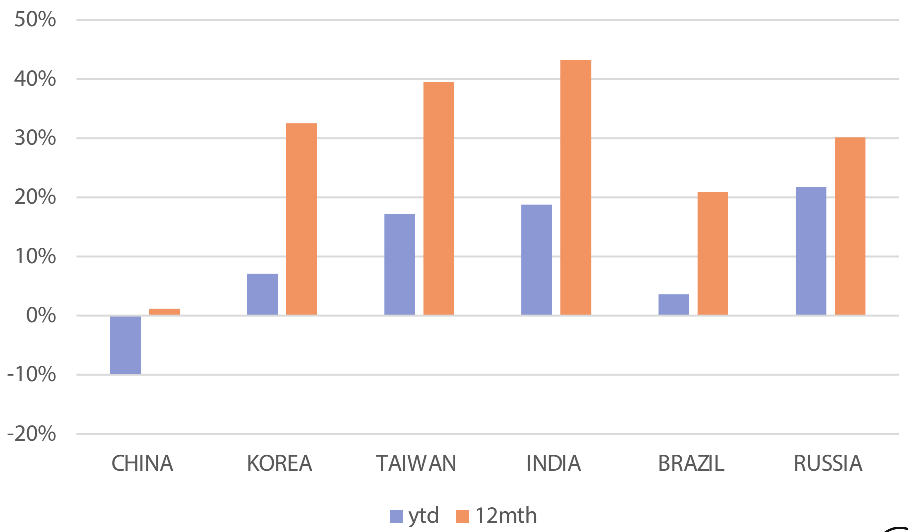


Exhibit 3: EM heavyweight China has dragged on EM performance recently



The Events Unfolding in China

A significant pick-up in regulatory actions across several sectors in China over the past few weeks has led to a sharp sell-off in Chinese equities.

The Chinese equity market fell 15% in the space of two weeks though it has bounced 8% off its lows over the past week or two. A number of stocks and sectors in the firing line have been sold down considerably more than the broad index.

The events of recent weeks cap off a year of heightened regulatory activity. Over the past year, Chinese regulators have taken significant action in the tech/fintech sector in respect of data privacy, cybersecurity, and anti-monopoly concerns.

The mega-cap tech companies were first in the firing line with Alibaba's planned IPO of affiliate Ant Financial scrapped by Chinese regulators last November. Other mega-cap Chinese tech/e-commerce companies such as Tencent (licencing exclusivity) and Meituan (worker underpayment) have also experienced a regulatory backlash.

The market sell-off appeared to reach a panic stage in late July when the attention of Chinese regulators turned to the "for-profit" education sector (private tutoring). The market's panic is arguably understandable given the severity of the regulatory measures aimed at severely crimping the profitability of the private (school-age) tutoring sector.

For some investors, the actions against the tutoring sector raised fears of a worst-case scenario involving an escalating regulatory clampdown across a broad range of industries that threatens a regulated step down in profitability of many sectors. We think on balance, many of these concerns are being overstated.

What is China Trying to Achieve?

The actions of Chinese authorities over the past weeks and months need to be seen in both a historical context and in the scope of China's stated growth and development goals. Regulatory intervention in China is nothing new. The step-up in the pace of measures came as a surprise, but the issues these measures seek to address have been well flagged.

China's specific areas of focus can be grouped into four categories or goals:

1. Inappropriate usage of market power (e.g. forced exclusivity arrangements)
2. Controlling monopolistic behaviour (e.g. addressing the poor treatment of food delivery and private taxi (Uber/DiDi) drivers)
3. Control and use of user data (e.g. transportation apps and various other apps)
4. Enhanced regulation that lowers social inequalities (e.g. private tutoring price controls)

It would be naive to think that all of these measures enacted by the Chinese Communist Party (CCP) are entirely altruistic (e.g. data privacy). Importantly, however, these are not overtly anti-capitalist aims and should ultimately encourage rather than stifle innovation and growth. For the most part, we believe the overarching objective of recent regulation is to foster sustainable, balanced growth and, at the margin, boost social equality.

The government's objectives are wide-ranging but seem to be fairly clear in their intentions:

- Enhanced data security in an increasingly digitised world
- A fair and competitive landscape for all industry players
- Protection of the interests of consumers and workers
- An enhanced focus on the "cost of living" concerns of a growing middle class

While the Alibaba IPO cancellation may have been a "special case", the general pick-up in focus on these aims in the past year is likely due in large part to the unequal economic recovery from the sharp economic downturn in the first half of 2020. 2021 is also a politically-sensitive year, with the upcoming CCP plenum in October.

Exhibit 4: EM has not had the big re-rating seen in developed markets

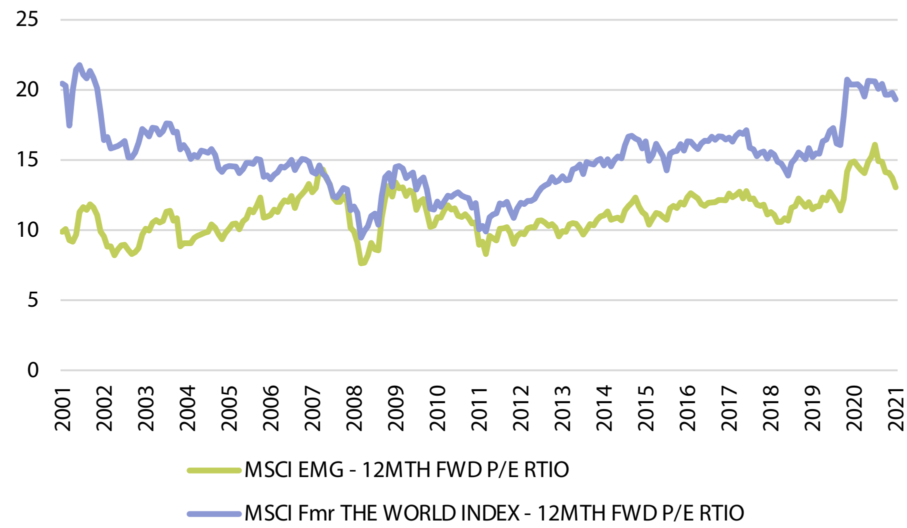
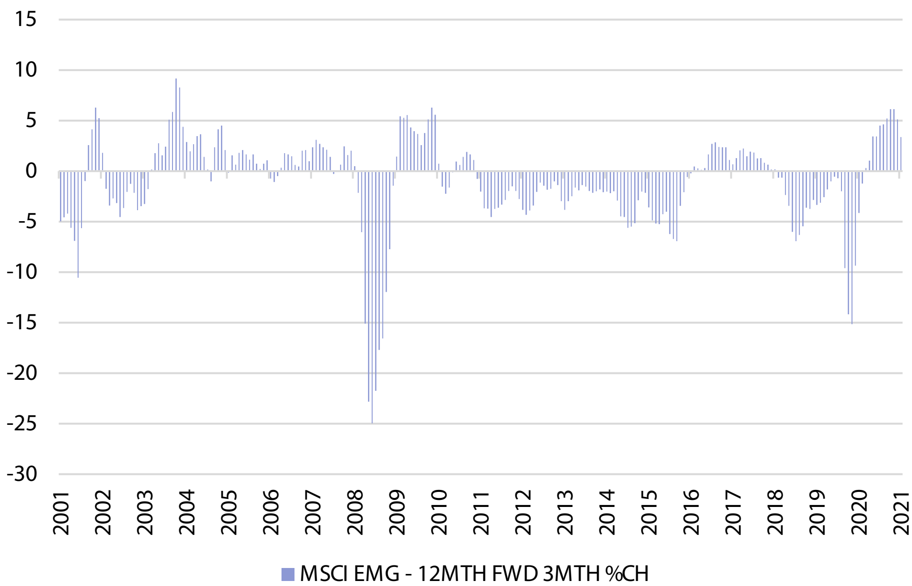


Exhibit 5: The EM relative PE discount did close in the last period of strong multi year global growth

Exhibit 6: EM earnings estimates continue to see consensus upgrades



The regulatory cycle will undoubtedly ebb and flow, but it will remain an ever-present reality of investing in China. On the ground expertise will be required, but the big picture story remains compelling in our view.

Despite the potential for policy headwinds in some sectors, China is still on track for vastly superior GDP growth (relative to the developed world) over the next 5 to 10 years. The Chinese consumer class should continue to grow even more rapidly than GDP.

Areas aligned with the government's long-term sustainability and innovation goals such as green energy, semiconductors, new infrastructure, electric vehicle supply chains and high-end manufacturing have the potential to provide particularly attractive investment opportunities in our view.

China Still an Attractive Medium to Longer-Term Investment Destination

The next 3-6 months may see more regulatory initiatives, but a large amount of bad news appears priced in, particularly relative to developed markets. Regulation is not the only near-term headwind with the pandemic still bubbling away, as it is in much of the world. Still, neither should change China's attractive medium to longer-term growth trajectory. We have already seen many companies adjusting strategies, and many valuations now look very attractive at the stock-specific level. Investing in EM and China will always come with a degree of volatility, but at current levels, we think it is likely to be rewarding over the medium to longer-term.

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Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

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