July 30, 2021

MARKET SIGHT LINES

A China Update

Michael O'Keeffe, *Chief Investment Officer*

With the "2020" Tokyo Olympics finally upon us now in 2021, I'm reminded of our 2020 outlook theme, *Productive Competition*. Athletes who compete in the Olympics train hard to prepare for competition, the effort leading to improvement as athletes. *Productive Competition*. We described the analogy with business competition, with companies working hard to compete with one another, and getting better along the way. We highlighted the competition between countries, especially focusing on U.S.-China competition. In this weeks Sight|Lines, we share an update on China, explaining some recent actions by China that will affect investors as well as current and future competition with the U.S.

What's been happening lately?

China's government has stepped in to influence, and sometimes transform, a number of Chinese companies.

The Ant Group, an affiliate company of the Chinese Alibaba Group, owns China's largest digital payment platform Alipay, which serves over one billion users and 80 million merchants. In October 2020, Ant Group was set to raise about $35 billion in the world's largest IPO, valuing the company at over $300 billion, but China stopped the IPO the night before the deal. In April 2021, we learned the company would be transformed into a financial holding company to be overseen by China's central bank.

DiDi is a Chinese ride sharing/transportation company with over 550 million users and tens of millions of drivers. The day after DiDi filed its IPO to go public to raise $10 billion, China's State Administration for Market Regulation (SAMR) launched an investigation into DiDi around pricing and other competitive practices. The company went public June 30, 2021, raising only $4.4 billion. Earlier this month, China ordered the removal of DiDi and other company apps as the investigations continue. Now, DiDi is considering going private.

These investigations include a look into the handling and security of user data, as well as possible viloations of the country's anti-monoply law. Other Chinese technology firms, such as Alibaba and Tencent, have been swept up in the probe. Ant Group's founder, Jack Ma, has dropped out of the public eye, likely the result of the these tech crackdowns and a tense relationship with President Xi.

On Saturday, in another aggressive move, China's State Council announced a comprehensive overhaul of the private education sector, with stated goals including protecting students, improving the quality of school education, and reducing the burden on parents. Education firms teaching core curriculum (e.g. math, science, and history) for K-9 are now barred from making profit and must be converted into nonprofit organizations. These companies may not go public, raise capital, or conduct tutoring on weekends and holidays.

China's Motivations

Let's consider China's long-term strategy to compete in the global economy and increase its economic influence. Since the 1950s, China has developed and implemented a series of five-year plans to advance its industry and technology, sometimes also establishing long-term plans. In 2012, President Xi set a goal for China to become a "fully developed, rich, and powerful" nation by 2049. China's been proactive, one example being the Made in China 2025 initative, whose purpose is to transform it from a low-end manufacturer to a high-end, technology-intensive producer. The latest five-year plan focuses on building self-reliance and technology independence, with the semiconductor industry being central to the plan. So, what to make of these recent moves?

China, with its long-term startegy in mind, is willing to experience short-term pain to advance its strategy. Through its actions with the Ant Group, China is signaling that it will take action to reign in any company or individual that's becoming too powerful and influential. In just six years, Ant grew to become the largest payment processor in the world and the largest mobile payment platform. Some believe the motive behind the cancellation of the IPO was to reduce exposure of the Chinese financial system to instability and systemic risk. This means more government influence and control, and the possibility a business may be nationalized for "the greater good." The crackdown on tech regulations may be a a little more subtle. China maintains that these moves are designed to ensure that these businesses are more competitive globally. This reasoning aligns with their long-term strategy. The transformation of the private education sector to a de facto nationalized state (nonprofit) is subtler still. Some believe China was motivated to make this change, in good part, to lessen the cost and burden of these services on families, removing one demotivating factor to growing a family. This follows the recent policy shift to allow couples to have up to three children after the latest census data showed a steep decline in birth rates.

Investment Implications

The China capital markets cannot be ignored. Based on the weightings of the MSCI ACWI Index, the China stock market represents 37% of the emerging markets and 5% of the world stock market, a weighting larger than the UK and France, for example. Many active equity managers investing globally select China stocks as a way to invest in the strong growth experienced there. And many large, influential asset managers consider China exposure a strategic investment, a top-down view and judgement about the overall growth there.

There are reports that senior leaders from the China Securities Regulatory Commission spoke this week to representatives of large global banks, telling them that China will consider the market impact before enacting future policies. They are attempting to ease investor concerns of these recent moves.

With all this said, the recent moves by China highlight the opportunities, and risks, of investing there.

Conclusion

China has recently taken actions with negative consequences for U.S. investors. These tensions, and the related U.S.-China competition, are here to stay. Investment in individual Chinese companies, and the country more generally, represents potential opportunity, and potential risk. We will continue to monitor China actions and U.S. moves as we make our investment decisions.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com

0721.3693871.1