

CHINA: RECENT MARKET VOLATILITY, OUTLOOK AND INVESTMENT OPPORTUNITIES

AS OF 30 MARCH 2021

On Recent Volatility In The Chinese Equity Market

Recent volatility in Chinese equities has primarily affected growth equities, particularly in internet, tech and health care categories. While ADRs and Hong Kong listed shares have been most impacted, A-shares also underperformed EM, indicating a broader rotation from Chinese equities. There are a few likely reasons behind Chinese equity underperformance including fears over increasing regulations, and the potential for tightening credit in China. Additionally, fears over rising inflation expectations globally have contributed to growth underperformance compared to value. In our view, the recent sell off is likely overdone and high quality, growth-oriented equities particularly in tech and tech-like categories should resume outperformance moving forward.

Recent government proposals for anti-trust measures and increased regulatory attention, particularly within the Chinese technology and internet categories, have increased uncertainty and weighed on sentiment. Proposals include tighter restrictions on food delivery services, online financial services and fintech, M&A and the potential creation of a state-backed company to oversee the user data collected by the large technology companies. Additionally, proposals to increase regulations on online education platforms indicates the government's regulatory crack-down is likely more wide spread than the technology sector, further weighing on sentiment. While these developments are negative and may continue weighing on sentiment in the short term, the impact to fundamentals over the long term is likely to be minimal. Notably, the threat of increased regulations is not new and Chinese internet and technology companies have a long history of navigating a changing regulatory environment from anti-trust laws in 2008, internet search regulations in 2016, and online gaming laws in 2018 among others. Though new rules can potentially create winners and losers in the near term tied to more competition and increased compliance costs, the underlying drivers of growing consumer demand and ecommerce penetration remain unchanged and should support continued growth. Lastly, many of the new regulatory proposals are subject to change following consultations with the affected companies and could end up being less than feared. While these developments are worth monitoring closely, our view that higher quality, growth oriented tech and tech-like companies should outperform remains unchanged. Importantly, our current portfolio holdings are well positioned to adjust to any regulatory changes, and in some cases may benefit given their size and scale as new regulations may create further barriers to entry.

Fears over tightening credit have also contributed to the recent volatility in Chinese equities. Notably, credit growth in China modestly slowed from its peak in October 2020 of 13.7% to 13.3% in February as the government attempts to stabilise leverage and contain financial risks, particularly as the economy recovered sharply following the impact from COVID-19 related containment efforts. While credit growth is likely to continue moderating, and the People's Bank of China (PBoC) may begin gradually tightening policy as the year progresses, in our view, economic fundamentals are likely to remain stable as COVID-19 containment measures are further eased globally. Notably, external demand remains strong helping drive export growth and domestic demand continues to strengthen driving consumption growth. Moving forward, as economic data recovers and restrictions fully ease, we would expect economic growth to return to a modest growth environment.

Lastly, rising inflation expectations, amid continued global stimulus spending, economic recovery as vaccine distribution progresses and the central banks' willingness to maintain loose monetary policies globally have put upward pressure on longer-term yields, likely contributing to recent value outperformance versus growth. However, in our view inflationary pressures are likely to be transitory given a low base effect and temporary

supply chain disruptions. Additionally, continued quantitative easing, and negative yields in many non-US markets remain headwinds for longer-term interest rates moving forward. Recent value outperformance is likely a countertrend that should prove short-lived as inflation expectations temper and economic growth moderates. In that type of economic environment, we believe growth equities will outperform.

Short-Term And Long-Term Opportunities Within Chinese Equities

Moving forward, volatility within Chinese internet, technology and health care categories may continue in the immediate term, particularly given the growing uncertainty surrounding new potential regulations. Additionally, value outperformance may continue in the immediate term, particularly within energy, financials and real estate tied to the continued economic recovery globally as restrictions ease further and vaccine distribution accelerates. However, we expect that to be temporary and we would expect growth categories, particularly within Chinese internet, technology and health care to resume outperformance and lead over the next 12 to 18 months, as uncertainty fades and economic growth moderates.

While many forecasters believe we are early in a bull market cycle following the end of the bear market in late March 2020 and expect value to lead, we believe we are in a market environment more like a late bull market cycle. In our view, the global bear market in 2020 behaved more like an oversized correction rather than a typical bear market. Typically, bear markets are long and slow moving, correcting the excesses of the previous economic cycle. However, the 2020 bear market fell quickly and sharply from peak to trough, lasting roughly 2 months—more characteristic of a correction, which did not reset the cycle. Market breadth remained narrow following the bear market rather than widening, with growth initially outperforming off the bottom, which is more typical of a late-stage bull market environment. Lastly, market sentiment improved significantly off the bottom of the bear market. The speed of the market recovery and the quick return of optimism towards equities further evidences that we are late in the bull market cycle. Late stage bull markets tend to favour large, high quality, growth-oriented equities, which should benefit Chinese internet, technology and health care companies as they often exhibit these characteristics. We are currently monitoring sentiment indicators for signs of euphoria, as euphoric sentiment does pose a risk to returns of Chinese and global equities over the next 12 to 24 months, but at this time remain bullish and expect above average equity market returns.

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