UOB Investment Insights

# Quick Note

**27 July 2021**

## Regulatory Concerns Weigh on Chinese Equities, but Megatrend Intact

- Following the Chinese government's data security concerns over technology and digital platforms, further regulatory tightening fears over the private education sector led to a major sell-off in education-related equities, weighing on the broader Chinese market.

- At this juncture, the uncertainty will likely continue to weigh on market sentiment until more policy clarity is provided.

- Despite this, we remain positive on China's long term structural growth story as rising middle class incomes and consumption create investment opportunities. Chinese equities are well supported by strong fundamentals and also reasonable valuations. We prefer the domestic A-share market to ride the China Megatrend.

### Regulatory uncertainty weighs on Chinese equities

- Chinese equities continued to face headwinds in recent weeks due to fears of regulatory tightening and policy uncertainty.

- With the government's emphasis on data security, internet companies and digital platforms are under scrutiny on-top of existing antitrust regulations. (See Quick Note: Chinese Equities – Riding Through Short-Term Risks, Towards Long-Term Gains) In particular, ride-hailer DiDi was flagged out following its IPO in the US, with China's cybersecurity regulators blocking the company from all app stores.

- Additionally, concerns that the Chinese government may ban private education and tutoring companies from making profits further added to investors' woes over tightening regulations. Education companies such as TAL Education and New Oriental Education plunged more than 50% on 23 July.

- Given the current policy uncertainty, market sentiment has been affected as investors remain concerned over a lack of clarity from the policy front.

### What is driving the changes in Chinese policies?

- Data security is now deemed as a strategic asset and crucial for national security. In particular, consumer-internet companies and digital platforms with huge troves of user-data could see them possess large market influence and the government is concerned over the potential for anti-competitive behaviour.

- Chinese authorities also see the need to increase regulatory oversight on data collected and used by the large technology companies. This issue is also hotly discussed in the US and Europe.

- The lack of regulatory oversight has led to fears of sensitive data being disclosed to foreign regulators and investors when listing overseas, contributing to the recent crackdown on companies like DiDi.

- Beijing is also implicitly encouraging companies to list in Hong Kong, announcing plans to exempt IPOs from cybersecurity reviews. This is likely to result in more companies tapping on the Hong Kong capital market, while also leading to a decrease in the number of Chinese American Depositary Receipts (ADR) going forward.

- While companies will be increasingly pressured to toe the line, it is unlikely that Beijing will regulate these internet platforms to "death" as they remain crucial to China's digital ecosystem and create jobs for millions of Chinese.

- As for the private education industry, authorities are concerned about high costs of private education and tutoring leading to higher financial burdens among households and the broader impact on education disparity resulting in wealth disparity, and social instability.

- Additionally, China's population demographic is also changing, impacting the country's economic structure (See Macro Note: China: Impact Of Demographic Transition). In addition to the recent three-child policy, the government aims to bring down the cost of child-raising, which has risen considerably due to high private education costs, to stimulate population growth.

- At this current juncture, it remains to be seen if the business models of private education players will remain viable. This will likely continue to weigh on market sentiment until more policy clarity is provided.

## Focus on domestic A-Share market to tap on China Megatrend

- The ongoing regulatory tightening remains a short-term pain for longer-term gain. Recent events may result in a lack of catalysts to drive share prices higher. But fundamentals in the broad domestic market stay resilient and opportunities for structural growth are intact. Investors can continue to tap on the China Megatrend via domestic-focused onshore A-shares, where there is less regulatory uncertainty, rather than the offshore market.

- A key pillar to the China Megatrend is the rising income of China's middle class, which can be seen in the high amount of spending in private education and tutoring services. However, the private education industry is not the only avenue to leverage off this trend as there are other investment opportunities. Decarbonisation and infrastructure developments are also initiatives that are in-line with government priorities.

- Additionally, the current "dual circulation" growth strategy employed by the government emphasises increasing domestic manufacturing to meet domestic consumption as a growth driver, reinforcing the consumption trend.

## What should investors do?

- Invest in line with your **risk tolerance,** and maintain **adequate diversification** across asset classes, regions and market segments to manage potential bouts of unforeseen volatility. Our proprietary Risk-First approach can help ensure that you take the appropriate amount of risks in accordance with your risk profile.

- Investors with a **higher risk tolerance** can adopt a **long-term perspective** and remain invested in offshore Chinese equities as many of these companies will continue to be growth pillars in the Chinese economy. However, be prepared for ongoing volatility and potential re-listing where required. Investing through active professional fund managers can mitigate some of the risks as they will make portfolio shifts as the situation develops.

- **Consider investing in onshore A-shares and other tactical ideas –** Market volatility may persist in the shorter-term due to regulatory uncertainty for offshore listing. Investors can consider the domestic onshore markets (A-Shares) as an alternative to continue tapping the benefits of China's growing domestic consumption. Other tactical ideas such as Megatrends (Healthcare, Sustainability) and High Conviction calls (US Financials and European equities) are alternatives to China A-shares.

- Investors who are not currently invested in China but wish to enter can consider **investing in tranches** and **buying on market dips** to accumulate positions in **China A-share funds** at cheaper valuations. Similarly, invest in tranches when accumulating other tactical ideas.

- Investors with **lower risk tolerance** can also consider increasing core holdings like growth-orientated multi-asset strategies such as Capital Builder.

- Please speak to your UOB Advisor to determine the appropriate courses of action for you in light of these latest developments.

*All data are sourced from Bloomberg unless otherwise stated.*

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