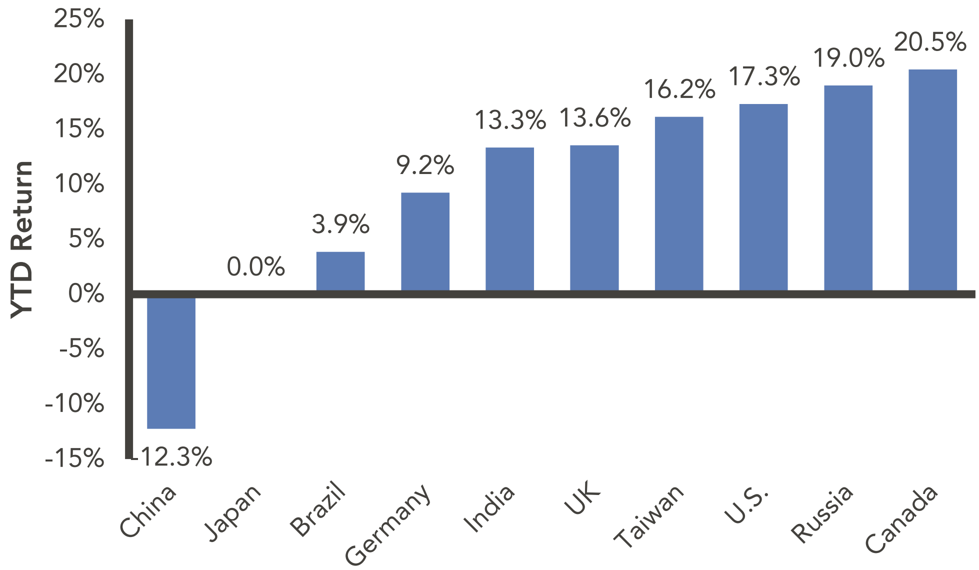
Perspectives

AUG 2021

China: From Leader to Laggard

In 2020, China was a top performer in the global equity market, returning 29.5%. In 2021, however, Chinese equities have struggled thus far compared to many of their peers. While several of the world's major equity markets have generated double-digit returns year-to-date, China has lost 12.3% with the majority of those losses occurring in the last several weeks. In this newsletter, we will review reasons why China has transitioned from leader to laggard and discuss future prospects from here.

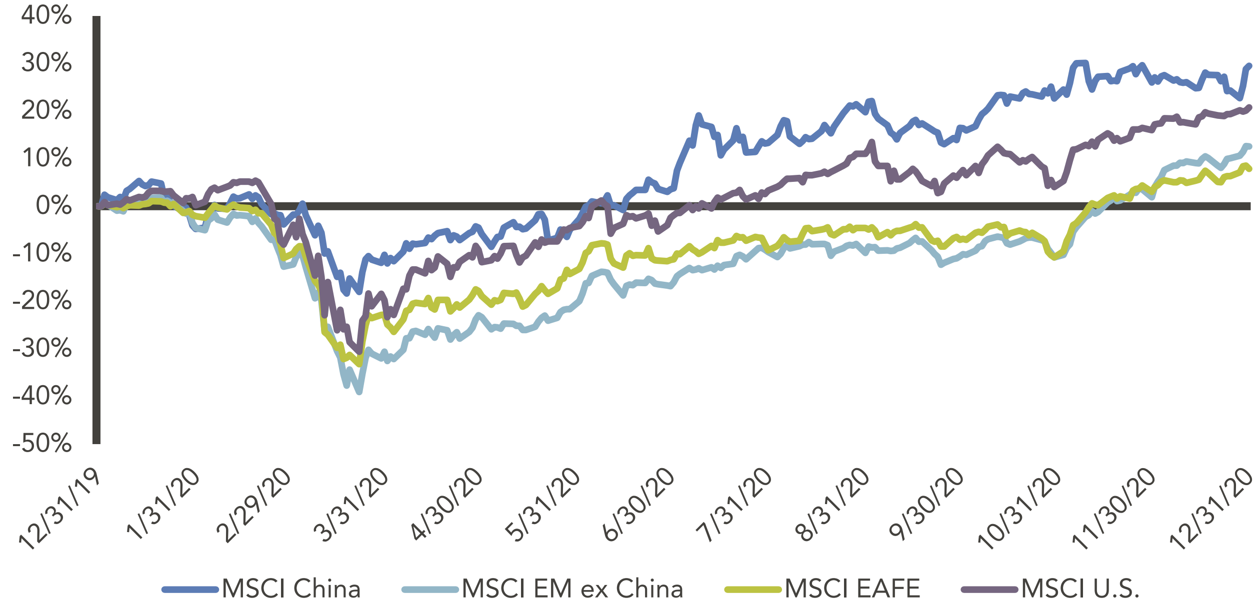
Exhibit 1: YTD Country Returns



Source: Bloomberg as of July 31, 2021

In 2020 China generated a 29.5% return leading most equity markets. However, that strong number is not indicative of the volatility that occurred last year. Readers likely do not need to be reminded how unique last year was. Interestingly, while China was one of the first major countries to experience a 10% drawdown, the sell-off was not nearly as dramatic as several other broad equity indices. China's cumulative return low point was -18.4%, while the U.S. hit -30.6% *(Exhibit 2)*.

Exhibit 2: 2020 Cumulative Returns



Source: Bloomberg

Headed into 2021, China had been a hot market and that strong momentum carried forward into the first part of the year. However, in late February, China came under pressure and gave up much of its year-to-date gains. By the end of the first quarter, China began to underperform the rest of the emerging markets universe. That performance gap started to widen and increased dramatically at the start of the third quarter. In July, the MSCI China Index lost 13.8%, dragging the broader MSCI Emerging Markets Index to a 6.7% loss for the month. Why did Chinese equities sell off?

Exhibit 3: 2021 Cumulative Returns

Source: Bloomberg as of July 31, 2021

On July 23rd, the Chinese government announced that private for-profit education companies were no longer allowed to make a profit as part of China's efforts to boost its declining birth rate and lower education costs. Among other restrictions, these companies are now required to transform into non-profit entities. As a result, two of the largest education companies — New Oriental Education and TAL Education — were down 73.5% and 75.9%, respectively, in July. This dramatic change is a recent event in a series of regulatory actions that have been taken by the Chinese government over the last 10 months. Previous changes predominantly impacted internet-based businesses and were much less severe. While the changes did dampen future profitability, they did not remove profitability altogether. The July decision regarding for-profit education companies alarmed investors with its severity and forced the market to assess the risks of the new regulatory climate and the potential impact to future profitability for Chinese equities overall.

Investors who have not looked beyond the headlines and eye-popping losses are likely unaware of some of the positive performers in the Chinese market. While there have been many recent stock losers, there have been winners as well. These winners and losers have largely been determined by China's recent policy actions. China has shifted priorities from growth at all costs to quality growth with a focus on common prosperity and sustainability. The previous pro-growth strategy led to higher levels of inequality for companies and individuals along with environmental repercussions. Over the last 10 months, China has implemented anti-monopolistic policies, addressed data security concerns, tightened regulation on internet financials, and increased focus on carbon emissions. These changes have had an outsized negative impact on larger Chinese companies, typically internet-based, who previously benefitted from less regulation to grow their market capitalizations. These companies along with the education stocks were hardest hit by the July sell-off. In contrast, companies connected to sustainability via alternative energy and data security performed exceptionally well on a relative basis.

Exhibit 4: July's Winners and Losers

Industry/ Company	Benchmark Weight (%)	July Return (%)
Diversified Consumer Services	0.7	-67.5
NEW ORIENTAL EDUCATIO-SP ADR	0.3	-73.5
TAL EDUCATION GROUP- ADR	0.2	-75.9
Internet & Direct Marketing Retail	22.2	-19.3
Interactive Media & Services	15.5	-18.5

Industry/ Company	Benchmark Weight (%)	July Return (%)
Metals & Mining	1.4	17.0
Electrical Equipment	0.9	14.7
Semis and Semi Equipment	1.3	7.2

Source: Bloomberg

This kind of regulatory reset is not a new phenomenon in China. Readers may remember China targeting gaming companies in 2018. With the goal of decreasing screen time for youth, China limited the number of approved new online games, implemented an age ratings system, and limited the amount of time that minors could play games online. As a result, gaming giant Tencent experienced a dramatic sell-off. After returning 114% in 2017, it was down 24% in 2018 and 35% off its high. The broader China index directionally followed Tencent's movement due to the company's size and investors' concerns around additional regulatory action from the government. Tencent navigated those regulatory changes by strengthening its focus on corporate internet services while still generating a profit from its gaming business. Between 2018 and 2019, Tencent returned 82% and the MSCI China Index returned 60%.

Exhibit 5: Cumulative daily returns for Tencent, MSCI China, MSCI EM ex China since Dec. 2016

Source: Bloomberg as of July 31, 2021

Regulatory changes are common for China, and it is part of doing business in the country. Periods of unchecked growth are often followed by increased regulation. Based on what we have seen in the past, investors will likely remain jittery on Chinese stocks over the short term, especially within regulated industries. However, the Chinese government will eventually slow the pace of regulatory changes and investors will settle in. We have seen this occur in the past, with 2018 serving as a recent example. We believe over the next six to 12 months the market will likely recalibrate to the new regulatory environment and identify the resulting winners and losers.

About Operose Advisors

Operose Advisors LLC is a Wisconsin-based investment adviser working in partnership with independent investment consulting firm, Marquette Associates, Inc. Our purpose is to deliver an institutional approach to individuals, families, trusts and closely held businesses with planning, execution, and feedback of investment programs. For more information, please visit www.operoseadvisors.com.