Private Bank

Citi Global Wealth Investments

Asia Strategy Bulletin

July 28, 2021

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China: The Non-Profit Tantrum

- The State Council guidelines to turn the after school tutoring business into non-profit triggered a precipitous selloff in Chinese equities wherever they're listed. Investors looked for who's next and worried whether China may be taking a left turn too big to own.

- We believe that regulatory risks remain, such as for property and healthcare, but are likely much less severe than for education. These are much bigger parts of China's economy, and are too expensive for the government to foot the bill.

- There is also evidence that China plans to continue to push forward market oriented development, as Premier Li Keqiang and Vice Premier Liu He both highlighted in recent days. Abandoning capitalism is also inconsistent with stability at this point.

- Ultimately, the purpose of all the regulations is sustainability. The measures are likely to support longer term development of consumer and middle class growth by curbing the cost of basic life needs. It would also solidify control of the central leadership.

- There are historical parallels. During the 13th Five Year Plan (2015-19), a lot of steel capacity was destroyed in very blunt ways, causing business owners substantial losses. But profitability followed. There were also retail price reform, manufacturing privatization, local government funding for infrastructure, housing privatization, etc. These were cases of major policy changes that created booms and regulation brought busts, followed by more sustainable development.

- The initial selloff is fueled by margin deleveraging and fund redemptions, which is likely to be short lived. Between now and sustained recovery, however, there is likely to be a period of volatility, as investors assess impact on earnings. But looking out 1 year and beyond, we remain convinced that China's consumption and technological development would still offer attractive returns.

What happened?

- On July 23, China's State Council released the guidelines for after school tutoring that included making core curriculum tutoring non-profit, and severing this industry from the capital market. This move differed from recent regulations in antitrust, fintech, data security and labor rights, in that it forbade an entire industry from making profit.

- This caused the biggest two-day selloff in Chinese equities since 2015 for the MSCI China and CSI 300 indices. For the Hang Seng index, it was the largest two-day selloff since 2008.

- Investors worried about other sectors that could face additional regulatory risk, particularly property and healthcare, as these sectors were also named as the three main anchors (mountains) for social stability, along with education. The fear was also elevated to whether China would abandon market based economic development.

Will China do it to other industries like property and healthcare?

- The State Council included education, property (residence) and healthcare, as basic needs. But they did not reveal new regulations on the property and healthcare sectors. Additional regulation may be forthcoming, but are likely to be far less severe than for education.

- On property, deputy Premier Han Zheng reiterated that the three red lines would be enforced and property would not be used as a lever for stimulus. This should not come as a surprise. Existing policy is already effective in curbing housing prices and over-development. A key question is actually whether Evergrande can survive. The firm is still struggling, trying to sell assets to raise cash, which could still sustain for a while since it has no offshore bonds coming due this year and it continued to make onshore payments. Creating a systemic financial problem in the property sector would not be consistent with sustainability.

- On healthcare, the issue is marginal innovation (copies of drugs with minor changes in formula) in new drugs did not improve effectiveness, but allows for charging higher prices. This seems a common practice with many global big pharma companies, but authorities want to encourage more genuine innovation. The less innovative second tier drug makers may be at risk as a result. However, China had already conducted comprehensive price reform three years ago, and the cost of most drugs is under effective control. Policymakers have also voiced support for online medical care to make the sector more efficient. So new regulations here, if any, should not be severe in our view.

- Will they make property and healthcare non-profit?
  No, because they can't afford it. All of public and private education adds up to about 2.5% of GDP. The government may have sufficient resources to foot bill for a much expanded public education to offset the lack of K-12 tutoring. But the real estate supply chain is about 11% of GDP and healthcare about 4.5%, the government simply can't afford them. The market panic assumes a lot worse for these two sectors.

Is China making a big irreversible left turn?

- No, it is sticking to market oriented development. Premier Li Keqiang and Deputy Premier Liu He said so at two separate meetings over the past week. But don't just take their words for it.

- The tech sector is instrumental in China's competition with the US. There may have been some excesses in the internet industry, but it is still the backbone of China's economic prowess needed to sustain this competition. Liu He's comments were made at a forum for small and micro enterprises (SME), encouraging innovation at SMEs, which was partly the purpose of antitrust regulation. He also highlighted China would not change its market-oriented economy and its path towards internalization. And Premier Li also reiterated that financial reform and opening would continue, with lower barriers of entry and continued push for RMB internationalization.

- Actually, capitalism is irreversible. Over 90% of China's households own at least one property. Ordinary people have come to depend on the convenience of online supply of goods and services. Millions are employed by internet based business models. Abandoning capitalism would not ensure social stability in this backdrop, but rather destroy it.

- Some historical context may be helpful. For example, local governments and SOEs paid for ubiquitous telecom networks and other infrastructure, which created a debt hangover, but also enabled the internet industry to deliver their services. During the 13th Five Year Plan (2015-19), a lot of steel capacity was destroyed, in very blunt ways. The business owners went through substantial losses. But in the past two years, profitability boomed for an industry with reduced capacity. Many other examples exist where major policy enabled booms and regulations brought busts, but the end result is a more sustainable business.

Why are they particularly harsh on education?

- "Involution" (内卷) is a term referring to endless work and competition for little gain or result. This was a problem before, but exacerbated by the pandemic. Online tutoring became ubiquitous, as easy as shopping on Taobao. Parents have to spend money and students have to spend countless hours after school for tutoring in order to keep up with everyone doing the same.

- Whether rich or poor, the cost of basic education have risen for the whole population. Much of the tutoring services focus on test taking skills rather than knowledge. And the result is not stronger education, but students with similar answers.

- This not only hurts the students involved, it reduces willingness to have more children and also restrains spending on discretionary consumption. Yes, the education system itself is to blame for this, which is why along with the non-profit guidelines, the government would invest in the public school system to better meet the needs of the students.

- The education guidelines are being trialed in 9 cities, after which implementation details would be drawn by the Ministry of Education and local governments. There remains some uncertainty as to what kind of content can be delivered online. But generally, higher education, vocational training, and specialized subjects like STEAM and physical fitness remain open to for-profit businesses.

How will this affect China's longer term growth?

- Middle class consumption is the key rationale to own China. From healthcare to e-commerce, from name brands to vacations, the central theme is the growing disposable income of the middle class. Involution over the long run shrinks disposable income and would be inconsistent with developing consumption driven economy.

- While "involution" isn't unique to China, as the middle class households in Japan, Europe and US could attest to. It is just more difficult to tackle in a country of over a billion people. China seems to be the only one so far to try to tackle this side effect of capitalism.

- We continue to expect solid revenue growth driven by household income and spending. The cost of compliance has risen, which would lower earnings growth compared to the under-regulated hyper growth phase of the past two decades. But the slower earnings growth is already well priced into this distressed market.

What about other tech regulations?

- If anyone is worried, China is not going to make the internet non-profit. Before this year's clampdowns, an "app culture" had developed that poured all resources into capturing more mind and wallet share of consumers, rather than genuine innovation. Small businesses and start ups faced significant disadvantages. These had to be rectified. As noted, it is the backbone of consumption and tech development and profitability is still the strongest incentive for innovation.

- As we've noted previously, the rule making phase of tech regulation (antitrust, fintech and data security) is already complete. The education guidelines came as an additional shock, but that does not change tech regulations already in place. We were encouraged by the approval Tencent-Sougou deal and the announcement by Tencent and Alibaba to allow connectivity between their platforms. These were evidence that tech regulation have moved to the rebuilding business model phase. China announced a six-month task force to oversee the implementation of the new regulations at affected firms, which is also a part of the rebuilding phase.

How might Chinese equities recover?

- The selloff this week represented a capitulation of investors. Mutual funds and ETFs have been relatively steady before July 23, but redemptions caused significant selling after the education policy announcement. Unwinding of structured products and margin squeeze added to the downdraft, which was similar to US market action last March before the Fed offered unlimited help. We believe this capitulation trade would only last a few days, followed by moderate rebound.

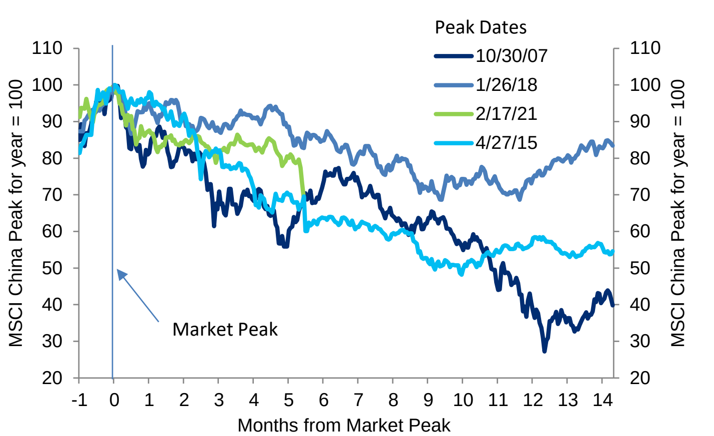
- Many observers look for historical comparables. In 2018, there were also significant heavy handed government measures to ban game approvals, cut high energy and pollution industries and tighten housing. But these did not stop the 2019-20 boom. In 2015, the whole world doubted whether China had enough FX reserves, but that did not prevent the 2016-17 boom. The enormous off-balance sheet lending business was regulated away after the 2015 episode, which leaves a more reasonable margin business and hence margin squeeze is unlikely to be nearly as extensive this time.

- In terms of intensity, the selloff this time was as severe as in 2008 (**Figure 1**). But there is not a global reinforcement to the drawdown. The regulatory panic was entirely created by Chinese authorities, who have the choice of pace and extent of implementation, especially after seeing the market feedback.

- Still, there is likely to be a period of volatility before more sustained recovery. Investors would need to weigh the impact of regulations on earnings and parse out the meaning of potential new ones. Fed policy and pandemic recovery may also add to uncertainty. In past episodes of significant correction, the recoveries typically followed this pattern (**Figure 1**).

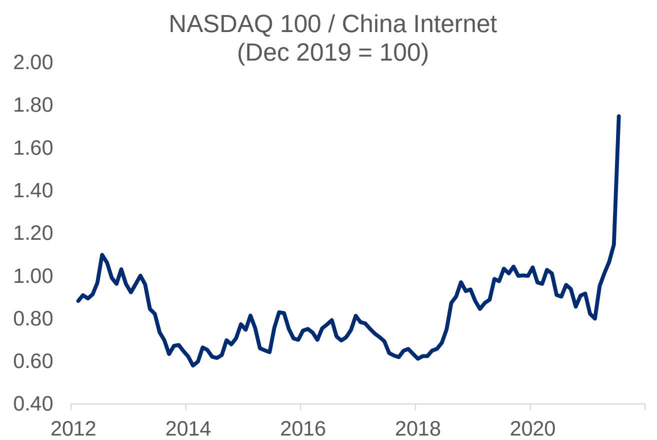
- For longer term investors, we believe that Chinese equities already offer potentially attractive 12-month returns at this stage after the panic selling. The education space faces existential risk and may be hard to call. But the internet industry likely offer the most potential for recovery, especially after the most severe underperformance on record relative to US peers (**Figure 2**). Healthcare and property services have already seen some relief. Meanwhile, tech hardware and green energy industries held up well through the selloff and continue to offer solid long term growth prospects.

Figure 1: Past episodes of major market correction have typically gone through a period of volatility between initial rebound and more sustained recovery



Source: Bloomberg, as of July 12, 2021

Figure 2: China internet stocks underperformed NASDAQ by most on record



Source: Bloomberg, as of July 12, 2021

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Glossary

Terms	Definition
AxJ	Asia ex-Japan
AFC	Asian Financial Crisis (1998-99)
GFC	Global Financial Crisis (2008-09)

Asset allocation definitions

Asset classes	Benchmarked against
Global equities	MSCI All Country World Index, which represents 48 developed and emerging equity markets. Index components are weighted by market capitalization.
Global bonds	Barclays Capital Multiverse (Hedged) Index, which contains the government -related portion of the Multiverse Index, and accounts for approximately 14% of the larger index.
Hedge funds	HFRX Global Hedge Fund Index, which is designed to be representative of the overall composition of the hedge fund universe. It comprises all eligible hedge fund strategies; including but not limited to convertible arbitrage, distressed securities, equity hedge, equity market neutral, event driven, macro, merger arbitrage and relative value arbitrage. The strategies are asset-weighted based on the distribution of assets in the hedge fund industry.
Commodities	Dow Jones-UBS Commodity Index, which is composed of futures contracts on physical commodities traded on US exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). The major commodity sectors are represented including energy, petroleum, precious metals, industrial metals, grains, livestock, softs, agriculture and ex-energy.
Cash	Three-month LIBOR, which is the interest rates that banks charge each other in the international inter -bank market for three-month loans (usually denominated in Eurodollars).
Equities	
Developed market large cap	MSCI World Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the equity market performance of the large cap stocks in 23 developed markets. Large cap is defined as stocks representing roughly 70% of each market's capitalization.
US	Standard & Poor's 500 Index, which is a capitalization -weighted index that includes a representative sample of 500 leading companies in leading industries of the US economy. Although the S&P 500 focuses on the large cap segment of the market, with over 80% coverage of US equities, it is also an ideal proxy for the total market.
Europe ex UK	MSCI Europe ex UK Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in each of Europe's developed markets, except for the UK.
STOXX 600	The STOXX Europe 600 Index has a fixed number of 600 components, representing large, mid and small capitalization companies across 18 countries of the European region.
Japan	MSCI Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure large cap stock performance in Japan.
Asia Pacific ex Japan	MSCI Asia Pacific ex Japan Large Cap Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure the performance of large cap stocks in Australia, Hong Kong, New Zealand and Singapore.
China & HK	The MSCI China Index is a free-float weighted equity index, representing Chinese companies listed in Hong Kong, as well as American Depository Receipts listed in the US. MSCI HK Index is a free-float weighted equity index, representing HK companies listed in HK.
Emerging market	MSCI Emerging Markets Index, which is free-float adjusted and weighted by market capitalization. The index is designed to measure equity market performance of 22 emerging markets.

Asset allocation definitions

Bonds	
Developed sovereign	Citi World Government Bond Index (WGBI), which consists of the major global investment grade government bond markets and is composed of sovereign debt, denominated in the domestic currency. To join the WGBI, the market must satisfy size, credit and barriers-to-entry requirements. In order to ensure that the WGBI remains an investment grade benchmark, a minimum credit quality of BBB–/Baa3 by either S&P or Moody's is imposed. The index is rebalanced monthly.
Emerging sovereign	Citi Emerging Market Sovereign Bond Index (ESBI), which includes Brady bonds and US dollar -denominated emerging market sovereign debt issued in the global, Yankee and Eurodollar markets, excluding loans. It is composed of debt in Africa, Asia, Europe and Latin America. We classify an emerging market as a sovereign with a maximum foreign debt rating of BBB+/Baa1 by S&P or Moody's. Defaulted issues are excluded.
Supranationals	Citi World Broad Investment Grade Index (WBIG)—Government Related, which is a subsector of the WBIG. The index includes fixed rate investment grade agency, supranational and regional government debt, denominated in the domestic currency. The index is rebalanced monthly.
Corporate investment grade	Citi World Broad Investment Grade Index (WBIG)—Corporate, which is a subsector of the WBIG. The index includes fixed rate global investment grade corporate debt within the finance, industrial and utility sectors, denominated in the domestic currency. The index is rebalanced monthly.
Corporate high yield	Bloomberg Barclays Global High Yield Corporate Index. Provides a broad-based measure of the global high yield fixed income markets. It is also a component of the Multiverse Index and the Global Aggregate Index.
Securitized	Citi World Broad Investment Grade Index (WBIG)—Securitized, which is a subsector of the WBIG. The index includes global investment grade collateralized debt denominated in the domestic currency, including mortgage -backed securities, covered bonds (Pfandbriefe) and asset -backed securities. The index is rebalanced monthly.

Indices	
CFETS RMB Basket Index	The China Foreign Exchange Trade System (CFETS) RMB currency basket measures the RMB versus foreign exchange currency pairs listed on CFETS. This index refers to the currency basket accepted by CFETS and the 13 currencies which make up the basket were selected based upon international trade-weights with adjustment of re-export trade factors.
DXY Dollar Index	The U.S. Dollar Index (USDX) indicates the general international value of the USD. The USDX does this by averaging the exchange rates between the USD and major world currencies. The ICE US computes this by using the rates supplied by some 500 banks.
ADXY Index / Asian Currency Index	This Bloomberg JPMorgan Asia Dollar Index is a trade and liquidity weighted index of 10 EM Asian currencies' exchange rate versus the US dollar.
Bloomberg Barclays Multiverse Total Return Index	The Multiverse Index provides a broad-based measure of the global fixed-income bond market. The index represents the union of the Global Aggregate Index and the Global High-Yield Index and captures investment grade and high yield securities in all eligible currencies.
Bloomberg Barclays Asian-Pacific ex-Japan local currency bond index	The Bloomberg Barclays Asian-Pacific Non-Japan Total Return Index Value Unhedged USD is a market capitalisation weighted index and measures the performance of local currency denominated government-related and corporate bonds of the Asia ex-Japan region.
iBoxx Asian US dollar Bond Index	Markit is a global index provider which is involved in designing, administering and calculating this index that covers USD segments of Asian fixed income markets.
CRB Industrial Commodities Price Index	A Thomson Reuters/Core Commodity Excess Return Index which uses an arithmetic average of commodity futures prices with monthly rebalancing.
CRB Industrial Metals Index	This data represents Commodity Research Bureau BLS Spot Indices (1967=100). The metals sub-index includes aluminum, copper, gold, iron ore, nickel, silver and steel rebar.
MSCI Asia ex-Japan Index	The MSCI Asia ex-Japan Index captures large- and mid-cap representation across 2 of 3 Developed Market countries (excluding Japan) and 9 Emerging Market countries in Asia. With 955 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. DM countries in the index include: Hong Kong and Singapore. EM countries include: China, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Taiwan and Thailand.

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Investment Grade			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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MBS are also sensitive to interest rate changes which can negatively impact the market value of the security. During times of heightened volatility, MBS can experience greater levels of illiquidity and larger price movements. Price volatility may also occur from other factors including, but not limited to, prepayments, future prepayment expectations, credit concerns, underlying collateral performance and technical changes in the market.

Alternative investments referenced in this report are speculative and entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in the fund, potential lack of diversification, absence of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds and advisor risk.

Asset allocation does not assure a profit or protect against a loss in declining financial markets.

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