On the Minds of Investors

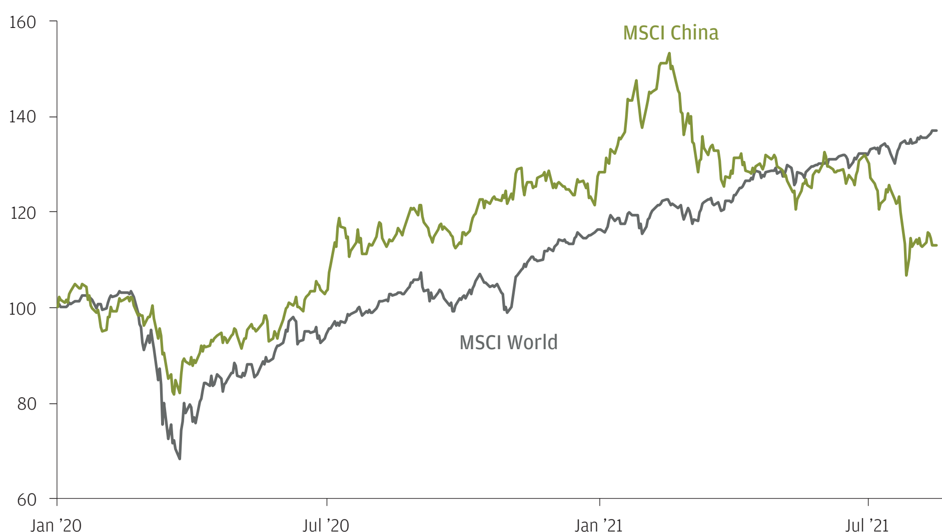
August 2021

Investment implications of recent Chinese policy interventions

Having outperformed other regional stock markets for much of the pandemic, Chinese stocks have fallen sharply over the past few months (**EXHIBIT 1**). Concerns around the Chinese economy slowing were blamed for the initial move, but more recent declines have been triggered by regulatory tightening focused in specific sectors. This piece sets out why we remain positive on the medium-term outlook for Chinese assets, although we recognise that it may take some time for the scope of regulatory tightening to become clearer before sentiment towards the stock market improves.

EXHIBIT 1: CHINESE AND DEVELOPED MARKET EQUITY RETURNS

Index level, rebased to 100 in January 2020



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results. Data as of 16 August 2021.

AUTHORS

Hugh Gimber
Global Market Strategist

Tai Hui
Chief Market Strategist, Asia Pacific

HOW SHOULD INVESTORS INTERPRET THE LATEST REGULATORY CHANGES?

Recent moves from policymakers are best understood in the context of Beijing's efforts to balance short-term growth against longer-run policy objectives.

In the technology sector, Chinese regulators are taking steps to address inappropriate use of market power, limit regulatory arbitrage opportunities and increase market competition. Cybersecurity is another emerging focus, with companies' treatment of user data receiving particular attention. There are clear parallels to regulatory actions witnessed in developed markets in recent years. Companies that have chosen to pursue overseas listings – often Chinese technology names trading on US exchanges – are also coming under additional scrutiny and may be particularly vulnerable to future rulings. While broadly we are seeing technology regulators take a more active stance, we do not believe it is in China's strategic interests to punish its domestic champions, particularly in the context of the longstanding US-China rivalry. Instead we think regulators want to ensure that technology giants are competing with the next cohort of innovators in a fair and well-functioning market.

The education sector has also seen significant regulatory changes. The Chinese government will no longer approve the setup of new private tutoring companies, and existing companies which tutor the school curriculum will be required to transform into non-profit institutions. While private sector tuition remains discretionary in most western countries, after-school tutoring has become so pervasive in China that authorities now view it as a key social policy challenge. The latest measures are designed to alleviate both the mental burden of extra tuition on students and the financial burden for parents, with a view to stemming the decline in China's birth rate over time. In this context, we do not expect that the severe actions taken in the education sector will become widespread across the private sector.

The tone of recent policy interventions has highlighted that Beijing is keen to ensure that corporate behaviour remains aligned with the administration's long-term policy goals. That said, we do not believe this represents a fundamental shift in another key long-term objective: to open up Chinese markets to foreign capital. Substantial efforts to integrate both Chinese equities and bonds into international indices are ongoing. In our view, policymakers will be acutely aware that they do not want regulatory actions to undermine the attractiveness of Chinese assets to the global investment community.

WHAT DO WE EXPECT NEXT?

The Politburo meeting at the start of August provided greater insight into the economic and regulatory policy direction for the rest of the year.

Further reforms are still on the cards for some of the 'new economy' sectors where the Chinese authorities wish to achieve better social outcomes or improve the competitive environment. Regulatory uncertainty will remain elevated until the scope of reforms becomes clearer, particularly for politically or socially sensitive industries. It is important to recognise, however, that many of China's new economy leaders will still have room to chart future growth; they have been working closely with the government for many years and will continue to do so.

There will also be sectors that benefit from future policy changes. Examples include climate-focused technology to support greenhouse gas reductions, industries related to accelerating the rollout of electric vehicles, and sectors critical to achieving self-sufficiency within key parts of the technology supply chain.

From an economic perspective, the Chinese government recognises the imbalances in the economic recovery, with small- and medium-sized enterprises and low-income households having lagged to date. As a result, targeted fiscal stimulus is likely to be preferred to monetary policy in supporting growth for the rest of the year. Monetary policy has shifted to a more neutral stance following modest tightening in the first half of the year, although further easing is possible if growth momentum continues to fade. Broadly, Beijing appears to be fine-tuning growth back on to a more stable path, having gone through the "boom phase" of its recovery last year.

The impact of the spread of the Delta variant remains something of a wildcard. The Chinese government was highly effective at stemming the spread of previous variants, but cases have been on the rise again. Vaccine rollout is proceeding at pace, although real-world studies of the efficacy of different vaccines remain limited. This will be an issue to watch closely over the coming months. We don't expect a repeat of the sharp slowdown witnessed in the Chinese economy last year, but given China's desire to pursue a "zero-Covid" strategy, there is a risk that restrictions will be applied periodically. This could well have knock-on impacts in the global supply chain; recent shutdowns linked to Covid-19 in Ningbo-Zhoushan – the world's third busiest port – are a prime example.

WHAT ARE THE INVESTMENT IMPLICATIONS?

The sharp declines over the past few months have served as a reminder that Chinese equities do come with a higher level of volatility than many other markets. Over the past 25 years, the annualised return from the Chinese stock market is over 5% in local currency terms, despite average intra-year declines of close to 30%. Calling the bottom of any market correction is an impossible task, although valuations have now fallen substantially, from over 18x 12-month forward earnings at the peak earlier in the year to below 14x today for MSCI China. While valuations may remain under pressure until the markings of the regulatory playing field become clearer, ultimately, we expect investor attention to gradually return to company-specific fundamentals.

In our view, Chinese assets remain an essential part of both global equity and global bond allocations. Beijing has made a huge push to open its capital markets to international investors, and we expect this to remain a priority. Short-term volatility has not fundamentally changed the long-term investment opportunity in China, which is based on technological innovation and the rise of the domestic consumer. The key for investors is to access the Chinese markets in the right way: via a diversified portfolio of both onshore and offshore companies and with an active approach that can differentiate between the winners and losers of the government's long-term policy goals.

The Market Insights program provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the program explores the implications of current economic data and changing market conditions.

For the purposes of MiFID II, the JPM Market Insights and Portfolio Insights programs are marketing communications and are not in scope for any MiFID II / MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programs, as non-independent research, have not been prepared in accordance with legal requirements designed to promote the independence of investment research, nor are they subject to any prohibition on dealing ahead of the dissemination of investment research. This document is a general communication being provided for informational purposes only. It is educational in nature and not designed to be taken as advice or a recommendation for any specific investment product, strategy, plan feature or other purpose in any jurisdiction, nor is it a commitment from J.P. Morgan Asset Management or any of its subsidiaries to participate in any of the transactions mentioned herein. Any examples used are generic, hypothetical and for illustration purposes only. This material does not contain sufficient information to support an investment decision and it should not be relied upon by you in evaluating the merits of investing in any securities or products. In addition, users should make an independent assessment of the legal, regulatory, tax, credit, and accounting implications and determine, together with their own financial professional, if any investment mentioned herein is believed to be appropriate to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without prior notice. All information presented herein is considered to be accurate at the time of production, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted. It should be noted that investment involves risks, the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yields are not a reliable indicator of current and future results. J.P. Morgan Asset Management is the brand for the asset management business of JPMorgan Chase & Co. and its affiliates worldwide. To the extent permitted by applicable law, we may record telephone calls and monitor electronic communications to comply with our legal and regulatory obligations and internal policies. Personal data will be collected, stored and processed by J.P. Morgan Asset Management in accordance with our privacy policies at **https://am.jpmorgan.com/global/privacy**. This communication is issued by the following entities: In the United States, by J.P. Morgan Investment Management Inc. or J.P. Morgan Alternative Asset Management, Inc., both regulated by the Securities and Exchange Commission; in Latin America, for intended recipients' use only, by local J.P. Morgan entities, as the case may be.; in Canada, for institutional clients' use only, by JPMorgan Asset Management (Canada) Inc., which is a registered Portfolio Manager and Exempt Market Dealer in all Canadian provinces and territories except the Yukon and is also registered as an Investment Fund Manager in British Columbia, Ontario, Quebec and Newfoundland and Labrador. In the United Kingdom, by JPMorgan Asset Management (UK) Limited, which is authorized and regulated by the Financial Conduct Authority; in other European jurisdictions, by JPMorgan Asset Management (Europe) S.à r.l. In Asia Pacific ("APAC"), by the following issuing entities and in the respective jurisdictions in which they are primarily regulated: JPMorgan Asset Management (Asia Pacific) Limited, or JPMorgan Funds (Asia) Limited, or JPMorgan Asset Management Real Assets (Asia) Limited, each of which is regulated by the Securities and Futures Commission of Hong Kong; JPMorgan Asset Management (Singapore) Limited (Co. Reg. No. 197601586K), this advertisement or publication has not been reviewed by the Monetary Authority of Singapore; JPMorgan Asset Management (Taiwan) Limited; JPMorgan Asset Management (Japan) Limited, which is a member of the Investment Trusts Association, Japan, the Japan Investment Advisers Association, Type II Financial Instruments Firms Association and the Japan Securities Dealers Association and is regulated by the Financial Services Agency (registration number "Kanto Local Finance Bureau (Financial Instruments Firm) No. 330"); in Australia, to wholesale clients only as defined in section 761A and 761G of the Corporations Act 2001 (Commonwealth), by JPMorgan Asset Management (Australia) Limited (ABN 55143832080) (AFSL 376919). For all other markets in APAC, to intended recipients only. For U.S. only: If you are a person with a disability and need additional support in viewing the material, please call us at 1-800-343-1113 for assistance.

Copyright 2021 JPMorgan Chase & Co. All rights reserved.

LV–JPM53320 | 08/21 | 0929211708095635

J.P.Morgan
Asset Management