POLICY ISSUES: CHINA'S REGULATORY PURGE, BREXIT and ESG INVESTMENT FACTORS

[7] China portfolio inflows continue despite 2021 regulatory purge and slowing growth

Chinese growth stalled last fall as new standards for real estate and other sectors curtailed growth, and as rising energy prices[15] and power rationing shifted its industrial production rebound into reverse. **Signals for 2022 are mixed, but we believe the positives will outweigh the negatives as it relates to onshore Chinese stocks**. We're still cautious for obvious reasons on offshore Chinese internet stocks.

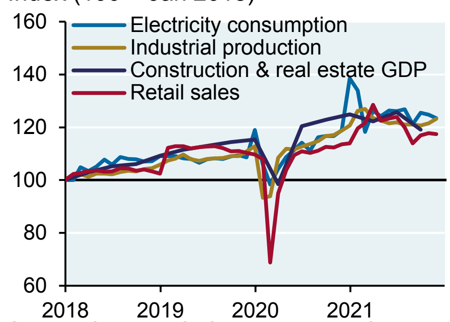
Positives: stimulus has been modest so far, just a 50 bps cut in bank reserve requirements but was accompanied by pro-growth statements and allowance for greater credit allocation to local gov'ts, small/medium enterprises, mortgages and developers. While Chinese corporate profits growth has weakened due to losses at hog farms, independent power producers and companies impacted by new regulation, JP Morgan Equity Research expects 19% earnings growth in 2022 along with 4.7% real GDP growth and just 2% inflation.

Negatives: in November, antitrust regulators were given tougher enforcement powers and broader reach. Internet regulation has been deemed essential for long-term governance which may result in lower revenue growth, higher compliance costs and more volatility from regulatory events. This follows growing regulatory costs and operating restrictions on overseas listings and tracking of consumer data. China hasn't provided much help to defaulting property developers, and some of their projects may end up transferred to state owned firms. Finally, zero COVID policies continue to constrain growth, and anti-pollution policies may constrain industrial production as China prepares for the 2022 Winter Olympics.

China economy: positive signs
Index (100 = Jan 2018)

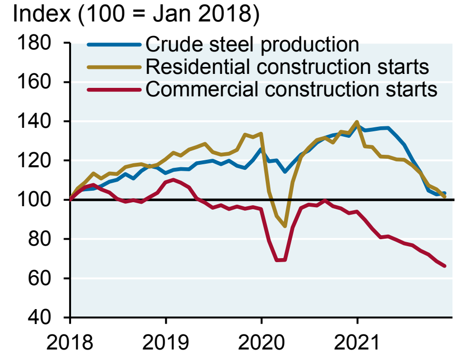
Source: General Administration of Customs, MSCI, JPMAM. November 2021.

China economy: stable signs
Index (100 = Jan 2018)



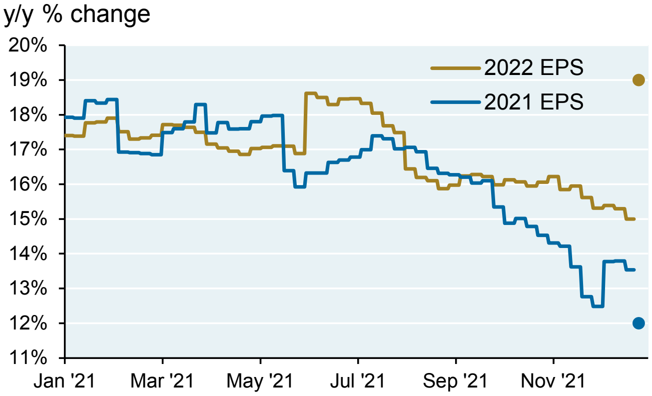
Source: China NBS, China Electricity Council, JPMAM. November 2021.

China economy: negative signs
Index (100 = Jan 2018)



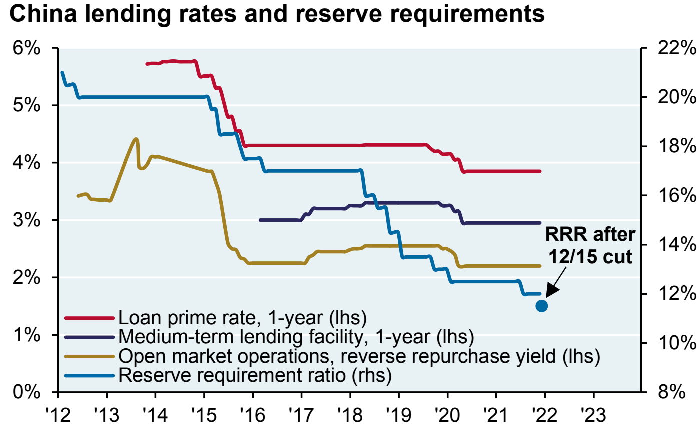
Source: China NBS, JPMAM. November 2021.

MSCI China consensus earnings expectations by year
y/y % change



Source: Datastream, JPMAM. December 28, 2021. Dots = JPM forecasts.

China lending rates and reserve requirements



Source: People's Bank of China. November 2021.

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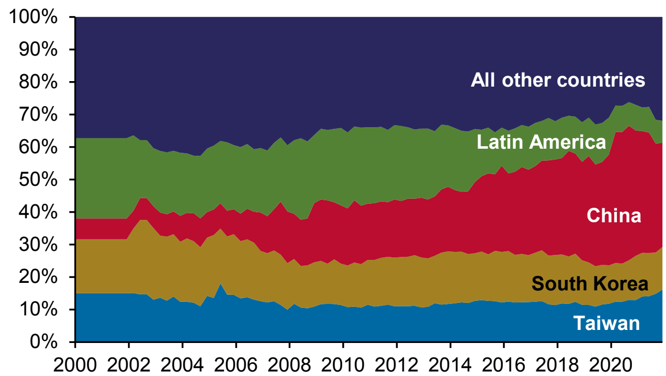
[15] **China's power problems** are the byproduct of a surge in its power demand as the global economy rebounded; lower China hydropower output which increased demand for coal powered generation; a slowdown in China coal production due to climate goals, safety concerns and a coal price cap, leading to power plants running down coal inventories below normal levels; and price controls in China's power sector which prevent utilities from recovering rising input costs (China has since relaxed coal production restrictions and implemented price controls on coal itself).

On China and portfolio inflows. Emerging Market equity index products used to provide more geographically diverse exposures. For reasons both good[16] and bad, this has changed: China, South Korea and Taiwan alone now comprise two thirds of the entire MSCI EM equity index. Most money managers tend to stick pretty close to these index levels; a pre-COVID look at the largest EM money managers showed median country weights that were only 1%-3% away from benchmark for these three countries. Also interesting: manager overweights tended to be out-of-benchmark positions rather than overweights elsewhere in the EM universe.

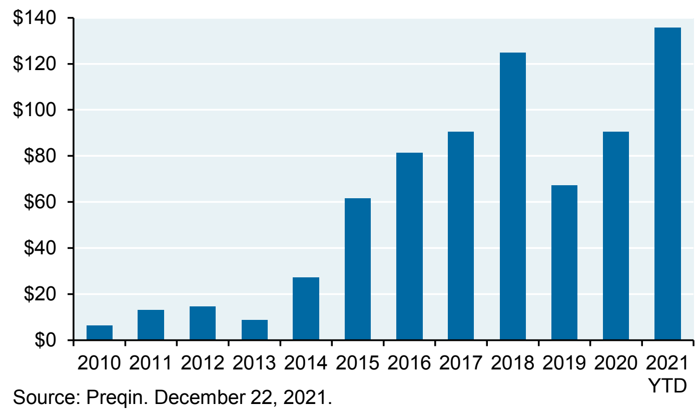
China's weight in the MSCI EM index could rise from 35% to 45% as more of its onshore market cap is included. **For this reason and given the ongoing rise of an enormous middle class in China, we will still believe the long run opportunity in China is compelling, despite the 2021 regulatory purge**. When looking at venture capital inflows in 2021 (YTD through late December), private investors apparently believe that the Chinese government will not permanently cripple long term growth prospects of many large and successful private enterprises. As shown below, private equity and venture investments in Emerging Asia (much of which is China) have substantially outperformed public equity markets. Private investors tend to focus on healthcare, staples, insurance and other sectors that are under-represented in China's public equity markets.

Emerging markets country weights
%, weight in MSCI Emerging Markets Index



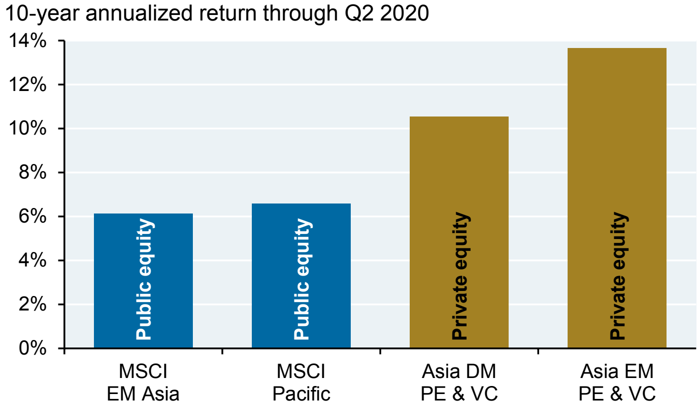
Source: Bloomberg. December 28, 2021.

China VC investments by US dollar denominated funds
US$, billions



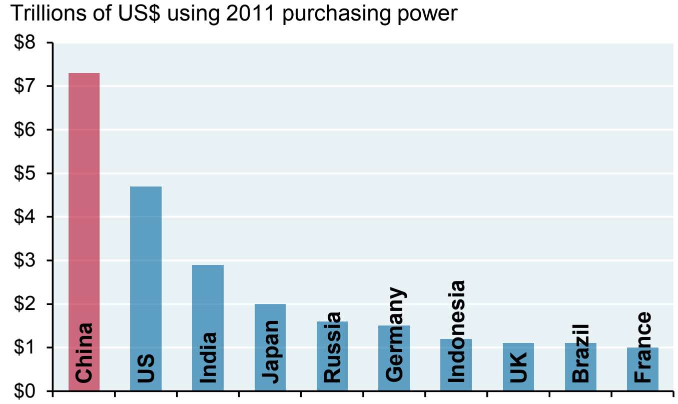
Source: Preqin. December 22, 2021.

Private equity performance versus public equity in Asia
10-year annualized return through Q2 2020



Source: Cambridge Associates LLC, Bloomberg, JPMAM. Q2 2020.

Middle class consumption in 2020
Trillions of US$ using 2011 purchasing power



Source: Brookings Institution. October 2020.

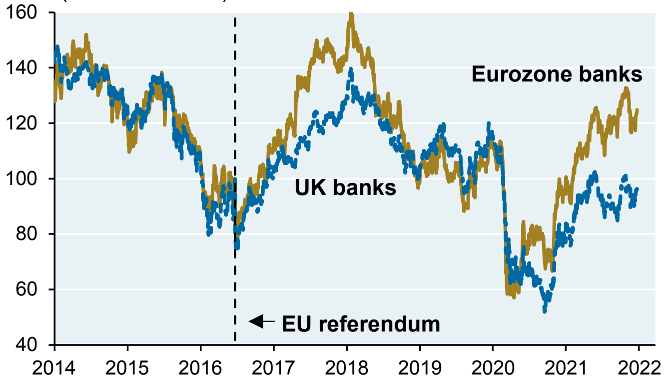
Sources include "*Regulatory risks remain*", Thomas Gatley, Gavekal Research, December 2, 2021 and "*China Equity Earnings Tracker*", JP Morgan Equity Research, December 3, 2021

[16] From the year 2000 to 2020, MSCI EM Asia and MSCI EM Latin America generated cumulative returns of 377% and 300%, respectively; that's outperformance by EM Asia of 1% per year on an annualized basis. Over the last ten years, the differences are even starker: -28% for MSCI EM Latin America and 95% for MSCI EM Asia. Both of these numbers pale in comparison to the S&P 500's ten year performance of 267%.

[8] Brexit and the high price of national sovereignty

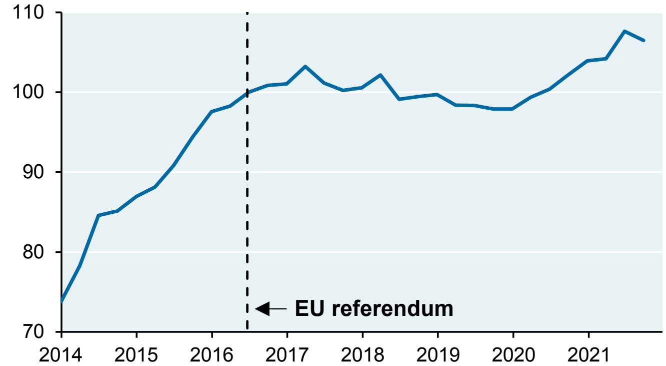
Some of the most pessimistic Brexit assessments ever written were published by British economists. I always wondered how being British might have affected their outlook; many are employees of financial institutions and owners of London real estate, so they had two oxes that were about to be gored. As shown in the first chart, UK banks have lagged European peers since Brexit. The ECB is still pushing EU banks to relocate staff and facilities back to the continent, so the process is not complete. London home prices did decline after Brexit, but have since risen in tandem with home prices globally.

UK banks vs Eurozone banks
Index (100 = Jun 2016)



Source: Bloomberg. December 29, 2021.

London home prices
Index (100 = Q2 2016)

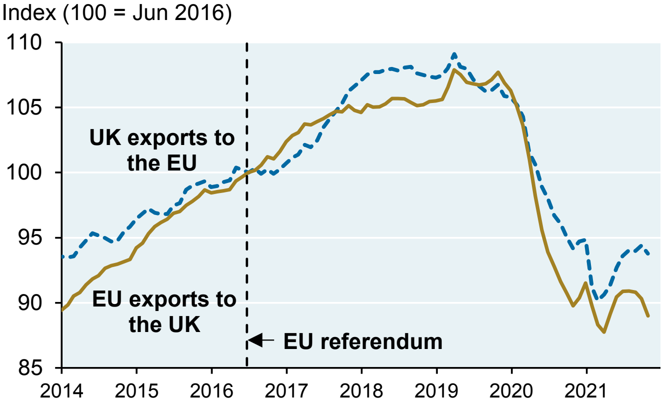


Source: UK Nationwide Building Society, JPMAM. Q3 2021.

Let's step back and consider the consensus view that Brexit was going to end badly for the UK overall. The hard part is that we are not very far into the Brexit era. While the referendum took place in 2016, the UK did not legally leave the EU until Jan 2020 and did not formally leave the single market until the end of the transition period in Dec 2020. Also, the impacts on and responses by UK consumers and businesses will be spread over time. Lastly, the COVID pandemic impacts a lot of the data, making it harder to interpret. Despite these challenges, we are going to try and make an early assessment anyway.

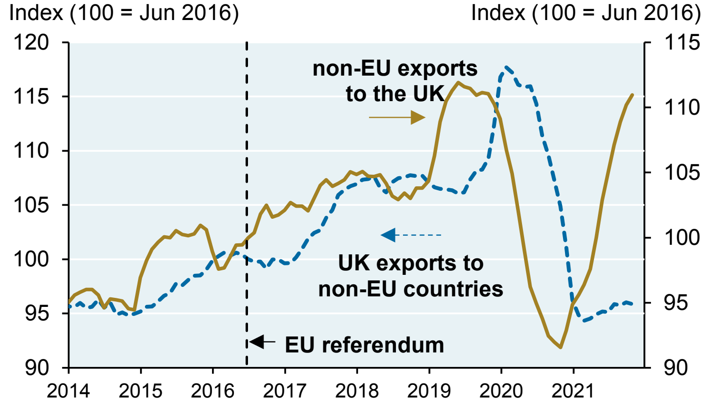
Trade with the EU rose in the aftermath of Brexit since new trading provisions took time to be implemented. It wasn't until early 2019 that UK trade with the EU began to decline; and as soon as COVID hit, it collapsed even faster due to domestic demand declines in both the UK and Europe. Trade with the rest of the world collapsed as well and so far, the only thing that picked up in 2021 was UK importation of non-EU goods (UK exports to the rest of the world did not offset EU trade declines as Brexit proponents hoped). Even so, the 15% decline in the Pound since the eve of the referendum has helped stabilize the overall UK balance of trade. The UK current account deficit of 3.3% (Q3 2021) is around the average of the last 20 years, following a period of much larger deficits (see p. 38). Bottom line on trade: not great but too influenced by COVID to know for sure.

UK trade volumes with the European Union
Index (100 = Jun 2016)



Source: UK ONS, JPMAM. October 2021. 12 month moving average.

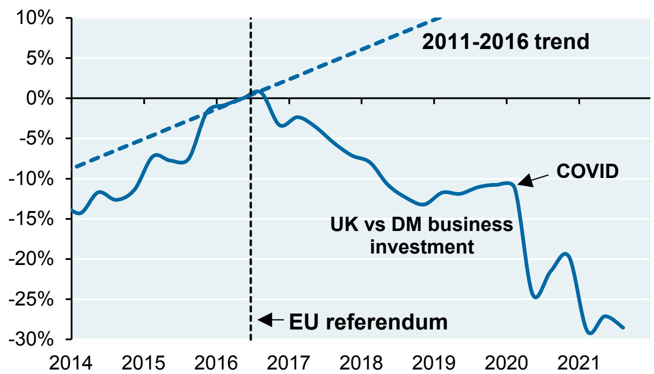
UK trade volumes with non-EU countries
Index (100 = Jun 2016)
Index (100 = Jun 2016)



Source: UK ONS, JPMAM. October 2021. 12 month moving average.

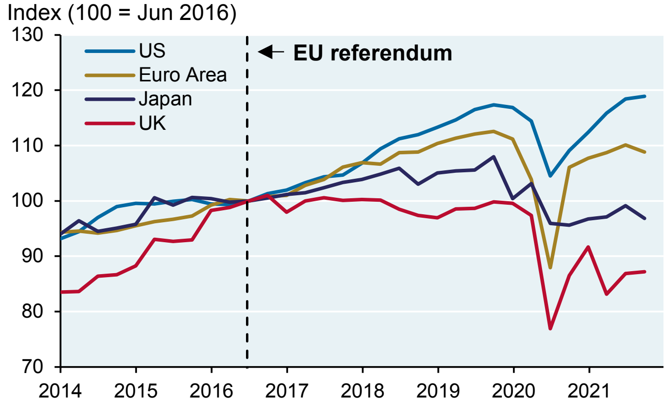
On business investment, the results are in: Brexit is pretty bad for the UK. The first chart shows how UK capital spending was rising vs the rest of the developed world from 2011 to 2016. Post-referendum, UK capital spending trends declined sharply vs the developed world even before COVID, after which it got even worse. The second chart shows the data by country; there is clearly a Brexit impact here, and it's a negative one. If you believe that business capital spending is one of the most important indicators of economic health, productivity gains, labor demand and growth, the current gap (if sustained) would be a very clear negative consequence from Brexit.

UK business investment relative to developed markets
%, indexed to 2Q 2016



Source: JPM Economic Research. Q3 2021.

Real business investment
Index (100 = Jun 2016)

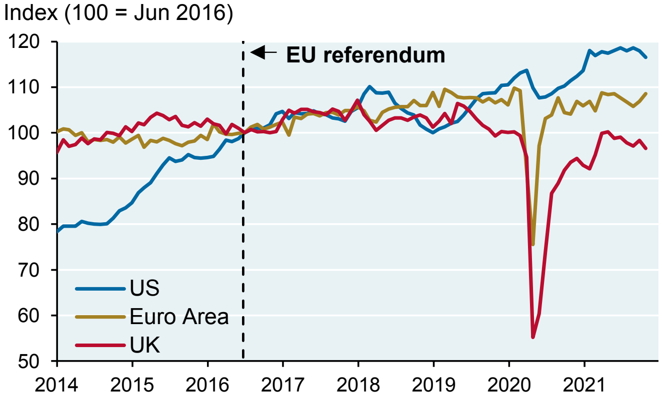


Source: BEA, Cabinet of Japan, regional statistical offices, JPMAM. Q3 2021.

The data on construction is similar; after Brexit there's a widening output gap vs the Euro area and the US, one that gets even worse after COVID. **Brexit is not just an issue for industry; it also ushered in a period of lagging UK real disposable income, particularly when compared to the US as illustrated below, right**. One example: the 2016 depreciation of the Pound is estimated by the London School of Economics to have increased consumer prices by 2.9% or the equivalent of a £870 increase in the cost of living per year for the average household.

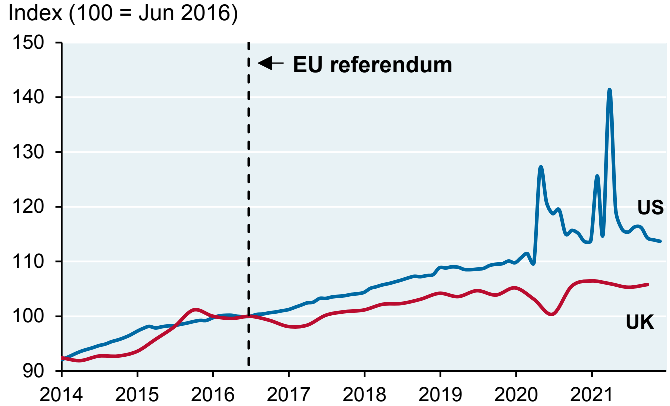
These are multidimensional cross country relationships, and there are a lot of other factors influencing them other than Brexit. But…the timing of widening gaps appears inextricably linked with the Brexit referendum. It's also possible that structural deficiencies which Brexit creates for the UK have hampered its ability rebound from COVID as fast as other regions. That's not proven yet but will be something to watch.

Construction sector output
Index (100 = Jun 2016)



Source: Census, BLS, Eurostat, UK ONS, JPMAM. October 2021.

US vs UK real disposable household income
Index (100 = Jun 2016)



Source: BEA, UK Office for National Statistics, JPMAM. November 2021.

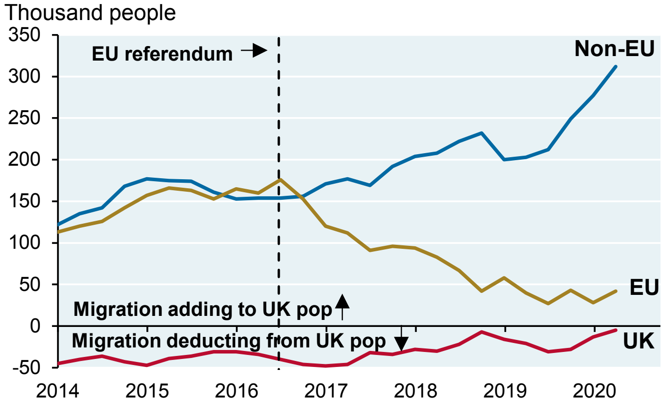
What might Brexit supporters point to as evidence that the journey is worth it?

After the Brexit vote, many analysts pointed to a deeply entrenched desire in part of the UK population to regain control over its borders, something it could not do as part of the EU. A desire to strengthen border control is kind of ironic: according to historian Stuart Laycock, Britain at some point in its history invaded 90% of the world's countries. Laycock uses a broad definition, of course: if Britain achieved a military presence in the territory through force, threat of force, negotiation or payment, he included it. Furthermore, incursions by British pirates, privateers or armed explorers were included if they operated with approval of the British gov't.

Anyway, what happened on immigration since Brexit? With increased border control now in place, the UK relaxed constraints on immigration. Migration from the EU to the UK did drop sharply after Brexit. However, in a departure from Theresa May's approach, Boris Johnson implemented policies to relax the cap on Tier 2 visas for non-EU relatively skilled or highly paid migrants, with mechanisms to raise the cap when needed for occupations with labor shortages. As a result, non-EU migration into the UK has been soaring. Bottom line: **the new policies created a more geographically diverse and selective system, designed to benefit the UK economy[17].** [Note: this is the kind of merit-based immigration system that exists in countries like Canada and Australia, and which Trump mentioned he was interested in but did nothing about.] UK opinion polls suggest voters have now become less concerned about immigration and are more positive about its economic impacts.

The strange thing about Brexit: the UK had obtained an advantageous position vis a vis Europe, having single market access, financial sector benefits and access to skilled labor without being stuck with the Euro albatross. Brexit now discards that advantageous position. One of my British economist friends describes Brexit as the "other great catastrophic policy mistake of the past 100 years", the first being the decision by Churchill to reinstate the gold standard at pre-war parity levels in 1925. He sees both as a consequence of nationalist pride and a misguided vision of the UK's place in the world. **We'll see; the ship has sailed and both the costs and benefits of Brexit to the UK are now clearer. While Brexit is not the disaster that many feared, at least not yet, the costs are piling up already and the post-Brexit era has just begun.**

UK net migration by citizenship
Thousand people



Source: UK Office for National Statistics. Q1 2020.

UK current account balance
Deficit as % of GDP

Source: Bloomberg. Q3 2021.

[17] "*Immigration and the UK economy after Brexit*", Jonathan Portes, Professor of Economics at Kings College and Senior Fellow at the Economic and Social Research Council, June 25, 2021

[9] ESG portfolio benefits look clearer but precede the 2021 recovery of traditional energy sectors

I prefer to wait for a large number of studies before making determinations about any factor affecting security selection in portfolios. On ESG, we now have a bit more evidence. A 2021 report from NYU aggregated 245 studies published from 2015-2020 to compare ESG portfolio performance with conventional ones[18]. The authors divided the studies into "corporate" studies which analyzed operational metrics (e.g. ROE, ROA, stock price) and "investor" studies which analyzed risk-adjusted performance metrics (e.g. alpha, Sharpe ratio).

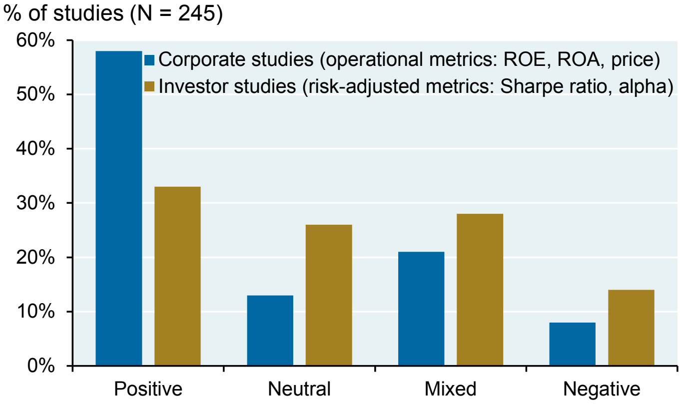
The results: 58% of the corporate studies found a positive relationship between ESG factors and financial performance and only 8% found a negative relationship. Among investor studies, 33% found ESG had a positive impact, whereas 14% found a negative impact as compared to conventional portfolios. The rest of the studies found a neutral impact or mixed results. Big picture: **an ESG focus appears to help more than hurt.**

The NYU study also aggregated 15 corporate and investor meta-analysis studies and found similar results. The 13 corporate meta-analysis studies (covering 1,272 unique studies) found a consistent positive correlation between ESG and corporate financial performance. The 2 investor meta-analysis studies (covering 107 unique studies) found that ESG investing returns were indistinguishable from conventional investing returns.

Caveat #1: oil & gas. While ESG outcomes reflect a lot more than the difference between renewable and traditional energy stocks, this gap did play a role in the outcomes of many studies cited above. As shown below this gap has now reversed, with traditional energy stocks outperforming a basket of renewable energy indexes by nearly the largest amount in a decade. Global plans to accelerate decarbonization may reinstate the prior trend, but that remains to be seen.

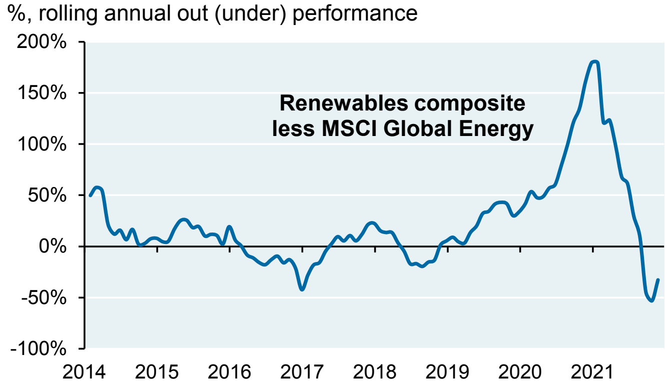
Other caveats: the last several years have created a perfect storm tailwind for ESG investing. In addition to the underperformance of oil & gas sector, there has been a surge of inflows into ESG strategies. These flows could explain *why* ESG stocks are outperforming, rather than reflecting intrinsically higher profitability or greater resilience to climate related risks; such parabolic inflows into ESG strategies may not last forever. Also: low real interest rates have boosted investor tolerance for unprofitable growth companies (see first chart on page 14), some of which are ESG-focused. In effect, the Trade War and COVID short-circuited the narratives for many cyclical and value stocks, shifting attention to growth at any price. If the world economy ever gets a chance to move beyond these two risks, valuations for long horizon growth stocks could fall sharply.

ESG impact on financial performance
% of studies (N = 245)



Source: *"ESG and Financial Performance"*, Whelan (NYU) et al. Feb 2021.

Excess return of renewables vs fossil fuels
%, rolling annual out (under) performance



Source: Bloomberg, JPMAM. November 2021. Renewables composite is the average of 5 energy indices: CELS, ECO, EORE, SPGTCED, SUNIDX.

[18] "*ESG and financial performance: uncovering the relationship by aggregating evidence from 1,000 plus studies published between 2015 - 2020*", Whelan (NYU Stern) et al, February 10, 2021.

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