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**NING MENG**
China A-Share Strategy Leader

# Should Investors Stay Onboard the Chinese Dragon Boat?

"To a man with a hammer, everything looks like a nail."

Those words may have been Mark Twain's, they may have been Abraham Maslow's—but at first glance they do appear to apply to the rather blunt social and industrial policies recently announced by the government of China. Some of these policies are constructive, but others are restrictive. Constructive measures support alternative energy, sports activity (at the expense of online gaming) and a higher birth rate. Restrictive policies include tighter regulation on private education, internet services (to favor smaller in-store retailers) online gaming, real estate, e-cigarettes, health care, and other industries.

Investors have naturally focused on the potential negative impacts and are concerned about how these regulatory uncertainties could evolve over time and across different industries. In this article, we examine the motives behind these policies, analyze what they might imply about future policy announcements, and attempt to re-evaluate the investment case for China. For now and in the future, do these policy developments present risks, opportunities or both?

Like many investors, we have been surprised by the breadth and timing of China's recent economic, industrial and social policy developments. At this time, we believe there are two forces behind the recent regulatory changes: (1) Evolving international relations; and (2) Pressure for domestic growth in the near and medium term.

## The Reasoning Behind the Rule Changes

The continued deterioration in U.S.-China relations in the past few years can be attributed to the differences between their respective political agenda. As China has reached a critical economic scale, worsening U.S.-China relations have forced a shift in policy focus from globalization to prioritizing domestic consumption, which it refers to as "internal circulation."

In our view, global cooperation and local specialization based on comparative advantage is ultimately the only way to achieve sustainable win-win economic outcomes. But given the current circumstances, China believes it has no choice but to pivot toward "internal circulation," which is predicated on a few factors:

1) Sufficient domestic demand and improved "common prosperity"

- The Chinese government has introduced a three-child policy to promote population growth and attempt to solve its aging demographic problem.
- As the broader economy develops, common prosperity will start to become more important to the authorities than efficiency, as common prosperity is required to stimulate consumption by the low- and middle-income classes.

2) Self-sufficiency of production materials

- This explains the regulator's focus on developing alternative energy and IT hardware sectors such as semiconductors.

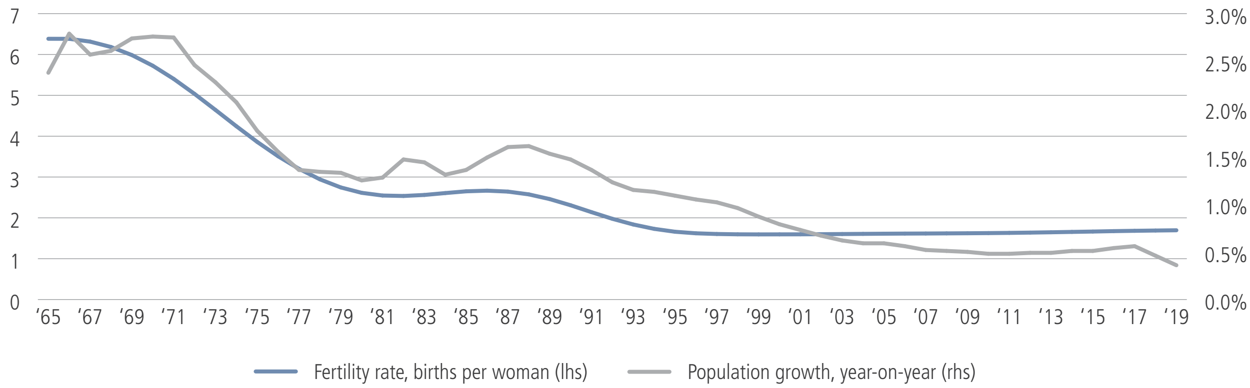
When we think about the new policies within this framework of supporting "internal circulation", and linked to demographics and import-substitution, we believe we gain a clearer perspective on the new restrictive policies and their potential impact on different industries.

So, for example, education and real estate policies are both about reducing the economic burden of the common citizen, with the ultimate objective of encouraging higher birth rates. Encouraging sports activity, regulating electronic games and controlling e-cigarettes are policies to promote healthier development for the nation's youth, again with the objective of encouraging childbirth. The objective of increasing the tax base of internet companies is to improve common prosperity and promote consumption. The centralized procurement of medicines and medical equipment is meant to reduce citizens' medical expenses and promote both good health and raise discretionary income.

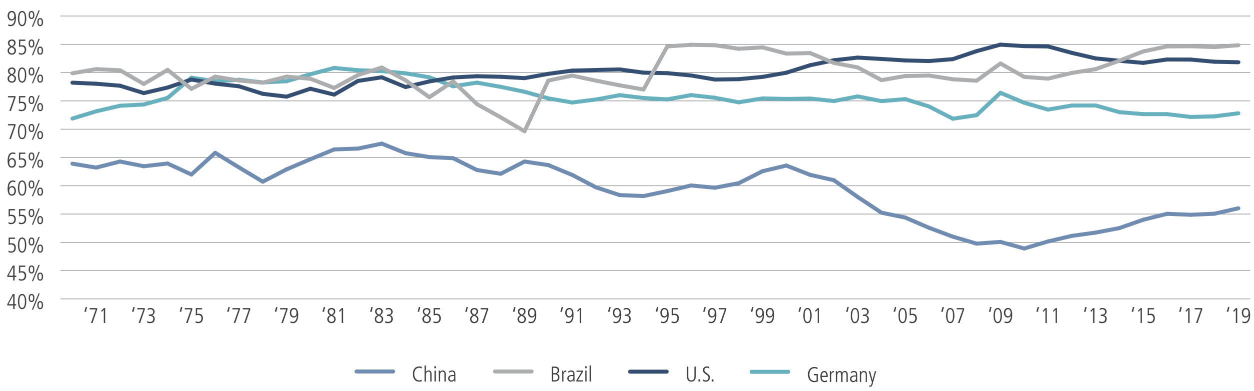
In short, the ultimate objective is to promote a higher birth rate and widespread domestic consumption.

**FIGURE 1. THREE AIMS: MORE CHILDREN, MORE CONSUMPTION, MORE ECONOMIC SELF-SUFFICIENCY**

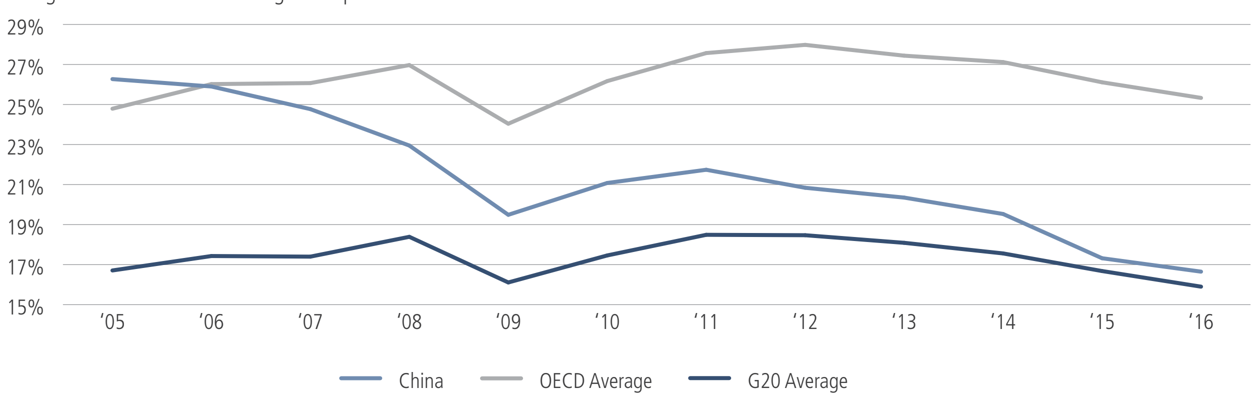
China's fertility and population growth rates




Consumption as a proportion of GDP




Foreign value-added content of gross exports




Source: World Bank, as of 2019 (top 2); OECD, as of 2016 (bottom); Neuberger Berman.

## The Regulatory Outlook

Non-market control mechanisms create uncertainties and can shake the foundation of a market-based economy. This is the main reason why many investors are concerned about the Chinese market's prospects. Foreign investors, in particular, need to assess whether they should stay invested in China if they perceive its economy is drifting away from widely accepted market-based principles.

In our view, these centralized policy mechanisms are characteristic of Chinese governance. When the Chinese government implements its centralized policymaking to control COVID-19, it is praised as efficient; but when it is used to mandate market regulations, market participants complain about uncertainties. We believe overseas investors first need to acknowledge that China is a policy-driven market—and then learn to deal with how policy evolves.

We believe the policies described above are well intentioned and necessary for long-term, broader societal development. However, we think it is debatable if these policies are optimal in the short term. Economic transformation, carbon neutrality and restarting population growth cannot be achieved overnight, and they could potentially be executed in a more market-friendly, less blunt manner, which treats mid- and long-term policy goals as short-term operational objectives.

Indeed, we don't think these policies, as currently formulated, are likely to last. China's policymaking, though centralized, has historically exhibited a self-correcting mechanism. For instance, during the economic slowdown in 2018, the Chinese government promptly shifted its policy focus from strict deleveraging to supporting small- and medium-sized enterprises and private business, which led to the subsequent economic recovery. We believe the government will adjust its policies if these measures encounter economic pressure, incorporating opposing views from a broad set of constituents. We do not think the government will rigidly pursue long-term goals at the expense of short-term economic growth and social stability.

## The Investment Implications

We believe the current market volatility arising from the regulatory uncertainties creates both potential opportunities and risks. Appropriately, the word for "crisis" in the Chinese language, *weiji,* is often said to be made by combining the symbols for opportunity and risk.

In terms of risks, there may be more market-unfriendly policy announcements in the near term, which could add to the concerns of wavering overseas investors. But, while regulatory uncertainties are likely to persist in the short term, we believe the new policies will gradually stabilize as China remains committed to developing its own version of a market-driven economy—and this is where potential opportunities lie. From a bottom-up perspective, high-quality companies affected by certain policies are falling to very attractive levels, in our opinion.

It is widely held that industries supported by government initiatives, such as alternative energy, photovoltaics, wind power, smart vehicles and semiconductors, tend to present investment opportunities. We believe they will develop into high-growth industries and that world-class Chinese companies will emerge from these sectors.

At the same time, we also see investment opportunities in industries that are currently hurt by recent policy announcements. At the industry level, we believe investors need to analyze which sub-sectors are likely to be structurally weakened by these policies over the long term, and which can survive the short-term challenges and take advantage of long-term development opportunities. At the individual company level, we also believe investors need to analyze which companies are capable of executing a transition through short-term policy headwinds, and whether the company valuation has fully priced for the negative factors but underestimated its future growth potential.

For example, the online gaming and video-sharing industries are currently facing more restrictive official guidance and negative public opinion, as well as concerns about a potential income tax rate hike. The secular 5G connectivity trend is set to enable industrial automation, smart vehicles and other developments, but before these developments can be fully realized, 5G demand will continue to be driven mainly by applications such as online games and video-sharing. We believe that the survival and continued development of the online-gaming and video-sharing industries is key to the next stage of 5G utilization by other industries. From this, we can draw links between seemingly independent industries. The ordinary citizen with a negative view of online gaming might miss these links, but the Chinese government is unlikely to, and we believe that supports the investment case for category-leading companies even in online gaming, as long as they can benefit from the long-term consumption growth and next stage opportunities.

Furthermore, we are convinced that high-quality Chinese companies can evolve themselves, adapting to changes in economic development and policy, navigating forced transformations and leading technological progress. After all, history has demonstrated that leading American internet companies have managed through similar environments and enjoyed a subsequent wave of growth.

## Conclusion: China Charts Its Own Way to a Market-Driven Economy

Our core belief is that Chinese society continues to make progress, and that China will determine its own version of a market-driven economy. We also believe that China and the U.S. are unlikely to decouple completely. We think that means global companies and investors cannot ignore the Chinese economy and capital markets. This is a premise for the stability of the global economy, interconnected markets, and even for regional security. Above all, we hold that rational and objective analysis of China's policy developments are essential to distinguish short-term from long-term impacts, and risks from opportunities.



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**Neuberger Berman**
1290 Avenue of the Americas
New York, NY 10104-0001



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