Turning a New Leaf in Chinese Investing

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Anu Rajakumar: As the second-largest economy in the world, China is a vital component to our global economy. As the home to the largest population globally, China's been sought out by investors for its high growth potential and unique diversification characteristics. However, considering the recent regulatory crackdown, geopolitical tensions, as well as ongoing issues related to the pandemic, many investors worldwide have started to pull away from their Chinese-based investments. But could investors perhaps be pulling out of this crucial market too early? And where do the opportunities lie, and what risks persist? My name is Anu Rajakumar, and joining me from Shanghai is Patrick Liu, General Manager of Neuberger Berman China, to discuss this evolving landscape in the Chinese markets today. Patrick, thank you very much for joining me.

Patrick Liu: Thanks, Anu. It's great to be here.

Anu: Now, Patrick, to get right to it: I'm sure it's been quite an extraordinary time, given that this topic has been all over international news. You know, investors are reevaluating their appetite for Chinese investments. So maybe, let's start today by having you give us an overview about what's been happening in China, and discuss some of the repercussions, along with your assessment of the situation.

Patrick: Thanks again, Anu. Obviously, the past few weeks [have] been stressful for the market. We've seen significant sell-off by both local and global capital; and, I think, last week alone, we've seen global capital sort of putting away $20 billion-plus from the Asian Market. The Hong Kong market has also seen quite a significant sell-off as well, by the global capital. So obviously, all this is done on the back of a number of quite heavyweight policy changes; and, to our view, I think the short-term concerns are rightfully justified. But if you were to take more of a long- or mid-term view of the situation, I think we still are sanguine and optimistic about opportunities in China, for the longer term.

I think, in a wave of all these regulatory and policy changes concerning certain specific industries, the first question we really ask ourselves is: is China rejecting capital, or is it moving back to the planning economy? Because the key thing is, so long China doesn't change its course to the market economy; so long the capital continues to be an important function of the economy; then we'll remain hopeful. So having spoken to a number of industry participants, as well as our internal colleagues, we come to a view that, no, we absolutely do not think the Chinese are going back to the planning economy. We don't think the government will want to be self-destructive. We believe the broad intention of the government is really to set up a certain standard and framework to really normalize the function of the capital to move the sustainability and fairness of the economic development in the years to come. In fact, we believe the intention is actually quite ESG friendly, if you're looking to what these policies are trying to do. From the latest media coverage and these changes, we believe China is indeed inaugurating a structural change within the broad economy. These changes are meant to steer the economy towards more sustainable growth and shared prosperity. They're not meant to really to reduce or eliminate the function of the market or capital, but really to resolve issues related to monopoly and fairness, or damage to public interests such as privacy infringement that have been accumulated over the past decades of economic developments.

And from the investment perspective, of what we really need to be aware is the structural changes that's taking place; and really try to identify areas where capital can still generate returns that are more sustainable. So that's our very high-level sort of overview or reaction to what's happened over the past few weeks.

Anu: Yeah. Thank you, Patrick, and I think that really helps to understand what has appeared to be sort of a tug-of-war between, you know, the Chinese government, capital markets functioning efficiently. As you've explained, there is some uncertainty right now; but as we all know, where there's uncertainty, there may also be opportunity. So maybe if we can pivot, would you please talk through what you believe investors should be thinking about when it comes to positioning in China at this time? And if you have comments about, you know, not just Chinese equities but other asset classes as well, I think that would be helpful to hear.

Patrick: Yeah. I think the reaction, or the overreaction, by the global capital to the latest policy changes, to be honest, is quite understandable. The Chinese system is very effective. What comes with it is the lack of processes that are well understood, or relied upon in other systems, such as solicitation of public opinions, legal proceedings, et cetera. It could lead to abrupt changes that may not have been properly communicated, or understood, which, in turn, will lead to misinterpretation, or overreaction. But very practically, we believe an active read of the policy changes will continue for a while. However, in the mid and long term, we believe it will be better understood that the policy intention is really to steer the capital to sectors that can make further economic development more sustainable while, at the same time, to really normalize the profitability of certain industries and to remove their negative impacts on the public welfare. And if you were to think about positioning, my personal view is there are certain sectors that clearly the policies are trying to steer the capital towards, such as very much in high-end manufacturing side. it's clearly structurally favored by the policy changes. it includes sectors such as new energy, semiconductors, telecom, even drones or satellites, and so on and so forth. In terms of other asset classes, I think fixed income is probably going to have a more positive return over the next few months. I think inflation is affecting China somewhat; but the economic developments and the latest data in July, actually led to some change in the monetary policy, which will see some relaxing in terms of liquidity in the industry.

And we do expect the fixed-income asset class to benefit from that. So, overall, we feel, in the short term, capital being cautious, and all that is justified; and I think, you know, as I mentioned earlier on, we wouldn't rule out the possibility for the policy changes, maybe underway, especially in view, of the next 12 months, when there'll be discussions about the succession in terms of the political system and so on and so forth.

So the next six to 12 months is probably going to continue to be volatile and chaotic; but I think if one is to really understand the policy intention behind these, and see through the short-term volatility and chaos, and position, really, for the long term for the sectors that the policy really want to steer the capital towards, I think that's a good way about positioning, in terms of investing in China.

Anu: Great. Thank you. You know, you mentioned sustainability, so would like to, to have you speak a little bit more on ESG trends, which have been of growing significance across the globe, including in China. where do you think the opportunities are in China as they relate to environmental, social, and governance issues?

Patrick: I probably want to talk about this from two angles. One is if you were to look at the intention of the policy changes recently, it's really ESG friendly in its own right. People might be really put off by the way the educational sector is reformed or restructured. But if you look at the intention behind it, this is really about seeking social equality for families of different backgrounds; and I think that's no different to what's going on in the U.S. or in Europe. If you think about you know, the clampdown on the monopoly position, or the anti-competition position that a couple of big internet companies got into, this is no different to what's happening in Europe or in the U.S. Because if any of these issues sort of gets more severe, then it actually affects the sustainability of the economic and the social growth, and the social development. So I really read these policies as being very ESG friendly, so that's the very first point I will make.

The second point I will make is investing with ESG as a theme has become a very hot topic in China. If you look at the mutual fund industry in China, you will see, a lot of mutual funds with ESG in the name have been launched recently. A lot of local investment houses, mutual funds included, have been signing up to the PRI membership. These are clear trends to say, "ESG investing is getting a lot of traction in the onshore market." And with that trend, industries, such as new energy, lithium battery, electric cars…these are the industries that are very favored by these ESG-themed new funds or portfolios; and does provide some insights as to how you want to position yourself, if you're considering an investment in China.

Anu: Yeah. Thanks, Patrick. Now, you've mentioned a few times your belief that the regulatory crackdown is, in large part, the government's effort to ensure a sustainable and equitable Chinese economy, which are, in your view, aligned with ESG factors. Now, income equality aside, critics of China, when it comes to ESG, have been very focused on environmental issues. Could you address those concerns about China, again, when it comes to the impact on environment and climate change?

Patrick: Sure. I think environmental issues seems to be a very important common ground, actually between U.S. and China. And as a result, President Xi, has already committed to a timing table, in terms of achieving carbon neutralization in China. And a lot of recent policy updates are related to that, and there've been developments in that area. For example, as I mentioned earlier on the electric car industry, the lithium battery industry, any form of new energy is set to grow. I think with these sorts of industries, I think Chinese are addressing the environmental issues quite actively; and also, too, a very pleasant, sort of recent discovery, China has just set up an exchange to actually trade the carbon-emission quota, although the volume and participants are still in very early days. But you can see the determination on the government side, because all the relevant companies and industries have been given their quota under that timetable, and that exchange is to facilitate the development of that. So we feel, and we believe actually in China, the environmental issues are being taken very seriously and the specific measures are being put in place to address exactly those issues.

Anu: Great. Thank you very much for that. You know, I want to shift back now to some of the risks associated with investing in China right now. What do you think are some of the key risks that investors might want to be aware of as they reevaluate their exposure to China?

Patrick: Yeah. As an emerging market, there'll be overreaction, actually on the downside, but as well as on the upside. So potentially you could see valuation going really high, pointing to the risk of overheating. So when you get into these sectors, and how you control your position and exposure at different time is something you definitely want to be very mindful of. Secondly, there are sectors that have taken quite a bit of correction recently on the share price; and people might find those being a good target in terms of a value play. In those instances, you need to be mindful of whether they are really value trap, because, as I mentioned earlier on, the changes are structural. For some stocks, you may not see again, a mean reversion kind of a trend; because the change can be structural, and you may have to be satisfied with the valuation at a lower level. All that being said, it is not to say there are no opportunities in these sectors. There still are, because China is a very big market; and so long as these companies in these sectors can adapt to the new policies and continue to grow their market share, and it's a big market, so the valuation may be trading down a little bit because of, you know, the fact that their profitability will take a dent because of the new policy. But so long as you keep driving your plan base, the volume of your business, there is still good opportunity for earnings growth, which will continue to drive up the valuation. Obviously that story changes from company to company, sector to sector, because the structural changes take different impact on different sectors, and that really requires detailed analysis; and that's what we do at Neuberger in Shanghai with the team on the ground, analyzing these sectors and these stocks.

And finally, as I mentioned earlier on, I wouldn't rule out the possibilities of further, you know, probably abrupt policy changes, again, on certain sectors over the next six to 12 months. Sectors such as, you know, healthcare and all the rest of it, might still have room for further reform; but I still firmly believe, whatever policies that might be implemented, it's really implemented with a really good intention that is ESG friendly. The government has really strived to establish a more fair, sustainable and equitable economy in China; and that's the firm believe we hold to, and that's how we – uh that's a base scenario we work to, in terms of building our own portfolio in China.

Anu: Great. Thank you very much for that, Patrick. As we start to wrap up here, would love to get your final thoughts, some takeaways for our listeners from our conversation to get – today; particularly those who are, perhaps, hesitant to invest in the Chinese economy.

Patrick: The first point I will make, and I hope the audience will take away, is the Chinese economy is the second largest globally; and it is very vibrant with a wide range of investment opportunities. And I do believe, in a world of emerging market equity, I think the scale and the potential of the Chinese equity market may not be very easily substituted. So, it is also a very good diversifier because it's much less correlated to other asset classes. So it is really, still, a very attractive asset class for you to have in a broader portfolio.

The second point is, really the recent policy changes, understandably, have caused a significant correction on share prices of companies in sectors such as internet, e-commerce, gaming, education, healthcare, and et cetera. But we do believe there are structural changes to this industry that may have a long-lasting impact on their profitability.

Finally, I'd say, you know, we believe China would not change its course to market economy and capital, but continue to function, and be able to really generate attractive returns on the back of a more sustainable economy. As government intention is better understood and hopefully coupled with emerging evidence over the next six to 12 months, we believe capital will return. So I'm very hopeful. I'll leave the thoughts with our audience.

Anu: All right, perfect. Thank you very much. now, Patrick, we like to end our episodes with a little bonus question, so for today's episode, I wanted to ask you about the annual Mid-Autumn Festival, which is almost upon us.

Patrick: Ah!

Anu: Now, Patrick, I would love to know, Patrick, could you share with our listeners what your favorite tradition is of this well-loved Chinese celebration?

Patrick: The Mid-Autumn Festival is a time for the family to get together and, usually the moon will hang in the sky, and the family will gather and have a nice meal. And you always have the mooncake, which is very oily, and we try to have a small piece, just symbolically.

Anu: [laughs]

Patrick: But my favorite is always the hairy crab that goes with a rice wine, produced locally. It gets you into a very happy mood.

Anu: [laughs]

Patrick: And, you know, the whole family will cheer to the moon.

Anu: Oh, that's lovely.

Patrick: So that's, yeah, that's what we usually do in the Mid-Autumn Festival.

Anu: Perfect. Well, thank you so much for sharing, and we wish you, your family and our listeners who celebrate around the world, a very happy, Mid-Autumn Festival, which is coming up very soon. Patrick, thank you so much for your thoughts and insights here today. Hopefully that has helped our listeners develop their own view as they think about the Chinese economy and the investment opportunities. So again, thank you so much for joining me.

Patrick: Thanks, Anu. Thank you.

Anu: And to our listeners, if you've enjoyed this episode of "Disruptive Forces," I encourage you to subscribe to the show via Apple Podcast, Google Podcast, or Spotify; or you can visit our website, www.nb.com/disruptiveforces, where you can find previous episodes, as well as more information about our firm and offerings.

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