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The great re-alignment:
What does China's "common prosperity" mean for investors?

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Industry regulations imposed in China over the past year have hit investors hard. It's important to understand what's behind the changes — and the related market volatility. In this paper we'll explore the causes, the connection to "common prosperity," and what all this could mean for investors in the future.

New regulations take investors by surprise

In November 2020, China began introducing strict regulations impacting many industries, including technology, education, health care and real estate. When authorities pulled the much-anticipated IPO of Ant Financial in an effort to tighten controls on online lending and insurance, it blindsided many investors. Authorities then levied fines on Ant Financial's sister company, Alibaba, for anticompetitive behavior, as they began launching extensive probes into some of China's largest tech companies. The probes focused on the use of personal data and privacy protection; authorities believed tech players had blocked competition and forced exclusivity. Beijing further expanded regulatory action to include gaming, enacting age restrictions and announcing limits on the use of video games and the algorithms that target users.

More recently, regulations have targeted after-school tutoring (AST). The Chinese government will no longer approve the setup of new private AST companies, and existing companies that tutor school curriculum will be required to transform into nonprofit institutions. Further, they'll be restricted from raising capital on public markets or receiving foreign capital. The extreme nature of the new regulations caught many by surprise, as prior to the announcement many government representatives and industry experts with ties to the Ministry of Education had expressed strong support for AST providers.

It's important for investors to understand the context in which these changes are occurring. Certain regulations in China are being updated for the first time in 15 years. Given the progress that's taken place over the past decade, the current framework of regulations could be viewed as outdated and somewhat irrelevant. Investors should view the current shift not as a broad-based attack on private industry, but as an attempt by authorities to ensure business investment is aligned with its ambitious policy goals.

During the third quarter of 2021, the China Securities Regulatory Commission met with many global financial institutions to clarify the policies and latest regulatory trends.

Key takeaways from that meeting:

- China understands they're integrally tied into global markets and none of the policies are meant to decouple China from global markets.
- Foreign capital plays an important part in their current and future policy objectives.
- Increased communication and transparency, and potentially advanced warning of future policies, would help avoid major volatility in global markets.
- More policies conducive to foreign and private capital may be in the works.

What is "common prosperity" — and what is it not?

All these regulations are being introduced as Beijing tries to establish policies that promote the goal of common prosperity, which focuses on expanding the middle class, bolstering social safety nets and keeping the cost of living in check. The concept of a fairer society figures very strongly into the agenda of common prosperity, which we've seen translated into the areas in which authorities have taken regulatory action. President Xi has stated that hard work needs to be rewarded and that entrepreneurs are vital, but not at any cost. The government is trying to prevent large companies from taking advantage of their huge economic bargaining power and ensure that merchants, labor and consumers get their fair share of the value-added benefit these giants are creating.

Another policy priority, overlapping with common prosperity, relates to addressing long-term demographic trends that concern the authorities: an aging population and low birth rates. So some of the regulatory actions affecting after-school tutoring and gaming can be viewed as measures to protect the younger generation, amid efforts by the authorities to reduce the cost of having children and to encourage families to grow.

All this is happening as the authorities are trying to strategically transform the economy so that domestic consumption becomes the main driver of growth. This helps frame President Xi's comments from earlier this year, that while digitization is important, China must recognize the importance of the real economy and never deindustrialize — including by channeling credit to high-value-added manufacturing investments and small-to-medium enterprises and encouraging consumption of domestically manufactured goods.

There's also a fair amount of political positioning involved in this policy undertaking, as the Chinese Communist Party (CCP) will hold its 20th National Party Congress in 2022. Elections at the event will decide many important positions, and it's becoming evident that many officials are trying to prove their worth within different regulatory bodies. Keeping the population happy, with a focus on income inequality, is a savvy political tactic.

For investors, it's important to understand what common prosperity is not, namely, egalitarianism. The authorities recognize that the private sector contributes more than 50% of the total tax revenue, represents 60% of GDP and accounts for 80% of urban employment.[1] The government has publicly recognized that most innovation in the economy has come from the private sector.

As we look at these issues globally, we see they're not unique to China. Policymakers in the U.S. and Europe are struggling to curb monopolistic practices of the big tech companies and to grapple with the impact of inequality.

Investors: Proceed with caution

Investors have been focused on the headwinds, including the potential for additional policy announcements, a slowdown in economic growth, and heightened geopolitical concerns. But as the second largest economy in the world, with GDP per capita at only around $10,000,[2] financial markets in China continue to provide many opportunities.

We believe the very bearish scenario the market is painting with the current regulatory cycle is misplaced. We view government initiatives as a reset that will create new winners and losers that are yet to be determined. Investing success in this fluid environment will require focusing on fundamentals first, rather than trying to predict further action by the CCP. This approach lends itself to staying away from the overheated real estate market and would have been beneficial to those investors who unfortunately invested in property conglomerate Evergrande. Several sectors and industries have significant tailwinds in China, including health care, semiconductors and electric vehicles. Finding companies that are poised to benefit from these trends is likely to be a more profitable approach.

The path forward in China should focus on investing with policy and with quality.

Bottom line

China is and will remain an important part of the international economic and financial landscape, providing compelling investment opportunities. Rather than broad-based exposure, active management — with deep knowledge of local markets and understanding of company fundamentals — will be needed to navigate the risks and uncover the new winners of tomorrow.

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1 Source: Securities. Envisaged tax reform and probability. Common Prosperity Series Report No. 6. Sept. 5, 2021.

2 Source: World Bank (2021)

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