Implications of Beijing's Recent Regulatory Tightening: Black & White or Shades of Grey?

Summary

- The series of policy actions from Beijing triggered a collapse in investor confidence, particularly on China's growth stocks.
- Social responsibility and addressing inequality, catch-up in regulations in the "new economy" sectors as well as intensified geo-political tension are the key drivers of the regulatory changes.
- Macro impact in the short term should be minimal, while there could be longer-term implications on risk premium of Chinese stocks, corporate capital raising, market reforms and economic growth. At the same time, if reforms are successful, it could boost competition and innovation. It is a fine line.
- It is likely too early to bottom-fish the heavily de-rated growth stocks amid high regulatory uncertainty and lack of short-term catalysts. Medium-term value could be emerging.

Loss of market confidence

Following the regulatory tightening in the internet and fin-tech sectors, Beijing announced tightening measures on the country's for-profit tutoring sector. As the crackdown is far more drastic than widely expected, this triggered a collapse in investor confidence and a big slump in Chinese equity markets, particularly growth stocks.

The series of policy actions – first with the Ant Group IPO, followed by anti-trust fines for the big techs, then post-IPO investigation into Didi, and the most recent the private education companies – would just amplify investor concerns over who will be the next candidate(s), and when will this end.

Looking from Beijing's perspective

What are the key driving factors of the regulatory changes?

- **Social responsibility** - The latest move is to limit excessive rent-seeking behavior in the education sector, a key source of public discontent in recent years. The government has also been tightening the property market and reforming the healthcare sector – all to fulfill the same goal of addressing the social equality issues.

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- **Catch-up in regulations** – The "new economy' sectors have grown rapidly in recent years and has been accelerating during the Covid-19 pandemic. The authorities aim to address regulatory loopholes to ensure fair competition and sustainable growth.
- **Intensifying geo-political tension** – Beijing is trying to remove the grey areas that have been used to tolerate regulatory inconsistency in cross-border regulations against the backdrop of intensified US-China tension. What happened most recently on Didi is to address the national security issues with overseas listings on data security.

Impacts & Implications

In the short term:

(1) The economic impact of the clampdown on individual companies and sectors as well as the recent equity rout should be limited and would not derail the cyclical recovery in China. Exports remain near record levels. Vaccinations are accelerating and any increase in virus cases are to be watched as services growth has lagged among high savings rates.

(2) The impact of the shakeout in stock prices on the stability of the financial system should be minimal as margin debt is only 2.2% of total domestic market cap. After the recent RRR cut, the PBoC may ease liquidity sooner than expected if required amid concerns over short-term liquidity drain. Local government spending budgets are still under allocated and could be accelerated.

(3) The weakness seems to be ring-fenced in companies and sectors that are under strong Chinese government scrutiny. There is not much evidence of direct global equity and commodity markets contagion so far, a signal that the market does not see great macro consequences to the government crackdown. For example, economically sensitive base metal prices have risen during the current period of uncertainty as well as global equities.

In the long term:

(1) Inequality policy issues remain a headwind. There is potential for more swift decisions by Beijing to maintain social cohesion. Chinese companies with a monopolistic advantage or are seen as exacerbating socio-economic issues could be subjected to significant regulatory oversight. This is also a growing global trend in the technology sector, but moving faster in China.

(2) In the short term, the regulatory uncertainty raises the risk premium of Chinese companies. Private businesses looking to raise capital could find it more difficult amid growing investor concerns over an unsteady business operating environment, which in turn could have a negative impact on economic growth. At the same time, Hong Kong would benefit as a listing centre for capital. Attracting foreign investment and currency stability are also medium-term policy goals.

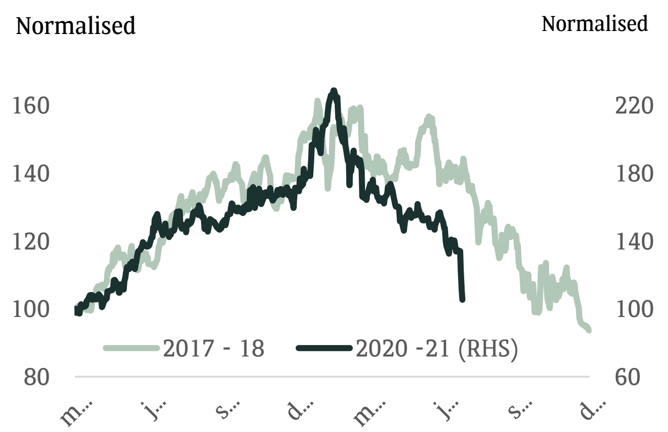
(3) It remains to be seen whether this is a systematic retreat from market-oriented reforms or just an effort to rectify bad market behaviours. Anti-monopoly measures and other regulatory changes, if enacted, could be beneficial in the long term and boost innovation. In addition, don't forget China's dual circulation strategy which emphasizes indigenous innovation. The private sector would still likely need to play a key role in this regard. Therefore, the proper lens could be shades of grey rather than a black and white outcome.

2017-18 Boom & Bust of China's internet sector….déjà vu?

China internet sector's boom and bust in 2017-18 was related to the government's measures to limit the impact of mobile and video games on the younger generation. The policy tightening was milder, but the sector still corrected by 42% from its peak. The internet sector stayed flat for about 2 months after the big decline and then regained traction. However, for other policy-driven meltdowns, such as Macau gaming due to the anti-corruption campaign in 2014 and the pharma sector on drug pricing reform in 2018, it took about 9 months for re-rating catalysts to emerge.

This time, the policy risks are more widespread and persistent. The overhang on China's growth sectors could sustain longer than our previous expectations. Furthermore, given the still high earnings forecasts, we should expect a period of earnings downgrade in the near term. In the medium term, value could be emerging in selected technology companies and related sectors.

China Internet Stocks' Boom & Bust Cycle In 2017-18...déjà Vu?



Source: Bloomberg, BNP Paribas (WM), 28 Jul 2021
Past performance is not indicative of current and future performance

When to bottom-fish?

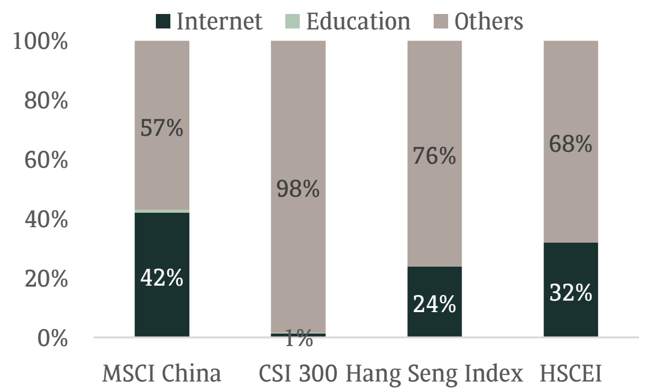
As regulatory uncertainty remains high and short-term catalysts are lacking, it seems premature to bottom-fish the heavily de-rated growth stocks at this moment despite more attractive valuations.

Markets need clarification in terms of details and scope of the administrative control measures. It may take a longer period of time for policy uncertainty to subside and market to re-gain confidence. That said, there will be some short-covering and opportunistic buying especially if there are further liquidity easing measures.

Domestic A-share markets with only tiny exposure (~1%) to the internet, fin-tech and education sectors would be fundamentally less affected. Nevertheless, as key technical levels of both domestic and offshore Chinese stock indices are broken, market sentiment onshore and offshore may continue to be weak in the near term.

In view of market volatility, we recommend a more defensive stance on Chinese equities, focusing on high dividend and value stocks. Severe weaknesses are buying opportunities for "green" megatrend themes, such as 5G, AI, electric vehicles, selective materials and consumption sectors. These sectors have performed well and are seen to benefit from current policy stance.

Chinese Equity Indices' Exposure To Internet, Fin-tech & Education Sectors



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