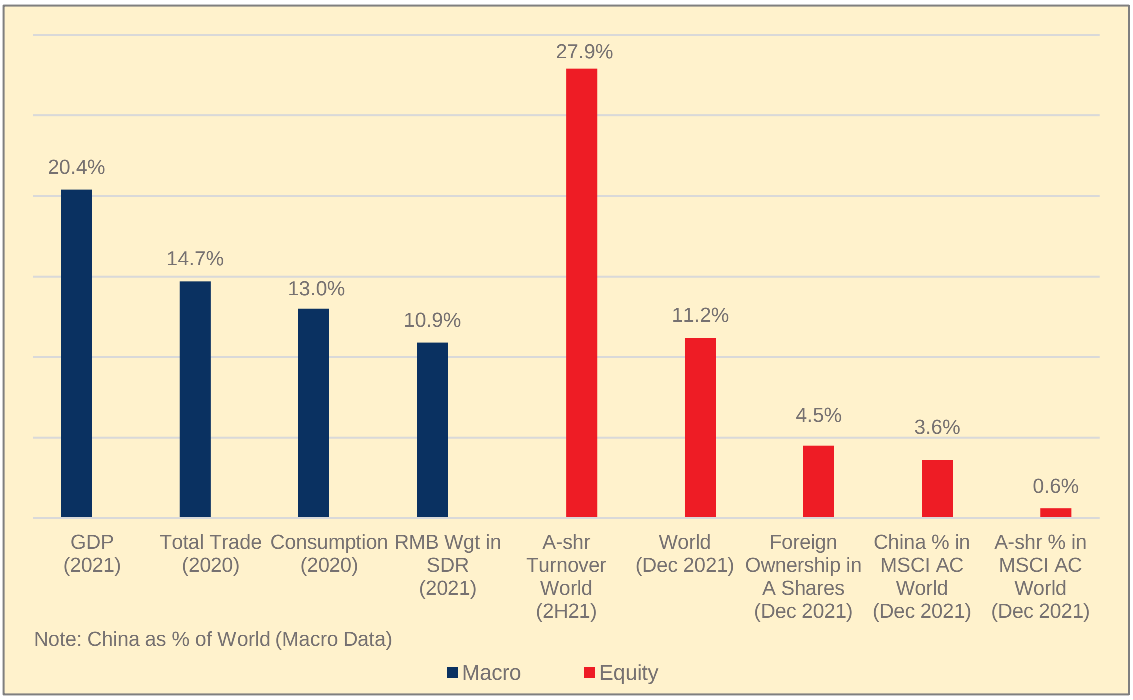
# CHINA MONTHLY

SEPTEMBER 2022



## The Big Picture




*Chinese equities look underrepresented in global indexes relative to China's economic influences.*

# THE BRIEFING

**Record Heat**

China’s battle against a record-breaking heatwave amid a drought in the Yangtze River Basin by deploying relief funds and seeding clouds has also led to power cuts and factory shutdowns. China's heatwave has run for over 60 days, making it the longest since full records began in 1961. China has repeatedly warned that it faces a proliferation of extreme weather as it adapts to climate change.

**Property Stabilization**

Local governments, banks, and asset management companies (AMCs) are becoming more active in guaranteeing the smooth completion of unfinished housing projects within their respective administrative regions. Beijing has directed a state-owned credit enhancement company to guarantee bond issuances by a select group of high-quality developers. This may help gradually boost financial markets’ lending appetite on the supply-side and alleviate new home buyers’ concerns on the demand side.

**Border Easing**

China is preparing for the return of foreign students shut out since Covid-19 border restrictions were imposed in 2020, with Chinese embassies announcing entry for overseas nationals with study visas for degree-level courses. Holders of APEC business travel cards are also now allowed entry, and visitors no longer need to report information regarding nucleic acid test results, their infection status and vaccination dates.

**Economic Support**

After the PBOC’s surprise mid-month 10 basis point rate cut, China’s cabinet in late August followed up with a surprise CNY300 billion of credit support by its policy banks, though the State Council statement noted that while “the foundation of economic recovery is not solid”, China will avoid “resorting to massive stimulus or compromising longer-term interests”.

**Preliminary Deal on ADRs**

The China Securities Regulatory Commission (CSRC) and the Public Company Accounting Oversight Board (PCAOB) signed a Statement of Protocol that opens access for PCAOB to inspect audit papers for Chinese companies listed on US exchanges. However, the inspections must take place in Hong Kong and redactions may be applied by the CSRC. Uncertainty remains as to whether the disclosures will meet the US regulators’ requirements.

# REINING IN WILD HORSES

By Tan Kong Yam

**Xi's Doctrine Creating a Tamer Landscape**

Some global investors ask: Is China investible?

I believe this is the wrong question. The appropriate question is: How best to invest in China under Xi's doctrine?

To answer this question, it is imperative to analyze the torturous process of President Xi Jinping's metamorphosis from vowing to give market forces a "decisive role" in 2013, to attacking the "disorderly expansion of capital" in 2020.

After five years in China's Politburo Standing Committee (PSC) as the leader in waiting, Xi came to power in 2012. He had been open to advancing market reforms that began in China under the late paramount leader Deng Xiaoping in the 1980s. In late 2013, Xi's leadership team vowed to give market forces a "decisive role". He supported market-minded regulators who encouraged stock investing and blessed relaxed government control over China's currency. At one point, his administration even considered a proposal to have the state-owned enterprises (SOEs) run by professional managers, rather than party apparatchiks.

Over time, one after another, some of these reform plans led to greater market turbulence. In addition, the groups of vested interests within the party and SOEs, as well as key princelings who support Xi, pushed back against these reforms.

The critical turning point came in the summer of 2015, when a major stock-market collapse greatly shocked Xi. The central bank's move to further free the Chinese Renminbi further undermined public confidence.

**The Trauma of the 2015 "Financial Coup"**

The origin of the 2015 stock market chaos could be traced back to Xi's struggle with the Jiang Zemin faction.

Xi had been dismissive of the corrupt officials of the Jiang faction. In an internal meeting, he intoned scornfully: "These people, they either died on the wine table or on the bed".

As the corruption investigation deepened, Xi was shocked and upset by the extent of the asset looting and the transfer of wealth to the US, Canada, and Australia.

As a princeling, Xi saw these actions as the greatest betrayal of the enormous sacrifices and arduous struggle for this new China by the pioneering generation of Mao Zedong and his father. They also reminded him of the asset stripping of the oligarchs when the former Soviet Union collapsed, leading to the demise of the party and Russia's sustained national decline.

The summer of 2015 saw both the meteoric rise and subsequent collapse of the Chinese stock market as well as the RMB. These events greatly tarnished Xi's regime and gravely shook the confidence of foreign investors in the Chinese capital markets.

By 12 June 2015, the Shanghai Composite Index had risen almost 150% over the past year to reach a high of 5,178 points. It then fell sharply and plummeted to 2,850 points by 26 August, a collapse of 45% over 10 weeks.

According to Forbes relating to the 2015 stock market crash, "Due to the heavy presence of the state in the Chinese stock market, some onlookers surmised that the stock market crash was engineered to create a financial coup d'état. This coup might have been caused by the Jiang Zemin faction to damage the reputation of President Xi Jinping. This group purportedly maliciously shorted the market." The Chinese-born Canadian billionaire financier Xiao Jianhua may have been a linchpin in that group.

Foreign financial analysts, not understanding the power game, did not see the shadow of this financial coup and interpreted this collapse as a bubble poorly managed by the regulatory authorities. This episode was possibly retaliation against Xi's anti-corruption campaign and was likely meant to undermine confidence in Xi's administration and deal him a fatal blow.

Xi counterattacked vigorously. From the "financial anti-corruption" to the "political and legal purge", he successively arrested a group of senior financial officials, speculators, as well as senior political and legal officials.

On 27 January 2017, Xiao was taken from a Hong Kong hotel and brought back to China. Since his detention in 2017, Xiao had been in Shanghai assisting authorities as they pored over a complex network of assets and interests across his financial and investment conglomerate.

The 2015 financial coup underpinned Wang Qishan's serious warning on 24 October 2020 at the Shanghai Financial Summit. Wang demanded that China "keep the bottom line of no systemic (financial) risks" and warned: "China's finance cannot take the form of speculative gambling. We cannot take the wrong path of speculative financial bubbles, and we cannot take the evil path of Ponzi schemes".

The next day during the same summit, Jack Ma, the billionaire behind the Ant Group, questioned China's financial regulations and suggested traditional banks should change their "pawnshop" operating model. The subsequent relentless crackdown on the Ant Group is well known.

On 19 August 2022, a Shanghai court sentenced Xiao to 13 years in jail – mitigated by his "commendable actions" in making restitutions – and his Tomorrow Holdings conglomerate was slapped with a record USD8 billion fine.

It is intriguing that Xiao's trial took place just before the Beidaihe meeting that began around the start of August 2022, when Xi and the other factions as well as the influential elders will carry out their final horse trading and firm up the composition of the politburo and its standing committee members for the next five years. Xiao's sentence was most likely meted out shortly after the meeting concluded. This process looks to have been timed to Xi's advantage.

**The Trump Shock**

Apart from the trauma of domestic factional challenges, former US President Donald Trump dealt the international blow that greatly heightened Xi's fears over national security and external destabilization.

When Trump's trade war started in January 2018, some of the liberal reformist factions in China felt that it could be good and helpful for China to put pressure on the powerful SOEs to spearhead reforms. The hardline nationalist faction argued that it was a naked attempt to bring down China.

When I was in Beijing delivering a speech to a group of government officials and businessmen in April 2018, I argued that the trade war would eventually be viewed as a side show and the real rivalry would be in the far more consequential tech war, and that it would get more intense. One senior government official came up to me at the end and wryly noted: "So you are not part of the surrender faction." Internally, the liberal reformists had been pejoratively identified as wishing to surrender to US pressure.

The eventual strangulation of Huawei and the arrest of Meng Wanzhou greatly strengthened the hardline nationalist faction under Xi. In internal meetings, they gloated: "I told you so".

Xi benefited greatly from playing the nationalist card against his rivals. As the CCP controls China's powerful propaganda machine, it can mobilize China's nationalist fervor against the United States.

Xi began to regularly mention "self-reliance" at the height of the Sino-US trade war. In September 2018, Xi "went north" and demanded "self-reliance" in the three northeastern provinces that were once China's heavy-industry bases. He admonished: "Internationally, advanced technologies are becoming more and more difficult to obtain, and unilateralism and trade protectionism are on the rise, forcing us to take the road of self-reliance. This is not a bad thing, China ultimately has to rely on itself."

**A Tale of Two Horses**

Jack Ma (马云) of Alibaba and Pony Ma (马化腾) of Tencent both share the same Chinese surname Ma (马), which means horse, but the two have taken divergent paths.

From his experience of the 2015 financial coup, Xi learned that the Jiang faction's extensive control over key players in finance and its key regulatory machinery was a serious threat. In addition, the information resources controlled by the giant private high-tech companies and e-commerce platforms closely aligned with the Jiang faction have become rising threats to the stability of the CCP regime.

In August 2020, before the failed listing of the Jack Ma-controlled Ant Group, media outlet Caixin Weekly, citing anonymous well-placed official sources, disclosed that Boyu Capital, controlled by Jiang Zemin’s grandson, was one of Ant’s shareholders. Caixin Weekly said that Boyu Capital holds 0.92% of Ant Group’s Class A shares and 1.92% of Class C shares through Beijing Jingguan Investment Center and Growth Succession Limited, respectively. When Jack Ma's Alibaba Group went public in 2014, only shareholders owning a combined 70% stake were announced and the owners of the remaining 30% were anonymous.

Jack Ma once made a high-profile claim that he would build a 300-year university. Lakeside University is an organization co-founded by him in 2015 with nine entrepreneurs and famous scholars including Liu Chuanzhi, Qian Yingyi, Cai Hongbin, Shao Xiaofeng, Feng Lun, Shen Guojun, Guo Guangchang, Shi Yuzhu, etc. It is located near Yuhu Bay, West Lake in Hangzhou province.

Under the banner of an academy and business school, Lakeside University has the financial capital, tech talent, intellectual resources, and business network to develop into a serious private sector organization that can eventually challenge the CCP.

The authorities eventually reacted. At the end of 2020, enrolment for the new academic year was terminated. Subsequently, a video of the stele at the entrance of Lakeside University having its school name removed has been widely circulated on the Internet.

Jack Ma had flown too close to the sun. He was viewed as a wild horse that might topple the CCP carriage.

On the other hand, Pony Ma of Tencent has been the strong and well-behaved horse faithfully pulling the economic carriage along.

In April 2021, Tencent announced that the company would invest RMB50 bn in the first phase of the "sustainable social value innovation" strategy, and planned to set up relevant business units to focus on basic science, education innovation, rural revitalization, carbon neutrality, pension reform, and the digitization of public welfare services, all key policy priorities for the government.

In June 2012, the Southern Metropolis Daily published an article saying Tencent counted more than 11,000 party members among its over 60,000 employees. There were 14 major party branches and 275 general party branches. The party committee members were the core executives of the enterprise. Tencent's online information censorship team was led by the deputy secretary of the Tencent Party Committee, and 80% of its members were party members. The censorship team was responsible for guiding public opinion and vetting information that could undermine the position of the CCP. Subsequently, Tencent was rated as an excellent online cultural enterprise by the Ministry of Culture.

Tencent is arguably the more powerful and potentially more threatening tech company compared to Jack Ma's Alibaba and Ant Financial. It has successively invested in many companies such as Meituan, Pinduoduo, Kuaishou, Station B, Maoyan, Yuewen, Xiaohongshu, Vipshop, Didi, and Boss Zhipin. They operate in a broad range of sectors, ranging from basic food and clothing as well as housing and transportation, to social entertainment, education, and many other fields. Tencent's tentacles have penetrated all aspects of people's lives. However, the CCP had imposed harsh punishment on Jack Ma while playing down the transgressions of Pony Ma.

Consequently, Jack Ma's career as a tech baron is likely finished. However, Alibaba and Ant Financial under Daniel Zhang and others are likely to behave more like Pony Ma's Tencent. A better future may await Alibaba.

In a commentary published in the 8 February 2022 edition of the People's Daily, the article cited a statement issued after the recent Central Economic Work Conference, which said, "Preventing the disorderly expansion of capital does not mean doing without capital." China must encourage the "orderly development" of capital, the article emphasized.

On 15 May 2022, the party theoretical journal "Seeking Truth" published part of Xi Jinping's speech at the Central Economic Work Conference on 8 December 2021. Among them, when talking about "capital supervision", Xi said: "All kinds of capital cannot be rampant. It is necessary to prevent some capital from growing savagely. It is necessary to fight against monopoly, huge profits, sky-high prices, malicious speculation, and unfair competition."

**Is China Still Investor Friendly?**

Following the moves of the last few years such as the regulation on the education sector, the crackdown on internet platforms, and the introduction of the "three red lines" policies on the property industry, many investors have questioned whether Beijing is still friendly to foreign investors as they hold a large portion of the affected sectors. If you look at these regulations in isolation, they each have a reasonable motivation behind them.

The new policies that have been introduced are intended to rein in excesses. The crackdown on after school tutoring was designed to save families from having to spend significant financial resources for tutoring. The regulations on the internet platforms are aimed at curtailing monopolistic practices, which are similar to the aim of other regulators around the world. The property curbs were intended to prevent a bubble forming among over-levered property developers.

Because these regulations were rolled out in a relatively short amount of time, both the economy and the markets were hit. Investors were left wondering why Beijing seems to have turned on investors and the private sector as the underlying reasoning behind the regulations was not clearly understood.

Examining the developments in capital market reforms will show that China has in fact become more open to foreign investors.

**Progress in Financial Market Liberalization**

In February 2018, China's chief trade negotiator Vice Premier Liu He visited Washington to avert a trade war. Apparently with the strong support of Xi, he turned to a select group of Wall Street executives and pleaded: "We need your help". They included BlackRock executive Larry Fink, David Solomon of Goldman Sachs, and JPMorgan Chase's Jamie Dimon.

In return, Liu He promised to speed up financial market liberalization and offered US financial firms a new opportunity to expand in China. It was a calculated attempt to counterbalance the hawkish anti-China groups with powerful Wall Street financial interests.

Unlike domestic capital and tech corporates, Wall Street interests are deemed to be mostly concerned about profit opportunities and hence are perceived to be less threatening.

They could also play an increasingly important role in spurring domestic financial markets development. In particular, they could increase competitive pressure on domestic financial institutions and enhance capital efficiency.

After the February 2018 meeting, Liu turned to Fink and BlackRock for ideas on how to reform China's pension system as a rapidly aging population threatens massive shortfalls in the years ahead. There was also rising concern that household assets have been too heavily concentrated in properties and needed to diversify to equities, bonds, insurance, and asset management to reduce systemic risks.

It was also an insurance policy. The assessment was that if China integrated into global financial markets and accelerated coupling by opening to key US players, then it could reduce future US leverage.

Consequently, when the US-China phase one deal was signed on 15 January 2020, one of the most prominent concessions by China was the opening of the financial sector.

In 2020, China doubled down and sped up financial market liberalization. The authority brought forward full foreign ownership in securities firms from 2021 to 1 December 2020. For wealth and asset management, full foreign ownership was brought forward from 2021 to 1 April 2020 and 1 January 2020 respectively. Similarly for the insurance industry, full foreign ownership was brought forward from 2021 to 2020.

**Markets Having a Greater Role**

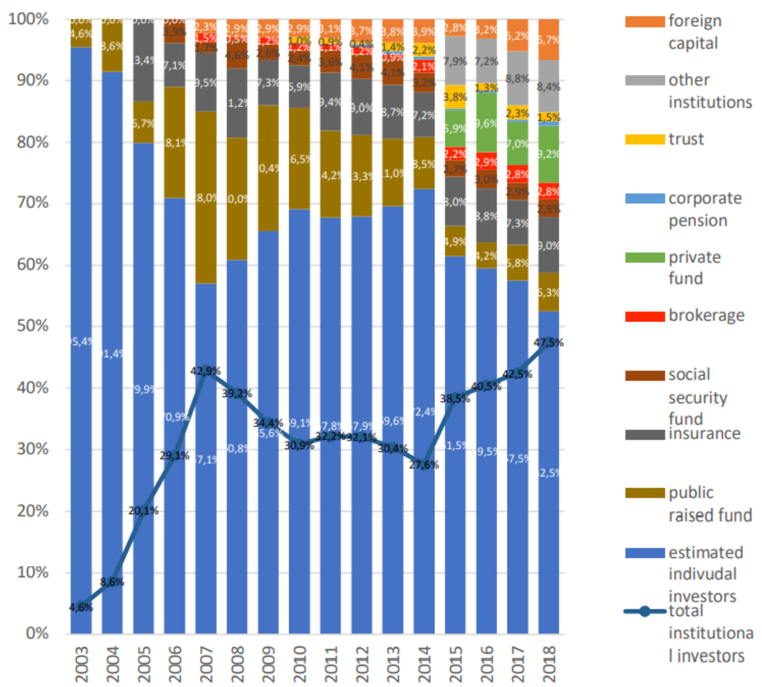
Capital market reforms that have been more market-oriented and investor friendly have steadily progressed under Xi's tenure. The Shanghai Stock Exchange Science and Technology Innovation Board (STAR) was introduced in 2019 while Xi himself announced the start of the Beijing Stock Exchange in 2021, which is designed to house China's "little giants". Both exchanges introduced market-friendly reforms such as a registration-based IPO system.

Foreign investor access has improved through both the QFII and stock connect schemes. Quota restrictions and lock-ups for QFII were abolished in 2020. Eligibility requirements for new applicants were simplified while the investment scope was expanded to the futures and derivatives markets.

Northbound net buying via stock connect reached a record high of USD67 bn in 2021 and through the scheme investors now have access to over 1,300 A-share names totaling USD11 trillion in market capitalization.

China's goal to institutionalize the stock markets has also progressed, with institutions accounting for 47.5% of the market's free float in 2018, versus just 4.6% in 2003. Although it is difficult to directly link institutional ownership with corporate governance, the two appear to be linked in cases of successful activist campaigns to protect minority shareholders. Furthermore, foreigner investors hold a relatively small 5.7% of free float but this figure is growing, and there is correlation between foreign ownership and corporate governance as well.

**Chart 1: A-Share Institutional Investors as a Percentage of Free-Float Market (2003 to 2018)**




*Source: CICC Global Institute*

**Implications for Global Investors**

Some western analysts speculated that Xi is surrounded by sycophants and is not well informed on domestic conditions, and could thus face serious challenges from political rivals. There are no signs that these speculations are well founded.

Xi is the only PSC member with control over the People's Liberation Army, the People's Armed Police, as well as the public security and the intelligence establishment. Xi's confidante Ding Xuexiang, the Director of the CCP General Office, assigns drivers, secretaries, and security details to all the Politburo members and party elders. Ding also maintains a surveillance system over both civilian and military leaders, which includes phone-tapping and close monitoring of their extra-office activities. It is almost impossible for these leaders to coordinate and seek to undermine Xi, whether overtly or secretly.

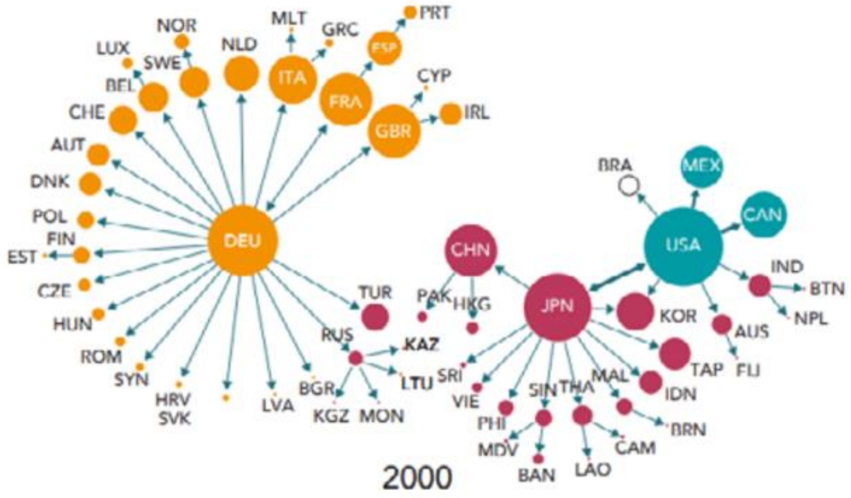
Another misconception of Xi is that he is anti-capitalism. Actually, he disdains powerful private sector groups that seek monopolistic profits, or violate regulations for extra profits, or conduct businesses that pose systemic risks. In his speech at the Symposium on Private Enterprises on 1 November 2018, Xi propounded his famous "five six seven eight nine" theory. He noted that the private economy has the characteristics of "five six seven eight nine", that is, it contributed more than 50% of tax revenue, more than 60% of GDP, more than 70% of technological innovation achievements, and more than 80% of urban labor employment and constituted more than 90% of the number of enterprises.

He then added pointedly: "I would like to stress again that the status and role of the private economy in the national economic and social development has not changed! Our country's basic economic system has been written into the national constitution and party constitution, which will not change and cannot be changed."

In 2020, China's share of world manufacturing exports stood at 19%, much higher than Germany's 9%, America's 7%, and Japan's 5%.

As indicated in Chart 2, in 2000, Germany was the center of the network of value chains in Europe. Japan and the US constituted the joint centers of the network of value chains for Asia and North America.

**Chart 2: Network of Global Value Chains (GVCs) Trade, 2000**

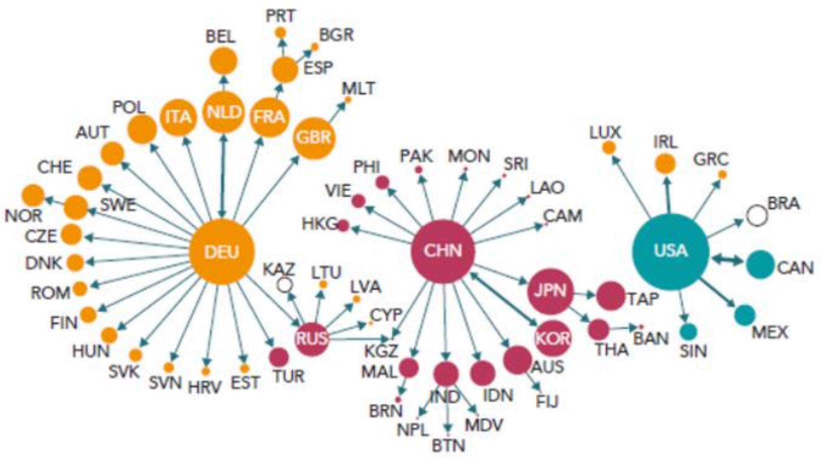



*Sources: WTO and World Bank*

China's entry into the World Trade Organization marked a major turning point. China's GDP as a share of US GDP rose from 12% in 2000 to 41% in 2010, and further to 77% in 2021. The corresponding comparison with Japan is even more stark, rising from 25% to 109% to 330%.

By 2017, Japan and the US have been marginalized and China has emerged as the center of the network of value chains in Asia (see Chart 3). It is now too late and almost impossible to marginalize China in the present global value chain network.

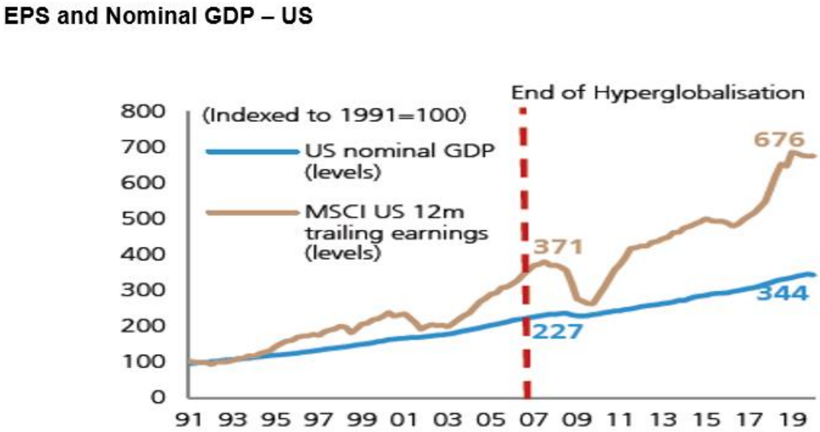
**Chart 3: Network of Global Value Chains (GVCs) Trade, 2017**




*Sources: WTO and World Bank*

Over the past 30 years, major US corporates' earnings and share prices grew at twice the rate of the domestic nominal GDP, largely due to global market expansion, especially into China (see Chart 4). US corporate profits, share prices, management bonuses, stock options, and retirement income increases, all rode on these returns.

**Chart 4: US Corporates Depend on Globalization to Sustain Earnings and Share Prices**




*Sources: IBES, MSCI, DataStream, OECD, Haver, UBS*

While political rhetoric, congressional legislations, and think tank pronouncements dominated the discourse, the underlying reality is that in the market economy where the private sector needs to make profits to survive, no government can afford to subsidize their private industries for a sustained period.

Taking the analogy of a pyramid, while US-China tensions will continue to cast a long shadow over tech- and security-related industries, they are mostly at the apex black zone of the pyramid. The bulk of China's production and trade are in the white or slightly greyish middle segment and broad bottom zone. These companies will continue to reflect the higher growth rate of China and prove attractive as an asset class less correlated with global returns.

Some of these alpha clusters would include factory automation, cybersecurity, artificial intelligence, semiconductors, health care digitalization, capital market digitalization, specialty drugs, medical devices, consumption upgrade, domestic products upgrading and appealing to nationalistic sentiment, an aging demographic, as well as winners of industry consolidation.

Contrary to speculation in the media, there is no evidence to suggest that Xi has abandoned his goal of the markets having a more "decisive role" in the economy. However, he has learned that the markets have been distorted by excesses, monopolistic forces, as well as manipulation for political gain. The actions taken over the past two years to tighten regulation, is to corral the wild horses, putting guardrails around the markets and the economy – the aim is not to hurt investors but rather engender an optimal environment for sustainable, healthy growth.

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