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Market Update: Volatility in China
July 27th, 2021

Chinese equities have under-performed in recent months and the sell-off has accelerated to the downside in recent days. We thought it would be timely to send a brief note to identify the key drivers of recent negative performance, articulate our conviction, and describe our process-driven actions and reactions to the volatile market activity.

What is going on?

Recent under-performance in Chinese equities has been exacerbated this week by the Chinese government's crackdown on the monopolistic tendencies of the country's largest and most influential technology companies. While emerging economies experience bouts of volatility sparked by government actions, it is important to remember that similar periods of re-valuation have occurred before and are characteristic of the growing pains of emerging economies.

Why do we have a favorable view of investments in China?

China's economy recovered more quickly than other countries and markets in the wake of the pandemic, thanks in part to strict lockdowns in targeted areas that effectively limited the spread and impact of the virus. In 2020, China experienced the equivalent of a double-dip recession (having gone through a slowdown period in 2015-16), and is currently positioned within the sweet-spot of "Stage 3" in their economic cycle. China's recovery is in force with annual trend growth of approximately 5.5% going forward, and policy initiatives geared towards long-term growth are in high gear (RCEP Asia Trade Agreement, China 2025 Initiative, "Belt & Road" Initiative, Asia Development Bank). The trade war with the U.S. is receding though some constraints remain.

Beijing has taken this opportunity to implement mid-cycle adjustments to continue to reform the Chinese economy and avoid a significant slowdown. The People's Bank of China (PBoC) recently cut reserve requirements by easing monetary conditions and have hinted at the potential for further monetary and fiscal support. The "crackdown" on large tech companies has, indeed, caused a scary selloff, but is likely to allow for a more competitive economic landscape going forward. In an article published this week, BlackRock articulated their view of Beijing's actions very well:

"We see an overall hawkish policy stance as critical to China's 'quality revolution' – an effort to move away from an overriding effort on the quantity of growth toward a greater focus on the quality of growth. China aims to become a more productive economy with each unit of incremental GDP generating proportionately less pollution, inequality and financial risk (debt). This is key to our China asset views. ***We are tactically neutral on Chinese equities but strategically positive because we believe ongoing reforms in China could weigh on near-term growth but potentially improve its quality in the long run****."* [1]

What are we doing now?

Though we are closely monitoring the potential for more policy changes and market action in China, our investment conviction has not changed. We are not interested in timing markets or reacting to day-to-day developments. Rather, our process centers on strategic exposures to various ETFs used to gain exposure to the world's second largest economy (MCHI, ASHR, KWEB). Our rebalance discipline leads us to trim positions when these markets outperform and add to exposures when they underperform, a discipline to which we have remained committed. Given that China's share of global GDP continues to rise, we will likely continue to add to take advantage of lower price multiples to add to our positions in the coming months.

[1] "Our views on China's policy finetuning", BlackRock Weekly Commentary, July 19, 2021. https://www.blackrock.com/corporate/literature/market-commentary/weekly-investment-commentary-en-us-20210719-our-views-on-china-policy-finetuning.pdf