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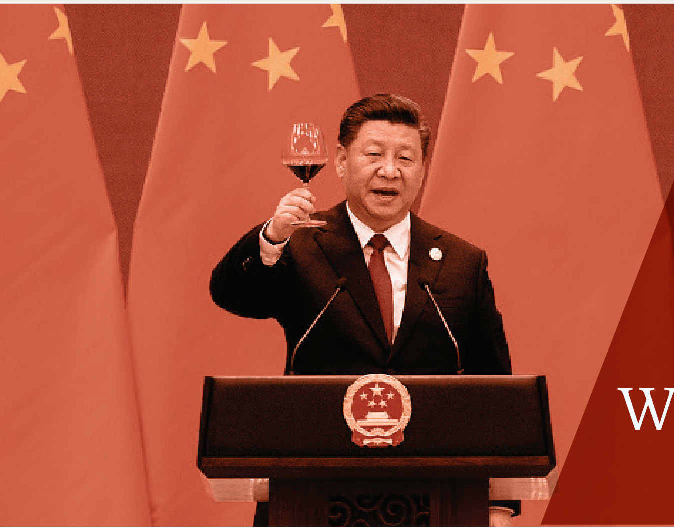

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China's "Common Prosperity": What Does it Mean for Investors?

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- "Common Prosperity" features two critical initiatives: The first aims to tame the country's real estate obsession and speculative excesses, which have been the key drivers of soaring inequality. Even though a financial crisis is unlikely, a successful deleveraging and rebalancing necessarily implies lower overall growth lies ahead.
- The second is a regulatory clampdown on a wide range of tech sectors, ostensibly to foster competition, share excess profits with employees, and protect national security. This involves discouraging some areas of tech (e.g., online tutoring, gaming and social media), while encouraging others (e.g., semiconductors, AI, biotech and green tech).
- In 2024 the SEC will begin delisting Chinese companies that haven't opened up their audits to U.S. oversight. Beijing has prohibited cooperation over fears that state secrets would be leaked. As a result, equity market decoupling is destined to accelerate over the next two years.
- Chinese equity indices have exhibited terrible performance over the past decade, but especially since the regulatory crackdown commenced. However, the market doesn't appear cheap as Chinese equities have just declined in line with earnings, leaving relative multiples close to 10Y means.
- There are three compelling reasons to underweight Chinese equities: (1) The real estate sector faces an extended period of deleveraging; (2) The elevated level of regulatory uncertainty impacting tech isn't going away anytime soon; and (3) "Common Prosperity" will limit the upside for successful tech companies. This is problematic for the increasingly digital economy, where a small number of firms account for a disproportionate share of market gains.

Over the last year China has launched a new policy framework, "Common Prosperity," which escalates government steerage of the economy and features two critical initiatives. First, Beijing is (finally) taking action to tame the country's real estate obsession and speculative excesses. Second, the "summer blizzard" of regulatory actions has targeted a wide range of tech-related sectors including fintech, e-Commerce, ride-hailing, social media, online tutoring and gaming (**Figure 1**). The purpose of this note is to examine the implications for investors of the pendulum swinging ever further in favor of the state.

Move Fast and Regulate Things

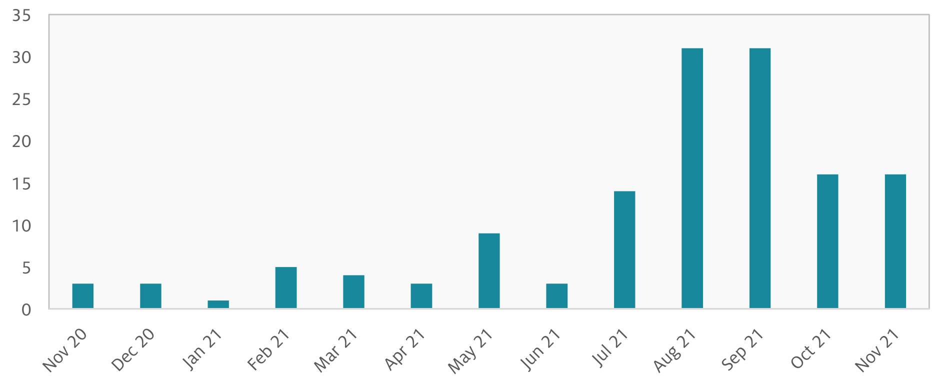
Beijing is moving with an intensity not seen in decades, which raises the question: Why the urgency now? Concerns about unfettered capitalism, rampant real estate speculation, surging income inequality and imperious tech titans are not new. However, two things are different now: first, the accelerating pace of digital technologies[1] and second, demographics, China's work force has begun to shrink (**Figure 2**). The labor force grew by over 20% between 1990 and 2017, but since then has contracted by 17 mn. This demographic time bomb is particularly troubling for Chinese real estate which, like all Ponzi schemes, requires fresh patsies to keep from imploding.

"The Chinese government now suddenly seems to be displaying something near panic about falling birth rates."

—Barry Naughton, UCSD

FIGURE 1: The number of regulatory actions from Beijing spiked this summer

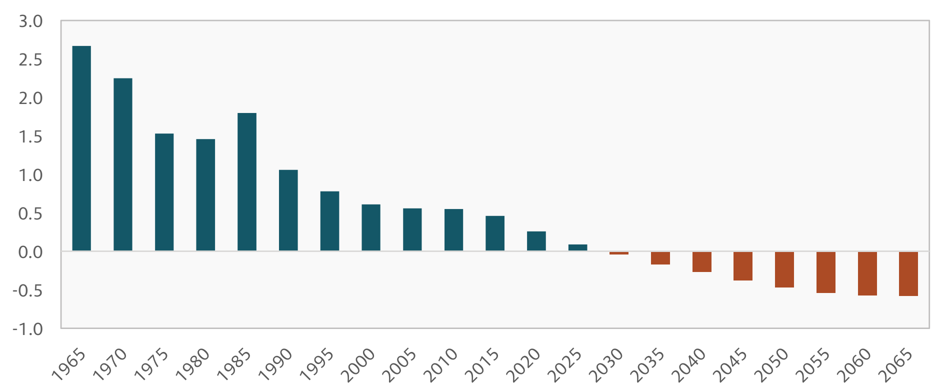
The regulations are ostensibly designed to reduce inequality of opportunity, foster competition and protect national security



Source: China National Press, Xinhua, South China Morning Post, SupChina, Bloomberg, WSJ, Financial Times

FIGURE 2: Annual rate of population change (%)

Demographics is destiny



Source: United Nations

"Common Prosperity": Placing the Private Sector on a Tight Leash

"A lot of Chinese companies are walking on eggshells to please the Chinese government."

—Edith Yeung, Race Capital (an early-stage VC fund)

Although Chinese regulators aren't interested in controlling the day-to-day operations of private companies, President Xi's "Common Prosperity" framework represents a cathartic transformation of the relationship between the government and corporate executives. With greater emphasis on ideological orthodoxy and social responsibilities (particularly to workers), the status of founders and shareholders has been taken down a notch or two. Companies in targeted sectors must operate in line with Beijing's ever more intrusive policies, which means, even though they may be privately owned, they are often effectively state-controlled.

Moreover, the timing of the new framework is deliberate, coming ahead of the 20th Party Congress slated for October 2022, which will feature the next Five-Year Plan and the quinquennial personnel changes (including President Xi's appointment to a third term). This made the summer of 2021 an opportune time to launch a populist slogan and a regulation tsunami aimed at curtailing both real estate excesses and the burgeoning power of tech.

"Correcting China's property market is the key pillar in the common prosperity framework. … And it's the ultimate test of Beijing's political drive."

—Lizzie Lee, SupChina

The Breath-Taking and Unprecedented Scale of China's Real Estate Boom

The motivation for Beijing's crackdown on real estate couldn't be clearer: It represents 70%+ of household assets and real estate-related activities

1. *Please see our recent White Paper "The Pandemic Accelerant Part II: Turbo-Charging the Digital Economy."*

account for a staggering 29% of Chinese GDP (**Figure 3**). Moreover, 87% of new home buyers already have at least one dwelling, price-to-income ratios in major cities are the world's highest (**Figure 4**), and the urban housing vacancy rate is 21%. These eye-popping statistics have finally forced policy makers to address the economy's over-reliance on debt-fueled property investment to fabricate growth.

"The footprint of China's real estate sector has become so large – with an impact of real estate production and property services on GDP of 29% – that it is hard to see how a significant slowdown in the Chinese economy can be avoided even if banking problems were contained."

—Kenneth Rogoff, Harvard

Chinese regulators have introduced a host of measures, most notably "the three red lines" announced last year to reduce leverage ratios at the dominant property developers. Policies announced this year include increasing mortgage rates in some major cities and accelerating the development of government subsidized rental housing. Finally, despite intense blow back, Beijing will trial property taxes in certain urban regions over the next five years, an initiative that's a key pillar of President Xi's "Common Prosperity" drive.

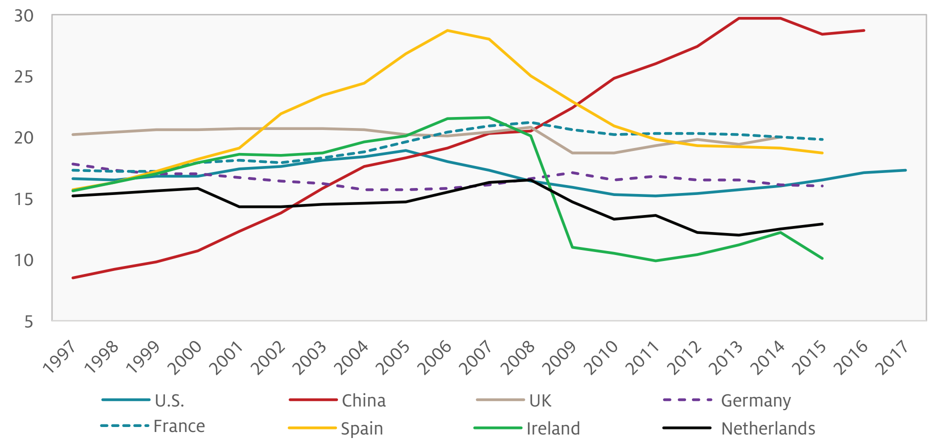
"Housing is for living not for speculation."

—President Xi

Even though the real estate sector has underperformed MXCN by 47% since the beginning of 2020, we do not expect a Lehman-type financial crisis as China's closed capital account and huge current account surplus provide Beijing with sufficient capacity to prevent contagion and ensure households are protected. Moreover, given how exposed and vulnerable households are (much of developers' enormous debt

FIGURE 3: Impact of real estate related activities on GDP (%)

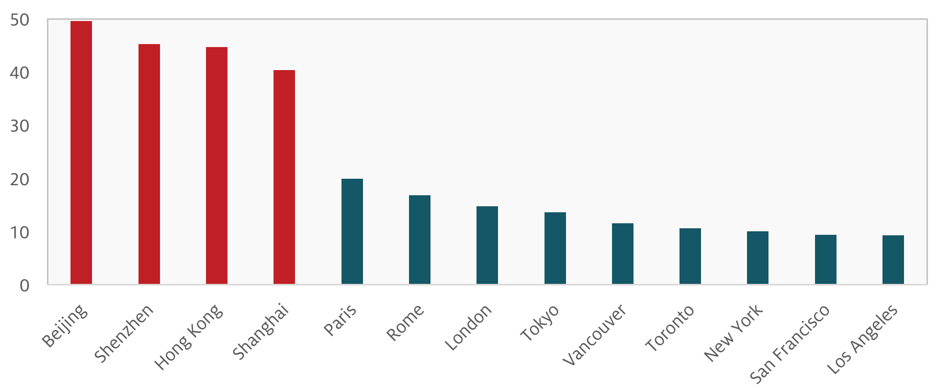
China is in a league of its own: A growth slowdown appears inevitable



Source: "China's outsized real estate sector," by Kenneth Rogoff, Harvard, Vox EU

FIGURE 4: Home price-to-income ratios in major cities

The key driver of inequality: Real estate in major Chinese cities is out of reach for most households



Source: Bloomberg

burdens consist of customer deposits), the government has every incentive to avoid a hard landing. Further, the best evidence that the market believes in the Too-Big-to-Fail maxim is the lack of any sell-off in investment grade spreads (**Figure 5**).

"Overinvestment in the real estate market and in all kinds of infrastructure projects artificially inflated GDP growth in the past years. Many of these projects are of little economic use, so the debt associated with them is unsustainable. The Party leadership knows this. … genuine growth is probably 2 to 3%, not more. In other words, there is an awful lot of fictional growth."

—Michael Pettis, Peking University

Even without a financial crisis, a successful deleveraging and rebalancing necessarily implies lower overall growth lies ahead. Moreover, such transitions are fiendishly complex and always involve collateral damage. This means investors should expect more shocks and volatility spikes over coming quarters.

Cancel Culture: The Attack on Tech

Having discussed the adverse implications of "Common Prosperity" for real estate we now turn to tech, where the list of casualties is a who's who of Chinese innovators. Pretty much everyone was caught off guard by this year's regulatory clampdown, which marked a 180 degree turn from the previous laissez-faire approach to the sector. (For examples of regulatory actions please see **Table 1** in the Appendix.)

Some of the regulatory actions strike us as rather arbitrary and capricious. For example, this summer the official press labelled gaming "spiritual opium," singling out Tencent for special abuse and demonization. Around the same time Beijing prohibited online private tutoring companies from making profits, raising capital or going public. Such mercurial regulations are inefficient, discourage innovation, and could take the wind out of China's entrepreneurial sails.

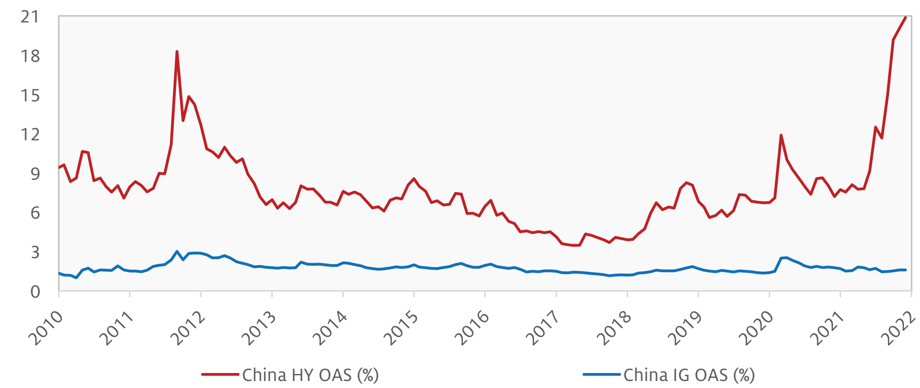
To the CCP, Data is a Crucial Factor of Production

Fortunately, though, many other regulatory efforts have been more constructive, aspiring to increase market competition, spur innovation and provide consumers with greater choice. To illustrate, the Personal Information Protection Law went into effect last month, with draft guidelines requiring apps to obtain explicit consent from users before collecting and using personal data.[2]

Representing an even bigger leap, Beijing is evaluating a so-called "data tax" on Chinese tech platforms. This reflects the CCP's belief that such data represents enormous value, which should be shared with the individuals who produce it.

FIGURE 5: Investors are not worried about contagion from the real estate sector

Chinese HY spreads have blown out to all-time highs (4 standard deviations above normal), while IG spreads remain narrow (and tighter than their 10Y mean)



Source: Bloomberg

"Platforms that possess large amounts of personal information should return 20% to 30% of revenue generated by transactions to the producers of that data."

—Huang Qifan, Chinese politician and economic advisor

A second example aimed at increasing consumer choice involves antitrust authorities opening up platforms to make them less exclusive. Regulators have issued strong warnings to social media companies, e-commerce companies, video companies and others to stop blocking rivals' links. As a result, a well-known social media company will soon allow chat groups to display links to external shopping sites. This is part of a broader campaign to eliminate the walled gardens that allow platforms to artificially perpetuate their dominance, and then control and profit from consumer data. If competently implemented, this could mark an important step in boosting competition among platforms and increasing the options available to consumers.

What Tech Does China Want?

"(President Xi) sees all forms of speculative investment, particularly in property ... as belonging to the "fictitious economy" which crowds out investment in the "real economy" of manufacturing, technology and infrastructure — sectors that will seal China's global economic dominance."

—Kevin Rudd, President of Asia Society and former PM Australia

The above discussion has made it abundantly clear which sectors Beijing is actively discouraging (e.g., online tutoring, gaming and social media). In terms of what tech will be encouraged, there are three overlapping themes. First and most urgently, China wants to reduce dependence on U.S. suppliers, as a shield against the risk of technology decoupling. Surpassing America and achieving tech independence has long been a key priority, with home-made cutting-edge semiconductors being the best example.

Second, President Xi frequently speaks of "great changes unseen in a century," referring to areas such as AI, quantum computing and biotech. Further, his government has repeatedly prioritized high-end manufacturing and hardware focused tech, with special emphasis on semiconductors, cloud computing, sensors and AVs.

2. *To gauge the potential impact of this law, since April, when Apple began asking iPhone users if they wanted to opt out of data tracking, 62% said yes. This has presented significant challenges for numerous companies, most notably Facebook.*

The third theme is green tech, which is one of China's strategic goals and includes EVs, power equipment, battery storage, nuclear fusion, solar and wind power, advanced biofuels, and carbon capture, as well as zero carbon cement, steel and plastics. China has made impressive strides in green tech and is the world leader in many applications required to achieve net zero targets.

"There's no such a thing as the Chinese economy. There is only the POLITICAL economy in China."

—Henry Gao, Singapore Management University

Top-down steerage of the economy has unequivocally increased under President Xi, especially over the past year. This means, when starting up a new company, entrepreneurs and investors must increasingly ask: Is this something Beijing is actively encouraging or discouraging? And if it's ambiguous, how probable is a regulatory action that could wipe out five years of toil, tears and sweat?

Will Regulatory Uncertainty Quash China's Entrepreneurial Energy?

One of the biggest risks is that the "Common Prosperity" regime suppresses the entrepreneurial spirit that has emphatically powered China's boom. It is certainly the case there has been a hit to entrepreneurial confidence over the last year, and the fast-changing regulatory environment is making long-term planning even more difficult. Further, the regulatory crackdown is still in early innings and will not end anytime soon.

More profoundly, has any country ever successfully sparked innovation through top-down redirection of capital and talent into favored sectors? The empirical evidence isn't encouraging, to say the least. Still, highly centralized systems can be efficient at achieving clear, well-articulated goals, like building needed infrastructure. They are also capable of advances in politically-directed areas of science (e.g., the USSR's space program). Regardless of these exceptions, tech companies are most likely to thrive in an environment that encourages creativity, risk-taking and destructive innovation. All this suggests "Common Prosperity" is likely to, at minimum, dampen China's entrepreneurial energy.

The Geopolitics of Tech: America Innovates, China Replicates, Europe Regulates[3]

The governments in the U.S., Europe and China are all determined to tame an increasingly unruly digital sphere. In America, numerous antitrust bills have been introduced, a majority of Americans are in favor of stricter regulations, and getting tough on Big Tech is one of the few issues both sides of the aisle agree on. However, the lack of progress over the last five years is telling. The combination of congressional dysfunction and Silicon Valley's potent lobbying power has meant that America's digital giants remain largely unrestrained.

The EU has made more progress in enforcing antitrust legislation and regulating personal data. The key reason is that Europe has few homegrown tech superstars, which makes passing ambitious legislation much easier. However, when it comes to tech, Europe is playing a very weak hand and playing it badly. The continent's anti-tech actions are likely accelerating its geopolitical decline, especially when compared to the two major powers.

"The most important question in geopolitics today might be, Will countries that break up or clamp down on their biggest technology firms also be able to seize the opportunities of the digital revolution's next phase, or will their efforts backfire?"

—Ian Bremmer, President of Eurasia Group

In contrast to the U.S. and EU, Beijing is channeling the power of the biggest technology companies in pursuit of national priorities. China's "national AI team" includes the country's top e-commerce and social media companies, as well as a voice recognition company. Further, core national champions include leaders in 5G and SMIC in semiconductors. This status is important because, as the U.S. and China decouple, China's national champions will be blessed with the full backing of the state. However, as Bremmer emphasizes, "Beijing ultimately faces the same tradeoffs as Washington and Brussels. If it tightens its grip too much, it risks harming the country itself by smothering innovation."

Since the 1950s, America has been the world's undisputed leader in tech innovation. This reflects four factors: its top research universities, readily available financing from the VC industry, the depth and breadth of its digital ecosystem, and a favorable regulatory environment. Unfortunately, Europe scores poorly on all four counts, and this is reflected in its tiny tech sector and small share of global unicorns. On the other hand, China is increasingly competitive on the first three factors, although the fourth will likely prove to be the real test. Having discussed tech regulation in some detail, we now turn to financial markets where both Beijing and DC are actively promoting decoupling.

Auditing the Auditors: SEC to Begin Delisting Noncompliant Chinese Stocks in 2024

This year the SEC has sent a clear message to Chinese companies listed in the U.S.: They need to allow the Public Company Accounting Oversight Board (PCAOB)[4] to inspect their financial audits, or they will be delisted as soon

3. This section relies heavily on "How Digital Powers Will Reshape the Global Order," by Ian Bremmer, Foreign Affairs, 2021.
4. The PCAOB was created by the Sarbanes–Oxley Act of 2002 (following the Enron and WorldCom accounting scandals) to oversee the audits of all public companies listed in the U.S.

as 2024.[5] As SEC chair Gary Gensler has repeatedly emphasized, "The path is clear, the clock is ticking."

There are roughly 270 Chinese companies listed in the U.S. (75 with market cap > $1 bn) and Gensler has stressed there is little to negotiate about, especially after the bipartisan passage in December 2020 of "The Holding Foreign Companies Accountable Act." This legislation requires foreign companies to undergo audits that are compliant with PCAOB rules by 2024, or else lose access to public exchanges in the U.S. While the 2020 Act applies to foreign companies in general, it was constructed specifically with China in mind.

> "It's up to Beijing to let the oversight board in so we can ensure the relevant audits are up to U.S. standards. Early next year we will announce which companies used an auditor that didn't open its work papers to U.S. overseers. … their shares will be prohibited from trading in our capital markets beginning in 2024."
>
> *—SEC Chair Gary Gensler*

More than fifty foreign jurisdictions allow the oversight board to "audit the auditors." However, two do not: China and HK. The PCAOB and its Chinese counterpart tried for years to negotiate a joint inspection agreement similar to the ones established with many other countries. However, the talks ultimately collapsed in 2015 and the PCAOB has expressed concern on numerous occasions about the accuracy of the numbers coming from Chinese audit firms.[6]

> "China has a very expansive definition of state secrets such that any transaction with a state-owned enterprise in China is considered to be a state secret. My mobile phone bill is technically a state secret."
>
> *—Paul Gillis, professor of accounting (and VIE expert), Peking University*

Why has the Chinese government prohibited auditors from allowing the PCAOB to inspect their handiwork? The reason is that China has strict laws on sharing information with foreign entities, reflecting Beijing's fears that proprietary business information containing state secrets would be misappropriated by the SEC and passed to U.S. companies.[7] Regardless of whether Beijing's concerns are valid or not, the SEC is statutorily required to strictly enforce the three-year deadline and this time there is no wiggle room. Chinese companies need to comply with the same rules as all other U.S.-listed companies, otherwise they will be delisted in 2024.

Mutual Decoupling: Beijing's Growing Hostility to Companies that List in the U.S.

> "Investors can still go to HK if they want to invest in Didi or other Chinese stocks. But China wants its companies to be only a short distance away. It is all part of a mainland government plan to 'bring them home' and disengage from U.S. regulation."
>
> *—David Webb, longtime investor in HK*

Beijing will not be a passive observer, waiting for the SEC's delisting clock to run out. At the end of November Chinese regulators ordered the country's premier ride-hailing company to delist from the NYSE, citing concerns about leakage of sensitive data ("state secrets" is being very broadly defined here, as the company only has data on taxi rides and how they were paid. Since the delisting reports first surfaced, the share price has declined by 20%, as some investors will be forced to sell (not permitted to hold HK-listed names) and others see the risk of additional regulatory torment.

Beijing's concerns about data security, and its determination to preempt the SEC's actions, will likely also apply to pretty much every Chinese company listed in the U.S. Given the SEC's hard 2024 deadline, it is likely that Beijing will actively encourage the vast majority of Chinese companies to move their listing from the U.S. during 2022 and 2023. While such "homecoming" listings might be unfortunate and regrettable, equity market decoupling has long been inevitable.[8]

China's "Common Prosperity" Regime: What Does it Mean for Investors?

Given everything that has occurred during the last twelve months, no one should be surprised that it has been a rough year for Chinese equities (**Figure 6**). The MXCN is off 21% ytd, which looks even worse when compared to the MXUS's 20% gain. Online tutoring companies have been especially hard hit, with one losing 89% of its market cap during 2021 and others by even more. The carnage has also affected e-Commerce companies, ride-hailing, and beyond. Further, the MSCI China real estate index is down 32% ytd.

However, the terrible performance of Chinese equities is not a recent development. Despite its booming economy,

5. Chinese companies facing this prospect have two main choices: Switch their primary listing to Hong Kong (around half already have a secondary listing there), or a straight-up privatization.

6. An added wrinkle is that about 70% of Chinese companies listed in the U.S. are Variable Interest Entities (VIEs). The legal standing of VIEs is unclear and it is possible U.S. investors would have no legal recourse in the Chinese legal system if, for example, the company was taken private at an unjustifiably low valuation.

7. Some U.S. companies operating in the mainland allege this is a common Chinese practice.

8. For the broader context, please see our note "Cold War 2.0: The Platform, the Players, and the Stakes."

robust exports and impressive tech innovations, the overall Chinese market has not been kind to investors. Since 2011, MXCN has underperformed MXUS by 59% (**Figure 7**), with IT being the only sector that did better than the U.S. index. The next two best were healthcare and consumer staples, both focused on the flourishing domestic consumer, while the worst were industrials and finance. The CSI 300's relative performance was equally dreadful, with similar outcomes at the sector level.

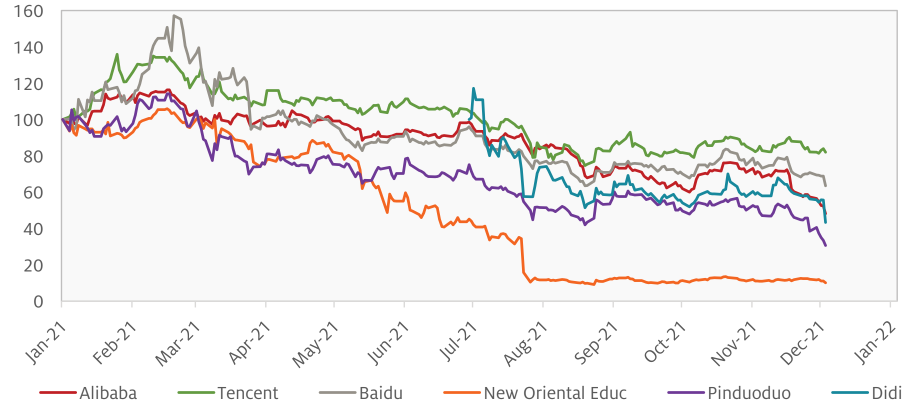
The most common question we receive about the above chart is: After such stunning underperformance, Chinese stocks must surely be cheap, so does this represent a good entry point? Our response is an emphatic no. While there might be some opportunities at the sector and company level, the overall equity market appears fairly valued. Since 2012 Chinese indices have always traded at a lower multiple than their U.S. counterparts, and the discount today is almost exactly at the 10Y mean (**Figure 8**). To be more specific, MXCN is currently trading at a 36% discount to MXUS, which is awfully close to its 34% average discount. Bottom-line: Underperformance has simply reflected weak earnings growth (vs the U.S.), meaning there exists neither a tactical nor a valuation argument to increase exposure to the Chinese indices.

Given this outlook we shouldn't be surprised that foreign investors have reduced their purchases of Chinese equities (**Figure 9**). While flows increased to record highs in 2019 and 2020, purchases this year have languished, with July 2021 being the worst month on record.

How concerned is Beijing that foreign investors are losing interest in their market? We think they're not at all worried. In fact, China seems to be encouraging financial decoupling. It has a huge current account surplus, enormous FX reserves and a gross

FIGURE 6: Performance of select Chinese stocks during 2021

China's effervescent tech scene succumbs to the new Beijing-first reality



Source: Bloomberg

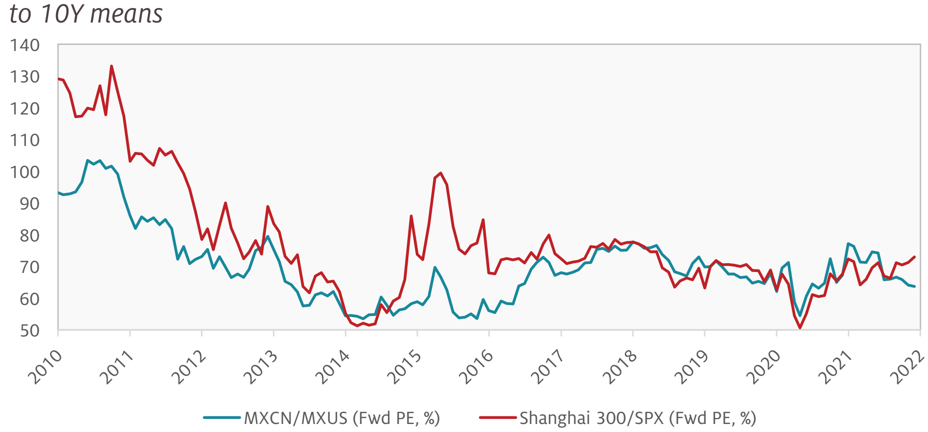
FIGURE 7: Chinese equity indices have dramatically underperformed their U.S. counterparts over the last decade

Tough to find a compelling reason to overweight Chinese equities

Source: Bloomberg, Epoch Investment Partners

FIGURE 8: Despite the recent selloff, Chinese indices appear fairly valued relative to their U.S. counterparts

Chinese equities have declined in line with earnings, leaving relative multiples close to 10Y means



Source: Bloomberg, Epoch Investment Partners domestic savings rate of 46% (compared to 27% for the EU and 19% for the U.S.). China simply doesn't need the money. This is reflected in the uncommonly small percentage of domestic market cap that is owned by U.S. investors, just 3% in China compared to 16% in Japan and S Korea, and 21% in Taiwan (**Figure 10**). Similarly, of U.S. residents' total foreign equity holdings, only 3.5% is held in China or HK. Pundits like to use the expression "financial market decoupling," but it strikes us that American and Chinese markets were never coupled to begin with.

There is one type of investor Beijing is actively courting though, and that is venture capital, which has remained remarkably active through 2021 Q3 (**Figure 11**). The reason is that VCs bring a lot more to the table than just capital. They typically play the role of a consiglieri, often taking a seat on a company's board and offering a wealth of experience, as well as access to an invaluable network of contacts. In contrast to its views on portfolio flows, Beijing believes an active VC presence will expedite its aspirations for the tech sector.

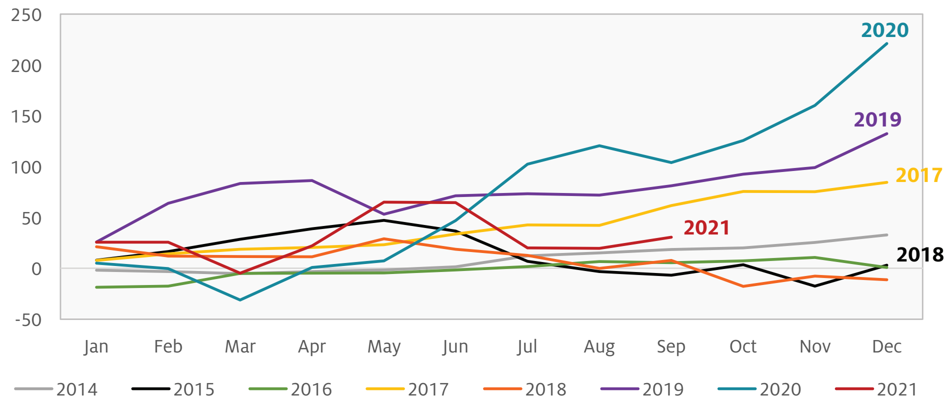
China's Tall Poppy Syndrome

Venture capitalists are always searching for the next Alibaba or Baidu but are increasingly worried the "Common Prosperity" framework will limit the upside potential of their Chinese investments. Beijing has made it clear that companies that become too successful and powerful, and whose activities don't fully align with public priorities, will find themselves in the crosshairs. This means the next generation of tech companies will be less lucrative and overweening than today's titans and it is quite possible that VC firms have seen their last ten-bagger in China.

While America celebrates "Tall Poppies," Beijing is now inclined to lop-off the tops and cut them down to size. Successful firms are increasingly dis-

FIGURE 9: Net foreign equity portfolio investments into China, USD bn (cumulative by year)

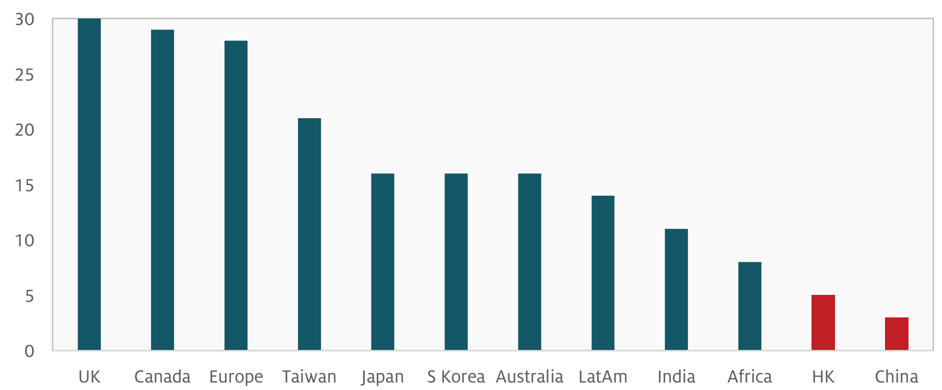
Foreign investors pulled back in 2021, responding to heightened regulatory uncertainty



Source: Bloomberg, Epoch Investment Partners

FIGURE 10: U.S. holdings as % of domestic equity market cap

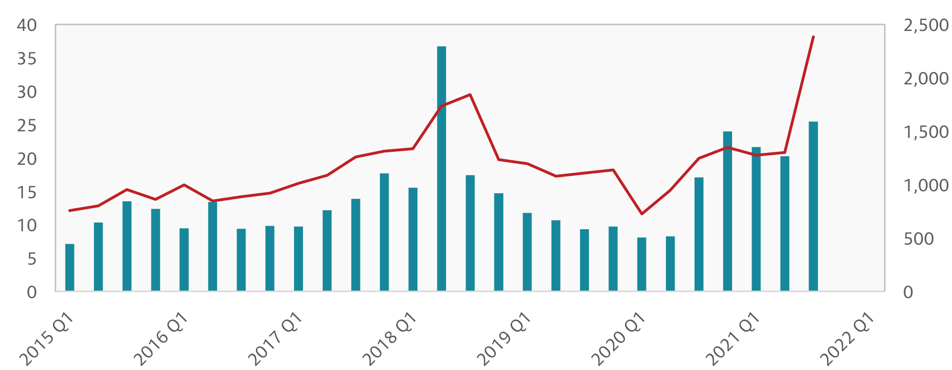
China has enormous domestic savings and doesn't need foreign capital to fund investment



Source: U.S. Treasury

FIGURE 11: VC funding in China remains strong, running at 40% the level of VC funding in the U.S.

The biggest deals in Q3 2021 included batteries, mRNA vaccines, EVs and semiconductors



Source: Bloomberg

Note: Much of the 2018 Q2 surge was driven by the $14 bn Series C round funding of Alibaba's Ant Financial, one of the largest VC deals ever.

couraged from just chasing profits for the benefit of shareholders. Rather, they must share with all stakeholders, including employees, delivery drivers, app developers, small merchants, and so on. This is especially problematic given the winner-takes-most nature of the digital economy. For example, 50% of the SPX's rise since 2015 is accounted for by just fifteen superstar firms. Given that we expect digital platforms to represent the majority of market capitalization by 2025, this provides yet another reason to be cautious about Chinese equities.

Are Chinese Equities Uninvestable?

The case against Chinese equities is as compelling as they get. First, the real estate and property sectors face an extended period of deleveraging, which is also likely to foment a challenging macro picture. In many ways this reminds us of Japan in the early-1990s. Second, the elevated level of regulatory uncertainty isn't going away anytime soon. It seems like almost every day there is yet another new regulatory action, government directive or policy change, with the vast majority affecting digital sectors. Moreover, "Common Prosperity" will limit the upside for many successful tech companies, which is especially problematic for the digital economy, where a small number of firms account for a disproportionate share of market gains.

While Chinese indices are likely to continue underperforming global benchmarks, it doesn't mean the asset class is uninvestable. Being strategically underweight doesn't mean zero exposure, as some companies will undoubtedly thrive regardless of the regulatory and market environment. This view is similar to how we approach Europe and Japan. To identify investment opportunities, whether in China or elsewhere, Epoch has always favored companies with effective capital allocation policies, including a demonstrated ability to deliver a ROIC above their WACC. We also look for companies with a record of generating FCF on a sustainable basis, and believe such companies are the most probable winners. This is true everywhere, including in China

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