What Does China's Stock Market Meltdown Mean for Investors?

Why China tech is under pressure, and what it means for investors.

Insight from sub-adviser Schroders Investment Management

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Key Points

- The pace of innovation has run ahead of legislation, a theme we've seen unfold in developed markets, especially in relation to tech companies, leading to a need for stricter regulations.
- Uncertainty and market deterioration is being driven by broad-based regulatory pressure around antitrust concerns, inequality issues, gig economy labor practices, and a potential review of variable interest entity structures.[1]
- Market uncertainty has lifted the risk premium and precipitated market stress, driven by an expectation that returns may be suppressed.

CHINESE MARKETS HAVE HIT HEADLINES AGAIN IN RECENT WEEKS. Geopolitical tensions surrounding trade remain, but market behavior and performance—particularly in the tech sector—have also been getting attention.

Tom Wilson, Head of Emerging Market Equities at Schroders, weighs in on what's causing the upset.

The Chinese government seems to be cracking down on tech. Why?

In certain circumstances, there is a need for stricter regulation.

The pace of innovation has run ahead of legislation, a theme we've seen unfold in developed markets, especially in relation to tech companies.

There is a desire to enhance the Chinese Communist Party's legitimacy and a new focus on what is termed "common prosperity." In recent decades, China has seen huge economic success, but inequality has been rising as well. Regulation is partly a desire to see economic gains more widely spread. In a way, there are similarities between what's going on here, and what's going on politically in developed markets.

There are also the state's own strategic goals with which companies increasingly need to align. The private sector is under pressure to be more mindful of the common good. However, US-China tensions could also mean a more polarized world, and that could potentially lead to issues in China's access to leading-edge technology. Thus, the Chinese have a strong desire to move towards tech self-sufficiency. There is huge intellectual and financial capacity in the private sector to support that ongoing push, be it from a software standpoint in relation to artificial intelligence, or from a hardware perspective in relation to semiconductors.

Markets in China have been among the worst performing in the world year-to-date. Was this expected?

Yes, because there is uncertainty driven by broad-based regulatory pressure. The main thrust is on antitrust, issues of inequality, gig-economy labor practices, etc., but there are other elements of regulation relating to a potential review of variable interest entity[1] (VIE) structures.

Generally, regulation drives uncertainty, which in turn drives a higher risk premium and, potentially, the suppression of returns. So market deterioration is normally expected when there are relatively broad-based changes to regulation.

[1] A variable interest entity (VIE) refers to a legal business structure in which an investor has a controlling interest despite not having a majority of voting rights.

You mentioned VIEs—could you explain what they are and why they are having an impact on markets?

VIE structures are typically used to navigate limits on foreign ownership. If you're a tech company in China seeking to attract capital from foreign shareholders, but there's a limitation on foreign ownership, you might employ a VIE structure in order to list in the US.

VIE structures are contractual agreements that provide access to a company's economic benefit without actual ownership of the underlying assets. They've been an accepted norm for some time and represent a reasonable share now of the MSCI Emerging Markets Index benchmark.[2]

So what's happened?

Recently we've seen moves to review VIE mergers and acquisitions. And, in recent days, we have seen a move to disallow VIE structures in the private-education space. These moves led to a reassessment of risk, specifically as to whether the structures are under threat. Any stock that employed a VIE structure saw a marked increase in risk premium.

Can you explain why the government has put particular pressure on educational companies?

Education is highly competitive in China, meaning that it's also difficult to get into top universities. Where a student goes to school can have a large impact on the student's opportunities later in life. As a result, there is very strong demand for private tutoring. This brings with it two issues:

First, you get a very serious burden on young students that may bring forth issues of societal harm. Second, there's a very heavy cost associated with private tutoring, which can exacerbate issues of inequality. Together, these issues can potentially have a negative impact on birth rates.

China has an aging population, and the birth rate has been falling. This may be because parents wish to focus all their attention and resources on a single child or on the general cost of housing. This all ties back into reform being driven by a combination of Communist party legitimacy and national interest.

Chinese companies have listed in the US through so-called American depository receipts[3] (ADRs)—a practice the Chinese government has indicated it does not favor. What do you think is going on there?

I think there are issues of control that have prompted a desire for regulation—e.g., the control of data and a simple desire not to see Chinese companies list in the US.

Obviously, the US itself might drive delisting. The Holding Foreign Companies Accountable Act—signed at the end of President Donald Trump's term—basically specifies that within three years, certain documents relating to audits must be supplied to the Public Company Accounting Oversight Board.[4] If you don't do that, then the relevant stock gets delisted. So it might not be the Chinese who force delisting, it might be the US. But it's clear that the Chinese would prefer that companies do not list in the US.

[2] MSCI Emerging Markets Index is a free float-adjusted market capitalization-weighted index that is designed to measure equity market performance in the global emerging markets.

[3] An American depositary receipt is a negotiable certificate issued by a US depositary bank representing a specified number of shares—often one share—of a foreign company's stock.

[4] The Public Company Accounting Oversight Board is a non-profit organization that regulates auditors of publicly traded companies with the purpose of minimizing audit risk.

We don't necessarily see a Hong Kong Special Administrative Region[5] (SAR) vs. a US listing as being detrimental. The US represents a huge pool of capital, and tech companies from China may also want to list there for reasons of status and comparability with US-listed tech.

But when you list in Hong Kong SAR, you can also get approval for southbound Connect,[6] enabling Chinese mainland investors to buy your stock (and there is a huge pool of savings in China). So our expectation is that US-listed Chinese companies will probably have a dual listing in Hong Kong SAR, if they don't already. They might also delist from the US, but we don't expect this alone to be materially detrimental to their valuation.

Some very well-known Chinese technology companies have seen shares fall 35-50%. Is that overdone?

There is a lot of uncertainty in the market at the moment. Regulatory uncertainty could impact corporate returns. The push to better align the interest of the private sector with national interest could also impact corporate returns. VIE structures are under scrutiny, and there is broader uncertainty around the impact of a policy shift toward common prosperity on the economy and the private sector. All of that uncertainty has lifted the risk premium and driven an expectation that returns may be suppressed. That has driven market stress.

So what now?

Ideally, Chinese authorities would offer some degree of confirmation that VIE structures will be respected. That's important. Additionally, we'd hope to see a degree of regulatory stability. If new rules are established with a degree of stability in regulation, that might give people the opportunity to assess the operational impact. We might then see the risk premium begin to come down, but it could take time.

How would you view China as an emerging-market investor?

We have been cautious regarding China throughout the first half of the year.

Initially, it was a function of valuations. China had a very good 2020. It managed COVID-19 well in terms of implementing stringent lockdowns, controlling the virus, and seeing normalization ahead of other countries. China's tech-heavy composition was supportive of the MSCI Emerging Markets Index last year because its tech names performed very well. This year we've been concerned about a couple of things. First, there was a "rollover" in China's credit impulse, the change in the level of credit extension, which peaked in Q1 and has moved negative. The second being the broadening out in regulatory pressure. We've also had a softer-than-expected consumption environment. We were already cautious, and have remained so.

Looking forward from here, regulatory headwinds could potentially fade. You might also see the authorities take their foot off the brakes in terms of stimulus withdrawal.

China is still a very large market with high levels of innovation. It's highly integrated with the global economic system and will remain a major supplier to the rest of world for a very long period of time. Even so, tensions between China and the US will, in our view, persist. And there may be additional implications from that.

[5] A Special Administrative Regions is an area that falls under the general auspices of one country but which has maintained a separate political and economic system. The term is most often associated with Chinese autonomous regions.

[6] The Southbound Connect is a mutual market access program through which Hong Kong and international investors can trade shares listed on the Shanghai Stock Exchange and Shenzhen Stock Exchange via the Stock Exchange of Hong Kong and their existing clearinghouse.

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