China-US tech decoupling – implications for global portfolios

- **Recent meltdown in Chinese tech equities points to a potential decoupling of the sector from that in the US. China appears to be charting its own course for this strategically important sector of innovation.**
- **For long-term global investors, China is too big to ignore – even after adjusting for a 'different' investing climate. Paradoxically, having a well-defined exposure to China is more important now than ever.**
- **While regulatory risks have clouded the near-term outlook, market reaction has been extreme too. We remain constructive on the broader theme for the long-term. We think investors with no China exposure risk missing opportunities there.**

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What

CSI Overseas China Internet index has fallen by c53% since its mid-February 2021 peak, as of July 27 2021. There are several reasons behind the poor performance of this equity market segment. Of course rise of Chinese regulatory risks has been the most prominent of all. Whilst markets are worried about the near-term regulatory risks, we see the current performance trends indicating an accelerated policy-driven decoupling of US and China tech. This could cause global tech industry to bifurcate into two spheres.

So what

China's share of global GDP adjusted for purchasing-power-parity was c18% in 2020 and is expected to climb to more than 20% by 2026. Chinese manufacturing sector contributes c30% to the global manufacturing. China houses one-fifth of the global population; boasts one of the highest middle income class populations and the e-commerce penetration is one of the highest in the world. We think long-term investors are better served by having a well-defined exposure to China, for it is too big to ignore.

Now what

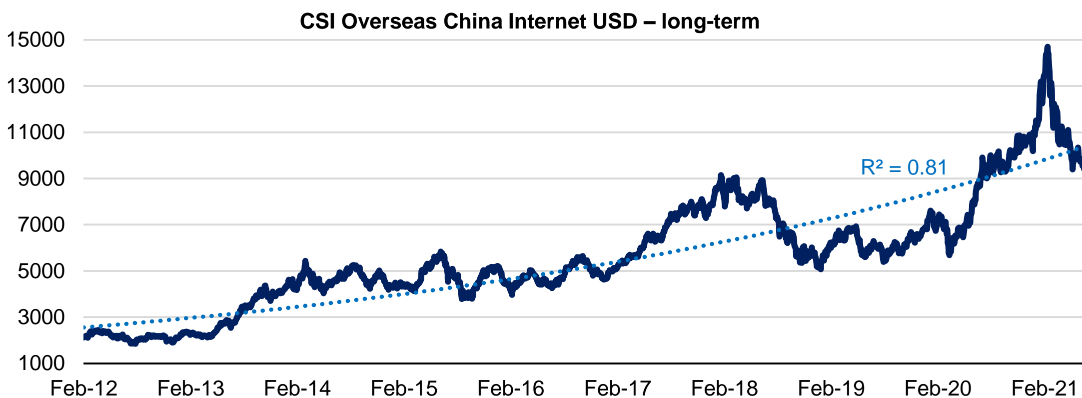
Near-term outlook for China technology sector was clouded by regulatory risks. However, constructive case for long-term investors remains in place. Further, we think the best way equity investors can play the decoupling is by having proportional allocations (in relation to benchmarks) to both US and China innovation themes. This approach, in our view, provides a diversified exposure to both models of governance. It also provides geographical diversification.

The recent melt-down

CSI Overseas China Internet index has fallen by c53% since its mid-February 2021 peak, as of July 27 2021 (exhibit 1). There are several reasons behind the poor performance of this equity market segment. Of course rise of Chinese regulatory risks has been the most prominent of all. But also adding to concerns were rising tensions between US and China which saw the US SEC make some progress on the Holding Foreign Company Accountable Act (delisting bill), growth-to-value rotation that persisted earlier this year, and concerns about a structural peak in the prospects for China internet sector. Also noteworthy is the year-to-date the underperformance of the broader Chinese equity market relative to global benchmarks – this can be attributed to weakening growth momentum in the world's second largest economy with the credit impulse there turning negative during the recent months.

A broader de-rating of the sector valuation has driven the price declines. For the context, P/E multiple of the Hang Seng Tech index has fallen from c45x at the peak in mid-February to the current level of 18.2x. For comparison, the current valuation multiple of Nasdaq-100 index is 36.8x. Of course while the earnings revisions have come through (12M forward EPS on Hang Seng Tech index were revised down by c20% since the mid-February peak), they have been far outpaced by the valuation de-rating. It is worth, however, in keeping in mind that earnings uncertainty (measured by dispersion of earnings estimates by earnings) remains high.

Exhibit 1: Overseas listed China internet sector equity prices – cyclical around a strong structural trend



Source: China Securities Index Company, Bloomberg, and ADCB Asset Management

China is charting its own course

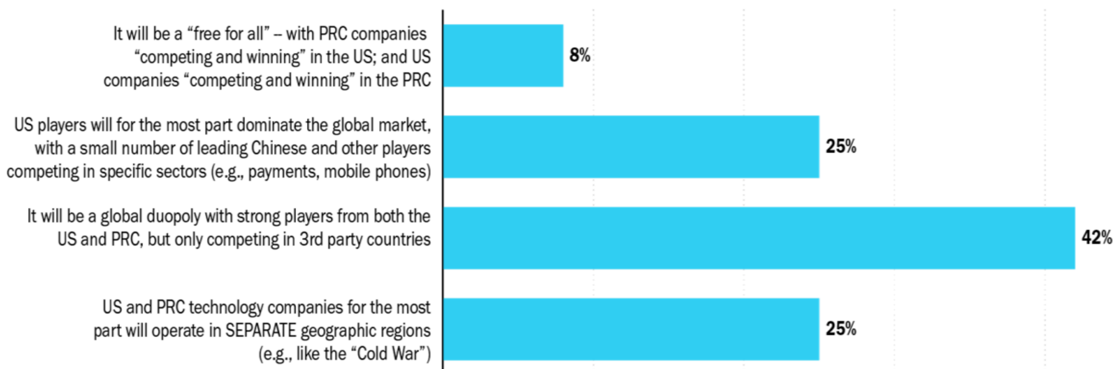
Regulatory crackdown in China has taken much of the mind space of investors over recent months – rightly so we believe, given the speed and scope of the curbs. There could be several reasons behind the ongoing regulatory tightening in China, these include making corporations share their prosperity with workers, reducing costs to the consumers, to protect start-ups from established giants, to rein in the most high-profile tech billionaires, to make companies focus more on social governance, and also perhaps China wants its big tech to do 'foundational research' and aid the Government in achieving goals laid out in the Five Year Plans.

However, an observation to be made is that the overseas listed Chinese companies have been impacted more than domestic companies as most of the regulations were targeted at the Chinese internet sector that has seen many overseas listings over the past several years. As a result, this rising regulatory scrutiny is straining the overseas listed Chinese companies that have acted as a bridge between the west and the east. US-China relations are likely to remain at least a background concern over next years, with the recent meeting between officials described as a "stalemate". Long-term investors should prepare for continued tensions. China's position as the world's largest manufacturer gives it economic leverage now, but localisation and digitisation will likely reduce that dominance over the next decade. That changes China's economic position, and changes the cost of economic action against China by other countries.

In one way, China is perhaps leading the pack in terms of setting suitable boundaries for its technology companies – which undoubtedly have gathered strategic importance over years. In our view, it would be a stretch of the imagination to think of the recent regulatory crackdown as akin to killing the golden geese. Instead, perhaps the new model that Chinese regulators want the big tech there to adopt is that of a 'China-centric' one rather than 'border-free' model that most new-age companies across the world have embraced over the past years. Also, making the large tech companies a part of the national strategic plans (14th Five Year Plan) appears to be the direction that Chinese authorities seem to be taking.

To us, recent changes in the regulatory environment point to more decoupling of the two tech worlds – China and the US, as the former embraces a 'new model' and charts its own course on shaping up this strategic sector. This is also evident from a poll by Brookings Institution (exhibit 2) – answered by 158 senior business executives working for American, Chinese, European, Japanese, Taiwanese, and Korean global high-tech firms – where the majority pointed to a potential decoupling of China and US tech sectors over the next 10 years.

Exhibit 2: What will be the competitive dynamics of the global technology industry in 10 years?

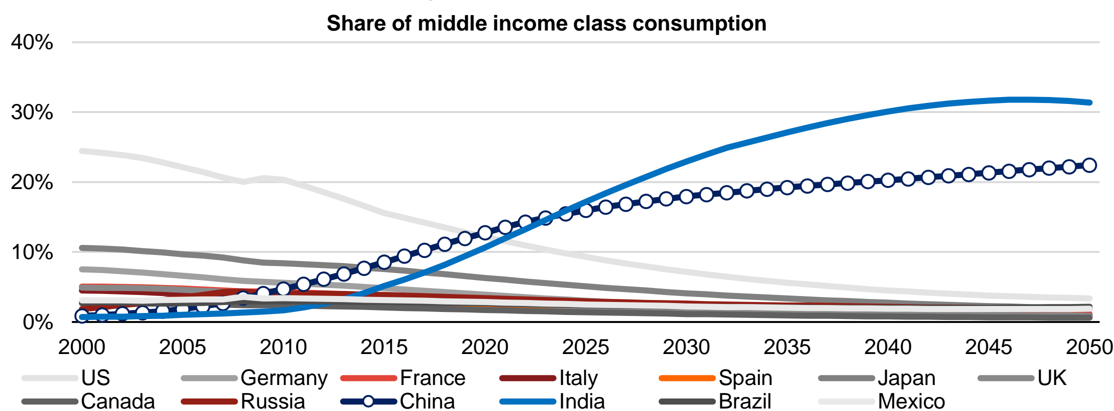


Source: Brookings Institution (How global tech executives view U.S.-China tech competition, February 25, 2021), Bloomberg, and ADCB Asset Management

China is too big to ignore

China's share of global GDP adjusted for purchasing-power-parity was c18% in 2020 and is expected to climb to more than 20% by 2026. Chinese manufacturing sector contributes c30% to the global manufacturing. China is home to one-fifth of the global population. China also boasts one of the highest middle income class populations (exhibit 3) and the e-commerce penetration is one of the highest in the world (exhibit 4). Yet the share of Chinese equities in global benchmarks remains low at c5%. This massive disconnect is further exacerbated by allocations to Chinese corporations by international investors remaining 'underweight' relative to benchmark despite efforts by Chinese policy makers to attract foreign capital on their domestic bourses.

Exhibit 3: China also boasts one of the highest middle income class populations



Source: Brookings Institution, Bloomberg, and ADCB Asset Management

China in global equity portfolios

This 'tech-decoupling' calls for investors to reassess their investment philosophy towards China, we think. Especially as China adopts a different model in terms of regulating and nurturing its strategic sectors, it might increasingly be important for investors to view China tech and US tech as two distinct ecosystems. We think the best way equity investors can play is by having proportional allocations (in relation to benchmarks) to both US and China innovation themes. For the context, US is c59% of MSCI All Country World Index (ACWI) while China is c5%. Both equity indices are however rich in innovation and technology themes.

This approach, in our view, provides a diversified exposure to both models of governance. It also provides geographical diversification. Some of the investors who are accustomed to the western model of investing over years might find the new model of China 'different'. However, in our view given the rising importance of China on the global stage, lack of allocations to the second largest economy in the world could cause investors miss the opportunities there. No doubt the risks around investing in China are going to be different and in many cases higher, yet we believe these are the risks worth taking – especially over the long-term.

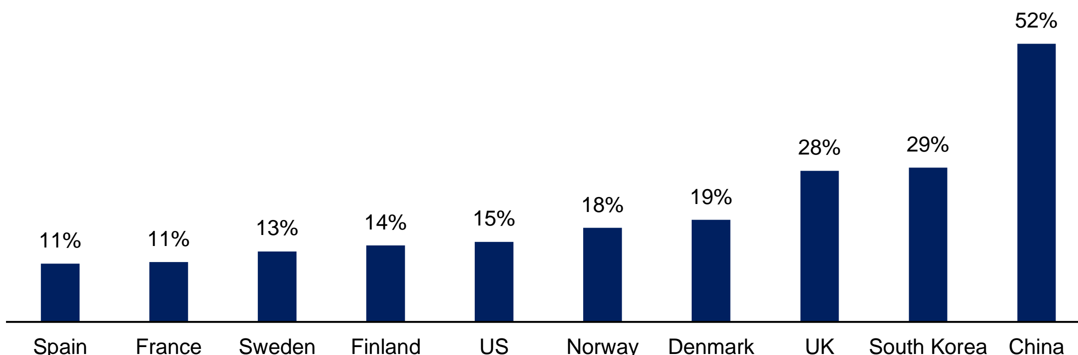
Regulatory risks and the near-term

In the very near-term there is reason to be worried about the scope of further crackdowns across the sectors. Also, the pace of the regulatory crackdown/reforms has been blinding leaving investors worried about the prospects for the overall market. This, we do agree, could influence the near-term risk-taking behaviour of the Chinese entrepreneurs and thus could impact the fundamentals.

Yet, it is also important to bear in mind that majority of the share price declines could be behind us already and now is not the time to panic. Whilst concerns around turning the after-school tutoring sector to non-profit status are widely prevalent, we would observe that the sector itself has a smaller fundamental bearing (than suggested by price declines) on the overall technology industry in China.

Also, e-commerce in China counts for a much larger proportion of overall retail than the US (exhibit 4). Therefore, disruption to the Chinese e-commerce activity has potential to also impact the consumption and subsequently the growth rates of the economy – creating a malicious feedback loop. However, the sooner the regulatory crackdown ends, the faster these concerns dissipate.

Exhibit 4: e-commerce in China counts for a much larger proportion of overall retail than the US



Source: eMarketer (December 2020), and ADCB Asset Management | Notes: *includes products and services ordered using the internet via any device, Management | Notes: *includes products and services ordered using the internet via any device, regardless of the method of payment or fulfilment; excludes travel and event tickets, payments such as bill pay, taxes or money transfers, food services and drinking place sales, gambling and other vice goods sales.

Positive long-term outlook

On the positive side, the new regulatory regime could in fact increase innovation and promote competition over the medium to longer-term. Also, should China turn successful in increasing the birth rates (this has been cited as one of the reasons behind cracking down on costly after-school tutoring industry), the country could get a demographic boost. This should then allow various industry players to benefit from increased volumes, while innovation could help boost profitability over years to come.

Looking at the history, the Chinese technology has delivered meaningfully higher returns relative to the broader Chinese market and the returns over the past decade were comparable to those from US technology, of course with some volatility around the trend.

In our view, long-term global equity investors should now be thinking of increasing the exposure to the sector rather than exiting/cutting the same. As such, the decoupling narrative – which is not being widely discussed in the market, but is the central thesis of this report – should provide another reason to maintain/increase exposure to China tech segments.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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