Investment Strategy

The Equity Thematician | March 14 2022

بنك أبوظبي التجاري
ADCB
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China technology sector update

- **China tech remains a strong long-term theme, but is in the crosshairs of geopolitical risks.**
- **The sector has been severely impacted by heightened uncertainty around regulatory tightening.**
- **We think investors need to differentiate the vehicles through which they get this exposure.**

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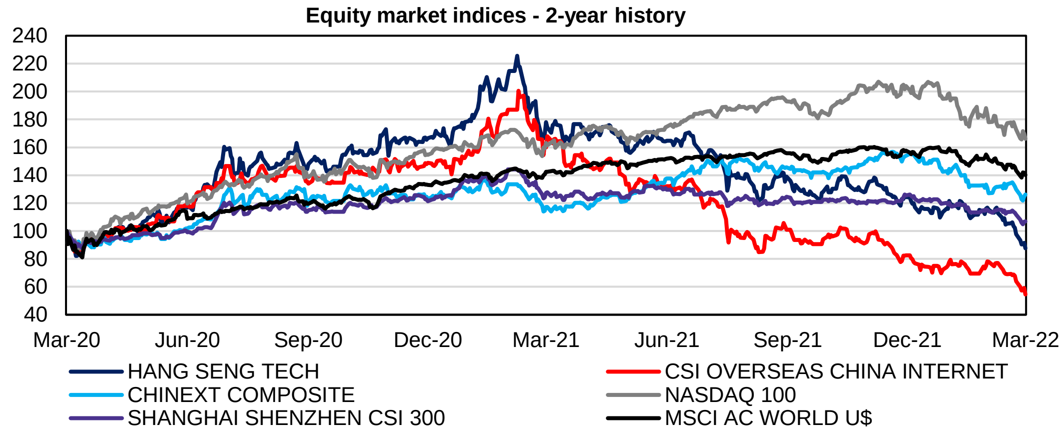
The context

About two years ago, in our note titled 'The Equity Strategist: Thematic thinking and portfolio tweaking', we identified Chinese technology segments as a long-term investment opportunity for investors. Whilst the theme represents only a small share of the global equity benchmarks (less than 3% of MSCI All Country World Index), we found the growth opportunity for the segment very compelling. After all, China is too big to ignore and technology is a strategically important sector across the globe. 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 and the e-commerce penetration is one of the highest in the world. Yet the share of Chinese equities in global benchmarks remains low at c5%. This massive disconnect is further exacerbated by international investors remaining 'underweight' relative to benchmark on Chinese corporations despite efforts by Chinese policy makers to attract foreign capital on their domestic bourses.

Performance trends – one year up and one year down

As can be seen from exhibit 1, for about a year since we introduced the call on China technology theme, it did outperform global equities quite strongly. However, over the past year the performance was quite negative. This made the index do a round trip over this two-year time-period. The reasons behind this are detailed in the following paragraph. For now, staying with the chart below, we would highlight the divergence building between the Hang Seng tech index and CSI Overseas China Internet Index – while both have lost value over the two-year period, the underperformance of the latter is noteworthy. ChiNext composite (which is a smaller cap way to play this theme) has in fact registered gains over the same period. Yet, the US tech (as measured by Nasdaq-100) has outpaced all its Chinese counterparts.

Exhibit 1: How do you want to play it? – various indices of Chinese technology sector



Source: MSCI, Hang Seng, CSI, ChiNext, Shanghai & Shenzhen, Nasdaq, Bloomberg, and ADCB Asset Management

What caused the weak performance over the past year?

There are several reasons behind the poor performance of this equity market segment over the last 12 months. 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), and concerns about a structural peak in the prospects for China internet sector. Also noteworthy is the underperformance of the broader Chinese equity market relative to global benchmarks – this can be attributed to weak growth momentum of the Chinese economy during 2021 after being the only major economy to have registered economic growth in 2020. However, we think 2022 could play out differently with Chinese growth accelerating and growth of the major developed markets decelerating (see Q4 2021 Outlook: Sequenced, not synchronised, October 2021).

What caused the weak performance over the past month?

Here again, there are several reasons to point out. To start with, persistent inflation and prospects for higher Fed funds rate has caused weakness in the global technology sector (which tends to be long-duration and hence vulnerable to rising rates). Russia-Ukraine war caused weakness across global equities. Perhaps, a little more so in the Chinese overseas listed technology names as markets extrapolated the Russia-Ukraine situation to China-Taiwan one (which we think is not an apt comparison in many dimensions). In addition, concerns about the ongoing COVID-19 related restrictions in Hong Kong caused weakness for the HK market broadly. On the idiosyncrasies relating to the Chinese tech sector, a more recent news flow – regarding China launching an internet 'purification' campaign, and US Securities and Exchange Commission (SEC) announcing that five New York-listed Chinese companies faced delisting in early 2024 if they failed to hand over audit documents backing their financial statements – all created headwinds.

How to think about China tech now?

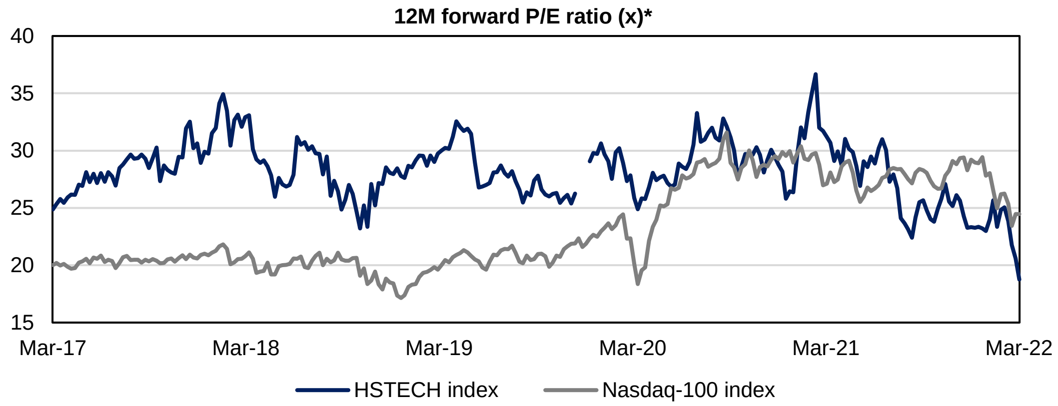
Regulatory crackdown in China has taken much of the mind space of investors over recent months – rightly so we believe, given the speed and scope of the curbs. There could be several reasons behind the ongoing regulatory tightening in China, these include making corporations share their prosperity with 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. In one way, China is perhaps leading the pack in terms of setting suitable boundaries for its technology companies – which undoubtedly have garnered strategic importance over years. 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) tell us about the direction Chinese authorities seem to be taking. One could argue that, taking a near-term pain for long-term gain approach, Chinese regulators seem to be preparing their tech companies for the long-haul.

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. This can also be seen in the massive underperformance of CSI Overseas China Internet Index relative to HSTech, ChiNext index, and MSCI China IT index. 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 few years. Long-term investors should prepare for continued tensions (see China-US tech decoupling – implications for global portfolios, July 28 2021). Here, we believe investors need to think about their vehicle (products) through which they should get exposure to the strong theme of Chinese technology. Near-home/domestically listed companies across market cap sizes (large/mid/small) could be of help. Over the near-term, regulatory headwinds from both China and the US could persist for the sector. But we see limited impact to the fundamental outlook of the sector overall. Reflecting the weaker sentiment and concerns of delisting, valuations have dropped quite significantly over the past few months (see exhibit 2).

Bottom-line

Whilst further near-term headwinds cannot be ruled out, we think the fundamental impact on the sector is limited. Yet, going forward, we think investors need to differentiate the vehicles through which they should get exposure to the still strong theme of Chinese technology.

Exhibit 2: Chinese technology (HSTech index) valuations have cheapened significantly



Source: Hang Seng, Nasdaq, I/B/E/S, Refinitiv, and ADCB Asset Management | Note: *Data for HSTech index based on bottom-up aggregation of 30 companies data using a one-company approach

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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