

Exchanges at Goldman Sachs

How Are Investors Navigating China's Regulatory Uncertainty?

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Allison Nathan: This is Exchanges at Goldman Sachs. And I'm Allison Nathan, a Senior Strategist in Goldman Sachs Research.

In this episode, we're going to discuss the impact of China's heightened regulatory scrutiny on the capital markets and the implications for investors. To do that I'm sitting down with my colleagues from the Asset Management Business, Stephanie Hui, Basak Yavuz and Prakriti Sofat.

We'll first turn to Stephanie who leads Goldman Sachs' Private Equity business in Asia with a focus on growth equity investments. Stephanie, welcome to the program.

Stephanie Hui: Thank you, Allison.

Allison Nathan: To start us off, we've seen a series of regulatory changes in China that have obviously rattled markets. Can you first just give us a sense of the nature of some of these changes and their significance?

Stephanie Hui: So, two weeks ago there have been announcements that rattled the stock market. It started with the edtech sector. There the government announced that after school tutoring for kids from K-12 need to turn non-profit. There were restrictions in capital raising for these types of companies. IPOs not allowed. And foreign investors should not make investments there. So, the purpose of that, stated, is to lower costs and anxieties of child rearing.

I think shortly after that there were other announcements that were made. The focus spans across different sectors. And I would say other areas include, for example, cyber security; specifically, companies that have more than 1 million users need to apply for cyber security approvals before they actually can list in another country. Antitrust is another area that people are looking in. And so, I think that flurry of announcements caused the market to be very jittery in the last two weeks.

So, I've been investing in the region in private equity for the

last 25 years. I would say over the years there have been a lot of cycles that came through. Right? I remember the Asian financial crisis '97, SARS. There was, of course, the GFC. And in between the volatility, it was always constant.

I would say this time around it came fast in terms of the regulatory changes announcement. It came quite broad. And it came serial in terms of, you know, every day, every other day. So, it did cause people to pause and take a look at it.

But that being said, I would say this change is not particularly very different from previous ones in the sense that, you know, there will be adjustments that will be made. And we'll learn and we'll grow from here. So, uncertainty, but definitely opportunity going forth.

Allison Nathan: And so, what are we seeing in terms of private investor flows? Are clients beginning to reallocate funds away from China? How have they responded?

Stephanie Hui: Because we're in the private markets, the reaction is not that stark yet. We're seeing people pondering, understanding, learning. But we're not seeing any dramatic reaction at this moment in time. I think, fundamentally, people still believe that China is a very important market. It's large. It's growing. And that this is more adjustment targeting internally to, quote/unquote, "fix" the economy so that it could be long-term sustainable.

But that being said, interestingly, if you observe the public markets, while all that volatility was coming through in China, in the last two weeks in India, we actually saw that there were a number of early-stage tech deals that were getting, you know, very strong funding closing. And also, some of the debuts of the public market trading tech companies were doing very well. So, while we'll try to put two and two together and say it's moving from China into India, I wouldn't conclude it that way. But I would actually say that it makes people think more about diversification of geographies and diversification of sectors and industries.

And I think a lot of the private investors remain very focused. I would say the pipeline deals that we have been discussing with all the discussions still going strongly.

Allison Nathan: So, has this changed your medium or longer-term thesis behind the growth opportunities in the region?

Stephanie Hui: So, we are focused on four sectors in terms of growth investments. Namely enterprise software, fintech, consumer and healthcare. And I do think that the whole theme of digitization, and hence enterprise software, fintech, it will continue. Infrastructure still needs to happen. And people are not going to go back on that. So, we continue to look into quality companies led by good management teams in those sectors.

And in consumer, for Gen Z, the whole theme about them being more individual, sustainable, you know, looking for products that are quality rather than clutter, I think that will continue. And we just have to, again, overlay with the lens of what is good for society as we make these investments.

And by the way, some of these sectors are new. So, we have to expect that regulations will catch up at some point. And so, that any of those coming through would not be a surprise.

And in healthcare, I think the key there is innovation. New stuff, which is good for society, which helps make the people healthier, I think that there will always be a need for that. That therapeutic gap is there and will remain there. So, we will continue to look into that. And the key, I would highlight again, is margins that are fair and sustainable. And that's how we're going to look at the sectors. But if you asked me today, I would still say that those four sectors are sound and good. And hopefully the valuations will be more reasonable.

Allison Nathan: Right. So, what I'm hearing from you is this really hasn't changed your view on the opportunities in the region, the sectors that feel the most compelling from a growth perspective. But ultimately, it's just putting a different lens on it as well?

Stephanie Hui: Absolutely. If there's one element that is constant, it is change. And from our perspective, it's understanding the change, seeing the change, and continue to look forward. But I do believe the size/scale of the marketplace will sustain our investments going forth.

Allison Nathan: I think that is a key question in the sense that, you know, can we still see the type of growth and innovation that the region has been known for in the wake of these type of developments? What is your sense of that?

Stephanie Hui: For sure. I think innovation, economic growth,

job creation--it's imperative. It will continue. I would see this as adjustment for quality, for social goodness. In fact, you know, for the last, I would say, two or three years there has been a lot of talk about ESG, about diversity. And I would see this as highlighting the S within the ESG side, right? Sustainability. When we make investments now, we need to consider increasingly, is it good for society? But what does it mean for equality? Is it good for the next generation? You know, what would regulators think about these types of industries? And it is imperative that we actually factor that in when we look at sectors, industries, and company.

So, I think as the market calms down, and by the way, we're starting to see a bit of that happening already, there will be renewed interest into the markets. And it's probably not a bad thing for the valuations to get adjusted because it was actually getting pretty hefty, I would say, in the run up in the last 12 to 18 months.

Allison Nathan: So, the market is beginning to digest this at this point and sort of looking ahead?

Stephanie Hui: Absolutely.

Allison Nathan: Well, thanks so much for giving us this insight Stephanie. We appreciate you joining the program.

Stephanie Hui: Thanks a lot, Allison. It's a real pleasure.

Allison Nathan: We'll now turn to Basak Yavuz who is Co-Head of Emerging Markets Equities, and Prakriti Sofat, a Fixed Income Portfolio Manager, to discuss the regulatory impact on equities and fixed income markets. Basak and Prakriti, welcome to the program.

Basak Yavuz: Thanks for having us.

Prakriti Sofat: Thank you.

Allison Nathan: We just spoke with Stephanie about the impact of China's regulatory moves on private investor flows. What's public investor sentiment looking like in the wake of these developments? And Basak, you're an investor in China on the equities side, so maybe you can give us a sense of how you're viewing these developments.

Basak Yavuz: Sure. It has been a busy and volatile summer for

sure for China investors. Year-to-date, China is down by 10 percent versus EM-ex China up by 10 percent. Last year, of course, China outperformed other EM markets significantly. But still, we are not expecting such a big divergence in performance from China this year. Of course, this was all because of the regulatory changes that we are seeing.

As investors in China, having regulatory uncertainty and volatility is not desirable, but some of these changes actually might end up being positive in the longer term. We are mainly talking about a regulatory catch-up in the internet sector. The internet sector has grown by leaps and bounds in the last decades. And that was on the back of continuous innovation on the technology and financing. But very lax regulatory framework also helped these very high levels of growth.

Now the Chinese government is defining the rules and making sure that big companies do not have monopolistic behavior, gig workers are treated well, and there are regulations around data privacy and data security.

Allison Nathan: So, what's an example of that?

Basak Yavuz: Until very recently, if you were a merchant wanting to sell goods online, you had to choose one of the platforms for exclusive distribution. And you wouldn't be allowed to sell your goods in other e-commerce platforms. So, the government intervened. This is one of the antitrust measures. And made sure that the merchants are able to sell their goods in different platforms.

Same goals with gig workers. Now the delivery drivers will have access to medical insurance, social security. They will have better workplace security and safety. And they will always be earning wages above minimum wage. So, these are the type of things that I mentioned, saying that it's not necessarily bad. And it will be long-term positive.

Allison Nathan: And Prakriti, what are your thoughts? What are you hearing and seeing from investors in the fixed income side in the wake of all this?

Prakriti Sofat: Thanks. So, maybe I would like to start with putting a little bit of context on the regulatory changes. Over the last 12 months, you know, we've already seen a lot of regulatory policy action from China on the property sector, which is consistent with President Xi's tenet that houses are

for living and not for speculation. And we've also seen a lot of regulatory action on deleveraging, especially around shadow banking.

From a fixed income perspective, what has also been relevant is an acceptance of defaults. And this is connected with the policy view that there needs to be credit differentiation and also address the moral hazard problem which exists in China credit. So, we have seen, for example, two SOE-linked corporates default, as well as two property developers. Right?

Now, from that context, if we shift to the recent headlines around the education sector as well as the technology sector, I think it's fair to say that it caught a lot of fixed income investors off guard. And the main question that we are getting right now is that which sectors will be impacted next. We think that the recent developments should actually be seen as part of a broad policy shift of themes in China as we are shifting from a focus on the quantity of growth to a focus on the quality of growth, as well as social equity and sustainability. We think that sustainability focus means areas such as data security, national security, monopolistic behavior, and also common prosperity and environment.

Now turning to your question on what are we hearing in terms of investor sentiment directly. I would say that for the corporate bond investors, the sentiment is quite fragile. And this is because the pace of changes has been quite high, which is increasing uncertainty and volatility. But also, in the context of acceptance of higher defaults. And that is making, you know, the sentiment fragile.

If I shift to local rates investors within the fixed income space for China, so Chinese government bond markets, I would say there the sentiment is constructive because it is a risk-free asset. And actually, as growth headwinds are picking up in China, policy is going to be supportive, as we saw recently in the RRR cut.

So what we've observed is that Asia high yield, as well as Asian credit market mandates, flows actually remain positive. And interestingly, a recent survey by a sell-side house showed that most investors are biased by the dip in China.

Allison Nathan: Basak, what about on your side? So, we've obviously seen this, you know, very substantial sell off in Chinese equities. You know, some negative sentiment is clearly

flowing through there. But given the sell-off, is it actually now time to buy?

Basak Yavuz: Sure. On valuation multiples, China was actually trading at a significant premium to the rest of emerging markets at the start of the year. And if you look at the benchmark, Chinese benchmarks were trading at all-time highs for the last 25 odd years. After the correction, now on multiples, China is in line with other emerging markets. So, I wouldn't call this very cheap, let's close our eyes and buy everything. There were times in the past where China was trading at lower multiples versus emerging markets. Having said that, we think that value is emerging in very selective sub-sectors.

Allison Nathan: So, what sub-sectors would you be most optimistic about?

Basak Yavuz: We should really align ourselves with the long-term developmental goals of the Chinese government. Decarbonization, for example, is very important. And there are many sub-sectors related to that. I'm thinking electric vehicles, battery producers, renewables and all relevant companies within that supply chain. The other theme is self sufficiency, especially related to semiconductors and other companies within the supply chain. There is a lot of focus on modernization and technology upgrades. There is also a lot of focus on blending online and offline. So, these are the areas where there is still a lot of innovation that is yet to come.

Allison Nathan: So, if you think about this broadly in a portfolio context, how should portfolio managers be thinking about their exposure to China equities right now? Should they be neutral? Should they be overweight? How are you thinking about that?

Basak Yavuz: We would recommend being neutral to overweights. However, as always, we want to have a very balanced portfolio between cyclical names and countercyclical. And it has to be a very balanced portfolio which is constructed bottom-up. And we should really avoid the temptation to have a call on the direction of the regulatory changes because, you know, we don't know what's going to happen with regulations. We don't think anybody knows what's going to happen next. So, it's so much better to stick to the bottom-up fundamental analysis.

If you think about it, China is the second-largest economy in the world. And there are 3,000 stocks to choose from. So, we

should be able to find companies that are really not in the eye of the storm when it comes to regulatory issues.

Allison Nathan: So, Prakriti, on the sovereign bond side, does anything look mispriced? Do you see opportunities? Is there value? What are you looking at at this point?

Prakriti Sofat: Yeah. So, the China government bond market, actually, has been very resilient in the face of these regulatory headlines. And in fact, since the middle of June, the China government bond market has rallied, primarily supported by the reserve requirement cut in early July. But also because, you know, it is a risk-free asset.

So, we think fixed income investors should be overweight in China bonds and received China rates. And this is because the risk reward is favorable. We expect additional reserve requirement cuts from the PBOC given the growth headwinds in the second half of this year on account of, you know, the property sector tightening, of course the recent resurgence in COVID. And with the regulatory tightening that we have seen over the last, you know, two months or so, we think that the risk of a policy rate cut has also increased. So, that sets a very supportive backdrop for China government bond market.

From a big picture perspective, Chinese bonds offer a very attractive carry relative to volatility versus other markets, both EM and DM of a similarly rated sovereign. There are very good diversification attributes of having China bonds in your portfolio given that they have low correlation with other rates, as well as credit markets. And finally, it is the world's second largest bond market and is also going into a multiple different indices. So, we think that there will be structural demand as well.

Allison Nathan: And what about the corporate bond market?

Prakriti Sofat: So, China offshore corporate bond markets, if you remove the idiosyncratic sectors which were impacted by regulatory changes, if you look at IG sector, there hasn't been much of a risk premium more broadly. But I think it's fair to say that a lot of risk premium has been built into the high yield sector. Most of this is, of course, concentrated in single B China property names which are currently trading at 10-year wides.

If we shift to the onshore corporate bond market, it's a very

similar story where investment grade has been holding up pretty well. But high yield, there has been a risk premium which has been built in.

So we are long, strong companies with improving balance sheets, as well as limited refinancing risks. We are tending to be short government supported or systemically important sectors within China. And the rationale being given the policy focus on credit differentiation and addressing the moral hazard problem. If you want specifics, I would just add that we are marginally overweight China property sector with a focus on national developers which have a diversified balance sheet and also have strong liquidity position.

Allison Nathan: So, let take a step back for a second and talk about liquidity. Prakriti, what are you seeing in terms of liquidity dynamics broadly in the market post these developments?

Prakriti Sofat: So, overall, liquidity conditions in the interbank markets are going to be stable. In fact, the PVOC in its Q2 monetary policy report stated that they're going to maintain reasonably sufficient liquidity. I think it's worth emphasizing that in China the policy trade-off is always between economic growth and financial stability. So, whenever growth risks are elevated, like we saw during the trade wars with the US or the pandemic last year, we see that there is a credit easing in a liquidity easing. But when the growth outlook is relatively constructive, such as 2017/2018, or even in the second half of last year, we see policy makers focusing on financial stability and increasing regulatory tightening. You will remember probably last year, you know, we had the three red lines announced for the property sector. And that was in the second half.

Now, in the current environment, growth is recovering in China. But it is bumpy. And it is uneven. Which means that while overall liquidity conditions are going to be stable, there is going to be a differentiation from the policymakers. And here we are seeing a clear focus on certain sectors such as small/medium enterprises, green and clean energy, higher value, and the tech sectors, especially for backward integration like Basak was saying earlier. But moving away from sectors like property and shadow banking. So, increased volatility has had some impact on corporate bond market trading liquidities as dealers were cautious. However, it is not big enough to constrain our ability to trade markets.

Allison Nathan: What about on the capital markets side? Basak, if we turned back to you and just think a little bit about some of these targeted sectors -- property, education, tech -- are companies in these sectors going to have difficulty raising money in their environment?

Basak Yavuz: I think education will be the most difficult, however, within healthcare there are many sub-sectors such as biotech, life sciences where a lot of innovation is taking place. And I think these sectors will continue to do very well. I doubt that given all the innovation, regulators will want to come after those companies and stifle the growth.

Property will be mixed. Property speculation is highly discouraged. That's for sure. So, on a selective basis, some property companies might find an audience. But I think it would be very, very few instances.

Prakriti Sofat: I would echo what Basak said that, you know, the education sector is going to be very difficult to borrow. And health sector somewhat better. I just want to add that, actually, health and education sectors reliance on corporate bond market is fairly limited, both offshore as well as onshore. So, the main focus on a fixed income perspective is actually on the property sector. And there, you know, the offshore bond market is shut. The onshore bond market, as well as trust financing, is shut. The property markets, you know, are able to borrow from the banks. But I think really the key point here is that given government regulation around the three red lines, it means that net borrowing is negative because property developers still need to deleverage. And companies simply need to accept this new operating environment and really focus on buying less land and selling their inventories faster, rather than just waiting for house prices to be higher before selling.

Allison Nathan: And there's also some talk about US-listed Chinese companies looking for secondary listings in Hong Kong. Basak, do you think we're going to see more domestically listed equities as a result of all of this?

Basak Yavuz: The migration from ADRs to local listings in Hong Kong, as well as mainland China, have already started. And this could be one of the very few areas where US government and Chinese government are in full agreement. They both want these companies listed in China. So, in total, there are about 250 companies, Chinese companies listed in the US through ADRs. And

most of the high-quality companies that we speak to already have deadlines and a roadmap. And they want to have listings back in Hong Kong or mainland China. And we think that stock exchanges and brokers, local brokers, will be the main beneficiaries of this trend.

Allison Nathan: So, finally, what's the risk that concerns about China spill over to the broader emerging markets universe? I mean, we often talk about contagion risk during these types of episodes. So, are you seeing any evidence of this at this point? Or do you think that's a risk going forward? Prakriti, maybe you can start.

Prakriti Sofat: Sure. So, I would say in terms of market impact, the China regulation-related volatility has not spilled over to Asia high yield, or in fact, you know, to the broader EM credit market. It's been very China specific. And in fact, within China, also, it's been very sector specific, you know, as we discussed earlier.

I think on a forward-looking basis, it could have some impact. And that would be a channel through China's growth. Right? So, the regulatory uncertainty is beginning to weigh on corporate sentiment in China. Overnight we got total social financing data. And it indicated that medium and long-term loans to corporates softened in the month of July amidst this, you know, regulatory uncertainty. And this is in addition to already existing headwinds to Chinese growth in the second half. Right? All the property-related deleveraging and also the resurgence of COVID that we are seeing.

So, I think it can impact overall risk sentiment towards emerging markets and also EM growth given that China is such a big component of it. And at the end of the day when you step back and think about it, EM is a growth asset, right? So, we could see, you know, some concerns on a forward-looking basis.

Allison Nathan: Basak, what about you? Do you see signs that this is spilling over on the equity side of the emerging market universe?

Basak Yavuz: I do agree with Prakriti. So far, it looks limited to certain sectors within China. And the rest of the EM doesn't seem to be impacted. On a one-year basis, all major EM markets are up nicely. And so far, we are not concerned about any contagion. But of course, Chinese growth is very, very important for the rest of the market. So, if Chinese growth disappoints,

it will have impact for EM, as well as DM in my view.

Allison Nathan: Thank you so much for joining us Basak and Prakriti and sharing your thoughts on these really interesting developments in China that, I'm sure, are going to continue to evolve.

Basak Yavuz: Thank you.

Prakriti Sofat: Thanks very much, Allison, for having us.

Allison Nathan: That concludes this episode of Exchanges at Goldman Sachs. Thanks for listening. And if you enjoyed this show, we hope you subscribe on Apple Podcasts and leave a rating and comment.

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