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Chinese Capitalism's Long March

- China's gradual embrace of private enterprises over the past thirty years has begun to recede and has become increasingly apparent in coincidence with the coronavirus pandemic.
- In the past year, signs of this retraction from private markets include forceful action to take away the profit motive for education companies, an attack on powerful technological companies, and let the downside of excess leverage in real estate fall on equity and foreign investors.
- This crackdown on some segments of the Chinese market and the risk that similar actions could be taken in other areas make China an impossible place to invest for now.
- That said, the Chinese government's objective of attaining greater social equality is noble and could reverberate in other parts of the world where the electorate is increasingly calling for a people-centric approach and capitalism that lifts all boats, not just a few yachts.

In China, physical assets, land and natural resources are controlled by the State. But starting in the late 1980's, China introduced an experiment of controlled capitalism with private enterprises. This experiment accelerated following China's accession to the World Trade Organization (WTO) towards the end of 2001 and continued, more or less unimpeded, until the coronavirus outbreak provided an opportunity to change direction.

There were signs of potential changes to the regulation of businesses before this year. In 2018, Xi Jinping became president for life with the elimination of term limits. Since then, *Jinping's Thought on Socialism with Chinese Characteristics for a New Era* – a set of policies and ideas derived from his writings and speeches – was progressively put into action. The first three basic points of Jinping's Thought are to ensure Chinese Communist Party leadership over all forms of work in China, taking a people-centric approach for the public interest, and continuing comprehensive and deepening reform. For an ESG-minded

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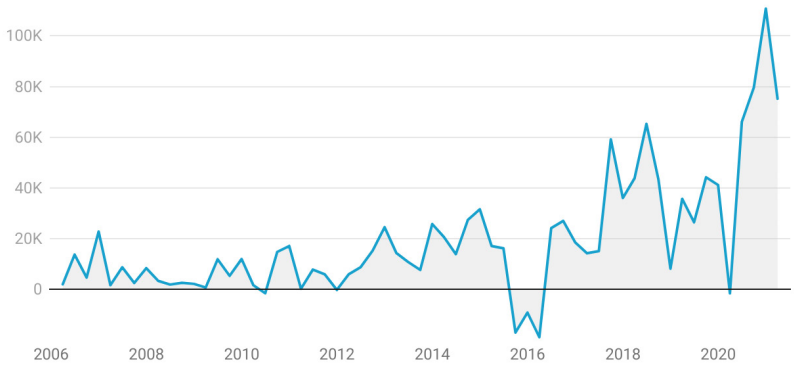
individual, this could be interpreted to combine societal and ethical objectives with profit incentives for businesses, narrow the wealth divide and reduce monopolistic rents. These are all commendable objectives that we expect to be part of the evolution of economies and markets around the world for the foreseeable future.

Why then do we see headlines like: "George Soros: Investors in Xi's China face a rude awakening"? George Soros, a renowned investor and philanthropist who has endorsed the report from the OECD looking at the 17 Social Development Goals of the United Nations as business opportunities, should - and probably is - in favor of more socially beneficial objectives for corporations, fewer inequalities and less monopolistic rents. We believe the underpinning of his objections lies in the governance structure of China with Xi Jinping's Chairman for life role. Another answer may reside in the speed and rigidity of action.

Indeed, a direct consequence of China's recentering around the State is that foreign investors are likely to significantly curb their enthusiasm for participating in Chinese financial markets; we expect fewer inflows into A-Shares going forward – especially in companies and sectors which have a high level of connection with the government. In the following section, we review certain sectors that have been particularly affected by recent government interventions.

Will investors change tack over China's (non) capitalist regime?

China BOP Securities Liabilities Non-Cumulative (USD millions)



Source: Sustainable Market Strategies via State Administration of Foreign Exchange of China • Created with Datawrapper

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SUSTAINABLE MARKET STRATEGIES

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Investments: Open the Floodgates to Foreigners

Foreigners have poured in significant capital in Chinese financial markets right before the crackdown started.

Education Becomes Non-Profit

Historical Performance of Largest Chinese EdTech Stocks



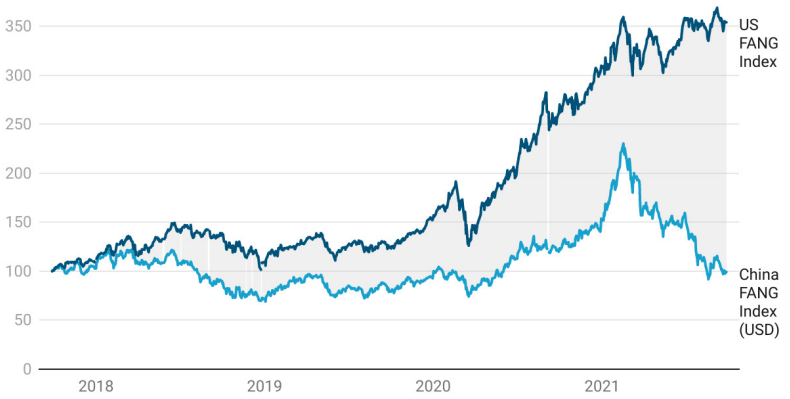
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Education: No Profits Allowed

In the education sector, profits can no longer be sought in China, by diktat. In July, the government barred tutoring companies from making profits, now requires all companies offering curriculum to register as non-profit enterprises and restricts new foreign investment in education-related companies. Businesses like TAL and New Oriental had essentially doubled their market value during the pandemic only to see their business models destroyed instantaneously.

With Great Power Comes Great Responsability

Relative Performance of Chinese and American FANG Indices



Source: Bloomberg and Sustainable Market Strategies • Created with Datawrapper

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Technology: No Laissez Faire

In the technology sector, profitability is enormous in both the US and China and issues of market dominance, personal data protection and mental health are prevalent in both countries. However, the Chinese government has taken a heavy-handed approach. The difference in regulatory approaches of the two countries is seen very starkly in the respective path of share prices of technology companies; U.S. and Chinese tech stock performance has diverged materially since the beginning of the year.

Too Big to Fail, Maybe Not?

Stock Performance of Real Estate Companies in China



Source: Bloomberg and Sustainable Market Strategies • Created with Datawrapper

Real Estate: Managed Laissez Faire

The real estate sector in China is one where debt levels have been unsustainable for a long time but where investors expected the Chinese government to bail them out in case issues surfaced. The desire for greater house affordability and reduced financial stability risks resulted in business constraints that hit levered real estate developers hard. While the Evergrande situation is not completely resolved yet, equity investors and foreign bond holders now anticipate a form of wind-down that will limit the impact on employees, house buyers and small investors but where investors counting on a bailout will suffer the financial losses. In essence, by limiting the downside on Chinese citizens at large while allowing investors to take a full hit, it appears that the Chinese government is

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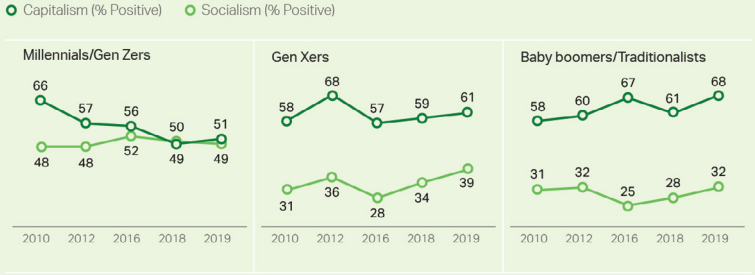
Chinese Capitalism's Long March

'showing' its citizens the risks and downfalls of free-market principles.

Overall, limiting the power of large technology companies and letting over-levered real estate developers fail while limiting the impact on workers and small investors are topics affecting policymakers around the world. Even ensuring education is a strictly public good is an appropriate discussion item. The concerns for investors arise from Xi Jinping having accumulated so much power with an opaque governance structure. Similar to the once-held belief in political circles that, with greater prosperity, China would follow democratic society's lead and provide greater representation for the people, investors are now finding that China operates under a different system where rules change without debate – so you need to be prepared. The big question for investors is: have prices fallen enough to warrant exposure to some blindside risks?

The choice between capitalism and socialism is political. Both forms of organization aim to provide the most efficient allocation of resources. Capitalism gives private actors ownership of property and the motive of profit as the incentive for proper allocation of resources. Conversely, Socialism allocates the means of production to meet human needs; there is no profit incentive to allocate resources.

Trend in Positive Views Toward Capitalism and Socialism, by Generation



Millennials/Gen Zers: Ages 18 to 39 in 2019
Gen Xers: Ages 40 to 54 in 2019
Baby boomers/Traditionalists: Ages 55 and older in 2019

GALLUP

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The results from different Gallup surveys in the United States over the years clearly show that Millennials and Gen Zers are losing faith in capitalism, while Gen Xers have a stable perception and Baby Boomers are increasingly favorable towards capitalism. Millennials, Gen Zers and Baby Boomers have a stable perception of socialism while Gen Xers are increasingly favorable towards it. The results still favor capitalism over socialism but it is interesting to see that those in older age groups who own financial assets are increasingly approving of free market concepts while younger people - those that perhaps struggle to find affordable housing - remain undecided about the best system.

Bottom Line

We cannot take for granted that capitalism, in its current form, is the most appropriate economic system. It has worked well for many decades in some countries to improve living standards, recent evidence supports the naysayers that argue that the burden of inequality in such system is too large. China is developing socialism with Chinese characteristics. For investors, it makes China a very difficult place to invest since the rules of the game are not pre-established and can change on a dime. In the long term, this competition from a new system may be a call for democratic governments to implement rules that reduce inequalities and monopolistic rents of large companies, most evident currently in technology and communication services.

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