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China crackdown

Last week, China unleashed a series of stunning and wide-reaching regulatory actions. This surprised investors and sent jitters to markets in Hong Kong and China. Particularly hard-hit were US-listed Chinese stocks. Though the damage was primarily felt in Chinese companies, emerging markets such as the Philippines were likewise negatively affected. Bloomberg estimates that investors lost $1 trillion in China's one week of market shocks.

Exodus from Chinese stocks

Expectations of further drastic actions from Chinese regulators have led to an exodus from Chinese and Hong Kong stocks. The Hang Seng Index fell by 9.5% in just three trading days and closed the week down 5.7%. Meanwhile, the CSI 300 dropped 7.8% before ending the week down 5.5%. The Nasdaq Golden Dragon China Index, which tracks the biggest Chinese firms listed in the US, fell 19.4% in the span of three days. These caused the MSCI Emerging Markets ETF (EEM) to decline 1.7%, further contributing to the 3.8% drop of the PSE Index last week.

Reforming key sectors of the digital economy

The regulatory crackdown has targeted internet-based Chinese companies which listed in the US stock market to raise more capital and potentially skirt the tight scrutiny of Chinese regulators. China's regulatory overhaul is focused on improving the cost and access to education, enhancing data privacy protection among overseas-listed companies, as well as reining the monopolistic behavior of giant digital companies. Below, we discuss four specific sectors / companies which were directly affected by the clampdown in China.

1. **Turning education into nonprofit.** The Chinese government has mandated that certain education tutoring businesses should be converted into nonprofit entities. This was a seismic shock for the sector as it totally negates the whole business model of some companies and puts into question their long-term viability. Private education stocks such as TAL Education Group (TAL), Gaotu Techedu, Inc (GOTU), and New Oriental Education & Technology Group (EDU) all fell by more than 50% when the regulatory overhaul was announced. These changes are meant to curb the rising cost of tutoring services and reduce unequal access to education in China.
2. **Cybersecurity review on Didi.** Popular-ride hailing company Didi Global, Inc (DIDI) held its US initial public offering (IPO) last month despite warnings from China's cybersecurity watchdog regarding its network security. The Chinese government recently launched a cybersecurity review of the company's data practices while also banning its app from mobile app stores. China is wary of the big data collected by Didi and how this can be used by foreign parties due to greater disclosure requirements in the US. Didi fell by as much as 49% from its IPO price of $14/sh before closing at $10.31/sh last Friday. The cybersecurity review not only covers Didi but also other US-listed Chinese tech companies.
3. **Tencent asked to give up exclusive music rights.** Tencent Music Entertainment Group (TME) was recently fined for anti-competitive behavior and was asked to give up its exclusive music rights, as well as other copyright fees for music content. Tencent has built an extensive library by purchasing

exclusive rights for content from the world's largest music companies. This has allowed Tencent to own more than 80% of exclusive music library resources and exercise monopoly control over the industry by earning fees from sublicensing content to other music streaming rivals.

4. **Breaking Ant Group's monopoly.** Ant Group's long-awaited IPO was abruptly suspended due to issues raised by Chinese regulators. Recently, the People's Bank of China (PBOC) has backed a restructuring plan that would cut the linkages between the company's payments business, virtual credit card operations, and consumer lending unit. Ant Group's parent, Alibaba, is likewise being investigated for monopolistic behavior.

Is China now uninvestable?

As a result of the slew of regulatory changes in China, many fund managers have significantly reduced or completely sold their Chinese exposure. Investors and portfolio managers are now assessing if China is still attractive considering its growth prospects, or if China is now uninvestable in light of rising regulatory risk. Some argue that the highly unpredictable business environment resulting from the Chinese government's recent actions have completely altered China's fundamentals.

US SEC halts Chinese IPOs

The US Securities and Exchange Commission (SEC) announced last Friday that it has halted the IPOs of Chinese companies pending more risk disclosures, particularly on the impact of the regulatory clampdown on financial performance. Considering this and the other developments on the China crackdown, we can see that regulatory risk is indeed part of investing in Chinese stocks.

Common prosperity

From an outsider's perspective, the actions of the Chinese government may seem irrational or counterproductive to its goal of opening up its country and promoting its digital economy. However, it appears that China may be asserting its long-term structural goals by adhering to a specific vision for its economy. China wants to promote common prosperity and equality by controlling the cost of education, keeping homes affordable to the masses, creating jobs, and enhancing data security among tech companies. In addition, China seeks to exercise more control over giant tech firms to prevent them from becoming too powerful.

In the meantime, the sweeping regulatory changes amid the China crackdown remain as major risks for Chinese and Hong Kong stocks. This can dampen the investment appetite for emerging markets such as the Philippines as fund managers favor the safety and predictability of companies which are operating in developed markets. Moreover, Asian countries are currently grappling with the Delta variant amid an uptick in COVID-19 cases. This can necessitate the imposition of strict lockdowns which can slow the spread of the virus but can also hamper economic activity and result in further stock market volatility.

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