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CHINA POLICY DEVELOPMENTS AND OUR TAKE

WHAT HAPPENED?

In recent weeks, regulatory uncertainties in China have intensified greatly, causing significant volatility in credit and equity markets. In the property sector, measures to stem-out speculation and restrict leverage at developers continue to be rolled-out. Additionally, new policy announcements have been made for the education and internet sectors.

	Sample of Recent Regulatory Actions
China Real Estate	- Three red lines framework - Higher mortgage rates in Shanghai - Introduction on land purchase caps - New notice on continued oversight of the sector and reforms in the next 3 years
China Education	- Restrictions on running for profit business models - Restriction on foreign investments (including through the VIE structure)
China Internet	- Food delivery platforms required to pay delivery persons above minimum wage and have access to social security - Banning of Didi from app stores, fining other internet companies and requiring Tencent Music to end exclusive music deals - Strengthened supervision on capital market developments

Given the current uncertainties, there are some fears in the market that China may be shifting away from its market-orientated economic model. There is also concern that regulations may be tightened even further as the state looks to control a larger share of the economy. In turn, this could stifle innovation, negatively impact corporate profitability and drag down growth potential of the economy.

On the capital market side, some corners have been jittery of China trying to distance its financial market from rest of the world by discouraging overseas listings. In fact, a lot has been written about whether the whole VIE structure would be dissolved following rulings in the education sector.

OUR TAKE

However, we don't share such extreme views. We believe policy measures are aimed at reducing systematic risks in the economy, bringing regulations up-to-speed with developments in the internet sector and also improving the balance between corporate power and the share of labor compensation.

From a holistic and strategic point of view the sectors being targeted are within our expectations of the government's long-term goals. These include **national security** (protection of data) as well as addressing the fundamental requirements of China's citizens, including **housing**, **education** and **healthcare**.

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In terms of housing, policies have long been directed at restraining home price speculation and abnormal price increases in order to keep homes affordable. A simultaneous objective is to avoid a major systemic bubble that could threaten the health of the financial system. Regulatory tightening in the property sector has been a continuous trend since 2017, and recent tightening measures must be seen in this context.

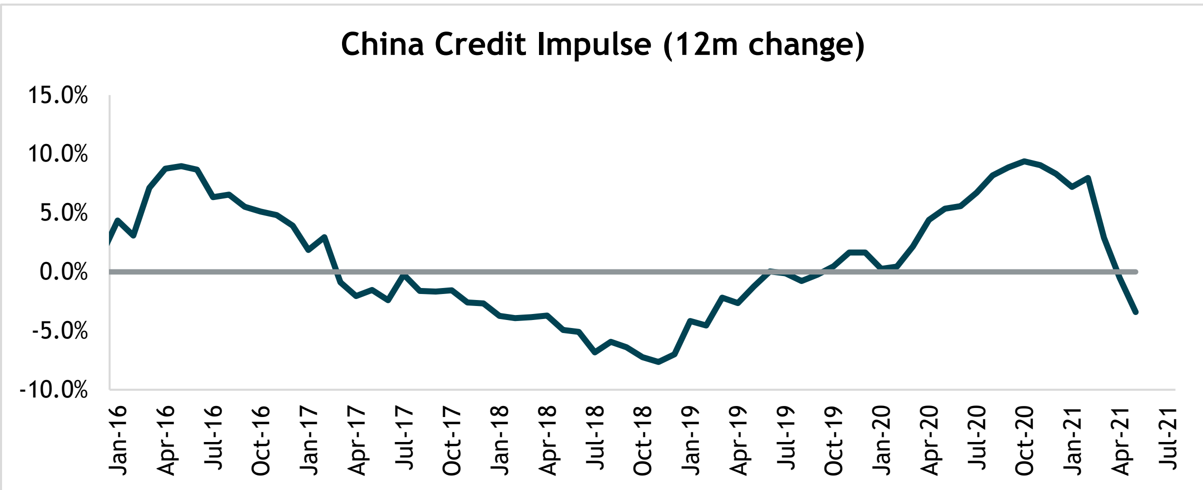
We believe that the previously widely held notion that the property sector is used by the central government as a countercyclical tool has weakened materially. The government is serious about a comprehensive policy package that addresses the property sector's "grey rhino" risk and seeks economic drivers in new directions such as the carbon neutral initiative and supply chain upgrade via technological advances.

Regarding education, by opposing capital in the sector, we believe the government aims to equalize accesses to education. Meanwhile, healthcare is already a heavily regulated sector.

It is not our view that the current moves are part of a broader attack on the private sector. China would still want and need a vibrant private sector to maintain the pace of innovation in new and old economy sectors alike. Additionally, this would be consistent with China's goals of attracting foreign capital and internationalization of the RMB.

PARALLELS TO 2018

In our view, the current market concerns and related repricing have some parallels to 2018, when China was also attempting to bring down leverage in the system (see credit impulse chart below) and defaults were increasing. The housing sector was already under scrutiny. Meanwhile, in the fast-growing gaming sector, new licenses were suspended.

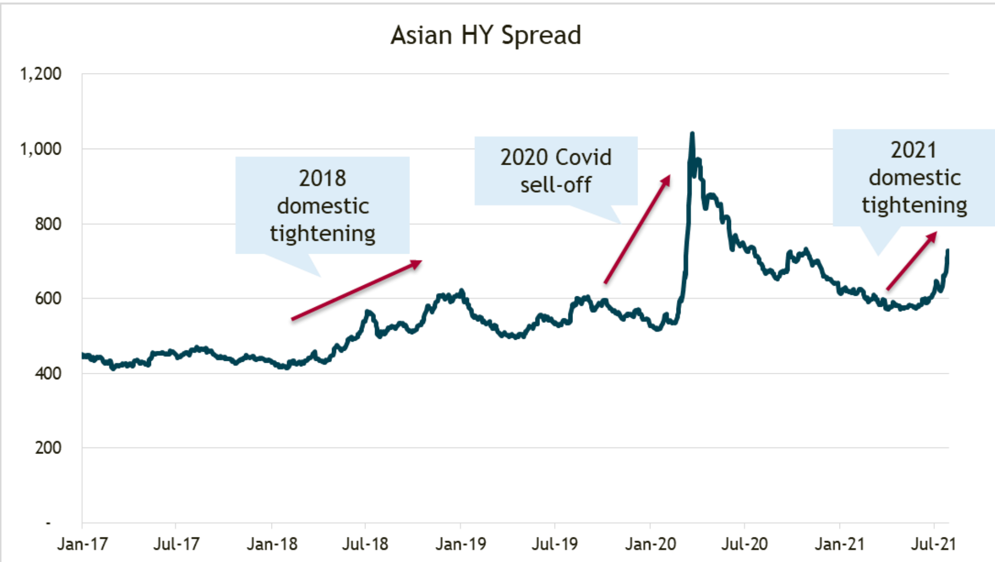


Source: Bloomberg, July 2021

The below compares the domestic and external environments as well as market reactions in 2018 and 2021.

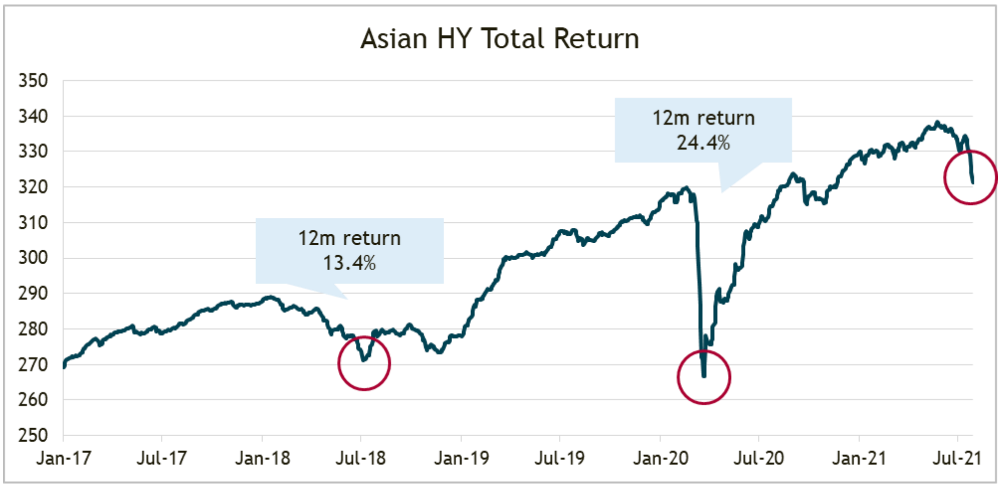
China Policy Tightening	2018	2021
Details	Internal Environment - Economic deleveraging - Property sector tightening - Sector-specific measures (gaming) External Environment - US-China trade tension - Higher US rates	Internal Environment - Economic deleveraging - Property sector tightening (3 red lines, sector lending caps and land auction policies) - Sector specific measures (education, internet) External Environment - Stable US rates
Asian HY correction		
Peak & Trough	Jan 2018 – July 2018	May 2021 - Current
Drawdown	-6.1%	-5.0%
MSCI China correction		
Peak & Trough	Jan 2018 – Oct 2018	Feb 2021 – Current
Drawdown	-32.9%	-27.2%

In 2018, credit spreads widened excessively amid market participant caution as seen in the below chart and tightened subsequently. We believe the current widening is also following a similar trajectory.



Post the July 2018 bottom, the **Asian HY market had a strong 12 month performance of 13.4%**. In our opinion, this time around too, valuations have gotten attractive driven by fears which are partially over stretched. Additionally, the sell-off has been exaggerated by forced selling and deleveraging.

The total return chart for the Asian HY market below pinpoints the bottom of previous sell-offs, subsequent to which the market has offered very strong returns.



While turning points are difficult to pick, valuations and levels of market anxiety do provide strong indicators. Moreover, we note that current policy action has not been one-way tightening.

Firstly, in July, the PBOC lowered the RRR by 50 bps. Secondly, the statement from the just concluded Politburo meeting provides indications that authorities are less optimistic about growth in the second half of 2021. This should limit the amount of additional policy tightening, and could also indicate some added fiscal measures.

Further, an added positive this time around vis-à-vis 2018 is the external environment – specifically interest rates. Recall in 2018, the Federal Reserve was increasing the Fed Funds rate with 10-year Treasury bond yields rising and the US dollar appreciating. Today the environment is much more conducive with US rates on hold and the Federal Reserve still expanding its balance sheet.

Thus for Asian credit our strategy remains to buy on weakness. We prefer to average in to the market, taking advantage of periods of market weakness to add to risk. Credit selection and diversification are key considerations to side-step credit events.

CONCLUSION

	IP View
Regulatory Measures	• Targeted sector measures to control financial risks in the property sector and bring regulations in the internet sector up-to-speed with technological advancements • Not a reversal of China's approach to the wider private sector

	• Do not expect decoupling of China's financial system from the Rest of the world
Systematic Risks	• We believe systematic risks remain under control, deleveraging is a chosen policy, not inflicted from external factors • Targeting the property sector will limit financial risks in the long-term • In the short-term, we could continue to see selected credit events in the property sector, which will hasten the consolidation process
External Environment	• US interest rates are expected to remain low, which should be supportive
Strategy	• We continue to advocate a buy-on-dip strategy • We favor the China property sector, which has been at the epicenter of the correction. Valuations imply unlikely default rate scenarios. Key is credit selection to avoid credit events and identify beneficiaries of expected sector consolidation

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