Fool me once…

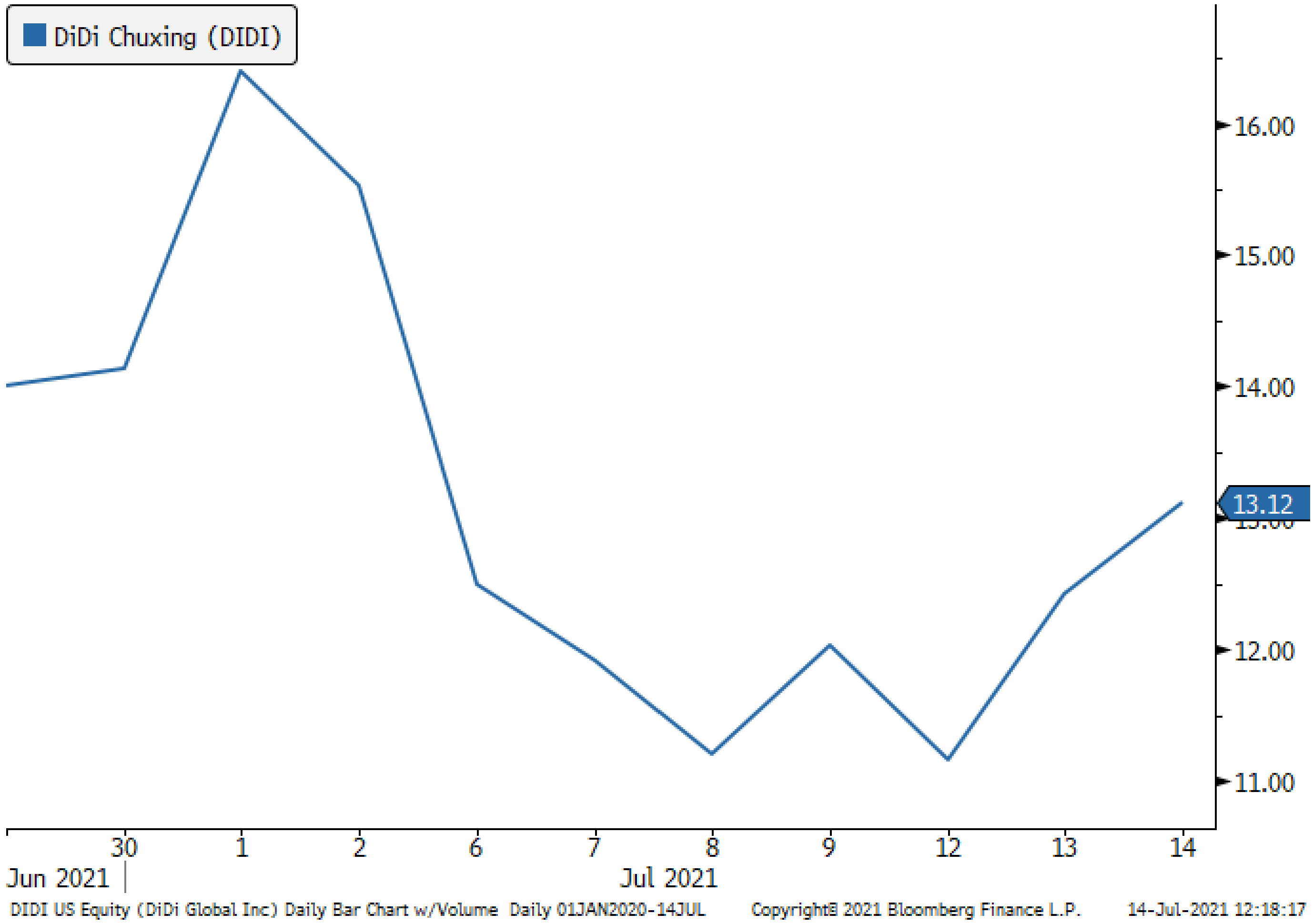
“U.S. investors will have to weigh the risks of owning [Chinese] ADRs at a time when tensions between Beijing and Washington remain elevated…with the possibility that officials may reshape company prospects at the stroke of a pen via the imposition of regulatory strictures.”
– BCA Research Chief Global Strategist, Peter Berezin

Fool me once…
One of the earliest known versions of the proverb “Fool me once, shame on you; fool me twice, shame on me” came from the 17th century book *The Court and Character of King James* by Anthony Weldon. The original reference reads slightly different than today’s modern saying, which was first recorded by the *Daily Ohio Statesman* newspaper in 1869. More recently, author Stephen King expanded on the saying by writing, “Fool me once, shame on you. Fool me twice, shame on me. Fool me three times, shame on both of us.” Former President George W. Bush further immortalized the adage in a now-infamous gaffe during a 2002 speech in Nashville, Tennessee.

Investors that have put their faith – and hard-earned dollars – in Chinese growth equities over the past few years can likely relate to this saying as Beijing has unleashed a series of rolling regulatory initiatives aimed at Chinese tech companies. At first, Chinese regulators directed their ire towards fintech companies before leading antitrust investigations into many of the country’s most successful technology companies. A couple of weeks ago, authorities announced a crackdown on ride-hailing giant DiDi shortly after its US-market debut. However, the proverbial cherry on top came when Beijing announced that it would step up its oversight on the flood of Chinese listings in the United States. Specifically, China’s State Council declared that the rules of “the overseas listing system for domestic enterprises would be updated, while tightening restrictions on cross-border data flows and security.”

As expected, Chinese securities sold off sharply in the following days as investors weighed the impact of these statements (continuing a downward slide that started in early-2021):


S&P/BNY Mellon China ADR Index
900
800
700
661.1000
600
500
400
2016
2017
2018
2019
2020
2021
BKCN Index (S&P/BNY Mellon China ADR Index (USD)) Daily Bar Chart w/Volume Dail
Copyright© 2021 Bloomberg Finance L.P.
15-Jul-2021 07:37:16



Source: Bloomberg, Evergreen Gavekal

The fear among investors is that these regulatory pressures will not only threaten IPOs in the pipeline but could also upend the popular Chinese ADR market. (ADR stands for "American Depository Receipt" and are essentially a way for US investors to own foreign companies.) In a rational market, this fear might be enough to establish a ceiling on top of these securities. But similar comments from regulators in the US and Europe aimed at large multi-national technology companies have shown that market reactions to these types of headlines typically wax and wane over time. In China's case, the difference might be how quickly – and with how much force – authorities move to impose these new regulations. As Michael Clendenin, founder and president of Gavekal RedTech, puts it:

> "This tightened regulation is not simply a matter of Communist Party caprice or desire for control. Many of the underlying concerns of Chinese regulators are similar to those of politicians and regulators in the US and Europe. Big tech companies are under the microscope everywhere because of their enormous size, allegedly anti-competitive practices, unaccountable control of consumer data, and potential to create financial risk. The difference is that China's system of governance allows it to act faster."

In past newsletters, we've highlighted how the current trade and technology war between the United States and China is reminiscent of the decades-long Cold War between the United States and Soviet Union. In what might be some of the most combative language we've heard from a Chinese leader since Mao Zedong, Xi Jinping deepened an already Grand Canyon-sized divide when he proclaimed the following on July 1st: “[The Chinese people] will never allow any foreign force to bully, oppress, or enslave us. Anyone who tries to do so shall be battered and bloodied from colliding with a great wall of steel forged by more than 1.4 billion Chinese people using flesh and blood.”

Forcing technology companies to play by the rules of the Communist Party undoubtedly helps Xi in his effort to build a police state that maintains control of its country’s data and technology in the midst of the unfolding Sino-US cold war (with ostensibly rising temperatures per the comments referenced above). However, doing so likely comes at the expense of the country’s growth securities that need a high degree of freedom and flexibility to meaningfully scale and capture China’s vast addressable market. In the United States, it has become apparent through the actions of the Federal Reserve and lawmakers that keeping stock prices elevated is a major priority – even in the midst of increased regulatory pressures on several tech behemoths. However, Beijing sees a different end game--one that establishes the renminbi as the world’s reserve currency.

It is for these very reasons why US stocks and Chinese government bonds have become such enticing investment opportunities. As noted by one of our regular guest authors, Vincent Deluard, go American for stocks and Chinese for bonds. But does that mean that Chinese growth securities are no longer investable? Not entirely, as many of these companies still present intriguing long-term growth opportunities. If recent policy moves are part of a genuine government effort to establish a new regulatory system for the Chinese tech sector, it could actually be a positive long-term development for these tech stocks. Granted, this assumes that the revised system doesn’t excessively constrain future growth. However, if the regulatory moves are in direct reaction to the Sino-US cold war then, tactically, investors are right to consider Chinese internet companies risky and should steer-clear of US-listed Chinese equities in the short term. With so much regulatory uncertainty swirling around Chinese growth equities, looking for a sign of when it’s “safe” to invest again may be a fool’s game.

For US-focused investors, the bigger question might be whether such draconian regulatory measures are heading to our shores. For now, the stock market is answering with a resounding no as US tech goliaths continue to make new highs on a regular basis. However, it's a question that we'll continue to monitor diligently.

Michael Johnston
Tech Contributor

DISCLOSURE: This material has been prepared or is distributed solely for informational purposes only and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy. Any opinions, recommendations, and assumptions included in this presentation are based upon current market conditions, reflect our judgment as of the date of this presentation, and are subject to change. Past performance is no guarantee of future results. All investments involve risk including the loss of principal. All material presented is compiled from sources believed to be reliable, but accuracy cannot be guaranteed and Evergreen makes no representation as to its accuracy or completeness. Securities highlighted or discussed in this communication are mentioned for illustrative purposes only and are not a recommendation for these securities. Evergreen actively manages client portfolios and securities discussed in this communication may or may not be held in such portfolios at any given time.