Market Watch

Regulatory headwinds persist

Regulatory tightening puts pressure on Chinese equity markets

Summary

Chinese equities declined sharply amid persistent regulatory concerns. Concerns extended beyond the education and technology sectors to other areas like online food delivery.

Near-term technicals remain weak. Several equity indices breached key technical levels, suggesting volatility could persist near-term.

We continue to view Chinese equities as a core holding on a 12-month horizon as monetary easing, cheapening valuations could offer long-term support.

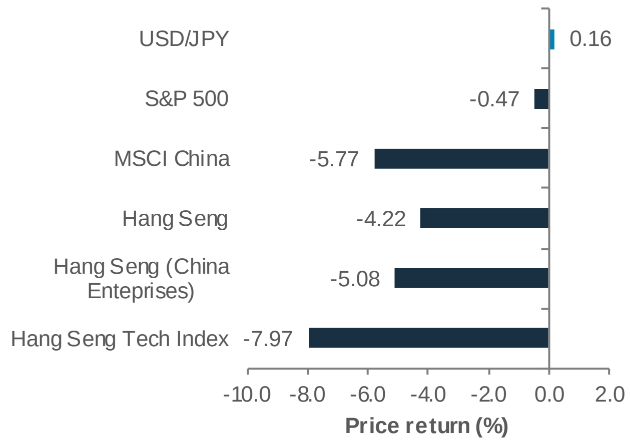
Background

Chinese equities sell-off extends. Equity indices extended their decline as concerns of tighter regulation on key sectors failed to abate. Apart from the sweeping policy changes in the education sector and continuing concerns of regulatory tightening in the technology sector, Chinese authorities have reportedly extended their scrutiny to the online food delivery sector as well. Additionally, the property sector is back under renewed focus as mortgage rates increased in select cities and developers come under renewed scrutiny. The broad-based concerns led the Hang Seng Tech and MSCI China indices to decline 8.0% and 5.8% respectively.

Weakness spills over. While concerns were largely China-focused, the weak sentiment spread to US and European markets with EuroStoxx 50 and S&P 500 closing modestly lower, down 0.9% and 0.5%. The 10-year US Treasury declined while JPY strengthened.

The fallout from China's regulatory tightening continues

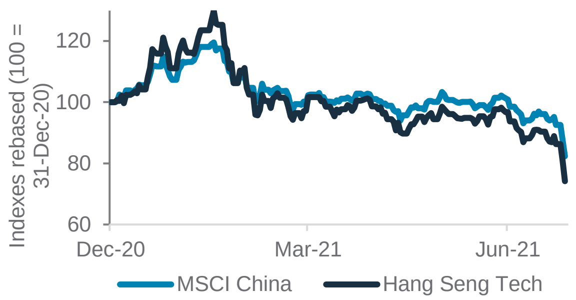
Performance of selected assets on 27 July 2021



Source: Bloomberg, Standard Chartered

Hang Seng Technology index and MSCI China have fallen sharply over the past few days

MSCI China and Hang Seng Technology index



Source: Bloomberg, Standard Chartered

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What does this mean for investors?

Regulatory concerns likely to persist. As the regulatory crackdown has intensified and broadened to multiple industries (Internet, online food delivery, Education, Property and Steel), there remains considerable uncertainty on future policy direction. There is a risk the current environment could persist beyond the next few days alone as many measures appear linked to China's long-term strategic objectives of "common prosperity", solving the demographic challenge and developing a robust digital economy.

Technicals remain fragile. The Hang Seng index's fall below crucial support – the 200-week moving average (WMA, at 27,560), slightly above the mid-2020 high of 26,782 – has opened the way towards the September 2020 low of 23,124 (7.8% below Tuesday's close). The MSCI China index is now testing key support on the 200-WMA (now at 89.50). Given the strong downward momentum, a dip below the support wouldn't be surprising, possibly towards 81.50 (78.6% retracement of the 2020-2021 rally; 8.9% below Tuesday's close). This, together with reports of foreign investor selling, suggest near-term volatility could extend.

MSCI China remains a core holding on a 12-month horizon. Regulatory tightening concerns have overshadowed the recent monetary policy easing (required reserve ratio cuts) and positive momentum in earnings revisions. Additionally, valuations for MSCI China have cheapened significantly. Hence, while further regulatory tightening is a short-term risk, we believe a lot of negative news is already reflected in prices, which is why we retain Chinese equities as a core holding on a 12-month horizon.

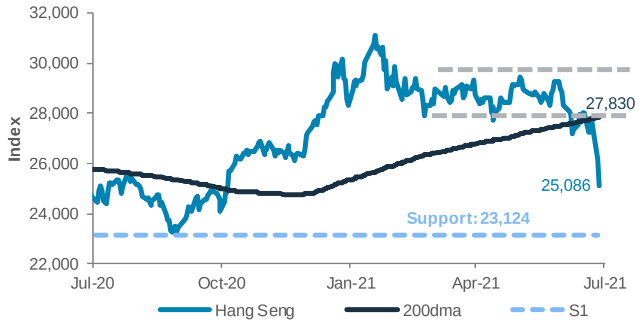
Global spill-over likely to be limited. US and European equities are likely to continue to focus on the ongoing earnings season as the key driver for equity markets over the next few weeks.

What's next?

Monetary policy may have turned, but regulatory tightening is still ongoing. While the People's Bank of China's (PBoC) decision to cut bank reserve requirements is a step in a positive direction, that alone is unlikely to ease pressure on equity markets in the short term. We would watch for signs of further policy easing, especially in regulatory policies, as well as signs of bottoming technical indicators before considering turning more constructive on Chinese equities.

A break below the 200-day moving average points to further downside in the near-term

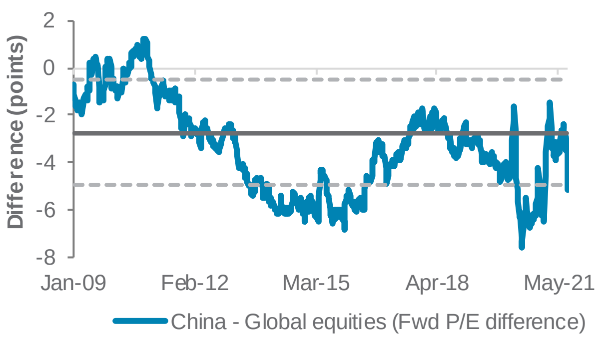
Hang Seng Index (daily)



Source: Bloomberg, Standard Chartered

Recent weakness has meant MSCI China has cheapened significantly relative to global equities

Difference in forward P/E ratios for MSCI China and Global equities



Source: Bloomberg, Standard Chartered

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