New Oriental Frogs

There is a 19th century frog experiment, impossible now for ethical reasons. Scientists found that a frog, immersed in cold water that was then heated, would boil to death. If immersed in hot water, the frog would jump out. Psychological inertia can be a powerful force in nature, even for frogs.

Online education stocks New Oriental Education and TAL Education were given the boiling water treatment by the Chinese government on Friday. They and others like them fell by about two thirds. The Chinese announced that they were to be deprived of their "For Profit" status in order to encourage an increase in the birth rate by making education cheaper. Social engineering of this kind goes hand in hand with the Chinese introduction of social credit scores for its population. Whilst the event itself was a shock, the government action was unsurprising, perhaps even logical.

The Chinese government has "form" here. Its recent anti-trust raid and imposition of fines on Alibaba and the re-education of its founder, Jack Ma, is a reminder that once the geopolitical and macro-economic aims of a sector –in this case, e-commerce- have been met, the individuals, investors and the company itself are no longer to be protected by the state. Such action is the polar opposite of the USA's "military industrial complex", France's "strategic assets" protection (which even seems to cocoon its supermarkets) and the pre-war Japanese "zaibatsu" system.

One of our HK analysts wrote this week: *"the USA government has issued a joint advisory on the risks of conducting business, studying, and investing in HK, in a direct response to the June 2020 National Security Law (NSL)…which effectively crushed the autonomous region's special freedoms. Certain multinationals in Hong Kong now face two-way political risk as the U.S.-China decoupling continues…Businesses will be forced to pick a side: adhere to U.S. sanctions and be penalized by China or potentially violate U.S. sanctions to maintain access to Chinese markets. Airlines will need to provide passenger information to authorities before flights depart…to prevent…political dissidents from leaving HK. The NSL allows authorities to conduct wiretaps or electronic surveillance, search and seize electronic devices, requires internet service providers to produce corporate or consumer data. The NSL has dissolved freedom of press in HK. The city's public radio station is also now under tight censorship…all media based in HK now reflects the political agenda of Beijing. The U.S. has placed sanctions on several individuals and entities within HK, barring U.S. businesses and nationals from transacting with them."*

It is clear that under President-For-Life Xi, the primary condition for portfolio investment in China –the safety of one's capital in a free system under a Rule of Law- does not, indeed *cannot*, exist.

This brings us back to the frog. The human tendency to cling onto hope and the status quo can be admirable, but it can also be a pathway to the poorhouse in investment. The destructive forces of late 1930s Germany were foreshadowed a decade before; "*Mein Kampf*" was published in 1925.

Why not invest in sectors that are actively encouraged by the Chinese state, such as semi-conductors, or which lie outside the ambit of state interference? For institutional investors tied to a global equity index, this is indeed an option, though the tendrils of the Chinese state reach everywhere. For private investors who have no compulsion to invest in China, and who see the world of investment as a "global beauty contest" it may be considered a risk too far. Other more beautiful shores, those that feel the radiation effect of a booming China, may offer more attractive prospects. ASEAN and the free-thinking members of the Trans Pacific Partnership spring to mind.
