THE DRIVE YOU DEMAND

SPOTLIGHT: CHINA

Insights from the 19th Communist Party Congress

President Xi Jinping used the 19th Communist Party Congress (CPC) to consolidate his position and introduce a broad set of reform proposals. Economic policy is likely to remain pro-growth, but with an increased focus on the quality of growth and measures to curtail excess credit. Reforms will focus on real estate, the corporate sector (state and private) and environmental protection. More forceful regulation of financial services and local government finance is coming too. Chinese technology, financial and consumer discretionary companies should benefit.

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Key points

- *China's once-in-five-years conference has ended with a broad range of economic policy proposals and greater powers for President Xi Jinping*
- *Economic reforms focus on real estate, the corporate sector (state and private) and environmental protection. More forceful regulation of financial services and local government finance is coming too*
- *A central policy will be a national champions model focused on state-owned enterprises (SOEs)*
- *President Xi has also embarked on making China's international standing much greater through the projection of 'soft power' outside of Asia Pacific*
- *Technology, financials and consumer discretionary companies should benefit*

China's all important 19th Communist Party Congress (CPC) concluded on 25 October with far-reaching political and economic implications. UBP is currently overweight Emerging Market equities, with a bias towards Chinese and Asian equities. From a sectoral perspective, UBP favours technology, financials and consumer discretionary companies.

With the CPC now over, we must wait about a month to discover the full details of how President Xi's ideas will be rolled out. Nevertheless, the broad-brush implications are clear. He announced wide-ranging reforms in real estate, the corporate sector (state and private) and in environmental protection. He also made it clear that we should expect more forceful regulation of financial services and local government finances (corporate debt is 250% of national income).

These policy ideas are designed to promote growth and reduce macroeconomic risk while leaving decision-making more firmly in the hands of President Xi, and his six-man Politburo Standing Committee (PSC). Specifically, the state-owned sector will play a more high profile role in economic development.

Xi's big idea, and perhaps the real driving force behind his centralisation of power, is to see China assume its former position as a central player in world affairs, partly through rolling out the Belt and Road Initiative (BRI). This is the infrastructure and trade plan that will link Asia, Europe and Africa. BRI has now been written into China's constitution as a national policy. 'Soft power' will now be exercised across a growing number of countries.

Looking ahead, readers should mark their diaries for the Central Economic Working Conference (CEWC) in December and then the National People's Congress (NPC) in March 2018. The CEWC refines ideas into actionable policies and then the NPC ratifies them for implementation.

Xi is deepening state control and reforms

From a political perspective two key conclusions follow on from events in Beijing. One, that Xi Jinping's immediate grip on power is now even tighter. Two, the manner in which membership of the PSC changed implies that come 2022, when the 20th CPC will be held, retirements in the Politburo will remove contenders for the top spot. Xi Jinping can then run again.

In essence, Xi's absolute authority is now real and potentially long-lasting. Premier Li Keqiang, a long-serving ally of President Xi, retained his position despite a downgraded profile in the last couple of years. Three of the five new members (Li Zhanshu, Zhao Leji and Wang Huning) have worked closely with President Xi since 2012. At the same time, the seven-man committee is balanced between factions headed by Xi Jinping and previous presidents Hu Jintao and Jiang Zemin.

Xi Jinping thus appears to have delicately balanced membership of the committee to restrain dissent while creating conditions that will lead to less chance of opposition if he chooses to run for office again in 2022. Inevitably, the *quid pro quo* for less political flexibility will be an increased role for state welfare provision and direction.

Figure 1: New Politburo Standing Committee (PSC)

	Name	Confirmed positions & pre-existing positions	Age
1	**Xi Jinping**	Party's General Secretary; Chairman of Central Military Commission; President of PRC	64
2	**Li Keqiang**	Premier	62
3	**Li Zhanshu**	Secretary of the general office of the party	67
4	**Wang Yang**	Vice Premier	62
5	**Wang Huning**	First Secretary of the Party Central Secretariat; Director of the policy research office of the party	62
6	**Zhao Leji**	Secretary of Central Commission of Disciplinary Inspection (Head of the Party Organization Department)	60
7	**Han Zheng**	Shanghai Party Chief	63

The proposed policy mix is broad

From an economic perspective, the post-CPC growth outlook is unchanged. UBP's growth forecast for 2017 is 6.7%, in line with consensus, with activity declining in 2018 to a still strong 6.1% as credit constraints bite and environmental controls will end production in high pollutant industries.

More importantly, it is encouraging that no growth target was announced for the first time in ten years. In the past, when growth dipped below the national growth target, banks would either start lending again, or be told to, to the detriment of credit risk metrics. The emphasis at this CPC is instead on microeconomics and setting out a preferred model for economic development. The post-2008 'Growth at all costs' model now appears to be waning in importance.

President Xi's model allows for much greater authority in setting and directing policy reforms. Key reforms to expect include:

- Promoting ownership over property investment projects
- Striving to escape the middle income trap
- Getting serious about environmental pollution
- Speeding up reform of state-owned enterprises and assisting them to move up the value chain
- Supply-side reforms of industry
- Tighter regulations on financial leverage and irregular local government borrowing

If the economy responds and re-balances away from investment-led growth proceeds as desired, then centralisation could be a very positive development. The opposite is also true, as was so obviously so in the final decades of the Soviet Union.

Main reform areas

Promoting ownership over property investment projects *"Housing is for living, not for speculation"*

Xi mentioned that the rental market should be promoted, to make the housing sector more sustainable.

In our view, this could signal more tightening for overheated property markets in lower-tier cities. Top-tier cities are likely to be less-vulnerable to policy tightening due to more inelastic demand, coming from, for example, increasing numbers of university graduates moving to cities for career opportunities.

INVESTMENT IMPLICATIONS:

1) Avoid property companies with higher sales exposure in overheated lower-tier property markets.
2) Seek property companies with higher exposures in top-tier cities as these have more inelastic demand.

Striving to escape the middle income trap *From 'Moderately Prosperous Society' to 'Chinese Dream'*

As noted, President Xi's long-term plan does not have a quantitative growth target. Instead, Xi aims to make China "prosperous and beautiful" by 2050. Instead of growth targets, Xi Jinping appears to be looking to build a more equitable society, rather than the 'winner takes all' model that led to massive income disparity from 2000 onwards and the eventual need for the austere anti-corruption drive beginning in 2014.

China's state newspaper, the *China Daily*, reports the China Dream to mean that, "…new heights are expected to be reached in every dimension of material, political, cultural and ethical, social, ecological and military advancement". In other words, national growth will no longer be the only measure of success. In any case, China only needs ~6.3% growth in the next three years to achieve the goal of doubling GDP from 2010's level.

Getting serious about environmental pollution *"Beautiful China"*

Environmental protection will likely grow in importance with enforcement becoming much more stringent. Heavy industries are already being shut down at a surprisingly rapid rate in order to cut emissions (China is now the world's worst emitter of greenhouse gases).

INVESTMENT IMPLICATIONS:

1) Environmental and clean energy plays will be beneficiaries,
2) High-pollution businesses (e.g. textile OEM, coal-related business) will face higher compliant cost pressure. This applies negatively to commodity producers in old economy industries and positively to those in high-end consumer industries.

Speeding up reform of state-owned enterprises and assisting them to move up the value chain

Reform of state-owned enterprise (SOEs) is happening, with 180 cases announced so far in 2017, and >1,000 in total. In the Hong Kong and China equity markets, mixed ownership reform has been well-received by investors so far.

After more than two years of preparatory work and small-scale pilot programmes, China is about to enter a stage of speedier execution of SOE reform. President Xi announced that state capital should become stronger, not just larger (this is not liberalisation; it is entrenchment of SOEs in a centrally-planned economy).

Price signals will need to be responded to if investment returns are to improve after years of malinvestment. Effective incentives should be provided and the mixed ownership model is probably China's best bet for now.

INVESTMENT IMPLICATIONS:

1) Sectors to watch out for include military and special equipment, materials, chemical, utilities, railway, and oil & gas.

Supply-side reforms of industry *'Development of Advanced Manufacturing Industries'*

Xi's speech emphasised that the "advanced manufacturing industry" (helped by technology innovations) should be further developed. We could see support for areas such as new energy vehicles, AI (artificial intelligence) and semiconductors. China's southern states are replete with venture capital activity in small and medium-sized enterprises, many of which are in light manufacturing and green industries.

INVESTMENT IMPLICATIONS:

> Technology and companies which have allocated decent capex on technology upgrades and R&D should benefit.

Tighter regulations on financial leverage and irregular local government borrowing

President Xi wants enhanced financial sector supervision through the recently-created Financial Stability and Development Commission (FSDC). At present, insurance, banking and the securities industry have individual regulators with the PBoC acting as coordinator, rather than as a universal regulator. Chinese policy makers have not yet decided on their preferred model for regulation, but either way tighter regulation of financial services is coming.

Urgency has been added to the mix by increasingly strident comments from PBoC governor Zhou Xiaochuan that effective measures to tackle debt accumulation in the non-financial corporate and household sectors need to be implemented and enforced immediately. China's policymaking bias will likely become more draconian against off balance sheet and shadow banking activities in 2018. Ultimately this means Chinese policymakers will be willing to accept lower growth if it comes with a more stable outlook.

Xi Jinping also stipulated that much greater scrutiny would be exercised on fiscal responsibility. Sovereign debt to GDP is still only around 40%, but if existing fiscal rules to prohibit local governments from using off balance sheet funding vehicles are not fully imposed then an unforeseen bank failure could lead to public debt levels doubling (according to International Monetary Fund analysis).

From now on, ministers in charge of local government finances will have a lifetime liability for their balance sheet management. This is a significant shift and indicates a much lower tolerance for regional practices that could leave Beijing with a large clean-up bill. Again, it also implies that growth may come second to stabilisation.

China Equity and FX Outlook

Historically, China's equity markets have tended to weaken post-CPC, and equity volatility has tended to rise. But this year's 51% year-to-date (YTD) total return has been supported by a combination of earnings growth +13% from the February low, sustained earnings revisions (+24% YTD and currently accelerating), in addition to multiple expansion.

As a result, headline MSCI China valuations are still reasonable at a price-to-earnings multiple of 15x 2018 earnings compared to 15% earnings-per-share growth. Reasonable valuations and attractive earnings growth should underpin Chinese equities looking through to year-end.

By sector, we favour technology / internet, financials and selected names in consumer discretionary as offering good investment potential

In terms of currency markets, the CPC's proposals leave our outlook for a lower CNH unchanged, unless tighter restrictions on credit expansion lead to a sharp drop in growth.

China's 3% spread on deposit rates over US and euro deposit rates make it likely that the currency will undergo a small depreciation versus US dollars. Controls on capital outflows have restricted access to foreign markets and relaxed the pressure on authorities to fight an FX market expecting large drops in the currency.

The outright 12 month forward sits at 6.75 while the median forecast looks for 6.68 by end-3Q 2018. We expect USDCNH to return to 6.8 over 12 months. Risks to the view that USDCNH will rise are: 1) a slump in the US dollar, which is not our baseline view, and 2) a rapid and uncontrolled deterioration in geopolitical risk on the Korean Peninsula.

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