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Should investors reconsider China?
Reflecting on the 20th National Congress of the Communist Party of China (CPC)

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Politics are messy during the best of times. Add de-globalisation, nationalism, populism, a cost-of-living crisis, an energy crisis, and Cold War dynamics to the mix, and you get a world that is rapidly fragmenting into new economic and ideological blocs. The political theatre playing out at a country level has spooked markets across the world, from recent political and policy changes in the UK to leadership contests in Italy and Brazil. The upcoming US mid-term elections in November will provide another dose of uncertainty, especially if the Republican Party can manage to re-take control of both the House and the Senate.

When leadership structures change, investors adjust their outlook and assumptions for the political economy. China has undergone a change in leadership structure over the last few weeks, and it is our responsibility as investors to read between the lines and investigate beyond the news flow and noise, remaining factual and discerning about what is truth and what is rumour. In this report, we unpack the outcomes of the 20th National Congress (Congress) of the Communist Party of China (Party). We will focus on two key elements; political leadership changes (Politics) and the policy framework set out by the Work Report (Report). Before we do so, we will revisit the journey and growing importance of China since 2012, when Xi Jinping took power initially.

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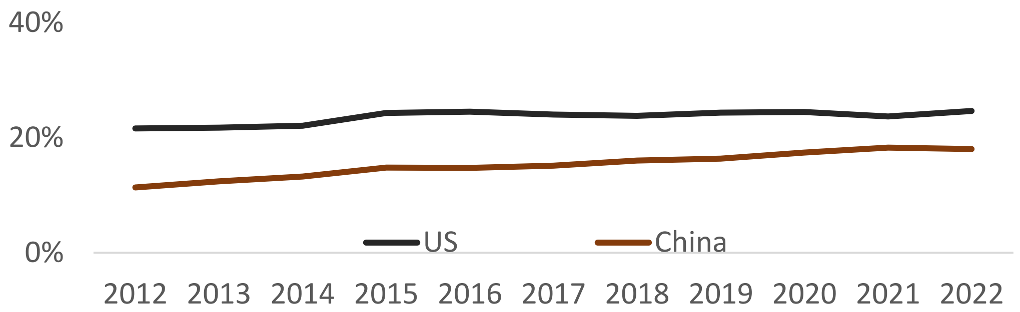
China's economy and markets under Xi's first two terms

China has undoubtedly grown into a superpower under Xi Jinping. When he first took power in 2012, the size of the Chinese economy was $8.5trn, around 11% of the global GDP. By the end of this year, the economy will be $18.3trn in size, or 18% of global GDP, according to the IMF.

Figure 1: Share of global GDP: US vs China

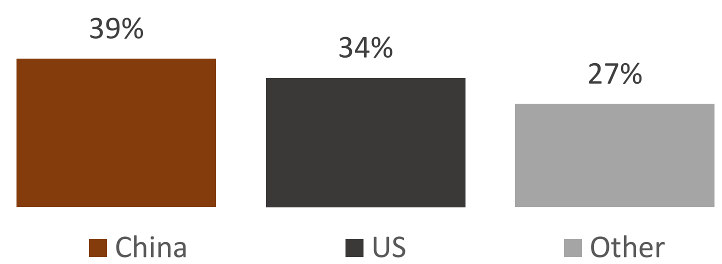


Source: IMF, World Economic Outlook October 2022

During the seven-year period prior to the pandemic - 2012 to 2019 - the economy grew at an average rate of 7% per year, slower than the average of 11% under his predecessor Hu Jintao. The growth rate has slowed further to between 4% and 5% today, according to the IMF.

Despite this slowdown in growth, China's contribution to annual global growth continues to outpace that of the US. While China remains the second largest economy behind the US, it has become the largest contributor to global GDP growth. Over the last 10 years, China has contributed around 39% to global GDP growth, while the US has contributed 34%. To put this in context, China is contributing the equivalent of two to three South African economies to the global economy each year.

Figure 2: Contribution to global growth (2012 to 2022)



Source: IMF, World Economic Outlook October 2022

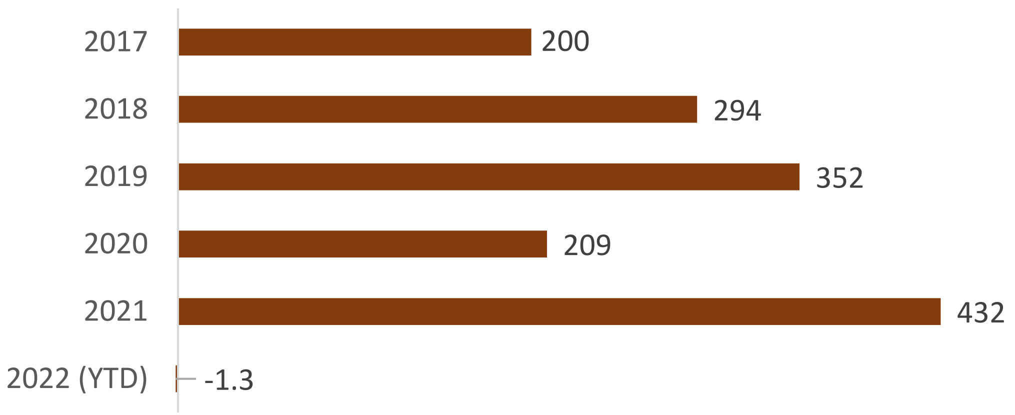
This, along with the fact that China is largely an industrial economy, explains why the country has the largest demand for many commodities among the global economies. It makes up about 60% of global iron ore demand and more than 50% of global copper demand.

China has become well-integrated into global trade and is growing its share in financial markets. Around 70% of the world's countries trade more with China than with the US. In 2012, China's weight in the EM MSCI was less than 20% but rose and peaked at 43% in 2020. It is currently around 27%.

Given the sheer size and growth of the economy, it has become much harder for investors to ignore China, and it will be very costly for the world to become independent from China. Foreign direct investment into China has remained strong, rising to $175bn in 2021, with the US alone investing between $12bn and $15bn per year since 2012, excluding the 2020 pandemic.

Foreign investors have been net buyers of Chinese stocks to the tune of $30bn to $65bn for each of the last six years except for 2022, the first year of potential net selling.

Figure 3: Foreign equity in and outflows (RMB bn)

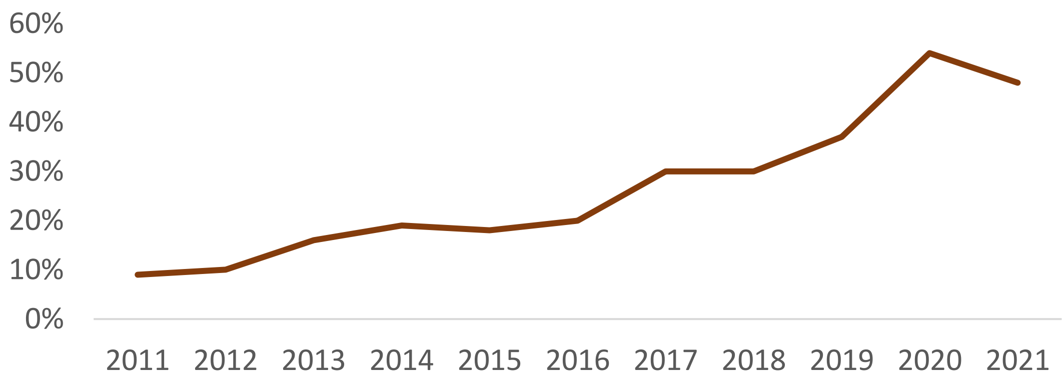


Source: Bloomberg, Shenzhen and Shanghai trading links. Data started in 2017

Under Xi, the private sector has also grown rapidly. Today, the private sector contributes almost half of the total market value of China's largest 100 listed firms, up from 10% in 2012.

In 2012, there were only 70 Chinese companies in the Fortune Global 500 ranking, and six of those were private sector companies. Today, there are 130 Chinese companies in the Fortune Global 500, of which 32 are private sector companies.

Figure 4: The private sector as share of market capitalisation of China's top 100 listed companies



Source: PIIE Peterson Institute for International Economic: Working Paper. The Private Sector Advances in China the Evolving Ownership Structures of the Largest Companies in the Xi Jinping Era. March 2022.

Under Xi, the economy has slowed, but has continued to grow at a rapid pace and is opening up to foreign investors, entrepreneurs and the private sector. From early 2021, this relatively market-friendly backdrop came into question with the regulatory crackdown on the tech sector, property developers and zero-COVID policy leading to a severe economic slowdown, equity market sell-off, property slump and general lack of "animal spirits" amongst local investors.

What can we learn from the recent Congress about future economic and political policy? Will Xi continue on this path of self-inflicted pain?

Clues from the CPC 20th Congress

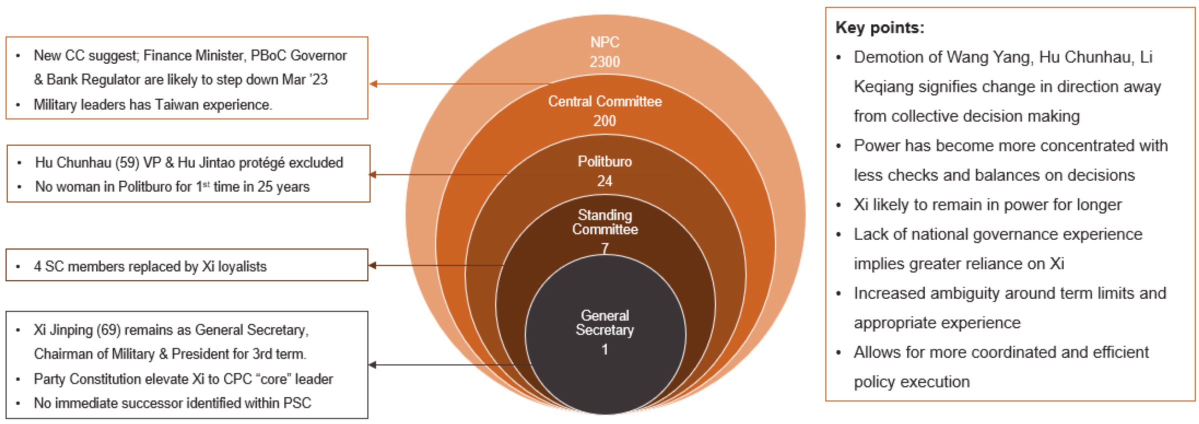
The Congress takes place once every five years when around 2300 Party delegates representing around 100 million Party members convene to elect about 200 Central Committee members in a week-long session. The new Central Committee then selects the 24-member decision-making Politburo. From the Politburo, a seven-member Standing Committee is unveiled along with the Party General Secretary. The Party Secretary then becomes the Head of State in March of the following year when both the Party and Government structures meet. The new Premier is also then unveiled.

During the opening of this year's Congress, Xi Jinping gave a speech and released the new Report, a 70-page document setting out the policy objectives for the next five years. The Report is typically light on specific economic details but contains important information about the policy direction for new leadership. In mid-December, the Central Economic Work Conference (CEWC) will provide a more detailed economic objective as set out by the newly appointed leadership. In the meantime, we can perform forensic analysis on the Work Report (Policy) and leadership changes (Politics). Below are our key findings and observations:

Politics – Xi cements power

Xi Jinping is 69 and remains General Secretary, Chairman of the Military & President for a third term, longer than the historic two-term norm. No immediate successor has been identified, which implies that Xi might continue to rule after his third term ends in 2027. He has also broken the 68-year age limit observed by the Party. Furthermore, Xi has replaced four members of the seven-member Standing Committee with his loyalists. This purging included Li Keqiang (previous Premier) & Wang Yang (a strong contender for the new Premier, a reformer and market-oriented) and Hu Chunhau (young and a Hu Jintao protégé). Xi's all-powerful position was further cemented with the abrupt removal from the Party Congress of his predecessor, Hu Jintao. The new Premier is likely to be Li Qiang (63), the Shanghai Party Secretary. Li Qiang lacks the typical national government experience required for the job but has a lot of experience working with the private sectors and foreign investors in Shanghai. The new Central Committee list also suggests that the Minister of Finance, Central Bank Governor and Bank Regulator may lose their positions. These leadership changes have resulted in significant centralisation of power and control under Xi with potentially fewer checks and balances in place.

Figure 5: Key leadership changes



Source: Internal – Fairtree

This does increase the risk of a policy mistakes but may also allow for more coordinated and efficient policy implementation.

Policy – pragmatism and continuity

Economic development remains the key focus

The Work Report is clear that the key objective remains economic development. Some analysts feared that a more ideological objective would replace the growth objective, but Xi specifically stated that the goal by 2035 is to increase per capita GDP to be on par with a mid-level economy. This implies an average growth rate of around 4.7% per annum. Given that growth typically slows as an economy grows bigger and older, the Chinese economy needs to grow even faster over the next few years, potentially above 5%, to achieve this goal.

Population growth in China has started to decline, one factor that can weigh on future growth. The government recognises this and has included in the Report a focus on education (mentioned 42 times vs 29 times in the 2017 Report) in sectors like science and technology to improve the quality of the workforce and productivity.

Xi also plans to shift the focus to the quality of growth. The old industrial growth drivers and over-reliance on investment in property and infrastructure will gradually need to make space for more sustainable household consumption. This rebalancing is key to economic success. The Report recognises that China must "expand domestic demand and better leverage the fundamental role of consumption in stimulating economic growth" and re-focus investment to supply chains. To ensure that households play a bigger role in the economy, the government will remain focused on their "common prosperity" goals.

"Common prosperity" is much better defined

"Common prosperity" is mentioned as many times as in 2017, but with greater clarity on what it actually means. In short, the Report defines this as:

1. ensuring that people have access to jobs and get paid fairly for their hard work,
2. improving public services, social security, access to healthcare and medical insurance,
3. improved taxation and transfer payment structures,
4. boosting birth rates by bringing down the cost of raising and schooling a child,
5. improving people's quality of life and preventing polarisation,
6. "protecting lawful income, adjusting excessive income, and prohibiting illicit income".

Success in this area should bring down the household savings rate from around 45%, allowing for domestic consumption to play a larger role in the economy. However, we suspect that regulation, including taxes, will continue to play a role to achieve these goals.

The private sector will remain supported

The private sector only gets a few mentions, but the language around support for the sector is stronger than in 2017. The government will "unswervingly" encourage and support the growth of the private sector and provide an enabling environment. It will protect property rights and interests of entrepreneurs, and foreign investors and foster a world-class business environment that is market-oriented, law-based and internationalised. The Report also adds that "it would take strong action against monopolies and unfair competition, break local protectionism and use regulation to promote healthy development of capital".

China's goals around national security, social stability, financial stability, and a clean environment has in the past, led to aggressive state interventions that hurt the private sector. These included stricter regulation of the financial sector; crackdown on corruption among party officials; controls placed on real-estate developers, aggressive decarbonisation targets; the restructuring of private education; and the regulatory crackdown on internet platforms. All these measures deliberately sacrificed short-term economic gains in favour of broader goals, so much so that, in many cases, they later had to be adjusted or scaled back. This is an important observation because it speaks to Xi's ability to adapt a policy if the outcome is too detrimental.

External environment to provide more headwinds

Probably the biggest shift in the 2022 vs the 2017 Report has been the focus on safety and security (mentioned 89 times vs 55 in 2017). Xi, in his speech and Report, warned against "major tests of high winds and high waves" and asked people to "strengthen their sense of hardship". To us, these signal the elevation of national security goals. China realises that it has to secure food, energy, resources and strengthen its supply chains to survive in a world that is rapidly de-globalising.

Xi emphasised that the re-unification of Taiwan remains a "historic mission and unshakable commitment". The aim is to do it peacefully and therefore engage with Taiwan across all sectors and political parties. Xi also mentioned during his speech that although peaceful re-unification is the ultimate aim, they may consider all measures necessary, including force. Xi mentioned two scenarios where China will take a hard stance: when Taiwan itself seeks independence, or outside forces interfere with the re-unification process.

It is clear to us that China does not want a hot war with Taiwan, and if left to China alone, they would seek to re-unify with Taiwan like they did with Hong Kong. China's military has not engaged in any wars over the last few decades. Although their military advancement has been rapid, they will not seek a war until they are 100% convinced that they can achieve their goal quickly against western forces. The risk of humiliation and loss of lives may be too big. Therefore, we don't see a risk of war around Taiwan in the immediate future. Recent tensions may deflate after the China Congress and US mid-term election have passed. The next increase in verbal tensions may arise in the run up to the 2024 Taiwan and US elections.

Green economy and technology

There was also a much bigger focus on green development, green industries, and green consumption, along with modernisation and technological development. Xi realises that many of his development, common prosperity and national security goals rely on technological advancement.

The US knows this as well, and in a move to counter it has put a ban on the use of US semiconductors, semiconductor equipment and intellectual property, including US persons, a few days before the Congress started. The move by the US will hit Chinese tech development hard. We are still waiting for China to respond to these measures. We look towards mid-November, during the G20 meeting, when Biden and Xi may potentially meet on the side lines.

COVID policy may ease gradually

Nothing in the Report or Xi's speech signalled a change in the current zero-COVID policy stance. In the run-up to the Congress, several state media reports highlighted that the policy would remain in place.

We believe that the political capital of keeping the zero-COVID policy in place has fallen post the Congress. Headlines that Hong Kong is relaxing their COVID restrictions, and that China is considering shorter quarantine time suggest that authorities may relax restrictions gradually and earlier than anticipated. Air travel for key personnel has started to resume over the last few weeks.

Short term outlook may improve, but the longer term warrants caution

The market had a very negative reaction to the recent Congress. We believe investors were most disappointed by:

1. lack of guidance around the potential end to the zero-COVID policy,
2. the purging of the old guard and concentration of power under Xi,
3. the growing intention to re-unify with Taiwan and potential conflict with the US.

Over the short term, China has no option but to continue to provide support to its economy and look for ways to ease the COVID restrictions more meaningfully. We expect a range of monetary, fiscal, credit and regulatory easing. Given that the China Party Congress and the US mid-term elections required political capital by taking stronger stances against each other, we may see a degree of easing tension between these two superpowers over the coming months. The G20 meeting later this month may provide some clues as to when Biden and Xi may potentially meet on the side lines. We don't expect a Taiwan invasion or hot conflict anytime soon.

Longer term, investors should be more cautious on China and monitor how Xi balances the Party's growth objective with his national security, social stability, and environmental objectives. China has become an integral part of the global economy. To shut it out will be very costly. But geo-politics have evolved to the point where tension between the US and China will continue to mount. Xi will derive his long-term legitimacy not just from economic development but also from providing safety, security, and stability to his people against an increasingly antagonistic external environment.

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Glacier Research would like to thank Jacobus Lacock for his contribution to this week's *Funds on Friday*

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