ABS GLOBAL INVESTMENTS
EMERGING MARKETS EQUITY

China: What's Next After The Party Congress

Local Views

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INTRODUCTION

As the Chinese Communist Party Congress came to a close on October 22, 2022, Xi Jinping's grip over China's future seemed to be tighter than ever. The weeklong event which occurs once every five years, is closely watched for signs for the future direction of Chinese politics and policy. While the confirmation of Xi's third five-year term as party leader was fully expected, the extent of his consolidation of power, particularly within the Politburo Standing Committee astonished investors.

Chinese investors have since been taking stock of the implications of the 20th Party Congress on domestic policy, the local corporate environment as well as what it may mean for international relations. The initial reaction was a -7.3% drop in the MSCI China Index in the first trading day after the Congress. Investors feared further regulations, more socialist policies (such as common prosperity) as well as lack of checks and balances within the government that could lead to deterioration of business environment.

As the largest economy in emerging markets faces more uncertainties, we spoke to our local partner, Dr. Tan Yong Yam, to understand the implications of the Party Congress to the future of the country, its economy and equity markets. Dr. Tan is the Deputy Chairman of APS Asset Management in Singapore. He has 40 years of experience studying China closely thru his various economic and academic roles in the Singapore government, the World Bank as well as two top universities in Singapore. ABS has known Dr. Tan and has been an investor with APS since 2014.

-Donald Leung, Partner and Analyst at ABS Global Investments

LOCAL VIEWS: AN INTERVIEW WITH DR. TAN KONG YAM

Who are the men leading China now? What do they tell us about Xi's vision for China's future? How has the balance of power changed with the recent Communist party national congress?

For two decades, successive Chinese leaders have declared at the party congress that the country was in a "period of strategic opportunity," implying that China faced no imminent risk of major conflict and could focus on economic growth. In this party congress, "strategic opportunity" was totally absent and replaced by "National security is the foundation of national rejuvenation."

"The journey ahead is long and arduous, but with determined steps, we will reach our destinations," Xi noted in his speech. "We will not be daunted by high winds, choppy waters or even dangerous storms, for the people will always have our back and give us confidence."

US President Biden's latest chip war escalation has played to Xi's advantage. Xi noted in his speech that "Jealous rival powers would try to blackmail, contain, blockade and exert maximum pressure on China."

Xi's warnings were also reflected in the underlying tone of his political message to the congress: "I told you so."

His thinly veiled message was that: "I had been warning you that this is likely to be the external environment for a while. But some of you like Li Keqiang and Wang Yang were being very nice and naively thought that China's external environment would be benign. Now, you see, I told you so, Biden's latest salvo in the 'Chip War' is the latest confirmation of what I've been saying all along."

Biden's CHIPS Act and other tough actions aimed at China has given Xi a lot of ammunition to strengthen his position, at the expense of more moderate figures like former President Hu Jintao, outgoing Premier Li Keqiang, Wang Yang, and Hu Chunhua.

"Be mindful of dangers in the midst of peace," Xi said. "Get the house in good repair before rain comes and prepare to undergo the major tests of high winds and waves, and even perilous, stormy seas."

To get our own house in order, don't quarrel with me.

Having said that, incoming Premier Li Qiang might surprise the world and the business community with a friendlier approach. Li Qiang's past actions reflect his "strong support" for the development of the private sector. In Shanghai, Li Qiang oversaw the *establishment of the STAR Market, a new technology focused stock market. He also oversaw the construction of the Tesla factory in Shanghai. Li Qiang has decades of experience in development and regional economic management. Most importantly, he has a lot of trust and rapport with Xi, who is likely to give him much more room and power to manage the economy, compared to outgoing Premier Li Keqiang. Li Qiang's ties with Xi date back to 2004 when Xi was the party boss of Zhejiang province and Li was his de facto top personal aide. During the Zhejiang years, Li accompanied Xi on almost every inspection trip and Li edited all his speeches. The material was later compiled into a book widely circulated among party cadres. Many of those policies have now evolved into "Xi Jinping Economic Thought", the guiding principle for the economic policy of China's ruling party.*

With his proteges holding all key positions, Xi Jinping, who turns 70 next year, may start to delegate some of his authority to his trusted lieutenants as he gets more advanced in age. An important consideration for Xi is to have only trusted loyalists in the Politburo Standing Committee, so that he can confidently delegate. This will ensure he is not overstretched if he needs to stay on for another 10-15 years.

More leaders with a strong science and technology background have been promoted to the upper echelon of the CCP. The emphasis on science and technology was evident not only in the new line-up of the powerful Politburo but also in the newly elected policymaking Central Committee. At least six new Politburo members boast qualifications in science and technology fields. Their areas of expertise range from rocket science to nuclear power safety and public health.

What are the implications for domestic policy?

Private Sector Business Confidence

While Xi committed himself once more to his theme of "common prosperity", Xi continued to avoid defining what the policy might entail. He steered clear of any mention of introducing an inheritance tax, a tax on investment gains, or a national tax on real estate. Xi spoke instead of the need to help people find jobs, and of the intrinsic value of hard work.

Regulation of the Internet and Technology Sector

The regulators have largely done what is needed, but we cannot assume that regulations will loosen in the face of a soft economy. Fundamentals in the sector are deteriorating as the competitive landscape has worsened.

The Looming Real Estate Crisis

We think this cycle of deleveraging and oversupply consolidation will likely last for another 1-2 years as homebuyer confidence will take time to recover. However, we do not believe this process will lead to systemic risk as property loans are less than 7% of assets at the major banks. Beijing has already started targeted loosening of policy, such as state backing for selected property loans, but we do not expect a wholesale bailout of the entire industry as we estimate that up to a third of property developers will declare bankruptcy before this downcycle is finished.

Zero-Covid Policy

Firstly, encouraging news and policy signs of reopening have emerged post the 20th Party Congress. BioNTech has been approved for foreign residents in China after German Chancellor Olaf Scholz met with President Xi Jinping and Premier Li Qiang on November 4; domestically-produced mRNA vaccines (CSPC and Abogen) could release data readouts in the foreseeable future; and, the mass local production of Paxlovid could begin shortly.

Second, the Aviation Bureau has increased the number of international flights between November 22 and March 23 by more than 100% YoY (but still only 3%-5% of 2019 levels) and news reports suggest that the authorities are considering relaxing quarantine requirements for inbound travelers and to ease Covid circuit-breaker measures for international flights.

Third, several high-profile multinational events, such as the F1 race in Shanghai and the Asian games in Hangzhou, have been scheduled domestically from the second quarter of 2023 onwarda. Beijing also just held a marathon with 30,000 participants.

And lastly, on November 3, a media account under the People's Daily cited an expert's view which downplays the symptoms of "Long Covid" for the first time. All these suggest that the authorities may have kick-started preparations for the eventual reopening.

What are the implications for expectations regarding China's GDP growth?

President Xi in 2020 set a target to transform China into a "medium developed country" by 2035. This pledge was unchanged in his address to the congress, which would imply a 4%-5% annual growth rate is needed to achieve this goal of nearly doubling the *country's per capita GDP. We will look for any signs of adjustments to this target when Beijing sets near-term GDP growth targets for 2023 and beyond.*

What are the implications for China's foreign policy, especially on US-China relations and Taiwan?

We do not expect any easing of tensions between the US and China. During the days when Henry Kissinger was Secretary of State, Taiwan was China's only foreign policy issue. Now, a secondary issue would be what China perceives as a US-led effort by The West to contain, constrain, and strangle China's advancement.

On Taiwan, Xi stressed that China would "continue to strive for peaceful reunification," but he also said that China reserved the right to use force and "all measures necessary". He will likely employ Sun Tzu-style psychological warfare against Taiwan, rather than a hot war. Strengthen the military to deter the US and Japan from starting a war over Taiwan. Xi referred to Taiwan in his speech much earlier than he did five years ago, a sign of Taiwan taking greater importance. Declaring a firm line on Taiwan, Xi drew the speech's longest stretches of applause from delegates. The lack of substantive commitments to specific policy approaches or instruments signals that China is still exerting what Xi also uses in the speech –– "strategic patience".

However, the report stated that the use of force was aimed at "external forces" and "Taiwan independence". He also claimed that unification "can be realized, and it must be realized."

The report mentioned that "the strategy and tactics of people's war should be developed and a strong strategic deterrent force system should be developed."

This sentence has never appeared in the past, and the strategic deterrence system most likely refers to nuclear weapons.

In this 2022 report, the Taiwan related part was less than 600 words, which is the shortest in length since 2002. Xi did not use the phrase "one country, two systems" in his references to Taiwan. It was in the written text of the work report, but not in his abridged delivered remarks regarding Taiwan.

As for public opinion in Taiwan, the results of a regular poll released by the Mainland Affairs Council of Taiwan on August 18 showed that more than 80% opposed the "one China principle" in the mainland's white paper, and even more were opposed to "one country, two systems" that treats Taiwan as a local government and a special zone (84.7%). The vast majority of Taiwanese advocated "maintaining the status quo in a broad sense" (86.1%).

What should investors watch for next as it relates to their investments in China?

On the first trading day following the closing of the party congress, the MSCI China dropped -7.3%. We believe that investors' initial negative reaction was premature in assuming that Xi will pivot away from market-friendly policies going forward. We will need 6-9 months to see who will be in key positions that will execute economic policies and whether senior leaders like Li Qiang are given a mandate to enact continued reforms that will help fuel the modernization goals that are central to Xi's long-term strategy.

Looking at Chinese equity investments, which areas of the market are expected to be winners and losers under this new political backdrop?

Areas that are in-line with the party's central goal of security and self-sufficiency will continue to enjoy policy tailwind. Some promising Alpha Clusters would include factory automation, cybersecurity, artificial intelligence, semiconductors, health care digitalization, capital market digitalization, specialty drugs, medical devices, consumption upgrade, domestic products upgrading and appealing to nationalistic sentiment, an aging demographic, as well as winners of industry consolidation.

Notably absent in Xi's report or speech to the congress are non-strategic areas such as the internet sector or "low-tech". While regulations may not intensify from here, the lack of strategic importance and deteriorating fundamentals make these areas less attractive from an investment standpoint.

CONCLUSION

While the equity markets never like uncertainties, we believe there remain opportunities in China. With a more unified party and government, Xi will be able to better focus on the goal of becoming the largest economy in the next 10 to15 years. There will be more focus on equality of income and wealth which will likely result in continued consumption growth as more people join the middle class. The tension with the US also means the government will provide strong financial and policy support to key industries such as advanced manufacturing, AI and semiconductors. With the equity markets trading at valuation levels not seen since the Asian Crisis, we believe investors with deep knowledge of China will be able to take advantage of current market dislocation and generate significant alpha in the future.

BIOGRAPHY: Dr. Tan Kong Yam

Professor Tan has been with APS since 1995 and is presently Deputy Chairman of APS China Asset Management. He is also Professor at the Lee Kuan Yew School of Public Policy and Director of the Asia Competitiveness Institute at the National University of Singapore as well as Professor of Economics at the Nanyang Technological University. Presently, he also serves as director on the boards of Changi Airport Group, Surbana-Jurong Private Limited, Ascendas-Singbridge Private Limited and CapitaRetail China Trust Management Limited.

From 1985-88, he was the chief assistant to Dr. Goh Keng Swee, the late Deputy Prime Minister of Singapore who was invited by Mr Deng Xiaoping to advise China on economic development strategy. From June 2002 to June 2005, he was a senior economist at the World Bank office in Beijing. In 2004, he was a member of the World Bank's expert group on China's 11th 5-Year Plan that ran from 2006 to 2010. The expert group was formed at the request of China's State Council, to provide analysis and policy recommendations to the Chinese government.

Prior to that, he was the chief economist of the Singapore government (1999-2002), Head of the National University of Singapore (NUS) Business School's Department of Strategy and Policy. He graduated from Princeton University in 1979, where he was a Scholar of 'Class of 1931 Scholarship Fund' and winner of the Paul Volcker Thesis prize. Taking only three years, he went on to complete his Master's and PhD degrees at Stanford University by 1983. Prior to joining NUS, he worked at the Hoover Institution at Stanford University, the World Bank, and the Monetary Authority of Singapore.

DISCLOSURES