

CHINA: 19th PARTY CONGRESS AND BEYOND



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What are the key takeaways from the 19th Party Congress?

QW. Overall, the results of 19th Party Congress were better than our expectations, with a clearer direction set out for the country, and the implication that power has been more strongly consolidated, though in line with the direction that we had forecast. Xi's name and thoughts about how to achieve the Chinese 'Dream' were written into the Party constitution, implying that he has reached the same historical positioning as Deng and Mao. The new decision-making bodies, including the Politburo and the Standing Committee, both showed a clear bias towards Xi's position. On the positive side, this could help improve implementation of policy and reform measures, particularly in some tough areas.

The strong consolidation perhaps also reflects consistent agreement with and support of Xi's blueprint for the country's future, at least from inside the Party. We saw clarification about and reaffirmation of the country's direction initiated in recent years: with China entering a "NEW ERA", the key task is to address the structural problem between "unbalanced and inadequate development" (supply-side) with the "people's ever-growing need for a better life" (demand-side), rather than just to pursue material prosperity. Therefore, the top priority is shifting from 'Growth towards Quality', and the means to achieve this is to "deepen reforms".

Beyond economics, there was a strong emphasis on Xi's and the Party's roles, regarding which global investors might need further clarification. Nonetheless, for now, we think the situation looks more like the focus is on practical issues to help strengthen Party discipline and improve governance rather than there being a move back towards Rule-by-Man or away from the market. In fact, there were signs of a leaning towards more institutionalised and rule-based governance.

How do you see the reform path progressing and what will be the key areas of focus in the short and medium term?

QW. We are waiting for more details about reforms. The messages in this regard so far have mostly confirmed the shift of focus in the last couple of years. We expect reforms to be more balanced, with some lagging areas perhaps catching up. First, the direction of reform seems to have been reaffirmed, with some key points written into the Party constitution, such as "let [the] market play [a] decisive role in resource allocation" and "supply-side structural reforms". Three hard tasks were re-emphasised: preventing financial risks, reducing poverty and fighting pollution. Regarding financial reforms, this appears consistent with messages from the Financial Work Conference in July, which suggested the focus would be more on reducing financial risks towards strengthening regulations and deleveraging, with further liberalisation and opening to continue, but at a more carefully managed pace.

There were signs that State Owned Enterprise (SOE) reforms could accelerate in coming years, ie, become more efficient, with better discipline. For example, "mixed-ownership" and "asset management system" were explicitly mentioned in the report. Meanwhile, no SOE heads were listed as being in the new Central Committee, which is unusual. It might help reduce pushbacks in potential harsher push of SOE reforms. In addition, we saw continued emphasis on reforms to help rebalance the economy and reduce income inequality, such as a nationwide social protection system, urbanisation with Hukou reforms which has already recorded meaningful progress over the last couple of years.

Interestingly, more than on the economic side, there was more emphasis on improving governance to be more rule-based and institutionalised, such as to set up a group to lead the process of advancing law-based governance, and to set up a national supervision commission beyond the Party with new a law focusing on a more institutionalised system for discipline and anti-corruption.

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In your view, has the risk of a slowdown in China – with significant implications for EMs and the global economy – increased or decreased for 2018, and why?

QW. Although China's economy is widely expected to slow, it appears more resilient than previously believed. The coming slowdown is likely to be moderate, as growth drivers are now more broadly based and meaningful supply-side adjustments, including cuts in overcapacity and property destocking, have already materialised. The main risks are largely in potential policy mistakes.

Such risks regarding policy mistakes also look to be lower following the Party Congress, with the direction of policy having become clearer, and we hope that policy implementation will become more consistent and effective, following further strong power consolidation to wide areas and lower level officials. As such, there could be a better chance for China to manage a relatively soft-landing ahead, without there being significant disruption to other EMs and the global economy.

Can Chinese policymakers help to lower the risk of a debt crisis?

QW. We think risks for a systemic crisis for China are limited in the near term, and longer-term risks could be lower, if policymakers move in the right direction. We have already seen signs of structural shifts in China's economy, with traditional sectors perhaps approaching the late stage of adjustments on the supply-side and the 'new economy' becoming more visible as a result of reforms. If policymakers are able to continue to move in the direction reaffirmed at the 19th Party Congress – i.e. to continue to push structural measures – the economy could become more efficient in resource allocation, with its structure more balanced towards fewer debt-dependent sectors, which could ultimately help solve debt problems and reduce systematic risks in the long term.

On the geopolitical front, how do you see the role of China after the Congress, and on what do you base your thinking?

QW. We have perceived a shift in China's foreign policy. With its economic developments moving into a new stage, China has shown a willingness to become more active in global affairs, which now appears to have become a higher priority in policymakers' agenda. "One Belt One Road" projects are likely to be among the key areas to receive further government support, which could be beneficial for many EMs. Regarding various geopolitical risks linked to the region, there might be less risks. For China, internal stability would likely mean that the government will see less need to make tough gestures overseas. For others, perhaps to be more careful, with less speculations given Xi's strong position internally and clearer stance.

What were the main themes raised at the Party Congress that could have an impact on Chinese equity markets?

AC. The 19th Congress of the Chinese Communist Party was a watershed moment for China. General Secretary Xi is now in control of the Politburo and had his "thoughts" were enshrined in the Party constitution. We expect Xi to be in the driving seat for many years to come. His statements at the Congress were very clear and, from the perspective of equity investors, we can identify some crucial themes that will likely impact equity markets: the emphasis on the quality of economic growth rather than the speed, and the aim to make growth more equitable. Last but not least, Xi has set a clear goal of raising China's international profile over the next 10 years.

How could an investor play these themes? Which stock market sectors could benefit?

AC. As a consequence of the direction taken by Xi, we expect to see the Communist Party take a bigger role in economic life and to play a stronger role regarding SOEs, which have become too dominant and seriously inefficient. The SOE reform is crucial for the future of China. We expect more policies focused on breaking down monopolies. Of course, implementation of these measure could be slow, but we think a positive impact will be seen regarding sectors such as telecoms, steel and energy, which have a big weight in the index. The redistribution of wealth is also a powerful theme that will gain momentum. This will likely support consumption stocks and the expanding sector of financial technology (Fintech), in particular in relation to the

China's foreign policy is focused on taking a more active role in global affairs.

The SOE reform has important implication for equity markets in sectors like telecoms, steel and energy.

area of consumer finance. As far as China's higher profile on the international scene, it means that China will seek consensus by spending more money on infrastructure projects abroad. The "One Belt One Road" theme has still to show all its potential and should be beneficial for the capital goods sector.

Lastly, a word on internet companies that are very rich and might be "asked" to contribute to Xi's goal to distribute wealth more equitably. Our impression is that it would be wiser to focus on second-tier players, as they will not be immediately targeted by the Chinese government.

What implications do you see for Chinese corporate profitability?

MM. Regarding China, among the most pervasive micro themes has been constrained investment, supply shortages and pricing power in upstream industries, i.e. metals, materials and energy. This supports the view that PPI will not change direction too sharply and supportive low real rates can be enjoyed for an extended period. Considering the quite healthy run rate of aggregate demand, it seems more likely that we will experience a milder moderation going forward (PPI easing) rather than the usual stop/start stimulus/collapse that we have experienced post 2009. While this supply constraint isn't necessarily positive for a sustained broad rebound in capex, profitability levels and "peak margin" may last a little longer than we might normally expect within the usual business cycle. China's long-term decay regarding both asset turns and margins could pause. On the other hand, along with reduced aluminum, steel and cement production through the "pollution" season, the decline in output will result in reduced demand for "heavy" industry infrastructure, with power demand softening and strain on logistics easing. Coal production could also correct from its current elevated level (also considering that rural gas replacement is picking up); clearly, if there isn't a decline in the use of coal in this period, one can question the logic of this entire environmental exercise. We do not see coal companies as attractive, despite what should be a pretty strong reporting period.

From a multi-asset perspective, what is your view on China – specifically relative to other EMs – in light of the recent Party Congress?

FS. We remain constructive on China, and we consider the medium-term structural story attractive. We see China as more resilient than in the past due to its broader-based growth profile and we see lower risks of policy mistakes, especially after the Congress reinforced the reform process. An additional factor to consider is the real estate sector, which is crucial not only for private demand but also for the fiscal sustainability of public initiatives. Even though property sales have cooled, residential investments is buoyant, with Tier 1 cities showing under supply.

That said, we remain moderately constructive on EMs as a whole. Fundamentals look to be holding up relatively well in most EMs and the global backdrop is favourable for the asset class. We prefer Russia relative to the GEM index, and we are positive on South Korea on the back of improved macro fundamentals and decent valuations. We will continue to monitor geopolitical events in the region regarding North Korea.

How should an investor play the China economic transformation with a MA approach?

FS. China looks to be entering the second half of its multi-year transition. At this stage, we maintain our conviction on "New" China into the medium term while expecting downward pressures on "Old" China to be easing with supply-side adjustments approaching a late stage. As a result, we remain positive on the MSCI index which better represents the New China. That said, we also turned more positive on the HSCEI which is more exposed to old China, including banks that also benefited from the recent targeted RRR cut with space for further cuts open.

"Peak margins" in place for longer, supported by low real rates and solid internal demand.

From a multi-asset perspective, we consider the Chinese medium-term structural story attractive.

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