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CHINA'S 19TH PARTY CONGRESS—WHAT COMES NEXT?

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KEY POINTS

- One of the most important political events on the Chinese calendar took place in October 2017 with the hosting of the 19th National Congress of the Communist Party of China.
- Held only once every five years, the Congress saw a shuffling of the deck at the apex of power in China as well as a reconfirmation of a number of key policy objectives and ambitions.
- President Xi Jinping has made it clear that there will be no significant changes to China's economic strategy, with the emphasis remaining on quality over quantity and on gradual progress toward a more market-driven, entrepreneurial economy.
- Domestic market reform, principally de-risking the financial sector, is a priority for China. Efforts aimed at cutting excess capacity and reducing financial leverage are also set to be deepened, as well as additional measures to allow mixed ownership of state-owned enterprises.
- While President Xi has made domestic reform the immediate "priority of priorities" for China, it is perhaps on the foreign policy front, specifically his "One Belt, One Road" (OBOR) vision, that his own personal legacy hinges.
- From an investment perspective, we expect that China will continue to be a positive and increasingly prominent force for the global economy for many years to come. A strong leader with a clear and ambitious sense of purpose, China appears to be firmly in control of its own destiny.

One of the most important political events on the Chinese calendar took place in October 2017 with the hosting of the 19th National Congress of the Communist Party of China. Held only once every five years, the Congress saw a shuffling of the deck at the apex of power in China as well as a reconfirmation of a number of key policy objectives and ambitions. In this article, we discuss some of the key outcomes from the Congress and also consider a number of broader influences potentially impacting the China investment thesis.

On the whole, we see this power consolidation as broadly positive for China. While President Xi is perhaps the most powerful leader since Mao himself, he also has a remarkably ambitious vision for China.

AN AMBITIOUS VISIONARY OR DICTATOR-IN-WAITING?

As widely anticipated, the Congress saw President Xi Jinping consolidate his power at the top of China's all-powerful Politburo Standing Committee. His heightened authority was confirmed by the Party's decision to include his name and signature slogans in its constitution, an accolade reserved for only the greatest leaders of the past. The Congress's deliberate failure to designate a successor to President Xi, as has been the norm at previous national meetings, further confirms Xi's standing, leaving the door open to extending his presidency beyond the next five years.

Some have voiced concerns about the level of power that President Xi now commands, seeing this as a calculated attempt to extend his will over China's future for many years to come. However, we do not share the view of Xi as a dictator-in-waiting. On the whole, we see this power consolidation as broadly positive for China. While President Xi is perhaps the most powerful leader since Mao himself, he also has a remarkably ambitious vision for China. In his Congress opening speech, he repeatedly referred to China as a "great power" and a country that is entering a "new era" of global influence and importance.

During his first five-year term as President, factional in-fighting within the Party leadership generally proved a hindrance to President Xi's policy objectives. However, as he begins a second term, his increased authority and power should allow him to press with his ambitious plans, relatively unimpeded.

CONFIRMATION OF POLICY OBJECTIVES AND AMBITIONS

From a policy perspective, President Xi has made it clear that there will be no significant changes to China's economic strategy, with the emphasis remaining on quality over quantity and on gradual progress toward a more market-driven, entrepreneurial economy. To this end, domestic market reform, principally de-risking the financial sector, is a priority. Efforts aimed at cutting excess capacity and reducing financial leverage are also set to be deepened, as well as additional measures to allow mixed ownership of state-owned enterprises.

There are some who believe that, while good for newspaper headlines, there is actually little incentive for President Xi to deliver some of the tougher reform measures, given the potentially painful near-term impact on the economy. However, it is worth noting that President Xi has not shied away from difficult promises he has made in the past, most notably his pledge to eradicate corruption within the Party. His far-reaching anti-corruption campaign has been very effective, sweeping through the ranks, from lowly administrators to top officials, so there is reason to believe that he can indeed push through his proposed domestic reform agenda.

This is certainly good news for China's long-term outlook. Many foreign investors see China's current structural problems as being progressively destructive of value over the long term. However, if President Xi can successfully deliver the planned reforms, some of which will be painful, then this should have a direct and positive impact on the long-term value of the China market. Of course, these reforms will likely have negative implications for the economy in the short term. Given that President Xi will want to get any painful reforms done as soon as possible so that the economy has time to recover and begin improving again in advance of the next Party Congress, we believe that there is a real possibility that Chinese growth might disappoint in 2018.

GROWTH RATE IS CRITICAL, BUT MAYBE NOT THE ONE YOU ARE THINKING OF

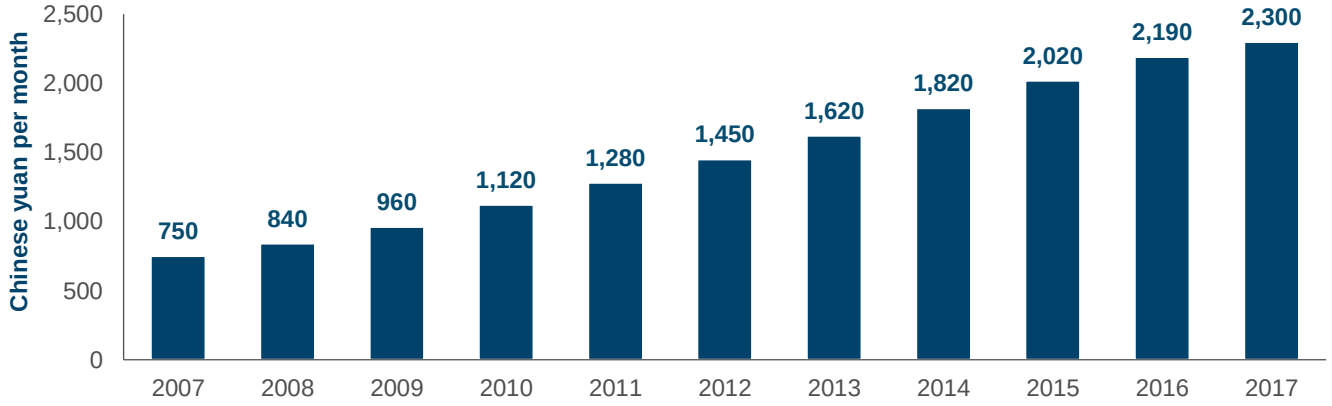
As the engine of the global economy, the subject of China's economic growth rate has become somewhat of an obsession for the global investment community. As such, it was noteworthy that, in a break from usual practice,

President Xi failed to provide a forward-looking growth target in his Party Congress speech. This leads us to believe that, while undoubtedly important, China's headline rate of economic growth is perhaps not the figure that leaders are watching most closely.

There is plenty to suggest that growth in the level of income is possibly an even more important number for China's leaders. This is at least partly reflected by the fact that, over the past decade, the government has consistently pushed through substantial minimum wage increases in the region of 7% to 8% every year (Figure 1). Indeed, growth in China's median income rate is among the highest in the Asia Pacific region, which is further indication of the high importance that China's leaders place on the level of income growth in the country. This is not terribly surprising as healthy annual income growth tends to have a knock-on effect, acting as an ongoing stimulus for the economy.

Figure 1: **China Mimimum Monthly Wages**

As of September 2017



Sources: Tradingeconomics.com and the China Ministry of Human Resources and Social Security.

FOREIGN POLICY IS WHERE LEGACY RESTS

While President Xi has made domestic reform the immediate "priority of priorities" for China, it is perhaps on the foreign policy front, specifically his "One Belt, One Road" (OBOR) vision, that his own personal legacy hinges.

The OBOR initiative is Xi's own personally devised road map for recreating a modern equivalent of the ancient Silk Road trade route, creating a network of railways, roads, pipelines, and utility grids linking Asia, Europe, and Africa. However, the initiative is more than just physical connections; Xi's vision is to create the world's largest platform for economic, social, and cultural cooperation and to establish China as its beating heart. The OBOR strategy is central to President Xi's longer-term plan for China. In his opening address, he spoke about China entering a "new era, one that sees China moving closer to center stage."

At one level, the OBOR policy seems at least partially aimed at helping China to export some of its excess capacity, providing a handy boost to the domestic economy in the process. China produces so much of so many things that the OBOR policy should help the country to more easily export this excess production to neighboring countries. However, at a broader level, the OBOR strategy is principally about China increasing its influence on the world stage. At the very least, it is a means by which to confirm its leadership within the Asia Pacific region. Historically, China has struggled to establish and maintain friendly relations within the region, too often adopting a hard-line approach with neighboring countries. The resulting environment has enabled the U.S. to maintain a strong and influential presence in the Asia Pacific region, something that continues to annoy China. The OBOR policy is essentially China's all-out attempt to buy influence throughout Asia and establish its authority in the region, once and for all.

TACKLING THE DEBT MOUNTAIN

China's ballooning level of debt, particularly corporate debt, remains a constant source of worry for policymakers and investors alike. Over the past decade, the level of corporate debt-to-GDP has surged to around 169%, the highest ratio in the world. Reducing this vast level of debt is certainly a priority for China, and with President Xi's consolidation of power, he is well placed to forge ahead and accelerate efforts aimed at reducing China's vast mountain of debt.

It is worth noting that, amid all the column inches dedicated to discussing China's ballooning debt over the past decade, one thing that is rarely mentioned is the comparative level of Chinese interest rates during this time. Ten years ago, official rates were around 7% to 8%, but in the decade since then, rates have essentially halved to the 4% levels of today. This is an important consideration given that this has effectively enabled companies to take on a higher level of debt without incurring a material rise in the level of risk. On this basis, the suggestion that the current level of corporate debt represents a systemic market risk seems overblown in our view. Certainly, if the level of interest rates in China was rising strongly, this would indeed pose a problem. However, this is currently not the case, and in all of our recent meetings and discussions with insurance companies in China, they have indicated that they feel interest rates could even move lower from current levels.

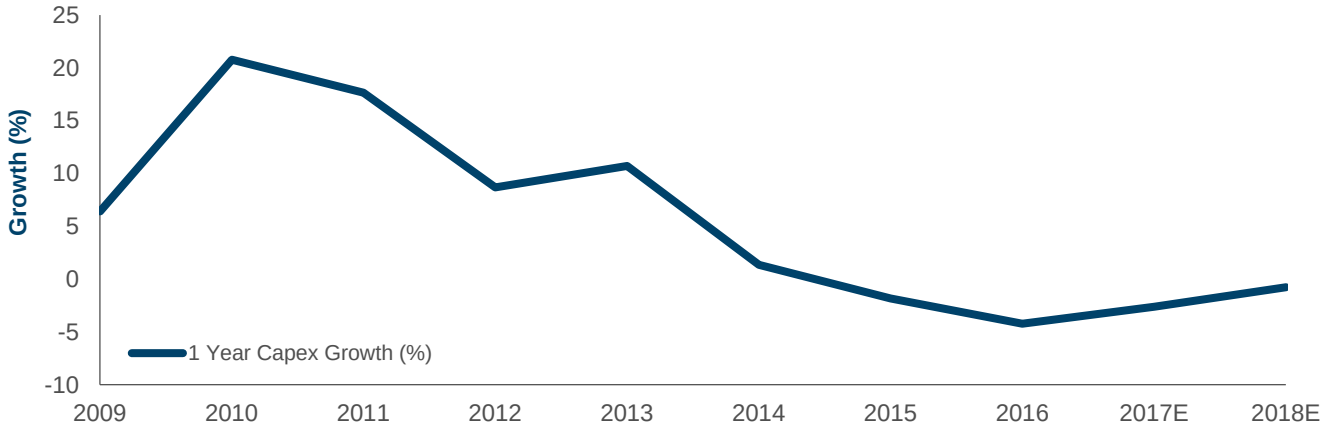
MAYBE THE BEST KEPT SECRET IN CHINA

At the corporate level, the deleveraging process in China is already underway. This is effectively being enabled by the boom in company free cash flow seen in recent years—something that remains underappreciated by investors, in our view. An intense focus on business efficiency and more disciplined capital spending by company management teams is at the heart of the surge in free cash flow generation (Figure 2). While many of these businesses were always generating a lot of cash, much of it would then be wasted on unnecessary or undisciplined capital spending. Crucially, however, many of these companies have seen the light and, over recent years, have made every effort to rein in capex and cut operational costs. In turn, the excess cash flow generated is being put to use in more productive, value-adding ways, such as paying out higher and special dividends, buying back shares, and paying down debt.

Foreign investors, in particular, continue to view Chinese companies through the prism of their earnings alone. However, this narrow focus only tells part of the story. When considered in the context of free cash flow generation and how this is being put to use, then the potential of many of these companies suddenly appears altogether more exciting.

Figure 2: **More Disciplined Capex Is Driving a Surge in Free Cash Flow**

As of September 30, 2017. In U.S. dollars.



Sources: FactSet and MSCI.

SO WHAT DOES IT MEAN FOR CHINA GOING FORWARD?

In broad terms, we believe that the consolidation of President Xi's power is positive for China, allowing him to press ahead with his near-term domestic reform agenda. Given our belief that he will look to push through potentially painful domestic reforms as soon as possible, we see a downside risk to growth in 2018. Taking the medicine now, however, should prove positive for China's longer-term growth outlook. In his Congress speech, despite focusing on the country's domestic challenges, President Xi did provide some insights into his view of China's position on the world stage. In this, he signaled a new confidence in China's social and economic model, its global standing, and its future development, with China ultimately "moving closer to center stage."

From an investment perspective, we expect that China will continue to be a positive and increasingly prominent force for the global economy for many years to come. Certainly, the OBOR initiative represents a fertile ground for bilateral cooperation and collaboration, while expanding China's global interests and influence. A strong leader with a clear and ambitious sense of purpose, China appears to be firmly in control of its own destiny.

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