What Happens Next in China?

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Our Take on the 20th Party Congress of the Chinese Communist Party

Clarity is perhaps the last thing one might expect to emerge from a highly secretive, carefully choreographed, twice-a-decade gathering of the world's largest communist party; yet, for better or worse, that is exactly what investors got this weekend. Xi Jinping has consolidated power in China in a manner not seen since the days of Mao Zedong; and unless something truly unforeseen happens, he looks to remain in power for a long time, with significant consequences for the world's second largest economy.

The outcome of the week-long gathering, which concluded Sunday, was unequivocal. All of Xi's perceived opponents, or at least those thought of as moderating influences within the Party, were removed from any positions of power. The Party's new seven-member Standing Committee is now populated solely by Xi's allies and loyalists, with every member essentially owing his position to the General Secretary. This means that, for at least five more years, there will be no checks and balances on Xi's power. Furthermore, former Party statesmen were unceremoniously removed from any positions of influence, and respected technocrats such as former premier Li Keqiang, Wang Yang, the former party chief of Guangdong province, and Hu Chunhua, a respected party leader seen as a potential candidate for the premiership, were also swept from power. Among the most worrisome developments, the newly elected Central Committee (China's rule-making body) lacks competent successors to the raft of members headed for retirement from the country's top financial positions.

The clear conclusion we derive from the significant personnel changes atop China's ruling party is that Xi's dogmatic ideology will continue to supersede the pragmatism of previous Chinese leaders, including Xi's first five-year term. This means a renewed emphasis on Chinese self-reliance, especially in key industries such as aerospace and semiconductors, a renewed role for the state (and SOEs) in determining the direction of the economy, additional uncertainty about China's draconian zero-Covid policy, and a sustained focus on the recent "common prosperity" theme championed by Xi. This does not, in our view, mean the end for China's dynamic private sector. It will, however, force investors to rethink their China playbook, which we address below.

Market Clarity

Markets spoke with even greater clarity following the conclusion of the Party Congress this weekend. The Hang Seng Index lost 6% when Hong Kong markets resumed trading on Monday, and the five largest Chinese tech stocks listed in New York shed more than US$50 billion in value in the first couple of hours of trading. The CSI 300 Index of large cap stocks traded domestically lost almost 3% in Monday trading. Following the Party Congress, investors expect China to continue its gradual decoupling from Western economies, especially the U.S., and a broader recalibration by foreign firms and investors of their engagement with the country. The bigger losers appear to be Chinese firms listed overseas, which suggests that they will continue to underperform their A share peers in the future.

No Return to 'Business as Usual'

A trend that has been clear to us for some time, well before the latest Party Congress, is that China and the "west" will continue a gradual but limited decoupling across trade, standards-setting, mutual market participation, and cross-border investing. We don't expect such decoupling to be absolute, but we also do not expect a return to the 'business as usual' environment of the late 1990s and early 2000s. China is too closely integrated into the global economy, and foreign firms too heavily invested in the country, for a complete decoupling to occur. We do expect, however, a new paradigm for China's development for the foreseeable future in which the local economy and certain key industries will play a significant role in the country's growth that will supersede previous growth engines, such as foreign direct investing, low-cost manufacturing and, to a limited degree, fixed asset investment.

Perhaps coincidentally the beginning of this bifurcation between China and the rest of the world can be traced back to Xi's first term, although it gained steam during the Trump administration and was clearly exacerbated by the Covid-19 pandemic. And while many China observers believe the Trump administration was the cause of global tensions between China and much of the world's developed economies, we disagree. In our view the Trump administration simply catalyzed what had been developing for some time but that few political leaders in the West dared to say: that China had abused its opportunity to integrate into global commerce following its accession to the WTO; that it had, for a long time, subsidized its SOEs to the detriment of foreign competitors across myriad industries; that it had failed to protect foreign intellectual property; and that it had refused to open its markets to foreign companies contrary to the promises it had made. One needs look no further for than the policies of the Biden administration to see this was not simply a 'Trump' phenomenon. Biden has not only continued with Trump's policies towards China but, in fact, taken them further. This is evident in the CHIPS Act, passed by the U.S. Congress earlier this year, which provides significant subsidies for the development of semiconductor manufacturing facilities in the country, and by the expansion of U.S. export restrictions of semiconductors and other advanced technologies to China.

Europe, while less vocal about it, has largely mirrored U.S. policy with similar efforts to re-shore key supply chains, especially in advanced technology such as semiconductor fabrication. Even emerging economies, heretofore recipients of China's largess through its 'Belt and Road Initiative,' have grown wary of the long strings that came attached to China's below-market rate loans and infrastructure "investments." Xi's confirmation for an unprecedented third five-year term and his unquestioned consolidation of power seems, thus, confirmation that in the next five years China will travel a path that will diverge from the preceding three decades.

Strategic Clarity and Tactical Uncertainty

Considering the headwinds described above, should foreign investors divest from China? No. Simply put, China is too big, its domestic markets too large and liquid, and its growth—even when it runs below trend—still accounts for about one third of global growth. And while China has some very real challenges it must deal with in the short-term, it is also doing plenty of things right in the long run that should give investors some pause before running for the exits. For starters, the country seems to have a clear energy strategy that balances its near-term needs while it transitions to a greater mix of renewable and sustainable energy, which is more than most developed economies can say these days. For example, China announced less than a year ago the construction of 150 new nuclear reactors in the next 15 years, which is more than the rest of the world has built in the last 35. This brings its total pipeline of nuclear (largely carbon-free) reactors to 228, with a combined capacity of 246 GW, which is more than the entire electricity generation capacity of Germany (225 GW), one of the world's most industrialized economies[1].

As its population ages, the government has embarked on significant pension reform, as it expects to shift most of the funding burden of future retirees from the government to individuals, which bodes well for its capital markets, as we have written before. Meanwhile, it continues to develop its human capital, with a 40% increase in university graduates in the last decade and a tripling of government spending in health care over the same time[2]. And while consumption has suffered mightily because of the country's strict zero-Covid policy, this has allowed Chinese households to save even more than they usually do, with family bank account balances up 39% from early 2020, on the eve of the pandemic. The country's savings glut will, in the long run, support the domestic equity market as savers are enticed into private retirement accounts. Foreign investors who own A shares directly should consider that 95% of the market's free float is owned by domestic investors, which means that even large foreign capital outflows are unlikely to dent Chinese stocks for long.

[1] China's nuclear pipeline as big as the rest of the world's combined. Energy Monitor, December 20, 2021.

[2] China's investment management opportunity. Deloitte Insights, 2019.

Near-Term, Tactical Concerns

While we are concerned about Xi's aggressive posture towards the private sector, especially the large platform tech companies, our biggest near-term concern for Chinese equities—and the economy at large—continues to be the government's zero-Covid policy, as we have written in the past has depressed consumption, significant parts of the country's growing service economy (such as travel and hospitality), and even some manufacturing as industrial hubs have experienced large shutdowns. Our guess is as good as anyone's as to when such policy will relax, although recent pilot programs in Hong Kong, as well as the government's ongoing discussions with foreign mRNA vaccine producers suggest we are closer to the end than the beginning. Another significant near-term headwind is the continued crisis in the country's housing market, which, along with the stock market's decline, has a negative wealth effect that will make Chinese consumers hesitant to open their wallets.

On the other hand, China is the only major economy engaged in some sort of monetary easing, while most of the world continues to tighten financial conditions. Combined with households' trove of savings, pent-up consumer demand, and clarity about the country's political direction, it might appear that tactical conditions could become more favorable in the not-too-distant future.

Post-Party Congress China Investment Playbook

While Xi has made it clear that he expects the state to play a leading role once more in economic policy, we don't think it would be prudent for investors to jump back into the shares of State-Owned Enterprises (SOEs). Some of these companies might be beneficiaries of state largess, but this will inevitably lead to poor capital allocation decisions, which will erode margins and lever up their balance sheets once more. Furthermore, as the state assumes greater control over the economy, it's likely that the burden of providing benefits such as health care and pension payments might be 'delegated' to some of the SOEs. We believe, that as in the private listings, selection is the key to investing in SOEs.

Compared to overseas listing, we are partial to domestic stocks (A shares), and to a lesser degree those on the Hong Kong exchanges. And while it appears that a truce was recently agreed to between the SEC in the U.S. and Chinese regulators regarding the audit requirements for Chinese companies listed in the U.S., we don't think the last word has been said regarding this topic. We wouldn't be surprised to see an acceleration of company delistings from U.S. exchanges, and with them a possible transfer of value from offshore to onshore shareholders.

We continue overweighting China's 'new economy' sectors even more now than in the past, as the partial economic decoupling we described above continues. The Chinese consumer and services market is simply too big to ignore, while health care should be a significant beneficiary of government investing as its population continues to age. Lastly, technology is clearly the economic 'battleground' of the future, in which we expect domestic players to benefit from additional government stimulus, domestic private investment, and a wide-open local market as access to foreign firms is either shut down by the Chinese government, or restricted by foreign government through export bans, or both.

In summary, investors in Chinese stocks should stay the course despite the deluge of market negativity. Valuations and poor market sentiment warrant it from a contrarian perspective. However, in light of a significantly different political environment from even just a year ago, they will need to be more selective than ever.

About the Author

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