Investment Insights

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China's 19th Party Congress – One man to rule them all

Old faces, new faces

The 19th Chinese Communist Party's National Congress ("Party Congress"), the most important event on China's political calendar this year, drew to a close in late October. The Party Congress is a twice a decade event where the future leadership for the party is installed. Around the world, investors tune in for insights to the future direction of the world's second largest economy.

This year, the event ran from 18th to 25th October, culminating in the announcement of the membership for the Politburo Standing Committee (PSC) and Politburo. Key highlights are summarised below.

Xi Jinping's position was strengthened

This is perhaps the most notable outcome from the Party Congress. After being named as "core leader" last year, Xi Jinping's ideologies, "Xi Jinping thought on Socialism with Chinese characteristic for a new era", were enshrined in the Party constitution. The honour has only been bestowed upon leaders like Mao Zedong and Deng Xiaoping in the past. As such, Xi Jinping could continue to influence China's policies years past his actual term.

PSC membership announced

Both Xi Jinping and Li Keqiang stayed on in the PSC. Li Keqiang's presence suggests that Xi Jinping and the Central Committee continue to hold Li Keqiang in high regards. An economist by training, Li Keqiang known for constructing the "Li Keqiang Index" which is widely followed by the investment community. The continuity in leadership could help strengthen confidence in the Chinese government.

Asides, five new members were introduced and the group appears to combine both Xi's supports and those from the opposite camp. The balance could help Xi garner support for challenging reforms. However, their positions in the new committee have yet to be announced.

No clear successor for Xi Jinping

All seven members in the PSC are above the age of 60. Hence, according to the soft retirement age of 68, none of them would be eligible for a second term in 2022. This has led to speculations that Xi Jinping intend to hang on to power beyond his second term.

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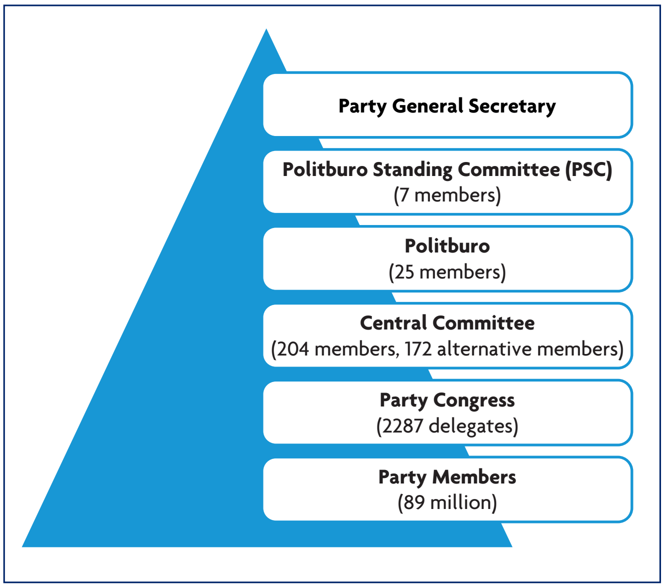
Figure 1: Simplified structure of the Communist Party of China.



Source: Caixin, The Straits Times, 25 October 2017
(compiled by UOB Investment Strategy)

Same direction, stronger execution

All in all, there was no major shakeup in the leadership makeup for China. Xi Jinping remained firmly in power, if not further strengthened in his mandate. Li Keqiang stayed on, dissuading speculations that he could be removed.

As such, we expect little changes to the current policy direction for China while strength of execution is likely to be reinforced. Policies are expected to centre on increasing financial and economic stability and achieving "quality growth". Current initiatives are likely to continue and include the restructuring of State-Owned Enterprises (SOEs), deleveraging of corporate and local government debt, reform of foreign exchange and interest rate markets, capital flows management and the Belt and Road Initiative.

Implications for investors ▶▶

The Party Congress has important implications for investors. Continued focus on reducing systemic risks could increase stability and sustainability of growth in China and by extension, the broader Asian region. However, ongoing reforms may lead to softer data in the near term, which may spark overreactions in the market.

To manage potential volatility caused by market scares, investors can consider accessing Asian opportunities through balanced Asian funds. Compared to pure equity funds, balanced Asian funds exhibit consistently lower volatility due to exposure to fixed income instruments, offering investors a smoother investment experience. Diversifying across different countries in the region could also help to reduce volatility. Investors with higher risk appetite can choose to invest in China-focused funds or pure equity funds.

Focus on preventing systematic risks

In his addresses during the Party Congress, Xi Jinping has notably omitted any quantitative growth target. Instead, he emphasised on the need to reduce systematic risks in the economy and the financial system. The shift in priorities showed that the Chinese leaders are well-aware of the challenges faced by the economy. Reforms are likely to be phased in to avoid disruptions to the economy. A stable Chinese economy could help anchor the investors' appetite for broader Asian risk assets.

Emphasis on supply-side structural reforms

Increasing supply-side structural reforms continues to be a critical theme to China's economic transition. The government is likely to push forward with capacity reduction in sectors with oversupply conditions, which could help inflate prices. This is evident in the materials sector. As illustrated in Figure 2, higher prices, indicated by the Producer Price Index (PPI), translate to higher forward earnings. The result could also help support earnings in similar industries outside of China and hence lift earnings for the broader region.

Figure 2: Forward earnings of the materials sector in China improved as PPI rebounded.

Source: Bloomberg, UOB PFS Investment Strategy, 30 September 2017

Some risks still remain

As the government embarks on reforms and deleveraging, some parts of the economy may be negatively impacted in the near-term. The property market, for example, is already showing signs of cooling. As seen in Figure 3 below, residential property sales in China have been slowing. Although we do not expect a China hard landing, caution is warranted as past episodes of China economic slowdown had often sparked investor overreactions. Investors should also be wary of equities linked to real estate companies, as many of them have high leverage due to excessive debt issuances.

Figure 3: China residential property sales showed signs of cooling.

Source: Bloomberg, 30 September 2017

Market Outlook and Strategies ▶▶

Macro

Global Growth	**The medium term economic outlook for US was trimmed slightly** on concerns about Trump's pro-growth policies. Europe and China are expected to enjoy firmer growth. Overall growth revised up.
Monetary Normalisation	Central banks continue on normalising path. Fed has already begun tightening. **ECB has announced its plans to taper its QE program**, though exit will remain gradual. BOJ is likely to continue easing.
Inflation & Rates	**Inflationary pressure stay subdued, partly due to tepid wage growth.** The Fed upgraded its growth outlook in its November meeting. Base case remains for December rate hike.

Risks

Trump Disappoints	**Tax reform saw some progress this month.** However, the devil is in the details and markets have already priced in the positives. Failure to implement tax reforms as promised could unsettle the markets.
China Policy Missteps	China concluded its 19th Party Congress and Xi's influence strengthened. Focus on stability and deleveraging likely to continue. **But overly aggressive policies could raise default rates and hard landing risks.**
North Korea Tension	**Tensions between the US and North Korea continued.** Both Trump and Kim have been quiet recently, but more provocations from North Korea could trigger military interventions and risk asset sell-offs.

Strategies

This month, we have removed the strategy linked to **Subordinated Bonds**. Yield pick-up over senior bonds has narrowed substantially since the initiation of the call. With US rates poised to grind higher, we advise taking profit on the call and reduce duration in the portfolio.

Tactical Strategy		Key Proposition	Key Risks
Position for higher rates.	**Short duration high yield bonds**	• Lower sensitivity to interest rates and offers attractive yields versus longer-dated Treasuries.	• Default risks could rise if economic conditions worsen. However, economic outlook remains constructive.
Participate in Asian growth story.	**Asian equities**	• Attractive valuations over DM equities, with improving fundamentals over the year.	• China slowdown could pose risks but we expect the process to be controlled.
Recovery and policy shifts in DM offer opportunities.	**European equities**	• Attractive discount versus US and tailwinds from improving economic activities.	• Strong Euro could negatively impact the exporters. We expect Euro to stabilise as ECB could respond by being more cautious to taper.
	Quality equities	• Tend to experience less drawdowns during sell-offs and outperform broad equity markets over longer investment cycles.	• Hefty valuations could increase probability of short-term corrections. However, global recession risks remain low.
Healthcare sector shows potential for long-term growth.	**Global healthcare equities**	• Attractive valuations and earnings likely to improve on higher innovative drug approvals and strong M&A activities.	• Repeal and replacement of Affordable Care Act (ACA) could affect outlook for industry, but we expect most provisions to remain intact.

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