ClearBridge Investments

China's Party Congress Shifts Focus to Quality Growth

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Key Takeaways

- The Communist Party's three-stage growth plan includes reform of state enterprises, fostering innovation and improving environmental policies.
- Party leadership will ensure continuity of "state-led market economy," with Xi Jinping maintaining influence beyond his term as president.
- Opportunities exist in the consumer, technology, space/defense and clean energy sectors and for domestic and foreign companies able to effectively partner with the government.

Every five years, China's communist party holds a party congress to introduce new leadership into both the 25-member Politburo and the seven-member Politburo Standing Committee. Earlier this month, President Xi Jinping opened the 19th National Congress of the Communist Party of China with a three-and-a-half hour speech which laid out a three-stage plan for the country. By 2020, Xi expects China to become a country of "modest level of prosperity," with the completion of a national poverty elimination campaign. By 2035, China will reach "socialist modernization," after reforming state enterprise to balance supply and demand capacity, reducing pollution, improving environmental protection and building an innovation economy while addressing income inequality and building a strong social safety/health care network. By 2050, China will become one of the most powerful countries with global economic, political, and military influence. The congress did not reiterate the prior goal of doubling the GDP from 2010-2020, but is instead shifting to "quality" of growth.

Policy Priorities

The party will control and lead everything. This is unshakable, and any Western-style political reform is out of the question. Economic growth, led by the party, will continue to be complemented by state-owned enterprises (SOEs) with market forces also playing very important roles. Instead of a GDP growth focus, the development will be measured by quality and the need for re-balancing uneven growth. This is a change from the previous directive of addressing the social supply/demand gap and paves the way for an upgrade to innovation-driven economic growth, with the long-term objective of achieving global economic and military superpower status.

Chinese leadership has seen the disruptive force in the U.S. and European Union in recent years, and does not want to repeat it. Upon studying the Soviet Union's collapse and Russia, they will not allow private enterprises (like Alibaba) to grow into oligopolies to take the party and economy hostage. As a result, state control continues to be paramount. The party's intention is to ensure policy continuity. Xi can only serve as president through 2022 unless the current constitution is revised, however there are no limits on how long he can remain Communist party chief — and basically maintain power and influence over economic policy. The leadership increasingly believes they have found the third path for the nation's growth. They ditched the communist planned growth path in the 1980s,

and believe the pure market economy creates periodic chaos and inefficiency for long-term growth. Instead, they regard the Chinese model, "the state-led market economy," as superb for emerging countries. That is why they stress the supreme leadership of the party, and the vital roles played by state enterprises.

The government is willing to pay the price of the lower-return earned by SOEs as an insurance premium to ensure steady, albeit slower controlled growth. The government believes the prosperity of the country has reached a level that enables China to regain its historical power on the world stage, and the remaining issues are "technical" issues such as income inequality, the environment and SOE reform. Quality and balance will take precedence.

The economic risk to China's three-stage plan is high, possibly driven by poor execution, as the seven committee members, although nimble enough, might make policy mistakes. The risk of Xi's own mistakes should be low, as unlike Mao, he is much more open to advice from below, and the seven-member committee does provide some level of democracy within the party on the operational level. The committee also brings experience in managing large-scale economies as four of the five new members have governed provinces the size of many countries.

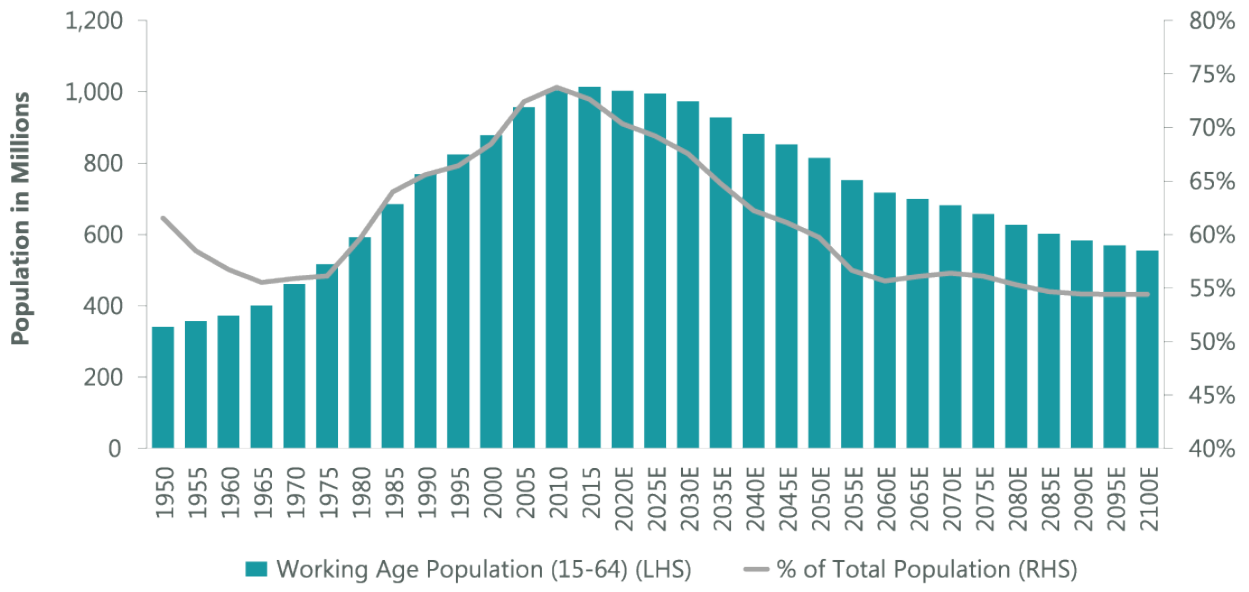
Investment Implications

The case for investing in SOEs is still intact. However, the supply capacity has to be reduced and prior momentum-driven investment into these SOEs will have major risks. Going forward, instead of chasing short-term growth drivers, the safe bet seems to be on those that can orderly reduce capacity or find new demand - especially the One Belt One Road driven capacity export — as well as on sectors on the growth priority list, such as semiconductors, software, space/defense technologies, new auto technologies and renewable energy.

For private platform companies directly touching common citizens — Tencent, Alibaba, Baidu — the government has been rumored to seek a 1% investment and a board seat. If company founders/operators are smart and flexible enough to not step on the party's toes, their companies can further prosper. In addition, big data, artificial intelligence (AI) and sophisticated surveillance will provide ample opportunities for these cash-rich private companies to work with the government and profit from it. Bottom line, more regulation should be expected.

For high tech and other industries, while technology transfer will still be required as always, the real losers will be the foreign companies who fail to set up partnership structures for long-term participation. Simply selling into China will be a losing game (high speed trains are the perfect example). However, joint ventures and local manufacturing investments will be protected, and even if China becomes the intellectual property leader in some sectors, foreign partners should be allowed to share the profit on a long-term basis. A case in point is the Volkswagen JV in Shanghai. Since 1985, local content into the cars produced by the JV has reached over 90%, yet it will still run through 2030, even after the Chinese side no longer needs Volkswagen's expertise.

Exhibit 1: China's Working Age Population Has Peaked



Source: United Nations World Population Prospects 2017.

Quality growth will benefit the automation/AI industry, especially when the population dividend of the past three decades in China has ceased. Automation and AI should help China address its aging population (Exhibit 1), and unlike India, it will not have to keep that many million young people joining the labor force each year employed. (AI helps aging countries while hurting young populous ones).

Consumer consumption should continue to be a safe theme to play, if health care and the social safety net are upgraded as promised, and as housing and rental prices settle down to slow growth. Financial innovation funded by the social platform companies and potentially in partnership with state-owned banks will open up more appetite for consumption. Also, as per the experience of other neighboring countries late in their developing-economy stage, higher growth will come from non-material-ownership consumption, as the rising living standard will move consumers to consumption via experience, such as travel, personal improvement and cultural events.

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