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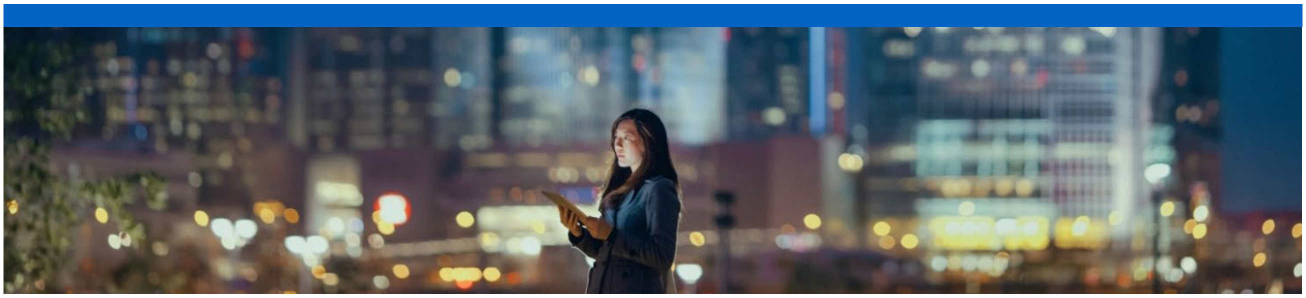

October 23, 2022

CIO Strategy Bulletin

After the Party Congress Is Over

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SUMMARY

- China's landmark leadership meeting, which finished this weekend, confirmed a third term for President Xi and revealed a new top leadership body consisting of only those loyal to him. This is likely to make policy implementation swift once a decision is made, while also diminishing debate, making errors potentially more costly and harder to reverse.

- President Xi also outlined the Chinese Communist Party's (CCP) priorities over the next five years and reaffirmed that economic development was the top priority. On broad economic issues, the report reaffirms China's socialist market economy status and continued support to both state-owned and private businesses, while also encouraging private firms to grow bigger. Decarbonization and tech innovation were also highlighted as economic priorities.

- President Xi defended China's stringent Covid-zero policy, without detail on when it might be relaxed. However, we believe easing domestic testing, lockdown requirements and business closures – all of which have crippled China's economy – is more urgent than reopening borders to the rest of the world.

- Chinese equities have performed miserably over the past year, with continued outflows from local and global investors, spurred by the COVID lockdowns, the real estate crisis and political headwinds. External risks have also risen, including a strong USD and potential US and EU recessions. But a cyclical recovery remains possible in 2023, and valuations may rebound from their current depressed state. Longer term prospects would depend on whether the leadership can truly deliver on its quality development goal.

The Return of Autocracy

This past week, the world turned its attention to the Chinese leadership convention that occurs once every five years. The 20th Party Congress is particularly suspenseful as the preceding years have seen China's weakest economic growth in modern times. A principal outcome is the selection of economic leadership that will inform "China watchers" on the likely direction for the world's second largest economy.

As expected, President Xi Jinping was confirmed for a third term, as the General Secretary of the CCP, as well as the head of the armed forces. However, the extent to which he was able to consolidate power by appointing those loyal to him exceeded expectations. Further, reading the meaning and intent of the text and events with true local context is required to understand the potential outcomes of the leadership meeting. It will differ from the literal translations that lack nuance.

The Politburo Standing Committee (PSC) consists of seven members and is the highest decision-making body within the CCP. Xi is the head of the PSC and the other six members implement different portfolios of policies. The six members of the new PSC (Figure 1) are either his loyal supporters (Zhao and Wang) or his political proteges (Li Qiang, Ding, Cai, and Li Xi). In the broader 24-member Politburo and the 205-member Central Committee, there were many senior officials unexpectedly removed and replaced with loyalists as well.

For economic matters, the top officials are Li Qiang, the next premier, and Li Xi, the next executive vice premier. They have been the party secretaries of Shanghai and Guangdong, China's financial center and the largest province by GDP and trade, respectively. As economic development returns as the central task for at least the next five years, there is no doubt that preventing the faltering economy from further decline will be their most urgent responsibility.

The fully consolidated power structure will allow Xi to implement his vision set for China in the political report of the 20th Party Congress. Policy implementation will likely become more effective and speedier than before once a decision is made, and second guessing of policy decisions and intentions is unlikely. For example, amid US semiconductor sanctions against China, the markets should not doubt China's resolve to double down on investments and turn it into China's "Sputnik moment" to compete with the US in a broad technology race (see our Oct. 16 CIO Bulletin, "Trade Wars Are Real Wars").

Figure 1: Members of the new PSC and their expected positions and key responsibilities

	Expected Party Position	Responsibility
Xi Jinping	General Secretary of the CCP, and of the Central Military Committee	
Li Qiang	Premier	Economy
Zhao Leji	Chair of National People's Congress	Legislature
Wang Huning	Chair of Chinese People's Political Consultative Conference	United Front, political advisory
Cai Qi	First Secretary of the General Secretariat	Policy coordination
Ding Xuexiang	Secretary of the Central Commission for Discipline Inspection	Discipline
Li Xi	Executive Vice Premier	Economy

Source: Xinhua News Agency, as of 23 Oct 2022

Less Debate, More Risk

On the other hand, the top-down style leadership will not be supportive of policy debates, which are much needed in a world filled with uncertainty and complexity. Thus, policy failures may become more likely. When compounded with zealous implementation, policy errors may escalate, and disasters could take place. In modern Chinese history after the founding of the PRC, the Great Leap Forward in the late 1950s and the Cultural Revolution in 1966-76 all occurred under Mao's absolute rule of the party and the country.

Will China's Leadership Refocus on Its Faltering Economy?

At China's 20th Party Congress on Oct. 16, the Chinese Communist Party (CCP) laid out its broad visions for the country's development. The CCP aims for China to reach a "prosperous society" status in 2035 and a "strong and prosperous" society status in 2050. Although there were some new statements and definitions such as "modernization with Chinese characteristics" (referencing its socialist market priorities), the party's political report underscored the importance of economic growth, placing a high priority on technology as the way to boost China's economic productivity. This is consistent with remarks made previously by President Xi Jinping.

Here are seven takeaways relevant to the Chinese economy, markets and values:

1) China's status as a socialist market economy remains unchanged. The report reiterated that the party will uphold and enhance China's *socialist market economy*, and reaffirmed its policies to provide "unwavering supports" to both State-Owned Enterprises (SOEs) and Privately Owned Enterprises (POEs). China will continue its economic reforms and continue its path of opening up to the rest of the world.

2) Development remains top priority. Xi dispelled the notion that China would prioritize national security over economic development and growth. He said it's "impossible to build a socialist, modern, strong economy without solid material and technology foundation," and repeated statements from previous party congress speeches that development remains its "top priority."

3) The importance of technology and innovation. China's regulatory crackdown on its tech industry since July 2021 has erased more than $1 trillion in combined market value, according to Bloomberg, and fueled a 20% youth unemployment rate. In his speech, Xi said, "we will focus on national strategic needs, gather strength to carry out indigenous and leading scientific and technological research, and resolutely win the battle in key core technologies." This development would have to take place with significant limitations in access to US equipment, software and personnel (see our Oct. 16 CIO Bulletin). While this hints at a potential easing of the crackdown, allowing Chinese tech companies to list in both domestic and Hong Kong equity markets would signal a true step forward.

4) Decarbonization goals upheld with a pragmatic and phased approach. Environmental protection has become a core element of Xi's legacy over the last 10 years. He has dramatically cut air pollution and established ambitious goals for China to reach carbon neutrality by 2060. After a false start last year that led to a spate of power shortages nationwide, the government has pushed to ensure sufficient coal production to avert power shortages this year.

5) Covid-zero policy defended, but few clues as to how it could be phased out. The political report defended China's Covid policy, stating the policy has "protected the people's health and safety to the greatest extent possible." We believe that the Covid-zero policy is likely to be reversed gradually and cautiously over the coming two quarters.

6) A peaceful reunification with Taiwan remains the ultimate objective. Xi hedged on the issue of the eventual reunification with Taiwan. The political report reaffirmed the CCP's long-held party policy on Taiwan – "to strive for peaceful reunification with the greatest sincerity and the utmost effort. The party will never promise to renounce the use of force, either." This indicated that a timetable for reunification may not exist. He also stated that the "complete reunification of our country must be realized, and it can without a doubt be realized," which some interpreted to mean there is a timetable for reunification.

7) Common prosperity will be advanced steadily. While the party will steadfastly push for common prosperity, the government will also need to improve the system of income distribution. In particular, it will refine the income distribution system and raise the share of household income as a percentage of total national income. Xi repeated a mantra used in the Deng's reform and opening-up era: "more pay for more work and achieving prosperity through hard work."

Short-Term Market Implications

We expect a slow relaxation of China's Covid-zero policy, limited by local government financing difficulties and economic development needs. Almost all Chinese provinces are running fiscal deficits, and some poor western provinces are facing fiscal sustainability issues. This means that without the support of central government, many of them will not be able to run the costly quarantines in city districts or whole cities. For example, free PCR tests are a significant fiscal burden for Chinese local governments.

That said, we also think there should be a differentiation between internal relaxation of Covid-zero policy and the reopening of China to broad national and international travel. Though there are some signs of a gradual return of greater personal mobility (see Figure 2), authorities may be still concerned with a potential run on medical services once Covid-zero is relaxed. Fear of a high rate of fatalities among the elderly and people with chronical illness remains. Improving vaccination rates among the elderly and the vulnerable and building more makeshift hospital beds are China's policy options. Some view the fact that Shanghai is expanding its makeshift hospital capacity as a possible sign that China may be preparing for further relaxation of its Covid policy.

As for the question of when China might reopen its borders, we think the authorities may want to wait out the cold winter season, as it coincides with flu season. Therefore, it is unlikely that China will open fully to the outside world until end Q1 2023. Once Covid-zero is relaxed, the fiscal stimulus begun in Q3 could be further extended in Q4, and the combination may boost China's financial markets.

Figure 2: Recent Signs of Policy Changes

Announcement Date	Policy Changes
Aug 30	The date of 20th party congress is earlier than anticipation (held on Oct 16-22), compared with party congress date of 18th (Nov 8-14) and 19th (Oct 18-24).
Sept 30	Hong Kong will announce to end quarantine on Oct 19. (Before it implemented "0+3" from Sept 26 and "3+4" from Aug 12.)
Sept 22 & Oct 3	Shanghai and Beijing Marathons will re-open on Nov 6.
Sept-Oct	Domestic airlines announced to resume more internatioanl airlines routes from Oct onwards, including Eastern Airlines, Air China, HNA, Spring Airlines, Juneyao Airlines and etc..
Sept 9	Shanghai's free Covid-test services will be extended to Oct 31.
Sept 24	Mainland tourists going to Macau in groups could be relaxed in later Oct.

Source: Citi Private Banking, as of Oct. 19, 2022

Chinese Markets and External Risks

A cyclical economic recovery is likely in 2023, but Chinese equities face enduring external risks, including further USD strength and a likely US recession.

Domestic politics, a real estate crisis and China's exposure to a slowdown in global growth were the main reasons for the dismal performance of Chinese equities over the past 20 months, but external factors have become bigger headwinds recently.

The USD's surge has been a central source of global market weakness, especially since August. Fed tightening reduced global liquidity and China was not spared. The CNY depreciated 7.1% over the past two months, as the gap between US and Chinese government bond yields widened from 47bps to 185bps (see Figure 3).

The People's Bank of China was careful not to waste large amounts of FX reserves to defend the currency, relying on restrictions on traders limiting short CNY positions. This approach allows for a market equilibrium to be reached without extensive reserve depletion, as happened in 2015-16. But it also suggests that if USD strength continues, there may be more weakness coming for the CNY and Chinese equities (see Figure 4). Separately, if the US enters a recession in early 2023, US equities may come under additional pressure, limiting gains in Chinese equities. Ironically, a US recession is exactly what would stop the USD surge.

Valuations: A Bottom Is in Sight if Chinese Reforms Take Hold

Low historic valuations have not stopped the decline in Chinese equities this year. A continued outflow from local and global investors, spurred by the real estate crisis, has underscored investor concerns. There are several steps policymakers can take to avoid deeper decline in equities.

What if China manages a policy-led economic recovery? President Xi affirmed that quality development is China's top priority, while reforms and economic opening remain the basic national strategy. Dealing more directly with real estate issues, achieving a slow recovery from Covid-zero, and a concurrent boost in consumer spending would make current valuations highly attractive.

MSCI China is trading at 0.94x book value (see Figure 5). This price/book ratio is 2.1 standard deviations below the 10-year mean. Only Hong Kong and the Philippines are worse. Rarely does an emerging economy see the entire market trade at 6% below book. Five out of 10 sectors are below book value This includes, unsurprisingly, financials at 0.45x, as banks and insurance firms are weighed down by the property crisis. But beyond financials, utilities, telecom, industrials and energy also trade below book (see Figure 6).

Poor valuations have persisted despite China's recent expansion of credit. Credit expansion amounted to 27.5% of GDP, three percentage points higher than last year's stimulus. This would have normally lifted the forward PE ratio to about 14x. Instead, the lockdowns and political risks have brought it to under 10x.

If the new leadership can deliver on the quality development initiatives laid out in Xi's policy, the sizable cash balances sitting on the sidelines can be a catalyst for a return to normal valuations.

Figure 3: Stronger USD weakened the CNY despite PBOC efforts to contain volatility.

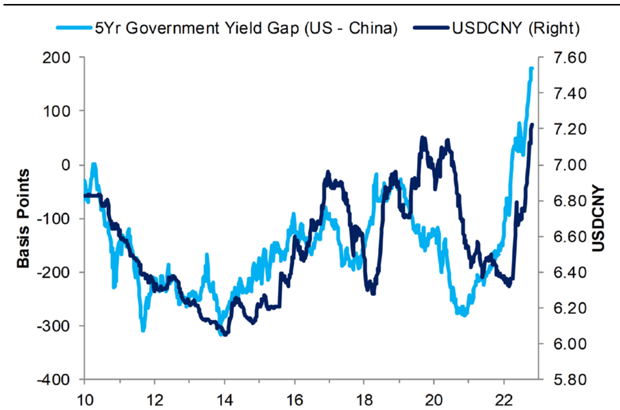
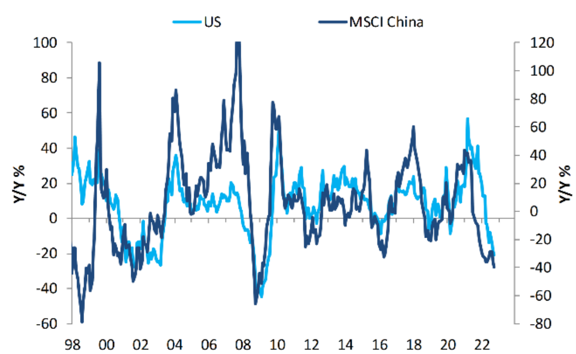


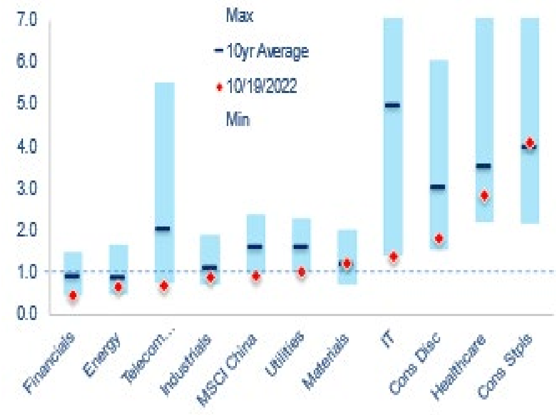
Figure 4: Potential additional weakness in US equities, if a recession were to occur, may also limit potential Chinese equity performance



Source: Bloomberg as of Oct. 18, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 5: MSCI China is below book value

Figure 6: Five of 10 MSCI China sectors are below book value



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