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Fighting with both hands

What a stronger Xi Jinping means for China's outlook
UBS Asset Management

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China's National Party Congress (NPC) meeting has major implications for investors. Xi Jinping's stronger power base following the NPC means he will fight with both hands on an agenda that will prolong China's mini-cyclical slowdown but create attractive opportunities for investors.

Xi Jinping: China's strongest leader since Deng Xiaoping
Xi Jinping has emerged from the NPC meeting as China's strongest leader since Deng Xiaoping with his political thought enshrined in the Party's constitution and allies occupying senior positions in all levels of government.

This marks a change from when Xi first took power in 2012. At that time, past leaders' protégés occupied the majority of the senior positions in the Party. Now, Xi and his allies dominate the Party and its most senior decision-making body, making up four of the seven members on the Politburo Standing Committee.

Xi's strengthened support base and elevated position means he has a freer rein and stronger resolve to execute the agenda he laid out in his opening speech on October 18th, which includes pushing reforms, controlling financial risks, regulating the real estate market, and protecting the environment.

Dropping the 'Presidential Put'
Tellingly, Xi omitted an explicit growth target for the economy in his speech, and that signals a different approach to managing the economy.

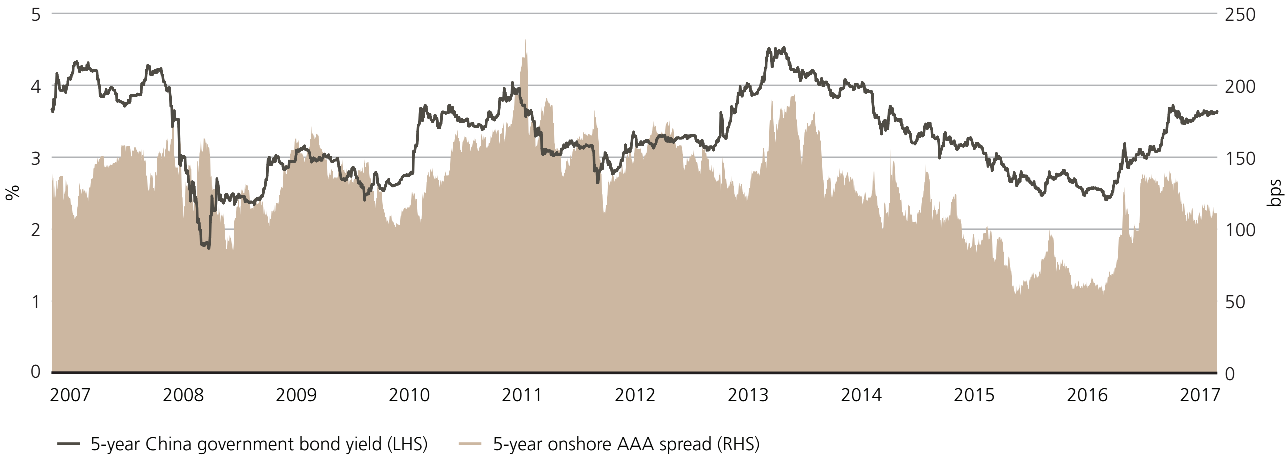
Successive Chinese leaders have focused on meeting defined growth targets, making China observers accustomed to the Chinese 'presidential put' - an unofficial guarantee of government credit support to achieve the growth number, often at the expense of the economy's longer term health.

In line with our earlier predictions[1], Xi's speech indicates that this 'presidential put' has been tossed aside and he now has the power and the political capital to weather slower growth and shift the focus of government policy toward reforms that improve the long-term growth potential of the economy.

Shifting the focus of government policy
That's why environmental issues are coming to the fore. Pollution is an increasingly sensitive issue for the public and one the government is now taking seriously, with centrally-sponsored inspection teams scouring the country to spot-check local officials and enterprises and force them to shut outdated, polluting factories and comply with new environmental standards.

Real estate policy, often used by the authorities as a tool to boost the economy in bad times, is also undergoing a change. Xi stressed that 'a house is for living in, not for speculation' in his speech and policy statements show that the government is increasingly focused on imposing new regulations, with rules barring speculation, as well as promoting rental market reforms and rolling back state-backed property buying being applied nationwide. This indicates that even with slower growth, a policy binge to support the market is off the table for 2018.

Rising government bond yields and wider credit spreads



Source: Bloomberg. As of 9 October 2017

Deleveraging and China's mini-cyclical slowdown

In addition to the above factors, Xi's focus on pushing reform and containing financial risks means the deleveraging process that has tightened liquidity, increased money market rates, raised bond yields, and forced credit growth to contract since late-2016 will continue, and China Banking Regulatory Commission (CBRC) officials confirmed as much in the days following Xi's NPC speech[2].

Xi's political reshuffling is aligning with this strategy too. Guo Shuqing - the reformist CBRC head and executor of the recent deleveraging campaign – is reportedly the most likely candidate[3] to take over from the retiring Zhou Xiaochuan as Governor of the People's Bank of China. With Guo Shuqing in charge, we expect a tough line on the financial sector and an extension of the deleveraging process.

These factors firm our expectation of a prolonged mini-cyclical slowdown through late-2017 and into 2018. Indeed, recent data shows weakening growth in real estate sales[4] and private investment[5], which we believe signals that a slowdown is underway.

Emerging markets to feel the impact in late-2017 and 2018

This marks a reverse from late-2016, when a rebound in China's economy boosted growth expectations, particularly in markets with strong linkages to China through commodity trade. That rebound drove higher Producer Price Index (PPI) readings, increased exports, and stronger fiscal balances, and supported upward earnings revisions for energy and mining companies.

Now that China is slowing, the key support for stronger growth expectations, particularly in emerging markets with substantial trade ties to China, has to be questioned. We believe the key to any investment strategy will be timing, given our expectation that emerging markets will feel the impact of China's slowdown in late-2017 and 2018.

Rising bond yields are a compelling opportunity for investors

While China's slowdown and the shift in the government's attitude change the outlook for emerging markets, it's also creating compelling opportunities for investors.

The steady rise in domestic bond yields during the past year offers investors the opportunity to add longer-term maturities into their portfolio, particularly as current yields in the 3.75%[6] range offer attractive value compared with fixed income opportunities globally and provide high nominal and real income and the potential for capital appreciation.

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