China – Where to from here?

Our Emerging Markets specialist investment partner, Northcape Capital, provides an update on the implications of China's recent Party Congress and the announcement of Xi Jinping's Presidency for a 3rd term. This paper examines how China's risks across every major category assessed by Northcape have risen following Xi's reappointment, and why China is a "least preferred sovereign" according to Northcape's sovereign risk framework.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Global Emerging Markets Fund.

Xi Jinping's 3rd Term Presidency

The bottom line, in our view, is that the implications of the 20th National Congress of the CCP and Xi's reappointment is negative for Chinese equities over the short, medium and long-term.

To put this in context, we refer to the Northcape Global EM Sovereign risk assessment framework (**Exhibit 1**). Specifically, China is currently in our "Least Preferred" category where it has been since the inception of our EM strategy in 2008.

Sadly, under our framework, when we analyse Xi's reappointment, changes to both the Standing Committee and Politburo and the contents of the associated policy speeches, China's risks have risen in every major category we assess in the heat map below.

In this paper, we briefly discuss each category in turn:

Political Risk – The breaking of the previous two term limit of China's presidency, by installing Xi Jinping for a third term (and probably more), is similar to Vladimir Putin's breaking the two term Russia limit in 2012. It entrenches a political dogma and further erodes the necessary checks and balances to prevent corruption and limit increased state capture of resource allocation or stop potential renegade geopolitical military action.

Like Putin, it seems Xi is clearly surrounding himself with extremely likeminded "Yes" men, strong loyalists, who will not challenge Xi's actions.

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Exhibit 1: China is Northcape's 'Least Preferred Sovereign'

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There are several important features of the structure of the all-important seven-member Politburo Standing Committee announced at the CCP Congress that are relevant for financial markets:

- First, all of the committee's members are very close Xi allies. The fact that Ding Xuexiang – a close friend of Xi who has never served as a provincial-level party boss or governor and has no obvious relevant experience for the role – was included in the group demonstrates that loyalty to Xi was the critical attribute of the successful candidates rather than competence per se.
- Second, Ding, who at sixty years old is the youngest member of the group, is important because many analysts expected to see a younger Xi protégé or potential successor announced. The lack of such a person on the Standing Committee suggests that Xi will indeed be "president for life" and there are no clear succession plans in place.
- Third, the departure of Li Keqiang – a pseudo-reformer who focused on economic growth – is also important as it signals that Xi and the broader leadership are more focused on stability and neo-Marxist purity than growth.
- Fourth, the entire China Youth League members were removed from the senior political hierarchy. Essentially the next generation of leaders have all vanished from the twenty-five member politburo.
- Finally, and sadly, there are also no women on the Politburo for the first time in 25 years, another major step backwards in terms of improving diversity in the top echelons of China's government.

The shocking forced removal of previous president Hu Jintao from the Congress stage was a terrible, orchestrated (and televised) indictment. Clearly Xi is saying we are done with the past leaders – see it, know it!

Note Hu Jintao had looked at some minor democratic reforms during the final years of his presidency. This paves the way for a further move away from liberalisation and a return to Maoist ideals.

There is no longer any rule by consensus in China; it's now rule by one person – Xi Jinping – with absolutely no checks and balances.

Economic and Capital Markets Stability – Risks in this category have clearly increased, with the prospect of further stifling of private investment and more importantly a consequent reduction in foreign direct investment (FDI).

In order for China to avoid potential equity, debt and currency markets collapsing from widespread capital flight (a la Argentina) the probability that Beijing will impose stricter capital controls (i.e. make it extremely difficult for foreign investors to repatriate both income and/or capital) has increased materially in our view.

In short there is an increased risk that foreign investors will not be able to convert RMB to USD to get funds out of the country.

China will be forced to try and preserve its limited FX reserves and protect the liquidity of its domestic banking system by potentially closing its capital account. The growing prospect of capital account closure will increase China's equity, debt and currency market volatility over the medium term.

Corporate Governance Rating – This rating has deteriorated substantially over the past decade on both an absolute and relative basis under our framework, and the announcements at the Congress have seen another down leg. The increased "state capture" of resource allocation under the new, hardened framework will further crowd out private investment.

Already, virtually all private companies in China must report their business plans to the government, which has a say in their resource allocation and the efficiency thereof. It is crystal clear now, that all companies (both state and private) will increasingly be run for central government political goals, and not in a balanced way for all stakeholders.

Unfortunately, foreign shareholders will continue to rank last in Xi's pecking order of fairness of compensation. Moreover, we are concerned that issues around modern slavery, forced labour and sterilisation in relation to Uyghur minorities will worsen, especially with the further erosion of transparency and accountability. This will be another factor that raises the risks of economic and trade sanctions, and reduction in FDI.

Climate Change – China is highly exposed to fossil fuels in its energy mix, and although it has made some undertakings to try and achieve carbon neutrality by 2060, the country is still expanding its fossil fuel mining and energy generation industry at the fastest rate of any country globally. This leaves the country highly exposed to sanctions and penalties under Carbon Border Adjustment Mechanisms (CBAMs).

Given weak corporate governance, there has been widespread evidence of corruption in the measurement and reporting of GHGs, and with the erosion of checks and balances under the regime such evasion will likely increase. We note from our own experience of analysing Chinese companies there is a distinct lack of data on environmental factors, and we believe this is likely to deteriorate in terms of integrity and reliability.

Growth, Demographics and Total Factor Productivity – This is where the impact of Xi's hard line policy regime and increased state capture will be felt greatest. The fallout will see reduced private investment within China and a substantial reduction in foreign investment, limiting crucial technology transfer from West to East.

This is already reflected in sanctions being placed on China's ability to access vital advanced semiconductor technologies, which will have a profound impact on the country's technology platform across virtually every industry in the years to come. China will essentially be forced to break away and have its own technologies, isolated from Western standards and innovation, which will have severe negative implications for its long-term growth, productivity, consumption and importantly listed and unlisted equity wealth creation. This is how Russia went backward technologically from the Cold War - China is setting itself up to be in lock step.

The hardline recommitment to COVID zero dynamic policy will restrict growth for a number of years, reflecting the fact that China refrains from using a proper vaccine with the appropriate level of efficacy to limit the spread of the virus. Unless China revaccinates with either a Moderna or Pfizer mRNA equivalent, the country cannot open up fully. To do so now risks China's public hospital system being totally overwhelmed and increases the risks of widespread social unrest.

The demographic outlook for China is also very challenged (see **Exhibit 2**) with only 27% of the population below 24 years of age, along with a very low fertility rate (1.3). Respected demographers suggest China's population could halve by 2070 to 700 million.

This alone is a significant challenge and major headwind for growth and social stability long-term. There was nothing in the policy statements to address China's woeful demographic outlook. It cannot open its doors to foreign migrants to arrest the population decline (like the US and Australia) given the systemic risk such a policy imposes to social instability through foreign cultures, Westernised ideals around democratic rights and freedom of speech infiltrating the country.

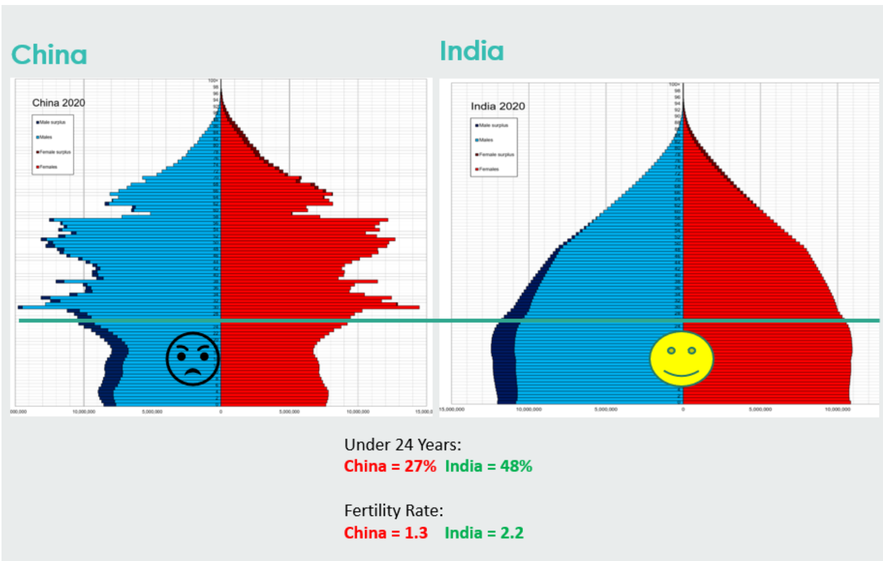
In sum we see China's growth risks significantly skewed to the downside making it potentially one of the lowest ranked growth countries in EM going forward. This is in stark contrast to India, our biggest country overweight.

China's equity markets may bounce for technical reasons; however, valuation in our opinion does not reflect the much-increased risks.

China is increasingly becoming like Russia, as such there is a risk that foreign investors could suffer significant capital losses. Note Russian equities looked cheap on a P/E of 5x in January 2022, and was many EM active manager's most popular overweight at that time (pre-Ukraine invasion).

We had zero exposure to Russia at the time, as under our sovereign risk modelling, the outcome on Russia was binary (i.e., one could lose 100% of funds under certain geopolitical scenarios, which were quite possible under the Putin regime with zero checks and balances).

Exhibit 2: China's Demographics are Challenged, Especially Relative to India's



The correction in China equities is not a buying opportunity in our view, rather reaffirmation of an increasingly negative view on Chinese equities over the medium term. Our assessment of the risk premium has gone up as per our framework, and across every category we assess.

As such, the Warakirri Global Emerging Markets Fund will retain its underweight position to China, and will adjust positions down where appropriate.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au