GUEST BLOGGERS

# China's Congress Convenes

October 17, 2017

This month, China's leadership kicks off its 19th Communist Party Congress, a meeting which sets the agenda for China's political, economic and even social path in years to come. More than 2,000 delegates from China's ruling elite attend the Congress, which takes place every five years. Xi Jinping, China's president and the Party's general secretary, is likely to score a second five-year term to continue his agenda. There will likely be some other leadership and/or procedural changes at the Congress which could have implications for the country going forward.

My Hong Kong-based colleague Eddie Chow, senior vice president and managing director, Templeton Emerging Markets Group, and I discuss the importance of the meeting and some of the investment implications.

**Mark Mobius:** Eddie, China's 19th Party Congress takes place this month, wherein the new Central Committee will immediately elect new members of the Politburo Standing Committee (PSC). The PSC contains seven to nine members and is where all authorities (of the Party and thus the country) are centralized. It is China's top decision-making group. From your perspective, what is the significance of this event and any changes in leadership that may result?

**Eddie Chow:** China is a one-party state under Communist Party rule, and any changes with the top personnel and the system in which how the leaders are elected will certainly impact the country. The National Party Congress (NPC) is the highest leading body with the Communist Party of China (CPC). The delegates meet once every five years and discuss and decide on major issues of the Party. These include leadership changes, approval of revisions to the Party's Constitution, and election of the Central Committee and the Central Commission for Discipline Inspection.

In addition to electing new faces at the PSC, it is widely believed approvals will also be sought to revise the constitution so that the PSC's structure can be changed. We may see a change in how the authority is distributed among PSC members, and how the next generation of Party leaders will be chosen.

**Mark Mobius:** General Secretary Xi Jingping kicks off the Congress' opening on October 18 with a Political Report, which addresses the priorities, themes, targets and the leaders' assessment on current economic conditions. Of course, who leads China and how they shape the country has implications for investors since China is a planned economy.

**Eddie Chow:** We expect Xi's Political Report will offer some hints for investors in terms of how the leaders aim to shape the country over the next five years. We'll see an outline of the priorities of different reforms, such as state-owned enterprise (SOE) reform, Hukou (household registration) reform, land reform, urbanization, industrial upgrading, structural rebalancing, etc. He will also likely present longer-term grand visions, which should offer insights on how China's economy can sustainably grow over the next decade.

**Mark Mobius:** Although it's very likely we will see new faces emerge as leaders of the PSC (the next generation of leadership beyond 2022), the direction and outlook for China's economy is not likely to see any major changes over the next two to three years. Do you agree?

**Eddie Chow:** Xi Jingping will continue to hold power, and he will continue to put forth reforms and give high attention to China's quality of growth. However, a change in the decision-making structure within the PSC may grant him greater power to push reforms more rapidly and in a more radical way. We see this, if it happens, as generally positive because the economy will then be able address the long-standing fundamental problem of low efficiency in resource allocation.

Another potentially positive outcome would be that Xi can bring a higher level of institutionalization to the country. I believe this is essential for China to grow itself out from just a middle-income country.

That said, I do not expect any major changes in direction from prior meetings. There is a general pattern on how power transitions from one generation to the next within the party. Xi, after his first term of five years as Party leader and president of China, will hold stronger political power and it will likely be easier for him to mobilize his political capital to push forward reforms.

**Mark Mobius:** In general, the leaders should become more united and effective in their second term. As you noted, the major change that we may see could be in revising the structure of PSC, which may bring some uncertainty on about the country's political development over the longer term. It's worth noting that China's relationship and response to North Korea's actions provides another challenge for China's leadership. The United States seems to be getting more involved in Asia, and we also face a possibility Japan will rearm and change its constitution.

**Eddie Chow:** China's leaders certainly have many issues to discuss. In addition to general challenges present in many other emerging markets, such as a weak regulatory environment, sub-standard corporate governance and a complex market structure, China itself presents a very unique case for the investor. It has been—and still is—under a very rapid and significant economic transition. China's economy has moved from a low-income one to a now middle-income one, and likely will move further to high-income, so these goals are progressing.

As China continues to push forward with different reforms, we believe the general outlook for the economy is positive. China social-economic system is also moving from one that is dominated by government to one that is now significantly dominated by market forces. China was a country with very low technology deployment, and has transformed into one which stands at the forefront in the deployment of certain new technologies.

As one of the world's most populous countries, China's people and government have been striving to attain higher economic achievements. This drive has given rise to many new companies with new business models not seen in any other markets before. China is a frontier market in this sense, and it requires investors to have their minds wide-open to the potential.

**Mark Mobius:** From an investment standpoint, we are certainly seeing opportunities in many areas in China. These include not only the widely followed internet e-commerce areas, but also the more traditional industrial sectors. So far this year, Chinese equities traded in Hong Kong (H Shares) have done well, outperforming the domestic market. Eddie, any thoughts on valuations?

**Eddie Chow:** The overseas Chinese companies—those listed in Hong Kong and the United States—have generally had a very good run year-to-date, but we have to remember that it came from a very low base when worries about capital outflow and the possible collapse of China's currency scared away many investors.

The domestic A-share markets (companies listed on the Shanghai or Shenzhen stock exchanges) are in fact still lagging behind without much advancement so far this year. Certain reforms are starting to show results and coupled with a stronger global-growth environment, we have seen many Chinese companies report stronger earnings this year. We believe given the continuous improvements within the structural side of the economy and a stable global environment, such a recovery seems likely to continue and could be more broad-based as we look further into 2018. We don't see valuations being a concern if the market is to expect higher earnings.

**Mark Mobius:** There are many types of reforms taking place in China. SOE reform is an important issue for investors as it can open up more areas to foreign investment.

**Eddie Chow:** I think China is still at the early stages of its SOE reform agenda, and it is being implemented cautiously. The major progress we have seen was in the mix of ownership; that is, introducing private capital to some major SOEs. And, the State Council introduced a more systematic means of assessing the performance of SOE management.

We can see some benefits of these efforts, as SOEs now seem to be more responsible in investing their capital, and are more willing to return dividends to the states (and to minority shareholders). I believe this is only beginning, and I look forward to Xi's efforts to speed up reforms in his second term, including a wider deployment of mixed ownership, closure of more "zombie" SOEs (those requiring government loans or bailouts to operate) and further-deleveraging (through closure and asset sales) of the SOE sector.

*The comments, opinions and analyses presented herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.*

**Important Legal Information**

All investments involve risks, including the possible loss of principal. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions.