

China's upcoming National Congress and the outlook for investors

China's biggest political event this year, the 19th National Congress, takes place in October or November. In the run-up to the event, the government is maintaining a stable stance that should minimise risk and support investor appetite. A more centralised government may emerge post-congress, creating opportunities for investment in corporates that could benefit from the state's reform agenda.



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At the congress, China's Communist Party will announce appointments to its Politburo Standing Committee. This is followed by a nationwide reshuffle, first of ministers and senior central government officials, and then of lower-level local government officials. Xi Jinping will certainly remain President of China and General Secretary of the Communist Party. Little visibility exists about other roles, though. We will probably see a government with more centralised power than in previous decades.

The new government's effectiveness in establishing a consistent policy direction will be crucial for China's economy. President Xi had a strong influence on economic policies during his first term, but that influence was diluted as policies were passed down to the central government and further to local governments. This "execution gap" could narrow and the pace of reform could accelerate in his second term if political power consolidates at various government levels.

Key among these reforms are an overhaul of state-owned enterprises (SOEs) and "supply-side reform" aimed at cutting excess industrial capacity, destocking corporates and lowering corporate costs. Other programs that could also be enhanced by consolidation include deleveraging of the financial system and the "Belt & Road" development strategy to promote coordination among Eurasian countries.

Impact for EMD investors

China's economy impacts the growth outlook of numerous emerging markets. The government's focus on stability ahead of the congress should be supportive for risk appetite among global emerging market debt (EMD) investors in coming months.

Investors in Chinese onshore (yuan-denominated) bonds need to have a view on the outlook for the Chinese currency and onshore yields. The yuan appreciated more than 3% against the US dollar this year. While this was primarily driven by USD weakness, the People's Bank of China (PBOC) appears intent on keeping the yuan stable on a trade-weighted basis. The central bank introduced a "counter-cyclical adjustment factor" to its currency fixing earlier this year, which should increase its leeway in managing yuan appreciation and depreciation expectations.

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The PBOC has also been more active in reducing financial leverage. The rise in interbank rates and regulatory tight-

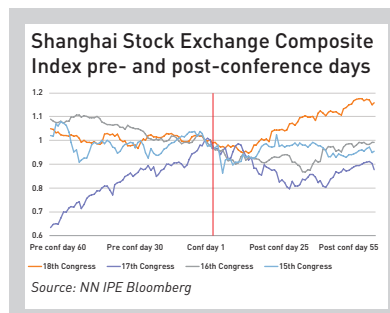
ening in China has caused onshore bond yields to rise this year. The pre-congress balancing act of containing financial risks and maintaining economic growth will probably continue post-congress. Financial deleveraging remains a priority for policymakers, so we do not expect this year's increase in onshore bond yields to reverse in the near future.

Within China, we see most opportunities in USD-denominated private-sector bonds. Chinese regulators have in the past increased vigilance or suddenly imposed bans, raising concerns about companies' abilities to raise money or stave off default. Before the congress, such idiosyncratic credit risks should subside. We prefer companies that are set to benefit from China's continued shift towards a more consumption-driven growth model.

SOEs have also become active USD bond issuers. Many of these state-owned issuers have weak standalone credit profiles, making them vulnerable if SOE reform momentum increases. Our approach is to focus on SOEs that have relatively strong credit fundamentals or are of strategic importance to the government.

Impact for China's equity markets

Historically, government policy remains stable and market volatility is low before the congress. Recent policy statements from the China Securities Regulatory



Commission have emphasised financial stability.

We see the quiet pre-congress period as an opportunity to select companies with the potential to do well post-congress. Stocks related to consumption "pre-miumisation", the internet economy, an aging population, and "Chinese champions going global" are less affected by the policy changes and the country's growth cyclicality. These structural trends are likely to continue to play out over the long run.

Stocks that can benefit from upcoming reforms and policies are also found in selective state-owned enterprises and segments related to the Belt & Road project. At the same time, China's economic growth rate of 6.9% is above the government target and is a cause for caution. Growth may revert to mean in the second half of the year and gradually slow down, impacting cyclical sectors such as construction and manufacturing.

As the 19th National Congress approaches, market risks in China are likely to remain subdued. After the congress, we expect a government with more centralized power to emerge. An accelerated reform tempo may create new equity and fixed-income investment opportunities.

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