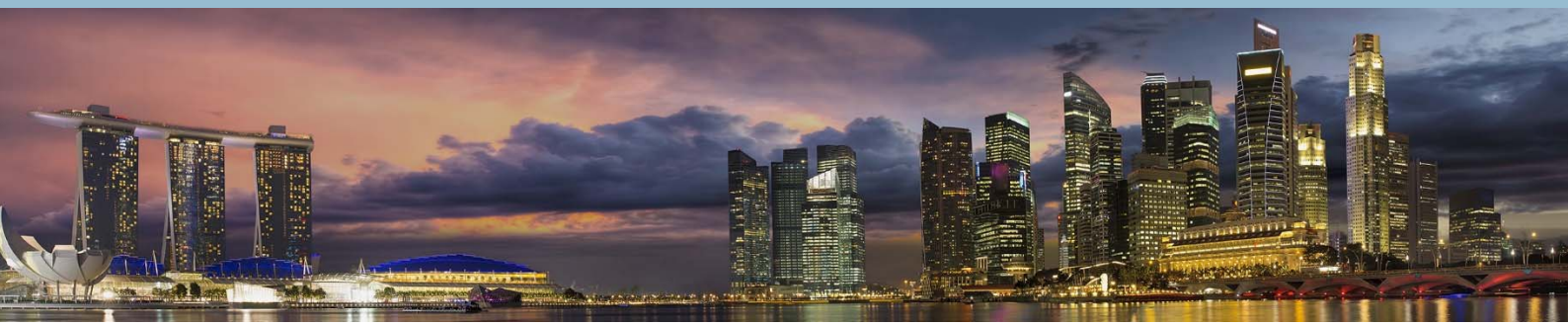
Reinforcing the Status Quo

December 2017

VIEWPOINT

By Christina Bastin - Portfolio Manager



What does the re-election of Xi Jinping mean for China's political and economic outlook?

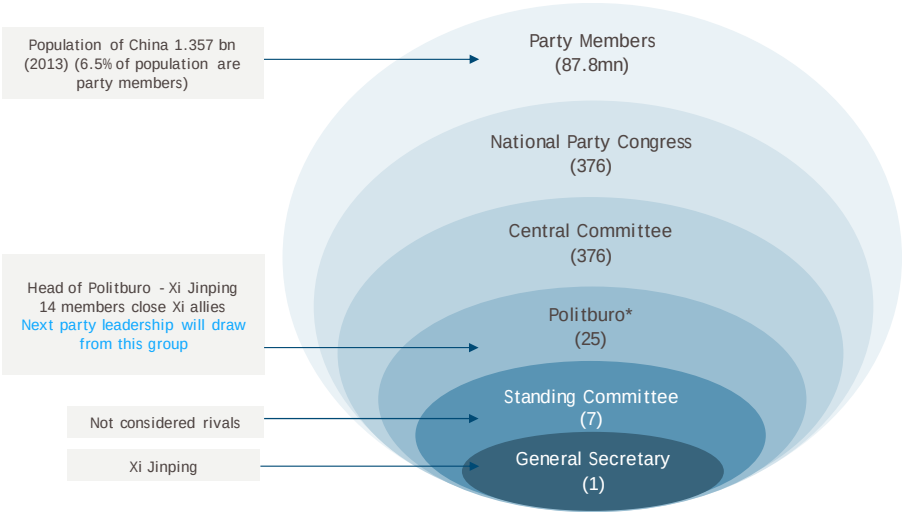
Towards the end of October, at China's 19th Congress, President Xi Jinping cemented his position for another 5-year term.

We believe Xi's re-election marks a defining moment in Chinese history which has perhaps been underestimated in Europe. It appears likely that he will be in power beyond his new 5-year term – possibly for the next 10 years or longer (although not in the role of General Secretary due to age considerations).

Xi has the support of the party behind him; the majority of the 25-member Politburo* are his allies. With the next party leadership drawn from this group, it is likely Xi will be re-elected.

The country is also at an important phase of structural reform and deleveraging, re-emphasising the crucial need for a stable political backdrop to ensure these reforms are carried through. Any change in leadership could create unnecessary political instability and disruption to this process.

We believe Xi's re-election is a positive in the sense of providing that crucial stability and decision making power for painful reforms. Given Xi has cemented his power, what do his key policies focus on?



Christina Bastin, Portfolio Manager

Christina joined Muzinich in 2013. She is a portfolio manager focusing on Asian credit markets and is the lead PM for the Asia Credit Opportunities strategy. Prior to joining Muzinich, she was a Director and Credit Specialist within the Global Rates Division at Deutsche Bank, managing credit risk within collateral pools, CDS counterparties and other rates vehicles. Previously, she was a Lead Credit Analyst at Schroders Investment Management and a Senior Analyst for fixed income research at Commerzbank. Christina also worked for Fitch Ratings (1995-2000) where she was responsible for rating Korean banks during the Asian crisis 1996 - and Japanese banks during their banking crisis. Christina holds a B.A. from the University of Oxford and an M.A. from the University of London. She was also awarded the Yamamuro Trust Foundation Scholarship for a 1-yr International Politics program at Keio University, Tokyo.

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Xi's Five Main Policies

The main themes underpinning the 2017 Congress were quality and sustainability; numeric growth targets were specifically avoided. Within this framework, Xi's vision towards 2050 focused on the quality of growth, the reduction of financial risks and leverage, continued capacity cuts and anti-pollution measures.

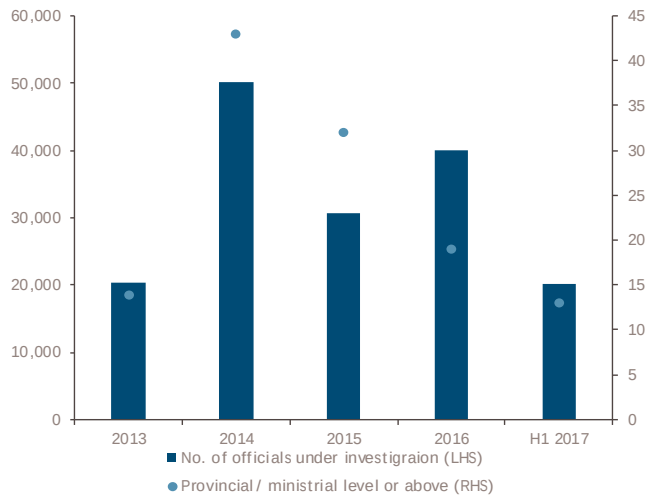
Anti-Corruption

After taking office in 2013, one of Xi's main priorities was to legitimise his power (not having come from anointed political aristocracy himself) and crack down on government corruption. For the country to function as effectively and efficiently as possible, Xi decided changes were needed – the first step being provincial government obedience.

We do not take a view on the merits or demerits of such a policy move, but note that it has been strategic in (i) cementing his power and (ii) helping with policy execution.

However, it does not appear to be a long-term trend; data (Fig. 1) highlights investigations peaked in 2014 and we expect there to be less emphasis moving forward.

Fig. 1 – Number of Government Officials Under Corruption Investigation



Source: CLSA Healthier Beat, China's economic rebalancing takes shape. September 2017.

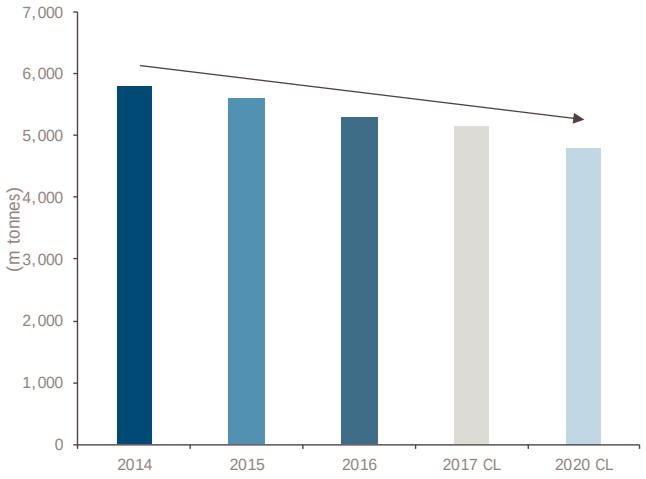
Supply-Side Reforms

China is the world's largest producer and consumer of commodities and as such plays a hugely important role in the global commodity market. Yet many of the country's commodity companies, which are often state owned entities (SOEs), have been struggling with excess capacity due to an overly-ambitious focus on growth.

As part of wide-ranging reforms and a change in focus towards quality, excess capacity sectors have been gradually reducing their inventories in order to optimise capacity and capex, such as in the coal sector (Fig. 2).

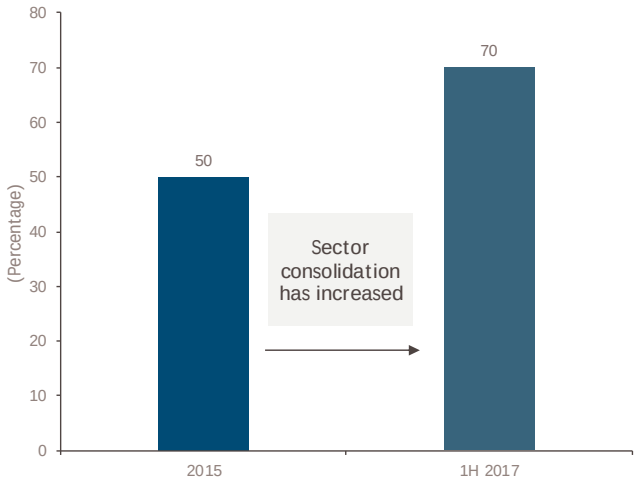
We are also witnessing an increase in corporate consolidation. Again using coal as an example, 70% of market share now comes from just 4 producers (Fig. 3). This is also proving beneficial from an environmental perspective as the less efficient, dirtier commodity producers have been shut down.

Fig. 2 – Coal Capacity is Falling



Source: Macrobond, as of August 31st, 2017.

Fig. 3 – Coal Producers are Consolidating

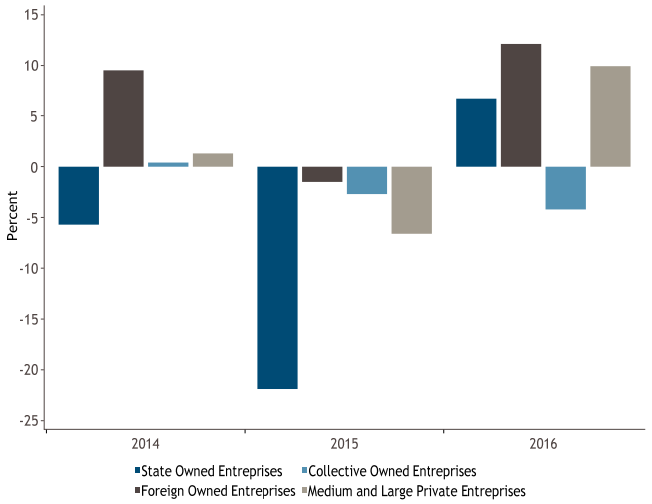


Source: CLSA Healthier Beat, China's economic rebalancing takes shape. September 2017.

While we do not seek to predict the path of commodity prices via Chinese economic progress, these reforms are partly responsible for the recovery and stability in global commodity markets.

This in turn is having a positive impact on industrial profits (Fig.4) – the first time they have been in positive territory for some time. SOE profitability is helping to underpin economic stability.

Fig. 4 – State-Owned Enterprise Profits are Recovering

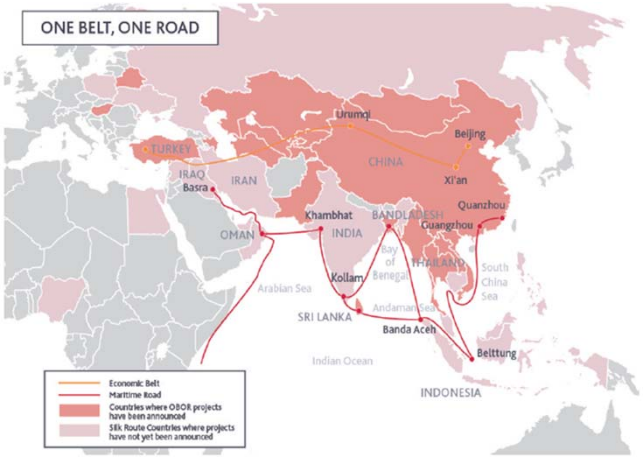


Source: Macrobond, as of August 31st, 2017.

One Belt One Road

The ambitious One Belt One Road (OBOR) initiative is Xi's brainchild. It is aimed at reinvigorating the Silk Road (the ancient trading route from China to Europe), to create an unbroken transport and infrastructure network across Eurasia. It will involve 40 countries in Central and South Asia, the Middle East and Europe (Eastern and Western).

Fig. 5 – An Economic and Maritime Silk Road for the 21st Century



Source: National Development and Reform Commission, Moody's Investors Service, China, One Belt, One Road is credit positive, despite rising overseas risk exposure. Data as of July 2015.

This hugely ambitious project is not only economically beneficial for China, it also has an ideological tilt with the country looking to extend its global influence.

It is a long-term plan, however, as these types of infrastructure projects will only be completed 10+ years from now. We believe it represents a tectonic shift in China's global economic influence as the country looks to the next generation for increased global power and influence.

We are already seeing a number of benefits from this project: boosting commodity producers, improving intra-regional and financial links, helping China's economically weaker areas and OBOR border countries, geopolitically strengthening and influencing OBOR regions and increasing renminbi usage.

Although there is some concern on how this project will be funded, over the long term we believe it is positive for the country, even though the majority of the financial burden is likely to fall on China.

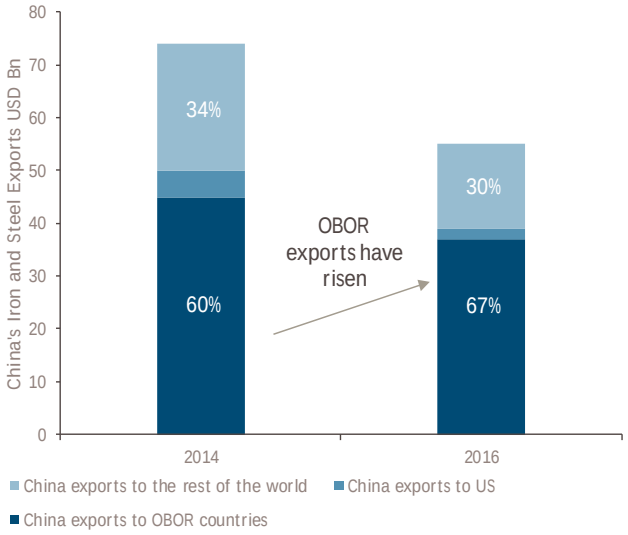
While some banks could be called on to provide financing, which could lead to elevated credit risk in certain areas, the majority of credit ratings agencies are relatively sanguine over OBOR financing.

Ultimately, opening up new trade routes is economically beneficial for China and will boost growth. It is also a boon for those (often poorer) OBOR border countries (such as Kyrgyzstan, Kazakhstan, Uzbekistan and Pakistan) who will benefit from much-needed infrastructure investments and economic stimulus.

OBOR ties in closely with Supply-Side Reforms; commodity exports to OBOR countries are likely to continue to remain above trend in order to provide the raw materials needed for the project as it develops (Fig. 6).

Although iron and steel exports as a whole are lower, the percentage to OBOR countries is higher.

Fig. 6 – Chinese Exports of Iron & Steel by Region



Source: UN Comtrade, Moody's Investor Service

Improving the Environment

Pollution is becoming a major concern in China, having reached unsustainable levels.

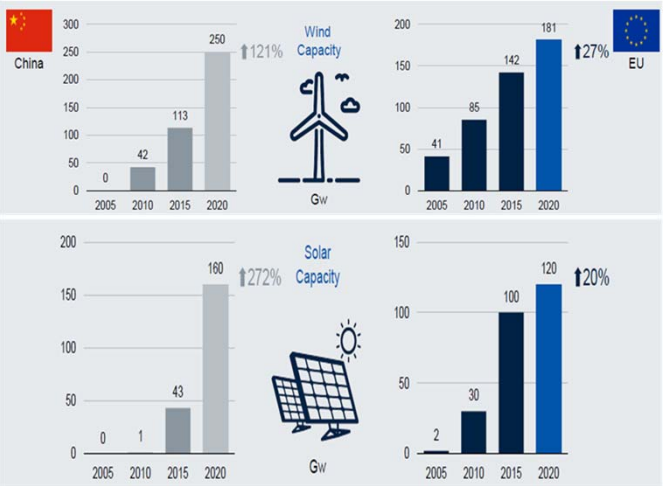
The need for Xi to address this issue is important, not only from a global environmental perspective, but also from a social stability standpoint where there is widespread social discontent on the issue.

As part of the government's commitment to increasing clean energy, wind and solar capacity are now two key target areas; the government plans a three-and-a-half times increase in investment into wind power and six times more into solar energy from 2016 to 2020 (Fig. 7), against which the EU looks likely to be left behind.

While it is easy to dismiss this initiative as a 'token' gesture, it fits well into Xi's long-term view of the country's position in the global community. China is also likely to be very effective at implementing changes to environmental policy because it is united under one party.

The EU, as well as being a smaller community, also comprises myriad nations with differing social and political agendas, making it more challenging to develop and implement aligned policy initiatives.

Fig. 7 – Wind and Solar Capacity Set to Increase



Source: Deutsche Asset Management, China's Green Transformation October 2017.

On January 1 2018, China's Environmental Protection Tax will come into effect. This marks a change from placing environmental expenses on manufacturers to a law-based tax system imposed on air pollutants, water pollutants, solid waste and noise, with the tax rate dependent on different pollutants and regional situations.

The Environmental Protection Tax Law is the fourth substantive tax law in China, following the Individual Income Tax Law, Enterprise Income Tax Law and Vehicle and Vessel Tax Law.

The promulgation of the Environmental Protection Tax Law is expected to have a profound and far-reaching effect on environmental protection in the country and the overall tax system in China.

SOE Reform and Deleveraging

Perhaps one of the major concerns for investors has been the elevated levels of leverage within China's SOE sector.

Over the past five years the government's main focus has been on consolidation. Mega-mergers such as Shanghai Baosteel and Wuhan Iron & Steel, and Minmetals and China Metallurgical Corporation, have created huge companies.

There are concerns this is more of a regression with SOEs getting bigger with more state involvement, than any tangible reform – be it on corporate governance or deleveraging.

Many SOEs are Communist relics - holding companies with numerous underlying subsidiaries with little relevance to one another and without a common identity or purpose.

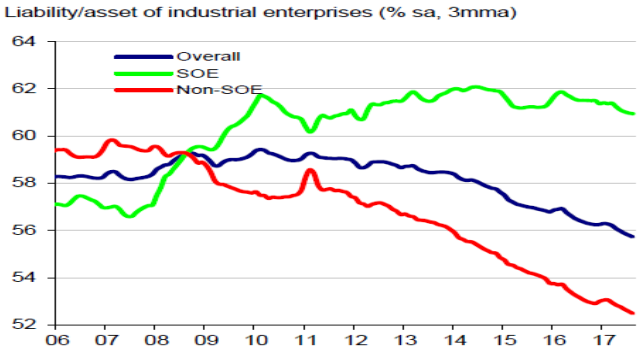
A key part of corporate governance reforms will be for SOEs to determine their purpose, aims and goals. Again, this ties in closely with Xi's 'quality not quantity' agenda.

Then there is the issue of deleveraging. While we acknowledge deleveraging is still relatively minimal, leverage does appear to have peaked and is now gradually falling (Fig. 8).

Over the last three quarters of 2017, we have seen a decrease in leverage at some of the largest SOEs.

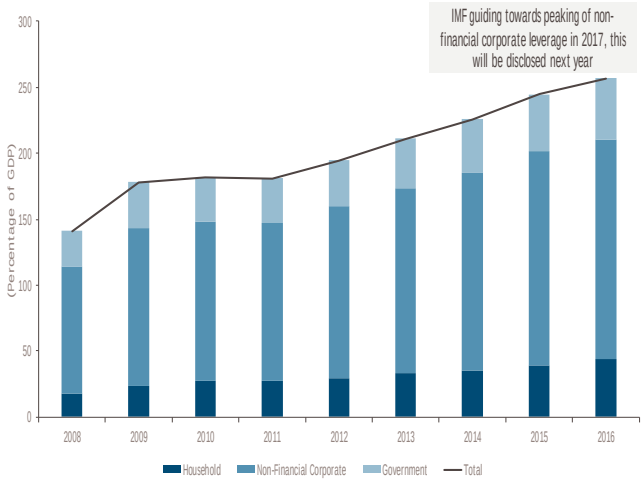
This is backed by the latest IMF stability report which expects leverage to have come down in 2017 (Fig. 9), although final numbers have yet to be released.

Fig. 8 – Liability/Asset of Industrial Enterprises (%sa, 3mma)



Source: UBS Macro Keys, China De-leveraging – Where Are We? Data as of October 10th, 2017.

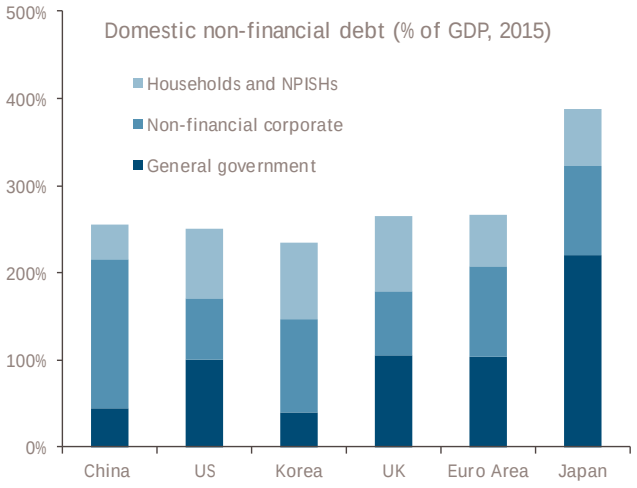
Fig. 9 – Debt to GDP Ratio



Source: CLSA Healthier Beat, China's economic rebalancing takes shape. September 2017.

It is also important to note that China's debt in aggregate is comparable to other nations – both in the developed and emerging world (Fig. 10), although the SOE sector remains the most indebted.

Fig. 10 – China versus A Rated Sovereigns



Source: BIS Data as at end-2015 taken from IMF China Report August 2016.

We are seeing signs of leverage reform such as falling net issuance in the shadow banking sector (Fig. 11).

Total social financing is the aggregate financing figure including bank loans, trust bank financing, corporate bonds and IPOs. This figure is released by the People's Bank of China on a monthly basis.

"Shadow banking" is the term used for financing outside the regulated banking sector. Some parts of this sector are actually asset managers/brokers owned by the official banking sector.

The main reasons it has been such a focus in recent years is because of i) huge growth, ii) it is outside the regulated banking sector (which is very prescriptive in terms of loan quotas etc.) and iii) hidden risks in wealth management products (WMP) – duration mismatch, leverage added onto these products and credit risks.

Although China's financing of the economy is still bank-dominated, the rise of the shadow banking sector cannot be ignored. While bank lending can be tightly controlled by the regulators, shadow banking is harder to control. Now the regulators are cracking down.

A slew of new regulations controlling the asset management industry have recently been released:

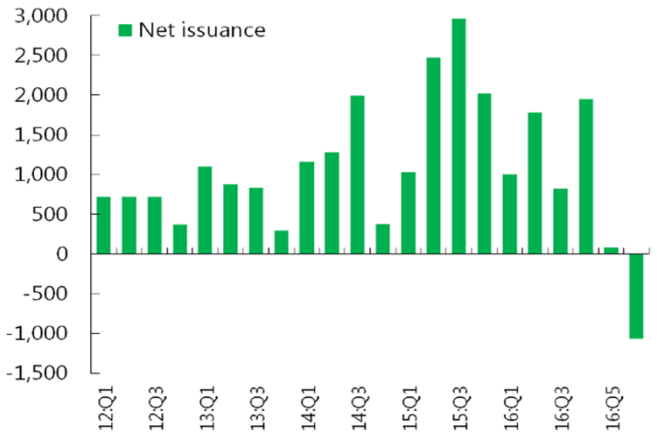
- Financial institutions will be required to set leverage ceilings on asset management products – e.g. total assets for an open-ended public offering should not exceed 140% of the product's net assets (200% for a closed-end public offering)
- Restrictions on types of instruments that WMPs can invest in - from now on funds sold to the general public will need to be in liquid instruments like shares or debentures
- If WMPs invest in non-standard debt, they must have at least the same maturity as the underlying instrument in which they are investing

These new rules are targeting investment firms (some could be subsidiaries of banks) that borrow short-term funds to invest in longer-term debt, then package these with more leverage added. The regulators are keen to curb tail risk from these instruments.

The regulator initially proposed a grace period until June 2019 to allow financial companies to phase out these instruments without spill-over effects to the real economy. In December, the regulator appeared to relent, discussing an even longer grace period until 2020 or 2022.

Again, this ties in with the regulator's wish for stability in the financial system. Any radical clamp-down could lead to unintended consequences – a sudden rise in corporate defaults which could then lead to a loss of confidence in these products, and in turn cause widespread panic among the general population.

Fig. 11 – Bank-Sponsored Wealth Management Product Net Issuance

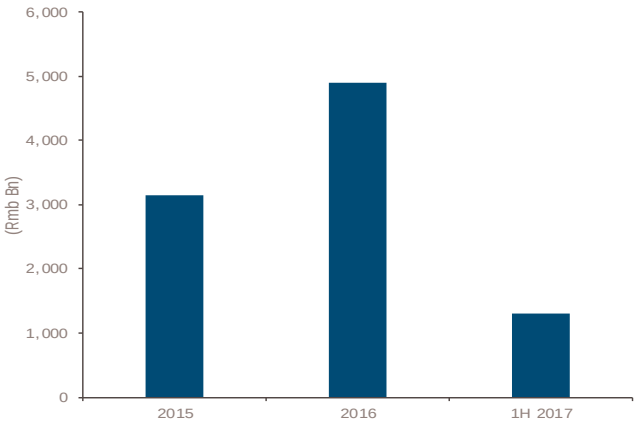


Source: IMF, Global Financial Stability Report. Data as of October 31st, 2017.

There have also been reforms in local government debt. Until recently it was illegal for local governments to issue debt, unless it was via a special purpose vehicle. Borrowing was very short term and at very high rates of interest.

The government has since implemented a debt swap plan to bring down debt levels at lower interest rates. As a result, about RMB9.5trn of expensive shorter-term bonds have been swapped into longer maturities (Fig. 12).

Fig. 12 – Local Government Borrowing has Fallen

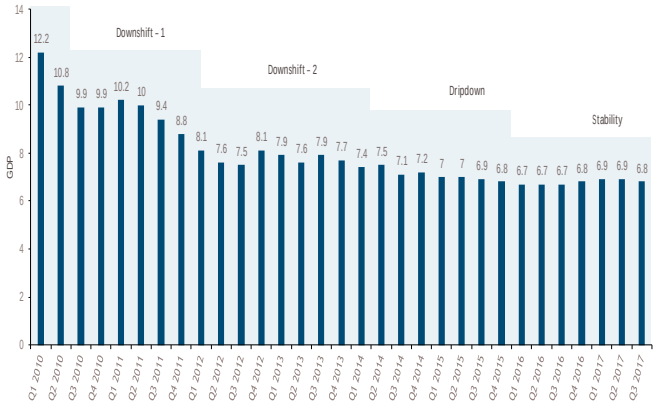


Source: LHG CLSA Healthier Beat China's economic rebalancing takes shape. Data as of September 2017. Muzinich & Co views and opinions.

Going forward, we expect there will be increased regulatory oversight on local government leverage to ensure it is maintained at manageable levels. Combined, these measures mean that the amount of tail risk (i.e. financial risk) in the system is falling, and the probability of an economic hard landing has been significantly reduced.

Growth meanwhile appears to have levelled off (Fig. 13), having remained stabled for the last six quarters.

Fig. 13 – Growth Appears to Have Stabilised



Source: Bloomberg. Data as of September 30th, 2017. China Real GDP quarterly.

Quality and Sustainability

In our view, these measures highlight China's stability and sustainability, which is attractive from an investment perspective.

Solid FX reserves, a high savings rate and strong support from an Asian investor base should help underpin investor demand.

The country is also likely to remain stable politically with Xi's political majority enabling the government to focus on a continued commitment to SOE reform and deleveraging.

Stability in China equals stability across the whole of Asia and we believe the country will be a positive influence for Asian markets in the years ahead.

Important information

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