Reflections on China's 20th Party Congress

Artisan Partners China Post-Venture Team

Viewpoints

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China's national congress set the tone for policy around key economic sectors. We're pleased to share our viewpoints with you from the Party Congress and some implications for investors in China.

What were the key takeaways from China's 20th Party Congress?

As widely expected, Xi Jinping was elected to a third consecutive term as general secretary of the Chinese Communist Party (CCP). Throughout the Congress, it became clear that the newly elected members of the politburo were Xi loyalists, including, most notably, Li Qiang, who will serve as the next premier. Li Qiang currently serves as the party chief for Shanghai and will replace Li Keqiang.

Meanwhile, the Party's foreign policy and onshore economic objectives remain centered around China's domestic goals. In his opening address to the Party Congress, Xi emphasized the importance of economic security—particularly in the areas of food, energy and supply chains. Xi highlighted the need for:

- High-quality development, which is still positioned at the very core of all economic goals
- Fostering education and talent advancement to support the growth of new industries
- Supporting renewable energy and other "green" development initiatives
- Security as a broad requirement, including national security and economic stability

Looking ahead, China continues its quest to become a global standard-bearer in key economic areas with a sharp focus on innovation and improved economic productivity.

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Why were Chinese equity markets so rattled following the close of the event?

Hong Kong equities, which tend to be traded by foreign rather than domestic investors, were particularly volatile. A few observations related to this indiscriminate selling include:

1. Foreign investors may fear that Li Qiang's promotion to premier could spell a slower reopening of China's economy and a pivot away from innovative industries. This assumption comes from Li's very conservative handling of COVID lockdowns throughout Shanghai. However, our on-the-ground analysts view Li's promotion more favorably. First, Li's hands-on experience in managing a large, economically important province was viewed as a plus. Additionally, his prior track record includes some notably pro-business accomplishments, including the 2018 opening of a Tesla factory in Shanghai and the 2019 launch of the Shanghai Stock Exchange STAR Market, officially known as the Shanghai Stock Exchange Science and Technology Innovation Board.
2. Xi's reshuffling of the politburo and further consolidation of power within the Party was viewed unfavorably by foreign investors with more western-leaning political views.
3. Tech shares of many Chinese internet giants were particularly hard hit as investors weighed the economic outlook for China's near-term growth. Fears of slower domestic economic growth in the near term has impacted many technology incumbents, including the internet platform companies. In our view, the new politburo members understand and appreciate the already well-developed internet sector, so policy is likely to remain focused on more pressing technology needs. The emphasis in tech has long been shifting from e-commerce to other areas like semiconductors and renewable energy.

What does Xi's consolidation of power mean for economic policy?

The new politburo is notably made up of seasoned political leaders, rather than academic types. While the new members of the politburo are solidly in Xi's camp, most have considerable government experience, which adds an element of political stability. This was viewed as a positive within China. For the past several years, Xi has been quietly moving policy decisions away from the politburo and toward various policy committees, which is where the policy experts and academics still have an important role to play. The Party's long-term economic goals remain intact. In the near term, we could see faster movement in some policy areas.

What this means for China as a whole is, with the full backing of the new politburo, Xi can move more quickly on key economic objectives. China's domestic priorities haven't changed that much, but global events may be speeding up some domestic initiatives. For example, geopolitical tensions between China and the US mean that China will need to ramp up its semiconductor supply chains faster. In addition, disruptions in global energy supplies and prices due to Russia's invasion of Ukraine mean that China will pursue renewable energy production, as well as enhanced coal and nuclear energy production, to create a more balanced energy mix.

What were the implications from the party congress for relaxing COVID policy in China?

Many market participants were looking for signs of moderation in the CCP's tone on relaxing its Zero-COVID policies. However, Xi Jinping's prepared speeches and remarks continued to emphasize the need for a strict approach to managing COVID outbreaks, which was a negative surprise. The official Party line continued to call for diligence in dealing with the virus.

Anecdotally, we see the potential for a more pragmatic approach ahead with regard to relaxing COVID policies. Our on-the-ground research team is seeing encouraging trends that suggest policymakers may be quietly preparing for a gradual easing of COVID lockdowns. For example, more international flights to China have opened up, increasing the potential for international travel. In Hong Kong, we have seen reduced quarantine times for international travelers, which seems to be a test area for re-opening mainland cities. We expect that any future relaxing of China's Zero-COVID policy would likely occur in small steps.

In positive news, China is developing its own homegrown mRNA vaccines, which could be approved by China's medical regulators by this winter or early spring. China is also developing COVID treatment therapies and enhancing its local treatment facilities. The recent launch of nationwide low-interest loans for medical infrastructure investment is a case where governmental plans to enhance the facilities of hospitals in lower-tier cities and more rural areas, and many believe this is to get better prepared when reopening comes. Health officials in China will also need to engage in extensive education programs to help local citizens reengage in daily activities, while continuing to focus on limiting regional and local outbreaks.

Looking ahead to next year's Dual Committee meeting in 2023, what industries are likely to benefit from any fine-tuning of regulatory policy in China? And what industries could face potential headwinds in China?

China's long-term policy goals continue to include building up national strength in science and technology. We believe that industries fostering innovation and increased economic competitiveness are likely to have regulatory support.

- On the science front, China aspires to set global standards in key areas of research, including telecom, aviation and agriculture
- On the technology front, China is looking to develop its own local supply chains in areas such as semiconductors and clean energy

Turning to health care, the sector as a whole plays an important role in improving overall wellbeing and quality of life. Xi prioritized a few aspects that are the most important:

- Encouraging childbirth
- Actively managing an aging population
- Encouraging innovation in traditional Chinese medicine, and
- Enhancing the capability to deal with epidemic diseases

In reviewing key economic accomplishments, Xi mentioned biotech along with other technological sectors that had made major milestones in the past five years. Biotech is a key area of innovation, and there should be continued regulatory support for innovative therapies, including accelerated approval and inclusion in China's National Reimbursement Drug list, which provides a pathway for coverage of drugs under China's national health insurance plan.

With regard to China's large consumer sector, the CCP remains focused on high-quality economic development, backed by a strategy of expanding domestic demand and deepening supply-side structural reforms. Strong household savings and rising income levels are likely to support domestic consumer brands with differentiated product offerings.

Turning to clean energy, policymakers continued with a positive tone on cleaning up the environment and developing renewable energy sources, consistent with prior policy goals. Broadly speaking, we have seen less of an impact from COVID policy on the new energy sector, as the solar and wind industries are almost entirely independent of COVID measures. Policymakers reiterated the need to:

- Promote the expansion and adoption of renewable energy sources
- Encourage cleaner and more efficient uses of coal
- Accelerate the planning and construction of a new energy system
- Actively participate in addressing climate change and global governance

On the other hand, industries that may be contributing to income and wealth inequality within China, such as private education, are more likely to face regulatory headwinds.

What are some of the impacts to key sectors that the Artisan China Post-Venture investment team is following?

Semiconductors

As semiconductors will continue to play an important role in China's economic security, our team has been closely following the semiconductor supply chain, including equipment makers. Equipment makers and other companies in the supply chain may be better positioned to capture both domestic and global demand for semiconductor production.

Looking ahead, we expect to see two distinct technology ecosystems emerge around the world—one revolving around US-based technologies and the other around Chinese-based technologies. Each ecosystem will feature its own security and data standards, and each is likely to be mutually exclusive by design. China's need to develop semiconductors will remain front and center. As investors, the way in which we access that theme continues to be informed by this decoupling trend.

Renewable Energy

We expect overall demand for new energy solutions to remain high globally. Similar to semiconductors, we've been researching companies in the renewable energy supply chain, as well as equipment makers, that may be less impacted by the ebb and flow of geopolitics.

Health Care

On the health care front, we expect that China's policymakers will continue to prioritize and encourage greater research and development among innovative therapies. China needs to make health care solutions more accessible and more scalable. On the supply side, we expect more investment in health care infrastructure and services. On the demand side, we see the potential for higher-volume procurement.

Real Estate

Turning to real estate, economic and political observers wonder if China may be poised to implement a system of recurring property taxes, similar to other large economies. In our view, it may be too soon to tell. We expect that China's policymakers will continue their efforts to stabilize the housing sector. So far, regulatory efforts have been aimed at developers, rather than homeowners. For consumers in China, homeownership represents a considerable store of wealth and policymakers are cognizant of the need to maintain a consumer-based economy.

How have you positioned the Artisan China Post-Venture Strategy for long-term growth amid a weaker near-term macro-economic outlook?

Relaxing China's Zero-COVID policies is likely to be a gradual process, so the earnings forecast for many Chinese companies appears to be very challenged over the next couple of quarters. Companies with weaker balance sheets may find it hard to survive any bumps in the economic recovery. As bottom-up stock pickers, we screen not only for companies with strong growth rates and ROIC, but also for those businesses with strong balance sheets. Generally, we like to see companies with at least two years of operating cash on hand so that they can fund their own growth amid a weaker macroeconomic environment. Companies that can survive the economic downturn may be likely to consolidate market share as the economy begins to accelerate. That is why we favor companies with deep competitive moats, large addressable markets and experienced management teams.

With the potential for a globally synchronized recession ahead, why should global investors consider Chinese equities?

Innovative companies in China today must compete on product quality, product differentiation and intellectual property. This inflection point creates outsized opportunities to identify disruptive, fast-growing businesses that solve large unmet needs in the marketplace.

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