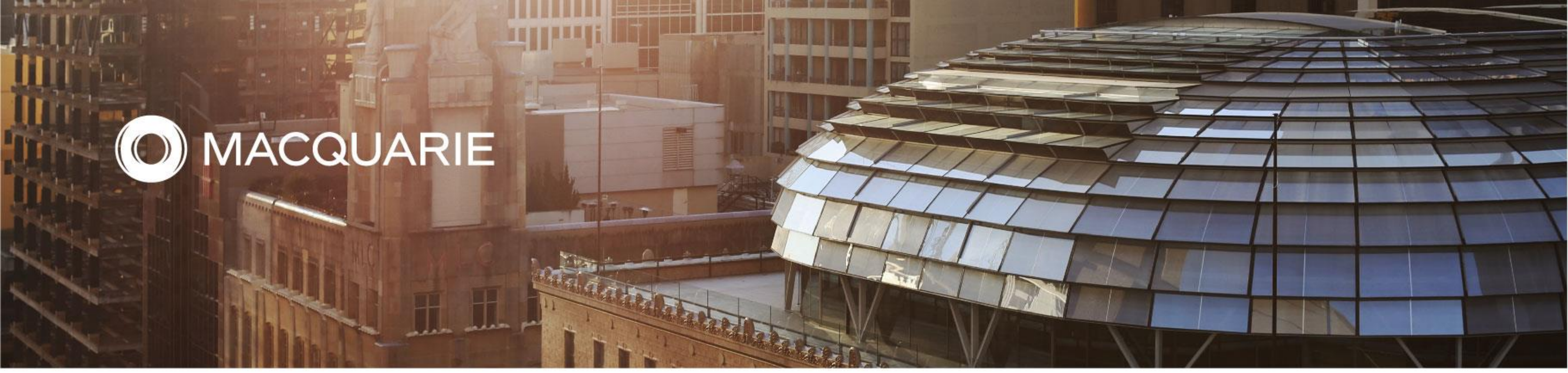


Investment Strategy Update #122

China: A less appealing long-term investment option

- China's 20th Party Congress meeting confirmed Xi Jinping is on course for a 4th term (and potentially beyond). Upcoming changes to the all-powerful Standing Committee will also help centre policy direction by removing plausible opposition.

- The Party Congress is not a policy-making body but rather sets the "Party Line" and the "Guide Lines" for various areas such as politics, the economy and foreign policy. While the most recent meeting did not mark a sharp turn from the previous policy stance, it continued to raise the emphasis on a greater balance between economic and social objectives. It is clear that China is not returning to "growth first" pragmatism.

- Greater emphasis on national security and technological self-reliance in order to build a socialist economy was highlighted, as was a softer economic growth target which focused on increasing GDP per capita to a level consistent with a "medium-level developed country" by 2035. Macquarie think this would require growth of ~4.75% p.a. for the next decade.

- China faces a number of near-term headwinds including a weak housing market, COVID lockdowns and a softening global backdrop. However, Macquarie believes an increased social focus makes China a more difficult investment proposition in the years ahead.

- It is likely that the cold war with the US is raising support for Xi's policies around security and technological advancement. But from an investment perspective, this creates less transparency around future policy and economic signals. Macquarie's global strategist believes the gap between the public and private sector will continue to narrow and that it will become increasingly hard to value listed companies.

- Over the long term, Macquarie think China is investible, but difficult to manage due to policy risks and uncertainty around valuation. This suggests a country allocation to China is not recommended as a "buy and hold" strategy. Instead, allocation to China should be made via funds that build bottom-up positions but are not required to hold a broad index weighting.

- We are underweight equities and, within that, underweight Emerging Markets, given a weakening cyclical economic backdrop and strong US Dollar.

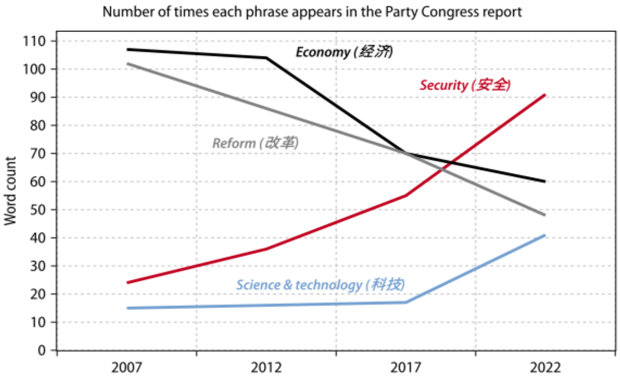
Decoding the 2021 Party Congress – Xi for Life

Macquarie's head of global equity strategy believes outcomes from the 20th Party Congress meeting are set to make China a much more difficult and less certain investment option in years to come.

For some time, China and its equity market has held structural investment appeal due to its growth potential and future role/relevance in the global economy. While expectations around China's economic and political relevance remain largely unchanged, profiting off this growth via the equity market is far less certain. This is because the most recent Party Congress meeting, while cementing Xi Jinping as *"leader for life"* and reducing future plausible opposition at the same time, also tilted more heavily away from the old ideology of 'growth above all else'.

Macquarie believe this political shift is permanent and this means the gap between state (public) and non-state (private) will continue to shrink until there is no discernible difference. In other words, China is likely to see a complete shift towards state capitalism which therefore makes it more difficult to put an economic value on investments.

Economy down, Security & Technology Up



Source: Gavekal Dragonomics, October 2022

What do leadership changes mean for China's policy priorities?

The Party Congress is not a policy-making body. The Party Congress sets the Party Line and the Guide Lines for various areas such as politics, the economy and foreign policy. These broad objectives were delivered by President Xi, followed by the announcement of the new Politburo Standing Committee. The key takeaways were as follows:

1. Xi Jinping's speech was angled towards continuity rather than setting a new agenda, as he did at the 2017 Party Congress. But there was a further tilt away from the "growth-first" pragmatism and greater emphasis on national security and technological self-reliance.

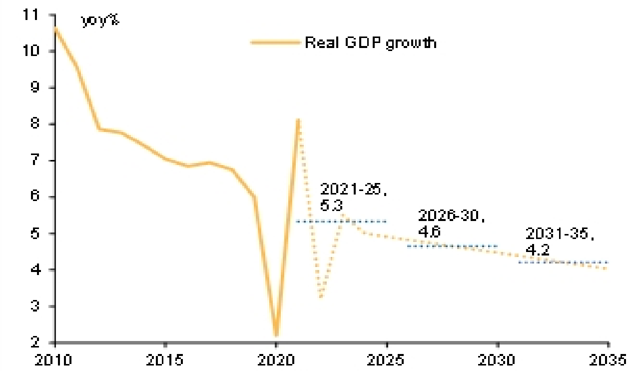
   "A two-step approach should be taken to build China into a great modern socialist country that is prosperous, strong, democratic, culturally advanced, harmonious, and beautiful by the middle of the century."

2. China's GDP per capita would reach that of a "medium-level developed country" by 2035. By comparison, the 19th Party Congress in 2017 didn't mention any growth target. The Party never specified the threshold for "a medium-level developed country", but a reasonable guess is a doubling of China's 2020 GDP per capita which would require an average annual growth rate of ~4.7% p.a. between 2021-2035.

What are the implications of policy priorities?

Macquarie do not think that Xi Jinping's speech marks a sharp turn from the previous policy stance, but it does raise the emphasis on security and the requirement of technological development in order to build a socialist country.

GDP growth rate required to doble per capita growth by 2035



Source: NBS WIND, Macquarie Macro Strategy, October 2022

While some further stimuli and a gradual elimination of COVID constraints should lead to relatively strong recoveries into 2023 and early 2024, achieving 5% growth over the coming decade will not be easy given the structural headwinds underway such as the property down-trend, an aging population and US-China tensions.

Macquarie's global equity strategist believes there are four key take-aways from this statement.

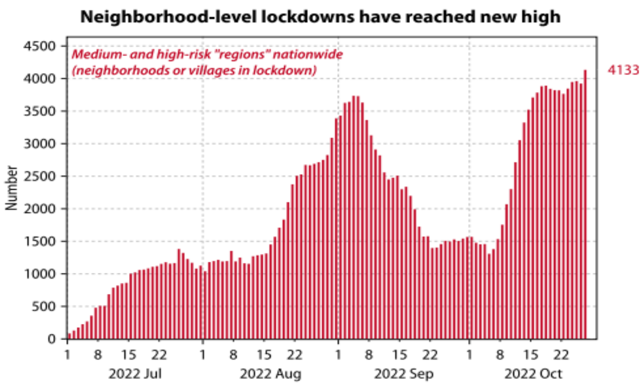
- **The disruption caused by technological and information revolution will intensify,** altering most aspects of life and economy, including industrial and technology sectors.
- **Social and geopolitical pressures will not ease,** and if anything, get stronger.
- **The party control over the society and economy should continue to strengthen** if China is to succeed in a disrupted world.
- **The space for amicable resolution of thorny global issues will narrow** such as Taiwan to technology and supply chains. This implies the need to strengthen defence and domestic supply. 'development'.

As our China economist highlighted, the word "security" was mentioned far more frequently than "development". The speech re-enforced our view that while economics is never irrelevant, China is on a societal and civilizational path that has multiple objectives. Hence, Xi's frequent messages preparing citizens for their 'historical mission' and 'great struggles ahead'.

What are challenges that lie ahead for China?

While China is still likely to grow much faster than the average developed economy, it is facing a number of significant challenges according to Macquarie's global strategist. This includes a shrinking labour contribution, extremely elevated levels of debt required to generate additional GDP and low multi-factor / agricultural productivity rates.

COVID lockdowns have not slowed



Source: Gavekal, October 2022

All of these headwinds will make it difficult for China to reach its long-term growth targets and would make returning to old growth levels highly improbable. In addition, the belief that China's zero COVID policy has ensured economic stability suggests no quick reversal of these policies is likely – at least for the next 6 months where there is no short-term vaccine or treatment solutions.

What does this mean for investors?

The centralisation of power and the continued shift away from growth at all costs will make investing in the Chinese equity market increasingly difficult in the years to come. In a world that is not driven by economics, determining the fundamental value of an investment becomes more difficult and subject to policy and/or political change at any point in time (i.e., an unforecastable outcome). Macquarie's global strategist believes China is now a long-term valuation de-rating story that will only be interrupted by cyclical upswings (in other words there will only be short periods of upside against a back drop where the valuation of the equity market continues to decline).

This may be an extreme interpretation of the current backdrop but intuitively, we have no strong disagreement. From an investment perspective this means taking a "country" bet on China may no longer pay off just because it is on a path to becoming the largest economy in the world.

We think a traditional "buy and hold" allocation on the basis that corporate earnings are leveraged positively into a rising economy is unlikely to provide the payoff options that were on offer when economic growth was the overriding priority. Unfortunately, because China makes up just over one-third of the emerging markets index (~31%), our global strategist believes that investors have no choice but to eventually structure China out of portfolios because while it is investible, it will become unmanageable dur to a lack of transparency on policy risk.

It is possible that higher stimuli, greater liquidity as well as discounted expectations and multiples could easily ignite a domestic rally in Chinese equities that then drive emerging markets higher. However, this is a cyclical and not a structural view. Ultimately, if Macquarie's global strategist's view is correct, then emerging markets become a trading call based on the cyclical outlook for China but that country allocations (a buy and hold view on China equities either passively or via an active fund) would not be recommended due to permanent de-rating risk. On the other hand, managers who are not required to take a country allocation and gain exposure via bottom-up stock allocations are best positioned to avoid having to own a broad basket of stocks which may be subject to policy uncertainty.

We are underweight equities and, within that, underweight Emerging Markets, given a weakening cyclical economic backdrop and strong US Dollar.

Macquarie WM Investment Strategy Team

Mentioned Reports:

The hard road ahead for EM investors - Between a rock and a hard place

China's national mission - The key challenges ahead

EM Foreign Funds Flows - Can investors outperform without China?

The report was finalised on 31st October 2022.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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