Market Bulletin

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Quality over quantity: Investment implications of China's new economic policy

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In brief

- The opening statements at China's 19th National Party Congress (NPC) indicate a shift from a pure focus on numerical growth targets to a wider appreciation of qualitative measures when formulating policy.
- This shift supports our view that the Chinese authorities now care more about financial stability than economic reforms. Though China's President Xi Jinping discussed a comprehensive economic reform plan in his opening statements, spreading wealth across society will now take precedence over high rates of growth.
- Policy will support stability in the investment outlook, and wider distribution of China's wealth should open up new investment opportunities. However, long-term systemic risks, such as the corporate debt load, have been kicked down the road.
- President Xi laid out a timetable for China to become a leading global power by 2050; he said that the first stage is on track, with China set to become a "moderately prosperous society" by 2020 and that China will complete the second stage by rising to the status of a leading global power by 2049—the People's Republic of China's centennial.

The 19th National Congress of the Communist Party of China (CPC) began on October 18. China's President and CPC General Secretary Xi Jinping made a comprehensive speech, summarizing the ruling Party's achievements in the past five years and laying out his policy roadmap for the next few decades. Investors have watched prior opening statements at the NPC for guidance on China's economic growth targets; President Xi's 2012 speech set China's growth target at 6.5% per year for the five years leading up to this Congress. This time around, President Xi's comments did not mention a numerical target for growth and instead shifted the emphasis of China's economic goals toward hitting more qualitative targets, such as wider distribution of economic prosperity and maintaining economic stability. We believe this shift has important implications for investors.

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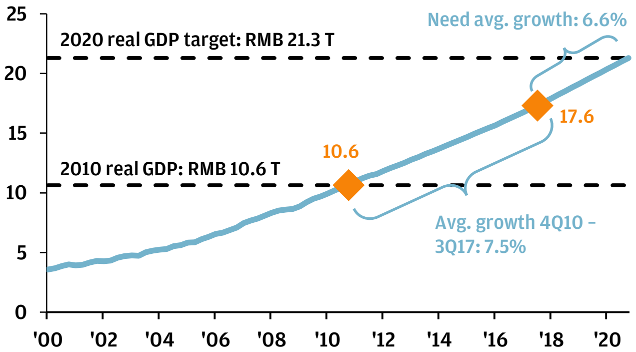
Balanced development is the focus

According to President Xi, the "principal contradiction" facing Chinese society today is "the unbalanced and inadequate development and people's ever-growing needs for a better life." This tweak from the official Party line (the Party Constitution currently reads: "between people's ever-growing material and cultural needs and backward social productivity") shifts the onus onto the problems presented by imbalances in China's development thus far. We see three major investment implications from such a change:

1. Economic policy will focus on income distribution among social groups and regions. China earlier set the goal of eradicating poverty by 2020 by transforming itself into a "moderately prosperous society." In practice, this means doubling GDP by 2020 from 2010 levels. As shown below in **Exhibit 1**, China is well on its way to achieving this goal and therefore can afford to focus on distribution of this wealth and other quality-of-life goals, such as investment in education, culture, the social safety net and environmental protection.

2. If 2017 real GDP growth comes in as we expect, a doubling of GDP by 2020 will require average year-over-year growth of 6.6% in real terms for the rest of this decade (**Exhibit 1**). While we interpret the NPC tea leaves as shifting away from numerical growth targets, we think policy will be supportive of this goal, meaning radical reforms in either company management or industrial policy are unlikely to occur. This should provide a stable investment outlook in the near term as investors do not need to worry about large policy shifts but may allow present imbalances to grow further, setting up tougher choices down the road.

China is well on its way to meeting its growth targets
EXHIBIT 1: REAL GDP AND TARGET LEVELS
REAL GDP, 2010 PRICES, TRILLION RMB



Source: CEIC, National Bureau of Statistics of China, J.P. Morgan Asset Management. Data are as of October 20, 2017.

3. The focus on improving quality of life will be supportive of new China-linked equities as wider income distribution and increased social spending will boost consumption. The activity indicators released last week support our current positive view on onshore equities, and the shift in policy focus will support earnings growth (**Exhibit 2**).

Strong economic growth momentum should support corporate profits
EXHIBIT 2: ACTIVITY INDICATORS
YEAR-OVER-YEAR % CHANGE

	September 2017	August 2017
Industrial production	6.6%	6.0%
Fixed asset investment	7.5%	7.8%
Retail sales	10.3%	10.1%
A-share EPS*	260.9**	259.9

Source: Bloomberg Finance L.P., FactSet, National Bureau of Statistics of China, J.P. Morgan Asset Management. Data are as of October 20, 2017.
*Bloomberg estimates of CSI 300 index NTM EPS in Chinese renminbi. **As of October 20, 2017.

Don't rock the boat

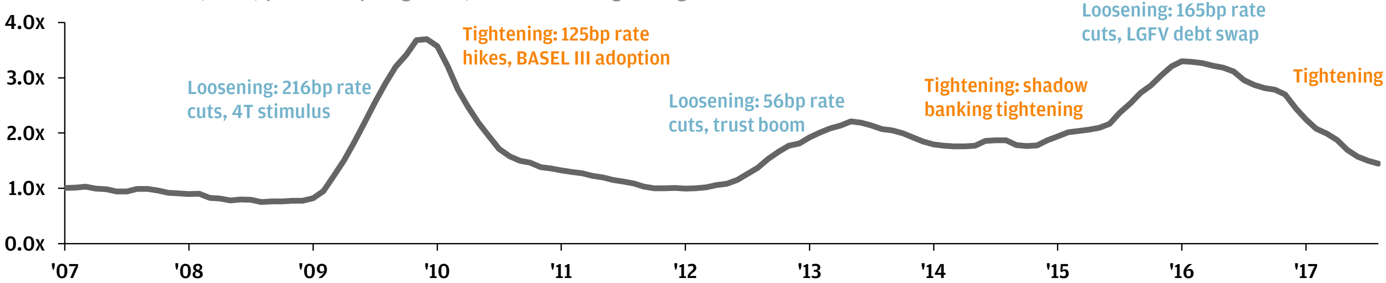
Stability is central to achieving the Party's economic goals, and the Chinese authorities have been relatively transparent about the risks they perceive could arise from financial or economic instability. In addition to President Xi's medium-term economic goals, he also laid out a roadmap for China through 2050, by which time China will become a leading global power with widespread economic prosperity. In order to get there, China will need to accelerate efforts to give market forces greater control within its economy. Reforms underway include greater protection of property rights and promotion of entrepreneurship under Party leadership. We interpret this focus to mean that the Party will tolerate market forces gaining influence over the economy, so long as they ensure stable growth with a Party hand at the helm.

The discussion of financial reforms at the NPC supports this view. President Xi declared that the framework of financial regulation, underpinned by monetary policy and macro-prudential policy, will be improved to forestall systemic financial risks arising from market forces gaining influence over interest and exchange rates. Comments from People's Bank of China (PBoC) Governor Zhou Xiaochuan alongside the NPC support our judgment that market forces will be given greater, but still limited, sway over the financial system.

China is unlikely to loosen policy across the board, but targeted easing may occur

EXHIBIT 3: CREDIT GROWTH TO GDP GROWTH

Broad credit measure*, ratio, year-over-year growth, 3-month moving average



Source: CEIC, People's Bank of China, J.P. Morgan Asset Management. Data are as of October 20, 2017.
Credit growth to GDP growth ratio utilizes rolling 12-month nominal GDP and broad credit. *The broad credit measure consists of all reported bank claims on the domestic economy, plus bankers' acceptances, entrusted loans, trust loans, new net corporate bond and non-financial equity financing, issuance of asset-backed securities and interbank loans.

To maintain stability, we see the newly created State Council Financial Stability and Development Commission (formed earlier this year at the Financial Work Conference) using creative applications of existing policy tools to carefully manage the extension of new credit (**Exhibit 3**) and direct financial activity into preferred channels. Benign third quarter economic data gives the PBoC more room to engage in reforms. As investors observed with the recent required reserve ratio cut, these reforms will become increasingly targeted and fine-tuned to meet policy goals.

Investment implications

Qualitative, not quantitative, targets will guide China's economic policy going forward. In keeping with the targets for development laid out in President Xi's speech, this cycle will be characterized by measures intended to ensure stability and distribute wealth, rather than large-scale stimulus and infrastructure investment. Given the emphasis on controlling systemic risks, outright monetary easing is also unlikely and policy will likely grow more and more specialized and targeted. We expect to see specific policy measures introduced in the fields of state-owned enterprise reform, market opening, environmental protection and controls on property market speculation. Already strong corporate and household consumption, shown in third quarter activity indicators, will benefit from these policies, which may support stronger equity market returns in the future.

For long-term investors, we see two important takeaways from these policies: 1. Stability as a top priority may ease some investor fears about financial risks in China, and 2. Spreading China's rapidly growing wealth will likely contribute to strong earnings growth in sectors linked to an upgrade in consumption, such as health care, consumer discretionary and information technology.

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