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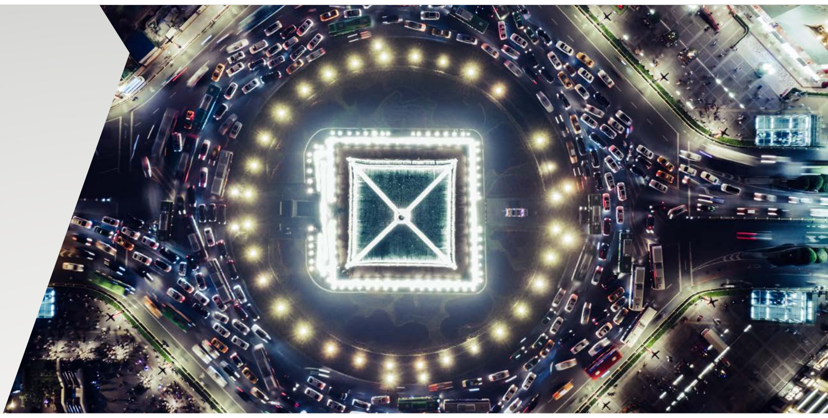


China: Navigating a policy driven market

An understanding of China's policy leanings is key to investing in its stock market. China will table its 14th Five-Year Plan in March 2021. While the five-year goal setting exercise is a regular feature of China's policy framework, the stakes are now higher amid rising internal and external challenges. The increasing importance of technology, advanced manufacturing and domestic demand are important shifts which investors should take note of.

In March 2021, the Chinese Communist Party will table China's 14th Five-Year Plan (FYP). The communique from the plenum held in October 2020 already offer hints of what to expect. While some of the themes have been featured in earlier plenums, the shift in priorities is clear. Innovation and advanced manufacturing, though prominent in the 13th FYP, have been elevated to become top national priorities. With the plenum taking place against the backdrop of swelling geopolitical tensions with the US, the desire to boost technological self-sufficiency and domestic demand has also become more pronounced.

A POLICY DRIVEN MARKET

China has often been described as a policy driven market. Research indicates that 69.5% of the stock market fluctuations in China can be explained by a policy-related factor[1].

There may be several reasons for this. In the early days, China's stock market aimed to support state-owned enterprises. The authorities were also keen to stabilise market operations and provide an implicit guarantee for investors. At the same time, the regulatory framework was still evolving and the market as well as market participants were relatively immature.

China's financial markets have since advanced – the spate of defaults by SOEs in the China onshore bond market in the fourth quarter of 2020 suggests that in order to instil greater market discipline, the Chinese government will no longer indiscriminately bail out all government-linked companies. China's market regulatory framework has also strengthened over the years, granting its equity and bond markets access to global benchmarks. Institutional investor participation has also increased over the last decade.

Source: [1]Wang et al. (2012)

Nevertheless, China's unique policy making process, where the strategic priorities of the government and the initiatives to implement those priorities are tabled every five years, implies that it is still important for investors to understand policy leanings and incorporate the potential implications into their portfolios.

KEY THEMES FROM THE PLENUM

Following China's impressive economic recovery from the COVID-19 outbreak, the key themes arising from the October plenum serve as a useful guide for investors as China charts its post-pandemic future.

1. Advancing manufacturing

The competitive advantage of China's supply chain, according to Eastspring's **Shanghai-based research team**, lies in its comprehensive eco-system. The diversity and flexibility of this eco-system helps reduce logistical and coordination costs, making production highly economical. The outbreak of the COVID-19 pandemic helped to further burnish China's credentials as a reliable supplier as Chinese manufacturers resumed production quicker than most, winning market share from global competitors. Following the initial scare from the pandemic, an EY survey in October 2020 found that 37% of multinational executives were considering reshoring, down from 83% in April. In the meantime, China intends to transform its manufacturing industry to become smarter and greener where 5G, Artificial Intelligence and big data will play important roles. **Michelle Qi**, Eastspring Shanghai's Head of Equity expects leading China players in the Machinery and Automation sectors to benefit from China's economies of scale and unique supply chain dynamics.

2. Increasing technological self-reliance and innovation

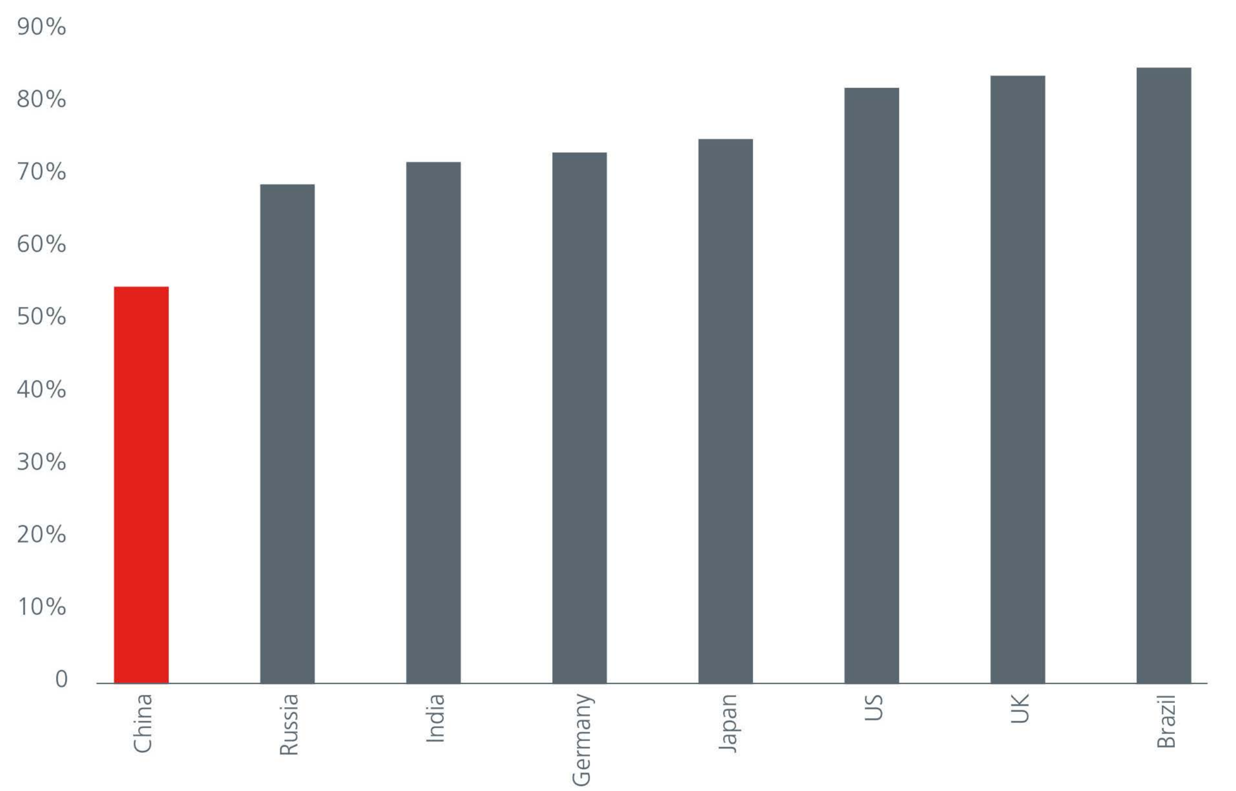
China has elevated technological self-reliance to become a national strategic pillar. This is particularly key in the area of semiconductor chips where China currently produces about less than 10% of the world's semiconductor chips but consumes 35% of global chip output. This huge imbalance poses a risk to China's economic security and technological ambitions given the US' widening restrictions on chips and semiconductor equipment.

China would need to devote significant investments and time to acquire and develop advanced semiconductor technologies. For a start, the government has announced corporate income tax breaks for Integrated Circuit and Software companies in August 2020. Yet, the road ahead is challenging – historically, technological development has required collaboration with international partners in the areas of intellectual property, expertise, equipment or raw materials. This appears increasingly difficult in today's geopolitical backdrop.

3. Raising domestic consumption

A key feature for China's new development phase is the "dual circulation" model which incorporates both "internal" and "external" circulation. "Internal circulation" includes efforts to expand domestic demand while "external circulation" looks to develop conditions to facilitate foreign investment and boost exports. There is significant room for China's domestic consumption to grow. As a percentage of GDP, China's domestic consumption remains substantially below that of many developed and emerging economies. See Fig. 1. Increasing domestic consumption's share of the economy will require supply side reforms including

Fig. 1: Consumption as a percentage of GDP



Source: Wind. Barclays Research. As at 2019.

higher wages, better social safety nets and labour market changes for a start. As China transitions towards a more consumption-driven economy, **Nathan Yu** from Eastspring's Greater China Equity team believes that demand for discretionary items like Education, Healthcare, Recreation and Travel will increase. At the same time, demand for Food & Beverage, Apparel, Housing and Autos will witness trends in brand upgrade and premiumisation.

4. Boosting urbanisation

China's urbanisation rate stood at 60.6% as at the end of 2019 while the rural-urban income gap has widened over the years. The ratio of per-capita disposable income of urban residents to that of rural residents increased from 2.5 in 1978 to 2.64 in 2019[2]. With research suggesting that there is a two-way causality between the urban–rural income gap and urbanisation[3], it should be no surprise that China intends to roll out a new urbanisation drive and co-ordinated regional development to reduce the income gap and development disparities between the prosperous coastal provinces and the hinterland. This urbanisation drive would be positive for the Infrastructure, Property and Basic Material sectors. However, for the drive to be successful, it would require a breakthrough in Hukou and land reforms. In 2015, it is reported that only 1.3% of migrant workers owned homes in their working cities. If migrant workers can become urban citizens and homeowners, **Kieron Poon**, Portfolio Manager from Eastspring's Greater China Equity team

Source: [2]China's National Bureau of Statistics. [3]Urbanization and the Urban–Rural Income Gap in China: A Continuous Wavelet Coherency Analysis. Yiguo Chen, Peng Luo, and Tsangyao Chang.

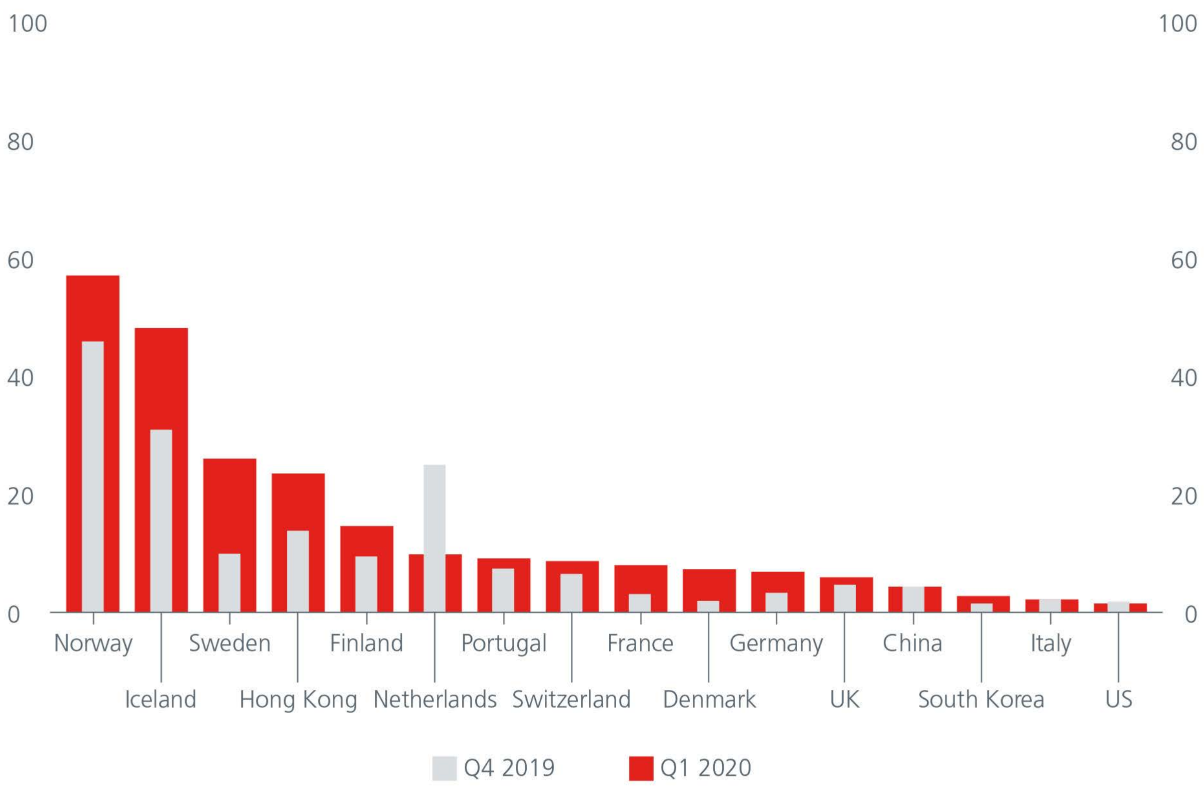
believes that it could unleash demand for Autos, Home Appliances as well as services in Finance, Healthcare and Education.

5. Accelerating green development

The political will to green China's economy appears strong. China is expected to implement a series of ambitious and aggressive plans for green and low-carbon development in order to reach peak carbon emissions by 2030 and become carbon neutral by 2060 – in line with the goals set out by President Xi at the United Nations General Assembly in September 2020.

In particular, China wants 20% of the new cars sold by 2025 to be New Energy Vehicles (NEVs), up from 5% in 2019. The central government has extended purchase subsidies and purchase tax exemptions for NEVs through 2022. The government's decision to invest USD1.42 bn in charging infrastructure in 2020 is also intended to boost EV sales over the longer term. As of Q1 2020, with the exception of Hong Kong, nine out of the top 10 markets with the highest EV penetration rate were European. See Fig. 2. **Michelle Qi**, Eastspring Shanghai's Head of Equity believes that the increasing focus on cleaner energy has engendered a permanent shift to the electrification of transportation. Eastspring's Shanghai-based research team is assessing b oth direct and indirect beneficiaries of the e-mobility trend.

Fig. 2: Electric vehicle (EV) penetration rate (%)



Source: McKinsey Electric Vehicle Index: Europe cushions a global plunge in EV sales. July 17, 2020.

MORE AT STAKE

While there may be some scepticism surrounding the goals which China has set out in the 14th FYP, some of the changes which we are witnessing today in China's banking, property and financial markets are the result of the reforms from earlier FYPs. The renewed emphasis on some of these goals during the government's Central Economic Work Conference in December 2020 further underscores the Chinese government's commitment to achieving these priorities. That said, many of the goals will require structural and institutional reforms which will carry risks while taking place amid significant changes in the global landscape.

Since the 13th FYP, the US has imposed multiple restrictions on Chinese companies and has used its technology edge to contain China's ambitions. Notably, the communique from the October Plenum referred to the "profound adjustments in the international balance of power". Amid rising internal challenges and external hostilities, the Chinese government's new strategic priorities will help define China's next development phase, determining winners and losers. Investors may want to pay heed to this year's key messages.

This is the first of six articles in Eastspring's 2021 Asian Expert Series. In this new series which focuses on China, our investment teams offer insights into the opportunities and challenges facing China as it rolls out its 14th Five-Year Plan.

Click here to read other articles in our Asian Expert Series.

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