Understanding the Confucian in Xi’s Populism

China has dropped norms to allow President Xi Jinping to remain in power after his second term ends. While worrisome at first blush, the populist turn and consolidation of power likely has near-term economic and financial market benefits, and longer-term political risks. Thornburg Portfolio Manager Lei Wang weighs in on the populist turn in China, which is among a growing contingent of populist nations.

Populism is on the march globally, although it’s hardly monolithic in nature or expression. U.S. President Donald Trump’s turgid brand sucks the air out of page-one editorial rooms, so it’s perhaps easy to miss the many varieties developing. Italy is facing a hung parliament following the inconclusive, early March elections, in which the anti-establishment 5-Star Movement garnered the most single-party votes, a conservative bloc that includes the right-wing League party received a bit more, but both fell well short of a governing majority. Turkish President Recep Erdogan has forged an unlikely coalition of religious conservatives and secular nationalists to firm his grip on power. Illiberal democracies of varying degrees now reign in Hungary, the Philippines, Poland, Russia, and Venezuela, though other examples abound.

Most proclaim the need to rescue their supposedly besieged nations from nefarious foreign designs, usually, but not always, the U.S., the E.U.—recall Brexit—or the West more generally. In Washington, for example, apart from continued talk of a wall along the U.S.’s southern border, Trump is imposing tariffs on U.S. imports of solar panels, washing machines, steel and aluminum, largely, if bluntly, aimed at Chinese producers. A different strain is evident in India, where Prime Minister Narendra Modi’s populism may derive from Hindu majoritarianism, but it now rails against statist corruption and the dynastic politics of the Congress party. Then there’s China’s newly minted hybrid: “Xi Jinping Thought on Socialism with Chinese Characteristics for a New Era.”

That mouthful, which effectively reinforces the Communist Party of China’s position atop the country’s political, military, and domestic security complexes, has made its way into the country’s constitution. As part of the constitutional changes, the rubber-stamp National People’s Congress has voted to allow President Xi, whose first five-year term began in 2013, to remain in power after his second term ends in 2023. At its annual meeting this month, the legislature has also approved the creation of a National Supervision Commission to consolidate anti-corruption efforts at the local level; a streamlined financial sector, securities market and central bank “super-regulator” with cabinet-level authority; established a more muscular Ecological Environment Ministry to replace the Ministry of Environmental Protection; and, among other reforms, created a government agency for veteran affairs.

The legislature approved supply-side reform targets in the steel and coal sectors, cutting capacity by 30 million tons and 150 million tons, respectively, as well as passed income tax cuts for individuals and a reduced value-added tax rate for manufacturers. This year’s economic growth target of 6.5% was also confirmed, reflecting the government’s push to rebalance growth at a slower, albeit more sustainable, pace by shifting the drivers from fixed investment to consumption. The anti-corruption, financial sector, and environmental regulatory reforms are together meant to ensure that growth is cleaner and greener, that debt-wracked state-owned enterprises continue to reform, and that shadow lending is moved back onto banks’ balance sheets so that financial sector stability improves.
Thornburg Portfolio Manager Lei Wang brings perspective to Xi’s consolidation of power, pointing out that in the near term, economic policy and regulatory risks are reduced. He notes that Xi’s populism employs frequent appeals to Confucius, the sixth-century B.C. philosopher who instructed that rectitude, virtue, and frugality for both rulers and ruled are necessary for harmonious living. They pepper his two signature ideological campaigns: the “Chinese Dream” to turn the country into a modern, socialist superpower, and “Beautiful China” that promises to create an environmentally clean, sustainable, high-tech economy.

If it sounds harmless enough, Xi’s power grab comes with a sharp edge. As Evan Osnos, a writer for the New Yorker and fellow at the Brookings Institution, discussed at this year’s Thornburg Global Research Summit, Xi’s ultimate objective is to reinvigorate the Communist Party of China. The idea is to prevent a repeat of the collapse of the Soviet Union, the fall of which Xi blames on Western influence and pressure. To restore the party’s credibility, Xi launched the anti-corruption campaign, in which well over 100,000 arrests have been made, alongside the economic rebalancing and environmental campaigns to reduce pollution and modernize the economy. How Xi manages China’s increasingly capable military, which has built and militarized islands on disputed shoals in the South China Sea, the question of Taiwan’s future status, and how, when, and to whom Xi transfers power down the road, remain open questions.

For investors and people more generally, if Xi’s populism, which includes a cult of personality around “Uncle Xi” and strict media and social media censorship, is ultimately Confucian and benevolent in nature, his time in power could echo Deng Xiaoping’s more than Mao Tze-Tung’s, that is, economic and social progress rather than turmoil. Modi’s populism has facilitated the passage of major structural reforms in India that should pay big economic and social dividends. But Xi will have a harder balance to strike, given that his efforts to raise China’s place in the world are confronting Trump’s efforts to counter China’s mercantilist trade practices and dubious acquisition of foreign intellectual property. A trade war between the world’s two largest economies would hurt both, and undercut the stimulative effects of tax and regulatory reforms in both countries, as well.

A Conversation with Lei Wang, CFA, Portfolio Manager

Lei joined Thornburg Investment Management in 2004 as associate portfolio manager and was promoted to portfolio manager in 2006. Lei holds a BA and an MA from East China Normal University and an MBA from New York University. He is a CFA charterholder. Prior to joining Thornburg, he served as an associate for Deutsche Bank as well as for Enso Capital Management. He has also worked as a bank supervision manager at China’s central bank.

Q: President Xi has become China’s most powerful leader since Mao Tze-Tung, with his name and political ideology recently enshrined in the constitution. Deng Xiaoping-established norms, which have facilitated the orderly transitions of power between competing factions within the Communist Party’s collective leadership, are also being dropped, allowing Xi to remain the president, party and military leader beyond the erstwhile two-term limit and conventional retirement age of 68. What do you make of this shift, and are there any near-term investment implications from it?

Lei Wang: In theory, Xi could rule China indefinitely. But I doubt that will happen. It’s a pendulum swing. Mao’s era was a one-man show. Deng changed it to so-called collective leadership. Behind the scenes Deng still made the final call on key decisions, even after he had officially stepped down. The collective leadership structure lasted for three decades, but with quite a bit of chaos and ups and downs. So now the pendulum is swinging back toward power consolidated in a single leader.

Xi wants effective authority over the other six members of the Politburo Standing Committee (the government’s top leadership circle) because he spent his first term consolidating power and thinks he needs more than another five-year term to deliver on his reform agenda, which basically aims to modernize China’s economy and make it the largest in the world. He would also like to cement his legacy by resolving the
Taiwan issue—bringing it back under Beijing's authority. These are ambitious goals, and he’s currently 64 years old. He no doubt thinks he’ll need more time to reach them after he turns 69.

Personally, I don’t think his “sole leadership,” in contrast to a “collective leadership,” should stifle intra-party competition. Factions still exist within the party, and policy debates between them seem to be continuing. Particularly on the economic agenda, so far as I can tell, the debates are intense.

In terms of the investment implications, if Xi runs China for the next 10 to 15 years, you could reasonably expect more visibility, stability, and consistency in his policies and their execution, which would not be disrupted by the typical political cycles we’ve seen in China in recent times. Such cycles don’t just affect China. Take the U.S., which has four-year, or at most, eight-year presidential cycles, which often result in sharp policy changes. We’ve clearly seen new U.S. economic policies since Obama left the White House and Trump entered it.

Xi’s agenda is clearly articulated to the public, which appears to broadly support it. He alludes to the Chinese empire’s historical zenith in the 17th and 18th centuries, during the pinnacle of the Qing Dynasty. So Xi is trying to set China on a path to becoming a modern, socialist superpower by 2049, which will be the 100-year anniversary, the centenary, of the country’s emergence as the People’s Republic of China.

The Chinese also like his anti-corruption campaign, and his focus on cleaning up the environment. They like his “Beautiful China” campaign and agree with his push to rebalance the economy so that growth is higher quality. It may be slower relative to the double-digit rates in recent decades, but less-polluting, cleaner, and more sustainable.

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Xi is more authoritarian than his predecessors, but many Chinese think that if he can fix things and make progress on his agenda, they’ll support him, at least for now. Many Chinese think he fits the Confucian mold, like Singapore’s Lee Kuan Yew, who was a benign authoritarian. That’s how Xi’s positioning himself, and it plays well to most Chinese, who simply want rising living standards, a cleaner environment, and political stability.

Q: China has been making considerable progress in reducing excess capacity in the steel and coal sectors, and it seems efforts to reduce supply in its aluminum sector were also gaining steam when the Trump administration announced its tariffs on steel and aluminum imports. Do you expect U.S. tariffs to elicit retaliatory tariffs on U.S. exports to China?

LW: Yes, if the protectionist rhetoric becomes reality and intensifies with more measures, I think China will retaliate, along with other nations. Its list of targeted U.S. products won’t be short, and, as Europe’s retaliation threats suggest, will focus on Trump’s base in specific states. China would target U.S. agricultural exports, especially soybeans—China is the U.S.’s largest soybeans customer—along with particular consumer products, such as iPhones.

Remember, Obama slapped tariffs on Chinese tire imports in 2009, and China retaliated with tariffs on imports of U.S. chicken parts. But the world is more inter-connected today. So a trade war would be a loss-loss for both sides. Short-term trade protectionism may serve a domestic political agenda, but at the expense of more workers outside the protected sectors, typically in downstream industries. In this case, U.S. steel and aluminum tariffs may help U.S. workers in those particular sectors. But consumers of steel in the auto or whiteline appliances industries will suffer, and you could see job losses as input costs rise. Higher input costs will also affect end-consumers, the buyers of cars and home appliances.

Chinese-made handsets are basically as good as Apple’s, but cheaper. They could easily ramp output if more U.S. import tariffs are slapped on Chinese exports to the U.S. China could promote its own product sales, substituting U.S. products domestically, and not just Apple’s. U.S. airplane manufacturers could also be vulnerable, as the Chinese may re-route orders to European competitors. Let’s hope a trade war doesn’t break out.

Q: Interestingly, one recent regulatory shift is forcing China’s telecommunications firms to upgrade network speeds and cut tariffs, including the cancellation of data roaming fees. What effect do you expect from these moves on the country’s telecom companies?

LW: China had already been eliminating voice roaming fees, so it was perhaps inevitable that they would target data roaming as well. It’s a natural extension of a policy designed to lower the communications costs to facilitate growth in advanced e-commerce, mobile payments, and the IoT (internet of things). That spurs broader information technology growth, as well as higher-quality economic growth generally. This shift is at the expense of telecom
companies in China. Telecoms have more or less become public utilities to support the growth of the digital ecosystem nationally.

This policy has placed a meaningful capex burden on the telecoms as they need to add more capacity to address the surging amounts of data after tariff reductions. But it’s worth highlighting the high elasticity of volume to price for data services.

Interestingly, as private sector internet giants, such as Tencent and Alibaba, benefit greatly from the extremely low cost of data infrastructure—they are essentially freeriding on the telecoms’ infrastructure—the government is asking them to invest in the telecom companies, such as China Unicom, to help the telecoms deleverage and finance their capex spending. This is a typical state-intervention in China, directing capital allocation at times more than market forces would.

Q: China’s banking regulator has just reduced the NPL (non-performing loan) coverage ratio to 120%–150%, from 150%, and lowered the provision-to-loan ratio to 1.5%–2.5%, from 2.5%. There has been much concern about the amount of debt, in particular the growth of corporate debt, along with related worries about non-performing or zombie assets, in China’s banking sector. Does the relaxation in provisioning signal that asset quality risk in China may not be as high as some fear?

LW: Apparently the regulator is sending a signal on that. With domestic supply-side reforms in recent years and rising commodity prices, corporate fundamentals are improving, corporate debt is falling, and banks’ capital ratios and asset quality are also improving. That gives the regulator some wiggle room to relax certain restrictive banking policies, including the 150% provision ratio.

But there is a caveat. This change won’t be applied in blanket fashion. There will be differentiated treatment for each bank, based on its individual metrics. They call it “one bank, one ratio.” So a strong bank can have lower provisions, but not a weak one.

This policy will incentivize banks to accelerate NPL recognition and treatment, especially during the current cycle in which bank earnings are on the upswing. So the regulatory move definitely sends a positive signal to the market and has been received positively.

Q: China’s private sector internet giants and green energy-related companies have garnered much investor interest, and securities prices in the two sectors have risen considerably over the last few years. How much near-term upside do you see in these two spaces, and where in China are you finding more attractively valued opportunities?

LW: I think the market has been quite efficient in recognizing and pricing in the strong momentum in those two sectors’ growth potential. Near-term upside is hard to predict as it’s subject to broad market factors that sometimes displace company-specific fundamentals. Such movements in share prices can be helpful for managing position sizes, though. Generally, I do believe underlying growth drivers, coupled with their own highly scalable business models, are still intact. So they deserve to be core holdings for China exposure in investor portfolios.

I currently see more opportunities in companies exhibiting a value tilt, including those going through restructurings and related reforms. That’s especially the case with those benefiting from more private capital involvement, which also helps on the corporate governance front. At the top of Xi’s agenda is SOE (state-owned enterprise) reform. SOEs have attractive assets which have huge monetization potential, but that’s underappreciated by the market due to misunderstanding of the reforms or a lack of confidence in them. That’s why they have lower valuation multiples. We think balancing exposures to the fast-growing companies with select SOEs undergoing reforms offers strong upside potential from differentiated sources of alpha.