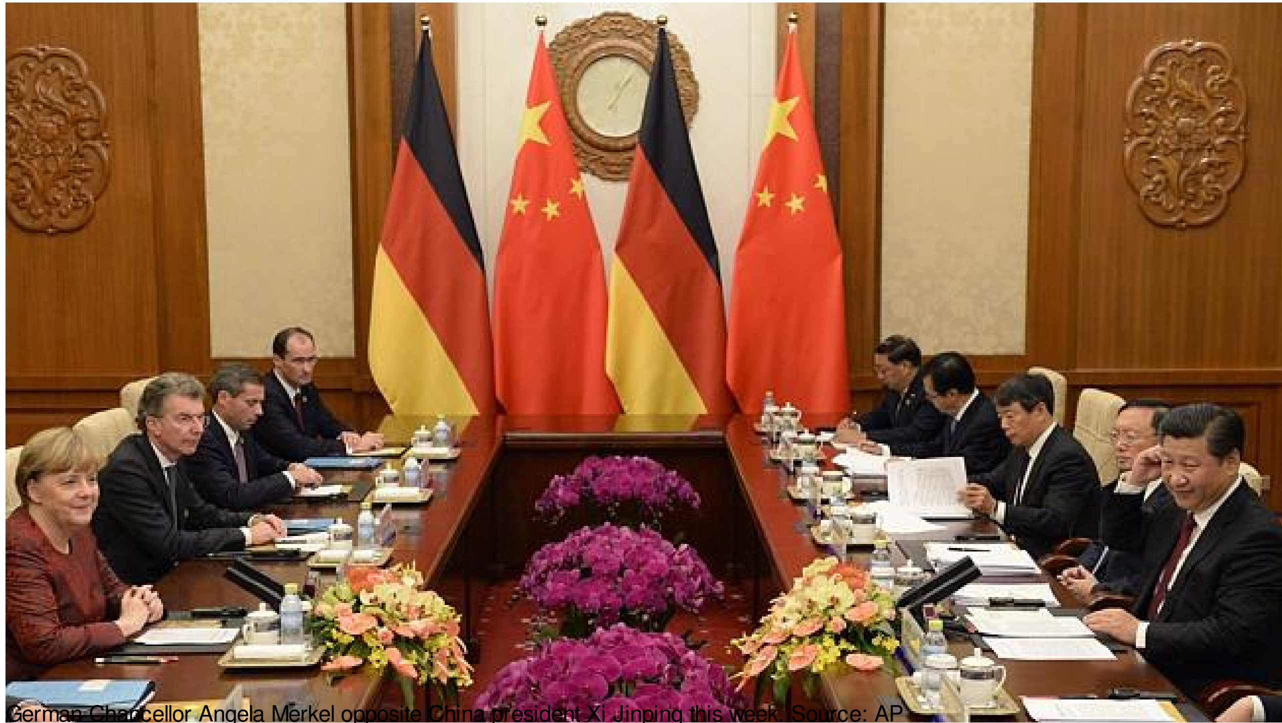
THE AUSTRALIAN

China plans new path to prosperity

STIRLING LARKIN THE AUSTRALIAN OCTOBER 31, 2015 12:00AM



German Chancellor Angela Merkel opposite China president Xi Jinping this week. Source: AP

Halloween has special meaning for the Chinese this weekend as they remember the haunted year that has spooked both themselves and global markets.

Given heightened global attention surrounding those events, and the emerging correlations between developments in China and the world economy, it becomes ever more timely to take pause and assess how China's fifth plenary session of the 18th Communist Party Central Committee, which met this week, really went.

These communist caucuses matter and ultra high net worth (UHNW) investors take them particularly seriously.

That's because this community, more often than not, not only invests its "fungible" wealth into mainland Chinese markets but also operates businesses or joint ventures that are directly affected by these communist five-year forward-looking manifestos.

Unlike US Federal Reserve FOMC meetings, which are all deemed "live and active" monthly roundtables, solely representing the monetary arm of the US government, China's plenary sessions, generally speaking, consist of seven sessions held during the five-year tenure of central committee members.

They also represent both the fiscal and monetary arms of the Chinese regime.

Importantly, the global investor needs to respect the ritual that has been continued since these sessions began in 1953, as unlike Western equivalents, each plenary session focuses on a certain predetermined agenda.

For instance, the first plenary session is for the arrangement of personnel, when central committee

members elect members of the Political Bureau and other committees. The last was held in November 2012.

Decisions concerning major national development and economic issues are usually passed at the third plenary, while the fourth typically discusses party-building issues, as was last seen in October 2014.

Traditionally the fifth plenary reviews the national economic development plan with the aim to map out strategies for overall economic and social development, setting growth targets and defining development policies. Given the extremely volatile northern summer Chinese markets experienced and the uncertainties linked to the accuracy of official GDP statistics, a plenary centred on national Chinese economic development under the leadership of president Xi Jinping will have visible market impact.

More than merely a "tea leaves" reading exercise, the communiques coming out of these caucuses matters tremendously, not only for those focused on Asia but also those deciphering US Fed Chairwoman Janet Yellen's next steps.

Yellen and the FOMC this week explicitly acknowledged "recent global economic and financial developments highlight the risk that a slowdown in foreign growth might restrain US economic activity somewhat further."

As the graph shows, China is succeeding in attempts to transition the groundings of its economic model.

But the question now for the global investor, following these meetings, is what happens to markets given the linkages between financial gearing and China's real economy?

From an economic perspective, the most important topic of the plenum will be the 13th five-year plan, the blueprint for development between 2016 and 2020.

Within this plan, analysts have zeroed in on two possibilities: 7 per cent or 6.5 per cent GDP growth targets.

The two possible targets will have very different implications on policy outlook.

Analysts believe that if the target is set at 7 per cent, the government will have to maintain its loose policy stance and execute more easing.

As a result, the leverage of the Chinese economy will continue to rise and such easings will immediately and directly affect Australian ASX and bond market valuations. On the other hand, if the plenary's growth target is set at 6.5 per cent, it means the government will tolerate slower growth to allow more space for structural adjustments, and in this case it is thought there will be fewer stimuli by the government.

For global UHNW investors, who not only approach mainland Chinese investing via listed equity bourses, but also via private equity channels, this matters greatly as well.

According to Stone Shi, senior partner of China's largest domestic law firm, Allbright, and a Larkin Group Advisory Board member, "China is still an attractive place for private equity investment, but Australian UHNWs make up a very small portion of the foreign PE base".

Dr Shi says "the legal entry channel for foreign PE investors, the QFLP (Qualified Foreign Limited Partners) mechanism, is still a valid and effective way, which is a permit system by selective Chinese municipal governments for foreign private equity funds."

Dr Shi notes most of these foreign PE QFLP permit requests now come from European and North

American domiciled family office and wholesale trusts, with few originating from Australia.

For other Australian investment communities, which look more to China's listed markets — where onshore and offshore equities have rebounded 13 and 15 per cent respectively from their September lows — the question has become, what visible catalysts are required to see a complete retracement back to pre-haunted levels?

Some believe the upcoming potential inclusion of China ADRs to the MSCI universe fits the bill and this may happen in the May 2016 semi-annual MSCI Index Review.

With 14 China ADRs potentially eligible for inclusion, the recent price volatility and changes in liquidity profile, as well as potential privatisation deals that may happen before the MSCI inclusion date, it becomes a "tea leaves" reading exercise for the active global investor wishing to purchase these names before the uptick seen from a MSCI index inclusion.

The three largest constituents — Alibaba (BABA), Baidu (BIDS), and JD.com (JD), are very likely to be included in any scenario as they collectively represent 74 per cent of the US quoted Chinese ADR universe.

Of course, what might spook markets next is a China back on the rise.

Larkin Group is a Wholesale Wealth Adviser focusing on high-yielding global investments.**www.larkingroup.com.au** *(http://www.larkingroup.com.au)*