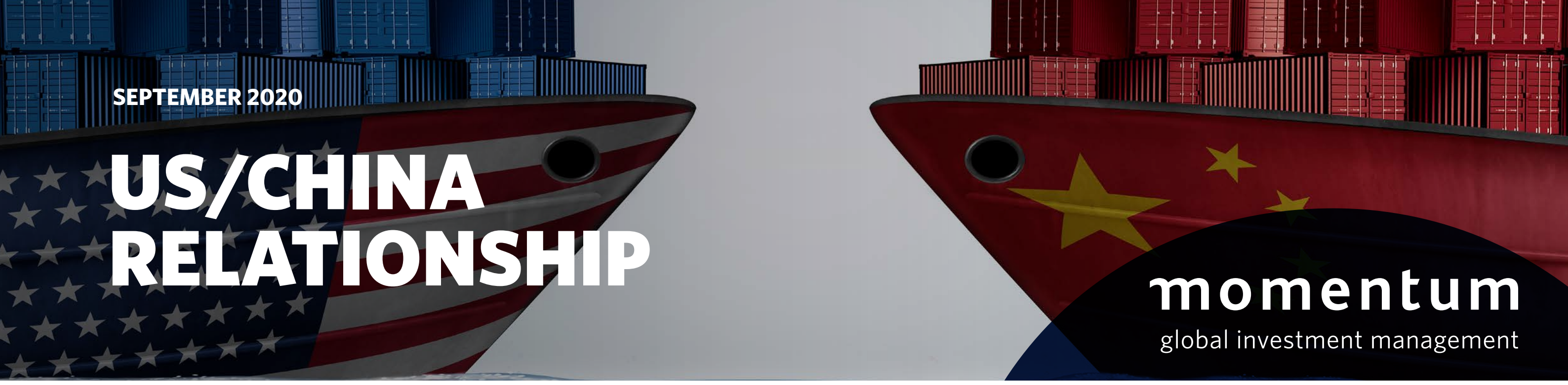


SEPTEMBER 2020

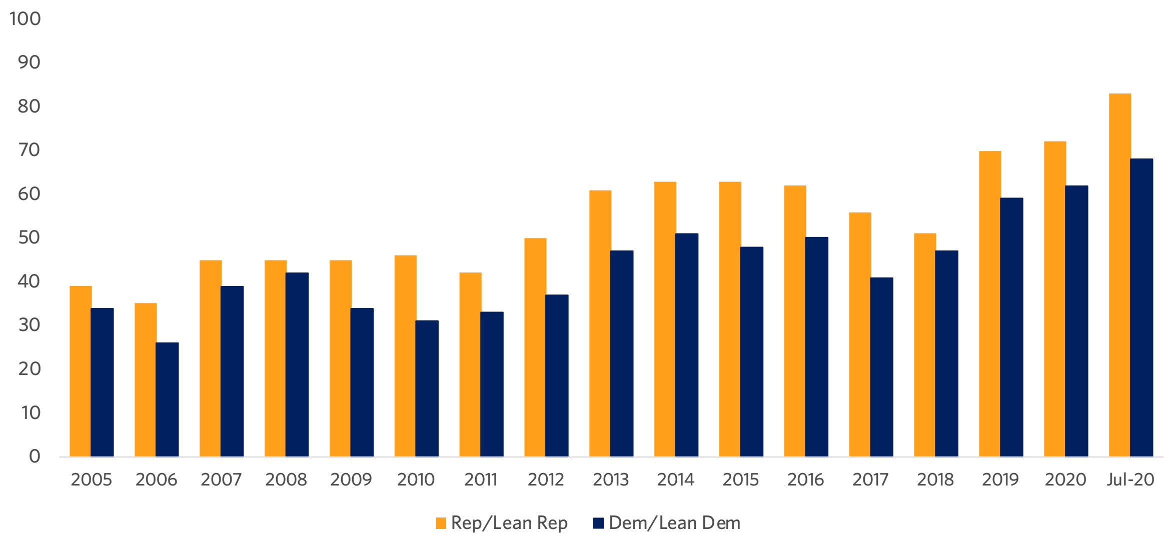
US/CHINA RELATIONSHIP

momentum
global investment management

US-China relations have deteriorated this year despite a promising start, as phase one of the trade agreement was signed off in January. That agreement partially addressed long-standing concerns the US has had on intellectual property theft and technology transfers, as well as committing China to $200bn of additional purchases of goods and services. It also left tariffs hikes on around $360bn of Chinese goods in place.

Phase two of negotiations was meant to start before the US election this November, but the Covid crisis has thrown this into doubt, with President Trump stating the relationship has been “severely damaged” by what he is calling the “Chinese virus”. This change in attitude is reflective of general American public opinion, and taking a tougher stance on China is one of the few topics on which both Republicans and Democrats seem to agree.

% who say they have an unfavourable opinion of China



Source: Survey of US adults conducted June 16th – July 14th 2020 by The Pew Research Centre

Of course the negotiations were never just about trade (and in any case the widening US deficit with China through this crisis shows that the tariffs have not have their intended effect); the dynamic has instead shifted to broader geopolitical issues as China has emerged as an economic powerhouse, increasingly more willing to assert its greater economic and political clout on the world stage. The Chinese economy has been the largest in the world in purchasing power parity terms since 2017, and it is forecast to rise to surpass the US in nominal dollar terms during the next decade. The World Bank has described China’s growth as “the fastest sustained expansion by a major economy in history”, and the US now legitimately sees China as a challenger to its technological and military dominance over the longer term.

A new Cold War?

This has led many commentators to declare the start of a new Cold War between these superpowers which could have far-reaching consequences for financial markets. Some in the US see China's rise as an ideological threat, much like communism was with the USSR. On this basis it is a political imperative to keep China in check, even at the cost of economic growth. This argument however ignores the fact that China's renewed prosperity has come from its embrace of capitalism, culminating in its accession to the World Trade Organisation (WTO) in 2001. This sparked a tremendous boost in global trade as well as giving more power to private firms over state owned enterprises, and is a far cry from Soviet-era central planning.

Foreign direct investment increased 4x over the decade following China's WTO membership as the country has become far more integrated into the global economy. US companies have built globalised supply chains benefitting from cheap labour and robust Chinese infrastructure, while the 400 million-strong middle class is already an important export market for American firms. For example, Apple generates around a fifth of its revenues from China, and the largest US semiconductor companies also rely on the country for between 25-50% of sales. Over the last year, the Chinese Communist Party have also relaxed foreign ownership rules, allowing US companies to own majority stakes in Chinese financial institutions for the first time. This level of integration is hard to reverse, and it appears that American companies have not yet been convinced to relocate production back onshore despite the tariff increases (as shown in a recent survey by the American Chamber of Commerce Shanghai).

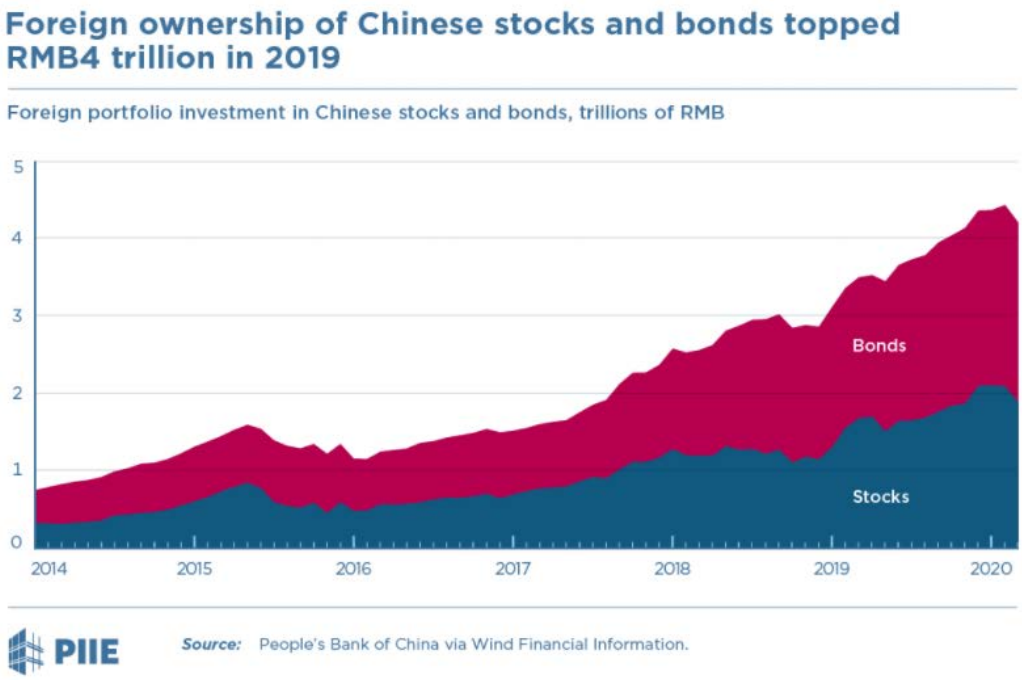
Recent policy from Washington does however appear to be embarking on a mutual 'de-coupling' as well-publicised bans of apps such as TikTok and WeChat and the exclusion of Huawei from 5G networks demonstrates. Technology has become a key battleground between the superpowers as they vie for supremacy in areas such as AI, machine learning, robotics and quantum computing, all of which have the potential to revolutionise economic productivity and military capabilities. China has long banned leading US tech companies such as Google and Facebook from operating, and instead has developed its own technology giants such as Tencent and Alibaba. The state-led "Made in China 2025" initiative also explicitly aims to further develop Chinese companies into world leaders in high-tech industries over the coming years.

It is possible that the grounds have been laid for two distinct, competing technology platforms to emerge, each remaining closed to the other using different hardware and operating in different countries, however we are not there yet (China for example is still heavily reliant on US chipmakers). This would increase production costs for companies and may even shut them off from certain markets which follow separate standards.

On the military front, thankfully US-China relations have remained calm, especially when compared with the Cold War era. There has been a notable pick up in Chinese ambition under Xi Jinping's Presidency however, and it should not be forgotten that China is a nuclear power. In recent years, Xi Jinping has installed military bases in the South China Sea, forced through the national security law in Hong Kong and signalled more aggressive intentions towards Taiwan. Taiwan looks to be a particularly sensitive area given its historical importance as well as its home to a truly world-leading semiconductor foundry in Taiwan Semiconductor Manufacturing Company.

Implications for financial markets

China's rise has undoubtedly been a positive for global financial markets; not only has their entry to the WTO helped boost global growth, but their partial liberalisation of capital markets has enabled international investors to participate in the success story through instruments such as H shares and American Depository Receipts (ADRs). The stock connect schemes have improved accessibility to mainland Chinese markets, and bonds and equities continue to become larger parts of MSCI indices.



Source: PBOC via the Peterson Institute for International Economics.

With the passage of the Holding Foreign Companies Accountable Act through the Senate, it may become more difficult for Chinese companies to maintain US listings in future which would negatively impact the ~$1.8trn Chinese ADR market. While this would restrict an important source of capital raising, investors would still be able to access Chinese markets via Hong Kong or through private equity transactions, and companies such as Alibaba, JD.com, NetEase and Baidu have either already established secondary listings in Hong Kong, or have plans to do so. Since most of the capital raised through Chinese ADRs is from international investors rather than US residents, it would likely find other channels if ADRs were not an option, however this would cause some disruption.

It should be said that there are dangers if Washington decides to go too far down this road. The status of the dollar as the world's reserve currency is a significant advantage for the US and relies on its openness and acceptance across the world. Imposing ever increasing sanctions and limiting international investment may challenge this position over the long run, and this would benefit the renminbi which is now recognised by the IMF as an official Special Drawing Rights currency. China is already developing its own international payments system (CIPS) to rival the existing SWIFT system, however it is only in the very early stages of adoption.

Looking forward

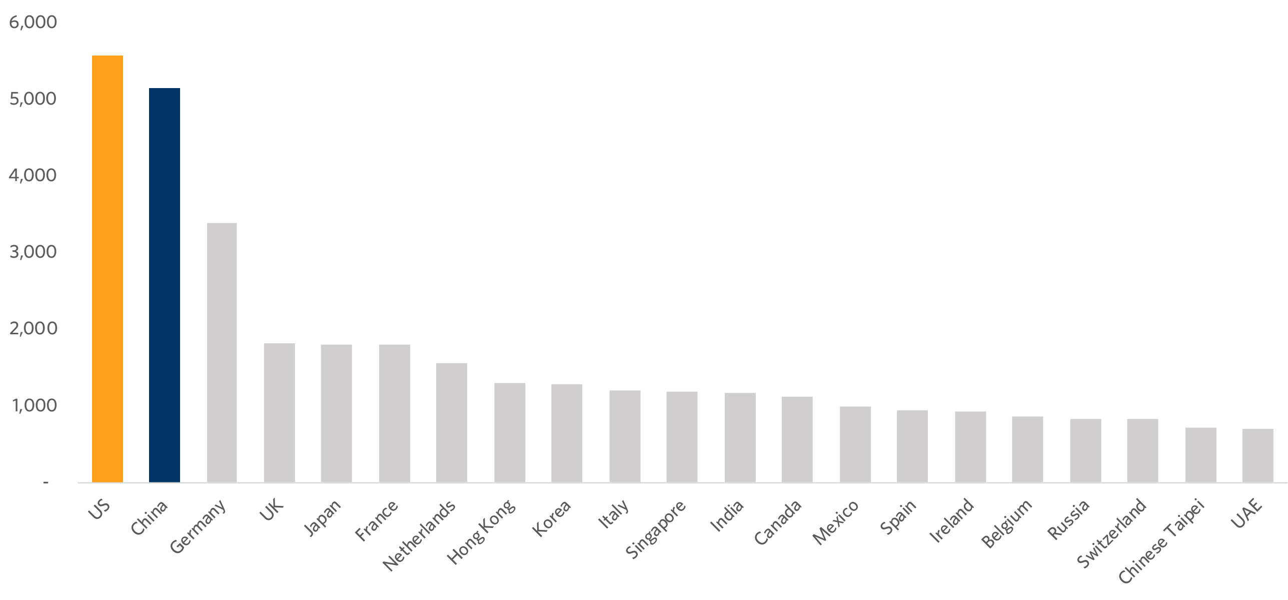
The US-China relationship is set to dominate geopolitics over the coming decades, and the extent to which other nations can remain neutral in this environment is uncertain. The development of two competing payments and technology platforms could lead to companies and governments being forced to align themselves with one system based on geopolitical ties, or otherwise spending money on implementing two separate systems at great expense (Deutsche Bank estimate that this could cost technology groups up to $3.5 trillion in total). It is possible that democratic powers such as the EU, Australia, Japan etc. could be forced to align themselves with the US, while China are building foundations with partners such as India and Russia through the CIPS system and more widely across Asia and Eastern Europe through the ambitious Belt and Road Initiative. If nations were forced to pick sides in this way, geopolitical tensions would rise and increase the likelihood of military conflict, likely through proxy wars similar to those seen during the Cold War.

This seems to us to be an absolute worst-case scenario where the associated costs for businesses will undoubtedly impact profitability. However even this bearish scenario would play out over many years given the level of integration between the two economies, giving businesses time to adapt to the new reality. This would also not necessarily lead to catastrophic bankruptcies; in most cases it should merely limit the growth potential of the largest Technology names which would call into question some of the hefty earnings multiples they currently trade on. Their total addressable market would still be large and they would be able to generate respectable profits.

We think a more normal relationship will resume after the rhetoric of the current US election passes, and the incentives for politicians to act tough on China abate. The economic costs of a full de-coupling should focus minds, especially with the US in recession and running a record peacetime budget deficit. That being said, the relationship will not always be smooth and there will undoubtedly be bouts of market volatility (as seen in 2018), but there are good reasons to expect normal long term equity market returns as China continues become more important on the world stage. Part of this comes from the fact that the market has started to price in some of this news; recent evidence of this can be seen from US ADRs of Alibaba and JD.com which have underperformed their Hong Kong equivalents by 10.6% and 7.2% respectively since their secondary listings at the time of writing (18/09/20).

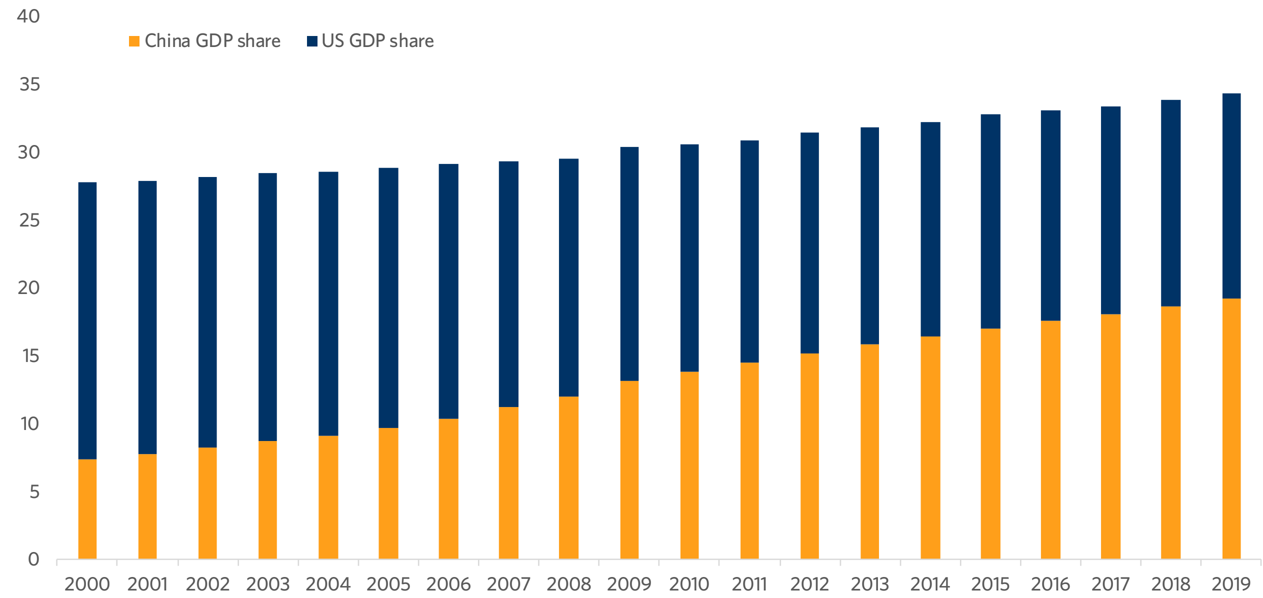
Furthermore, the US-China relationship is part of a wider trend of de-globalisation fuelled by a surge in populist politics across the globe. Brexit is the most obvious example of this in Europe, but President Trump has also increased tariffs on the EU, Canada and India, as well as threatening to pull out of the WTO itself. This is likely to depress growth globally and is not specifically related to the China issue, and there is again evidence that these concerns are priced into markets through long term inflation and interest rate expectations. Valuations of more cyclical trade-linked equities such as export driven EMs are also at relative lows, and Energy stocks are at their cheapest levels for decades in absolute terms.
In terms of portfolio positioning, investors should remain open-minded as the scale of possible outcomes remains wide. The US and China combined make up 34% of global GDP and are the largest trading nations by far, responsible for 19% of global trade in goods and commercial services in dollar terms. Their dominant combined share of public markets means that a serious deterioration in relations would affect markets around the world and would not just be limited to China.

World's leading traders of goods and commercial services, 2019 (US$, billions)



Source: World Trade Statistical Review 2020

US and China IMF GDP % share based on PPP of World Total



Source: IMF, Bloomberg

Given this level of integration and the still impressive levels of Chinese growth, it would not be appropriate to simply avoid Chinese equities in order to protect against the risk of the most bearish Cold War scenario described above. It is interesting to note that China has been the best performing major equity market YTD despite recent tensions, and it is quite capable of prospering in the face of US hostility over the long term. The best defence against such inherent uncertainty is through portfolio diversification, particularly across asset classes and regions. This is a philosophy that is deeply embedded in all of the portfolios we run, and is a core part of our investment process.