THE FRACTURING US-CHINA RELATIONSHIP

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As the US-China relationship permanently transitions to a more adversarial one, the approach to investing in China must evolve as well.

The U.S. and China have moved decidedly from a geo-political phase of accommodation that marked the period from 1990 to 2018 to a phase of competition and confrontation that will increasingly dominate the relationship going forward and that will impact the way we invest in China as well as in the United States. Clearstead has noted China's dramatic economic rise in the world (see June-2019 Clearpoint) beginning in the early 1990's and the incredible deepening and sophistication of its private sector and its investable universe. The Chinese economy will soon be the world's largest and in many sectors its firms will be on the cutting edge of science, technology, and innovation. We believe that Chinese equities should be included in a diversified portfolio for long-term investors, but China's posture towards the world has changed and, as a result, the way one invests must adapt as well.

Past performance is no guarantee of future results

To understand where the US-China relationship stands today, one needs to look back at the course of the last 30 years. In a series of speeches in 1989 and 1990, then Chinese Premier Deng Xiaoping championed the principle that to promote China's economic rise China must "hide our strength[1]" and "bide our time." Deng's strategy was to avoid confrontation with other countries, particularly in relation to China's long-term goals relating to thorny international relations involving Hong Kong, Taiwan, and several smaller territorial issues on its borders (claims in the South China Sea, its borders with India, etc.). This principal, to essentially keep a low-profile on the international stage, while the Chinese Communist Party focused on the domestic economy and pulling several hundred million Chinese people out of poverty, was continued by several Chinese premiers throughout the 1990s and 2000s. What's more, it worked.

For more than two decades China imported Western capital, technologies, and best practices and the Chinese economy soared. In some cases, intellectual property was coerced or even stolen outright, but Chinese productivity jumped by leaps and bounds. As China's capabilities increased, its reliance on foreign capital and "know how" diminished. Finally, as Western economies experienced a sluggish and anemic recovery from the Global Finance Crisis, China emerged as the engine of global growth, created a middle class of over 400 million people, and built-up world-class firms across a myriad of industries. Given that its economic development reached critical mass, China, under its current premier Xi Jinping, has charted a new foreign policy course that is likely to endure for the coming decade.[2] In a three-and-a-half-hour address to the Chinese Communist Party in 2017, Premier Xi announced that time had come for China to take center stage in the world and to make a "greater contribution to humankind." China, he said, was "standing tall and firm in the east." In the run-up to this speech and in the years that followed, China embarked on a massive lending program to developing countries called the Belt and Road Initiative designed to spread Chinese influence, along with Chinese controlled infrastructure across South Asia, Africa, and the Middle East. Along with the Belt and Road Initiative came a more aggressive action regarding China's reaffirmation of its control of Hong Kong, claims to Taiwan, and interest in dominating the South China Sea.

Over the past decade, China has become the world's single largest official creditor with over $1.5 trillion in direct loans and trade credits to more than 150 countries.[3] More than a dozen countries—mostly in Africa—owe at least 20% of their nominal GDP to China. Including portfolio debts—which includes about $1 trillion in US treasuries it holds—China's aggregate claims to the rest of the world exceed $5 trillion in total. In other words, close to 6% of world GDP is owed to China. This lending provides it with enormous leverage, particularly with poor and developing countries, which it uses to advance its global viewpoint on the issues central to its sovereignty and territorial integrity. The global COVID-19 recession will test many countries' abilities to honor their debts, and China may use the global crisis to extract additional concessions from these countries in terms of future support for political issues as well as lay claim to collateral that underlies their lending, which in many cases are the assets that were built with the Chinese funds.

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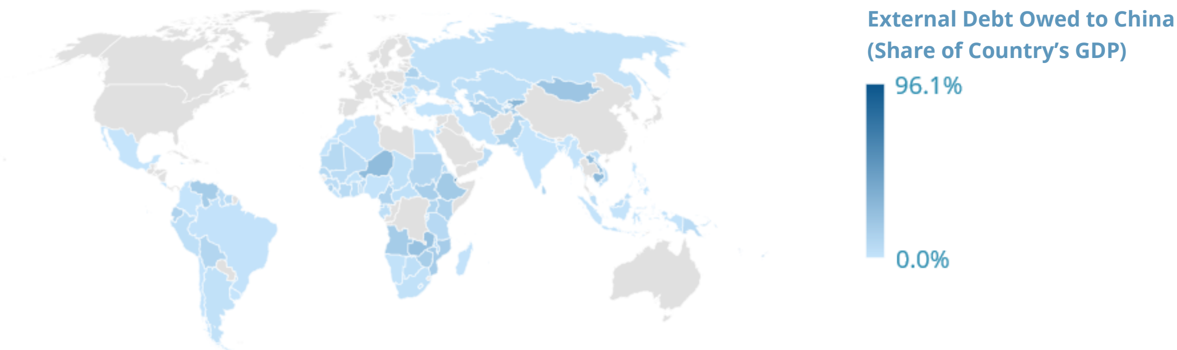
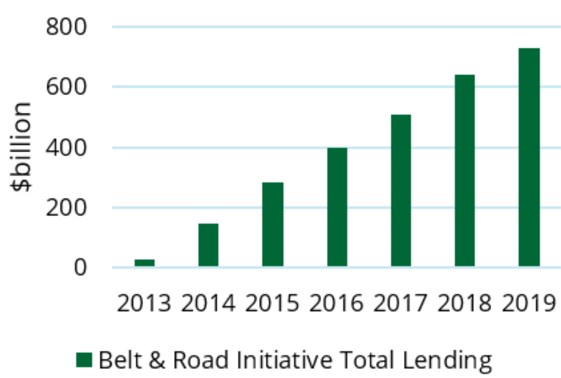
[1] Sometimes the phrases used by Deng Xiaoping are translated as "conceal our capabilities"
[2] FT "Xi Jinping signals departure from low-profile policy" Oct-2017
[3] Harvard Business Review "How Much Money Does the World Owe China?" Feb-2020

CHINA'S GLOBAL REACH: BEIJING LENDING CASTS A LONG SHADOW

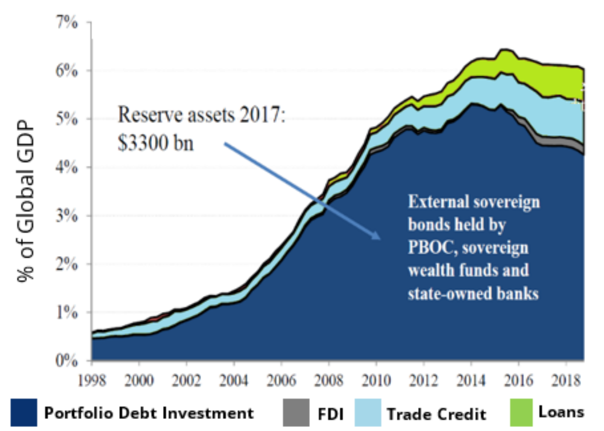


Source: Clearstead; Horn, Sebastian, Carmen M. Reinhart, and Christoph Trebesch. 2019. "China's Overseas Lending." NBER Working Paper No. 26050; AEI/Heritage Foundation – China Global Investment Tracker

CHINESE BELT & ROAD LENDING OVERSEAS CONTINUES TO GROW



CHINA'S DEBT CLAIMS ON THE WORLD



A more assertive China found a ready sparring partner in the combative Trump Presidency, which sought multiple avenues to reset the US-China relationship on more favorable terms for the US. Since late 2017, the Trump Administration has sought to improve the terms of trade with China and lessen US reliance on Chinese technologies. US-China relations may have hit a new low this past May when the Trump administration and the US Congress moved on a series of initiatives designed to build resilience into US supply chains—particularly in key areas such as pharmaceuticals, medical devices, telecommunications, and other high-tech areas—and to lessen Chinese global influence. In addition to these moves, Congress has introduced bills that could potentially de-list Chinese firms from trading on US exchanges and sanction top Chinese over human rights abuse of China's Muslim minority, while the Trump administration moved to remove Hong Kong's special status due to China's attempt to limit Hong Kong's autonomy. In July, both the US and China closed each other's consulates—the US Consulate in Chengdu and the Chinese Consulate in Houston—with each alleging espionage and other illicit behavior taking place at each location.

What does this mean for investors? First, it is increasingly clear that, no matter which candidate wins the US Presidency in the Fall, the US-China relationship is likely to be more adversarial than friendly in the coming years.[4] This competitive dynamic reinforces pre-existing trends promoting deglobalization and a regionalization of the global economy. Given this, firms that benefited most from rising global trade, China-centric supply chains, and global industrial standards, will increasingly lose out at as supply chains re-orient closer to their home markets, the global economy splinters into more regional US-oriented or China-oriented markets, and increasing customization rule the day.

Second, it means that the approach to investing in China may need to change. Overall, deglobalization means it could be less appealing to access China's tradable sector. Firms catering to global supply chains and exports could face increasing headwinds to profitability and see demand from their key foreign markets shrink. Deglobalization along with some changes to China's demographic profile could slow the brisk pace of growth of the past decade in China. Slowing headline growth in China could challenge firms whose business model is based solely upon an ever-expanding Chinese economy. But quality Chinese management teams that can drive innovation and cost-cutting (margin improvement) should continue to grow profits. This could be ever more problematic for investors utilizing passive investment options for Chinese markets as well as in the emerging markets space, as most of these indices include a disproportionately large number of firms reliant on exports, many of which are either fully or partially state-owned. However, active investment managers that thoroughly vet firms for the quality of their management and the robustness of their balance sheets could avoid firms that are unlikely to consistently grow profits in the face of these dynamics. Additionally, investors can find ample investment opportunities resilient to US-China geo-political struggle and a gradually slowing Chinese economy by seeking firms oriented towards China's vast and rapidly growing domestic consumer market.

As Clearstead's research has highlighted before, the growth of the Chinese middle class has been staggering and, over the next decade, companies oriented to servicing the needs of China's middle class should be poised to reap exceptional profits and growth.[5] China's middle class is under-banked and under-insured, lacks many appliances found in Western homes, consumes private education in record numbers, and consumes modern healthcare services at record levels. The companies catering to this demand are local brands because they better address consumer needs in three areas: value for money, quality, and aftersales service. Investors seeking to exploit the mass-market Chinese consumer growth trend should consider investing in firms that are primarily oriented towards the Chinese consumer first and foremost—few non-Chinese firms can credibly make this claim.

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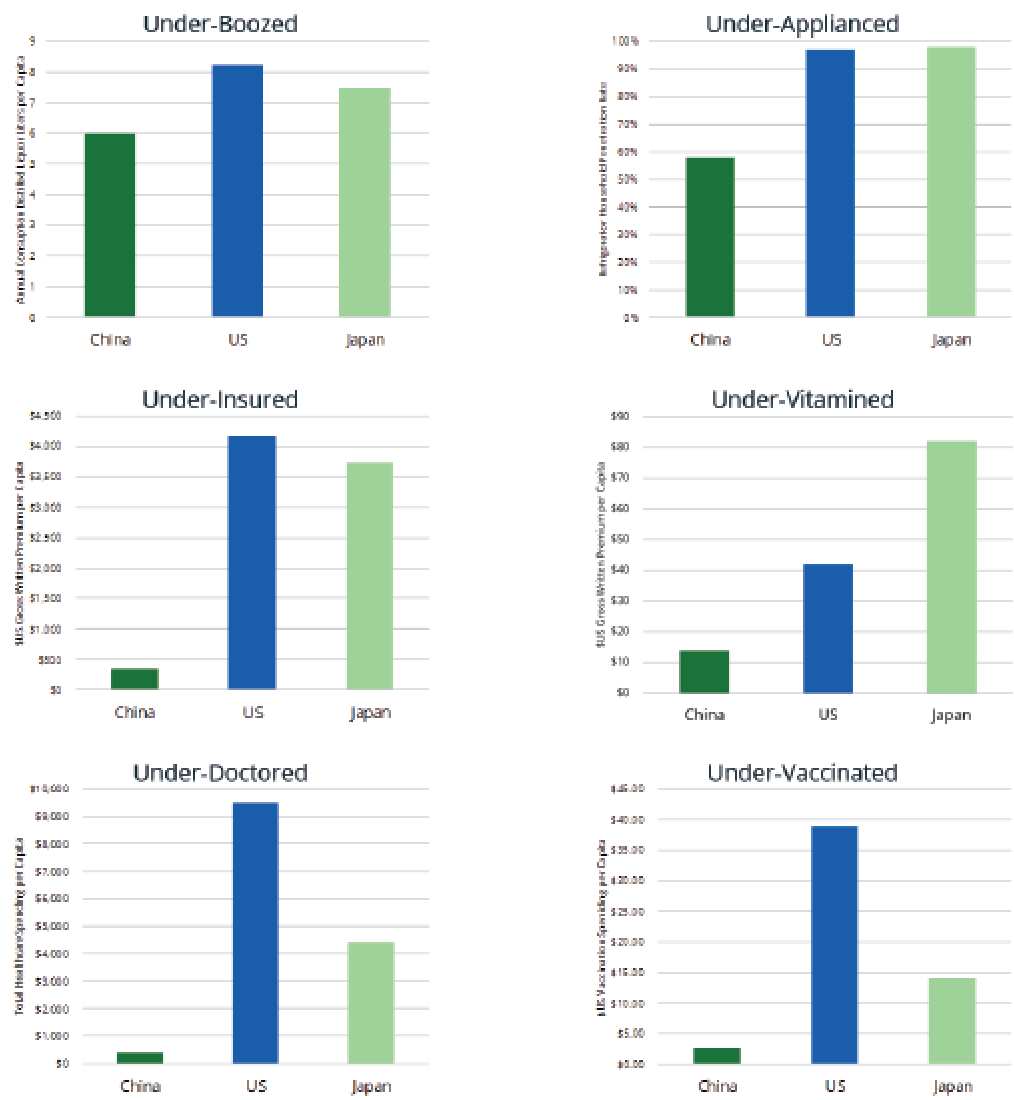
[4] The US and China are locked in dance much akin to that of Britain and Germany at the turn of the 20st century as the authoritarian Germany emerged a global economic powerhouse at the expense of the reigning, democratic superpower Great Britain. See Brunnermeir et al "Beijing's Bismarckian Ghosts: How Great Powers Compete Economically" TWC Fall 2018

[5] Clearstead June-2019 Clearpoint; McKinsey Quarterly "Mapping China's Middle Class"

The Chinese Consumer will Power Sustained Growth



Sources: Clearstead, OECD, World Bank, NIH, William Blair, Electrolux.

Clearstead has been developing a plan to increase our clients' exposure to China, which we judge to be one of the key markets for diversifying portfolio risks and delivering exceptional long-run returns. China is still a fantastic market in which to invest, but our investments in China will have to be made in light of the volatile and competitive US-China relationship. We are actively monitoring any US legislation that could de-list Chinese companies from US markets to ensure our clients' China holdings will not be impaired by this legislation. Similarly, we have identified active managers that invest in the Chinese market, but who are clearly oriented towards the Chinese consumer and wary of Chinese firms reliant on external demand to generate sales and profits. Investing in China should be profitable for investors over the next decade but will require more sophistication and skill than it did in previous decades. Clearstead will be there to help our clients navigate these challenges.

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