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SPECIAL WEBCAST

Appraising the US-China trade conflict – what's next?

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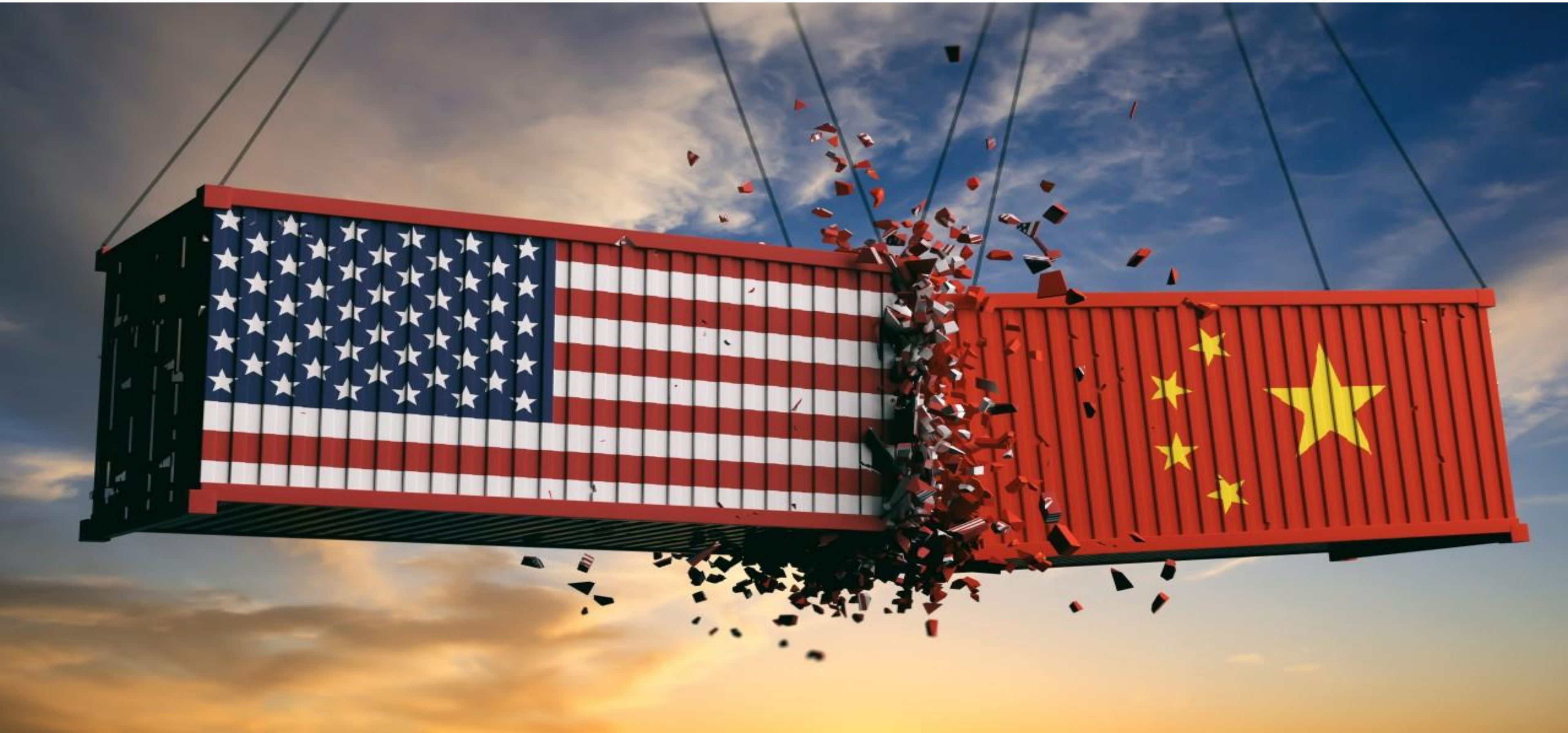

Today's Presenters

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Recap: the US-China trade conflict – four key premises
(*geo-strategic/military concerns notwithstanding)

1. **The change in status quo is permanent –** The end of America's "strategic patience" with China's economic policies predates Trump's presidency, although he has substantially intensified the US approach. This widespread pivot was primarily driven by two factors: (1) political blowback from China's aggressive M&A activity in the US and globally; and (2) the publicity of China's nationalist industrial policy and protectionist practices and intentions.

   Similar change in sentiment is manifesting outside the US: Europe, Australia, Japan, Canada, etc.

   - ✓ The status quo will not return with a change in the US administration.

2. **The White House policy orientation has been consistent, and the current approach was pre-meditated –** The Trump team has been extremely consistent on 1) their claims that China has long taken advantage of the US, and 2) how the US can win a trade war. During the campaign they described how they would approach China, and they have done exactly that.

3. **Tariffs are likely to be temporary; technology blockades are not –** While current tariff actions can be considered a Trumpian phenomenon, the "technology cold war" aspect of the contest is not. The clampdown is widely supported in DC, and is necessarily here to stay.

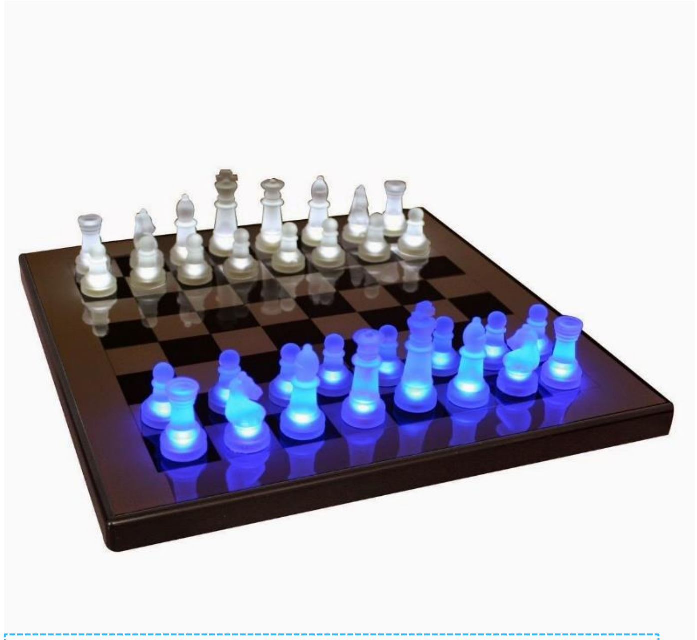
4. **The two sides are very far apart –** What the White House purportedly wants and what China wants are diametrically opposed, undermining the probabilities of a grand bargain in the near-term.

   - ✓ Even huge China concessions on market access, IP, reciprocity and level playing-field issues may not do the trick.

Descent into Trade Warfare? An act in 4 parts (so far)

2017 was a period of tactical preparation for the US administration's trade team. 2018 was about action. Will 2019 be about resolution or retrenchment?…

- **Act I** – anti-dumping and countervailing duties on selected products in late 2017 and early 2018, followed by China's tit-for-tat retaliation
- **Act II** – section 232 tariffs on steel (and aluminum dumping), followed by China's tit-for-tat retaliation
- **Act III** – section 301 USTR findings on IP infringement and subsequent mega-tariff announcement(s) by the US, followed by China's tit-for-tat retaliation
- **Act IV** – ramp up of the "tech cold war", including ZTE fiasco, Huawei investigation, CFIUS 2.0, new export controls, etc.
- **INTERMISSON** – A 90 day 'pause' following the G20 meeting in Argentina, but will it yield anything?



Act V (pending) –

- ✓ US levy increase from 10% to 25%
- ✓ $267 billion in additional US tariffs
- ✓ More technology prohibitions; more legal actions….

Technology competition is the real front line

US national security concerns about IP flows to China will have extensive repercussions for MNCs in China and globally – for a very long time to come

CFIUS: More blocks, wider mandate, stronger supervision, tighter regulations…

- ✓ Dramatic increase in CFIUS action vis-à-vis Chinese interests since Trump
- ✓ Chinese buyers and US sellers shying away from one another
- ✓ **The Foreign Investment Risk Review Modernization Act (FIRRMA)** and the **Export Controls Act of 2018 (ECA)** extend USG's reach to cover the global operations of US firms like never before
- ✓ FIRRMA plus the new export controls could disrupt traditional partnership approaches MNCs have been using for years – including co-investment arrangements
- ✓ New compliance and reputational risks now span minority investors, technology licensing agreements, IP sharing arrangements, open-source collaboration, JVs, and technology transfers
- ✓ "Emerging and foundational technologies" of all types will soon be "controlled" vis-à-vis China

Shutting the door on China?

- ✕ Ant Financial (Alibaba) blocked from acquiring Moneygram
- ✕ Canyon Bridge blocked from buying Lattice Semiconductors
- ✕ Chongqing Casin Enterprise blocked from acquiring the Chicago Stock Exchange
- ✕ ZTE hobbled and Huawei blacklisting intensified
- ✕ New inbound HNA investment frozen
- ✕ Westinghouse shielded from Chinese purchasers
- ✕ Navinfo blocked from buying HERE Technologies
- ✕ China Zhongwang Holdings drops bid to acquire Aleris
- ✕ China Integrated Circuit Industry Investment Fund blocked from Xcerra
- ✕ Chinese VC money in Silicon Valley drying up
- ✕ Chinese PE tech firms in NYC closing up shop

Pressure is mounting on both sides…

China –

- China's economic slowdown is deepening; financial market hazards are intensifying
- Diplomatic and trade "pushback" is gelling across a number of countries and regions, potentially fomenting into an anti-China bloc:
  - TPP-11
  - Eastern Europe pivoting back to EU
  - Advanced economies aligning with US/Trump China plan?
- BRI stalling: hype-fatigue and disappointments abound; even stalwart hosts reconsidering positions (Malaysia, Pakistan, Sri Lanka)
- Nationalist shouting notwithstanding, much whispering in Beijing faults Xi for mismanaging the US relationship and miscalculating on Trump

The US –

- Equity markets are now gyrating in response to "trade war" news
- Certain "red" farm districts did punish the GOP during midterms
- Business community lobby for "constructive engagement" and compromise is growing louder (ref Bloomberg NEF)
- Trade deficit growing wider every month – tariffs aren't working/make no sense (US losing market share in China without harming China's market share in US)
- China patience testing White House resolve?
- Advanced economies may not follow Trump's lead on China due to personality/diplomacy problems

Word on The Hill

The level of unification on a hard stance toward China is unprecedented

What we're hearing…

- There is "no patience" with China's incrementalism – neither in the US government or broadly in the business community. Wall Street is a disgruntled outlier.
  - But, business does want more policy engagement, clarity and consistency.
- US negotiators can accept short-term impacts on the agriculture sector; manufacturing is the focus.
- For the White House, multilateralism is not on the table. Instead, "US allies are expected to pick a side."
- US law enforcement agencies have been encouraged to aggressively advance their China cases…
  - Many more indictments are expected to follow on the heals of Huawei.
  - Under the radar: Jeff Sessions' "China Initiative" (Nov 1*) activated law enforcement agencies to prioritize and prosecute trade theft issues.
- Even if the current US Administration "blinks", the "hard stance on China" policy agenda will continue, if not intensify.

* A look at the Justice Department's new 'China Initiative' – "Compliance Week", December 3, 2018

The big question for both sides

Is this about…

Fair Competition and Conformance OR **Geostrategic Containment and Isolation**

Fair Competition and Conformance:

- ✓ Fair trade
- ✓ IP protection
- ✓ Open markets
- ✓ Competition policy

Geostrategic Containment and Isolation:

- ✓ Decoupling
- ✓ Prohibitions
- ✓ Enforcement
- ✓ Militarization

1. IP infringement penalties
2. Negative list; legal revisions
3. Removal of ownership restrictions
4. 0 tariffs
5. Regulatory safeguards

Three Key Questions –

1. Will US negotiators soften demands (temporarily) due to fears of stock market volatility or declining US growth?
2. Is China prepared to offer the kind of structural reform the US is asking for, even in lesser form? Can China's political-economy superstructure survive such a reformation?
3. Will legal action against Huawei and its executives undermine negotiations?

Even assuming the “fair trade” agenda, a “grand bargain” seems improbable

The interest of the two sides appear to be in direct opposition…

What the US Wants…?

1. A re-alignment of supply chains back to the US
2. A huge reduction in the trade deficit with China
3. Reduction in Chinese steel capacity
4. Deter Chinese acquisition of US technology
5. Cut off purchases of Iranian oil and gas
6. Help on North Korea

? Greenfield Chinese investment in the US
Chinese financing for US infrastructure plan

What China Wants…?

1. Maintenance of the trade status quo which has benefited China so greatly in the WTO era
2. More US financial and long-term investment flows into China
3. Technology to drive Made In China 2025
4. Multiple / cheap sources of energy
5. The US to go away on North Korea

? Economic stability – employment stability.

Endgames for the US-China Trade Confrontation: the most plausible scenarios

- **Scenario 1: China concedes –** The US team tightens the screws, resists political pressure at home, causes significant pain in China over an extended period, and eventually Beijing offers extraordinary concessions because the fight proves too costly. [*But Beijing claims a “win” in communicating the outcome*.]
- **Scenario 2: Permanent divorce –** China never gives in – which proves to be serendipitous for hawkish cohorts on both sides that are seeking to fundamentally and permanently decouple the US-China economic relationship – and the tariff barriers become a long-term phenomenon.
- **Scenario 3: The US backs down –** An economic downturn in the US – manifesting in several ways but potentially led by a US market correction in response to trade war-related bad news – leads to an overt softening of the US position, putting the potential for a more moderate negotiated settlement back on the table. [*But the White House claims a “win” in communicating the outcome*.]

- **The 90-day window produces a negotiated settlement …** What will the US accept? What can be done in such a short time? <u>Is Scenario 3 now on the table</u>?

The latest: 90 Days to Save the Day?

Although…March 1st deadline is arbitrary and extendable…

Optimism on tariffs –

- Economic stress increasing on both sides
- Pressure to find a ‘deal’ of some kind to relieve market pessimism and generate ‘good news’
- Most likely outcome: 2019 1H agreement for US to refrain from further tariff increases while China “undertakes reforms” –
  - ✓ Beijing will need to ‘prove’ to USTR and White House that its commitments are serious
  - ✓ Decline in trade deficit over time will need to be shown
  - ✓ Market openings and IP protections will need to be maintained over time
- But – tariffs will likely only be removed gradually based on agreed benchmarks
- China has offered good-faith concessions in advance (e.g. soybeans, auto…)

Pessimism on the “tech cold war” –

- Commerce Department has released draft of new export control regime
- List of “emerging technologies” that will be restricted from countries like China is extensive (AI, robotics, quantum technologies, 3D printing, advanced computing, etc.)
- Fujian Jinhua slapped with ZTE-style death penalty restrictions (for broad “national security” based reasons)
- Huawei investigation and law enforcement ramping up in the US, and Huawei 5G bans proliferating in advanced economies
- Accelerating US indictments on China cyber espionage, industrial IP theft, and illegal tech transfers
- Chinese R&D innovations in the US blocked from returning to China

Key assumptions – this will be a protracted conflict; but significant progress is not implausible

1. For many MNCs, a bi-furcated global technology sphere and a de-coupled US-China technology ecosystem represents a greater long-term challenge than the ebb and flow of tariff regimes.
   - ✓ **The "technology cold war" is here to stay unless China makes fundamental concessions on critical playing field issues.**

2. Given the deterioration in US-China relations and the bipartisan sense in DC that it has become imperative to 'get tough on China', a small or ambiguous deal is not likely to last.
   - ✓ **The pressure on China to "reform" will persist until major concessions are made.**

What would fundamentally change the competitive playing field?

1. **Sensible negative list-based market access rules**
2. IP infringement penalties set at world-levels
3. Sensible data use/ownership rights/rules
4. Verification and enforcement mechanisms:
   a. US firms obliged to report on operating conditions
   b. Chinese agency obliged to respond to disputes (Leading Small Group)

Navigating the current environment – "mind the gaps"

Base Case Assumptions –

- China will not close the door.
- US/EU obstacles be finessed by business, as has been the case for many years.
- Ultimately, pragmatism should prevail, and a rational – if not substantially improved – trading relationship will emerge, with China making important concessions. China desperately needs inbound capital and technology, and global trade and investment connectivity.
- Signals point to a protracted resolution process…

  …but this doesn't mean opportunities stop for MNCs in the meantime.

Strategic Premises –

- Breakthrough opportunities for MNCs in China always lie in the gaps between indigenous capabilities and national targets.
- Current planning targets – more grandiose than ever – are far beyond indigenous capabilities to achieve them.
- In the more centralized and surveilled policy environment, the pressures to achieve progress-to-plan are also greater than ever.
- These pervasive capability gaps provide fertile ground for MNCs across numerous sectors to sustain and expand their businesses in China by filling them.
- Counterintuitively, the investment restrictions being placed on MNCs (i.e. US firms at present via FIRRMA) to contain technology sharing can serve to strengthen the bargaining power of MNCs vis-à-vis Chinese regulators.

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In doing this – through rigorous data work, empirical research, and on-going senior-level engagement with Chinese officials and institutions – we gather unique market intelligence and generate valuable insights on China's complex and often difficult business environment to help our members develop a deep "structural understanding" of China's economy and business environment, and thereby make better business decisions.

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