

Investment Considerations of a Bipolar World

Daniel Graña | Portfolio Manager

Daniel Graña, Emerging Market Equity Portfolio Manager, believes that the beginning of the end of the post-Cold War order and the rise of an assertive China have enormous investment implications.

KEY TAKEAWAYS

- ▶ With globalization waning and end markets likely to fragment, Daniel believes that trade is expected to become more localized, which is inherently less efficient than a globalized world.
- ▶ Many developed market companies may lose access to the Chinese sphere of influence and/or may be required to create parallel supply chains.
- ▶ Balkanization of end markets will be painful for many but could be quite powerful for those businesses gaining market share from exiting U.S. companies.

The world of mostly free movement of capital, people, goods and technology is ending. Faith in global trade being more than a zero-sum game has been undermined. The seemingly inevitable “balkanization” (fragmentation) of end markets is likely to lead to localization, which is inherently less efficient than a globalized world. Many developed market companies may lose access to the Chinese sphere of influence and/or may be required to create parallel supply chains. I expect that the road to a Bipolar World will be fraught with volatility and unexpected turns.

Background

When China was brought into the World Trade Organization (WTO) under U.S. President Clinton, there was a presumption that economic development, a growing middle class and interactions with the outside world, that were all part of globalization, would fundamentally change China and eventually allow democracy to flourish. After all, the great success stories of South Korea and Taiwan, and even the lesser ones like Chile and Mexico, all passed through economic change first under some version of dictatorship before inevitably moving toward democracy. WTO was effectively a Trojan horse. It was inconceivable to many that the path to economic development would not eventually establish the conditions for democracy and a general acceptance of the global norms of Pax Americana.

That notion was wrong.

On the economic side, it could be argued that China did not follow the letter nor the spirit of their WTO ascension agreement. Policy makers protected State-owned enterprises. Foreign intellectual property was allegedly forcibly transferred or stolen. Plentiful leverage created the conditions for near zero cost of capital which helped many Chinese companies gain global market share. China created non-tariff barriers (for example the Great Chinese Firewall) as part of their industrial policy to produce national champions in critical areas. China had seemingly found a different recipe to greatness.

And democracy never came. Recently, Xi Jinping’s anti-corruption drive and pivot to sustainable economic development (lower growth with less environmental damage) are wildly popular in China. The Chinese Communist Party’s (CCP’s) grip on power has probably never been so strong.

**FOR FINANCIAL PROFESSIONAL USE ONLY / NOT FOR PUBLIC VIEWING
OR DISTRIBUTION**

Moreover, America's failed adventures in the Middle East, disastrous role in the Global Financial Crisis and painful COVID-19 pandemic experience have emboldened Chinese policymakers to believe the U.S. is not only in relative decline but also in absolute decline. The timing for a separate sphere of influence is auspicious from China's point of view.

Enter Trump

Chinese policy makers believed a trade and tech war with the U.S. was inevitable but they had expected such a conflict in a decade or two. The U.S. political system's failure to address technology's and globalization's losers accelerated that time frame by creating the conditions to elect Trump. The "America First" doctrine believes trade deficits are signs of abuse, and even allies were taking advantage of the U.S.

After relatively quick deals with South Korea, Canada and Mexico (in our view, burning a lot of goodwill in the process), the Trump administration moved on to China. However, the complexity of the Sino-American relationship and Xi Jinping's immovable core philosophy of state-sponsored development prevented a broad trade deal. The Phase 1 agreement was supposed to be an appetizer ahead of the more robust Phase 2 agreement, which never came.

Trump's political calculus then shifted. With falling poll numbers due to what many deem to be the mishandling of the pandemic and the ensuing economic damage, Trump the dealmaker is now the China hawk. The trade war has morphed into a broad-based push for decoupling of the entire relationship from technology, capital and information. There will be no tolerance of economic espionage (Houston consulate closure), dual purpose technology (Huawei attack) or surveillance of American digital information (goodbye TikTok). A foreign war is a useful distraction for the electorate ahead of elections, and the broadsides fired at China are certainly the beginnings of an unconventional cold war.

Why has China seemingly under-reacted to the many provocations of the Trump administration? The inevitable conclusions are China still depends on U.S. technology, expects U.S. multinationals with businesses in China to lobby the U.S. government to soften the attacks and hopes Democratic presidential candidate Joe Biden can prevail in November.

Should we expect a change in tone or direction after the U.S. elections? Regardless of whether Trump is re-elected or Biden is declared the victor, I believe the die is cast. Biden would likely be more multilateralist in his approach with China but neither man is likely to change the endgame of Sino-U.S. relations, only the speed. These countries have incompatible systems with diverging interests and natural flash points. The U.S. and China today are less like Great Britain and the U.S. in the late 19th century where similar systems decided to share the world, and more like the U.S. and the USSR after World War 2 when conflict was inevitable after their common Nazi enemy was defeated.

Investment Implications

1. Supply chains will be diversified and shortened

There is a difference between portfolio managers (PMs) who invest in publicly listed securities and corporates who invest in factories, supply chains and technology. PMs can easily change their minds and sell their exposures but investors of hard assets and builders of businesses cannot do so as easily. Faced with greater uncertainty about the direction of Sino-U.S. relations, even if there is a reprieve in the war, I believe that investors of long-term capital must seriously consider diversifying their supply chains away from China. We as investors must ask our companies the extent of the required capital expenditures, their timeframe and the operating cost differences of such a move. In some cases, Vietnam, Mexico and even the U.S. (a TSMC semiconductor plant, for example) can be beneficiaries but government support may be necessary to smooth the transition. Supply chain diversification without government support is clearly less efficient than the alternative.

2. Companies should not count on a global end market

Why wouldn't China find a Chinese replacement for Cisco routers, CRM enterprise software, QCOM chips and so forth? Where there is a good replacement, localize. Smaller end markets have enormous implications for the speed of innovation (less R&D given smaller sales base), margins (less sales to dilute costs) and sales growth. If returns on capital and sales growth rates are likely to be affected, shouldn't valuations be affected too? Balkanization of end markets will be painful for many but could be quite powerful for those gaining share from exiting U.S. companies.

3. A cold war can turn hot

Should President Xi's patience wear thin, why not step up the retaliation? Boeing, Apple, Starbucks, Ford and other U.S. multinational corporations have significant exposures in China, a country that some may argue has no rule of law but rule of party. In such situations, emerging market governments can surprise with a tax audit, supply chain investigation or market abuse study.

4. Taiwan and Hong Kong are flash points

Hong Kong (HK) is China's financial window to the world and could potentially replace the U.S. capital markets for Chinese companies seeking to list abroad. Shanghai-HK and Shenzhen-HK Connect programs are crucial in bringing Mainland Chinese capital to HK. The implementation of the new National Security Law and the resulting US response must be watched. China cannot be so cavalier about leaving U.S. capital markets if HK cannot play a constructive role.

Another flash point between the U.S. and China is Taiwan. The CCP probably would be toppled if there were a property market crash on the Mainland or if China "lost" Taiwan. And yet, Intel has effectively surrendered advanced node semiconductor manufacturing to Taiwan's TSMC. Moreover, China is counting on Taiwan to replace some of the technology widgets coming from the U.S. Taiwan has clearly become extremely important geopolitically. Watch this space. For example, will the U.S. provide more explicit defense guarantees to Taiwan in exchange for changing the Taiwanese law, which currently prohibits the most advanced node manufacturing to be 'exported' abroad?

5. There are other known unknowns but also unknown unknowns

This list of investment implications is not all-encompassing. However, the situation may evolve in ways none of us have contemplated.

While planned trade talks between the U.S. and China have been postponed, we believe that staying close to these developing issues, and how they may affect our investment decisions, is key to active investment management.

For more information, please visit janushenderson.com/en-us/institutional/.

The opinions and views presented are as of the September 2020. They are for information purposes only and should not be used or construed as investment, legal or tax advice or as an offer to sell, a solicitation of an offer to buy, or a recommendation to buy, sell or hold any security, investment strategy or market sector. Nothing in this material shall be deemed to be a direct or indirect provision of investment management services specific to any client requirements. Opinions and examples are meant as an illustration of broader themes, are not an indication of trading intent, and are subject to change at any time. It is not intended to indicate or imply that any illustration/example mentioned is now or was ever held in any portfolio. No forecasts can be guaranteed and there is no guarantee that the information supplied is complete or timely, nor are there any warranties with regard to the results obtained from its use. In preparing this document, Janus Henderson Investors has reasonable belief to rely upon the accuracy and completeness of all information available from public sources. Past performance is no guarantee of future results. Investing involves risk, including the possible loss of principal and fluctuation of value.

Not all products or services are available in all jurisdictions. The distribution of this material or the information contained in it may be restricted by law and may not be used in any jurisdiction or any circumstances in which its use would be unlawful. The contents of this material have not been approved or endorsed by any regulatory agency. Janus Henderson is not responsible for any unlawful distribution of this material to any third parties, in whole or in part, or for information reconstructed from this material.

This material may not be reproduced in whole or in part in any form, or referred to in any other publication, without express written permission. We may record telephone calls for our mutual protection, to improve customer service and for regulatory record keeping purposes.

In Europe, issued by Janus Henderson Investors. Janus Henderson Investors is the name under which investment products and services are provided by Janus Capital International Limited (reg no. 3594615), Henderson Global Investors Limited (reg. no. 906355), Henderson Investment Funds Limited (reg. no. 2678531), AlphaGen Capital Limited (reg. no. 962757), Henderson Equity Partners Limited (reg. no. 2606646), (each registered in England and Wales at 201 Bishopsgate, London EC2M 3AE and regulated by the Financial Conduct Authority) and Henderson Management S.A. (reg no. B22848 at 2 Rue de Bitbourg, L-1273, Luxembourg and regulated by the Commission de Surveillance du Secteur Financier). Advisory services in the U.S. are provided by SEC registered investment advisers that are subsidiaries of Janus Henderson Group plc. In Canada, products and services are offered through Janus Capital Management LLC only to institutional investors in certain jurisdictions. Issued in (a) Singapore by Janus Henderson Investors (Singapore) Limited, licensed and regulated by the Monetary Authority of Singapore. Janus Henderson Investors (Singapore) Limited Company Registration No. 199700782N. This advertisement or publication has not been reviewed by Monetary Authority of Singapore. (b) Hong Kong by Janus Henderson Investors Hong Kong Limited, licensed and regulated by the Securities and Futures Commission, (c) Taiwan R.O.C by Janus Henderson Investors Taiwan Limited (independently operated), licensed and regulated by the Financial Supervisory Commission R.O.C. Suite 45 A-1, Taipei 101 Tower, No. 7, Sec. 5, Xin Yi Road, Taipei (110). Telephone: (02) 8101-1001. Approved SICE licence number 023, issued in 2018 by Financial Supervisory Commission, (d) Japan by Janus Henderson Investors (Japan) Limited, regulated by Financial Services Agency and registered as a Financial Instruments Firm conducting Investment Management Business, Investment Advisory and Agency Business and Type II Financial Instruments Business, (e) Australia by Janus Henderson Investors (Australia) Limited ABN 47 124 279 518 and its related bodies corporate including Janus Henderson Investors (Australia) Institutional Funds Management Limited (ABN 16 165 119 531, AFSL 444266) and Janus Henderson Investors (Australia) Funds Management Limited ABN 43 164 177 244, AFSL 444268 (f) the Middle East by Janus Capital International Limited, regulated by the Dubai Financial Services Authority as a Representative Office. No transactions will be concluded in the Middle East and any enquiries should be made to Janus Henderson.

Janus Henderson, Janus, Henderson, Perkins, Intech, Alphagen, Knowledge Shared, Knowledge. Shared and Knowledge Labs are trademarks of Janus Henderson Group plc or one of its subsidiaries. © Janus Henderson Group plc.

151 Detroit Street, Denver, CO 80206 | www.janushenderson.com