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NEWSLETTER

Ant, Cold War 2, and You

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"HE WHO CONTROLS THE MONEY SUPPLY OF A NATION, CONTROLS THE NATION" — JAMES A GARFIELD.

The past few days have seen two events that have had a large impact on prices and, in the view of Capital Dialectics, are an indication of what lies ahead for investors as we navigate Cold War 2. The first was the last-minute cancellation or postponement of the Ant Group IPO. The second was the US President's Executive order banning US citizens from owning shares in companies associated with the Peoples' Liberation Army (PLA).

Soldier Ants & worker Bees

What should investors make of the last-minute requirement to pull the Ant group IPO? In our view it is this: The Party rules; the perpetuation of the Party is paramount, and perpetuation requires control. Innovation and entrepreneurship are welcomed so long as they do not challenge party control and help achieve that national goals set by the Party. Alignment with the party goals is crucial but increasingly this conflict with investor desires for returns on capital and their ESG requirements.

The Ant IPO debacle serves as a reminder of the centrality of the Communist Party of China (CPC) to all things societal, economic, and political. It is amazing how frequently discussion about the pros and cons of investing in China are carried on without any reference to the Party. The Party is omnipresent in the economy and finance. Any discussion about commerce in China without reference to the role and interests of the Party and its leadership are, in my view, almost bound to lead to false conclusions.

It matters not if the cat is black or white, but the party choose which mice to catch...

The confusion arises because of a widespread belief that China was on a long-term trend towards becoming a market economy. In reality, the CPC did harnessed the incentive structures of the market to develop a highly entrepreneurial business class to pull the country out of the abject poverty the polices of the party had created, but there was no ideological conversion to the merits of a market economy. Free enterprise was a means to an end, not an end it itself, and there is little demarcation between the private sector and the Party-State to which the rejuvenation of Party committees within private sector companies is great testimony. Private enterprise in China is as much an instrument of national power as state enterprise, it is just deemed a better way of achieving some of the goals the Party has set, such as export growth in the past.

To get rich is glorious but...

The only end goal that matters is the perpetuation of CPC rule. Where there is tension between commercial activity and Party control, control comes first, and we have been remined of that yet again by the events pertaining to the Ant IPO. There are at least four ways in which the Alibaba connected companies potentially threaten Party control:

— Jack Ma's personal credibility, that stems from his persona and his achievements, pose a potential threat to China's leadership through the influence and profile that accrues to him as a result.

— The extraordinary growth in Alipay and Wechat pay in mobile payments pose a potentially existential threat to the state-owned banking system by taking payment revenue away from it and competing for deposits. More importantly perhaps, by facilitating lending outside of the state banking system, fintech companies loosened the Party-State's control over the allocation of capital. In addition, there is the question of the threat posed to the financial system and therefore social harmony.

— The goal of the digital RMB (EP/DC) is to enhance the tool kit of the central bank, increase seigniorge, increase the power of the state, and spread China's geopolitical influence along China's trading routes through its adoption overseas. Existing digital payments systems are potential obstacles to its widespread adoption.

— Rapid innovation in the way commerce is conducted (on-line) has diminished the economic performance of state-owned companies that compete (off-line) and reduced the need for commercial retail space. Remember land sales bring in about 3% of GDP each year by way of local government revenue. Jack Ma himself attributes much of the early success of Alibaba to the terrible shopping experience delivered by state owned retail and the high land prices faced by would be private sector challengers. In short, everything innovative about the Alibaba group, in one way or another, can be construed as posing a threat to CPC power. All good new business after all tend to disrupt the status quo.

In China, more than any other major economy, the state can and will redirect capital and economic rents to its preferred ends. If a business model conflicts with national goals it is the business model that suffers.

Sleeping with the enemy?

Capital is political in China and becoming more so in other countries as they struggle to formulate a strategy to face the power challenge posed by China's rise. This brings us on to the Executive order banning US investors from buying or holding shares in PLA linked companies on 12th November.

In "Investing in Cold War 2", we argued that investors had to ask themselves three questions regarding their China investments: What will they be allowed to do? What ought they to do? And Who or what could impact the profitability of what they actually do? Broadly speaking the rising jurisdictional risk can be divided into three parts corresponding to the three questions: Legal and regulatory; reputational and ESG; and geo-economic.

"The Executive Order on addressing the threat from securities Investments that finance Communist Chinese military companies" clearly falls into the legal and regulatory category and lists 31 companies ranging from Shipbuilding to telecoms. There must be two concerns for existing investors in China: 1) Will the scope of the ban be broadened? 2) Will other countries such as the UK follow the lead of the United States? 3) Will the order be over-turned by a new US administration?

The language in the executive order makes clear the link between portfolio flows and funding the military up-grading of China's industrial-military complex. The emphasis below is my own.

"(PRC) is increasingly **exploiting United States capital to resource**

and to enable the development and modernization of its military, intelligence, and other security apparatuses, which continues to allow the PRC to **directly threaten the United States homeland** and United States forces overseas, including by developing and deploying **weapons of mass destruction,** advanced conventional weapons, and malicious cyber-enabled actions against the United States and its people."

Furthermore, the order acknowledges that there is only an "ostensibly" private sector and that no part of the economy is beyond being purloined for national service.

"Key to the development of the PRC's military, intelligence, and other security apparatuses is **the country's large, ostensibly private economy.** Through the national strategy of **Military-Civil Fusion,** the PRC increases the size of the country's military-industrial complex by compelling civilian Chinese companies to support its military and intelligence activities."

The phrases "direct threat to the US homeland"; "ostensibly private sector"; and "weapons of mass destruction" should I would have thought convince investors that there is a) scope to broaden the number of companies on the list and b) a potential desire to bring allies on board given that the stated intention is to prevent China from putting itself in a stronger position to threaten the US homeland.

Would a future administration revoke the order? This would be politically hard to do, even if it were deemed desirable. More likely is that in the run up to 20th January, we may see more executive orders. Trump's legacy is that he has changed the debate on US-China economic relations and he may be keen to cement it in place with actions that will be politically costly to unilaterally undo without a quid pro quo from China.

Wake-up call

Why is portfolio investment becoming weaponized? In the absence of large current account surpluses, China needs to obtain US dollars from other sources, and selling non-controlling stakes in its huge, and arguably mis-allocated, capital stock is the easiest way to obtain them. Helped by benchmark changes and the huge quantity of indexed money, USD432bn was invested through portfolio flows in the three years to 2019 and a further USD60bn in 1H20 according to SAFE.

The dollars are required a) to add hard currency backing to the RMB money supply through reserves, that are still the best part of a trillion dollars below where they were in 2014 and b) to finance its economic expansionism through 'going out" and the BRI. The best way for the United States and its allies to restrict Chinese expansionism is to deny them access to Dollars.

It is not hard to see, therefore, how from the perspective of a foreign policy practitioner, investors giving dollars to the Chinese government, by purchasing RMB denominated financial assets, are frustrating US policy goals.

Double jeopardy

The bottom line for investors is that their China exposure looks as if it increasingly seen to be obstructing US foreign policy goals on the one hand, while, at the same time, the more innovative companies are being seen as a threat to the CPC. "Don't fight the Fed is perhaps being replaced by don't fight the state department." What is equally true, as it is always has been, is do not invest in China against the interests of the CPC.