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Investments

Recent US policies and likely impacts on China Portfolios, a view from China Asset Management Co., Ltd, sub-advisor to Mackenzie All China Equity Fund

Recent US policies update and potential impact

Since the US-China trade war started around 2017, the Trump administration ramped up pressure on China through various measures and policies. Recently as the dust settled on the presidential election but prior to the transition, Congress and former President Trump put in place further policies that increased pressures on Chinese companies further.

1. Executive Order 13959 (the "EO"), and the Communist Chinese Military Companies ("CCMC") list

- Since June 2020, the US Department of Defense announced four batches (24th June, 28th August, 3rd December and 8th January) of companies that it believed to be Chinese Communist Military Companies ("CCMC"). Currently there are 44 CCMC companies in total. [1, 2] Office of Foreign Asset Control ("OFAC") has also recently issued an FAQ which clarified that any subsidiary company which is over 50% majority owned by a CCMC will also be considered as a CCMC. This could impact over a thousand companies/entities.
- President Trump signed an Executive Order 13959 (the "EO") into force on 18th December, 2020. The EO states that from 11th January, US persons (including corporations) may not invest or hold securities issued by a CCMC. Any existing investment held for over 365 days, must be unwound within 365 days of when such companies are determined to be CCMC.

Likely impact: Short-term negative impact on US asset management industry

We think the EO and the CCMC List have had a significant short-term impact on the asset management industry, as many US entities scrambled to comply with these new restrictions with a very short notice period. At the same time the US government has continued to add firms onto the CCMC list (for example the addition of Xiaomi on 8th January).

However, we think the EO and CCMC List will have limited impact on Chinese companies in terms of availability of funding and cost of funding. Only three telecommunications companies (China Mobile, China Unicom and China Telecom) have been de-listed by NYSE, and the shares delisted represent a small proportion (around 1 to 2%) of their total market cap. In addition, many Chinese companies listed in the US are either already dual-listed or are in the process of seeking dual-listing on the Hong Kong Stock Exchange ("HKEX"). Recent policy from Beijing encourages domestic pension funds to increase exposure to south-bound flows (i.e. allocating to Hong Kong equities) and should provide ample liquidity and funding for companies seeking to re-list or dual-list. There is an argument that the cost of equity could increase as a result of losing access to the NYSE – one of the lowest cost of equity markets globally. In our view, a case by case analysis will be required, since it isn't obvious that the risk premium demanded by the HKEX investor base is noticeably higher for many leading companies (Alibaba for example).

2. Holding Foreign Companies Accountable Act (the "Act")

- Following Congress' approval on 3rd December 2020, the Act was signed into force on December 18, 2020.
- Requires foreign companies to have less than 3 "non-inspection" years, a requirement which many Chinese companies cannot comply with. This means Chinese firms and relevant authorities have 3 years to work out a solution with SEC/ PCAOB to permit inspection before delisting is enforced. [3]
- As the Act was passed by Congress, it is unlikely to be reversed. Although the 3 year timeline does give us optimism that a solution will likely become worked out.

Likely impact: Long-term positive impact, more transparency and investor friendly

To comply with the Act, Chinese firms and Chinese authorities will need to work with the SEC and PCAOB to ensure inspections are permitted and information made transparent. We think whilst 3 years seems like a long time away, should these issues be resolved, it could lead to a more welcoming / transparent environment for investors.

3. The Entity List

- First published by the Bureau of Industry and Security in 1997, as part of its efforts to inform the public of the entities who have engaged in activities involving weapons of mass destruction programs. [4]
- However the purpose and constituents of the Entity List have expanded over the past twenty years. Effectively, being added onto the Entity List means such entities will no longer be able to purchase from or sell to the US.

Likely impact: Immediate threat to Chinese companies that rely on US technology, long-term uncertainty

The Entity List could propose a significant or even existential threat to Chinese firms that rely on US technology. For Example, Huawei had to spin off one of its mobile phone sub-brands, Honor, because it was no longer able to source sufficient chipsets to support production of multiple product lines. In certain cases, this also leads to increase R&D spending by many Chinese companies in key industries, and over the long-term this could result in faster erosion of the technological lead that the US holds in industries such as aeronautics, micro-processing chips and communications equipment. It is worth noting that not all companies placed on the CCMC List are on the Entity List (for example, the recent addition of Xiaomi to the CCMC list has not resulted in its addition onto the Entity List).

As President Biden begins his presidency, it remains to be seen how the situation will evolve. A possible (extreme) scenario as a result of delisting of Chinese firms, should more companies be added to the CCMC List in the future, is that managers/ funds with a global and international mandate will no longer be able to access Chinese companies through developed market stock exchanges. This could lead to a reduction in their opportunity set, and may raise the importance of a dedicated China A or All China allocation in portfolios.

Implications for China portfolios

For our actively managed China equity portfolios, we believe the impact is minimal. Our rationale is threefold:

a) US listed Chinese companies only make up around 10% of the total market capitalization of all Chinese companies worldwide. Whilst admittedly this includes some of the best (in our opinion) internet and e-commerce businesses that China has to offer, we note many are also already dual-listed in Hong Kong or are considering the option. In addition, HKEX and Shanghai STAR board have both recently reformed their listing rules so as to encourage US-listed Chinese companies to re-list or dual-list in local markets. As a result we think such policies will have minimal impact on our opportunity set.

b) Whilst US domiciled trading platforms and custodians such as Bloomberg and JPM have informed clients that they are no longer able to process transactions in securities issued by CCMCs, we note most non-US (in particular, Chinese) trading platforms/brokerages and custodians are still able to process transactions seamlessly at no extra cost.

c) We do not hold any of the companies on the CCMC List, and based on current outlook do not believe they make up a meaningful part of our opportunity set.

Amidst uncertainty around the current situation, our view is cautiously optimistic. We think the scenario where an eventual work-out between the governments is high. As a result we remain focused on our primary investment objective of selecting the best Chinese companies that will most likely benefit from the long-term growth trajectory of economic expansion of China.

Appendix and source

1. https://home.treasury.gov/policy-issues/financial-sanctions/sanctions-programs-and-country-information/chinese-military-companies-sanctions
2. https://www.treasury.gov/ofac/downloads/ccmc/ns-ccmc_list.pdf
3. https://pcaobus.org/oversight/international/denied-access-to-inspections
4. http://www.bis.doc.gov/index.php/policy-guidance/lists-of-parties-of-concern/entity-list

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1529357 03/21