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Stralem & Company Incorporated
551 Madison Avenue, New York, NY 10022
Tel 212.888.8123 | Fax 212.888.8152
stralem.com

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Dear Clients:

We recently spent time in China and as you might expect, the anxieties surrounding the trade dispute and its many ancillaries -- including the December engagement with the U.S. in Buenos Aries conducted concurrent to our trip -- was topic number one. We have been making annual research trips to China for over thirty years and have relished being along for its economic and socially transformative ride.

Historically, America's approach to China had been grounded in the challenging goal of convergence, where political and economic integration would lead to a more diverse, democratic, and economically open nation. Yet, while both countries benefitted from the epic growth in economic activity that bilateral trade provided, integration of the type the U.S. imagined never materialized. Indeed, as we turn the page on 2018, the U.S. has re-classified Beijing as a national security threat and it is safe to say convergence is likely dead. Worse still, the administration has failed to produce a forward-thinking trade strategy that allows businesses to allocate capital with the support of a policy framework. We therefore enter a new year in an environment that has all the feel of a geopolitical adaptation of "only the paranoid survive".

Our president is neither subtle nor predictable but, as we see with Canada and Mexico, bullying as a negotiating tactic can lead to modified trade pacts (even if it's just rearranging the deck chairs). China, however, possesses far more leverage and will not be so easily pushed around -- its economy is transitioning and depends less on exports to America than our immediate neighbors. And, with Beijing continuing to pour resources into advanced technologies like artificial intelligence, quantum computing, and biotechnology, it's not likely that its leaders will disavow the Chinese Dream of economic autonomy.

Initially, China thought it could simply buy its way out of a trade conflict by ramping up purchases of U.S. goods and implementing modest reforms on market access and foreign investment. They would happily purchase enough stuff to allow the U.S. to claim "victory". Reinforcing China's approach was the belief that Chinese tariffs would take a financial toll on American consumers (whose living standards had improved thanks to inexpensive Chinese goods), firms dependent on Chinese-made parts, and the hundreds of U.S. multinationals with lower-cost China-based assets. Beijing also assumed that, with midterm elections looming, the president would have little appetite for a mutually destructive trade war that would put him at odds with Wall Street and his constituencies.

Beijing's strategy has thus far fallen short as the sting has been subtle enough, and tariff targets marginal enough, to prevent the president's policies from becoming a major political issue. However, if a trade war is a competition about who can withstand more misery, China holds at least one crucial advantage: as its own propaganda declares, they can outlast the U.S. in a trade war because its people "are willing to bear losses in their personal life and share hardship with the state". The administration has not offered *any* thoughts on its plan to counter a war of attrition, which begs the question, "what comes next for American's businesses and our role in globalization"? With this thought in mind, we launch into our observations and anecdotes obtained from this, our fourth and final quarterly trip **West of the Hudson** ™ in 2018.

- Economic Storm Chasers

According to Hong-Kong-based financial research firm GaveKal, the U.S. and Chinese economies have contributed between one-half and two-thirds of global GDP growth *annually* since 2002. It's therefore appropriate to ask, 'how destabilizing would a trade war be'? This question elicits a wide array of responses. According to the Peterson Institute, current tariffs target just 12% of U.S. imports and many of us in the West dismiss the rhetoric as nationalist political theater. Unsurprisingly, our acquaintances in Asia tend to be a lot more anxious and introspective. Regional sensitivities aside, the path to a future of free trade appears increasingly narrow.

The U.S. president came into this convinced that China is a financial and economic house of cards and -- like the big, bad wolf -- he could just huff and puff and blow their house down. This thesis is not original and has been proselytized by China economic bears for years. Bears argue that Chinese debt has soared 2,000% since its 2002 World Trade Organization (WTO) admittance. Crucially, these massive, state-directed sums weren't invested in cash-flow generating assets but non-productive infrastructure-heavy assets requiring constant streams of new debt to pay off the old debt. The linear reasoning is the epitome of conventional economics and goes as follows: debt levels can be maintained while an economy is growing, but any economic calamity or trade shock will upset growth, reduce profits, and inflict severe pain on highly indebted companies. This is turn would spark a massive debt crisis, loss of confidence and, eventually, economic meltdown. Hence the president's initial posturing that this was going to be an "easy" trade war to win.

One rebuttal shared with us reflected on the differences in our financial systems. Ours is an open capital market (mostly) grounded in fair competition and creative destruction; while theirs is a planned authoritarian capital market where only the pre-ordained can prosper. These distinctions alone should result in separate outcomes. China's brand of controlled capitalism is insensitive to the interests of big corporations or its financiers -- only the national interest is paramount -- so when economic stability is at risk, systemically important companies are swiftly nationalized and capital injected. The recent case of Anbang Insurance comes to mind where the massive, overleveraged, company was taken under national trusteeship and its chairman arrested. In the U.S. a powerful lobby has shaped a regulatory structure that protects corporations and allows for egregious levels of public risk-bearing (i.e. the bailouts of our banks and automakers in 2009), so that Congress, the White House, and the Treasury fight drawn out legal battles with armies of lawyers and lobbyists, always with socially-dubious outcomes.

American prophesies that a trade war will provoke a Chinese economic meltdown are convincing the president to be excessively hawkish. However, if China defies typical classification, mainstay western thinking about conventional economic outcomes may not yield the expected outcome. While trade wars may start benignly, they never end neatly…or predictably.

More than a few noted that Chinese leaders have been slow to pick up on the gravity of the situation, however. Their thinking was that the president was ultimately an ego-driven businessman whose bullying ways could be ameliorated with a few buying missions and a splashy red-carpet welcome in Beijing. For a time they were right but what they did not count on was the conviction of those whispering in the president's ear…and those voices have a far different vision for the future world order.

This raises the thornier issue that the conflict isn't *just* about trade. Yes, intellectual property and market access are central to the narrative, but what if at its heart it's about China's other ambitions: their move to control the South China Sea, their Belt & Road initiative linking them with the Indian Ocean and Europe, and their exploitation of Africa's vast resources? If the America's motivation is to counter China's rise, then any concessions made on trade or technology are likely to be rejected. Under this scenario, tariffs aren't meant to force concessions, but to get American manufacturers *out of* China.

- From the Corporate Seat

> The only thing worse than an unlevel playing field is no playing field at all.
> -- Tom Linebarger, CEO, Cummins Inc.

A review of the data indicates the “easy win” thesis has not coalesced. The presidential economics team clearly skipped its behavioral economics classes as the first effects of uncertainty drive the trade balance ever wider -- a consequence of the threat that even higher future tariffs might be levied.

Indeed, the assault on globalization has had a paradoxical effect on trade as a rush to get ahead of higher tariffs has motivated American companies to increase orders. And yet at the same time, despite the record volumes reported by West Coast ports, tariffs have reduced U.S. exports *to* China. The port of Long Beach noted a surge in empty containers being shipped back to Asia and, in November alone, the port saw more than 186,000 containers *sent back empty* (an 11% year/year increase). So, while the U.S. has stepped up purchases of Chinese-based products, Chinese businesses are not reciprocating (hence less demand for U.S. exports and more empty containers).

So, despite another robust earnings season, the headlines from 3Q earnings calls were notable by the amount of statements and queries surrounding tariffs. There is a growing sense that the U.S. is insensitive to the interests of U.S. businesses abroad and that the tariff bite is moving to the front and center. This was given life in a November study by the American Chamber of Commerce of China, which found the first rounds of tariffs disproportionately affected U.S. imports from China-based affiliates of multinational firms as 85% of U.S. companies said they were affected (compared with 70% of Chinese companies).

U.S. companies said they are “tempering the effects of escalating tariffs with China through price increases or changes to their supply chains but warn investors that “the picture could worsen”. Trade hawks want U.S. companies to reduce their reliance on China but, given the size and growth of the Chinese market, companies we spoke with view this as an utterly unrealistic demand. So, looking ahead, there are two questions that await answers: 1) how aggressively will the hardliners push on their effort to decouple the U.S. and Chinese economies? And 2) how hard will the business community push back?

- China Plus One: Supply Chain Migration

The uncertainty around trade has added complexity to the supply chain equation for companies that have spent decades building and optimizing their resources. But the cost of doing business globally has always forced larger companies to invest fairly consistently -- in this case in other South Asian locations. According to the aforementioned American Chamber of Commerce of China study (one that included more than 3,300 participants from 900 companies) 70% of U.S. firms surveyed said they were “mulling whether to delay or cancel new investments” (for the record, just 1% said they were planning on moving operations to the U.S.).

Still, there are ample reasons for firms operating in China to stay put. Less than 19% of Chinese exports went to the U.S. (2017), and other major consumer markets have yet to follow the U.S., so many of the largest manufacturers -- ones that serve consumer markets across the globe -- feel well-equipped to absorb the tariff costs *and* keep their operations in place. Shifts in supply chains out of China was described as “more of a trickle than a flood”.

For firms dependent on the U.S. market, relocating is neither quick nor cheap. Relocation requires new facilities, new workers to recruit and train, new regulations, and new hiccups that cause disruptions. Deep-pocketed multinational firms have the resources to manage through this, but the small and medium-sized enterprises operate on thinner margins and can’t afford business disruptions. All told, relocation is a surprisingly long three-to-five-year process and, lacking any useful visibility from Washington,

companies have thus far been loath to take on this burden. Moreover, if the administration is truly bent on restoring lost U.S. manufacturing jobs and bringing the U.S. trade deficit down, it will need to apply tariffs to other low-cost manufacturers, too. We didn't meet anyone who thought this was realistic.

Multinational companies are pursuing a "China plus one" strategy, in which current production remains largely in place, but new investment will go to countries with lower labor costs. These "plus one" countries include Indonesia, Vietnam, Bangladesh, Malaysia, and India. The lower-margin, labor-intensive industries (apparel, furniture, toys, etc.) are the most exposed to changing cost pressures and the most likely to relocate. Of these -- and we discussed this in a 2006 trip/letter to you under different circumstances -- Vietnam is the best placed to capture investment from companies trying to diversify away from China. It offers an appealing mix of political stability, good infrastructure, and labor costs that run ~30% lower than China. And, as it shares a boarder with Vietnam, it makes it easier to transfer one stage of production (usually final assembly) while keeping the other stages in China.

- Too Big to Avoid

There's another huge and obvious incentive to stay in China: it is home to the second largest consumer market in the world. According to research from Bain & Co. (11/28/18), if current trends hold, household consumption in China is expected to grow 5-6% annually over the next decade, as some 180 million additional people move into the middle class. General Motors sold more than four million cars in China in 2017 -- over *one million more* than it sold in the U.S. So, even if a company decided it had to avoid U.S. tariffs to stay competitive, it doesn't stand to reason that they will relocate their entire supply chain because so much production in China is meant to serve the growing local market. The size of the market means there is a practical limit to how much production firms are willing to shift abroad.

For electronics companies in particular, production in China is difficult to replace as the economies of scale and scope available make it hard to relocate. Workers are considerably more expensive than those in Vietnam or India, but they were also described to us as "more dependable with more experience putting together complex and expensive electronics". In addition, because of the depth of manufacturing, assemblers can be close to suppliers of almost all their components. Even as Chinese economic growth slows -- and even if things get really tough in the coming years -- there are massive consumption gains still to be made as urbanization further integrates with technology and boosts living standards. Rising competition from Chinese firms to meet this demand is already putting U.S. multinational companies at a disadvantage and who can afford the loss of tariff-free access? South Asian alternatives, though growing in their own right, lack the same allure. That's especially true since the U.S. withdrawal from the Trans-Pacific Partnership. Signatories like Malaysia and Vietnam, for example, won't be able to dangle tariff-free access to the U.S. market unless the U.S. re-embraces global trade. While we certainly expect this to happen *eventually*, it could take a decade to get back to par.

- Strategic Vulnerability

We had one particular conversation with a chemical company executive who made an especially useful point: when looking at the administrations' tariff *exemptions*, the inclusion of "fluorine salts", "carbonate esters", and "barite" says a lot about U.S. susceptibilities. These first two chemicals are used in the manufacture of electric-car batteries (Chevy Volt, Tesla), while Barite is a mineral used by oil and gas drillers. According to another multinational, Mitsubishi Chemical America, who got an exemption for those two obscure chemicals, "there simply is no other viable source of these key inputs outside China in the volumes and the quality levels that we require. Developing new sources outside of China to replace existing production would take massive long-term investments and many years". These exclusions highlight an unfavorable disadvantage in our preparedness for a prolonged war of attrition. China has become an indispensable supplier of obscure industrial commodities on which modern American industry is reliant.

- China & Chips: The Ongoing Tech War

All the noise aside, technology is at the heart of the conflict. “Made In China 2025”, Beijing’s ambitious manifesto to develop leading capabilities in the technologies of the future, was repeatedly cited in the administrations report to Congress that launched the first tariffs against Chinese goods. Chinese firms have invested heavily, developing on both the hardware and software sides of the technology roadmap. Its digital sector is thriving, with formidable smartphone producers, world-leading internet companies and a strong position in the development of artificial intelligence (AI).

Smartphones are the primary way most people in the world access the internet and are the world’s most important consumer electronics devices. Chinese smartphone companies command ~20% of the global market and its four biggest -- Huawei, Oppo, Vivo, and Xiaomi -- are spreading globally (although not particularly profitable). Chinese largest internet companies have also become formidable. Ten years ago, these companies were dismissed as poor copies of U.S. ones. While true *then*, those claims are dated as companies like Facebook and Snapchat study the user engagement techniques of competitors like Tencent. That doesn’t mean that juggernauts like Tencent and Alibaba (which handles a far higher volume of transactions than Amazon) developed anything original, only that they have leveraged what was available to create dominant brands and positions in enormous and fast-growing markets. It is these internet companies that have driven progress in developing the machine-learning algorithms that we commonly refer to as AI. The combination of a large population with heavy mobile usage and a large base of talent has made China a credible peer to the U.S. on emerging technologies.

Where the big question remains is in what is considered the holy grail of technology manufacturing: semiconductors. China imports more than 95% of the high-end chips it consumes. DRAM memory chips that go into virtually all consumer electronics are manufactured by just three companies: two South Koreans and one American. It is widely believed that the lack of sourcing options was an important motivation behind “Made In China 2025”.

The consensus amongst the contacts we discussed this with -- people with decades of in-country operational expertise -- is that China is *at least* twenty years away from successfully building material semiconductor manufacturing capabilities. If so, that is significant and hard to grasp considering the pace of change in other areas. But therein lies the complexities of this business: it’s easy to marvel about but far harder to produce. The fact is that a lot of China’s success to date has been in downstream, consumer-facing technologies. The focus of the “China 2025” manifesto by contrast is on upstream component-supplying sectors, such as semiconductor manufacturing. The question at the heart of many of our conversations is, will the vibrancy of China’s downstream technology sectors invigorate the capabilities in upstream sectors?

Chinese ambitions are not limited to technology and they are heavily invested in aerospace, shipbuilding and pharmaceuticals; however, the objectives laid out for technological advancement are the most high-profile. Importantly, vulnerabilities to achieving these goals remain in the form of a heavy dependence on U.S. manufactured parts. Chinese companies trying to compete will continue to be tightly scrutinized not just by regulators but, as evidenced by Huawei, criminal prosecutors. If these companies are dealt any major setbacks, “Made In China 2025” will likely lose a lot of momentum.

The administrations’ actions come as a “blessing in disguise” (as the China Daily put it) as U.S. tactics have reinforced the critical importance of this quest for independence. Take, for example, giant telecom equipment maker, ZTE. Washington forced the company out of business by banning U.S. companies from selling it crucial components. While a settlement was reached, the Chinese learned their lesson -- just not the one Washington intended. Rather than scaring Beijing into compliance, the incident reinforced how badly the country needs its economy to be less reliant on foreign technology.

- Conclusion: Interesting Times Have Become Menacing Times

It is no secret that the U.S. president is surrounded by men who want to "take China down" who have argued that China is a glass house built on unsustainable credit and that all we need to do is throw rocks for the whole edifice to collapse. So far, Chinese economic vulnerability has proven to be nothing more than folly. With all the dire predictions of an imminent debt crisis and financial meltdown, China remains very much upright. China's dependence on the U.S. was shrinking before the trade war even began, and rather than force Beijing to rethink its trade policies, the conflict has convinced the government that it must reduce its dependence on our market and our technology sooner rather than later.

Should the system become stressed, the Chinese will likely resort to what they do best: intervene directly to stabilize its market and currency; push toxic assets onto state-owned banks; rescue ailing exporters; and force state-owned enterprises to soak up surplus labor. Yet, while China works to perfect its brand of authoritarian capital, they have also done the cost benefit analysis of its excess capacity and aren't afraid of change. 1.8 *million* Chinese coal and steel workers reportedly lost their jobs in 2017 -- victims of the mandated shift to cleaner industries. To put that in perspective, in the U.S., those two industries -- ones the president is eager to revive as a matter of "national security" -- employ just 192,000 workers (Axios).

The next rounds of negotiations will determine the pace of economic decoupling, and while it will be noisy and anxiety-laden, it won't be quick and certainly not easy. The U.S. will likely have to incentivize manufacturers to find suppliers outside China and, while a dubious strategy, it will not alter Chinese behavior. China cannot give in to U.S. demands without abandoning their core state-led industrial model and its pursuit of sustainable high-tech export growth. And, with a growing secondary market, they won't have to as their expansion into countries Washington has ignored will open new and expanding markets.

Washington is demanding Beijing to do something it can't do without significantly weakening its economy. A weakened economy would, in turn, threaten Chinese national security and undermine the very legitimacy of the Communist Party. The geopolitical rivalry between the world's two largest economies is a result of -- and a threat to -- the global economy, and its effects will be felt far and wide.

We were warned decades ago that the quintessential Chinese proverb, "may you live in interesting times" was a curse. However, we were younger then and there was nothing better sounding than 'interesting times' as it implied opportunity and the chance to stand apart. Change was fun! We must say that as we mellow with age -- and after a most challenging 2018 -- we concede the true meaning isn't so nifty after all.

From our families to yours, we wish you all a peaceful and prosperous 2019.

Yours truly,

Hirschel B. Abelson
Chairman

Adam S. Abelson
Chief Investment Officer

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