NAVIGATING THE U.S.–CHINA RIVALRY

IMCO's View on Investing in China

FEBRUARY 2023

CONTENTS

INTRODUCTION

Global geopolitical dynamics are shifting. The United States' position as sole global leader has been a constant since the Soviet Union's collapse more than three decades ago. However, following a series of developments – ranging from lengthy wars to financial crises and internal political strife – the United States (U.S.) has become increasingly focused on domestic issues. Meanwhile, China has enjoyed some economic wins, including joining global trade agreements, evading the worst of the Global Financial Crisis' (GFC's) fallout, and benefiting from the draw of its expansive domestic consumer market. As a result, China is poised to challenge the U.S. for its position as the world's largest economy.

Recognizing its growing power, China has been more open about its global ambitions and desire to be seen as an equal to the U.S., with an ability to compete head-to-head across the commercial, technological, political and cultural spectrums of power. China has also been emboldened diplomatically, engaging with hostility and retaliation against countries and entities that openly criticize its policies.

> "China is poised to challenge the U.S. for its position as the world's largest economy."

The U.S. has identified China as its most significant rival and threat – a view that is broadly shared on both sides of the political aisle. The bi-partisan nature of this perspective in American policy circles adds to its durability and suggests that it will not "disappear" with the next electoral cycle.

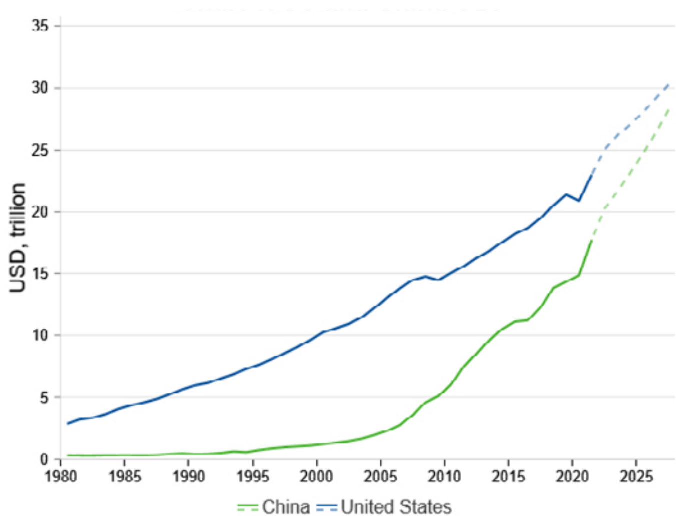
Tensions have also been rising between Canada and China, with the tone of recent meetings between Prime Minister Trudeau and President Xi Jinping reflective of the difficult relations between the countries. Canada's newly released Indo-Pacific Strategy – which refers to China as an 'increasingly disruptive global power' necessitating a 'clear-eyed approach' – will do little to ease these tensions and highlights the need for Canadian investors to be cognizant of the rising domestic policy risks surrounding Chinese-related investments and potential retaliatory actions by China.

This paper seeks to characterize China's ongoing rivalry with the U.S. and increasingly-confrontational relationship with Canada; looks at the risks from a Canadian institutional investor's viewpoint; and lays out IMCO's perspective on investing in China in light of these considerations.

MACROECONOMIC AND GEOPOLITICAL CONTEXT

China is rapidly catching up to the U.S. in terms of its economic might. Some projections suggest that the Chinese economy could surpass the U.S. in absolute size around the mid-2030s. This catch-up has been a recent and rapid phenomenon, with most of the gap narrowing occurring since the GFC. The Chinese economy is also undergoing a renewal process, shifting away from 'old' areas of economic growth such as housing, manufacturing and infrastructure, in favour of 'advanced' ones that are more centered on technology and the consumer.

CHART 1. U.S. and China GDP in USD



Source: Macrobond, International Monetary Fund (IMF)

China has also become bolder on the global stage. China spent much of the 1980-2000 period keeping a relatively low profile internationally, while quietly advancing economically and joining major international initiatives. In recent years, China has become increasingly emboldened, taking a more proactive approach to geopolitics and making its views and aspirations known. This has been accelerating under President Xi Jinping's leadership.

China is focused on consolidating Xi's power over the Chinese Communist Party (CCP). As the CCP's leader, Xi Jinping is rapidly becoming one of the most powerful figures in Chinese history. He secured election to an unprecedented third term in 2022, solidifying his hold on the CCP in the process. With power increasingly in hand, Xi has removed political rivals from the CCP and elevated national security to one of the top priorities of the nation.

Taken together, these moves increase the risk of confrontation with the West – especially the U.S. – on conventional fronts (e.g., military, Taiwan-related, trade) as well as potential new ones (e.g., technology development, cyber-security). The scope for a wide and varied set of battlegrounds is reflected in Xi's announcement of China's "comprehensive national security concept" which spans the spectrum of policymaking. A key element of this concept relates to "technology self-reliance", with Xi resolving to see China "win the battle in key core technologies".

In the U.S., there is a bipartisan focus on containing the rise of China. Over the last decade, the American policy stance on China has shifted from the view that engagement and economic integration would be sufficient to quell the threats stemming from the rise of China to the diagnosis that China poses an acute ideological, economic, and technological challenge to the U.S. This view is now truly bipartisan, with the previous Trump and current Biden administrations both treating the issue as the top foreign policy priority.

At the same time, the relationship between Canada and China has also become more confrontational. In its newly updated strategy on the Indo-Pacific region, Canada outlines the need to defend national interests and challenge China when it engages in coercive behaviour, such as its human rights obligations. While the tone remains pragmatic, this represents a clear shift from Canada's previous 'business-friendly' approach to China. New measures to protect Canada's national security interests, as outlined in the Investment Canada Act, and sizeable monetary commitments (about $2B CAD) to be directed towards navy patrols, improved intelligence and cybersecurity in the region, show that Canada is moving beyond rhetoric when it comes to confronting the challenge and threat from the world's second largest economy.

IMCO VIEWPOINT: CO-DEPENDENCE LOWERS RISK

The current U.S.-China rivalry cannot be easily compared to previous geopolitical rivalries, such as the Cold War that took place between the U.S. and the Soviet Union from the end of World War II through to the early 1990s. The key differentiating factor is the fact that, after decades of trade and globalization, the American and Chinese economies are now much more intertwined than the U.S. and Soviet ones ever were. This is reassuring in some sense: with both countries able to inflict significant economic harm on the other, it is less likely either one will choose to do so. In essence, even under a very anti-China U.S. administration, there are limits to the pain that can be inflicted on China without inducing substantial reciprocal harm at home.

Another significant difference relative to the Cold War is that the U.S. and China do not view each other as existential threats. While China is focused on taking its place in the world, the U.S. seeks to contain – but not necessarily erase – China's influence globally.

> Both the U.S. and China are facing important domestic challenges...Given these dynamics, both countries will find it difficult to endure a long conflict that could be damaging economically and politically.

Finally, both the U.S. and China are facing important domestic challenges that draw attention away from their global rivalry: China is managing an unfavourable demographic transition and shifting economic priorities, while America deals with heightened political divisions domestically. Given these dynamics, both countries would find it difficult to endure a long conflict that could be damaging economically and politically. That said, tensions breed risks, and there is no guarantee of avoiding a strategic mistake by either side.

IMCO VIEWPOINT: TENSIONS ARE LIKELY TO ENDURE

While the economic interdependence between the U.S. and China lowers the risk of extreme conflict, U.S.-China strategic competition will likely persist. China's economic power is set to continue to grow, albeit at a slower pace than in recent decades, which should feed its increasingly emboldened approach on the global stage. Ideological differences will also likely continue, and quite possibly deepen, as President Xi leads China ever closer to a near-absolute authoritarian regime. For its part, the U.S. will strive to prevent China from gaining strategic advantages – especially militarily and technologically – and will increasingly seek the help of allies and like-minded democracies, including Canada, to do so. Against this backdrop, both sides will continue to act in ways that promote their strategic autonomy.

IMCO VIEWPOINT: RISKS TO CHINESE-RELATED ASSETS

Rising geopolitical tensions and related policy uncertainty have added to the risk premium associated with investing in China. In addition to navigating local policy risks (such as recent regulatory crackdowns on "big tech" and education-related businesses) and other more typical investment concerns, investors with exposures to China-related assets also need to pay extra attention to U.S. and Canadian policy dynamics and broader geopolitical tail risks.

U.S. policy risk

The U.S. is working hard to prevent China from accessing American capital and technology. In recent years, control and sanction lists have become an important instrument of the U.S. government to contain Chinese companies and their access to American technology. Of these lists, the two most important are: 1) the Chinese Military Industrial Complex list, which designates Chinese companies that Americans are not allowed to invest in; and 2) the Entity List, which names entities that are prevented from receiving items subject to U.S. export control, such as American technologies, without a licence. Given the far-reaching and impactful nature of these lists, investors need to be extremely cautious about companies that may have a connection to the Chinese military and/or are highly reliant on U.S. technology (such as Huawei).

Additional limitations on U.S. investment flows into China are also in discussion, although the current administration recognizes that these measures could also have a negative impact on U.S. investors. Further, without coordination and cooperation with allies, the effectiveness of these measures would likely be limited. Nonetheless, a limited set of measures targeting U.S. capital inflows into strategic sectors like artificial intelligence (AI), semiconductors and quantum computing are seen as likely over the coming year. These, in combination with other potential U.S. policy moves (e.g., technology transfer restrictions, broader trade policy, wider investment restrictions, etc.), could have a significant impact on institutional investors and the performance of Chinese markets. This environment heightens the potential for volatility in Chinese stocks, adding to their risk but also creating some opportunity for active investments.

Canadian policy risk

To date, Canada's actions to confront China's strategic interests have primarily been on the domestic front. In October 2022, Canada announced major changes to its "Investment Canada Act" alongside updates to its Asia-Pacific strategy. The Act grants new powers to Ministers that allow them to initiate national security reviews of new foreign investment deals in Canada, impose conditions on deals, introduce new requirements prior to filing, and enact greater penalties for non-compliance. This impacts Chinese businesses with operations in Canada, particularly those operating in strategic sectors such as aerospace, defence, communications, mining, and technology. A case in point was provided in early November 2022 when, pursuant to the updated "Investment Canada Act", the Canadian government ordered three Chinese companies to divest their stakes in Canadian lithium assets.

To date, Canada has not taken measures to restrict Canadian investment into China beyond a few specific sanctions related to human rights violations in the Uyghur region. However, there is a chance of increased restrictions on outflows going forward, especially if the U.S. takes similar action as expected. Some form of economic retaliation by China is also possible.

Geopolitical tail-risks

Canadian holders of Chinese and Chinese-related assets are also exposed to risks stemming from broader geopolitical developments. Key potential flashpoints on this front include China-Russia relations, Taiwan independence, and Chinese domestic human rights issues.

1. **China-Russia relations:** China was seemingly caught off-guard as it pronounced its "no limits" relationship with Russia days before the invasion of Ukraine in early 2022. It has since backed off somewhat from its support of Russia, diligently complying with U.S. sanctions and trying to avoid any negative impact on the Chinese economy. That said, it remains strategically aligned with Russia, albeit having the upper hand in the relationship, with Russia relatively more dependent on exports of materials and energy to China than vice versa.

   While China has been careful not to align too closely with Russia, it is possible that China could choose a different track going forward, potentially crossing a line that would lead to a much deeper fallout in relations with the U.S. and its Western allies.

2. **Annexation of Taiwan:** China takes the view that regaining control of Taiwan, a democratically governed island off its coast, is essential to strengthening its global status. However, this sentiment does not align with that found in Taiwan, where rising numbers of Taiwanese favour full independence.

   Despite strong ambitions to regain control of Taiwan, China is likely to take a calculated approach before considering and risking an invasion. The potential negative fallout from any sort of military action against Taiwan is very high, with the expected response from the U.S. and its allies likely to come with heavy economic costs, and potentially physical ones (i.e., casualties). The economic costs would be felt beyond the region itself, given the negative knock-on effects to global supply chains, trade flows, and financial markets.

   While these factors lower various parties' willingness to risk an event, they also increase the consequences should anything materialize. The possibility of a U.S. military response appears to be higher now than in the past, as suggested by President Biden's repeated pledges to militarily defend Taiwan in the event of a Chinese invasion. Although there has been no "official" change in U.S. policy relating to Taiwan, the frequency and consistency of these statements hints at a potential shift in America's longstanding approach of "strategic ambiguity" towards the Taiwan-China issue. Taken together, the above factors suggest that a Chinese invasion of Taiwan is likely a low-to-medium risk event with an extremely high impact. Over a longer time horizon, however, the dynamic could become increasingly unstable and unpredictable as China's economic and military might continues to grow.

3. **Human rights Concerns:** China has been widely criticized for human rights issues, particularly in the Xinjian region – a landlocked autonomous province in the northwest corner of the country that is home to several ethnic groups, including the minority Muslim Uyghur population.

   The international community has responded to reports of enforced labour camps by condemning China's actions, pausing trade negotiations, and imposing sanctions and import bans. The most significant of these actions was the December 2021 U.S. ban on all tomato and cotton products originating from Xinjiang, as well as sanctions on solar imports tied to Uyghur forced labour. Canada has also similarly banned all imports deemed to be the product of forced labour.

IMCO'S APPROACH TO CHINA: ACTIVE, FLEXIBLE AND EYES-WIDE-OPEN

KEY INVESTMENT SUPPORTS (+) AND HURDLES (-)

- Growing, three-way (US, Canada, China) policy risk (-)
- Shifting Chinese policy landscape (-/+)
- Large but unsophisticated stock market (-/+)
- No Canadian advantage (-)
- Heightened ESG risks (-)
- Too big to ignore (+)

PILLARS OF IMCO'S CHINA APPROACH

1. We aim to avoid overweighting Chinese equities within our Emerging Market (EM) Equity strategy;
2. We do not recommend an overweight to Chinese equities in our clients' total public equity allocation (i.e., we do not recommend an overweight to the EM equity strategy);
3. We rely on partners to invest in China due to lack of in-house strategic advantage;
4. We primarily hold active investments, in order to better enable alignment with our ESG beliefs and navigate the Chinese policy landscape;
5. We are working on ways to ensure that our passive holdings are also consistent with our ESG beliefs;
6. We focus on investing in liquid, broadly held investments in order to be able to adjust our exposures to evolving conditions as needed.

Given the long term geopolitical, policy, and other (e.g., human rights) risks associated with Chinese investments cited above, we believe client exposure to China should be managed prudently. This exposure in client portfolios is contained within our public equity strategies. As a result, within our EM equity strategy, we will not overweight Chinese exposure relative to the EM public equity benchmark. As well, within our clients' total public equity allocation, we will not recommend an overweight to EM equities (and by extension China).

While we believe that a well-diversified global portfolio should have exposure to China, we do not believe this is an area where we have a particular advantage. In such cases, a key pillar of our overall investment strategy is to establish relationships with strong external partners, particularly when we do not believe we can replicate their investment capabilities or expertise at the same cost.

In general, IMCO's public equity investment strategies seek to add value over the benchmark through stock selection and strategic off-benchmark exposures and, to a lesser extent, factor exposures and country/currency tilts. IMCO's exposure to China is, for the most part, actively managed, consistent with our belief that the risks to investing in China require ongoing oversight and active management, with only a small portion of our Chinese investments held within passive index instruments (e.g., via ETFs and futures) to manage liquidity and hedging activities in a cost-effective manner.

Generally, we seek to avoid passive investing in China where possible. Most indices are constructed mechanically using metrics such as market capitalization, with little-to-no weight given to other criteria relevant to institutional investors' goals and values. These considerations could include a desire to manage concentration risks and ESG risks, the latter of which is particularly important in China's case given the elevated human rights concerns noted above (e.g., treatment of the Uyghur population). As well, using passive exposure in China can also lead to increased risks stemming from regulatory crackdowns on specific sectors and mega-cap companies, and from rising tensions with the U.S.

By adopting an active approach with our external partners that have local presence and/or specific expertise in the region, IMCO can also ensure there is active oversight on the key risks and considerations of investing in China. IMCO partners with like-minded external managers who share IMCO's commitment to ESG, and practices stewardship by actively monitoring, influencing, and engaging with external managers and companies on ESG matters. IMCO conducts ESG due diligence on all managers and discusses ESG performance and stewardship activities during our regular reviews to improve their practices and address any concerns we have. If an external manager fails to meet their commitments to ESG over time, IMCO can consider an escalation process by notifying them about placement on a watch list or engaging with the external managers' leadership to affect the necessary change.

Finally, IMCO will avoid any material investment exposure to China within our Real Estate, Infrastructure and Private Equity strategies. Given the dynamic nature of risks in the Chinese market and considering the growing prospect of retaliation towards Canada for its hardening China approach, we think it prudent to avoid holding illiquid investments, thus allowing us to maintain flexibility to adjust our exposure over time.

CONCLUSIONS

The deepening and broadening rivalry between the U.S. and China, coupled with more interventionist economic policy on the part of the Chinese Communist Party, suggest that long-term investors will have to weigh a growing number of issues when managing their China-related exposures. The rising risk of escalation across multiple fronts – from military to political, economic to technological – has altered the risk-return trade-off of these investments. Canada's increasingly difficult relationship with China adds further risks for Canadian investors. That said, China is “too big to ignore” and its impact on global markets and the economy all but impossible to avoid.

Considering these realities, IMCO has made it a priority to monitor and manage these risks. We believe that IMCO's exposure to China and Chinese assets remains prudent given our assessment of the current economic and policy environment and is also consistent with our broader values and investing approach. By partnering with external managers, we can leverage local experience and regional expertise and better navigate political themes and policy risk. Our chosen hands-on active approach allows us to gain exposure to the China growth story while also giving us the ability to adjust this exposure as opportunities – and risks – evolve.

Given the fluidity of the geopolitical backdrop generally and China-related developments more specifically, our views and approach will be consistently reviewed and – if necessary – revised going forward. This dynamic and flexible approach will help ensure that portfolio design decisions are made holistically and in a manner consistent with our ESG strategy and guidelines on an ongoing basis.