



Tom Herrick: Welcome to the CIO Conversation Series, I'm Tom Herrick, Cary Street Partners Chief Investment Officer. On this episode, we head into the thicket of the complex relationship between the US and China. China has been in the news and under the microscope a lot in recent years. As the most populous nation on earth, China is simultaneously America's most important economic partner and competitor. My guest on this episode is Paul Korngiebel, a thought leader from Boston Partners who has deep experience investing in China. Paul is a leader in the firm's emerging market strategies and a part of its global equities team. Boston Partners works with Cary Street Partners to provide first class value equity solutions for our clients. There's clearly a lot to keep an eye on, given the extensive reach of the two nations, but Paul and I will do our best to focus our lens, to hone in on the ways China does business and how those variously competitive, adversarial and sometimes cooperative forces are likely to affect the global marketplace for investors around the world. Paul Korngiebel, thanks for being here.

Paul Korngiebel: Hey Tom, thanks for having me. Pleasure.

Tom Herrick: We're recording this the third week of April, and I'd like to start with what I'll call the state of play, which is essentially I'm going to ask Paul, what's the status of our complex relationship with China, the US China relationship, and what are the geopolitical threats to the relationship that you see over the next five years or so?

Paul Korngiebel: I'd say that US China relations are at a fairly low, absolute level, Tom. There's a bipartisan consensus in Washington that China under the Chinese Communist Party, which I'll refer to as the CCP going forward, is currently the greatest threat to the geopolitical order. And that geopolitical order is what the US has architected since the end of World War II, where or I should say when perversely, the US and China were actually allies. The split occurs when Mao's Communist Party takes over China and Chiang Kai-shek is booted off onto Formosa, which is now Taiwan.

Tom Herrick: So when you reference the CCP, the Chinese Communist Party, is that embodied literally in a chairman or is there a slightly wider group there? I think there's a lack of understanding amongst Americans as to who the leadership in China actually is, beyond just referencing it as a Chinese Communist Party.

Paul Korngiebel: Yeah, let me, if memory serves, it's something like less than one percent of Chinese nationals are members of the Chinese Communist Party. There are some very powerful families that were on the long march with Mao, the heirs to these people are called princelings. And so you have essentially a type of communist aristocracy that earns rents, economic rents, by being in the Chinese Communist Party and in the leadership. And they tend to have factions, some are hard liners, some are more open to change, etcetera. And with all political processes, it's contested and it can get pretty nasty. You're saying, Xi's corruption campaign is also one where he gets to target his political enemies. So it's a pretty rough and tumble political environment, but it is autocratic and it is a single party, and the CCP squashes dissent and any type of political opposition.

Tom Herrick: So relative to 1.3 billion people, which I believe is around the population size of China, that it's a small group of people. It's always authoritarian to some degree, narrow and rough and tumble, competitive, but within a very narrow scope.

Paul Korngiebel: Yeah, let's say you're an entrepreneur who becomes very successful, you're then co-opted and brought into the Chinese Communist Party as well. So it's very important to remember there's nothing higher than the CCP in China. And I think there are some pretty clear examples of this, you know, Jack Ma, the founder of Alibaba, was bringing ant financial public via an IPO. He mouthed off about the financial regulators – the IPO was canceled. And apparently this one came straight from the top from Chairman Xi, so CCP is number one in China.

Tom Herrick: So the leash is as long as they want it to be, basically.

Paul Korngiebel: That's a great way of putting it.

Tom Herrick: So under Xi, the current chairman, what's the nature of the competitive relationship/threat look like at this point?

Paul Korngiebel: Yeah, so I don't know the entire back story here, but my understanding is that Xi kind of squeezed his way up into the chairmanship between two competing factions. And he's consolidated his power and he's now made himself chairman for life. Historically, you would have the head of the Chinese Communist Party maybe serving two five-year terms, but Xi is more of a hard liner and he's promoting a more muscular type of foreign policy where China is flexing its new economic and political and military muscle in the Indo-Pacific. And to some extent globally, through some initiatives, one is called the Belt and Road Initiative, where he's trying to essentially develop a foreign policy that's targeted along traditional Chinese trade routes. So this friction has definitely developed after the Trump administration, I think correctly pointed out that China was not exactly engaging in free and fair trade. And I think the Biden administration is more or less picking up where the Trump administration left off on that point.

Tom Herrick: So it seems like the CCP under Xi is very, at least wants to create more of a bipolar world as opposed to, you know, what they might view as a Western-led world from the U.S.. Is that fair?

Paul Korngiebel: Yeah, well, I think it's even in the West. The French have a term for the US post the fall of the USSR, and it's called the hyper power, hyper pouvoir. And essentially that's been the case until this rise of China that we've seen, which really kicked off when China was admitted to the WTO. So their economy has been growing in leaps and bounds since ninety-three. And the issue is for China to continue its rise, which is what keeps the CCP in business, it's no longer good enough to take older Western technology and implement it in China, they need to innovate. So that's the real question. Where is China going to get its incremental gains in IP from? And then that brings us to some of the charges of IP theft from both Western Europe and the US against China.

Tom Herrick: So adversaries in the past, I think in my youth when the Iron Curtain was down, it was very clear who the adversary was. And we didn't interact a whole lot with the adversary. This relationship seems a lot more complex because it's so intertwined, not just with trade relations, but also the desire for market opportunities. I mean, anybody running a company in the US has to look at 1.3 billion consumers. If you're Proctor and Gamble, that has to look appealing, as a for instance. Is that fair? True? Not true? Or is there a more nuanced answer to that?

Paul Korngiebel: I think that's pretty spot on. The CCP, the Chinese leadership looked at the collapse of the Soviet Union and said, by gosh, we better embrace capitalism. Now, it's called socialism with Chinese characteristics. But essentially, they had a bunch of Western economists come over and say, what do we do? And there's sort of a mythology about how the economic system that's been invented is uniquely Chinese and only the CCP could pull it off. But what is it? It's as much capitalism as they can bear because capitalism requires entrepreneurs. Entrepreneurs tend to be disruptive people who like to break things and make them anew. And we often just think about entrepreneurs as business entrepreneurs. But in a much broader sense, we have political entrepreneurs, we have cultural entrepreneurs. Any place there is a need that's not being fulfilled, you have somebody who's clever and can marshal resources in an interesting way, solve that problem. You're going to get change. And what does it do? It dissipates rent seeking behavior in the economy, the worst thing you can have, and this is why you have a lot of underdeveloped countries. You have political leadership working hand-in-hand with business elites to make loads of money for themselves and suppress competition and growth. So to a lesser extent than, let's say in sub-Saharan Africa, that's happening in China. So China then has opened itself the trade, and the trading system is underwritten by essentially the United States. We use the dollar as a currency, you open up big Western markets for China, our Navy essentially guarantees free passage of goods across the world's oceans, etcetera. So, yes, it's a much more complex relationship, but the Chinese have not entered into this relationship thinking, wow, it'd be a great thing if we could eventually join the League of Liberal Democratic Capitalist Nations and have a free citizenry much like Taiwan. No, no, no. They'd like to stay in power. The CCP is on that these days, is to stay in power forever.

Tom Herrick: So all this relates to ultimately, when you think of innovation, quickly you think of technology, and then you think of - at least I think of - when you think of China US, you think of all the fights over technology, for lack of a better phrase, you know, the Huawei situation. Maybe you could comment a little bit on where these technologies overlap in between the private sector and maybe defense-related technology, dual purpose technology, commercial and military applications. It seems like that is inevitably a

point of contention going forward. Is that fair?

Paul Korngiebel: Yeah, that's definitely fair. I was just reading an interview with Joe Rutherford, who is the, or was, the chairman of the Joint Chiefs of Staff from 2015 to 2019, they're talking about using artificial intelligence and decision making in the US defense system. There's a big race in quantum computing, which would allow for decrypting pretty much anything that exists today. And so clearly, the West would like to be the first ones to develop and own this technology, I mean, think of this in the hands of Xi or Putin, or people who essentially have positioned themselves as adversaries to the US. So, there's a lot of dual-purpose technology, certainly as we keep cramming more and more software into every aspect of our life. So General Rutherford was saying that we may need more partnerships between government and industry, with government providing funding for those particular technologies in which it's most interested in, and squeezing out Chinese capital because China is happy to come over and buy up technologies in the US and in our free market system, and that's possible bring those back to the mainland. So that's definitely an access of competition. I think the industry itself, the one area where China struggles mightily and is unlikely to close the gap any time soon is in the production with reasonable yield of its own chips. They have a company there called Semiconductor Manufacturing Inc of China, something like that, it's known as SMIC. They can't compete with the Samsung's, the Taiwan Semi's, the Intel's, the AMD's of the West, and in addition, not being able to manufacture the chips, all of the equipment manufacturers who provide the equipment to actually physically make the chips, all of those are oligopoly or better niche markets that are controlled by companies that are headquartered in this, for lack of a better term, Western alliance, but it obviously includes Japan and South Korea.

Tom Herrick: So turn into that a little bit, then SMIC obviously is the mainland effort when we're talking about the semiconductor market and there's a global shortage of semiconductor chips right now, this is also in the news. We start to look at Taiwan Semi, which you mentioned earlier as being sort of a very amazing company that will eventually, I suppose, be manufacturing some in the US, but that's a ways off. It's a really important economic island and it seems like they have developed a lot of democratic institutions. Maybe you could tell us why, if I'm right, you know, why is it important economically and how that plays out a little bit more?

Paul Korngiebel: When you say plays out, meaning from a geopolitical standpoint?

Tom Herrick: Yeah, I'd like our audience to understand the importance of Taiwan Semi and also from a geopolitical standpoint, there's a lot of saber rattling that's gone on between the mainland and in Taiwan, a lot of tension. We saw last year the mainland effectively, completely co-opt Hong Kong 30 years before they were supposed to. And the West reinforced it with the Hong Kong protests with a few press releases, and that was about it. Hong Kong is not Taiwan, though, Taiwan has a self-defense force, which I believe has some substantial characteristics. So, is there an actual likelihood of a hot war there? What are the ramifications to that?

Paul Korngiebel: Ok, yeah so just a great question and just rewind a little bit. The nationalist sentiments in China have sort of been drummed into the citizenry about what's called the century of humiliation, which ended with the Chinese Communist Party unifying China 1949 and throwing out all foreigners. The US was an early guarantor of Taiwan's independence, let's say. The Chinese, the CCP views it as a renegade province. And so when the US and China had their détente, the issue of Taiwan came up and the agreement is that there will be a peaceful resolution. Now with Xi in the driver's seat, he talks about the reunification of China, which means all the bits that were sort of carved off. So Macao is the Portuguese colony where all the casinos are. There's still instructions written in Portuguese, but it is a separately administered region and it's 100% under the control of China. Hong Kong is now being what the Sino-British Joint Declaration that Thatcher signed during the handover, that's been gutted, as you rightly point out, and that leaves Taiwan. Now, if you're a citizen of Taiwan and you've seen what's happened to Hong Kongers, that's what's stirred up opposition and a sense of Taiwanese nationalism. And say, hey, we really don't want to do a deal with the CCP because we know how it's going to end up. Now, Taiwan has its own defense forces, as you rightly point out. The US helps support the Taiwanese to make the cost of a Chinese invasion of Taiwan very costly. In addition to the military aid and technology that we provide, there would be pretty serious economic and political consequences, even though I don't think the US could really, I think it would be hard to eject the CCP once they were across the straits. So that, I think would be a card that the CCP or Xi would only play if he was really threatened internally and sort of needed to whip up sort of a nationalist frenzy.

Tom Herrick: Have we seen from the Hong Kong situation last year, is there evidence of what used to be called the brain drain, are firms and or people leaving Hong Kong?

Paul Korngiebel: Yeah, oh sure. This is sort of the self-inflicted gunshot wound of running an authoritarian regime. If you're a super bright Chinese national and you're getting educated as many are in a technical subject in the West, you can return home. I think they call those sea turtles, you can stay abroad. If, let's say you have a really great idea and it's not specific to the Chinese market, it's just a sort of general technology that could be applied in any market. Which market do you benefit from monetizing your idea the most? In mainland China, subject to the CCP with weak rules of law and limited IP protection, or the much bigger market of Western Europe, United States and developed Asia, where you can get IP protection and you can live as you would like to live. So I think the West is always going to be a place where the world's talents or the developed liberal democracies are always going to be a place where the world's talents want to be, versus an authoritarian regime that squashes your dreams. So we definitely have that going for us.

Tom Herrick: So we've talked quite a bit about the tensions, the challenges, the hurdles, which there will never be a world without a certain amount of that. Despite all that, there's opportunity in China for best investment opportunity now I'm speaking to market opportunity. Maybe you could comment on the opportunity US-based investors have in China, and maybe even a little more broadly, Southeast Asia in general, which constitutes, your sort of portfolio expertise in emerging markets that constitutes a lot of the emerging market world right there. Once you get outside of Southeast Asia, the opportunity set diminishes considerably. Despite all these hurdles, does it make sense to still have exposure there?

Paul Korngiebel: Yeah, the twenty first century has been labeled by some as a forecast that it will be the Asian century. I think there's some truth to that. We see the rise of China and admittedly, the CCP and the US government have their challenges. But as you pointed out, the economic integration of the world is really quite profound and it's in no one's best interest to totally undo that. Isolated from global trade is not the road to prosperity. So I think commentators are talking about instead of Globalization 2.0, they're talking about Globalization 1.5. We just have to dial back the integration somewhat and make sure that it's instead of all out free trade, fair trade, where political constituencies on both sides of the trading are benefiting. Meaning you can't blowout US manufacturing and not have some political problems in our own country, and we can't be just handing over our amazing IP to the Chinese for nothing.

Tom Herrick: This is a very large, wide ranging topic. Paul, thanks for your perspective and insights.

Paul Korngiebel: Yeah, Tom, thanks for the opportunity. A lot of fun to talk shop with you.

Tom Herrick: Great. So I'd like to thank Paul Korngiebel and our friends at Boston Partners, and thank you for listening to the Cary Street Partners CIO Conversation Series podcast.

We'll be back with more thought leadership on a new episode next month as we strive to maintain our higher standard on the airwaves. Coming up in May, the deep dive into the revolutionary innovation in health science. In the meantime, for more information and insights, please visit our website at CaryStreetPartners.com. I'm Tom Herrick, talk to you next time.

Past performance is no guarantee of future results. The investments discussed may not be suitable for all investors. Investors must make their own decisions based on their specific investment objectives and financial circumstances. Additional information is available upon request.

Any opinions expressed or implied herein are subject to change without notice. The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to buy any security or instrument or to participate in any trading strategy.

Global/International investing involves risks not typically associated with U.S. investing, including currency fluctuations, political instability, uncertain economic conditions and different accounting standards.

Cary Street Partners is the trade name used by Cary Street Partners LLC, Member FINRA/SIPC; Cary Street Partners Investment Advisory LLC and Cary Street Partners Asset Management LLC, registered investment advisers.