Key Questions January 11, 2021

Have US-Chinese Relations Morphed into a Financial War?

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Deciphering the executive order ban on Chinese companies linked to the military.

On November 12, 2020, President Trump issued an executive order limiting investment in companies deemed by the Department of Defense (DoD) to either directly or indirectly benefit the Chinese military. The order was designed to limit investors who might unwittingly funnel financial capital to the Communist Party's military wing, the People's Liberation Army.

Since the order's enactment, asset managers, index providers, and US financial exchanges have scrambled to interpret the order and to determine appropriate compliance initiatives. While short-term market effects should be small and confined to the named companies, longer-term implications could include the further deterioration of US-China relations.

The order states that US persons may not open either long or short positions in securities of those companies on the restricted list once 60 days have elapsed since the company was identified as a Communist Chinese Military Company (CCMC). Full divestment should ensue within one year. To date, the DoD has listed 35 companies that fit their definition of a CCMC, representing mobile phone manufacturing, chip processing, telecommunications, oil production, construction, and aerospace industries.

January 11, 2021 was the final date that positions could be initiated in those companies on the original list, and Veteran's Day 2021—November 11—will be the date on which the order assumes full divestiture. Affected companies have the right to appeal the classifications, but to date none have done so. It is also possible that a future executive order rescinds the current investment restrictions.

In the nine weeks since the order's issuance, market index providers and US exchanges have worked feverishly to gain clarity on the order and its ramifications. Language in the order was vague regarding whether companies that hold beneficial interests in the restricted companies would also become restricted themselves.

A strict reading of the order could have led to US asset management firms, traditional mutual funds, and ETFs falling under the order's provisions because of small equity positions in Chinese companies on the DoD's restricted list. In such a draconian interpretation, ownership of even one share of a restricted company would poison the entire fund for investors.

But this is not the case.

In a clearly worded answer to a frequently asked question, the Office of Foreign Asset Control (OFAC) under the US Department of the Treasury unequivocally stated on January 6 that US asset managers are not required to fully divest banned securities until the 365-day deadline, or November 11, 2021, for the first batch of restricted companies. It also stated that US persons are permitted to transact in funds that hold such securities.

Until the clarification was issued, market participants were confused as to the path to pursue moving forward. The venerable New York Stock Exchange performed a full 360-degree turn, first issuing guidance that it would delist three Chinese phone carriers listed on its exchange as American Depositary Receipts (ADRs), then backtracking

and providing guidance on a continued listing, and then reversing course again after speaking with the relevant authorities — all in the span of a single week. As of January 11, 2021, major index providers MSCI, S&P, Morningstar, and FTSE have removed restricted securities from relevant benchmarks. It was a seamless transition.

While the fundamentals of near-term compliance seem clear, assessments of potential longer-term effects are undergoing their own evolutionary process. Not only has volatility increased in the securities, so too has the rhetoric between the United States and China. A cold war has already been raging on intellectual property and technology — a main element of trade tariffs and sanctions between the two nations over the past two years — and now financial market restrictions may lead to a second front in that cold war. This is something we addressed in a previous Key Questions article. China's foreign ministry spokeswoman said that the order is meant to hinder competition with US firms and will limit the order of global financial systems; she also warned that China will enact necessary countermeasures to protect companies if appropriate. The rhetoric continues.

When access to financial markets is used as a weapon, the confidence in such markets deteriorates. Any company could become a target for action, which would inherently make investing more volatile. There has to be reliability and confidence in the system itself. Many asset managers have spoken out on such restrictions, believing that the market should be a neutral entity where tides of confidence and skepticism battle for supremacy each and every day.

At Key Private Bank, we will continue to monitor compliance with the executive order and be proactive where appropriate about navigating potential market volatility. We will monitor longer-term effects and may make tactical asset allocation changes to combat changing sentiment.

For more information, please contact your Key Private Bank Advisor.

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