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# GEMOLOGIST

Banning Huawei: an act of economic war

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For more than a year, the US and China have been embroiled in a bitter trade war, which is now centred on Chinese telecommunications company Huawei. The world's dominant 5G company has been blacklisted by the Trump administration after being charged with stealing trade secrets and violating US sanctions, spurring US technology companies to cut it off from vital supplies. In this issue of *Gemologist*, we ask: is this a tactic in protracted trade negotiations, or the outbreak of an economic war?

As long-term investors in Chinese companies, we ask ourselves: is the Trump administration's move to blacklist Huawei a tactic in ongoing trade negotiations, or the outbreak of an economic war? To us, severing Huawei from currently irreplaceable suppliers in the US does not appear to be a tactic aiming to establish fairness in trade between the two nations, but an assault by the world's incumbent superpower on its only true strategic opponent. It's likely that this rivalry won't end in a trade deal, if one eventuates. It will endure and shift to other strategic theatres; it is the geopolitical conflict of our times.

In late May, China's weighting in the MSCI EM index rose by 2% to 34%, and two further increases are scheduled for this year. We have already discounted the effects US tariffs will have on the Chinese stocks we own. Looking further ahead, we aim to understand the impact that a protracted economic war between the world's incumbent and challenger powers will have on these companies, and the economic and political systems they operate in.

In the Q1 2019 issue of *Gemologist*, we assessed the strategic rivalry between the US and China, and why it is driven by the desire of both countries for technological supremacy. The Huawei ban is consistent with this theme. With the trade war escalating into an economic war, we continue to look ahead to anticipate the impact on Chinese companies and the world they operate in.

## AMERICA FIRST: TRUMP'S APPROACH TO TRADE

In his inaugural speech as US President, Donald Trump said: "We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs. Protection will lead to great prosperity and strength." His commitment to protectionism – which extends back to the 1980s, when he believed that Japan and Germany's economies were benefiting at the expense of America's – has not wavered since he took office in January 2017. He has delivered on campaign promises of withdrawing from the Trans-Pacific Partnership, renegotiating NAFTA, and imposing tariffs on Chinese imports.

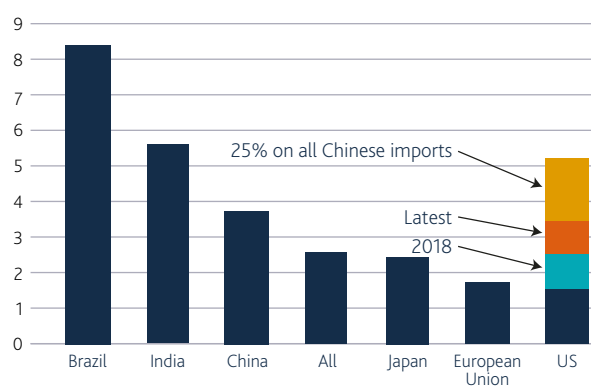
The US launched an investigation into Chinese trade practices in 2017. Since then the two nations have been locked in a trade battle: the US argues that China's trade surplus with the US is the result of unfair practices, and that China is stealing intellectual property from US firms. In April this year, talks to end the trade war broke down and reports suggest that the US added new demands – such as opening up China's internet to US businesses – in the late stages of the negotiations, which would directly impact China's political and social stability<sup>1</sup>. Since then, both sides have escalated tariffs: the Trump administration hiked tariffs

## KEY POINTS

- As long-term investors, we look beyond the effects that US tariffs will have on the Chinese stocks we currently own and analyse the impact of an economic war on these companies.
- Huawei is a true technology leader in 5G technology, but its future is at risk after the US Government effectively cut the company off from its American suppliers, which are currently irreplaceable.
- The Chinese companies we are invested in do not have significant exposures to Huawei, nor is this news likely to prevent the global rollout of 5G, limiting the impact on our portfolio in the short term.
- We are more concerned about the long-term geopolitical implications of the Huawei ban: the Trump administration's entrenched distrust of Chinese technology and resolve to block the rise of the emerging power, potentially drawing the two countries in to the Thucydides Trap of economic or even armed conflict.

to as high as 25% on \$200bn worth of Chinese goods, while China retaliated by placing tariffs on \$60bn worth of US goods. This, compounded by the by the blacklisting of Huawei, has caused relations between the two nations to deteriorate further.

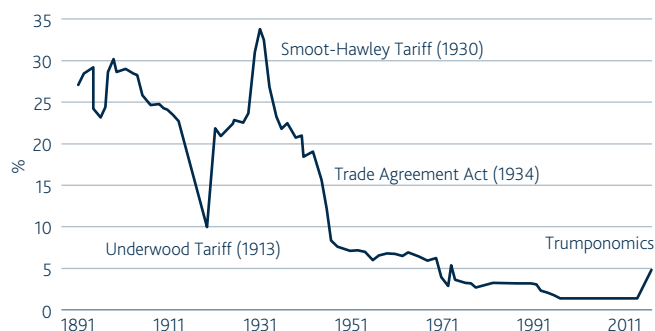
Figure 1. US tariffs in context: weighted mean tariff, 2017



Source: World Bank, Datastream, TS Lombard as at May 2019

<sup>1</sup> "Was this the moment US-China trade talks fell apart," published by the South China Morning Post on 28 May 2019.

**Figure 2. US tariffs: back to the future? Ratio of US duties collected to dutiable imports**



Source: TS Lombard as at May 2019

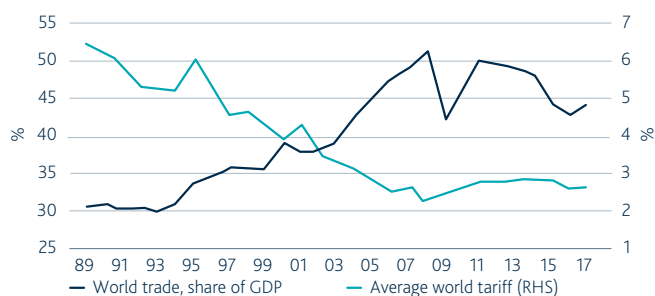
True to his word, Trump has not only targeted China. He has also cracked down on trade practices in Canada, Mexico and the European Union (EU), invoking doubtful national security concerns to impose tariffs on steel and aluminium imports and threatening to do the same with car and auto-parts imports from the EU and Japan. Given his track record of delivering on protectionist promises, the likelihood that car imports will be hit with sanctions is high.

### Global impact

The Organisation for Economic Cooperation and Development (OECD) predicts that economic growth in both the US and China could be 0.2%-0.3% lower on average by 2021 and 2022 if the two countries fail to settle their trade dispute. According to the OECD's biannual Economic Outlook, the global economy could grow this year at its slowest pace since 2016 (3.2%) as estimates suggest that growth in trade flows will almost halve to 2.1%<sup>3</sup>. An increase in tariffs, which would reverse the overall trend since the mid-1990s, would weaken global trade and therefore economic output worldwide (see figure 3).

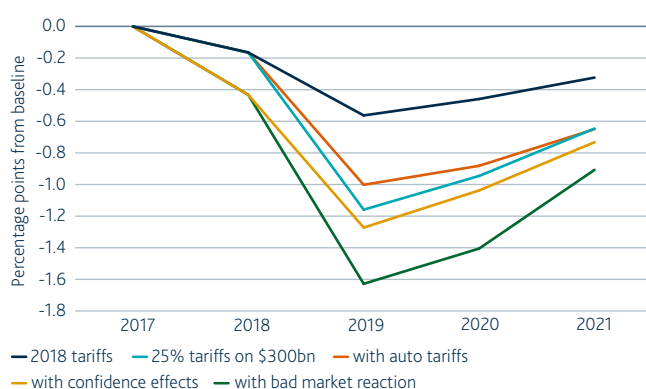
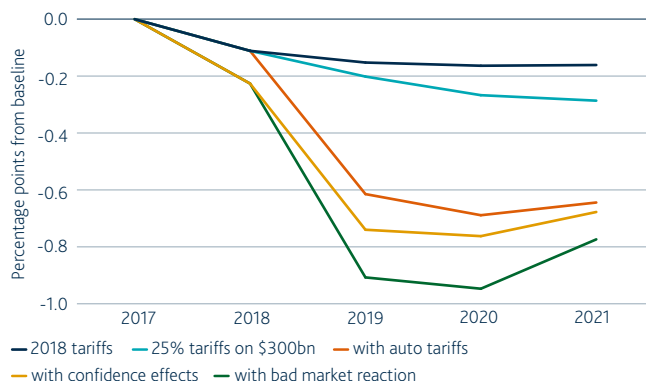
A number of international institutions have attempted to measure the impact of the US-China trade spat on the global economy. Simulations by the International Monetary Fund (IMF) suggest that if a full-blown trade war erupted – resulting in high tariffs across industries, sanctions and blacklistings not only of companies, but sectors – it would cause a global recession. It estimates that such a scenario would see GDP declines of almost 1% in the US and 1.6% in China (see figure 4)<sup>2</sup>. The model employed by the IMF assumes large spill-over effects to financial markets and confidence levels, which other models are unable to capture.

**Figure 3. The impact of tariffs on global trade**



Source: TS Lombard, based on OECD and World Bank Data, as at May 2019.

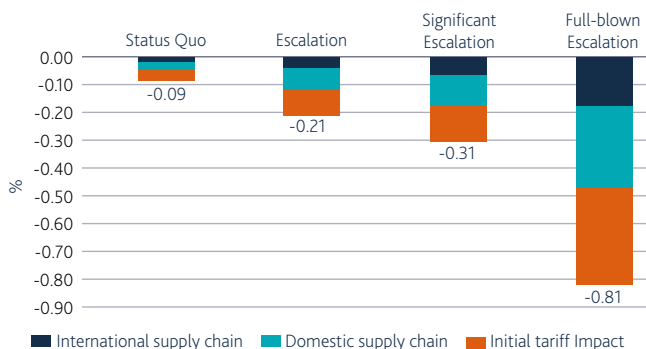
**Figure 4. US v China trade war: macroeconomic simulations**



Source: TS Lombard, IMF World Economic Outlook as at October 2018.

Studies by other institutions have focused on the impact of tariffs (see figure 5). They suggest that foreign producers have not absorbed the costs of the new US tariffs by reducing their margins. This finding is significant: Trump's tariffs have increased US customs revenues, but much of the burden has fallen on Americans. The US government appears to have taxed Americans rather than putting the cost on China. In addition, import prices rise due to the introduction of tariffs, which could potentially stoke US inflation and weaken GDP.

**Figure 5. A full-scale US-China trade war would threaten the global economy: estimated impact on global GDP**



Source: Morgan Stanley as at May 2019.

<sup>2</sup> "World Economic Outlook 2019," published by the IMF in April 2019.

<sup>3</sup> "Trade uncertainty dragging down global growth," published by the OECD in May 2019.

## HUAWEI AND THE US: SUPPLY-CHAIN WARS

Huawei is a Chinese national champion and a true leader in its field. It is the fifth-largest R&D spender in the world (and the only Chinese company in the top 10). The company is considered to be the frontrunner in building high-speed 5G networks around the world – and the absence of a major US alternative to foreign suppliers of 5G equipment underscores Huawei's growing dominance.

The US, concerned that its technology will be used by the Chinese government to conduct espionage or to otherwise undermine its national security, moved to isolate Huawei from key US suppliers in May. It placed the company on the so-called 'entity list' – which means American businesses cannot do business with it without obtaining a licence from the US Commerce department. The action came after Huawei was charged with stealing trade secrets and violating US sanctions. The ban will come into effect in mid-August, following a three-month reprieve to allow US companies to manage the disruption.

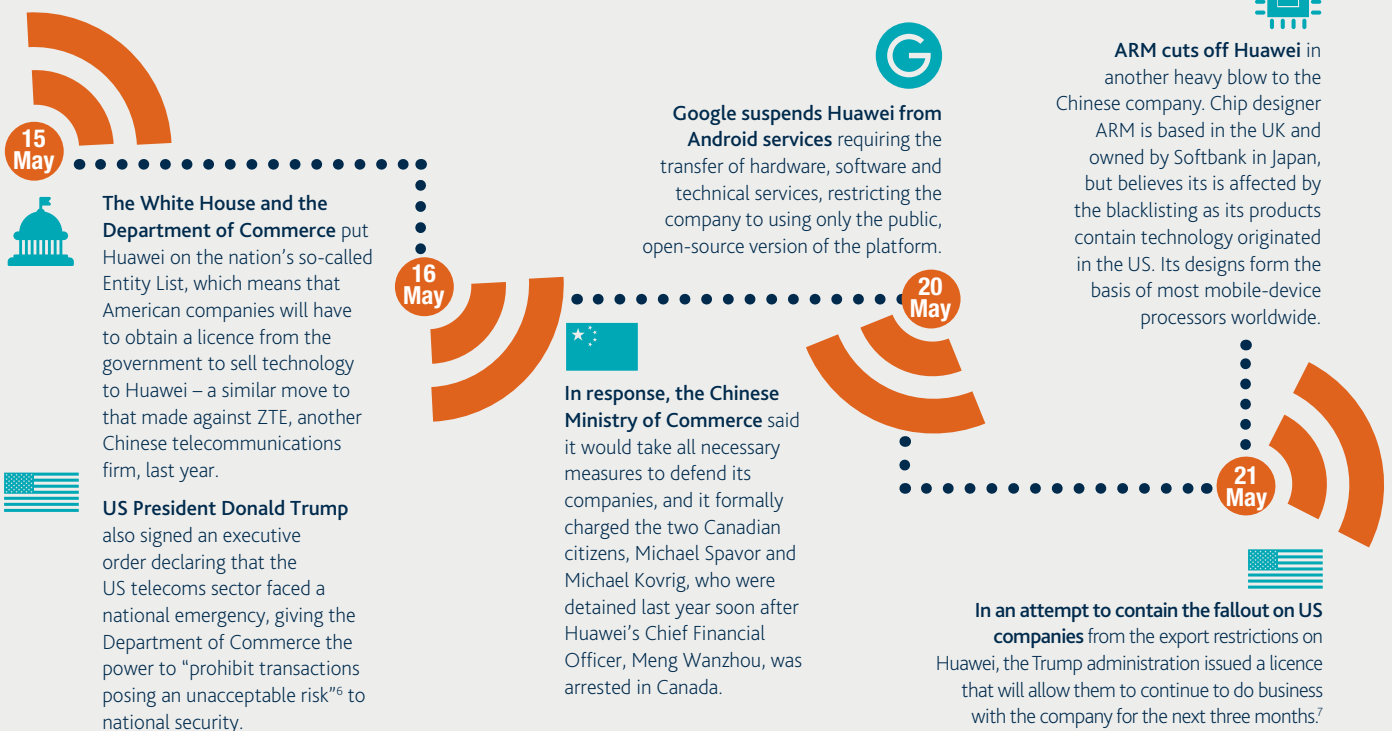
In the weeks that followed the ban, it became clear that Huawei had suffered a loss of access to critical US suppliers of cyber-security technology and semiconductors – including Qualcomm, Xilinx, Broadcom and Google's Android operating system. More broadly, the move is set to impact about 1,200 US suppliers to the Chinese telecoms group<sup>4</sup>. It is understood that the US's move was not a complete surprise to the company: reports suggest that it spent about \$11bn last year to stockpile components and services from US suppliers. According to Dang Wenshuan, the company's Chief Strategy Architect, "it is a huge impact, but not a crisis, because we have been preparing for this since a long time ago".<sup>5</sup>

We estimate that US companies comprise one-sixth of Huawei's suppliers, and that it procures about \$16bn worth of goods and services from these firms. It is difficult to know how irreplaceable they really are. The stockpile includes about six-to-seven months' worth of smartphone inventory and nine-to-12 months of 5G base-station inventory, according to estimates from CLSA. The company will add to this inventory during the 90-day period before the ban comes into force. This will limit its immediate vulnerability, but its long-term future is uncertain. Despite these preparations, Huawei boss Ren Zhengfei has said that revenues are expected to slow by 20% as a result of the ban. Orders for Asian suppliers are being cut.

The blacklisting has the potential to bring down the world's 5G frontrunner. US companies are inextricably involved in the global technology supply chain, and reconfiguring Huawei's so that it no longer relies on US firms and finds new suppliers from Japan, Taiwan, the EU or other countries will be difficult (but, given time, not impossible). Given Huawei's status in corporate China, it will likely receive government support, but its long-term viability depends on its ability to reduce its reliance on US technology by expediting R&D and further diversifying its supplier base. Already, reports suggest that Huawei is preparing to find alternative suppliers by the time the ban comes into effect in mid-August, while its semiconductor unit, HiSilicon, has been designing chips similar to those it buys from US firms.

### Huawei's blacklisting: the story so far

By effectively cutting Huawei off from key US suppliers, the Trump administration has intensified its efforts to restrict the 5G-technology leader's ability to participate in worldwide auctions. At the time of writing, the key events were as follows:



<sup>4</sup> "Huawei warns ban set to hurt 1,200 US suppliers," published by the Financial Times on 29 May 2019.

<sup>5</sup> "Huawei warns ban set to hurt 1,200 US suppliers," published by the Financial Times on 29 May 2019.

## US-CHINA ECONOMIC WAR: AN INVESTMENT RESPONSE

We count 5G networks – along with the artificial intelligence, robotic process automation and the internet of things – as a major emerging-markets investment theme, and our exposure includes Taiwanese companies within Huawei's supply chain. In our view the short-term implications for our portfolio are easier to ascertain, and less severe, than the long-term impact of an US-China economic war and geopolitical rivalry.

### Portfolio implications

Since the blacklisting, there have been negative stock-price moves for companies throughout the Huawei supply chain, including some of our holdings. However, the businesses we are invested in do not have significant exposures to Huawei, and they do not face heightened structural risk as we do not think a ban on Huawei by the US and its allies will stop the global rollout of 5G in its tracks (at worst, it will simply be delayed).

We have analysed our real exposure to the Huawei ban. There are five Taiwanese companies in our portfolio with direct sales exposure to the firm. Two companies – Taiwan Semiconductor Manufacturing Corporation and Chipbond – have revenue exposure of between 5-10% to the firm. One company, Landmark, has a slightly larger exposure but is a small position in our portfolio.

Huawei's US suppliers of optical components, Finisar and Lumentum, source epitaxial wafers from Landmark, and this will stop after the ban comes into force. However, Landmark also supplies the same or somewhat more advanced solutions to clients such as Accelink and

Innolight in China, who are likely to become suppliers for Huawei. Although Huawei has always preferred US suppliers to their Asian counterparts, Accelink and Innolight can provide similar solutions in optical components and base solutions to Huawei. Such a shift in suppliers would be positive for Landmark.

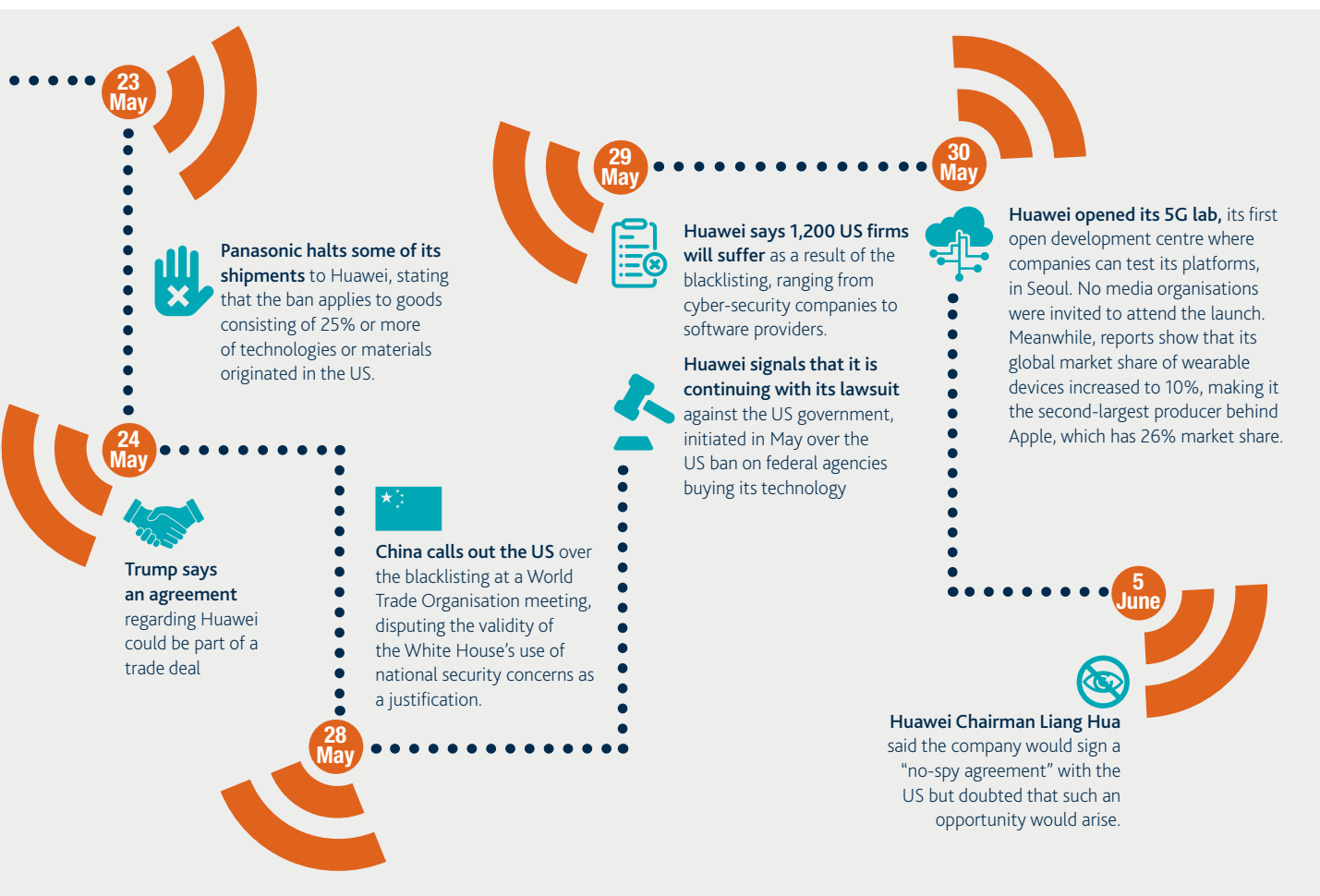
More broadly, the seeming inevitability of the rollout of 5G means that if these companies do not sell components to Huawei, they will likely supply them to whichever firms secure the contracts that Huawei would have won.

Investors should also note that the Chinese equity sell-off caused by the Huawei ban has driven the market's price-to-earnings multiple down to its long-term average of about 11.4x, providing valuation opportunities.

### It's not about trade

Trade policy may have been an instrument used to strike at Huawei, but the White House's actions were not part of the US's trade war with China. Its motives were driven by an entrenched distrust of Chinese technology firms on national security grounds. This, in turn, is a feature of its intensifying rivalry with an increasingly powerful and influential China.

The above does not represent all of the securities held in the portfolio and it should not be assumed that the above securities were or will be profitable. This information does not constitute a solicitation or offer to any person to buy or sell any related securities or financial instruments.



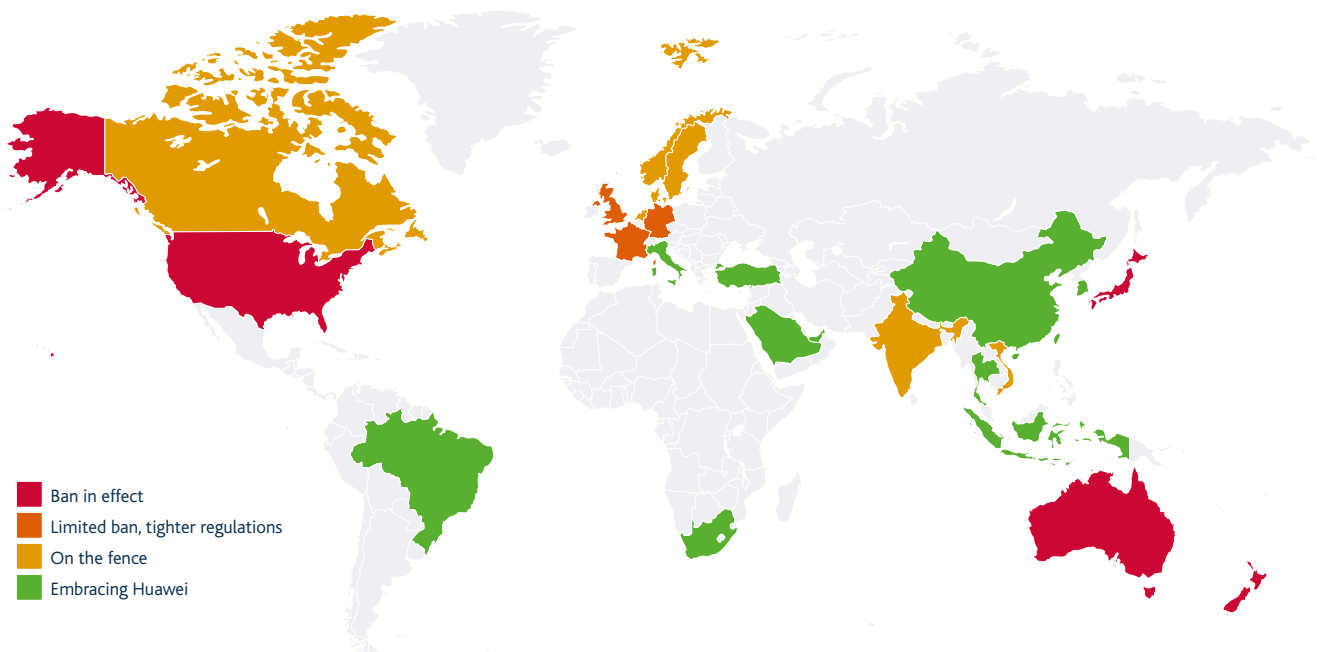
<sup>6</sup> "Statement from the Press Secretary," published by The White House on 15 May 2019.

<sup>7</sup> "Trump grants temporary reprieve for Huawei ban," published by the Financial Times on 21 May 2019.

We are sceptical that the ban has anything to do with increasing US leverage in the trade talks – the US already has plenty of levers through tariffs, and striking a Chinese national champion will, if anything, make China less willing to come to the table. The real motivation seems to be the distrust of many in the US government who have long felt Huawei to be a security concern due to its allegedly tight links with the People's Liberation Army and Chinese intelligence services<sup>8</sup>. They now believe the risk to be unacceptably high given Huawei's leadership in 5G network technology. It's possible that Washington will make further efforts to stem the flow of technology from the US to China by enforcing investment restrictions, export controls, and limits on visas for tech-oriented students and workers.

Seeing Huawei as a strategic threat, the US aims to cripple the company or at least prevent it from installing networks in allied or friendly countries. To date, full Huawei bans are in effect in Australia, New Zealand, Japan, Taiwan and, of course, the US. In Europe, where Huawei already provides one-third of telecommunications systems, the UK has proposed excluding the firm as a supplier of core parts for its new 5G network. Germany and France aim to increase security regulations rather than enforce an outright ban. Several other countries, such as Sweden, the Netherlands and Denmark, remain undecided, whereas Italy and the Czech Republic are allowing the firm to compete (see figure 6).

Figure 6. Approve or block? Which countries have banned Huawei?



Source: Bloomberg, Statista as at May 2019.

## WHY THE US-CHINA TRADE WAR IS AN OPPORTUNITY FOR TAIWAN

Kunjala Gala, Co-Portfolio Manager,  
Hermes Global Emerging Markets

We visited Taiwan on a recent research trip, finding the country caught in the crossfire of the US crackdown on Huawei and rivalry with China, and assessed the investment landscape.

### US-China trade war: a sweet spot for Taiwan

As tensions between the US and China continue to escalate, Taiwan has found itself – more so than other economies – with some delicate decisions to make. The Taiwanese economy relies heavily on global trade, and the US and China are its top two trading partners.

We see two trends emerging, both of which are promising for the island nation:

- The US will increase its dependence on Taiwan. To avoid tariffs, US companies will move their production or supply chains out of China to Taiwan-based firms. Already, several suppliers have facilities in Taiwan – such as Accton, Advantech and Delta.
- Similarly, China will become more reliant on Taiwan as the US denies Chinese companies access to critical technology supplies. Some of these technologies are available in Taiwan. For Taiwanese companies that export to China, there is a risk that Taiwan could give in to American political pressure and ban exports of certain technologies to the mainland. However, TSMC, the world's largest contract chipmaker, has made it very clear that the technology is very much their own – not the property of the company's country of origin.

<sup>8</sup> "What makes China telecom Huawei so scary?" by Sheridan Prasso. Published in Fortune on 28 July 2011.

Opportunistically, the Taiwanese government started an 'Invest Taiwan' campaign last year in an attempt to attract companies to the country amid escalating US-China trade tensions.

### Huawei fallout: crisis or opportunity?

The Trump administration's assault on Huawei has further impacted the investment landscape in Taiwan. Taiwanese companies continue to supply components to Huawei. As far as they are concerned, it is business as usual, but they are monitoring the situation.

- 1 Huawei has a roughly 50% share of the telecommunications equipment market in China. While ZTE is still reeling from the export ban the US imposed and subsequently rescinded in 2018, other local players such as Fiber Home remain active. Huawei's Chinese competitors – such as smartphone makers Oppo, Vivo and Xiaomi – are keen to regain lost market share, and Samsung, Ericsson and Nokia will also aim to advance their interests. As such, the rollout of 5G should continue regardless of whether Huawei survives the US blacklisting.
- 2 The majority of Taiwanese companies have diversified customer bases and therefore do not face existential crises on the back of the Huawei ban. Most are confident of being able to shift to Huawei's competitors due to existing supply relationships. The only risk here is execution, as relationships with Huawei will not always be smooth and filling the gap with competitors will likely be delayed as Huawei digests inventory before demand from new buyers ramps up.

- 3 Most Taiwanese suppliers are therefore not heavily dependent on China for their revenues and generate substantial income from overseas operations including those in the US and Europe. A number of companies in Taiwan possess critical technologies, such as silicon photonics (Landmark), gold bumping and chip-on film (Chipbond), advanced logic nodes (TSMC) and switching technology (Accton) that are difficult to replicate. This puts them in a strong position, as they also benefit from long-term secular drivers such as cloud computing, 5G, artificial intelligence and high-performance computing.

### In demand: Taiwanese tech

Amid the poor sentiment caused by the Huawei crisis, short-term volatility in the Taiwanese market is inevitable. However, from a medium-term perspective, the challenges faced by its technology companies are not insurmountable. Some firms are moving up the value chain by focusing on solutions, platforms and software applications rather than components alone. In many cases, Taiwanese technology is unique, and in other cases of equal quality to that produced in Japan. In a few cases, it can substitute for American technology – such as Mediatek mobile's system-on-a-chip being used instead of Qualcomm for 4G and 5G applications. The Chinese have achieved expertise in back-end testing and memory but lack cutting-edge semiconductor equipment and manufacturing capabilities – making Taiwan a critical source of supply in the current geopolitical climate.

## BEATING HUAWEI: A PHYRRIC VICTORY?

If the US cuts off all exports of semiconductors and components to Huawei, we think it is likely that the company will struggle, even with state support. But this outcome might be too costly for America given that Huawei is a big revenue source for US technology firms, which comprise the strongest sector of the S&P 500. In the short-term, businesses like Intel, Qualcomm and Nvidia, which generate much of their revenues from sales to Chinese firms, will be less profitable.

The long-term implications will play out beyond the nation's borders. To assess them, the Huawei crackdown needs to be seen in the context of the starkly different trade policies that the US and China are implementing. Xi Jinping's Belt and Road initiative is gaining traction beyond Asia and Africa. Italy has become the first G-7 country to join China's international investment and development programme, joining fellow EU members Portugal and Greece in the process. In contrast with

Trump, who is advancing a protectionist agenda, Xi brings investment and cooperation. This will support the expansion of Chinese influence, and will support, over time, the emergence of the renminbi as a reserve currency, undermining US financial superiority on yet another front. If the US continues with its economic campaign, in time the Huawei crackdown could prove to be a hubristic move.

The US might have found the Achilles heel of Huawei. But the crippling of a Chinese national champion is likely to backfire, spurring China to redouble efforts to achieve its strategic aim: regaining economic, political and cultural pre-eminence as the 'Middle Kingdom'.

Today, trade wars are a policy response to rising inequality and populist desires for wealth redistribution. We will examine these underlying phenomena in the next issue of *Gemologist*.

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