The Recentralization of China

Many themes and trends are influencing markets and the global economy. These themes include COVID and COVID variants, central bank policy, and stimulus bills (just to name a few). One theme in particular that is occurring is the "recentralization" of China, for lack of a better word. That recentralization sometimes sparks immediate market responses, like the recent crackdown on Chinese internet companies did, but there also are longer-term implications. While the **delinking and recentralization** is occurring slowly, it is occurring nonetheless and is going to reshape the global economy. We will demonstrate that this trend has been in place for some time and seems to be accelerating. If China is following this path, not only will the global economy change, but some allegedly "temporary" changes may be permanent in nature.

This month's Around the World with Academy Securities addresses China, **China and Cyber**, **China and Afghanistan**, as well as growing tensions between **China and NATO**. The Geopolitical Intelligence Group also analyzes Russia and Cyber, Nord Stream 2, Iran and the JCPOA, Haiti, Cuba, and the Sahel Region in Africa, but I wanted to highlight the importance of China in this month's report.

Where is Orwell When You Need Him?

I've chosen the terms "delinking" and "recentralization", but I'm sure there is an Orwellian word that would better describe what we are seeing. Not only would an Orwellian word be great, but it would have the advantage of driving my editors crazy. I'd insist on using a word that isn't technically a word, which they'd grudgingly agree to use. But, for today, no small victories for me and we are stuck with the inadequate phrase of "**delinking and recentralization**", but you get the gist of just how inadequate this is. We will demonstrate the steps China has already taken and what comes next.

Who is John Galt? Where is Jack Ma?

I always enjoy spending time with Art Cashin, but I'll never forget how excited he was when Jack Ma came to ring the NYSE bell and while a media circus followed Jack around, all he wanted was a picture of himself with Art. Pretty cool if you ask me. But where is Jack Ma? We could talk about the Chinese crackdown on Chinese internet related companies in so many ways, but **just asking "where is Jack Ma?" might be the simplest way to express an entire series of events and consequences.** You can search for him under Google Trends and see just how effective China has been at making him irrelevant.

We can also see what has gone on by comparing KWEB vs the Nasdaq 100 (KWEB is the KraneShares CSI China Internet Fund, which is a $5 billion fund, that, to be perfectly honest, wasn't even on my radar screen until recently, but it demonstrates there is an ETF for everything). Speaking of which, someone filed an ETF with the ticker SARK to short ARK stocks/funds, but that is a story for another day. **Since February, when the crackdown started in earnest, the difference between KWEB and the Nasdaq is shocking**. It got even worse after the DiDi U.S. listing and steps taken by the Chinese government thereafter.

The Domestic Recentralization

These are some key steps we've seen taken and where we think they lead to:

- **Mobile Facial Recognition**. We can start with September 2019, when China created rules to ensure that people accessed their mobile devices with facial recognition. This wasn't done for the ease and convenience of their citizens. This also wasn't done to ensure their AI and machine learning teams had enough data to enhance their capabilities (though it was probably a side benefit). It was done so that the authorities could **ensure that mobile users were who they said they were**. **Control and identification**.
- **Crypto Mining**. We fast forward to 2021, (but I'm sure I missed a lot of events between enforcing facial recognition and the crackdown on bitcoin miners). Is China really that concerned with the energy used by crypto miners and motivated by conservation? China is embracing sustainability and decided that crypto mining was the main culprit. It would be nice to believe this, but since China added three times as much coal power plant capacity as the rest of the world combined in 2020 (according to Reuters), that doesn't ring entirely true. Let's say, on the other hand, that the biggest "use" case for crypto (that is legitimate) is that people in a country with a distrust for centralized power want money outside the system. That would seem to fit China well. **The halting of crypto mining is likely just one step that China will take in its efforts to squeeze Chinese citizens out of crypto**. It is difficult to control things outside of the "system" so you do what you can to force people into the system. I think that we are going to see multiple steps taken regarding this in China (hence, why despite the recent Amazon job posting and the Cathy/Elon/Jack podcast runup, I'm increasingly bearish on bitcoin). **Control and identification.**
- **Digital Yuan**. China is launching the digital yuan under the auspices of helping the unbanked and facilitating commerce. Seems plausible, though it is pretty easy to point out that if I'm correct and China would like to squeeze people out of crypto, they probably **wouldn't mind seeing a cashless society**. As the crypto proponents often point out, cash (or "fiat") is another favorite choice for criminals and a way to evade authorities on taxes. So, why not **squeeze from both ends?** It may be coincidental that Alipay and WeChat Pay were becoming the de facto "currency of choice" for domestic commerce as the digital yuan was introduced (*cough* *cough*, I don't think so). **Control and identification.** I highly recommend reading the short "Parachute Pants and Central Bank Money" speech by Fed Vice-Chair for Supervision Quarles. While he discusses a Fed Coin and seems to support stable coins, I think, if you read between the lines, that he might be hinting at what he doesn't like about the digital yuan (okay, maybe I've gone full "tin foil hat", but read it with that in mind and I bet you'll agree).

In the end, we could focus on the recentralization in so many ways, but I think these three bullet points are a good start and give us a clear direction of what to expect – **a controlled and identifiable economy and payment system.** For now, this is **largely domestic**, but the digital yuan could further help China in their push for more global acceptance of the yuan (which we've discussed in terms of SDR's, central bank reserve lobbying, and even futures trading of oil and gold in Chinese currency). I'm not going to bring up **the "R" word** here, but the topic of reserve currency status will likely come up with more frequency in the coming years.

These are trends that we as investors and corporations need to be thinking about and preparing for.

Tariffs, the Trade War, and "Bottlenecks"

I will never forget how many economists came out against tariffs on China. Almost all economists were against tariffs. Virtually every economist that advises the Democrats was very vocal about how bad tariffs were. I'll highlight Krugman, mostly because he is so visible, but also because you can **search for Krugman Tariffs** and after getting a barrage of hits, you will realize that apparently, he has no opinion on tariffs since the election. It is almost mind boggling how the haters have become very quiet now that the Biden administration has chosen to retain the tariffs. **I was okay with tariffs, because unlike many economists, I feel that we have been in a trade war for 20 years or more, but only one side was firing live ammunition (and it wasn't us).**

We have come a long way since Academy published "A D.I.M.E. Framework for China, Trade, & Strategic Competition" in 2019. We are in a "trade war" whether we like it or not (again, I'd argue that we were in a trade war long before we accepted it, but I won't belabor that point).

The most important news last week was Biden proposing to strengthen Buy American policies. We get a lot of pushback on why manufacturing would come back to America. We argue, repeatedly, that there are two reasons manufacturing comes back to America:

- **Government spending can be easily directed to buy American.** Medicare and defense spending can be redirected fairly easily. In an era where deficits don't seem to matter, spending can be directed more easily, even if it costs more. Add to that, with the realization by everyone that medical equipment, supplies, and pharmaceuticals are crucial to national security (when pandemics are a risk), you have a path to spending more to manufacture these things domestically (or at least with strong allies and close neighbors). Add in the infrastructure bill and look for the government to focus on **building** and **making** in America (a direct "attack" against China and why this trade war is far from over).
- **ESG.** I continue to believe that as ESG investing matures, **supply chain attribution will become one of the top talking points**. Scrutiny of suppliers (and the countries where they are based) will become a bigger consideration than it already is. As ESG investors scour companies for suppliers that don't treat workers well (or pollute), there will be some negative headlines that I suspect will favor domestic manufacturing and maintain the trade war.

The trade war is alive and well, and is being fought by both sides now.

Delinking

I didn't address bottlenecks in the previous section because I think it is a crucial question that hinges on where you think China is in terms of their economic focus.

If China is becoming more focused on their domestic economy, expect bottlenecks to continue.

I believe that the pendulum has shifted in China and that they are moderately more domestic driven than export driven.

- **The Alaska Summit**. As virtually every member of the GIG stated, Xi's attitude was dramatically different than anything they've seen from him or any Chinese leader in a long time. He basically said their way was working better than our way!
- **Currency appreciation**. China is looking to quell raw material inflation, because they import so much, and a stronger currency helps that more than it hurts exports.
- **Outsourcing**. China is already outsourcing low value-added production to other nations. That would seem to be a move that would dovetail well with a domestic focused economic shift.

China will still export, but maybe, we should start assuming that some bottlenecks are more than just temporary.

Ironically, with the fact that there is global consensus being built around trade and other areas with China, will they feel more compelled to delink than when it was a more unilateral approach? Unintended consequences?

Food

More and more frequently, food and agriculture are becoming an issue and this is one area where the U.S. has a clear advantage over China. Our ability to feed ourselves is far superior to China's. How that plays out, I'm not yet sure, but it is something we need to be thinking about as we figure out how trade with China resolves itself.

Still Vital

China is and will remain an important trading partner. That is not going to change any time soon. But how that relationship evolves (and staying ahead of the curve) will be crucial to the success of investors and companies. What I think we should be preparing for:

- **National Security Focused Trade.** National Security, whether high tech or basic healthcare needs, will influence trade.
- **A Controlled Internal Environment.** China will exert more control and influence domestically than they appeared to recently. The Communist Party will reassert itself in Western eyes as being dominant (that was never lost on the populace of China, but may have been lost on outsiders looking in).
- **Tariffs for Agriculture?** I see a path where we free up trade, for now, on anything not linked to national security while getting a ready market for our agricultural production.

There are opportunities in the very near future if I'm correct, but it is also time to make sure your policies surrounding China reflect the risk that China is delinking and recentralizing.

Disclaimer

This document and its contents are confidential to the person(s) to whom it is delivered and should not be copied or distributed, in whole or in part, or its contents disclosed by such person(s) to any other person. Any party receiving and/or reviewing this material, in consideration therefore, agrees not to circumvent the business proposals explicitly or implicitly contained herein in any manner, directly or indirectly. Further, any recipient hereof agrees to maintain all information received in the strictest confidence and shall not disclose to any third parties any information material to the opportunity contained herein and, upon review hereof, agrees that any unauthorized disclosure by any party will result in irreparable damage for which monetary damages would be difficult or impossible to accurately determine. Recipients recognize, and hereby agree, that the proprietary information disclosed herein represents confidential and valuable proprietary information and, therefore, will not, without express prior written consent, disclose such information to any person, company, entity or other third party, unless so doing would contravene governing law or regulations.

This document is an outline of matters for discussion only. This document does not constitute and should not be interpreted as advice, including legal, tax or accounting advice. This presentation includes statements that represent opinions, estimates and forecasts, which may not be realized. We believe the information provided herein is reliable, as of the date hereof, but do not warrant accuracy or completeness. In preparing these materials, we have relied upon and assumed, without independent verification, the accuracy and completeness of all information available from public sources.

Nothing in this document contains a commitment from Academy to underwrite, subscribe or agent any securities or transaction; to invest in any way in any transaction or to advise related thereto or as described herein. Nothing herein imposes any obligation on Academy.

Academy is a member of FINRA, SIPC and MSRB. Academy is a Certified Disabled Veteran Business Enterprise and Minority Business Enterprise and is a Service Disabled Veteran Owned Small Business as per the US SBA. Investment Banking transactions may be executed through affiliates or other broker dealers, either under industry standard agreements or by the registration of certain principals.