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Outside the Wire Will China Unite America?



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“America is more polarized than ever.” Imagine receiving a dollar every time you heard that phrase. If I had a dollar, I would have been quarantined on a yacht in the Caribbean. But last I checked dollars were not being handed out for offhanded political observations. Just my luck...

To say American politics is polarized is the understatement of all understatements. It is not news. So, the headlines should be blaring when there is finally an issue that finds bipartisan support. The headline should shout “CONSENSUS REACHED” in all caps.

America’s political leaders are finding that moment of consensus with respect to the People’s Republic of China (PRC) led by the Chinese Communist Party (CCP). Investors across multiple asset classes should take notice. In fact, they should lead the charge especially as environmental, social, and governance (ESG) gains steam. Unfortunately, ESG scores are too narrow and do not account for the issues that we focus on as we observe the geopolitical landscape. Nevertheless, we will wade into a few recent areas of consensus and discuss possible investment ramifications.

Consensus Topic #1 – China and American Higher Education

The news is reporting extensively on the case of Rep. Eric Swalwell (D-Ca). The short version is that an [Axios story](#) broke that Rep. Swalwell was the target of Chinese intelligence operatives. Specifically, a Chinese national named Fang Fang gained access and influence with Swalwell and his office.



Illustration: Sarah Grillo/Axios

The media is interested in the political intrigue behind the story and building it into the WWE-style storyline of Democrat vs. Republican. But, in the backdrop is the real story of Chinese Communist Party intelligence making inroads into American higher education and government. A quote from the *Axios* article speaks to that:

“The case demonstrates China’s strategy of cultivating relationships that may take years or even decades to bear fruit. The Chinese Communist Party knows that today’s mayors and city council members are tomorrow’s governors and members of Congress.”

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Where is the consensus? House Speaker Nancy Pelosi (D-Ca) responded to the Swalwell incident with concern about the Chinese: “In terms of their undue influence at Universities in our country and their overtures they try to make to members of Congress.” She also added, “I have been fighting them for 30 years.”

Those comments came no later than a day after Secretary of State Mike Pompeo spoke at Georgia Tech and stated, “Americans most know how the Chinese Communist Party is poisoning the well of our higher education institutions for its own ends and how those actions degrade our freedoms and American national security.”



A lecture hall at Baruch College, NYC/Wikipedia Image

As we survey the landscape of higher education, there are some helpful numbers to consider. Over 1 million international students study in the United States every year. Roughly one third of those students are from China. In the book *Stealth War* by Brigadier General Robert Spalding (USAF-Ret.), he estimates that there were 350,000 Chinese students studying in the U.S. in 2017. In his book, General Spalding goes on to assume that based on an average tuition cost of \$30,000 per student, the amount of revenue for higher education can be estimated around \$10 billion each year. Additional revenue can be generated to the municipalities that surround these colleges and universities.¹

We have seen where the effects of the COVID-19 pandemic have negatively impacted higher education. Drexel Hamilton has been involved in many bond offerings throughout the year in which investors have questions about the credit quality of these higher-ed issuers. If the federal government were to restrict Chinese students for national security reasons, we can see an adverse impact on these issuers. However, the most likely scenario will be trying to vet Chinese students for ties to Chinese intelligence and pressuring schools to protect research and intellectual property.

Nevertheless, this points to a growing and important tension between the capital markets- both investors and issuers- attracted to China’s market opportunity and the growing consensus among both political parties that China is a serious national security threat.

One final item to note, according to Secretary Pompeo, the number of U.S. students that studied in China was only 11,000 last year.

Consensus Topic #2- De-listing Chinese Companies

The U.S. House of Representatives recently passed the Holding Foreign Companies Accountable Act, and the legislation is pending President Trump’s signature. The bill received bipartisan approval. It is designed to enforce SEC requirements that all listed companies must register and have their audits verified by the Public Company Accounting Oversight Board. Chinese companies to include Alibaba (ticker: BABA) have not had to comply. The reason is that the Chinese government does not allow foreign entities to conduct these audits on Chinese companies. Congress is taking notice and calling it a double standard.



Michael Nagle/Bloomberg Image

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We have noted the trend of Chinese companies moving back to exchanges in Hong Kong and Shanghai especially as regulatory scrutiny intensifies. As *Barron's* magazine noted in a recent edition, the number of U.S.-listed Chinese companies currently stands at 200 with 100 listed exclusively in the U.S. This represents a total market value of \$2 trillion.

This does not speak to other issues that we see developing over time and deserving scrutiny. What about U.S.-based asset managers and investors buying Chinese companies on Chinese exchanges that are working directly against our national security interest? For example, China Shipbuilding Industry Company Limited, which is listed in Shanghai, is a company that is in the business of making navy ships and military equipment that will be used by the PLA. At what point, will Congress begin to take a long look at the U.S. based asset managers that hold positions in a company that is working directly for China's military?

We can also think of this in terms of ESG as this issue goes beyond China- U.S. relations. Consider China's territorial claim to the South China Sea. This claim has been rejected by the UN Convention of the Law of the Sea (UNCLOS) and was re-affirmed in July by the State Department. China's violation of the rules based international order through a false territorial claim should be a violation of the "G" part in governance.



Photo Illustration/ISTOCKPHOTO

What type of ESG score would a Chinese company receive when they are working to build navy ships that will be used to violate international law? At what point will American investors look at their portfolios and realize that these companies are incompatible with ESG standards? Or will Congress eventually force their hand?

How did we reach consensus?

There are a few issues that have tipped the balance and brought the political parties together in 2020. First, China's human rights abuses against the Uighur Muslim population has been one catalyst to bring the two parties together in condemnation. Second, both parties have found common cause in opposing China's actions with respect to Hong Kong.

Finally, while President Trump took unilateral action with respect to trade and tariffs, the philosophy and motivation behind this action is something that both sides have long felt needed to be addressed. We see the objections to President Trump's actions being more about method and style rather than the underlying issue. That is more a critique of means than ends.

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All told, we see consensus building around the notion that the PRC has not been a fair actor, and America has been playing checkers while the CCP has been playing chess. We believe that a tipping point has been reached in 2020. In terms of how assertive an incoming Biden administration might be remains to be determined. But we see Republicans remaining aggressive on the issue. To the extent that human rights abuses gain attention and revelations of Chinese espionage against politicians like Swalwell make the news, we see Democrats having a hard time not joining them. All told, cue the headline because it seems the PRC could be put in the crosshairs as one of the few target issues that could unite an otherwise divided Congress. Wall Street should take notice.



Photo Illustration/ISTOCKPHOTO

ⁱ Spalding, R. S., & Kaufman, S. (2019). *Stealth war: How China took over while America's elite slept*. New York: Portfolio/Penguin.

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