M.M.WARBURG & CO
BANK

ECONOMIC SITUATION AND STRATEGY

28 October 2022

After the Party Congress in China: Recommendations for Investors, Companies and Policymakers

Under Mao, public humiliation and political purges were part of the standard political toolbox before somewhat more civilised methods of political decision-making found their way into Chinese social life. But that seems to be over now, if one takes the carefully orchestrated and meticulously planned CP Party Congress as a symbol that a different wind is finally blowing. And those who did not see it should urgently recollect what happened in particular at the closing ceremony of the CP Party Congress: here, before the eyes of strangely puppet-like deputies and the world public (but not before the eyes of China's citizens), the former Chinese president Hu Jintao was led away to make it clear once again that even the slightest and most subtle criticism of the leader will no longer be tolerated.[1]

In the spectacle staged there, it is not clear to the viewer all the time what is more serious: The message obviously sent to foreign countries that we are dealing with a ruthless regime that implements its goals with military precision and is prepared to mercilessly break down even internal resistance? Or simply the iciness with which the comrades present simply let the event happen?

If this event had not taken place in the plush communist setting of the Great Hall of the People, which is somewhat out of date in terms of design, it would almost have passed for a scene in a James Bond film in which the villain kills his last (actually quite cautious and even quite harmless) critic before the villain strokes the small white cute cat.

But why such a long and somewhat politically charged introduction? Well, at the moment political considerations about China cannot be separated very well from economic considerations. We are experiencing a turning point that goes far beyond what we are seeing in Ukraine. More and more autocratic states are developing into neo-imperialist states organised according to the leader principle. And while in Germany the German government's strategic planning rarely has a time horizon that goes beyond the next upcoming state election (i.e. about three months), in countries like China, Russia, Iran, North Korea and Turkey (to name just a few examples) a strategic view is gaining ground that thinks in terms of decades and unwaveringly implements precisely these strategies step by step with harshness, patience and sometimes even violence.

Germany, on the other hand, stumbles through world affairs with a bona fide naivety that almost makes one drool. No wonder that Emmanuel Macron and ultimately the entire EU Commission despair of the German government and that many people from Warsaw to Washington wonder whether parts of the German government have perhaps smoked a little too much themselves in a field trial on marijuana legalisation. And perhaps smok-

[1] CHINAS NEUER MAO: Xi Jinping setzt sich beim Volks-kon-gress knallhart durch - Gegner gedemütigt - YouTube

ing intoxicating substances is still far too harmless an explanation or excuse for the spectacle presented to the German public. For how else could one explain that after the disaster with Russian operators of German gas storage facilities and the suspension of Russian gas deliveries, the next dependency is being pushed through by the federal government in a night-and-fog action against the will of ministries, federal authorities, secret services and friendly states by selling part of the port of Hamburg to China. By the way, it should be noted that, to make matters worse, parts of the opposition parties are indifferent to the deal or even positively inclined towards it. It is exasperating.

Of course, it could be argued that the buyer is not China, but a Chinese company. The same argument was used by the German government at the beginning of the year to show why the state should not interfere in the private sector Nord Stream 2 project (but perhaps this is no longer so well remembered). Now we have the salad. Moreover, no one should believe that the shipping company Cosco Shipping is a normal shipping company. Because Cosco ships supply Chinese warships on the world's oceans with supplies, and when the annexation of Taiwan is practised in manoeuvres, Cosco ships are also often involved. It would be interesting, by the way, to examine China's entry into the port of Hamburg from the point of view of sustainability, but that is a completely different matter.

In general, it is absurd to believe that contracts can be made with private, independent companies when these companies are based in neo-imperialist countries. In such countries, companies have one main purpose: to increase the fame, power and honour of the ruling party and to bring the whole country forward economically, even if some business activities, viewed in isolation at the company level, make no economic sense at all. Here, companies and their actions are always part of a big plan for decades, while in Germany we only think about the turnover and profits of the next quarters.

The fact that economic dependencies can be used and deployed more and more as a weapon seems to be still not really understood by anyone. And this despite the fact that we have been able to experience quite vividly for over three years now, in the context of the Corona pandemic, what it means when established supply chains collapse and alternative supply chains do not exist. German politics - but also part of the German economy - does not seem to want to really build up a learning curve.

A respected colleague commented on the Chinese partial purchase of the port of Hamburg as laconically as aptly with the following statement: "This is now our Nord Stream 3". And so Germany lurches awkwardly from one embarrassment to the next, while the USA, for example, has recognised the writing on the wall and is drawing its conclusions. The latest example: Tough China export restrictions on high-value semiconductors and semiconductor manufacturing machinery, as well as the ban on US citizens from assisting in the production and development of Chinese semiconductors. But even the smallest countries like Denmark, Estonia, Latvia or Lithuania now have a much more mature relationship to the new reality than Germany, which seems to be moving somnambulistically in the political sleeping car.

As a reader, you are probably somewhat surprised at this point to be allowed (or forced, depending on your point of view) to read such clear words. And indeed, one is not used to such commentary in Germany. But how could it be otherwise? As an economist of a bank or a strategist of an asset manager, you would have to be pretty crazy to make such statements if your employer is either partly owned by a Chinese company or if part of your business is done with China. And so an estimated 70% of all possible economists and strategists now drop out as commentators on this matter.

Even at universities there is now an unhealthy self-censorship of statements in order not to endanger joint research projects and their financing. And who, as a board member of a company, will find such clear words when they would like to continue doing good business in China for the next 18 months? This brings us to the next problem: we completely close our eyes to what it means for the freedom of opinion and expression when we are economically too closely interwoven with neo-imperialist countries.

There is no question: there can be no simple "business as usual". It is time to face the new realities. The sooner, the better. We must finally understand that free trade and free action between companies will only ever lead to positive social welfare effects if the resulting dependencies are not used as a weapon. For this reason alone, too great dependencies should be avoided anyway. This is especially true for dependencies on countries that explicitly do not share our values. And so, in view of this turning point, we take the liberty of giving financial investors, companies and politicians some unfiltered recommendations for action - completely free of any conflicts of interest and a misunderstood, noble restraint that serves no one.

Recommendations for financial investors

Not so long ago, positions in Chinese equities or bonds were perfectly normal in asset management portfolios. This picture has changed quite significantly in the last 18 months. Constant government intervention in the business models of various Chinese companies has led to irritation among investors, which in turn has led to a reduction in China quotas. In the meantime, however, the Chinese stock market is so favourably valued that, at least taking into account classical valuation characteristics, a renewed entry seems sensible. And in relation to some individual stocks, the valuation is now so low that a buy seems almost compellingly logical. And yes: Those who rely on this logic may be happy to try their luck and may even be able to generate performance in the short term.

Basically, however, the following applies: structurally, one can no longer invest in Chinese shares and bonds. After all, what on earth would be a discount on valuation ratios in order to be able to take into account recurrent state intervention in entrepreneurial activity in a sufficiently meaningful way? The honest answer is: nobody knows. It has always been a little ambivalent and perhaps even schizophrenic to hold securities retained by companies from a communist state. But now the point has come where it is not only ambivalent or schizophrenic, but structurally more than problematic.

Our advice would therefore be to refrain completely from new investments and to successively reduce existing investments to zero over the next few quarters and depending on the timing of price movements. And then never to build up again as long as China functions as it currently does.

Recommendations for companies

It is a largely open secret. When a large German company wants to increase sales or production in China, the following happens: The Chinese government demands that, as part of the deal, the company's research be moved to China for a specific purpose. The IT infrastructure of the new research centre is then designed in such a way that Chinese industrial espionage is no longer particularly difficult. Nobody wants to know that exactly, and people like to look the other way, but that's how it works. For board members who still have to hold out a few quarters until the end of the contract, such an approach may be a propitious means of maximising short-term profits. For shareholders it is a different story. The value of a company is not measured by the profits of the next ten quarters, but rather the next ten years. Such an approach seems more than dubious. Therefore, companies are well advised to comprehensively weigh up to what extent they want to expand their business with China at all.

This is also true against the background of the fact that China will be less and less of an engine of global growth in the coming years - GDP growth rates are now too low for that. In addition, China's share of world trade has long since reached and passed its maximum - if only because people in other parts of the world do not act as naively as in Germany, but proactively implement alternative trade flows and supply chains. Companies that rely on China as a sales and production market are betting on the wrong horse in any case. An increasingly communist and militaristic country with an ever more intimidated and monitored population and an ever less pluralistic formation of opinion under the thumb of a dogmatic and ideological leader elected for life is hardly in a position to maintain an above-average high factor productivity.

Even if one disregards all other problems: China will lose its economic attractiveness in the medium term. If only because there is hardly a country in the world that will experience such a strong population decline in the coming years as China. Those who bet on China are betting on yesterday's winner.

Recommendations for policy-makers

The mistakes that have been made can hardly be healed. Now it is important not to make any more mistakes, at least not in the future. Therefore, from now on, politicians must ask themselves the question in every economic interaction with China: Does this interaction affect Germany's strategic interests? Could this interaction result in a strategic disadvantage for Germany and Europe? Do facts arise from this interaction that could even be used actively and directly against Germany and Europe? Admittedly, we have completely forgotten how to ask such questions. And we have forgotten even more to answer this question consistently and honestly and without romantic transfiguration of problems. So here is a small case study to help us. Let's start with the energy transition.

Germany has decided to pursue ambitious climate targets while at the same time decommissioning the last three of its former 18 nuclear power plants next year. That this was in itself a crazy idea can be seen from the fact that we would already have reached the ambitious climate targets of 2030 if the nuclear power plants had simply continued to run - but that is another topic. Now the decision has been made, and solutions must be sought. The solution is to build about 50,000 massive wind turbines (and massive hydrogen storage facilities) - if you don't believe it, it's comparatively easy to do the maths yourself; all you need is intermediate maths.

A very large modern and efficient wind power plant today consists of about 7,000 tons of concrete, steel, copper and plastic.[2] To put that into perspective: The Eifel Tower weighs almost exactly 10,000 tons and thus only slightly more than such a wind turbine. So from now on we will have to build several Eifel towers day after day (for many, many years) in terms of material consumption. Again: several Eifel towers day after day, for very many years.[3]

The demand for steel, but especially copper, rare earths, precious metals and plastics seems almost limitless here. Now guess who we are implicitly counting on here for supply? You guessed it. It will not work. This is the next dependency that will be our undoing. As a state, Germany must learn to enter into strategic raw material partnerships with various countries, just like any other country, instead of naively outsourcing this issue and the associated tasks and capabilities to China.

Outsourcing of research projects should also be strictly reconsidered from now on. Here is another concrete practical example for better illustration. At the renowned Max Planck Institute of Colloids and Interfaces in Potsdam, a process has been developed that can massively improve soil quality at high speed using artificial humic substances. What at first sounds interesting to the nonprofessional, but not earth shattering, actually has revolutionary potential. If it were possible to apply artificial humic substances to agricultural land on a large scale, it would be possible to compensate for the loss of soil quality due to the lack of sustainable crop rotations. Soil quality would quickly increase significantly, so that artificial fertilisers could increasingly be dispensed with.

But even better: a healthy soil with a lot of humus formation can also store enormous amounts of CO_2, so that this technology would make a real, noticeable contribution to the reduction of CO_2 in the atmosphere in a nature-friendly and even nature-improving way (especially with regard to biodiversity). Now guess in which country the open-air experiments are taking place that are testing this process on a large scale? You guessed it, China again, of course. Not because German researchers have an excessive interest in doing research in China. But because German authorities obviously did not recognise the potential of this approach and in fact had not even allowed field trials for quite absurd reasons.

There are two reasons why one has to scratch one's head here. Firstly, because German authorities are unable or unwilling to recognise economic and ecological potentials due to technical deficits and successful praise efforts by certain circles. On the other hand, because these developments with enormous potential are then allowed to happen in China with a shrug of the shoulders.

So here's my advice to politicians: Stop dreaming! If we keep losing capabilities to China and unilaterally increase dependencies, we will end up in disaster. Recent developments, however, suggest that politicians have not even

[2] Enercon E-126 6.000 - 6,00 MW - Windkraftanlage (wind-turbine-models.com)

[3] The calculation looks as follows. Germany will need about 655 TWh of electricity in 2030 (BMWi increases forecast for gross electricity consumption in 2030 - IHK Lippe zu Detmold). Under perfect conditions, an installed capacity of one gigawatt can produce two terawatt hours of electricity per year. Assuming that 75% of the required power would be generated by wind power, this would amount to 490 TWh of electricity. At first glance, this would require about 245 GW of installed capacity. In order to produce this, about 40,000 huge turbines of the type Enercon E-126 6000 with an installed capacity of 6 MW (as an example!) would be necessary.

But this is a milkmaid's calculation. This calculation underestimates the fact that in 2030 (or even more clearly in 2040) there will be no more gas-fired power plants available as back-up in slack periods. This means that additional hydrogen would have to be produced for slack periods if we do not want to turn every valley in every low mountain range in Germany into a reservoir with a pumped-storage power plant. It is very difficult to estimate the amount of wind power plants that would be needed, since the efficiency of hydrogen production is likely to increase in the coming years. However, it is probably not entirely wrong to estimate at least (!) 10,000 more very large wind turbines. This would bring the total to 50,000 massive wind turbines. It is often argued that this calculation does not take into account the existing 30,000 wind turbines. However, it should not be forgotten that the majority of these wind turbines have a very low output (often only 1 MW) and are so old that they will have to be replaced within the next 20 years. The figure of 50,000 wind turbines to be built in the coming decades is therefore very plausible.

begun to understand their responsibility. And yet it is actually already five minutes to twelve. One wonders what still has to happen for something to change.

Market data

Stock marktes	As of 28.10.2022 08:18	Change versus 21.10.2022 -1 week	27.09.2022 -1 month	27.07.2022 -3 months	27.10.2021 -1 year	31.12.2021 YTD
Dow Jones	32033	3,1%	9,9%	-0,5%	-9,7%	-11,8%
S&P 500	3807	1,4%	4,4%	-5,4%	-16,4%	-20,1%
Nasdaq	10793	-0,6%	-0,3%	-10,3%	-29,2%	-31,0%
DAX	13211	3,8%	8,8%	0,3%	-15,9%	-16,8%
MDAX	23941	4,5%	7,2%	-9,6%	-31,6%	-31,8%
TecDAX	2846	4,0%	7,2%	-6,3%	-25,4%	-27,4%
EuroStoxx 50	3605	3,7%	8,3%	-0,1%	-14,6%	-16,1%
Stoxx 50	3509	2,8%	5,4%	-2,8%	-4,2%	-8,1%
SMI (Swiss Market Index)	10707	2,8%	5,7%	-3,2%	-11,4%	-16,8%
Nikkei 225	27105	0,8%	2,0%	-2,2%	-6,8%	-5,9%
Brasilien BOVESPA	114641	-4,4%	5,8%	13,0%	7,8%	9,4%
Russland RTS	1106	5,2%	5,0%	-4,2%	-41,5%	-30,7%
Indien BSE 30	59947	1,1%	5,0%	7,4%	-2,0%	2,9%
China CSI 300	3571	-4,6%	-8,3%	-15,5%	-27,1%	-27,7%
MSCI Welt	2524	2,5%	5,0%	-5,7%	-19,9%	-21,9%
MSCI Emerging Markets	859	-0,6%	-3,6%	-13,2%	-33,0%	-30,2%
Bond markets						
Bund-Future	140,26	514	312	-1590	-2928	-3111
Bobl-Future	120,56	212	205	-655	-1385	-1268
Schatz-Future	107,22	52	58	-266	-489	-481
3 Monats Euribor	1,58	92	92	166	213	217
3M Euribor Future, Dec 2017	2,18	-9	-17	0	272	2
3 Monats $ Libor	4,37	2	73	157	425	416
Fed Funds Future, Dec 2017	4,15	-3	12	0	407	3
10 year US Treasuries	3,96	-25	-1	123	243	246
10 year Bunds	2,01	-42	-23	113	219	219
10 year JGB	0,25	0	-1	11	16	18
10 year Swiss Government	1,08	-25	-40	54	123	122
US Treas 10Y Performance	573,10	2,4%	0,5%	-8,7%	-17,3%	-18,0%
Bund 10Y Performance	551,00	4,2%	2,6%	-8,7%	-16,8%	-16,8%
REX Performance Index	436,99	1,6%	-0,4%	-6,5%	-10,8%	-11,0%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	3,35	-41	-12	140	298	287
IBOXX BBB, €	4,74	-40	3	160	397	387
ML US High Yield	9,03	-47	-50	98	430	413
Convertible Bonds, Exane 25	6412	0,0%	3,1%	-3,1%	-22,0%	-21,7%
Commodities						
MG Base Metal Index	376,67	3,1%	4,2%	-0,9%	-16,6%	-18,3%
Crude oil Brent	96,01	2,7%	11,3%	-9,9%	13,4%	22,5%
Gold	1658,51	1,0%	1,4%	-3,4%	-7,5%	-9,0%
Silver	19,52	2,2%	5,2%	4,6%	-19,1%	-16,1%
Aluminium	2279,02	4,1%	8,9%	-6,2%	-14,5%	-18,8%
Copper	7838,25	1,5%	5,6%	2,8%	-18,9%	-19,5%
Iron ore	92,81	-2,2%	-6,0%	-12,6%	-24,2%	-17,5%
Freight rates Baltic Dry Index	1612	-11,4%	-10,8%	-19,7%	-57,7%	-27,3%
Currencies						
EUR/ USD	0,9966	2,4%	3,3%	-1,8%	-14,2%	-12,0%
EUR/ GBP	0,8636	-1,6%	-3,3%	2,7%	2,1%	2,9%
EUR/ JPY	146,01	-1,1%	4,8%	5,1%	10,6%	12,0%
EUR/ CHF	0,9888	0,3%	4,1%	1,2%	-7,3%	-4,3%
USD/ CNY	7,2377	0,1%	0,8%	7,1%	13,2%	13,9%
USD/ JPY	146,29	-0,9%	1,0%	7,1%	28,5%	27,1%
USD/ GBP	0,87	-3,2%	-6,6%	4,3%	18,9%	17,4%

Source: Refinitiv Datastream

Carsten Klude
+49403282-2572
cklude@mmwarburg.com

Dr. Rebekka Haller
+49 40 3282-2452
rhaller@mmwarburg.com

Martin Hasse
+49 40 3282-2411
mhasse@mmwarburg.com

Dr. Christian Jasperneite
+49 40 3282-2439
cjasperneite@mmwarburg.com

Mark Simon Landt
+49 40 3282-2401
mlandt@mmwarburg.com