China – U.S. Phase One Deal

Embracing new relationship in the new decade

After rounds of tenacious negotiations, China and U.S. finally signed the "historic" and enforceable "Economic and Trade Agreement" (Phase One Agreement) that requires commitments from both parties to address long-standing concerns such as intellectual property, technology transfer and currency, trade barriers, and etc. China shall also purchase an extra of US$ 200bn U.S. goods and services in the upcoming two years.

- **First milestone.** The Deal contains seven chapters, including intellectual property, technology transfer, trade in food and agricultural products, financial services, macroeconomic policies and exchange rate, expanding trade and bilateral evaluation and dispute resolution. We believe enforcement of the deal will act as the first milestone of China-US relationship in the new decade, which features simmering tariff chaos but intensified competition in almost all arenas as well as fragile confidence. Although economic rationale shall dominate to mutually benefit the two parties, we need to be prepared for deviations from that rationale from time to time, upsetting hard-earned business confidence.

- **Import expansion from U.S. to China.** The US$ 200bn increment through a two-year window encompassing manufactured goods (US$ 78bn), agriculture products (US$ 32bn), energy (US$ 52bn) and services (US$ 38bn). Targeted increment would imply challenging and much higher growth rates for U.S. imports than historical trend. We think the commitment is easier to achieve for some categories of goods, such as farm products, given China's high import dependence on soybeans and agriculture supply structure of the two nations being more of complements than substitutes. For other categories, such as manufactured goods and energy products, however, maneuvered increase could prove more difficult. Services import growth could be driven by financial services, fees for use of IP, cloud services and etc.

- **Challenges in implementing the Deal.** To China, risks could involve 1) trade expansion causing disturbance to global trade flow and supply chain; 2) more intensive and international competitive landscape expediting elimination of weaker players; 3) institutional and cultural differences, or other unresolved issues.

- **Technology decoupling prevails. Cooperation remains delicate.** Although both parties agree to carry out scientific and technological cooperation "where appropriate", the U.S. remains alert to China's progress in technological innovation. The Deal prohibits state-supported or directed outbound foreign direct investment activities aimed at acquiring foreign technology in sectors targeted by its industrial plans that create distortion. Business environment could continue to be tense while cooperation should be handled with delicacy.

- **Follow-up details and timetables to focus on.** Phase One Agreement also specified timetable or deadline for certain commitment to be fulfilled within 30/60/90 days after date of entry. Financial services open-up marks 1 Apr 2020 as a deadline for slashing foreign equity cap or business scope limitations. Also, investors should follow future phases of negotiations between the two countries to address unsettled issues.

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Intellectual property – mutually beneficial

The IP chapter benefits both parties, to help secure a level playing field and to foster innovation. The chapter addresses long-standing concerns in the areas of trade secrets, patents and pharmaceutical-related intellectual property, geographical indications, trademarks, and enforcement against pirated and counterfeit goods. We believe these high-standard provisions will bring mutual benefits to both parties over the long term with to stay competitive. Robust and steadfast protection of IP is critical to incentivizing innovation.

Other IP issues will be addressed in future negotiations. While pharmaceutical-related IP infringement are touched upon in this deal, regarding establishing early resolution mechanism for patent disputes and patent term extensions in compensation for delays, other IP issues will be addressed in future negotiations, including those with respect to data protection for pharmaceuticals, unauthorized camcording of motion pictures, and copyright protection for sporting event broadcasts.

Actions to address IP infringement will be taken, for example, 1) regarding the online environment against e-commerce platforms that fail to take necessary measures against IP theft; 2) against counterfeit pharmaceuticals and related products; 3) against IP theft that creates health and safety risks from counterfeit products such as semiconductors, automobile parts, apparel, footwear, toys and cosmetics; 4) to ensure government agencies and SOEs only use licensed software. China shall publish work guidelines and implementation plans *within one month* after date of entry into the agreement. We believe these expeditious and effective actions may bring short-term pressure to certain names of industries and companies.

Technology transfer

Specifically,

1) Prohibit technology transfer as a condition for market access, administrative approvals and etc.
2) Prohibit state-supported or directed outbound foreign direct investment activities aimed at acquiring foreign technology in sectors targeted by its industrial plans that create distortion.

Financial services – expand mutual opportunities

China shall commit to expanding opportunities to a wider scope of U.S. financial institutions via,

- **Eliminating foreign equity cap** for U.S. i) securities companies, ii) suppliers of life, health and pension insurance, iii) fund management companies, iv) futures companies by 1 Apr 2020.

- **Expanding business opportunities** for U.S. financial services providers, for example, to allow U.S. banks to supply securities investment fund custody services, and to grant provincial-level licenses to acquire non-performing loans directly from Chinese banks.

- **Removing discriminatory regulatory requirements** and processes.

The U.S. also affirms that 1) current pending requests by Chinese institutions, including those by CITIC Group, China Reinsurance Group, and CICC, will be considered expeditiously; 2) it accords non-discriminatory treatment to Chinese rating services providers and electronic payment service suppliers, including UnionPay; 3) it allows Chinese financial institutions to acquire non-performing loans in the U.S.

Figure 1: Open-up of financial services sector

	China	U.S
Banking Services	·China will expand opportunities for U.S financial institutions, including bank branches, to supply securities investment fund custody services by taking into account their global assets when they seek licenses ·China will take into account the international qualifications of U.S firms when evaluating license applications for Type-A lead underwriting services for corporate bonds in China's bond market	·U.S affirms it will consider expeditiously pending requests by Chinese institutions, including by CITIC Group
Credit Rating Services	·China will continue to allow U.S credit rating service suppliers, including wholly U.S owned suppliers, to rate all types of domestic bonds sold to domestic and international investors ·China will allow U.S credit rating service suppliers to acquire a majority ownership stake in the supplier's existing joint venture	·U.S affirms it accords non-discriminatory treatment to China credit rating service suppliers ·U.S will allow China credit rating service suppliers to acquire a majority ownership stake in the supplier's existing joint venture
Electronic Payment Services	·China will ensure a timely licensing process for U.S suppliers of electronic payment services	·U.S affirms it accords non-discriminatory treatment to China electronic payment service suppliers, including UnionPay
Financial Asset Management (Distressed Debt) Services	·China will allow U.S financial services suppliers to apply for asset management licenses that would permit them to acquire non-performing loans directly from China banks, beginning with provincial licenses ·China will treat U.S financial services suppliers on a non-discriminatory basis when China resumes issuing new national licenses	·U.S will continue to allow Chinese financial services suppliers to engage in acquisition and resolution of non-performing loans in U.S
Insurance Services	·By 1 Apr 2020, China will remove foreign equity cap for U.S suppliers of life, pension, and health insurance services ·By 1 Apr 2020, China will remove all discriminatory regulatory requirements and processes in all insurance services sectors, and will expeditiously review and approve licensing applications	·U.S affirms it will consider expeditiously pending requests by Chinese institutions, including by China Reinsurance Group
Securites, Fund Management, Futures Services	·By 1 Apr 2020, China will eliminate foreign equity limits and allow wholly U.S owned services suppliers to participate in the securities, fund management, and futures sectors ·China will ensure that U.S suppliers are able to access China's market on a non-discriminatory basis, including in regard to review and approval of qualified license applications	·U.S affirms it will consider expeditiously pending requests by Chinese institutions, including by China International Capital Corporation

Source: Phase One Agreement, CMBIS

Expanding trade – phenomenal growth in 2020/21

China committed to US$ 200bn additional purchases and imports from the U.S. During the two-year period from 1 Jan 2020 to 31 Dec 2021, China shall ensure that imports from the U.S. of manufactured goods, agricultural goods, energy products, and services identified in an attached list exceed the corresponding 2017 baseline amount by no less than US$ 200bn. However, detailed breakdown of increment within each category of products were not disclosed for a myriad of concerns.

Figure 2: Increase in U.S. exports to China over two years (2020-2021)

in US$ bn	Year 1	Year 2	2-Year Total
Manufactured goods	32.9	44.8	77.7
Agriculture	12.5	19.5	32
Energy	18.5	33.9	52.4
Services	12.8	25.1	37.9
Total	**76.7**	**123.3**	**200**

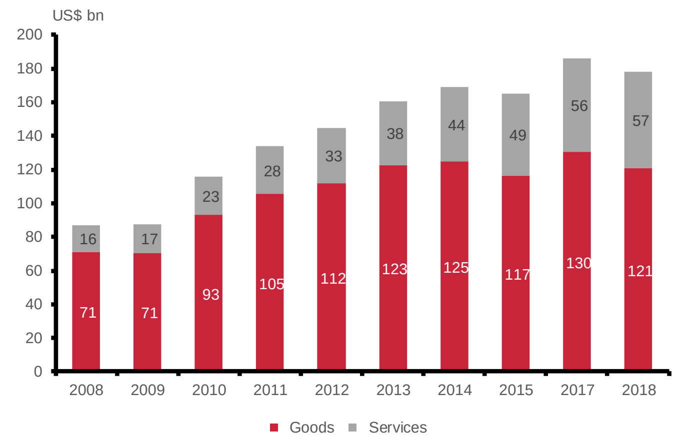
Source: Phase One Agreement, CMBIS

Figure 3: Imports of U.S. goods and services, targeted value and imputed growth rate

in US$ bn	2017A	Target 2020T	Target 2021T	Imputed growth rate 2020	Imputed growth rate 2021
Manufactured goods	58.6	91.5	103.4	56.1%	13.0%
Agriculture	24	36.5	43.5	52.1%	19.2%
Energy	8.3	26.8	42.2	222.9%	57.5%
Services	58	70.8	95.9	22.1%	35.5%
Total	148.9	225.6	285	51.5%	26.3%

Source: Phase One Agreement, Census Bureau, CMBIS

Figure 4: Overall U.S. exports to China



Source: BEA, CMBIS

Manufactured goods

For the category of manufactured goods, including industrial machinery, electrical equipment, pharmaceutical products, aircraft, vehicles and etc, imports from the U.S. shall increase by no less than US$ 32.9/44.8bn in 2020/21 on top of 2017 baseline amount. According to USTR, imputed import growth rate would be 56.1% in 2020 (relative to 2017) and 13% in 2021 (relative to 2020).

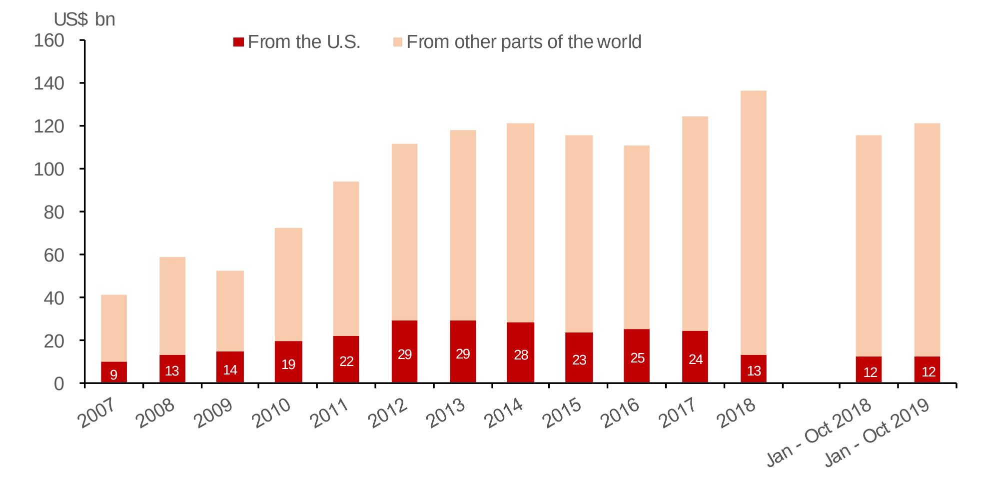
Agriculture products

Agriculture imports shall increase by no less than US$12.5bn/19.5bn in 2020/21 on top of 2017 baseline amount. Imputed growth would be 52.1% in 2020 (relative to 2017) and 19.2% in 2021 (relative to 2020).

Soybean is the largest farm product U.S. export to China every year. Meanwhile, China was a major destination for U.S. soybeans. Prior to 2018, over 60% of U.S. soybean exports goes to China before the tariff war.

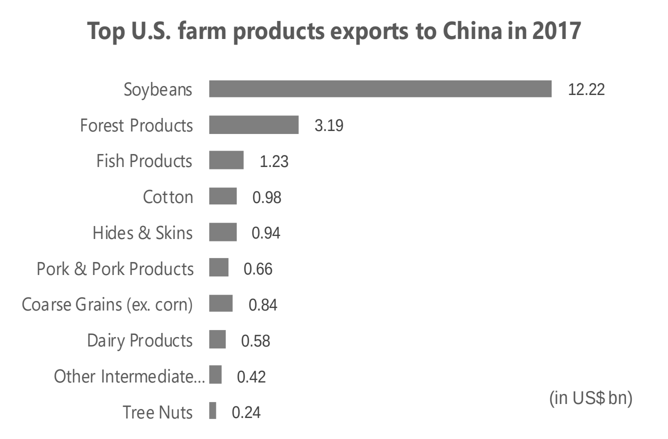
We expect rebound in soybean import from the U.S. in the upcoming years, whereas growth for meat, seafood, cereals, dairy products could be higher to achieve the commitment.

Figure 5: China import of U.S. farm products – US$24bn in 2017



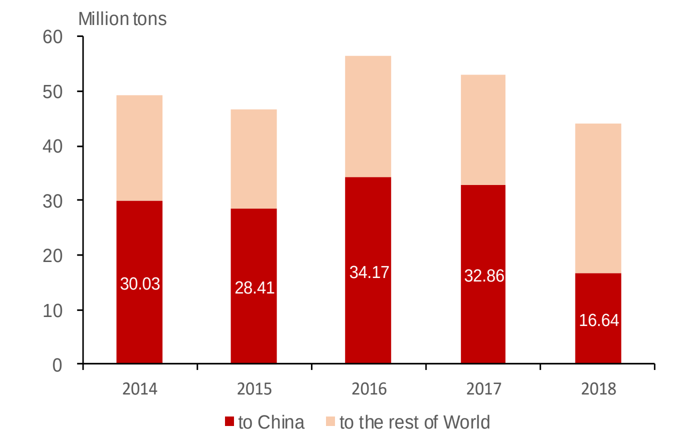
Source: USDA, Wind, CMBIS

Figure 6: Top U.S. farm product exports to China



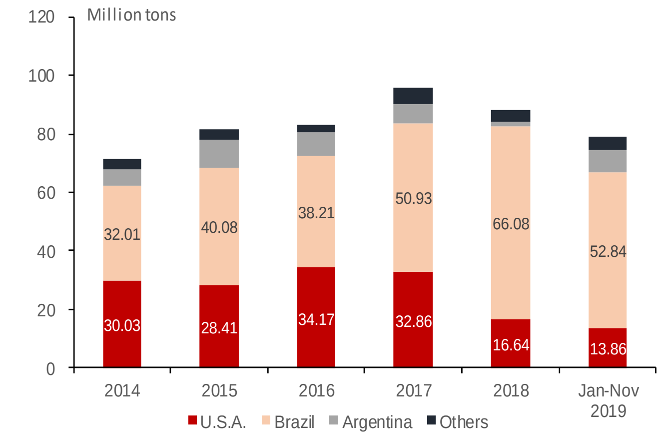
Source: NBS, Wind, CMBIS

Figure 7: U.S. soybeans export destination



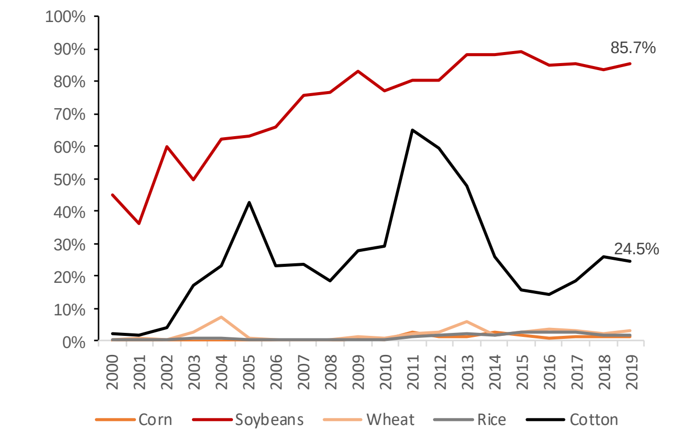
Source: NBS, Wind, CMBIS

Figure 8: China imports of soybeans by origination



Source: NBS, Wind, CMBIS

Figure 9: China import dependence of farm products



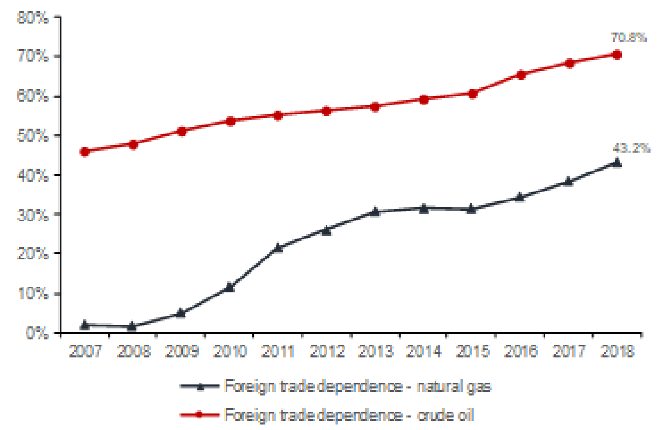
Source: NBS, Wind, CMBIS

Energy

According to the Deal, energy imports shall increase by no less than US$18.5bn/33.9bn in 2020/21 on top of 2017 baseline amount. Imputed growth would be >200% in 2020 (relative to 2017) and >50% in 2021 (relative to 2020).

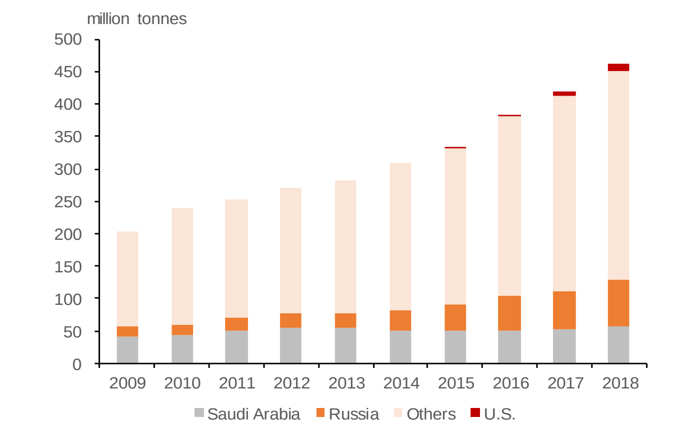
To the U.S., China is a key and strategic target market for increasing energy exports. However, climbing foreign trade dependency could spark real concern for China, at over 70% for crude oil and >40% for natural gas. That said, enlarging energy imports from the U.S. could be duplicated and requires balancing interests between other trading partners.

Figure 10: Climbing foreign trade dependency of China - LNG and crude oil



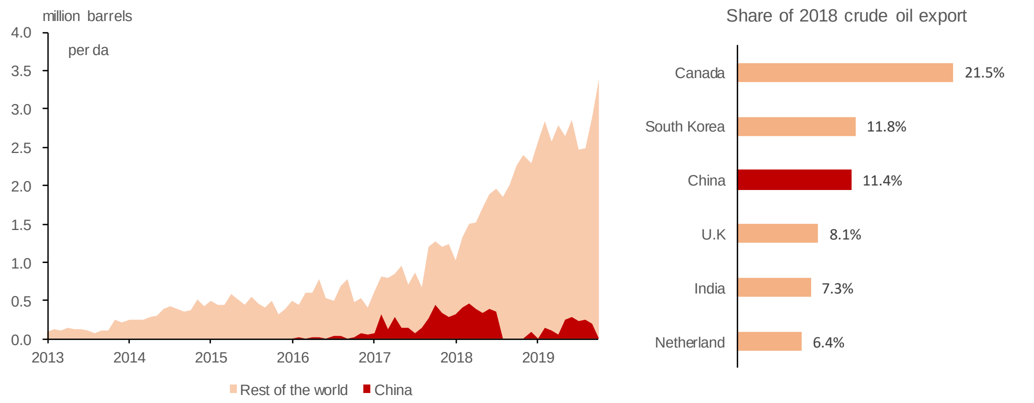
Source: NBS, Wind, CMBIS

Figure 11: China crude oil imports by originations (in quantity)



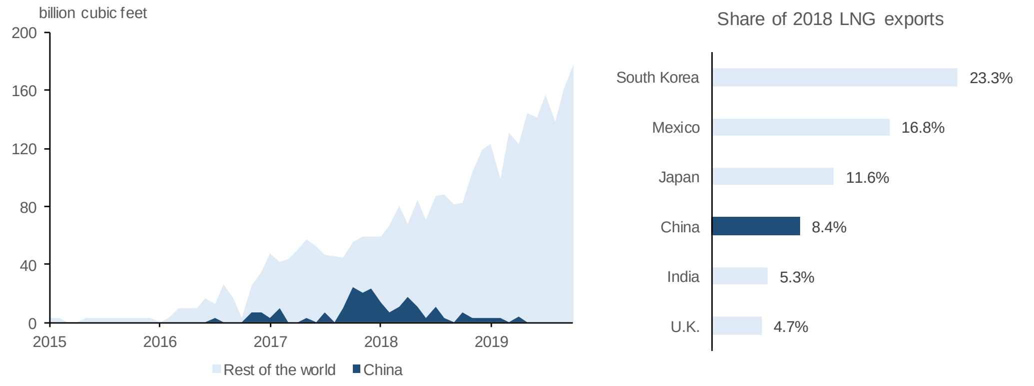
Source: NBS, Wind, CMBIS

Figure 12: U.S. export of crude oil to China and the rest of the world



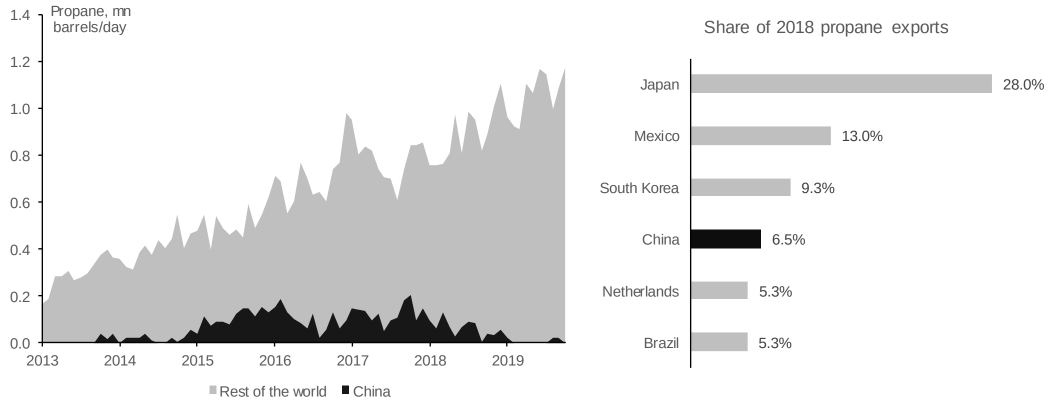
Source: EIA, CMBIS

Figure 13: U.S. export of liquefied natural gas to China and the rest of the world



Source: EIA, CMBIS

Figure 14: U.S. export of propane to China and the rest of the world



Source: EIA, CMBIS

Services

Services imports from the U.S. to China shall increase at least US$ 12.8/25.1bn in 2020/21, on top of 2017 baseline figure of US$ 58bn. Imputed growth rate would be 22.1% in 2020 (relative to 2017) and 17% in 2021 (relative to 2020), significantly higher than 2.8% CAGR in 2016-2018.

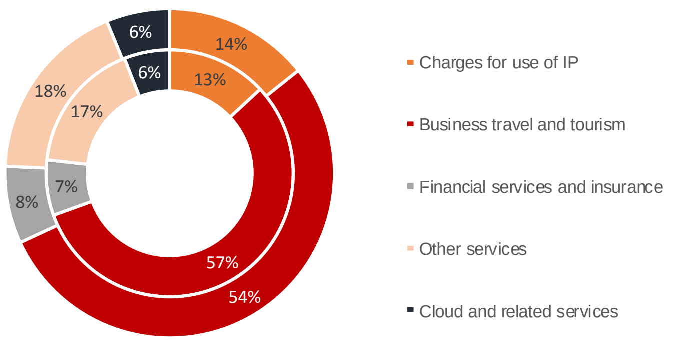
We expect high growth of imports in financial services, cloud services and charges for IP use. Financial services imports will be boosted by expanded market access for U.S. financial service providers, while IP charges by enhanced IP protection. A little bit eye-catching is the fact that cloud services, including data hosting and processing, was singled out as one subcategory. Given massive addressable market, we bet U.S. cloud services providers will compete rigorously with domestic players.

Figure 15: Services imports from U.S. to China

				Target in the Deal		YoY Growth rate		
in US$ bn	2016	2017	2018	2020T	2021T	2020T	2021T	2016-18 CAGR
Services	**56.1**	**58.0**	**59.3**	**70.8**	**83.1**	**22.1%**	**17%**	**2.8%**
Charges for use of IP	7.4	7.6	8.5					6.8%
Business travel and tourism	31.4	32.7	31.9					0.9%
Financial services and insurance	4.0	4.2	4.5	n/a		n/a		6.4%
Other services	10.2	10.0	10.7					2.6%
Cloud and related services	3.2	3.5	3.7					7.8%

Source: BEA, CMBIS
*Note: Inner circle denotes 2017, and outer circle 2018.

Figure 16: Services imports from U.S. to China



Source: BEA, CMBIS
*Note: Inner circle denotes 2017, and outer circle 2018.

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