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THE PRESSURE TIGHTENS ON CHINA'S STATE-OWNED ENTERPRISES

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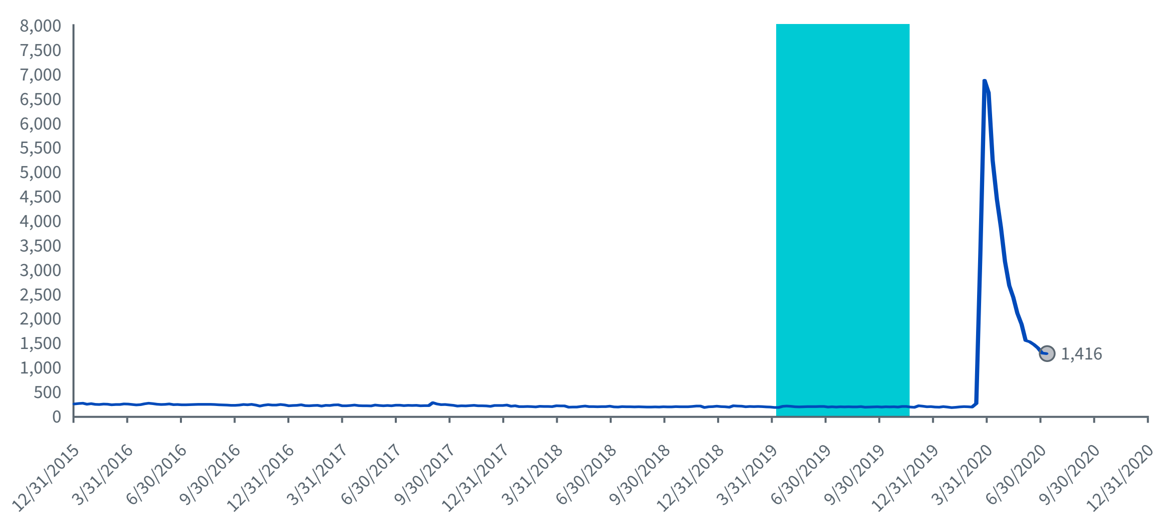
There may be no better recipe for U.S. pressure to be put on China, a strategic rival, than tens of millions Americans thrown onto the unemployment rolls in 12 weeks because of a virus that came from there.

Figure 1 is awe-inspiring.

Figure 1: U.S. Weekly Initial Jobless Claims (Thou.)

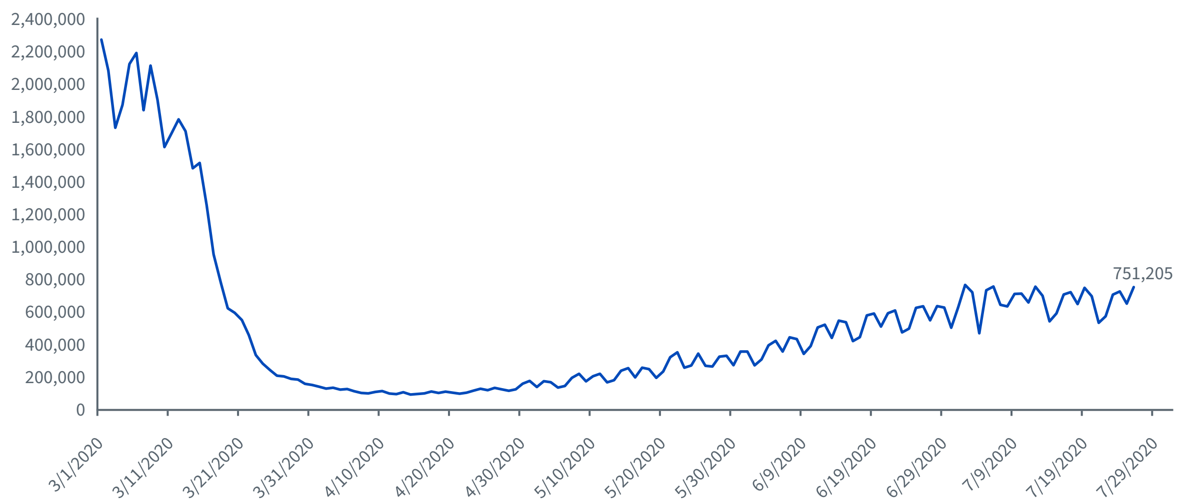


Source: Department of Labor, as of 7/17/20.

A long slog awaits the U.S.

Fewer than 800,000 Americans are passing through TSA checkpoints each day this summer—one-third the level of January, which itself is a dead month for air travel. While China gets back on its feet, many Americans are locking themselves in their homes.

Figure 2: U.S. TSA Checkpoint Numbers: Total Traveler Throughput



Source: Transportation Security Administration, 3/1/20–7/26/20.

CHINA'S INTERNATIONAL RELATIONS

After years of intellectual property theft, military espionage, wage arbitrage, dumping of goods, wanton environmental pollution, ignoring due process, operating internment camps and so on, it's safe to say the "rules-based international order" receives little obeyance from the Chinese Communist Party (CCP).

If you think China was unpopular in the West before any of us ever heard of COVID-19, put a finger on the pulse now.

China's officialdom was aware that COVID-19 was transmitted from human-to-human when it hosted a Wuhan event attended by tens of thousands.[1] Yet international flights still went to their destinations. The CCP put millions of its own and foreign innocents in harm's way with its mishandling and malfeasance with regard to the virus.

[1] "China Didn't Warn Public of Likely Pandemic for 6 Key Days," Associated Press, 4/15/20.

Ask the question: does China have any real friends that are considered legitimate actors? Not friends of convenience, but real friends?

Venezuela is one. The Maduro regime isn't legitimate. How about North Korea? Iran? The Democratic Republic of Congo, the source of China's cobalt?

Don't say Russia. That's a friend of convenience, and maybe a failing state at that. Russia is unable to get its birth rate out of the doldrums; many of its university graduates run to London at their first chance. Then there is the matter of climate change; there is no country save Saudi Arabia that fits the bill of a petrostate quite like Russia. It is hard to concoct a recipe where the Kremlin regains its days of partial global dominion on the back of robust crude oil exports.

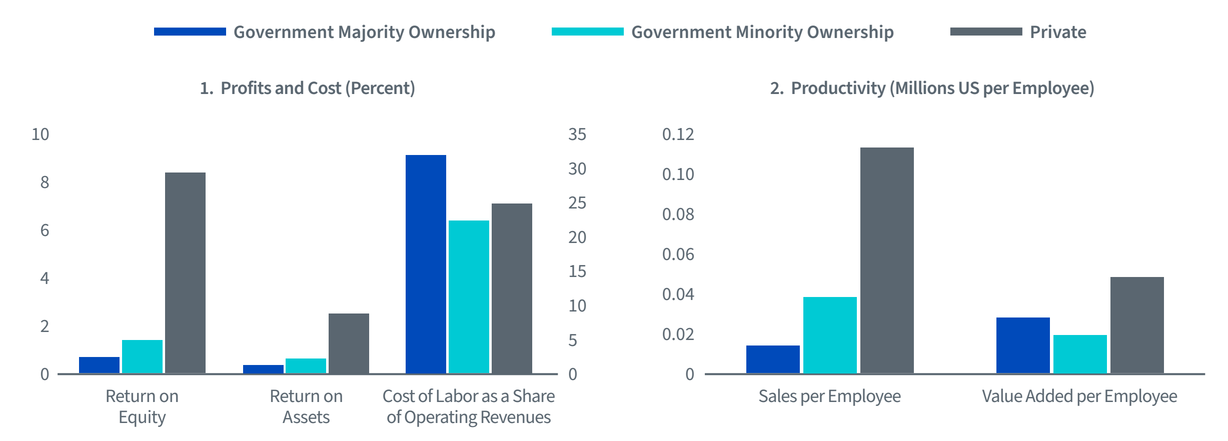
It is possible that the twenty-first century's "rise of China" could be one of those supposed inevitabilities that doesn't pan out, much as Argentina was supposed to rise to prominence in the twentieth century. Bogged down by internal weakness and a power structure that is ever fearful of another Tiananmen-style uprising, the CCP has had to resort to stoking nationalism—by proposing that COVID-19 came from the U.S., for example.

This is why WisdomTree is so keen on our strategies that exclude China's state-owned enterprises.

To the extent that China's power structure is a paper tiger—with incompetencies on the front page of the newspaper—we want to invest in businesses that are as distant from the CCP as possible, to capture the very real strides being made by Chinese individuals and society, not the government.

Figure 3 shows some of the fundamental metrics in *global* SOEs. We will look at China itself next.

Figure 3: SOEs' Performance Relative to Private Firms

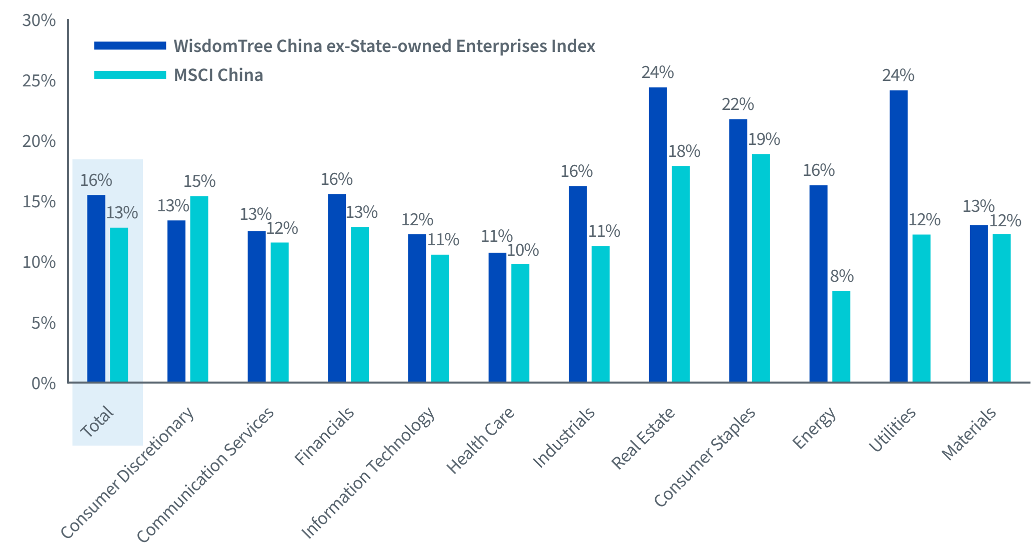


Source: "Policies to Support People During the Covid-19 Pandemic, Chapter 3 (State-Owned Enterprises: The Other Government)," Fiscal Monitor, IMF, April 2020. Data cited: Authorities' annual reports on SOEs; Natural Resource Governance Institute; Orbis; and IMF staff estimates. Note: The panels are based on median values. Weighted averages show a similar pattern. Past performance is not indicative of future results. Return on assets (ROA): Firm profits (after accounting for all expenses) divided by the firm's total assets. Higher numbers indicate greater profits relative to the level of assets utilized to generate them. Value added per employee is operating profit added to salaries, wages and payroll expenses divided by the number of employees.

Now let's focus on the return on equity (ROE)[2] for China specifically, comparing the WisdomTree China ex-State-owned Enterprises Index and the MSCI China Index (figure 4).

The WisdomTree Index ranks higher on return on equity, which is the most commonly referenced metric for the quality stock factor[3], in all but one sector.

Figure 4: Return on Equity (ROE)



Sources: WisdomTree, Bloomberg, as of 7/10/20. **Past performance is not indicative of future results. You cannot invest directly in an index. These metrics should not be considered reflective of any Fund performance and favorable metrics may not translate to favorable performance. Recent Fund performance can be found at WisdomTree.com.**

SOEs: THE TARGET

One of my long-held theses regarding U.S. perceptions of the Chinese government is that there is at least one component of official CCP policy that irks everyone. Climate change? China. Due process, prisoners' rights? China. Surveillance? China. Workers' wages? China. IP theft? China.

And which companies tend to violate these core tenets of the rules-based international order? Our research shows the worst offenders are the state-owned enterprises, namely the banks.

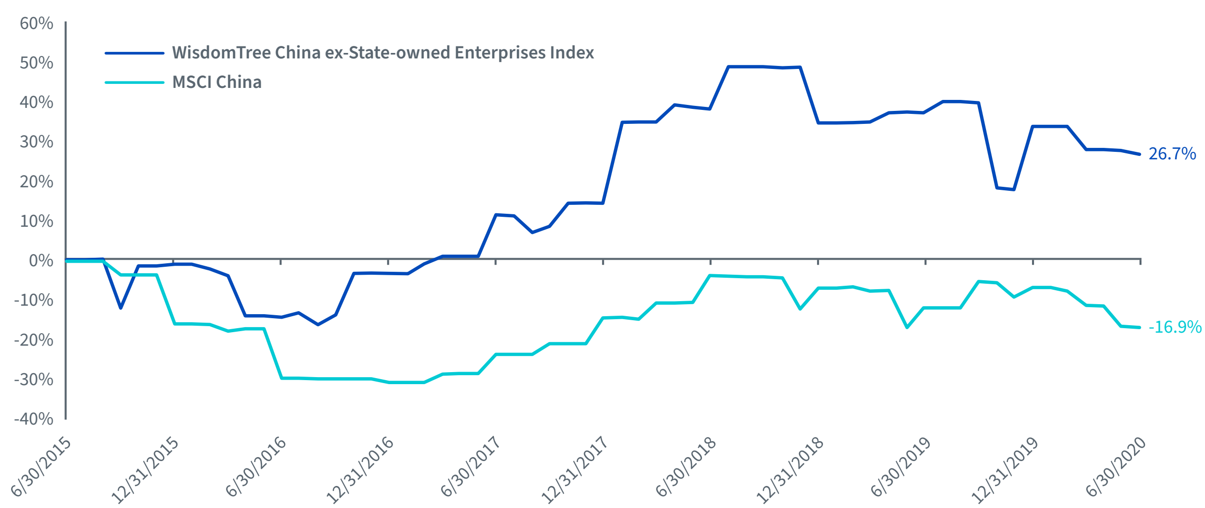
2 Return on equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.
3 Quality factor: Characterized by higher efficiency and profitability with excess returns versus the market over time. Typical measures include earnings, return on equity, return on assets and operating profitability, as well as others.

Though we are not so naive as to believe that having low, or zero, explicit state ownership means independence from the CCP, it does allow for *more* autonomy from Beijing than the companies that have the government as their primary shareholder.

While the CCP battles its own vulnerability, Chinese research and development continues to accelerate. According to the World Intellectual Property Organization, 58,990 patent applications were filed from China in 2019, a 200-fold increase since the turn of the century, according to WIPO Director General Francis Gurry, and greater than the 57,840 filed from the U.S.[4] Give credit where credit is due—that is impressive. Again, this is from the collective genius of 1.4 billion people, *despite the government*.

It wasn't the old-line companies that existed under the Mao regime that filed all those patents. Two of the WisdomTree China ex-State-Owned Enterprises Fund's (CXSE) largest holdings, Tencent and Alibaba, filed 718 and 470 of those patents, respectively, for blockchain *alone*.[5] Cutting-edge companies like Alibaba, which came into being in the twenty-first century, often have little or no official state ownership. The result is a propensity to grow earnings faster than companies in benchmarks like the MSCI China Index (figure 5).

Figure 5: Earnings Growth: Q2/15–Q2/20



Sources: Bloomberg, WisdomTree, as of 6/30/2020. **Past performance is not indicative of future results. You cannot invest directly in an index. These metrics should not be considered reflective of any Fund performance and favorable metrics may not translate to favorable performance. Recent Fund performance can be found at WisdomTree.com.**

4 "China Becomes Top Filer of International Patents in 2019 amid Robust Growth for WIPO's IP Services, Treaties and Finances," World Intellectual Property Organization, 4/7/20.

5 "Chinese Tech Giants Tencent, Alibaba Filed for the Most Blockchain Patents Last Year," Yogita Khatri, The Block, 4/12/20. Tencent and Alibaba comprised 14.4% and 11.5% of CXSE, respectively, on 6/30/20.

Think about where China's youth want to work. We know that many of China's savviest businesspeople are opting to study at home instead of reflexively jetting off to Stanford or Harvard; in the Financial Times 2020 Global MBA ranking, nine of the top 100 business schools were in China. The best one, fifth-ranked Ceibs, came in ahead of MIT, London Business School and Columbia.

Say you are graduating from one of China's elite schools. Would you prefer to work at an SOE or at a company like JD.com, Baidu, Pinduoduo or Alibaba, the Silicon Valley-type firms?[6] The question answers itself.

But beyond the dollars and cents of operating efficiency and the employment roads of China's best and brightest, let's hit on risk itself. In this case, political risk.

FRAYING RELATIONS

I came across a Redfield & Wilton Strategies poll from May 7 that found only 1 in 10 Germans want closer relations with China.

Sound familiar?

No surprise then that 74% of them said China had dishonestly reported its COVID-19 infection figures. I see that statistic and wonder if the other 26% of respondents ever picked up a newspaper while in quarantine.

Take it closer to home, to Canada, where something dreadful is happening before our eyes: two Canadian businessmen may soon be put in front of a Chinese court on charges of espionage. You know the punishment.

If you thought the rollout of 5G, the next generation mobile network—and the involvement of the telecoms giant Huawei—was an acutely Sino-U.S. issue, think again. Recall that Washington asked Ottawa in December 2018 to arrest Huawei's chief financial officer, Meng Wanzhou, on fraud charges. She was apprehended at the Vancouver Airport. But Meng isn't rotting in some B.C. jail cell; she wears an ankle bracelet that allows her to walk freely from her seven-bedroom, C$12 million home, exploring Greater Vancouver as she pleases.

If I have her house arrest rules assessed correctly, she could go for a jog in Stanley Park if she chooses, or go out to dinner at any restaurant, so long as she sleeps each night at the house.[7]

In contrast, Michael Kovrig and Michael Spavor, the Canadian businessmen, were detained by China in the wake of Meng's arrest in an action that is widely accepted as retaliatory trumped up charges of violating China's national security. Neither has been provided legal counsel or the ability to speak to their families.

[6] These firms comprised 3.7%, 2.4%, 2.2% and 11.5% of CXSE, respectively, on 6/30/20.
[7] "Canadians Detained in China after Huawei Arrest Have Now Spent a Year in Custody," Anna Fifield and Jeanne Whalen, Washington Post, 12/10/19.

Canada's CTV News interviewed Richard Fadden, former director of the CSIS (Canada's equivalent of the CIA) in the wake of Canada's decision in late May to keep Meng under house arrest, an announcement that angered Beijing. He warned the CCP may respond by putting other Canadians residing in China "at some risk of (joining) the two Michaels in Chinese detention." Further, he believes China may "meddle in" Canada's bid for a seat on the UN Security Council, among other tactics.[8]

BRITAIN

Until just weeks ago, the "special relationship" between the U.S. and Britain had been in a state of increasing strain because the latter had decided to allow Huawei a role in building out its 5G network. But the U.K. is backtracking now that playing hardball with China is more politically feasible in our coronavirus world.

The issue that is acutely important to British sensibilities specifically is Beijing's strong-arming of Hong Kong. If the obsolescence of the official "One Country, Two Systems" policy with respect to China's treatment of Hong Kong since its 1997 handover from the U.K. was ever in question, it is being put to rest this summer.

The issue in Hong Kong is China's new security law, which allows for dissenters and political foes to be extradited to the mainland. China hawks in London and Washington were incensed by the move; Donald Trump and the U.S. State Department reacted by threatening to remove Hong Kong's special status as an autonomous trade zone, which would mean treating it like the rest of China. The U.K. had a different response; it is offering citizenship to any of the 3 million Hong Kongers who hold a British National Overseas (BNO) passport.

Many multinational corporations were put in a tough spot by the news. Take HSBC, the Hong Kong bank that has some flavor of Britishness to it. Its Head of Asia declared support for Beijing's security law, an action that was taken as an affront to the U.K. Standard Chartered, the British multinational financial services company with heavy Asian operations, followed suit.

HSBC and Standard Chartered are two of the most visible. But any corporation with operations in both Hong Kong and a liberal democracy is being forced to pick sides. Which companies don't have a tough decision to make? The ones where the decision was already made: China's state-owned enterprises.

Whether it's Ottawa, Berlin, London or Washington, angry eyes are focused on China's state-owned enterprises, the firms that operate to serve political masters. If I'm right on this one, Beijing's SOEs are prime candidates for a portfolio headache.

[8] "Could More Canadians Be Detained in China Over Meng Decision? Former Spy Head Says Yes," Rachel Aiello, CTV News, 5/30/20.

CHINA'S BELT & ROAD INITIATIVE: THE NEW SILK ROAD

Figure 6 shows the Wall Street Journal's rendering of China's multi-trillion dollar build-out of land and sea routes westward, the "New Silk Road" that some compare to the Marshall Plan[9]—though I think it is more like the Marshall Plan squared.

Figure 6: China's Belt & Road Initiative

Source: Wall Street Journal.

Again, Beijing doesn't have any "real" friends. A country like France has a friend in Germany. And though the U.S.'s ties with, say, Canada have frayed in recent years, when push comes to shove, the two are bedfellows.

I point this out because it is glaring that the Belt & Road Initiative completely ignores Japan.

China and Japan have one of the ugliest histories of mutual fear and bitterness on the planet, with the lack of healing from World War II a completely different story than the European experience.

[9] The Marshall Plan was an American initiative passed in 1948 for foreign aid to Western Europe. The United States transferred over $12 billion in economic recovery programs to Western European economies after the end of World War II.

In recent years, China and Japan have been mired in a squabble over territorial claims over what Japan calls the Senkaku Islands, and China, the Diaoyu. A little spat, really, but one that is used by both Beijing and Tokyo whenever stirring the pot makes political sense.

It isn't easy to get by in the twenty-first century when there is a mutual hostility between you and your wealthiest neighbor, with the top of your list for most "reliable" allies being Venezuela, Iran and North Korea—but that is the situation confronting President Xi Jinping. With all those squiggly lines on the Belt & Road map, China needs its neighbors to let their guard down and trust it. But the planned blue lines through the Indian Ocean are now seriously called into question, too.

It was just a few months ago that Indian Prime Minister Narendra Modi was doing photo ops with Xi, smiles all around. But now we have scores of dead Indian and Chinese soldiers on their historically disputed border. The official death count thus far in the ugliest melee between the two countries since 1975 is 20 Indian troops; China did not disclose how many of its soldiers died in the June battle.

Read this and tell me if you think the maritime passage through the Indian Ocean can continue forward without some serious relationship mending:

> *For hours into the night on Monday, Indian and Chinese forces fought with fists, rocks, batons and clubs wrapped in barbed wire at an altitude of more than 14,000 feet in a remote part of the Himalayan mountains. In the melee, some soldiers fell off cliffs into a river, Indian security officials said.*[10]

Something not shown in the Wall Street Journal's map is China's arctic ambitions in the One Belt, One Road plan. The waters above Siberia become that much more important if scientists' climate change models are prescient. It makes sense as a back-up plan. If South Asia becomes fraught in a world where India decides to play tough, perhaps China looks northward, to the pole. The goal is a passage to Northern European ports, over Siberia, with a guiding hand of a smiling President-Putin-for-life giving the nod.

Robert Rasmussen, a Foreign Affair Specialist with the U.S. Department of Energy's National Nuclear Security Administration, writes for the Center for International Maritime Security:

> *The Northern Sea Route is largely in operation already. A portion is open year-round to support domestic Russian commerce, and a remainder is open during the summer season which allows for trade between Europe and Asia. This route is open due to open waters and additional support from the Russian Federation's fleet of 14 nuclear-powered icebreakers. China has also invested heavily into what they refer to as their Polar Silk Road, as part of their larger Belt and Road Initiative, including the construction of two more icebreakers. As the Arctic melts, this corridor will be able to accommodate significantly larger traffic flows. Such a shift will be fundamentally transformative to the Russian economy, allowing for Russia to achieve its centuries-old dream of holding blue water ports and subsequent access to global commerce.*[11]

In other words, we could be staring at a possible Sino-Russian axis, up against a unified West in the other corner.

[10] "The Deadly India-China Clash: Spiked Clubs and Fists at 14,000 Feet," Niharika Mandhana, Rajesh Roy and Chun Han Wong, Wall Street Journal, 6/17/20.
[11] "An Emerging Strategic Geometry – Thaw in Chokepoints and Littorals in the Arctic," Robert C. Rasmussen, Center for International Maritime Security, 6/30/20.

As it appears now, my guess is that the traditional West—Europe plus North America plus Japan plus South Korea—picks up the old eastern bloc countries via European Union federalization. Add in India, the English-speaking democracy, and we have the coalition that counterbalances what you will have to decide is either a rising power or a paper tiger.

That makes for a lot of global might in this newly defined "West," with plenty of money and incentive to contain China, and as it applies to our investments, the firms most closely aligned with the regime. It is not hard to imagine a scenario where the targets of the 2020s' ESG (environmental, social and governance) divestment campaigns are right in front of our noses: the SOEs.

The three WisdomTree ETFs that cut out companies with more than 20% state ownership are:

CXSE: China ex-State-Owned Enterprises Fund

XSOE: Emerging Markets ex-State-Owned Enterprises Fund

IXSE: India ex-State-Owned Enterprises Fund

In review:

+ The Chinese Communist Party's obfuscation with regard to COVID-19 may prove a catalyst for Western capital to shift assets from China's SOEs to firms that have looser ties with Beijing.
+ Eliminating SOEs from indexes may increase sales, employee efficiency and return on equity, boosting the aggregate quality factor in a portfolio.
+ Though the Chinese Communist Party may be a paper tiger, the country has made great strides in recent decades, filing more patents than any other country, elevating its university system and creating tech giants that rival those in Silicon Valley. The Chinese people are set on advancing into the future; placing capital behind their ventures is optimal when the government is kept at arm's length.
+ If there is a next evolution in so-called ESG investing, it may be one in which the West turns its focus on the relationship between China's SOEs and the Chinese Communist Party. To the extent that they are avoided, China's investment risk may be mitigated via the WisdomTree China ex-State-Owned Enterprises Index.

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WisdomTree China ex-State-Owned Enterprises Index: Measures the performance of Chinese stocks that are not state-owned enterprises. State-owned enterprises are defined as companies having government ownership of more than 20% of their outstanding shares. MSCI China Index: A free float-adjusted, market capitalization-weighted equity index designed to measure the performance of the Chinese equity market.

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