

Muddy Waters

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Tensions between the United States and China continued to ratchet higher this week as House Speaker Nancy Pelosi visited Taiwan despite warnings and provocations from Beijing and concerns from President Biden. Pelosi's visit comes on the heels of news last Friday that the U.S. Securities and Exchange Commission (SEC) added one of China's largest and most well-known companies, Alibaba (BABA), to its list of Chinese companies at risk of being delisted from U.S. exchanges.

Alibaba joins a long list of over 260 US-listed Chinese stocks that have been caught in the crosshairs of U.S. regulators since 2021, when Congress passed the Holding Foreign Companies Accountable Act (HFCAA). The law outlines new rules that require U.S.-listed Chinese companies to prove they're not state controlled and open their books to auditors for three consecutive years.

While U.S. regulators largely turned a blind eye to U.S.-listed Chinese companies prior to HFCAA, the new requirements are part of a broader push from Washington to get tougher on China. Pelosi's visit to Taiwan this week highlights a potential shift in strategy from Washington, as lawmakers and regulators push back against what many view as an autocratic threat to democracy and free markets.

Former Secretary of State Henry Kissinger is often credited with the term "constructive ambiguity", which is the deliberate use of ambiguous language on a sensitive diplomatic issue. Over the years, the United States has largely deployed this tactic in reference to its position on Taiwan however, recently, rhetoric and actions have been less opaque, as Washington has continued to push boundaries that were formerly avoided.

In response to Pelosi's visit to Taiwan this week, China responded with a barrage of propaganda, naval exercises, and missile tests around Taiwan, plus the suspension of some Taiwanese imports. While cyber and national security responses are also a concern, history shows the chance of worst-case near-term escalations remains low.

A response that's more likely – especially considering the SEC's decision to add Alibaba to its list of Chinese companies at risk of delisting in the U.S. – is that Chinese companies continue to turn their back on unfriendly U.S. policies and attempt to take control of their economic and financial future. This is one of the reasons why some Chinese firms are beginning to upgrade their "secondary" listing status to "primary" in Hong Kong.

For some background, when a foreign company goes public in the United States, it must fulfill the requirements of the market or exchange. Secondary listings in another country (like Hong Kong) are often subject to less rigorous regulations but offer increased liquidity and access to additional capital. By upgrading these secondary listings to primary or dual-primary listings, these companies could keep trading in the event the stock is forced to delist in the United States. Several companies, such as electric-vehicle makers XPeng Inc. and Li Auto Inc., have dual-primary listings in Hong Kong and New York. Others, like Alibaba and Bilibili, have signaled their intentions to follow suit.

Investors are watching from the sidelines, trying to make sense of a wide range of outcomes for U.S.-listed Chinese stocks. For many companies, listing in the United States remains the

preferred choice, and continued negotiations between the United States and Chinese regulators will further define what information, if any, can be redacted as part of audit requirements. From China's perspective, the risk of leaking state secrets remains the dominant concern.

Negotiations have been on and off for nearly 20 years, but with a deadline looming and increasingly hostile relations between the world's largest economies, time is of the essence for US-listed Chinese companies and their shareholders. In the near-term, the risk of a delisting event will continue to loom over these stocks, notwithstanding broader economic, monetary, and geopolitical factors. However, despite these risks, there is a case to be made that current valuations and very low exposure in index's (that will grow over time) are positive long-term catalysts.

Risk versus opportunity has always been the calculus for those investing in China, and nothing about the last two weeks has shifted the arithmetic for investors wading in these muddy waters.

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