

Magellan – In The Know: Episode 28

Understanding China and the impacts for investors



Arvid Streimann: [00:00:02] Welcome to our podcast Magellan in the know. I'm Arvid Streimann, portfolio manager and head of macro here at Magellan. And today I'm joined again by my colleague and technology analyst Adrian Lu. Adrian, great to have you back. Thanks, Arvid. Great to be here as always. And we're also lucky to have with us today two leading voices on understanding China, which would help investors navigate the China investment landscape. The first guest is John Garnaut. Now, John is the founder of an investment advisory firm Garnaut Global. He's also a senior fellow at the Australian Strategic Policy Institute. He led the Australian Government's analysis and policy response to authoritarian interference. As a principal advisor to the Department of Prime Minister and Cabinet from 2016 to 17, and he was previously Fairfax's China correspondent from 2007 to 13 before he joined Prime Minister Malcolm Turnbull's team in 2015. So welcome, John.

John Garnaut: [00:01:03] Thank you, Arvid. Good to be here.

Arvid Streimann: [00:01:06] And we also have Matt Pottinger. Matt is a distinguished visiting fellow at the Hoover Institution, which is at Stanford University, and he most recently served for four years in senior roles in the US government, and that was at the National Security Council. And that also included a stint as deputy national Security adviser between 2019 and 2021. So welcome Matt, to.

Matt Pottinger: [00:01:30] Arvid and Adrian. It's great to be with you.

Arvid Streimann: [00:01:33] And it's great to have both of you here now. I think what we should talk about today are some key issues for investors when it comes to China. And the first one is what is the impact of the recent National Party Congress? Secondly, how decoupling between China and, quite frankly, most of the rest of the world might play out. And thirdly, what is the outlook for China's zero COVID policy? And perhaps where we'll start is on the National Party Congress, which recently wound up. And, John, I've got a question for you. It was the 20th National Party Congress. Xi Jinping formally received his third term as leader. And what was really interesting, I think, from an investment perspective was that this all happened, or at least the last part happened over the weekend. And on the following Monday in Hong Kong, the local stock market index, the Hang Seng fell over 6%. And when we see big moves such as that, it usually means that something unexpected has happened. So, John, in your view, what were the main outcomes from that National Party Congress for investors?

John Garnaut: [00:02:36] Yeah, Thank you, Arvid. Look, the the indices moved because something did shake in Beijing over that weekend. In our view, the dial did move from from what had been a Congress that was panning out towards the midpoint of our expectations, towards something that was more extreme and to take it through the different parts of the Congress. I think there's there's three components to it, really. One is the the general secretary work report, which this is ostensibly a backward looking self appraisal of the previous five years. And not surprisingly, he gave himself some pretty good marks. And then the second part of it is an amendment to the party charter, the Constitution. And this is what really sets the KPIs for what is now 95 million cadres and sets the the long term parameters of policy over the following five years. And the third thing, I think this is the biggest

deal. The third thing is the party Congress or just after the Congress, is the place at which they unveil the new leadership team. And going through those three elements, one by one, the work report was roughly at the midpoint of our expectation. And this is it's harsh and it's ambitious and it's very being centred. But it was it was continuity from what we'd seen before. That's not necessarily a rosy outlook for investors, but it was predictable and within expectations on the party charter, there was something really interesting here and that is that Jinping has now introduced the word struggle into the charter in a way that there's there's almost as many mentions the word struggle and great struggle as there is opening and reform in the party charter, which shows a comprehensive rebalancing of emphasis from from the old Deng Xiaoping goals of opening the economy to making a more prosperous country to an emphasis on politics.

John Garnaut: [00:04:28] And there's no part of the Leninist, Stalinist and the Maoist lexicon which is more resonant than the word struggle. Struggle means to define your enemies, to isolate them, and to neutralize them. It's a constant, relentless process, process of political struggle. So that's a big deal seeing that written into the charter like it was. Now, some of that might have gone over the heads of of investors, but the piece that really caught everyone's attention was the movements on the. Leadership line up now, I don't know if you remember it. I'm sure you do. Actually. The that footage of Hu Jintao being literally lifted out of his chair and carried off the stage. Now, as more elements of that footage came out, it's pretty clear that that was a a spontaneous eviction. And what we were seeing is a very dramatic political event. The full repercussions only became clearer the next day. And what we do know is that none of the former president, Hu Jintao, his proteges, made it into the Politburo. Two of them were taken out of the Central Committee, even though within the ostensible age limits, and none of them made it to the popular.

John Garnaut: [00:05:38] So that's a big deal. That's a big deal because these three three Hu Jintao proteges, that's the other premier, Li Keqiang, very senior, former party secretary of Guangdong, one young and third, a guy who had been previously seen as a future leader. Who? Chunhua They're probably the three most economically literate or credentialed or well known list of Western investors figures that were expected to be in the leadership lineup. With all of them gone. That means at least, at least a hole where where market oriented economic credibility used to be in their place with a very, very different lineup in their place was if you think of the Politburo normally has got 25 people, this time it's got 24. Makes you wonder if there wasn't a last minute kind of eviction from that number of those 25, The top seven of the standing committee, those that's standing committee meets most regularly. The Politburo tends to meet still regularly, but not as not as often the first in so Xi Jinping and six others. All six of the new members of the Politburo Standing Committee owe their careers decision. Yet. That is probably the the easiest way to kind of imagine where people's loyalties lie. These are seasoned kingsmen. That's not to say that they're there without capability, without talent, but they're there. Their primary characteristic is loyalty and a history of getting things done for camping. So now we have, which is really quite unique in the modern period, a standing committee which is populated entirely of people who are instinctively and perhaps congenitally wired to getting things done to a for being so a a politburo of the political, to use a less flattering word, apparatchiks who are going to be not only implementing Camping's edicts because they need to survive, but very good at preempting, anticipating what he wants.

John Garnaut: [00:07:43] And so this is a a more aggressive, a more streamlined and efficient transmission from SI to policy to impact. And then the rest of the Politburo. If I could just fill out the last piece, I think this is what was most striking to us. So what I've described is significant on its own, but the rest of the Politburo, it included a new cohort of technocrats, But they weren't technocrats. They were technocrats who are trained in in defense, industry, space industry and the intelligence system. And we

go into more detail afterwards. But it looked to us and certainly this it looked this way to many investors that C has now picked a team to match that program that it outlined of political struggle and political struggle to find to me not only internal politics and purges, but externally external competition, perhaps resilience, perhaps confrontation with the outside world. So that's why taken all together, markets thought this is not something we can bank on. This is not a good signal for the medium or the long term investment outlook in China.

Arvid Streimann: [00:08:56] So, John, there was quite a lot which happened in. I'm going to ask you in a moment what your interpretations of the National Party Congress were. But, John, I just wanted to pick up on one of the things you said there, which was the alliances or the people that have been put into the the Politburo, which are all close to Xi Jinping. Do you see that as a let's call it an act of strength or an act of weakness? Because in one sense, he may say it's an act of strength because, hey, I get to choose who who I want, so I'm putting all my friends in. But you may see it as an act of weakness as well, where you maybe could explain it by circling the wagons, so to speak. So would you say that it's an act of strength or an act of weakness by almost stacking the board in your favor?

John Garnaut: [00:09:41] Look, I think it's almost certainly an act of strength. So we've never seen in the modern period and even in the Maoist period, it wasn't quite like this. A leader who's been able to to appoint his own people everywhere, this is an act of strength. The implications are that it is almost impossible to imagine how a an opposition group could assemble, could organize in any meaningful way and get there and get their hands on enough levers of power to make life difficult for decision making causes. Well, circling the wagon is one way of seeing it. I see it differently. He's chosen people who can now get things done, and that's what the rest of the Politburo is about. It's about picking people, getting a team to be able to implement his program more effectively than they did before. Rather than just defending his position, I think that was what the last ten years is about. The next ten years is about getting things done.

Arvid Streimann: [00:10:38] Okay. Okay. So, Matt, I'm going to ask you the same question, the original question, which was directed to John, but what did you make of the National Party Congress?

Matt Pottinger: [00:10:48] Yeah, well, to fill in some some other details from John's account, which is which I agree with completely. It's you remember that Xi Jinping has a lot of different titles, right. President not being even one of the top two. He's also the party secretary. He's also the chairman of the Central Military Commission of of the Communist Party. And we learned from this party, Congress, who his two deputies will be, the two vice chairmen of that central military commission. One of them is going to be Jiang Yosfiah. Now, Jiang Xiao was already in the role, but Xi Jinping, interestingly, decided to retain him, even though he's 72 years old. That's, you know, three or four years older than than the point at which you usually have to retire rather than than be elevated. And this is interesting because Xi Jinping's father had fought alongside Jiang Josiah's father in the Chinese revolution. And so it's clearly someone that he trusts and who has already been working for years on on Xi's various objectives for the military. Remember when Xi Jinping came to power ten years ago, a lot of people thought, gee, I wonder if he's going to be an economic reformer or maybe even a political reformer. We now know that. No, he's neither of those things, but he is a military reformer. He is purged the top ranks of the PLA. He is purged deep down into the ranks and then and then really reorganized the combat combatant commands and put an enormous emphasis on training for war, realistic training, increasingly joint types of of training to make the People's Liberation Army more effective at war.

Matt Pottinger: [00:12:48] So Jiang Xia will be one of the vice chair chairmen. The other is a more. Junior officer who got promoted, in fact, promoted two levels in order to become the other vice chair. And his name is Hawi Dong. He's 65 years old, is someone who's really been focused on improving joint operations in

the PLA. And then also notably, he was the commander of the ground forces in the Western Theater Command during the bloody confrontation with Indian soldiers in the summer of 2020, as China was making deliberate and coordinated incursions into those areas that are contested between India and China. And then after he was in that role, he was sent to the to the Eastern Theater to lead the Eastern theater, which has responsibility for Taiwan. And he was in that role when China launched missiles over Taipei for the first time and missiles into Japan's exclusive economic zone and ran a dress rehearsal for a blockade just this past summer in August, following the visit to Taiwan by the US Speaker of the House, Nancy Pelosi. So that gives you a little bit more color on on the personnel picture.

Arvid Streimann: [00:14:15] Okay, great. So a couple of things that you touched on, which we'll talk about later on, particularly with regards to Taiwan. But, John, I just wanted to flip back to you. When we're thinking about China, there's all sorts of risks that investors can face. You can face regulatory risk. You can face political risk and geopolitical risk. But I think most people think about China in terms of economic risk, and maybe that's a positive risk. Okay. So maybe we think that China's going to grow. So we're interested in what's going to happen with Chinese growth. So in the past decade, China's real GDP growth has slowed from, let's call it, around 8% to something like 3% this year. So it's a bit of a slowdown and we know that in China, which is very similar to other countries, there's a kind of a deal where politicians get to stay in power so long as they keep the economy strong. So I wonder whether in your mind there was anything that came out of the National Party Congress which suggested more focus from the Chinese authorities on supporting growth?

John Garnaut: [00:15:16] Look, a good question of it, and if I could break that down. One, it's never been entirely clear what the what the foundation is for this. The compact that people talk about between the Chinese people and and the system, because it also occurs to me that if they didn't like the growth, the growth figures, there's not much that they can really do about it. But nevertheless, it's been clear that that successive Chinese leaderships have placed a high value on high growth. No question about that. And something change under Jinping where growth is no longer the priority. He has shown himself to be more interested in what he can do with the economy, the way that he can harness capital for particularly for state objectives than just the fact of growth of itself. What came out of the Congress, there was not much that we could see anywhere in any of the Congress documents which were supportive of of a new emphasis on economic growth. But that said, there's been some really significant moves since I don't know if you want to jump to that now, but we are watching very closely some of the things that are happening on a bunch of policy fronts, particularly on the zero COVID policy program.

Arvid Streimann: [00:16:33] Okay. So we'll get onto that in a moment. But just before we go back to Matt, I actually wanted to ask you about something which you touched on before John, which was Hu Jintao and when he was leaving the stage, so to speak. And and the Chinese government's official mouthpiece said that he was feeling unwell. But you were sort of painting a picture that perhaps he was a little bit upset at the fact that some of his acolytes were no longer in the at the long table, so to speak. So I guess what I'm asking here is because that footage made such a splash around the world, would would Hu Jintao have known beforehand, or was his reaction part of him just finding out on the spot? And perhaps that's what caused that reaction?

John Garnaut: [00:17:20] Look, you know, we to to delve into a little bit of speculation here. We're just watching the footage like everybody else. But I think there's a few things that we can that seem clear from the footage. One, something upset Hu Jintao and something new happened to Hu Jintao. Two, it seemed to be related to him wanting to to being nervous about something and wanting to read a document. And he wasn't allowed to read a document. We can infer that maybe that was the names list, but we're only inferring we're only speculating there. But that seems like a reasonable. Proposition. We can also. There's been lots of rumors that that that. That Hu Jintao is infirm in some way. Look, I don't know if that's true and I don't know if it matters. What we do know is something changed which led Xi Jinping or the people around him to

unceremoniously remove Hu Jintao. And that looked to me completely spontaneous. It looked to me like an exercise of sheer power that we very rarely see on camera and perhaps we never have seen in the inner sanctum like this before. But look to me to be a spontaneous exercise of breathtaking and rather worrying power, which later we found out was potentially not unrelated to the fact that all of which entails proteges have been removed.

Arvid Streimann: [00:18:53] I guess I'm going to break it just there because, John, you cut right out. I'm not sure whether everyone else saw that. Yeah, it was certainly very interesting, and I think these things are usually very highly choreographed and I don't think anyone's expecting anything like what just happened there. But Matt, talking earlier about the military side and when we're talking about China and military, the the conversation inevitably goes to Taiwan. So was there anything in China's language or perhaps even signaling towards Taiwan? I know that some folks in the US have been talking about a window for a Chinese invasion later this decade of Taiwan, as some of their military power increases relative to America's in in that theater. And the President Xi and Biden meeting on the sidelines of the recent G20, Xi publicly called out Taiwan as a red line issue for China. So I guess there are a couple of questions there. Number one for you, Matt, were there any changes in language by China towards Taiwan in the NPC? And secondly, do you think there really is a window of opportunity for Taiwan when it comes to China, potentially taking a closer look at the island later this decade?

Matt Pottinger: [00:20:49] Well, let's let's let's back up for a moment and look at the ways that Xi Jinping has been talking about Taiwan during his first decade as as dictator because because there's already a departure in in the rhetoric compare as compared with his predecessors. You remember that Deng Xiaoping famously said on at least one occasion that if we have to wait 1000 years to unify Taiwan, we can wait. But. But Deng reserved the right to use force if Taiwan declared independence. That was more or less the same rhetorical sort of bumper sticker for things that followed. The idea that Taiwan could be attacked if it sought independence. Xi Jinping changed the the the rhetoric to talk early on in his tenure and then repeatedly after about how he does not want to pass on this unresolved question Taiwan question from generation to generation any longer. He also talked about in in a couple of speeches, he has said that a failure to unify Taiwan would, in essence, mean the failure of his broader signature legacy policy, which is the Chinese dream for the great rejuvenation of the Chinese people. And so he said that without Taiwan unified, that that that Chinese dream cannot be realized. So he set a bar for failure for himself that that he, I think, is intent on on surmounting.

Matt Pottinger: [00:22:47] Now, what did he say in in this event? Well, he said in the work report at the beginning of the party Congress that resolving the Taiwan question and realizing China's complete unification is for the party a historic mission and an unshakable commitment. He said that the we will never promise to give up the use of force and reserve the option of taking all necessary measures. This is aimed at the interference of external forces. And the very few Taiwan independent separatists and their separatist activities. So that is not he didn't put a timeline on when he must achieve unification. There wasn't anything that went dramatically beyond what he'd already been saying. But but the the changes that have occurred since he first came to power have been dramatic enough already. There is there is a change in the general approach which had been to preserve the status quo and threaten the use of force in order to preserve the status quo from an independent Taiwan to now threatening the use of force in order to compel a proactive movement by Taiwan towards unification with the mainland. So, So, yeah, you know, your question, is there a window? I think that it would be prudent to assume that this is something that Xi Jinping intends to get to handle on his watch to resolve, as he puts it, the Taiwan question.

Matt Pottinger: [00:24:34] He's just given himself roughly another decade in power. You know, he's he's just given himself a third five year term. But he didn't he didn't elevate anyone who would appear to be a future successor to him, which suggests to me that he's probably just given himself another ten years and maybe longer. So so we're really we're on the actuarial table for Xi Jinping now. Right. This is something that he wants to get done in his lifetime. I think it'd be prudent to assume that that's the case. And then you have to start looking at things like what capabilities he's brought to bear, what capabilities he still believes he needs. And and is Taiwan, the United States, Japan and others, are they beginning to bring new capabilities to bear that would complicate Beijing's war plans? And I think that that there is an argument that could be made that we're looking at at a very dangerous decade and that the front half of the decade or the next, call it four or five years may be even more dangerous than than the tail end of that decade, because she could perceive that things will begin to get harder the longer he waits after new capabilities begin to get fielded in Taiwan, anti-ship missiles and the like.

Adrian Lu: [00:26:01] And John, why don't we expand on Matt's comments here? And Matt, definitely feel free to chime in here as well. On your comments about reunification. There's this popular belief that global dependency on Taiwan for chips provides some sort of protection from China. This notion of a silicon shield, so to speak. How much do you think Taiwan's position in the semiconductor supply chain actually factors into China's calculus of a forced reunification? And how do the recent US export controls on advanced chip technologies actually change the equation, if at all?

John Garnaut: [00:26:44] Look. Great question. Look, I actually think Matt's the world expert on this set of questions. But let me give you my short answer. And the short answer is I don't believe there is a silicon shield.

Matt Pottinger: [00:26:55] And I second that view. I mean, if we look for any evidence in Chinese propaganda or in official statements that have been made, we can find no evidence that Beijing is concerned that that that a war would disrupt its own economy, even though it would. We see little sign that it's worried that about a disruption of the broader global economy. In fact, we've seen some propaganda to the that suggests the opposite rather dangerously. We've seen some very strange assumptions made by a vocal Chinese scholars and others who have who have written or given jingoistic speeches in which they've said actually it's something that should be a reason why we ought to invade, because we would then gain control of the world's most important semiconductor manufacturing company, Taiwan Semiconductor Manufacturing Corp, TSMC. In fact, if China were to invade Taiwan, that would be the end of Tsmc's ability to make high end chips because it is so reliant on outside inputs from the United States and Japan and the Netherlands and other countries, it would things would grind to a halt rather rapidly. So so there is no such thing as taking control of TSMC and inheriting that capability. It would really be the end of that capability. But but, but that's not how it's spoken about in jingoistic publications and speeches by Chinese professors who actually listed as as a an attraction to the idea of war.

Adrian Lu: [00:28:48] That makes complete sense. And Matt, you talked about Dong's philosophy of of biding your time. Do you think there's any remnant of that philosophy today when it comes to semiconductors in terms of maybe waiting until they've acquired or developed a minimum level of of ability or threshold in terms of being self sufficient before deciding to actually pull the trigger on anything?

Matt Pottinger: [00:29:12] Yeah, you know, it is something that Jinping has been rather explicit about in the 14th Five-Year Plan in early 2021. And some of the speeches that he gave in 2020 leading up to that, he has identified semiconductors as one of the key areas where he wants China to achieve self

sufficiency. In both the design and manufacture of chips. That's why he's he's bulldozing literally hundreds of billions of US dollars into fab capacity. The US and its allies are now taking reactive steps to try to prevent China from achieving self sufficiency, mainly because she has been rather explicit that he wants to use that that future self sufficiency in order to attain coercive leverage over high tech economies, the industrialised economies of the world. And so the US is now rather intent. The Biden administration has taken some significant steps to try to prevent China from achieving that, that self-sufficiency. So that's that that is an area that I think. Would not necessarily prevent or deter China from taking military action against Taiwan. But it is a complicating factor.

Adrian Lu: [00:30:46] Right. And as we look at some of the recent actions that have been taken, particularly the additional export controls that were published by the US Commerce Department, and it seemed to me, looking at that document, to be a reasonable amount of ambiguity in the be it intentional or otherwise, and then others, which seem like they could have been really, really specific and targeted. How much do you think the Biden administration actually. Consult with industry about these rules? And do you think they adequately considered the second order implications and beyond? Or was this something that was just hastily thrown together to to to get something happening?

Matt Pottinger: [00:31:33] I don't think it was hasty at all. I think that there was a there was an intention going back to the earliest days of the Biden administration. But but the industry is a powerful lobby. I think I think that the administration, the Commerce Department, the White House and other parts of the US government have have gotten an earful for months and months and months on on this question and decided to move forward with some significant export controls in spite of the wishes of some parts of the US semiconductor industry. By the way, it's a very complicated it's not a monolithic thing because you have you have American companies that make the leading software for designing equipment. You have tools, tool making firms, Applied Materials and lam that that like to export their wares to any country that wants to build new fabs, including China. But then you also have companies that make chips in the United States and and would benefit from a bit more, you know, from an effort to prevent China from becoming a low cost near monopoly manufacturer of legacy logic chips and the like. So so it's a complicated picture, I think, that the administration heard from all comers ad nauseum, but decided that this was in the the strategic interest of the US and its allies. If you look at the speech, I believe it was in September that the national security adviser, Jake Sullivan, delivered. He said, look, it's no longer enough for us just to be have a relative lead on ahead of China on semiconductor technology. We actually have to increase that lead as much as possible. And the implication there is that the US has to take steps not only to improve its own capabilities and to invest and even subsidize fab capacity in the United States, but also needs to take some steps to slow down China's ambitions because those ambitions are predatory, they are not commercial, they are very much geo strategic in nature. We know that because we've heard it straight from Xi Jinping's lips.

Adrian Lu: [00:33:51] And those restrictions, the the wording of the the controls was very much focused on the national security of the United States. To what extent do you think there was also an element of protecting either US technology, protecting us on shoring of manufacturing capacity and it being more about economic considerations as much as it was about national security? And I guess where do we go from here? How does the Biden administration assess whether these controls achieve their objective? What are they looking out for? What are the sort of milestones here? And do you think there's more restrictions to come if these whether it's in semiconductors or other industries?

Matt Pottinger: [00:34:39] I think these were these objectives are squarely in the national security interest. People were not so concerned that China was going to overtake the US in design or or in even even the the level of or generation of chips that China would be able to make this. This was more about

preventing China from becoming a monopoly provider of fairly advanced chips, not necessarily the most cutting edge. And so I think I think the test for the success of these measures will be less in the restrictions on chip exports to China, because that is a very difficult and sort of fraught mission to try to prevent some Chinese end users like PLA affiliated companies that make weapons systems or that make supercomputers to test atom bombs and the like, preventing China from obtaining chips on the market and from shifting those chips to where there is military need is a very tricky, difficult endeavor. The more important piece of those October seven semiconductor rules were the part that are designed not to prevent China from obtaining chips, but to prevent China from becoming the lead manufacturer of chips. And I think that those I think that those will hit their mark. I think it will slow China down. And that will be the true measure of success of these of these semiconductor rules.

Adrian Lu: [00:36:23] And John, China's reaction to all of this has been fairly muted or tepid. Have they just been caught up in the NPC? Are they sort of still sitting back and evaluating their options? And where could China retaliate before we sort of start to see? Actually, let me repeat that question. I was meant to say red lines earlier. So, John, in considering all of this, China has been fairly muted in its response to all of these restrictions. Where do you think the red lines are for China here as far as how much further the United States could push this? What do you think? They've been fairly low key in terms of a response so far. Has it just been the the National Party Congress keeping sort of taken up the time of the party? And where do you see areas that China could retaliate in the meantime?

John Garnaut: [00:37:28] Thanks, AJ. Look, we didn't expect China to retaliate directly against the United States, and that's because there's no real precedent for them doing that. It's been we've had very close look, including back to the time when Matt was deputy national security adviser in the previous administration, where there was no direct and commensurate response to actions from Washington that looked like they would be perceived as being provocative. There's lots of noise. There was lots of English language fury in the Twittersphere, and there was a bit of foreign ministry kind of angry talk. But in terms of substantive policy reaction, it's never been directly retaliate against US interests. It's more been following, I guess, the almost the Maoist precept of guerrilla warfare. The enemy retreats, the enemy advances, we retreat and the enemy retreats we harass. And that so far, that pattern is playing out with respect to the United States. Now, this is not necessarily always going to be the case. Up until now, we've seen Beijing exercise, I guess, a deal, a degree of respect and restraint against the United States. And they've been much more likely to be aggressive at times when the United States might not be frontally looking at them or it's it tends to be asymmetric.

John Garnaut: [00:38:55] China has been much more willing to retaliate sideways against allies, partners, for example. And we really expect this to broadly hold that when the United States is in a mode which China perceives to be aggressive, that is unlikely to be the time when China responds directly to it, they will bide their time. They will look for a moment that they perceive to be a vulnerability or just as likely they'll kick sideways to others. And so far that pattern is holding. That's broadly how I expect it to hold at the moment. I don't expect China to retaliate against these measures or future measures. However, China will always be searching for rationales or even pretext to explain its own actions that are perceived to be aggressive. So the story will always be this is just about defending China's interests. This is because of what the United States did before. But actually, in reality, I don't think the response reaction function is like that at all.

Arvid Streimann: [00:40:02] Hey, John, I just wanted to get back to something that we were talking about earlier when we were talking about the economy. And you mentioned something along the lines of a zero COVID strategy. And and, you know, I'm a little bit confused about the zero COVID strategy. On the one hand, I'm I'm pretty sure you can't keep 1.4 billion people locked up forever. But on the other

hand, I'm not sure how they're going to unwind that policy in a smooth fashion. I know everyone's sort of talking about this, but, you know, in the lead up to the National Party Congress, the official Chinese media made some statements suggesting that that policy was not going to change. But right after the National Party Congress, there were whispers that it was about to be eased. And then right after that, some government officials came out and said, more or less, we're pouring cold water on those rumors. So it does seem as though China is reducing some of its restrictions, particularly those on inbound passengers into the country. But, you know, it is still confusing as to what the ultimate intention here is, at least in the I guess, more so in the short term. So what's your take on the Chinese government and the zero COVID policy in the short to medium term?

John Garnaut: [00:41:12] Look, this has been fascinating to watch and it is confusing and contradictory, But I think that the trajectory is clear on the one hand, because the zero COVID policy comes from Xi Jinping himself. And keeping is really the definition of truth. It can't be wrong. It has to hold. So there's been no deviation from the rhetorical commitment to zero COVID, and that's likely to stay for the foreseeable future. At the same time, we were watching this and we've been talking about this before, but we've been watching a couple of things happen since the Congress, which have been really striking. One. We've been watching how the proper propaganda has been has morphed, has mutated. So it's no longer talking about how catastrophic the virus is. It's been downplaying the impact of the virus. It's in some cases, it's more like the common cold. That's significant, too. We've seen we've seen the the construction of really large what has been termed as sort of hospital care. Whether that rises to the level of hospital care or not. But they're creating beds for what looks like the preparation for mass outbreaks. Three, we're actually watching a systematic dismantling of the testing system. Whereas before, it was all emphasis on on being able to find the virus, test for the virus and shut it down and lock it down wherever you can. They're actually dismantling that early warning system. So by design, they're letting it through. And most importantly, they have shifted in their messaging, shifted the KPIs of officials. Whereas before and officially it was really easy. You knew that as long as you were hard, hard on the side of lockdowns, you were going to be safe. If COVID got out your watch, you're going to be in trouble.

John Garnaut: [00:43:04] That is now flipped. It's not clear that just safe if COVID gets out, but you definitely no longer safe by erring on the side of lockdown. So so we're seeing officials being punished and a lot of rhetoric about officials being being out of line for being too aggressive on lockdowns. And all of that adds up to, at best, policy confusion. But in reality, and we're still seeing lockdown, but with a lag and not the same sort of forward, ruthless, eradicated at all costs. And so what this means and we've been describing in our client notes for the last three weeks is we're seeing an attempt to implement what we call the controlled burn. Of other country. Society they would prefer it doesn't engulf the country all at once. Like every country has tried to smooth the peaks of. We're concerned that the public health system is not overwhelmed and China is particularly vulnerable because it's got an under-vaccinated population, particularly elderly population and its effects. These aren't particularly effective. So it definitely attempts to slow it down. And there's there's lockdowns now in major cities at the moment, including Beijing and Gwangju in Shenzhen. And I should add one, but this is not the same as trying to actually implement zero COVID like they were before. So we think the direction is this controlled burn throughout the Chinese economy and society, which would take months or take longer than it has in the West. But nevertheless it's happening. So now we can see a post lockdown possibility for China at some point, perhaps in the first half of next year, whereas before we couldn't see that at all. So everything's changed, even though the commitment to the headline policy remains unchanged.

Matt Pottinger: [00:44:48] Yeah, they're moving from they're moving from containment to mitigation to use the public health parlance, even though that may not be how they're describing it. But that's

effectively what's happening now. They're moving from zero COVID to what you could call a zero COVID deaths strategy. And I don't know if you've noticed, but there's only been a few deaths reported in China in spite of tens of thousands of new cases each day. Miraculously, no one's actually dying of it. So what's happening here is they're simply not reporting COVID deaths as COVID deaths. They're attributing the cause of death to anything but COVID. And that's been that's been a feature of this of this pandemic in China since its early, earliest days.

Arvid Streimann: [00:45:41] Okay. So for investors, there is some opening of the pathway to a reopening of of China. But it's going to be a it's not going to be a straight line by the sounds of it. Correct.

John Garnaut: [00:45:52] It's going to be messy and it's going to be tragic for a lot of people. You know, COVID is not a this is a lot of people are going to die and this is going to take months to work itself through the country. But there will be a point when they're on the other side.

Arvid Streimann: [00:46:08] Okay, Now I know we're getting towards the end of our little discussion here, but I just wanted to throw in one last thing here, which is and it's a really a question to both of you, and perhaps we can split spill up the question. But as I mentioned earlier, Xi Jinping and Joe Biden met on the sidelines of the G 20 Summit. And our very own Prime Minister Albanese also met with Xi Jinping, which I think was their official first official face to face meeting between a prime minister of Australia and the leader of China since 2016 face to face. So I wanted to get both of your takeaways on those meetings. And perhaps the best way to divvy this up is, Matt, if you provided your takeaway on the Xi Jinping Biden meeting and and John, if you could perhaps give your thoughts on what the implications of this reengagement between the two leaders of Australia and China are.

Matt Pottinger: [00:47:02] Sure. Well, look, it's it's good that the two leaders are talking because Xi Jinping is the only one who makes decisions in that system, increasingly so. And so it's important that you have that high level diplomacy taking place. There's no substitute for the two leaders speaking to one another. You know, my my interpretation is that, you know, Xi Jinping's goals are contained in the canon of speeches and work reports and amendments to the party charter that that he has made up to and including just a few weeks ago at the party Congress. If we're paying attention, we should feel confident that we have a pretty good idea of what his ambitions are, the scope of those ambitions and his means of achieving them through what he calls a spirit of struggle, struggle in the Stalinist sense of the word. So to the extent that that she might be trying to charm, turn on a little bit more charm on the international stage right now I view as purely tactical. It is it might even be a sign of weakness within his own recognition of the state of weakness that the Chinese economy is in right now. Let's face it, their economy has cratered. If they're reporting 0.4% growth in the second quarter, you can bet that it's a it's a large negative number that that. That we've seen. So it might be from from a sense of weakness, but I view it as as temporary and tactical.

Arvid Streimann: [00:48:52] And, John, your interpretations of the Australia China meeting.

John Garnaut: [00:48:57] Yeah, look, I agree with all of of that, which doesn't mean it's inconsequential. It doesn't mean it's unimportant. So in Australia's case, less perhaps less, less significant for the big guy on the block for Australia, it matters that our biggest trading partner is no longer that every official in China is not is no longer incentivised to beat up on Australia. This will mean an opportunity for some relief on the export front, on the various export embargoes and blockades. That's not a prediction of short term movement, but it opens the door to progress there. It opens the door to the possibility that Australian hostages will be released, particularly young Honduran, a a terrific and important pro-

democracy writer, Australian citizen, and also Cheng Lei, the journalist who are both detained. And their fate is tied very much to the fate to the state of bilateral relations. So these are all good things because the window of opportunity to get important things done and unlocked, while sticking to caveat that this is not structural, this is tactical, There's a window here. It won't last forever. At the moment, it looks like Canada has taken Australia's place on the on the geopolitical dart board. So it just shows that the wheel has turned. The game remains the same. And in the short term, this is on balance, good news for Australian producers and Australia generally.

Arvid Streimann: [00:50:30] Okay, great. So start that again. Okay, great. So let's celebrate the re-engagement, because I think that that you're right, as I often tell people, the worst thing that people can do is not speak to each other. But I think we're coming towards the end of our conversation. I just wanted to say that there had been a great conversation about some things that are very big issues for investors. So thanks very much for your time, both Matt and John.

John Garnaut: [00:51:01] Thank you it and thank you, Adrian. What a great pleasure. Always good to talk with you.

Matt Pottinger: [00:51:05] Yeah, it's great to speak with you all.

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