Investment Insights

Still Open for Business?

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Highlights

- While investors were focused this week on Telsa, Tencent, trade and Turkey, Washington passed a law that makes stricter rules around inbound foreign direct investments.
- The enhanced "CFIUS" legislation seems likely to mute foreign interest in U.S. investments and/or acquisitions, well beyond simply Chinese investments.
- Other countries are employing similar rules; we are increasingly considering what reduced foreign direct investment and cross-border capital flows — in the U.S. but also globally — could imply for our economic and market assumptions in the years to come.

With a lot of other market-moving events this week, it wouldn't be a surprise if many investors missed one coming from Washington. Tucked into the John S. McCain National Defensive Authorization Act for fiscal year 2019, signed into law Monday, was language that raises hurdles for select foreign firms looking to invest in the U.S.

CFIUS, or the Committee on Foreign Investment in the U.S., is a panel made up of policymakers from different government entities, including Treasury, Justice, Energy, State and Commerce departments, among others. Created in the 1970s with investment from the Middle East in mind, its goal is to examine possible transactions and assess if they create national security risks for the U.S. If CFIUS determines that a transaction poses security concerns that cannot be resolved, it refers the transaction to the president, unless the parties choose to abandon the transaction. The president may suspend or prohibit the transaction, including requiring divestment.

CFIUS is among the trade-related tools the Trump administration has employed much more forcefully than predecessors, in particular to address the U.S.' trade deficit with China and, especially, the possible theft of U.S. technology by China. Indeed, CFIUS appeared to be part of the story in two failed deals just this spring. President Trump blocked Singapore-based Broadcom's bid for the U.S.' Qualcomm in March, and a month later, the Chinese firm HNA Group withdrew its bid for most of SkyBridge Capital, a U.S. hedge-fund investment firm. (In the case of Qualcomm, CFIUS documents related to the deal noted relationships between Broadcom and third parties as a risk — presumably these parties included China.)

The Broadcom-Qualcomm deal illustrates what appears to be a growing focus of CFIUS —U.S.-bound investments where the foreign firm could have ties of different sorts to China. Such an approach could significantly broaden the number of deals reviewed and potentially prevented. Also likely to increase CFIUS involvement, the legislation expands oversight to new areas, including minority stakes and other non-controlling investments, as well as real estate transactions (including leases near security-sensitive locations). The process, before and after this new legislation, can be cumbersome, costly and relatively opaque for the would-be acquirers — in itself potentially slowing inbound foreign direct investment (FDI).

As investors, we need to ask whether such efforts could have meaningful market and/or macro-economic impacts. This is not particularly easy to answer. On one hand, without steps to prevent technology transfer, could the U.S. lose revenue over time that it might otherwise have kept at home? Could jobs be at risk in that process? If other countries gain economically, could that also pose risk to the U.S.' geopolitical standing over time? These issues certainly appear to be at least part of why the CFIUS rules were tightened in the first place.

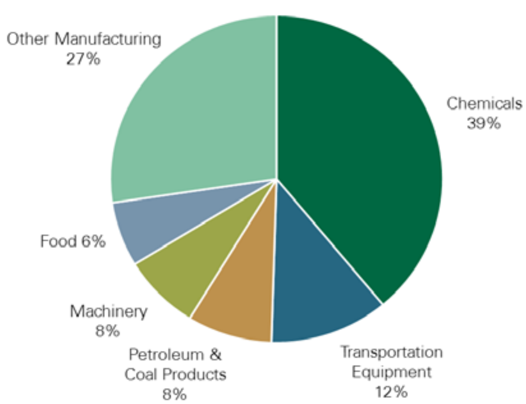
At the same time, there is no free lunch. CFIUS has a cost as well that warrants understanding for macro-economic and market implications. For now, we see the greatest possible impact as more psychological than anything —a chilling effect of sorts; a sense that the U.S. may not be as "open for business" as it was in the past. In addition, we see room for possible market and economic impacts at the margin through a few different channels, including jobs, merger and acquisition (M&A) activity, and currencies.

Jobs

According to government data, there are currently about 6.8 million Americans working for majority-owned U.S. affiliates of foreign multinational firms (in other words, jobs created via FDI). That's equal to 5.5% of total private U.S. employment — to put that number further in context, it is more than total employment today in the state of Pennsylvania. According to the Organization for International Investment, most of those jobs are in manufacturing and are driven by companies ultimately domiciled in Japan, Europe and Canada (Exhibit 1).

Exhibit 1: Breakdown of Cumulative FDI in U.S. Manufacturing

Percent of Total Dollar Amount of FDI in U.S. Manufacturing

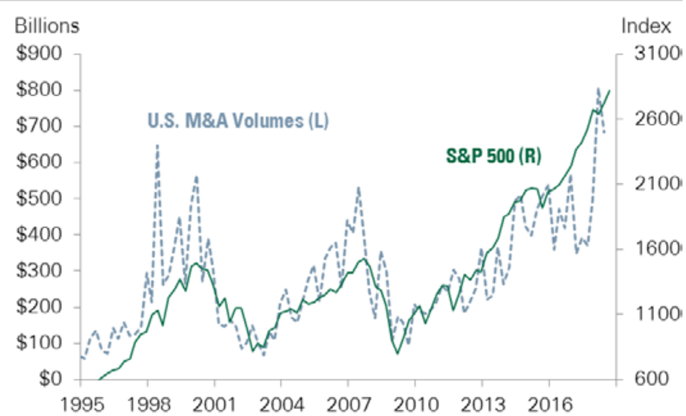


As of 2015.
Source: OFII

M&A Activity

History shows a consistent, positive relationship between M&A (a large component of FDI) and equity markets (Exhibit 2). It seems that causality goes both ways — positive equity market trends may give corporate executives confidence to pursue a deal, and deals suggest to the investing public that companies are confident enough to commit to large undertakings such as a merger and see a positive outcome from the event, even after all the cost and time they entail. A tougher CFIUS process, alongside global uncertainty tied to the ongoing trade war, could easily weigh on M&A activity, especially when Chinese firms are involved, and in certain, more politically sensitive sectors. The greater CFIUS focus on "third parties" could exacerbate the trend. What if a Japanese or German auto company wants to expand operations in the U.S. today, but it has a joint venture with a Chinese firm? That would-be acquirer may instead look to expand elsewhere and avoid the regulatory and political hurdles. All else equal, a notable decline in M&A activity would remove a measure of support from stocks broadly. So far in 2018, such a trend is not apparent. The first half of 2018 marked the strongest six months of M&A activity since the financial crisis. However, cross-border deals were reportedly down sharply over the period; six out of the 10 largest deals were domestic.

Exhibit 2: U.S. M&A Volume by Quarter and the S&P 500



As of June 30, 2018 for M&A volume and August 16, 2018 for S&P 500. S&P 500 reflects the price level.
Source: Bloomberg

Currencies

In recent decades, the U.S. has tended to run a current-account deficit (currently around 2.3% of GDP). That means the U.S. is a net seller of its currency to pay for imported goods. Without offsetting capital inflows, the dollar will generally be under pressure — it will weaken. Those capital flows are primarily made up of foreign buying of U.S. stocks and bonds, and FDI (the largest part of which is cross-border M&A). Last year, using U.S. government data, foreign investors bought a net $156 billion worth of U.S. equities and $644 billion worth of U.S. debt. Meanwhile, net inbound FDI was $355 billion, representing a third of these total capital flows. We are not suggesting that CFIUS, the trade war or other factors would take this number to zero; what we are suggesting is that a large reduction in FDI inflows without a shift in other flows and/or a reduction in the current-account deficit would reduce the probability of dollar strength. Given the global role of the dollar, sustained trends in either direction have a slew of global implications (see “Common ‘Cents’ - All About the Dollar,” July 2014).

Global Barriers Rising

While the enhanced CFIUS process appears likely to impact the U.S. economy and markets going forward, at least to a degree, it is also worth noting that the U.S. is not alone in these efforts. Last summer, Germany became the first European Union country to introduce regulations meant to block corporate takeovers if there was a risk of technology transfer abroad. Meanwhile, the European Commission has set up a “Group on Trade and Harnessing Globalization,“ and is expected to share its latest thoughts in a policy speech in September, focused on preventing technology transfers and unwanted takeovers. The U.K. in July proposed that government ministers would have the power to block foreign takeovers across different industries on national security grounds. A comment period on the proposal is currently underway. Clearly, much of this is aimed at the same thing CFIUS is: losing technology to other countries through M&A activity and protecting local firms and jobs.

Chinese officials, in particular, argue that firms partnering with China are not forced to do so; they seek the opportunity to gain access to China's 1.3 billion population and growing middle class. They have lots of examples of benefitting firms to point to, including the U.S.'s own General Motors (GM). Last year, GM and its Chinese joint ventures (JV) sold more than 4 million vehicles in China; China was GM's largest retail market for the sixth consecutive year. Chinese policymakers feel that the JVs and partnerships they sometimes require are meant to protect and help local firms — just like the U.S. looks out for its own interests, so does China. Without these JVs, more mature foreign firms could capture more market share in China and crowd out local ones.

This global trend of raising cross-border barriers and checks and balances, in our view, does not necessarily have immediate investment implications. However, less global trade suggests potentially slower global growth. And fewer global capital flows suggest less liquid currency markets, the latter creating the risk of more market volatility. There are understandable worries among countries and companies about protecting firms and sources of comparative advantage at home — especially in a world where technology is playing an increasingly high-profile, important role. However, we also know from history that policy choices made with the best intentions can sometimes have unintended consequences, in this case, creating a different set of macro and market risks.

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