

U.S.- China breakup getting messy with Trump's executive orders restricting TikTok and WeChat in U.S.



Jay Ritter, Equity Research Analyst, BMO Wealth Management - U.S.

Yung-Yu Ma, Ph.D., Chief Investment Strategist, BMO Wealth Management - U.S.

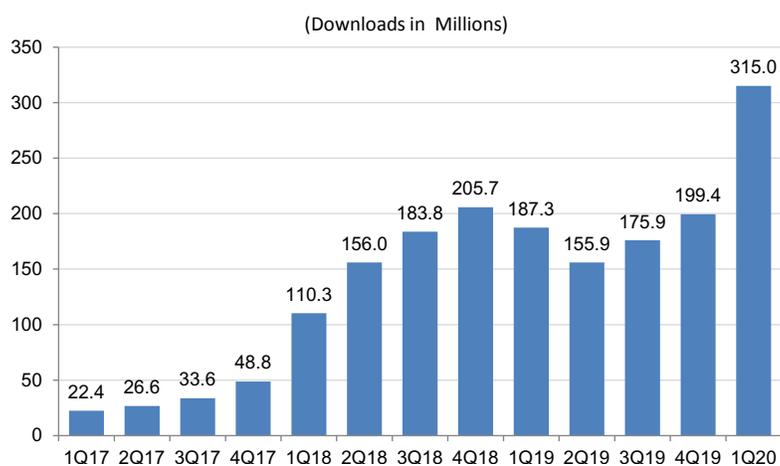
Thursday, August 27, 2020

What happened?

The latest chapter in the unfolding U.S.-China trade war has moved to the Internet, focused on the potential national security threat posed by Chinese companies operating in the U.S.

On August 6, President Trump issued two executive orders that would limit the ability of Chinese social media apps TikTok and WeChat to operate in the U.S. beginning 45 days from the date of the orders. The orders are quite broad but subject to interpretation. They bar anyone in the U.S. from transacting with the China-based owners of the apps. TikTok is the incredibly popular short video app which is owned by Beijing-based ByteDance. The app is especially popular among teenagers and has been downloaded over 2 billion times globally and 165 million times in the U.S. (see Exhibit 1). WeChat is the ubiquitous Chinese messaging app (and much more) which is owned by Tencent.

Exhibit 1: TikTok global downloads by quarter



Source: SensorTower; sensortower.com

National security concerns are legitimate

Until now, Chinese-based Internet companies haven't had a large presence in the U.S., so government controls haven't been a big concern. Last year, *The Guardian* obtained documents¹ revealing that TikTok's content is subject to "moderation guidelines" that advance Chinese foreign policy (e.g. banning material that refers to the "Tiananmen Square incidents"). The same goes for Tencent's WeChat which is used by Chinese students and immigrants living in the U.S. The Trump Administration may be concerned that TikTok's algorithms could somehow influence the 2020 elections. Seems like a stretch, but not impossible to imagine. A big part of TikTok's secret sauce is in the algorithms designed by engineers in China that determine which videos appear in the user's feed.

Why is Microsoft pursuing a deal with TikTok?

Following President Trump's executive order, TikTok's parent ByteDance is left with few options besides selling its U.S.

operations to a U.S. company. Microsoft (MSFT) is the logical buyer given its deep pockets and limited exposure to the social media market which should help with regulatory approval. Others (including Oracle) have also expressed an interest in buying TikTok but MSFT seems most likely. Microsoft's management apparently sees the benefit of acquiring a unique asset at what could be a fire sale price (rumored to be in the range of \$10 - \$30 billion) given TikTok's tremendous growth potential.

While TikTok is a consumer-oriented company that would seem to be outside of MSFT's core competency, the hope is that MSFT's recent

¹ <https://www.theguardian.com/technology/2019/sep/25/revealed-how-tiktok-censors-videos-that-do-not-please-beijing>



success with acquisitions such as LinkedIn could be replicated with TikTok. TikTok is in the early stages of building out its advertising stack and Microsoft has some experience with that from the Bing search engine. Finally, there would be cost synergies from moving TikTok's cloud database onto Microsoft Azure.

What if the Microsoft / TikTok deal falls through?

If the deal with Microsoft falls through other buyers would likely step in. In the event that TikTok is forced to shut down in the U.S., Facebook (FB), Google (GOOGL/GOOG) and other ad-driven internet players would be the main beneficiaries as the long-term competitive threat from TikTok would be removed. To capitalize on the TikTok controversy, Facebook has already rolled out a competing service called Instagram Reels and it has reportedly been poaching talent from TikTok's roster of content creators.

How will China respond?

TikTok's owners and the Chinese government are obviously not pleased about being forced to sell the business or shut down in the U.S. While there are number of ways the Chinese government could retaliate – e.g., restrict rare earth mineral sales or take action against specific U.S. companies in China – we believe that China is likely to bide time and “lie low” until after the U.S. presidential election. The long-term relationship between the U.S. and China will continue to be contentious but the specific nature of U.S. policy, and by extension China's strategy, will differ depending on whether Trump or Biden occupy the White House. Biden, should he be elected, is likely to form a coalition with our European allies to confront China. In this case, China's response is fairly predictable – string everyone along and attempt to exploit self-interest and lack of priority alignment between the U.S. and Europe – put simply, try to divide and conquer.



Disclosure

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

This report contains our opinion as of the date of the report. It is for general information purposes only and is not intended to predict or guarantee the future performance of any investment, investment manager, market sector, or the markets generally. We will not update this report or advise you if there is any change in this report or our opinion. The information, ratings, and opinions in this report are based on numerous sources believed to be reliable, such as investment managers, custodians, mutual fund companies, and third-party data and service providers. We do not represent or warrant that the report is accurate or complete.

To the extent this report contains information about specific companies or securities, including whether they are profitable or not, it is being provided as a means of illustrating the investment manager's investment thesis. The investment manager may or may not have invested in these securities at the time this report was prepared or is accessed by the reader. References to specific companies or securities are not a complete list of securities selected and not all securities selected in the referenced timeframe were profitable.

Other Bank of Montreal affiliates, and their agents and employees, may provide oral or written market commentary or trading strategies to clients that reflect opinions that are contrary to the opinions expressed in this report. These same persons and affiliates may make investment decisions that are inconsistent with the recommendations or views expressed in this report. We and our affiliates, directors, officers, employees and members of their households, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities referred to in this report. We and our affiliates, directors, officers, employees and members of their households, may have positions in the securities mentioned that are inconsistent with the views expressed by this report.

This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, a recommendation to buy, hold or sell securities, or a recommendation of any investment manager or investment strategy. Do not use this report as the sole basis for your investment decisions. Do not select an asset class, investment product, or investment manager based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Any forward-looking statements in this report involve known and unknown risks, uncertainties and other factors that may cause the actual performance of future markets to differ materially from the projections depicted in the report. Past performance is not indicative of future results and current performance may be higher or lower than that shown in the report. There can be no certainty as to the extent or depth of any market downturn, nor any assurance regarding the nature, extent or timing of markets rebounding. When evaluating the report, you are cautioned not to place undue reliance on these forward-looking statements, which reflect judgments only as of the date of the report. Investment returns fluctuate, and investments when redeemed, may be worth more or less than the original investment.

Standardized performance returns include reinvestment of dividends, other income and capital gains, which depict performance without adjusting for the effects of taxation or the timing of purchases and sales. Performance data is presented without deducting the investment advisory fees and other charges that may be applicable. The deduction of such fees and other charges (and the compounding effect thereof over time) will reduce portfolio return. Unless otherwise indicated, traditional investment performance data generally represents a composite or representative portfolio return and is shown gross of the investment manager's advisory fees. Unless otherwise indicated, alternative investment performance data is shown as net of fund expenses, management fees, and incentive fees. Index performance data is shown as total return. You cannot invest directly in an index. Due to a system conversion, the ability to manipulate or restate client specific performance data prior to December 31, 2007, may be limited.

Any discussions of specific securities, investment managers, or strategies are for informational purposes only and should not be considered investment advice. The report does not constitute an offer to sell or a solicitation to buy any security or investment product. Any offer to sell or solicitation to buy an interest in any private security, investment product or fund may only be made by receiving a confidential private offering memorandum, prospectus, investment advisory agreement or similar documents from the investment manager, which describes the material terms and various considerations and risks relating to such security, investment product or fund.

Alternative investments, such as private equity and hedge funds, contain risks that are amplified when compared with other asset classes, such as illiquidity, stock or sector concentration, financial leverage, difficulties in valuation, and short selling. Alternative investment vehicles have minimal regulatory oversight and alternative managers have the latitude to employ numerous investment strategies with varying degrees of risk.

We are not licensed or registered with any financial services regulatory authority outside of the United States. Non-U.S. residents who maintain U.S.-based financial services accounts with us may not be afforded certain protections conferred by legislation and regulations in their country of residence with respect to any investments, investment solicitations, investment transactions or communications made with us.

You may not copy this report or distribute or disclose the information contained in the report to any third party, except with our express written consent or as required by law or any regulatory authority.

"BMO Wealth Management" is a brand name that refers to BMO Harris Bank, N.A., BMO Family Office, LLC, BMO Harris Financial Advisers, Inc., BMO Delaware Trust Company, and certain affiliates that provide certain investment, investment advisory, trust, banking, securities, insurance and brokerage products and services. "BMO Family Office" is a brand name that refers to BMO Harris Bank, N.A., BMO Family Office, LLC, and BMO Delaware Trust Company. The BMO Family Office brand provides family office, investment advisory, investment management, trust, banking, deposit and loan products and services. These entities are all affiliates and owned by BMO Financial Corp., a wholly-owned subsidiary of the Bank of Montreal. Capital Advisory Services are offered by a division of BMO Harris Bank, N.A. Member FDIC.

NMLS #401052



Broker-dealer and investment advisory services and insurance products are offered through BMO Harris Financial Advisers, Inc. Member FINRA/SIPC. SEC-registered investment adviser.

Securities, investment advisory services and insurance products are offered through BMO Harris Financial Advisers, Inc. Member FINRA/SIPC. SEC-registered investment adviser. BMO Harris Financial Advisers, Inc. and BMO Harris Bank N.A. are affiliated companies. Securities and insurance products offered are: **NOT FDIC INSURED – NOT BANK GUARANTEED – NOT A DEPOSIT – MAY LOSE VALUE.**

Not all products and services are available in every state or location or through all entities within BMO or BMO Family Office.