



Sino-US tensions in a post-COVID world

23 September 2020

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Even before the current pandemic, tensions between the US and China were already rising, and this trend has been accelerated by the fallout from COVID-19, raising the spectre of a new Cold War. There are some parallels with what happened between the US and the Soviet Union, particularly on ideology. A key difference is that China is much more integrated with the US and global economies than the Soviet Union ever was, implying a higher cost from any reduction in economic links. The US network of partners offers a key advantage that China cannot match in the near future — Beijing may attempt to disrupt this network instead. How third countries react as they balance the greed for a large and growing Chinese market against the fear of a powerful authoritarian state remains to be seen. For now, there does not appear to be huge appetite in Europe or Asia for a materially different economic approach, but this could change.

Thucydides's Trap: background

In *Destined for War: Can America and China Escape Thucydides's Trap?* Graham Allison demonstrates a long history of conflict when an existing power feels threatened by a rising one, or a rising one feels stifled by an existing one. His chronology goes back to Ancient Greece, when Athens went to war with the incumbent power of the time: Sparta. Allison catalogues many other examples, including the Hapsburgs challenging France in the first half of the 16th century, Japan challenging the US in the mid-20th century and the Soviet Union challenging the US from the 1940s to the 1980s. In the latter case, the increased probability of conflict never resulted in direct military action.

Previous episodes of existing and rising powers have been associated with increased tensions and conflict



Rising and ruling power tensions			
Period	Ruling Power	Rising Power	Result
First half of 16th century	France	Hapsburgs	War
16th–17th centuries	Hapsburgs	Ottoman Empire	War
17th century	Hapsburgs	Sweden	War
17th century	Dutch Republic	England	War
Late 17th–early 18th centuries	France	Great Britain	War
Late 17th–early 18th centuries	United Kingdom	France	War
Mid-19th century	United Kingdom, France	Russia	War
19th century	France	Germany	War
Late 19th–early 20th centuries	Russia, China	Japan	War
Early 20th century	United Kingdom	United States	No war
Early 20th century	Russia, UK, France	Germany	War
Mid-20th century	Soviet Union, UK, France	Germany	War
Mid-20th century	United States	Japan	War
1970s–1980s	Soviet Union	Japan	No war
1940s–1980s	United States	Soviet Union	No war
1990s–present	United Kingdom, France	Germany	No war

Source: Graham Allison / Fathom Consulting

In total, Allison identifies sixteen examples of rising and ruling power tensions. In twelve of them, the two parties involved went to war. However, the last three examples (Soviet Union and Japan in the 1970s and 1980s; the United States and the Soviet Union from the 1940s to the 1980s; and the United Kingdom/France and Germany from the 1990s to the present), did not end up in war. One possible reason for this is that nuclear weapons now act as a deterrent, due to the theory of mutually assured destruction (MAD).

Thucydides’s Trap: Sino-US context

China’s economic rise has been rapid. In 2000, it accounted for 4% of global GDP (at market exchange rates). As of last year, that figure had quadrupled to 16%. Over that same period, its share of US GDP (at market exchange rates) rose from 12% to 66%. That rise poses a challenge for the United States, which has led the ‘liberal international order’ since the end of World War II. Some believe the world’s two superpowers could be entering their own Thucydides’s Trap.

Evidence of this can be seen in rising tensions over a range of issues, predating the current administration. In August 1999, while running for president, George W. Bush labelled China a ‘strategic competitor’, later levying tariffs on steel imports during his presidency. Meanwhile, the Obama administration became increasingly concerned about Beijing’s more belligerent presence in the South China Sea. That was one of several reasons behind attempts to ‘Pivot to Asia’, which itself received an ice-cold welcome in Beijing.

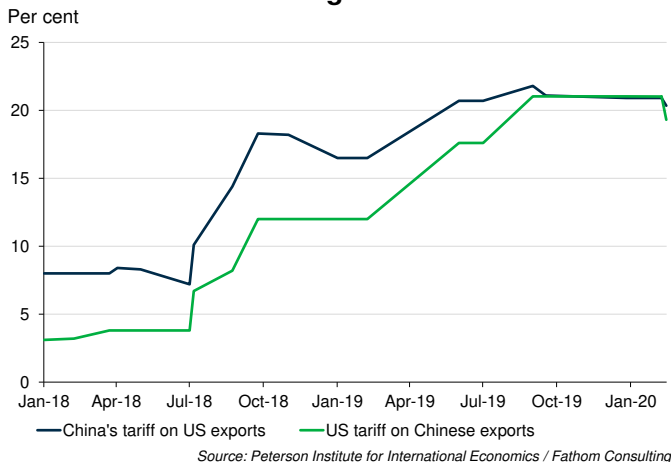
While Sino-US relations had already deteriorated after the turn of the century, they have soured further under the Trump administration. The US has introduced various levies on imports from the Mainland that now cover around half of all goods. Beijing has retaliated in kind, increasing the average tariff rate applied on goods imported from the US in return. The Phase One trade deal is far from a panacea. But it is not just trade. In its first National Security Strategy document, the current administration officially labelled China a strategic ‘competitor’. That designation was maintained in recent White House document (*US Strategic Approach to the People’s Republic of China*) that promised a ‘whole-of-government approach’ that would be guided by principled realism in response.

The most recent examples have avoided direct conflict, perhaps due to theory of mutually assured destruction

The increase in tensions between the US and China predates this administration



Sino-US effective average tariff rates



But they have increased over the past four years

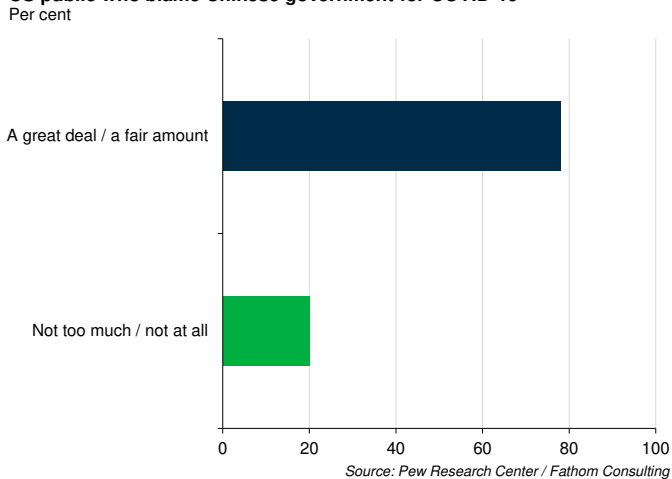
Thucydides's Trap: impact of COVID

These trends have been accelerated by the COVID-19 crisis. The novel coronavirus was initially identified in Wuhan, China. It has since spread all over the world, causing severe health and economic consequences. At the time of writing, the official number of fatalities was just below one million while the global economy faces its steepest decline in recorded history. Our expectation is that world GDP will drop by 6% in 2020, far surpassing the 0.1% decline notched up during the Global Financial Crisis.

The US has criticised China for covering up and downplaying the initial outbreak of the virus and for not doing more to contain it within its borders. President Trump has routinely called it the "China virus". Meanwhile, Republican Senators, including Lindsey Graham, have called for China to pay "big time" for the economic damage caused by COVID-19. Secretary of State Pompeo has said that China could have "prevented the deaths of hundreds of thousands of people worldwide". It is not just politicians. Almost four-fifths of the American public blame the Chinese government's initial handling for the global spread of coronavirus. Meanwhile, the number of Americans who report having an unfavourable view of China has risen to a record high. Being a China hawk is now a relatively bipartisan position, likely to gain support from the majority of Americans.

Being a China hawk is a bipartisan position in DC, and would probably be supported by majority of Americans

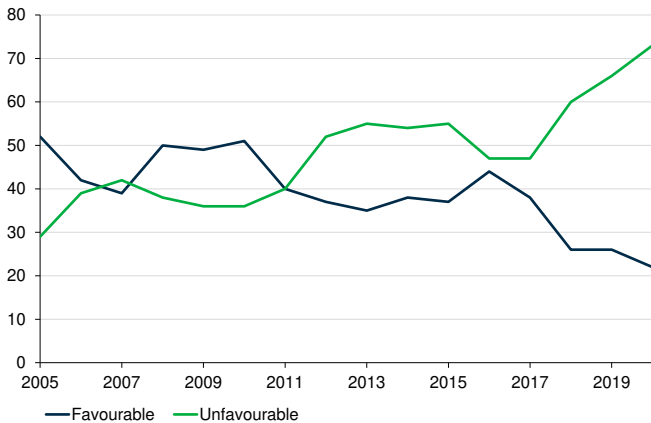
US public who blame Chinese government for COVID-19





US public's view of China

Per cent



Source: Pew Research Center / Fathom Consulting

With relations between the US and China already under severe strain due to the fallout from COVID-19, developments in Hong Kong have heightened tensions further. The Chinese government imposed a draconian new security law that made secession, subversion, terrorism and collusion illegal. If someone is found guilty, they could face life in prison. Many believe the new law will give Beijing much greater control over Hong Kong. The US has said that Beijing has violated the principle of 'one country, two systems', imposing sanctions in response and withdrawing Hong Kong's special trading status rights.

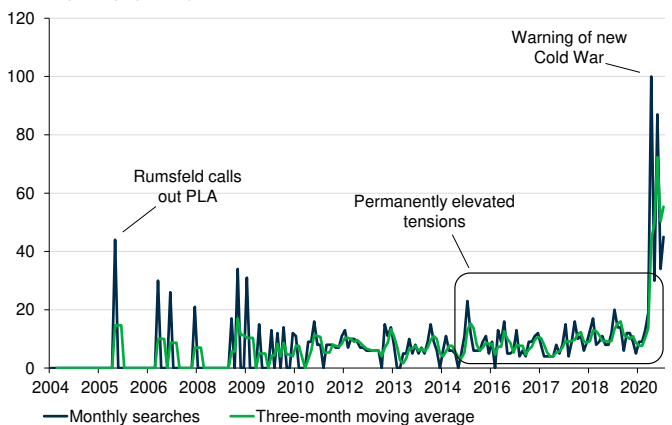
Over the summer, Foggy Bottom ordered the Chinese consulate in Houston to shut, alleging that it was a breeding ground for spies. And Secretary Pompeo called on the Chinese people to alter the behaviour of their government. Beijing responded in kind, by ordering the US consulate in Chengdu to be shut. In the background, tensions between Beijing and Taipei continue to rise, with Taiwan continuing to rank highly as a probable catalyst for steep leg-up in Sino-US tensions.

Against that backdrop, it is no surprise that measures of Sino-US tensions have increased to record highs. Google trends show that searches for the three words "China US tensions" have reached peaks far higher than anything previously seen. As with other things, COVID-19 is accelerating an existing trend. In this case, it seems to have turbo-charged already worsening Sino-US relations. The Chinese Foreign Minister, Wang Yi, has warned that the world's two superpowers could be entering a new Cold War. Other researchers have identified clear resemblances between the rise of China and the US, and the rise of Germany and the UK ahead of World War I.



Google searches for "China US tensions"

Index, peak popularity = 100



Source: Google / Fathom Consulting

Sino-US tensions have increased to record levels in the wake of the coronavirus pandemic

This change in what president Obama labelled the “most important bilateral relationship of the 21st century” will have clear economic consequences. This is apparent when looking at Sino-US trade flows, which have dropped by 20% over the past couple of years as both sides applied levies on each other’s imports. Foreign investment screenings have increased, and we estimate that foreign investment from China to the US dropped by 91% between 2016 and 2019, outpacing the 61% drop in Chinese foreign investment to the rest of the world over the same period. The effects of this more fraught Sino-US relationship are unlikely to be limited to those two countries. One big question looking forward is how this will affect the economic relationship of third countries.

Cold War parallels: ideological competition

This new era of Sino-US relations is most commonly compared to US-Soviet relations during the Cold War. One of the closest similarities is that both periods involved superpowers with opposing ideologies. Unsurprisingly, our proprietary measure of political ideology puts China and the US on opposite sides of the spectrum. The Fathom Political Index (FPI) covers over 150 countries and weights together four political variables: institution type, alongside World Bank measures of rule of law, corruption, and voice and accountability (V&A). A lower FPI score is associated with more autocracy, corruption and weak justice systems. The three countries with the lowest FPI scores are: Syria, North Korea and Eritrea. A higher FPI score is associated with more democracy, less corruption and judicial independence. The three countries with the highest FPI scores are: Finland, Norway and New Zealand.

The chart below plots each country by FPI score, ranging from smallest to largest, and makes clear the well-known fact that China and the US have very different political systems. China’s latest FPI score (0.26) places it just above Afghanistan but below Egypt. Meanwhile, the latest US FPI score (0.80) means that it ranks just above Spain but below France. This ideological gap is one reason both countries are likely to disagree on a range of issues including freedom of the press, democratic consent and the principle of universal human rights. There was a clear ideological gap between the US and the Soviet in the post-war environment. However, the FPI begins post-Cold War and so we cannot compare directly on this measure.

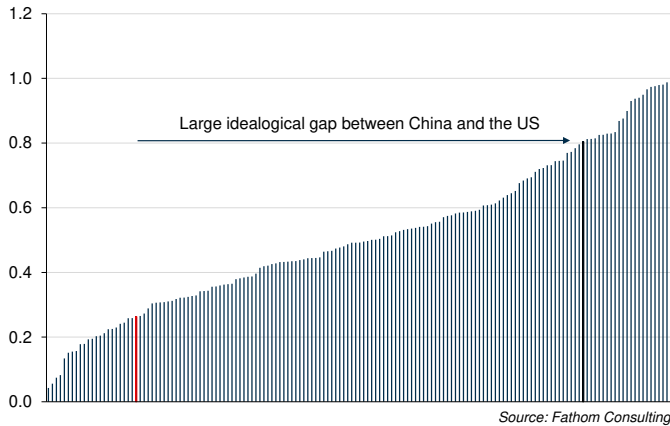
There are some parallels with the Cold War





Countries ranked by FPI score

Index, 0 to 1, where 0 = full autocracy



The world's two superpowers are at opposite ends of the ideological spectrum

Cold War differences: ideological competition

One key distinction when it comes to ideology relates to the global ambitions of the Soviet Union versus China. The Soviet Union was a socialist state, whose economic set-up was incompatible with US-style capitalism. For a long time, there was support in western Europe and the US for the Soviet model. In that sense, a rising USSR was a direct threat to US attempts to promote capitalism after World War II. In addition, the Soviet Union was more active in international affairs, as it tried to combat capitalism and imperialism around the world.

Historically, China's foreign objectives have been more muted, officially claiming to not have any desire to promote its system of governance to the rest of the world. However, there are signs that this is changing. China's more muscular international approach can be seen in its behaviour in the South China Sea and more recently in Hong Kong. Meanwhile, China's economy relies heavily on market forces and may therefore pose less of a threat to the US. There is little domestic support in western Europe or the US for a Beijing model, so its rise is not an ideological threat in the same way the Soviet Union's was. However, it may be a threat to Beijing if countries that it sees as part of China, such as Hong Kong and Taiwan are seen to be doing better than China following a different model.

Cold War parallels: economics

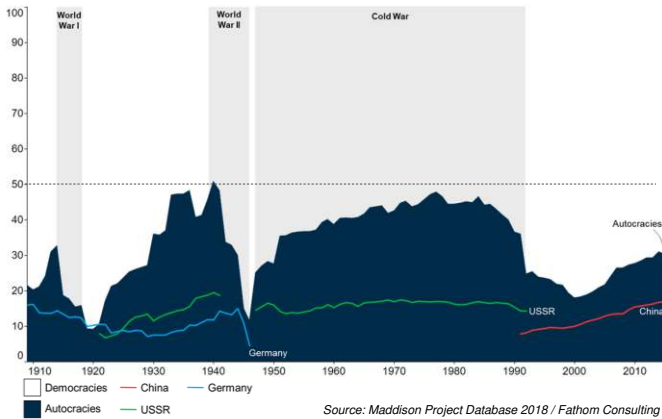
Another similarity between the Cold War and current Sino-US relations is the relative economic position between the existing power (US) and rising one (China and the USSR). The Soviet share of world GDP (at PPP exchange rates) was around 15% for most of the Cold War. According to the latest IMF figures, the equivalent Chinese figure in 2018 was 19%. During the Cold War, there was a sense among some that Communism's state-led model offered stability via equality while still fostering improvements in the standard of living via sustained economic growth. Indeed, as late as 1988 the Nobel Prize-winning economist, Paul Samuelson, wrote that "the Soviet economy is proof that, contrary to what many sceptics had earlier believed, a socialist command economy can function and even thrive." Looking back, we can see that the USSR economy was never really 'thriving'.

Relative economic positions are similar now, too



Share of world GDP by political institution

Per cent (PPP, multiple benchmarks)



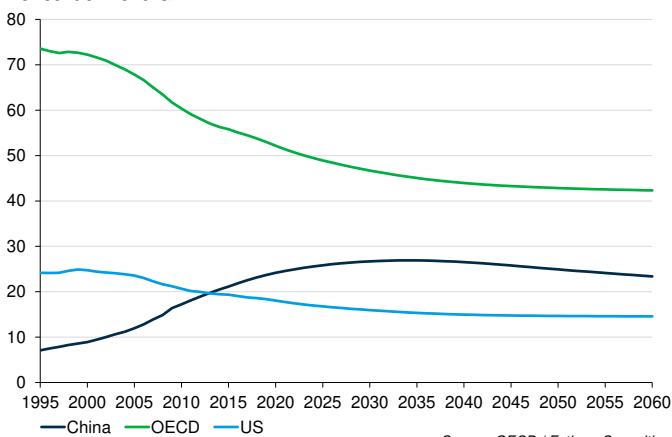
China seems to be a more credible challenger when it comes to absolute levels of GDP. First, its population is more than four times that of the USSR, so it requires less productivity per person to achieve an equivalent level of total economic output. Second, its trajectory has been more promising, with its share of global GDP (at PPP exchange rates) rising from 7% in 2000 to 19% in 2018, surpassing the US equivalent along the way. China has for several decades managed to increase living standards within its borders faster than the global average or the US.

Despite its strong period of growth in recent decades, we should be careful not to extrapolate China's recent economic success out into the future. Long-run forecasts from the OECD suggest that China's share of world GDP will peak in the coming decade before gradually fading. This partly reflects the country's demographics. The working-age population is set to decline indefinitely, slumping from over a billion today to 838 million in 2050 and 579 million in 2100, according to UN projections. Second, China's productivity growth has been dropping. Fathom has long-argued that its 'old-model' growth strategy that focuses on debt and investment would return less and less bang for its buck. China's new normal for growth is likely to be closer to 2-3% in the decade ahead.

However, China faces secular challenges that mean its growth rates are likely to slow

Long-run GDP forecasts

Per cent of world GDP





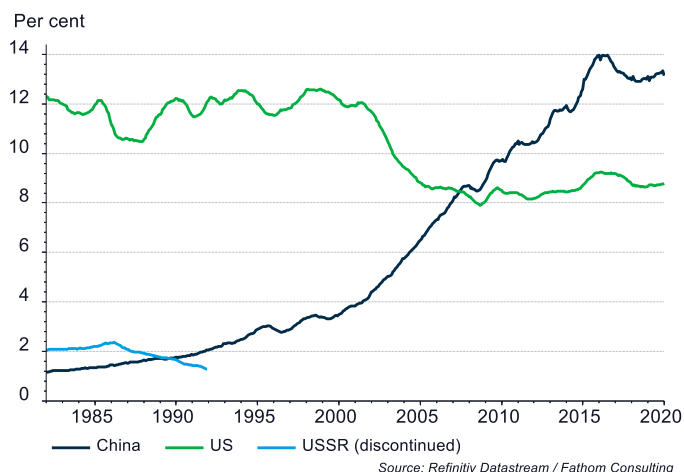
Cold War differences: economics

There are, however, some key differences between the Soviet-US relationship and the Sino-US one. On economics, the most important one may be the relative integration of either party into the global economy. Economic links between the US and the USSR were close to non-existent. US exports to the USSR totalled \$3 billion in 1990, accounting for just 0.1% of US GDP. Likewise, the USSR sent very little to the US, exporting only \$1 billion worth of products stateside, which amounted to 0.1% of GDP according to UN estimates of the latter. More broadly, Soviet exports were barely noticeable from a global perspective. In 1990, total exports amounted to just 1.9% of total world exports. Their peak over the previous decade was not much better, coming in at 2.4%.

The situation with China today could hardly be more different. US exports to China in 2019 totalled \$106 billion, making up 0.5% of US GDP. Something similar is true for key US partners in the region. Exports to China account for large shares of domestic GDP in Japan (2.6%), Korea (8.4%) and the EU (1.2%). Moreover, China is the world's manufacturing powerhouse, with a trading presence that is on a completely different scale to anything that the Soviet Union achieved. China's exports made up 13% of the world total in 2019, far surpassing the Soviet figure of 2% in 1990.

China is far more integrated in the global economy than the Soviet Union ever was

World export share



While the Soviet Union was completely isolated from the US from an economic perspective, China is not. The same is true for US allies and partners around the world. Today, all tend to have much stronger economic relationships than they ever did with the USSR. Increased confrontation therefore risks more economic damage than it did during the Cold War. As a former Australian Prime Minister put it, countries are motivated by greed (access to China's large domestic market) and fear (concern about the rise of a large authoritarian state in its neighbourhood). US allies and partners around the world continue to be pulled in both directions on this. The dependency goes both ways too. China is far more reliant on US consumer spending, US financial assets and the US dollar than the Soviet Union ever was.

This means increased dependencies for all sides

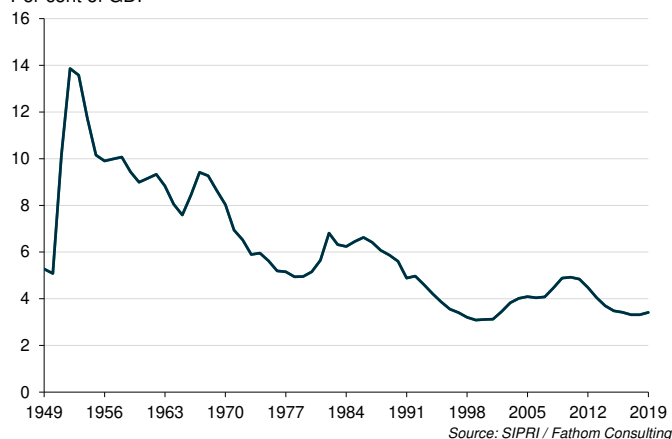
Cold War differences: arms race

Another important distinction is the military context today versus during the Cold War. Back then, the threat of military confrontation was ever-present. Both sides dedicated increasing resources to their power projection around the world. Soviet spending on its military peaked at almost 30% of GDP by 1990. Meanwhile, US military expenditure rose sharply in the initial stages and remained elevated for the duration of the Cold War, averaging 7.6% of GDP versus a post-Cold War average of 3.9%.



US military expenditure

Per cent of GDP

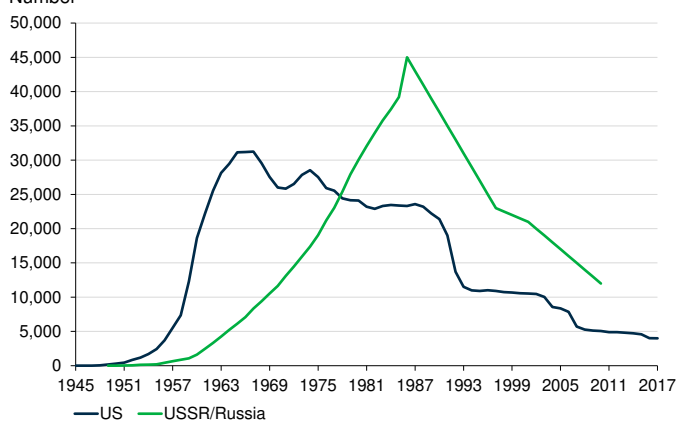


The threat of direct and indirect conflict appears reduced when compared to the Cold War

This increased military spending added an extra layer of danger to US-Soviet tensions and can be seen in figures such as the number of missiles each country had at its disposal. The US ramped up its nuclear capacity after the end of World War II, prompting a similar surge on the part of the Soviets. That tension spilled over into proxy wars around world. The Soviet Union interfered on the side of several communist governments including in East Germany (1953), Hungary (1956), Czechoslovakia (1968) and Afghanistan (1979). Meanwhile, the US supported the overthrow of left-wing governments in countries such as Guatemala, Cuba (unsuccessfully in 1961), the Dominican Republic (1965) and Grenada (1983). The US also launched a war in Vietnam in an attempt to defeat the Viet Cong, who received supplies from the USSR to fight back. Amid rising Sino-US tensions, there is not the same increase in military expenditure, nor the proxy wars that we saw during the Cold War.

Nuclear warheads by country

Number



UK-Germany parallels: economics

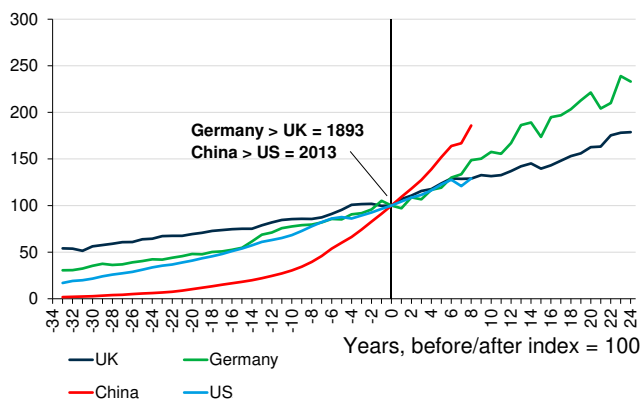
In many ways, current Sino-US tensions more closely resemble those of Germany and the UK ahead of World War I than they do the Cold War. Back then, geopolitical tensions were driven by a rising Germany that threatened the UK. Today, it is China that is rising and the US that feels threatened. In both cases, the GDP of the rising power overtook that of the existing one. And in both, cases the existing power put tariffs on imports from the rising one.





Germany and China's rise compared

Index, year rising power GDP > incumbent GDP (PPP) = 100



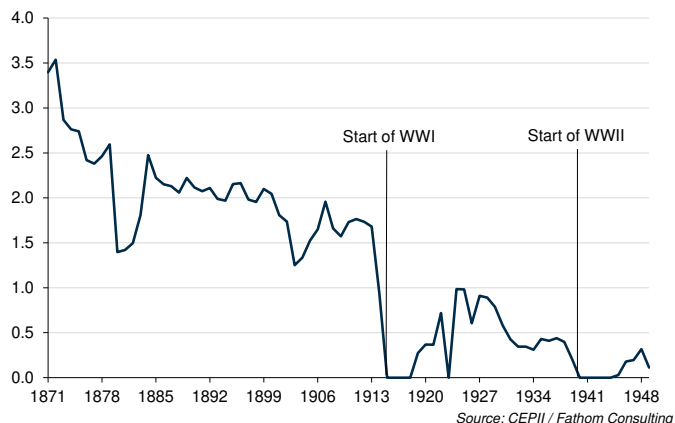
Source: Refinitiv Datastream / Maddison Project Database / Fathom Consulting

There are other similarities, too. Britain and Germany were much more integrated with each other than the US and Soviet Union ever were. During the run up to World War I, exports from one to the other regularly came in at over 2% of domestic GDP. That is 20 times larger than the US or USSR achieved during the Cold War. Of course, Britain and Germany eventually went to war, raising some doubt about the argument that economic integration brings peace. It serves as a cautionary warning that economic factors will not necessarily be sufficient to prevent a severe flare-up in Sino-US tensions. At the moment, China's military spending, at market exchange rates, is around one-third of that of the US. Rapid increases in military spending are often viewed with suspicion, and this is one area to watch. It could be a catalyst for a further leg-up in tensions.

The relationship between the UK and Germany ahead of WW I may offer a better economic comparison than the Cold War

UK exports to Germany

Per cent of GDP



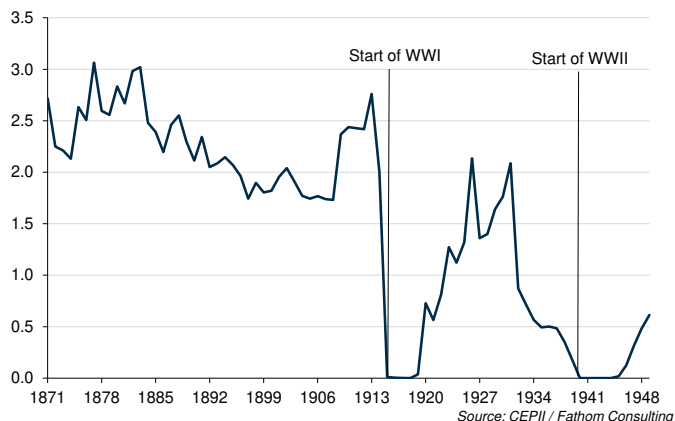
The UK and Germany were economically integrated amid rising tensions





Germany exports to UK

Per cent of GDP

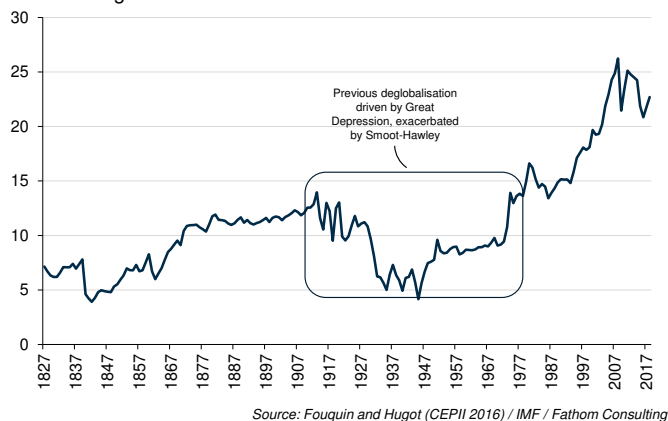


One final similarity that is yet to be determined is that tensions between Britain and Germany put the prior wave of globalisation into reverse. From 1850 until the eve of World War I, the share of global exports in global GDP rose from 5.5 per cent to 14 per cent, spurred by the Industrial Revolution. This nascent period of open trade came to a halt in 1914 and did not recover until 1979. The real slump came during the Great Depression. It was exacerbated by policy measures that increased tariff rates, including the Smoot-Hawley Tariff Act of 1930. Some wonder whether a second period of deglobalisation beckons. Any such outcome would require tariff increases from a range of countries — not just the US and China.

That eventually led to a period of deglobalisation — an outcome that some are worried about now

Global goods exports

Per cent of global GDP



New Cold War or deglobalisation requires third countries to participate

Drawing on the historical parallels is notable. But one key factor is what happens to third countries. The possibility of a new Cold War or deglobalisation hinges on the ability of the US to convince its partners to 'gang up' on China. It is unclear that there is the appetite for a sweeping change in economic relations with China any time soon.

The big question is: how do third countries react to increased Sino-US tensions?

More than half of what can be loosely termed 'US influence' comes from its network of alliances and partners around the world. To estimate this, we place countries into four separate groups based on their FPI score. Countries with a lower FPI than China, indicating extremely low levels of governance, are placed in Core China. This group of countries can be

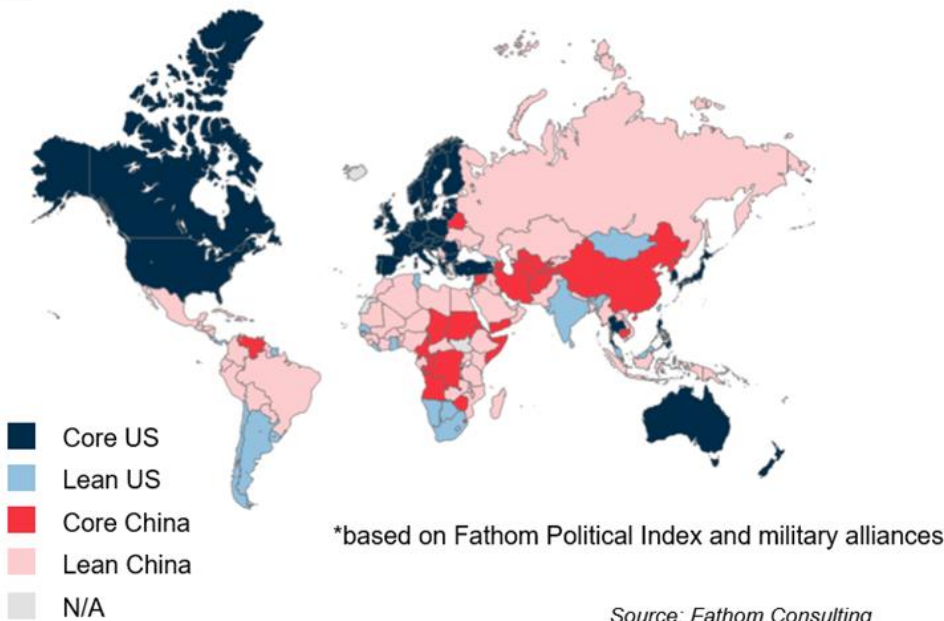


seen as more natural bedfellows for Beijing on a range of issues. Meanwhile, those with FPI scores higher than the US, pointing to high levels of governance, are grouped in Core US. Countries in between China and the US are either denoted 'Lean China' or 'Lean US' depending on which of the two their score is closest to. US security allies are placed in Core US regardless of their FPI score.

The output is displayed map below and is relatively intuitive: western Europe as well as large democracies in the Asia-Pacific are grouped within Core US. A few autocracies in Africa and the Middle East show up as being Core China. Most other countries are stuck somewhere in the middle, either leaning a little bit closer to China or a little bit closer to the US. On the surface then, there is a lot for both superpowers to play for.

Most countries in the world are stuck somewhere in the middle between the US and China

Connective tissue with the US vs China, geopolitical influence 2020



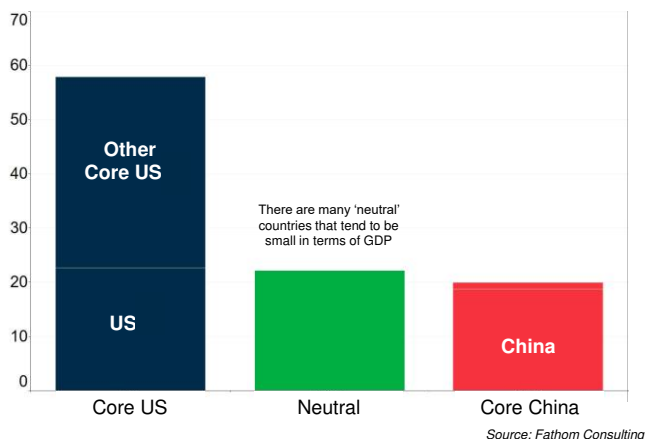
While only a minority of countries are within Core US, they account for a majority of global GDP (at market exchange rates). Core US accounts for more than 60% of global GDP — a figure almost three times higher than Core China. More than half of Core US's global clout comes from other Core US economies — from allies and partners. We expect that figure to remain above 50% in 2030. The share of global GDP accounted for by neutral countries increases slightly, from 21% to 24%. Finally, we expect the share of global GDP accounted for by Core China to increase only slightly from 17% to 23%, with almost all of that accounted for by strong Chinese growth. The US advantage over China is not under threat any time soon, unless it loses its allies and partners around the world under current alliances.

However, the US and its partners account for the majority of global GDP



Distribution of global GDP in 2030

Per cent of world GDP

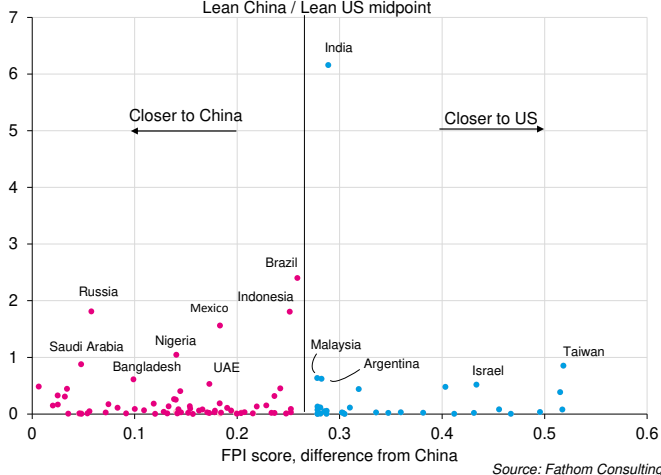


If existing partnerships endure, the US advantage over China is likely to only diminish slightly over the coming decade

To rule out the possibility of a multilateral coalition against it, China could recruit allies and partners of its own. However, it famously has a policy of non-intervention, ruling out (for now) the possibility of formal military alliances. Indeed, Beijing often criticises the US for its large network of allies and partners. More fundamentally, there are not many rich countries that share China’s authoritarian form of government, making any powerful coalition difficult to achieve. There are quite a few with political models in between those seen in China and the US. Looking at the graphic below, Malaysia, Indonesia and Russia all look like possible targets. But all three combined account for just 3.5% of world GDP. Building up a group of alliances or partnerships that seriously challenges that of the US appears impossible within the next decade. Indeed, China’s current strategy for international relations can be summed up as ‘buying’ rather than ‘building’ partnerships. These links, without shared mutual beliefs, are likely to be less effective.

Fathom Political Index and GDP in 2030

Per cent of world GDP at market exchange rates
Lean China / Lean US midpoint



Since China is unlikely to be able to put together a matching coalition of its own...

If US influence, including third countries, is going to only slowly diminish, and China is unable to put together a coalition of its own, one final option would be for Beijing is to try and dismantle the US network. As mentioned before, more than half of what can be loosely called global US influence is tied up in its network of partners. There are already signs that China is

...Beijing may attempt to disrupt US partnerships in order to weaken US overall leverage

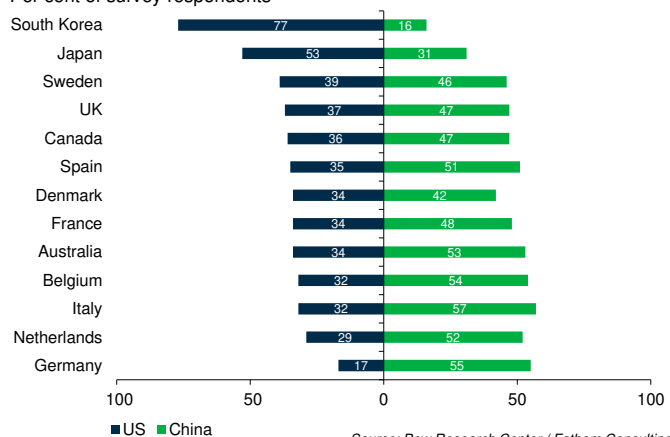


trying to weaken these relations. This is likely to create more volatile international system relative to status quo, increasing uncertainty and the risk of tail events. There are recent examples, including threatening Australia over its push for an independent investigation into the origins of COVID-19 as well as the UK over its decision to remove Huawei equipment from its 5G infrastructure by 2027. China's targeting of third countries is not something new, developed in response to fading popularity in the wake of COVID-19. It has form, particularly with issues related to its territorial integrity.

All told, any Chinese attempts to put together a coalition of its own or pick apart that of the US, appear doomed to disappoint, but that does not mean a new Cold War or deglobalisation beckons. Asian and European partners have more to lose from isolating China than they did from restricting interaction with the Soviet Union. German exports to China make up 3% of GDP, and Angela Merkel has recently stressed the importance of having "good relations" with Beijing. Asian economies, including Korea and Japan, are even more integrated with the Chinese economy, and their leaders have so far shown little desire to break these ties apart. Indeed, recent surveys suggest that large swathes of the general public in Europe already see China as the leading economic power.

Per cent saying US or China is leading economic power

Per cent of survey respondents



Third countries so far appear to be unwilling to adopt a meaningfully different economic relationship with China

Conclusion

Sino-US relations had already deteriorated and were set to continue to do so. COVID-19 has accelerated that process. Many have compared the current situation with the Cold War. And on ideological divergence there are similarities. There are also parallels in terms of the share of GDP that is accounted for by the existing and rising power. However, there are some key differences. China is much more integrated with the US economy than the Soviet Union ever was. It is also much more integrated with America's traditional partners in Asia and Europe. Tensions between the UK and Germany ahead of World War I may offer a better comparison, when relations between those two countries deteriorated sharply, despite strong economic links.

Sino-US tensions are likely to remain high, whoever is in the White House. Some decoupling in economic ties appears likely. While the US is set to maintain an advantage when it comes to allies and partnerships, it remains unclear how partners in Asia and Europe will respond to this new normal. Economic factors suggest neither a new Cold War nor deglobalisation. However, the mood music is shifting. China is an authoritarian state, has the world's second largest economy and appears increasingly emboldened on the international stage. It is not just the US that worries about this. Events in Taiwan and Xinjiang have the potential to shift the



balance more decisively against Beijing. History does not repeat but it does rhyme. The spectre of a new Cold War appears overdone, likewise 1930s-style deglobalisation. However, the old normal is gone, too. US allies and partners may need to take a more aggressive stance on issues related to national security and perhaps climate.



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