Capital Markets Strategy

Essential inCights for the C-Suite

MUFG

THE UNITED STATES & CHINA

From Co-Dependency to Unsustainable Imbalances

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Global Corporate & Investment Banking Capital Markets Strategy Team

Tom Joyce

Managing Director
Capital Markets Strategist
New York, NY

Tom.Joyce@mufgsecurities.com
(212) 405-7472

Hailey Orr

Managing Director
Capital Markets Strategist
New York, NY

Hailey.Orr@mufgsecurities.com
(212) 405-7429

Stephanie Kendal

Vice President
Capital Markets Strategist
New York, NY

Stephanie.Kendal@mufgsecurities.com
(212) 405-7443

Angela Sun

Analyst
Capital Markets Strategist
New York, NY

Angela.Sun@mufgsecurities.com
(212) 405-6952

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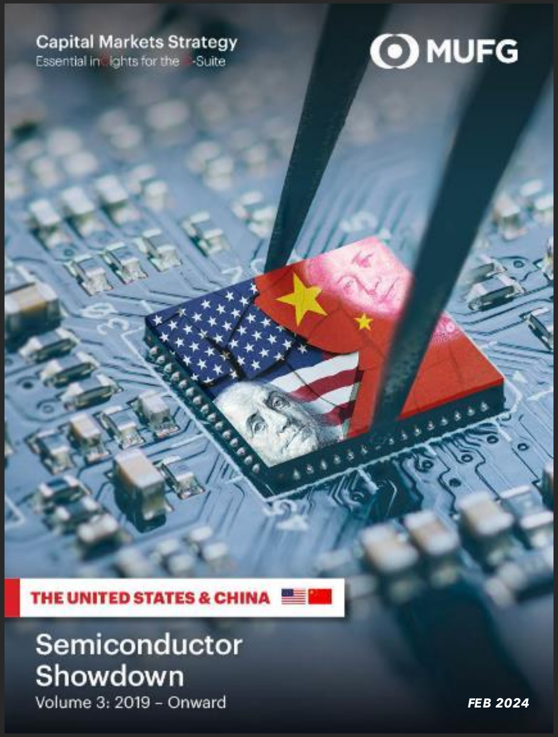
AUTHORS

The United States & China



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Most Important Bilateral Relationship of 21st Century

> "The Sino-US rapprochement started out as a tactical aspect of the Cold War; it evolved to where it became central to the evolution of the new global order."

Henry Kissinger, 56th US Secretary of State (1973-1977)

The Arc of US-China Relations & Rivalry

For more than 30 years, US-China relations could be described as largely symbiotic and mutually beneficial. Over the last decade, co-dependencies between the world's two largest economies became unsustainable, and a gradual unwind began. More recently, US-China relations have devolved into a more intensive structural rivalry and decoupling. Trade and technology wars may soon evolve into a larger and more serious "economic Cold War."

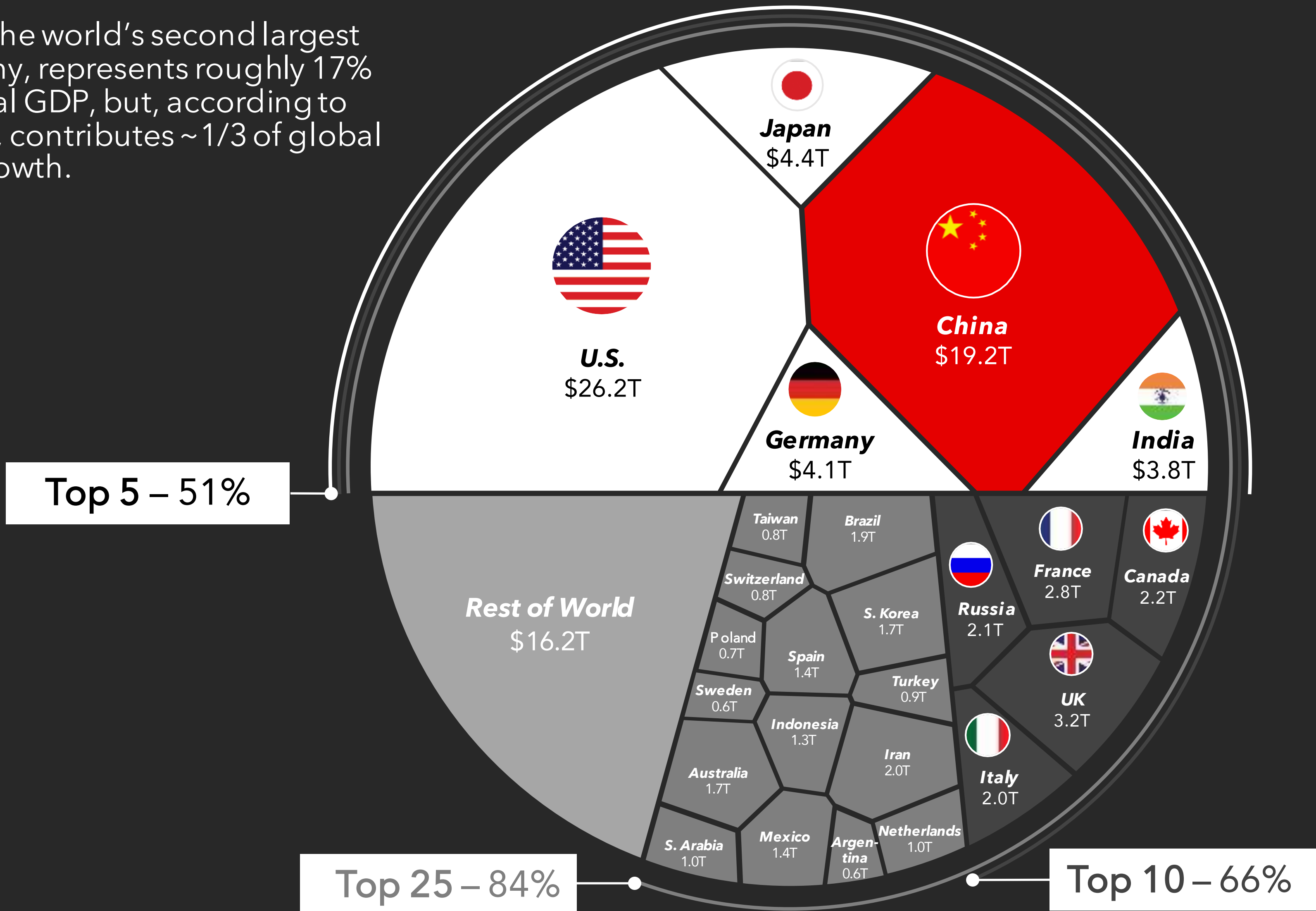
1970s:	US-China Rapprochement
1980s:	Strategic Convergence
1990s:	Post-Tiananmen Cooldown
2000s:	Co-dependencies & Unsustainable Imbalances
2010s:	Structural Rivalry, Trade Wars & Competition
2020s:	Tech Wars & Decoupling

Decoupling between the world's two largest economies – across trade, technology and financial markets - is likely to be the most defining geo-economic event in the 1H of the 21st Century.

Initially intended as a brilliant tactical move by US Secretary of State Henry Kissinger to isolate Russia, the historic visit by US President Nixon to China in 1972 ended up accelerating the end of the Cold War, the rise of China and the evolution of a new 21st Century global order.

World's Two Largest Economies

China, the world's second largest economy, represents roughly 17% of global GDP, but, according to the IMF, contributes ~1/3 of global GDP growth.

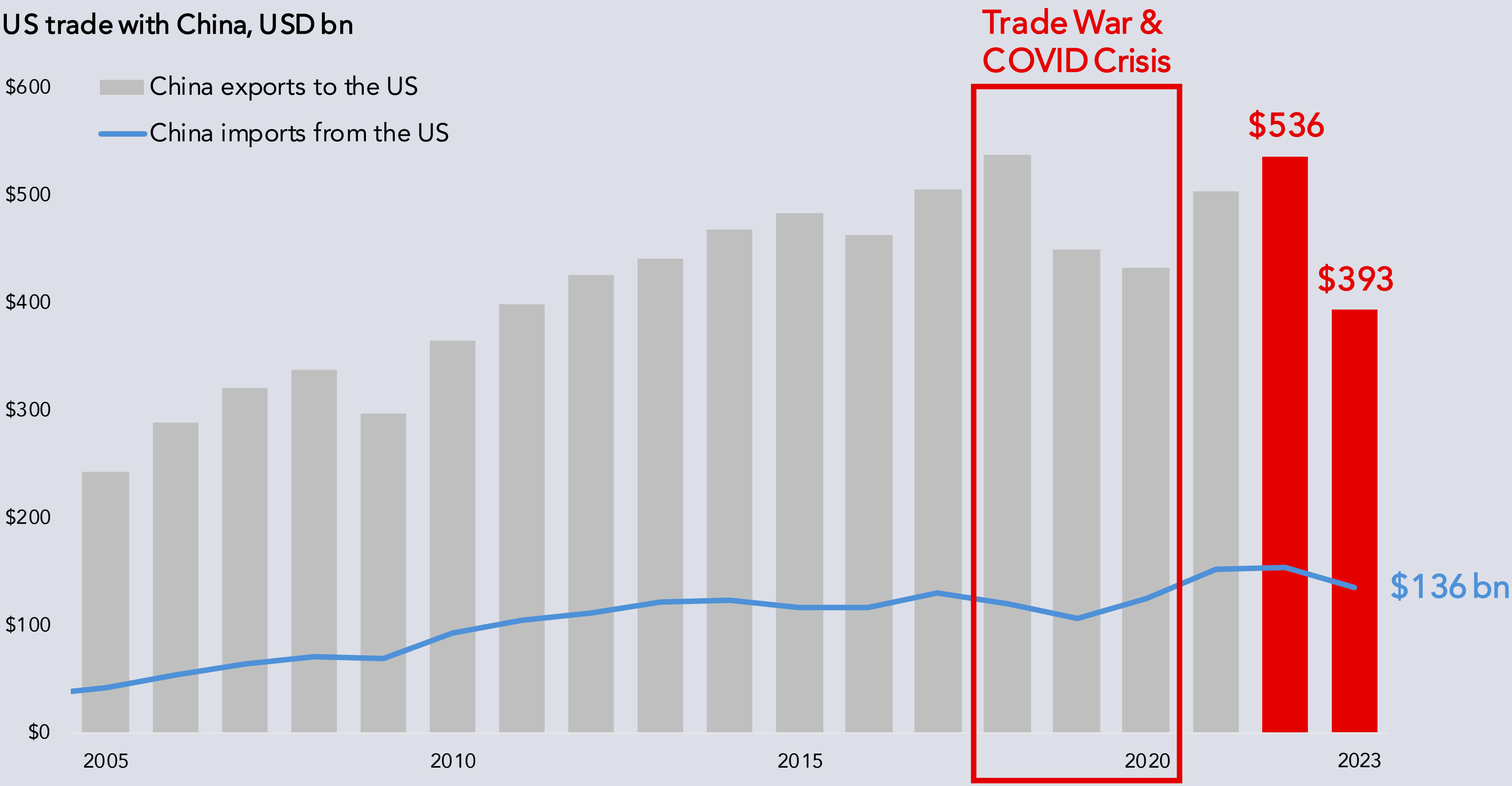


Source: International Monetary Fund. "Asia Poised to Drive Global Economic Growth, Boosted by China's Reopening". Visual Capitalist

World's Largest Trading Relationship

Despite escalating tensions between the US and China, trade in goods between the US and China reached a record $690 bn in 2022. US imports from China rose to their highest level since 2018 (the start of the trade war and increased tariffs) and exports to China reached their highest level on record, in data dating back to 1985.

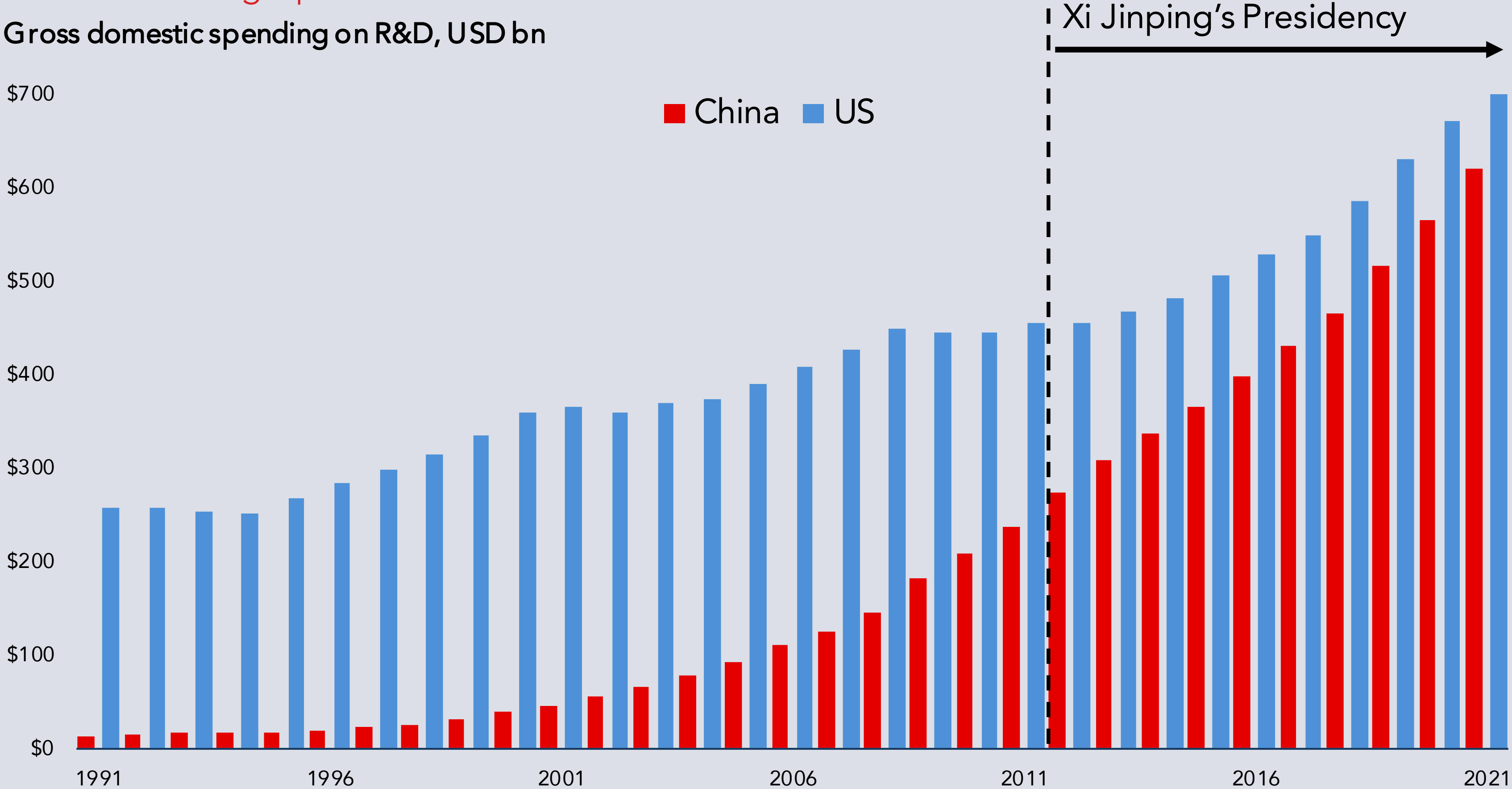
US trade with China, USD bn



Source: (1) US Census Bureau. Trade is in goods. Data through November 30, 2023.

The World's Two Most Formidable Technology Powers

As noted by Nigel Inkster at the IIS, technology is at the heart of a contest between the United States and China for global dominance which is likely to shape the global geopolitical landscape in the first half of the 21st Century. Against the backdrop of increasingly restrictive US tech policy, China is moving rapidly, and is highly vulnerable, in trying to close its technology deficits – most notably in software and high-performance semiconductors.



Source: (1) OECD. Bloomberg Government. Latest data available as of January 2024 is YE 2021.

The World's Two Largest Militaries

China today boasts the world's largest Army and the largest Navy (as measured by # of ships). While the US remains the world's most dominant military power, President Xi Jinping has accelerated the modernization and expansion of China's military with the explicit aim of becoming the dominant regional power in the South China Sea and winning a war in the Taiwan Strait, if needed.

	US	China
Annual military spend (gross dollars, bn)	**$877 bn**	**$292 bn**
Annual military spend (% of GDP)	**3.5%**	**1.60%**
Nuclear arsenal (# of warheads)	5,244	410
Active military personnel	1,395,350	2,035,000
Active aircraft carriers	11	3
Destroyers	92	50
Frigates	0	43
Submarines	68	78
Fighters/attack planes	2,757	1,570
Main battle tanks	5,500	4,950

Source: (1) SIPRI 2022. Global Firepower. Federation of American Scientists (FAS). WiseVoter.

2 The Rise of China

“Let China sleep, for when she wakes, she will shake the world.”

Napoleon Bonaparte, French military leader (1769 - 1821)

Restoration of China’s Foundation Narrative

In 1820, China was the world’s largest economy, accounting for an estimated 30% of global GDP. As part of the restoration of its foundation narrative, China’s goal is to revive its status as a leading global power after more than a century of “humiliation” which spanned from mid-19th century colonialism to the end of the Cultural Revolution in the late 1970s. By 1976, following the damage of the Cultural Revolution, China’s economy accounted for only 1% of global GDP.

1820
China is world’s largest economy

1842
Treaty of Nanking; HK ceded to UK

1945
China becomes permanent member of UN Security Council

1949
Founding of PRC

1972
Nixon / Kissinger visit to China

1979
Deng reforms / Normalization of US-China relations

1997
Hong Kong “handover” to China

2001
China joins WTO

2010
China becomes world’s #2 economy

2018-19
Trade wars / HK civil unrest

2020
COVID Crisis begins

2049
PRC 100th Anniv.
(Goal: Leading Global Power)

At midnight on July 1, 1997, then Prince Charles "handed-over" the keys to Hong Kong back to China's President Jiang Zemin, ending 156 years of British rule and "humiliation" that began in 1841.

The Rise of China

By virtue of his strength and consolidation of power, any detailed assessment of China today, in terms of both domestic and foreign policy, should begin and end with President Xi Jinping.

Mao Zedong

"Standing Up"

Deng Xiaoping

"Becoming Rich"

Xi Jinping

"Becoming Strong"

"The great revival of the Chinese nation is not only an economic and political revival. It is also the revival of political education…that will result in the great revival of Chinese civilization… Chinese civilization is spreading and extending itself into even more parts of the world."

Jiang Shigong, prominent Chinese intellectual

Source: As stated in "The New Silk Road" by Peter Frankopan.

At the end of the Cold War in the late 1980s, few would have predicted that China's meteoric rise as a global economic superpower would occur in just a few decades.

After 40 years of a largely symbiotic, and mutually beneficial relationship, the US and China have likely entered a new multi-decade period of complex disentanglement, economic warfare, technology rivalry and geopolitical competition. A deeper understanding of this evolving US-China relationship will therefore be critical to markets, economies and business strategy in the years ahead.

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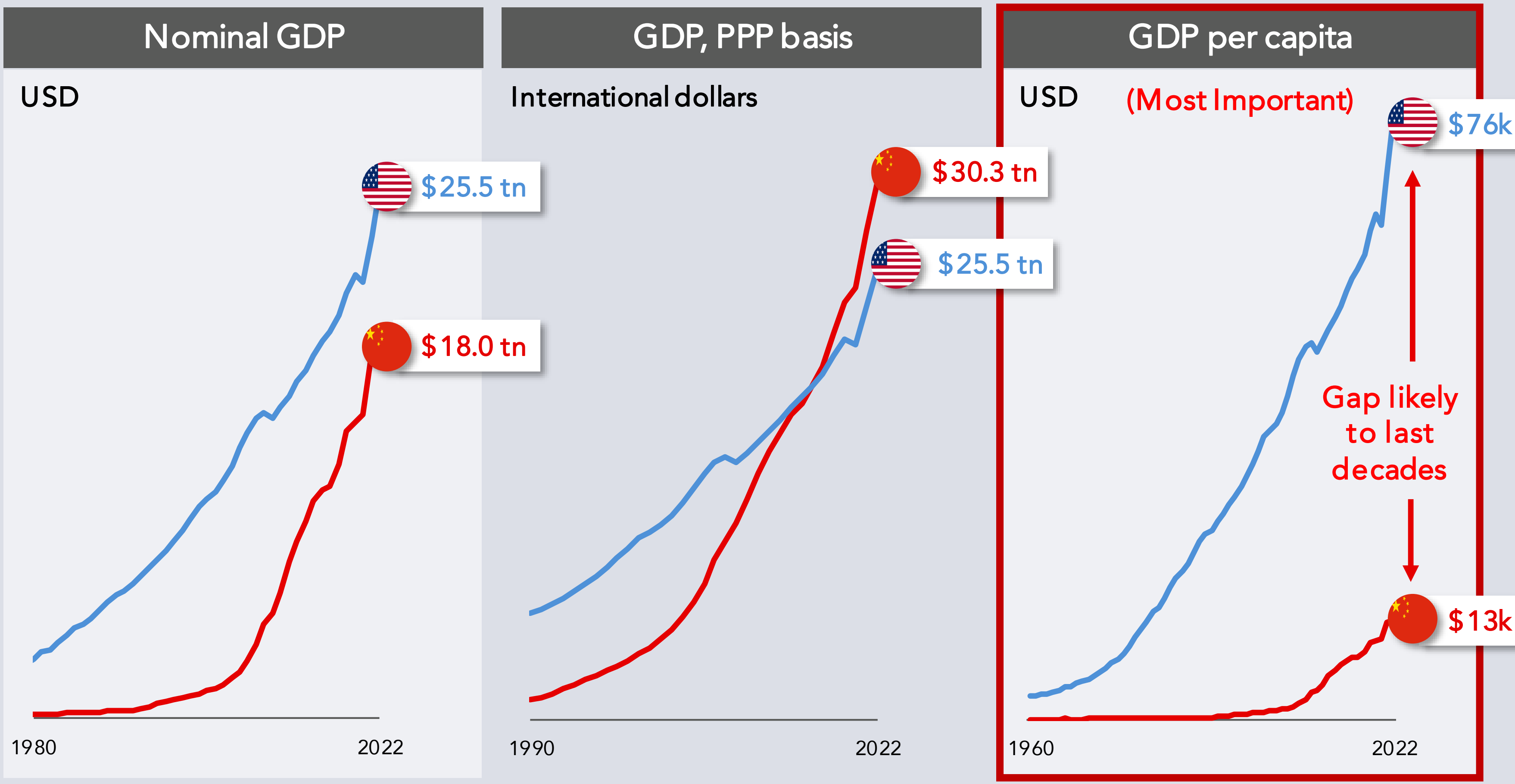
#2 Global Economy

In 2010, China surpassed Japan as the world's second largest economy. In 2014, China surpassed the US as the world's largest economy on a PPP basis. China's per capita income, a critically important metric, has increased 30-fold since 1980, but may take several decades to achieve parity with the US.



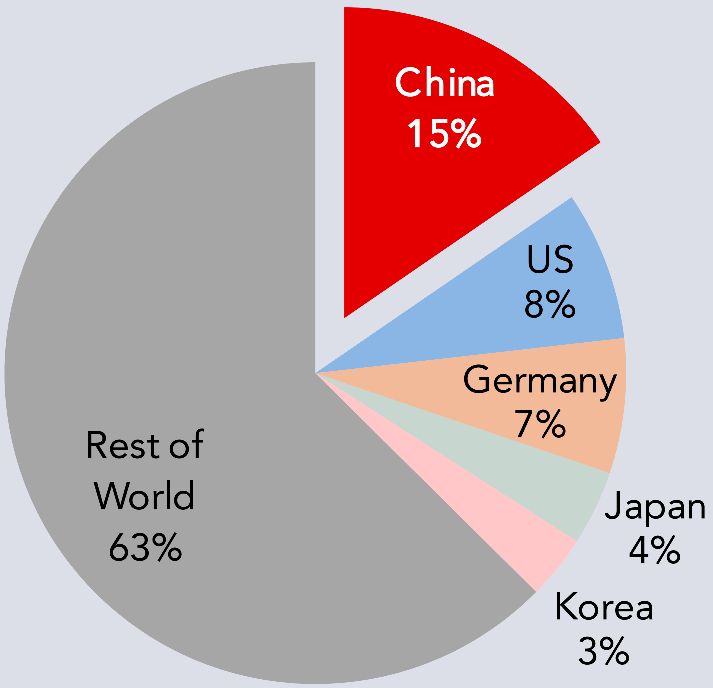
Source: (1-3) World Bank national accounts data & OECD national accounts data files. Nominal GDP is current USD. PPP in current international dollars. Per capita GDP in current USD.

Following Mao's death in 1976, and the damage of China's Cultural Revolution, China accounted for only 1% of GDP. Standing only 5'2 in height, Deng Xiaoping would open up China in the late 1970s, initiating a remarkable and unrivaled four decade economic expansion.

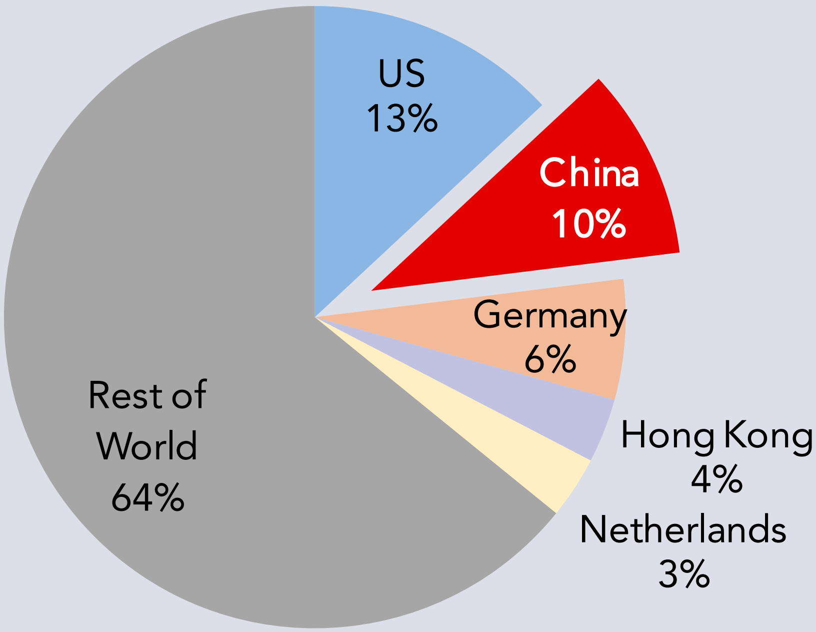
#1 Global Trading Nation

China is the world's largest exporter of goods and second largest importer of goods, accounting for 15% and 10% of global exports and imports, respectively. China is also the top trading partner to over 120 countries, including Japan, South Korea, Vietnam and Taiwan.

China's share of global exports



China's share of global imports



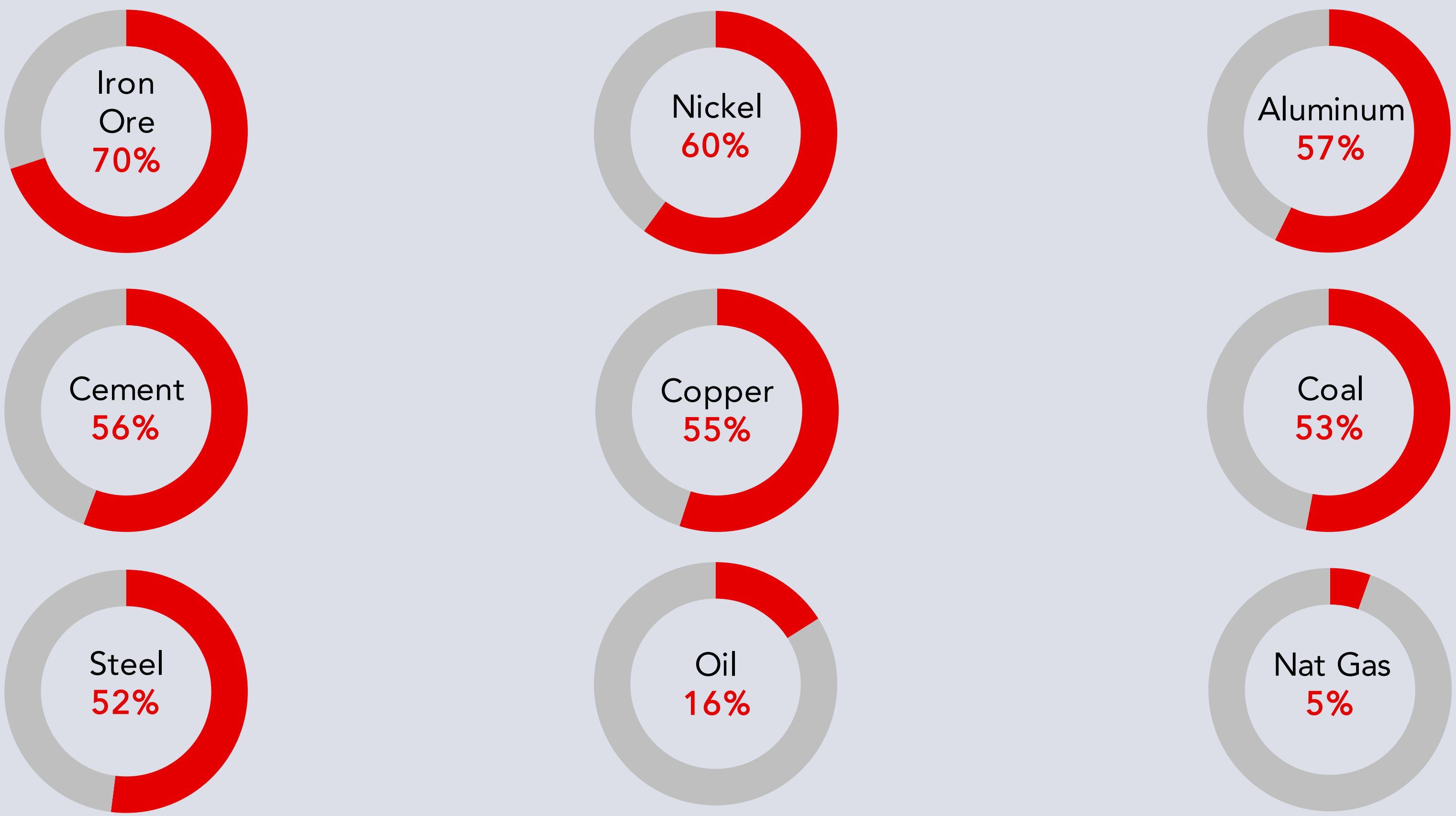
China is the world's largest trading nation

Source: (1-2) World Bank WITS (World Integrated Trade Solution). Most recent data available is 2021.

#1 Consumer of Global Commodities

China is the largest consumer of global commodities, accounting for over 50% and 15% of total global demand of industrial metals and oil, and an even larger percentage of global demand growth.

China's share of global demand

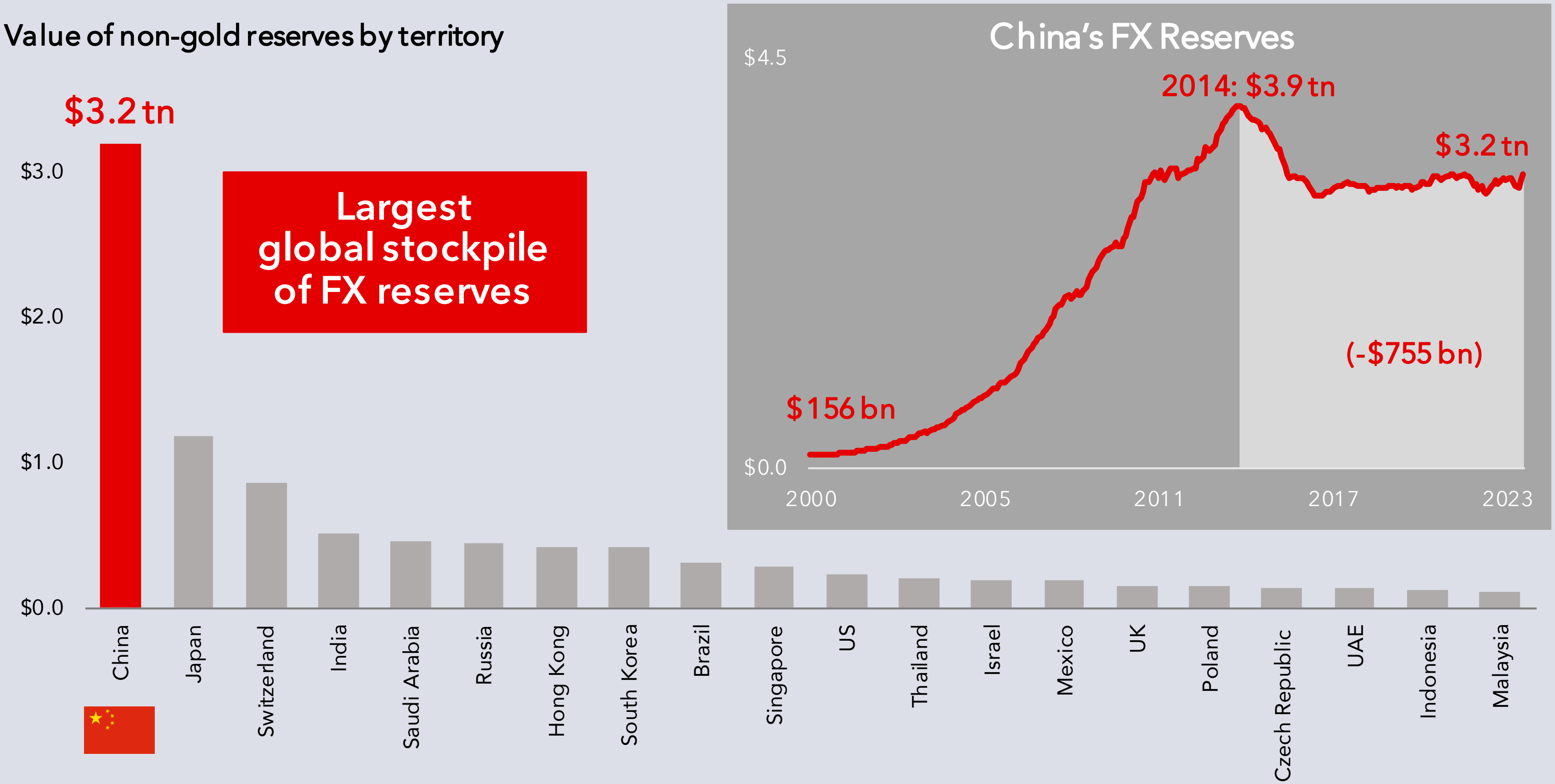


Source: (1-9) S&P Global Commodity Insights. Refers to Seabourn iron ore. Jan 2024. 2022 data for Copper (Statista). Steel data from World Steel Organization, data as of YE 2022. and Nickel. 2021 for Aluminum (Statista). OECD. 2020 data. Cement (Cemnet 2019 data). IEA. 2022 data. EIA. 2021 data. Natural Gas (Worldometer).

#1 Global Stockpile of FX Reserves

China holds $3.2 trillion worth of FX reserves, the largest stockpile of any country in the world and nearly 3x the second largest holder (Japan at $1.1 trillion). While the exact composition of China's reserves is not publicly available, China has announced a declining share of US dollar assets in their reserve portfolio.

Value of non-gold reserves by territory

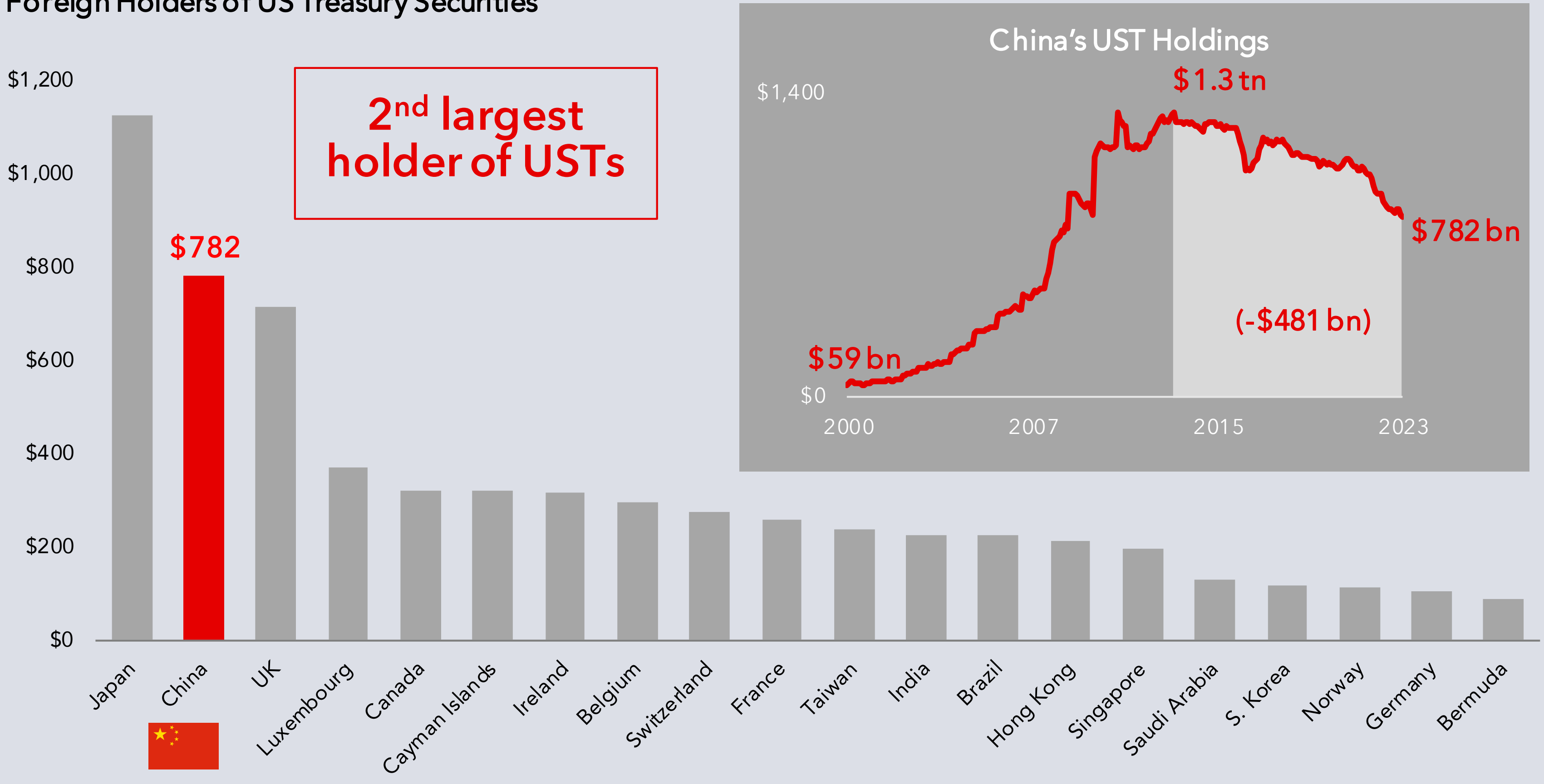


Source: (1) Council on Foreign Relations "The Dollar: The World's Reserve Currency". World Bank data as of year end 2022. Central Bank of the Republic of China (Taiwan) With the exception of Taiwan, total comprise foreign exchange reserves held by monetary authorities, reserves held by the IMF, and IMF Special Drawing Rights.

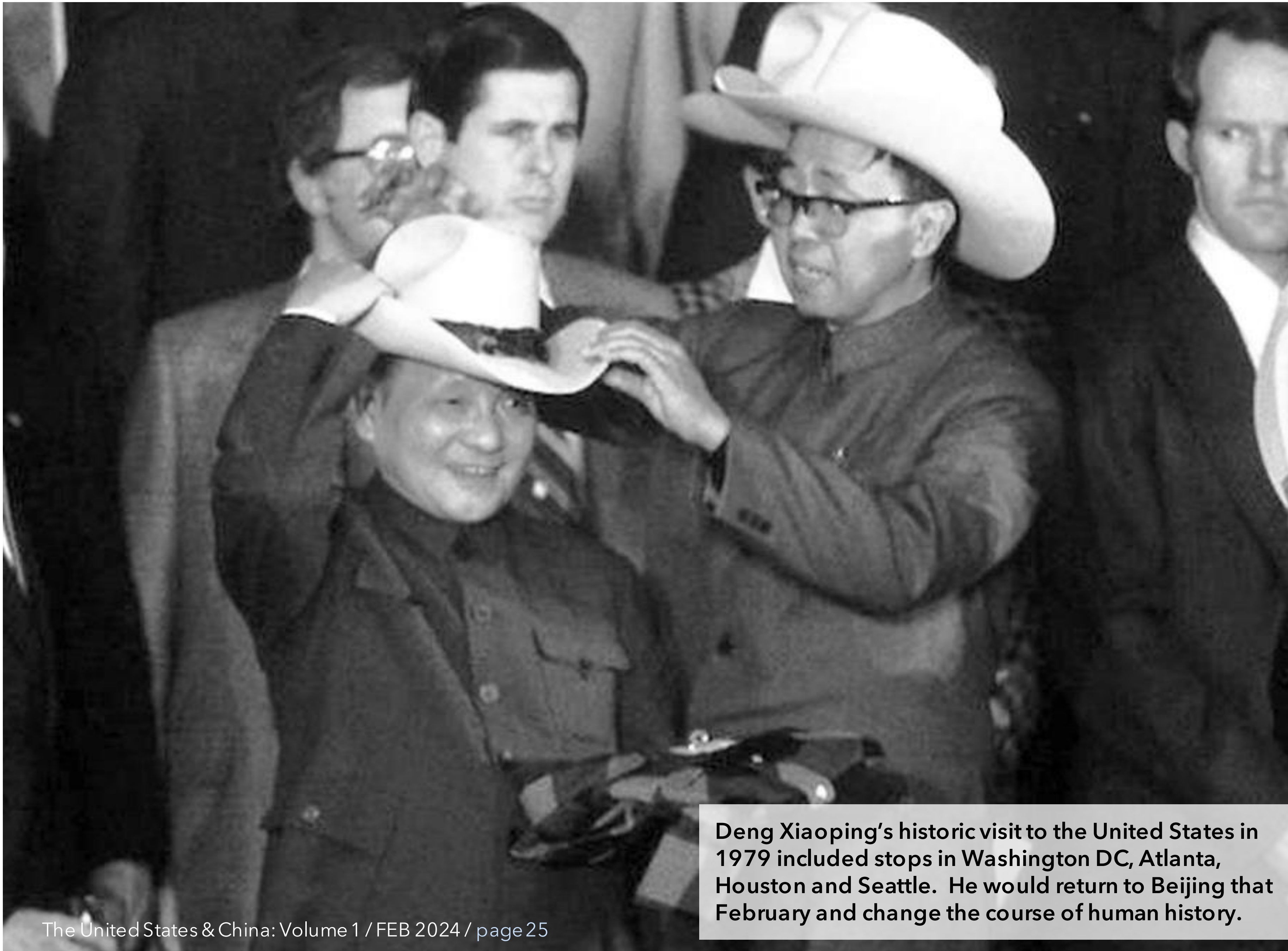
#2 Foreign Owner of US Treasuries

China's holdings of US Treasuries peaked in 2013 at $1.3 trillion. Despite selling over $100 bn in USTs over the past year, China is still the second largest foreign holder of US government debt. In fact, evidence suggests that UST sales have been offset by purchases of US agency debt and other USD bonds.

Foreign Holders of US Treasury Securities



Source: (1) US Department of the Treasury. Data is latest available - November 2023. Reuters "China slips away from Treasuries but sticks with dollar bonds".

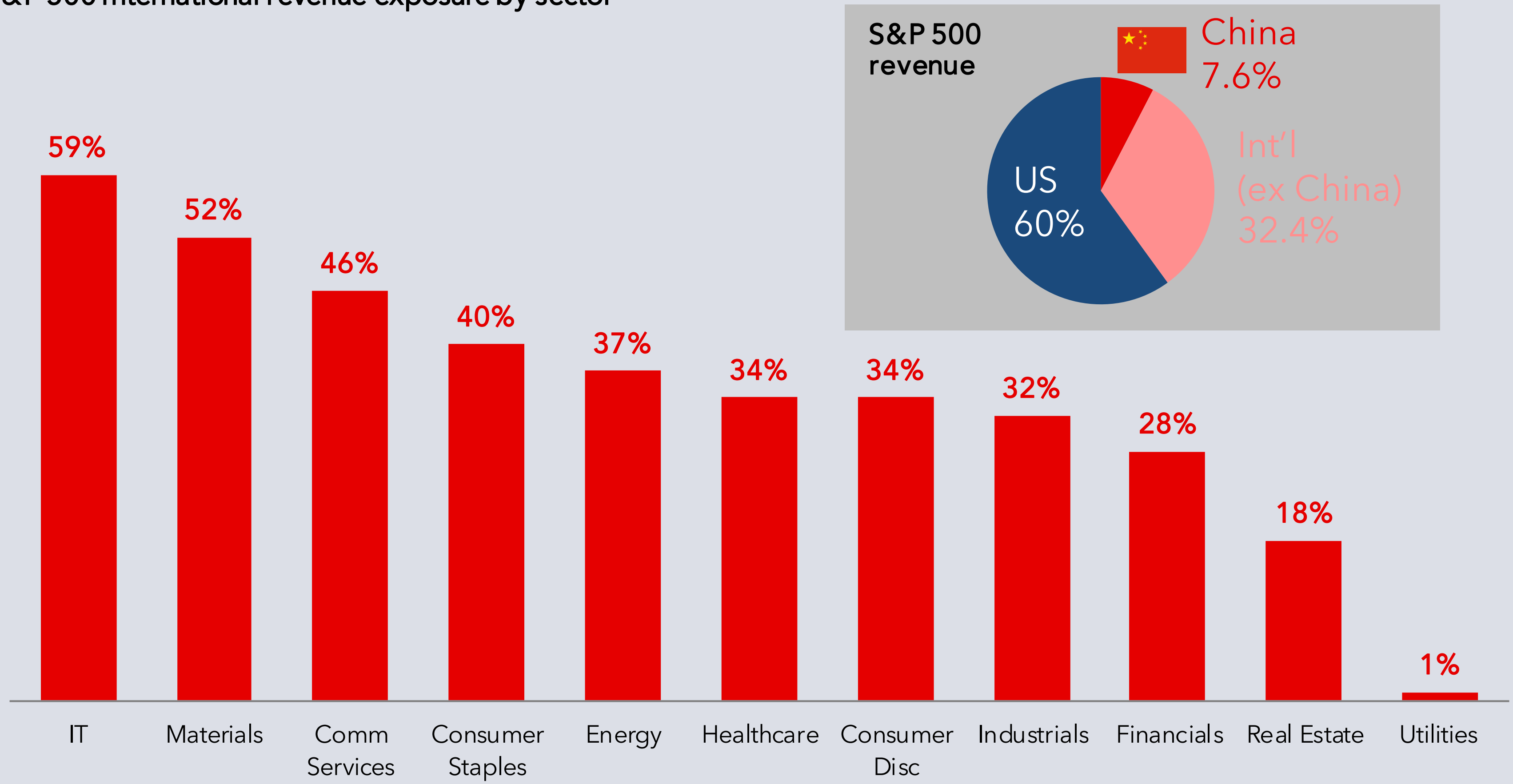


Deng Xiaoping's historic visit to the United States in 1979 included stops in Washington DC, Atlanta, Houston and Seattle. He would return to Beijing that February and change the course of human history.

Nearly 8% of S&P 500 Revenue

Roughly 40% of S&P 500 revenue is generated internationally, nearly 8% from China. However, China exposure varies sharply by sector with IT and Semiconductor companies deriving 16% and 27% of revenues from China, respectively.

S&P 500 international revenue exposure by sector

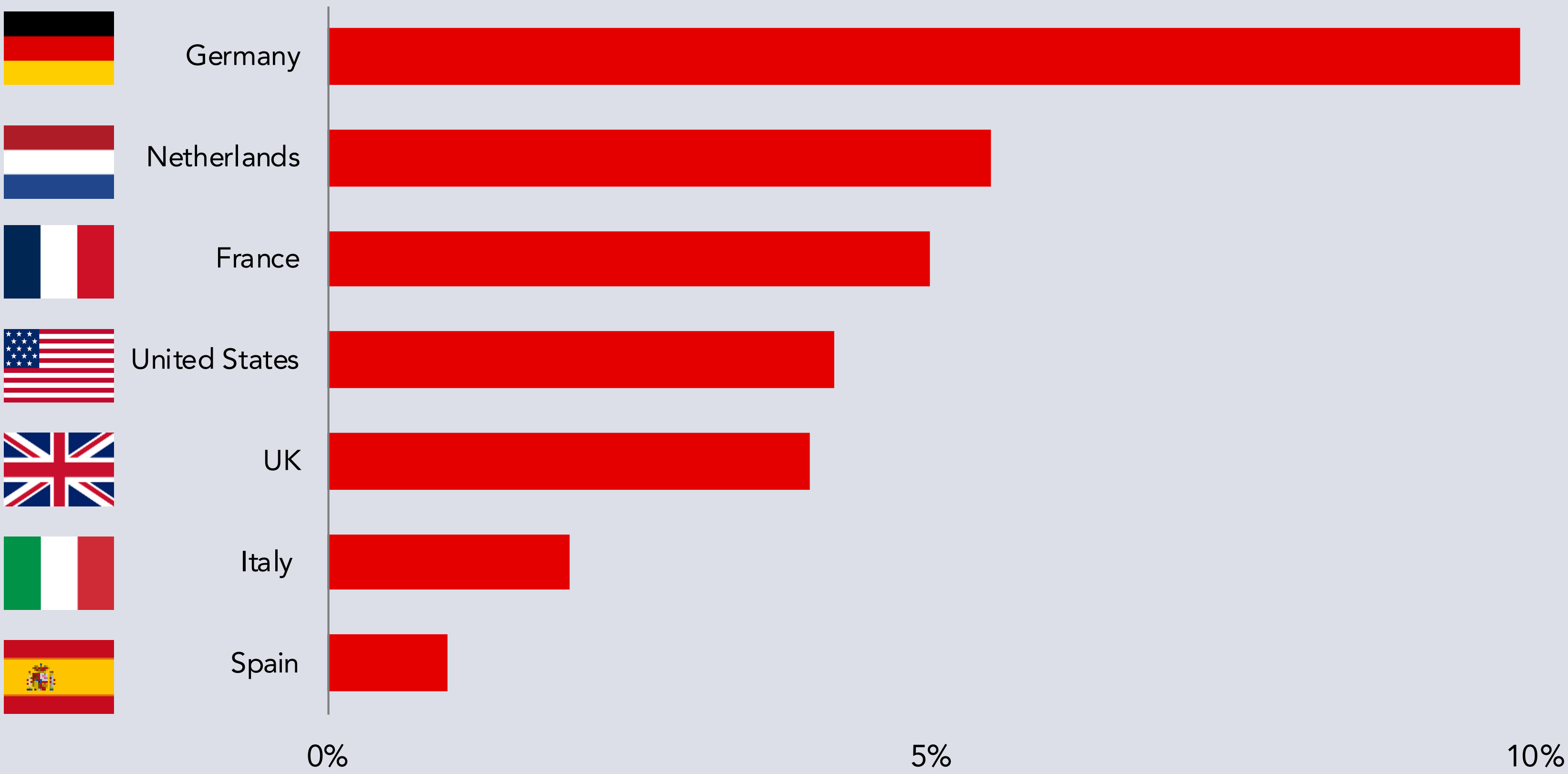


Source: (1-2) FactSet, "Earnings Insight" (January 26, 2024). WSJ, "China's Reopening Trade is Fizzling Out." July 2023.

Dominant Source of Global MNC Revenue

According to Bloomberg, the 200 largest MNCs in the US, Europe and Japan made 13% of their sales in China in 2021, earning $700 bn.

Exposure to China, total exports and Western-owned subsidiaries' revenues (% of GDP)

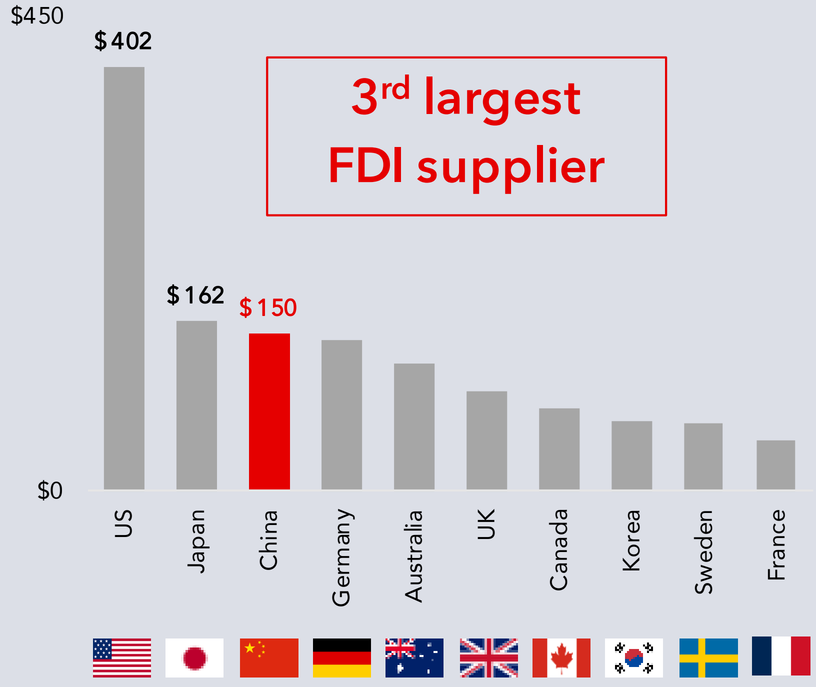


Source: (1) Bloomberg; Capital Economics; Eurostat; IMF; OECD. Goods exports are mainland China only. Services exports and affiliates' revenues include Hong Kong.

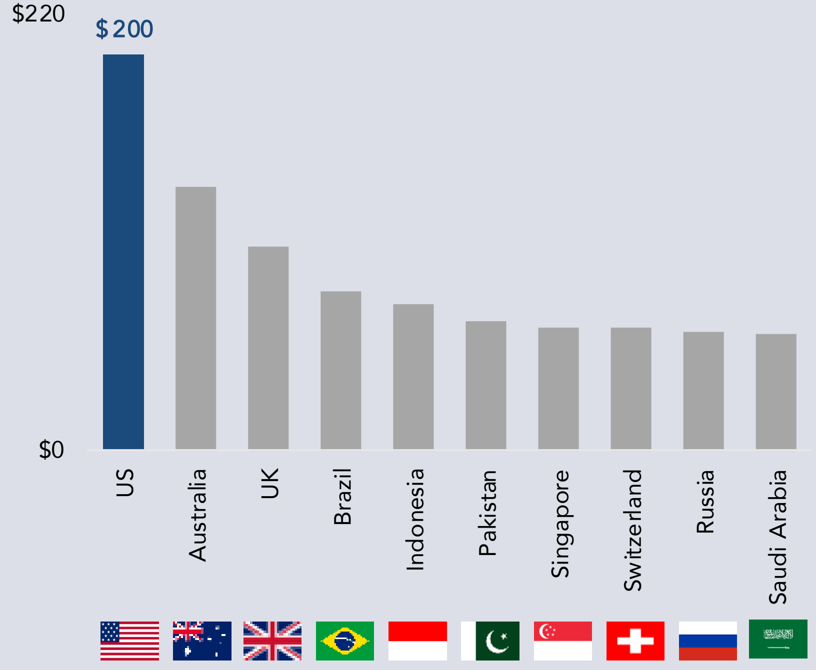
#3 Global FDI Supplier

FDI by foreign companies into China dropped $4.9 bn in Q2 2023, an 87% decline, and the largest drop since 1998. Numerous US and multi-national companies (MNCs) continue to reduce their footprint in China due to: domestic prioritization of national champions over competition; MNCs choosing repatriation of profits over reinvestment; supply chain diversification; & tech-related investment restrictions. In terms of outbound FDI, China invested $150 bn abroad in 2022, the 3rd highest outbound FDI volume globally. Including Belt & Road initiatives, China's outbound FDI volumes are significantly higher.

Outbound FDI, 2022, USD bn



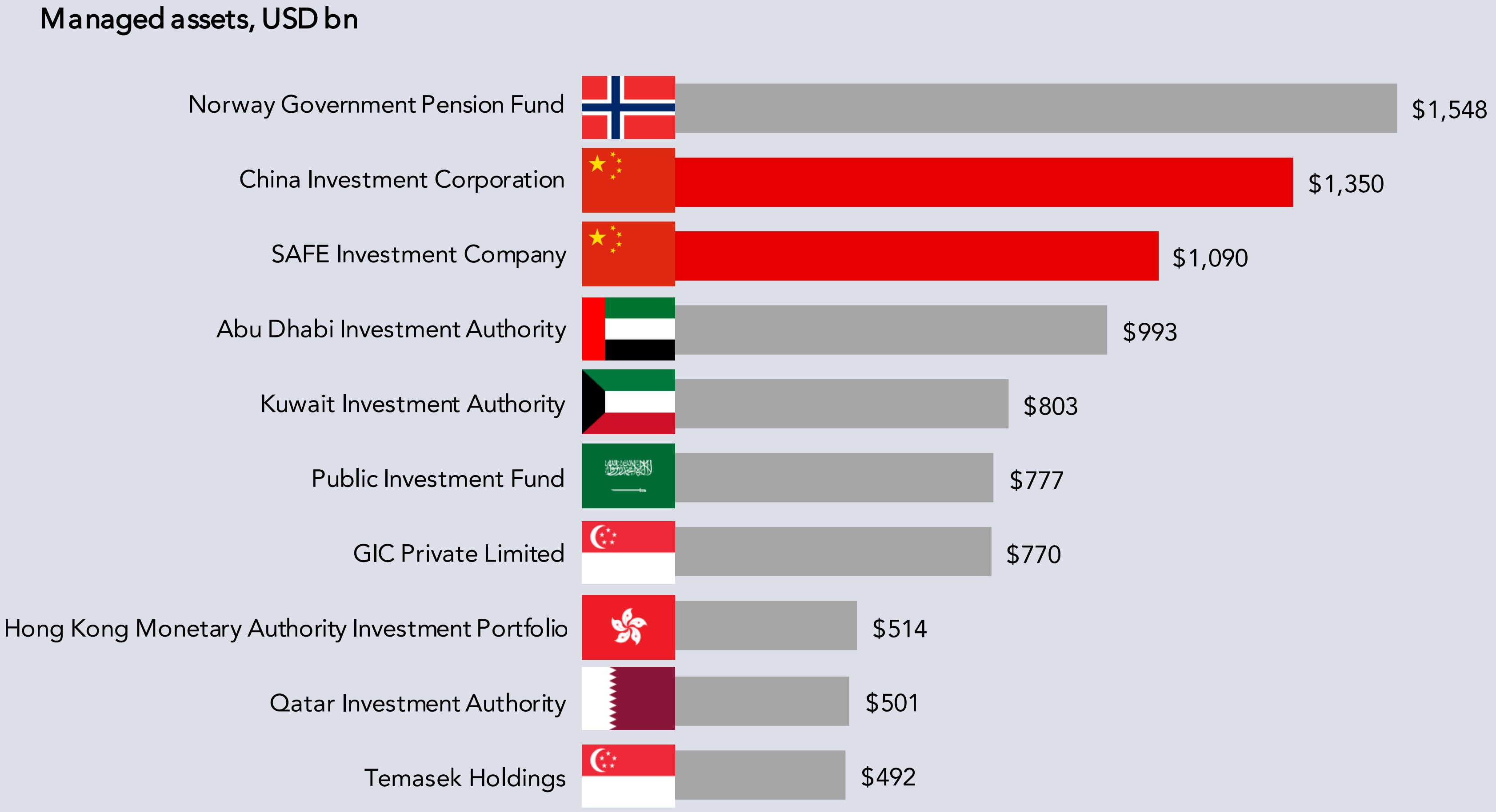
Top cumulative destinations for China investment & construction, 2005-2023 cumulative, USD bn



Source: (1-2) OECD. Data is full year 2022, updated November 2023. China, Australia and Korea data based on asset/liability basis as opposed to directional basis. AEI Heritage Foundation.

China Has 2 of the World's Top 10 SWFs

China has 2 of the world's top 10 SWFs, with over $2 trillion of managed assets between CIC and SAFE alone.



Source: (1) SWFI. Data as of January 2024.

3 Co-Dependencies & Unsustainable Imbalances

In December, 1978, just over 40 years ago, Deng Xiaoping initiated a shift in China policy that would change the course of economic history, and become the defining event of the new world order. Called gǎigé kāifàng, which translates to "reform and opening up", China embarked on a production and export driven economic model that has vaulted it toward the top of the world's largest economies.

The path chosen, however, has entailed the creation of unsuitable imbalances and inextricable linkages with the United States. Today, the US and China are at a crossroads in what has become the most important bilateral relationship of the 21st century.

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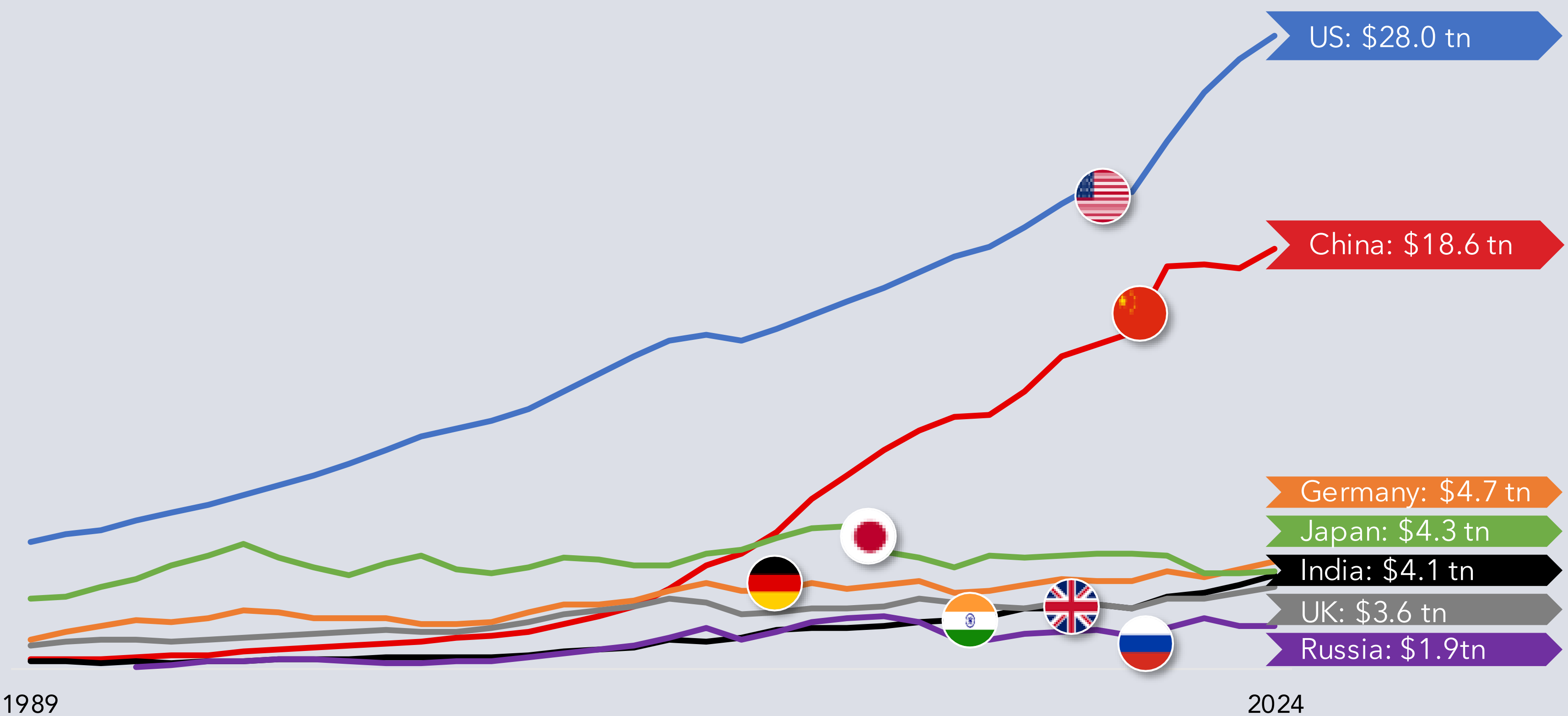
Growth & Co-Dependency

Over recent decades, the US and China's economies became inextricably linked, largely to one another's benefit, in a complex web of inter-dependencies across production and consumption, supply chains, and end markets.

Nominal GDP, current USD



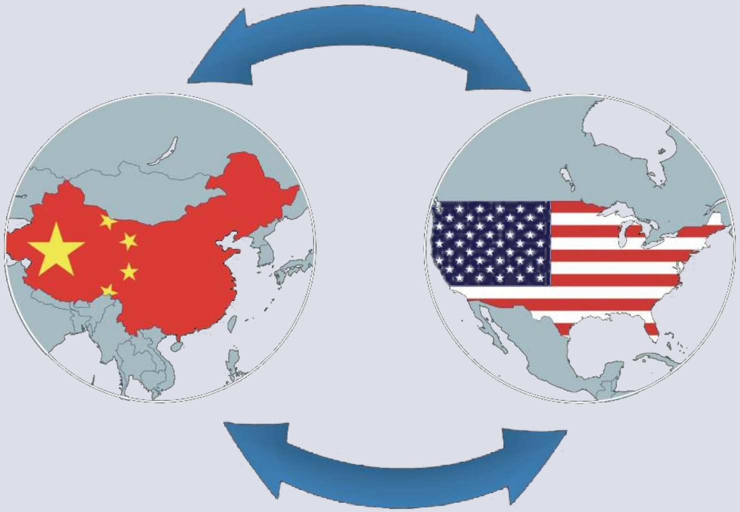
Source: (1) IMF. Data as of October 2023. 2024 GDP is an estimate.

Unsustainable Imbalances

While US and China co-dependence created numerous mutually beneficial outcomes, numerous unsustainable imbalances built over time that became more evident following the Global Financial Crisis (GFC) in 2008-9.

China

1. Investment driven growth (supply driven)
2. Highest savings-generating global economy
3. High local government and corporate debt (SOE's)
4. Highly concentrated bank-centric, state-directed funding model
5. Insufficient social safety net (healthcare, retirement)
6. Tightly managed RMB currency policy
7. Asymmetry between CCP state-directed growth & productivity
8. Income inequality
9. Environmental degradation
10. Dependence on MNCs and FDI



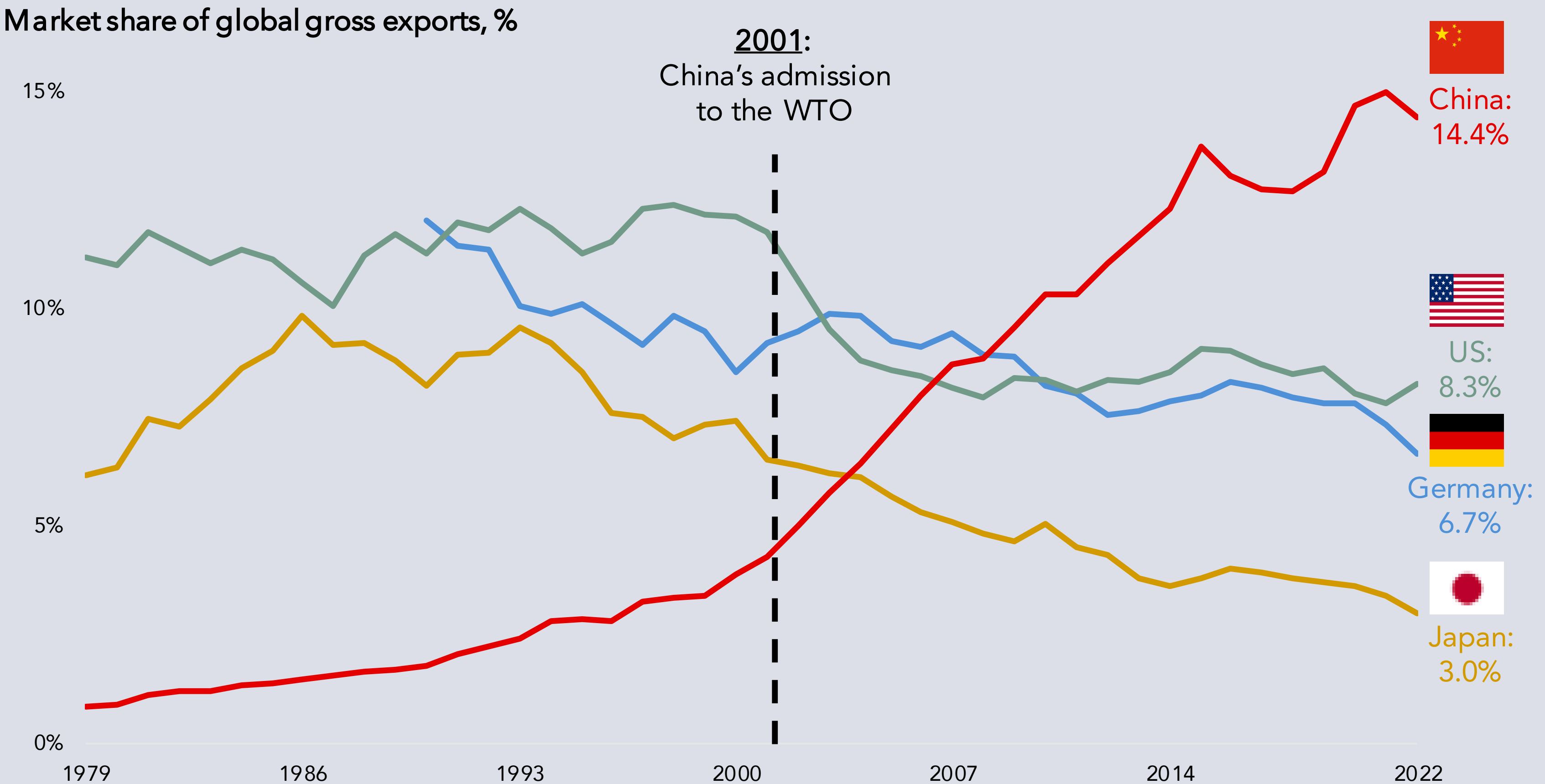
United States

1. Consumption dependent growth (demand driven)
2. Most savings-deficient global economy
3. High government debt
4. Reliance on external funding (UST purchases)
5. Asset based wealth creation (stocks, housing)
6. Dollar dominant global financial system
7. Washington gridlock
8. Income inequality
9. Aging infrastructure
10. Underinvestment in education and skills training

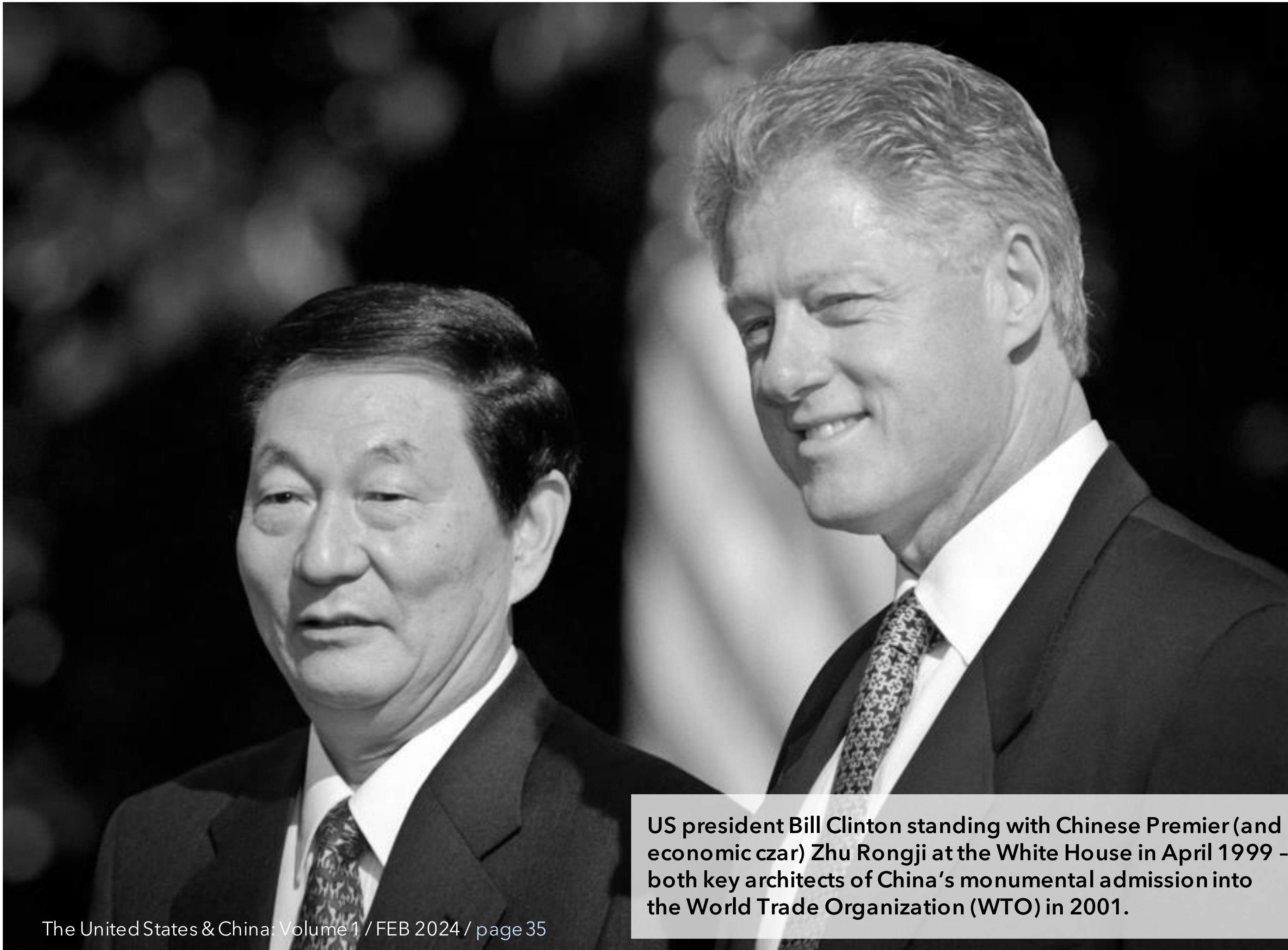
Source: Stephen Roach, "Unbalanced, The Codependency of America and China" (2014). Council of Foreign Relations. Brookings Institute. Kissinger Institute for US and China. IMF. World Bank.

China: The World's Largest Exporter

Accelerating after their admission to the WTO, China soon became the world's largest exporter. However, while China's export dependencies highlighted vulnerabilities during the GFC (2008-9) and Euro Crisis (2010-12), complaints were also rising across a broad range of Chinese trade practices including: state subsidies, protection of domestic markets, IP theft, forced technology transfer and a judicial system favoring domestic actors.



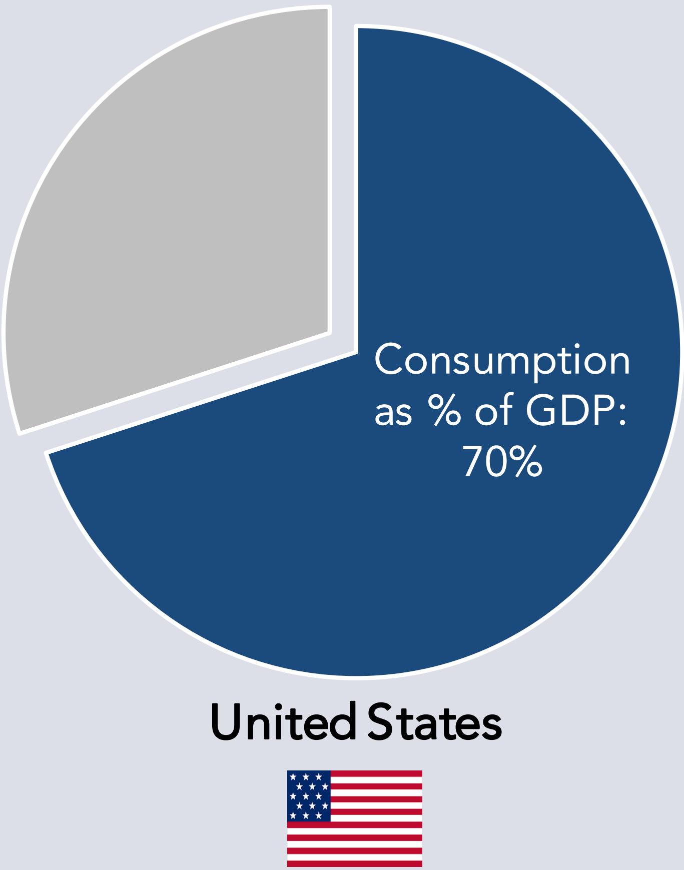
Source: (1) UNCTAD Statistics. Data last updated September 2023 through YE 2022. Merchandise exports.

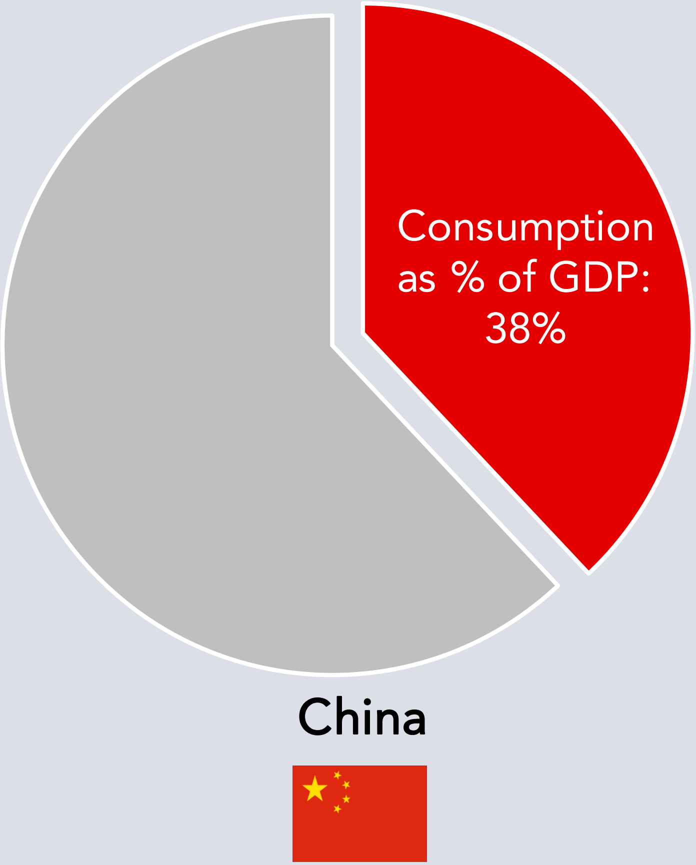


US president Bill Clinton standing with Chinese Premier (and economic czar) Zhu Rongji at the White House in April 1999 – both key architects of China's monumental admission into the World Trade Organization (WTO) in 2001.

United States: The World's Largest Consumer

The US consumer and economy have benefited enormously from a larger variety of low cost "made-in-China" goods than had previously been available, driving growth and also reducing late 1970s hyper-inflation. Over time, however, the magnitude of outsourcing its manufacturing base offshore began to take a toll, economically and socio-politically.





Source: (1) OECD. Household spending as % of GDP for 2021 (latest available data as of January 2024).

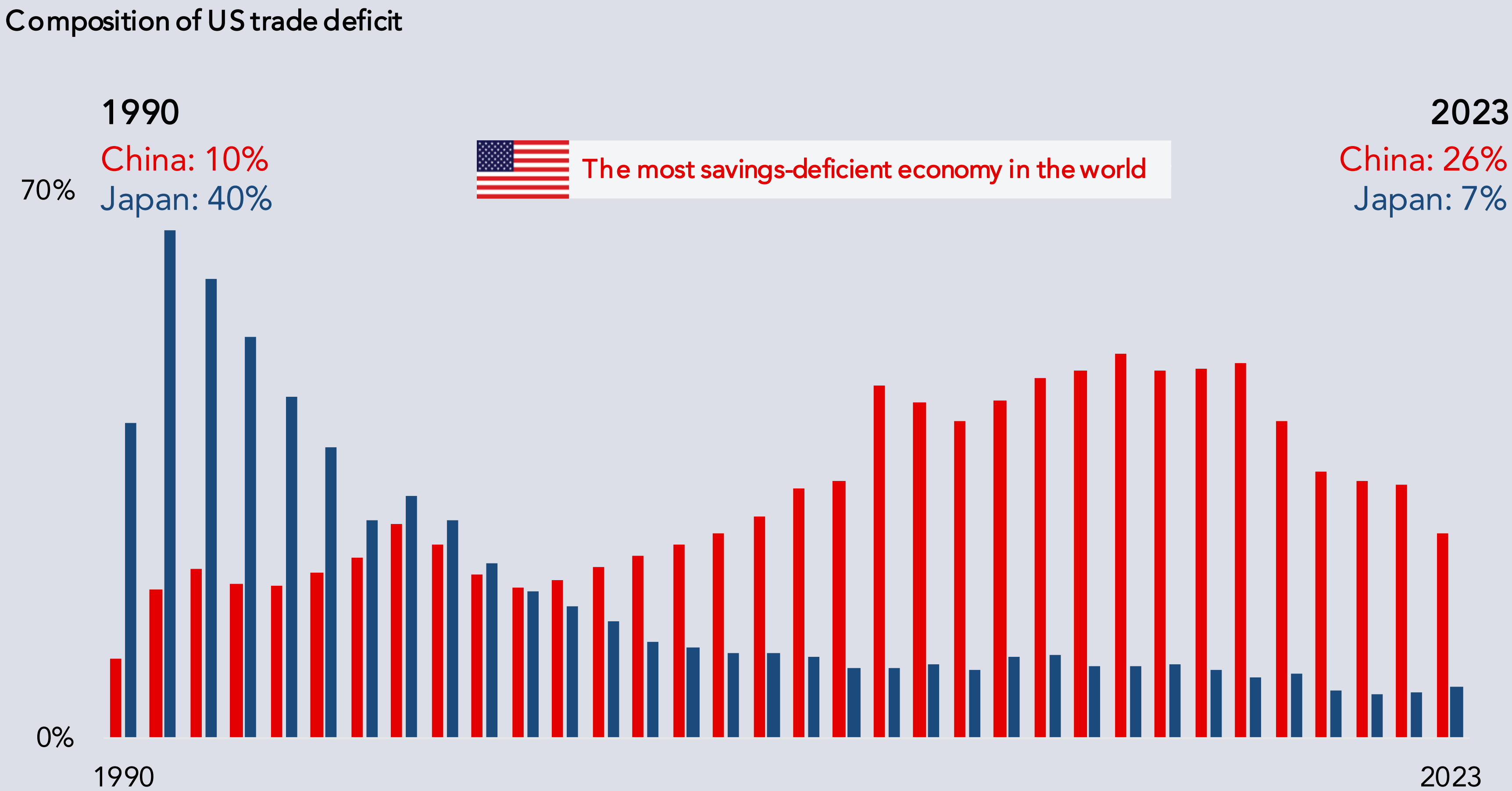
Unsustainable US Trade Deficits

The US had trade deficits with 103 countries in 2021, up from approximately 80 countries in 1990. While our largest trade deficits are with China, the sheer number of counterparty deficits suggest that the origins of our weakness in this regard may also have roots in our own structural domestic shortcomings.

Source: (1) World Integrate Trade Solution. Full year data as of 2021.

Unsustainable US Trade Deficits

Just three decades ago, the United States was looking East toward another strategic competitor, Japan, as the primary source of its unsustainable annual trade deficits.

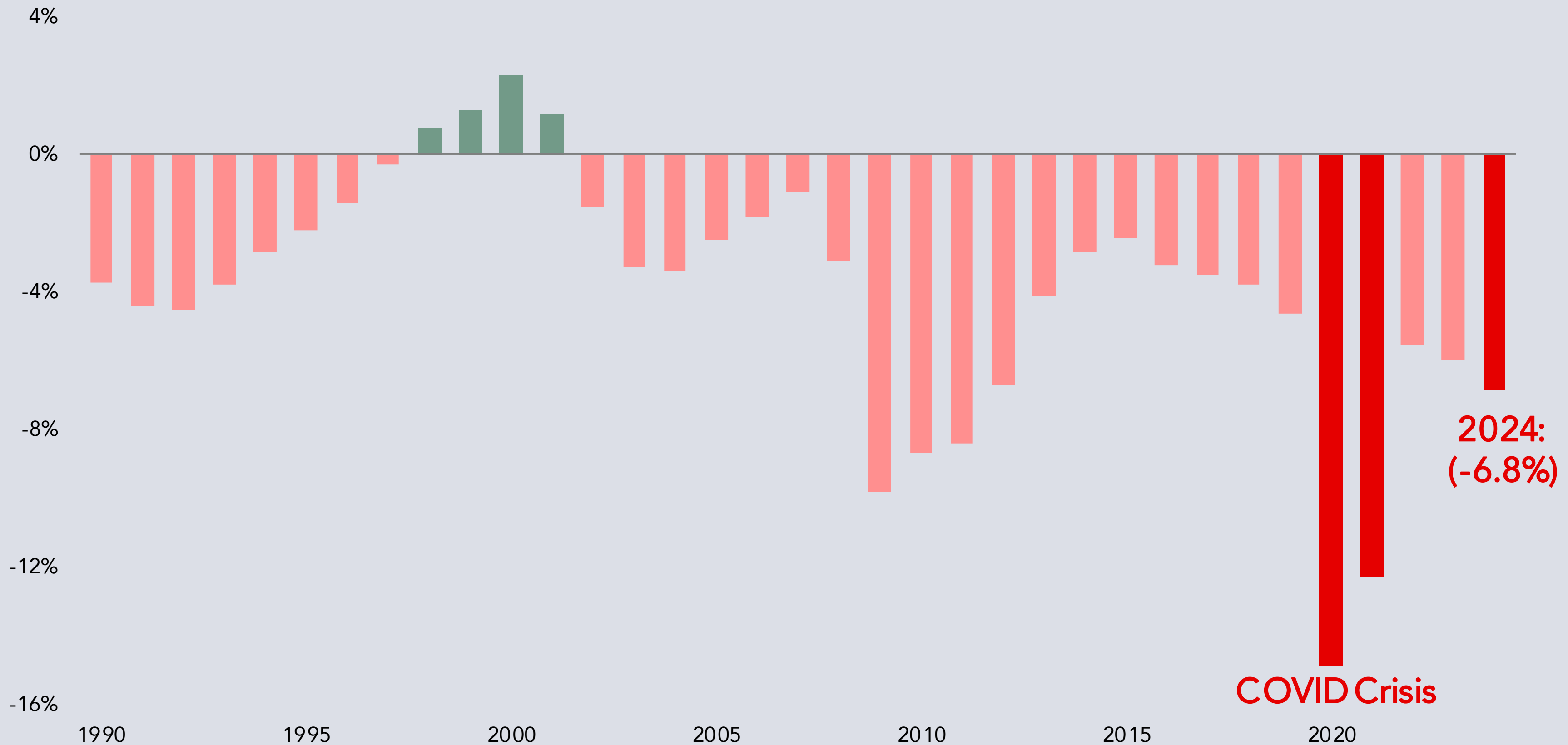


Source: (1) US Census Bureau. 2023 data through November 2023.

US Debt & Deficits

Since the decline of Bretton Woods in the early 1970s, a US dollar dominated global financial system has been a "national treasure," providing the US both low cost debt and a powerful toolkit in foreign affairs. However, many experts have warned that excessive use of this toolkit and unsustainable debt and deficits have weakened US competitive advantages.

US Federal budget deficit, % of GDP



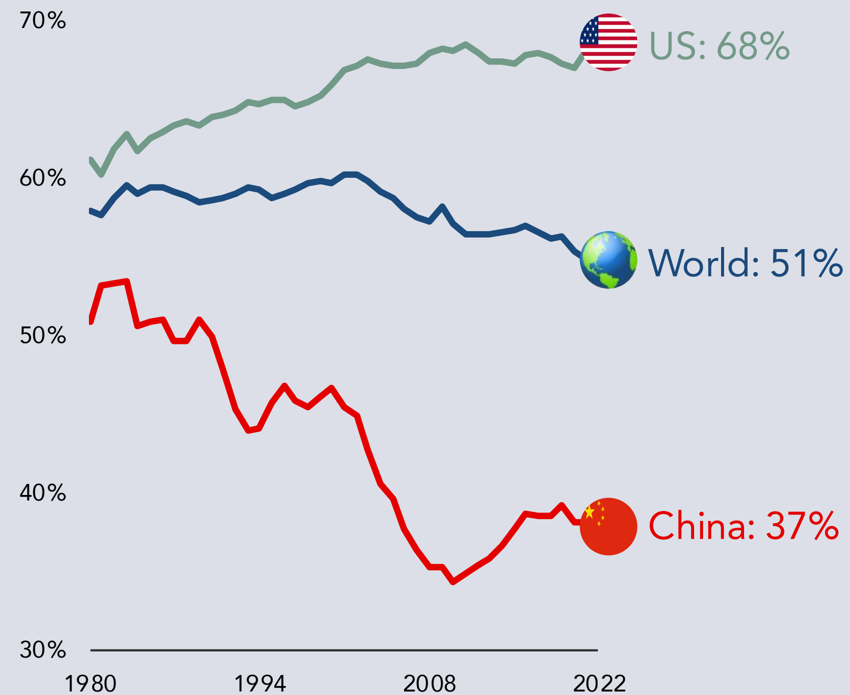
Source: (1) Bloomberg. Data as of January 31, 2024. US Treasury.

China's Slow Progress in Rebalancing its Economy

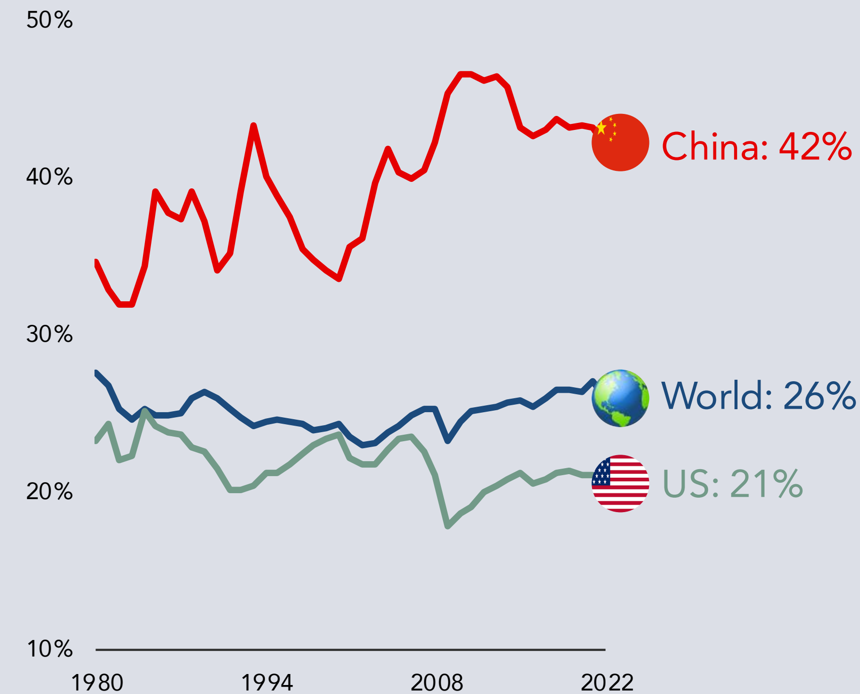
Xi Jinping and China have made very slow progress over the last decade in rebalancing their economy away from less productive (and externally vulnerable) investment led growth, toward more durable and domestic consumption driven growth. Despite a plethora of policy pronouncements and initiatives, China's investment / GDP ratio is more than double US levels, while consumption / GDP has remained relatively stagnant below 40%. In a post COVID world, aging demographics and a weak social safety net have been formidable headwinds to rebalancing.

Slow progress on consumer led growth over fixed investment

Household expenditure as a share of GDP



Investment as a share of GDP



Source: (1-2) WSJ, "China's 40 Year Boom is Over. What Comes Next?" World Bank. Household expenditure data through YE 2022, US is through 2021. Investment is gross capital formation through YE 2022, US through 2021.

China's Externally Dependent Surpluses

Aided by a managed currency and accusations of unfair trade practices, China maintains trade surpluses with 162 countries, up from approximately 100 in 1992. Dependencies on such surpluses, however, become more challenging in a low visibility, higher volatility world with greater geopolitical friction and competition.

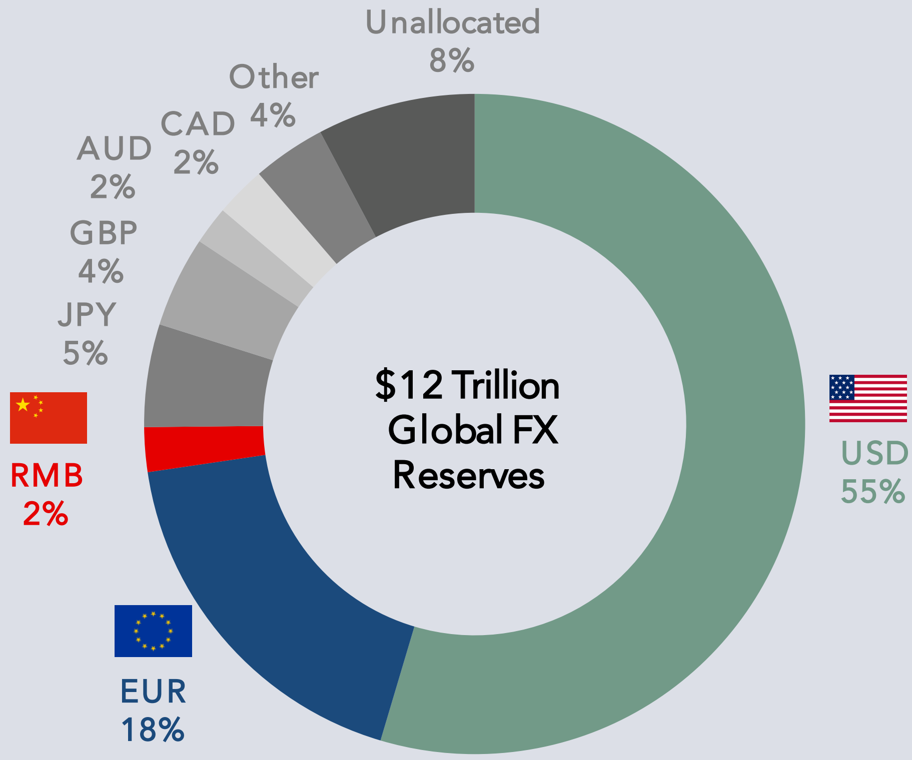
China is highly vulnerable to the unwind of global supply chains

Source: (1) World Integrate Trade Solution. Full year data as of 2021.

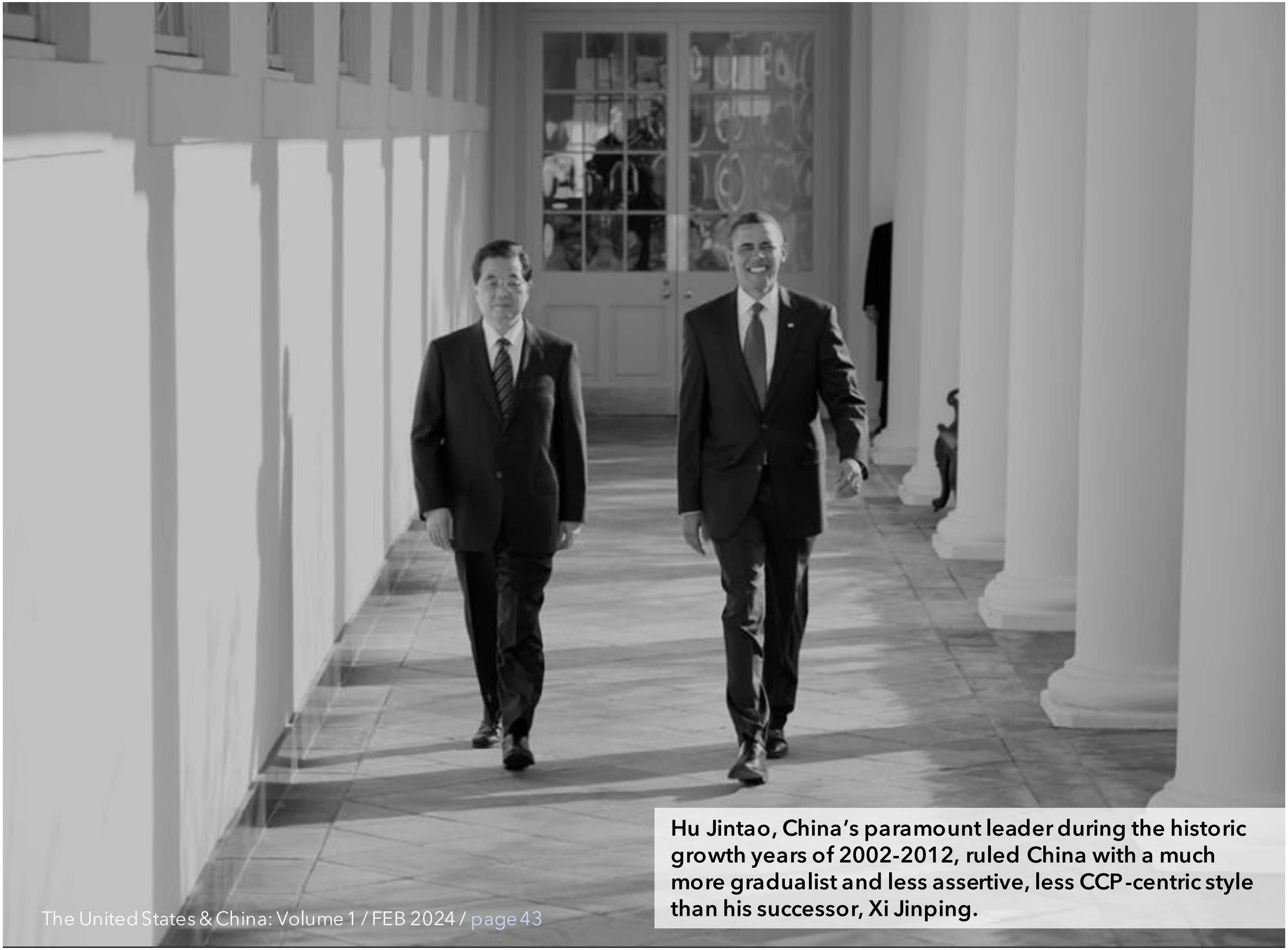
China's Vulnerability to US Dollar Dominance

While the RMB has more than doubled its share of global FX reserves since 2016, it still represents less than 2% of global reserve portfolios. Despite a push to internationalize its currency, China has been cautious in allowing full financial liberalization, slowing its adoption as a reserve currency. A slowing economy and elevated capital outflow pressures run counter to the policy liberalization China would need to substantively enhance the trade settlement and global reserve currency status of the RMB.

Share of global FX reserves
(By currency)



Source: (1) IMF World Currency Composition of Official Foreign Exchange Reserves. ECB "Internationalization of the renminbi and capital account openness". Data as of January 2024.

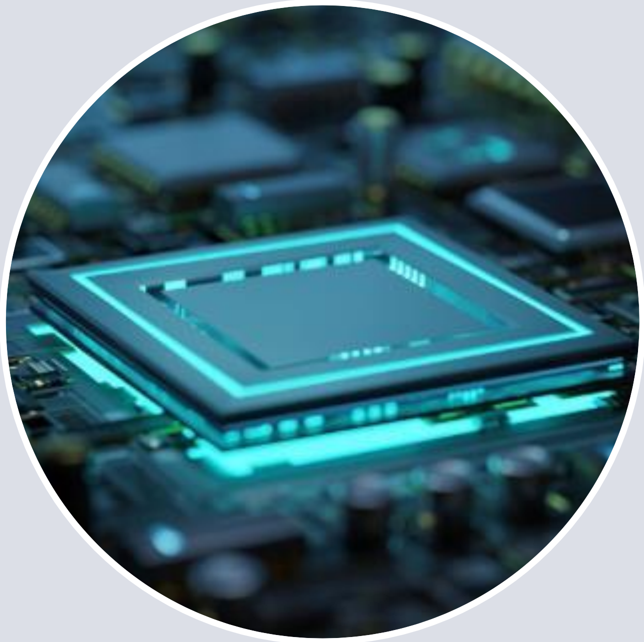


Hu Jintao, China's paramount leader during the historic growth years of 2002-2012, ruled China with a much more gradualist and less assertive, less CCP-centric style than his successor, Xi Jinping.

China's Twin Technology Deficits

More so than most other areas, China notably lags US and western innovation in two fundamental, core technology arenas: software and advanced microprocessors. Though China is moving quickly to close the gap, their vulnerabilities amidst a more restrictive and assertive global technology policy regime are a notable area of concern. Longer term, maintaining global tech competitiveness with a domestically-focused strategy will also be a challenge.

Software



Advanced Semiconductors

4 China's Structural Slowdown

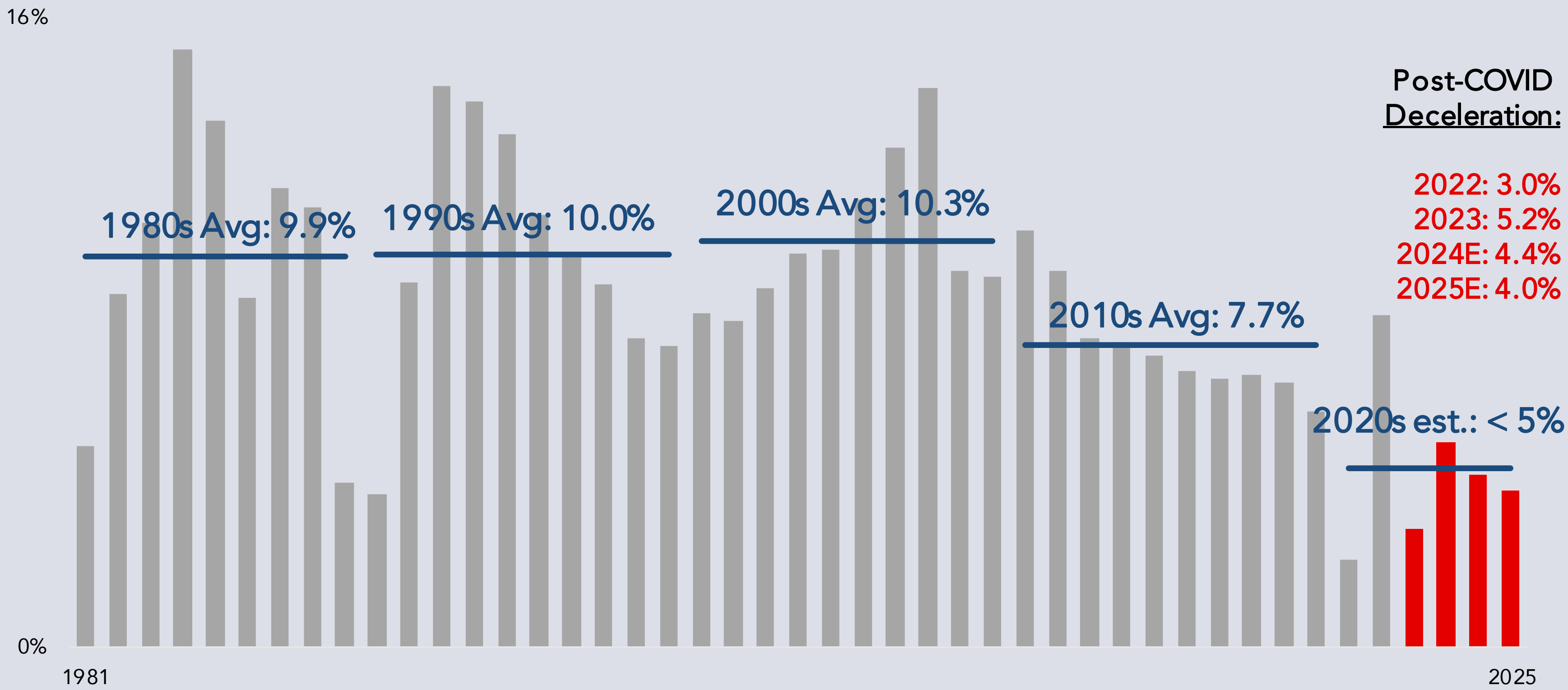
"Scale does not compensate for persistent macroeconomic imbalances, nor does it insulate the Chinese economy from financial crises, debt implosions, and other shocks those imbalances might render even more destabilizing."

Stephen Roach, Economist at Yale School of Management, formerly Chairman of Morgan Stanley Asia

New Normal for China Growth < 5%

After four decades of super-charged growth well above advanced economy rates, the new normal for post-COVID China growth in the decade ahead will likely fall below 5%. In fact, the IMF is forecasting China growth < 4% in coming years, less than half the rate of recent decades. The slowdown in China's economy has been broad based and driven by a plethora of structural and cyclical factors, both internal and external.

China real GDP growth, y/y

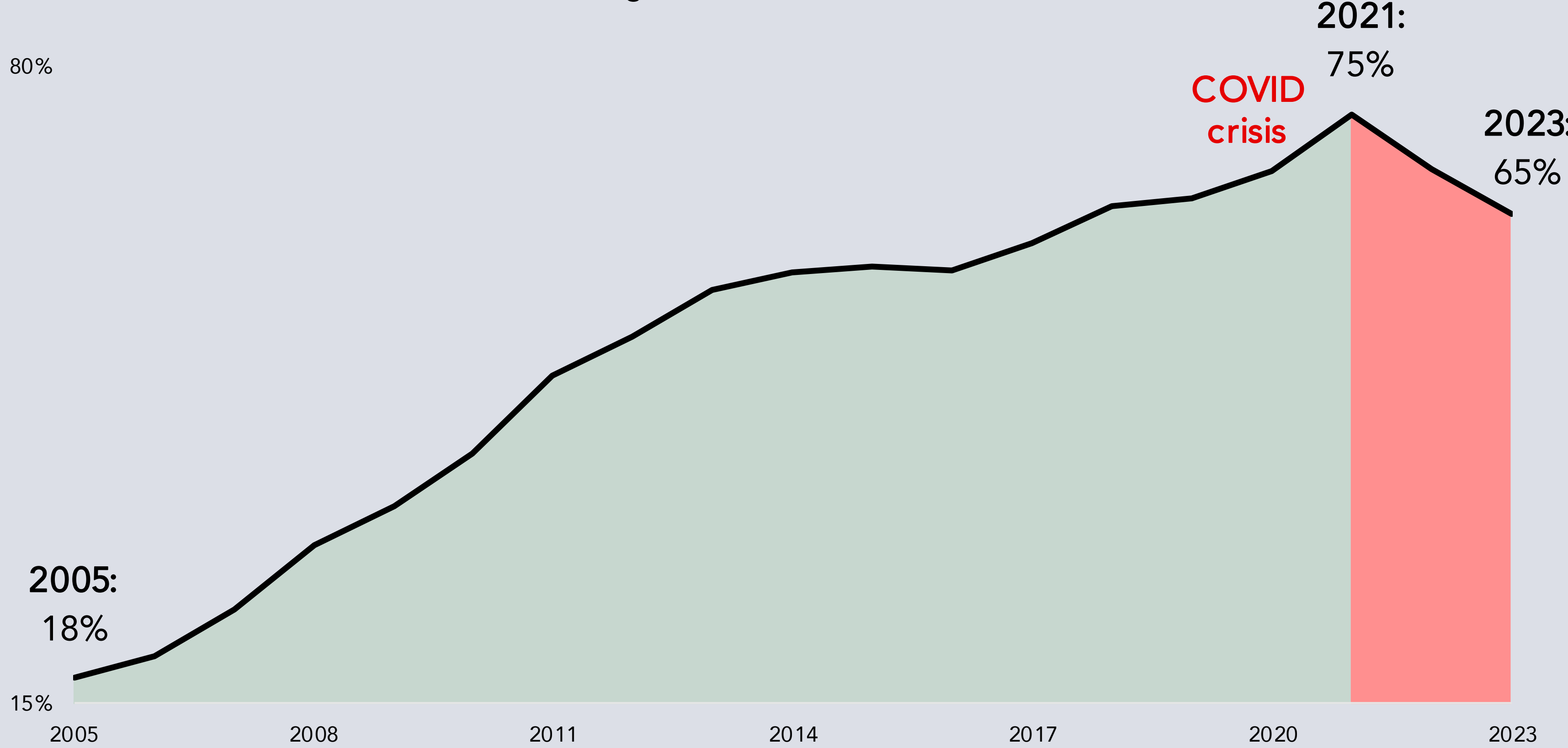


Source: (1) Oxford Economics. Data as of February 2, 2024.

Post COVID US GDP Growth Outstripping China

US economic "exceptionalism," led by resilience and innovation despite the twin shocks of the COVID crisis and historic inflation / policy tightening, has been an important theme for markets over the last year. At the same time, a tepid Chinese consumer and more stringent state directed growth have fallen well below expectations coming out of the two-year lockdown in late 2022.

China GDP as share of US at USD market exchange rates



Source: (1) Bloomberg, "US Outstrips China, Adds a Korea Worth of GDP". Data as of January 29, 2024. World Bank.

China's Slowdown More Structural than Cyclical

By virtue of being more structural than cyclical, China's slowdown is likely to be multi-year in duration.

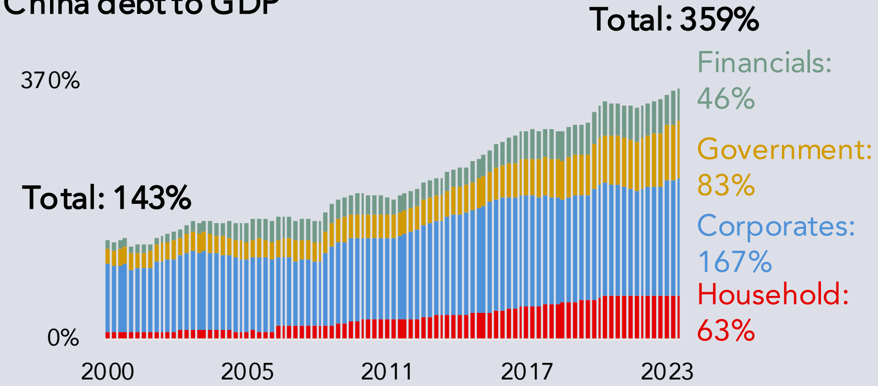
	Key Challenge	Primary Driver: More Structural	Primary Driver: More Cyclical
1.	Tepid Post COVID Consumer	●	●
2.	Weak External Demand		●
3.	Policy Restraint & Caution	●	●
4.	Rebalancing the Economy	●	
5.	Demographic Headwinds	●	
6.	Declining Productivity	●	●
7.	Rising Debt Levels	●	
8.	Over Levered Property Sector	●	
9.	Highly Concentrated Banking System	●	
10.	"Higher Friction" Geopolitics	●	

The 4 Ds Driving China's Slowdown

The COVID-crisis did <u>not</u> so much create, as it did exacerbate and accelerate, the pervasive structural forces driving the multi-year slowdown in China's economy.

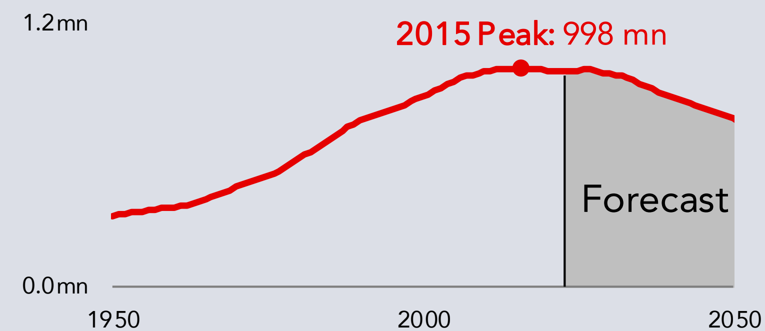
#1: Debt

China debt to GDP



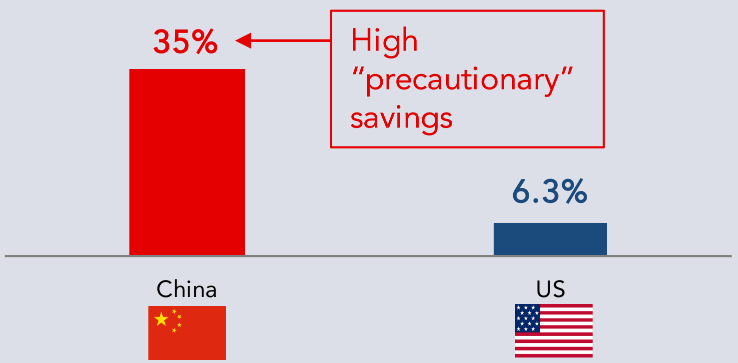
#2: Demographics

China's working age population (Age 15-64)



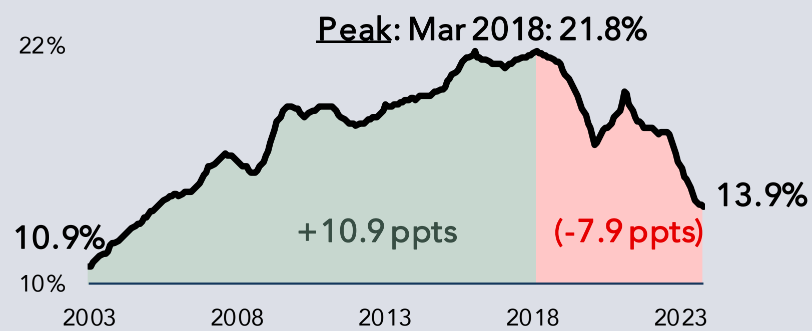
#3: Demand

Average consumer savings rate since 1991



#4: Decoupling

Share of US goods imports from China



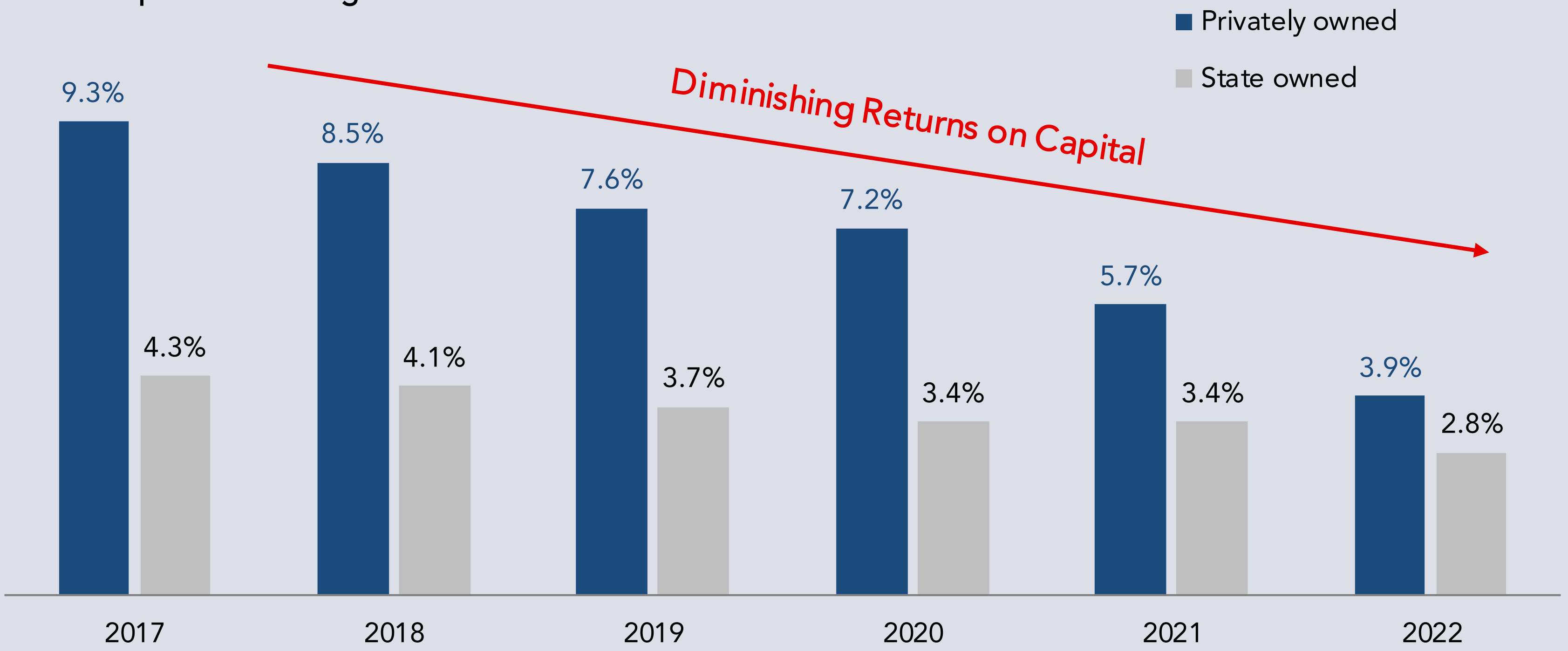
Source: (1) IIF Global Debt Monitor. 2023 is Q3 data. (2) UN World Population Prospects 2022. Based on Medium variant estimates. (3) Bloomberg. Data as of September 8, 2023. PBOC. (4) US Census Bureau. Data is rolling 12-month average through November 2023.

Pivot Back to State & CCP Centric Growth

Over the last decade, Xi Jinping has pivoted away from the blended private-public economic growth model engineered by Deng Xiaoping four decades ago (the incorporation of market economics, or "socialism with Chinese characteristics"). Under Xi, China has clamped down sharply on the private sector (60% of GDP, 80% of urban jobs), shifting the trajectory of economic policy toward Party-dominated, state-directed growth. Diminishing returns on capital investment have followed, led by state owned companies in particular.

Shift toward State / Party directed growth

Chinese corporations average return on assets

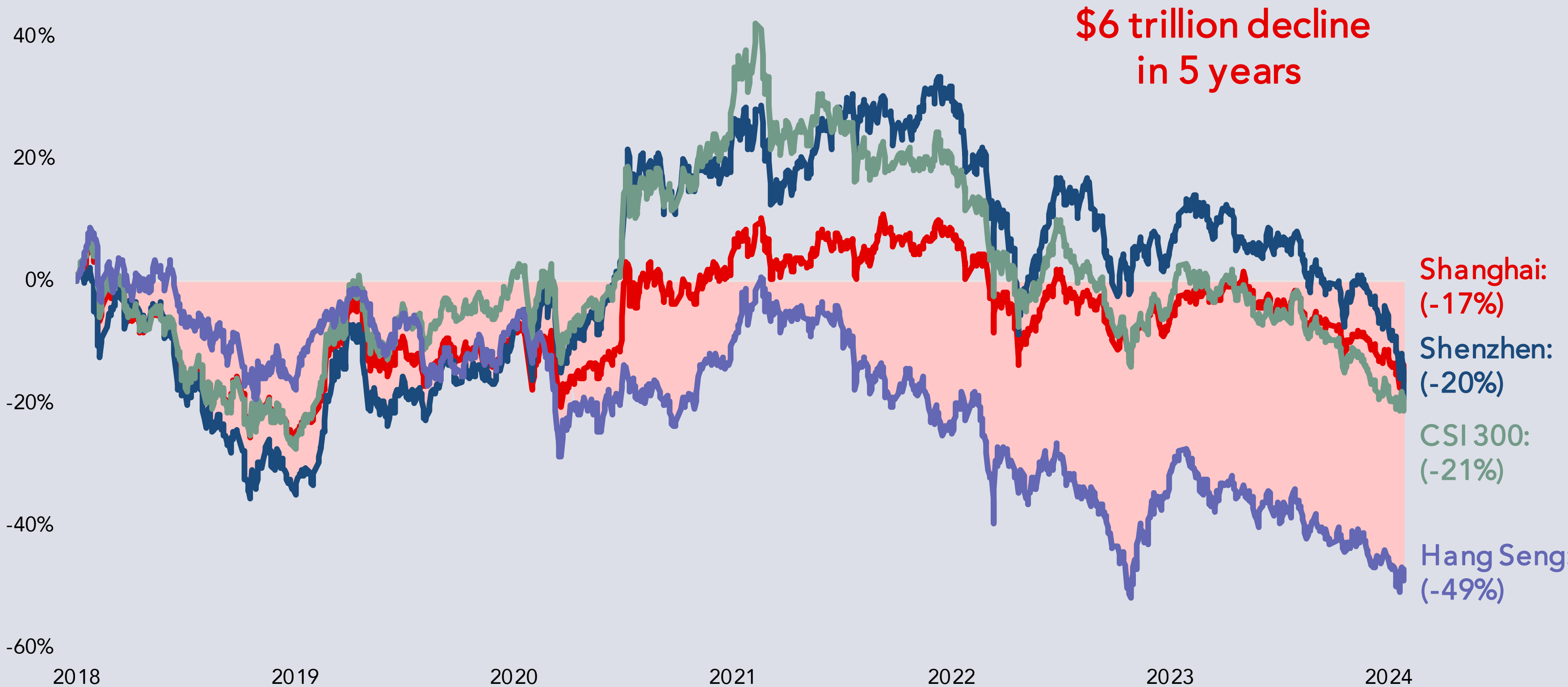


Source: (1) WSJ, "China's 40 Year Boom is Over. What Comes Next?" Bruegel, "Can Chinese Growth Defy Gravity?"

Confidence Crisis in China's Equity Markets

As President Xi Jinping tightens the grip of Communist Party control over the private sector, China's equity markets have declined more than $6 trillion over the last five years. Contributing factors to the "crisis of confidence" have included: (1) a tepid post-COVID Chinese consumer, (2) recurring regulatory crackdowns on private sector enterprise and "animal spirits", and (3) the pervasive policy pivot of the economy toward less productive, state and SOE driven-growth.

Shanghai Composite, Shenzhen Composite, CSI 300, & Hang Seng



Source: (1) Bloomberg. Data as of January 31, 2024.

About the Authors

Tom Joyce

Managing Director
Capital Markets Strategist
New York, NY

Tom.Joyce@mufgsecurities.com
(212) 405-7472

Role

Tom Joyce is a Managing Director and Capital Markets Strategist within MUFG's global capital markets and investment banking business. Based in New York, Tom heads a team that creates customized analytical content for multi-national S&P 500 companies. His team provides in depth analysis on the impact of economic, political, public policy and regulatory dynamics on the US credit, foreign exchange, rates and commodities markets.

Experience

Tom has over 25 years of Investment Banking experience in New York, London, Hong Kong, and San Francisco. Over the last 15 years, Tom created and built the Capital Markets Strategy role, advising corporate C-Suite executives (Boards, CEOs, CFOs, and Treasurers) on the pervasive macro forces driving markets. Tom also presents at dozens of corporate events each year including Board meetings, CEO ExCo sessions, CFO and Treasury off-sites, corporate leadership events and conferences.

Education

Tom's educational background includes a year of study at Oxford University from 1991 - 1992, a Bachelor of Arts in Political Science from Holy Cross College in 1993, and a MBA from Kellogg Business School, Northwestern University in 2000.

Personal

Tom resides in New Canaan, CT with his wife and four sons, where he serves on the Board of Trustees of the New Canaan Library as well as the Holy Cross College President's Council.

About the Authors

Hailey Orr

Managing Director
Capital Markets Strategist
New York, NY

Hailey.Orr@mufgsecurities.com
(212) 405-7429

Role

Hailey Orr is a Managing Director in MUFG's Capital Markets Strategy group within the global capital markets and investment banking business. The team provides market based content for corporate clients to assist in strategic decision making. Focus areas include the impact of economic, political, public policy and regulatory dynamics on the US credit, foreign exchange, rates and commodities markets.

Experience

Hailey has a decade of Wall Street experience, including three years as a Consumer Sector Specialist in Equity Sales and seven years as a Capital Markets Strategist. Hailey is also a member of MUFG's Inclusion & Diversity Council and has devoted years to participating in and developing Wall Street recruiting programs.

Education

Hailey graduated with honors from the University of Michigan's Ross School of Business with a BBA and a minor in International Studies.

Personal

In March 2020, Crain's New York Business Magazine named Hailey one of the "Rising Stars in Banking and Finance".

About the Authors

Stephanie Kendal

Vice President
Capital Markets Strategist
New York, NY

Stephanie.Kendal@mufgsecurities.com
(212) 405-7443

Role

Stephanie Kendal is a Vice President in MUFG's Capital Markets Strategy group within the global capital markets and investment banking business. The team provides market based content for corporate clients to assist in strategic decision making. Focus areas include the impact of economic, political, public policy and regulatory dynamics on the US credit, foreign exchange, rates and commodities markets.

Experience

Stephanie has spent over six years as a Capital Markets Strategist. She is an active member of the University of Michigan recruiting team and is focused on the diversity recruiting effort at MUFG. Stephanie is also a part of MUFG's DEI, Culture & Philanthropy (DCP) Council.

Education

Stephanie graduated with honors from the University of Michigan's Ross School of Business with a BBA.

Personal

Stephanie is actively involved in NYC's iMentor program, mentoring high school students with their journey to college graduation. She also volunteers at Experience Camps, a free summer camp program for grieving children.

Angela Sun

Analyst
Capital Markets Strategist
New York, NY

Angela.Sun@mufgsecurities.com
(212) 405-6952

Role

Angela Sun is an Analyst in MUFG's Capital Markets Strategy group within the global capital markets and investment banking business. The team provides market based content for corporate clients to assist in strategic decision making. Focus areas include the impact of economic, political, public policy and regulatory dynamics on the US credit, foreign exchange, rates and commodities markets.

Experience

Angela previously interned at MUFG working in Capital Markets within the Equity Capital Markets and Leveraged Finance divisions. She is also an active member of the Carnegie Mellon University recruiting team.

Education

Angela graduated with honors from Carnegie Mellon University's Tepper School of Business with a BS in Business Administration with an additional major in Statistics and a minor in Media Design. She was a member of Alpha Kappa Psi business fraternity and the Undergraduate Entrepreneurship Association.

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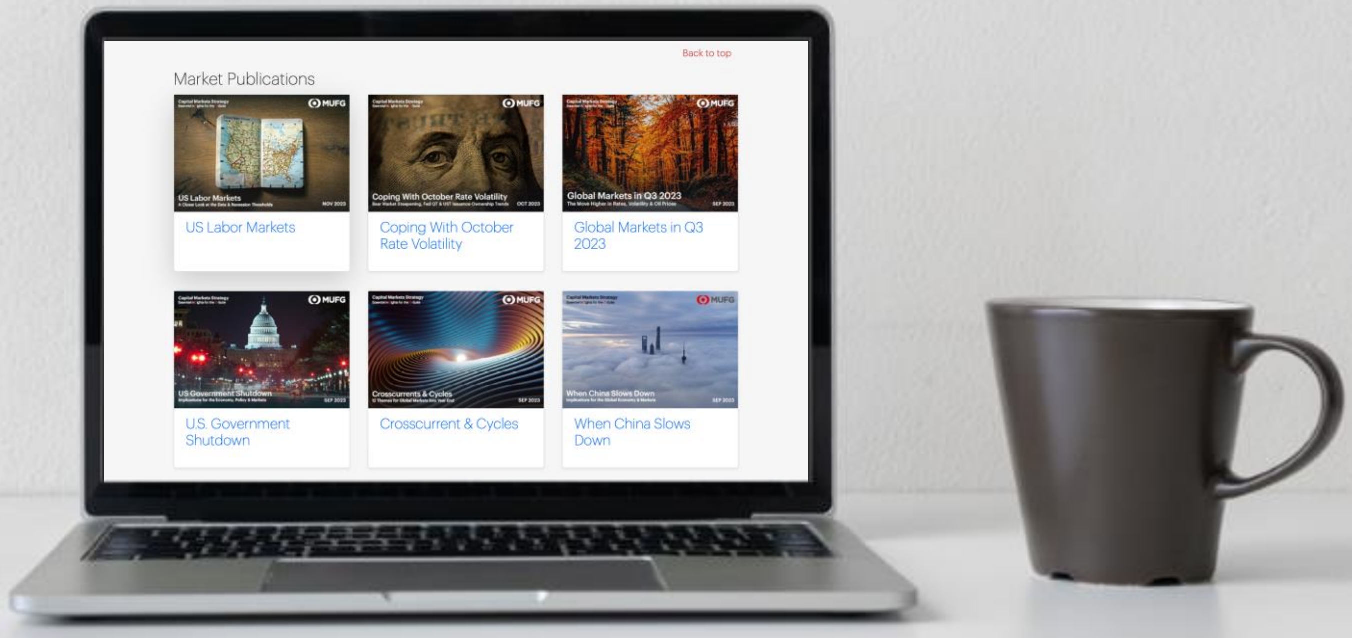

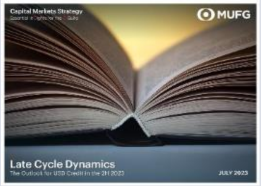

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