



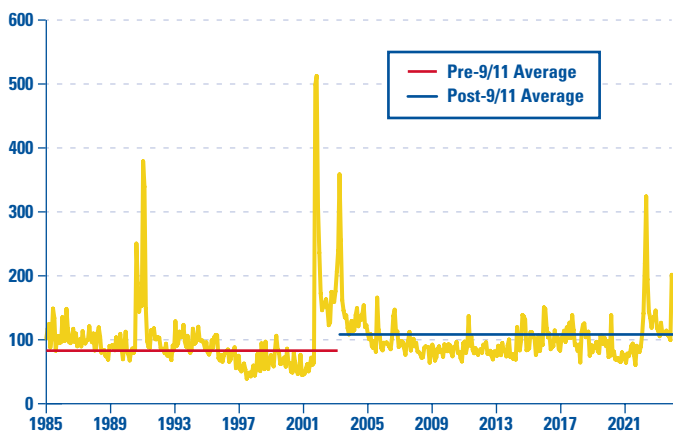
Summary

- Historically fraught US-China relations will continue to be tested by disagreements over Taiwan's independence and technology.
- The US and China will remain political and economic competitors in a new multipolar world. In addition, China's goal of "unification" with Taiwan means that military escalation is a risk.
- However, the US and China are incentivised to set up guardrails and clear boundaries.
- Progress towards 'competitive co-existence' should allow for a more stable investment environment and a moderation in geopolitical risks priced into markets.

Introduction

Concerns around the deterioration of relations between the United States (US) and the People's Republic of China (China) have become a mainstay of investment strategies with exposure to emerging markets and China over the past few years. Disagreements between the two countries have tended to focus on trade and investment, along with Taiwan's right to independence and self-defence. However, ideological differences and the competition to be the global superpower lie at the heart of US-China tensions. Therefore, future efforts will likely focus on establishing a framework to manage the US-China strategic relationship rather than a return to the relationship of the past.

Figure 1: Fed's Geopolitical Risk Index



Source: Caldara, Dario and Matteo Iacoviello (2022), "Measuring Geopolitical Risk," *American Economic Review*, April, 112(4), pp.1194-1225

The rise in US-China tensions falls under the broader trend of geoeconomic fragmentation, best illustrated by the steady increase in the Fed's Global Geopolitical Risk Index (Figure 1). Given this structural rise in recent years, our country allocation framework has placed greater emphasis on how geopolitics impacts macro and

market fundamentals. The upcoming US election will likely keep the fraught US-China relationship at the top of the news. We, therefore, refresh our views on how we expect US-China tensions to evolve over the short and long-term.

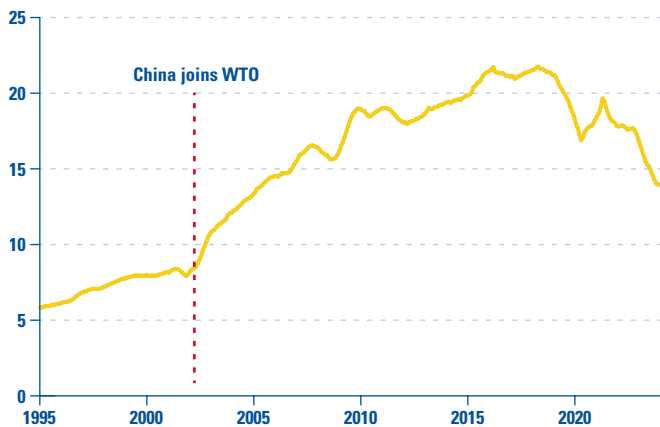
Background: US-China Relations

Since China was established in 1949 by Mao Zedong, the US and China have had a complex bilateral relationship marred by periods of elevated tension. Relations were first tested during the Korean War, followed by the First Taiwan Strait Crisis in 1954-1955, which led to Washington signing a mutual defence treaty (Sino-American Mutual Defense Treaty, 1955) with the Republic of China (Taiwan). The Sino-Soviet split resulted in gradually warming US-China ties for the next few decades, notably culminating in President Nixon's visit and the signing of the Shanghai Communiqué in 1972. This Communiqué first mentions the US's "One-China policy", an acknowledgement that "all Chinese on either side of the Taiwan Strait maintain there is but one China and that Taiwan is a part of China". A non-diplomatic relationship that allows for commercial and cultural relations with Taiwan was established via the Taiwan Relations Act (1979), which sets out a "de facto" diplomatic relationship with Taiwan without violating the One-China policy. Crucially, the act does not guarantee US military intervention in the event of a Chinese invasion of Taiwan but requires the US to "provide Taiwan with arms of a defensive character". Both decisions paved the way for the US's delicate balance of strategic ambiguity on the political status of Taiwan, a significant source of US-China tensions to this day.

Since the establishment of formal US-China relations over 50 years ago, there have been many incidents that have tested the relationship, such as the Tiananmen Square Massacre (1989). In contrast, economic ties between the two countries flourished following China's accession to the World Trade Organization (WTO) in 2001 (Figure 2). However, China's growing economy became a point of contention in the US, resulting in a steady defensiveness

towards China. Indeed, then-Secretary of State Hillary Clinton's essay in 2011 outlined the US's "pivot" to Asia and set out the approach to counter China's influence. Today, this hawkish posture is held across the US political spectrum. Talks of "cooperation" with China have been replaced by "strategic competition". Hostility between the two nations has also changed public perception, with 83% of US adults having an unfavourable view of China in 2023, up from 35% in 2005¹.

Figure 2: China Share of US Imports (% , 12m avg)



Source: Bloomberg

Besides China's economic clout, the US's change in stance is also ideological as the Chinese Communist Party (CCP) has embraced a more socialist approach than in the past under the leadership of Xi Jinping (Xi Jinping Thought, Xi'ism). Since assuming power in 2013, Xi Jinping's presidency has been marked by an aggressive foreign policy, a clampdown on civil liberties, an anti-corruption campaign and an emphasis on common prosperity. China has also sought to reinforce its global influence through the Belt and Road Initiative, the Chinese government's infrastructure development strategy that has around 150 countries signed up to the memorandum of understanding.

The US has sought to pare back its economic relationship with China by enforcing restrictions on trade and investment, most notably with President Trump's sweeping tariffs in 2018. However, shifting away from China will take time, given entrenched supply chains. In recent years, tensions have been centred on the semiconductor industry, with the US curtailing investment and exports given their military usage.

The Future of US-China Relations: Short Term

The US and China have indicated that they are wary of each other and have differing views on key issues. Therefore, in the future, both countries' goals would be to manage and contain the competitive relationship and prevent escalation. The lauded success from both sides following the recent Biden-Xi meeting in November 2023 serves as a reminder that both countries have some interest in cooperation.

When considering the direction of the US-China relationship, it is best to differentiate between the near and longer term. In the short term, the results of the Taiwanese and US elections in 2024 will determine the tone that officials on both sides will take. In Taiwan, while the incumbent pro-independence Democratic Progressive Party (DPP) won a third consecutive term, President Lai's popular mandate is weaker as the DPP lost its legislative majority and received the lowest winning share of votes since 2000. As such, the more China-friendly Kuomintang (KMT) and newly-formed Taiwan People's Party (TPP), who won a combined 53% of the legislature, will curb the DPP's legislative power. The DPP's win, therefore, should not be perceived as a direct threat of secession from China, which should help reduce, or at least prevent, a rise in geopolitical tensions.

In the US, neither the Democratic nor Republican presidential candidates have been finalised, but both Presidents Biden and Trump are running for re-election. A hawkish approach to China has become a bipartisan stance, as demonstrated by President Biden keeping Trump-era trade tariffs on China in place and introducing restrictions on Chinese access to US technology. While varying in approach, foreign policy under both Presidents will likely be pursued in a way that prioritises domestic interests.

A second Trump presidential term could increase US protectionism if his proposal of a 10% tariff on all US imports is taken at face value. He has also expressed an interest in expanding investment restrictions on China. These measures would likely result in USD strength, albeit stretched valuations and US rate cuts could be a headwind for the dollar. Meanwhile, like his first term, President Trump could alienate traditional allies with his divisive rhetoric, leading to an opening for China to strengthen relations with them. Given that US restrictions on Chinese tech require cooperation with other countries such as Taiwan, Japan, South Korea and the EU, any Trump-driven wedge between the US and its allies could result in lower enforcement of US restrictions, providing China's industry with some breathing space.

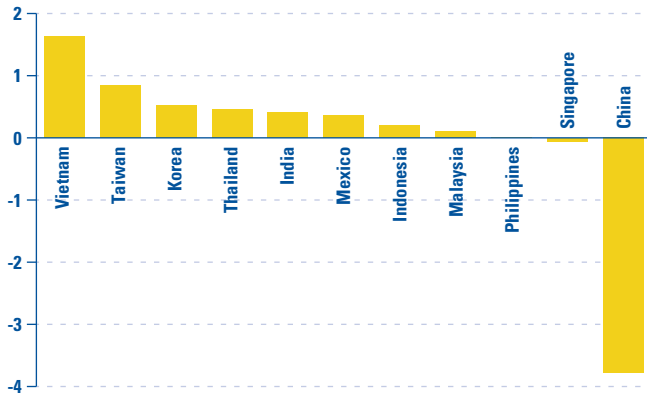
An additional wrinkle in US-China tensions is Taiwan's vital position as the world's largest producer of semiconductors. Over 60% of total semiconductors and over 90% of advanced semiconductors are manufactured on the island, making it a critical component of the global economy. Semiconductors are a key point of contention in US-China tensions. The US has offered generous subsidies and tax credits to promote domestic manufacturing and investment in chip research as part of the "invest" pillar outlined in Secretary Blinken's 2022 speech². The US also restricted the export of domestically made advanced computing chips and related equipment to China in 2022 and expanded this list in October 2023. The US has argued that its restrictions are a way of curbing China's military capabilities and protecting its national industry. To offset these restrictions, US-based firms like Nvidia are tweaking their products to comply with regulations, while Huawei has been developing its version of Nvidia's chips. Nonetheless, China's domestic tech sector will be set back. Lower processing speeds mean China will lag behind the US in artificial intelligence (AI) capabilities. There are reports that the US might expand restric-

¹Pew Research Center, April 12, 2023. "Americans Are Critical of China's Global Role – as Well as Its Relationship With Russia".

²US Department of State, May 26, 2022. "The Administration's Approach to the People's Republic of China".

tions to cloud computing, which is currently used by Chinese firms to train generative AI models.

Figure 3: Change in US Import Share, 2018-22 %pt



Source: Bloomberg

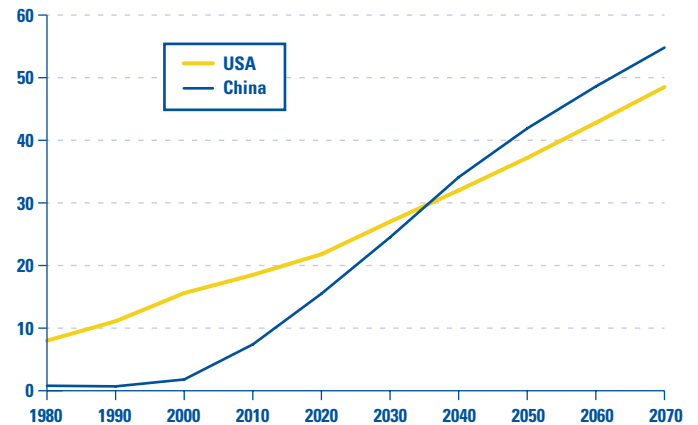
The US's tough stance on technology trade restrictions falls under the broader US-China decoupling that is underway. The US and its allies have been attempting to reduce geopolitical risk by diversifying and restructuring supply chains away from China. The pandemic and the Russia-Ukraine war raised the urgency of shifting manufacturing closer to home (nearshoring) or allies (friend-shoring). US-China decoupling is evident in the trade data, as China's share of US imports has steadily declined (see Figure 2). A 2023 CEPR paper found that US imports from alternative countries, such as Taiwan and Vietnam, have increased over the same period (Figure 3). Yet crucially, these same countries have also increased their trade with China, indicating that the US is still indirectly dependent on China. Indeed, import supply chains have been lengthened, but the US has yet to fully diversify away from China. This reflects the high cost of reshuffling supply chains, with the IMF estimating that the long-term cost of geoeconomic fragmentation could range from 0.2-7.0% of global output. Specific sectors, such as semiconductor manufacturing, require specialised plants and a skilled workforce, which have proven difficult to replicate in friend-shoring countries such as Vietnam and India. Therefore, the US-China decoupling process will likely continue to move slowly.

The Future of US-China Relations: Long Term

In the long term, tensions between the US and China will remain, given that both countries offer alternative world orders. A multipolar world is likely to replace the current US hegemony. In economic terms, China's real GDP is approaching parity with the US, albeit the gap is much wider in per capita terms. However, this process will take time as China's economy faces structural constraints. The property sector, one of the main engines of its strong growth performance, is over-leveraged. Its population con-

tracted for the first time in six decades in 2022, and productivity growth is slowing. China's attempt at transitioning from export-led growth to a services-based economy could be curtailed by high income inequality. Additionally, US technology restrictions will likely hinder growth and productivity gains in China's domestic tech sector, which is high value-add. Nonetheless, Goldman Sachs projects China's economy in real USD terms to overtake the US to become the world's largest economy by around 2035, retaining that spot out to 2075 (Figure 4).

Figure 4: Real GDP (2021), US\$ Trillion



Source: Goldman Sachs

On the Taiwan question, while there could be a military détente following Taiwan's election, China's overall goal is "unification" by any means necessary. Taiwan's population has developed an identity, with around 67% of respondents identifying as primarily Taiwanese, signalling distance from the *mother country*³. Yet around 61% of respondents in Taiwan want to maintain the status quo of de facto independence and no war, implying that their cultural identity might not be strong enough to warrant fighting for sovereignty⁴. China will resort to political subordination, economic integration and threatening moves short of war before an all-out invasion. However, China's long-term strategic interest is to contain Taiwan, so military escalation is a risk over the coming decade. The expansion of China's People's Liberation Army (PLA) and President Xi's sweeping reforms to weed out corruption within the PLA point to China preparing for military conflict. However, the PLA is still plagued by issues such as lack of combat experience (their last war was with Vietnam in 1979), poor recruitment, and an inefficient command structure. In addition, China's economy remains closely integrated with Taiwan, the Asia region, and the US. A 2016 study by the RAND Corporation, a US-based think-tank, estimated that a military standoff between the US and China would be catastrophic for the Chinese economy – a 25-35 percent reduction in Chinese GDP in a yearlong war, compared with a reduction in US GDP of 5-10 percent⁵. The Rhodium Group concluded that a China-Taiwan war would lead to "incalculable" damage to the world economy given how engrained semiconduc-

³PEW Research Center, January 16, 2024. "Most people in Taiwan see themselves as primarily Taiwanese; few say they're primarily Chinese".

⁴Election Study Center, National Chengchi University, July 12, 2023. *Taiwan Independence vs Unification with the Mainland*.

⁵RAND Corporation, 2016. "War with China - Thinking Through the Unthinkable".

tors are in the economy. Taiwan's dominance of semiconductors has been touted as a reason the US should defend the island and why China might think carefully before launching an invasion, a theory widely referred to as Taiwan's 'silicon shield'.

Meanwhile, Taiwan has been bolstering its military capabilities with support from the US. Taiwan's army is significantly smaller than China's and inefficient, while the military has been criticised for spending too much on ill-suited big-ticket equipment. The US is not obliged to defend Taiwan after its mutual defence treaty expired in 1979; therefore, Taiwan has been preparing for conventional defence. For the US's part, its strategic ambiguity, Taiwan's all-important semiconductor sector and its ideological alignment with Taiwan afford it some space to support the country in the event of a Chinese invasion. A war game by the Center for Strategic and International Studies (CSIS) that was run 24 times found that the US/Taiwan/Japan defeated a conventional amphibious Chinese invasion⁶. Reflecting the current weakness in the PLA, intelligence from US officials suggests that President Xi wants the PLA to be ready to invade Taiwan by 2027. As part of the preparation for war, China also wants to establish a domestic semiconductor sector capable of serving its military goals and adequate access to a financial system outside the US's sphere of influence. The ostracisation of Russia in response to its 2022 invasion of Ukraine is seen in China as a cautionary tale. As such, China has focused on improving ties with Europe and the 'Global South' (developing countries mainly in the Southern Hemisphere). However, the consolidation of power within the CCP means that President Xi faces no domestic checks and balances, which raises the risk of a policy mistake.

The US-China relationship is expected to remain fraught. But a weakened DPP in Taiwan could usher in a period of relative calm and thereby lower geopolitical risk. The positive coverage of the November Biden-Xi meeting in official Chinese media suggests some willingness on China's part to soothe tensions.

Over the long term, the US and China will remain political and economic competitors in a multipolar world. Both countries must establish better guardrails and a framework for strategic competition. The path to 'competitive co-existence' may be challenging. Still, the US and China are incentivised to find common ground given their close economic linkages and need to collaborate on global issues such as AI regulation and climate change. While this will mean a different relationship from the past, setting boundaries in the US-China relationship should allow for a more conducive and stable global investment environment. In terms of market implications, Chinese and Taiwanese assets will likely continue to price in some geopolitical risks. However, we think investors may be under-pricing the potential for cooperation in the long-term as both sides seek to avoid costly conflicts in a multipolar world.

⁶CSIS, January 2023. "The First Battle of the Next War - Wargaming a Chinese Invasion of Taiwan".



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