



Global Political Drivers

US-CHINA TRUCE IS NOT PEACE

Christopher Granville

- The powerful market driver of the US-China 'trade war' is underpinned by political drivers that are short-term positive and long-term negative.
- Trump's re-election campaign underlies the bullish short-term outlook on a 'Phase 1' trade deal.
- Clinching any such deal won't stop Trump's habit of blowing hot and cold on China, causing market volatility: but that is not the main, or even the real, reason for viewing the US-China rivalry as a long-term negative factor for the global economy and markets.
- That reason is not mysterious: since Trump launched his trade war in the spring of 2018, its geopolitical foundation has been clearly visible. This, in turn, has removed Trump-dependency – with the entire US political class rallying to the cause of the global struggle for mastery against China.
- To the counter-argument that the geopolitical agenda could easily be dropped if expedient (with US public opinion still relatively malleable in this area), we would reply that the intractable 'tech' war will, on the contrary, entrench an adversarial approach to China.
- The new development that we highlight in this note is the formalization of this approach in the US alliance system – as seen in last week's NATO Summit.
- This 'alliance contagion' sows dissensions that, in turn, will intensify the negative driver: this applies particularly to America's Asian allies – now on the receiving end of a Chinese charm offensive.
- As for the timing of this driver, next year's US election looks pivotal.

Truce: Nice but brief

Our view on the US-China trade/tech etc war is tactically positive but strategically negative. Markets have been actively pricing in the up-front positive part of this story, and this confidence is underpinned by the experience of the latest phase of constructive negotiations aiming at a so-called 'Phase 1' deal. Our timeline graphic below points up this contrast between the rapid unravelling of previous 'ceasefires' and the relative steadiness of the present 'Phase 1' negotiations.

Breaking the trade war cycle



This recent experience of more protracted de-escalation amounts to much stronger underpinning for market confidence than Trump's constant tweet swings – even if, at time of writing, his latest and very bullish heralding of an imminent deal with China might impress the most jaded observers. At the very least, this tweet must underwrite the assumption that Trump will refrain from imposing the 15% tariff on the last segment of around \$160bn-worth of consumer-related imports from China that had been previously announced for next Sunday. That alone warrants the market welcome for this "very close to a big deal" tweet, regardless of whether that additional tariff hike falls away altogether in the event of a deal being formally announced before 15 December.

The decisive timing driver for this truce is a political one: the US election. Trump's obvious motive in pursuing a 'Phase 1' deal with China a year out from his re-election bid is the same as for his relentless browbeating of the Fed – that is, to maximize the economic 'feel-good' effect,

and in any case, avoid a serious stall. The maxim that US presidential elections are decided by 'pocket books' has been more precisely formulated as: how consumers see the economy in July is how they vote in November: whenever the Conference Board consumer confidence number is 100 or higher, incumbent parties/presidents almost always hold on to power. Our Chief US Economist Steve Blitz has highlighted the unprecedentedly strong link between the US equity market and consumer spending.

Trump will likely disappoint any hopes of calmer waters in the months after the prospective clinching of 'Phase 1'. Even if the market is spared any tweeting brinkmanship in advance of the deal itself, Trump may be counted on to resume thereafter his reliably contrarian commentary, maintaining the constant two-way short-term market bet that must keep some event traders occupied.

The (thin) substance of the 'Phase 1' agenda will provide him with ample scope for keeping up the pressure on China, and thereby keeping this part of his record visible to voters. Regardless of how specifically any deal spells out conditionality and implementation provisions, the Trump administration will treat China as being on probation. Any concessions now – such as refraining from imposing new tariff hikes or even rowing back some previous hikes – would be conditional on China honouring its commitments as the US saw it, allowing Trump to threaten the reversal of such concessions as, or more likely when, China is suspected of falling short on its side of the bargain.

Mastery matters

Our reasons for longer-term pessimism on the US-China rivalry run deeper than this prospect of business-as-usual from Trump in the coming months – even post-'Phase 1' – and the associated market volatility. The apparently imminent clinching of 'Phase 1' is a good time to revisit the theme of entrenched geopolitical rivalry as the underpinning of a perennial negative market driver.

Much has been said about this big geopolitical theme. The title of our own take (published last March in our Global Political Drivers series) – Costly Struggle for Mastery – aimed to capture the essence. Whatever relief for bilateral trade tensions comes from 'Phase 1' or any conceivable subsequent phases, the US will continue to worry about China winning the race to one or more decisive technological frontiers, in turn jeopardizing America's position as the secure global hegemon. A crucial point is that in this context "the US" does not just mean Trump, or the China hawks in his administration like Trade Policy Director Peter Navarro.

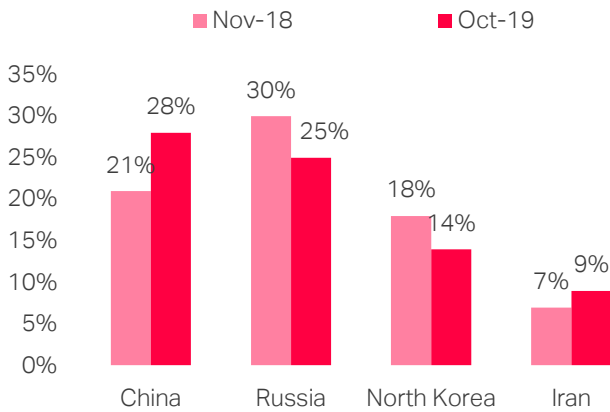
The whole US political class is now signed up to standing up to China. The Democrats – very much including all serious candidates for the presidential nomination – aim to prevent Trump monopolizing the political dividends from pro-worker protectionism while adding their trademark emphases on human rights by highlighting the repression of Uighurs and other Muslims in Xinjiang and the handling of the pro-democracy protest movement in Hong Kong.

Despite Trump's indifference to such questions, we have not had to wait for the possibility of a Democrat victory in the November 2020 election to see the component of civilizational rivalry being injected into the 'trade' war. Only last October, important Chinese tech companies such as Hikvision and Megvii joined Huawei on the US Entity List on the grounds that their products facilitate the abuses in Xinjiang. And since then, the Hong Kong Human Rights and Democracy Act has been enacted.

The anti-China consensus in the US political class is beginning to be reflected in broader public opinion. The charts below show relevant highlights from the Reagan Foundation’s annual survey of popular attitudes to defence and security questions.

Which country is the biggest threat?

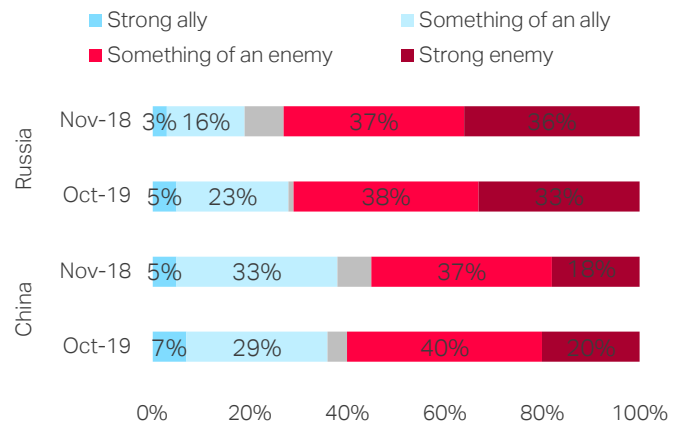
China overtakes Russia



Source: Annual Reagan National Defence survey (October 2019)

China/ Russia: friends or foes?

How do you see these countries?



Source: Annual Reagan National Defence survey (October 2019)

A counter-argument to our view of geopolitical/civilizational rivalry as a long-term negative market driver might be to say that such abstract arguments will be used by the US only when convenient, and can be forgotten whenever that suits.

The same evidence about the state of public opinion might even support this contrary view. The decisive importance of a strong public consensus on US external policies has been demonstrated this decade in the way that both the Obama and Trump administrations have scaled back military engagement in the Middle East, facing down opposition from the Washington DC security establishment in the process.

There is still no strong anti-China consensus among the US population. In this perspective, however, the American public’s view of China is far from being so overwhelmingly hostile as to, in effect, dictate policy to Washington. As shown in the right-hand chart above, barely a fifth of respondents regard China as a strong enemy. Perhaps more remarkable given official US policy positions is that well over a quarter see both China and Russia as an “ally”. (There has even been a flurry in military circles caused by the same survey’s finding that nearly one half of armed services households questioned viewed Russia as an ally.)

These relatively relaxed views of the American public might in turn reflect the intuitive limitations of warnings about the danger from China (or Russia). In contrast to the original Cold War, where the Soviet Union’s stated project was to convert the world to its system, the core elements of the Leninist system of power that survive in present-day China are clearly not for export in the same way.

But that probably does not matter. Our answer to such points would be that they will have little or no practical relevance. Yes, present or future US governments would have the scope to lighten up on the ‘geopolitical’ struggle with China should that be expedient. In practice, however, expediency points in the diametrically opposite direction for the foreseeable future in which technological rivalry with China will remain elevated, if not intensify. This sobering prospect is

highlighted by the main new development that we flag in this note – namely the US mobilizing its alliance system for ‘tech’ war purposes.

Alliance contagion

There is nothing new, of course, about the US pressuring its allies on Chinese tech. The most public point of contention has long been the use of Huawei’s 5G technology in the network infrastructures of US allies in Europe and Asia. Last week, however, this whole question received a kind of formal ratification at NATO’s 70th anniversary Summit in London. The relevant paragraph in the resulting [London Declaration](#) on China was clearly a product of one of those fraught drafting negotiations among senior officials. While taking care not to declare China an adversary, the document left no doubt that America’s China agenda has now been extended to its alliance system:

We will continue to increase the resilience of our societies, as well as of our critical infrastructure and our energy security. NATO and Allies, within their respective authority, are committed to ensuring the security of our communications, including 5G, recognising the need to rely on secure and resilient systems [. . .] We recognise that China’s growing influence and international policies present both opportunities and challenges that we need to address together as an Alliance.

This ‘agenda escalation’ got immediate results. Boris Johnson, the Summit’s host, indicated a shift in policy on Huawei and 5G that he inherited from his predecessor Theresa May. In the process he revealed the decisive lever of the US in the ‘Anglosphere’ – namely, the so-called ‘five eyes’ arrangement for sharing secret intelligence between the US, UK, Canada, New Zealand and Australia. Already last year, Australia announced its decision to exclude Huawei, and Johnson indicated last week in a press conference after the NATO Summit that the UK policy would shift in the same direction for the sake of ‘five eyes’.

Concerns about the cyber security threat from China are also having an effect outside that inner intelligence circle within the US alliance system. In Germany, for example, the security and foreign policy establishment together with some circles in the governing CDU party have hardened their position against Huawei. For now, however, the priority of Angela Merkel’s government remains to avoid undermining Germany’s wider relationship with China.

This tension highlights how this geopolitical and security theme will run and run. Even in the UK, Huawei equipment is already too deeply enmeshed in networks to be easily extracted, and the practical compromise is likely to involve limiting the further expansion of Huawei’s presence. As for Europe’s champions in 5G technology – Ericsson and Nokia – their supply chains and some of their manufacturing are anyway embedded in China.

Dissension on this subject within the US alliance system will likely enflame US perceptions of the geopolitical threat posed by China. This factor will persist even if Trump leaves office at the end of next year – and, with him perhaps, the tensions with US allies caused by his “America First” pressure on allies to spend more on their own defence. While given the usual prominent outing at last week’s NATO Summit, this last topic is particularly sensitive on the Asian flank of the US alliance system. Japanese opinion was tiring of the US military presence in Okinawa long before the Trump administration invited Tokyo last month to quadruple its financial contribution to the upkeep of that base.

The same story applies even more strongly to South Korea. Speaking in London last week, Trump implied that current US forces levels might be reduced unless South Korea (“a rich country”) paid more of the cost. This plays particularly badly in a Korea now governed by the nationalist centre-left.

China, meanwhile, is clearly seeking to turn such tensions to its own advantage – in the same way as “driving a wedge into the Atlantic Ocean” is a permanent Russian foreign policy setting. Here, there is an upcoming set piece event that contrasts pointedly with last week’s NATO Summit: the first trilateral China-Japan- South Korea Summit since 2016 that is due to be held in Chengdu on 23 December.

In the run-up to this Summit, China has been on something of a charm offensive in its neighbourhood. China’s artificial island construction in the South China Sea has passed its peak, and the PLA invasion of Hong Kong has not materialized. The exception here is Taiwan, ahead of the expected nationalist victory in next month’s presidential election and in reaction to the Trump administration’s increased military and political support for Taiwan. All these developments in their different ways point to an environment of permanent geopolitical struggle.

Conclusion: Pivotal US election

The US-China struggle for mastery will remain the long-term underlying cause of global economic fractures that will exert steady downward pressure on asset valuations. Market vulnerability to this adverse political driver will logically be greater when, as now, valuations are stretched – but only if other things are equal. At present, other things may not be equal in the favourable sense that Trump has an election-related interest in avoiding a market-unfriendly derailment of economic relations with China (even if, as noted above, he may be expected to continue disturbing the equity market by blowing hot and cold over China with or without a ‘Phase 1’ deal).

Once the US election is out of the way, and whoever ends up in the White House, the long-term negative driver of the US-China strategic rivalry will reassert itself.

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