

Daily Note

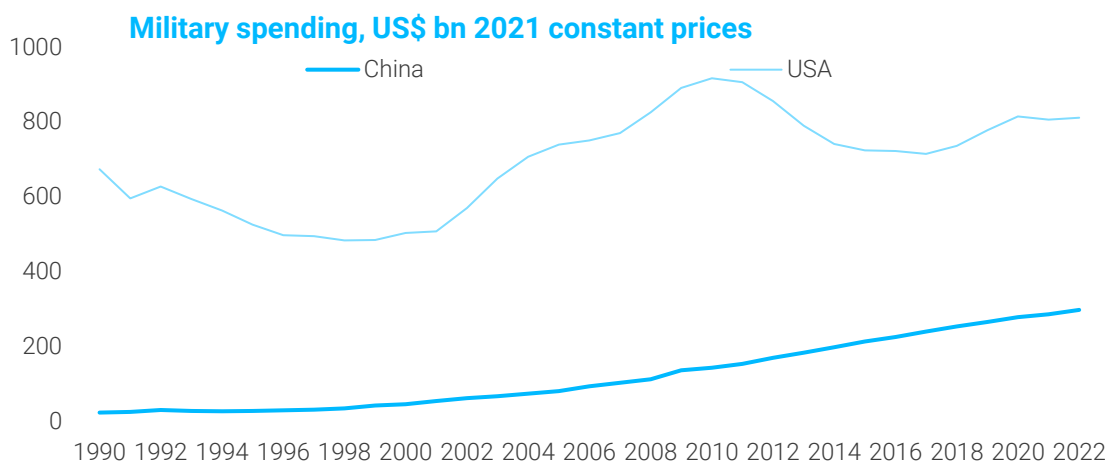
TAIWAN INVASION – LEADING INDICATORS

Rory Green

- Preparations for the largest and most ambitious amphibious assault in history would be impossible to hide
- Invasion highly unlikely, but “grey zone” warfare and blockade threat will only increase
- 2024 Taiwan presidential election carries binary geopolitical risk for markets – Asia defence industry a useful hedge and structural winner from tension

Predictions of a Chinese invasion of Taiwan are increasing in frequency and temporal proximity, with some in the US intelligence community forecasting a military conflict [as early as next year](#). We disagree and reckon that the immensity of the political, economic and military risks entailed by a deliberate attempt at conquest far exceed the risk tolerance of the present PRC leadership. That, however, is just a judgment: in this note, we review a range of possible future signals which, on a two-year horizon, might falsify that judgment. Given the scale of the military task and the regime change it would entail for China’s society and economy, if the PRC decides to fight a war of choice over Taiwan the world will see it coming. At present, our indicators covering politics, economic and military signals, show greater tension but very low probability of deliberate military conflict in the next 24 months. Although we think the chance of invasion is small, **“grey zone” warfare will continue to escalate, as will the danger of military action that falls short of direct assault, constituting a permanent headwind for related assets.** [The presidential election in Taiwan in January 2024 carries a binary risk to markets, with DPP re-election increasing the chance of cross-Strait tension.](#) [Asia defence stocks](#) are a useful hedge, particularly for tech heavy portfolios, and a structural winner from growing Taiwan-US-China risk.

Chart 1: China narrowing gap with the US

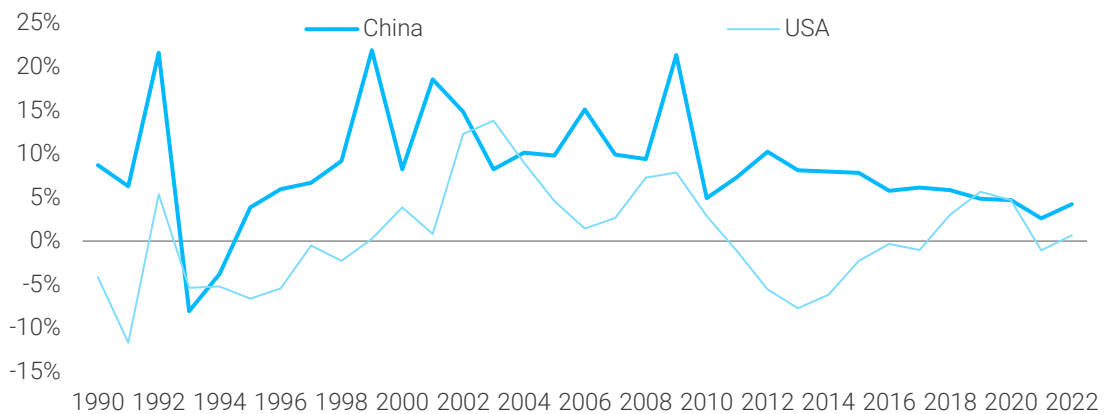


Sources: SIPRI, GlobalData TS Lombard.

The national security economy. An emerging Common Prosperity economic model promotes security to equal ranking with high-quality growth as core Party objectives. Improving “anti-sanctions capability” and “self-reliance” were core features of the 20th Party Congress last year, and are major components of the 14th Five-Year Plan (2021–25). However, deducing Chinese intentions or the timeline for potential conflict based on a structural political-economic shift is challenging. Beijing is undertaking these measures at least partly in a defensive capacity (especially in the technology sphere). The existence of a trend towards “self-reliance” is not enough to provide early warning of an invasion. Instead we focus on the intensity of policy implementation across the political, economic, tech and military arenas.

Chart 2: PRC defence spending slows under Xi Jinping

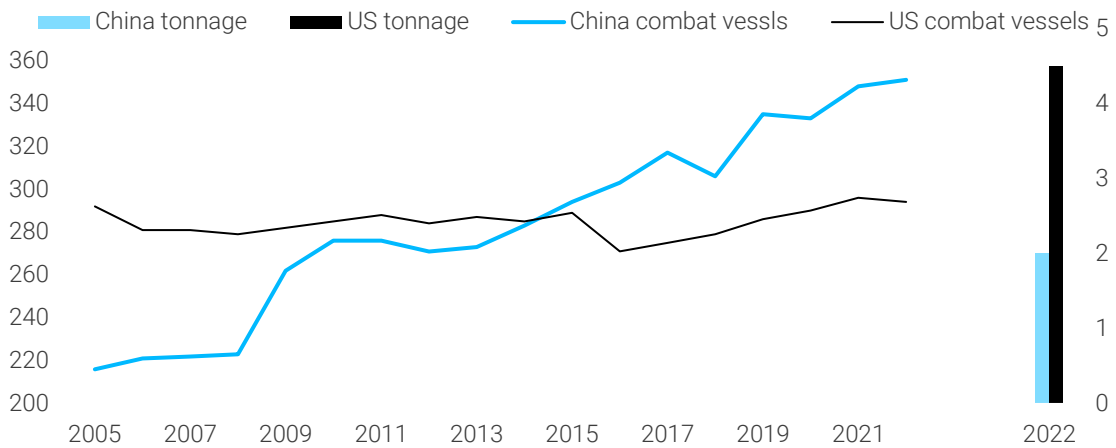
Military expenditure, yoy



Sources: SIPRI, GlobalData TS Lombard.

D-Day times 100. A key factor that makes an invasion hard to envision and harder to conceal is the extreme difficulty of the military operation. The Taiwan Strait is 110 miles across, amphibious assault is only possible in April, May and August, and suitable landing sites are sparse. All indications suggest that the PLA and central leaders are aware of these difficulties and that nothing short of fully and highly visible mobilization is required for success. Preparations would begin at least 12 months before an invasion and would include (but not be limited to): surging

Chart 3: China’s navy is larger but not more powerful



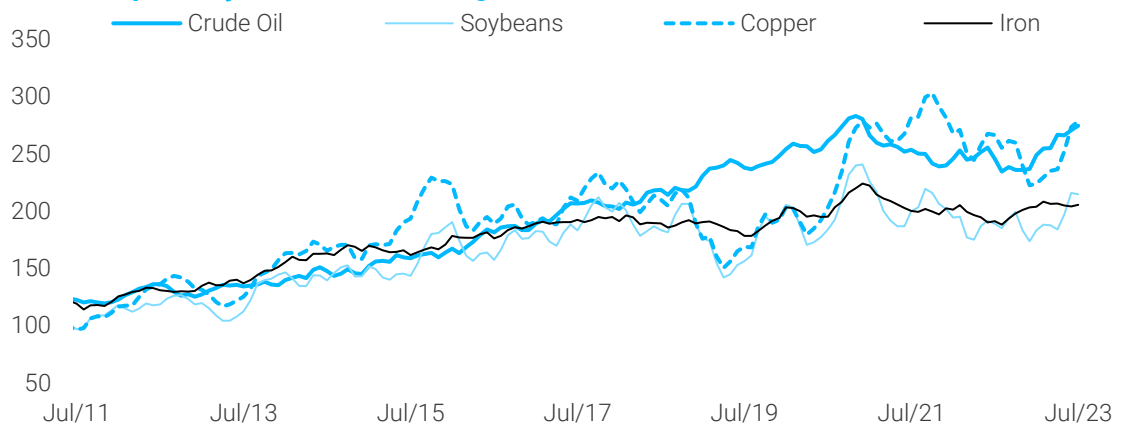
Sources: US Congress, Janes, GlobalData TS Lombard.

production of munitions, maintenance of equipment, a PLA-wide stop-loss halting demobilization, flight/shipping disruption for transport, creation of bloodbanks, and conversion of civilian transport to military use. The build-up on the Ukraine border was clear; it would be the same in Zhejiang and Fujian.

Estimating the speed and extent of military spending and the production of large-scale military equipment is also possible. Civil-military fusion and greater emphasis on data security make open-source analysis increasingly difficult, but for now at least, credible estimates are still possible. [The Stockholm International Peace Research Institute estimates Chinese military spending at US\\$ 290 bn in 2022.](#) PRC expenditure is still largely a function of economic growth, and as a result spending has actually slowed under Xi Jinping and fallen slightly as a % of GDP. A similar trend is visible in the size of the navy, which now surpasses America's in ship numbers if not tonnage. China is clearly increasing its military might but has not materially accelerated the pace of spending or production in recent years. Acceleration in either variable would be a clear red flag, signaling increased potential for conflict.

Chart 4: No signs of stockpiling

China imports by volume 3m average, 2010 = 100

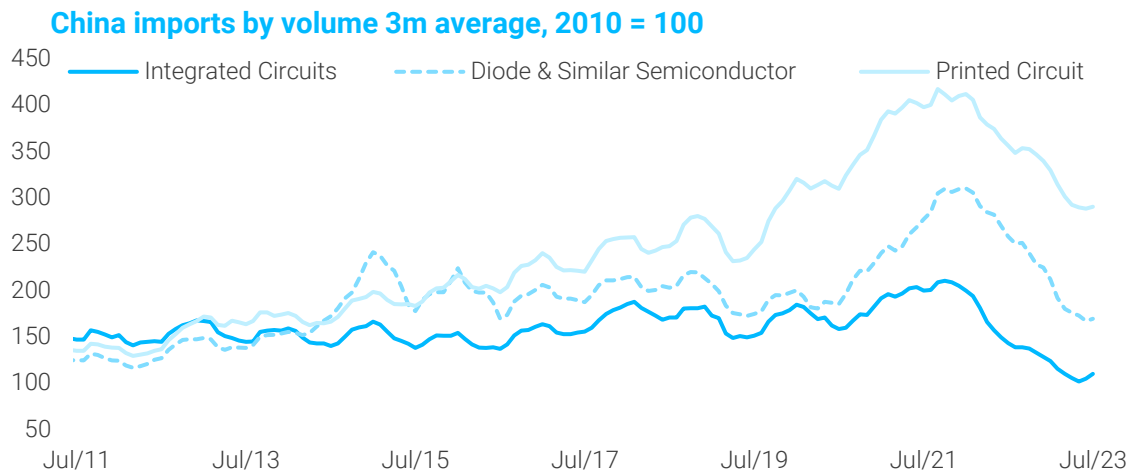


Sources: China Customs, GlobalData TS Lombard.

Invading Taiwan would constitute an irreversible break in geo-economic relations and result in a severe global recession. China, reliant on a wide array of imports to simply feed, heat and power its population, let alone maintain a war effort, would face severe challenges. Prior to any deliberate conflict, the PRC is likely to engage in major stockpiling efforts for a range of commodities, from metals to semiconductors. Estimating the scale of China's reserves is difficult; even government supplies of pork are a state secret. We can, however, look to trade data, which always have a foreign counterparty, to gauge PRC imports relative to underlying demand. A prolonged period of import growth above economic trend would suggest inventory-building. Current data show that anaemic domestic demand is largely matched by weak imports. Even imports of semiconductors and related products, where PRC firms have stockpiled ahead of future US sanctions, are well below trend.

China will also need to insulate itself financially in the event of invasion. There is little it can do to diversify its financial holdings; almost all safe liquid offshore assets are vulnerable to global sanctions (gold/commodity buying only helps at the margin). Beijing could attempt to mitigate the financial fall-out by imposing stronger cross-border capital controls, freezing foreign financial assets within China, and rapidly liquidating and repatriating Chinese assets held abroad, including sales of US bonds.

Chart 5: Even China tech stockpiling has stopped



Sources: China Customs, GlobalData TS Lombard.

A final aspect to consider is actions by Washington and Taipei. Beijing is highly reactive to perceived provocations and deeply resents closer US–Taiwan relations or the so-called “[salami slicing](#)” of the One China policy. Among all factors that could shift the Chinese leadership’s risk calculus in favour of a military ‘solution’ to the Taiwan problem, the most potentially powerful might be perceptions in Beijing that some new actions by the Taiwan and/or US governments pose an intolerable/strategic/existential threat to the PRC’s status and statehood (this could include more aggressive semiconductor sanctions). Prospective US–Taiwan visits, weapon sales and political declarations (particularly by Taipei) are all guaranteed to produce a response from Beijing, ranging from economic sanctions to naval exercises and grey zone warfare. This external leading indicator is particularly important as Taiwanese and American presidential elections approach. [The current front runner in Taipei and our expected winner, Lai Ching-te of the DPP, has advocated for Taiwanese independence in the past, and his actions during this campaign have even caused concern in the White House.](#)

Invasion of Taiwan represents an immense political, economic and military gamble for the Party-State: a gamble we think Xi Jinping is unlikely to take, especially while Beijing thinks it has time on its side and plenty of levers to pressure Taipei that fall short of all-out attack. The largest and most ambitious amphibious assault in history requires a concomitant major mobilization effort, one that will be highly visible. Of greater concern is the risk of military action that falls short of all-out attack. Grey zone warfare has accelerated and will continue to do so, especially if the DPP wins re-election in January. Geopolitical risk is a permanent feature for Taiwanese assets and related supply chains.



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