CIO Viewpoint

The US and China's bilateral cooling

Investment Solutions

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The dispute between the US and China over trade and global dominance has now broadened to arguments over responsibility for the global pandemic and technological leadership to financial regulation and the status of Hong Kong. The tensions complicate many global challenges, starting with pandemic management.

On 20 May, the US administration outlined a "Strategic Approach" that says, since establishing diplomatic relations four decades ago, American governments have overestimated China's appetite for economic and political reform. US criticisms, including of China's Covid-19 transparency and 5G telecommunications technologies, "are taking China-US relations hostage and pushing our two countries to the brink of a new cold war," Chinese foreign minister Wang Yi said on 24 May.

The world's two largest economies began raising import tariffs in March 2018, until agreeing a truce in December 2019. In addition to longstanding frictions over Taiwan and sovereignty in the South China Sea, tensions have spread with increased regulatory demands on Chinese companies listed in the US and China has cracked-down on democratic demands in Hong Kong.

Trading phases

US/China trade tensions predate the Trump administration. Under Barack Obama, the US tried to create an alternative alliance of trading partners, the Trans-Pacific Partnership, which excluded China. President Trump's decision to use tariffs on Chinese imports as a tool to tackle the US trade deficit was misguided but encouraged a global shift in supply chains that has accelerated under the coronavirus pandemic.

Despite recent rhetoric, the 'Phase 1' tariff truce reached late in 2019 between the US and China remains in place. Both countries see the commercial value of the agreement. Trump lauds the deal as a political accomplishment, for which the Treasury dropped the "currency manipulator" tag, and China is honouring its purchase commitments, despite Covid-19's economic challenges that led to it dropping a GDP target for the first time in 30 years.

World trade forecasts point to stagnation. Trade was already stuttering as the two superpowers explored their differences. Covid-19 may restructure many nation's strategic priorities by making them look again at supplies of many taken-for-granted products that have suddenly achieved a strategic importance, such as face masks, reversing the off-shoring trend of recent decades.

Stéphane Monier
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Key takeaways

- US/China tensions have intensified over Covid-19, the latest in a series of disputes with trade, technological and ideological dimensions
- China's move to impose a national security law on Hong Kong is providing another source of friction
- The road to full internationalisation of the Chinese yuan will be long
- Whoever wins the US presidency, the world's most important geopolitical rivalry will remain a source of risk for years to come.

Also last month, the US Senate approved a bill that, if it became law, would require foreign firms to meet US audit standards and financial regulations. That could force Chinese firms to disclose whether they are government-owned or controlled, or persuade them to look for listings outside US exchanges.

The US has also put controls on 5G telecommunications and chip technologies, freezing Chinese firm Huawei out of government procurement tenders on security grounds, and continues to pressure allies, including the UK, to do likewise.

One country, two ambitions

Now, Hong Kong is a litmus test for short-term US/China tensions. Hong Kong's import/export infrastructure and financial centre acts as a gateway between China and the rest of the world, to everyone's benefit. After anti-government/pro-democracy protests began last year in Hong Kong against an extradition law, China has sought to increase its control of the city.

On 28 May, China went a step further and criminalised dissent that threatens Chinese national security and may allow Chinese security forces into the city, undermining what's left of its autonomy from the mainland. The US said it would drop Hong Kong's Most Favoured Nations (MFN) trading status, to which China replied that the US is guilty of "double standards and gangster logic" and should "immediately stop meddling."

As a trade centre, Hong Kong can afford to lose its trading status with the US, but there is no timeline from the US for this to happen. The territory exports USD45 billion worth of goods to the US annually, and less than one percent of this total is given MFN tariff treatment, so the immediate impact would be limited. Longer term, and more broadly, the erosion of Hong Kong as a centre for China to interact with the wider world to move capital, would be a negative for all.

China's 'One Belt, One Road' investments, stakes in developing nations' debt, as the world's biggest creditor, and global buying power, mean that individual nations struggle to oppose its ambitions. Australia's government set up an enquiry into the origins of the Coronavirus and saw its coal and beef exports sanctioned. The UK, Hong Kong's former colonial power, has promised immigration rights to the 2.9 million Hong Kongers born before the 1997 handover, and so earned a Chinese reprimand.

The long-term bill

China wants a reserve currency on its own, but recognises that takes time, and comes at a cost. The USD, the world's number one reserve currency, acts counter-cyclically to the global economy. This is one reason that we expect the dollar to perform poorly as the world's economies emerge from the effects of Covid-19 in the second half of this year.

In October 2016, the International Monetary Fund included the Chinese yuan to its special drawing rights (SDR) basket, an international reserve created in 1969 to supplement member states' reserves. The yuan's initial weight of 10.92% of the basket was higher than either the Japanese yen or UK sterling (8.33% and 8.09% respectively). Today, the US dollar and the euro account for more than 72%. The path to China becoming a recipient of world savings remains long. Further internationalisation of its currency needs deeper economic evolution, including capital account opening and liberalised capital flows.

The tensions that are playing out between the world's most powerful economies look set to continue over the long term and act as a persistently volatile geopolitical background to investments for the next decade and more.

China, while it has lifted millions out of poverty, is still working on the challenge of re-inventing its economic model to make it less dependent on external demand. The US is working through a time of profound social polarisation and reckoning in this presidential election year. Whoever sits in the White House next January, there is much work to be done to repair the world's most important international relationship for the decades ahead.

Investment implications

In the short-term, renewed US/China tensions, mostly over blame for the pandemic, suggest that heated US rhetoric in the run up to the November's presidential elections will continue to weigh on the Chinese currency. We therefore closed our long yuan position in early May. Longer term, investors should make sure that investments properly reflect China's economic and geopolitical weight. There is little doubt that China needs to be treated as a standalone allocation in private investors' portfolios, and we plan to adjust our strategic asset allocation accordingly in the months ahead.

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