Should investors be worried about US-China relations?

A rising China creates the potential for tension between itself and the leading world superpower, the United States. Investors should pay attention to the shifting of global power structures and allocate accordingly.

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For much of the last century, the United States has enjoyed a long-standing position of dominance within the world political system. However, we believe we are entering a new political paradigm and are moving towards a 'multi-polar' world, one where the US is joined at the top by other powers such as China. The US must find a way to share its global power or risk falling into what is known as a 'Thucydides Trap'. This concept speculates that when a ruling power (in this case the US) feels sufficiently threatened by a rising power (China for example), the ruling power may engage in pre-emptive measures with the challenger in order to protect its position. Where these measures of the past may have consisted of slings and arrows, the threat of a China-US standoff today might consist of trade tariffs and cyber-warfare. In recognising both the changing political as well as economic landscape, we can better inform our investment outlook. This thinking feeds into our medium-term view that investors should remain cautious in their allocation to risk assets.

PELOPONNESIAN PEDAGOGY

In fifth century BC, Sparta was the dominant ruling power in ancient Greece. However, as the city-state of Athens developed its economic and military power, it came to challenge Sparta's position. Thucydides, a contemporary historian, had the following interesting reflection on why the war between Sparta and Athens was more or less a given:

> It was the rise of Athens and the fear that inspired in Sparta that made conflict inevitable.

According to the Greek historian, human emotion through a mix of hubris and fear was both the trigger and the reason conflict could not be averted or stopped. Does this mean that tension is also inevitable between the US and China? To answer this question, Professor

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Graham Allison of the Harvard Belfer Center for Science and International Affairs has examined conflicts from the Early Modern period to the present to determine how a Thucydides Trap developed and its outcome. In 12 out of 16 cases, the result was a major conflict (see Figure 1) showing that while a conflict is not inevitable, the odds as presented here are high.

Figure 1: Destined for conflict?

№	Period	Ruling Power	Rising Power	Domain	Result
1	Late 15th century	Portugal	Spain	Global empire and trade	No conflict
2	First half of 16th century	France	Hapsburgs	Land power in western Europe	Conflict
3	16th and 17th centuries	Hapsburgs	Ottoman Empire	Land power in central and eastern Europe, sea power in the Mediterranean	Conflict
4	First half of 17th century	Hapsburgs	Sweden	Land and sea power in northern Europe	Conflict
5	Mid-to-late 17th century	Dutch Republic	England	Global empire, sea power, and trade	Conflict
6	Late 17th to mid-18th centuries	France	Great Britain	Global empire and European land power	Conflict
7	Late 18th and early 19th centuries	United Kingdom	France	Land and sea power in Europe	Conflict
8	Mid-19th century	France and United Kingdom	Russia	Global empire, influence in Central Asia and eastern Mediterranean	Conflict
9	Mid-19th century	France	Germany	Land power in Europe	Conflict
10	Late 19th and early 20th centuries	China and Russia	Japan	Land and sea power in East Asia	Conflict
11	Early-20th century	United Kingdom	United States	Global economic dominance and naval supremacy in the Western Hemisphere	No conflict
12	Early-20th century	United Kingdom supported by France, Russia	Germany	Land power in Europe and global sea power	Conflict
13	Mid-20th century	Soviet Union, France, UK	Germany	Land and sea power in Europe	Conflict
14	Mid-20th century	United States	Japan	Sea power and influence in the Asia-Pacific region	Conflict
15	1940s–1980s	United States	Soviet Union	Global power	No conflict
16	1990s–present	United Kingdom and France	Germany	Political influence in Europe	No conflict

Source: Graham Allison: Destined for War: Can America and China escape Thucydides's trap?

Professor Allison acknowledges that each case is, of course, unique and that circumstances that might lead to conflict in the 17th century would unlikely unfold in the same way in the 21st. His team's work has not only popularised Thucydides' concept but also inspired many within this debate to identify why and how conflict may be avoided. Broadly speaking, conflict has been avoided if one or both of the following conditions can be achieved:

- The rising power does not see the ruling power as placing undue burdens or obstacles to its advancement: the 'right to rise' principle

- The ruling power does not see the rise of the emergent power as an existential threat to its system (in this case a capitalist, rules-based international order): the 'continued prosperity' principle

A power struggle does not therefore prove inevitable so long as the powers involved recognise that unilateral 'exceptionalism' is ultimately an untenable goal and accept the global trend towards multipolarity. A concomitant rise of China and increased acceptance of the international order should ideally be encouraged by the US, not hampered. As former-President Obama has stated, "I've been very explicit in saying that we have more to fear from a weakened, threatened China than a successful, rising China".

WHAT SHOULD INVESTORS BE ON THE LOOKOUT FOR?

Much like our work on populism, globally-allocating investors can use the paradigm of the Thucydides Trap as a tool to understand how political risk should affect their investment outlook. However, as highlighted by examples from the past **(see: A (lucky) turn of events)**, a fraught set of circumstances can make the actions of individuals all the more significant.

The tone of the rhetoric coming from President Xi Jinping and President Donald Trump and their respective administrations can give investors an indication of both heightened and soothed political tensions between the two powers. Despite Trump's China-sceptic statements, it is worth keeping in mind that a number of his campaign promises have not come to pass. China has not officially been labelled a currency manipulator at the WTO and a 45% tariff on Chinese imports does not appear imminent. Similarly, after a brief diplomatic incident involving the President of Taiwan, Trump has also formally recognised the One China policy, a cornerstone of US-China diplomatic relations since President Carter. Finally, the first meeting between the two presidents seems to have been a successful diplomatic endeavour. During trade talks, it was the Chinese delegation who proposed the idea of a 100-day plan to discuss trade, a particularly American concept which dates back to President Roosevelt's 100-day plan to deal with the Great Depression. President Trump and his team agreed to the idea and accepted an invitation for a return visit later on during the year.

It is easy to get caught up in over scrutinising the constant information flow, each event seemingly demanding an appropriate investor response. Very recently, we have seen this occur around Syria (the US retaliation to the chemical weapons attack in Syria) and North Korea (US sending an aircraft carrier to the region to deter further missile testing). These irregular incidents will flare up on a regular basis and investors should not re-evaluate their entire world view because of each one. While it is vital that we monitor and absorb the most important pieces of information, we must also filter out the 'noise' of the day-to-day and take careful consideration of what is the current state of relations and where might the trend lie.

HOW SHOULD INVESTORS REACT?

As we argued a few years back[1], translating geopolitical risk assessment into an investment portfolio is far from straightforward. Almost by definition, most geopolitical incidents are quite unpredictable, the impact on markets is immediate (so it is difficult to get ahead of the curve) and, while sometimes the instantaneous impact is really significant, it is rarely lasting.

The usual initial market reaction is an increase in equity risk premium, a rise in volatility, a fall in government bond yields (even though some shocks are actually inflationary) and a fairly mixed reaction in oil and gold, depending on the nature and the location of the incident. Usually geopolitical market sell-offs are temporary peaks in risk aversion. After that it becomes crucial to assess lasting impacts on fundamentals like earnings and growth which are often smaller than feared immediately after the incident. So as we go ahead, we have to get used to a higher frequency of incidents and their market effects. All else being equal, this means

1 Log on to www.lgim.com or click here: http://www.lgim.com/library/knowledge/thought-leadership-content/macro-matters/Macro_Matters_AUG_14_ENG.pdf

that the equity risk premium should be higher and the risk of a large drawdown greater. Higher risk of tension would also increase the value of safe haven assets in any portfolio (like government bonds, gold, defensive low beta equities and dollars). If we add populism to that mix – which we believe often leads to inflationary pressures – this makes us more positive on inflation linked bonds. Moreover, the increased risk of trade protectionism causes us to be cautious on emerging market (EM) equities relative to developed markets and EM currencies, at least initially. But in the end, developed market companies and consumers are also set to lose from a decline in global trade. Looking at this combined with other risks, leads us to position our portfolios cautiously in their medium-term allocation to risk assets, whilst taking opportunities in what we call mid-risk asset classes such as REITS and emerging market hard currency debt.

It is important that these are very long-term trends that take a long time to play out. Fundamental growth data remains strong for both China and the US. The relationship between the two leaders has developed better than we expected in first few months of the Trump administration. In this light we would like to repeat our advice of a few years back: Diversify and stress-test portfolios, manage risk, and focus on the bigger picture.

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MACRO MATTERS

A (LUCKY) TURN OF EVENTS

Though a nuclear war between the world's 'super powers' is consciously irrational as a result of mutual assured destruction, there are some fascinating but also worrying examples in the past 50 years in how the world has avoided a conflict by a combination of luck and the brave actions of a single individual.

During the Cuban missile crisis of 1962, US war ships located a Russian submarine (B-59) in international waters. The Russian ship, which was in possession of the latest advancement in nuclear missiles, did not respond to demands from the US to surface due to a technical fault in their radio. Not knowing that the B-59 had such weapons on board, the US navy began to drop practice depth charges (PDC) on the nuclear-armed submarine in a not-so-subtle way of getting their point across.

Unaware that the depth charges that hit B-59 were PDC intended to force the submarine to the surface, Captain Valentin Savitsky assumed that they were under attack: 'maybe the war has already started up there, while we are doing summersaults here'. It also appears that Savitsky was unable to communicate with the Soviet General Staff at the time, and therefore was under pressure to retaliate without being able to clearly assess the nature and context of the risk that the submarine faced. The standard Russian protocol required just the captain and the political officer to agree to authorise the use of nuclear weapons. Luckily for the world, Vasili Arkhipov, a flotilla commander, who happened to be on board, opposed the launch. Even though he formally wasn't part of the chain of command, he outranked the captain and eventually persuaded him to surface.[2]

2. Lewis, Williams, Pelopidas, and Aghlani (2014), Too Close for Comfort: Cases of Near Nuclear Use and Options for Policy, London: Chatham House, the Royal Institute for International Affairs