

June 3, 2024

The Philippines, China & Escalation in the South China Sea

On the short list of seemingly constant topics in the news today is the rising tension between the United States and the People's Republic of China. Across the spectrum of issues, disagreement between these two great powers seems increasingly unavoidable. Geopolitical developments in every corner of the globe often find a way to become another point of US-Chinese friction. When conditions become stormy like this, the question arises as to whether this tension will escalate into greater conflict, possibly even outright war. If it does, what will be the flashpoint? Where will the spark occur?

A storm is currently brewing in the South China Sea (SCS) that might make this body of water the area of greatest risk. Like so many conflicts in history, this one does not involve a direct conflict between the opposing great powers, but rather a local dispute involving a small but significant country, the Philippines, and China. This dispute holds the potential to stir up a storm that engulfs the region or that even spills into the world beyond it.

This report explains how the current Philippine-Chinese dispute developed and how it could further escalate. After providing a recent history of key developments in the SCS, we explain in detail the dispute at hand. Next, we show the strands that connect the tiny outcropping of land at the heart of the dispute to the

broader world. As usual, we conclude with a review of implications for investors.

South China Sea Recent History

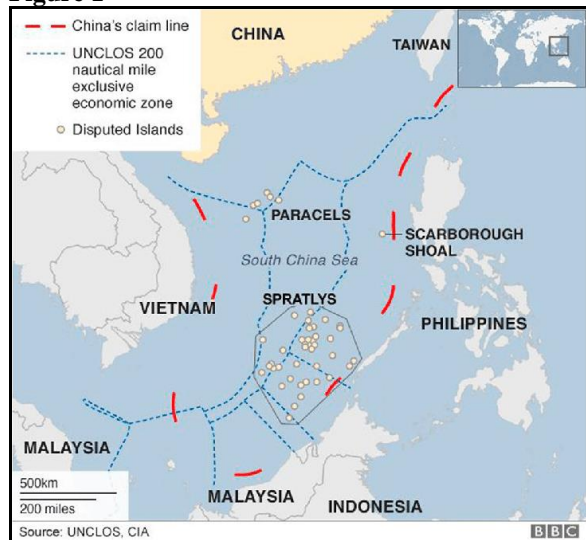
Over the last 15 years, the SCS has been the scene of Chinese activity that has challenged global norms and threatened the interests of neighboring countries. One of those neighbors, the Philippines, conducted policies that, for a while, aided China's initiatives.

Nine-Dash Line. The SCS is a 1.3 million square mile patch of ocean roughly bordered by China to its north, the Philippines to its east, the Indonesian archipelago to its south, and Vietnam to its west. Although estimates widely vary, [somewhere between 20% and 33% of the value of all seaborne global trade passes through the SCS](#). Countries such as Japan, Singapore, and South Korea rely on the free flow of shipping through this vital waterway for well more than half of their trade. Due to the area's geographic congestion, the territorial and economic claims to the SCS by neighboring countries overlap, leading to disputes.

Among these claims, China's "Nine-Dash Line" stands above the others for its expansive audacity. The term originates from a now-famous map that the Chinese government produced before the communist take-over in 1949. It shows an area bounded by nine dashes, encompassing virtually the entire SCS. According to the view depicted by this map, the entire area is geographically part of China. The Chinese justify the claim by saying that [286 bits of rock, reef, and other exposed land in the area are their "South China Sea Islands."](#) Although the

Permanent Court of Arbitration at the Hague (a universally recognized international court) has ruled that this claim is illegitimate and baseless, China rejects the judgment and stands by its claim. Exemplifying the many implications of this policy, China is heavily fishing in the universally recognized territorial waters of other countries.

Figure 1



Chinese Militarization. To reinforce its claim to the SCS, China has taken a series of steps to establish a military presence and capability within the SCS. This began with land development projects, in which Chinese civilian and military naval assets built artificial islands at the locations of several reefs and similar outcroppings of land. There are now [dozens of these man-made features dotting the SCS](#), comprising more than 3,000 acres of developed land. Although most of these features are assessed to have only civilian facilities on them, [at least three are fully militarized, with airfields capable of supporting advanced combat aircraft](#). An unknown number are dual-use civilian-military, including the installation of anti-ship and anti-aircraft missile systems. To complete the picture, the Chinese Maritime Militia (CMM), a kind of paramilitary naval force, now has [more](#)

[than 235 armed “fishing” vessels capable of protecting these “islands.”](#) Ultimately, this suggests an intent to militarily control the SCS and dictate who may gain access to it.

Figure 2



PRC Airfield on Fiery Cross Reef (Source: CSIS)

Duterte-Era Relations. [When Philippine President Rodrigo Duterte took office in 2016, he pledged to shift his country’s foreign policy away from the US — a longstanding treaty ally — in favor of China and Russia.](#) On a trip to Beijing that year, he said that it was “time to say goodbye to Washington.” In Duterte’s view, the Philippines was not adequately benefitting from its relationship with the US, while a turn toward Beijing would yield long-term economic benefits in the form of investments as a part of China’s “Belt and Road” initiative. Chinese leadership used this political support as cover to accelerate its SCS agenda, especially in Philippine territorial waters. As it turns out, Duterte became disillusioned with China’s promises and pivoted back to a pro-US policy before his departure from office in 2022.

Brewing Conflict

The two years since Duterte left office have witnessed increasing tensions between the Philippines and China due to a shift in Philippine policy, China’s response, and a

particular dispute that is troubling the waters that both countries claim.

Post-Duterte Shift. Duterte’s successor, Ferdinand Marcos Jr., has completely reversed the foreign policy of his predecessor. [Among the countries that border the SCS, the Philippines under Marcos Jr. has become the most pro-US and hawkish toward China of them all.](#) While most Southeast Asian countries seek to balance their relationships with the US and China and strive to avoid even the perception of taking sides, Marcos Jr. has stepped forward as the first regional leader to “choose” between the two contending powers. One clear example of this was Marcos Jr.’s strong congratulatory statement to the recent winner of the presidential election in Taiwan — a statement that went notably further in its tone of support than those of other countries. More broadly, he has dramatically increased existing defense ties with countries such as the US and Japan, and he has initiated new security relationships with countries such as Australia and Vietnam. A [dramatic increase in joint military exercises](#) with these partners and a [welcoming of more partner-nation military forces on Philippine soil](#) further demonstrate these commitments.

Increasing Friction. [Throughout the past decade, tensions in the SCS have been the greatest between China and the Philippines,](#) except for the temporary lull under Duterte; however, tensions have further escalated in this decade. Despite being at the farthest reaches of the area encompassed by the Nine-Dash Line, China has concentrated its more recent island-building activities and paramilitary sea patrols in the area claimed by both countries. With increasing regularity, Chinese coast guard vessels and CMM “fishing boats” patrol these waters, conducting risky maneuvers close to

Philippine vessels that occasionally involve collisions. While covering all of these actions, [the Chinese government regularly issues statements accusing the Philippines of violating Chinese sovereignty in the area and of being the cause of increased tensions.](#)

Second Thomas Shoal Dispute. These tensions have recently come to a head at a place called the Second Thomas Shoal (STS). [The STS is a submerged reef in the Spratly Islands, located in the internationally recognized exclusive economic zone of the Philippines](#) but over which China claims “indisputable sovereignty.” To support its own sovereignty claim, in 1999 the Philippines intentionally grounded a World War II-era ship, the Sierra Madre, on the reef and stationed a detachment of marines on it. For the last 25 years, the Philippine Navy has maintained a rotation of marines onboard the vessel and has kept them resupplied.

[During this decade, Chinese coast guard and CMM vessels have escalated tensions by harassing and blocking Philippine units during rotation and reprovision missions, particularly when China accuses Philippine ships of carrying construction supplies to reinforce the Sierra Madre’s structural integrity.](#) Since 2021, China has increased the number of its ships in the area by 14 times. Since 2023, these ships have water-cannoned Philippine resupply vessels five times and have thrice initiated collisions. The Philippines has responded to this behavior with vigorous increases in its activity to support the Sierra Madre, strong condemnations of China’s actions, and further invitations to foreign military forces to be stationed on the Philippines.

Figure 3



(Source: Asia Times)

The “Gentlemen’s Agreement.” In early May 2024, China publicized what it claims was a [“gentlemen’s agreement”](#) reached in 2016 with President Duterte. According to this alleged agreement, China secretly granted the Philippines a [“temporary special arrangement,”](#) allowing small-scale fishing rights in and around the STS but forbidding the presence of any kind of military or coast guard vessel or official aircraft within the 12-nautical mile limit of territorial waters normally accorded to sovereign territory. Both former President Duterte and current President Marcos Jr. completely deny the existence of any such agreement.

The Alberto Carlos “Recording.” Also in May, China separately released an alleged [transcript of a telephone call that occurred in January](#) between Vice Admiral Alberto Carlos, at that time the commander of the post overseeing the STS, and China’s military attaché in Manila. According to the transcript, Vice Admiral Carlos agreed to a “new model” for activity in the vicinity of the STS, in which the Philippines would notify China in advance of resupply missions and conform to a set of restrictions. Vice Admiral Carlos, with the support of the Philippine government, has strenuously denied that he made any such agreements, also asserting that he did not consent to the call being recorded. Further, the Philippines

asserts that the released transcript has been altered, meaning that it is a false rendering of the recording. Notably, China has not released the actual recording. Whereas China stands by its claim of the transcript’s authenticity and accuracy, the Philippine national security advisor has called for the expulsion of Chinese diplomats in response to the affair.

Risk of Escalation

The risk that this local dispute could escalate into a broader conflict and draw in other countries begins with the special relationship between the US and the Philippines, extends to the increasing involvement of other major countries in the region, and is punctuated by the intensity of Chinese rhetoric on the issue.

US-Philippine Mutual Defense Treaty. [The US and the Philippines entered into a mutual defense treaty in 1951.](#) This makes the Philippines the US’s oldest treaty ally in the region and extends a close relationship between the two countries that began in 1898, when the [US acquired the Philippines from Spain at the conclusion of the Spanish-American war.](#) Except for the Japanese occupation during World War II, the US has maintained a continuous military presence in the Philippines for 126 years. This includes access to critical airfields and naval bases that have played a central role in US force projection in the Far East throughout this time. This means that the US has a strong vested interest in geopolitically supporting the Philippines; however, it also means that the US is obligated to defend the country should it be attacked.

As the current dispute unfolds, determining what constitutes an attack will likely prove an extremely delicate question, both militarily and politically. [The US State Department has issued a formal statement](#)

condemning China's actions in and around the STS, including a reaffirmation that the US-Philippine mutual defense treaty “extends to armed attacks on Philippine armed forces, public vessels, or aircraft — including those of its Coast Guard — anywhere in the South China Sea.”

Responses of Other Countries. The US is not the only country that has responded with alarm to the STS escalation. [The Ministry of Foreign Affairs of Japan issued a formal statement](#) supporting the Philippine position, opposing Chinese actions, and characterizing them as endangering the peace and stability of the region. [The Department of Foreign Affairs and Trade of Australia issued a similar statement](#), also supporting the Philippine position and asserting its view that the Permanent Court of Arbitration's judgment against China's claims in the SCS are legitimate and binding. While other countries in the region have limited themselves to calls for restraint, we expect that a continued rise in tensions over the STS will eventually force their hands.

China's Response. China's statements have held a firm line that [the STS is part of its sovereign territory, that the Philippines is to blame for escalating the situation, and that China will continue to take all actions necessary to uphold its interests in the dispute](#). The Chinese Ministry of Defense stated that its coastguard “resolutely foiled the Philippines' provocative attempt” to resupply the Sierra Madre and accused the Philippines of instigating the confrontation, saying that the Philippine convoy “forcibly intruded into the area despite China's repeated warnings and route controls,” and described the Chinese coastguard's actions as “reasonable, legal, and professional.” It warned the Philippines against any further provocative statements or incursions on its

territorial sovereignty over the STS. [China has also warned the US](#) not to “stir up trouble” or take sides on the issue.

Geopolitical & Economic Implications

While we think that the US and China are committed to preventing escalation of the STS dispute into broader conflict, the tensions themselves and the potential for escalation have investment implications.

Transportation Routes & Costs. Thus far, seaborne trade traffic continues as normal through the SCS; however, if armed conflict were to occur in the area, it would carry the risk of closing the sea to trade. Although most of this trade could be rerouted, it would come at significant increases in costs and transit times. Some of the trade could not be rerouted at all, because the destination ports lie completely behind or within the SCS. According to a [study by the National Bureau of Economic Research](#) (NBER), the 19 countries in the region would suffer losses of GDP ranging from little effect to a 50% loss. The most heavily impacted countries are Taiwan, Singapore, Vietnam, Thailand, and the Philippines, while New Zealand and Australia are relatively unaffected. In some scenarios, China is almost entirely unaffected, which carries obvious implications for its intentions, depending on how the scenario evolves. Among the countries outside the region that could also suffer losses, major oil exporters such as Saudi Arabia would probably experience reductions in their ability to transport petroleum products to their customers in the SCS region.

More Increases in Military Spending. The same NBER study revealed noteworthy implications for military spending. The trend of rising military expenditures, both worldwide and in this region, is already a well-known story; however, there appears to

be a positive association between the economic risk level faced by SCS-region countries and their levels of defense spending (i.e., the greater the potential loss from SCS conflict, the higher the observed increases in defense spending). Even if the situation does not escalate, we expect that the general perception of risk will continue to rise along with tensions. While we recognize the presence of many other intervening factors, we still consider it likely that countries such as those listed in the previous section as well as Japan and South Korea will continue to increase their spending levels.

Contribution to Bloc Formation. There is a clear correlation between the countries who have most strongly opposed Chinese actions in the SCS, especially concerning the STS affair, and those whom we have identified as aligning themselves to the US bloc. Similarly, those who have either supported China's position or remained mute are the countries that we have identified as either members of the China-Russia bloc or those attempting to stay neutral. In our view, the troubled waters of the SCS and the brewing conflict between the Philippines and China are already reinforcing the pattern of bloc formation, and we expect this to continue.

Investment Implications

Each of these geopolitical and economic implications translates into implications for asset classes and economic sectors. Rising transportation costs, which we expect to be a durable trend, filter through to the costs of each product being transported, be it crude

oil or a consumer good. These increased costs would contribute to higher inflation and interest rates, which would have a negative effect on long-term bonds. We also suspect that global shipping companies themselves will struggle to pass on all of their increased operating costs to their customers, which would put pressure on the stocks in the transportation sector most closely involved with Southeast Asia.

Rising military spending highlights a theme that we have emphasized before, but it bears repeating. Companies that sell to the world's militaries, but especially to those located on the rim of the SCS, will have a long-term opportunity. Although this includes traditional defense stocks, we are also scanning the investment landscape for emerging defense-related opportunities such as companies that provide new, critical-enabling technologies to the world's militaries. Finally, as we have been emphasizing, the decoupling of the world into competing blocs will deglobalize markets for critical commodity inputs such as iron, copper, and uranium. As countries strive to secure supplies of these items, we expect long-term upward movement in commodity prices.

Daniel Ortwerth, CFA
June 3, 2024

This report was prepared by Daniel Ortwerth of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics, and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.