

*August 10, 2020*

## **The Evolving U.S. Policy Toward China and Its Impact on Investors**

Looking forward to the coming years and decades, today's long-term investors face a stark question: will they be investing in a China-dominated world molded by authoritarian leaders in Beijing? Or, will they be investing in a more familiar, Western-dominated environment reflecting the historic leadership of the U.S. and incorporating the values of freedom, private property, and justice, as handed down from British common law? Here at Confluence, we have long discussed the global public goods of security and a reserve currency that the U.S. has provided in its traditional role as global hegemon, and we've shown that U.S. citizens have become tired of providing those goods. We've argued that the most likely future is one in which the U.S. relinquishes its global dominance, producing an unstable and dangerous transition period from which some new hegemon—perhaps China—will eventually arise.

But the end of U.S. hegemony and its replacement by China are not yet set in stone. High-level "China hawks" in the Trump administration have launched an audacious effort to convince the American people and America's foreign allies that they must push back against China and its effort to assume the throne of global leadership. At the dawn of the Cold War, the architects of U.S. "containment policy" faced a similar challenge as they built the case for thwarting Soviet expansionism. The question now is

whether the new tough-on-China argument will resonate to the same extent.

### **Four Speeches**

During the first years of the Trump administration, U.S. policy toward China was personalized and constrained. By all accounts, President Trump operated under the belief that a warm, direct relationship with Chinese President Xi Jinping coupled with firm, focused pressure on bilateral exports and imports would advance his overriding goal of "fairer" trade, especially regarding traditional U.S. industries like agriculture, basic materials, capital equipment, and auto manufacturing. For example, to avoid spoiling the atmosphere for a new trade agreement in late 2019, Trump [said little about China's territorial aggression in the South China Sea, human rights abuses against its Uighur minority in the province of Xinjiang, or the clampdown on democratic freedoms in Hong Kong.](#) The limited "Phase I" trade agreement signed by China and the U.S. in January 2020 initially seemed to vindicate Trump's approach.

Since January, however, much has changed. China's secrecy as the novel coronavirus spread from Hebei Province along with [pressure on the World Health Organization to hide its role in the initial spread of the virus](#) were some of the most fateful factors touching off the global pandemic, which is now arguably the greatest risk to Trump's reelection. At the same time, China is running far behind in its import commitments under the Phase I trade deal. In a sign that Trump may have given up on his relationship with Xi, the president

indicated in July that he is [no longer hopeful about a follow-on trade deal with China](#).

Trump's apparent write-off of the Chinese relationship has made space for the anti-China hawks in his administration, led by Secretary of State Mike Pompeo. Free to push a more muscular China policy than was previously possible, Pompeo arranged a series of speeches this summer in which he and his allies tried to lay out the intellectual foundation for a new tough-on-China policy. On June 24, National Security Advisor Robert O'Brien [spoke in Phoenix on the ideology driving China's global aggressiveness](#). On June 26, Attorney General William Barr [spoke at the Gerald Ford Presidential Museum in Michigan regarding China's threat to U.S. technology and business](#). On July 7, FBI Director Christopher Wray [spoke at the Hudson Institute in Washington on Chinese computer hacking and surveillance](#). Finally, on July 24, Secretary of State Pompeo [summed up the argument at the Richard Nixon Library in California](#). Together, the speeches lay out an argument for what might be a new Cold War against China.

### Red Scare

Whether you're planning a cold war or a hot war, the first step is to decide who you'll be fighting. Defining the enemy helps keep your focus on the strengths and weaknesses you'll be up against. For leaders in a democracy, defining the enemy is also critical for motivating the nation's citizens to fight. Painting the enemy as extraordinarily menacing and fanatical is often necessary to ensure the population will sacrifice its blood and treasure in the conflict. In the Pompeo speeches, a key theme was that the enemy isn't Chinese culture or the Chinese people, but rather the Communist Party of China (CPC). As during the U.S.-USSR Cold War, the

speeches raised the specter of expansionist, totalitarian Marxism-Leninism bent on dominating the world and molding it into a communist society.



*National Security Advisor O'Brien speaking in Phoenix. (Source: Wall Street Journal)*

According to Pompeo and the other speakers, the idea that engaging with China would make it more politically and economically liberal was naïve from the beginning. In their view, the U.S. opening to China and subsequent efforts to engage with it arose from Americans' innate optimism and a certain hubris after the U.S. victory in the Cold War. What the U.S. and its allies missed was the CPC's *ideology* as reflected in its own statements and actions. The speakers argued that a close look at those statements and actions shows the CPC and President Xi have but one motivation: to maintain and expand their dictatorship.

In these speeches, they claimed that in order to maintain and expand their dictatorship, the CPC and Xi are bent on total control over the Chinese political system, economy, and individuals, creating a unitary state in which all officials, companies, and individuals are controlled by and serve the government in Beijing. The speakers stressed that this effort also extends to other countries. In the words of O'Brien, "The CPC's stated goal is to...re-make the entire

world according to the CPC.” For example, they cited Chinese government pressure as the reason several U.S. airlines stopped referring to Taiwan as an independent country on their websites, and also cited instances of Hollywood movie studios self-censoring their scripts to avoid casting China in a bad light. They argued that China’s massive computer-hacking and theft of U.S. consumers’ personal information are aimed at creating a database on virtually all U.S. adults to subject them to influence, coercion, and blackmail in the future.



*Attorney General Barr speaking at the Ford Museum. (Source: Justice Department)*

### Technology Thought Control

Curiously, the speeches touched relatively little on some of the most longstanding complaints about Chinese behavior in the global economy. They barely mentioned issues like Chinese currency manipulation, unfair subsidies to Chinese companies, or predatory pricing in traditional industries like basic materials and industrial equipment. Rather, the speeches focused on Chinese theft and extortion to gain U.S. advanced technology. According to Barr, China’s goal is to “surpass the U.S. as the globe’s technological superpower.” Wray goes further, arguing that China is aiming to become “the world’s only superpower.”

Besides stealing advanced technology from U.S. companies, the speakers emphasized how China is using digital communications to actively influence U.S. individuals. The

hacking and theft of personal data for future blackmail is just one example. The speakers also described Chinese efforts to manipulate U.S. public opinion through cultural exchanges and social media, while limiting the ability of U.S. and Western journalists to report on events within China. According to them, the Chinese effort to manipulate U.S. opinion is massive and wide-ranging, impacting every American.



*FBI Director Wray speaking at the Hudson Institute. (Source: C-SPAN)*

### Regime Change?

On one level, the speakers’ prescription for dealing with China is simply for U.S. officials, companies, and individuals to reassess their benefit/cost calculations for engagement with China. They argued that democratization, truly free markets, fair and unfettered trade, and other such dreams for China are unlikely to be fulfilled as long as the CPC and Xi are in charge. Indeed, the actual business benefits of engaging with China are so small that Pompeo argued, “They depend on us more than we depend on them.” At the same time, China will continue to exploit its contacts with the West to build up its military, its economy, and its influence to the detriment of U.S. interests. In other words, these speakers are arguing that the net benefit of engagement with China is much smaller than perceived.

In terms of active policy measures against China, it’s notable that they are not simply calling for a “decoupling.” Pompeo

explicitly asserted that what he’s calling for is not “containment” as practiced during the Cold War, since China is already so well integrated into the global economy. In fact, Pompeo didn’t even try to give his policy prescription a label. He simply called it a policy aimed at a “complex new environment we haven’t faced before.”



Secretary of State Pompeo speaking at the Nixon Library. (Source: CourthouseNews.com)

Against those who say the U.S. needs to give up its geopolitical dominance and settle for mere deterrence or accommodation, Pompeo argues that the U.S. needs to “induce China to change” using more creative and assertive ways than have been tried in the past. For one thing, Pompeo says that involves telling the truth that China is under a communist dictatorship bent on world domination. He also says it involves taking concrete action to push back against China militarily, diplomatically, and economically. Most important is Pompeo’s assertion that the proper policy can’t be mere containment because China is already integrated into the global economy. Coupled with his argument that there is little net cost in disengaging from China, this statement can only mean that Pompeo wants U.S. policy to go *farther* than containment to roll back China’s global presence until it starts acting less aggressively.

Even more dramatically, Pompeo argues the U.S. must encourage the Chinese people themselves to “change” the CPC. He

remains vague on how that would be accomplished, but it’s notable that immediately after arguing for that course, he said, “We’ve done it before,” and then ticked off the many mistakes the USSR took before it disintegrated. Taken as a whole, it seems clear that Pompeo is calling for regime change similar to what happened to the Soviet Union. More ominously, after outlining the various concrete steps the administration has already taken against China, O’Brien promised, “There’s more to come.”

### **Analyzing the Policy**

Two important questions now are whether Pompeo’s ideas will be implemented as U.S. policy and whether they would be the best way to manage the U.S.-China relationship.

### ***Will a Rollback Policy Be Implemented?***

It’s not entirely clear that President Trump will leave China policy in the hands of Pompeo and the other hawks. If China unexpectedly offers trade or other concessions that might be helpful to Trump’s reelection prospects, he could take back control over China policy and soften U.S. pressure on China. One example of a Chinese concession that Trump might accept is [last week’s news that Chinese tech firm Bytedance is negotiating to sell the U.S. and other foreign operations of its popular TikTok app to Microsoft \(MSFT, 213.04\) in order to avoid having it banned from the U.S.](#) Of course, if Joe Biden wins the presidency in November, he might implement a different policy against China (see discussion below).

### ***Would a Rollback Policy Be Effective?***

The Pompeo speeches don’t offer a clear, concrete program of specific actions against China, but they do describe actions that the U.S. has already taken, and those actions show what Pompeo is promoting. As a

corollary to his call for the U.S. and its allies to reassess the benefits and costs of engaging with today's China, Pompeo wants to change China's benefit/cost calculation when it considers territory grabs, technology thefts, unfair trading practices, human rights abuses, and other actions that impinge on U.S. interests. For Pompeo, rolling back China's malign influence in the world is accomplished by raising the cost of its bad behavior. When China seeks to expand its sovereignty in the South China Sea, the U.S. calls out its actions as illegal and sends two aircraft carriers into the area to highlight China's inability to keep them out. When Chinese students are caught spying, the U.S. arrests them and slams shut the Chinese consulate in Houston. Since there is no logical limit to the costs the U.S. and its allies could impose on China (including the threat of regime change mentioned above), we judge that this policy could indeed change the country's behavior so long as it is implemented strongly and consistently over time. This is certainly why the speakers promised there is "more to come."

### **Analyzing the Politics**

Even more fundamental than the questions of whether a rollback policy will be implemented and whether it would be effective, it is important to ask whether such a policy would garner political support.

***Would a President Biden Adopt a Rollback Policy Against China?*** Pompeo may have launched his speeches in order to lock down a tough-on-China policy in case the Democrats regain the presidency (and potentially even the Senate), but he may not need to worry. [A bipartisan consensus about the threat from China and the need for tough countermeasures already seems to be in place.](#) Even if his policy specifics might differ, [Biden's commitment to the working class implies he would take action to crimp](#)

[China's activities around the globe if he becomes president.](#) Even if Biden's policy might be less aggressive than what Pompeo is encouraging, it's important to remember that Biden is more of an internationalist than Trump. He has called for a broader, multilateral effort against China that would make fuller use of U.S. allies. Under a President Biden, U.S. policy might not be as sharp as Pompeo prefers, but it would probably be more broadly applied and coordinated by the U.S. and its allies.

***Would U.S. Voters Once Again Take on the Burdens of Global Hegemony?*** As the U.S. and other major democracies accept that the benefit/cost ratio of engaging with China is lower than previously thought, and as evidence accumulates that the risk of continued Chinese misbehavior is high, it could become politically untenable for U.S. and allied leaders to acquiesce to China's current integration in global geopolitics, economics, finance, or society. The problem is that rejecting this integration and actively rolling back China may require the U.S. to recommit to its traditional role as global hegemon, reversing its retreat from global leadership that we've described so often. This is why it would be critical for a Pompeo-style rollback policy to be couched in terms that can resonate with U.S. voters. Given the amount of money, blood, and risk that would be needed to support a recommitment to U.S. dominance, voters would probably need the powerful motivation of either an inspiring, morally certain ideology, or a sense of great dread at the prospect of Chinese domination.

***Would Anti-Communism Be Enough to "Sell" Renewed Hegemony?*** The key question is whether the menace of expansionist, totalitarian communism will resonate with the American people enough to convince them to recommit to global

hegemony and support Pompeo's rollback policy. When George Kennan and the other architects of Cold War containment were making their case against the Soviet Union in the late 1940s, radical communism had been a serious global issue for at least three decades. Now, it's been at least three decades since communism has been a viable model of political economy. Relatively few voters in the U.S. or the other major democracies remember what it was like to face a communist opponent. Painting the threat as communism may not be enough to generate strong, emotional pushback against China. Pompeo's inability to come up with a pithy, easily understood label for his policy could also be an impediment to swinging the American people behind it.

### **Ramifications**

In summary, Pompeo and his allies have made a good case for a tough rollback policy against China, but the case may not be good enough. Whoever is U.S. president in 2021 will likely push back against China to some extent, but their policy may not match what Pompeo is advocating for or amount to a recommitment to U.S. global hegemony.

Still, however sharp and broad Western policy against China becomes, it is likely to be disruptive and risky, just as the Trump

administration's initial steps have been against China in trade and technology. Trump's policy steps have often weighed on riskier assets since 2018. Likewise, a future tough stance against China would likely weigh on global equities and commodities, at least temporarily. The risks are probably highest for Chinese equities trading in the U.S., Chinese technology firms, and Chinese financial institutions that might be shut out of the U.S. financial system or dollar funding. Emerging markets that trade heavily with China could be caught in the crossfire, so they might also be at risk.

In contrast, countries like Vietnam or Mexico could benefit if production now centered in China is transferred there instead. And, of course, safe-haven assets like fixed income or precious metals might benefit from the increase in tensions. In the longer term, if Western democracies reduce their reliance on low-cost manufacturers in China, price inflation could also accelerate again, so precious metals might become even more attractive.

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August 10, 2020

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### **Confluence Investment Management LLC**

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