

*August 3, 2020*

## **Rethinking China: Part II**

In Part I, we described China's situation using Japan as a historical analog. This week, we will complete the analogy and examine in some detail the potential motivations of Chinese and U.S. policymakers. As always, we will conclude the discussion with potential market ramifications.

### **China's Situation**

Similar to Japan in the 1930s, China has become a large economy showing geopolitical power that is threatening the established order. Similar to Japan in the 1980s, it has an economy overly reliant on investment, trade and debt. And, like Japan, it is dependent on sea lanes it does not control. Finally, as was the case with Japan during both the 1930s and 1980s, China has reached a point where the U.S. is refusing to accommodate its rise. However, unlike Japan, China is not as dependent on the U.S. for its security (although it is quite vulnerable to a blockade).

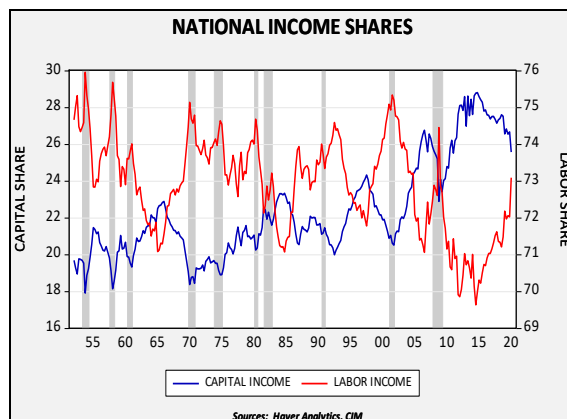
It is arguable that Deng realized China would eventually reach this state and thus encouraged Chinese leaders to bide their time. Simply put, Deng wanted to extend China's ability to stay "under the radar" for as long as possible before it would inevitably trigger a response from the U.S.

It is important to realize China is not acting in a vacuum. The U.S. has a clear role in how this situation evolves. The American response to China's rise appeared to be guided by two principles. The first is that

eventually China would accept U.S. hegemony and the trading system America had created after WWII. The second was that communism was fundamentally flawed and China would eventually develop into a capitalist democracy.

People and nations develop narratives around victory and defeat. We are always amused in sports how a team that wins a World Series, Super Bowl, Larry O'Brien Trophy or Stanley Cup believes it is on the cusp of a dynasty. It does occur sometimes, but most teams fail to repeat. Despite a clear history of the rarity of dynasties, why does the belief persist? It happens, in part, due to the lack of scrutiny of success. Failure is examined in great detail, while victory is seen as the result of superior skill and knowledge. However, any analysis of a championship run often turns up evidence of luck, a break that could have gone differently.

The U.S. narrative after winning the Cold War was that the superiority of capitalism and democracy made it self-evident that all other systems were inferior, and that right-thinking people and nations would all eventually gravitate toward that outcome. There is no doubt that capitalism and democracy were key elements in winning the Cold War. However, there were also unappreciated elements. The U.S. tended to restrain capitalism during most of the Cold War, in part, to make it a more attractive alternative to communism. It is interesting to note that after the Berlin Wall fell, capital income began to rise relative to labor income as the capitalists no longer needed to prove that capitalism was better for workers.



Note that after 1990, the capital share of national income made a new high in each business cycle.

Another part of the Cold War win was likely due to the particular ineptness of the Soviet Union. Russia has a long history of expansion and contraction. This is because it protects itself with a buffer that forces invaders to traverse long distances to reach the critical parts of the state. Russia wages that long supply lines and winter will give it an edge; history shows this strategy worked against Napoleon and Hitler. Thus, the collapse of the Soviet Union may have been more due to the periodic cycle of empire collapse endemic to Russia and not necessarily due to its economic system.

However, these possibilities were not really considered. Therefore, policymakers tolerated China's communist system and unfair trade activity, which included blatant technology transfers, because they expected that exposure to democracy and capitalism would eventually lead to the same result as what was seen at the end of the Cold War—China would fold itself into America's democratic and capitalist hegemonic system. It was abundantly clear that China's actions were harming U.S. interests, but given the expected "inevitably" of capitalism and democracy, it wasn't worth the cost for the U.S. to confront China. This seemed to be

the U.S. position from 1990 to 2018, but it didn't mean the U.S. completely ignored China's behavior. It filed trade complaints with the WTO and engaged in freedom of navigation naval operations. But, the realization that China wasn't going to change appears to have only recently become the dominant American position.

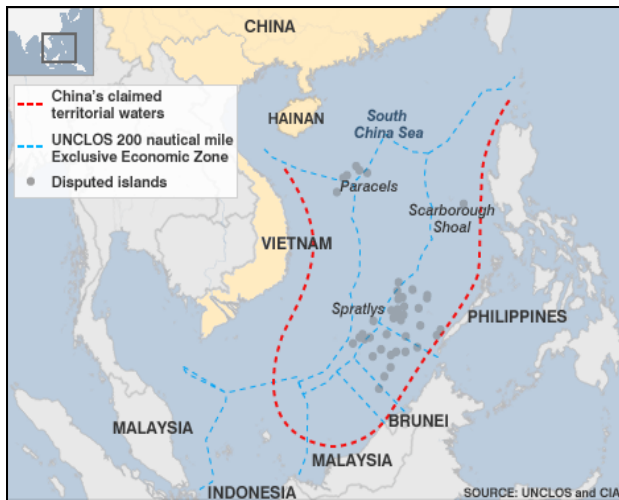
### What Has Changed?

Chairman Xi wants to become an inflection point in CPC history, similar to Mao and Deng. As noted above, [his governance is a clear break from Deng's model](#). Not only has he removed term limits, but he has made himself the center of policy and power.

However, recent actions are bordering on reckless. The list of clashes in recent months is a broad laundry list.

- China has made persistent threats to neighboring nations [using commercial fishing vessels and coast guard ships to harass and threaten other countries' fishing and commercial ships](#). It sank a Vietnamese [fishing boat off the Paracels](#), sent its aircraft [carriers to waters near Japan, Taiwan and Guam](#), and has [regularly been violating Taiwan's airspace](#). [China also threatened a Malaysian drillship](#) in April.
- China has engaged in military activity, threatening [India and Bhutan in the Himalayas](#).
- Its decision to forcibly implement the new Hong Kong Security law was a show of force. Given enough electoral manipulation, it is quite possible the Hong Kong legislature would have eventually passed the law. Instead, it was ["passed" by the Chinese legislature](#) in an irregular and highly noticeable fashion.
- China has been slowly building infrastructure on numerous outcroppings in the South China Sea. The actions

were provocative but slow and modest enough that no particular action was considered egregious enough to trigger a strong response. It has claimed most of the South China Sea as its own, going back to when the Nationalists controlled China. The communists have maintained this position which no other nation in the region accepts.



- China has built facilities on the Paracels and the Spratlys, and is [likely to build naval infrastructure on the Scarborough Shoal](#). It has [recently moved fighter jets](#) to Woody Island which is part of the Paracels.
- Chinese diplomats have been making unusually undiplomatic speeches, calling themselves “[Wolf Warriors](#).” These diplomats peddled a story [that the U.S. was the originator of COVID-19](#). China has sent personal protective equipment to COVID-19 stricken areas, [but demanded praise for doing so](#). It has aggressively pushed back against an Australian request for an outside investigation of the COVID-19 spread in China. In return, [it threatened trade sanctions on Australia](#). These same Wolf Warrior diplomats [have even confronted Brazil](#). The [EU](#) and [Canada](#) have also come under Beijing’s wrath. The U.K. has been at loggerheads with

China over Hong Kong and 5G equipment.

### Why the Aggression?

Essentially, Xi has accelerated aggressive actions recently. The key issue is, “why”? There are four theories as to why China’s behavior has become so belligerent. They are listed below, along with the likely assumptions from China’s perspective for supporting the particular theory.<sup>1</sup>

1. Opportunistic: Beijing sees the world’s distraction over the pandemic and November elections in the U.S. as an opportunity to make rapid gains before the virus is contained and a potentially new president moves into the White House. *China’s assumptions: The damage being caused by China’s actions are repairable and won’t trigger a lasting coalition against it. It is a likely assumption, based on the notion that China’s integration into the world economy is too deep and the potential economic disruption too great to trigger a strong reaction with duration.*
2. Imperious: The world has changed. The U.S. is a fading, declining superpower with little appetite for conflict. *China’s assumptions: This is a bit of believing one’s own press releases. If this is the theory for China’s actions, it believes that (a) the time has come to assert its power, and (b) the communist system is so superior that it can’t be defeated.*
3. Reactive: China is merely reacting to pressure from outside the country. The extended trade conflict with the U.S. coupled with the pressures from the pandemic are leading China to defend its position and reputation. *China’s assumptions: There is a case to be made that China has faced myriad pressures due to the trade war and the pandemic,*

<sup>1</sup> This section borrows heavily [from this report](#).

*but the response appears to be excessive compared to what it has suffered. This position may be based on the notion that there is great power in victimhood. But, if what we are seeing is a mere reaction, it is worrisome that Beijing would react so aggressively to modest affronts.*

4. Insecurity: China has clear problems. As we have outlined, it has an excessive debt overhang and needs to implement a painful restructuring of its economy away from investment and exports toward domestic consumption. It is reacting to internal pressures and worries that internal dissent and foreign pressure will topple the regime. *China's assumptions: This may be a proper reckoning of China's position. Much like Japan in the 1930s or the late 1980s, it has had a favorable run which is coming to a close and is uncertain how to navigate the future. Japan's example is sobering; it means either war with the U.S. (which it would likely lose) or decades of stagnation (to which its citizens would likely rebel). Thus, it is accelerating its response to these affronts to prove to itself and the outside world that it isn't weak.*

It is possible that there are elements of all four theories in the recent reactions. It is also possible that factions within the CPC harbor one or more of these beliefs, but the only one that really matters is what Xi believes. We could speculate, but that also doesn't matter. It matters what U.S. policymakers think is China's motivation.

### **Making Decisions Under Conditions of Uncertainty**

In our [Confluence of Ideas](#) podcast series, the fifth episode, "[Arriving at Decisions](#)," is all about the problems of making decisions under conditions of uncertainty. Decision theorists have concluded that the only way to make good, consistent decisions is to have

a process. So, given our China problem, how should policymakers frame this decision?

The first step should probably be to examine the best response to each theory. If **theory #1**, Opportunistic, is the reason China is acting this way, a strong counter-response should be undertaken to show that there is actually no opportunity being presented by the pandemic. A strong but measured response with an exit ramp would probably be most effective (stop this, get that, e.g., ease up on the National Security law, impose fewer impediments on Hong Kong). If **theory #2**, Imperious, is behind China's actions, then a very strong and lasting response is in order. The U.S. should make it clear that American hegemony is still operant and take steps to "show the flag." These would include freedom of operation navigation, active coalition-building and defense of smaller nations in the region, the application of sanctions and the buildup of arms in the region. If **theory #3**, Reactive, is the real reason for Chinese belligerence, then diplomacy and confidence-building measures would make sense. After all, if China is merely reacting, then it should calm down if it gets less criticism. If **theory #4**, Insecurity, is behind China's recent moves, similar diplomatic confidence-building may be in order; at the same time, a media blitz to offer democracy as an alternative might be effective as well.

Here is the problem—if there is a mismatch between theory and response, it could be catastrophic. If China is following theory #2, Imperious, but the U.S. believes it is operating under #3, Reactive, then confidence-building diplomacy will be seen as weakness and lead to increasingly belligerent behavior. If theory #4, Insecurity, is the actual theory, then the #2 solution for Imperious would be a disaster as

it would likely trigger an overwhelmingly inappropriate response from China, one that it didn't plan or want. If theory #1, Opportunistic, is the real deal, then acting under the assumption of #2 will lead to escalation above what China was likely prepared to make. On the other hand, if the remedies for #3 or #4 are followed, China would likely try to take further advantage, seeing it as a windfall.

So, what do policymakers think? It depends on the policymaker. We suspect the Secretary of State and right-wing populists in the Senate believe China is working under theory #2. The right-wing establishment would probably lean toward #1, whereas the left-wing establishment likely tend toward #3 or #4.

This analysis suggests that getting this framing correct is paramount. History tended to support George Kennan's theory of Soviet behavior and outlasting the U.S.S.R. turned out to be a pretty good strategy. Current policymakers don't have to get it perfectly, but a major mismatch (e.g., China is operating under theory #1 or #2 with a policy response for #3 or #4) would cause a problem to arise. On the other hand, the policy responses to #1 and #2 are similar, as are #3 and #4. Thus, perfection isn't necessarily required, but a major miss is a recipe for trouble.

### **Ramifications**

Miscalculations cause wars. Historians still marvel at the mistakes that were made before WWI. PM Chamberlain's assumption that he could appease Hitler was a terrible mistake.<sup>2</sup> As investors, our task is to determine the impact of policy on asset classes. In this situation, we estimate China's motivation for recent policy actions,

<sup>2</sup><https://www.nytimes.com/2019/06/10/books/review/tim-bouverie-appeasement.html>

the U.S. response and the motivation for that response.

Like policymakers, we are also working under conditions of uncertainty. We try to reduce that uncertainty through careful analysis, but some degree of ambiguity will always be present. In our judgement, the most likely motivation from China is either #1 or #2, with the most likely being #2. As Chairman Xi has stifled dissent, it is unlikely he is receiving opinions he would not like. His policy of the "Chinese Dream" would suggest he is leaning toward China's continued rise. In reality, China may be closer to #4; it has similar characteristics to Japan at previous peaks—high debt and vulnerability to U.S. control of the seas. If the Chinese leadership is mistaken, they will engage in actions that will put their country at risk.

On the U.S. side, it appears the China hawks are ascendant in determining policy. This rise is due, in part, to [election strategy](#); it appears the administration is touting a hostile position toward China with an eye toward November. But there is also the idea that an aggressive response will leave little room for a new administration to reverse policy.

What does this mean for financial markets? Chinese equities have performed well this year. Government stimulus and a recovery from COVID-19 have been supportive. However, as this report details, there is rising geopolitical risk that could adversely affect Chinese equities. Emerging market index weighting is heavily skewed toward Chinese equities. This is both a positive and negative for Chinese stocks. Recent dollar weakness will likely lead to increased foreign exposure, with many investors using index products to achieve this allocation. Indexing would be favorable to Chinese

equities. Chinese equities could find themselves between support for increasing foreign allocations and the negative fears of escalating geopolitical tensions. Given these crosscurrents, a neutral position is warranted but careful monitoring is required.

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Companies with supply chain exposure are also at risk. On the other hand, we could see stockpiling of commodities as China worries about the security of supply, which would be bullish for those prices. In times of stress, precious metals will also tend to do well.

*This report was prepared by Bill O’Grady 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.*

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