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FIRST ANALYSIS
Institute Alert

News or events that may affect your investments | February 7, 2023

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One balloon down, and a bi-polar world is closer

Key takeaways

- On February 4, President Joseph Biden ordered an Air Force F-22 Raptor to shoot down a Chinese balloon that had cruised across the U.S. at 60,000 feet.
- Increasingly, the U.S. and China are disinclined to interpret each other's actions as accidental, but in our view, conflict may not be inevitable, as the two countries compete diplomatically and even make progress in long-standing disagreements.

What it may mean for investors

- Flashpoints for conflict remain around potential catalysts, but our long-term view remains that mutual economic dependence can continue, with some selective investment opportunities.

On February 4, President Biden ordered an Air Force F-22 Raptor to shoot down a Chinese balloon that had cruised across the U.S. at 60,000 feet. The U.S. Department of Defense news release alleged that the balloon was spying and had traversed most of the continental U.S., and that the Air Force dropped the balloon into the Atlantic Ocean off the coast of South Carolina. The same communication also acknowledged that Chinese balloons had overflown U.S. airspace on at least three occasions prior to 2021.[1]

1. "F-22 Safely Shoots Down Chinese Spy Balloon Off South Carolina Coast", U.S. Department of Defense, Feb. 4, 2023.

Diplomatic reactions on both sides of the Pacific were swift. Beijing insisted that the balloon was a weather monitor that winds had pushed off course and strongly protested the balloon's destruction. U.S. Secretary of State Antony Blinken canceled his planned trip this week to Beijing. The U.S. may take additional steps, once the Navy and Coast Guard recover the wreckage, spread across a wide area in ocean roughly 50 feet deep.[2]

Escalation, yes, but there's more at work

As the U.S.-China competition deepens, events are generating more response than in the past, but the two sides still appear to calibrate their responses carefully. For example, after the U.S. downed the balloon, Beijing warned of "serious repercussions" and said it would use necessary means to deal with "similar situations," but did not elaborate.[3]

Looking ahead to other potential catalysts, it is worth watching whether this event and the responses make it more likely that House Speaker Kevin McCarthy visits Taipei in the spring, reprising Speaker Nancy Pelosi's August 2022 trip. To demonstrate dissatisfaction about her visit, Beijing deployed warships and planes for exercises around Taiwan.

We believe additional technology restrictions are likely. In December 2022, the Biden administration tightened its containment of technology transfer to China, banning commercial exports of advanced U.S. technology. The move followed an October 2022 ban on the sale of advanced semiconductor chips to China for use in artificial intelligence and supercomputers.[4]

Each side is increasingly disinclined to interpret the actions of the other as accidental, but there is much more going on than just the exchange of threats. To take a broader view, both are competing diplomatically, especially throughout the western Pacific Ocean. The U.S. brought the U.K. and Australia into a trilateral security pact in 2021, and, more recently, China eased restrictions on Australian and South Korean exports, signaling that Beijing wants to improve economic relations with these two neighbors, despite their increased military cooperation with the U.S.[5]

There is even progress on long-standing legal issues. In December, the U.S. accounting watchdog said it finally has full access to the financial records for inspection and investigation of Chinese firms seeking to list their equities in the U.S. The breakthrough ended the risk that approximately 200 Chinese companies would be prohibited from listing their shares on U.S. exchanges.[6]

We take a longer view of the investment implications

Our view is that China and the U.S. have a symbiotic relationship, which events are fraying more rapidly but have not broken. The U.S. still depends heavily on China for goods, and China needs the revenue to prop up a heavily indebted economy that is no longer as efficient as it was 30 years ago.[7] We can see this in the diplomacy, as well. Before the balloon incident, both sides were taking diplomatic steps to work past recent disagreements. Flashpoints for conflict remain and are fraying that symbiosis faster today, but both countries appear to be taking a

2. Ibid.
3. David Shepardson, "US imposes security zone in search for Chinese balloon", Reuters, Feb. 6, 2023.
4. Ellen Nakashima et al., "US widens ban on military and surveillance tech sales to China", *Washington Post*, December 15, 2022.
5. "China Cracks Open the Door to Improved Ties With Australia and South Korea", RANE-Stratfor, Jan. 24, 2023.
6. Chris Prentice, et al. "Chinese firms avert delisting as U.S. audit watchdog gets full inspection access", Reuters, 15 Dec 22.
7. One way of gauging China's loss of efficiency is to note the amount of capital expenditure it takes to produce one dollar of output. Through 2014, investment in roads, bridges, factories, and other productive investments drove China's economy to double-digit growth rates. But domestic investment is no longer so productive, and foreign investment is slipping. For much more detail, please see: Carsten Holz, "China's Investment Rate: Implications and Prospects", CESifo Working Paper 6496, Oct. 31, 2016.

long-term view. We believe their mutual economic dependence can continue, and we favor taking a long-term view toward investment opportunities.

Our September 2021 report "The Future of Globalization" lays out specific investment preferences for the coming decade in a bi-polar world economy that operates around this strategic competition. We expect that Europe and Latin America will align as production and distribution centers with the U.S., and Southeast Asia similarly with China. Africa and India remain the main uncommitted players.

We continue to expect the following opportunities for long-term investors:

Diversify via fixed income and commodities: For now, we foresee continued restraint between the U.S. and China, but the latest incident shows that tensions can rise quickly and unpredictably. We continue to favor investment-grade fixed income positions for ballast against equity market volatility. In addition, we favor a modest, long-term exposure in a diversified commodity position. This may include gold, which historically has tended to hold up and even gain when geopolitical tensions rise.

Asia still needs Western investment in services: Low crop yields, and weak health care, pollution control, and banking and finance are ripe for infusions of Western multinationals. Investment directly in China is becoming more difficult and the risks less transparent, but selective investment in Southeast Asia may be the way to access the broad need for these services in Asia.

The U.S. is likely to keep its lead in developing advanced technologies: In terms of regional markets over the coming decade, we favor U.S. Large-Cap Equities. One way for investors — especially those with more conservative investment goals — to take international exposure is through U.S. multinationals that compete against local firms in the Information Technology and Consumer Discretionary equity sectors, as well as in Health Care.

Risks Considerations

Diversification does not guarantee investment returns or eliminate risk of loss.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

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