Navigating the US-China standoff

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Overview

The US-China economic standoff has escalated with unprecedented tariffs, transforming into a contest of political will, industrial strategy, and global influence. The US trade deficit gives it coercive power, but tariffs may harm its own manufacturers. Meanwhile, China leverages its dominance in critical minerals, controlling 90% of refining capacity for rare earth elements. With reduced reliance on US exports and conservative fiscal policies, China is better positioned to endure prolonged economic pressures. The US faces political challenges with the upcoming elections, while maintaining geopolitical influence. All factors considered, the escalation dominance may be more equal between the US and China than thought. This conflict is about great power rivalries and industrial models. The future is likely to hold an uneasy coexistence. For investors, this may usher in new opportunities and risks.

Trade, power, and precipice: Navigating the US-China economic standoff

As the United States and China ratchet tariffs to levels unseen since the Smoot-Hawley era – 145% on Chinese goods, 125% on American exports – the two superpowers are plunging into a new phase of economic confrontation. Yet, this is no longer just a trade dispute. It is an all-encompassing contest of political will, industrial strategy, and global influence.

This latest surge in tensions is a culmination of long-building pressures since the 2018 invocation of Section 301 of the US Trade Act. The Trump administration at the time looked to counter what it called China's "unfair trade practices", including forced technology transfers, subsidies for state-owned enterprises, and constraints on market access. These complaints, while not without merit, mask a deeper issue from the Chinese perspective: the erosion of American hegemony by China's rise and accordingly, a shift in US strategy from engagement to active suppression.

Who holds the escalation dominance?

Escalation dominance is a concept from strategic theory that refers to a party's ability to escalate a conflict in ways that impose greater costs on the opponent than on itself, thereby deterring the opponent from continuing or intensifying the conflict.

On the surface, the US commands dominance in trade given its large deficit with China and hence, tariffs wield significant coercive power. However, the administration's rationale for imposing wide-ranging tariffs on over 100 countries is rooted in a 17th-century mercantilist framework that sees trade surpluses as profits and deficits as losses; this is fundamentally flawed in a globally integrated economy.

According to Alpine Macro Research, two-thirds of total imports of American manufacturers are intermediate goods. Tariffs, in this context, could be more self-harming than protective to the Americans.

For China, escalation dominance comes not from tariffs alone but from its command of critical minerals. China controls upwards of 90% of the world's refining capacity for rare earth elements. These materials are crucial for electric vehicles, semiconductors, and defense systems. The critical mineral industry is sometimes described as a USD 5bn industry feeding into products worth USD 8trn. With control over every stage of the supply chain and consolidation of the industry into six major state-owned enterprise groups since 2016, China's end-to-end dominance is not easy for other countries to replicate.

China is also less vulnerable to economic pressures today. Exports to the US now account for just 14% of China's total exports, down from 20% in 2016. As a share of China's GDP, those exports have fallen below 3%. Moreover, the economy has undergone several years of painful adjustment from the real estate bust as well as excesses in the financial system. The Chinese government has also been conservative on large-scale fiscal stimulus in past years; this puts them in a stronger position to mitigate the fallout from the disruptive decoupling.

While it is understandable that the US trade deficit is unsustainably high, the global outsourcing system allows US corporates to access lower cost and correspondingly, high profit margin. One example is Apple, where the company enjoys a remarkably high return on equity (ROE) of over 100%. The outsourcing of manufacturing allows the company to incur significantly less fixed-asset investments while keeping the most lucrative parts of the product value-chain: design and marketing.

Moreover, China is also Apple's second largest market by revenue. This likely explains the subsequent move by the US to exempt electronic products from tariffs. The singular focus on trade deficit also ignores the significant US services surpluses which include software service exports, movies, and financial services.

From an economic point of view, a current account deficit reflects a savings-investment imbalance most evident in the US government's USD 2trn fiscal deficit in 2024. Unwinding the trade deficit also requires the US to consume less, save more, pay higher prices, and lower corporate profits as well as asset prices. The sudden imposition of these tariffs raises questions about the US commitment to global trade and commerce, catalysing a sell-off in both US treasuries and the dollar. One of the factors that contributed to the unrivalled US reserve currency status is its current account deficit, allowing it the exorbitant privilege of a lower cost of financing and hence, stronger growth.

The influence of politics and geopolitics

A key factor in escalation dominance is resilience or the ability to endure the economic pain of a tit-for-tat escalation. In this regard, China will undoubtedly suffer the economic consequences; the US imported USD 438bn worth of goods from them in 2024, including a significant amount of machinery. However, China has a political system that could withstand the pressure of a protracted standoff. The US, on the other hand, faces a mid-term election in 2026. A consumer fallout, whether inflation or job loss, will have an impact on election outcomes, and could reverse the super-majority of the Republican Party.

Finally, the US retains considerable influence in the geopolitical sphere given its military and technological dominance. Against this backdrop, the US could set trade deals with other countries at the expense of China. This poses a difficult situation for many countries in Asia, given the size of the Chinese market and its geographic proximity and concomitant dependence on the security umbrella of the US.

Conclusion: A system in strain

All factors considered, the escalation dominance may be more equal between the US and China than thought. Given the symmetry of risk, the optimal outcome would be a negotiated settlement. There are promising signs that the April 2 tariffs could be negotiated to less catastrophic levels. In our view, markets could recover in the months ahead following a tariff-induced selloff, especially augmented by the market-friendly agenda of the US administration in areas of deregulation and tax cuts. The current sell-off in the US treasury market could also offer investors opportunities in the fixed income market.

Meanwhile, China is likely to pursue more aggressive policy stimulus to mitigate the fallout from the current stalemate. Given the low exposure of major listed Chinese firms to international sales, domestically driven Chinese stimulus could culminate in a more enduring market rally than export performance alone.

It is tempting to imagine this conflict ending with a deal or a handshake. Yet, it is more likely that the future holds uneasy coexistence. The US-China trade war is no longer about trade deficits or market access. It is about great power rivalries and whose industrial model will define the future. The West favours rules-based capitalism, while China champions state-led development. The clash is as much ideological as it is economic. The challenge for both nations — and for the rest of the world — is to build new institutions that can manage rivalry without ruin and to re-imagine a new development model ahead. For investors, this may usher in new sources of opportunities and risks.

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