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## Thucydides' Trap: US-China Relations in the wake of COVID-19

June 2020 | Robert R. Fragnito | Chief Operating Officer | Financial Advisor

As the United States emerges from lock-down measures, actions in recent weeks by the US and China on the geopolitical stage seem to be solidifying what many analysts are calling Cold War 2.0.

In October 2018, I analyzed this “cold war” narrative at the peak of the US-China trade war. I believed that resurrecting a cold war narrative was effectively [a tempting yet inappropriate assessment](#) of US-China relations. This assessment was based on a lack of fundamental elements that define a cold war, namely a lack of competing ideologies, proxies, and economic detachment.

In this regard, I concluded that we were witnessing a new frontier in international affairs. It seemed the future of this relationship would resemble a competition between dueling corporations rather than dueling super-powers. Although unfolding events and narratives continue to offer swaying credence to the Cold War 2.0 scenario, it is perhaps driving towards something far worse in the long run.

### The Thucydides' Trap and a Return to World War I

What we are witnessing in the international system is a power struggle between two states where the US is maintaining and reinforcing its global [hegemonic](#) power while China is trying to replace it. This refers to the Thucydides Trap, a theory put forward by American political scientist [Graham T. Allison](#) in his 2017 book, *Destined for War: Can America and China Escape the Thucydides's Trap?*

Allison basis his theory on an ancient Greek text about the [Peloponnesian War](#) (431-404 BC) written by [Thucydides](#). In his text, Thucydides wrote that war in the [Peloponnese](#) was inevitable because Sparta feared the growing power of Athens in the region. Allison's theory [states](#) that “when one great power threatens to displace another, war is almost always the result.” Although this theory has come under a great deal of criticism, it has not evaded the attention of Chinese scholars and was covered in the [Journal of Chinese Political Science](#) in 2019.

More recently, two former Trump Defense and State Department officials voiced similar concerns by comparing China to [Germany prior to World War I](#). Elbrige Colby and A. Wess Mitchell wrote in the Wall Street Journal, “Germany initially pursued a path of economic growth and expanded influence, only to embark on an arms race that created the conditions for World War I. The signs are ominous that China may choose a similar path today.” They went on to say, “history is replete with examples of rising powers that grew more aggressive after losing the ability to glide to dominance.”

Colby and Mitchell are correct, there are plenty of historical examples that offer some guidance on where US-China relations are headed. More specifically, the pre-World War I comparison offers a great deal of insight considering where China's broader global strategy is headed after the coronavirus pandemic.

### The 2020 National People's Congress

The National People's Congress (NPC), China's national legislative body, recently met for its annual meeting to deliberate key issues facing the nation. The outcome of NPC helped us determine what types

of major policy decisions Beijing will make over the course of the next year and will likely test the validity of several arguments being made by scholars and analysts.

The meeting wrapped up with some significant policy measures in our view. Chinese Premier Li Keqiang stated in his May 28 concluding address that China will continue to [keep its door open to the world](#), but highlighted declining international cooperation caused by the pandemic is a dangerous trend.

The week prior Li addressed Taiwan, drawing concern from officials in Taipei over the lack of using the word [“peaceful”](#) to describe Beijing’s plans to reunify with the island. For the last four decades China has called for peaceful reunification, but recent comments by Li seemed to briefly break tradition. Note that following the NPC, the head of China’s Taiwan Affairs Office reasserted that the best way forward for both parties is to achieve “one country, two systems” through [“peaceful reunification.”](#)

With the advent of the overwhelming reelection of Taiwan’s President Tsai Ing-wen, a staunch opponent of reunification, it is unlikely in our view that China will seek a diplomatic solution to reunification and will not reverse its 2016 decision to [cut off official communications](#) with Taipei.

Following Tsai’s election in January 2020, China flew military jets close to Taiwan’s airspace signaling Beijing’s discontent with her victory. Most recently, General Li Zuocheng, the chief of the Joint Staff Department and member of the Central Military Commission said on May 29 that if “peaceful reunification” is not possible, [the military will use all means](#) to join Taiwan to the mainland. Such statements by China’s military brass should be taken seriously considering Beijing passed a law in 2005 authorizing the use of force if it deems an evident secession by Taiwan.

Military spending was another key policy that emerged during the NPC. China’s Finance Ministry announced it [decreased military spending](#) from 7.5% (2019) to 6.6% for 2020. Although Premier Li said on May 22 that his government will continue to strengthen China’s military, the recent budget decrease highlights potential inconsistencies with his government’s overarching military policy.

Analysts believe the minor spending decrease will not impact the People’s Liberation Army (PLA) greatly, but if this trend persists, the PLA’s capabilities will be affected in the long-term. Finally, analysts also view the drop as a positive signal while US-China relations remain tense signaling a potential reprieve from creating an arms race.

### **The Hong Kong Security Law and the US Response**

The most important measure following the NPC was the passing of the [Hong Kong security law](#) which aims to prevent and punish any activity in Hong Kong related to national security threats, secession, subversion, foreign interference and terrorism. The measure has sparked tremendous backlash in Hong Kong with renewed [protests](#) and international criticism by [western powers](#).

By our assessment, Hong Kong’s fate was essentially sealed long before the passing of the security law. We came to this conclusion in September of 2019 after attending a [conference](#) held by the Hong Kong Trade Development Council in Los Angeles, California. It became clear midway through the conference that the purpose of this event was to showcase more of China and less of Hong Kong.

We walked away knowing that the city’s best days were well behind it and that the Chinese Communist Party would diminish Hong Kong’s position only to reconstitute it as another Chinese city serving the economic interests of the mainland. Finally, we concluded with no doubt that China’s long-term ambition is to replace the US on the international stage.

The Trump administration responded on May 29 to China's security measure by beginning the process of [revoking](#) Hong Kong's special trade status. Speaking from the Rose Garden, Trump said he is prepared to require Chinese companies to abide, by mandate, to US audit and accounting standards. Trump also said he will [revoke](#) or suspend visas for Chinese graduate students who are suspected of attempting to acquire trade knowledge for military purposes.

Prior to the announcement, the White House issued a [report](#) on May 20 laying out the future of US policy toward China by rejecting the long held theory that China will act in accordance with global norms and [acknowledges](#) competition between the two nations.

### **What does this mean for investors?**

US-China relations are headed for lower lows while tensions are reaching new highs. So far, Wall Street is effectively unphased by Trump's speech or China's actions. The S&P 500 for the week of [May 25](#) finished up at 0.5% and the iShares MSCI China ETF rose by 3%. Despite several concerning developments such as Trump's speech, the threat of delisting Chinese companies from US exchanges, Huawei drama, China listing American companies on their unreliable entities list, and the Hong Kong security law—investors are not fleeing the market.

The longevity of the US Phase 1 trade deal with China also remains in question for investors, but we feel the implementation of this deal is still to China's benefit and will continue. During the NPC, Premier Li Keqiang said China vows to work towards liberalization of global trade and investment. Li also said that [his government will continue to work with the US](#) on the phase one deal, but we are doubtful that a Phase 2 trade deal will take place in the future.

Wall Street in our view sees the decoupling of both economies as reality and that this will have a net-positive impact on the US economy. It may take some time to achieve this goal, but it is increasingly apparent that corporations are looking to [diversify their supply chains](#) away from China into other markets. This is being taken seriously by Beijing and is prompting the government to look inward to develop its [western provinces](#) to thwart the risk of geopolitical isolation.

For investors' concerns over the US Presidential Elections, we view China as a wrapped domestic and foreign policy issue for major consideration by American voters. Relative to China, voters will also consider the economic fallout of the coronavirus pandemic and will assess which candidate is best suited to rebuild the US economy while keeping China contained. This issue has become so important that we feel that it will be one of three issues that will determine the election's outcome for both the White House and Congress.

### **Where do we go from here?**

The idea of a [40-year cold war](#) between the US and China may not serve the long-term strategic interests of both nations. If we follow the logic of China expert and Trump adviser [Michael Pillsbury](#), China is seriously attempting to replace the US as the world's dominant power, yet China's resolve in this matter may not warrant a patient approach to achieving this goal.

In *The Hundred Year Marathon*, Pillsbury writes that China is prepared to use a "warning strike" to deliver a psychological shock against its enemies in a broader military confrontation. He states that this strategy is used to China's advantage and has been used in previous engagements along its borders with neighboring states. Pillsbury believes that a confrontation with China will emerge because of a calculated misunderstanding. This may be used by Chinese officials to test how its military will fare against the US in

a live confrontation to create new strategies for future engagements or to avoid such confrontations all together.

Increasing tensions in the South China Sea and Taiwan are likely candidates for a “warning strike.” As the [US](#) and its [allies](#) continue to conduct military operations to ensure the freedom of movement in the region, China is countering by beefing up operations. China recently [deployed two new aircraft carriers](#) for an eleven-week conflict simulation in both the Yellow and South China Seas.

Taiwan is also raising eyebrows in Beijing as President Tsai is set to purchase more [arms from the US](#) and offering “[necessary assistance](#)” to Hong Kong citizens seeking to leave the city. In the weeks to come, we will be watching developments in the South China Sea and Taiwan to assess if a broader military conflict is evolving. We must also note that tensions along the [India-China border](#) are worth monitoring.

If we take into consideration the Thucydides’ Trap and the Pre-World War I theory, it seems that an armed conflict with China could be on the horizon within the next five to ten years. Despite this dismal forecast, we cannot get ahead of ourselves either. We must remember that China is not as strong as the US both [economically](#) or [militarily](#), making this is a major counterpoint to this argument.

As the fallout of the COVID-19 pandemic weighs on both economies, Beijing must recalculate if it believes it can displace the US or if a cold war is feasible. By our understanding, the US is poised and frankly better suited to respond to any moves that China will make in future months or years to come. The US has made itself clear that it will no longer tolerate China’s behavior and it will not relinquish its global hegemonic position.

Unlike the last Cold War, international institutions are less likely to play a major role as it appears both the US and China are disregarding their relevance. This was evident with the Trump Administration’s withdrawal from the [World Health Organization](#) and China’s refusal to face the [UN Security Council](#) over the Hong Kong security law. In today’s terms, we may be witnessing direct diplomacy absent of international institutions in the wake of the COVID-19 pandemic as [western powers](#) question China’s domestic and international [management](#) of the crisis.

If this is Cold War 2.0, then we must answer three questions: What are the competing ideologies? Who are the proxies? And is economic detachment a reality?

Recalling the [Peloponnesian War](#), we note that the war lasted over twenty-five years with multiple phases and intermittent peace. Athens was defeated by Sparta and the Golden Age of Ancient Greece came to an end. Like this ancient conflict, tensions between China and the US also constitute a multi-phase conflict that started as a trade war and is rapidly evolving into—for lack of a better phrase—a short-term cold war.

The third phase depends on what China will do next.

***If you enjoyed this article and have any questions please contact us directly at 949.472.4579, and feel free to forward this article and our contact information to anyone who might be interested.***

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