OPINION

The New Cold War

A new conflict has begun between the United States and China that will shape the coming decades. No country will be unaffected, and Europe some day may have to pick sides. Risk premiums for financial assets will rise. **By Felix W. Zulauf**

The first meeting between representatives of the new U.S. Administration and China in Anchorage was spiteful and accusatory from both sides. While Donald Trump in the past years had been primarily concerned with economic issues, Joe Biden's envoys also attacked the People's Republic on human rights grounds.

Beijing does not put up with this kind of interference in internal affairs. Instead of an easing of tensions, a new cold war is brewing between the two great powers.

More dangerous than the Cold War of the 20th century

The Cold War of the 20th century, between the Soviet Union and the United States, was about ideology. On one side was the West, united behind the leading power, the United States, whose values were based on market economy and freedom; on the other side was the East, led by Moscow based on planned economy and oppression. It was capitalism versus communism.

The Soviet Union was never a serious challenger economically, however, only militarily. It was a bipolar world, with practically no points of economic contact between the two superpowers. Therefore, the world economy outside the communist bloc was only threatened if there had been a military escalation.

The new conflict between the U.S. and China is more problematic and dangerous in comparison. In today's multipolar world, China is closely intertwined economically with the U.S. and the rest of the world. Companies from every continent have production and sales points in China and America. As a result, the new cold war is injecting latent insecurity into diverse economies around the world.

Risk of military conflict

Economic logic should prevent a confrontation, but in the ideological and geostrategic struggle between Washington and Beijing, it is not logic but power, self-determination and pride that will dominate.

Today's situation corresponds to what the Greek historian Thucydides described some 2,500 years ago using the example of Sparta against Athens: The conflict between an established hegemonic power and a rising challenger. In the last 500 years, this situation has occurred 16 times in world history – and twelve of them ended in war. If you add proxy wars like Vietnam or Korea, there have been even more.

The risk of military conflict must therefore be considered high in view of historical experience. However, this is completely underestimated by today's politicians, business leaders and the broad society. Our Western society sees the big problems of today in issues such as inequality, gender and race, climate and political correctness.

This glorified view neglects the harsh realities of the world. This could backfire. In Europe, we are as unprepared for a new cold war as we were for a pandemic. Yet this conflict is already in full swing, with protectionist and sanctioning steps decided by both sides.

Far-sighted leadership in Beijing

Measured by gross domestic product, the United States is still the world's largest economy. But if Hong Kong and Taiwan are added to the People's Republic, China is already number one and the largest market for many consumer goods, from automobiles to cell phones.

The rapid rise of China is breathtaking to anyone who has visited the country regularly over the years. No other country has such a good and modern infrastructure. Of course, China has its problems: Its rapid rise, to a large extent financed with debt, has led to a poorly capitalized banking system and over-indebted companies. However, the leadership in Beijing, which in my view is much more far-sighted and in touch with reality than Western politics, is aware of this and is working on it.

President Xi Jinping told his own people and the world a few years ago that China aims to be the largest economic power in a few years. He also said that the Middle Kingdom will assert its influence in geopolitics. This was a wake-up call for the current hegemon, the USA. In fact, China is arming itself militarily in order to close the gap with the U.S. It is not quite there yet, but the goal is clear.

Wrong assessment in Washington

For too long, the U.S. has rested on its throne as the sole superpower. After the collapse of the Soviet Union, America was no longer disciplined by any other power; accordingly, their mistakes piled up.

Bill Clinton ensured that China was admitted to the World Trade Organization (WTO), which spurred the economic rise of the People's Republic. He and his successors, George W. Bush and Barack Obama, subsequently committed the folly of letting China's misconduct – theft of intellectual property, patent infringements, lack of reciprocity, to name a few – happen and not sanctioning it. Unfortunately, the WTO also looked the other way.

Everyone believed that as China rose economically, it would liberalize and conform to the rules-based democratic Western model. However, the Chinese Communist Party saw and sees things differently. Its absolute claim to power sits at the top of the agenda; everything is subordinated to it.

Washington has slept through this development for too long. China is about to overtake America in terms of the number of new patents. The country has created an outstanding education system that churns out more than a million new engineers every year. In some technologies, such as artificial intelligence, China has not only closed the gap, but is slightly ahead of the West.

Biden embarks on a planned economy approach

Under President Biden, the U.S. continues to live beyond its means. In the early 1980s, America went from being the world's largest net creditor to the largest net debtor; for decades, it has run chronically high budget and current account deficits.

China is not to blame for this, but rather failed domestic education, economic and social policies. This has not just been the case since Biden or Trump: It had started before Ronald Reagan, without any president ever seriously trying to improve it. Those who neglect their own education system for the general population in such a grave way should not be surprised when jobs migrate overseas.

After realizing that the massively expansive monetary policy by the Federal Reserve has brought too little for the real economy in recent years, the Biden Administration is now stimulating through fiscal policy. With a government program of around $4 trillion in infrastructure, alternative energies, digitization and education, Biden wants to create jobs, income and growth.

Instead of creating incentives for private individuals and companies, Biden is now fully embarking on a planned economy approach. Whether this will end well is questionable. Just forty years ago, the U.S. federal debt was $1 trillion; today it is nearly $30 trillion and rising rapidly.

Europe will have to show its colors

Joe Biden is trying to strengthen the NATO alliance and is courting allies in Asia to build a broad coalition against Beijing. China has a much harder time in this regard, as its rise has been too rapid for many and has fueled envy, even in Asia. But China's economic strength inevitably means that Asian nations will find themselves in the Middle Kingdom's orbit and will have to come to terms with it, whether they like it or not.

One day in the not-too-distant future, even Europe will have to show its colors in this new cold war. It owes its freedom to the United States, but today's generation has forgotten that and often looks across the Atlantic with disdain.

Europe is an economic heavyweight, but weak in new technologies and without a powerful military. The Old Continent cannot defend itself, nor can it protect its interests in the world. In terms of power politics, Europe is a dwarf and is therefore no longer respected in the world.

Europe will try to stay out of the conflict as long as it can. But is that possible? The U.S. and China are the biggest buyers of German, French or Italian exports, and Europe therefore is vulnerable. Europe is largely integrated into NATO, so Washington will insist on loyalty and alignment of interests should the conflict with China intensify. But China is one of the most important customers of the European export industry and will also state its demands.

The European Union will be in hot water. The boomerang of naive European pacifism of the last decades, even if historically justifiable, and of its economies one-sidedly trimmed for exports, will hit it hard.

From this point of view, it is advisable for Switzerland, with its oversized export industry, to remain neutral on all sides. An integration into the EU by means of a proposed framework agreement is therefore dangerous, because Switzerland would get into dependencies, which it could better avoid as a neutral small state. But even our politicians and captains of industry have not yet understood that the time of the serene, peaceful world is over.

Rising risk premiums for financial assets

The new cold war will inevitably have economic consequences, although we cannot accurately assess the outcome of the conflict today. It is likely that global supply chains will increasingly have to be built on the principle of security and robustness rather than maximum cost efficiency. A certain de-globalization will follow. It is also conceivable that in the course of the conflict, retaliatory measures will increasingly be used against individual companies on both sides.

We can only speculate about the consequences for investors. The view is foggy, and capital markets should never be judged in a monocausal way. But the conflict is likely to intensify over the course of this decade. The environment for companies is therefore becoming riskier on all continents because China and the USA are competing against each other almost everywhere.

This requires an increased risk premium, which consequently means lower asset valuations. Today, valuations do not include such a premium. We must also expect that the free flow of goods may be temporarily interrupted and that certain companies may face consumer boycotts in one country or another.

Investors have to expect more modest returns

If de-globalization were to accelerate, this would mean less international division of labor, less trade, lower efficiency and productivity, but higher prices. Consequently, prosperity would decline. This would also put pressure on capital markets because it would mean higher interest rates and lower returns than in the ideal world of the last decades.

There could also be occasional disruptions in financial markets as a result of political maneuvering. Capital controls, already in place in China, cannot be ruled out. Companies that are heavily export-oriented and multinational would be more vulnerable than those that have production and sales congruently in the same region.

We do not know whether the new cold war will some day escalate into a hot war. But it is virtually certain that defense spending will be increased again worldwide.

For the time being, we must assume that there will be disruptive maneuvers of all kinds at the economic level in the next few years, which may cause temporary uncertainty in equity markets. Therefore, the application of competent risk management and a certain opportunistic trading behavior is an advantage.

Prices of commodities can increase in conflict situations because their supply is often tightened and made more expensive by producers as well as by transport bottlenecks. In general, investors will probably have to expect more modest investment returns from bonds and equities over the course of this decade compared to the past ten years.

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Felix W. Zulauf, born 1950, has worked in the financial markets and asset management for more than 40 years. He started his investment career as a trader for a large Swiss Bank and received training in research and portfolio management thereafter with several leading investment banks in New York, Zurich and in Paris. Felix joined Union Bank of Switzerland (UBS), Zurich, in 1977 and held several positions over the years including managing global mutual funds, heading the institutional portfolio management unit and at the same time acting as the global strategist for the UBS Group. After two years with a medium-sized Financial Organization as a member of the executive board, he founded his wholly owned Zulauf Asset Management AG in 1990, allowing him to independently practice his own individual investment philosophy. He sold the majority of his firm several years ago and spun his remaining minority off, which is today primarily his own family office. He is a consultant to investment firms and family offices around the world and publishes regularly an investment report about his views on macro issues.