

CHIEF INVESTMENT OFFICE

# Investment Insights

## The Great Rivalry: A New U.S.-China Cold War?

August 2020

The opinions are those of the author(s) and subject to change.

Following on the releases of the Chief Investment Office (CIO) Insights “Great” series—The Great Separation, The Great Acceleration, The Great Convergence, The Great Clash and The Great Consolidation—comes The Great Rivalry. Here we examine the emerging great power competition between the United States and China, its origins and its implications for the U.S.-led international order. Once viewed as an opportunity for the U.S., the rise of China is now viewed as a strategic threat, recasting how both parties engage on trade, investment, technology and diplomacy. The 2020s began with the U.S. and China as global competitors across a range of fronts, both economic and geopolitical. And we expect this strategic rivalry between the world’s two largest economies to persist as we move further into the new decade.

**AUTHORED BY:**

**Ehiwario Efeyini**

Director and Senior Market Strategy Analyst

**Rodrigo Serrano**

Director and Investment Strategist

Data as of 8/3/2020 and subject to change.

### TRACING THE ORIGINS OF THE CONFLICT

Economic frictions between the U.S. and China have reached a boiling point in recent times, with each side introducing successive rounds of new tariffs on bilateral goods trade and imposing new restrictions on individual companies over the past two years. But the U.S.-China rivalry did not begin with the 2018-2019 trade war, it did not end with the Phase One agreement signed earlier this year and it could yet intensify in the wake of the COVID-19 crisis. The seeds of the current U.S.-China conflict have been sewn over many years (Exhibit 1). Since the start of China’s economic opening in the late 1970s and the end of the Cold War a decade later, the U.S. approach to the country has shifted under successive administrations. The fall of the Berlin Wall in 1989 not only brought an end to years of authoritarian leadership in the former Soviet Union, but also accompanied a period of political liberalization across parts of Latin America and north Asia. During the 1990s, the conventional wisdom in Washington was that China could follow if it was brought into the international system and linked to the rest of the global economy. This led by the end of that decade to a push for China to enter the World Trade Organization (WTO), which it would eventually join in 2001. WTO accession marked a critical point in China’s economic development and its relationship with the U.S. and the rest of the world. Over the years that followed, lower tariffs and reduced barriers to foreign investment helped to boost China’s manufacturing activity, trade and economic growth. As a share of the global total, Chinese manufacturing output more than doubled from 7.2% in 2000 to 15.2% in 2008, overtaking that of the U.S. in 2010 to become the highest in the world. Similarly, goods exports doubled from 3.9% of the global total in 2000 to 8.0% in 2006, with China surpassing Germany as the world’s leading exporter in 2009 according to both United Nations and World Trade Organization. This fast pace of economic progress in China led to the inaugural U.S.-China Strategic Dialogue in 2005, in which the U.S. would first call on a rising China to act as a “responsible stakeholder” within the international system. Over the course of the 2000s, China’s real gross domestic product (GDP) grew at a double-digit average annual rate, allowing it to overtake Japan in 2010 to become the world’s second largest economy.

### INVESTMENT PERSPECTIVE

The rivalry carries significant implications for U.S. investors given the size of the Chinese economy and the high degree of interdependence between the two markets. As we have seen over recent years, escalating tensions between the U.S. and China have the potential to increase market volatility and could pose headwinds for industries and companies with significant cross-border exposure. But as competition grows between the two powers in the wake of the coronavirus (COVID-19) pandemic, we ultimately expect market segments related to technology and the digital economy to benefit from secular demand and innovation drivers in both countries. These include biotechnology, electric vehicles, digital media and internet retail; hardware applications for semiconductors such as telecommunications equipment, consumer electronics, cloud servers and industrial robots; and defense-related areas including next-generation military equipment and cybersecurity.

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## Exhibit 1: Origins of the Growing U.S.-China Strategic Rivalry

### Key historical events in the U.S.-China strategic rivalry



\* Belt and Road Initiative (BRI) is an outward investment program for global infrastructure development adopted by the Chinese government in 2013.

\*\*Made in China (MIC) 2025 is a strategic initiative adopted by the Chinese government in 2015 to upgrade domestic manufacturing to higher value-added output.

Source: Chief Investment Office. Data as of June 2020.

Rapid GDP growth has enabled China to lift over 800 million people from poverty over the past four decades. But the past 10 years have seen China move away from growth alone as its main priority. Since the appointment of Xi Jinping as president in 2012, China's leadership has shifted the focus from the quantity of its economic output to the quality of its output, both at home and abroad. This shift has been most clearly formalized under two strategic projects: (1) the Belt and Road Initiative (BRI) of outward investment across Eurasia, Africa and the Middle East announced in 2013, and (2) the Made in China (MIC) 2025 program of state-led industrial policy in advanced technology announced in 2015. These projects reflect China's growing importance on the global stage. But they also lie at the heart of the current U.S.-China frictions. Alongside its economic rise and growing technological capacity, the more recent U.S. charge has been that China has neither adhered to international trade and investment rules nor made the political reforms that had been expected since the 1990s. Chinese firms have instead been advantaged relative to their global counterparts through low-cost financing by state banks, subsidies from the Chinese central government, and the forced transfer of intellectual property from joint ventures with foreign companies. At the same time, ideological differences persist on a range of questions from data security to online censorship, domestic surveillance and the status of Hong Kong. Tensions between the U.S. and China had therefore been simmering before the start of the recent trade war, reflected in a number of strategic U.S. actions including the pivot to Asia in 2011 and several blocked notices for Chinese acquisition of U.S. companies. This shift in attitude away from the optimism of the late 1990s culminated in the U.S. position taken on China in the latest National Security Strategy Report released under the current administration in 2017:

*"China...challenge[s] American power, influence, and interests, attempting to erode American security and prosperity... The United States will respond to the growing political, economic, and military competitions we face around the world... These competitions require the United States to rethink the policies of the past two decades—policies based on the assumption that engagement with rivals and their inclusion in international institutions and global commerce would turn them into benign actors and trustworthy partners. For the most part, this premise turned out to be false." (U.S. National Security Strategy Report, December 2017)*

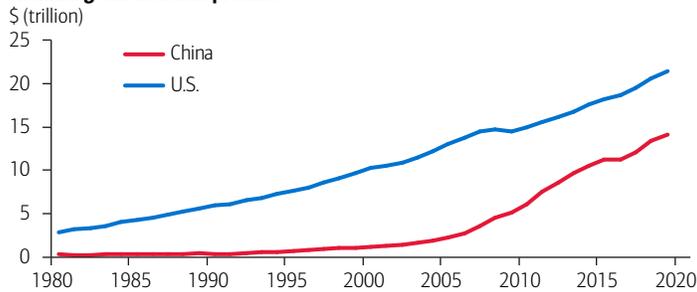
The report would be followed 10 months later by a major vice-presidential speech in Washington that echoed this tougher stance and has since been widely identified as a critical turning point in the U.S.-China relationship.

## THE EMERGENCE OF A GREAT POWER COMPETITOR

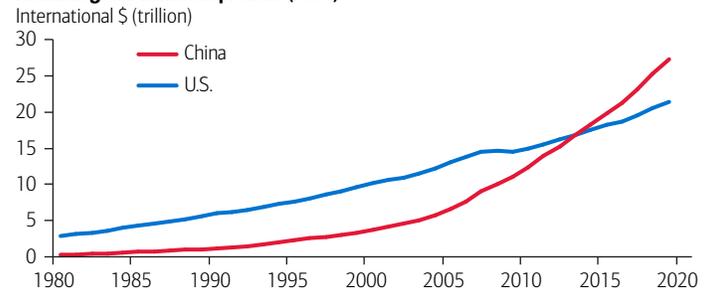
China has made significant economic gains in the 20 years between joining the WTO and the current coronavirus pandemic. It has not only become the world's largest manufacturer and exporter, but on purchasing power parity (PPP) terms it has already overtaken the U.S. as the world's largest economy according to both United Nations and World Trade Organization. PPP looks at national incomes based on local buying power instead of market exchange rates—Chinese incomes are adjusted upward for example if one U.S. dollar converted into Chinese yuan buys more in China than it does in the U.S. While PPP is a better measure of local living standards, nominal dollar income better captures international purchasing power for globally traded products such as commodities, financial assets and imported goods. This latter measure is therefore the more relevant for any cross-country comparison of global economic power. In nominal dollars, China's economy at \$14.1 trillion remained roughly 35% smaller than the \$21.4 trillion U.S. economy in 2019 coming into the current crisis (Exhibit 2). And by most projections, China should not overtake the U.S. in nominal dollar terms for several more years—by 2030 according to the World Bank. Even when it does become the world's largest economy, China would still be much poorer than the U.S. on a per capita basis (Chinese per capita GDP was less than one-sixth that of the U.S. in 2019). The average Chinese citizen may therefore still have far fewer resources with which to participate in the global economy than the average American.

### Exhibit 2: China's Economic Output is Rising, But Remains Behind the U.S. on Most Measures

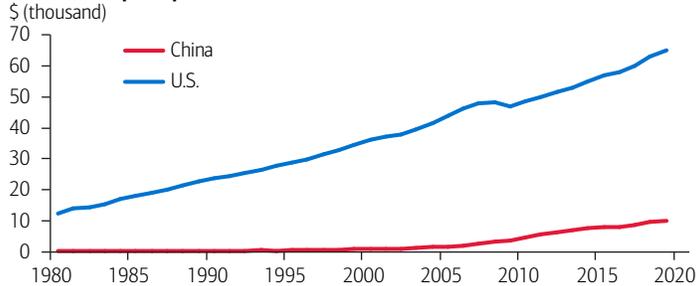
#### Nominal gross domestic product



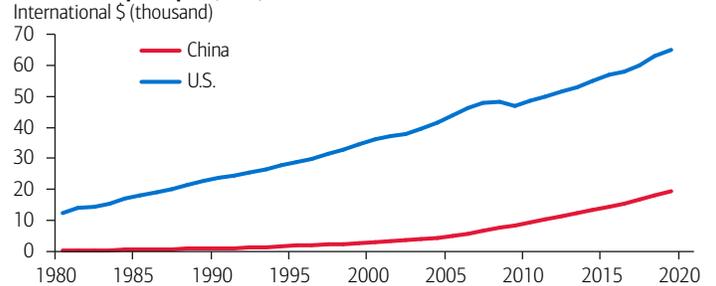
#### Nominal gross domestic product (PPP\*)



#### Nominal GDP per capita



#### Nominal GDP per capita (PPP\*)



Source: International Monetary Fund. Data as of 2019. \*PPP measures output in purchasing power parity terms instead of market exchange rate terms.

But beyond pure size, the current economic rivalry is more fundamentally driven by China's efforts to increase its domestic capacity in advanced technology. China has de-emphasized the MIC 2025 brand name as tensions with the U.S. have risen, but the objective behind the program of directing more state resources toward higher value-added industrial output remains central to the government's medium- to longer-term goal of turning China into a higher-income economy. The plan targets growth across a range of strategic emerging industries from information technology equipment to biopharmaceuticals, electric cars and alternative energy (Exhibit 3). Through state investment, public credit and government procurement, the aim is to help expand China's domestic share of production in these key sectors of the future.

### Exhibit 3: China's Strategic Emerging Industries

Strategic Emerging Industry	Target Growth Segments
Next-generation information technology	Semiconductors, cloud computing, telecom networks, Internet of Things, servers, displays
High-end equipment manufacturing	Aerospace, high-speed rail, urban metro systems, marine engineering, satellites
Biotechnology	Pharmaceuticals, medical equipment, genetically modified agriculture
New-energy vehicles	Electric, hybrid and energy-efficient vehicles, batteries
Energy efficiency and environmental conservation	Clean coal, waste recycling, desalination, low power-consumption electronics
New energy	Solar and wind energy, nuclear power, biomass
New materials	Advanced plastics, glass and ceramics, high-quality steel, nano-materials, carbon fiber

Source: U.S.-China Business Council. Data as of 2020.

As the most fundamental building block in information processing, domestic capacity in semiconductors is a central priority for China, and the government has targeted a 70% manufacturing share of local chip consumption by 2025. China today still lags well behind this target, however, making just over 15% of its domestic chip demand in 2019. Though China is increasing its semiconductor production capacity, particularly in memory chips, the U.S. remains by far the global leader in chip design accounting for 45% of total global value compared to just 5% for China (Exhibit 4). Support for the industry will help China to boost its domestic contribution to manufacturing output across a range of high-end products such as consumer electronics, telecommunications equipment, cloud servers, industrial robots and supercomputers as well as in defense and security systems that also use embedded processors. The production of the Apple iPhone (counted as a Chinese export by official customs trade figures) serves to illustrate the importance of local chip design in technology hardware output. According to IHS Markit teardown analysis, \$120 of the \$999 U.S. retail price for a 64 gigabyte iPhone X (one-third of the total bill of materials) comes from chipmakers in the U.S., Europe, Japan and Korea, while just \$30 to \$60 is estimated to come from final assembly by contract manufacturers in China. Similarly for Chinese information technology (IT) equipment makers, a larger domestic semiconductor industry would help to boost local production value. China's internet companies and hardware manufacturers are investing in the long-run development of their own processors, but at this stage China remains highly dependent on U.S. and other foreign chipmakers in its domestic technology sector.

China has made greater advances in electric vehicle (EV) production over the past decade, with its total stock of battery and plug-in hybrid electric cars surpassing that of the U.S. in 2017 to become the highest in the world. Last year, China claimed 46% (3.3 million) of the 7.2 million fleet of electric cars on the road worldwide, up from just 14% five years earlier and close to double the total in the second-placed European market. The Chinese government remains committed to raising EV deployment further, including a 25% target as a share of total car sales by 2025, compared to a recent peak of just under 5% in 2018. As well as being the largest global consumer of electric cars, China is already the world's largest EV manufacturer according to International Energy Agency. And explicit in the MIC 2025 program is the government's aim to further raise its share of global output with the dual aims of controlling air pollution and advancing its global leadership in new energy vehicle technology.

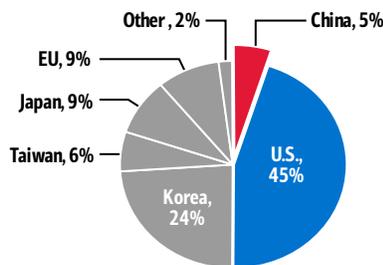
Life sciences and biopharmaceuticals are also being targeted as part of China's push for technological leadership. With the highest number of graduates gaining degrees in science, technology, engineering and mathematics and over 100 government-supported life science parks across the country, China has established a strong base for domestic research in biotechnology and currently commands a leading position in the global effort to develop a COVID-19 vaccine as cited by the World Health Organization.

Over recent years, China has also surpassed the U.S. on the number of biotechnology research papers published annually. A total of 10,166 were released in China last year compared with 7,337 in the U.S., and China is now making rapid advances in the latest biopharmaceutical techniques. It currently leads the U.S. on the total number of active clinical trials for next-generation CAR-T immunotherapy in cancer treatment and is also the only country known to have conducted human trials in gene editing according to the National Institutes of Health. Chinese researchers have faced fewer institutional constraints than their U.S. counterparts in testing new life science techniques, and this along with efforts to broaden the reach of Chinese biotechnology products internationally should support domestic growth in the sector over the coming years. The MIC 2025 strategy aims to have five to 10 new China-developed drug treatments approved by U.S. or European Union (EU) regulators by 2025.

#### Exhibit 4: U.S.-China Strategic Rivalry Driven By Technological Progress Across a Range of Domains

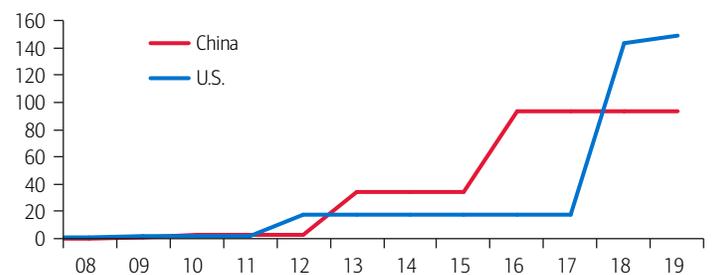
**Semiconductor design output**

Share of total global value



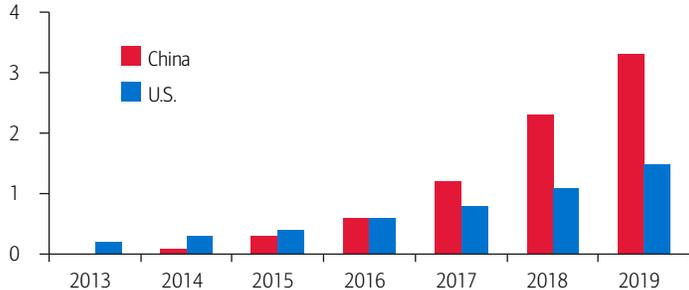
**Supercomputing maximum achieved performance**

Floating-point operations per second (quadrillions)



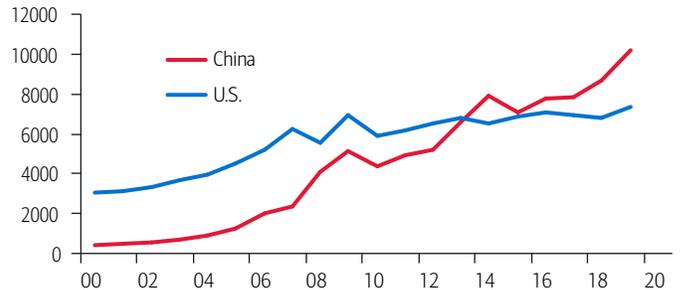
**Electric vehicle stock**

Total (millions)



**Biotechnology academic journals**

Number of research papers published

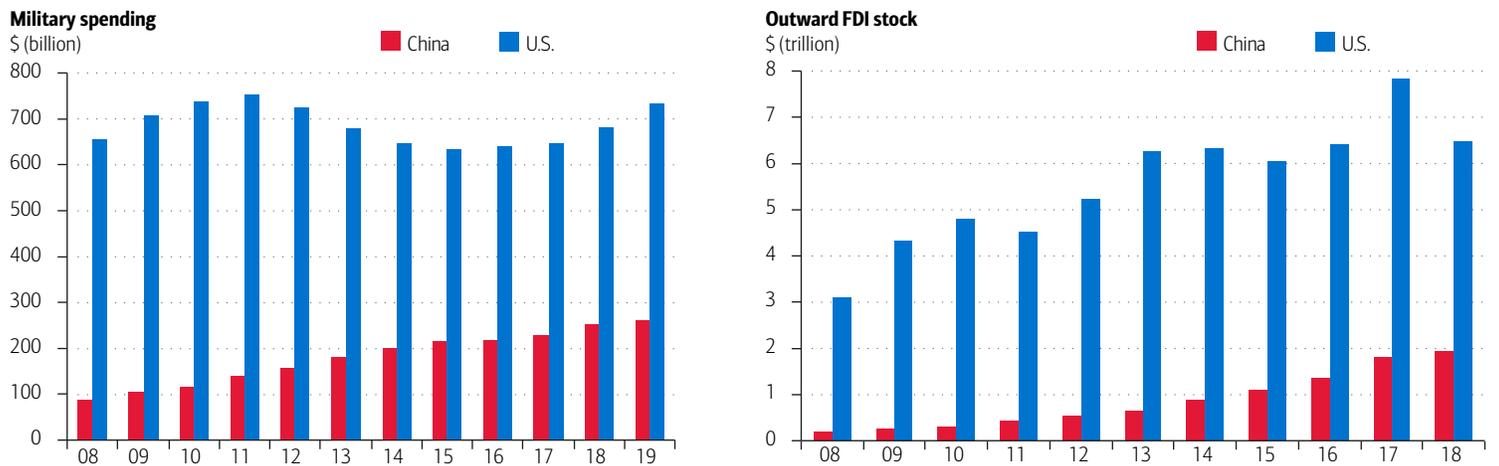


Sources: Semiconductor Industry Association; International Energy Agency; The TOP500 Project; Scopus database. Data as of 2019.

China's economic rivalry with the U.S. may be tied most closely to its improving technological capacity and its growing strength in advanced manufacturing. But China's interactions with third countries and its increasing level of power projection on the global stage will also be sources of geopolitical friction with the U.S. over the coming years.

Maritime territorial claims over U.S. allies in the South and East China Seas, a remilitarizing Japan, and the continuing U.S. troop presence on the Korean Peninsula are all potential points of geopolitical antagonism between the two largest global military spenders, and we would expect China to continue pursuit of its regional defense interests. China has boosted its military capacity across air, naval, ground, space and cyberspace through spending on a range of new capabilities. This includes expenditure on next-generation fighter aircraft and reconnaissance drones, submarines, aircraft carriers, hypersonic missiles, anti-satellite weapons and cyber capability. China has grown its defense budget every year over the past decade at a nominal average annual rate of 9.5%. And though the U.S. still outspends China by close to three-to-one (Exhibit 5), U.S. annual growth in military spending has been close to flat over the same period. We would expect to see greater competition across each of the key defense domains as the gap closes further.

## Exhibit 5: China's Defense and Outward Foreign Direct Investment (FDI) Spending Still Well Behind the U.S., But Rising Quickly



Sources: Stockholm International Peace Research Institute; United Nations Conference on Trade and Development. Data as of 2019.

Through its expanding outward FDI and international cooperation, China's soft power influence is also likely to grow in the years ahead. China's total outward FDI stock was \$1.9 trillion in 2018, close to one-third of the U.S. level and up more than tenfold from a decade earlier. China already has a major presence in civil infrastructure systems around the world, and over the coming years the BRI is expected to be a catalyst for even more outward investment and even greater international influence. The BRI is a dual strategy of investment in land-based transportation, power and telecommunications infrastructure, and maritime ports and terminals across Eurasia, Africa and the Middle East. The initiative is expected to deliver a range of economic benefits to China in the form of stronger markets for its exports, greater access to energy and mineral resources, and new loan markets for international expansion of the yuan currency. And alongside China's other investment and security frameworks such as the 17+1 (with 17 countries across Central and Eastern Europe) and the Shanghai Cooperation Organization (with seven countries across Central and South Asia), the BRI should also allow China's geopolitical influence relative to that of the U.S. to grow. It should nonetheless be emphasized that China still lags significantly behind the U.S. in the global role of its currency. Despite China's efforts to internationalize the yuan, the dollar still accounts for over 80% of foreign exchange market share in global trade finance and more than 60% of global allocated reserves, compared to around 2% on both measures for the yuan. And with the fundamental U.S. advantages of an open capital account, liquid capital markets and strong legal institutions, the gulf is unlikely to narrow in the foreseeable future. Crucially, this preserves a key U.S. asset in the capacity to use financial pressure as a foreign policy tool.

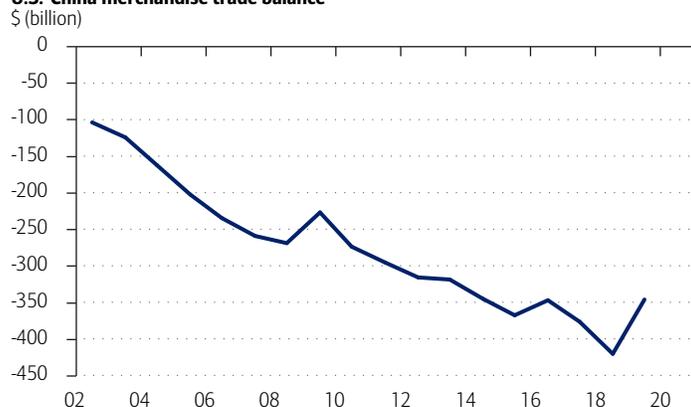
### WHERE ARE THE MAIN U.S.-CHINA FRICTIONS?

Given the wide range of domains in which the U.S. and China are now in strategic competition, the rivalry is often likened to a new cold war. A key difference however between the current tensions and the 20th century Cold War between the U.S. and the Soviet Union is that the two sides enter the conflict with high levels of interdependence on trade, investment and financial markets. This implies that economic linkages would be forced to unwind or "decouple" should frictions continue to increase. The bilateral U.S.-China trade imbalance for example has risen consistently over the past two decades, with growing U.S. dependence on manufacturing imports from China causing the deficit to multiply from \$103 billion in 2002 to \$346 billion in 2019. On the capital account side, China's holdings of U.S. Treasuries have ballooned from \$118 billion to \$1.1 trillion over the same period (Exhibit 6). U.S. companies also have a major presence in China, gaining close to \$550 billion in sales from their mainland operations in 2017.

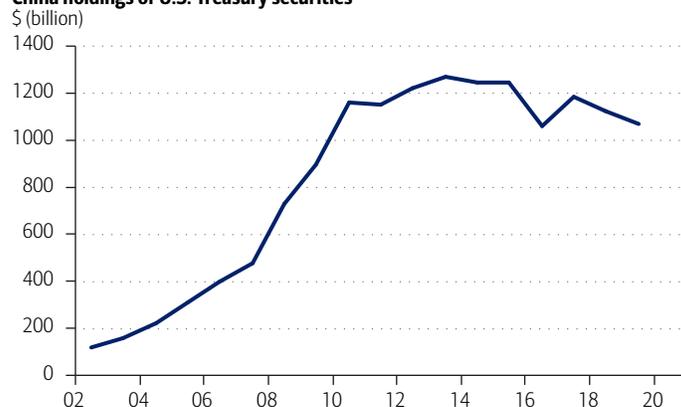
And according to the latest update from the U.S.-China Economic and Security Review Commission, a total of 156 Chinese companies were listed across the three largest U.S. stock exchanges in 2019.

## Exhibit 6: U.S. and China's Economies Remain Highly Interdependent

**U.S.-China merchandise trade balance**



**China holdings of U.S. Treasury securities**



Sources: U.S. Census Bureau; U.S. Treasury. Data as of 2019.

Over the past two years, tensions between the two countries have ostensibly been focused on trade. The escalating trade war of 2018-2019 resulted in new tariffs on the majority of bilateral trade in goods (Exhibit 7). And the subsequent Phase One deal agreed in late 2019 emphasized tariff de-escalation and a reduction in the trade imbalance through new Chinese purchases of U.S. agriculture, energy, manufactured goods and services totaling \$200 billion for 2020 and 2021.

## Exhibit 7: China-U.S. Tariff Escalation in 2018-2019

Announced (Implemented)	U.S. tariffs on China	China tariffs on U.S.
June 15, 2018 (July 6, 2018)	\$34bn (25%)	
June 16, 2018 (July 6, 2018)		\$34bn (25%)
August 7, 2018 (August 23, 2018)	\$16bn (25%)	
August 7, 2018 (August 23, 2018)		\$16bn (25%)
September 17, 2018 (September 24, 2018)	\$200bn (10%)	
September 18, 2018 (September 24, 2018)		\$60bn (5% to 10%)
May 5, 2019 (May 10, 2019)	\$200bn (increased to 25%)	
May 13, 2019 (June 1, 2019)		\$60bn (increased to 10% to 25%)
August 13, 2019 (September 1, 2019)	~\$125bn (10%)	
August 13, 2019 (December 15, 2019)**	~\$156bn (10%)	
August 23, 2019 (September 1, 2019, December 15, 2019)*		\$75bn (5% to 10%)
August 23, 2019 (October 15, 2019)	\$250bn (increased to 30%)	
August 23, 2019 (September 1, 2019)*	~\$125bn (increased to 15%)	
August 23, 2019 (December 15, 2019)**	~\$156bn (increased to 15%)	

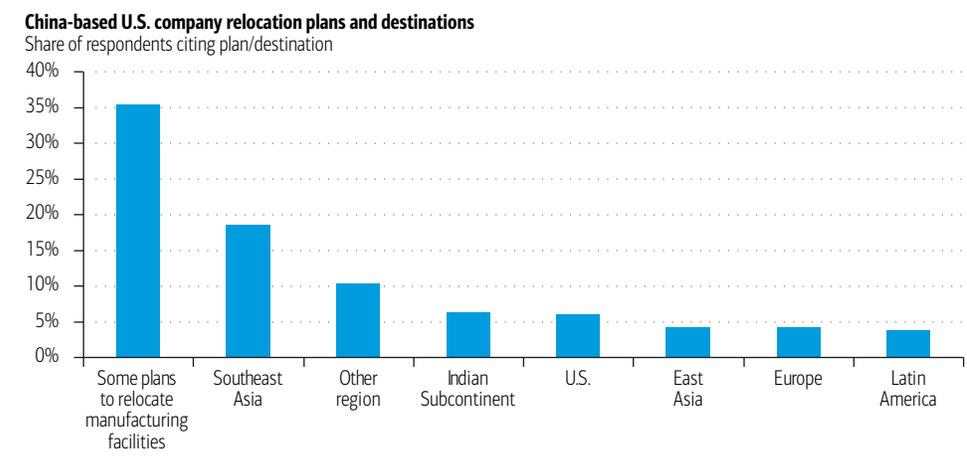
Source: Chief Investment Office. Data as of 2020. \*Reduced as part of Phase One agreement. \*\*Canceled as part of Phase One agreement.

However, the Phase One agreement made limited progress on new measures to address China's adherence to international trade and investment rules. No conclusion was reached on Chinese state subsidies. And while China pledged to strengthen its intellectual property protections and end the practice of forced technology transfer, these were largely agreements to deliver on past commitments and crucially were not attached to any independent means of enforcement. Disputes will instead be settled by further negotiation, which is likely to make them harder to resolve. More than trade

alone, it is these structural concerns over intellectual property, technological leadership and national security that will be central to the longer-term strategic rivalry between the U.S. and China and any risk of a decoupling.

The U.S. tariffs may nonetheless have accelerated this process. Rising labor and environmental costs had already made China less attractive as low-cost base for U.S. and global manufacturers over recent years. But the trade war led to a collapse in U.S. imports of manufactured goods from China in 2019. And over the coming years, further escalation could cause a more lasting shift in global manufacturing capacity away from the mainland in areas such as electronics, autos, chemicals and machinery. A 2018 survey of 432 member companies by the American Chamber of Commerce revealed that around 35% of manufacturers operating in China had plans to move their operations based on risks to future U.S.-China relations (Exhibit 8). The most commonly cited destination was Southeast Asia, with other allied markets such as India and Latin America also identified alongside some plans to re-shore. Any shift in supply chains would have to be implemented over time and at a high initial cost. And any proposed destination would in practice depend on a range of factors such as infrastructure quality, wage levels and proximity to end demand. But some degree of relocation seems likely in the period ahead, and the COVID-19 crisis may only strengthen the national security case for reduced supply chain concentration.

### Exhibit 8: U.S. Companies Considering Shift in Manufacturing Operations Away From China

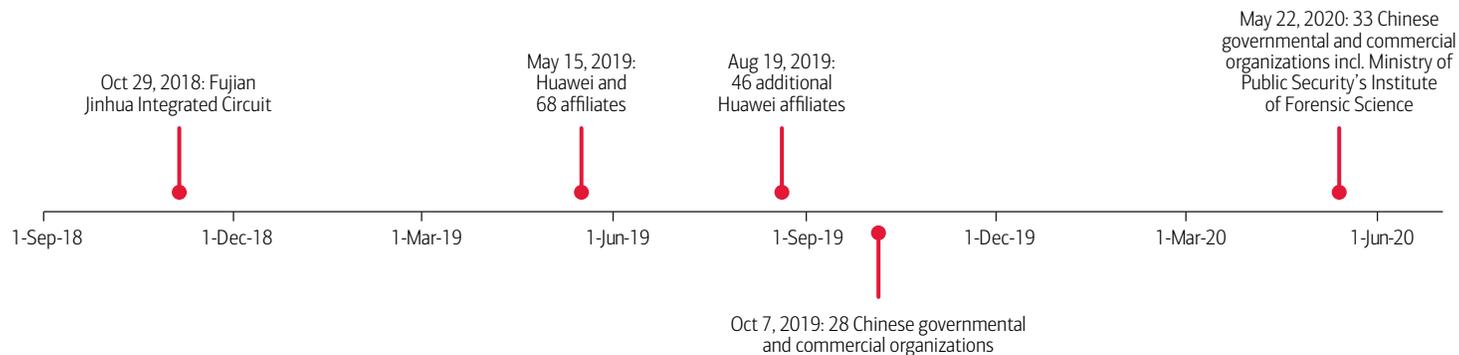


Sources: American Chamber of Commerce; Chief Investment Office. Adapted from American Chamber of Commerce. Data as of 2018.

Decoupling risk may also increase with the extension of limits on the use of U.S. technology in China and bans on the adoption of Chinese technologies in the U.S. China is still heavily dependent on the U.S. market for advanced chips in its domestic manufacturing of electronic devices and telecommunication networking equipment. But deteriorating relations have led the U.S. Commerce Department to include more Chinese companies and government institutions on its Entity List. This is a list of organizations and individuals around the world deemed by the Bureau of Industry and Security to pose a risk to U.S. national security. Exports to parties included on the list are restricted by tough licensing requirements that make it harder to supply them with sensitive technologies, products or components. Several Chinese commercial and government organizations were added to the Entity List as U.S.-China tensions escalated in 2018 and 2019, and more were added earlier this year (Exhibit 9).

## Exhibit 9: U.S. Extending Limits on Use of Domestic Technology in China

### Recent Chinese additions to U.S. entity list



Sources: U.S. Department of Commerce; Chief Investment Office. Data as of June 2020.

The most important addition has been Chinese telecommunications equipment leader Huawei, which has also had limits or bans placed on the use of its hardware in 5G telecom networks within the U.S. and other allied markets such as Australia, the U.K. and Japan due to concerns over data security. China has in turn created its own “unreliable entities” list of U.S. and other foreign firms that have restricted product supply for non-commercial reasons. These companies are made subject to local investigations and potential sanction by the Chinese government. Security-related frictions may only increase with China’s renewed focus on next-generation technology investment in the wake of the COVID-19 crisis. And to the extent that U.S.-China decoupling pressures rise, this would only increase the importance to China of moving up the manufacturing value chain and developing a greater level of technological self-sufficiency, particularly in semiconductors.

As competition between the U.S. and China continues to unfold along technological, economic and geopolitical lines, it will also be important to assess the main implications for third markets outside the direct bilateral relationship. Europe remains a close U.S. ally, but in an environment of widening differences between the EU and the U.S. across a range of areas including digital taxation, North Atlantic Treaty Organization (NATO) defense spending, climate change and Brexit, transatlantic ties risk coming under greater pressure. European leaders may be more willing to take a separate stand from the U.S. administration on information technology and telecommunications sector linkages with mainland China, especially if they fear losing trade access to the Chinese market. This leaves open the question of which way Europe would align should U.S.-China tensions intensify. Given its economic size, the EU could become a swing state in any growing global divide on technology standards as 5G infrastructure is built out around the world.

Similarly, the BRI has the potential to increase China’s relative geopolitical influence. The total number of BRI participant countries had risen to 138 by early 2020 and the program could potentially become a greater source of soft power for China across Asia, Europe, Africa and the Middle East as regional economies look to recover from the COVID-19 crisis. However, fallout from the pandemic in the form of travel restrictions, import bans and weak demand growth has led to stalled or canceled projects in a range of countries such as Indonesia, Pakistan, Egypt, Bangladesh and Tanzania. And this on top of ongoing concerns over the debt burdens imposed on recipients of BRI loans could yet increase the appeal of new competing U.S.-led initiatives. The Blue Dot Network of the U.S., Australia and Japan and the U.S. International Development Finance Corporation for example were both formed in 2019 as alternative providers of institutional support for global infrastructure development, and both could come to rival China’s BRI as we move further into the 2020s.

## IMPLICATIONS FOR INVESTORS

The U.S.-China trade war and the COVID-19 crisis have been destabilizing events for the Chinese and U.S. economies, as well as for the bilateral relationship. China has been one of the first countries to begin its recovery from the pandemic in 2020, and it will be equally keen to prevent a resurgence of the tariff escalation of 2018 and 2019. Preservation of social stability and the survival of the Communist Party remain the two core priorities for China's leadership and an extended period of economic weakness would undermine both. But for the same reason, China will also remain committed to its domestic and international agendas of strengthening technological capacity at home and gaining geopolitical influence beyond its borders. Strategic rivalry with the U.S. should therefore be expected to continue as both economies emerge from the current crisis.

More bilateral frictions of the type seen over the past two years clearly have the potential to increase market volatility as they did intermittently in 2018 and 2019. And on top of the decoupling risks in trade and technology, capital market links could also come under stress. New rules proposed earlier this year would make it more difficult for Chinese firms to access U.S. capital through tighter accounting and auditing rules for U.S. listings of Chinese companies, higher minimums for initial public offerings or outright restrictions on U.S. investor purchases of Chinese equities. This represents an extension of the U.S.-China conflict to financial markets and adds new political risk to Chinese stocks. The trade tensions of the past two years contributed to the equity market underperformance of China in the 2018-2019 period. And a new phase of the U.S.-China conflict targeting capital markets would have the potential to be even more disruptive were it to escalate. Both the U.S. and China could also be at risk from any new restrictions on trade and technology. Tighter controls on U.S. semiconductor sales to China could delay the rollout of 5G on the mainland while hurting profits for U.S. leaders in the chip industry. And potential retaliatory actions from China would risk lost access to the fast-growing Chinese market across a broader set of U.S. companies with China exposure.

We nonetheless see continuing longer-term strength within technology-driven sectors in both markets. The pandemic should accelerate the underlying global shift toward automation and digitization in traditional segments such as media and retail, and a prolonged period of competition for technological leadership between the world's two largest economies is likely to involve greater levels of government support for investment in research and innovation. China will need to increase its spending across strategic emerging industries as it aims to move toward greater self-sufficiency. And policy measures like the Endless Frontier Act<sup>1</sup> introduced in the U.S. earlier this year would also support domestic innovation. For investors, this should mean long-term growth opportunities across biotechnology and life sciences, electric vehicles and battery technology, in addition to hardware applications for semiconductors such as, telecommunications equipment, consumer electronics, cloud servers and industrial robots. The growing geopolitical rivalry should also boost defense sector spending on next-generation military hardware including hypersonic missiles and anti-satellite weapons as well as on enhanced cyber capability. Alongside ongoing growth in the global digital economy, this reinforces our view that, as the equity sectors most closely tied to these future trends, information technology, communication services, healthcare and consumer discretionary should retain their market leadership in the new decade.

<sup>1</sup> Endless Frontier Act is a bipartisan, bicameral bill introduced by the U.S. Congress in 2020 to boost public investment in next-generation technologies.

## Important Disclosures

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