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EPISODE 50

The US and China: Growing Farther Apart, Needing Each Other More

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Presidents Donald Trump and Xi Jinping talked last week amid heightened vulnerability for the global economy. The meeting of the world's giant unilateral actors overshadowed talks about major conflicts at the UN General Assembly. And it took place while bond yields globally rose to their highest levels since before the Global Financial Crisis.

Whether the two leaders can find a way to achieve their national objectives, help stem global conflicts or exacerbate them remains to be seen.

Call a Friend?

The criticality of the US/China relationship cannot be overstated, nor can the value of cooperation at this time.

On the US side, China's military support for Iran's military purposes must have been the elephant in the room during the leaders' private discussions (please see Wall Street Journal 09/24/2026). On China's side, the US blockade of Iran is cutting off 12% of China's crude oil imports. That's a material issue, as China imports more than 70% of its petroleum. Of course, China has done more than any large economy in diminishing its reliance on petroleum, with a vast increase in electrification (please watch Episode 31). Nonetheless, cheaper oil would be better for China even now.

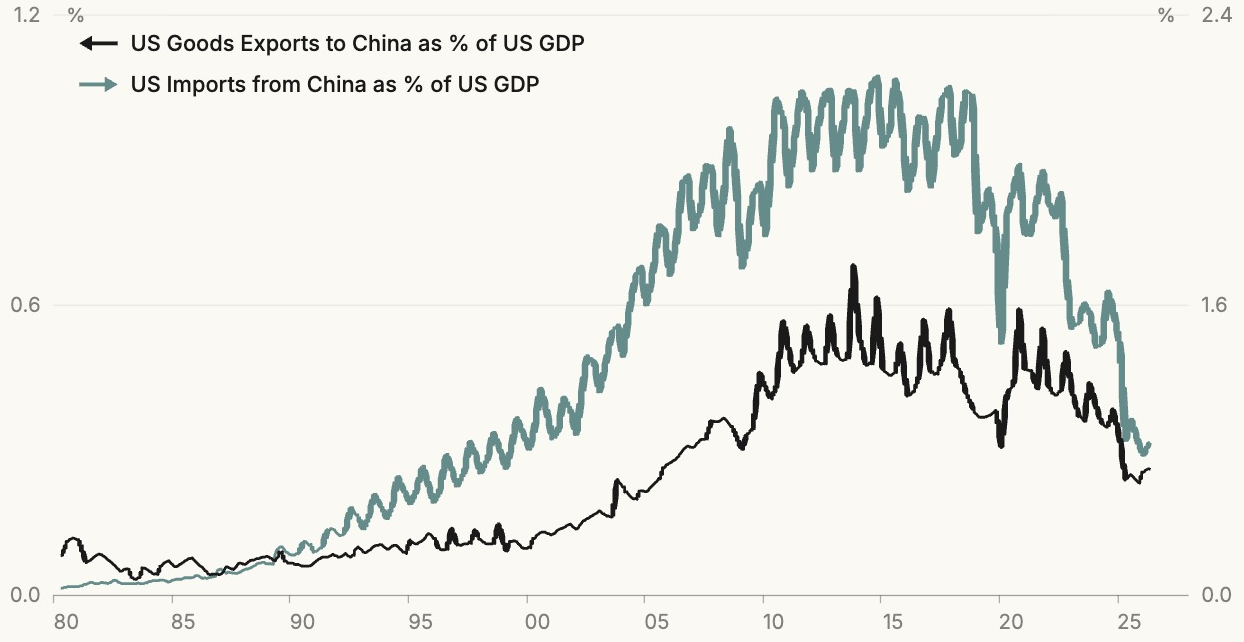
The Transmission of Harm

The harm from the Middle East conflict, Russia/Ukraine and any major tensions between China and the US is transmitted in many ways and is cumulative.

The loss of energy and agricultural inputs from the Middle East will hurt many of the US and China's trade partners, feeding back on them. China's goods exports are still a massive 4% of global GDP (2X the US's). With its property market in a long contraction, exports remain a key driver of China's economy, critical to social stability. This is even as China and the US are less reliant on trade with one another directly. Compared to peaks a decade ago, China's exports to the US have fallen 50%, the US's to China -40% (see figure 1).

FIGURE 1

US/China Bilateral Goods Exports as % of US GDP



SOURCE: CIO GROUP, HAVER ANALYTICS

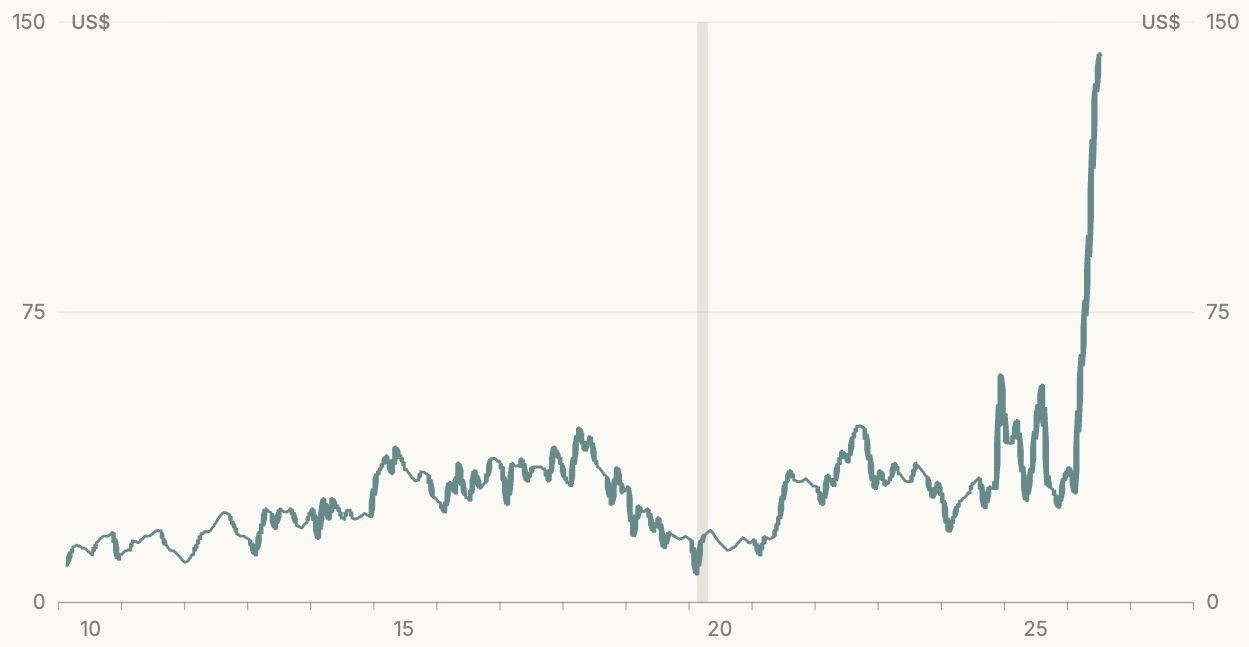
The US's vulnerability to China is more acute than the dollar value of its trade suggests. As the US builds out its tech hardware capacity and restocks defense arsenals, China's rare-earth exports to the US remain an essential input (see figure 2). Following agreements made in October 2025, the US's decision to extend a trade truce to "January 10" with China seems minimal recognition that it has its "hands full." The US can ill afford another supply shock amid its new commitments to the Middle East conflict and, closer to home, a focus on contentious trade negotiations with Canada.

Taiwan and the Exports Critical for AI

Most critically, the build out of AI capacity is dependent on the continuity of semiconductor supplies from Taiwan (see figure 3). The mere mention of Taiwan supply chains by Japan's Prime Minister as a security issue left Japan/China diplomatic relations in tatters. China retaliated with reduced food imports from Japan, curtailed tourism between the countries and menaced Japan's security through incursions at its maritime borders.

FIGURE 2

China's Monthly Exports of Advanced Materials (Rare Earths) to US $Mlns



SOURCE: CIO GROUP, HAVER ANALYTICS

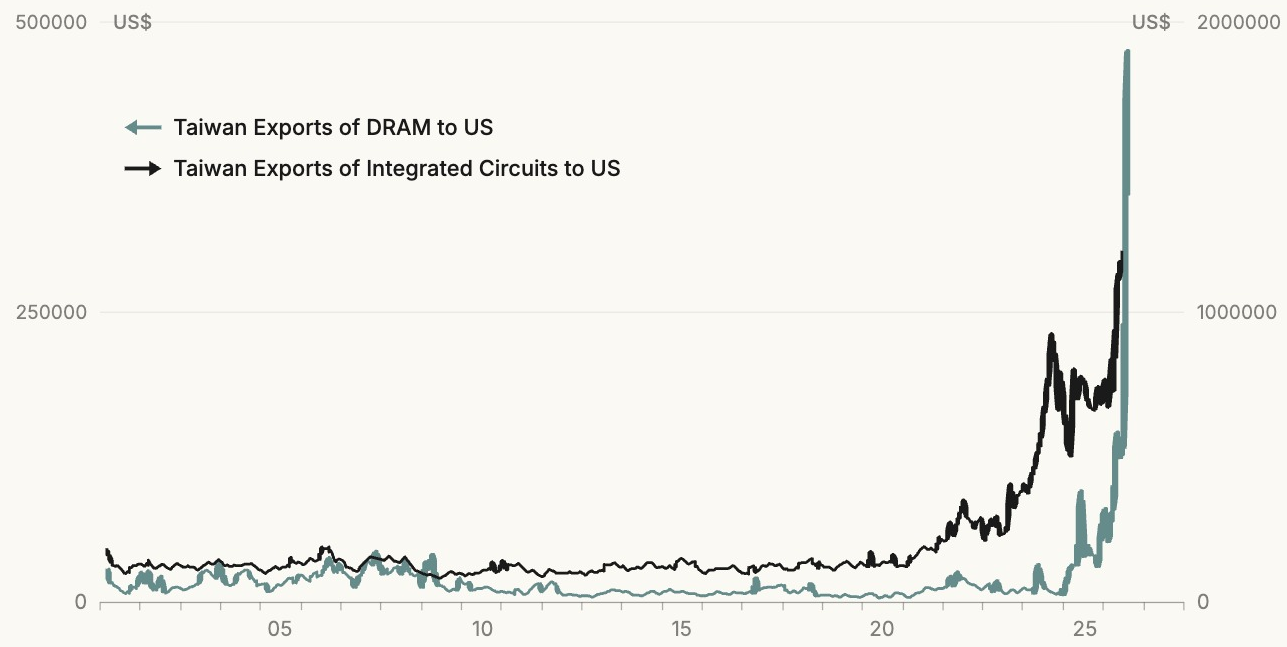
To avoid escalation, the US must walk a rhetorical tightrope on dealing with the Taiwan issue. In discussing such matters, China might draw attention to US defense exports to defend its own. Normally, there is no room for the US to waver in discussing its strategic interests. However, the backdrop of the Iran conflict suggests the US may be unusually receptive to China asserting its own.

US/Iran, Russia/Ukraine

Though markets often grow "numb" to conflicts that only impact the lives of those living closest to the danger, the length and breadth of wars have a negative cumulative impact on trade and markets. The Russia/Ukraine conflict hasn't been the largest driver of global growth concerns for four years even as the conflict remains unresolved. Though the Iran conflict is newer, we sense increasing vulnerability as supply disruptions accumulate.

FIGURE 3

Taiwan: Semiconductor-Related Exports to US (Monthly, $ Mln)



SOURCE: CIO GROUP, HAVER ANALYTICS

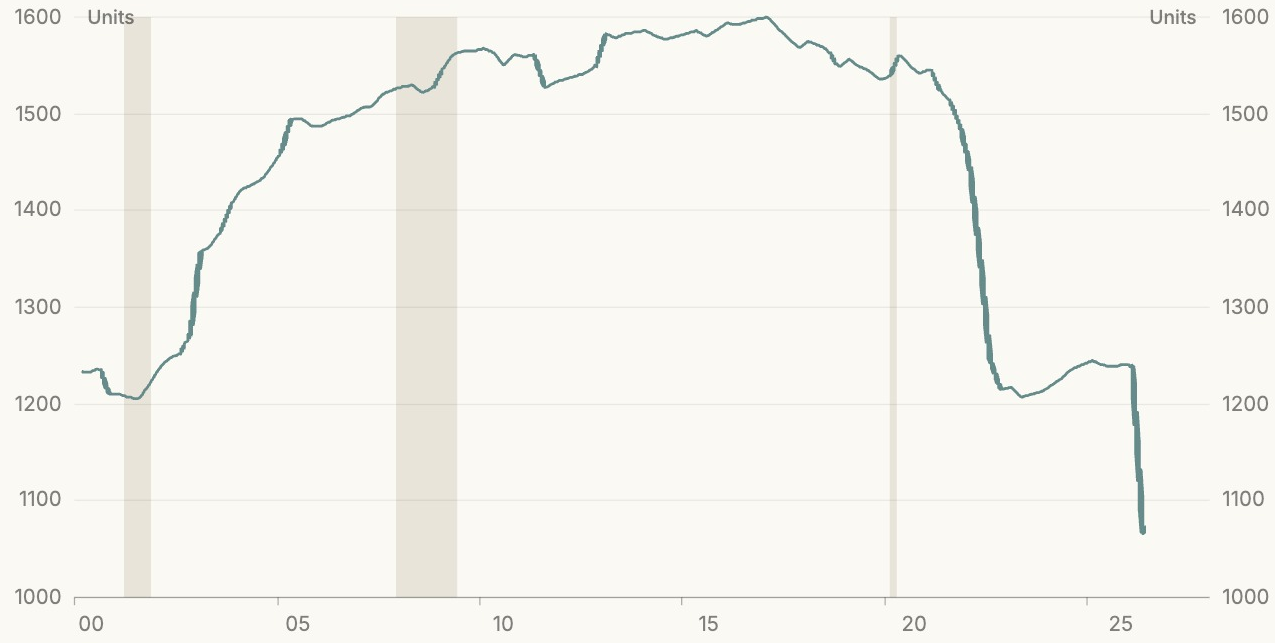
The newest and clearest risk is the attack on pipelines that have delivered the bulk of Saudi Arabia's crude oil supplies to the world since the closure of the Straits of Hormuz. Saudi's oil exports have been rerouted through the Red Sea while the Straits have been strangled by Iranian attacks. Iran's proxy force in Yemen, the Houthis, now significantly threaten at least one route out of the Red Sea.

As figure 4 shows, governments have run down emergency strategic reserves as the conflict has persisted for seven months. The month of October is one of the two weakest months of the year for refinery throughput. But demand will pick up in the early winter. China, even with its greatly reduced oil consumption, needs to return to world oil markets for supply.

FIGURE 4

OECD Countries: Strategic Petroleum Reserves

(Millions of Barrels of Crude Oil Stocks)



SOURCE: CIO GROUP, HAVER ANALYTICS

Rising Oil Prices, Higher Bond Yields and the Risk for Equities

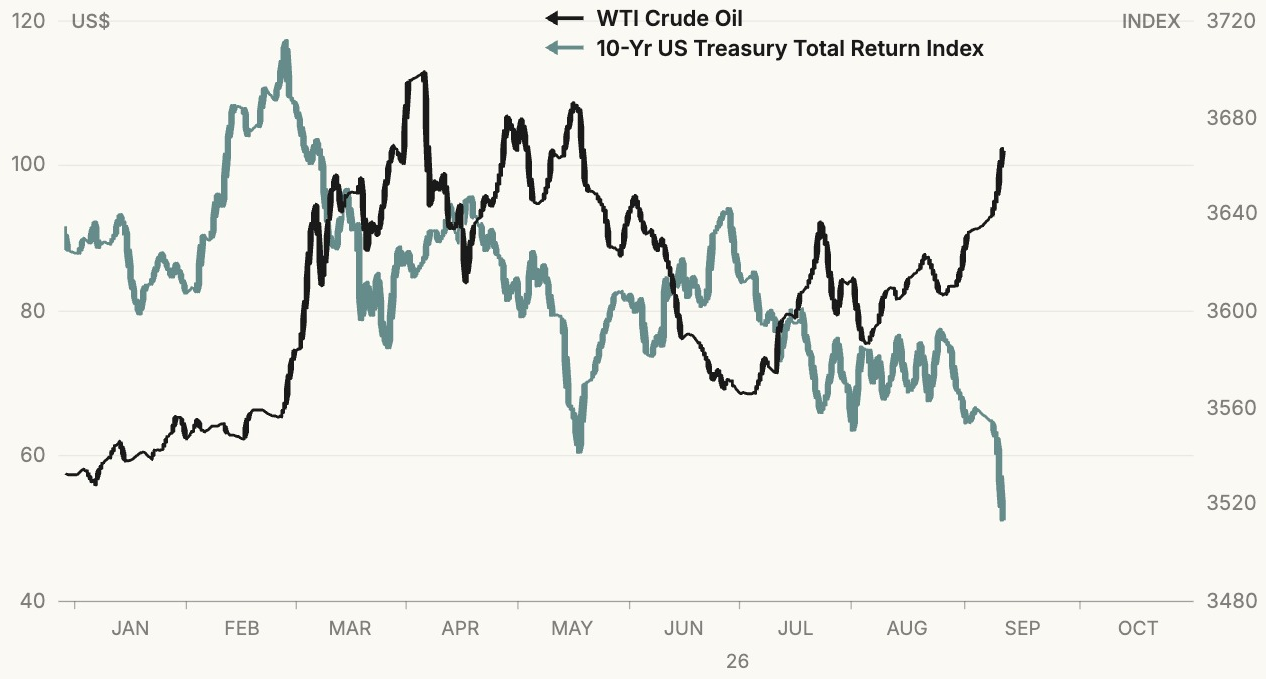
The impact of rising oil on bond yields is presenting a vicious circle for the equity market. This past week, crude oil prices swung in wide ranges but continued to increase overall. Fear and hope of a new conflict or accord between the US and Iran gripped markets.

As we discussed last week, Fed Chair Warsh's post FOMC comments added significant further weight to the impact of higher oil prices given his approach. Asked why the Fed chose to tighten this month rather than July, he said "there's no hiding from hot spots around the world." **In short, this means the Fed views supply shocks as a reason to raise rates.**

With this view, the correlation between US Treasury yields and crude oil has jumped sharply since the start of the conflict in Iran, markedly higher than over the long run (see figure 5 below). During the peak of the war/shock period (2Q), the negative correlation between crude oil and equities also spiked.

FIGURE 5

US 10-Year Note Total Return Index and Crude Oil Price



SOURCE: CIO GROUP, HAVER ANALYTICS

Mistakes in the Short Run Risk Long Term Consequences

As the "world's central bank," the Fed has historically been a stabilizer during shocks, rather than an "amplifier" of shocks. While there's reason for the Fed to err on the side of policy restraint because of the current investment boom, tightening on shocks presents unusual risks. There's a strong possibility of mistiming given the long lags in which monetary policy impacts growth and inflation. Consider that yields have risen out to 30 years on this issue. This even as most energy supply disruptions have been centered on a year of impact.

When will the economy suffer? The housing market has been morbid for the last few years and can't drive the economy down much further. However, when business investment peaks, markets will likely judge that rates have moved up too much. The projected 95 basis points of additional rate hikes over the coming year is beginning to look excessive.

Outcomes and Clues

If the US and China fail to cooperate on particular issues, larger strategic risks will increase. China's reported support for Iran might drive the US to punish it with sanctions that might lead to critical trade disruptions between the two economies. This is even as the US already restricts a great deal of high technology trade with China on national security grounds. At the extreme, Taiwan's role in semiconductor production makes it a supply chain risk of the highest caliber.

Conversely, cooperation between the US and China - including proposals to reduce tariffs on less sensitive trade categories - could ease supply pressures that are negatively impacting the US economy now. China might also sway Iran to accept a truce and resume its energy trade. At the margin, such developments could even influence the Fed to pursue a less restrictive monetary policy, reducing economic risks.

CIO Group Current Positioning

CIO Group reduced its global equities allocation to neutral on Aug 31 reinvesting in AAA-rated floating rate debt on concern for the issues discussed above. We also hold about 30% of US Treasury holdings in the form of short-duration Inflation-linked bonds.

We view the coming earnings reporting season as a positive catalyst for equities, and would note the propensity for US equities to rally when mid-term election results are clear. We weigh the strong growth of corporate earnings, causing valuations to contract, as a near-term positive while the rise in bond yields is an offset making fixed income more attractive.

For reasons discussed in this article, we continue to hold thematic overweights in security-related industries including defense deterrents, energy infrastructure and cyber security.

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