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Donald Trump has made no secret of his dislike of the c. $400bn trade deficit the US currently runs with China and has announced a series of tariffs on Chinese goods. This has elicited responses from China in an escalating trade war. However, while this grabs the headlines it is merely a symptom of a much more tectonic battle that is underway between the incumbent economic hegemon and its challenger.

Since China's ascent from economic backwaters, the US policy towards her was one of inclusion and engagement. This culminated in China's inclusion in the World Trade Organisation in 2001 despite remaining a closed economy in many important ways. The US strategy was predicated on China adopting and playing by the rules of the (US designed) world order of free trade, policed by US military and crucially, transacted and reserved in US dollars. As capitalist induced prosperity permeated through the system, it was expected that democracy would follow, and China would become a new and very important member of the club, much in the same way as South Korea and Taiwan had done before. This policy spanned both Republican and Democratic administrations and importantly found a cheerleader in the powerful US corporate lobby, who were very keen to offshore manufacturing to a much lower cost venue, driving record profit margins.

From a US perspective, this policy has unequivocally failed. It is now obvious to all that China has no intention of being a submissive participant in a US dominated world order, and the communist party's authority has never been more absolute. To understand China's ambition, consider the two main pillars of its long-term strategy: The One-Belt-One-Road (OBOR) Initiative and China 2025.

The OBOR Initiative has just completed its fifth anniversary and has two main components. Firstly, several land transport and infrastructure corridors connecting China with Southeast Asia, South Asia, West Asia, The Middle East and finally Europe. Secondly, a sea route linking Asia, Africa and Europe. Dubbed the "project of the century" by President Xi Jinping, OBOR is the infrastructure strategy to drive trade, development and project Chinese power and influence across the Eurasian landmass and into Africa. This is nothing less than a 21st century version of "all roads leading to Rome".

China 2025 is a state-led industrial policy that seeks to make China dominant in global high-tech industries. The program aims to use government subsidies and state-owned enterprises to pursue (by fair means or foul) intellectual property to surpass Western prowess and dominate the key industries of the future in the way the West has in the past. Key industries include electric cars, next generation IT and telecoms, advanced robotics, artificial intelligence, agricultural technology, aerospace, biotechnology; the list goes on. By 2025, China aims to achieve 70% self-sufficiency in high-tech industries and by 2049 – the 100th anniversary of the People's Republic – to be dominant in global markets.

Taken together, these are not the ambitions or actions of a passive actor who intends to dance to Washington's tune, the way the world has been compelled to since the end of WWII. For the US, these tactics undermine international trade rules and are a direct threat to US interests. The US military has been warning of the threat for years. US intelligence agencies recently reported that Chinese recruitment of foreign scientists, theft of intellectual property and targeted acquisitions were an unprecedented threat to the US industrial base. Chinese intentions to dominate entire supply chains threaten not only the US economy but the whole system of global innovation. President Trump's confrontational approach to China is not a flash-in-the-pan that will disappear with a new administration. There is consensus on a bi-partisan level and across government agencies that the previous approach to China has failed and it is now a threat that must be addressed. Even the corporate sector which once embraced cheap Chinese labour, now sees a competitor where it once saw a customer and supplier.

Hank Paulson, former US Treasury Secretary and head of Goldman Sachs was one of the most ardent cheerleaders of the policy of engagement with China. In early November 2018, he gave a speech where he admitted that this policy had failed and that an economic iron curtain had formed between the US and China. Graham Allison in his book "Thucydides Trap" which looked at the history of a rising power causing fear in an established power, often leading to war said, "Relations between the US and China are destined to get worse before they get worse".

Once we understand China's ambition; to become the dominant economic power across Eurasia and Africa and that this is a direct challenge to the current hegemon, how and when this issue is resolved becomes of critical importance. China has much to do to achieve its goals and the US is a powerful adversary. However, the course is set, and a collision is unavoidable.

In many respects China is still an emerging economy. GDP per capita is around $9,000 versus around $60,000 in the US. Clearly, China is growing much faster and has a lot more people and hence will quickly become a much larger economy. In order to fulfil its ambition, not only will China have to deliver on the OBOR and China 2025 plans, but it will also have to develop its capital markets, its institutions and its military. This final area is of particular importance. The US military remains the most powerful and sophisticated on the planet. However, China (and Russia) doesn't need to match them in order that have a realistic deterrent and pursue their own regional ambitions. They just need to have the capability to inflict unpalatable damage to the US in the event of conflict. A goal they have arguably already reached. The second thing to consider in this regard is that the cost of projecting US military influence around the globe is enormous. The discussion below illustrates why the US's ability to fund this presence in the future will be greatly diminished.

However, the greatest impediment to the China realising its ambitions is not technological or its military capability, it is financial. The US Dollar (USD) is the world's reserve currency and the currency in which all commodities are transacted. This "exorbitant privilege" meant the US could never face a balance of payments crisis, because there would always be demand for USD debt and in extremis, the US could print the dollars to pay for its imports.

Being the only major world power not totally devastated by the Second World War allowed the US to set the rules of the post-war world order. This included the USD taking over from Sterling as the world's reserve currency. Up to 1971 it was a gold-backed USD until President Nixon took the US off the gold standard. Since then, the unbacked USD has continued unchallenged as the global reserve currency. It managed to do this due to a deal made with the Saudis when Nixon sent Secretary of State, Henry Kissinger to Riyadh in 1973. The deal he struck was that the US would provide military protection for Saudi Arabia and its oil fields and in return the Saudis would only accept USD in payment for their oil. The "petrodollar" was born and spread around the world. The dollar's dominance was underlined at the beginning of the 1980s when Paul Volcker demonstrated he was prepared to crash the US economy to preserve the international trade value of the USD.

This arrangement, which has endured to this day, had several important implications most notably Triffin's dilemma. Triffin's dilemma is that a country that issues the world's reserve currency that foreign nations need to hold, must be willing to supply this currency by running persistent trade deficits. Once acquired, these dollars circulated outside the US as deposits, known as Eurodollars, or got recycled back into the US via purchases of Treasury Bonds. In addition, the US used these deficits to finance the projection of its military supremacy around the globe. Finally, it can control access to the global dollar payments system and hence can effectively cut a nation off from global trade. This is one way that it has imposed sanctions on the likes of Russia, Iran and North Korea in recent years.

Back to today and China. China is on a path to supplant the US as the world's largest economy. However, it faces challenges in doing so under the current system of world trade. China currently imports around $1.3tn of goods, around 60% of which are commodities. In the first half of 2018 China likely ran its first current account deficit in the modern era. This position is likely to deteriorate as the economy matures and China imports more and more commodities at higher prices to fund its growth. Add to this a US president that wants to cut off China's main source of USD – its trade surplus with the US – and you see the potentially precarious position that China is in. Unless it does something soon, it will face a balance of payments crisis much like the Asian economies did in the late 1990s. China does not have the luxury of being able to print the dollars it needs. The result is likely to be one or a combination of: an economic crash that reduces demand for commodity imports or a depletion of its foreign exchange reserves followed by a collapse of its currency. This in turn could lead to domestic and political disruption that could overwhelm the communist regime. It wouldn't be much fun for the rest of us either. It is a matter of Chinese national security to avoid this outcome. In the long term, the only way it can reasonably do this is to pay for its imports in Chinese Yuan.

Think about this issue from a different perspective. By 2050 the combined GDP of China and India will be three times that of the US. In this world, does it make sense for the USD to dominate global trade and reserves? It certainly doesn't if you are Chinese.

What is China doing to solve this problem? In a nutshell, it is aggressively looking to de-dollarise the global commodity markets and move away from the dollar as the global reserve currency. In 2013 The Peoples Bank of China announced that "it was no longer in China's favour to accumulate foreign exchange reserves". China's US Treasuries holding peaked in late 2013. Global FX reserves peaked in Q3 2014. Both have been declining ever since. China recently launched a Yuan-denominated oil futures contract traded in Shanghai. Interestingly, settlement of the contract is convertible into physical gold. It is early days, but the new contract has already taken significant market share from Brent and WTI. China is already the world's largest oil importer and its market share is only going to get larger. Russia and Iran are the first natural partners in this trade but in recent weeks there is talk of Saudi Arabia moving to accept Yuan as payment. In addition, as part of the OBOR project, China has extended massive loans in Yuan across Africa and Eurasia. It is only natural for the recipients of those loans to start to stock-hold reserves in the Chinese currency. The other thing China is doing, along with much of the other members of the Eurasian bloc is reserving gold instead of US Treasuries. This points strongly to gold's future role as a neutral reserve asset, a role it has played throughout history, the only exception being the last 45 years.

Turning to the US perspective, things look very different. The US has enjoyed being the world's hegemonic power for 70 years. However, the dollar's role at the centre of global trade has been crucial in sustaining this position and financing the projection of US military dominance around the world. Today the US is pregnant with massive structural deficits driven by entitlement programs, defence spending and interest expense on the existing debt burden. For 70 years, US deficits haven't mattered because the system mandated that foreign nations accumulate dollar reserves, creating structural demand for US Treasuries. Now they are no longer doing so, US deficits matter again.

The current US budget deficit is roughly $1tn or 4.5% of GDP. Consider that this is at the end of a near decade long economic expansion. What does this number look like in the next US recession? 10%? Italy is currently being hauled over the coals for daring to propose a deficit of 2.4% in a stagnant economy. The aggregate US deficit is projected to be around $4.6tn over the next 3.5 years. To put that into context, that number is around 50% of projected global GDP growth. However, this new debt is only part of the story. There is the existing stock of debt that must be continually rolled. In the next 12 months this amounts to $10tn. The US must sell $200bn of debt securities per week just to maintain the existing debt stock, before any new borrowing. And somebody MUST buy them; the question is who? Again, for context, the "massive" emerging market dollar short that must be rolled in the next 12 months is around $1.7tn.

Historically, foreigners have funded over half of the US deficit. However, this process stopped in 2014. Since then, the gap has been filled by several sources. Firstly, new regulations mandated US banks to hold a greater proportion of their reserves in US Treasuries. This was followed shortly by a similar process in money market funds. Next came US corporate tax reforms which brought $650bn back to the US and into the Treasury market. Finally, US retail investors have been big net buyers as baby-boomers portfolio flight-paths on autopilots "de-risk" into more Treasuries. Taken together, this has provided a further leg of stealth QE, even as the Fed has backed away.

Going forward however, if we assume that foreigners continue to not grow their holdings of US Treasuries (or heaven forbid fail to roll even a small proportion of them) then the following vicious cycle is engaged. Rising US deficits must be financed by the private sector, creating a crowding out effect, forcing up savings at the expense of consumption. This slows the US economy, to the point of recession, causing deficits to rise further. Wash, rinse, repeat until either the US defaults externally on its debt or internally on its entitlements/defence commitments or the Fed steps in, prints the money and buys the debt. This is turn, will dramatically weaken the USD.

If foreign nations choose not to sterilise US deficits going forward, which appears to be virtually certain, the US, via the Federal Reserve, has a choice. It can try to maintain the dollar's omnipotence in global trade by refusing to monetise US deficits and maintaining the exchange value of the dollar, as Volcker did in 1980. However, to do so it will literally have to "burn down the world", destroy the US economy and smoke every asset class your portfolio. Bonds, equities, commodities and gold would all be crushed in USD terms. Alternatively, the US could accept the inevitable transition to multi-currency reserve/neutral asset reserve world as the natural evolution of things. US deficits would be monetised to whatever degree was necessary to keep the economy afloat with the attendant inflation this would bring. Holders of US Treasuries would be left holding the baby in real terms without losing a cent in nominal terms. The safe havens in this scenario are assets more finite in supply that the tsunami of newly minted USD and freshly issued Treasuries. Equities rally in nominal terms but struggle to make real gains. Emerging markets and commodities out-perform. Gold goes through the roof.

To be clear, it is not China's intention for the Yuan to replace the dollar as the world's reserve currency. It is nowhere near ready for this. However, it is a matter of national security for China to free itself from the dollar's grip. It is a matter of US national security that they don't. Historically, such titanic clashes between a rising and incumbent power have been settled by war. This is more difficult in the modern era due to the catastrophic downside to all parties. There are lots of historical examples of changes in currency regimes and reserve currency status. However, none of these occurred in a purely fiat currency world. Also, there are no investors alive today with any practical experience of managing investments during such a transition.

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