

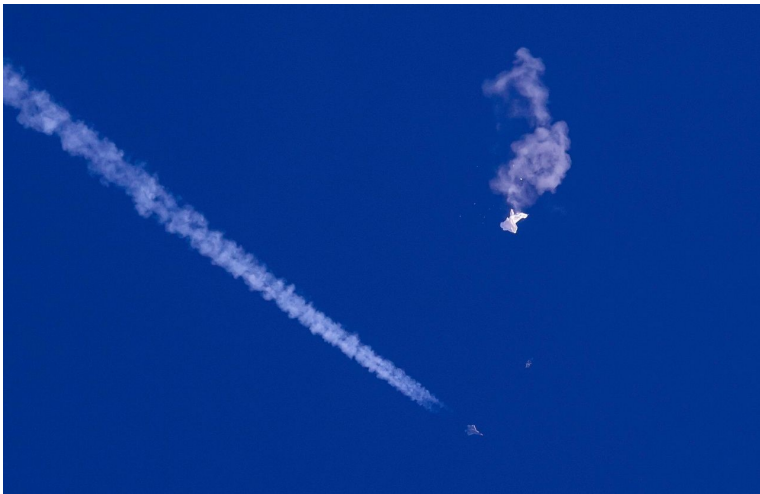
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MARKETSHEARD ON THE STREET

# When U.S.-China Relations Go 'Pop'

Even with both sides trying to re-engage, Sino-U.S. relations keep getting more tense



A jet fighter flew by the remnants of a suspected Chinese balloon after it was struck by a missile over the Atlantic Ocean this month.

PHOTO: CHAD FISH/ASSOCIATED PRESS

By *Nathaniel Taplin* [Follow](#)

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U.S.-China relations, as complex as they have always been, used to be largely governed by a simple law—the law of common interests. These days, however, another well-known principle, is driving events—Murphy’s Law, or whenever something can go wrong, it will.

The diplomatic furor about alleged spy balloons over the U.S. and its allies from China is only the latest example of this phenomenon. That should deeply worry both investors and the general public—particularly with regards to Taiwan—and has already had a significant negative impact on markets this year.

What is remarkable about the latest diplomatic row is how obvious it is that both the Biden administration and Beijing actually want to put a floor under the relationship. The catfight erupted just days before Secretary of State Antony Blinken was due to visit Beijing, a meeting that had been in the works for weeks.

Mr. Blinken’s visit was meant, among other things, to help lower the temperature after the high-stakes brinkmanship over Taiwan last summer. It would have come on the heels of a remarkable positive turnaround in Beijing’s posture

towards business, both foreign and domestic, since December.

Moreover, reporting from both The Wall Street Journal and the Washington Post indicates that the balloon's passage over the continental U.S. may well have been a mistake. Top Chinese officials were caught off guard when Washington informed Beijing of the sighting. The balloon appears to have originally been bound for Guam, a U.S. territory. And China's initial response was highly conciliatory by recent standards.

None of that mattered.

By last week, Washington and Beijing had reverted to full outrage mode, Mr. Blinken's visit was indefinitely postponed, the balloon had been shot down over the ocean and Chinese stocks were following suit.

To be sure, the incident is far from the only factor weighing on markets recently. But Chinese shares, particularly U.S.-traded ones, have been sagging. The MSCI China, which had been handily outperforming both the S&P 500 and the Nasdaq Composite in early 2023, has lost nearly 10% in the past 15 trading days according to Factset, compared with a 2% gain for the S&P 500.

The MSCI China and Hong Kong's benchmark Hang Seng Index also both lagged behind the broader MSCI Emerging Markets Asia Index, which is only off 5%. Meanwhile China's onshore CSI 300 Index—dominated by domestically-focused, state-owned firms like Chinese banks—is only down 2% in dollar terms. It is hard not to read all this as the impact of the flyover.

Needless to say, nobody likes foreign objects of dubious intent floating over their territory—the U.S. arguably was within its rights to shoot it down. But the fact that the cautious rapprochement underway was so easily derailed by, quite literally, hot air illustrates a very worrying deeper trend.

Hawks in both capitals, and especially the U.S. Congress, have now gained so much clout that any small problem can easily escalate, even when top leaders in both Beijing and Washington are actively trying to calm the waters.

Consider, for example, what would happen in the event of a mid-air collision near Taiwan or over the South China Sea—as nearly occurred less than two months ago. As long as this dynamic persists, it will put any “relief rallies”

4%

2

0

-4

-6

■ S&amp;P 500

■ China CSI 300

■ MSCI Emerging Markets Asia

related to warming relations—particularly in U.S.-listed Chinese shares—at risk of sudden and more-or-less entirely unpredictable reversals.

■ Hang Seng

■ MSCI China

Washington and Beijing are reportedly considering a tete-a-tete for Mr. Blinken and top Chinese diplomat Wang Yi at the upcoming Munich Security Conference this weekend. With a U.S. presidential election just over 18 months off and being “soft on China” becoming even more of a political liability, new confidence-building steps and robust mechanisms for handling emergencies will be essential.

Otherwise, buckle your seatbelts. Mr. Murphy is in the driver’s seat.

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