Opinion **Markets Insight**

US needs to prepare markets for the risk of a Chinese invasion of Taiwan

More planning required to reduce disruption and mitigate volatility if hostilities break out

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A Taiwanese soldier. Military experts in the US believe President Xi Jinping has told the Chinese military to develop the capability to invade Taiwan by 2027 © Ann Wang/Reuters

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The past few years have shown investors that they should expect the unexpected in geopolitics. Russia's full-scale invasion of Ukraine and the widespread conflict in the Middle East were probably not the base-case forecasts for scenario planning for many.

That experience underlines why policymakers, market participants and investors should treat seriously one of the biggest and long-standing geopolitical risks — an invasion of Taiwan by China — and prepare for it.

Military experts in the US believe President Xi Jinping has told the Chinese military to develop the capability to invade Taiwan by 2027, according to a Financial Times to develop the capability to invade Taiwan by 2027, according to a Financial Times report. Although an attack is not seen by these experts as an immediate risk, US defence secretary Pete Hegseth recently warned: “The threat China poses is real, and it could be imminent.”

Despite this risk, there has not been much preparation for the critically important impact of Chinese hostilities on global financial markets.

The tariff-induced volatility that began in April would pale in comparison with the type of extreme chaos we could experience if Taiwan, the dominant source of the world’s supply of computer chips and other critical technology, is cut off, and if China is slapped with sanctions and its stocks delisted from US markets. Note Nvidia — a mainstay of markets and 401k retirement plans — still derives almost half its sales from Taiwan, China and Singapore.

My firm, which is responsible for making markets for more than 900 public companies on the New York Stock Exchange, estimates a short-term US stock market collapse of up to 34 per cent in the event of a Chinese invasion of Taiwan. And a recent study by a Federal Reserve Bank of St Louis economist declared “such a conflict would likely produce a flight-to-safety in the asset market, huge disruptions in international trade, and banking problems, and it would greatly exacerbate existing fiscal pressures.”

Although market turmoil from such a conflict would be unavoidable, the overall impact on US investors could be mitigated if we start planning now. For example, if there is an invasion, there are likely to be calls to delist Chinese companies from American exchanges and ban US companies trading the stocks from China. But that risk immediately creates uncertainty for financial market participants.

If policymakers intend to go down this route, they need to determine how far a prohibition on trading Chinese shares should go. Would it end at the shores of America, or would it also extend to entities affiliated with US companies that are based overseas? We also don’t know how a prohibition would apply to exchange traded funds that include these companies in their underlying portfolio or index funds that reference their prices. These might seem like minor details in the context of sweeping economic sanctions, but the answers are critical when enforcement includes substantive civil and criminal penalties for any breach.

The impact related to China could be extremely far-reaching. The US at present has about 450 listed equity ETFs that maintain significant exposure to stocks listed in China. China accounts for almost 30 per cent of the $8.8tn MSCI Emerging Markets Index — by far the most of any country — with Tencent and Alibaba as the top two China constituent holdings. As of March 7, there were 286 Chinese companies listed on US exchanges with a total market cap of $1.1tn, a $250bn increase from the start of 2024, according to the US-China Economic and Security Review Commission.

Policymakers and market participants must also look at how markets operate in times of stress, including the current limit up-limit down price bands for individual stocks, marketwide circuit breakers and other potential regulatory interventions that could mitigate the volatility. These important protections should be reviewed based on recent experience to ensure they are correctly designed.

A good step in this direction is bipartisan legislation introduced in May called the Fortifying US Markets from Chinese Military Aggression Act. The bill would create an advisory committee with public and private sector financial market experts under the Treasury's Financial Stability Oversight Council to develop a plan to safeguard US markets in the event of Chinese military action against Taiwan.

Without thoughtful planning and communication, the overarching threat could immediately dry up market liquidity at precisely the moment when it is most needed. But with dedicated effort now, I believe US markets will rise to the occasion in even the most dire of geopolitical events.

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