US–China NatSec
2025 Preview

CAPSTONE

US–China Tensions: Growing Restrictions and Expanding Global Risks

THE BOTTOM LINE

Capstone expects the US-China competition to intensify as the incoming Trump administration has made reining in China a cornerstone of its foreign policy. We believe that Trump will build on the first-ever restrictions on US capital to invest abroad, increasing risks for public market investments in Chinese entities. We also believe the US will prepare for a conflict with China by expanding munitions stockpiles.

Outlook at a Glance

- OUTBOUND INVESTMENT RESTRICTIONS TO BEGIN BITING; RISK OF EXPANSION UNDER TRUMP TO INCLUDE PUBLICLY TRADED SECURITIES
- FOCUSING ON CHINA, THE TRUMP ADMINISTRATION WILL MOVE TO REBUILD US MISSILE STOCKPILES, DRIVING MISSILE SALES FOR MAJOR MANUFACTURERS

Outbound Investment Restrictions to Begin Biting; Risk of Expansion Under Trump to Include Publicly Traded Securities

Winners	None
Losers	Capital markets investors with exposure to Chinese equities, in addition to private equity, venture capital, and corporates that the new US Outbound Investment Security Program already impacts.

President-elect Trump has made being tough on China and protecting American workers from China's alleged predatory economic practices a key campaign issue and continues to be a theme that cuts across many of his signature policy areas, including using tariffs to support the US economy. "De-risking" and other tough-on-China policies are also an area of bipartisan agreement on Capitol Hill, particularly among Republicans who will control both chambers of Congress beginning in January 2025. All investors, including capital markets investors, should oversee these developments as potential risks to portfolios with China exposure, that are likely to grow.

In addition to expanding the types of technologies prohibited for US investment, we see growing risks that Congress will add more restrictions on public market investments in Chinese entities. The Treasury Department's Outbound Investment Program will go into effect on January 2, 2025, which implements the first-ever restrictions on the ability of US capital to be invested abroad. While tailored to focus only on certain advanced technologies linked to China, consistent with the Biden administration's "small yard, high fence" approach to export controls and similar restrictions, the program is nevertheless groundbreaking. Capstone has been advising clients since the regulations were first proposed that they are subject to significant expansion risk because of Trump, as well as future administrations, and Congress.

At its core, the Treasury Department has focused this first-ever Outbound Investment Program on three areas of critical and emerging technology—artificial intelligence, semiconductors and microelectronics, and quantum computing. However, the emergence of tech CEOs as part of the Trump transition team, notably Elon Musk, could blunt some of the restrictions the Trump administration might pursue. For both AI and semiconductors, investments are either prohibited or require that the covered US person notify the Treasury Department. Investments in quantum computing are prohibited altogether. There are exceptions for publicly traded companies and certain Limited Partner (LP) investments, among others.

Given that the regulations will only be in place for a few weeks before the Trump administration is inaugurated, it will be up to Trump's Treasury Department, including the person nominated to be Assistant Secretary for Investment Security, to enforce them. An even more hawkish approach to China could also see the administration move to refine further or even expand the rule based on the program's perceived effectiveness once in place.

Investors also need to be watching what happens in Congress about outbound investment, as there are parallel efforts underway to codify the outbound investment program into law that meaningfully expand the risk and compliance requirements to a broader set of investors. While there has been proposed legislation on outbound for nearly two years, a compromise piece of legislation called the Comprehensive Outbound Investment National Security (COINS) Act of 2024 was introduced in November 2024 with the support of House Speaker Johnson. There is momentum for this bill, particularly after one of its primary opponents, House Financial Services Chair Patrick McHenry, will be leaving Congress.

The COINS Act would blend both a sanctions approach and a technology-specific approach to regulating outbound investment to China—meaning that it would both prohibit investments into those included on US sanctions lists and establish specific technologies that would be prohibited from investment. Examples of the types of technologies include semiconductors meeting specific technological specifications, semiconductor fabrication equipment, equipment used in hypersonics, and certain nuclear technologies and components. Although publicly traded securities would still broadly be exempt, investment into entities on US government sanctions lists, such as the Entity List or the NS-CMIC List, would be prohibited. Even this inclusion alone could have significant market impacts, as major Chinese companies that do attract US capital markets investment, such as Huawei, are on the Entity List, for example.

There are other efforts to limit Chinese entities from gaining access to US capital that investors should be mindful of, as well. One is Senator Marco Rubio's (R-FL)-sponsored bill, the Patriotic Investment Act. This bill, which has bipartisan support in Congress and we believe will be taken up in the next Congress, would nearly double the capital gains tax rate on all public market investments into Chinese entities, including American Depositary Receipts (ADRs). While it is still early days for the Patriotic Investment Act, this is another piece of legislation that could have a significant market impact and that we will be watching in the year ahead.

In addition to the use of trade and tariffs, as well as export controls on semiconductors, Capstone will be watching other, perhaps more below the radar, dynamics for our investors.

Focusing on China, the Trump Administration Will Move to Rebuild US Missile Stockpiles, Driving Missile Sales for Major Manufacturers

Winners	Lockheed Martin Corporation (LMT), RTX Corporation (RTX), Northrop Grumman Corporation (NOC), L3Harris Technologies Inc (LHX)
Losers	None.

THE DEMAND FOR MISSILES WILL GROW IN THE COMING YEARS REGARDLESS OF OVERALL DEFENSE SPEND

We expect the Trump administration's policies to further stimulate the US defense industrial base in preparation for a conflict with China, which includes further accelerating the replenishment of US munitions stockpiles. This presents an opportunity for US defense primes that dominate the market, as well as new entrants.

The Trump administration will make a concerted effort to rebuild US and allied missile stockpiles, which have been depleted in recent years by the ongoing conflict in Ukraine and the Middle East, as part of an effort to prepare for a potential conflict with China. For example, US air defenses have proven to be highly effective at blunting Russian air strikes on Ukraine. Likewise, air defense has played a critical role in defending Israel against Iranian strikes, as geography has made long-range cruise and ballistic missiles Iran's weapon of choice. Even Iranian proxies like Hezbollah have relied heavily on rockets and missiles for asymmetric attacks and Israel needed to draw on US stockpiles to protect its skies through its "Iron Dome" air defense system.

Capstone believes that missile demand will remain elevated throughout the Trump administration and likely beyond, even if the Russia-Ukraine War and Middle East conflicts see reduced intensity. This is because munitions are becoming an area of increasing emphasis for US war planners as they plan for potential contingencies with China—a fundamentally different adversary than the US has been fighting in recent decades.

The US industrial base supporting munitions has atrophied and is in the process of being rebuilt. It began during the 1990s "Peace Dividend" and the subsequent War on Terror, when investment into high-end missiles was deprioritized as key threats were seen as terrorist organizations rather than nation-states. There is now a bipartisan consensus that the US needs to reinvest in defense manufacturing. While defense spending has traditionally favored large platforms like aircraft and ships, there is a strong conviction in defense circles that munitions need further investment in the immediate term.

Air defense sees a relatively higher rate of consumption as they are often used as defensive tools. For example, the US Navy expended billions of dollars' worth of missiles defeating Houthi missile attacks in the Red Sea. However, all types and classes of missiles, from anti-air, anti-surface, and anti-surface, cruise and ballistic, will be in high demand over the near term. Uncrewed and autonomous air vehicles also necessitate a large stockpile of weapons as the uncrewed fleet also needs munitions to deploy.

In addition to replenishing stockpiles, the incoming Trump administration promised to expand US air defense capabilities, including building an American equivalent of the "Iron Dome," an Israeli-integrated air defense system capable of intercepting a wide range of threats. While it is unclear how the US would approach such a program, further investment into air and missile defense, particularly against sophisticated ballistic and cruise missiles, is expected. A growing area of emphasis is on hypersonic defense as US adversaries field new hypersonic missiles, which are capable of hitting speeds of Mach 5 and maneuvering to avoid defenses.

Efforts to boost the production of missiles, from final assembly through the entire supply chain, are underway; however, even if existing initiatives were successful, the industrial base would take years to return the US to pre-war inventory levels. This does not account for the higher operational requirements the US is aiming for to deter China. Beyond existing models, there is currently a range of modernization efforts to build next-generation munitions, which could include new families of weapons, such as hypersonic missiles.

International demand is expected to remain high because of elevated global tensions, as well. European countries have significantly increased defense spending following the Russian invasion of Ukraine in 2022, and, regardless of the Ukraine endgame, European policymakers will look to expand their military capabilities to deter Russia credibly. The same is true in the Asia-Pacific, where countries like Japan and Australia are looking to increase their long-range strike capabilities to deter Chinese aggression.

Many US companies are well-positioned to capture this growing business. Lockheed Martin (LMT) and RTX Corp. (RTX) are the incumbent prime contractors in many of the most important systems being employed, such as Standard Missile 6 (SM-6), PAC-3 Missile Segment Enhancement, AIM-120 Advanced Medium-Range Air-to-Air Missile (AMRAAM), AGM-158 Joint Air-to-Surface Standoff Missile (JASSM). Other major companies that could benefit include NOC and LHX, which hold a near monopoly on the Solid-Rocket Motors (SRMs) used to propel these munitions.

The Department of Defense and broader industry are looking for new sources of SRMs. In July 2024, RTX announced a decision to purchase SRMs from Avio (AVIO), an Italian rocket manufacturer. Lockheed announced in August 2024 that it would be partnering with General Dynamics (GD) to produce SRMs, although the partnership is focused on rockets for artillery. This is a potential area of growth for both companies, although their current capabilities are modest to minimal (respectively).

About Capstone

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