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Since the end of WWII, there have generally been three factors that have caused recessions. The first, and most important, is policy error. Although fiscal tightening can cause recessions, major tax increases have become less common. The usual source of policy error comes from the monetary side, where the central bank either raises rates too high or doesn't move quickly enough to lower rates when business conditions weaken. The second cause comes from geopolitical events. The 1973-75 recession was triggered by the Arab Oil Embargo, a direct result of U.S. aid to Israel during the Yom Kippur War. The 1990-91 recession was due to the Persian Gulf War. The third cause is due to inventory mismanagement. The third reason has become rare due to improved logistics technology. Although inventory issues can affect sectors of the economy, it hasn't led to a national downturn since the 1950s.

As a result, currently, there are two factors we watch most closely to predict recessions, monetary policy and geopolitical issues. Although predicting recessions is difficult, at least with monetary policy, there are consistent indicators, such as yield curves, financial stress indexes, volatility indexes, Phillips Curve measures, etc. Obviously, timing is difficult, even when the indicators flash warning signs, but at least there are fairly consistent indicators one can monitor.

Geopolitical indicators are far more idiosyncratic. Global tensions are constant. There are always geopolitical tensions so it is hard to parse the signal from the noise. To some extent, this is always a problem with geopolitics. It's not that there is a lack of situations that could develop into a threat to the business cycle; it's just that most don't.

Perhaps a better way to think about geopolitics and their impact comes from the book, *Ubiquity: Why Catastrophes Happen*.¹ In this book, Mark Buchanan makes the case that geopolitical events are much like sandpiles where grains rise steadily, making the structure increasingly unstable. A final grain triggers a collapse and, due to the *post hoc, ergo propter hoc* fallacy, that last "grain" becomes the "cause" of the collapse. In reality, the structure had been losing stability for some time and the triggering event may not have led to the catastrophe under conditions of stability.

For example, the Persian Gulf War occurred mostly because Saddam Hussein miscalculated the reaction of the world to his invasion of Kuwait. He probably would not have invaded Kuwait if

¹ Buchanan, Mark. (2000). *Ubiquity: Why Catastrophes Happen*. New York, NY: Three Rivers Press.

the Kuwaitis had been willing to reduce production to allow Iraq to have a greater market share of world oil markets, something that Iraq felt it was owed from the Persian Gulf states due to its prosecution of the war against Iran. In addition, if the Soviet Union hadn't collapsed, Moscow would have probably not supported the invasion by its client state. The trigger to the war, [the reports that Kuwait was using horizontal drilling to tap Iraq's oil fields](#), was the proximate cause of the war. But, the mere act of taking the oil may not, by itself, have triggered the invasion without the other factors in play.

The current trade conflict with China has similar complicated characteristics. The U.S. has been struggling to develop a consistent foreign policy since the end of the Cold War. Policy toward China has mostly been to support its economic development on the idea that the richer it becomes, the more likely that it will democratize, following the path of other Asian nations. Unlike Japan, South Korea and Taiwan, however, China was not as reliant on American security. Those nations were directly protected by the U.S., whereas China only relied on America's sea lane security. In addition, China viewed its commitment to communism as something to be maintained. The construct of the Trans-Pacific Partnership, which was designed to isolate China, showed that the U.S. was rethinking its relationship with China by 2008.

Under President Trump, the relationship with China has become increasingly contentious. The application of tariffs and continued negotiations have caused increasing equity market turmoil. Nevertheless, so far, the impact on the economy has been less dramatic. However, we may be reaching the point where the trade conflict will begin to affect the economy. The most recent decision by the Trump administration to apply 10% tariffs on \$300 bn of imports, by itself, is probably not enough to trigger a downturn. But, the culmination of earlier tariffs and the impact to technology restrictions may be creating conditions that lead to recession.

History suggests that recessions induced by geopolitical events are difficult to avoid even with stimulative economic policies. The unknown is whether we are near a point where geopolitical risks are great enough to trigger a downturn. At this point, we are probably not at that level but risks are escalating and the odds of a geopolitical mistake are rising. Although it is probably too soon to position portfolios in a defensive manner, tactical planning is in order.

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