

December 12, 2022

## The 2023 Geopolitical Outlook

*(This is the last BWGR of 2022; the next report will be published on January 9, 2023.)*

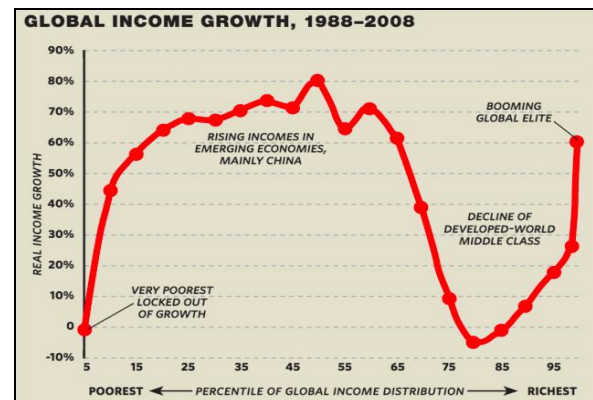
As is our custom, in mid-December, we publish our geopolitical outlook for the upcoming year. This report is less a series of predictions as it is a list of potential geopolitical issues that we believe will dominate the international landscape for 2023. It is not designed to be an exhaustive list; instead, it focuses on the big-picture conditions that we believe will affect policy and markets going forward. They are listed in order of importance.

### Issue #1: The Big Picture

One of the problems with providing an annual outlook is that some factors are in the midst of a long cycle that will not just affect the upcoming year but will be an issue for years to come. For the past 30 years, since the end of the Cold War, the world has been in a situation that was built around the “Washington Consensus,” a concept which meant there was no alternative to market capitalism and democracy as the organizing principles for economic and political systems.<sup>1</sup> This idea led to deep global integration, and after the Cold War ended, firms around the world concluded that geopolitical risks were no longer factors in investment decisions. Aiding this progress was the advent of the internet, which facilitated the separation of production from design. The end of the Cold War unleashed

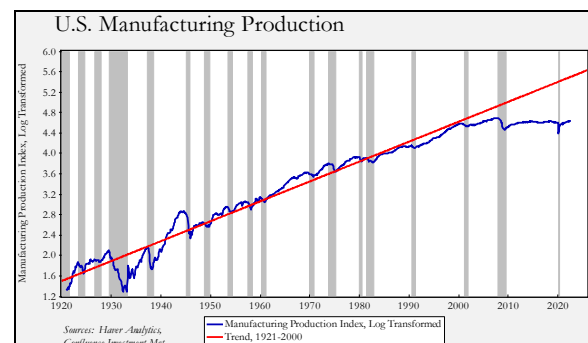
widespread globalization, which caused major changes to economic and social relationships across the world.

The famous “elephant chart” shows the emergence of the emerging-economy middle class at the expense of the developed-economy middle class.



(Source: Branko Milanovic)

Meanwhile, the U.S. suffered de-industrialization.



U.S. manufacturing production fell below its long-term trend in 1980, but activity essentially stopped growing after 2000.

For the most part, the American working class bore the costs of globalization. This

<sup>1</sup> See [this BWGR for details](#).

development has led to the rise of populism, and the concept of globalization has now probably become politically untenable.

Internationally, the Cold War was framed as an ideological battle between capitalism and communism. With communism ousted, global leaders assumed there was nothing left to really fight about. However, with the ideological conflict eliminated, other sources of conflict emerged. China's fear of encirclement and Russia's worry about encroachment from the east have led both countries to reject the U.S.-led world order.

There are two obvious examples of the lack of regard for geopolitical risks. The first is the fact that the world's most sophisticated semiconductor foundries are within range of China's short-range missiles. Putting such important resources at risk is only reasonable if one assumes that China will never attack Taiwan. Second, Europe's reliance on Russia for energy made sense only if one ignored a few centuries of Russian belligerence against Europe.

The general expectation that geopolitics didn't matter led firms to optimize supply chains for efficiency, creating multiple points of vulnerability. The pandemic exposed these weaknesses, such as the reliance on a few providers of key personal protective equipment.

It is now evident that globalization has become politically untenable in the U.S. Although political polarization isn't just because of de-industrialization, it is reasonable to assume it is an important component. One answer to de-industrialization is industrial policy designed to bring back production to the U.S. The Inflation Reduction Act has provisions intended to accomplish just that. The relative abundance of energy in North

America, especially when compared to Europe, could lead European firms to move production to North America.

Second, the return of geopolitical risks means that building redundancies into supply chains will become necessary. Using our semiconductor example, it may be okay to keep production in Taiwan, but duplicating those key foundries in safer places is prudent...and expensive. We have built a vulnerable world because we didn't think certain risks existed anymore. The [recent severing of fiber optic lines](#) in both the North Sea and around France are examples of how key assets have been left unprotected. Perhaps even the attacks on [substations in North Carolina](#) are another example.

This is the new world that is emerging. We have been warning about the onset of this world for some time, but developments over the past two years have made it clear that the patterns of the past three decades are not likely to continue for the next three.

In terms of market impact, the primary effect is inflation. The decline in efficiency and the focus on security will be costly and will likely be borne by consumers in the form of higher prices, lower wages, and/or a narrowing of profit margins. There will be beneficiaries, though, as developed-economy workers could benefit.

## **Issue #2: The Expanding, Strengthening State and Populism**

As U.S. voters push back against the costs of their country's global hegemony, U.S. foreign policy officials have been pulling their punches for more than a decade. The U.S. has drawn back from its traditional role as global hegemon, that is, as the top power that provides order and security for the whole world. As discussed in Issue #1, the

result has been a return of geopolitical risks, military and economic warfare, and deglobalization. In this section, we focus on a key implication as the world fractures into competing geopolitical and economic blocs. Perhaps ironically, the evolving world of competing camps and new efforts at national industrial policy imply a need for bigger, stronger governments. The strengthening of the state will in turn create frictions with the rise of populism that has become so apparent in Western democracies in recent years.

To the extent that the fractured world and its competing camps fall into warfare or the threat of war, the need for a strong state is obvious. For example, nations facing major war have long used conscription to raise enough troops to fight. Such troop levies have generated pushback, as in the North during the Civil War and throughout the country during the Vietnam War. Nevertheless, the U.S. and other countries, [including Russia and Ukraine today](#), retain the right to force young men and women to become soldiers and fight for their country. Governments also raise taxes and/or borrow to pay their soldiers, buy new weapons and supplies, and conduct military operations. Based on the imperative of defense, they can adopt laws allowing the government to channel private firms' resources into military production, [as the U.S. does with its Defense Production Act](#). Countries can also use the imperative of defense to stop the export of certain military-related goods and technologies to their enemies or stop capital flows to their adversaries' military firms, [as the U.S. has also recently enacted](#).

Geopolitical conflicts aren't the only fights that call for a strong state. Today's "fight against global warming" has also been used to [justify new taxes, new subsidies, and new regulations in service to the cause](#). Much

the same can be said of the Johnson administration's "fight against poverty" in the 1960s and other large-scale government initiatives fueled by a sense of national urgency and priority.

Amid today's deglobalization and worsening geopolitical conflicts, the rise of national industrial policy and protectionism discussed in Issue #1 show how trends are likely to keep moving toward a stronger state in the coming years. Although an alarmed European Union [is threatening to adopt its own protectionist measures to fight back against the Biden administration's new subsidies and "buy American" policies supporting the U.S. semiconductor and green technology industries](#), it's notable that U.S. officials, to date, haven't been warning the Europeans about taking such a stance. Indeed, U.S. Trade Representative Tai [has suggested that the EU adopt similar policies in order to cut its dependence on China](#).

The trend toward a stronger state would seem to be at odds with the rise of populism in many Western democracies. Western populism can be seen as a set of policies focused on the interests of the relatively more traditional, non-elite classes (typically those of a modest income and less than a college education). This populism in recent years has been at odds with the idea of big government and big business in favor of small business and individual workers. Resolving this tension is likely to require elites with their "hands on the rudder" of the government to present and implement their strong-state policies with due consideration for the populist classes.

As with Issue #1, a bigger, more interventionist state is likely to result in less economic efficiency, higher prices, higher inflation, and increased interest rates compared with where they would be

otherwise. Another result would likely be compressed margins and lower stock values, but that impact will probably be partially offset by renewed onshoring of investment and corporate adjustment. The more negative impact will be on fixed income, where higher inflation and interest rates will likely hold down bond values.

### **Issue #3: China Learns to Lead a Bloc**

As we continue to see globalization moving in reverse and the world fracturing into relatively separate geopolitical and economic blocs, one of our key studies in 2022 aimed to objectively forecast which countries would end up in various economic blocs. We projected which countries we thought would join the evolving U.S.-led or China-led blocs, which countries would merely lean toward one or the other, and which countries would remain neutral. Our analysis showed that China's bloc [would likely consist of many of the world's large, commodity-focused emerging markets, especially those with an authoritarian bent,](#) such as Russia, Iran, Iraq, Kazakhstan, and Venezuela, in addition to China itself. A key issue is how Chinese leaders will attempt to lead their bloc and how successful they will be at it.

We have long argued that the U.S. built its post-World War II position as the world's "benevolent hegemon" on two foundational policies. First, it used its overwhelming military power to provide global security and order. It signaled that it would take action to protect its allies' territorial integrity and sovereignty, while it secured the global sea lanes and fought to protect global trade. Second, it made the U.S. dollar the world's reserve currency by opening itself up to other countries' exports and allowing unfettered capital flows. Will China follow a similar path to attain hegemony over its own bloc? We think not.

For one thing, China's military power is still geared primarily toward keeping the U.S. Navy out of the seas along China's coast in the event of conflict. China [has vastly strengthened its forces in that regard by building the world's biggest navy,](#) but it is only slowly developing its ability to project military power globally or to protect its allies' commercial sea routes. Moreover, China still has a lopsided trade balance in which it exports much more than it imports, building up foreign reserves but doing little to make the renminbi a preferred currency. Even if it did accept trade deficits, its own capital controls and underdeveloped financial markets mean that the renminbi is probably far from becoming a reserve currency even within the China-led bloc.

More likely, China's efforts to control its evolving bloc will look like a modernized version of 19<sup>th</sup>-century colonialism or imperialism. Because of over-investment during its long period of breakneck economic growth, China is now saddled with immense excess industrial capacity. To use that capacity and generate enough income to cover its debts, China's incentive now is to build a "captive market" that will supply it with cheap commodities and, in return, buy up its high-value manufactured goods.

How will China accomplish this? One way will simply be to leverage the huge size of its economy and increasing technological prowess. For example, as Russia loses access to Western energy markets, [it will likely become increasingly dependent on Chinese demand.](#) Moreover, China is rapidly improving its military technology, making it less dependent on Russian arms and more likely to become a weapons provider to Russia. We suspect China will also position itself as the preferred market for commodities and a ready source of

relatively high-value factory goods for the rest of the evolving China-led bloc.

For the last decade or more, China has also been trying to garner a quasi-colonial relationship with dozens of countries [through its “Belt and Road” initiative, which finances ports, roads, and other trade-related infrastructure, mostly in less-developed countries](#). The program [has often left the recipient nations caught in a debt trap and at China’s tender mercies](#). Finally, by championing the charms of authoritarianism as an alternative to Western democracy and rule of law, and by pushing the vague vision of a “community of nations with a shared future,” China is trying to build up its own “soft power” as a source of influence over the rest of its bloc.

For U.S. companies and investors, China’s neo-imperialist strategy will likely mean that some emerging markets are no longer available to sell to or invest in. Losing those countries as a source of cheap products will probably work toward boosting prices in the U.S.-led bloc and will weigh somewhat on profit margins. The resulting increase in inflation and interest rates will probably have a bigger negative impact on bonds, while China’s influence over its allied commodity producers will likely threaten the U.S.-led bloc’s access to needed energy, minerals, and other commodities and boost prices for those goods.

#### **Issue #4: The Race for Space**

On May 25, 1961, in a joint session of Congress, President Kennedy announced the goal of putting an American astronaut on the moon by the end of the decade. The USSR appeared to have the lead in the space race with the launch of the Sputnik satellite in 1957. NASA set to work on meeting the task, and the resulting Apollo project was designed to put American astronauts on the

lunar surface. There were 15 Apollo missions<sup>2</sup> in total. The [first was a tragedy](#) when astronauts Grissom, White, and Chaffee were killed in a fire in the command module during a preflight test. The [first manned Apollo mission was #7](#). The first successful [landing on the moon was Apollo 11](#), with Neil Armstrong and “Buzz” Aldrin disembarking from the lunar module and walking on the moon, which occurred on July 20, 1969, meaning the U.S. had met Kennedy’s goal. After Apollo 11, five more moon landings took place.<sup>3</sup> The last humans to visit the moon were with the Apollo 17 mission, which left the moon on December 14, 1972.

It became apparent that the race for the moon was a project to prove the superiority of the U.S. compared to the USSR. Once that goal had been achieved, it became difficult to maintain the project and humans stopped making the trip. The Soviets’ competing program, Luna, continued sending unmanned craft to the moon, but never sent a manned mission. That project ended in 1976.

The U.S. and Japan conducted a few missions that either orbited or flew by the moon after the Apollo and Luna programs ended. These missions occurred periodically from 1978 into 2007. The EU also conducted a lunar orbit in 2003. In 2007, China successfully orbited the moon, and in 2008, India landed a vehicle on the moon.

In recent years, activity has been increasing rapidly as national programs and private sector efforts are accelerating. [No less than](#)

<sup>2</sup> Although the missions were numbered Apollo 1 through 17, missions 2 and 3 didn’t occur in the wake of the Apollo 1 tragedy.

<sup>3</sup> The infamous Apollo 13 mission scrapped the lunar landing after an oxygen tank exploded in-flight.

[33 missions representing 15 nations have projects to send unmanned missions, and the U.S. and China are planning manned missions to land on the moon.](#)

Why all the activity to engage in lunar launches, in particular, and space, in general? Quietly, we see three factors driving this frenzy.

1. ***Taking the high ground:*** Age-old military doctrine supports holding the high ground. Fortresses are not constructed in valleys; rather, they are built on the highest elevation. It's easier to shoot down at your enemy and, perhaps even more importantly, spot enemies on the horizon. Since there is no higher ground than space, controlling the moon might be the most advantageous strategy. The benefits of using satellites to conduct intelligence and aid in military planning, targeting, and logistics are now obvious. [Attacking your adversaries' satellites is easier if you are above them.](#) Thus, the U.S. and China are in a race to capture that high ground.
2. ***Gaining minerals:*** On December 3, 2018, NASA landed the OSIRIS-Rex on the asteroid Bennu. It took samples from the asteroid and is expected to return with them in September 2023. Initial analysis suggests key elements for electronics and defense might be available from these rocks. Mining space objects offers the chance to access key minerals without the environmental damage to the earth, so mining the moon or using it as a logistics base for space mining makes sense.
3. ***Solar power from space:*** The U.S. began funding research on [space-based solar power](#) in 1978. One of the major problems with land-based solar power is intermittency: when the sun sets, so does

solar power. Space-based solar power could gather power nearly 24 hours per day, whereas earth-based systems generally only capture power 29% of the day. The energy would then be transmitted back to earth either by microwave or laser, and an earth-based rectenna would convert it into electricity. Even the moon might be used to base solar panels which could then send power back to earth.

So, what does space offer? The high ground for defense, nearly unlimited key minerals, and perhaps unlimited clean power. The allure is hard to overstate, and thus, the competition will be fierce.

Although defense contractors and companies involved in aerospace clearly benefit, private actors could also do well. We have been favoring defense stocks for some time, and this new frontier only adds to the attractiveness of that sector.

### **Issue #5: The Brittleness of Authoritarianism**

One of the questions we often get is, "Will China/Russia/Iran face revolution?" Predicting revolutions is difficult. Political science has a few approaches to examining revolutions, but they all tend to fail because it is hard to assess human agency. Some models try to dispense with agency completely; the structural school argues that when outside powers interfere or internal elites lose power, revolution often follows. The rational-choice school focuses entirely on the individual, suggesting that revolutions occur when the benefits of overthrowing the government exceed the costs. Unfortunately for this school of thought, it is hard to construct a model that doesn't require martyrdom in order to bring about revolution. By design, rationality usually excludes martyrdom.

Perhaps the greatest test case was the fall of the Soviet Union and the unwinding of the communist regimes in Eastern Europe. None of the models predicted that outcome. Anyone born before 1970 can remember just how remarkable that rapid collapse was, given that those communist regimes appeared impregnable only a few weeks before.

So, when asked the question at the beginning of this section, our usual answer is that it doesn't look likely, but one never knows. And yes, that response is unsatisfying...but honest. Authoritarian regimes can collapse very quickly, and the unwinding can seem to come out of nowhere.

One of the more interesting analyses of the fall of communism comes from [Timur Kuran](#). He specifically studied the end of communism in Eastern Europe, which shocked analysts at the time. Virtually no one predicted the decline or the speed at which it occurred.

Kuran argued mostly from a rational-choice perspective, but he made some interesting observations on why sentiment sometimes reverses quickly. His first point was that under conditions of authoritarianism, there is almost universal preference falsification. Preference falsification is the public signaling of support or opposition to government policies that a person doesn't truly agree with. It may mean carrying around a copy of Xi Jinping's works, joining a pro-government rally in Russia, or wearing a hijab in Iran even when you actually oppose what is outwardly being supported. According to Kuran, preference falsification has a psychological cost—one isn't being true to oneself. On the other hand, not complying also carries costs as it can lead to being ostracized, arrested, or, in the case of

the [Mahsa Amini](#), killed while in custody. Kuran postulated that when the psychological costs exceed the fear of consequences of non-compliance, a person joins the opposition.

But Kuran also realized that mere opposition won't trigger revolution. To overthrow a government, mass involvement is required. Kuran postulated that mass involvement for the opposition grows when a rising number of people decide that the psychological costs exceed the costs of non-compliance. So, there appear to be two factors at play. First, how widespread is preference falsification and how bad is it making people feel? Second, what are the consequences of non-compliance?

In the first case, all governments, even democratic ones, have some degree of preference falsification. We may really oppose paying taxes, but if the penalty is high enough, we probably will go along. In most democracies, complaining about it won't get you arrested; however, if you put out a website encouraging tax non-compliance, you might run into trouble.

Authoritarian regimes generally don't tolerate much dissent. China aggressively censors social media and arrests demonstrators, as does Russia. Iran has several layers of regime police that enforce religious restrictions. Although difficult to measure, we can safely assume there is a high level of preference falsification. But because there is general outward compliance, it may be nearly impossible to know just how much dissatisfaction there is with the regime.

If there is one lesson to be learned by the leadership of the regimes in Iran, Russia, and China from the fall of the Soviet Union and the collapse of the communist regimes

in Eastern Europe, it's that liberalization is dangerous. The [Iranian regime holds that the Shah's liberalization accelerated his overthrow](#), and had he cracked down, he may have stayed in power. [President Xi believes that Gorbachev's reforms were a mistake](#) that should not be repeated by China. Thus, we would not expect these three governments to offer any degree of liberalization; if anything, repression will likely accelerate.

The problem with this policy of extended repression is twofold. First, dissatisfaction with policies will likely expand, meaning the psychological costs of preference falsification will only grow. Second, this sort of repression tends to hurt economic growth, and economic weakness tends to reduce support for the regime.

Kuran's paper did seem to confirm the fears of Xi Jinping, Vladimir Putin, and the Ayatollah Khamenei—that any sign of weakness fosters revolution. Of course, under Kuran's analysis, repression also increases the psychological costs of preference falsification, meaning that repression must also expand. This puts these leaders in a bind as they can't ever let up, but the repression constantly breeds dissatisfaction. Under such pressure, something minor can seemingly trigger a revolution.

In 2023, we don't expect an overthrow of any of these regimes; however, of the three,

Russia is probably the most vulnerable, followed by Iran. The Putin regime may be saved by emigration, but those fleeing were often educated, meaning that the economy is facing "brain drain." Iran has similar issues. China is facing dissent, but our observation is that there hasn't been much call for a new system, mostly because, until recently, China has delivered strong growth. However, the longer the economy stalls, the greater the chance that opposition will grow.

The market impact of an overthrow in Russia or Iran would be bullish for commodities. It isn't obvious that the territorial integrity of either nation would be maintained in a revolution, and an outcome similar to Syria or Lebanon is possible, meaning commodity flows would be disrupted. A revolution in China would generate widespread shortages and would likely be inflationary.

### **Ramifications**

As noted earlier, we don't view these issues as exhaustive, but they do represent the concerns we will be most closely watching as the year progresses. We encourage readers to monitor our reports throughout the year for updates.

Bill O'Grady & Patrick Fearon-Hernandez  
December 12, 2022

*This report was prepared by Bill O'Grady and Patrick Fearon-Hernandez of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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