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The 2016 Geopolitical Outlook

(This is our last issue of 2015. Our next issue will be published Jan. 11, 2016.)

As is our custom, we close out the current year with our outlook for the next one. 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 in the upcoming year. It is not designed to be exhaustive; 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 Election Transition

During the Cold War, transitions of power between U.S. administrations were generally stable and consistent in terms of foreign policy. That's because each government had to deal with containing the Soviet Union. Clearly, there were differences between Presidents Carter and Reagan in their approaches to foreign policy, but the focus was always the same.

In the post-Cold War environment, American foreign policy has been adrift. This is because there has been no singular focus for policy. Because of this lack of focus, foreign policy has to be created anew by each new administration and, to a great extent, has simply become a reaction against the policies of its predecessor.

This lack of continuity has caused a myriad of problems. Allies cannot count on consistent policies; enemies hope that new

policies from the next administration will be more favorable. It becomes almost impossible to plan for external security; for example, allied military leaders never know for sure what the focus of the new administration will be. For example, will the emphasis be on asymmetric warfare, on conventional defense, or something else?

The U.S. has been gifted with substantial natural and created defenses in the form of two large oceans and secure borders, and as such we can indulge in policy volatility. Other nations tend to bear the brunt of our lack of consistency. Until the U.S. decides on a foreign policy priority, policy variance will continue.

What does this mean for next year? Every presidential candidate is offering a different foreign policy than President Obama. This includes those running from his own party. There is widespread dissatisfaction with Obama's foreign policy, therefore it is natural for candidates to offer different policies to exploit this discontent.

Thus, one would expect that foreign leaders presume a reversal of current U.S. policy once the new president takes the oath of office. If a Republican wins (assuming it isn't Rand Paul), policy could become rather belligerent. Even a return to neo-conservative policies could occur. Hillary Clinton has generally been critical of President Obama's policies as well.

Nations that tend to have difficult relations with the U.S., such as Russia, Iran and China, will likely view 2016 as a closing window of opportunity to expand power and influence. Nations friendly with the U.S.,

such as Israel, Saudi Arabia, the Eurozone and the Pacific Rim democracies, will see this as a year to fend off aggression from the aforementioned “difficult” nations. Thus, we would expect geopolitical volatility to increase in 2016 in anticipation of a change in the White House.

Issue #2: Western Populism

Across the West, middle class households are being buffeted by a myriad of adverse circumstances. Incomes have stagnated. The combination of technology and globalization has led to persistently slow wage growth. For much of the past three decades, households have offset declining wages by increasing debt. The 2008 financial crisis ended that mechanism for maintaining consumption. Meanwhile, households with workers able to manage new technology and compete in a global environment have seen their economic lot improve dramatically over the past 35 years, leading to greater income inequality.

At the same time, social structures are changing as well. In Europe, the refugee situation has exacerbated the problems many nations face in assimilating existing immigrants. In the U.S., there is rising opposition to immigration, with a strong focus on undocumented aliens. As income growth has slowed, tensions are rising between various ethnic groups.

As we will discuss below, citizens of the West also face threats from terrorism. Across Europe and the U.S., there is great fear of a rise of “lone wolf” attackers that are nearly impossible to stop in advance.

Simply put, the Western middle class feels beset by both internal and external threats that give them a feeling their world is out of control. Additionally, the political establishment seems detached from the

travails they face. In fact, the elites, who benefit from globalization and automation and generally support immigration to keep wage costs low (the establishment also tends to own capital or directly services those who do), are inclined to dismiss the worries of the middle class.

The populists are revolting. In the U.S., populist candidates are primarily represented by Donald Trump and Sen. Bernie Sanders, but several other GOP candidates are either in this mode or are trying to convince voters that they are populists as well. Ben Carson and Sen. Ted Cruz are pushing their populist credentials.¹ The rise of populism isn’t limited to just the U.S. Across Europe, populist parties are gaining influence. Earlier this month, the National Front party in France scored major gains in regional elections. Both left-wing and right-wing anti-establishment parties have emerged in Greece. In Denmark, the Danish People’s Party is a right-wing populist party, as is the True Finns Party in Finland. In Spain, Podemos is a left-wing populist party. In the U.K., the Independent Party has become increasingly popular.

What do these parties have in common?

They are nationalistic: This is especially true of right-wing populist parties, but even left-wing populists tend to focus more on domestic than foreign issues. Right-wing populists in America tend to be Jacksonians²; this position eschews nuance. For example, in dealing with Islamic State (IS), one often hears comments such as “bomb them into oblivion.” Destroying IS

¹ We examined the rise of populism in three earlier reports. See WGRs: 3/31/2014, [2016 \(Part 1\)](#); 4/14/2014, [2016 \(Part 2\)](#); and 4/21/2014, [2016 \(Part 3\)](#).

² See WGR, 1/9/2012, [The Archetypes of American Foreign Policy](#).

is meaningless unless one deals with the aftermath—what replaces IS? Do you restore the Sykes-Picot borders? What do you do with Syrian President Assad? Jacksonians like to win unconditionally and come home. Multinationalism is also generally opposed, meaning that the U.N. is considered, at best, ineffectual and, at worst, a tool to undermine U.S. sovereignty.

In Europe, the populist parties oppose the EU and the Eurozone. They tend to see Brussels as intrusive and undermining national sovereignty. They want border controls restored, and generally want to see the end of the euro project and the return of legacy currencies. They see the EU political establishment as detrimental to the goals and aspirations of the average European.

They are anti-immigrant: In general, populists from both the U.S. and Europe tend to be xenophobic, especially on the right. From an economic perspective, they view immigrants as competing for the jobs they currently hold (or used to hold). Socially, they view immigrants as representing an alien culture that threatens the established society. This condition is especially true in Europe but also exists in the U.S. to a lesser degree.³

What do the populists want? From an economic standpoint, they want to reverse the policies of globalization and deregulation. Import competition and automation have undermined the economic prospects for the middle class. Consequently, they want to see trade barriers erected and workplace regulation that prevents job loss.

Since the early 1980s, inflation has steadily declined. Although many economists

believe central bank action has been the key to this decline, we believe that the real reason is globalization and deregulation. Both have essentially flattened and shifted the aggregate supply curve rightward, leading to lower inflation despite rising global demand. If one looks at the lack of inflation in Europe, Japan and the U.S., despite aggressive, unconventional monetary policy easing, it is clear that monetary policy has had less impact than most investors believe.

The populist movement threatens the status quo. In one sense, the rise of populism may simply signal that the long political cycle that favored the political establishment, the center-left and center-right, has come to an end. If it does, it may or may not lead to a multipolar world. However, it will certainly lead to higher inflation.

Issue #3: Small-Scale Islamic Terrorism

Osama bin Laden believed that the best way to re-create the caliphate, the pure Islamic state, was to develop conditions that would lead to the spontaneous overthrow of corrupt nations in the Middle East. He believed that these puppet states would collapse if the West withdrew its support, and so he focused al Qaeda on attacking the “far enemy.” A series of attacks against U.S. targets culminated in the horrific events of 9/11. Bin Laden believed that the West would either not retaliate from these steadily escalating strikes and show themselves as weak, or wildly retaliate and reveal that the West’s true agenda was another crusade against Islam. In either case, bin Laden assumed that local Muslims would rise up against their corrupt leaders and oust them from power, creating conditions for al Qaeda leadership to enter and create the caliphate.

³ The “Know-Nothings” in the 1850s are an American example.

Another position argues that attacking the West is folly and that the best way to create the caliphate is to simply create an Islamic state. Once the caliphate is declared, it would be the duty of all observant Muslims to join the effort to relentlessly spread the new nation's boundaries until it is the only nation in the world.

Bin Laden's assessment of the West's reactions was generally accurate. The Clinton administration mostly failed to react to the attacks on the U.S. embassies in Nairobi and Dar es Salaam in 1998 and the attack on the U.S.S. *Cole* in 2000. The lack of action suggested the U.S. would not necessarily support its "puppets" if attacked and, in fact, local branches of al Qaeda began springing up on the Arabian Peninsula.⁴ After 9/11, President Bush reacted strongly to the attacks on New York and Washington by ousting the Taliban in Afghanistan and invading Iraq. Bin Laden argued that this was clear evidence of a new crusade against the Islamic world; however, his hope for spontaneous uprisings failed to develop. Al Qaeda's leadership found itself bottled up in the mountains of Afghanistan, facing constant attacks from drones and becoming increasingly irrelevant.

The leadership of al Qaeda was familiar with Western intelligence agencies; after all, they were supported by them during the Afghan War with the Soviets. The original al Qaeda was focused on operational security, which thwarted Western intelligence agencies from preventing the aforementioned attacks of 9/11. This meant the original al Qaeda was nearly impossible to infiltrate. However, it also meant that the organization was slow to replace fallen leaders, a consequence of tight operational security. The attrition from American

⁴ However, these franchises were mostly contained by local security forces.

"decapitation"⁵ policies, the sacrifice of operatives to execute attacks, the invasion of Afghanistan and the ousting of the Taliban dramatically undermined the ability of al Qaeda to plan and execute major terrorist attacks on the U.S.

It appears that the 9/11 attacks probably represented the high-water mark for al Qaeda, at least for the foreseeable future. Western intelligence agencies have become much more proficient in discovering and thwarting major attacks. In response, terrorist organizations are now relying on smaller scale operations. The recent attacks in Paris probably had some support from IS, but the bombing of the Russian airliner was mostly a franchise operation in which a recently affiliated group likely performed the act with modest support from IS. The shootings in San Bernardino appear to have been carried out by two terrorists inspired by, but not directly connected to, IS.

The fact that Islamic terrorist groups can no longer plan and execute a 9/11 style attack is an improvement. However, that does not mean that the West is now free of Islamic terrorism. Lone wolf and franchise attacks are likely the next evolution of this movement.

Dealing with these attacks shifts the focus from the military to police and domestic intelligence. Balancing civil liberties and security will be difficult for governments and, interestingly enough, will tend to increase support for populist candidates, who tend to support measures that restrict civil liberties.

Issue #4: The Weakening of the European Union

The primary reason for the creation of the EU was to prevent war on the continent by

⁵ The policy of attacking the leadership of al Qaeda.

suppressing nationalism. Since the early 1950s, the European political establishment has been steadily increasing the scope of EU power. The creation of the Eurozone was designed to tie together the economies of Europe.

However, the travails of Italy, Ireland, Spain, Portugal and especially Greece have given pause to other nations in the EU that are not using the single currency. Recently, U.K. PM David Cameron dropped something of a blockbuster on the EU. He suggested that some nations will forever choose to stay out of the Eurozone and that would be acceptable.

In the Maastricht Treaty, EU leaders created the standards for Eurozone membership, with the idea that all members of the EU would eventually join the single currency. The U.K. and Denmark were granted waivers due to domestic opposition, and other nations that didn't meet economic guidelines were expected to join once they met the necessary standards. Since its founding, the Eurozone has grown from initially 12 nations to 19.

Cameron's comments suggest that joining the Eurozone isn't a requirement for being a member of the EU. Poland has indicated that it might prefer to remain outside the Eurozone indefinitely and there is no indication that Denmark is about to change its stance either. The U.K. will likely hold a referendum in 2016 about EU membership; we expect the country to stay in the union but this rift on the currency is another indication that the steady, unifying trend of the EU may have run its course.

The other major issue pressuring Europe is the refugee crisis and the threat it brings to German Chancellor Angela Merkel. The chancellor has been the *de facto* leader of

the Eurozone and the most influential political figure of the EU. However, the refugee situation has dented her popularity across Europe and domestically. For the first time in her career as chancellor, Merkel may face a rebellion and lose her position. If she is unseated, there is no obvious replacement.

Even if Cameron is able to keep Britain in the EU, his position on the Eurozone will tend to weaken the EU's prospects for unifying Europe. If Merkel loses power, Europe will not have a leader and we could easily see further political fragmentation. If the EU begins to fray, the euro could be vulnerable to further weakness.

Issue #5: Trouble in the South China Sea

Since 1979, when Deng Xiaoping set China on its current course of modernization, the country has seen remarkable economic growth. In 1979, China was around 2.3% of global GDP; as of 2014, it was 16.5%, just above the U.S. reading of 16.3%.⁶ As China's economy has expanded, its geopolitical influence has as well.

To some extent, tensions between China and the U.S., along with China's neighbors, are a classic example of the risks that come when a new power rises in a region. China wants to expand its power and insists that the U.S., the incumbent superpower, accommodate its rise.

The dynamics of this situation play out in a number of ways. The Trans-Pacific Partnership (TPP), a trade agreement that includes a dozen nations in the Pacific Rim, excludes China. The U.S. is trying to establish the rules of regional trade and assumes that, eventually, China will join the

⁶ Source: IMF, based on purchasing power parity. Using other methods, the U.S. remains larger.

TPP and be forced to abide by the U.S. trade framework.⁷

At the same time, China is working to create a new infrastructure bank for Asia, the Asian Infrastructure Investment Bank (AIIB), as a competitor for the Asian Development Bank and the World Bank. The Obama administration strongly opposed the creation of the AIIB; despite U.S. pressure, numerous nations, including some G-7 partners, decided to join the bank, a blow to the administration's foreign policy.⁸

China fears the U.S. is trying to prevent it from projecting power in the region. This is probably true. Although America welcomes China's "peaceful rise," the assumption among U.S. policymakers is that China would eventually democratize as its economy grew. Historically, many developing nations use authoritarian systems in their early development. However, domestic political pressure to give citizens a greater voice and the need to allow markets to allocate investment usually forces strongmen to democratize. In general, successful states manage this transition to democracy; those that can't tend to see their growth stall. For example, South Korea made the transition; Pakistan did not.

However, China represents a different case. In these other cases, these states did not necessarily have a developed ideology. In China, the communist ideology has become one of the bases of legitimacy. Most authoritarian regimes become cults of personality that don't outlive the dictator. Although China clearly has personality cults in its history, the Communist Party of China (CPC) has become the primary conduit of political power. It's not obvious if any of the CPC members really believe in Marx

anymore, but they all say they do; perhaps this belief system remains in order to keep the power structure in place. In addition, the ability to deliver economic growth has bolstered the CPC's legitimacy. For now, the CPC leadership seems to believe it has created a new paradigm of market capitalism with non-democratic governance that is superior to market capitalism with democracy.

China is trying to project power in the Far East and Southeast Asia. It is rapidly building its navy. The "Silk Road" program of creating land and sea bridges to Europe and the Middle East appears to be due to fears that the U.S. Navy could block China's trade by sealing off the Strait of Malacca and the first island chain surrounding the country. Extensive road-building through Pakistan is part of this program.

In the South China Sea, China has begun an aggressive dredging program to build up coral atolls and use them to claim sovereignty and create potential military bases to project power in the region. As one would expect, other nations in the area are quite concerned about this activity. The Philippines, for example, appears to be welcoming the U.S. back after forcing the closures of American military bases in the early 1990s.

The Obama administration has been testing Chinese resolve by sending U.S. Navy ships close to these artificial islands. Thus far, these actions have been well-telegraphed and the militaries on both sides have been courteous, avoiding any unexpected escalations. Nevertheless, anytime militaries are in close proximity, mistakes can happen.

The other major worry is that the Xi government is trying to manage a critical

⁷ See WGR, 1/27/2014, [The TTIP and the TPP](#).

⁸ See WGR, 4/20/2015, [The AIIB](#).

economic transition from relying on investment and exports for growth to depending on consumption to expand. Other nations have struggled with this transition.⁹ If growth slows more than the government wants, it will be tempted to distract Chinese citizens with a “foreign adventure.”

Ramifications

In our opinion, these five issues are the most geopolitically important for the upcoming year. In general, geopolitical events tend to be bearish for risk assets and so, if these concerns become critical, they will likely

weigh on equities and higher credit risk debt. On the other hand, if any of these conditions were to worsen significantly, it will tend to boost Treasuries, which have been weak lately, and the dollar. It is worth noting that commodity prices have been under pressure for some time due to weakening Chinese economic growth, rising interest rates and a strong dollar. If oil supplies from the Middle East were to be affected by geopolitical events, oil prices would likely rise.

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⁹ One could argue that Japan never accomplished this shift, leading to 25 years of stagnation.

This report was prepared by Bill O’Grady 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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