Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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The 2021 Geopolitical Outlook

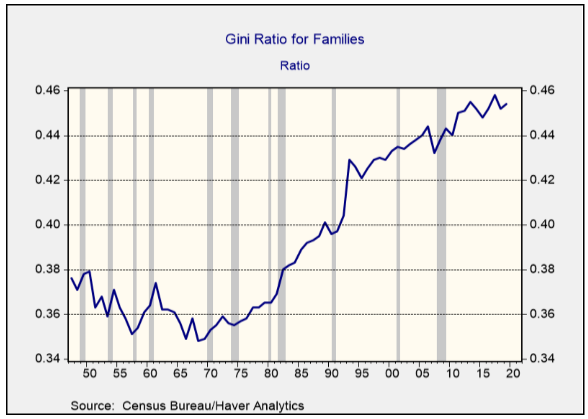
(This is the last report of 2020; the next report will be published on January 11, 2021.)

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 2021. 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 Establishment Strikes Back

The Great Financial Crisis (GFC) signaled that the consensus of policy that emerged in the late 1990s—deregulation and globalization—was no longer sustainable. These policies were implemented in the late 1970s to deal with a persistent and increasing inflation problem. The policies worked to end inflation, but the cost of adjustment fell to working class labor. This isn't just a U.S. issue but one seen, in various degrees, across much of the industrialized world. The cost of ridding the economy of inflation was rising inequality.

The following chart shows the "Gini ratio" for the U.S. It is a measure of inequality; the closer the reading is to one, the higher the level of inequality. Since the late 1970s, inequality has been trending higher.



History shows that globalization isn't really possible without a functioning hegemon. The hegemon provides two global public goods, global security through power projection and the reserve currency. If the U.S. was no longer open to providing global security or absorbing persistent trade deficits to supply the world with dollars, then globalization would likely fail.

In the wake of the GFC, American voters reacted against the consensus policies of deregulation and globalization. The rise of the Tea Party on the right and Occupy movement on the left showed grassroots opposition to the consensus policies. That doesn't mean opposition didn't exist before. The WTO protests in Seattle in 1999 and Pat Buchanan's presidential campaign against incumbent George H.W. Bush showed that support for establishment policies was far from universal. But, the backlash against the establishment was clearly evident with the election of Barack Obama.

In terms of domestic policy, Obama was more conventional than the left-wing populists who supported him expected. Our contention is that many voters hoped they were voting for a president who would govern more like Sen. Bernie Sanders. But, instead of "Medicare for all," they got the Affordable Care Act. In terms of foreign policy, Obama tried to reduce America's overseas power projection, consistent with his Jeffersonian leanings.[1] He was content to "lead from behind" on Libya, not the traditional stance of a hegemon. He established "red lines" in Syria, only to ignore them when crossed. He allowed American troops to leave Iraq.

The political foreign policy establishment, known as "the blob" by Obama officials, was mostly frustrated with Obama's foreign policy. The policy establishment was mostly filled with Hamiltonians or Wilsonians during the Cold War, but Wilsonians dominated after the Berlin Wall fell. They tend to support democracy promotion and values-based policy. Concepts like "responsibility to protect," or humanitarian intervention, became prevalent. These policies led to seemingly endless conflicts where military families bore the burden. American hegemony is key to globalization, but Wilsonian foreign policy was undermining domestic support for hegemony.

President Trump was a rare breed—a Jacksonian president. There have been Jacksonians in Congress but the last president with such leaning was probably Teddy Roosevelt, who was a mix of Jackson and Hamilton. Jacksonians are similar to Jeffersonians in that they want to avoid foreign involvement, but Jacksonians are honor-bound and thus will engage in foreign involvement to defend America's honor. Trump eschewed alliances and multilateralism, both characteristics supported almost as matters of faith by the blob. He vowed to reduce American military commitment to the Middle East and South Asia and fulfilled that goal.

The key point here is that the last two presidents wanted to reduce U.S. global involvement even at the cost of American hegemony. These positions have strong, although not universal, support among the American people. At the same time, maintaining American hegemony is consistently held by political elites across the political spectrum.

The election of Biden is likely a return to the establishment policies of 1992-2008. Although many of his cabinet selections in the foreign policy area are from the Obama era, it is important to note that Obama himself often clashed with his own foreign policy apparatus. Secretary of State Clinton and National Security Advisor Rice tended to support more aggressive policy actions; Obama was reluctant to get involved in Libya compared to his staff, for example. And Biden himself has argued to restore American leadership. It isn't clear that there is much support for this restoration outside the beltway.

What does this mean for foreign policy? Biden's win brought relief to some countries and concern to others. But to those nations that welcome a change in administrations, the concern is how long-lasting will it be? And for those who preferred Trump, will this presidency be a mere "time out"?

All presidents have great ambition when they take office. They all find out soon enough that there are always constraints. For example, currently, policymakers are almost universally opposed to China; this

[1] When examining foreign policy, we use Walter Russell Mead's taxonomy from his 2001 book, *Special Providence*. Here is our synopsis of the archetypes. It should be noted that no president is a pure archetype.

may make it difficult to end the current tariff regime. Making any accommodation to China might be politically impossible. Iran has become so jaded with American foreign power that returning to the JCPOA, as Biden has suggested, is probably impossible. After all, from Tehran's perspective, why bother if policy can abruptly shift every four years?

Until a president can craft a foreign policy that allows for the U.S. to maintain hegemony in a fashion that is acceptable to the majority of Americans, the path away from America's superpower role looks entrenched. We haven't seen anything so far that makes us believe Biden has that plan, and, in fairness, that plan may not be possible. Therefore, we view this incoming administration as a reaction to the past 12 years but view it as a temporary and modest reversal of the dominant trend.

Issue #2: Anti-China Alliance Building
With the growth in China's global economic heft over the last two decades and the aggressive geopolitical policies of its leader, Xi Jinping, the defining question for U.S. policymakers is how to manage the rise of China at a time when many Americans have become weary of the traditional U.S. role as global hegemon. Now that the Trump administration has helped focus attention on China's malign behavior in international trade, technology, territorial aggression, and espionage, the need to counter the Chinese threat has become solidly bipartisan.

President Trump focused on unilaterally pushing back against China's trade and technology abuses, and administration hawks like Secretary of State Mike Pompeo tried to define the threat from China in ideological terms. In contrast, the Biden administration will probably start to broaden the U.S. pushback against China in 2021. For example, National Security Advisor-designee Jake Sullivan recently pledged that the U.S. would resist China's crackdown on Hong Kong's civil liberties. Just as important, Biden has signaled he will rebuild and strengthen U.S. alliances in order to more effectively confront China.

Because of China's massive population, its potential military manpower is almost five times greater than that of the U.S. Chinese GDP has grown to become 10% larger than U.S. GDP, when adjusted for the relative purchasing power of the currency. Therefore, it is now widely accepted that the U.S. would need to act in concert with allies in order to effectively counter China's rising power around the world. The problem is that the U.S. currently has no network of allies specifically organized against China. In 2021, we suspect the Biden administration will start building such an alliance network on the basis of one or more pre-existing groupings, such as:

The Quad. Consisting of the U.S., Japan, Australia, and India, the Quad was originally formed in 2004 for humanitarian aid and disaster relief after an Indian Ocean tsunami. It collapsed after Australia withdrew in 2007, but it was reestablished in 2017 and has expanded into military, economic, and other areas of cooperation, driven in part by concerns about China's rise.

Five Eyes. Made up of the U.S., the U.K., Canada, Australia, and New Zealand, this Cold War-era intelligence sharing group has been the focus of the U.S. effort to keep Chinese equipment out of its allies' telecommunications networks in order to limit espionage risks. Japan also enjoys many privileges of the group but has long wanted to join formally. South Korea, Germany, and France are also partners that could become formal members.

NATO/Europe. With Biden's electoral victory promising to ease U.S.-Europe tensions, some European leaders have called for renewed coordination with the U.S. to thwart malign Chinese behavior. The North Atlantic Treaty Organization also recently released a study calling for NATO to focus more on the security threats posed by China even as it seeks to deter Russian aggression.

"Magna Carta" Coalition. Biden could also try to build a China-facing alliance based on a regional group like the Association of Southeast Asian Nations, or ASEAN. Some experts have even suggested an "Anglosphere" coalition of mostly English-speaking countries. A more interesting and powerful grouping might be based not on language but on shared cultural values. For instance, a "Magna Carta" alliance could bring together all countries committed to private property, free markets, and personal liberty as developed under British Common Law. That grouping would naturally include the U.S., the U.K., Canada, Australia, New Zealand, Japan, and India.

In any case, any alliance building by the Biden administration in 2021 would irritate China. Beijing has already complained that the Quad is a "mini-NATO" that reflects the "Cold War mentality" of the U.S. China has also complained that the Five Eyes group is now an anti-China alliance. If Chinese leaders come to feel hemmed in, they could become even more aggressive, leading to a downward spiral of intensifying tensions with the West that would pose a risk to Chinese and non-Chinese assets alike. On the other hand, a solid alliance could help discipline China and improve its behavior even if it didn't reach the level of a formal treaty. Activities like joint military exercises, coordinated force development, and common trade policies could eventually help the allied countries regain leverage over China. Importantly, a strong alliance would also reduce China's ability to punish individual members who fall under its ire.

Issue #3: The Middle East

The problem is that the U.S. wants to reduce its involvement in the region. China and Asia are far more important issues and with the security of oil supply less important (between U.S. shale supplies and the likely path of peak demand coming this decade, the Middle East is less critical), it is difficult to justify the deep commitment to Middle East security that has been in place since 1945.

The question is how can the U.S. reduce its commitment and maintain stability? The Middle East is unstable mostly because the states created after the fall of the Ottoman Empire were structured for the convenience of the colonial powers, not based on any tribal, religious, or ethnic structures. In fact, the colonial powers deliberately granted authority to minority groups in order to make them dependent on the colonial powers. When they left, these states devolved into fragile authoritarian regimes. The absence of an outside power will likely lead to a restructuring of the region that could look like the 30-Years War.

So, if the U.S. is backing away, who does it align with to be a regional hegemon? The Obama administration seemed to favor a plan similar to one sketched out by Robert Baer. In this scenario, Iran becomes the dominant power. The idea is that Iran is powerful enough to do so and is better than the alternatives. We suspect Obama negotiated the JCPOA as a first step toward normalization with Iran, but that plan was thwarted when Trump won in 2016.

Trump quickly reversed this policy, exiting the JCPOA and applying new sanctions on

Iran. Accordingly, other nations that had been unhappy with Obama's pivot to Iran moved to improve relations with Washington. Saudi Arabia and Israel moved quickly and saw their stature in the region rise.

Relations between the Arab states and Israel have markedly improved. The UAE has normalized relations along with several other nations and the Saudis appear to have deep backchannels to Israel. However, it isn't clear if Israel and the Arab states can cooperate enough to stabilize the region. Russia is attempting to make inroads in the area, but we doubt it has staying power. Turkey might recreate the Ottoman Empire, but it doesn't have the capacity to do so in the near term. The region has bedeviled presidents since George H.W. Bush; Biden will have no obvious path to reducing U.S. influence and maintaining stability. We may be reaching a point where the latter may simply be unattainable. If so, the region could see escalating turmoil.

Issue #4: North Korea

Kim Jong-un's regime had a tumultuous four years during the Trump administration. In 2017, tensions with the U.S. were high, but then there were historic meetings between the leaders of the two nations. However, talks failed to resolve the goals of the U.S. and North Korea. The U.S. wanted North Korea to denuclearize, whereas North Korea wanted sanctions lifted. We ended up in something of a suspended state. North Korea hasn't launched any ICBM tests and the U.S. has mostly avoided provocative actions against Pyongyang.

North Korea has a history of testing new U.S. administrations. Thus, we would not be surprised to see an ICBM test or a border incident. We expect the incoming administration to mostly ignore whatever North Korea tries, but the potential for escalation and error could be elevated in the first half of 2021.

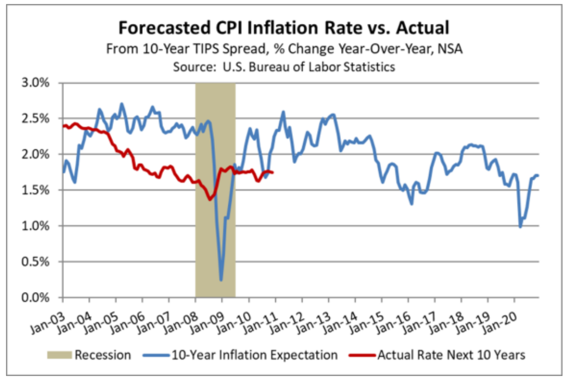
Issue #5: Inflation Up, Real Yields Down

One big driver of geopolitics that investors often ignore is the relative performance of prices for goods, services, and assets. Inflation and market developments have been particularly notable during the coronavirus pandemic. The massive reduction in demand for many goods and services during the lockdowns of early 2020 pushed annual consumer inflation (as measured by the Consumer Price Index, or CPI) almost back down to 0% in the U.S., and below that level in other key economies. If mass vaccination programs around the world bring the pandemic under control in 2021, inflation is likely to stage at least a short-term rebound and have a major impact on asset markets, as follows:

Short-Term. Assuming a global economic recovery in 2021 and 2022, we would expect a modest cyclical rebound in inflation. One simple but useful indicator of U.S. inflation over the short term is the average of inflation over the last one, three, and five years. That average, which has historically had a high correlation with actual inflation one to three years forward, currently suggests U.S. inflation will rebound to about 1.7% in late 2021 from just 1.2% in late 2020. As consumers rebalance their spending and reduce their purchases of "work from home" goods, prices are likely to soften for some items. However, as consumers shift spending back to other goods and services, those prices are likely to rebound strongly, especially where the pandemic has left supply constrained. Service prices could rebound especially strongly and drive overall inflation up as demand normalizes and activity rises. We expect to see a similar short-term rebound in inflation in other key developed countries.

Medium-Term. A cyclical inflation rebound in 2021 and 2022 could be significant, but probably not enough to boost annual price increases much above 2.0%. Perhaps the more interesting question is what happens with inflation in the medium term, i.e., around five years in the future. For longer-term forecasts, we focus on market-based indicators like the yield spread between nominal Treasury securities and inflation-adjusted obligations (Treasury inflation-protected securities, or TIPS). That spread provides a measure of what market participants expect inflation to be. The five-year TIPS spread has recently risen to approximately 1.6%, suggesting a small moderation in inflation following any recovery-inspired rebound in the short term. In other words, it appears that the broad, longstanding downward pressures on inflation from factors like slowing population growth and new technologies will reassert themselves after any inflation bump in the next few years.

Long-Term. Looking further into the future, the 10-year TIPS spread suggests investors expect U.S. inflation of just 1.7% over the next decade, only slightly higher than expected inflation over the next five years. All the same, market inflation expectations for the longer term have risen significantly in recent months in key developed countries, but especially in the U.S. (see the following chart). This likely reflects concerns that the secular downward pressures on inflation mentioned above will eventually be offset by factors like continued loose monetary and fiscal policies, reregulation, and deglobalization.



If inflation does stage a temporary rebound in 2021 and 2022, it could have a big impact on "real" interest rates (nominal rates minus inflation). Rising inflation would threaten to boost nominal bond yields and threaten the economic recovery, so the Fed and other central banks would be more likely to adopt yield curve control, where they adjust their asset purchases to pin both short-term and longer-term rates at low levels. With nominal rates constrained but inflation rising, real rates would fall further. Falling real rates would likely push yield-seeking investors further into investment-grade corporate bonds, high-yield corporates, dividend-paying equities, and emerging market obligations. The outsized rise in U.S. inflation expectations would also add to downward pressures on the dollar. Moreover, falling real yields and a weakening greenback would add to the upward pressure on gold and other precious metals.

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. Readers can monitor our reports throughout the year for updates.

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