Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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The 2020 Geopolitical Outlook

(This is the last report for 2019; the next report will be published January 13, 2020.)

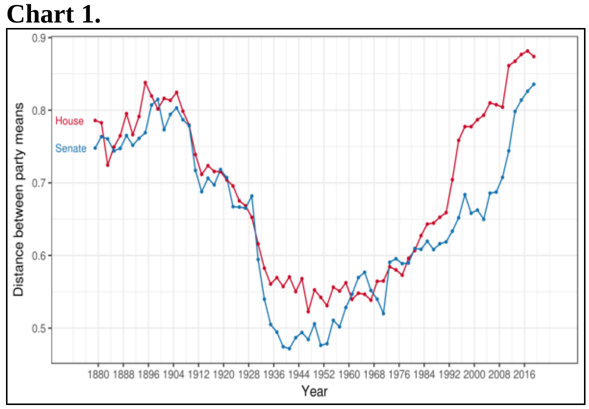
As is our custom, in mid-December, we publish our geopolitical outlook for the upcoming year. This report is less a series of predictions as it is a list of potential geopolitical issues that we believe will dominate the international landscape for 2020. It is not designed to be exhaustive; instead, 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: U.S. 2020 Presidential Election
Foreign meddling in elections is nothing new. The U.S. has engaged in such activities but mostly through overt, democracy-promoting policies. Although the U.S. tended to view such activities as a means to expand liberal democratic order, foreign autocrats usually viewed these programs as intrusive.

However, it is possible we will see expansive foreign efforts to sway the U.S. electorate in the November 2020 elections. There are three factors behind this assertion. First, the U.S. is unusually susceptible to attempts of manipulation due to deep political divisions. Second, social media has given foreign nations a low-cost, effective path to influence voters. Third, several nations have an incentive to affect the outcome; what is interesting about the third point is that their desired outcomes are not uniform. This means that foreign actors may work at cross-purposes.

The divided electorate.
Two political scientists, Keith Poole and Howard Rosenthal, have done exhaustive research into the level of partisanship in Congress.

Chart 1.



(Source: Rosenthal and Poole)

The data is structured in such a way that the higher the level of the score, the greater the degree of partisanship. The data suggests that Congress has never been as deeply divided between conservatives and liberals as it is currently.

This data is supported by anecdotal reports of deep political divisions. Surveys suggest that parents are more comfortable with their offspring marrying someone of a different race or creed than one of the opposite political party. Political divisions now define news sources; at the same time, there is a high degree of distrust of news reporting.

In this hyperpartisan environment, voters are inclined to believe only the positive aspects of their favored party and expect the worst from the opposition.

Political divisions have mostly eliminated the concept of the "loyal opposition." Historically, in a functioning democracy, the losing party believes that elected officials of the opposition are legitimate officeholders. They may disagree with them on many issues but they don't believe they are illegitimate. However, in the past three presidencies we have seen a growing tendency for the opposition to view the president as illegitimate. President George W. Bush was seen as illegitimate due to Florida's vote being decided by the Supreme Court. President Barack Obama was in question because of allegations that he was foreign-born. And, President Donald Trump is seen as tainted because of Russian interference in the electoral process. When a president is seen as gaining office through illicit means the opposition is no longer loyal; it becomes the resistance. Resistance tends to foster an attitude where the end justifies the means, whereby preventing an illegitimate president from exercising power becomes justified. The U.S. has political conditions in place where a sizeable minority views the president as illegitimate and thus the country is susceptible to foreign manipulation.

Social media

Rosenthal and Poole's data tends to suggest that bipartisanship was mostly a Cold War artifact; prior to the Cold War, the U.S. was quite partisan. The media was also divided; the "yellow press" fanned the flames that led to the Spanish-American War in 1898. Partisan media isn't anything new. However, what is new is that the advent of social media means that dispersion of information, or disinformation, is low cost and easy. Anyone can start rumors or inuendo on social media and it can become a "meme" before anyone can fact check. The social media firms, so far, have proven unable to fully manage this issue. Thus, we expect more of what we saw in the 2016 election.

Foreign actors

It is important to realize that foreign interference is nothing new to American elections. The U.S. has done its share of interference, although we tend to couch such activities as extending the liberal democratic order. What we view as democracy-building is often seen by foreign leaders as meddling. Here are the nations that are most likely to interfere:

1. *Russia:* Russia was involved in 2016 and will likely be in 2020 as well. Russia is a master at disinformation and has been at it for years. Russia has two goals: to undermine the legitimacy of whomever is president, and to elect a populist, not an establishment figure, as president.
2. *China:* China has significant cyberwar capabilities, but they are mostly used for industrial espionage. The Chinese are relatively new at political manipulation, so we expect them to be involved but their methods probably won't be as effective as the Russians' techniques. China wants the establishment back; the U.S. political establishment wants globalization and that works best for China's economy.
3. *Israel:* Israel has impressive cyberwarfare capabilities and a deep understanding of U.S politics. It wants a GOP candidate to win as the Democratic Party is seen as hostile to its interests.
4. *North Korea:* The Hermit Kingdom also has sophisticated cyber capabilities but little evidence of democratic nuance. Its preferred outcome would be a Jeffersonian isolationist who would pull back from the hegemonic role.

5. *Iran*: Iran has also developed cyber capacity. Its goal, similar to North Korea's, would be to bring a populist to the White House. However, if that isn't possible, it would prefer a Democrat who would likely bring back the Iran nuclear deal.

These are the five nations we deem to have the most capacity and interest to interfere, but this roster is not exhaustive. This is an issue we intend to write about more in-depth in 2020. Overall, the combination of deep partisan divisions, social media and incentivized foreign actors creates a notable risk for next year.

Issue #2: Iran

The decision by the Trump administration to reapply sanctions has caused severe damage to the Iranian economy. Although reliable data is becoming increasingly difficult to find, two charts highlight the country's difficulties. First, inflation is at eye-popping levels.

Chart 2.

Sanctions returned in mid-2018; in less than a year, inflation rose from 7.1% to over 50%. Although price momentum has declined recently, this is mostly due to base effects[1] and slowing economic growth. Iran's problem is that sanctions have crippled oil exports, the lifeblood of Iran's economy.

Chart 3.

Oil exports have fallen from 2.1 mbpd to just over 0.4 mbpd. The price required to balance Iran's fiscal accounts is nearly $200 per barrel.

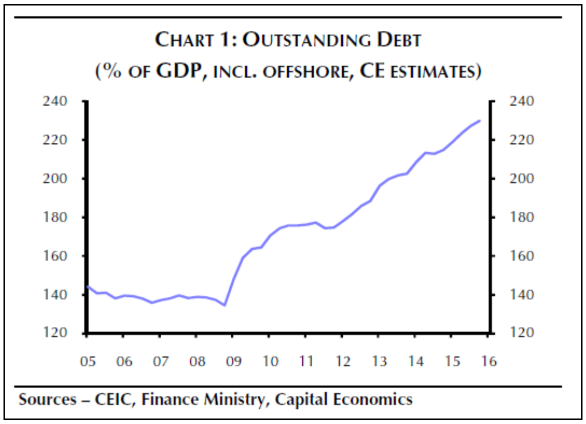
This situation is unsustainable. Iran will need to negotiate with the U.S. and establish a new nuclear agreement. However, Iran does not want to engage in talks from a position of weakness. To improve its bargaining position, Tehran needs to threaten to disrupt regional oil supplies but not in such a fashion as to trigger a U.S. military response. Iran has already attacked Saudi Arabia and pretty much gotten away with it. That lack of response by the West will almost certainly encourage Iran to "up the ante."

Issue #3: China's Debt

Measuring China's debt is an inexact science. Clear data isn't readily available and the scaling variable, GDP, may be overstated. However, there is enough evidence to suggest that it is large and growing. *Capital Economics* estimates China's debt at about 235% of GDP.

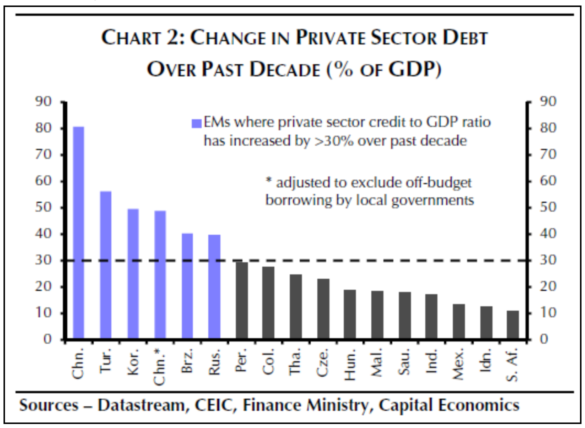
[1] Compared to high prices a year ago.

Chart 4.



Although this level is high, it isn't out of line with other nations. What has been raising concerns is the growth rate.

Chart 5.

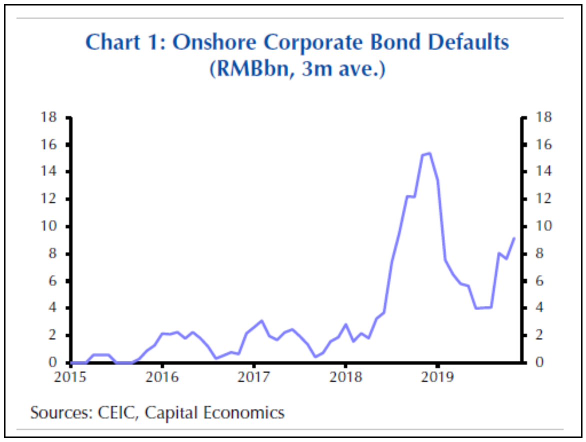


In general, a private sector debt growth rate in excess of 30% over a decade is a warning sign of a debt crisis. China's private growth over the past decade is around 80.

It should be noted that most of China's private sector debt is in CNY. Household and non-financial corporate debt is around $21.5 trillion, $605 billion of which is foreign currency denominated. So, China should be able to manage the debt problem internally.

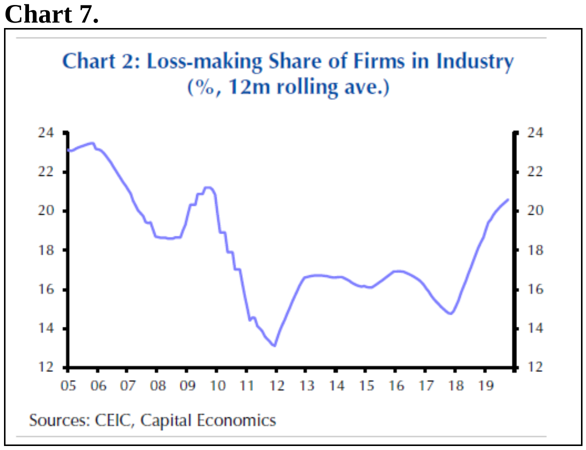
The issue is how exactly it will do this. The danger of debt growth of this magnitude is that it is highly unlikely that much of the investment behind this debt is going to useful purposes. Corporate bond defaults were not permitted until 2014 and only on a limited basis from 2014 to 2018. However, recently, defaults have been increasing, although the level is still a low percentage.

Chart 6.



The number of loss-making firms is also rising.

Chart 7.



One immediate step would be to reduce loan growth but that would reveal which borrowers are in trouble. The other issue is that rising defaults could trigger financial panic among lenders. Our base case is that Chinese financial authorities will handle this debt problem in a manner to avoid a financial crisis. The most likely outcome is that the debt overhang will adversely affect growth. But, losses will need to be assigned and the potential for a mistake is elevated.

Issue #4: Demographics

With this year's continued slow inflation in most major economies, and with many central banks continuing or returning to interest rate cuts, there's been renewed concern about spreading "Japanification," i.e., persistently slow economic growth and falling prices generated by an aging population. For the United States, that concern is probably misplaced for now, since it still doesn't face the outright population decline and extremely high debt levels that distinguish Japan. Nevertheless, we think the U.S. and other major countries will face increased economic and financial headwinds in 2020 from the global trend toward falling birthrates, slowing population growth and population aging.

In theory and practice, population trends affect investment returns, even if it's hard to separate their impact from other shorter-term economic and financial forces. For example, demographics affect the supply of labor in the economy, which in turn impacts wage rates and corporate profitability. Demographics also affect the demand side of the economy because consumer spending changes over a person's lifetime. Spending tends to drop as a person nears or enters into retirement, which suggests an aging society will have weaker demand, reduced inflation, a need for lower interest rates and greater negative effects from debt. Many investment firms discuss demographics in broad, abstract terms, but we are launching a concerted effort to look at the impact in more specific, measurable terms.

To lay out the broad context for our analysis, we note that the U.N. Population Division's recently updated forecasts call for the world's population to reach 7.795 billion in 2020. However, the rise of 1.05% from 2019 will be much less robust than the average annual increases of 1.14% over the last 10 years, 1.20% over the last 20 years and 1.30% over the last 50 years. Mostly because of lower birth rates, the U.N. forecasts global population growth will average just 0.93% in the next decade to 2030, and even less in the years after that. Not a single major country is expected to grow faster in 2020 than its average rate over the last five years. On the contrary, the forecasts show 31 countries with a combined population of 860.9 million will be in outright population decline, up from 30 countries in 2019.

Traditionally, the key demographic variable for geopolitical analysis is the size of a country's conscription-age population. For example, in order to measure a country's potential military manpower and its ability to sustain high-intensity, mass-mobilization warfare, the Central Intelligence Agency tracks each country's total military-age population (males and females aged 16-49). As shown in Table 1, the U.N. data suggests that at recent growth rates the major country with the biggest annual increase in potential military manpower in 2020 will be India. One of its key geopolitical rivals, China, will be the major country suffering the biggest annual decline in potential troops. The U.S., Canada and Australia are the only major developed countries with an expanding pool of potential military manpower. Although the Trump administration is focused on boosting the Europeans' financial commitment to defense, a bigger issue may be the long-term decline in their ability to commit human resources to defense.

Table 1.

Potential Military Manpower: Selected Countries

Source: United Nations Population Division

Country	Gross Military Age Population (16-49), Millions	Share of Total Population	2015-2020 CAGR	Annual Change, Millions
India	725.9	39.3%	1.3%	9.5
Mexico	66.1	52.6%	1.0%	0.7
United States	148.1	52.3%	0.4%	0.6
Turkey	42.9	40.4%	1.2%	0.5
Brazil	111.1	40.4%	0.4%	0.5
Saudi Arabia	20.5	44.7%	1.6%	0.3
Iran	45.1	44.6%	0.2%	0.1
Canada	16.8	41.1%	0.5%	0.1
Australia	11.6	43.3%	0.6%	0.1
Israel	3.9	48.4%	1.4%	0.1
UK	29.4	45.3%	-0.1%	(0.0)
France	26.8	46.9%	-0.4%	(0.1)
Germany	33.8	43.3%	-0.5%	(0.2)
Spain	20.2	53.7%	-1.3%	(0.3)
Venezuela	13.7	48.2%	-2.1%	(0.3)
Italy	24.4	58.9%	-1.2%	(0.3)
Korea	24.0	44.9%	-1.4%	(0.3)
Russia	66.0	45.5%	-0.7%	(0.5)
Japan	49.7	51.3%	-1.1%	(0.6)
China	695.9	50.8%	-1.3%	(9.0)

Table 2.

Working Age Population: Selected Countries

Source: United Nations Population Division

Country	Working Age Population (16-64), Millions	Share of Total Population	2015-2020 CAGR	Annual Change, Millions
India	902.9	58.3%	1.5%	13.4
Brazil	145.0	60.4%	0.9%	1.3
Mexico	83.6	63.4%	1.4%	1.2
Turkey	55.2	69.2%	1.6%	0.9
United States	210.9	65.1%	0.3%	0.6
Saudi Arabia	24.5	63.7%	2.1%	0.5
Iran	56.5	62.6%	0.9%	0.5
UK	42.5	65.1%	0.4%	0.2
Australia	16.1	62.8%	0.7%	0.1
Canada	24.6	68.2%	0.4%	0.1
Germany	53.1	70.8%	0.1%	0.1
Israel	5.0	65.4%	1.2%	0.1
France	39.4	64.6%	-0.1%	(0.1)
Spain	30.2	70.5%	-0.2%	(0.1)
Korea	36.3	64.8%	-0.2%	(0.1)
Italy	37.9	65.5%	-0.2%	(0.1)
Venezuela	17.9	62.9%	-1.3%	(0.2)
Japan	73.7	67.3%	-0.8%	(0.6)
Russia	95.0	58.2%	-0.9%	(0.9)
China	995.6	63.3%	-0.2%	(1.8)

Another key metric for a country is the size of its potential labor force, given the impact it can have on the country's economy and financial markets (as mentioned above), and on its capacity for military innovation and defense industry. The slowdown in overall population growth in most countries is being matched by weaker labor force expansion, which we expect will be a continuing drag on world economic growth and inflation in 2020. Table 2 shows that the U.S. and its English-speaking allies will be almost the only developed countries whose workforces are still growing. All else being the same, we think that will give them geopolitical, economic and financial advantages over most of the other developed countries, and even some of the emerging markets. We expect to dive deeper into those dynamics in future publications.

Issue #5: North Korea

Three years into the Trump administration, it's easy to forget the dangerous U.S.-North Korean tensions that prevailed right after Trump's inauguration back in 2017. Those tensions included acerbic rhetoric and insults between the countries, North Korean military provocations like missile launches and a suspected nuclear test, and North Korean sanction-busting. However, intense diplomatic effort by South Korean President Moon eventually led to North Korean participation in the 2018 Pyeongchang Olympics and thawing relations with the U.S. President Trump and North Korean leader Kim Jong-un finally held a summit in Singapore in June 2018, producing a joint communiqué that vaguely referred to denuclearization of the Korean Peninsula.

As heady as that meeting was, the last 18 months have proved to be a disappointment for the relationship. As we and other observers pointed out at the time, the U.S. and North Korean concepts of denuclearization differ radically. Even the process of denuclearization is in dispute, with the North Koreans demanding a gradual, step-by-step approach with simultaneous concessions from each side, while the U.S. demands that any relief from U.S. or U.N. sanctions must come after North Korea takes concrete steps to dismantle its nuclear program and has those steps verified.

With the two sides at loggerheads throughout 2018, President Trump pushed for a second summit in Vietnam in early 2019. However, the leaders still found themselves at odds on denuclearization and President Trump walked out on the summit. Since then, little progress has been made to reach an understanding. The intensifying U.S.-China trade negotiations have allowed North Korea to drop off many investors' radar screens.

In recent weeks, it appears that North Korea has begun to get impatient and is now willing to embark on risky, new provocations in order to get attention again and try to wring concessions out of the United States. Despite its ability to work around some sanctions – transferring prohibited oil imports to North Korean ships at sea, for example – reports suggest Pyongyang is struggling with the economic impact of the sanctions. In an effort to push back, North Korean state media has been ratcheting up its negative rhetoric against President Trump (even calling him a "heedless and erratic old man"). More importantly, it has also recently resumed conducting missile tests and upgrading its military facilities. The U.S. and its allies have responded in kind, with President Trump again referring to Kim as "rocket man," and the U.S. and South Korean militaries expanding their surveillance of the regime.

We believe there is an increased risk that the North Koreans will ratchet up their provocations again in late 2019 or in 2020, even beyond their potential interference in the U.S. elections as mentioned above. At the same time, President Trump faces a domestic political threat from his right as former National Security Council Director Bolton criticizes the administration's approach to North Korea at the U.N. There is therefore a risk of miscalculation and mistake on each side. Unfortunately, the media has given surprisingly little attention to the renewed tensions, which means that if some new crisis develops between the two countries, investors would likely feel like it came from out of the blue and react irrationally. The situation therefore qualifies as a significant downside risk for the markets in 2020.

Honorable mentions: In January, Taiwan will hold general elections to decide on a new president. Independence-minded incumbent Tsai Ing-Wen is currently the front-runner ahead of the more China-oriented Han Kuo-yu. In March or April, Bolivia will hold a presidential election to replace the recently ousted Evo Morales. Britain and the EU will negotiate a free trade deal in 2020. If it fails, a hard Brexit is still possible.

Ramifications

Election uncertainty could weigh on confidence and thus undermine risk assets. Although disruption would need to be pervasive to affect financial markets, the chances of that outcome are elevated. Any issues with Iran would be bullish for crude oil. A Chinese debt crisis means slower world growth, at best, and might trigger a global financial panic, at worst. Demographics are mostly a "slow burn" issue but the expected fall in birth rates is creating a world of persistently slow growth and low inflation. If North Korea becomes a problem, look for weakness in risk assets, in particular, in South Korea and Japan.

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.

Bill O'Grady & Patrick Fearon-Hernandez
December 16, 2019

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