Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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The 2018 Geopolitical Outlook

(N.B. This will be the last WGR of 2017. Our next report will be published January 8, 2018.)

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 Big Picture

A common theme in our geopolitical research since the founding of our firm a decade ago has been uncertainty surrounding the superpower role. The U.S. is an ideal nation to act as global hegemon. It is a large country with a big economy. The U.S. was built on immigration; national identity has not been tied to ethnicity or religion but rather by birth or naturalization. This allows America to attract the most ambitious and committed people of the world to join the "project." The U.S. borders two oceans, giving it influence in both the Atlantic and Pacific Oceans. It is also surrounded by two weak and pacified nations so it faces no persistent regional threat.

Because the U.S. is generally safe from invasion and enjoys a large domestic economy, it is not compelled to participate in world matters. For most nations, international involvement is a requirement, not a choice. That perspective isn't true for America. Therefore, U.S. leaders can decide if, when and how much to become involved in the world. Simply put, isolationism is a viable option for the U.S.

At the end of WWII, the U.S. took on the superpower role and chose to be involved in the world. American political leadership decided that retreating to isolationism was a recipe that would eventually lead to WWIII. However, the political leadership had to "sell" this decision to the American people. For the most part, most Americans preferred to remain uninvolved with world problems. In other words, the superpower role was not a natural desire of Americans. Think of it this way…the majority of Americans have ancestors who were immigrants who purposely left their home countries. Getting involved in the "old country" was precisely what they were trying to avoid by coming to the U.S.

America's hegemonic task had three elements. The first element was the containment of communism.[1] The U.S. viewed communism as an existential threat. Communism offered an alternative system of government and society that was antithetical to democracy and capitalism. President Truman believed that the U.S., exhausted from fighting WWII, was not prepared to go to war against the Soviet Union. The development of nuclear weapons made conventional war even less

[1] For background, George Kennan's "long telegram" is key to understanding the concept of containment. https://www.trumanlibrary.org/whistlestop/study_collections/coldwar/documents/pdf/6-6.pdf

likely. Thus, American policy evolved into the containment of communism with the idea that democracy and capitalism were superior systems and, given enough time, communism would fail. Containing communism, essentially keeping the U.S.S.R., the Eastern Bloc and China within their borders and preventing the spread of the ideology, became the working policy of the U.S. And, more importantly, it also became the political rationale for the sacrifices Americans made to provide the world with security and prosperity.

The success of American hegemony, which ushered in the era of *Pax Americana*, required more than just containing communism. The world had suffered through two world wars in the first half of the 20th century. The fact that another world war did not occur in the second half is a testament to the effectiveness of American hegemony. In addition, global trade had also collapsed. This problem was addressed as well. Unfortunately, the other two policies implemented by American policymakers were critical to the success of the project but were never well articulated to the American public.

The second policy was the freezing of perpetual conflicts in three parts of the world—Europe, the Far East and the Middle East. In Europe, Germany was the problem. The country is situated on the Great Northern European Plain, meaning it enjoyed the significant economic advantage of few barriers to the free flow of goods and people. At the same time, this openness made it vulnerable to invasion. As a result, Germany became an economic and political threat to Europe. Germany feared its neighbors and thus became belligerent in order to protect its borders. The inability of European leaders to resolve "The German Problem" led to two world wars. The U.S. resolved this problem by essentially demilitarizing Germany and taking over the security of Europe through NATO.

In the Far East, the U.S. created a similar solution. China and Japan had been vying for control of the region for centuries. Japan's invasion of China in the late 1930s and the subsequent military expansion during WWII was simply the latest iteration of this pattern. The U.S. demilitarized Japan and guaranteed its defense, relieving not just Japan from its desire to secure resources but also ensuring its neighbors that they would not face another Japanese invasion.

In the Middle East, the U.S. committed itself to maintaining the colonial era borders even though the independent nations that emerged from colonialism were nearly ungovernable. Most of these states devolved into authoritarian or theocratic regimes that relied on oil revenue for economic activity. Although far from the democratic ideals that the U.S. espoused, the U.S. ensured stability in the region and secured critical oil supplies for the Free World.

The third element to American hegemony was trade promotion, which involved two policies. First, the U.S. developed a large carrier-based navy that protected the sea lanes and was able to react quickly to global unrest. Although the U.S. didn't become involved in every troubled area of the world, the navy gave America the capacity to do so if necessary. The navy tended to keep regional conflicts contained. The second policy was the reserve currency. The U.S. opened its economy to imports, and the rest of the world used the U.S. dollar as a universal currency for trade. This required the U.S. to run ever larger trade deficits in order to provide an adequate supply of dollars to the world. These trade deficits made the U.S. a consumer paradise at the expense of job loss to foreign trade. Foreign nations deliberately structured their economies to promote exports, fostering development at the expense of U.S. workers.

There was a high degree of policy consensus during the Cold War. Americans were prepared to bear the burdens of hegemony when communism was a threat. However, the fall of the Berlin Wall and the collapse of the Soviet Union ended that consensus. Nevertheless, just because containment is no longer necessary, the other two elements are still important to global peace and prosperity.

Since then, subsequent administrations have struggled to formulate a consensus on American hegemony. The Clinton administration was mostly focused on domestic issues and only became globally involved when crises developed. The Bush government was consumed with transnational Islamist terrorism but, unfortunately, fostered the breakdown of the Middle East through its invasion of Iraq. The Obama administration struggled to devise a policy; he tried to "pivot" to the Far East but needed to reduce attention to the Middle East in order to do so. Unfortunately, a series of errors, including unenforced "red lines" and support of the Arab Spring, led to regime collapse across the region. The Iranian nuclear deal signaled that the Obama administration was preparing the clerical regime to become the regional hegemon, which was strongly opposed by most other governments in the area.

President Trump represents a populist rejection of the superpower role. Encouraging the rearming of Japan and Europe and the rejection of free trade agreements reverses the primary pillars of the postwar era. There is a case to be made that the bottom 80% of the income brackets were mostly disadvantaged by the *Pax Americana* policies. Globalization reduced the number of moderately skilled, high-paying jobs in the economy and tended to support urban concentration to the detriment of the "rust belt." Trump's policies are an attempt to correct this disparity.

Much of the geopolitical risks the markets face this year are due in part to this broad unwinding of *Pax Americana*. Although the decision to abandon these policies is understandable, our fear is that there is a lack of understanding surrounding these changes. At its core, the key drivers of many of the geopolitical risks we see evolving are due to the rejection of the two unacknowledged policies. In a sense, U.S. policymakers have not been able to articulate why American hegemony should continue in the absence of communism. As a result, without a good reason to bear the costs, Americans are generally rejecting the burden. This issue will likely be with us not only in 2018 but beyond; the new development is that this rejection is now evident.

Issue #2: China Deleveraging

China's debt/GDP ratio has reached 257%,[2] a level that is likely unsustainable. This debt is the byproduct of a development model that supported domestic saving and exports. Essentially, households faced financial repression which curtailed consumption and boosted saving. The saving supported massive investment but was still large enough to also cause trade surpluses, which are nothing more than the export of saving. Domestic investment used the saving, through borrowing, to develop the economy. We have now reached the

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[2] http://nationalinterest.org/blog/the-buzz/scary-statistic-chinas-debt-gdp-ratio-reached-257-percent-22824

point at which (a) malinvestment likely exists, and (b) debt has become unsustainable.

Fixing the problem requires a reversal of China's development model so that household income and consumption rise, while saving and investment decline. In theory, there are three ways to achieve this outcome. First, one can grow so fast that household incomes outpace overall economic growth. That has never occurred in history. The second is how the U.S. rebalanced in the 1930s during the Great Depression. GDP collapsed as did household income but the latter fell less quickly, thus allowing for deleveraging. Investment essentially collapsed. The third method is how Japan has handled the problem since the early 1990s. Growth has been very slow for nearly three decades, while household incomes rose a bit faster than overall growth. Unfortunately, too much of the saving in Japan was held by the corporate sector, which has hindered private sector deleveraging.

Although China suggests it can execute the first method, we suspect it will be forced to either use the U.S. or Japanese model. To be really successful, income must shift from the corporate and government sectors to the household sector. This is clearly an economic issue but it is a political one as well. During the Deng reforms, China decentralized the economy, leading to faster growth but higher levels of income inequality.

History shows the political solution to China's problem is either to (a) democratize, or (b) recentralize. The chosen solution appears to be option "b." Chairman Xi spent his first term implementing an aggressive anti-corruption campaign, eliminating potential rivals. At the recent party congress, he was given political status equal only to Mao. We suspect Xi is going to start the process of boosting household incomes and encouraging spending in a myriad of ways, all designed to depress household saving and begin the process of deleveraging. Simply put, if one has done well economically in China for the past three decades, that is about to change. The moves are massive and the potential for a misstep is elevated.

Issue #3: European Politics

There are three areas of concern in Europe. First, Italy will hold elections in early 2018. We expect a centrist coalition to emerge as the winner, although the Five-Star movement may surprise and join the government. In any case, support for the Eurozone is low in Italy, only about 55% of the population. A surprise could bring a government that decides to exit the Eurozone. If that occurs, the Euro project may be doomed.

The second area of concern is the U.K. PM May's government is a weak coalition of the Conservatives and the Democratic Union Party, a small Ulster-based political party. The Brexit negotiations have not gone well; PM May has made a number of unforced errors that have undermined her support. If her government falls, there is a good chance that the Labour Party, led by Jeremy Corbyn, would win. Corbyn is an unreconstructed leftist who would seek to nationalize major industries and raise tax rates.

The third area is Russia. President Putin will run for re-election in March and it is certain he will win. However, as soon as the results are in, political figures will begin jockeying for position to replace Putin. The Russian constitution doesn't allow for a fifth term and, given that Putin will be 69 at the end of his fourth term, he will likely be pushed aside. Putin as "lame duck" could boost political instability in Russia.

Issue #4: North Korea
It is almost certain that North Korea will have a deliverable nuclear weapon next year; in fact, it may have one now. We suspect that Kim Jong-un will probably use this fact as the basis for beginning negotiations with the U.S. Although the stated U.S. policy is that a nuclear North Korea is unacceptable, it appears that policy won't be enforced, short of military action.

Kim Jong-un is a mostly untested ruler and the potential for a mistake is unusually elevated. President Trump is untested as well (although it should be noted he does have a very experienced staff). While we don't expect military action, the combination of stated U.S. policy and policy inexperience raises the potential for such an event.

Issue #5: South American Populism
Venezuela remains a mess and it isn't likely to get better in 2018, but our larger concerns are elections in Brazil and Mexico. Widespread corruption in both nations has led to support for populist candidates. In Brazil, three populist candidates, Marina Silva, Luiz Lula and Jair Bolosonaro, have combined support of 60% to 65%. In Mexico, Andres Manuel Lopez Obrador is polling strongly and is currently the leading candidate for president.

In one way or another, we would consider all these candidates unfriendly to markets. Although populism has been common in South America, it has been less popular in Mexico and Brazil. A return to anti-market policies would be a reversal of recent behavior.

Issue #6: The Middle East
U.S. Cold War policy was designed to maintain borders in the region. In the post-Cold War era, these borders have become increasingly flexible. Although Islamic State will likely completely disappear in 2018, numerous parties will try to fill the ensuing vacuum, including the Kurds, Arab Sunnis, Arab Shiites and Iranians. The region has the potential to become a cauldron of unrest.

Although the U.S. remains involved in the Middle East, the degree of American commitment is being undermined by the expansion of shale oil production. At the same time, Mohammad bin Salman, the crown prince of Saudi Arabia, is making aggressive changes in the kingdom. With the U.S. role potentially changing, Iran, Turkey and Saudi Arabia are all vying for leadership in the region. We expect unrest to escalate next year.

Issue #7: U.S. Domestic Politics
The study of geopolitics is different than domestic politics because the former includes geographic and international factors. Therefore, we seldom mention domestic politics in this report. Nevertheless, when domestic politics affects international relations, it does become a relevant topic.

There are three issues we are watching in U.S. politics. The first is the Mueller investigation. We view impeachment as a political, not a legal, action. As long as Congress is controlled by the GOP, the odds of impeachment are very low unless the president is seen to have committed the most heinous of crimes. If Congressional control changes after the mid-terms, this concern could change. Prediction markets are currently signaling a divided government (House goes to the Democrats, GOP maintains the Senate). This outcome would lead to gridlock but not impeachment.

However, if there is a steady drip of revelations and indictments from the investigation, it will tend to weigh on sentiment and may lead foreign governments to believe they can take advantage of the domestic distractions.

The second issue is that if the GOP loses its control of the legislature and gridlock develops, President Trump will likely turn his attention to foreign policy. That is a common pattern observed with other presidents—when domestic policy becomes stalled, they move to foreign policy as a way to accomplish something. One way this could develop is if Secretary of State Tillerson is replaced by current CIA Director Pompeo and Sen. Tom Cotton (R-AR) takes over the CIA. Both Cotton and Pompeo are Iranian hawks and would be inclined to press the president to jettison the Iranian nuclear agreement and consider a conflict with Iran.

The third domestic matter is related to trade. As noted in Issue #1, the dollar is the reserve currency and, as part of this role, the U.S. is required to run trade deficits to maintain the supply of dollars on world markets. President Trump's policies appear focused on ending American hegemony and trade protection would be an element of this reversal. If gridlock develops, the president can focus on trade protection because the executive branch can act with significant independence on trade policy and doesn't need legislative approval for most actions. If the U.S. begins to engage in trade protection, it is likely that other nations will eventually adopt this position as well, which will reverse the steady expansion of globalization observed since WWII.

Ramifications

We have generally viewed Issue #1 as a longer term problem. However, as each year passes, it is becoming a more immediate concern. In general, the U.S. withdrawal from the world will make conditions more dangerous and should support safety assets, such as gold, commodities and Treasuries. We would also put the dollar in this category if a reserve currency rival fails to appear, but, at present, we don't see any national currency able to replace the greenback. Cryptocurrencies, if they mature, could be that replacement. We doubt bitcoin will be that currency but blockchain technology might foster a form of Keynes's universal currency proposed at Bretton Woods, the Bancor.

China's deleveraging will eventually slow its growth. In the past, China has consistently indicated its desire to delever, but would reverse the process once it becomes clear that growth is being adversely affected. It appears that Chairman Xi has amassed enough power that he can reduce China's debt levels if he has the political will to do so. If he does cut growth, commodities and emerging markets will be vulnerable. However, until proven otherwise, we should assume that China's current pattern of avoiding slow growth will continue.

European political uncertainty will likely weigh on the EUR; if Italy elects Euroskeptic parties, then a full-fledged bear market might develop. But, a more likely outcome is a coalition with enough centrists involved to keep Italy in the single currency. Regarding Brexit, we expect a workable outcome and a stronger GBP. But, the risk is elevated that Jeremy Corbyn's Labour Party could force elections and win; that outcome would be profoundly bearish for U.K. financial assets.

North Korea is a purely binary outcome. If war is avoided, which is the most likely case, the effect of the Hermit Kingdom on global financial markets is nil. However, if a war develops, we could see a significant drop in global risk assets. This is an issue we have been closely monitoring for some time and will continue to watch next year.

South American populism could weigh on emerging markets next year. If trade protection in the U.S. expands, it would be quite bearish for Mexico. Although other emerging markets should keep the indexes supported next year (assuming Chinese growth doesn't collapse), South America will likely be a weak spot in 2018.

The Middle East will likely continue to see rising instability. Holding oil and energy-related assets is the best way to cope with those problems.

Finally, the U.S. domestic situation will bear watching. One of our observations is that a president's political capital is usually consumed by the middle of the second year in office. Thus, passing legislation will become increasingly difficult as 2018 wears on. We are worried about protectionism. If trade restrictions become widespread, it will be bearish for Treasuries and bullish for the dollar as a narrower trade deficit will reduce dollar supply. Over time, it will make U.S. financial assets more attractive relative to international ones. At the same time, this process could take several years and may not be a major issue in 2018. Finally, we have observed that headlines from the Mueller investigation tend to be dollar bearish. If the Special Counsel comes up with damning evidence, it will likely weaken the greenback.

Obviously, there are some inconsistencies in these market ramifications. To some extent, this should be expected. Investors should use these issues as guideposts; if they become a concern, we would expect the aforementioned market actions to take place. However, it is unlikely they would all occur at the same time. For guidance, we recommend monitoring our publications, including the Daily Comment and the Weekly Geopolitical Report.

Have a Happy 2018!

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