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Losing the Philippines: Part 2

(Next week, we will publish our 2017 Geopolitical Outlook; it will be the last issue of 2016.)

In Part 1 of this report, we discussed the geography of the Philippines and examined the nation's history, focusing on its relations with the U.S. In Part 2 of this report, we will discuss President Rodrigo Duterte's recent foreign policy decisions and their impact on U.S. policy in the region. We will conclude with the impact on financial markets.

President Duterte

The 2014 Enhanced Defense Cooperation Agreement (EDCA) led to a significant shift in U.S./Philippine relations. As the maps in Part 1 showed, the Philippines are key to controlling the sea lanes in the region. If the Philippines were to become hostile to American interests, allies such as Japan, Taiwan and South Korea would be vulnerable to supply interdiction as the sea lanes would no longer be secure.

While the EDCA improved the security posture of the U.S. in the Far East, the Permanent Court of Arbitration's ruling in July against China was a huge moral victory. The international tribunal at The Hague offered a sweeping rebuke of China's behavior in the South China Sea, completely rejecting China's "nine-dash line" claims. The Xi regime is furious over the outcome and has decided to simply ignore it. Like most international agreements, there is no enforcement mechanism other than global reputation. However, reputation does have

some currency and it isn't out of the question that the U.S. could decide to enforce the rule. The U.S. Navy is powerful enough to dislodge Chinese forces off the rocks in the South China Sea, although it would likely trigger a wider war. Still, at a minimum, the EDCA and the verdict at The Hague have given the Philippines leverage when negotiating with China.

However, the new Philippine president has jettisoned any advantage he gained from the court's ruling by deciding not to press the issue with China. Instead, Duterte met with Chinese officials and essentially told them he would not dispute Chinese sovereignty. This decision followed a series of comments from Duterte which signal a rupture of relations with the U.S. and a turn toward China.

In October, Duterte indicated that he is "separating" with the U.S., claiming that "America has lost now." He also intimated that he would consider allying with Russia and China.¹ Later in the month, he indicated that he wants U.S. troops out of the Philippines "in the next two years."² Although the U.S. continues to hold joint patrols, Duterte has indicated that he wants those to end as well, ostensibly because China doesn't like them.³ Obama

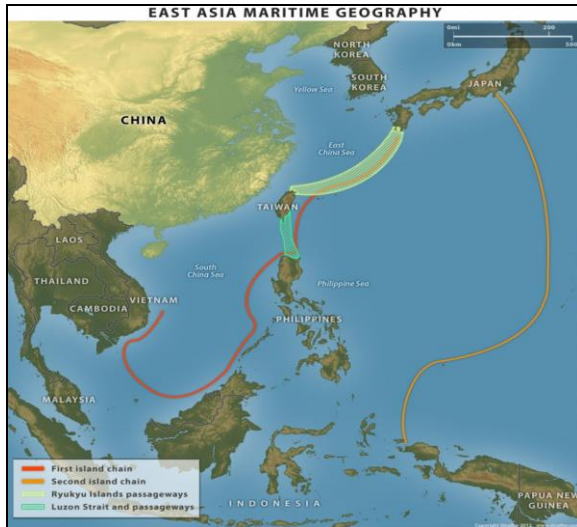
¹ <http://www.cnn.com/2016/10/20/asia/china-philippines-duterte-visit/>

² https://www.washingtonpost.com/world/philippine-s-duterte-now-wants-us-troops-out-in-two-years/2016/10/26/32bec8a5-8584-4d95-8e9d-4d7762865055_story.html

³ <http://www.wsj.com/articles/philippines-leader-to-end-joint-military-exercises-joint-naval-patrols-with-u-s-1475086567>

administration officials note that there have been no official requests to end these arrangements, but the tone has clearly been set.

It would be a major win for China if Duterte is able to follow through on this shift. Not only would it have a clear exit from the first island chain (see map below), but China would have effectively divided that chain and put U.S. allies at risk. In fact, American geopolitical objectives in the Far East are arguably in danger of being undermined.



(Courtesy of Stratfor.com)

What is Driving Duterte's Behavior?

Duterte's anti-American stance appears to be driven by four factors. These are:

A lingering opposition to the colonial power. It is not unusual for a leader to oppose a colonial power; in the Middle East, for example, the British are still disliked by many in the region even though they exited the area years ago. Although the Philippines became independent in 1946, the large military presence during the Cold War was a constant reminder of Philippine dependency on the U.S. President Obama's criticism of human rights abuses with regard to Duterte's drug policy would tend to fuel these

feelings. Thus, wooing a foreign power other than the U.S. is likely to be a popular stance.

Uncertainty surrounding the degree of U.S. commitment to the security of the Philippines. U.S. administrations face a delicate decision on how strongly to signal their support for an ally's regional security. Overstate the degree of support and an ally might act more aggressively than the hegemon is prepared to defend. Understate the level of backing and an ally might make deals with other powers, or another regional power may assume the hegemon won't defend the ally.⁴ The Obama administration has not reacted strongly to China's island building. Other than "freedom of navigation" actions where a U.S. warship sails near an installation, the U.S. has done very little to bolster the confidence of allies. Duterte appears to have concluded that the U.S. will probably not risk war to prevent China from further militarization of the South China Sea. If that is the case, it makes sense for him to make peace with China.

The Meiring Incident. Duterte was the mayor of Davao on the island of Mindanao for more than 20 years. While mayor, in 2002, an American man named Michael Meiring accidentally blew himself up when an explosive device went off in his room at an inexpensive flophouse in Davao. Meiring was described as "unfriendly" and worked as a treasure hunter. After the explosion, Meiring was taken to the hospital. Local police were interested in interviewing him and were likely to press charges. It is worth

⁴ This assumption may have triggered Saddam Hussein to invade Kuwait in 1990. See: <http://www.nytimes.com/1990/09/23/world/confrotation-in-the-gulf-us-gave-iraq-little-reason-not-to-mount-kuwait-assault.html?pagewanted=all>.

remembering that Mindanao had an active Islamic insurgency and this event occurred during the height of fears of Islamic terrorism. Security officials in Mindanao probably wanted to know if this explosion had thwarted a potential terror event. According to reports, which have not been verified by the U.S. government, Meiring was removed from the hospital by U.S. operatives and was taken from Davao to Manila on a chartered plane. The hospital administrator was apparently bribed with a visa for his daughter.

The official explanation is that Meiring was severely burned and needed treatment in a U.S. hospital. However, it is generally believed in the Philippines that Meiring was a U.S. intelligence operative working in a difficult region of the country who was removed from his proper jurisdiction where he should have been tried for his crimes. According to reports, Duterte took this incident personally and has opposed the U.S. ever since.⁵

The need for foreign investment.

Economic growth was rather strong during Aquino's term, but the benefits of the expansion were mostly captured by upper income Filipinos.⁶ In addition, infrastructure has been neglected. Duterte could very well be following an old script of appearing to favor two different outside powers with the hopes of attracting economic support from both. This was a common tactic during the Cold War, where nations would shift allegiances between the Soviet Union and the U.S. to extract aid. Duterte could be engaging in a similar practice.

⁵<http://www.npr.org/sections/parallels/2016/10/11/497487363/why-philippine-president-rodigo-duterte-distrusts-the-u-s>

⁶<https://www.foreignaffairs.com/articles/philippines/2016-05-26/duterte-filipino-strongman> (paywall)

Duterte's Gamble

Shifting allegiances from the U.S. to China does carry risk for the Philippines. The West and Japan are economically important to the Philippines. For example, over the past decade, Japan and the U.S. have supplied \$8.4 bn in net foreign investment to the Philippines; over the same period, China has provided \$0.05 bn.⁷ The U.S. has given the country \$90 mm in military aid.⁸ In response to the 2013 typhoon, the top four nations providing aid were the U.K., U.S., Canada and Japan, which in total offered \$340.2 mm (the U.S. share was \$90.6 mm). China gave \$2.7 mm.⁹ Japan, the U.S. and Singapore absorb 42.7% of Philippine exports. China and Hong Kong absorb 22.4%. In terms of imports, China provides 16.1%, while nearly all the rest come from the U.S., Japan, Taiwan, Singapore and South Korea.¹⁰ Perhaps an even larger issue is remittances from Filipinos working abroad. Last year, these workers sent \$24.3 bn home, about 10% of Philippine GDP. The U.S. represented 42.6% of these flows, or \$10.4 bn. Although many Filipinos work in Asia and the Middle East, remittances per worker in the U.S. are double those in other areas.¹¹

Simply put, the economy of the Philippines is heavily dependent on the U.S. and its allies. China plays a much smaller role and has fewer allies that could support economic growth in the Philippines. China is offering membership in its "one road, one belt" and

⁷ <http://www.wsj.com/articles/philippine-leader-rodigo-duterte-rolls-dice-with-embrace-of-china-1476639455>

⁸ <http://www.cnbc.com/2015/07/21/philippines-remittances-under-threat.html>

⁹ Op. cit., *WSJ*.

¹⁰ <http://foreignpolicy.com/2016/10/20/rodigo-dutertes-flip-flop-into-bed-with-china-is-a-disaster-for-the-united-states-south-china-sea/>

¹¹ <http://www.cnbc.com/2015/07/21/philippines-remittances-under-threat.html>

“Silk Road” programs, but these may not be the fount of funds that Duterte assumes. It should also be noted that China was quite surprised by Duterte’s offer to give up the claims from the court at The Hague. So far, China has allowed Filipino fishermen back to the Scarborough Shoal, but has kept its warships in place.¹² China has also indicated that it has no plans to give up its sovereignty claims over the shoal. In fact, according to reports, Chinese officials were rather surprised at Duterte’s comments about abandoning the U.S. as an ally, describing it as “...a gift, not a victory.”¹³ Chinese officials have to be thrilled with their windfall but also cautious as this mercurial president could reverse his position as quickly as he rejected the U.S. We do know that China will not retreat from its steady encroachment in the South China Sea unless forced to do so by either military or financial means.

Although it is difficult to know with certainty, it’s quite possible that Duterte’s actions are simply designed to pull in aid and investment. Thus, frightening the U.S. into thinking the Philippines will move into China’s orbit could be a form of extortion. However, it’s a dangerous move on his part because he is now dealing with a U.S. President-elect that is perhaps equally unpredictable. It isn’t out of the question that the new administration could react by pulling aid or deporting Filipino workers. This isn’t likely but the probabilities are higher than they would have been under a Clinton administration. Although we doubt the Philippines will be a high priority issue for the incoming government, it probably should be. Losing the Philippines would

¹² <http://www.reuters.com/article/us-philippines-southchinasea-china-idUSKBN12U0RU>
¹³ <http://www.nytimes.com/2016/10/25/world/asia/rodrigo-duterte-philippines-china.html>

create circumstances that would make it very difficult to maintain U.S. hegemony in the Far East.

Ramifications

In the short term, the key issue to watch is the behavior of the other nations near China’s “nine-dash line.” Malaysia, already angry at the U.S. Department of Justice’s investigation of Malaysia’s sovereign wealth fund, is considering buying Chinese military hardware.¹⁴ The failure of TPP and China’s promises to craft a trade arrangement for Asia do appear to signal an American retreat. President-elect Trump’s Jacksonian foreign policy stance will likely support this emerging power vacuum that China seems poised to fill.

So, what does this mean for markets? China probably won’t be as benevolent of a hegemon as the U.S. It will tend to treat the surrounding nations more as colonies rather than partners. We strongly doubt it would willingly run trade deficits to support the growth and development of regional economies. And, it isn’t likely that India or Japan will submit to Chinese dominance. Regional conflicts are more likely.

Thus, defense companies should benefit from increased spending as nations that previously relied on the U.S. for security will be forced to protect themselves. The dollar will tend to benefit from capital flight. A stronger dollar, the potential loss of U.S. markets to trade protection and a reduction in American military security will likely be bearish for emerging markets.

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¹⁴ <http://www.nytimes.com/2016/11/01/world/asia/malaysia-china.html>

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