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Thinking About Deterrence

In his book *Leviathan*, published in 1651, the English philosopher Thomas Hobbs argued that human society in the state of nature would be marked by conflict and mistrust, as each person would be free to attack his or her neighbor to acquire needed resources. According to Hobbs, government evolved to end this chaotic, violent state by providing security and order to society. Without a powerful central government, Hobbs posited, life would be “solitary, poor, nasty, brutish, and short.”

But what about the community of nations, where each country could be tempted to attack its neighbor for political, economic, or other reasons? No world government has evolved to provide order and security in international relations, even if the UN has been given some powers aimed at helping it keep the peace. As we’ve written before, the more typical source of international security and order has been when a powerful country gained hegemony over much of the globe, as the United States did in the decades after World War II. As US voters now question the costs and benefits of that hegemony, and as the US hesitates to enforce order, rival countries have begun to assert themselves. “The Jungle Grows Back” is the term we use to describe the situation. This report examines how, in this newly chaotic world with weakened hegemonic order, nations may increasingly rely on “deterrence” to protect themselves, with potentially big implications for investors.

What Is Deterrence?

Nations exercise power over each other in various ways. For example, they may use moral persuasion or incentives to induce another country to act in some way. At the other extreme, they can use full-on war, brute force, or *coercion*. International relations scholars define coercion as leveraging the threat of punishment to induce some behavior by an adversary. One type of coercion is *compellence*, i.e., compelling the other country to undertake some action by imposing or threatening to impose costs if it doesn’t. The other type of coercion is *deterrence*, i.e., dissuading the adversary from taking some action by imposing or threatening to impose costs. “Direct deterrence” is when the deterring country seeks to dissuade an attack only on itself, while “extended deterrence” involves seeking to dissuade an attack on itself and its allies.

Under rational deterrence theory, deterrence is expected to successfully dissuade an attacker if:

(the probability of the deterrer carrying out its threat x the cost if the threat is carried out) > (the probability of the attacker accomplishing its goal x benefit if the attacker’s goal is accomplished)

This formulation suggests several conditions must be met for deterrence to be successful. For instance, the potential attacker must see a sufficiently high likelihood that the deterrer will carry out its threat of punishment, and/or the attacker must believe that the potential cost of the punishment

would be high. Scholars often refer to these conditions as *credibility* and *severity*.

Civilians and military planners alike often express the concept of credibility by saying a country must show it is “willing and able” to impose some punishment on an attacker. Indeed, strategists may look for real-life opportunities to demonstrate will and ability by talking tough (saber rattling), pouring resources into their armed forces, or holding visible military exercises. As we’ll show below, policymakers also work hard to show their punishment would be severe indeed, in part by developing powerful, formidable weapons.

It’s important to remember that deterrence can theoretically be achieved with many different types of military forces. For example, a large, well-equipped, well-trained conventional army in Ukraine might have deterred Russia from invading that country in 2022. However, since the advent of atomic weapons and their use to quickly end World War II in 1945, nuclear weapons have become the gold standard for deterrence. The fact that the Cold War between the US and the USSR ended without a major direct war between those states is evidence of the deterrent power of nuclear weapons. We will therefore mainly focus on strategic nuclear deterrence in this report.

Deterrence by Mobilization. While deterrence has been a tool of international relations for centuries, the deterrence of the past is not the deterrence of today. Far back in history, large and well-equipped standing armies were luxuries that few states could afford. Military mobilization during times of war was the norm, whether it was princes pledging to contribute knights to the liege lord’s forces in medieval France or plans to call up and rapidly equip wartime fighting

forces using industrial surge capacity in the early 20th century.

Deterrence by Existing Weapons. The idea of industrial mobilization to fend off an adversary who has just attacked or is preparing to attack was historically known as “economic war potential.” This approach to deterrence was fundamentally reactive. A country would normally keep its industry oriented to civilian needs, but its potential ability to call up troops and shift industrial output to equip them once attacked was considered adequate deterrence. In the nuclear age, however, the weapons are so powerful and easily delivered by missile that the advantage shifts decisively to the attacker. Consider that a nuclear missile can reach its target on another continent within roughly 30 minutes of being launched. The defender simply doesn’t have the time to mobilize as the US did in World War II. Today, therefore, deterrence is thought of as requiring “weapons in being,” i.e., existing weapons that are always at the ready to retaliate immediately upon attack.¹

US Nuclear Deterrence: The Triad

The current US nuclear enterprise retains the structure and posture that it developed and employed during the Cold War. The structure is known as the nuclear “triad,” consisting of land-based intercontinental ballistic missiles (ICBMs), sea-based submarine-launched ballistic missiles (SLBMs), and land-based bombers. The US has retained this structure because its soundness is [supported by rigorous analysis and success throughout the Cold War](#). Each leg of the triad provides a distinctive capability. ICBMs are immediately launchable and convey the most destructive

¹ This paragraph is based on the groundbreaking *Economics of Defense in the Nuclear Age*, by Charles Hitch and Roland McKean (Santa Monica, CA: The Rand Corporation, 1960).

power. SLBMs, borne by ultra-quiet submarines with unknown locations and movements throughout the vastness of the oceans, can survive an initial enemy nuclear strike. Bombers can be moved from place to place to send a political message, and they can be recalled from strike missions almost up to the last minute.

The Downsizing of the Triad. Since the end of the Cold War, the status and size of the triad has changed in response to a prevailing view that the threat and associated need for nuclear deterrence had greatly diminished with the fall of the Soviet Union. A combination of [arms-control treaties](#) with the USSR/Russia and US defense budget cuts has reduced its size and breadth in terms of types of weapons and delivery systems:

- At the end of the Cold War, the US had 1,000 ICBMs in service, carrying 2,450 warheads (some loaded with multiple, independently targetable warheads). The US now has 400 ICBMs in service, each carrying only one warhead.
- At the end of the Cold War, the US had 42 nuclear missile submarines in service, carrying 600 total SLBMs and 5,216 independently targetable warheads. Today the US has 14 total nuclear missile submarines capable of carrying 240 total missiles.
- The US's nuclear-capable bomber force has similarly shrunk from 260 (capable of carrying 4,648 warheads) at the end of the Cold War to about 60 (capable of carrying 1,000 warheads) today.

Although specific figures are not available, it should also be noted that during the Cold War, these forces were kept in an extremely high state of maintenance, readiness, and alertness — meaning that they could be

launched at a moment's notice. Reports today suggest the US nuclear enterprise is now much less prepared for service or is even in a state of disrepair with a low state of readiness.

Figure 1



Today's Triad Modernization. This trend began to reverse in 2010, when President Obama authorized a comprehensive [refurbishment of the nuclear enterprise](#), with a modernization program expected to take 30 years and roughly \$1 trillion to complete. The program addresses all components of the enterprise, including not just the triad, but also the research and development laboratories and command and control systems. As to the triad, it includes both new weapons systems and life extensions for the existing ones in order to bridge the gap until the new ones come online. The planned successors in the triad include a new ICBM, called the Sentinel, to replace the current Minuteman III (first commissioned in 1970); a new ballistic missile submarine, called the Columbia class, to replace the current Ohio class (first commissioned in 1986); and a new stealth bomber, called the B-21 Raider, to replace the B-2 Spirit (first commissioned in 1992).

Deterrence in the Jungle

With the US showing reluctance to keep acting as the “global policeman” and the guarantor of free trade, authoritarian powers such as China, Russia, North Korea, and Iran are seeking to take advantage of the situation to revise the global system to their favor. Our thesis is this: *Without the security and order provided by an active hegemon, countries around the world will have a greater incentive to develop their own, powerful deterrence capabilities to protect themselves from their adversaries.*

Even if the US doesn't formally end its role as global hegemon, and even if it doesn't formally end its extended deterrence policy over its allies (the “nuclear umbrella”), a US pullback from the international stage or rifts with allies that create doubts about US commitments would still encourage countries to build up their own defenses.

Indeed, we are already seeing this. Not only is China now aggressively expanding its strategic nuclear arsenal, but:

- Manfred Weber, chief of the center-right European People's Party (EPP) that is expected to place first in the European Parliament election in June, said in a recent interview that Europe [needs to develop its own, independent military power outside the North Atlantic Treaty Organization \(NATO\) so it can defend itself even if the US refuses to come to its aid](#). Weber even suggested the EU develop its own nuclear weapons, perhaps under the leadership of the UK and France, which already are nuclear powers.
- In South Korea, opinion polls in recent years have found that as much as 71% of the population [supports the country developing its own nuclear weapons to deter aggression by North Korea or China](#). The risk of South Korea going

nuclear was enough to prompt the Biden administration to quickly negotiate the April 2023 “Washington Declaration,” in which the US pledged greater security cooperation in return for Seoul renouncing any effort to develop its own nukes.

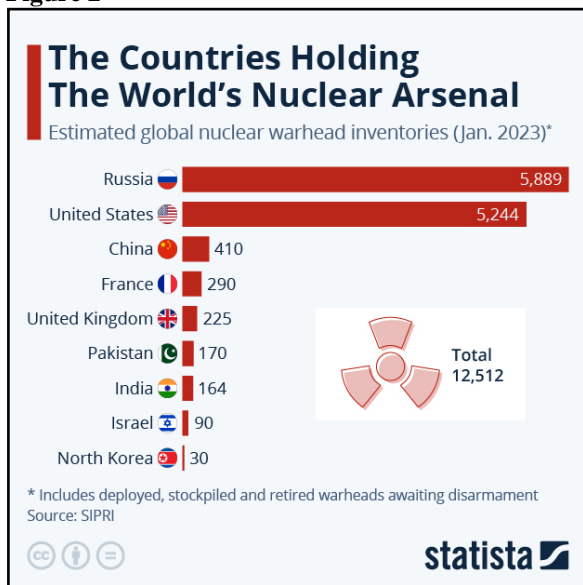
- In late 2022, Japan's government [issued a new national security strategy pledging to double the country's defense budget and develop a new offensive missile capability that would allow Japan to strike military bases in mainland China with conventional weapons](#).

In this new, chaotic security environment of the future, many countries will only be able to increase their conventional (non-nuclear) deterrence forces. In the face of Russia's aggression against Ukraine, many European countries have already started increasing their defense budgets and trying to rebuild their conventional forces. However, those with sufficient economic strength and technological expertise will be tempted to go nuclear. Among these, it's important to remember that, as discussed above, strategic logic argues for developing a nuclear triad of ground-launched, air-launched, and sea-launched weapons. As one country develops nuclear weapons for the first time, its rivals or regional competitors will be tempted to develop their own, potentially leading to mass proliferation of nuclear weapons including missiles, bombers, and submarines.

This potential nuclear proliferation could be especially risky for the China/Russia geopolitical bloc. Without doubt, leaders like Chinese General Secretary Xi and Russian President Putin believe that if they can drive a wedge between the US and its European and Asian allies, then those allies will acquiesce to Chinese and/or Russian leadership. If we're right about the allies

responding by developing their own deterrent forces — especially nuclear — then China and Russia could find that their strategy has backfired. For instance, if the US pulls back from aiding Europe, it's not inconceivable for Germany, Poland, or even the Baltics to develop their own nukes. Japan, South Korea, and Australia might also go in that direction. In the end, China and Russia could find themselves surrounded by new, threatening nuclear powers and might well then respond by boosting their own nuclear forces even further, helping to touch off a global nuclear arms race.

Figure 2



Investment Implications

This analysis is consistent with what we've been writing for a long time: With the US hesitating in its role as global hegemon, international relations will become more chaotic and prone to violence. At the very least, many countries will respond by increasing their military budgets, and many will seek a more robust deterrent than a merely reactive, conventional force. Nuclear proliferation is likely to increase, even to the point of a broad nuclear arms race.

From an economic standpoint, fractured supply chains and higher defense spending will likely lead to higher inflation and interest rates than were the norm in recent decades. As a result, **bonds** are likely to suffer in the new environment. In general, **stocks** are likely to offer better total returns, but we expect the very best opportunities to be among traditional defense companies, technology and industrial firms with a lot of defense business, and basic materials and energy firms. Among **commodities**, safe-haven precious metals, some industrial metals, and uranium are likely to offer good opportunities as well.

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This report was prepared by Patrick Fearon-Hernandez and Daniel Ortwerth 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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