

March 26, 2018

The North Korean Summit: Part II

(Due to the Easter holiday, the next report will be published on April 9.)

Last week,¹ we discussed the six major nations involved in the North Korean issue and each country's geopolitical goals, constraints and meeting positions for the recently proposed summit between the U.S. and North Korea. This week, we will examine why the talks are being proposed now and offer reasons why they may fail or succeed. We will summarize the costs and benefits of the summit meeting and conclude with market ramifications.

How did this happen?

The key figure in setting up this meeting was South Korean President Moon Jae-in. Since his election last May, Moon has been working furiously to prevent a war on the Korean Peninsula. When he took office, the U.S. was steadily ratcheting up pressure on North Korea, adding sanctions and using military intimidation. The Kim regime was testing missiles and conducted what appeared to be a thermonuclear device test on September 3, 2017. The U.S. and North Korea appeared to be careening toward war.

Moon comes from a political tradition of pushing for unification through improving relations with the North. Previous left-wing governments in South Korea have run afoul of U.S. policy toward North Korea but Moon seems to have avoided this problem. He defended South Korean sovereignty by

insisting that no war could occur on the peninsula without South Korean acquiescence. At the same time, he supported sanctions against the Kim regime and didn't push for removal of the THAAD anti-missile system advocated by the U.S.

Perhaps his most well-executed policy was to avoid criticism of the Trump administration and, at times, praise it for its sanctions policy. Moon refrained from responding negatively when Trump accused Moon of "appeasement" last September. Moon has decided that direct opposition to American policy is counterproductive as that approach has been the downfall of previous leftist governments.

The Olympics offered Moon a rare opportunity to improve relations with the North. Kim likely realized South Korea would be fearful that the North would implement some kind of attack on the games, which would embarrass the South and perhaps lead to a military confrontation. Instead, Kim offered to send a delegation to the games and even participate. Moon seized the opportunity and accepted Kim's proposal. The Korean hockey team comprised athletes from both nations and all Korean athletes walked together at the opening ceremony under a unified flag.

The U.S. sent VP Pence to the opening games. He studiously avoided any contact with the North Korean delegation and maintained a stony presence. This was considered an inappropriate response.² At

¹ See WGR, North Korean Summit: [Part I](#), 3/19/18.

² <https://www.usatoday.com/story/sports/winter-olympics-2018/2018/02/12/vice-president-mike->

the closing ceremony, the president dispatched his daughter who presented a warmer presence.³

During the Olympics, the Moon government conducted extensive talks with Kim's sister, Kim Yo-jong. At these meetings, President Moon made the case for negotiations between Washington and Pyongyang. Moon insisted that nuclear weapons be part of the discussion. Soon after, a dinner took place in North Korea with officials from both nations and this gathering led to the invitation for a meeting between Kim and Trump.

Other important factors that should not be underestimated are the impact of sanctions and the threat of war. The U.S. has been steadily increasing sanctions and China, fearful of American military action, has been enforcing sanctions with greater diligence. Although there is no way to independently verify North Korea's currency reserves, there are reports suggesting they have fallen to dangerously low levels.⁴ Kim doesn't want a war with the U.S. Although North Korea would inflict severe damage on South Korea and may be able to attack the U.S. with missiles, any significant action would lead to the annihilation of North Korea. That destruction would undermine Kim Jong-un's primary goal, which is regime survival.

How the Talks Could Fail

First, it isn't clear how each party defines "denuclearization." The U.S. defines it as the North giving up its weapons and

[pence-north-korea-embarrassed-america/328254002/](https://www.washingtonpost.com/news/energy-environment/wp/2018/03/26/pence-north-korea-embarrassed-america/328254002/)

³ <http://www.telegram.com/news/20180224/latest-n-korea-official-ivanka-trump-in-vip-box>

⁴ <https://www.bloomberg.com/news/articles/2018-03-07/kim-jong-un-comes-round-to-talks-as-his-currency-reserves-shrink>

agreeing to intrusive inspections. North Korea probably defines it as more of a freeze. It is hard to believe that Kim, after years of sacrifice, would be willing to give up the deterrence of a deliverable weapon. It would not be a surprise to see Kim use his nuclear program as a bargaining chip. It would be nonsensical to simply give it away for mere security guarantees.⁵

However, even an agreement to give up weapons would not be enough. North Korea would need to accept aggressive inspections that would impinge on its sovereignty. This requirement is likely a non-starter.

Second, North Korea wants the U.S. to remove its troops from South Korea as part of any deal. Although the U.S. would maintain a sizeable military presence in Japan, Guam, et al., it would prefer to also keep its bases in South Korea. Overseas bases are key to America's ability to project power thus base closures are not preferred.

Third, the summit could be yet another maneuver in Pyongyang's "Lucy and the football" tactic with the West. North Korea has a long history of escalating tensions, offering talks to ease tensions then reneging on promises made. The Trump administration is naïve if it believes North Korea would uphold any bargain that violates Pyongyang's first goal, which is regime preservation.

Discussions may de-escalate the current high level of tensions. But, unless the U.S. is willing to accept North Korea as a nuclear power, it's hard to see how there will be any significant progress.

⁵ Ukraine did so in return for security guarantees after the breakup of the Soviet Union; it now stands divided.

How the Talks Could Succeed

First, Kim is different than his father and grandfather. He has probably concluded that a market economy will not diminish his power. China's experience shows that a market economy doesn't necessarily mean democracy will follow and thus Kim can remain supreme leader with a much better economy.

To achieve a better economy, North Korea needs foreign investment. If its foreign policy is sufficiently deft, it may be able to create conditions where foreign nations are vying for access. In other words, China, Russia, South Korea, Japan and the U.S. would all try to gain influence through investment in the depressed North Korean economy.

Second, the personalities of the two leaders could be significant. Previous U.S. presidents have avoided direct talks with North Korea due to concerns that engaging in negotiations without preconditions rewards North Korea's previous (bad) behavior. In addition, it boosts the stature of North Korea with nothing in return. In other words, merely speaking face to face with an American president elevates North Korea's status but does nothing for the U.S. The usual summit procedure is for lower level officials to negotiate the details of an agreement. Only then do leaders meet and hold a signing ceremony. That way, the leaders' meeting is a predetermined success. The problem with such procedures is that major changes in policy are unlikely because lower level operatives don't have the authority to make such adjustments.

Since the fall of the Soviet Union, U.S. policy toward North Korea has been to simply outwait the regime for its eventual collapse, assuming the flaws of Stalinism would lead to its eventual demise. Although

North Koreans have suffered greatly, dealing with famine and the steady weight of economic sanctions, the Kim regime has survived. It is unlikely that it will collapse by itself. In addition, U.S. policy was at odds with other important nations in the region. Neither China nor South Korea wants to see the North Korean government collapse and bring a refugee crisis. Thus, both nations are reluctant to support crippling sanctions and China has tended to weakly enforce trade restrictions.⁶

Simply put, the strategies that have been used since 1990 haven't worked. North Korea not only continues to exist but has developed nuclear weapons and improved its missile technology to the point where it could likely strike the U.S. Direct talks may not be successful but trying something different may be worth it.

President Trump is not a traditional American president. He believes his negotiating skills are one of his strongest virtues. From his standpoint, direct negotiations, *mano a mano*, will play to his strengths. Due to North Korea's isolation, it is more difficult to determine Kim's personality; however, we suspect he is equally confident.

One of the problems in evaluating history is shown in the "great man" versus "great wave" theory of historical analysis. Much of history is written from the great man perspective, where history is a parade of significant figures changing the face of society and the world. Great wave theorists argue that societal trends are more important and those perceived as great men are really just figures who correctly assessed trends and pushed them forward.

⁶ Although, in China's defense, its enforcement has tightened considerably in recent months.

I am a great wave theorist. It's not that people don't matter, but latching onto a trend can improve the odds of success. A sports analogy offers an illustration. Putting a player into a game situation where his skills are well suited for that part of the game increases the odds of success. In baseball, it's common in the late innings to bring in a left-handed pitcher to face a left-handed hitter because the opposite matchup (lefty/righty) can improve the batter's odds of hitting safely. In the recent movie *The Darkest Hour*, the British political system had to decide whether to make diplomatic overtures to Berlin or go to war. If they wanted the former, Lord Halifax was probably the appropriate choice. If war was the answer, Churchill was best. The decision was war and Churchill excelled. However, by July 27, 1945, a mere 12 weeks after VE day, Churchill was out of office. The British people took the position that an ideal wartime prime minister might not be an ideal peacetime prime minister. Essentially, a great man isn't great in all circumstances.

In this circumstance, Trump might be the right man. Breaking the entrenched pattern regarding North Korean policy will require bold action and probably a person without firm ideological convictions. There are other situations where the president's personal traits are problematic, but he may just be the proper person for these discussions with North Korea.

If the summit is going to work, the U.S. probably needs to back away from full denuclearization. Instead, limits on missile technology might be a more feasible option. That outcome would raise concerns for Japan (most likely North Korea would keep its shorter range missiles), but it would offer some comfort to the U.S. Of course, some sort of surveillance would be required. At

the same time, if Kim concludes the U.S. is no longer interested in regime change, a freeze with gradual drawdown in return for a reduction of sanctions might be very attractive.

High Risk, High Reward

The failure of these discussions, assuming they do occur, could be devastating. If the two decision makers cannot resolve the North Korean problem, what alternative remains? It is possible the leaders could agree to confidence-building intermediate steps to keep communications open. But, given North Korea's historical record of not complying with agreements, it would be difficult to expect that other countries would have any confidence in half-measures.

If negotiations fail, it would seem the only logical next step is military conflict. From the U.S. and surrounding points of view, the status quo prior to North Korea's development of a nuclear weapon would be acceptable. However, the development of nuclear weapons changes the status quo and demands some sort of resolution.

On the other hand, if negotiations are successful, Trump will have resolved one of the most intractable problems in American foreign policy, one that has bedeviled his predecessors. The talks have been compared to the "Nixon to China" moment. President Trump would make his mark on history if the summit is successful. Kim would also benefit greatly, especially if the end result is an end to the threat of regime change and the potential for the North's economy to benefit by opening to the world.

Both leaders have great incentive to strike a deal, but, as we have detailed above, verifying success will be difficult. Still, the fact that the parties have come this far is remarkable.

Ramifications

Determining the market effects will be binary, depending on the outcome of discussions. If the logjam of policy is broken, it should boost investor sentiment and support risk assets. If negotiations fail, the manner of failure becomes important. If they end amicably with promises of more discourse but no real progress, it's likely a

market-neutral event. If they end badly, with the parties showing animosity, the world will prepare for conflict. Gold and Treasuries would probably rally, while equities, outside of oil and defense, would come under pressure.

Bill O'Grady
March 26, 2018

This report was prepared by Bill O'Grady 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.

Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics and geopolitical analysis with a value-driven, fundamental company-specific approach. The firm's portfolio management philosophy begins by assessing risk, and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.