Confluence INVESTMENT MANAGEMENT

Weekly
Geopolitical Report
By Bill O'Grady

April 6, 2015

The New World Order: Part IV

In this final installment of our four-part series on The New World Order, we will examine how, in light of winning the Cold War, policymakers have been unable to settle on a set of key priorities and offer what we see as "glimpses" of a new policy emerging. In a sense, the U.S. never really wanted to be a superpower; the nation's founding story is one of wresting independence away from a colonial power. Americans were willing to put up with the economic and political distortions that came from becoming a superpower in order to defeat communism. Now that this existential threat has ended, the political class has struggled to create a foreign policy that can simultaneously provide the required hegemonic global public goods and create a working economic policy and political coalition that will build domestic harmony.

In this report, we will recap why the current policy mix is unsustainable and yet, why the U.S. remains indispensable for world peace and global growth. And so, if the U.S. cannot be replaced anytime soon, American policymakers need to create a solution that will allow the U.S. to fulfill at least some of the hegemon's responsibilities and also create a sustainable domestic economy and political coalition. We will conclude with a broad examination of the potential long-term market effects from this evolving New World Order.

The Unsustainable Situation

As noted in earlier segments of this report, the Roosevelt Coalition created a wide road to the middle class for mostly white households. The economy it created generated steady economic activity with impressive median family income growth. However, attempts to diversify the coalition to include racial and ethnic minorities and to expand the "middle class road" to women weakened the coalition as white men rebelled against these changes. In addition, as the rest of the world recovered from the devastation of WWII, the inefficiencies required to create high-paying, low-skilled jobs led to persistent and uncontrolled inflation.

In order to maintain the superpower role and end inflation, the Reagan Coalition deregulated and globalized the economy, dramatically improving its efficiency. This change ended the economy's ability to create high-paying, low-skilled jobs. To meet the hegemon's importer of last resort role, policymakers needed American households to consume more goods, especially as the American economy became smaller relative to the rest of the world. The solution to this problem was to deregulate financial services and allow for an explosion of household debt.

The 2008 Financial Crisis effectively ended this solution to superpower consumption. And so global growth has been sluggish, with the rest of the world waiting for the return of the American consumer. The path to development since 1945 has been to create an export-promoting economy. As part of this process, exchange rates were kept artificially low to suppress imports and foster exports. This is done by suppressing domestic demand, which boosts savings and creates investment to build an export industry. Export promotion has been the course of nearly all successful development since WWII, as seen by the economic "miracles" of Germany, Japan, South Korea, Taiwan and China. This development model requires that the global superpower absorb these nations' exports and also create a global free trade architecture to support their export-oriented economies.

The U.S. was willing to provide these services for two reasons. First, America needed to offer an alternative to communism and create a free trade zone for the Free World, which fostered recovery and development. Over time, the contrast between the Communist Bloc and the West, in terms of economic development, became stark. Second, policymakers became convinced that trade protection led to the Great Depression and thus wanted to avoid a repeat of that experience.

Militarily, the U.S. had to make difficult adjustments to the superpower role. America was essentially on a permanent war footing. Several inconsequential wars were fought in South Korea, Vietnam, Afghanistan and Iraq. In Western Europe, the U.S. ensured that another war for local supremacy wasn't fought by effectively demilitarizing the continent and taking over its defense. The U.S. effectively did the same thing in the Far East with Japan. This allowed both Europe and Japan to concentrate on economic recovery and expansion without the usual cost of defense. Again, these actions were taken in part to win the Cold War. For Americans, fighting limited wars, the common conflicts that engage a superpower, ran against the grain of the American narrative. The U.S. sees itself as avoiding war until it becomes impossible to circumvent, then entering the conflict, finishing it and going home to demilitarize. Every war fought since 1945 has been framed as a fight to prevent "the next Hitler" and thus characterized as "unavoidable." Instead, Americans find themselves either leaving conflicts unfinished (e.g., Vietnam, Afghanistan, Iraq) or being forced to maintain a sizeable troop presence for years to prevent further conflicts (South Korea, Western Europe, Middle East).

The increased anger of both the right and left-wing populists in the U.S. is an indication of rising discontent with the superpower role. When right-wing populists pine for small government, they are really saying the U.S. should end its hegemon role. After all, one cannot be a small government superpower. While left-wing populists want reduced income inequality, policies designed to bring that about will eventually be inflationary. It may take a decade or two, but these policies will make the economy less efficient. In the current circumstances, such policies would not be inappropriate as long as one knows that the eventual outcome will be unpleasant.

However, all this assumes that the U.S. could walk away from global hegemony, which may not be reasonable. Unlike Britain in the 1940s, there is no capable superpower replacement "waiting in the wings." And, history shows that a world without a superpower becomes a Hobbesian[1] cauldron for human suffering. It is also important to remember that not only is there no other nation in the world at this juncture

[1] Thomas Hobbes, a 17th century political philosopher, described a world without hegemony leads to a human existence that is "mean, brutish and short." See Hobbes, Thomas, *The Leviathan*, reprinted by Hackett Publishing, Indianapolis, IN, 1994. Originally published 1688.

that can fulfill the superpower role, but there is no nation that really wants it, either. It is politically much easier to let the superpower secure the world with that nation's "blood and treasure" and "free ride" off its consumption. No nation would reasonably want that role and, as the U.S. did 70 years ago, it is only undertaken because the alternative is seen as worse.

So, in reality, the U.S. needs to create a "scaled down" model of hegemony that will allow the country to maintain global order in a sustainable fashion. This is what we see emerging.

The New World Order

The emerging New World Order, like the superpower role, has two elements, the military/foreign policy role and the economic role.

The Military/Foreign Policy Role: The U.S. spends more on its military than any nation in the world. That's because it's the only nation with global responsibilities and thus must be able to project power everywhere. Over the past seven decades, the U.S. has demilitarized large segments of the world, primarily Europe and the Far East, to prevent future wars from developing. It has also been heavily involved in the Middle East to ensure oil flows remain uninterrupted. This costly policy mix has become difficult to sustain. In recent conflicts, the volunteer army has been stretched, with military personnel being required to make multiple deployments. Unless the U.S. is willing to consider a draft, public support for military incursions will wane, even among the right-wing populists that usually support such endeavors. Thus, future presidents will need to be very selective with where they intervene militarily.

This selectivity will require determined prioritization. It means that policymakers will have to agree that some regions get attention and support while others will have to work it out for themselves. Unless "all hell breaks loose," the U.S. will only offer modest assistance. This policy is formally known as "offshore rebalancing."[2] The U.S. would have the military power to intervene but would prefer to have regional powers balance each other, creating stability. The U.S. could act if one or the other became overly strong or weak, creating conditions for conflict. In the areas of focus, the U.S. would be more actively involved.

The Obama administration has been moving to de-emphasize the Middle East and Western Europe, shifting the focus to the Far East, and, perhaps, Eastern Europe. Unlike American presidents since Nixon, President Obama has been less open to intervening in the Middle East region. He "led from behind" in Libya, letting Europe do most of the heavy lifting on conducting the air campaign. He decided against bombing Syria and has refused to put ground troops in place against IS. His negotiations with Iran are designed to eventually create a regional hegemon. The goal of these negotiations goes far beyond nuclear weapons, which isn't as much of a threat as advertised. Ever notice how Iran has been just two years away from a bomb for nearly 15 years? The real goal is normalization of policy with Iran to create a balance of power in the region that will require less American involvement.

This move to normalize relations between the U.S. and Iran is being opposed by Sunni states. In Yemen, the Saudi Royal Air Force is conducting the air campaign while Egyptian ground troops are being prepared for an invasion against Houthi rebels seen as sympathetic to Iran. Both nations are

[2] See WGR, 11/5/2012, The Foreign Policy Choice.

conducting a naval blockade of Yemen. Earlier, Saudi Arabia sent ground troops into Bahrain to quell a Shiite uprising. Former Secretary of Defense Robert Gates had once quipped that the Kingdom wanted to fight Iran "to the last American." Now, it appears they are taking on much of their own defense.

As the U.S. lessens its involvement in the Middle East, local power centers are developing rapidly. This is a risky strategy; the region could erupt into what has been described as a potential "30 Years War." However, with the U.S. approaching energy independence, the direct need to secure oil from the region has been reduced. Of course, this will increase energy vulnerability to the Far East and Europe, who depend on this region for oil. The alternative policy is to increase U.S. presence in the region to act as a counterbalance to Iran. Our current president has decided that this alternative is too costly; we suspect the next president will make the same decision.

In Europe, it appears the U.S. is prepared to allow the Eurozone to sort out its own problems. Germany has become the regional hegemon and will likely continue to dominate the region. However, containing Russia has become a more important priority. Thus, we would not be surprised to see the U.S. create treaty relationships with Eastern Europe and the Caucasus in an attempt to encircle Russia. Russia will be a difficult situation, but the Russian economy and demographic problems are so profound that, over time, containing the collapse may become the bigger issue. Thus, look for the U.S. to keep Russia at arm's length and build up support for surrounding nations.

However, the biggest area of focus will likely be the Far East. We expect the U.S. to attempt to contain China by building up regional alliances. This will require less focus elsewhere; hence the decision to reduce support in the Middle East. China will face an increasing naval encirclement designed to reduce its ability to project power. Japan and India will be enthusiastic participants in this process.

Will these changes be popular? No. Most Americans view policy from the perspective of friends and enemies. In reality, nations have interests. Some nations were critically important during the Cold War; they are less so now. When the U.S. needed Middle East oil, relations were really important. That is no longer the case.

The Economic Role: The U.S. appears to have given up on global free trade. The Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP)[3] with Asia and Europe, respectively, are designed to support U.S. economic hegemony at a lower cost. Instead of supporting the Doha Round of the World Trade Organization, the U.S. is trying to build two free trade zones that will put the U.S. in the controlling middle of both. The agreements are designed to protect intellectual property rights and reduce the ability of individual nations to use local laws to restrict trade. Opposition to both is fierce; not only are Asian and European activists opposed, Congressional support is lacking. Still, we think there is a good chance that both will become law. Economic elites in all affected regions support the agreements as it will enhance their global power.

China is not part of the TPP; the U.S. is trying to create a trade infrastructure that will be so encompassing that the Chinese will eventually join the group that is

---

[3] See WGR, 1/27/2014, The TTIP and the TPP.

designed to maintain American power. In Europe, the trade program will mainly shift power to the EU and away from nation-states.

It is notable that many emerging economies are not part of either trade group. As trade becomes regionalized, emerging economies may lose their best chance to develop, mainly by supplying exports to the U.S. consumer. Will China fill that role? Only if the Chinese Communist Party (CPC) decides it is willing to give up control of its financial system and allow foreigners to hold Chinese debt, a critical component of a reserve currency. This means, of course, that China will struggle to maintain (and eventually may lose) its trade surplus. In a sense, the U.S. is taking the developed and high developing world while leaving China the rest.

The dollar will remain the primary reserve currency and, in fact, the U.S. will likely begin to restrict access to the dollar to enhance its global power. The TPP and TTIP will effectively shut out much of the rest of the world and force them to scramble to acquire precious dollars. This plan will allow the U.S. to reduce its trade deficit and improve the U.S. economy.

We also expect the U.S. to further use finance as a weapon. Economic and financial sanctions have become a very effective tool in diplomacy. Removing Iran from the S.W.I.F.T.[4] system turned out to be very effective in weakening its economy and forcing it to the negotiating table. Restricting access to the U.S. financial system can make trade very difficult for most nations. Instead of war, we expect an increased use of sanctions.

Essentially, we are seeing signs that the U.S. is changing how it exercises its superpower role. These changes should make the American economy easier to manage as trade pressures ease and foreign inflows are not necessarily tied to recycle current account surpluses.

The world has become accustomed to the U.S. dropping in and fixing problems, both economic and security-related. President Obama appears to be pushing policy away from this reliance. Although Obama has been developing these policies, we see them less as coming from him and more due to America's difficulty in maintaining the current superpower role. The next president may change the pace of change or shift it modestly. But, the overall reduction in U.S. involvement is more due to the fractured American economy, a political system that cannot coalesce around a workable set of themes, and a military that is dangerously stretched. The next president may make adjustments, but the trend in policy will likely continue.

Ramifications

If our analysis is correct, the market ramifications are significant. Here we list eight ramifications that we think are most important.

Commodities Recover: Although the strong dollar and weakening Chinese growth will continue to plague commodity prices in the short run, persistent and escalating regional insecurity will tend to bring commodity hoarding. The U.S. supported global trade infrastructure by providing the reserve currency, a steady source of demand, and world security. If the U.S. allows regional unrest and restricts a nation's ability to acquire dollars, the desire to "grab" key commodities and build strategic reserves will rise. This trend may take time to

[4] See WGR, 3/5/2012, Iran and S.W.I.F.T.

develop, but we would expect it within the next decade. It should also be strong enough to overcome the expected strong dollar (see below).

A North American Oasis: North America will likely become the most stable area on Earth. Wealthy foreigners looking for a safe place to store their assets will likely move these to Canada, the U.S. and, to a lesser extent, Mexico. The first two have stable and deep financial systems, transparent legal systems and relative security. In a more volatile world, moving assets to North America makes sense. This trend is already occurring; anecdotal evidence of capital flight coming to the U.S. is ample. Simply put, the rest of the world will become unstable; being in the U.S., in particular, and North America, in general, both physically and financially, will probably be preferred.

A Persistently Strong Dollar: Since floating in 1971, the dollar has seen periods of strength, but the constant trade deficit has tended to weigh on the exchange rate. If the U.S. is less willing to provide the importer of last resort role, nations will fight to acquire dollars and will be willing to "bid" higher prices for greenbacks.

Foreign Investing Uncertainty: Foreign investing, both in developed and emerging markets, has been recommended in asset allocation models for years. Although not unreasonable, we believe foreign investing rests, in part, on America maintaining its current superpower role. If the U.S. role changes, all the correlation, performance and volatility information that has emerged over the past 50 years may not be reliable in the future. If we are correct, foreign markets will tend to underperform, have lower valuations and higher volatility. At the same time, those areas that the U.S. supports will likely do better than those abandoned by American policy. Thus, the Far East and Eastern Europe may become attractive investment targets.

Small and Midcaps Perform Well: Large companies have clearly benefited from globalization. What is generally unappreciated is that globalization is supported by America's superpower role. If the U.S. backs away from that role, the benefits that large corporations have enjoyed (a subsidy of sorts) are reduced. In general, a stronger dollar, on a relative basis, tends to support small and midcap stocks compared to large caps.

Inflation Rises: Globalization and deregulation have, in our opinion, been the most important factors in controlling inflation. If the U.S. reduces its global footprint, world economic capacity will shrink to some degree. This doesn't necessarily mean that inflation roars back, but it does suggest that disinflationary/deflationary pressures become less intense.

Interest Rates Rise Globally: Greater inflation pressures have historically lifted global interest rates. However, the strong dollar and capital flight will likely keep a lid on U.S. rates.

The Defense Industry Benefits: As the world becomes less stable, the global arms trade will flourish. The U.S. industry will benefit but so will foreign defense providers.

It is worth noting that these outcomes are not necessarily immediate, but we would expect them to unfold over time.

Bill O'Grady
April 6, 2015

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, SEC 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.