By Patrick Fearon-Hernandez, CFA

April 17, 2023

U.S. Intelligence Sharing as a Tool of International Relations

Why should investors care about international relations? Why should they pay attention as great powers jostle for influence and dominance across the globe? One simple answer is that the global economy tends to grow better when there is one dominant country or "hegemon" that provides security, order, effective instruments for trade and investment, and perhaps even a common culture or set of values. Since World War II, investors have benefited from relatively fast and stable economic growth as the United States provided those public goods in its role as the world's "Benevolent Hegemon." Investors in the U.S. have enjoyed especially strong, risk-adjusted returns.

But as we've written before, the military, economic, and social costs of hegemony have now given the U.S. pause. Whether the U.S. ultimately abandons its role as hegemon, and how fast it might do so, will have major implications for investors. In this report, we look at one way U.S. officials today are trying to maintain their influence on other countries without the big economic costs they've accepted in the past. As always, we will also examine the investment ramifications of that strategy.

Classical U.S. Hegemony

Since WWII, the U.S. has built its global influence, dominance, and hegemony based mainly on two key policy tools, both of which served as incentives for other countries to follow Washington's leadership voluntarily. Sometimes, these policy tools were wielded to punish countries that threatened U.S. interests, but they were primarily used to provide the carrots that would generate support for the U.S.'s benevolent hegemony. These policy tools consisted of military power to provide the public good of global security and the U.S. dollar which has served as the world's reserve currency.

Policy Tool #1: Military Power. As might be expected given its military dominance at the end of WWII, the U.S. has actively leveraged its armed forces to provide the public good of global security. The U.S. has protected other countries from aggression, and it has used its navy and other forces to protect the global sea lanes and other commercial trade routes. Acting as the "global policeman" in this way boosted U.S. legitimacy and secured a consensus supporting U.S. dominance. However, the costs in blood and treasure have now generated such sufficient political pushback here at home that the U.S. will probably be constrained from using this tool in the future, unless the military assistance provided is minimal or there is a direct threat to the U.S. or U.S. citizens.

Policy Tool #2: The U.S. Dollar. Since WWII, the U.S. dollar has been the economic glue binding nations around the world to the U.S. This was achieved by keeping the U.S. relatively open to other countries' exports and supporting U.S. corporate investment abroad, despite the resulting trade deficits and loss of jobs domestically. Before China's huge, lowcost industrial base really entered the global economy in the 1990s, those trade deficits and job losses were politically viable. Now, however, they have generated intense anger and pushback, which we think will keep U.S. officials from offering any big, new trade and investment deals in the future (although smaller, more targeted agreements could be made to persuade the members of the evolving U.S.-led geopolitical bloc to follow Washington's lead).

U.S. Hegemony Today

For U.S. elites and traditionalists who want to preserve America's international dominance and leadership, the domestic political constraints discussed above are a major impediment. Internationalist officials today have fewer carrots to offer to other countries to incentivize their cooperation and support. Politically, they can't offer big, new security promises, free-trade deals, or mutual investment agreements.

On the other hand, it appears that U.S foreign policy officials are now trying to make up for those constraints, at least partially, by sharing the most modern of resources: information. We don't want to suggest that this policy tool will be as powerful as exercising military power or offering free trade and investment flows. In fact, the U.S. has long shared its secret intelligence with trusted allies, but that sharing was never the key glue binding those allies to Washington. Nevertheless, it does appear that intelligence and knowledge sharing with key allies is an under-appreciated carrot that could help preserve U.S. hegemony. Below are several examples of how the U.S. is currently using this policy tool.

Ukraine. The U.S.'s most innovative and notable use of intelligence sharing today is for ***public diplomacy***. For example, in the weeks and months prior to Russia's invasion of Ukraine in February 2022, the U.S. declassified and publicly released a wide range of detailed intelligence on Russian troop and equipment movements to underscore its concern that the Kremlin's forces were preparing to cross the border. The U.S. was careful not to reveal its sensitive intelligence sources and methods, and it was surely selective in deciding what information and assessments to release. Nevertheless, the information was widely accepted as credible, especially after it was corroborated by "open-source intel analysts" using commercial satellite imagery and other information to track developments on the ground. The information provided was seen as reliable data that otherwise wouldn't have been available, so it succeeded in raising the global public's concern and pushback against Russia. This public intel sharing was therefore an important supplement to the U.S.'s provision of intelligence to the Ukrainian government in secret.

India. Reports last month revealed that the U.S. secretly provided intelligence to India before an attempted Chinese military incursion across the disputed India-China border in the Himalayas. The provided intelligence included real-time satellite imagery showing Chinese forces preparing for the incursion and advancing to the unmarked border. This allowed the Indians to block them and ensured that the contact didn't become any worse than a scuffle. Importantly, the intelligence was more detailed and delivered more quickly than anything the U.S. had ever previously shared with the Indian military. The U.S. has long shared such intelligence with its close allies, but this successful instance probably helped earn India's appreciation and could help cement India's cooperation with the U.S. in its growing geopolitical rivalry with China.

Europe. Outside the realm of military operations, the U.S. also appears to be sharing intelligence about Chinese and Russian spying. For example, over the last few years, the U.S. has put pressure on its European allies to jettison telecom equipment made by Chinese technology giant Huawei on concerns that the equipment could be used to eavesdrop on sensitive communications. The U.S. has also urged other countries to ban the Chinese social media app TikTok based on similar concerns. Even though the U.S. hasn't provided detailed examples of such spying to the public, it has nevertheless managed to convince several allies to follow through on bans against Huawei and TikTok. That suggests the U.S. has secretly provided its allies with convincing evidence that Huawei and TikTok really could be used for Chinese spying.

United Arab Emirates. Finally, the U.S. has also been sharing its secret intelligence to undermine China's stealthy build-up of foreign ports that it could use as naval bases in the future. In 2021, for example, the U.S. discovered that China was secretly building what was suspected to be a military facility at a port in the UAE, one of the U.S.'s closest Middle Eastern allies. UAE officials apparently were not aware that the construction was military related. After meetings with U.S. officials, which almost certainly included the sharing of U.S. intelligence, the UAE put a stop to the activity.

Analysis

Intensified U.S. intelligence sharing has continued in recent months. For instance, in February, the U.S. publicly revealed that it had intelligence showing that China was considering providing weaponry to Russia for its war against Ukraine. In March, European Commission President von der Leyen delivered an unusually hawkish speech against China just days after meeting with U.S. officials in Washington, suggesting that secretly shared intelligence emboldened her to adopt a firmer stance. All these continuing signs of stepped-up intelligence sharing suggest a deliberate plan to shape both public perceptions of international threats and the policies of individual allied governments.

Although there is some risk that this program could reveal sensitive intelligence sources and methods, it may help U.S. officials make up for the way domestic politics is limiting the kinds of carrots they can offer to foreign leaders. U.S. voters may not accept big, new security commitments or free-trade deals that benefit allied countries, but in a world where China, Russia, and other authoritarian governments are expanding their territorial aggressions, U.S. allies are likely to place a high value on actionable information that helps them protect themselves and advance their own interests. U.S. intelligence sharing could therefore help keep the U.S.-led geopolitical bloc more united than it otherwise would be.

Investment Implications

As domestic political trends force U.S. foreign policy officials to step back from the country's traditional role as global hegemon, deglobalization is likely to continue and the world will likely keep fracturing into relatively separate geopolitical and economic blocs. As we've previously written, that means corporate supply chains will be shortened. Companies in the U.S. and the rest of its bloc will likely re-channel their capital investment and operations away from China and other potentially adversarial states and instead invest more in the U.S. and its allies. The result will be greater investment needs, less efficiency, higher production costs, and smaller markets.

Higher prices, faster price inflation, and elevated interest rates will likely become the norm.

In this evolving world, we think the prospect of higher inflation and interest rates will be a strong headwind for ***fixed income*** assets. Indeed, we suspect bonds are now on the verge of a prolonged bear market. At the same time, corporate profits are likely to be more constrained, as will stock valuations, creating some headwinds for ***stocks***. Nevertheless, we think companies will have some flexibility to adjust to the new world and keep their profits growing, albeit at a slower pace than in recent decades. We believe stocks will therefore continue to offer better long-term returns than bonds. Finally, we think the constricted global supply chains and the China-led bloc's likely weaponization of natural resources will buoy prices for ***commodities***. In our view, that means investors should consider a higher exposure to commodities than they would have over the last few decades.

Patrick Fearon-Hernandez, CFA
April 17, 2023