Confluence Investment Management

Weekly Geopolitical Report

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The Mid-Year Geopolitical Outlook

(Due to the Independence Day holiday and a short summer hiatus, the next report will be published July 15.)

As is our custom, we update our geopolitical outlook for the remainder of the year as the first half comes to a close. This report is less a series of predictions as it is a list of potential geopolitical issues that we believe will dominate the international landscape for the rest of the year. It is not designed to be exhaustive; instead, it focuses on the "big picture" conditions that we believe will affect policy and markets going forward. They are listed in order of importance.

Issue #1: Deglobalization

There is a natural tension between national sovereignty and international markets. During the initial period of the industrial revolution, the lack of technology to move people, capital, finished goods, data and ideas across long distances cheaply allowed for a high level of national economic autonomy. However, the introduction of faster ships increased the flow of goods and supported immigration, while the gold standard supported the flow of capital and international investing. The flow of ideas and data remained costly until the past three decades. National economic sovereignty eroded as nations intruded on other nations in the form of goods, people, ideas and capital. The rise of populism in the 1890s was due, in part, to the demands of capital forcing austerity on debtors. Under a gold standard, the labor markets make all the adjustments to money supply constraints. The ability to enforce the gold standard only worked because of limited suffrage.

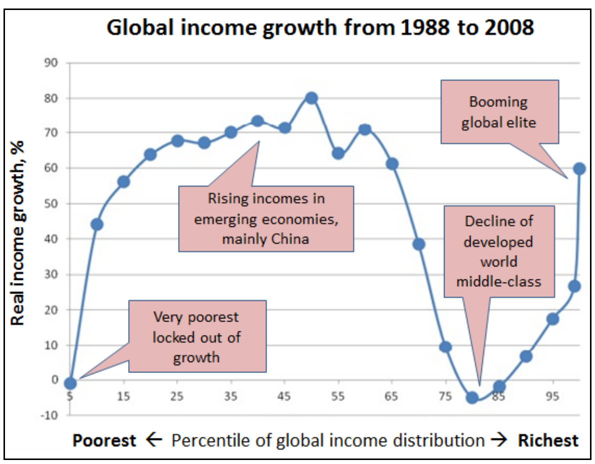
The previous peak of global economic integration was achieved just prior to WWI. That conflict was the first multinational mass mobilization war. It not only required a large number of soldiers but the cooperation of the civilian populations in the war effort as well. In the aftermath of the war, populations agitated for broader voter representation. As elections started to include women, minorities and, in many nations, those without property, it became increasingly difficult to implement the austerity needed to maintain the gold standard. For the gold standard to function, the cost of adjustment had to fall almost completely on the labor markets. That solution became politically difficult to execute as voting rights spread.

By the end of the 1930s, few nations remained on the gold standard and these nations tended to have slower recoveries from the global depression. Policy flexibility was important in a nation's recovery. As a result, in the postwar world, under Bretton Woods, nations were able to constrain capital flows and maintain trade impediments that were only slowly removed. There was a high degree of economic sovereignty at the cost of less efficiency.

Beginning in the 1970s, the Bretton Woods system collapsed. In the ensuing years, inflation became a problem in the West. To combat it, the supply side policies of deregulation and globalization were broadly adopted. After the fall of communism, the

Washington Consensus developed, which supported the free flow of capital and the global reduction of regulation. Trade agreements, such as NAFTA and the WTO, tended to favor consistent international regulations of labor markets, environmental rules and intellectual property over national sovereignty on such issues. In a sense, the global trade infrastructure began to look more like the gold standard and less like the postwar Bretton Woods system. Free capital flows and the needs of international investors have become more important than local regulations.

A backlash was inevitable. Early signs of unrest occurred at the WTO meetings in Seattle in 1999. Eventually, populists on the left and right became jaded by international trade, and with good reason. Globalization and deregulation have played havoc on the Western middle class.



(Source: Pew Research Center)

This is the famous "elephant chart" from the research of Branko Milanovic; it shows how the emerging economy middle income households enjoyed remarkable growth during the three decades from 1988 to 2008, while only those in the highest income brackets had income growth in the developed world.

Establishment leaders treated globalization as an impersonal force, impervious to national influence.

Globalization is not something we can hold off or turn off…it is the economic equivalent of a force of nature, like wind or water.

--Bill Clinton

I hear people say we have to stop and debate globalization. You might as well debate whether autumn should follow summer.

--Tony Blair

The positions stated in the above quotes are simply not true. Globalization is a policy choice that can be reversed; we know this is true because we have historical precedent. Globalization retreated after WWI and didn't really return to similar levels of integration until the late 1980s.

Populists across the Western world want a return to national economic sovereignty, and we suspect they will get their way over time. Deglobalization will lead to shorter supply chains and higher prices but it holds the promise, perhaps false, of a return of jobs to the Western working class.[1] It will also certainly mean lower returns to capital. Nevertheless, much like what we saw with the collapse of the gold standard, the current level of globalization appears unsustainable. The Trump administration's trade policies are reflecting these changes.

Finally, there is a belief that high levels of economic integration reduce the odds of war. World War I remains a strong counter-argument to this position but it is likely true that economic integration increases the costs of war. As globalization diminishes, it may

[1] As long as technology can be introduced without regulation, the promise of mass industrial job growth is likely false.

make the decision to enter a conflict easier than it would otherwise.

Issue #2: Election Meddling

One of the findings of the Mueller report was that Russia clearly tried to interfere in the U.S. 2016 presidential election. To some extent, Russia's goals in election interference are nothing novel. The Soviets tried to affect electoral outcomes during the Cold War.

However, what has changed is the advent of social media. These platforms have improved the effectiveness and reduced the costs of political messaging.

Unfortunately, the political class in the U.S. may be ignoring the most important lesson of the 2016 election. The issue wasn't that the Russians interfered—it was that they showed other nations the path to repeat the process.

For nations that want to weaken U.S. hegemony, supporting the election of a populist makes sense. A tenet of American populism is to reduce U.S. power projection. In the last election, nations with this goal would have supported Donald Trump, who argued against foreign entanglements, over Hillary Clinton. However, if the race had been between Trump and Bernie Sanders, the support would have likely shifted to the senator from Vermont, who would probably be more isolationist than Trump.

It isn't hard to envision foreign powers trying to manipulate U.S. voters via social media for all sorts of goals. Foreign nations that have an interest in the U.S. maintaining its superpower role, such as Germany or Japan, could try to influence the election using social media to boost a candidate who supports that policy. Social media could foster a "free for all" of foreign influence in our electoral process.

We will have more to say on this issue in the coming weeks. However, a way to frame this issue is to consider von Clausewitz's three phases of war; social media manipulation could be used to skip the first two stages (defeating the military and physical occupation) and go straight to undermining the civilian population's will to resist. Combating this problem without creating a regulated internet might be very difficult.

Issue #3: Iran

The Obama administration tried to reduce America's exposure in the Middle East to allow for a "pivot to Asia" by improving relations with Iran. If the U.S. reduces its footprint in the region, then some other nation will need to fill the power vacuum. We suspect that President Obama assumed that the Iran nuclear deal would eventually lead to a normalization of relations by his successor.

Needless to say, this was a controversial policy stance. Iran has been at odds with the U.S. since the fall of the Shah. Nevertheless, some nation, either a global or regional hegemon, needs to stabilize the region; if the U.S. is going to be less involved then another regional power will need to fill the gap. President Obama seemed to take the position that no other power in the region besides Iran could play that role.

However, President Obama's successor turned out to be different than he expected. President Trump rescinded the Joint Comprehensive Plan of Action (JCPOA) and put sanctions back in place. Iranian oil exports have plunged and there is evidence to suggest Iran has attacked civilian shipping in the Persian Gulf.

As we noted in last week's report, we don't think a broader war with Iran is likely. We would expect the U.S. to take steps to protect oil shipments in the Persian Gulf. However, the lack of communication lines between Iran and the U.S. does create conditions for the potential of an accidental escalation.

Issue #4: China

China is trying to navigate the transition from being a high-growth/low-cost nation to a developed nation. Since the industrial revolution the world has seen a series of nations accomplish this transition, although none has done so without significant disruption. In this growth phase, the economy is dominated by investment; the nation has an industrial base to build and therefore has to find funds to pay for this project.

Historically, there have been two models to funding this development. The first involves attracting foreign money to the economy to pay for the investment. The foreign investor risks malinvestment or expropriation at the hands of the developing nation in hopes of high return. At the same time, the developing nation can't get the reputation of "stiffing" foreign investors, otherwise the terms of investment will become too onerous or the flows will simply stop.

The second model involves generating the funds internally by suppressing consumption. This suppression can be accomplished in a myriad of ways. The currency is usually undervalued in order to raise the price of imports to reduce consumption. Taxes are often placed on consumption as well. Household deposit rates are usually below the rate of inflation to force higher saving, and there are restrictions on the capital account to prevent funds from leaving the country. Under this model, it is also normal to have a modest, or non-existent, social safety net to further boost precautionary savings.

The weakness of the first model is that it is dependent on foreign investors. If foreign investors become jaded on investing in the high-growth/low-cost country, then the model fails. The weakness of the second model is that, at some point, the industrial capacity exceeds domestic demand. If the model is to be maintained, new sources of consumption must be found. In nearly all cases, that source is exports. Another feature of this model is that development is often funded with debt. As a result, at the end of this phase, the economy is saddled with too much capacity, often for the production of low-cost goods (or the mere assembly of higher value goods) and excessive debt.

China has both characteristics. It faces four avenues to address this problem.

Revaluation: The existing capacity needs to be revalued to a price level where a new owner can profitably produce with existing industrial capacity obtained at a lower cost.[2] This is a painful process; if debt was used to fund the industrial capacity, a debt crisis is another element of the revaluation.

Mass mobilization war: During periods of war, the excess capacity is either absorbed by the war effort or destroyed during the

[2] When the U.S. entered this phase, it suffered through the Great Depression, which was a rapid revaluation of this excess capacity. When Japan faced this revaluation, it opted for a more measured approach, which has led to three decades of stagnant growth.

conflict. This method is how Japan and Germany resolved their excess capacity situations before WWII. The U.S. also used its excess capacity to supply goods for the war effort. The heavy government intervention in the economy, as noted above, supported the facilitation of assets to a broader base of households, supporting consumption that was able to utilize the production capabilities.

Imperialism**:** Acquiring colonies creates a compliant outlet for exports. The colony can be forced to buy the excess production of the restructuring high-growth/low-cost producer. This was the favored method of absorbing excess capacity among European nations before WWII. However, it is still used today; we would argue that the Eurozone is essentially a German colony that is forced to absorb excess German capacity.

Value chain advancement**:** Usually, the high-growth/low-cost nation is a producer of a large amount of low-value goods. If this nation can shift its industrial base to more sophisticated goods then the revenue gained from these products can be used to restructure the economy. In other words, the higher value products replace the lower value goods in the economy and allow the excess capacity to be transformed.

Ideally, China could adjust by revaluing its industrial capacity through transfer of ownership to households. That would not only allow for a new lower capital valuation to the new owners but also lift consumption and help absorb the excess capacity. After all, the new owners will be richer and wealth effect spending could ensue. However, this transfer would reduce the wealth, power and influence of ranking members of the Chinese Communist Party (CPC); thus, it isn't likely.

Instead, China appears to be focusing on value chain adjustment (China 2025) and imperialism (the "One Belt, One Road" initiative). However, the Trump administration is putting obstacles in the way of these methods. First, the U.S. is restricting technological transfers which slows value chain adjustment significantly. Second, the U.S. is offering an alternative to joining the one belt, one road program. Given the debt issues that some nations are facing from Chinese "investment," the U.S. offer looks attractive. In reality, the trade conflict between the U.S. and China is something of a sideshow. The real threats are technology transfer restrictions and impeding foreign investment.

If the U.S. doesn't allow China to use value chain advancement or imperialism, then China must either choose mass mobilization war or debt restructuring. We strongly doubt China will choose war, although the likelihood isn't zero. Debt restructuring runs the risk, at best, of a massive growth contraction or a long period of stagnation. Either outcome would put the CPC in deep trouble. Faced with a difficult decision, China continues to search for the least painful way of adjustment. Unfortunately, history suggests that none of the options are without risk and the deterioration of U.S. and Chinese relations increases the odds of a conflict or significant decline in Chinese economic growth.

Ramifications

Deglobalization will tend to decrease efficiency and, over time, lead to inflation. Undermining the electoral process will tend to weaken overall confidence and depress the value of all financial assets. The problems with Iran, if they escalate, will lift oil prices. The tensions with China are more difficult to handicap. If the trade war widens, it will weaken global growth. A hot war would be bullish for defense stocks, gold and Treasuries but likely bearish for everything else.

Overall, the message of the mid-year outlook is that the likelihood continues for rising instability. These factors have the potential to undermine confidence and weaken risk assets.

As noted earlier, we don't view these four issues as exhaustive, but they do represent the concerns we will be most closely watching as the year progresses.

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