

June 25, 2018

The Mid-Year Geopolitical Outlook

(Due to the Independence Day holiday, the next report will be published July 9.)

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.

#1: America's Evolving Hegemony

All hegemonies throughout history have provided two major public goods for the world. First, they maintain global security. The hegemon tends to prosper under conditions of peace and therefore has an interest in enforcing stability. The terms “Pax Romana,” “Pax Britannica” and “Pax Americana” all reflect peaceful periods enforced by Rome, Britain and the United States, respectively. Second, the hegemon supports global economic growth and trade, which include financial stability and protection of sea lanes.

Although there have been other hegemonies (e.g., Spain, Netherlands), all except the United States developed colonies. Controlling colonies helps offset the costs of hegemony because the colonial regions can be forced to accept trade surpluses from the host nation. The U.S., given its

revolutionary history, did not make colonization a tenet of American hegemony.

In fact, the U.S. was a reluctant superpower. After WWI, it was becoming clear that Britain was struggling to maintain its superpower role and the U.S. was not interested in filling the gap. The Smoot-Hawley Tariff ensured that foreign nations that had borrowed from the U.S. would be unable to run trade surpluses with the U.S. to service the debt and as a result the global financial system collapsed during the Great Depression. Charles Kindleberger, an economic historian, argued that (a) the world economy requires a hegemon in order to function properly, and (b) the Great Depression was caused by a superpower vacuum.¹

Since the U.S. really didn't aspire to hegemony, it had to have good reasons for taking on the role. The two primary reasons were the fear of communism and avoiding a third world war.

Communism was a significant threat to the capitalist/democratic world. It offered an alternative to markets and democracy and promised an eschatology where capitalism, the state and work would mostly disappear. Even though the U.S. cooperated with the Soviet Union against the Axis Powers, the Truman administration concluded soon after the war ended that a communist Soviet Union would be a strategic competitor.

¹ Kindleberger, C. (1986). *The World in Depression, 1929-1939* (2nd ed.). Berkeley, CA: University of California Press.

In response, the U.S. developed a foreign policy based on containing communist expansion. The theory, first discussed by George Kennan and executed by President Truman, was designed to surround the communist states and “wait them out” on the assumption that capitalism and democracy would prove superior and eventually lead to the collapse of communism.

The containment of communism is how the security side of American hegemony was “sold” to U.S. voters. However, there was an additional element that, in our opinion, was not fully explained but was critical to the reasons behind the U.S. accepting the mantle of hegemony, which was the avoidance of WWII.



(Source: Wikipedia)

The lines on the above map roughly highlight the area of communist expansion. We have also included three circled areas; these are conflict zones that the U.S. purposely “froze” but never fully explained to the American public.

The problem in Europe was Germany. No power since Rome has been able to successfully dominate the continent. This is mostly due to geography; large islands, seas and mountain ranges isolate parts of Europe. Germany, on the other hand, sits in the middle of the Northern European Plain. After unification in 1870, Germany faced

persistent land threats from Russia and France, and the British Navy could bottle up the German fleet in the Baltic Sea. At the same time, its location on the plain supported economic development as the lack of geographic barriers allowed for easy logistics.

The combination of rapid German economic growth and the insecurity due to the lack of geographic barriers created conditions of instability. Germany became the source of two world wars. The Truman administration, as part of the Marshall Plan, essentially guaranteed European security, thus preventing another mass mobilization war from developing in Europe. Because of this policy, Europe has essentially been a “free rider” on U.S. security.

A similar situation existed in the Far East. Japan became a major industrial power after the Meiji Restoration, which began in 1868. Although Japan rapidly industrialized, it is an island with few natural resources. As a result, Japan was always fearful of foreign powers interdicting the flow of raw materials to the island nation and became aggressive in the region. Imperial Japan invaded China in 1931 and bombed Pearl Harbor in 1941 after the Roosevelt administration, along with Britain, embargoed oil flows to Japan. Japan’s neighbors feared aggression from Japan in its pursuit of raw materials and Japan feared having those supplies cut off by outside powers.

Again, after WWII, the U.S. guaranteed not only Japan’s territorial security but also the trade flows into the country. Because of this action, Japan no longer threatened its neighbors and also no longer feared having its supply of raw materials restricted.

The Middle East was dominated by European colonial powers until WWII. After the war, the colonies became independent but the “nations” created by the colonial powers were not really functioning states. The European governments configured proto-states that were better suited for colonial control, not independence. Ethnic and religious groups that should have been unified were kept apart and groups that should have been separated were forced into the same state. Furthermore, the colonial powers would usually put a minority sect in charge of government, which would make the local government reliant on the colonial power.

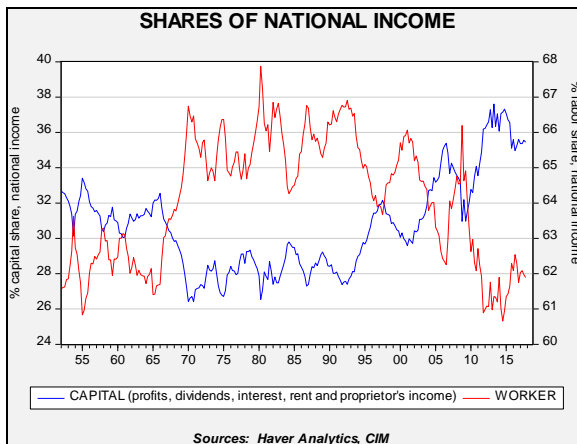
When the colonial powers left the region after WWII, the U.S. enforced the borders even though they were obviously flawed, in part, to prevent Soviet expansion into the region and to ensure oil supplies would remain available to the Free World. The structure of the colonial governments, which carried over into independence, led to political situations where the new governments could only maintain power by authoritarianism. Although the U.S. naturally opposed such oppressive regimes, the fear was that the process of establishing more natural states would lead to years of conflict that the U.S. felt it couldn't allow to happen. Consequently, the U.S. generally intervened to prevent any other power from dominating the region.

Another element of hegemony was providing the reserve currency. The dollar became the currency of choice for much of global trade. In order to acquire dollars, nations deliberately constructed their economies to oversave and generate exports, which were absorbed by U.S. consumers. This burden was manageable so long as the U.S. economy dwarfed the rest of the world. However, as the rest of the world recovered

from the devastation of WWII, the distortions brought upon the U.S. economy became serious. Although Americans with high incomes enjoyed offering their skills on a global platform, the majority of workers faced consistent foreign competition that reduced jobs and lowered wages. The reserve currency status coupled with globalization did reduce inflation but, at the lower end of the income scale, the perceived benefits from trade were considered inconsequential compared to the costs.

Ensuring these three conflict zones remained frozen was a costly endeavor but the American people agreed to the situation under the guise of containing communism. Americans were also willing to deal with the job losses caused, in part, by the reserve currency status in order to defeat communism. And, the owners of capital were willing to restrict the returns to capital to prove that capitalism was superior to communism.

However, since communism was defeated, the political class has been unable to create a rationale for maintaining American hegemony. Even though a case could be made that allowing Japan and Germany to remilitarize and letting the Middle East restructure itself into more legitimate states would lead to widespread war, the case was simply never made. Instead, with communism out of the way, Americans wondered why they were required to provide security to the critical frozen conflict zones. In addition, the benefits of open trade also came under question.



Note that since communism ended in 1991, the share of national income going to labor has steadily declined. At the same time, capital's share has risen with each business cycle.

The successful presidential candidacies of Barack Obama and Donald Trump indicate to us the desire for change among American voters. It appears the burdens of hegemony have become so great that Americans are no longer willing to maintain the role as it is currently configured.

President Obama's attempt to reduce American exposure in the Middle East by elevating Iran and President Trump's trade policy both have the common theme of trying to restructure how the U.S. exercises hegemony. President Obama's nuclear deal with Iran was likely part of the "pivot" to Asia that would have reduced American influence in the Middle East. Trade impediments undertaken by the Trump administration are an attempt to rebalance the U.S. economy with a different trade relationship. President Trump has also made reference to Europe and Japan taking on more of their own costs of defense.

It seems to us that neither of the last two presidents has had a clear vision of how they want to manage the hegemon role. Backing

away from the Middle East required the appointment of a regional hegemon. Although Iran is a potential choice in a region bereft of alternatives, it wasn't necessarily a good option. Forcing Germany and Japan to take on more of their own security costs will almost certainly lead them to also demand a greater say in their regions' foreign policies. One of the benefits of paying for Europe's and the Far East's security was that they would be forced to follow America's lead in policy decisions. If Germany is defending itself, it would be naïve to think it wouldn't also want to project power.

Retreating from free trade will undermine globalization. As Kindleberger noted, the world needs a hegemon to provide the reserve currency; without one, global trade tends to dry up.

If the U.S. continues down this path, and all indications are that the trend is accelerating, expect more regional conflicts, higher inflation and, at least initially, a stronger dollar. If the U.S. impedes trade, foreigners will go to greater lengths to acquire dollars; it's simple supply and demand. If the global supply of dollars falls due to a narrower trade deficit (which is how the U.S. supplies dollars to the world), then even steady demand for the greenback will likely lift the dollar's price.

#2: Rising Western Populism

The chart above showing shares of national income offers some insight into the growing anger over inequality.



(Source: Branko Milanovic, Medium)

This chart shows global real income growth in the two-decade period between 1988 and 2008. The developed world middle class did not participate in the global boom.

Populism has two variants, a left-wing version and a right-wing version. At present, the right-wing version has seen more success. The AfD in Germany did very well in the last German elections, and a right-wing populist party won the most votes in recent elections in Slovenia.

Additionally, right-wing populists control Hungary and were instrumental in Brexit.

On the other hand, in Italy, the left-wing populist Five-Star Movement shares power with the right-wing populist League party. We dub such political configurations as “Nader coalitions.”²

Nader’s argument is that the two versions of populism share common economic interests despite deep divisions on numerous issues. Both want to see less income going to the holders of capital with more private sector and government support for “common people.” They usually oppose free trade due to job losses.

² Nader, R. (2014). *Unstoppable: The Emerging Left-Right Alliance to Dismantle the Corporate State*. New York, NY: Nation Books.

However, there are stark differences between the two groups that shouldn’t be discounted. Right-wing populists tend to oppose means-tested transfer payments, viewing them as funding for minority groups. They also oppose immigration. Right-wing populists tend to be socially traditional and thus are usually not inclusive to various identity groups. Left-wing populists tend to support targeted aid to ensure those that most need help receive it. They are usually inclusive and open to immigration.

Usually, the populists of either stripe are co-opted by establishment parties. While establishment factions differ on social issues, they are mostly in agreement on economic policy. Both support globalization and the unfettered introduction of technology. And so, during the past few decades, when populists joined their establishment brethren they received some support on social issues but little help on economic issues.

For investors, there is a clear bottom line—populism is inflationary. Populists of all stripes tends to support increased government spending and regulation to protect jobs. Rising fiscal deficits coupled with regulation and trade interference are a classic recipe for inflation.

#3: Rising Authoritarianism

After the Cold War ended, there was an idea, postulated by Francis Fukuyama,³ that capitalism and democracy had won and there was no viable alternative to these organizing principles for government and the economy. This notion became known as the “Washington Consensus.” Unfortunately, what initially looked like an unstoppable march of democracy and

³ Fukuyama, F. (1992). *The End of History and the Last Man*. New York, NY: Avon Books.

market-based economies turned out to be a superficial adoption in many nations. Since the financial crisis, we have seen a steady rise of variants of authoritarianism.⁴

China, although nominally Marxist, is an authoritarian regime, in reality. Chairman Xi is offering China as an alternative to Western democracy, arguing that single-party domination can be more stable and lead to stronger growth.

Under normal circumstances, this trend would not be a major risk. The Cold War was won by capitalist democracies, in part, by offering a better life to their citizens. However, as the income share chart above shows, once communism fell, U.S. leaders allowed the economy to evolve in such a way that it weakened the claim that capitalist democracies could provide a better lifestyle. China still endures significant poverty and rural “immigrants,” which lack urban *hukou*, or residency permits, can lead uncertain lives on the margins of society. On the other hand, China can argue that the

trend is improving, which isn’t really the case in the West.

Although this development coincides with the rise in populism, the difference is that an alternative system can inspire nationalist feelings that can destabilize global security. In other words, history shows that competing visions for government and society lead to either hot or cold wars. If China offers an alternative organizing principle relative to democratic capitalism, the potential for war does increase. Obviously, war is inflationary and bullish for the defense sector and commodities.

Ramifications

Although we offer market comments at the end of each section above, rising price levels are common to all these issues. While we don’t expect runaway inflation to emerge in 2018, a steady rise in price levels is likely in the coming years and the aforementioned issues are likely to support higher inflation over time.

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⁴ <https://www.economist.com/graphic-detail/2018/01/31/democracy-continues-its-disturbing-retreat>

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