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The 2015 Mid-Year Geopolitical Outlook

N.B. Due to the Independence Day holiday, the next report will be published July 13, 2015.

As is our custom, at mid-year, we update our geopolitical outlook for the rest of the year. This report is less a series of predictions as it is a list of potential geopolitical issues that we believe will dominate the international situation into year's end. 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: The South China Sea

Since 1979, when Deng Xiaoping set China on its current course of modernization, the country has seen remarkable economic growth. In 1979, China was around 2.3% of global GDP; as of 2014, it was 16.5%, just above the U.S. reading of 16.3%.¹ As China's economy has expanded, its geopolitical influence has as well.

To some extent, tensions between China and the U.S., along with China's neighbors, are a classic example of the risks that come when a new power rises in a region. China wants to expand its power and insists that the U.S., the incumbent superpower, accommodate its rise.

The dynamics of this situation play out in a number of ways. The Trans-Pacific Partnership (TPP), a trade agreement that the U.S. is working to form among select nations in the Pacific Rim, excludes China. The U.S. is trying to establish the "rules" of regional trade and assumes that, eventually, China will join the TPP and be forced to abide by the U.S. trade framework.²

At the same time, China is working to create a new infrastructure bank for Asia, the Asian Infrastructure Investment Bank (AIIB), as a competitor for the Asian Development Bank and the World Bank. The Obama administration strongly opposes the creation of the AIIB; despite U.S. pressure, numerous nations, including some G-7 partners, decided to join the bank, a blow to the administration's foreign policy.³

China fears the U.S. is trying to prevent it from projecting power in the region. This is probably true. Although America welcomes China's "peaceful rise," the assumption among U.S. policymakers is that China would eventually democratize as its economy grew. Historically, many developing nations use authoritarian systems in their early development. However, as the economy reaches the point where a growing middle class has achieved its basic needs, it usually begins agitating for a larger political voice. In addition, authoritarian regimes usually direct investment within the economy. In the early stages of development, any investment is effective. As the economy grows, investment is best allocated by markets. This change generally

¹ Source: IMF, based on purchasing power parity. Using other methods, the U.S. remains larger.

² See WGR, 1/27/2014, [The TTIP and the TPP](#).

³ See WGR, 4/20/2015, [The AIIB](#).

leads to democracy as the power of the authoritarian government is reduced by its giving up control of investment spending. Successful states manage this transition to democracy; those that can't tend to see their growth stall. For example, South Korea made the transition; Pakistan did not.

However, China represents a different case. In these other cases, these states did not necessarily have a developed ideology. In China, the communist ideology has become one of the bases of legitimacy. Most authoritarian regimes become cults of personality that don't outlive the dictator. Although China clearly has personality cults in its history, the Communist Party of China (CPC) has become the primary conduit of political power. It's not obvious if any of the CPC members really believe in Marx anymore, but they all say they do; perhaps this belief system remains in order to keep the power structure in place. In addition, the ability to deliver economic growth has bolstered the CPC's legitimacy. For now, the CPC leadership seems to believe it has created a new paradigm of market capitalism with a non-democratic governance that is superior to market capitalism with democracy.

China is trying to project power in the Far East and Southeast Asia. It is rapidly building its navy. The "Silk Road" program of creating land and sea bridges to Europe and the Middle East appears to be due to fears that the U.S. Navy could blockade China's trade by sealing off the Strait of Malacca and the first island chain surrounding the country. Extensive road building through Pakistan is part of this program.

In the South China Sea, China has begun an aggressive dredging program to build up coral atolls and use them to claim

sovereignty and create potential military bases to project power in the region. As one would expect, other nations in the area are quite concerned about this activity. The Philippines, for example, appears to be welcoming the U.S. back after forcing the closure of American military bases in the early 1990s.

The Obama administration will likely allow China to continue its dredging and island-building but, to prove that these atolls are in international waters, expect the U.S. Navy to send ships close to these operations. The U.S. would see its power diminish if areas become off limits to American power. For example, Taiwan would certainly be vulnerable without the ability of the U.S. to project naval power into the area.

Two key potential dangers exist. First, as the U.S. shows it can still project power in the region, the chances of an accident increase. Close contact without clear rules of engagement are a problem. Second, the Xi government is trying to manage a critical economic transition from relying on investment and exports for growth to depending on consumption to expand. Other nations have struggled with this transition.⁴ Currently, the Chinese equity market is showing signs of being in a bubble. In part, the government has supported equity investment in what we believe is an attempt to create a massive debt/equity swap, where state businesses will issue new stock and use the proceeds to pay down debt. Of course, that practice works best if companies can issue high priced stock. If the household sector finds itself "stuck" with inflated equities in a market correction, the CPC may need a diversion and a "splendid little war" is a temptation. The fault lines in the region

⁴ One could argue that Japan never accomplished this shift, leading to 25 years of stagnation.

between the U.S. and China could be a problem as the second half of the year evolves.

Issue #2: Russia Returns

The geopolitics of Russia are fairly straightforward. The Russian heartland does not have formidable natural defenses; there are no mountain ranges or deserts to deter an invader. Instead, navigable rivers are about the only geographic features that break up the plains. From time immemorial, Russian governments have defended themselves by expanding their territory, forcing a potential invader to march long distances to attack the heartland. By stretching supply lines and taking advantage of Russia's cold climate, the country has used distance as its primary defense. In two classic examples, Napoleon's invasion in 1812 and Hitler's invasion in 1940, the Russian military retreated, the winter ensued and the Russian military counterattacked, leading to disaster for the invading armies. After WWII, Stalin expanded Russia's sphere of influence into Eastern Europe, offering the Russian heartland even more protection.

The flaw in Russia's defense system was that it didn't have a strong enough economy to encourage areas surrounding the heartland to join Russia willingly. Instead, Russian governments have relied on suppression to maintain control of these regions and suppression isn't without costs. Eventually, the cost of empire overwhelms Russia's economic capacity and the empire collapses. The loss of a security buffer is terrifying for Russian leaders, who then work to rebuild that buffer.

This is what President Putin is in the process of doing. Adding numerous former Eastern Bloc nations to NATO was bound to be seen as a direct threat to Russia, even if Western states thought otherwise. When the Orange

Revolution in 2004-05 threatened to pull Ukraine out of Russia's orbit, Putin retaliated. He continued to meddle in Ukraine, relying on his ally, Viktor Yanukovich, to keep Ukraine allied with Russia. When Yanukovich was ousted during the Euromaiden protests in 2014, Putin retaliated by supporting an insurgency in eastern Ukraine, which continues to the present.

Although we doubt Putin will be able to recreate the former Eastern Bloc, he can nearly accomplish the same goal by causing divisions within NATO. If Western European nations refuse to stand unified against Russia, Putin will be able to reward and punish various states to neutralize threats on his western border.

We look for Putin to continue his "hybrid war" in Ukraine, using a combination of support for an insurgency, disinformation, cyber-attacks and diplomacy to effectively extend Russia's influence. Although the U.S. will attempt to unify the major nations in Western Europe, growing divisions in Europe will make America's policies difficult to execute there.⁵ Additionally, as President Obama's time in office comes to a close, his influence will wane.

Issue #3: The End of Sykes-Picot

From November 1915 through March 1916, Sir Mark Sykes, a British representative, and François Georges-Picot, a French diplomat, divided up the Ottoman Empire in anticipation of its eventual collapse. Both nations, with minor negotiations with Czarist Russia, planned to colonize the region once the Ottoman Empire fell. After the Bolshevik Revolution, Lenin released the terms of the deal. Although news of the deal were a grave disappointment to the Arabs in the region who were hoping that

⁵ See Issue #4 below.

the end of Ottoman rule would lead to independence, Britain and France drew the borders that, until recently, have delineated the nations of the region.

In the process of creating dependencies, the British and the French created nations of ethnic and religious groups that would not have occurred under normal circumstances. By creating royalist governments from the minority ethno-religious groups, the rulers of these statelets were dependent on the European powers for support. Although this structure made it easier for the colonial powers to control the state, it created conditions in which the majority ethno-religious groups were marginalized. In the long run, it created conditions of instability.

The states that the colonists created were constructs; they were not natural nations. As time passed, it became apparent that the only way to hold these nations together was through brutal authoritarianism, either in the form of royalist or secular governments. The U.S. and the U.S.S.R. managed to keep their patron governments in power and the region remained stable. However, the forces of division continued to simmer under the surface.

The Soviets' defeat in Afghanistan began the process of ending the region's stability. The defeat gave rise to a transnational radical Islam, best shown by the rise of al Qaeda. After the U.S.S.R. collapsed, the secular states lost their patron. The economies of Syria and Iraq languished without Soviet assistance; Egypt survived because it made peace with Israel and received American aid. Perhaps more importantly, the fall of communism ended its influence as an alternative to either democracy or royal governments.

Transnational radical Islam became an increasingly powerful threat after the Gulf War; Osama bin Laden saw King Fahd's invitation to American forces to defend the kingdom as heresy. Bin Laden wanted to create a new caliphate by ousting America from the region and overthrowing the secular and royalist governments. This goal led to 9/11; although it appeared, at least initially, that bin Laden had miscalculated, the combination of the Arab Spring and the rise of Islamic State (IS) confirm that the Sykes-Picot era is coming to an end and the region's borders will likely be redrawn. In fact, IS should probably be viewed as the successor to al Qaeda.

Iran, Saudi Arabia, Turkey and Israel are the buffering powers that surround the cauldron of IS. All have different ideas on how to deal with the breakdown of borders in the region. Iran sees IS as a major threat and is trying to draw the Obama administration into increasing its involvement against the group. Saudi Arabia also rightly fears IS as a threat to the kingdom; however, IS is also attacking Shiites in Iraq and Iran and is therefore useful for containing the rise of Shiite power. Thus, the Saudis probably will tolerate IS as long as it doesn't opt to directly attack the kingdom. Israel has a complicated position; it has opposed the Assads in Syria for decades but, if the regime's replacement is IS, it might find itself having to support its old enemy. Turkey appears to be supporting IS to inflict damage on Syria, Iran and the Kurds; President Erdogan must believe he can control the group for his own ends or else he is taking a huge gamble.

Into the mess, the Obama administration is mostly hewing to a minor role. Although this position will be wildly criticized by seemingly scores of candidates running for the presidency, there isn't a clear alternative.

Defeating IS will simply create a power vacuum that may be filled by Iran, Turkey or Saudi Arabia...or perhaps worse.

We suspect this issue will be with us far beyond the next six months. There is no easy solution to this issue and lots of potentially bad ones. If we are at the end of Sykes-Picot, as we believe, the region will become increasingly unsettled and be a major headache for world leaders.

Issue #4: The Unwinding of the European Union

The problems in Greece are the most obvious manifestation of this issue. Greece has debt at unsustainable levels. At some point, the debt will have to be written off. However, the current negotiations between creditors and Greece suggest that such adjustments are not being considered. Some of this is due to the fact that it takes a while for creditors to adjust and prepare to declare that the debt is not payable. If the debt were held at banks, they would be reserving against the loans. In the bond markets, yields rise as prices fall and sometimes debtors and creditors can swap the bonds for some other paper. We expect that such an outcome will happen eventually. However, in the short run, we believe the EU establishment is loath to allow a leftist government with radical elements within its coalition to receive relief on fears that it will encourage other debt-laden nations to choose a similar path.

This situation leads to a broader issue within the EU, namely, the deterioration of European unity. The geography of Europe has generally prevented any power from dominating the continent. Several mountain ranges and seas, along with the British Isles, have meant that no government has been powerful enough to capture all of Europe. Of course, that hasn't prevented some from

trying. The last two world wars originated in Europe as Germany tried to control the area.

In the wake of WWII, Europe was more or less demilitarized with America shouldering most of the defense burden under NATO. The EU was created. The basic idea was that nationalism was probably too strong to be overcome, meaning a “United States of Europe” wasn't possible by peaceful means. However, the European leadership believed that its next best alternative was to build a prosperous Europe based on reducing trade barriers. The hope was that the continent would become so intertwined economically that wars of domination would end. The capstone of the process was the creation of the Eurozone, a single European currency.

At first glance, it would appear that the EU project has been a great success—WWIII hasn't been fought on European soil. But, the EU probably isn't the only reason this outcome has occurred. The Cold War placed Europe at the fault line of the superpower conflict but also led to the region's demilitarization. The security focus was on superpower issues, not internal European concerns. The reduction in defense spending allowed the EU to spend more money on social programs, helping to reduce tensions. Decolonization further reduced the need for a large military and lessened European international commitments.

The end of the Cold War led to the demise of the Eastern Bloc and some key European “frozen conflicts” thawed, especially in the Balkans. Still, the fall of the Berlin Wall was a major achievement and raised hopes that peace and prosperity would act as a replacement for nationalism.

Unfortunately, nationalism is on the rise. In nearly every EU nation we are seeing political parties that oppose immigration, globalization and, in the Eurozone, the single currency. The opposition is both from the left and right of the political spectrum. During the Cold War, opposing the EU project was dangerous; it might mean Soviet dominance of Western Europe. However, in the absence of this threat, those who feel they have been left behind from globalization and broader competition within Europe, and those who fear they are being dominated by Germany, are raising their political voices.

Although we would not expect a return to a pre-Cold War Europe in the next six months, we are seeing increased social and political fragmentation on the continent. This development will support Russian efforts to neutralize opposition from Europe to its efforts to expand influence. The current U.S. policy is to “pivot” toward Asia but foreign policy since WWI has been to oppose any power trying to dominate Europe. A breakdown of the EU will either

pull the U.S. back in or show that American foreign policy has changed significantly. We would expect the former.

Ramifications

In our opinion, these four issues are the most geopolitically important for the upcoming year. In general, geopolitical events tend to be bearish for risk assets and so, if these concerns become critical, they will likely weigh on equities and higher credit risk debt. On the other hand, if any of these conditions were to worsen significantly, it will tend to boost Treasuries, which have been weak lately, and the dollar. It is worth noting that commodity prices have been under pressure for some time due to weakening Chinese economic growth, rising interest rates and a strong dollar. If oil supplies from the Middle East were to be affected, oil prices would likely rise.

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