Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

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The 2023 Mid-Year Geopolitical Outlook: The Polycrisis

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.

We have subtitled this report "The Polycrisis" to reflect the complicated and multifaceted geopolitical world that is rapidly evolving. The number of issues we cover here is much greater than our usual mid-year update, but we felt that all these matters were important enough to mention. They are listed in order of importance.

Issue #1: Russian Political Instability
More than a year after Russia launched its full-scale invasion of Ukraine, the war has largely receded in investors' concerns, at least temporarily (see below). Nevertheless, in late June, Yevgeniy Prigozhin and his Wagner Group of Russian mercenaries launched a short-lived mutiny that could destabilize Russia for years and worsen the global political and investment environment. The rebellion was ostensibly aimed at toppling Defense Minister Shoigu and Chief of the General Staff Gerasimov for their incompetent conduct of the war and their withholding of resources from Wagner fighters. It was nonetheless also a threat to President Putin, who supported Shoigu and Gerasimov. That's especially the case because the rebellion appeared to generate strong popular support for Prigozhin, while the formal armed forces proved unable or unwilling to stop the mercenary forces.

Belarusian President Lukashenko brokered a murky deal between Putin and Prigozhin in which the Wagner fighters withdrew before reaching Moscow and Prigozhin went into exile in Belarus, but the insurrection still suggests Putin is weaker than expected. That alone will put him at risk of a direct attack in the future from Prigozhin or some other power-hungry individual, clan, or region among Russia's political elites. Prigozhin has also been weakened by the debacle as has Putin's patron, Chinese President Xi Jinping. On a more positive note, the failed mutiny has likely strengthened Ukraine and its NATO allies, who will now be more unified and energized to confront Russia.

– PFH

Issue #2: Ukraine's Military Prospects
As of this writing, the Ukrainian military remains in the probing and feinting phase of its expected major counteroffensive against the Russian invaders. The counteroffensive appears to be going slower, and with greater cost, than anticipated, but that doesn't necessarily mean it will fail. A careful, methodical effort to sniff out the weak spots in Russia's well-prepared defenses and continued deliveries of advanced Western weapons could ultimately allow Kyiv to regain significant territory. If the Wagner mutiny further undermines the Russian military's morale and organization, there is a chance that Ukraine could also accelerate its counteroffensive plans and push the Russians back even further.

Increased momentum in Ukraine's counterattack would help ensure continued support from the U.S. and NATO, but we suspect that President Biden and some key European leaders will be increasingly anxious to end the fighting and will pressure Kyiv to start negotiating as the U.S. presidential election gets nearer. Ultimately, we continue to think the most likely future scenario would be for Ukraine to push the Russians out of some additional territory, but for the two sides to ultimately begin peace talks as they exhaust themselves. We see a high chance that the result will be a "frozen conflict" like the North Korea-South Korea one, in which the fighting generally stops but tensions remain worryingly high on NATO's eastern flank.

– PFH

Issue #3: China Navigating Great Power Relations

U.S. foreign policy has been unsettled since the end of the Cold War. During the Cold War, managing relations with the Soviet Union dominated American foreign policy. But after the U.S.S.R. collapsed, policymakers struggled to find a new focus.[1] The Middle East captured attention, with policy dominated by the difficulty in managing Saddam Hussein after the First Gulf War along with the 9/11 attacks and the wars in Afghanistan and Iraq. At the same time, administrations during the post-Cold War period assumed that globalization would continue unabated. Economic policy was mostly on autopilot, focused on efficiency.

Until the middle of the last decade, U.S. foreign policy assumed that American hegemony would continue. It also therefore assumed that "great power" competition was no longer a factor. However, both China and Russia increasingly engaged in activities that were hostile. Russia's annexation of Crimea and parts of eastern Ukraine were clearly outside the norm. China began to take a more aggressive posture in claiming control of the South China Sea, including building military installations .

The Trump administration changed course with China, opening a trade conflict and implementing widespread tariffs. The Biden administration has continued that policy by restricting exports of key semiconductor chips to China. The Russian invasion of Ukraine and China's support of the Putin regime made evident the split in the world order.

Some 33 years after the end of the Cold War, the U.S. finds itself in a great power competition with a China/Russia bloc. During the Cold War, after a couple of near confrontations, the U.S. and U.S.S.R. built a series of "ground rules" to manage their differences. Hot lines were established, and various spheres of influence were generally accepted. That didn't completely stop wars or attempts to woo nations into the orbit of the respective blocs, but the competition was generally held to a level that precluded a global "hot war."

The U.S. and China are in the early stages of trying to create "guardrails." So far, the efforts have been unimpressive. There have been a series of "near misses" between the U.S. and Chinese militaries. It has also come to light that China has listening posts in Cuba. Although U.S. Secretary of State Blinken has recently visited Beijing, steps to establish relations are still halting.

We expect that managing great power relations between China and the U.S. will be an ongoing issue. Here are the key concerns we are watching going forward:

[1] For an interesting take on the failures of post-Cold War American foreign policy, we recommend this podcast.

1. China remains deeply integrated into the global economy. U.S. and EU leaders have talked about "de-risking" which sounds less threatening than "decoupling" but, in reality, isn't much different. Both Treasury Secretary Yellen and National Security Director Sullivan have recently discussed the primacy of national security over efficiency in terms of policy. Increasingly, we expect the global economy to become more regional.
2. Domestic politics in both the U.S. and China will likely become more hostile to the other. During the Cold War, it was risky for a politician to be seen as "soft on communism." Hostility will make it politically risky to engage in diplomacy, increasing the possibility of conflict.
3. It was only after near misses that the U.S. and the U.S.S.R. established guardrails. There is a risk that similar brinkmanship may be necessary this time, too.

By year's end, the U.S. presidential election cycle will be underway. Being seen as accommodating to China will be politically risky, creating an atmosphere where an accident could be more likely.

– BOG

Issue #4: China's Youth Unemployment

Official statistics indicate that the unemployment rate among China's urban youth is nearing 20%.[2] A cursory examination of academic literature on youth unemployment and political stability suggests that most of the concern is with less developed nations. It's unclear if China's level of development is strong enough to merely make this generation of graduates a "lost generation" or if it fosters a threat to the Chinese Communist Party (CCP). One solution to the problem could be emigration; however, China's demographics suggest this would be a suicidal outcome.

There are likely several reasons for high youth unemployment. First, economic growth is slowing and, normally, slowing growth tends to increase unemployment. Second, China is undergoing adjustments to great power competition; China's "dual circulation" policy is designed to simultaneously reduce China's dependence on imports and increase the world's dependence on China. This policy change has likely affected the labor markets, leaving some positions unfilled and causing redundancies in others. Third, CCP General Secretary Xi's policies have tended to boost the power and attractiveness of the CCP and the state, while weakening the image of the private sector. There simply may not be enough government/party positions to absorb new entrants into the workforce.

This level of unemployment is a negative factor for China that could create political tensions if it isn't addressed. The CCP is adept at managing stability, but disappointment at a young age may lead to a future workforce more focused on stability and less on growth.

– BOG

Issue #5: China's Debt Problem

It is no secret that China has a debt problem. Of course, it isn't alone. China's domestic debt/GDP ratio is just under 300% compared to the U.S. ratio of 340%. However, one major difference is that China's non-financial corporate debt/GDP ratio is 145% compared to 48% for the U.S. China's corporate debt reflects real estate debt which is partly financed by local governments. The actual level of local government debt is difficult to ascertain; complicating matters

[2] Given China's rapidly deteriorating demographics, high unemployment among China's youth may suggest the economy is much worse off than the official data suggests.

further is that it isn't clear how these governments can service their debt.

When debts sour, the loan is usually resolved by allocating "pain" between the debtor and the creditor. There is no clear formula for that process; arguments can be made on both sides as to who best can shoulder the loss. Often, the powerful can force the weak to bear the burden of resolution. China's real estate problems that have been in place for the past few years suggest that financial authorities will tend to "extend and pretend" on debt. The good news is that a sudden crisis isn't likely, but the bad news is that the overhang of bad debt will likely crimp economic growth.

– BOG

Issue #6: U.S. Superpower Status and Fracturing Domestic Consensus

Since the Great Financial Crisis, American domestic politics have become increasingly polarized. Although there were signs of deterioration in the early 1990s, the problems became pronounced after 2008. Voters appear desperate for some figure to improve their situation and are willing to test radical solutions. Many of these issues are tied to American hegemony. The need to be the world's importer of last resort, which is required to provide the global reserve currency, has led to the "rust belt" and widened income inequality. The need to provide global security has led to the overtaxing of the military.

It is unclear whether the political class can craft policies that will allow the working class to support hegemony. We doubt that the policies implemented from 1990 into 2008 can return, but some form of accommodation is likely. Nevertheless, we are uncertain whether these policies will be enough to maintain hegemony.

– BOG

Issue #7: Re-Industrialization

As the U.S. steps back from its traditional role as a superpower and the global hegemon, authoritarian nations such as China have stepped into the breach and become more threatening. We have long argued that the resulting U.S.-China tensions and populist opposition to globalization will force companies to shorten their supply chains and shift production to friendlier countries or back to the U.S. itself. Importantly, recent data suggests this is already prompting a re-industrialization of the U.S. The data shows a major boom in U.S. factory construction began around the end of 2022 and appears to be gathering strength. Private nonresidential construction outlays, a proxy for commercial construction, are up more than 20% year-over-year, and outlays on factory construction have more than doubled. These increases are largely driven by new factories for electronics and information-processing goods such as electric vehicles, electric-vehicle batteries, semiconductors, and other green-tech products.

Press reports ascribe the boom in factory construction to legislative initiatives such as the 2021 infrastructure law, the CHIPS and Science Act, or the Inflation Reduction Act. However, we doubt that much of the spending and subsidies in those initiatives has made it through the bureaucracy yet. The bulk of that spending will come only later, as will even more factory construction from the future build-out of the defense industrial base. In other words, the factory building boom and re-industrialization are probably just getting started. Over time, they promise to create new opportunities for workers without a four-year college degree, but the resulting factories will still be costlier and less efficient than the Asian production facilities opened during the heyday of globalization. Re-industrialization will therefore feed into the future's higher inflation and elevated interest rates.

– PFH

Issue #8: Climate Change and Great Power Competition

The issue of climate change remains controversial. Although it is clear that the climate is changing, there is no precise way to determine how much is occurring due to natural processes and how much is due to human activities. Still, policymakers are taking steps to reduce carbon emissions.

Now, a conflict between policies is developing. As noted above, the U.S. and its allies are engaged in great power competition with China. As part of "de-risking," the U.S. and its allies are trying to reduce dependence on China. However, China is the world's leading producer of numerous products tied to energy transition. China dominates the solar power industry and has a large wind power industry as well. It has become a leading producer of electric vehicles and batteries. It also leads the world in rare earth processing, metals which are critical for the energy transition.

Essentially, the U.S.-led bloc will have to choose—will nations in the bloc prioritize the transition and move quickly, at lower cost, but at increased dependence on China? Or will they maintain independence by building redundant capacity away from China? So far, the U.S. seems to be leaning toward the latter outcome, but Europe is clearly weighing its options. For the political class, if the energy transition is the most important issue, then China dependence seems logical. If great power competition is the primary concern, then the energy transition will be slowed.

– BOG

Issue #9: The Problem with Mexico

Analysts who have studied hegemony have noted that an important factor for success and longevity in the role is the threat from nearby neighbors. The Netherlands was unable to maintain hegemony, in part, because it was forced to protect itself from France. The U.K. had greater success because it was an island; the last successful invasion of Britain was in 1066.

In this regard, the U.S. is extraordinarily fortunate. Otto von Bismarck purportedly said that the U.S. was favored because it is bordered by "two weak powers and fish." In its history, the U.S. pressed the Canadian border far enough north to leave only a narrow strip of land conducive to population growth. To its south, the U.S. pushed the Mexico frontier into the desert.

Bordering two powers that were not a threat allowed the U.S. to project power globally. That doesn't mean there haven't been tensions between the U.S. and its Canadian and Mexican neighbors. But neither nation required a large military commitment to defend the border, allowing the U.S. to focus on other issues.

However, there are issues in Mexico that bear watching. These are:

1. The president of Mexico, Andrés Manuel López Obrador (AMLO), is an old-style nationalist with political roots in the PRI when it was the dominant political party in Mexico. His cooperation with the U.S. is spotty. He is quite popular, and whomever he selects to succeed him has a good chance of winning the next presidential election in June 2024. The leading candidate at present is the current mayor of Mexico City, Claudia Sheinbaum. However, it is unclear whom AMLO supports. But it is

safe to assume that current policies will likely continue.

2. As the U.S. de-risks from China, there is an emphasis on “friend-shoring.” Mexico would be a logical venue for U.S. foreign investment. However, China has been expanding its investment into Mexico, allowing Beijing to take advantage of the USMCA free-trade agreement between the U.S., Mexico, and Canada. Some of this investment likely aims to help Chinese businesses trying to avoid trade restrictions. But it’s not a stretch to assume that Chinese influence will accompany investment.
3. Illegal drug trafficking has been an issue between the U.S. and Mexico for decades. There are growing concerns that areas of Mexico are no longer under control of the state; essentially, drug cartels have undermined the state’s monopoly on violence. Apparently, the U.S. has considered military operations against the cartels. Although we put a low likelihood on such actions, the fact that they are being discussed at all is a concern.

In a world that is breaking into blocs, Mexico has a clear advantage. However, the domestic political situation, China’s inroads into its economy, and the instability caused by the drug cartels undermine this advantage. With elections coming in the next year, Mexico bears close monitoring.
– BOG

Issue #10: Artificial Intelligence[3]
Artificial intelligence (AI) has the potential to restructure the economy. Much like the internet, it holds the promise to improve productivity and perhaps end the drudgery of routine work. At the same time, it could be autonomous enough to remove control from humans.

OpenAI's ChatGPT partnership with Microsoft (MSFT, $334.21) has sparked a technological frenzy, with the NASDAQ Composite Index posting its biggest rally in 52 years on the back of market euphoria over generative AI. Major tech companies such as Amazon (AMZN, $128.01), Google (GOOGL, $119.48), and Meta (META, $283.30) have made major investments in generative AI, which is seen as the future of business. These machine-learning algorithms are popular due to their ability to generate content, translate languages, and write different kinds of creative text formats.

Despite the hype, the craze over AI is not similar to the dot-com boom of the early 2000s. The most notable difference is that many of the companies developing AI technology are not startups. The major movers in AI are well-established tech giants, such as Microsoft, Amazon, Google, Meta, Baidu (BIDU, $133.89), Tencent (TCEHY, $42.17), and Alibaba (BABA, $83.16). Each of these companies has a proven track record of success. Thus, they are unlikely to face going concern risk if the AI bubble goes bust. As a result, the recent rally in tech stocks will potentially be more resilient than the internet boom at the start of the millennium.

However, the disruptive nature of generative AI is likely to make it a potential target of government regulation. The European Union has already released its proposal for regulations regarding AI, while China and the U.S. are working on rules to protect society from the negative effects of technology. The general framework of the rules will revolve around the gathering and usage of consumer and proprietary data. Critics have argued that generative AI can take private data without permission and

[3] For a primer on this issue, see our recent Bi-Weekly Geopolitical Report.

disseminate trade secrets. As a result, onerous restrictions on AI remain one of the biggest threats to AI.

For regulators, the goal is to capture the benefits of AI but reduce the risks from its abuse. Since the technology is global, it's possible that what is forbidden in some nations will be permissible in others. Thus, the potential for disruption from this technology is elevated.

– TW

Issue #11: EU vs. Poland and Hungary
As in the U.S., populist pushback against globalized elites has given a tailwind to right-wing politicians in Europe. From Spain to Italy and Greece, right-wing politicians have taken control of core EU countries. The trend has been even more pronounced among newer EU members in Eastern Europe, especially Poland and Hungary. Now, those governments are likely to complicate and disrupt policymaking in Brussels and raise fresh questions about the EU's stability or even its political viability.

Poland has long been a thorn in the side of EU leaders because of the conservative government's policies aimed at preserving its power and rolling back liberal civil rights. The stand-off over "rule of law" issues had seemed to be going nowhere, but that now could change because of Poland's leading role in calling for a stronger EU and NATO defense effort following Russia's invasion of Ukraine. With Poland's new status, Brussels will find it increasingly hard to bring Warsaw under control. Meanwhile, Hungary has long taken a similar illiberal path. The friction between Brussels and Budapest has prompted some EU officials to consider ways to keep Hungary from taking over the rotating presidency of the Council of the EU in late 2024. Any effort to deny Hungary that position or undermine its power could spark a major political crisis for the EU that could theoretically lead to its future disintegration.

– PFH

Issue #12: Middle East Realignment
Because of factors like populist pushback against the "long wars" in Afghanistan and Iraq and the U.S.'s growing self-sufficiency in oil and natural gas, U.S. leaders for more than a decade have been downshifting the country's military presence in the Middle East. For example, the U.S. Navy has sharply curtailed its deployment of aircraft carriers to the region. The Air Force is replacing many top-of-the line fighters in the region with less capable and soon-to-be-replaced A-10 "Warthogs." President Biden has spoiled relations with Saudi Crown Prince Muhammed bin Salman by branding him as a "pariah," even as he angered Israeli Prime Minister Netanyahu by criticizing his policies toward Palestinians.

The reduced U.S. presence in the Middle East has cost the U.S. influence and opened the door for China and other countries to boost their influence. Earlier this year, for example, the Chinese government helped broker a rapprochement between Iran and Saudi Arabia. It also appears that the United Arab Emirates are looking the other way as China builds a port facility capable of supporting military ships on its territory. Unless U.S. policy reverses, we expect to see China, Russia, Turkey, and perhaps other U.S. rivals trying to boost their connections to the region. If successful, the Chinese are likely to strengthen their evolving geopolitical bloc by bringing Saudi Arabia and other regional powers even deeper into the fold. That could crimp the U.S.-led bloc's access to any Middle Eastern energy resources that may be needed in the future.

– PFH

Issue #13: Iranian Nuclear Breakout
Even though the Biden administration tried in its first two years to revive the 2015 international deal limiting Iran's nuclear program, it has now abandoned those efforts. Throughout the discussions, Iran had continued to refine uranium toward weapons-grade purity, but now it is even more free to keep developing its program. Scientists and intelligence officials now seem certain that it could develop a working nuclear weapon in only a short amount of time, if it hasn't done so already. Tehran has also begun to further harden its program by dispersing its different elements into deep underground facilities, for example.

If Iran announces or is found to be on the verge of nuclear weapons capability, it would likely touch off a major crisis. Israel would be tempted to launch a preemptive strike against Iran's nuclear facilities, potentially with U.S. or Saudi help. If the attack didn't destroy all of Iran's nuclear arsenal, Tehran would probably use its surviving weapons to retaliate. It would be difficult to predict what other countries or terrorist groups might become involved on one side or the other. The violence would put Middle Eastern energy supplies at risk, likely sparking a huge run-up in oil and gas prices.

– PFH

Issue #14: Emerging Market Debt
For less-developed "emerging markets," which often rely heavily on foreign borrowing in dollars, rising U.S. interest rates and a strong greenback can be big risks. High interest rates and an expensive dollar make it harder for those countries to service their foreign debts. On top of that, interest rate hikes by key central banks in the developed world are typically aimed at slowing down economic growth and inflation. Slower demand from the rich, developed countries often weighs on the emerging markets, making it even harder to service their foreign debts and further raising the risk of default. Excessive lending by Chinese institutions under Beijing's "Belt and Road Initiative" has also put many emerging markets at risk of default.

Over the last couple of years, some emerging markets have already gotten into trouble, including Sri Lanka and Pakistan. Further interest rate hikes by the Federal Reserve, the European Central Bank, the Bank of England, and other key central banks will likely tilt even more poorer countries into dire straits, especially if the dollar rebounds. Some of the countries most at risk include Egypt, Kenya, and Ecuador. One positive aspect of increased debt defaults by Belt and Road debtors is that it would probably further chasten China's lending. All the same, such defaults would likely lead to domestic political instability, economic carnage, and financial market losses in those countries, along with losses by the developed-world institutions that extended loans to them.

– PFH

Ramifications
This extensive list of risks shows how complicated the geopolitical situation has become. Therefore, the most obvious risk in the financial markets is volatility. As the outbreak of the war in Ukraine showed, a world with great power competition and unsettled hegemony is one where outlier events occur with greater frequency. For investors, higher volatility suggests caution. During the unipolar moment, investors were often rewarded for taking risk. The world is evolving into one where reducing risk is prudent.

So, how does that notion translate into investing? First, it means shortening duration, which suggests fixed income should be in shorter maturities and equity investing should focus on cash flow and dividends. Or, put another way, value stocks and dividend stocks will be preferred. Commodities, and their associated equities, often are a short-duration asset and should also be considered. An unsettled world is one with less efficiency. Thus, protecting portfolios from inflation is paramount.

Second, some areas of the equity market will likely be favored. The West, especially the U.S., is reindustrializing. This process should support that sector. Defense stocks should also benefit as governments rebuild their militaries.

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Confluence Investment Management LLC

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