Confluence INVESTMENT MANAGEMENT

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The End of the World is Just the Beginning: A Book Review

Soon after founding Confluence Investment Management, we formulated a position that the U.S. was in the early stages of ending its hegemonic role. We postulated that this event would have a profound effect on the domestic and global economy, and, consequently, financial markets. In traveling around the country discussing this idea, we[1] were often asked, "When are you going to write a book about this?" It seemed like something we should do, although finding time while meeting a tight publication schedule and trying to run a business made it challenging. When Mark and I discussed the idea of a book, we wanted it to cover the material in an accessible manner.

And then the idea died…because Peter Zeihan beat us to it. His 2014 book *The Accidental Superpower* hit all the themes we wanted to cover and did so in a manner that we probably couldn't improve upon. Zeihan has worked for the State Department and other think tanks. I saw his work with Stratfor when he was with that private intelligence firm, and he now runs his own consulting firm, Zeihan on Geopolitics. He frequently sends out short videos on various topics; you can join his mailing list here. Since *The Accidental Superpower*, he has written three books, the most recent of which was published in July and is the topic of this week's report.

[1] Mark Keller (Confluence CEO/CIO) and me.

In this report, we will review Zeihan's new book, *The End of the World is Just the Beginning*, briefly discussing its content, the major insights, and the overall strengths and weaknesses of his argument. We will conclude with market ramifications.

What's in the Book?

Zeihan is a classic geopolitical analyst. He focuses on two factors—the geography of an area and the demographics of the people who live in a specific place. By covering these two basic factors, one can see the strengths and weaknesses of a nation and its people; even more importantly, it becomes possible to observe the nation's security and economic constraints and its imperatives to survive and thrive. However, these two factors are not the only ones that matter. Technology can overcome natural impediments. For example, navigable river systems are good for economic development as they allow for the cheap shipping of goods. However, railroads offer a reasonable alternative and can overcome the lack of a river system.

Zeihan uses this framework to describe how nations and peoples with supporting geographies have levered that factor to become powerful. In Egypt, the Nile delta produced a fertile area and the river itself allowed for navigation, which, coupled with a harsh desert surrounding the river, created conditions that fostered a major power. The development of ocean-going vessels together with a peninsula of mountain ranges that isolated Spain and Portugal allowed them to become global powers and, for a time, global hegemons. The isolation offered by being an island helped the development of England, but the industrial revolution, fueled by coal and accelerated by the advent of the steam engine and railroad, allowed the U.K. to blossom into a global hegemon.

But no place on earth is more favorable to hegemony than the area controlled by the United States in North America. The U.S. is graced with the most useful river system in the world. The American government was able to push the Canadians and Mexicans far enough north and south, respectively, to establish bordering nations that couldn't threaten the growing nation. On top of that, the aforementioned river system interlaced some of the most fertile land in the world, meaning the U.S. was destined to become an agricultural powerhouse. Once the crop was harvested, it could be cheaply shipped to the rest of the country and eventually the world. In addition, the country was so large that it naturally created an internal market that supported economic growth. Even America's coastline was advantageous, with numerous large bays and inlets that became deep water ports.

European hegemons tended to have fewer of these advantages. For example, the Dutch had a period of hegemony, becoming a formidable naval power, but faced constant threats from the French on land and the British across the English Channel. Portugal could not protect itself from Spain, and the latter faced threats from the French that the Pyrenees couldn't fully protect. The British Isles weren't large enough to foster an internal market that could consume the goods of the industrial revolution. France faced overland threats.

When the European powers wielded hegemonic power, they tended to face constant military threats. In response, they all found they needed colonies to acquire raw materials and act as captive markets for the goods their industry produced. These factors made them vulnerable to disruption.

The Unique Hegemony of the United States

At the end of WWII, the major powers of the world were mostly destroyed. In the Far East, Japan and China were devastated as were numerous areas of Southeast Asia. Europe was also in terrible shape. As Zeihan notes:

> *If there was a moment in history where a power could have made a bid for global domination—for a new Rome to rise—this was it. And if there was ever a good reason to make such a bid, it was the nuclear-tinged competition that was arising with the Soviets the day after the guns fell silent in Germany*.[2]

Instead, the U.S. made a deal with the world—America would deploy its navy globally to protect trade routes and it would open its markets to trade as well. Although Zeihan doesn't mention it, being open to trade was a change in policy for the U.S. During its development, the U.S. had implemented tariffs, including the infamous Smoot-Hawley Tariff that some economists have argued was a key reason for the Great Depression. Given the state of the world, this was a very attractive offer. What was the catch? Nations that accepted the deal had to acquiesce to U.S. foreign policy. In effect, they became the front lines of Soviet containment.

From the end of WWII into the Fall of Communism, trade steadily expanded as did the economic integration of the free world.

[2] Zeihan, Peter. (2022). *The End of the World is Just the Beginning: Mapping the Collapse of Globalization*. New York, NY: HarperCollins Publishers, p.36.

When communism fell, China, which had already started to integrate into the world, was joined by the rest of the Eastern Bloc to create a globalized world. After 1990, globalization expanded rapidly, supported by the end of the Cold War and rapid improvement of communication technology. Increasingly, the world has become economically integrated.

The Key Point of the Book

Zeihan's key point is that the globalized world we live in is fully dependent on U.S. hegemony. A world where goods and services are produced by far-flung supply chains is only operational if a power protects the sea lanes, damps down wars, and provides a reserve currency and reserve asset.[3] With the U.S. acting as hegemon, nations were mostly freed from the constraints of geography and demographics. Nations with aging and slow-growing populations could tap resources from younger and faster-growing parts of the world. Because the U.S. protected ships at sea, it was economically attractive to build massive, lumbering container ships. These vessels pushed down the cost of shipping to very low levels. Between low-cost shipping and internet-based communications, sourcing production around the world became possible. Commodity markets became unified through financing and guaranteeing trade flows. Price benchmarks for oil, grains, metals, and other commodities developed, supporting global trade in those products. By creating arbitrage opportunities, price shocks could be managed through both trade and financing.

This globalized system supported by U.S. hegemony led to the industrialization of numerous countries. At first, Europe and Japan recovered from the devastation of WWII, supported by exporting to the U.S. In the 1980s, the "Asian Tigers" joined in, following the similar path of export promotion. China began that process in the late 1970s and it has accelerated in this century. It's important to realize that export promotion requires an importer of last resort and global security. The U.S. has provided those factors.

In all these cases, industrialization led to urbanization and falling birth rates. Initially, falling birth rates trigger economic expansion. This is because the "dependency ratio" declines, which is the ratio of the working-age population relative to the elderly and the young. However, it declines from the "front end," meaning that populations age over time. In many nations, the dependency ratio is now rising from the "back end," meaning the numbers of elderly people are rising. This situation leads to stagnant growth. Japan is the country most affected by this demographic situation, but several European nations and China are rapidly facing a demographic deficit as well. Immigration is the most obvious response to this problem but managing an influx of foreigners can be challenging. Of course, increasing birth rates is another alternative, but creating social structures to encourage family development is difficult. As Zeihan discusses, many parts of the world are aging

[3] Ibid, p.177. Zeihan notes that the U.S. trade system was incompatible with asset-backed currencies (e.g., gold) and argues that global peace isn't compatible with asset-backed currencies. When Nixon exited the Bretton Woods system, there was no longer a monetary constraint, and the U.S. could expand the money supply to the needs of the global trading system (p.179). Another element of this system is that capital controls steadily eroded to the point where they are mostly non-existent in the developed world. Although Zeihan doesn't say it, supply chains are mirrored by payment chains, which need a currency and reserve asset to function efficiently. The U.S. provides all these global public goods.

and it will have profound effects on their economic growth and social stability.

Why is the U.S. finished with the hegemon role?

> *Let's begin with base structure: part of why American manufacturers feel cheated by globalization is because that was the plan. The core precept of the Order is that the United States would sacrifice economic dynamism in order to achieve security control. The American market was supposed to be sacrificed. The American worker was supposed to be sacrificed. American companies were supposed to be sacrificed.*[4]

It's no wonder why Americans have soured on hegemony. Globalization did bring benefits, but they were far from equally distributed. The "Rust Belt" is evidence of who paid for the policy. In addition, this quote only covers the economic costs, saying nothing of the military costs.

Without the U.S., the world will devolve into blocs dominated by competing powers. My colleague, Patrick Fearon-Hernandez, CFA, has recently written a couple *Bi-Weekly Geopolitical Reports* analyzing how these blocs may develop.[5] Zeihan's position is that the blocs won't trade much with each other, leading to a fractured global trading system. We mostly agree with this position, insofar as it is compared to globalization as it existed from 1950 to 2020. Nevertheless, our position is that there will probably be more integration than Zeihan expects.

Criticisms

When an author tackles a complicated topic, they must decide on the target audience. If the author wants a wide readership, the content will usually need to be less technical. If writing for the academic crowd, the content can be more technical. Zeihan has clearly targeted a broader audience. Most of the footnotes are humorous quips, there are loads of statements that are not directly backed with data, and the writing style is "breezy." That makes the book accessible, but if a reader wants a formal argument supported by data, it won't be found with this book. And that's OK; the book is highly readable and was on the *New York Times* non-fiction best seller list for a few weeks earlier this summer. That's a rare honor for a book on such a weighty subject.

Our second criticism is that there is an element of determinism in the analysis. Geopolitical analysts tend to gravitate toward the "great wave" as opposed to the "great person" school of historical analysis. Since geopolitics focuses on demographics and geography, it makes sense that they tend to see the world in terms of constraints and imperatives. As Zeihan points out, the world is aging rapidly, and the current world economy depends on a hegemon providing global public goods. If that hegemon decides to curtail supplying said goods, conditions will worsen.

But, even with those constraints, the breakdown of globalization could be avoided. Needless to say, doing so would require major adjustments. First, U.S. elites would need to address inequality; in other words, the top 10% of households have reaped most of the gains of globalization and saving it would require them to offer transfers to the bottom 90% and bear high taxes on themselves. Second, elites would also need to bear more of the military burdens of hegemony. Third, China would need to back down from its current stance and assure the rest of the world that it

[4] Ibid, p.360.

[5] See *BWGRs* from May 9, 2022, and June 6, 2022.

remains a safe place to invest. These changes still might not necessarily reverse the regionalization trends Zeihan identifies, but they could slow down the course.

A third criticism we have noted recently isn't directed specifically at this book but at those resistant to the notion of deglobalization. We have seen a number of commentators present charts that show global trade is growing and make assertions such as, "See, all this deglobalization talk just isn't real." This is what is known as the "straw man fallacy." To deploy this strategy, one argues that the position, to be true, must fulfill some nearly impossible standard, and then shows the standard isn't fulfilled and thus isn't true. It's a bit like looking at a roiling sky with dark clouds and saying, "It isn't raining right now, thus worrying about rain is irrational." Global trade is clearly still happening, but the underlying factors supporting that trade, as Zeihan demonstrates, is under great threat. It's important to remember that the elites around the world have benefited greatly from the current practice of globalization and they really don't want to see it go away. Thus, what may be occurring is willful ignoring or downplaying of uncomfortable trends.

In Summary

This book is worth reading. It's accessible and informative. We accept Zeihan's underlying premise, as we have been arguing for more than a decade that (a) the U.S. was increasingly unable to create the political will to maintain hegemony, and (b) the world was in trouble because of that loss. Zeihan does a great job of explaining why this is the case.

Ramifications

If Zeihan is right, what are the investment ramifications? Here is our take:

1. Inflation will become a more persistent problem. The world under U.S. hegemony was capital friendly. The ability of firms to securely expand supply chains across the world will be severely compromised, leading to redundancies and less efficiency. Without protected sea lanes, global trade will eventually decline, driving up costs.
2. Labor power will rise as workers are no longer forced to compete globally. Rapidly aging societies will exacerbate this situation.
3. Global investing will change. It is arguable that the emergence of China solidified emerging markets as an asset class. Going forward, we will likely see select opportunities in emerging markets but investing in them as a broad class may not be as viable.
4. Several nations have greatly benefited from the U.S. hegemonic system, such as Germany and China. Losing reliable export markets coupled with adverse demographics mean these nations are likely facing decline.
5. Securing commodities will become paramount. Without protected sea lanes, holding inventory of key materials will be necessary.
6. The U.S. will probably fare OK. It faces no immediate threats on its borders, has a much more favorable population profile than most developed and many emerging economies, and is better equipped to absorb immigrants.

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