Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

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Reflections on the New Cold War

Note: Due to the Labor Day holiday in two weeks, the next edition of this report will be published on September 18.

Our geopolitical research over the past 15 years has had a consistent theme—that U.S. hegemony is under strain. Essentially, costs of America's hegemonic role have become unbearable for the domestic economy and society. As America's hegemonic position comes under pressure, we think a new Cold War is emerging.

In this report, we will examine the key features of American hegemony and how those features were closely tied to the Cold War. From there, we examine the shock of the end of the Cold War and how various aspects of American policy and global economics changed as a result. As always, we close with market ramifications.

The Key Features of American Hegemony
There were three features of American hegemony, which began just after WWII, that were different when compared to earlier hegemons, namely the Spanish, British, Dutch, and French hegemonic periods.

The U.S. didn't extend power through colonies, but through alliances. After WWII, the U.S. had to manage three global areas of potential conflict. The first was Europe. In the first half of the 20th century, Europe had spawned two world wars. Essentially, the problem with Europe was that Germany was a dominant but threatened power. Sitting in the middle of the Northern European plain, Germany enjoyed low transportation costs (no mountain ranges to manage) but was also vulnerable to invasion (no major natural barriers). The U.S. solved the German problem by pacifying Europe and taking responsibility for its defense. Through NATO, the U.S. guaranteed Europe's defense to ensure that Germany was no longer threatening its neighbors or was threatened by them.

In the Far East, the Japan problem had to be resolved. Japan had become an economic powerhouse that was desperately short of natural resources for its industrial base. This led Japan to attempt to secure these resources through colonization; in fact, President Roosevelt's oil embargo was an important factor in Japan's decision to attack Pearl Harbor. After Japan surrendered at the end of WWII, the U.S. forced a pacifist constitution onto the new government. Washington guaranteed Japan's security, which meant that Japan would no longer threaten its neighbors. At the same time, U.S. protection of Asian sea lanes meant Japan didn't need to use force to secure resources.

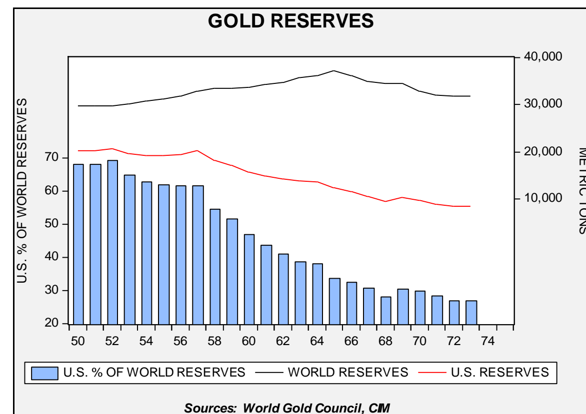
Finally, in the Middle East, the U.S. enforced the colonial borders, and although it was not a perfect solution, it did tend to keep wars in the region contained. In addition, the U.S. made it clear that it would not tolerate any outside power taking control of the region's oil supplies.

The U.S. managed the reserve currency role by being open to trade and eventually establishing the world's first ever fiat reserve currency. One of the roles of a

hegemon is to provide the reserve currency and reserve asset for global trade. Until the early 1970s, gold was the ultimate reserve asset, although in practice, nations tended to use the currency of the hegemon for the majority of trade.

The reserve currency nation generally has the burden of running a trade deficit with the world in order to provide the currency. Earlier hegemons dealt with this issue by holding colonies with which they ran trade surpluses. This made the trade deficits tolerable. Using a gold standard gave holders of the reserve currency confidence that the hegemon would have policy constraints, or put another way, the gold standard meant the hegemon would, at times, be required to implement austerity.

As WWII ended, the U.S. was determined to wind down the colonial system. Therefore, the U.S was not going to have colonial dependencies to offset a growing trade deficit. Although the Bretton Woods system did maintain a link to gold, it was tenuous. In the heyday of the gold standard, democratic participation was limited since, in many nations, women were not allowed to vote and property restrictions on voting were common. For the gold standard to work, austerity needed to be implemented. Narrow voting participation made passing austerity easier as the costs of the policy were usually applied to the working class. World War I required a whole-of-society mobilization; not only were militaries large, but societies were forced into austerity in order to supply the war effort. After bearing the costs of the war, the wider population demanded a political voice. Thus, after the war, suffrage expanded which made austerity harder to implement. Initially, after WWII, the U.S. held large gold stores, but by the late 1960s, the level of gold was inadequate to maintain a gold standard.



This chart shows the gradual deterioration of the U.S. gold position.

In 1971, President Nixon faced the choice of either implementing austerity to bolster the U.S. gold position or jettisoning the gold standard altogether. Since austerity would have undermined his re-election, Nixon closed the gold window on August 7, 1971. From this point forward, the world officially had a fiat reserve currency for the first time.

The U.S. didn't view its hegemonic role in traditional geopolitical terms but framed its role as the standard bearer for an ideology. Every nation likes to frame its power projection in heroic terms. Spain included expanding the reach of Christianity as part of its colonizing mission. Spreading Western civilization was part of later hegemons' goals. However, these claims tended to be a thin veneer for mere domination. Europe was a dangerous place, and the need to conquer threatening nations meant that populations knew war was always a possibility.

The geography of the U.S. was different. After forcing the Canadians north enough to be left with mostly inhospitable forest and the Mexicans south into the desert, the U.S. faced no nearby threats. Otto von Bismarck noted that the U.S. was surrounded by weak powers and fish. As a result, the U.S. didn't need to exercise hegemony to protect itself

from nearby dangers. This reframed the decision to become a hegemon to one of choice rather than one necessary for survival.

Complicating matters further is that the U.S. was mostly populated by immigrants. For the most part, immigrants *want* to come here and *want* to leave somewhere else.[1] The desire to "get away" from the rest of the world's problems tended to encourage isolationist leanings in American foreign policy.

So, why did the U.S. decide to accept the mantle of hegemony after WWII? After fighting two world wars in less than 50 years, American leaders concluded that only U.S. involvement in the world would prevent WWIII. However, given the constraints noted above, selling this position to the population led policymakers to frame America's hegemonic leadership in ideological terms. America's hegemony wasn't a mere exercise of power for its own sake. Instead, the U.S. was on a holy mission to overcome communism and to establish free markets and representative democracy. Fighting for anything less was seen as "impure."[2]

The Shock of the End of the Cold War

A series of events led to the downfall of the communist bloc. Moscow rapidly lost control of Eastern Europe, and the event that captured the era was the fall of the Berlin Wall. The Soviet Union, a classic empire with numerous regions, eventually devolved as large areas declared independence.

When a major event occurs, there is usually a scramble to explain what happened. As noted above, the U.S. viewed the Cold War as an ideological battle. Thus, if communism collapsed, it must have been because the U.S. system of capitalism and democracy was superior to authoritarian communism. The article that captured the mood was penned by Francis Fukuyama, who suggested that with communism defeated, we had reached the "end of history" and there was no alternative to democratic capitalism. This notion was intellectually powerful, because it was the promise of Marxism that communism would be the end of history, meaning that society could not be further improved upon. Fukuyama stood Marx on his head by arguing that capitalism, not communism, represented the end of history.

That powerful lesson led to a series of "lessons learned" by American and foreign policymakers and leaders. For the Americans:

Democratic capitalism was the clear winner, and thus, all nations would be better off adopting the U.S. model. The policy of free markets and democracy became known as the Washington Consensus., which had a number of elements:

1. Adopting democracy, which was usually defined as voting rights for citizens. During the Cold War, the U.S. wanted allies and often aligned with authoritarian, non-communist regimes. In the post-Cold War era, the U.S pressured states to adopt democracy. The classic example was the invasion of Iraq and the attempt to foster a

[1] Obviously, this statement isn't universally true, but it is the case for the majority of immigrants.

[2] Often, when the U.S. is involved in a conflict in the Middle East, opponents will frame the war as "all about oil" as if fighting for access to oil means the conflict is illegitimate. However, given how important oil is to economic growth, going to war over a key commodity is arguably justifiable. The notion that fighting over a commodity is unjustified would have been considered odd by earlier hegemons.

democratic system with little regard as to whether supportive conditions were in place for democracy to flourish.

2. Adopting market economics, which in practice meant:
    a. Openness to foreign investment
    b. Reduced trade barriers
    c. Floating exchange rates
    d. Low levels of regulation
3. Although other economic development models existed, America's willingness to be the global importer of last resort meant that export promotion proved to be the best development model. This led nations to suppress domestic consumption, undervalue their exchange rate, and build industries designed to export to the U.S.

Winning the ideological war with the Soviet Union meant the end of great power competition. This lesson meant that the world was safe for investment, or, put another way, globalization was destined to expand. During the Cold War, national security concerns had led to restrictions on efficiency, which meant that some investment may not be secure. For example, one should not build important facilities in areas that might be vulnerable to security concerns. It also meant that redundancy would be tolerated as a margin of safety.

With the Cold War at an end, almost the whole world was safe for investment. The end of the war, coupled with the development of the internet, fostered the separation of design from production.[3] These two changes allowed firms to design products in high wage areas but "farm out" the production to the lowest cost labor.

Perhaps the most potent symbol of this position was U.S. support for China's entry into the WTO. Although China was far from a democracy or a totally free market economy, U.S. policymakers, confident in their narrative that explained the fall of communism, took the position that anything that integrated China into the world economy would lead the country on the path of democracy and open markets. In other words, the belief was that China was on a steady march toward democracy and capitalism.

The other lesson learned was that just-in-time inventory logistics was the best way to handle the flow of goods. Such logistics methods are very efficient but have little margin of safety. In other words, just-in-time only works if supply chains are secure.

China took different lessons from the fall of the Soviet Union.[4] The Communist Party of China viewed Gorbachev's reforms as suicidal. Instead of implementing reforms that undermined the power of the Communist Party, Beijing doubled down on social control. The crackdown exhibited at Tiananmen Square made clear that the party would not tolerate dissent. Until the Great Financial Crisis, China tended to maintain a low profile on the global stage, but since 2008, which was perceived to be a signal of American decline, China has become increasingly aggressive.

So, Where Are We Now?

The post-Cold War consensus led to an economic management system that focused on efficiency. Since great power competition was no longer a risk, investment, labor sourcing, trade flows, and

[3] Baldwin, Richard. (2016). *The Great Convergence: Information Technology and the New Globalization*. Cambridge, MA: Harvard University Press.

[4] Doshi, Rush. (2021). *The Long Game: China's Grand Strategy to Displace American Order*. New York, NY: Oxford University Press.

inventory management were structured for efficiency.

However, great power competition has now returned. Russia's invasion of Ukraine and China's increasing belligerence with Taiwan have made it clear to U.S. policymakers that the old order is rapidly fading. The key changes are that efficiency is no longer paramount and national security can no longer be ignored.

Consequently, far flung supply chains with important production facilities near the China/Russia/Iran axis are now at risk. The most obvious example is Taiwan Semiconductor (TSM, $91.75), which has the most sophisticated semiconductor foundries within reach of China's short-range missiles. If a hot war were to erupt over Taiwan, it's highly likely the world would lose these key facilities. The U.S. is starting to build duplicate facilities in Arizona but replicating the ecosystem of Taiwan will be difficult. Post-Cold War production processes, designed for efficiency, are now being adjusted for resiliency.

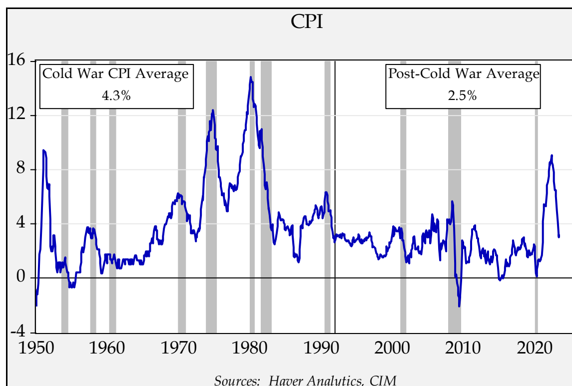
As Zoltan Pozsar has noted, payment chains are supply chains in reverse. A key support for globalization was America's willingness to supply the reserve currency and reserve asset. This meant that U.S. companies (and their workers) faced unwithering foreign competition. This competition was generally "unfair" because these nations needed dollars to participate in the global economy. Of course, the need for dollars was a key element in the expansion of the U.S. financial services industry. As the world acquired surplus dollars, it needed to invest the excess. U.S. financial and real assets benefited from these flows.

The flip side to dollar/Treasury hegemony was that it gave the U.S. tremendous power. If Washington wanted to punish a nation for its behavior, the U.S. could exclude it from the dollar system. Losing access to the dollar market would cripple trade and hurt the offending nation's economy. The U.S. fully deployed its financial weaponry against Iran; given America's long animosity toward Iran, the actions against Tehran were not expected to be used elsewhere. However, after Russia invaded Ukraine, the U.S., supported by the EU, applied broad sanctions that forced Russia out of the dollar system. Russia is still engaging in trade, but it's having to function by accepting other currencies that lack reliable reserve assets. Other nations have taken note that clearly getting "offside" the U.S. can be costly. To protect themselves, several national reserve managers have been aggressively buying gold. The BRICS nations are flirting with an alternative payment system that would likely use gold as the ultimate collateral.

It is our position that the characteristics of the past three decades since the end of the Cold War are rapidly changing. In a nutshell, efficiency is no longer the primary determinant of investment and policy, and globalization, as it has been practiced since the early 1990s, is likely over as well.

Ramifications

What does this mean for investors? Changing the focus from efficiency would suggest that inflation will likely be higher. After all, someone must pay for resilience. The data supports this idea.

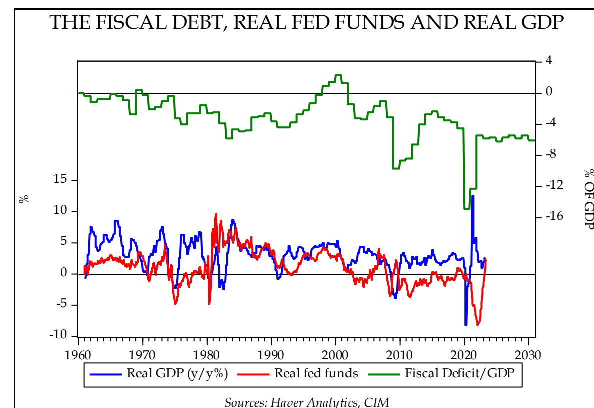


We assume the Cold War ran from 1950 through the end of 1991 when the USSR dissolved. During the Cold War era, CPI averaged 4.3%, but after 1991 until the present, the average is 2.5%. Perhaps even more important, the standard deviation during the Cold War was 3.3%, whereas it has fallen to 1.6% during the post-Cold War period. Not only was inflation lower, but the variance was less, meaning that investors and consumers could be more confident about the impact of inflation during the post-Cold War period. If we are correct and another Cold War is underway, inflation will likely be higher, more persistent, and more volatile.

Higher inflation usually means higher interest rates, lower equity multiples, and higher prices for inflation "hedges," such as commodities and gold.

Long-duration fixed income is especially at risk. As we have noted in our [2023 Outlook](), the secular downtrend in 10-year yields has been broken. We suspect that higher interest rates are likely in the future.

Here is one way of thinking about the macro-conditions surrounding long-duration Treasuries. In 1981, Tom Sargent and Neil Wallace published a paper arguing that the sustainability of the monetary/fiscal policy mix depended on the real policy rate, the real growth rate of the economy, and the growth rate of the stock government debt scaled to GDP. Essentially, if the growth rate of the debt exceeds the growth rate of real GDP, then the central bank must accommodate this debt with easy monetary policy. If the central bank attempts to tighten policy, perhaps to contain inflation, then there is a risk that government debt growth will become unsustainable.

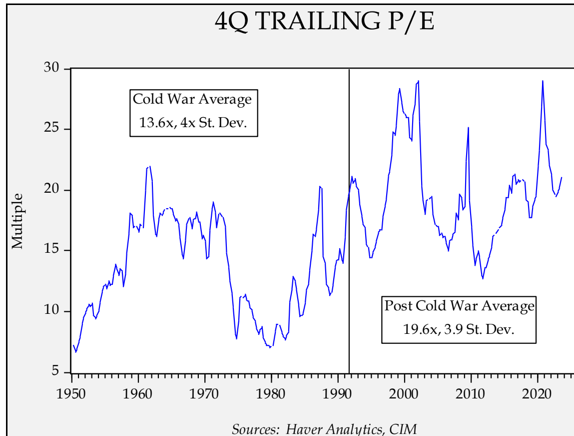


Note that as the deficits increased in the 1970s (notably after the Nixon Shock), the Fed was running easy policy, defined as the policy rate below the rate of real GDP growth. Volcker and the executive and legislative branches were at odds in the early 1980s through the 1990s, but with the end of the Cold War, the drop in defense spending and tax increases led to surpluses. Essentially, the president and Congress blinked. Since 2000, the Fed has run mostly easy policy and was able to do so because inflation was tamed by globalization.

Note the projection of deficits by the Office of Management and Budget. These levels of deficits are incompatible with tighter monetary policy because, eventually, the debt service costs will be unsustainable. We believe the secular bull market in bonds was driven by investor expectations that policymakers would engage in austerity to prevent serious inflation. Given that these deficits will be done, in part, to fund a new Cold War, it's likely the Fed will be forced

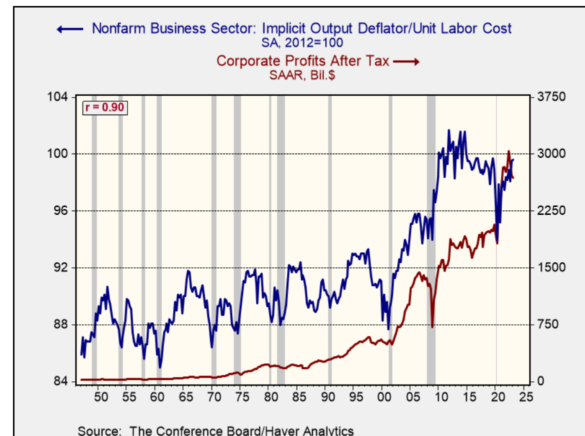
to "blink." If so, there appears to be little value in long-duration.

When examining the four-quarter trailing P/E, we see there was a notable shift in the multiple after the Cold War ended.



Although timing is uncertain, a weakening multiple would be consistent with a new Cold War.

The post-Cold War period was friendly to capital as well. This final chart shows the ratio of output prices to unit labor costs. The numerator is a representative of the price businesses receive for their goods and services and the denominator is productivity-adjusted labor costs. The other line shows profits after taxes for corporations. From 1947 through the early part of this century, businesses saw modest gains over labor. However, after China entered the WTO, output prices soared relative to labor costs and corporate profits also rose. As trade with China is reduced, and as the U.S. re-shores and friend-shores, the disinflationary impact of foreign trade will likely be reduced. Although firms' market power may allow them to hold profit margins for a while, overall, we expect the ratio of implicit output costs and unit labor costs to decline over time. If so, profit margins are at risk.



If this is the future path, what should investors do? We think the watchword is short-duration. That means holding fixed income with short-duration, value equities, and dividend payers. Those positions haven't worked for much of the past 30+ years, but as geopolitical conditions change, we expect to see investing patterns change as well.

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August 21, 2023

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