Confluence Investment Management

Weekly Geopolitical Report

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Using History

Geopolitics is the study of the exercise of power within a specific geographic area. Geopolitical analysis is a multi-disciplined examination that starts with geography and includes economics, sociology and, of course, history. Geopolitics is generally used for two purposes. First, it offers a multi-faceted way of looking at how nations behave. Second, it may be able to offer insights into future behavior.

Although all of the above disciplines offer insights into geopolitical analysis, for prediction purposes, history can, in many respects, offer the most concrete path of future behavior. After all, history can tell us what happened when a nation faced a problem.

However, there is a particular problem with history. The successful use of a historical analog requires selecting one that has the best fit to the current situation. Because historical events are specific, especially compared to the more general theories from the social sciences, selecting an inappropriate historical analog can be seriously misleading. Behavioral economics has a concept called "anchoring," which means that a certain idea colors a person's ability to analyze a situation. For example, if investors become accustomed to a certain interest rate and assume it is normal, then investors may be slow to act when rates change because the original rate acts as an anchor. In other words, an anchor is considered what is normal and where rates should return. The presence of an anchor in investors' minds can blind them to changes in conditions that may support an interest rate different than the anchor.

History isn't a science; there isn't a theoretical construct in history that is usually available from social sciences. Thus, there is no generalized method to inform analysts on the proper way to select a historical analog. However, picking a good analog is critical because of the problem of anchoring. An analyst that uses an inappropriate analog can find himself "trapped" by that historical parallel and thus miss differences that may lead to mistakes.

Although history will never be a science, there is a working model for analyzing historical parallels. Richard Neustadt and Ernest May wrote a working handbook[1] for practitioners and policymakers to analyze history and pick an effective analog. We will begin by offering a brief discussion of Neustadt and May's methodology. To show how it is used, we will compare the current superpower uncertainty to three historical analogies using this book's structure. As always, we will conclude with market ramifications.

Analyzing History

The aforementioned authors were professors at the Kennedy School of Government at Harvard University. They taught classes to government professionals who usually became aides and assistants to cabinet level officials. The goal of their class was to teach these officials how to use history in a

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[1] Neustadt, R. E. and May, E. R. (1986). *Thinking in Time: The Uses of History for Decision Makers.* New York, NY: The Free Press.

systematic manner to help policymakers make better decisions using history. The authors were very concerned that these professionals use appropriate historical analogies; they worried that using an improper one would frame the analog in such a way that it could distort decisions and lead to mistakes.

At the same time, Neustadt and May realized that history didn't offer a structure for deciding the appropriateness of a historical parallel. Thus, they decided to build their own "cookbook" to help officials select the best analog. Their method isn't statistically tested; in fact, it probably can't be. But, it does offer a structure that is probably better than merely attaching to an analog without thought.

Their method begins by looking at a particular issue and separating out three factors—what is *known*, what is *unclear* and what is *presumed*. What is known is purely factual. What is unclear is if uncertainty exists around how other parties will react to a policy change or if another party will change behavior in light of a policy change. What is presumed is very important. These are assumptions that the policymaker believes are true or may have been a motivating factor in a certain behavior. These presumptions may or may not be correct but every decision-maker has them and they are most dangerous when they are unexamined.

Thus, determining the known, unclear and presumed factors clearly delineates the parameters of a decision. It is at this point, once these three components have been fleshed out, that the decision-maker begins to examine historical analogies.

Although there is no hard and fast rule about how many analogies should be examined, it makes sense that more is better than few. Each analogy is compared to the current decision situation for *likenesses* and *differences*. This process is critically important. Analogies can lead to anchoring; looking at multiple analogies and carefully parsing them for similarities and differences can sharpen the decision-making process.

By this point, the decision-maker should know the areas of concern and develop objectives from there. However, if this hasn't been accomplished, the authors recommend *placement*, where some history of the persons or institutions involved is analyzed. This process may include timelines and special events that the "other side" may be dealing with that affects their judgment and decisions. This part of the exercise offers background to the historical context and can further clarify the analog.

If at this point, objectives still haven't been developed, there are four other processes the decision-maker can deploy. The first process was called the "Goldberg Rule" by Neustadt and May; instead of asking "what's the problem?" they ask "what's the story?" In other words, understanding the narrative may offer a much better framework to address the decision. Second, treat the problem as a journalist would, by asking the "five Ws."[2] This can create conditions of bringing fresh eyes to a problem. Third, offer odds on presumptions. For each presumption, ask what one would be willing to bet that it was true. Finally, the authors offer what they call "Alexander's Question," which is, "what would cause you to change your presumption (or decision)?"[3]

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[2] Who, What, When, Where, Why?

[3] Op cite, page 153. Dr. Russell Alexander was a public health professor at the University of Washington who asked this of Ford administration officials during their disastrous swine influenza mass immunization program in 1976.

Does every decision require all of these tests? The authors suggest no, but each one does give a structure to analyzing a decision. The other feature that is attractive about this methodology is that it is designed for practitioners. This report isn't designed as an academic exercise; that's why it concludes with market ramifications, which are essentially decisions about investing. As a practitioner that uses history extensively, this book's structured program for making decisions is useful.

An Example: The Superpower Decision
One of our stable themes is that the U.S. is probably preparing to end its superpower role. Using Neustadt and May's methodology, let's examine this decision.

Thesis: America is ending its superpower role.

Known factors:

1. Inequality has reached historical levels due to globalization and deregulation, which were implemented to control the inflation of the 1970s.
2. The reserve currency role requires a willingness to be the global importer of last resort. This has led to unsustainable levels of household debt and was a triggering event for the 2008 Financial Crisis.
3. Rising populism is a result of a political revolt against the policies of globalization and deregulation. Americans are facing superpower fatigue.
4. The U.S. military is stretched due to hegemonic wars in Iraq and Afghanistan. These wars have distracted American leaders from the rise of China, a resurgent Russia and a belligerent North Korea. At the same time, the wars in the Middle East have destabilized the region, threatening continual war there. The four ship collisions in the Far East this year can be partly blamed on overstretch. The U.S. military is reaching the limits of its ability to project power given the current political environment.
5. The relative size of the U.S. economy has been shrinking compared to the world economy. This increases the burden of providing global public goods by making the trade deficit too large and exhausting the military

Unclear factors:

1. Can the U.S. political class create a framework that will relieve the current tensions on the economy (inequality, excessive debt) through a new social contract that would allow hegemony to continue?
2. Even with a new social contract, does the U.S. have the capability to maintain hegemony?

Presumptions:

1. The current political situation in the U.S. is not conducive to a political settlement that will allow for American hegemony to continue.
2. The U.S. does have the capacity to continue its hegemonic role if it can create a workable social contract.
3. Presumption #2 assumes that a new group of deeply talented thinkers will emerge, similar to those who developed after WWII. So far, there is little evidence this cadre of thinkers exists.
4. Thus, we expect the U.S. to steadily withdraw from the superpower role.

Historical analogs:

Britain in the 20th century:

1. *Likenesses*
    a. The U.S. economy and military are stretched, much like the

British were from 1900 into WWII.

b. Policymakers appear unable to make adjustments that would allow hegemony to continue; they are wedded to older models which have probably outlived their usefulness. The U.S. continues to lean toward deregulation and globalization when the problem is debt and lack of aggregate demand, while Britain made a disastrous return to the gold standard in the mid-1920s.

2. *Differences:*
   a. U.S. has adequate domestic resources; Britain was dependent on less reliable colonies.
   b. Unlike in the 1930s, there is no legitimate contender to replace the U.S. as hegemon.

U.S. in the 1970s:

1. *Likenesses*
   a. American policy was designed to create high-paying/low-skilled middle class wages. This policy led to excessive inflation.
   b. At the time, America's ability to act as hegemon was questioned. The U.S. lost the Vietnam War and the failed attempt to rescue the hostages in Iran made the U.S. appear inept.
   c. Currently, the U.S. looks inept, with one endless war in Afghanistan, an evolving mess in the Middle East and persistent threats from North Korea.
   d. All this was reversed by President Reagan, who embarked on deregulation and globalization policies, which addressed the inflation problem, and a military buildup that improved America's military standing.
2. *Differences:*
   a. The political leadership has not reached a point yet where it is prepared to try a radical solution, although the rise of populism does suggest the voting public wants change. What we may be seeing here is the fact that there is no populist leader that can actually govern, and a "traitor to his class" political figure, such as Franklin Roosevelt, hasn't emerged from the political establishment.

Britain in the late 19th Century:

1. *Likenesses*
   a. Britain was finding itself struggling to maintain a global projection of power. It was especially concerned with the rise of Germany.
   b. President Teddy Roosevelt was strongly indicating that the U.S. intended to enforce the Monroe Doctrine and was willing to confront European powers who were considering actions with its colonies or former colonies in the western hemisphere.
   c. The U.S. faces a similar situation in the Far East. China is an emerging power that is indicating it wants to project power into its near abroad. The U.S. continues to face turmoil in the Middle East and problems in Europe with Russia.
   d. Britain decided not to challenge Roosevelt in the New World, effectively ceding regional hegemony to the U.S. This allowed Britain to focus on

maintaining its empire and containing Germany.

e. The U.S. could cede the Far East to China which would allow the U.S. to focus on stabilizing the Middle East and Europe.
f. Britain could have prevented the rise of the U.S. and the loss of the western hemisphere if it had actively supported the Confederacy during the U.S. Civil War. It refused due to its own decision to abolish slavery.
g. China is constantly accusing the U.S. of trying to divide the Middle Kingdom by supporting the Dalai Lama and by calling out human rights violations. Perhaps China is thinking about this in light of the U.S. Civil War.

2. *Differences*
   a. The U.S. and Britain shared a common culture. The U.S. and China do not.
   b. Britain's decision was mostly a *fait accompli*; the U.S. was dominant and it wasn't clear that Britain could have won a war against the U.S. in the western hemisphere. The U.S. remains dominant in the Far East, although a war with China would be quite costly.

Our position is that the best analogy of these three is America in the late 1970s. The U.S. is capable of maintaining the superpower role but will need to make painful and difficult policy changes that the political establishment is loath to execute. If these domestic policy changes cannot be implemented, the U.S. may simply give up on the superpower role without much reflection on the potential costs.

However, to offer "signposts" for this decision, there are two other elements of Neustadt and May's structure we want to use. The first is the Goldberg Rule, which is the narrative around this decision. America has a self-image that isn't consistent with hegemony. The U.S. didn't consider itself a colonialist power and, at least in our self-perception, Americans don't see themselves as an empire. The U.S. sometimes behaved as an empire during the Cold War, but that was to protect the Free World from the encroachments of communism. Since the fall of the Soviet Union, the U.S. has struggled with developing a new narrative to justify its hegemonic role. Without the development of a new narrative, the U.S. may simply not have the political support for hegemony.

The second is Alexander's Question, which is what would need to change to adjust our presumptions? If we discovered that the U.S. simply doesn't have the resources to maintain hegemony, then the decision would change. Under those conditions, the goal would be to either protect the U.S. from the chaos of a "G-0" world or to support the rise of a new hegemon and avoid war. On the other hand, if a political figure emerged that could forge a new consensus on policy that would address the current domestic problems (inequality and debt) and maintain the hegemon role, we would also change our presumptions.

Finally, what are the odds that we place on our analysis being correct? We put them at 70/30. In other words, there is still a chance that the U.S. will maintain the superpower role, but the odds favor an eventual withdrawal.

Ramifications

The goal of this report was to discuss Neustadt and May's structure for analyzing history. Our conclusion probably isn't a surprise for regular readers. On the other hand, by showing how we "do" it, it offers readers an insight into the process we use to make use of historical analogies. We don't claim perfection in our analysis. In fact, the chances for being wrong in making predictions about the future are quite high. At the same time, such predictions are unavoidable and by using this "cookbook" one has a chance to see the process, examine the historical parallels and be aware of what would change our position.

In terms of the markets, not much has changed in our outlook. We expect the U.S. to eventually withdraw from global influence, which would be bullish for U.S. assets and commodities, while bearish for foreign assets. However, we do expect that, unlike during the 1930s, the process will be gradual because the U.S. still has the capacity but lacks the political consensus to remain as hegemon. That should delay significant market effects for some time.

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