

## The 2016 mid-year geopolitical outlook

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Bill O'Grady | Confluence Investment Management | 02 August 2016

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. 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 RISE OF POPULISM

As we noted in our 2016 Geopolitical Outlook published last December 2015, middle class households across the developed world are being buffeted by deregulation and globalisation. Middle class incomes have stagnated. In the US, middle class and working class households have tried to maintain their lifestyles through debt accumulation. The 2008 Financial Crisis effectively closed that avenue for keeping up appearances.

In Europe, similar economic conditions exist, which are exacerbated by a "North/South" divide, best exhibited by the Greek debt crisis. The refugee crisis in Europe is also triggering social and economic changes that are raising concerns about the social fabric of many European nations.

In the face of economic stagnation and social upheaval, many middle and working class Americans and Europeans see the political elites as detached and unconcerned about their welfare. The political elites are cosmopolitan and internationalists – we describe them as "Davos people," the types that go to Switzerland every winter to talk about the importance of globalisation, deregulation and the rapid introduction of new technology. These factors, while clearly bringing inflation under control, are blamed for undermining wage growth and causing income inequality.

In response to middle and working class unrest, there has been a surge in populism. In Europe, the most clear-cut example of the populist rise is Britain's decision to exit the EU. However, it isn't the only example. The National Front party in France scored major gains in regional elections last year, and only the combined efforts of the mainstream parties denied electoral success to the right-wing populist party. Its leader, Marine Le Pen, applauded Brexit. Both left-wing and right-wing anti-establishment parties have emerged in Greece. Right-wing populist parties have emerged in Denmark and Finland, namely, the Danish People's Party and the True Finns Party, respectively. The leader of the Dutch Party for

Freedom, Geert Wilders, immediately proposed a referendum in the Netherlands similar to the British vote. In Spain, Podemos has emerged as a left-wing populist party.

However, the most apparent expression of populism is evident in the improbable primary performances of Donald Trump and Senator Bernie Sanders. Both were running as anti-trade, anti-bank, anti-superpower populists. The former projects a right-wing strain of populism, expressing a nativist position similar to right-wing parties in Europe. Senator Sanders was a left-wing version of populism, calling for free health care and college education. He also promised a "revolution."

The importance of this rising populism is that it leans against the establishment consensus of at least the past 25 years and, in many cases, the entire postwar period. This consensus supports globalisation, deregulation and the rapid adoption of new technology with few regulatory restrictions. Those who have struggled in this policy environment are rebelling against the consensus. They want a less global world, one with job and trade protections, less immigration and, for the US, a renunciation of much of the superpower role.

The danger of this populism is that it will likely lead to a leaderless world characterised by regional trading blocs, which could involve fighting within each bloc as well as fighting with other blocs.<sup>1</sup> A world without a military and financial hegemon is a dangerous one. A positive outcome from this threat would be a leadership that does not abandon the superpower role but successfully addresses the fears and instability that globalisation and deregulation create for much of the developed world's working class. If that policy mix cannot be found, the world could fall into a dark period.

## ISSUE #2: THE US ELECTIONS

The US has been fortunate throughout its history that transitions of power have generally occurred smoothly. We have witnessed a couple of tense moments in the past six decades, including the Gore-Bush election uncertainty that was eventually resolved by the Supreme Court, and the Kennedy-Nixon election that had serious voting irregularities. For the most part, candidates seem to understand how important non-violent transitions are to the stability of the country, unlike what is occasionally seen in other nations, and thus elections are held, a winner is declared and the new president takes control.

We are not worried about this transition of power with regard to the process. Instead, we are concerned that nations at odds with the US perceive that there will be a major change in foreign policy with the next president. That perception rarely occurred during the Cold War; all presidents had to deal with the Soviet Union and so foreign policy was mostly consistent during this period. However, after the Berlin Wall fell, the deviation in foreign policy increased. President George H.W. Bush built a large coalition to push Saddam Hussein out of Kuwait. President Bill Clinton mostly enjoyed the "peace dividend," although he did engage in a police operation in Kosovo. President George W. Bush adopted a neoconservative policy

stance, invading two nations after 9/11. President Obama's foreign policy has mostly been a recoil from his predecessor's policies.

A President Hillary Clinton would tend to revert to a policy mix that leans to neoconservative. In fact, President Obama was able to portray her policies as similar to President Bush's in his successful nomination bid in 2008. As secretary of state, Clinton was often seen pressuring the president into more aggressive positions. On the other hand, a President Trump would be Jacksonian,<sup>2</sup> meaning the US would generally remain uninvolved in world affairs until US security is directly threatened. Russian President Putin and the Supreme Leader of the Democratic People's Republic of Korea, Kim Jong-un, have spoken favorably of Mr. Trump. Their hopes would be a Trump foreign policy that would abandon the superpower role, giving nations challenging the US – such as China, North Korea, Russia and Iran – a freer hand in expanding their regional power.

Thus, it would make sense that foreign nations will want to sway the outcome of this election more so than usual. For the rest of this year, US election uncertainty will be a growing risk to financial markets.

### ISSUE #3: THE SOUTH CHINA SEA

China is working to build itself into a regional power. It is using both military and financial means to accomplish this goal. On the latter, China has created the Asian Infrastructure Investment Bank (AIIB) as a competitor to the Asian Development Bank and the World Bank. The Obama administration strongly opposed the creation of the AIIB; despite US pressure, numerous nations – including some G-7 partners – decided to join the bank, a blow to the administration's foreign policy.<sup>3</sup>

The US is preparing to vote on the Trans-Pacific Partnership (TPP), a free trade pact that includes a dozen nations in the Pacific Rim but excludes China. The US 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 US trade framework.<sup>4</sup> Meanwhile, China is proposing an alternative group, called the Free Trade Area of the Asia Pacific (FTAAP), that would establish China as the center of Asian trade. Given that the TPP is opposed by both presumptive presidential nominees from the major US political parties, China is clearly prepared to "fill the gap" if the TPP isn't ratified by the US.<sup>5</sup>

On the military side, China has been steadily expanding various land protrusions in the South China Sea, allowing air strips to be built on them as a way to project power in the region. At the same time, the US has sent warships through these islands in order to maintain that these outcroppings are in international waters and do not signal an expansion of China's sovereignty.

The fact that the US is now sending Navy vessels from the Third Fleet to the Seventh Fleet's area suggests a buildup of forces. This decision by the Obama administration is rather

surprising – in general, this president has tended to shy away from such displays of power. In our 2016 Geopolitical Outlook, we speculated that it would be likely that both presidential candidates would be more hawkish than the current occupant of the White House. If true, that might encourage nations trying to expand their influence to do so before the next president takes office. Since Mr Trump may be much less likely to intervene, we suspect these nations (Iran, Russia, China, North Korea) may wait to see how the election evolves. Still, it is clear that tensions are rising in the South China Sea and the potential for a geopolitical "accident" is rising.

#### ISSUE #4: LONE WOLF ISLAMIC TERRORISM

Islamic State (IS) is in trouble. It is facing the steady loss of territory as Iraqi forces supported by Iran, and Kurdish fighters supported by the US are pressuring IS positions in Iraq. In Syria, Russian support of Bashar Assad will probably keep him in power. IS has been trying to establish an outpost in Libya, but it isn't clear how the group can justify that it has established a caliphate<sup>6</sup> in the Levant and then expand to North Africa.

In the face of these pressures, IS is trying to prove it still matters. The most likely way to do this is to inspire small scale, "lone wolf" attacks. Even in democratic societies, security services can discover conspiracies. Since 9/11, there have been numerous terrorist plans that have been penetrated and arrests have been made. Clearly, not all were stopped – but, in general, the larger the conspiracy, the greater the likelihood of discovery. On the other hand, small attacks, such as the Boston Marathon bombing, the San Bernardino shooting or the Fort Hood attack, are almost impossible to stop because there are fewer avenues for discovery. In fact, in a democratic society, lone wolf-style attacks are almost impossible to contain if civil liberties are to be maintained.

The problem is that lone wolf attacks are terrifying. There is a natural human desire to find the "root cause" of such events and eliminate the threat. Other groups of differing ideologies have carried out similar acts in the past but have faded over time. For example, the Red Army (Baader–Meinhof Gang) in Europe or the Weathermen in the US engaged in terrorist acts that were Marxist or leftist in nature. Such groups have faded. Islamic terrorism could face a similar fate over time. However, the consistent pattern is that society continues to face such threats. In general, we learn to live with them.

Nevertheless, these threats can affect policy and could potentially affect markets. If IS prefers Donald Trump to Hillary Clinton, it would not be a shock to see the group try to inspire an increasing number of attacks. On the other hand, about all that IS can do is inspire – there isn't much evidence to suggest that the group can train terrorists beyond the most basic parts of tradecraft. The bottom line is that we expect to see lone wolf attacks continue, but we doubt they have much impact on the economy or markets.

## ISSUE #5: THE NEW OIL WORLD

As petroleum became the key energy source for the world, producers determined that the unique way oil is discovered makes cartel creation attractive. Oil discoveries tend to be "lumpy," meaning that the addition to reserves is not always smooth. In addition, the demand curve for oil, especially in the short run, tends to be price inelastic. As major finds occur and supply suddenly rises, prices decline precipitously. The drop in price often encourages even faster production on fears that future prices will be even lower.

From John Rockefeller to the Texas Railroad Commission to OPEC, some cartel body has existed in the oil markets for most of the past 120 years. The cartel holds some production off the markets to boost prices – at the same time, this excess production can be brought on line when unexpected outages occur which dampens the price increase. Essentially, society trades higher prices for lower volatility. Consequently, the key to price forecasting in a cartel market is to determine how the cartel will manage prices.

In oil, there have been periods where high oil prices have led to problems for the cartel. Although oil demand is price inelastic in the short run, it is more elastic in the long run. High prices support conservation and consumers change their behavior if prices persist long enough. At the same time, high prices encourage investment by non-cartel producers which increases supply. To maintain prices, the cartel manager needs to increase the level of idle production capacity. Past experience shows that eventually the cartel cannot maintain the level of idle capacity and a price war develops. After prices decline, production outside the cartel tends to decline and conservation efforts eventually wane and the cartel defends a new, lower price. The longer the lower price stays in place, the more production outside the cartel is depressed and demand is fostered.

This process works as long as petroleum has a future. However, the recent actions by Saudi Arabia to boost production and reform its economy may signal that the kingdom is concerned that environmental restrictions will eventually take oil the way of coal. If that is the case, producing more now and driving down the price is the best way to maximise the value of reserves, which may fall to zero before they are fully exploited. In other words, the oil market may be abandoning the cartel structure for good, which means lower but more volatile prices.

If this is actually occurring, the potential for disruption is high. Most oil producers have structured their economies and political systems for a cartel oil price structure. They all exhibit rentier state characteristics and suffer from the "Dutch disease."<sup>7</sup> Already, Nigeria, Libya, Venezuela, Russia and others are experiencing severe economic problems. In the past, the Saudis and OPEC would eventually return to policies designed to boost prices and conditions would improve. That outcome may not happen this time around. If that is the case, there are several major oil-producing nations that will face civil unrest and the potential for sudden changes in government. These may trigger short-term rallies in oil but, over the long run, we may be facing a new, uncharted oil world.

## RAMIFICATIONS

In our opinion, these five 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 worsen significantly, it will tend to boost Treasuries, which have been weak lately, and the dollar.

## ENDNOTES

1. See (1) Temin, P. (2013). *The Leaderless Economy: Why the World Economic System Fell Apart and How to Fix It*. Princeton, NJ: Princeton University Press; and (2) Kindleberger, C. (1973). *The World in Depression, 1929–1939*. Berkeley, CA: University of California Press.
2. Using Walter Russell Mead's archetypes. See WGR, 4/4/2016, *The Archetypes of American Foreign Policy: A Reprise*.
3. See WGR, 4/20/2015, *The AIIB*.
4. See WGR, 1/27/2014, *The TTIP and the TPP*.
5. At present, we would not be shocked to see President Obama try to pass the TPP during the "lame duck" session after the November elections.
6. See WGR, 4/27/2015, *The Ideology of IS*.
7. The "Dutch disease" references the discovery of natural gas in the Netherlands in the late 1950s. Selling natural gas led to a large trade surplus which lifted the exchange rate, making most other exports uncompetitive. The bottom line is that a large natural resource sector can seriously distort an economy and political system.



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