

December 15, 2014

The 2015 Geopolitical Outlook

N.B. This is our last report for 2014. The next report will be published January 5, 2015.

As is our custom, we close out the current year with our outlook for the next one. This report is less a series of predictions as it is a list of potential geopolitical issues that we believe will dominate the international situation in the upcoming 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: America's Strategic Drift

This issue has dominated our thinking for the past several years. Essentially, the U.S. has struggled with developing a coherent foreign policy strategy since the end of the Cold War. Although terrifying, the Cold War at least led to a consistent strategy; essentially, communism had to be contained and all foreign policy decisions had to face that test. That doesn't mean there were no policy disagreements during the Cold War. Clearly, significant policy differences existed between Presidents Carter and Reagan. However, the general requirements of defending the Free World established a strategic constraint that all administrations followed from Truman to G. H. W. Bush.

America's role as superpower isn't one that comes naturally to a nation founded as a republic. The founders created a government with numerous checks and

balances designed to protect its citizens from a tyrant, not to create an efficient system.

Until the U.S. became a superpower, it had a very small federal government. The military only expanded during times of war and was demobilized after conflicts ended. Defense spending was low; the nation was mostly defended by two large oceans and enjoyed the global public goods that the reigning superpower, Britain, provided. These public goods included the reserve currency and a global military footprint that protected the sea lanes. America's reluctance to accept more global responsibility after WWI was partly responsible for the Great Depression and WWII. Britain, whose economy was severely damaged by WWI, struggled to maintain the necessary services the global hegemon provides, like the reserve currency and global military projection. As such, Britain began to retreat from the position which left a power vacuum that the communist and fascist nations threatened to fill.

As WWII was coming to a close, America's leadership generally decided that the U.S. must replace Britain as the global superpower or prepare to eventually fight WWII. This sentiment was not universally held. Robert Taft (R-IL) argued vehemently that taking this path would change America in ways that would undermine its republican nature. Government would expand, intelligence gathering would be required, a large standing military would be necessary and individual liberties would eventually be at risk.

However, the dictates of the Bill of Rights do not support torture. The recent revelation about CIA torture is a reflection of this problem. Clearly such behavior isn't how many Americans believe their country should act. However, the temptation to engage in overly aggressive tactics to gain precious information, not just to protect the U.S. but the world as a whole, tends to rise for the superpower. It is much more difficult for the superpower to preserve national morals because so much is at stake; as a nation becomes supremely powerful, the tendency rises to justify the means to an end.

To a great extent, Taft's warnings were borne out. America has changed since it accepted the superpower role after WWII. The government has grown. The U.S. went from having no intelligence agencies to 17. Scandals have occurred, with the U.S. actively involved in the overthrow or attempted ouster of unfriendly governments in Iran, Chile and Cuba. The U.S. also found itself fighting a parade of small wars in Korea, Vietnam and the Caribbean. These wars created the need for a large standing army and defense budget. These are actions the U.S. was able to avoid prior to 1945.

America exercised its hegemon role in a manner different than Britain. Instead of colonies, the U.S. created a series of treaty organizations (e.g., NATO, SEATO) and international organizations (U.N., IMF, World Bank, GATT, WTO) that allowed America to exercise power without colonization. For many years, the U.S. dominated these organizations and was able to use them as tools to further its geopolitical aims. Although using organizations to project power was probably less efficient than simple colonial control, it was probably less expensive and allowed the

U.S. to maintain its image as a supporter of freedom and independence, an image created at the founding of the United States. It should be noted that, over time, these international organizations have become increasingly independent and are less than reliable vehicles for American power projection.

At the same time, the U.S. took a direct role in ensuring that the belligerent nations that triggered WWII would not return to cause another world conflict. The U.S. solved the "German problem," the issue of integrating a strong Germany into Europe by demilitarizing Germany and taking over its security. By wedding the German economy to the dollar's reserve currency role and by permanently stationing troops in NATO, Germany ceased to be a threat to its neighbors. Similar policies were implemented with regards to Japan. The U.S. essentially wrote Japan's post-war constitution which is pacifist by design. And, the U.S. guaranteed Japan's security, ensuring that the island nation would not be a threat to its neighbors. Essentially, America ended the persistent threats that Japan and Germany represented by demilitarizing both nations, allowing both to become export-promoting economies that were reliant on the U.S. consumer, and by shouldering defense responsibilities for both countries.

In the Middle East, the U.S. recognized that this area of instability held enormous oil reserves. President Roosevelt made personal contact with Saudi king and founder, Ibn Saud, and cemented U.S./Saudi relations even before WWII ended. One problem with the Middle East is that the borders created by the process of European colonization were designed to support foreign control, not create viable independent states. As the U.S. steadily

reduced British influence in the region, it maintained the established borders even though they required the leaders of these rather artificial states to become increasingly authoritarian to maintain control. The U.S. has acted as a balancing power in the region, becoming both directly and indirectly involved in numerous conflicts. Without U.S. influence, the region would likely evolve into new, self-determined states. Although such an evolution would create a more stable region in the long run, in the short run it would be chaotic and vulnerable to outside powers' influences. Thus, the U.S. has leaned toward stability and declared the region an area of vital interest, meaning that America is the primary defender and stabilizer.¹ The primary reason for this policy was to protect the massive oil reserves in the region.

Despite the distortions to America's self-image that the superpower role caused, the majority of Americans were willing to tolerate these burdens because communism was seen as a mortal threat. However, after the Berlin Wall fell and the U.S.S.R. was no longer a hegemonic threat, Americans' dedication to the superpower role came under pressure.

Populists on both the left and right wings increasingly call into question the burdens of hegemony. The populist classes often bear greater costs than members of the establishment. This explains their growing opposition to the superpower role. The left sees the continued high spending on defense and wants to shift these outlays toward social programs. The right wants a smaller government and opposes the "small wars" that superpowers are required to fight. Both are ardent opponents of globalization, reluctant to support free trade and, at least

for the right wing, have a general discomfort with immigration.

Meanwhile, the establishment, which tends to support the superpower role, has not been able to create an acceptable model for power projection. Policy has generally drifted toward Wilsonian² positions, which has led the U.S. into questionable conflicts in Iraq, Kosovo, Libya and Afghanistan. In two of these small wars, Iraq and Afghanistan, mission creep set in as goals and objectives of the campaigns changed over time. The Hamiltonians, who dominated the Cold War world, fell out of favor, while rising isolationist leanings, Jeffersonian or Jacksonian in nature, are rising among the populists. It is worth noting that during the sequester the GOP was willing to see defense spending cut as part of an overall reduction in government spending. The populist wing of the GOP approved of defense cuts, a clear indication that it favors a smaller military as part of its goal to reduce the size of government.

President Obama's foreign policy has increasingly shown reluctance to get involved in foreign problems. His handling of the Syrian situation is an example, in which he vacillated on executing airstrikes in response to the Assad regime's use of chemical weapons. Another potential policy failure was the decision to then deploy air strikes against IS with no clear plan for how to move forward if air power fails to stop the growth of the jihadists. The lack of action beyond sanctions against Russia's annexation of the Crimea seemed weak as well; although military action against a fellow nuclear power is probably ill advised, more aggressive sanctions, such as depriving Russia's banks access to the S.W.I.F.T.

¹ This is the "Carter Doctrine."

² See WGR, 1/9/2012, [The Archetypes of American Foreign Policy](#).

network, would have been more effective.³ The administration’s decision to “lead from behind” on Libya has become another problem; although Moammar Gaddafi was successfully ousted, Libya has descended into chaos with no government able to claim sovereignty over the entire country.

However, as tempting as it is to assign blame to the current administration for the lack of policy clarity, in reality, the problems run far deeper than the current government. The lack of foreign policy goals that most Americans can support and the absence of a clear vision of what American foreign policy should provide is becoming a crisis.

Our concern is that due to this lack of policy direction America is steadily moving toward isolationism. If the U.S. retreats, the world will become a volatile place, with a rising likelihood of regional conflicts that will unsettle financial markets, boost commodity prices and bring to an end the overall expansion of globalization. The human cost of this decision is difficult to calculate but we assume it will be massive.

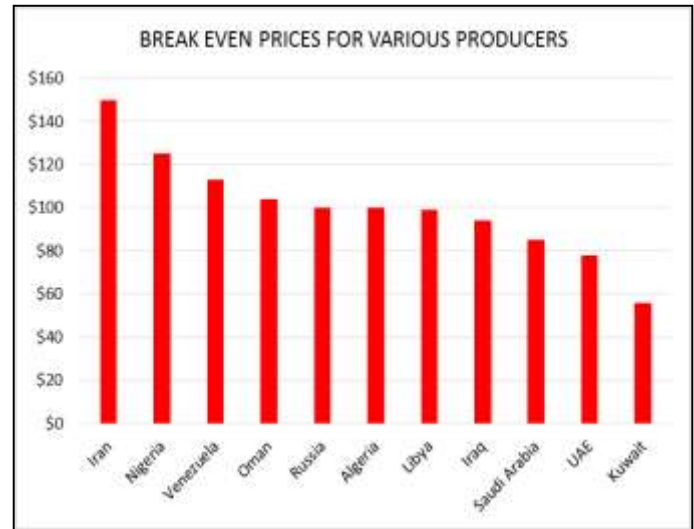
It is always important to remember that the WWII-era policymakers that set America on its course of global hegemony were likely aware of the costs of this policy direction. After all, the aforementioned Senator Taft made these costs clear. However, their position was that these costs were acceptable given the incalculable costs of WWIII.

³ In the president’s defense, S.W.I.F.T. is not an American body but an international one. The network did cooperate on Iranian sanctions but has expressed some reluctance to becoming a regular tool of sanctions for fear that it would create an opportunity for rival networks to develop. To some extent, this situation does show some of the weakness of using international organizations as a hegemonic tool for power projection.

Unfortunately, the current generation of policymakers appears to have forgotten why Roosevelt, Truman, Kennan, et al. made the decisions they did and can only see the burdens of hegemony. Without a new policy narrative, current trends suggest a gradual withdrawal of U.S. influence and power, with the likely outcome being an end to globalization and a world wracked with regional conflicts. Think of it this way—if the U.S. can no longer be relied upon to provide security for conflicts that have been ostensibly frozen since 1945, what happens as these potential conflicts “thaw”?

Issue #2: The Collapse in Oil Prices

In June, oil prices began to fall as Libyan production returned to the market and U.S shale production continued to rise. As the price decline gained momentum, there was a general expectation that OPEC, led by Saudi Arabia, would move to reduce production and support prices as most cartel members need rather high prices to maintain their fiscal budgets.

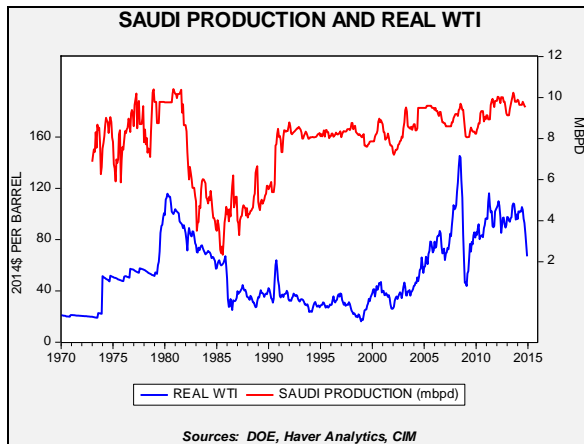


(Sources: IMF, Reuters, CIM)

This chart shows the fiscal breakeven prices for various oil producing countries. Because many oil producers have state-controlled oil companies, the revenue generated by these

companies either partially or totally fund government spending.⁴ OPEC and other oil-exporting economies have become dependent on rather high oil prices to fund their government spending. Thus, these states have an incentive to cut production to maintain high prices.

However, at the November OPEC meeting, the cartel decided to make no adjustments to production. This action was led by Saudi Arabia. The chart below explains why the kingdom made that decision.



In the early 1980s, Saudi Arabia acted as the global “swing producer” for OPEC and the world. In order to maintain prices, the kingdom aggressively cut production from over 10.0 mbpd to 2.5 mbpd. However, because the price was high, OPEC found itself facing non-OPEC supply competition from the North Sea and the North Slope; the high prices caused demand destruction as Europe and the U.S. took steps to constrain demand. As the above chart shows, despite Saudi Arabia’s aggressive output cuts, prices continued to decline.

⁴ This circumstance is actually typical; 56% of Alaska’s total state government revenue and 89% of its discretionary spending comes from oil taxes, showing that even parts of a developed country can become dependent on oil for fiscal spending.

By December 1985, the Saudis decided to abandon the role of swing producer and reclaim market share. Oil prices collapsed. The decline in oil prices had ripple effects across the world. The U.S. oil patch, including Texas, Oklahoma and Louisiana, experienced bank and housing crises. Mexico defaulted on its debt. The biggest outcome was that the drop in oil prices was one of the precipitating events that led to the fall of the Soviet Union.

Although it is less obvious on the chart, in the late 1990s, there was another sharp decline in oil prices as Saudi Arabia and Venezuela competed for global market share. Saudi Arabia increased oil supplies just as the Asian Economic Crisis was developing. The combination of falling global economic growth and rising output led to nominal prices briefly falling below \$10 per barrel. Oil prices recovered when a new Venezuelan government, led by Hugo Chavez, agreed to output cuts. Had the Saudis prevented the collapse in oil prices, the Bolivarian Revolution may have never occurred.

Thus, history does suggest that when the Saudis engineer weaker prices there is geopolitical fallout. There is a rising likelihood this event will be no exception. Below is a list of potential trouble spots:

Russia: The Russian economy is being battered by falling oil prices and Western sanctions which were enacted in the wake of Russia’s annexation of the Crimea and its support of rebels in eastern Ukraine. The ruble has declined precipitously and the economy will likely slip into recession next year.

We doubt President Putin will sit quietly and watch his economy collapse. He has two primary avenues to improve his situation.

First, he can use his relations with Syria to foment unrest in the Middle East. This may include defending the Assad regime if it deploys chemical weapons, selling arms to the regime, prompting Assad to support IS, etc. Rising unrest in the region would likely increase oil prices. Second, he could increase pressure in Eastern Europe by threatening gas supplies, supporting unrest in areas where there is support for Russia, and trying to lobby firms in Europe that are suffering the effects of Russian sanctions to pressure their governments to reduce or end sanctions. Or, if Putin becomes very desperate, he could invade a NATO nation (the Baltic States would be particularly vulnerable) to undermine NATO and make the U.S. appear weak. The fear of global unrest would probably lift oil prices and may stun European leaders into acquiescing to Russian demands to end sanctions.

Iran: It seems hard to fathom that Iran will allow the Saudis to destroy its economy without the Mullahs taking steps to either foment unrest on the Arabian Peninsula or by taking military action on its own. Given the reluctance of the Obama administration to act in the region, it isn't clear whether the U.S. would come to Saudi Arabia's aid if Iran took either overt or covert actions against the Persian Gulf monarchies. However, as long as nuclear negotiations are continuing, we doubt Iran will "misbehave." The risks of retaliation against Saudi Arabia's oil policy will rise in June, when the next deadline looms on nuclear talks.

Venezuela: The Maduro government is in deep trouble. Years of mismanagement of PDVSA, the Venezuelan state oil company, and the lack of investment in the oil industry has led to falling oil production. At the same time, expansive government spending funded mostly by oil sales and a byzantine set of price controls has led to recessionary

conditions. Inflation is reaching 60% per year. The collapse in oil prices is a major threat; in fact, the Maduro government was most vocal in asking OPEC for a production cut to lift oil prices.

The most likely outcome in Venezuela is a civil war of sorts within the ruling coalition. The coalition consists of technocrats, sympathetic members of the military and hard-left adherents to Cuba's communist model. We would expect the military and the hard left to eventually come to blows. The former joined the Bolivarian Revolution for influence. They are willing to allow Maduro to run the government as long as they can continue to plunder the country. The hard left has been an uneasy partner with the military but, as the "pie" shrinks, it is much more likely that a fight will brew.

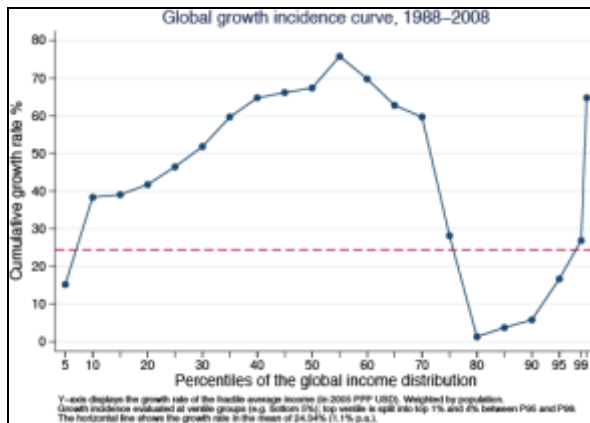
Oman: It is something of a surprise to add this nation to the list as it is one of the most stable and best run nations on the Arabian Peninsula. However, the elderly Sultan Qaboos is ill; for the past half-year, the sultan has been hospitalized in Germany, reportedly being treated for colon cancer. Qaboos has no heirs and the most likely successor will come from a set of cousins. The drop in oil could not have come at a worse time. Qaboos has run the country since 1970. Falling energy prices will force the government to reduce fiscal spending, which means a drop in social spending. If discontent rises in the midst of a succession crisis, it could cause instability in the oil producer which lies at the mouth of the Persian Gulf.

Overall, falling oil prices increase the odds of a geopolitical event somewhere in the world. Often, such events help set a floor under prices. It is possible that Saudi Arabia is actually banking on such an outcome to allow prices to recover without the kingdom

cutting production. If so, it is a risky policy because the Saudis may face “blowback” that adversely affects the kingdom.

Issue #3: The Rise of the Populists

In the developed world, income and wealth inequality has been growing. However, what has generally been unappreciated is that this increase in income inequality has not been a global phenomenon.



(Source: Milanovic, Branko and Lakner, Christoph, *Vox*, May 27, 2014.)

This chart shows the cumulative global income growth by income deciles for the period from 1988 to 2008. This data shows the impact of globalization on incomes. Income growth was very strong up to the 50th decile. From the 70th to the 98th decile, growth was significantly weaker. Only for the top 2% was there a return to strong growth.

Essentially, as production shifted to the emerging economies, the middle classes in the developed world lost income to poorer workers in developing economies. In fact, it can be argued that in the developed world, only the highest income brackets saw income growth. The above chart generally confirms data from individual developed countries; in the U.S., most of the income gains have gone to the upper income brackets alone.

These income differences will have a political impact; for the most part, this impact is rising opposition to globalization. In the U.S., this is evidenced by the Occupy Wall Street and Tea Party movements; the former oppose trade deals and the latter oppose immigration, the human side of globalization.

This trend is also evident in Europe as well. Recently, the Sweden Democrat party, a right-wing anti-immigration party, triggered a rare government failure. Elections will be held in March to try to form a new government.

Populist parties are gaining power throughout Europe. The National Front in France, the Independence Party in the U.K., the Golden Dawn and the Syriza Parties in Greece, the True Finns Party in Finland and the AfD in Germany are all examples of populist movements that want to reverse global integration and reduce immigration.

Elites in the developed economies have supported globalization. The U.S. sustained such efforts to bind the West together in the face of the communist threat. Greater trade does increase economic efficiency and immigration allows people to find the optimal venue for their skills and talents. However, as the above chart shows, developed country middle classes have not benefited from globalization since roughly the fall of the Berlin Wall. And so, it makes sense that they would oppose further measures to expand globalization.

If these populist parties are successful, it will likely lead to a reversal of globalization. Globalization has probably made the world more peaceful and has improved global economic efficiency. This could be lost if populist parties gain power and enforce measures to restrict trade and immigration.

If the European populists succeed in undermining the euro, it is quite possible that the gains Europe has made in security since WWII, fostered in part by steady integration, will be lost and this potential trouble spot could “thaw.”

Issue #4: Taiwan

In early December, the ruling Kuomintang (KMT) party suffered massive losses in state and local elections. President Ma Ying-jeou of the KMT tendered his resignation as party leader and the entire 81-member cabinet resigned. Ma’s resignation does not end his presidency; he will remain in power until the 2016 national elections. However, the drubbing that the KMT took is an indication that the ruling party has lost touch with the populace.

Taiwan has been in an unusual political situation since the Chinese Nationalists under Chiang Kai-shek were ousted from mainland China in 1949. The KMT decamped to Taiwan and became the Republic of China (ROC), while Mao declared the People’s Republic of China (PRC) on the mainland. Until the 1970s, the U.S. only recognized the ROC as the legitimate government of China. The KMT had representatives in its legislature for mainland districts even though the ROC had no control over the mainland. While the KMT became the face of free China, the local residents of Taiwan saw their aspirations for independence quashed.

Think of it this way—both the ROC and PRC claimed to be the legitimate government of China, and although they were at loggerheads, they both agreed that Taiwan was part of China. Both violently opposed Taiwan’s independence. The local residents, on the other hand, would like to have their own nation and be free of Chinese domination.

Over the past 15 years, political support for separation has increased, infuriating Beijing. When Ma won the presidency in 2008, he toned down the separation rhetoric of the previous government and worked to improve economic ties to the mainland. As the Chinese economy prospered, the policy generally boosted Taiwan’s economy. However, the desire for independence hasn’t been dampened even with Ma’s generally successful policies. The election losses appear to be driven by three factors. First, the KMT’s handling of student protests, which led to the occupation of Taiwan’s legislature, was considered poor. Second, a food-safety scandal has weakened support, raising fears of government corruption. Finally, and perhaps most importantly, China’s reaction to protests in Hong Kong has brought into question the idea of unification with the mainland, a KMT policy.

Increased investment by China into Taiwan, along with growing dependence on China (exports represent 64% of Taiwan’s GDP and 40% of that number goes to China), has led to the usual rise in inequality that globalization brings. This trend has led to a disaffected class that wants to reduce ties to China. Still, even if the KMT loses to a more independently minded party in 2016, extricating from China will be very difficult.

It isn’t known how China would react to a declaration of overt independence. China views Taiwan as a “wayward province,” and thus a declaration of independence would be akin to the southern states’ secession at the onset of the Civil War. In the past, the U.S. has intervened when tensions arose, keeping both sides from doing anything rash. However, with China’s rising military strength and the perception that the U.S. is waning, another drive for independence may trigger a shooting war. Unfortunately, a war

could be ugly. Taiwan could not invade China but it is well defended. It would be quite costly for China to invade the island; Taiwan has a formidable military and China's armed forces are probably less impressive than their numbers. After all, China hasn't fought a real war since it skirmished with Vietnam in the 1970s. Still, we would look for tensions to escalate in the coming year as the KMT falls from grace and the Taiwanese independence movement becomes more vocal.

Given China's deteriorating relations with other nations in the region, a crisis with Taiwan could trigger a wider conflict. We expect this issue will become more heated next year, which should support the dollar and trigger broader flight-to-safety to U.S. assets.

Ramifications

In our opinion, these four 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 were to worsen significantly, it will tend to boost Treasuries and, in some situations, commodities. Although gold has been range bound this year due to dollar strength, deglobalization would tend to support reflation and commodity prices.

Policymakers are facing difficult conditions. We expect monetary policy to remain accommodative outside the U.S. As we will detail later this month in our Current Perspectives 2015 Outlook, FOMC policy will be the biggest issue for markets. As the Fed tightens American monetary policy, it may actually exacerbate the issues noted above. The risk also remains high that policymakers, especially in Europe, will succumb to protectionism and reregulation.

Bill O'Grady
December 15, 2014

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