Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

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June 17, 2024

Mid-Year Geopolitical Outlook: Uncertainty Reigns

As the first half draws to a close, we typically update our geopolitical outlook for the remainder of the year. 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. The report is not designed to be exhaustive. Rather, it focuses on the "big picture" conditions that we think will affect policy and markets going forward. We have subtitled this report "Uncertainty Reigns" to reflect the fact that chaos and unpredictability have become entrenched as the post-Cold War era of globalization gives way to a new period of Great Power competition. Our issues are listed in order of importance.

Issue #1: China-South China Sea
The South China Sea (SCS) presents what may be the world's single-most ominous risk of conflict escalation: the intensifying territorial dispute between the People's Republic of China and the Philippines at the Second Thomas Shoal. In our *Bi-Weekly Geopolitical Report* from June 3, 2024, we explain in detail the competing sovereignty claims, the history of aggressive Chinese actions throughout the SCS and especially at the Second Thomas Shoal, the actions that have raised tensions this year, and the implications of the Philippines' mutual defense treaty with the United States. Since publication of that report, new developments have further raised tensions and the risk of escalation. Chinese state media have recently claimed that personnel on a Philippine ship pointed their rifles at Chinese coast guard vessels in the disputed waters. State media now also claim that Philippine military personnel have been damaging and removing Chinese fishing nets in the area. The nature and timing of these accusations raise the question of whether China might use them as pretext for military action at the Second Thomas Shoal.

The China-Philippines dispute is happening alongside the better-known, overlapping China-Taiwan dispute, which will also likely remain a key risk for the rest of the year. The China-Taiwan dispute began in 1949, when the Chinese communists won the Chinese civil war and established the People's Republic of China, forcing the losing Chinese nationalists to flee to Taiwan. China considers Taiwan to be a break-away province; however, the constitution of Taiwan, whose formal name is the Republic of China, claims sovereignty over mainland China as well as Taiwan. Although it virtually never gets said, this means that China and Taiwan still claim sovereignty over each other.

This is significant now because Taiwanese elections in January produced a new president who hails from the political party more inclined to assert Taiwanese independence. His defiant inauguration speech in May inspired China to respond with a two-day military exercise, which it called "strong punishment" for the island's "separatist acts," eerily simulating a full-scale blockade of Taiwan. Taken together with the recent stockpiling of critical war materials, China is clearly taking steps to increase its preparedness for potential military action against Taiwan.

More generally, the South China Sea is the scene of multiple overlapping disputes. There are currently nine different territorial disputes in the SCS, which involve eight different countries (counting China and Taiwan separately). In each of these disputes, both China and Taiwan claim sovereignty over a territory claimed by another country. Some of these disputes have been relatively dormant in recent years, while others have ominously flared this year. There is a possibility that more of these other disputes could flare up in the near future.

Due to the caution that great powers normally exercise to avoid open hostilities, we do not necessarily expect outright military conflict in the South China Sea over the next six months; however, the risks continue to rise. In such an environment, there is a greater chance of a situation growing out of control. If this were to happen anywhere in the world this year, the SCS is the place where we would most expect it. This reinforces our recently emphasized geopolitical implications of elevated costs of transportation and seaborne freight, as well as rising defense spending. In the near term, this could inspire safe-haven buying of Treasurys and gold; however, the longer-term investment implications are higher interest rates, decreasing values for long-term bonds, rising costs for critical commodities such as copper and uranium, and strengthening both defense and defense-technology stocks.

– DO

Issue #2: Russia-Ukraine-NATO

Russia's invasion forces continue to hold about 20% of Ukraine's territory, despite retaking some areas in the northeastern part of the country in the spring. Those modest Russian gains came as the delay in getting fresh US military aid to Ukraine left Kyiv's forces starved for ammunition and equipment, while its own conscription system was failing to produce enough new troops to replace casualties. Looking forward, some observers believe the Russian military will try to launch a big, new offensive against Ukraine during the summer's good weather. However, Russia's failure to make more progress during Ukraine's springtime resource famine could mean that Russia's equipment and troop losses to date have left it unable to generate substantial offensive momentum.

Looking forward, there is a possibility that neither Moscow nor Kyiv will be able to generate enough force to change the front lines substantially in the near term, even with the help that each side is now getting from its allies. This is consistent with our view that the war could drag on for some time until both Russia and Ukraine are exhausted to the point where they come to a negotiated settlement. In the meantime, rising frustrations could prompt either side to launch dangerous "Hail Mary" attacks. For example, Ukraine could launch more attacks on Russian territory, while Russia could try to weaken Western resolve by ramping up its aggressive influence and sabotage campaigns in Europe. As these risks ebb and flow, European governments could become even more intent on hiking their defense budgets, allowing European defense stocks to perform strongly again in 2024, just as they did in 2023.

– PFH

Issue #3: Israel-Hamas-Iran

Recent conduct in the Israel-Hamas conflict in Gaza reveals a pattern of restraint among the major players, suggesting they want to avoid escalation. This is despite continued vigorous military and diplomatic actions across the range of players as they jockey for position in ceasefire negotiations. In a conflict where key outcomes remain uncertain, such as who will govern Gaza after the armed conflict ends, the major players have a lot at stake. To highlight just a few of the stakes:

- Israel faces heightened security concerns relating to potential future attacks on its territory from Gaza.
- Hamas faces an existential threat to its future survival as a viable political and military entity.
- Iran, long a patron of Hamas, stands to lose the potency of a key client in its bid for regional influence.
- The Palestinians remain in limbo concerning their long-sought goal of independent statehood.
- Egypt faces the threat of its 45-year peace with Israel being compromised by internal political pressures.
- The US struggles to balance support for Israel with pressure from pro-Palestinian protests amidst an election campaign.

At the same time, these major players display a keen awareness of the potential for escalation, due to the myriad fault lines running through the Middle East, which we described in a recent report. Each player seems intent to pursue its own interests without tripping one of these lines. For example:

- Israel scaled back its Rafah invasion plan to avoid crossing the Biden administration's stated red lines.
- Hamas continues to constructively engage with Qatari and Egyptian intermediaries to craft a truce.
- Iran refrained from responding to an Israeli reprisal attack on installations near its nuclear facilities.
- Egypt is showing restraint in the wake of a cross-border incident that killed an Egyptian soldier.
- Balanced against an earlier suspension of a weapons shipment to Israel to show opposition to the Rafah invasion, President Biden put the onus on Hamas to accept the US's most recent ceasefire proposal.

We expect the fighting to continue for months, possibly beyond the end of 2024, but we do not expect escalation into a broader war. Each player in this conflict certainly continues to press its agenda, reflecting the gravity of the stakes across the board. For instance, just as Israel commenced its operation in the southern Gaza area of Rafah, fighting erupted anew in the northern Gaza area of Jabalia, near Gaza City. This was an area considered pacified and under Israeli control, and yet an Israeli spokesman called it some of the fiercest fighting of the entire conflict. Still, this balance of action and restraint paints a picture of a conflict that will continue for quite some time and remain a source of high risk, and yet it will probably stay contained.

Investment implications of a contained but continuing Gaza conflict center on considerations of heightened risks, in both a broad sense and as it specifically relates to high costs for transportation and internationally traded goods. In times of heightened risk, investors tend to buy safe-haven assets, and gold tops the list. We expect the Gaza conflict to contribute to upward pressure on the yellow metal. Additionally, heightened risks in the Middle East historically tend to cause the price of oil to rise. The oil market has recently been responding to a host of opposing factors, keeping prices rangebound; however, we expect the ongoing tensions surrounding Gaza to be a force for rising oil prices. Even in the event of a ceasefire, the geopolitical competition playing out between Iran and its Middle Eastern adversaries is not going away, and this is restricting the normal flow of trade through the region. Reduced and rerouted trade volumes will have long-lasting ripple effects on a wide range of prices, generally supporting the recent trend toward higher long-term inflation.

– DO

Issue #4: The US Elections

In our "2024 Geopolitical Outlook," published last December, we noted the US elections as an important issue. With the elections now a mere five months away, they will likely have an increasing impact on financial and commodity markets. Here are the key concerns, in our opinion:

- At present, it appears the election will be very close. However, "if the election were held today" type polls suggest President Biden would lose. Perhaps even more important, current polls in the battleground states are all leaning toward former President Trump. The decision markets indicate similar outcomes. That being said, there is still time for the race to change. This month, for example, we will have the first of two presidential debates. A lot can change over five months, but one conclusion we can safely draw is that this is likely to be a very close election.
- Voter research suggests that trust among the population is declining. Lower trust levels are reported among the less affluent, minorities, and the young; in general, trust is highest among older, wealthier, educated voters. Weakening trust levels can raise doubts that a reported election outcome is accepted. Thus, a close election may be disputed or rejected by the losing side. This outcome makes governing more difficult, because the losing side sees the winner as, at best, lacking a mandate, and, at worst, illegitimate.
- Because states have varying rules about voting and when the votes are counted, it's quite possible that the winner won't be known for days after the election is held. And, if the margins in the swing states are close, recounts are likely, which could further delay the determination of the outcome.
- Given how close the election is (a recent podcast suggested the presidential race will come down to 19 counties), it is not out of the question that neither candidate will acquire enough electoral votes to win. The table below suggests one way this could unfold. In this outcome, the president would be selected by the House of Representatives and the vice president by the Senate. Both the House and Senate bodies would represent the new Congress, i.e., the ones elected in November. The procedure is that each state's delegation votes for president, which means "one state, one vote." Only twice in American history has a president been elected in this manner: 1800 and 1836. Given the trust issues described above, a president elected like this would struggle for legitimacy.

A PERFECT TIE: 269-269 COULD HAPPEN IN 2024, REALLY

How 269-269 Can Happen In 2024

Biden Electoral College Votes		Trump Electoral College Votes	
Safe Seats	191	Safe Seats	121
Likely Seats	30	Likely Seats	97
Lean & Toss-Ups		Lean & Toss-Ups	
Michigan *(Toss-Up)*	15	Arizona *(Toss-Up)*	11
New Hampshire *(Lean D)*	4	Georgia *(Toss-Up)*	16
Pennsylvania *(Toss-Up)*	19	Maine-02 *(Lean R)*	1
Wisconsin *(Toss-Up)*	10	**Nebraska-02 *(Lean D)***	**1**
		Nevada *(Toss-Up)*	6
		North Carolina *(Lean R)*	16
Total Votes	269	Total Votes	269

(Source: Strategas)

- The high degree of political polarization in the US electorate gives America's adversaries (and, for that matter, allies as well) an opportunity to either sway the election or at least sow dissention. Foreign intervention in US elections isn't anything new, but the tools available to these actors is unprecedented. The fractured nature of the media, with numerous social media outlets, offers a plethora of opportunities to inject misinformation into the election. Also, artificial intelligence can create "deepfakes" that could raise concerns among voters about "what can I believe" and "who can I trust."

Despite these issues, we do expect a president will be elected before the established inauguration date. Given that both presidents have recent experience in office, it would seem as though there shouldn't be much uncertainty about what either candidate would do if elected. If Biden is re-elected, we expect he would continue the policies he has been promoting in his first term. However, history shows that second terms tend to be less successful than first terms with regard to policy. Much of the reason for this pattern is that a second-term president is "term limited" the day he is elected, where his ability to sway Congress diminishes since he can't run again. With Biden, we can expect "more of the same but less so," which means continuing to foster alliances with a broad focus on Europe, Asia, and the Middle East and maintaining his industrial policy goals.

Based on this pattern of second terms, President Trump would arguably face similar issues. However, Candidate Trump has suggested he would press for another term under the idea that the 22nd Amendment only means consecutive terms. Now, we note that he has also suggested that he wouldn't seek another term. The uncertainty alone, though, might give him more influence than that of a typical second-term president.

Another feature of a second Trump term is that he was a political neophyte in his first term. Unlike the majority of presidential candidates, Trump had no political experience — he had never occupied political office at any level. And so, as president, he had to learn the practice of governing on the job. If given a second chance, he has already made it clear that he intends to remedy what he views as the failings of his first term in office. Specifically, he is looking to apply broad tariffs (even against key allies), more strictly close the southern US border, and likely focus more on China and less on other parts of the world. It's also important to remember that Trump values optionality; thus, he is open to all sorts of policies, meaning markets would have to cope with elevated ambiguity.

So far, financial markets have been mostly ignoring the upcoming US elections. Much of the focus appears to be on monetary policy and tech earnings. But the election will become an issue in the second half of the year. Risk markets usually abhor uncertainty, as we have noted above, and this election season holds great potential for uncertainty. As a result, we would anticipate greater volatility for equity markets and perhaps flight-to-safety assets, such as Treasurys and precious metals. From a geopolitical risk standpoint, the distractions from an undecided election could give adversaries a perceived "window" to engage in behaviors they might otherwise avoid. The election will be an issue that we will be closely monitoring as the rest of the year unfolds.

– BOG

Issue #5: US Defense Rebuilding

So long as the US retains its position as global hegemon, the geopolitical backdrop for investors will largely depend on one key question: Is the US military big enough and strong enough to deter the rising, aggressive, authoritarian states, such as China and Russia? And if it fails to deter them, can the US military win a war against them?

Despite increasing threats from authoritarian states, top leaders in the White House, the Defense Department, and Congress still show little urgency to rapidly bulk up US defenses, perhaps in fear of voter backlash or due to a reluctance to upset current fiscal priorities. Nevertheless, we see early signs that US military services and the defense industrial base are starting to rise to the challenge. Examples of this include:

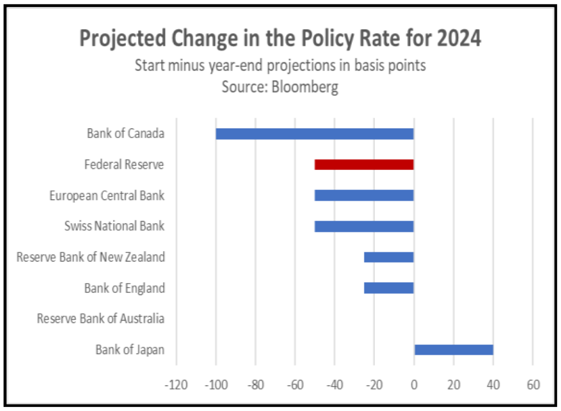
- The US Marine Corps continues to implement its "Force Design 2030" plan, in which it replaces its tanks and artillery with anti-ship missiles and reorganizes its troops to become island-hopping vessel killers in the event of a war with China in the Western Pacific. In May, the Marines were in joint training with the Philippines to access that country's islands within 100 miles of Taiwan, a potential US-China flashpoint.
- Similarly, the US Army says it will soon deploy medium-range interceptors and strike missiles in the Indo-Pacific region for the first time in nearly four decades.
- The US Air Force is investing enormous sums to expand, upgrade, and harden its network of airfields and logistics nodes in the region. In some cases, the USAF is bringing abandoned airfields from World War II back into service.
- The Pentagon is having some success with its new "Replicator" program to field thousands of low-cost, expendable drones by the end of 2025. The program has already begun sending these weapons to the Indo-Pacific. Similarly, six NATO allies have begun planning a "drone wall" to protect their borders from a Russian invasion or sabotage.
- Finally, just as orders from the UK and France hastened US defense industry expansion years before Japan's attack on Pearl Harbor in 1941, orders from Europe prompted by Russia's invasion of Ukraine have begun to spur US weapons and ammunition output. In May, for example, a new, highly automated ammunition factory came on line in Mesquite, Texas, immediately doubling the nation's output of 155-mm artillery shells. Other defense industrial plants have also begun boosting output by revamping production methods and improving their approach to hiring.

Ultimately, we expect higher defense spending to have a more noticeable impact on US defense industry output and profits, which should benefit large, traditional defense contractors. Still, the early focus on new, innovative operational approaches and smart weapons suggests there will be opportunities in smaller, innovative firms outside the traditional defense industry.

– PFH

Issue #6: Global Monetary Policy

This year has seen a significant shift in global monetary policy, with several key central banks moving toward normalization after hiking interest rates to very high levels to fight consumer price inflation in 2022 and 2023. Most recently, the Bank of Canada and the European Central Bank lowered their benchmark interest rates by 25 basis points for the first time since the pandemic began. These shifts came as inflation pressures appear to be moderating and economic growth has slowed. Meanwhile, the Bank of Japan has taken decisive steps to move away from its ultra-accommodative monetary policy as Japanese inflation has firmed. The chart below shows how investors expect major central banks to adjust their policy rates by the end of 2024.



As shown in the chart, most major central banks are expected to cut rates between now and the end of the year. However, one big question is how much the foreign central banks will cut their interest rates compared to the Fed. Most major central banks currently have their policy rates below the Fed's level. If they now cut rates more aggressively than the Fed does, the wider gap between US and foreign rates could weaken foreign currencies, leaving their countries with more expensive imports and higher inflation, especially if they are reliant on US dollar purchases. Therefore, any delay in the Fed's anticipated rate cuts, currently expected to start in September, could lead other central banks to hold off on their own rate cuts. Foreign countries forced to put off rate cuts would likely face slower economic growth and continued headwinds for their stock values.

– TW

Odds & Ends

The heavy schedule of ***national elections*** in 2024 has already produced some surprises, such as weakening support for Indian Prime Minister Modi and a surge in support for right-wing populists in the European Parliament. … Because of the tensions described in this report, we think there is an elevated risk of terrorism or sabotage at the ***Olympic Games in Paris*** from July 26 to August 11. … Finally, recent reports suggest that ***Syrian President Assad*** is seeking rapprochement with the US and its allies, in a move that could weaken Russia and Iran.

Summary

Taken together, the issues we have outlined here paint a picture of increased and sustained uncertainty in geopolitics. Great Power competition and worsening international tensions have made the global investment environment riskier than was typically the case during the post-Cold War era of globalization.

This new, scarier investment environment will be disconcerting for many investors. Some will be tempted to ignore the risks and pretend they don't exist. However, we believe the better approach is to face the facts head-on, look for ways to manage the risks, and consider whether the new environment might offer some intriguing investment opportunities. For example, we believe the US's continued strong economic growth could keep US interest rates relatively high and buoy the dollar. A strong dollar has historically weighed on precious metals prices, but today's global tensions are encouraging central banks in China and elsewhere to ramp up their gold purchases, lifting prices for the yellow metal. In our view, the investment implications discussed here illustrate how important it is for investors to keep track of the global geopolitical landscape.

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June 17, 2024

This report was prepared by Patrick Fearon-Hernandez, Thomas Wash, Daniel Ortwerth, and Bill O'Grady of Confluence Investment Management LLC and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.

Confluence Investment Management LLC

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