

November 5, 2012

The Foreign Policy Choice

Tomorrow is Election Day. After months of campaigning and hours of watching insipid political commercials, the time to decide is upon us.

This election comes at a turbulent time in American history. The economy is growing at a very slow pace due to ongoing deleveraging. The voting public, like Congress, is deeply polarized; both sides mistrust the other and any circumstance that occurs to aid either side is thought to be part of a conspiracy. In other words, both sides are convinced of the ill will of the other. Thus, the election appears to be a major event; both parties are painting a scenario that if their party loses, unmitigated disaster awaits.

The actual situation is probably not so stark. Presidential candidates promise as if they were kings—in reality, they are chief executives hemmed in by a clever system of checks and balances. The office of president carries enormous prestige but much less power.

In terms of foreign policy, candidates often campaign on one vision only to be forced by events into another. President George W. Bush ran on a platform of foreign policy humility with the promise not to become involved in nation-building. After 9/11, he conducted a strongly unilateral foreign policy, started two wars and was heavily involved in nation-building. Candidate Obama promised to close Guantanamo Bay,

try foreign terrorists in U.S. domestic courts and mend relations with the Muslim world. On election eve, Guantanamo remains open, none of the inmates at the facility have seen a U.S. civilian court and relations with the Muslim world remain strained. Although he did make good on his campaign promise to leave Iraq, relations with that state are not good. In fact, Iraq is rapidly becoming an active supporter of the Assad regime which the U.S. wants to remove.

This doesn't mean that Presidents Bush and Obama are liars. It simply means a president's ability to conduct his foreign policy is not without constraints. President Bush didn't want to nation-build, but found himself doing so as part of his "war on terrorism." President Obama wanted to "reset" relations with the Muslim world; instead, America's drones prowl their skies looking to kill jihadists. It's a bit like a football coach wanting to conduct a ground game against a defense putting nine defensive players "in the box." Sometimes the defense dictates your offense.

In this report, we will discuss the foreign policy constraints the next president will face after the election in terms of America's superpower status. We will focus particularly on fiscal and economic limitations that will shape the process of policy for the next four years. As always, we will conclude with potential market ramifications.

What the Next President Inherits

The next president will inherit a rapidly changing global environment. In general, we believe the roots of this issue are due to the lack of an accepted narrative.

Since the Cold War ended, the U.S. has lost its primary policy focus. Presidents in the post-Cold War era have struggled to redefine American foreign policy. There has been a streak of Wilsonianism among all of these presidents. The first President Bush, a mostly Hamiltonian policymaker, placed U.S. troops in Somalia without any obvious strategic interest. President Clinton did something similar in Bosnia. The second President Bush attempted to democratize the Middle East through invasion. President Obama became involved in Libya without an obvious overarching U.S. interest.

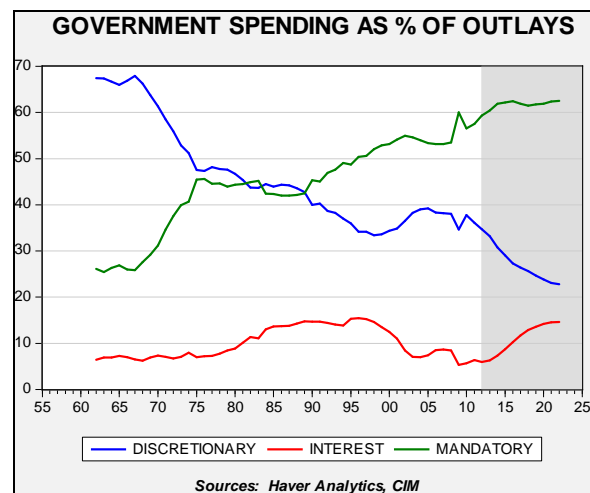
In part, this move toward Wilsonianism is probably due to the fact that America could indulge in such forays. President Eisenhower didn't come to the rescue of the Hungarians in 1956 because it could have touched off WWII. The U.S. didn't face a similar threat in Bosnia in 1995.

One of the key problems of the Wilsonian paradigm is that the world is an evil place and even a superpower cannot easily eradicate it everywhere. In addition, it assumes the superpower is also pure of heart. Although one can demonstrate the U.S. is probably more virtuous than other nations, it doesn't mean that America is morally perfect. In fact, much of the rest of the world assumes the U.S. acts in its self interest as much as any other country. Our interest in the "color" revolutions of the past two decades is seen as support of indigenous democratic movements by Americans. It is often seen as inappropriate undermining of legitimate governments by others.

In addition, the Wilsonian superpower can find itself wading into civil conflicts where both sides attempt to gain the mantle of victim. Once a side can claim victim status, retaliation is easy to justify. If that side can

convince the U.S. of its purity of motives, it can even get the superpower to fight its battles. In Iraq, we know the Kurds and Shiites were severely oppressed by Saddam Hussein. However, this fact doesn't mean that if these groups gain power that they will behave any better.

Finally, this shift to Wilsonianism has been expensive. The Iraq and Afghan wars were (and remain) expensive. These costs, coupled with the debt crisis, which we believe is caused by the other part of America's superpower role as the reserve currency supplier, has led to an unsustainable situation.



This chart shows government spending as a percent of total outlays divided by discretionary, mandatory and debt service spending. Mandatory spending is essentially social spending—Social Security, Medicare, Medicaid, etc. Discretionary spending is dominated by military expenditures, usually at least 50% in discretionary spending in any given year. Mandatory spending has been steadily growing and currently is nearly 60% of total outlays. We include OMB forecasts of these numbers (shown in gray on the above chart). Going forward, it is clear that discretionary spending is expected to decline and interest costs are forecast to rise.

Threading this political needle will be very difficult. Although it seems that all budget pundits believe entitlement reform is the key to corralling spending, one thing they don't seem to take into account is how cutting entitlement spending will square with the reserve currency role. As the supplier of the reserve currency, the U.S. has to run persistent trade deficits to supply dollars to the world. These dollars come, essentially, from domestic consumption. Means testing may allow enough transfer payments to the less affluent to maintain consumption but the political fallout could be nasty. It appears easy to deny Social Security to billionaires. However, the cutoff point to have a significant effect on cutting spending will probably be much lower. Support for Social Security will decline once it becomes simply a welfare program and ceases to be a universal retirement package.

In addition, a policy of cutting Social Security or rationing Medicare to maintain military spending will become unpopular quickly. It would take a true political talent to package this program and, at present, it doesn't appear that any such person is on the horizon.

Rethinking the Military's Role

If military spending is likely to decline, how does America maintain its hegemony? One way would be to shift from the Wilsonian paradigm to a Hamiltonian stance. A school of thought emerging from this tradition is calling for a program of "offshore rebalancing." Such a program focuses on acknowledging that the U.S. has the most powerful military on the planet; however, being most powerful is different from being omnipotent. Offshore rebalancing suggests that the U.S. only becomes actively involved in conflicts that affect America's direct interests. In other conflicts, the U.S. may provide a supporting

role but leaves the active fighting to others. In such a military, the ground forces shrink while the Navy and Air Force grow.

Critics of offshore rebalancing argue that this is a veiled form of isolationism. Deciding if intervening in a conflict is in America's interest is more art than science. For example, northern Mali has fallen under control of jihadists with ties to al Qaeda. Is extricating these rebels in America's interest? Probably. Should the U.S. become actively involved? Much tougher call. It could be argued that Europe has a more direct interest given that Mali was a former French colony and a jihadist state in Africa is probably a greater threat to Europe. On the other hand, as we saw with 9/11, jihadists in Afghanistan can attack the U.S. directly so it may be worth direct U.S. intervention.

The key to offshore rebalancing is burden shifting. Occasionally, analysts will call it burden sharing, but, in reality, to make this policy work the superpower must create regional hegemons. To do this, the superpower must allow these regional powers some latitude in conducting foreign policy. After WWII, the U.S. prevented Germany and Japan from rearming to allow America to dominate their foreign policy. In an offshore rebalancing world, the U.S. would have to become comfortable allowing allies to take a larger role in managing regional issues. This process isn't sharing the burden—it's forcing the burden onto others.

Burden shifting allows the U.S. to spend less on defense and more on deficit reduction and social programs. There are clear risks involved; allies can run policies we don't agree with or create messes that require American attention. Managing such a world is much more difficult than simply retreating

into isolationism or maintaining the current policy. However, it may be the best affordable option going forward.

The Candidates

Our position on the president was that he had a rather thin resume and little foreign policy experience and that he would develop a policy over time. He started out by apologizing, making speeches and trying to reset relationships. What seemed to occur was that other countries liked this stance compared to President Bush but were no more likely to do what the U.S. wanted. Since then, President Obama has developed a more workable foreign policy. Although criticized for “leading from behind” on Libya, in fact, that is a defensible policy because Libya isn’t a vital interest to the U.S. The U.S. didn’t import oil from Libya and was in little direct danger from the regime. On the other hand, the Europeans were much more exposed to Libya and should have taken the lead.

His policy toward Iran is rather straight forward as well. The likelihood of a military campaign is low; instead, the president intends to pressure Iran with sanctions, cyberwarfare and covert attacks. This may or may not prevent Iran from developing a nuclear weapon, but it is probably a safer policy from a U.S. standpoint than attempting an attack. The policy toward Syria is similar; others in the region have higher exposure and thus should take a more active role with U.S. support.

The policy toward jihadist terrorism is similar as well. Obama is aggressively deploying drones and Special Forces; he clearly intends to withdraw ground troops from most areas. Although such a policy won’t end the root cause of terrorism, it doesn’t appear that invasion will either. In fact, the problem may be intractable.

We would expect this policy to continue if he wins a second term. However, we do expect Secretary of State Clinton to resign. Clinton is a Wilsonian and has surrounded herself with like minds. We would look for Obama to replace the Wilsonians with more Hamiltonians in a second term.

In his campaign rhetoric and in his choice of advisors, Governor Romney appears to be bringing back the Wilsonian neo-conservatives of President Bush’s first term. However, it is unclear if the campaign will actually translate into policy. As we noted earlier, candidates sketch out their policy goals; reality often forces other policies instead. But, if we take the governor at face value, he is calling for a different foreign policy than the one operated by President Obama. A President Romney, presumably, would be more interventionist and need more military spending than a second Obama term would require. However, he may find it difficult to find the revenue for such spending.

Ramifications

George Friedman of Stratfor had a recent comment that is worth quoting in its entirety.

*On a recent trip in Europe and the Caucasus, I was constantly asked what the United States would do on various issues. I responded by saying it would do remarkably little and that it was up to them to act. This caused an interesting consternation. Many who condemn U.S. hegemony also seem to demand it.*¹

A world with a significant change in the behavior of the superpower is a world in flux. Inflection points are the most difficult to manage because all humans are subject to

¹ “The Emerging Doctrine of the United States” Stratfor, Oct. 9, 2012, George Friedman

the principal of induction. What has occurred in the recent past is expected to continue indefinitely. When a trend that has been in place for a long time begins to change, the preponderance of the evidence suggests that mean reversion will occur and conditions will return to “normal.” The U.S. has conducted its superpower policies in a fairly consistent manner since 1945. Countries could count on the U.S. to behave in a certain manner. This pattern would give them some power over the U.S. in that they could get in trouble and then get rescued.

Even with a Romney win, that previous policy may not be possible. In fact, as Georgia discovered after its confrontation with Russia in 2008, that policy was becoming less reliable even under President Bush. That doesn't mean that other countries have figured this out yet. Thus, nations in the Far East may think the U.S. will come to their aid if they face Chinese belligerence. In reality, we may not be so quick to respond.

If a new program is developing, it will take countries time to adapt. Mistakes will be made. However, if the trend is for offshore rebalancing, then a couple of potential trends may develop. First, global military spending patterns could change dramatically. The U.S. may spend less but

others will spend more. We could easily see U.S. exports of defense goods rise as foreign governments rearm. This would be part of the aforementioned “burden shifting.” The second consequence would likely be stronger commodity prices. Although offshore rebalancing would focus on naval power and protecting sea lanes as part of that function, foreign nations would probably still be concerned that the U.S. may not be as reliable in protecting foreign trade. To protect themselves, it would be reasonable to hold larger commodity stockpiles.

To some extent, tomorrow's vote could determine the future path of U.S. foreign policy. However, the constraints to deficits and superpower fatigue are affecting the U.S. economy and financial markets, and we doubt that a Wilsonian policy is sustainable. Romney is suggesting he will return to these policies. Whether they can be maintained is another matter. If Obama is re-elected, we would expect the process of offshore rebalancing to gain momentum. Although it may be easier to sustain, it will be hard to execute effectively. Given the uncertainty, we would expect markets to remain volatile.

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November 5, 2012

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