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## **Trump and the Political Economy of Alliances**

Now that President Trump is back in office, we think investors are about to see major changes in how the United States deals with the rest of the world. Trump, Treasury Secretary Bessent, and other key officials have signaled they will push to dramatically shift US policies on national security, foreign affairs, and international trade and capital flows. They haven't necessarily laid out specific, detailed plans. However, based on their initial statements, it's clear that they aim to reverse the traditional US approach to global hegemony and force US allies to shoulder more of the cost of allied security and prosperity.

In other words, Trump and his aides want to revamp the "political economy of alliance," not only in formal military alliances such as the North Atlantic Treaty Organization (NATO), but also in the broader US-led geopolitical and economic bloc. At the same time, the China-led bloc is changing its internal relations. In this report, we show how the Trump/Bessent plan could cut costs for the US but at the risk of reducing its influence or hurting the cohesion of the US bloc. At the same time, the China bloc is moving toward greater cohesion and increased power. We wrap up with the implications for investors.

### **Alliances: Building Power, Cutting Costs**

As we've written before, US leaders after World War II were tempted to return to the

isolationist "America First" policies of the 1930s, but they ultimately decided that avoiding World War III would best be achieved by staying internationally engaged. Indeed, the US took on the role of global "hegemon," i.e., the big, strong, dominant country that provides international security and prosperity. To stabilize the postwar world, the US first used its overwhelming military, economic, and diplomatic power to freeze longstanding conflicts in Europe, Asia, and the Middle East. Then, for more than seven decades, the US used its armed forces to limit international aggression and protect the world's sea lanes for trade. It also made the dollar the world's reserve currency by keeping the US open to trade and capital flows. After the Cold War ended in 1991, these policies supported the 30-year era of globalization, the key moment of which was China's entry into the World Trade Organization in 2001.

The US has also buttressed its hegemony with many formal and informal alliances. In the Western Hemisphere, the most important military alliance is NATO, which today encompasses 32 nations ranging from Canada and Iceland to the United Kingdom, France, Germany, and Poland. In the Eastern Hemisphere, the US built a "latticework" system focused on bilateral alliances, the most important of which are those with Japan, South Korea, and the Philippines. These are all mutual defense treaties, meaning that an attack on one member obligates the other members to come to the victim's aid (as the non-US NATO nations did for the US after the terrorist attacks of 9/11). The US also has many free-trade and

other commercial pacts with other countries and often coordinates informally with nations on various issues.

Why did the US build this alliance system as part of its postwar hegemony? And why do countries enter alliances at all? Our view is that every alliance is a big deal, with enormous possible benefits (such as survival in war) and the possibility of devastating costs (such as being drawn into an unwanted conflict). Nations therefore tend to enter alliances primarily to secure their most important national interests. A list of vital interests that could apply to all countries would likely include a) defense of the homeland, b) access to foreign markets and resources, and c) preservation of the nation's key institutions and values.

The US's broad policy of global hegemony has certainly aimed for these goals, and the policy has been successful (there has been no World War III). But achieving national security, prosperity, and freedom has also been why the US and its close friends have set up formal or informal alliances with each other. Focusing on the more formal groups, our view is the following: ***Nations pool their resources and coordinate their activities in an alliance to enhance their overall power against a potential adversary (preferably finding synergies), to cut the cost of achieving their vital interests (finding efficiencies), or to achieve both.***

- For a military alliance, this formula boils down to minimizing the country's cost to achieve one "unit" of defense. For instance, the US could conceivably decide that defending itself and having access to the wealth and productive capacity of Europe and Canada are so important that the US should shoulder the entire cost of defending the North Atlantic region. However, doing so would almost certainly require a US

defense budget several times higher than its current \$925 billion per year.

- Instead, the US has pooled its military, economic, technological, and demographic resources with those of its NATO allies, creating opportunities for both synergies and efficiencies. As a member of NATO, the US has been able to push its defense perimeter 4,000 miles to the east of New York, Washington, and Miami (just like its Asia-Pacific alliances push the US defense perimeter 5,000 miles to the west of Seattle, Portland, and San Diego). NATO's joint exercises, common equipment standards, and single command structure are also force multipliers that enhance the combined military power of the US and the other NATO members. The specialized geographies of some members also boost NATO's capabilities (for example, Iceland's unique location enhances its surveillance and communications mission versus Russia). Overall, NATO allows the US to achieve its security position in the North Atlantic at a much lower cost than if it adopted a go-it-alone strategy.

#### **Alliances: Social and Political Costs**

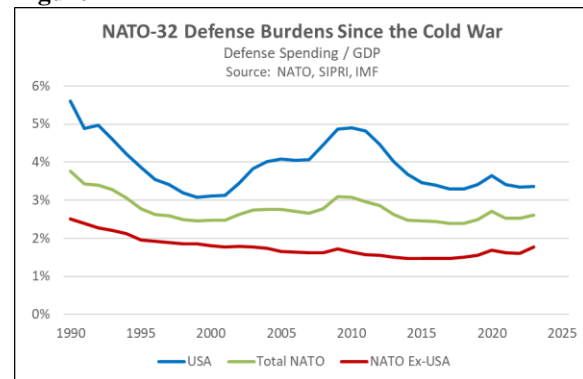
Despite the benefits outlined above, US citizens have shouldered enormous costs to maintain global hegemony and support the alliance system since World War II. Most seriously, those costs have included long, bloody wars in places like Korea, Vietnam, Iraq, and Afghanistan.

Gigantic US defense budgets have been another cost of hegemony and alliance. Since a global hegemon has security and economic interests spanning the globe, it naturally needs a large, strong military that can project power globally and ensure its position as the world's top dog. Similarly, even though alliances aim to cut the cost of

achieving national security or other vital interests, *leading* an alliance can require an outsized defense budget. That's because there is a trade-off between influence within the alliance and defense cost savings. Understanding this dynamic is critical to comprehending President Trump's agenda regarding US allies and friends:

- Every country entering a formal or informal alliance faces a dilemma. On the one hand, the availability of pooled resources and the other alliance members' promises of mutual defense assistance create incentives for the country to cut its defense effort as much as possible. Every alliance member is tempted to rely on the resources of the other members and be a "free rider." We suspect that virtually every formal or informal alliance throughout history has had to deal with this challenge. Indeed, US leaders have complained for decades that their NATO and Asian allies are spending too little on defense and are essentially guilty of free riding.
- On the other hand, contributing resources and coordinating activities with other alliance members requires a country to give up some sovereignty and decision-making freedom. Countries that contribute less to the alliance are likely to give up more influence. This is simply politics. The corollary of this law is that a country that wants to build its prestige and justify having more authority in the alliance must have a bigger military and contribute a relatively large amount to the alliance's total resources. If a country wants to lead the alliance, it may need to give up a lot of the defense cost savings that it otherwise would enjoy. That's certainly one underpinning of the US's leadership of NATO, and it helps explain the US's enormous defense budget (see Figure 1).

Figure 1



Finally, hegemony and alliances have also imposed high economic and social costs on US citizens. Since we've written extensively on this topic elsewhere, we won't explore them in detail here. Rather, we provide only a summary of these costs to help the reader further understand the Trump agenda:

- **De-Industrialization.** As noted above, one key policy to support US hegemony was to make the dollar the world's reserve currency. Specific US currency policies have passed through several iterations, from the Bretton Woods system, in which the dollar was backed by gold, to the current system, in which the dollar is still the reserve currency but US Treasury obligations are the reserve asset. In each iteration, the challenge has been to ensure the dollar's attractiveness and provide all the greenbacks the rest of the world demands. Ever since Federal Reserve Chair Paul Volcker surged interest rates to stamp out the high price inflation in the early 1980s, the US has achieved these goals by a) maintaining Fed independence as it seeks to achieve price stability, and b) running ever-bigger trade deficits and budget shortfalls. The key negative consequence of these policies was that they helped gut the US manufacturing and industrial sector.

- ***Inequality & Domestic Instability.*** The transfer of manufacturing and industrial jobs overseas has crimped opportunities for US workers and pushed many into poorly paid service jobs. In contrast, new technologies and the rise of global supply chains have boosted the pay of highly educated “knowledge workers.” Over the last decade, the resulting income and wealth inequalities have angered many voters and contributed to the rise of populist nationalism.
- ***The Balance Sheet Economy.*** The reduced incomes of the working class and the rising economic dominance of highly educated elites have helped make US consumer spending increasingly driven by asset values rather than incomes. In other words, “balance sheet” measures have become more important relative to “income statement” measures.
- ***High Debt Loads.*** As a corollary to the Balance Sheet Economy, private-sector US debt has ballooned relative to the size of the economy. Nonfinancial private-sector debt as a share of gross domestic product is now close to a record high, creating economic vulnerabilities for the US.

### **The Trump/Bessent Agenda**

To summarize, the US’s global hegemony and strong alliance system have successfully forestalled any new world war and helped boost global prosperity for more than seven decades, but this has come at the cost of several bloody regional wars, enormous defense budgets, and a transfer of income and wealth from the domestic working class to foreign workers and global elites. Some US politicians, economists, and social analysts have finally understood these dynamics in recent years and started to look for solutions. Our read of the evolving agenda of President Trump and Treasury

Secretary Bessent suggests they are planning a major restructuring of the US relationship with the rest of the world to address this problem. We lay out the broad contours of their plan below.

Based on their public statements and writings to date, we think the gist of the evolving Trump/Bessent plan is to ***re-set the “terms and conditions” under which countries participate in the US-led geopolitical and economic bloc.*** In our view, the overarching goal of this agenda is to ***rebalance the burden sharing in the US bloc, shifting many costs of hegemony and alliance away from the US to other members of the bloc.*** To our knowledge, neither Trump nor Bessent has provided a detailed, comprehensive strategy in this regard. Indeed, their strategy is probably still under development at this point. Nonetheless, it appears to us that the strategy’s main elements will be to:

***Pressure Allies to Boost Defense Spending.*** President Trump has repeatedly complained about US allies not spending enough for their own defense. [He has therefore threatened to abandon them to an invader if they don’t boost their defense budgets to as much as 5% of GDP.](#) It appears that Trump’s goal would then be to hold the US defense budget steady or even cut it.

***Adopt Bessent’s “Three Arrows” Plan.*** In addition to Trump’s plan to shift more defense spending to US allies, Treasury Secretary Bessent has developed a three-part plan to rebalance the benefits and costs of trade and capital flows in the US bloc and boost US working class incomes. The elements of his plan are as follows:

- ***Restructure the Reserve Currency / Reserve Asset System.*** To halve the federal budget deficit to 3% of GDP and help shift costs to other members of the



US bloc, Bessent wants to stop foreign central banks from buying regular US Treasury obligations as a reserve asset. Instead, he wants them to swap their current Treasury holdings for special, non-tradable, long-duration Treasuries with ultra-low interest rates. The other countries in the US bloc would also be encouraged to boost investment in the US industrial sector. [Those that agree to these moves would be spared from big, new tariffs and enjoy continued US military protection.](#) Countries outside the US bloc would face higher tariffs, penalty rates for buying Treasuries, a need to use gold or some other alternative asset for their reserves, and the risk of military confrontation with the US.

- ***Deregulate the US Economy.*** Bessent and other members of the new administration have also espoused quick, radical deregulation of the US to boost investment and increase economic growth. Under Bessent's plan, the goal would be to achieve average annual economic growth of 3% after inflation.
- ***Boost US Energy Production.*** [Finally, the new administration has prioritized unshackling the US oil and gas sector to boost output and bring down prices.](#) Low energy prices could help incentivize foreign manufacturers to invest in new US factories, boosting prospects for the US working class. Low energy prices would also help workers and offset some of the potentially inflationary impacts of other Trump policies, such as higher import tariffs.

### **Benefits and Costs of Trump/Bessent**

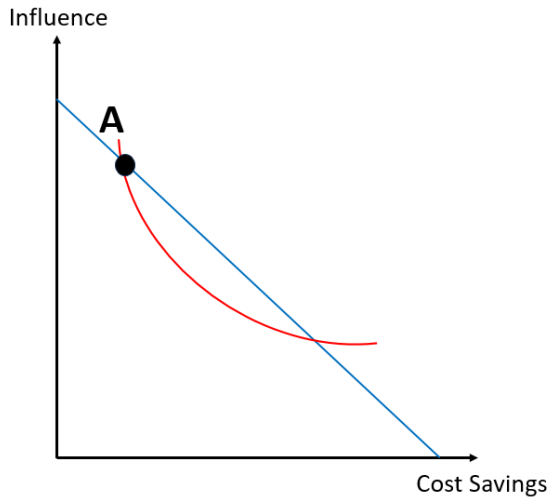
If we're right about the broad contours of the Trump/Bessent plan, we think it could shift a lot of the cost of US hegemony and alliance to other countries. Binding other

members of the US bloc to the new US dollar/non-tradable Treasury system could also help shore up the greenback and term out a large portion of US Treasury debt, cutting the federal government's interest costs. Deregulation could boost economic growth and federal revenues, further helping to balance the budget.

All the same, the Trump/Bessent plan would also entail risks. One key risk is a possible negative impact on the cohesion of the US bloc and the level of US national security.

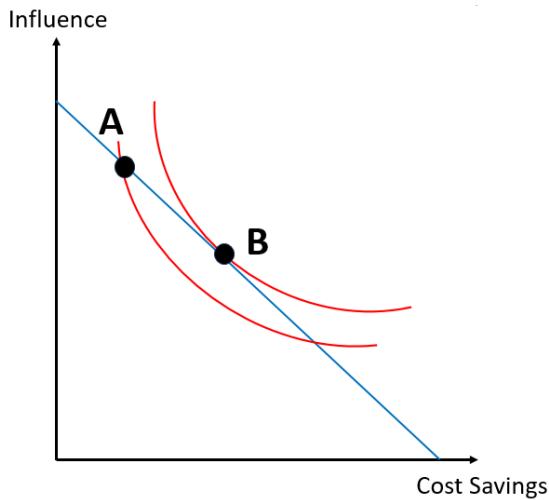
As a reminder, we showed above that there is a trade-off between a country's influence and the defense cost savings it achieves in an alliance. A country that contributes more to an alliance's overall resources will have more influence, and vice versa. (This is most obvious in a formal military alliance, but we think it also applies in informal alliances or a geopolitical bloc.) This influence/savings trade-off is illustrated by the blue line in Figure 2 on the next page. Further, if the achievement of an alliance member's vital national interests depends on both its influence within the group and its cost savings, there should be any number of combinations of influence and cost savings that equate to the same level of national interests. An example of such an "isoquant" is shown in red. Point A on the chart shows roughly where the US sits now regarding its various alliance partners: By maintaining such a big, strong military (buttressed by its enormous economy), the US has a very high level of influence within its alliance system, but its cost savings are low compared with what they could be.

Figure 2



In our view, the Trump/Bessent plan aims to push the US position in its alliance system to something like Point B in Figure 3. Here, by spending less and pushing other countries to “put more of their own skin in the game,” the US would give up some influence in the alliance, but that would be more than offset by its cost savings. As a result, the US would achieve a higher overall level of its national interests, i.e., it would move up to a higher isoquant. This would represent a success for the Trump/Bessent plan.

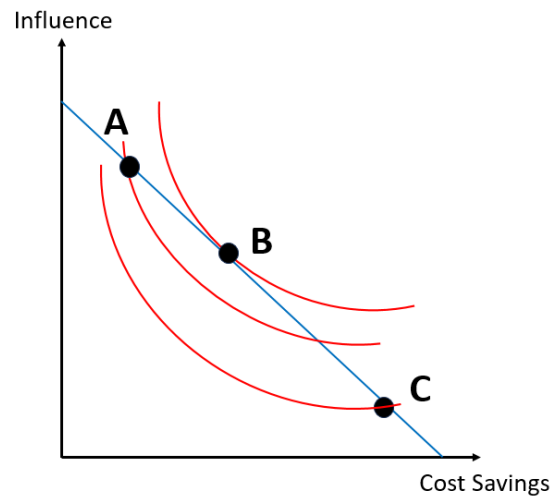
Figure 3



Finally, however, there is a risk that the US effort to push costs onto its allies could

backfire by undermining their trust and reducing US influence. This situation is illustrated by Point C in Figure 4, where the US has achieved a dramatic drop in its defense costs (an increase in its cost savings) by pushing the burden onto its allies. However, the value of those savings is more than offset by the resulting loss of US influence. Trying to push too much cost onto allies could prompt them to go their own way on defense. Unsure that the US would stand by its treaty commitments if they were attacked, some might decide to build their own nuclear weapons. Some might even cozy up to the China bloc. In any case, the US would end up achieving less of its national interests than it had before. This would be a failure for the Trump/Bessent plan.

Figure 4



We often hear people say that Trump’s brash, over-the-top threats are merely “negotiating tactics,” implying they don’t have much downside. However, real words have real impacts. If any of our readers have doubts that the Trump/Bessent plan could undermine the US relationship with its allies, we think they should consider the following hypothetical scenario: Imagine that a husband having a dispute with his wife threatened, “Honey, if I don’t get my

way, I'm going to have an affair!" Faced with such a shocking and dangerous threat, the wife might well concede. However, realizing that the husband had countenanced an affair, if only as a threat, she would likely never trust him again, and the relationship might never recover.

#### **A Note on the China/Russia Bloc**

Finally, we want to note why we're so focused on the risk of fracturing the US bloc and undermining its alliance system. The reason is simple: The economics of alliance laid out above also applies to Beijing's geopolitical bloc. In particular, China, Russia, Iran, and North Korea have apparently decided in recent years that the trade-offs between influence and defense cost savings are worth it, and they are increasingly cooperating and coordinating to improve their geopolitical and military positions. [To aid in its invasion of Ukraine, for example, Russia has already received defense industry supplies from China, drones and missiles from Iran, and troops from North Korea.](#) In late November, [the Russian navy surfaced an advanced attack submarine off the western Philippines, likely to show support for China's illegal territorial claims in the area.](#) Chinese and Russian aircraft and naval forces have also greatly boosted their provocative joint patrols, including in the waters off Alaska.

Acting in a more coordinated, collaborative way would enhance the China bloc's power, even if its members don't build formal alliances or sign mutual defense treaties. If Beijing and its partners can accept ceding some of their autonomy to act in concert, then they may be able to increase their overall power and/or cut their total defense costs. China, Russia, Iran, and North Korea certainly have some diverging interests, and they have a history of distrust, enmity, and even war among themselves. Nevertheless,

as they sense growing isolationism and stress fractures within the US bloc, they may well see a reason to bury the hatchet now.

#### **Summary and Investment Implications**

In sum, we think the Trump/Bessent analysis has rightly concluded that the military, economic, and social costs of global hegemony and the US alliance system are no longer politically tenable in their current forms. The costs might have been manageable during the Cold War when the threat from the Soviet Union was palpable and economic competition from other countries was relatively mild. However, the costs have become unbearable since the fall of the Berlin Wall, the rise of globalization, and the entry of China's enormous population and increasingly competitive economy into the world trading system. Modest adjustments such as the anti-China tariffs in Trump's first administration and the industrial policies of the Biden administration haven't solved the problem. Trump and his new administration now seem intent on a broad revolutionary program to push more of the costs of Western security and prosperity onto other countries. As we've shown with our analysis of burden sharing in alliances, such efforts could be successful, but they risk fracturing the US bloc or weakening US alliances.

The new administration's sweeping, radical, innovative effort to restructure US foreign relations sets up a range of possible scenarios for future investment returns. We think the program is more internally consistent than most observers acknowledge. It may have a good chance of being successful. If so, the increased economic growth, new industrial investment, lower energy costs, and reduced fiscal deficit would likely be positive for US stocks. We would expect continued strong performance from US stock sectors such as

Information Technology, Communication Services, Financials, Consumer Discretionary, and Industrials. The dollar would probably remain relatively strong, but at least some foreign stocks could do well, especially those associated with countries that accept the plan and therefore see reduced tensions with the US. On the other hand, continued weak economic growth in China and even higher US energy production would likely be negative for commodities. Despite lower energy costs, overall inflation could move higher, undermining bonds.

Of course, the Trump/Bessent plan could also falter in various ways, such as by fracturing the US bloc and/or by prompting foreign countries to go their own way or cozy up to China. The result would be a more chaotic, tension-filled geopolitical and

economic environment around the world. While it's difficult to foresee all the potential negative consequences in such an event, we suspect that failure of the plan would be negative for many US and foreign stocks, but the new tensions might be positive for European and Asian defense stocks, gold, and many commodities. Safe-haven bonds might be attractive if tensions worsen considerably, but inflation might also be worse than in the successful case, and that would likely be negative for most bonds.

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