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GEOPOLITICAL RISK & MARKET IMPLICATIONS

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June 2024

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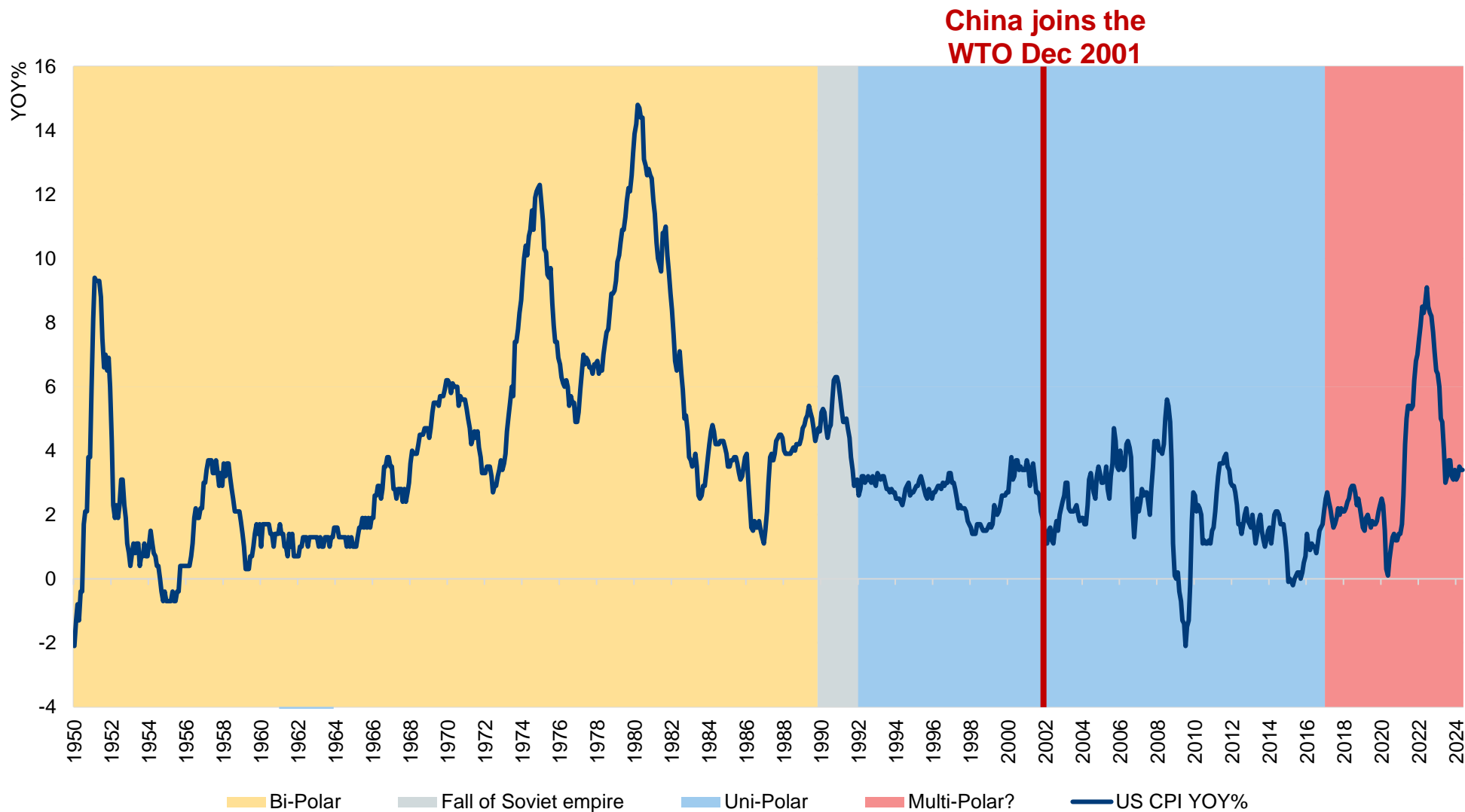
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DATA CLASSIFICATION: CONFIDENTIAL

INTRODUCTION

From a uni-polar world to a multi-polar world

Geopolitical competition makes a comeback



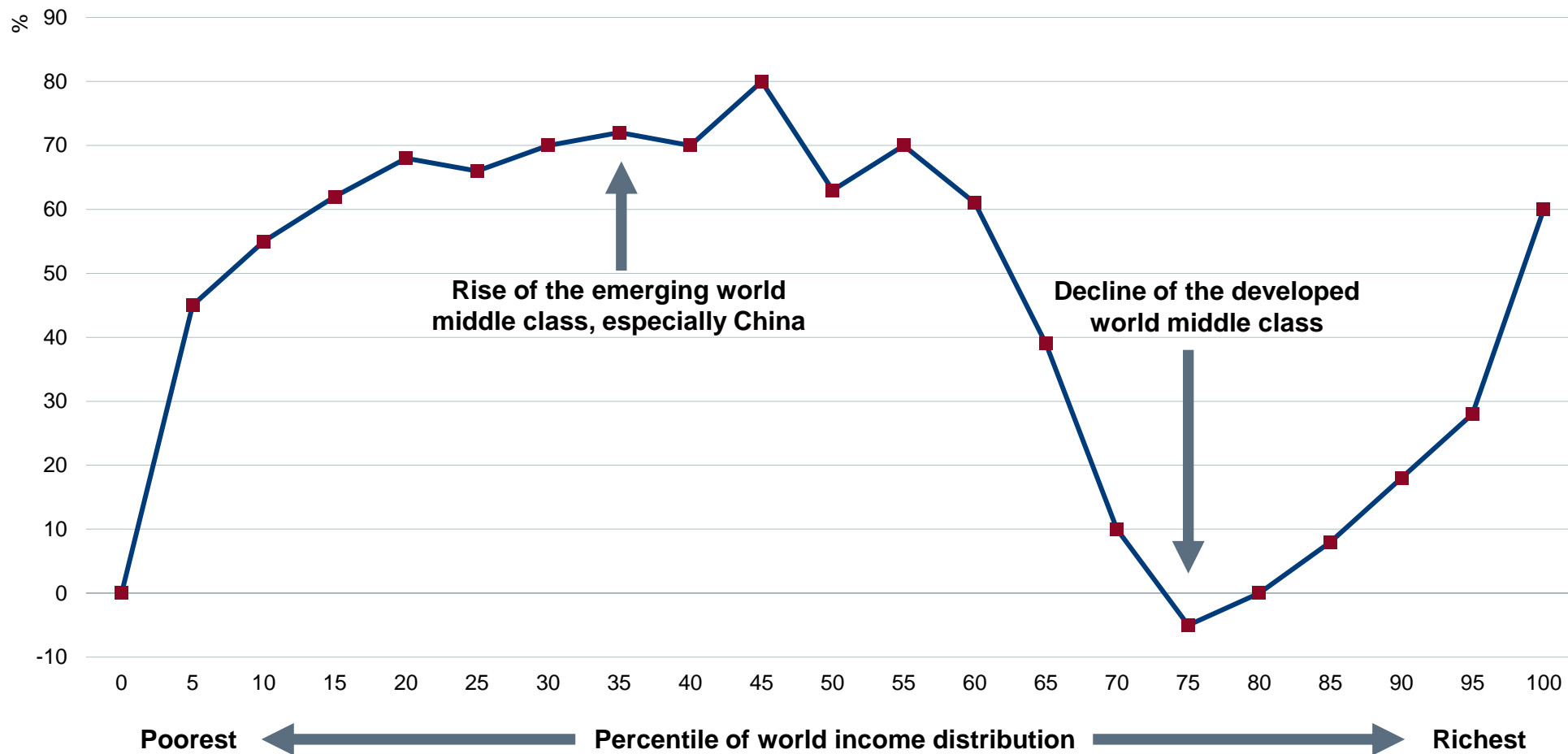
Source: Bloomberg, 31 May 2024.

The US remains the global superpower, but the gap has closed

Shifting attitudes towards globalisation

The developed world middle class has stagnated for decades

Income growth by percentile 1988-2008

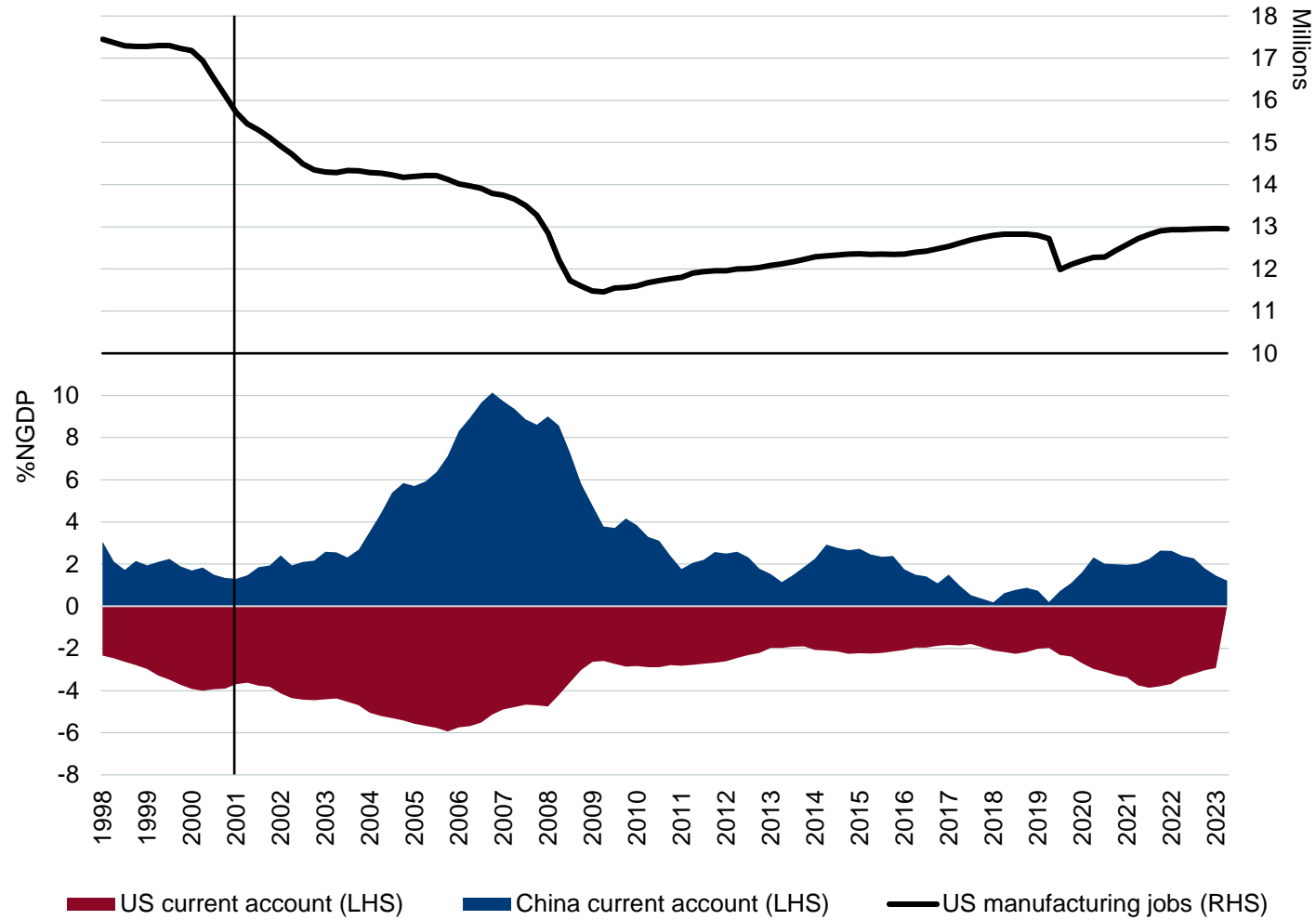


Source: World Bank, 2008.

From mutually beneficial to a zero sum game

US-CHINA

Trade War

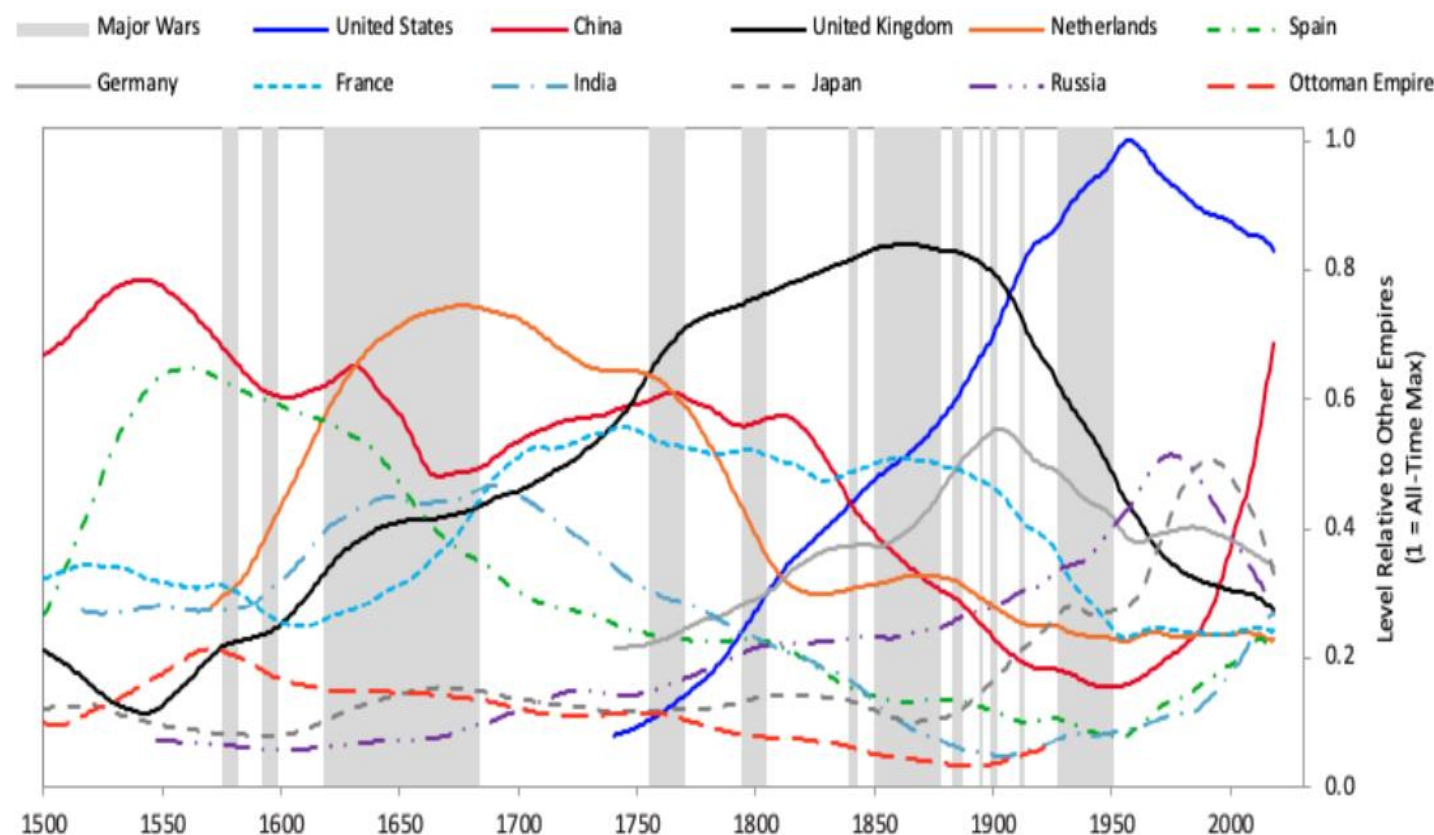


- Between Dec 2000 and Dec 2008 China's current account surplus increased from 1.5% of NGDP to 10%
- Over the same time period the US lost 5.7m manufacturing jobs (-33%)

Two superpowers on a collision course

US seeking to curb China's economic rise

Rough estimates of relative standing of great empires



“

While we are not in a position to outline specific policy changes at this time, we are taking a comprehensive approach to implement additional actions necessary related to technologies, end-uses, and end-users to protect U.S. national security and foreign policy interests”

US Department of Commerce

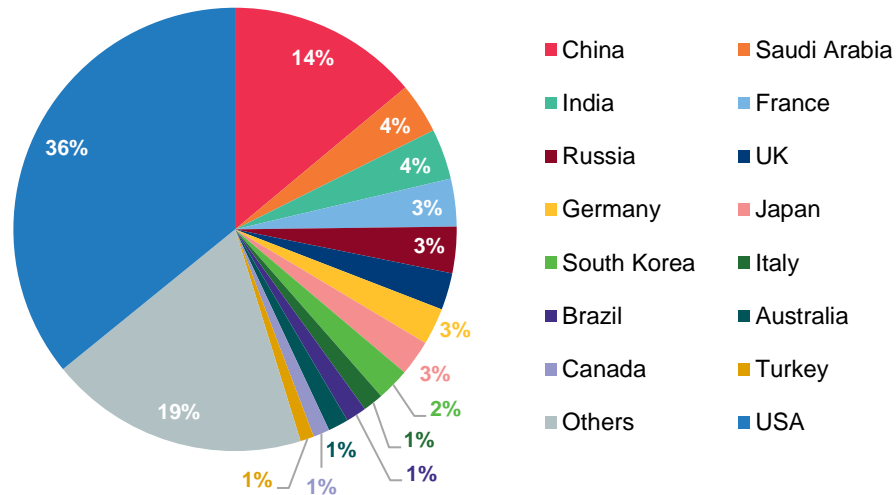
Source: Ray Dalio, Principles for Dealing with the Changing World Order, published 30 November 2021.

US and China now engaged in a Tech War



- Indo-Pacific has become the main theatre of US security focus.... until Russia invaded Ukraine on February 24th 2022.
- Security frictions in more places than at anytime since Cold War. In addition to potential kinetic threats, the US is occupied with other security threats: Terrorism, cyberattacks, nuclear proliferation, information warfare.
- US security spending is 36% of world total and more than rest of G7 combined. How sustainable is this? Post Ukraine, other countries seeing sharp increases in defense spending.
- Recalling the Century of Humiliation (1839-1939), China's leadership is determined to restore its past greatness including its military modernization. China now takes a much more aggressive stance on sovereignty issues.

Global military spending in 2018



Source: Stockholm International Peace Research Institute, Andrea Villari/Stars and Stripes, 2018.

- South China Sea – China has competing territorial claims with six other countries in the South China Sea based on its “Nine Dash Line” interpretation. Land reclamation in the SCS was officially deemed unlawful by US in July 2020.
- Taiwan – Beijing considers the mainland's reunification with Taiwan as destiny and has not ruled out the use of force. Under the Taiwan Relations Act (1979) the US exercises ‘strategic ambiguity’ towards Taiwan's defense.



Source: Forbes, Making Sense of the South China Sea Dispute, August 2017.

Summary

US-China relations are not about to improve anytime soon

- The countries are now locked in a geopolitical rivalry
- Having become highly integrated throughout the 1990s and 2000s the US is implementing policies designed to curb economic China's rise
- Expect more US policies and practices designed to “keep advanced technologies out of the wrong hands”
- Expect global supply chains to be gradually diverted from China in favour of onshoring or ‘friend-shoring’
- China is responding by heavily investing in developing strategic industries
- China will limit export of its own strategic goods – e.g. rare earths
- China attempting to create a renminbi-based system of trade
- Expect tensions in the South China Sea including Taiwan



RUSSIA-UKRAINE



BORDERS

Russia's borders are long and impossible to defend, prompting the **Russians to endlessly expand outward until they hit significant geographic or military resistance.**

RESOURCES

Russia is a huge producer of oil and natural gas, and its vast geographies sustain massive mining and even more massive grain production. Much of the activity is seasonal, most Russian territory vacillates between frozen and swamp.

MILITARY MIGHT

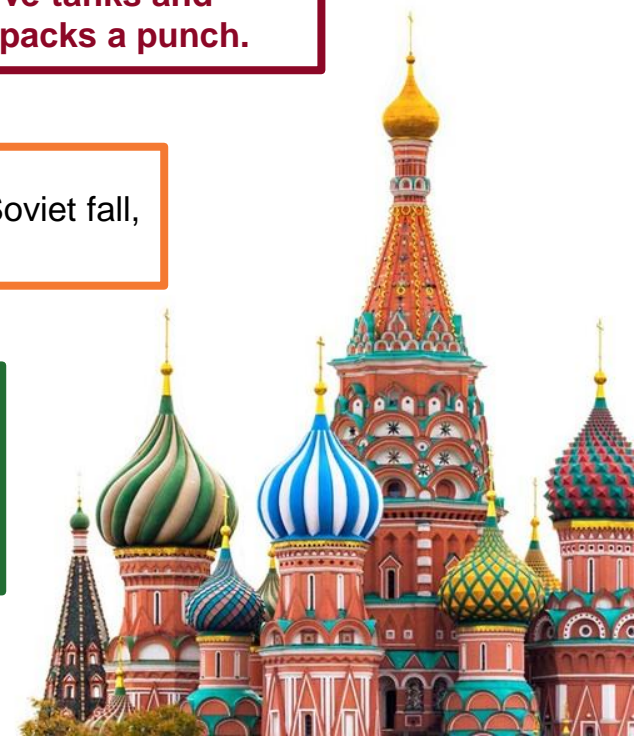
Russia still invests heavily in defence, though much of the hardware is showing its age. Thirty-plus year old submarines and an aircraft carrier that habitually catches fire, but impressive tanks and aircraft and the world's largest nuclear arsenal – Russia's kit may be old, but it still packs a punch.

ECONOMY

Sanctions and overreliance on commodity exports have made Russia struggle since the Soviet fall, but Russian geography never supported a successful, industrialised economy.

OUTLOOK

Russia is an ageing, insecure, former power determined to make a last stand before it is incapable of doing so. American disengagement from the global scene **couldn't have come at a worse time**, but the reactivation of Russia's traditional local foes couldn't have come at a worse one.



RUSSIA'S LAST STAND?

Russia underestimated the
resolve of the West

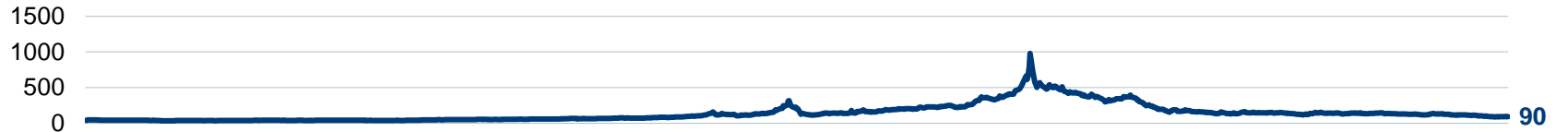
Western sanctions have been very aggressive



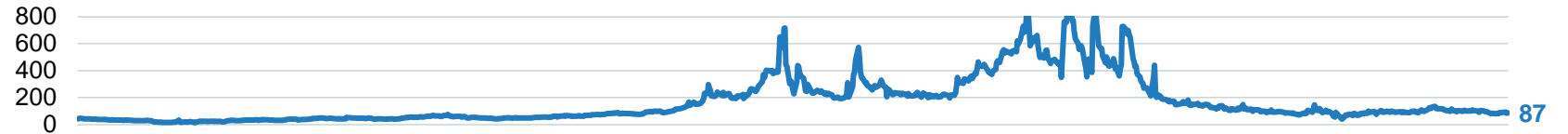
European energy crisis

European energy policy was built on cheap Russian gas

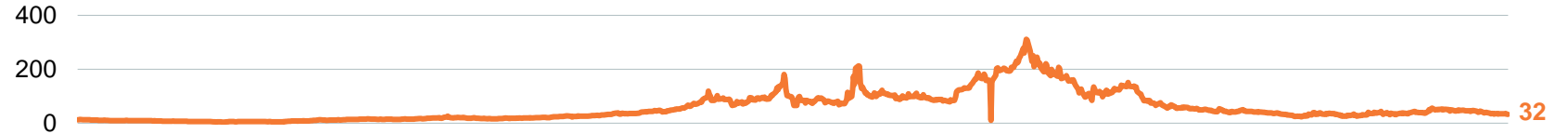
**GERMAN
BASELOAD
1Y FORWARD**



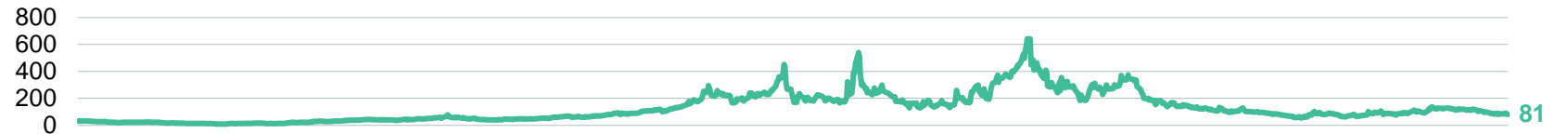
**FRENCH
BASELOAD
1M**



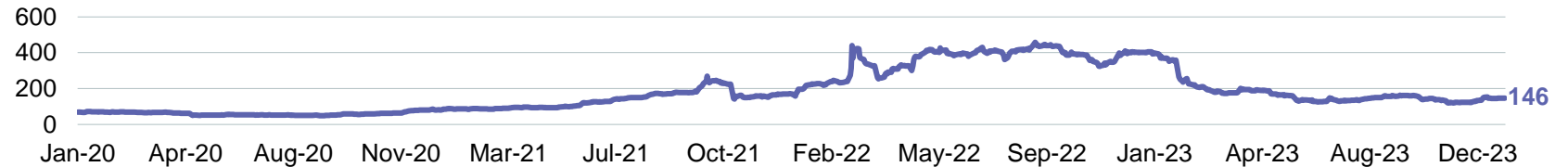
**DUTCH
NATURAL
GAS 1M**



**UK
NATURAL
GAS 1M**



**NEWCASTLE
COAL**



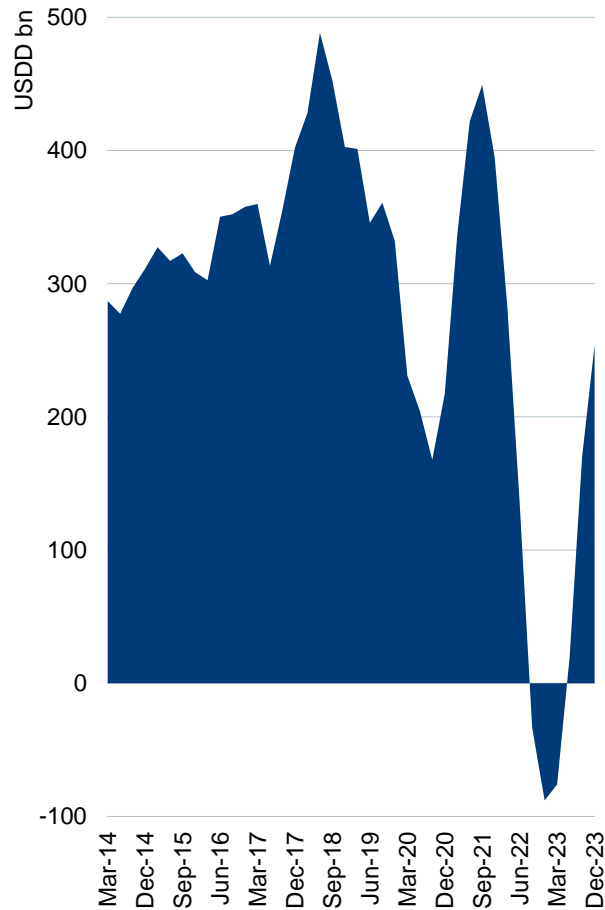
Source: Bloomberg, 29 December 2023.

Sanctions have caused havoc in European energy markets

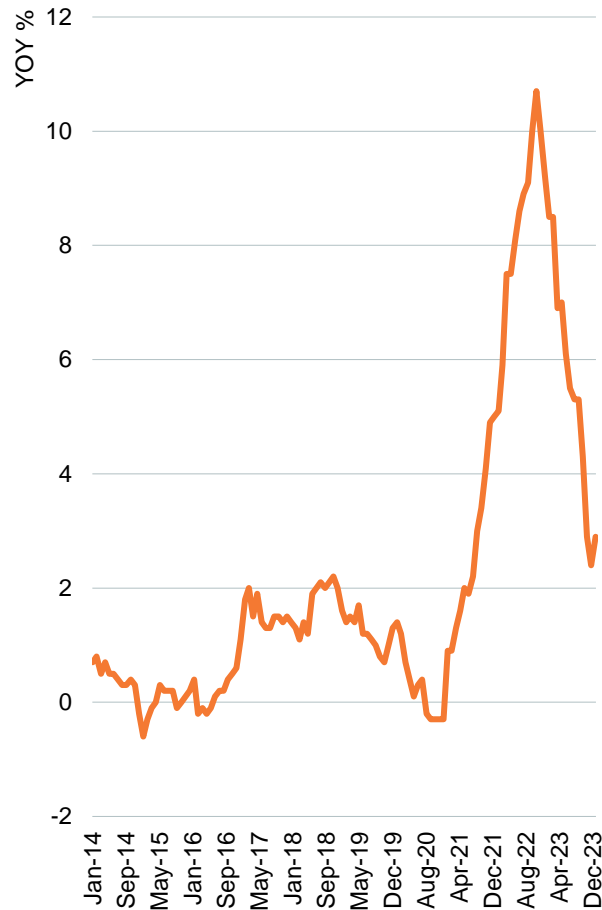
European energy crisis

Major headwind to the European economy

**Eurozone current account balance
(USD bn)**



Eurozone inflation (YOY %)



EUR/USD

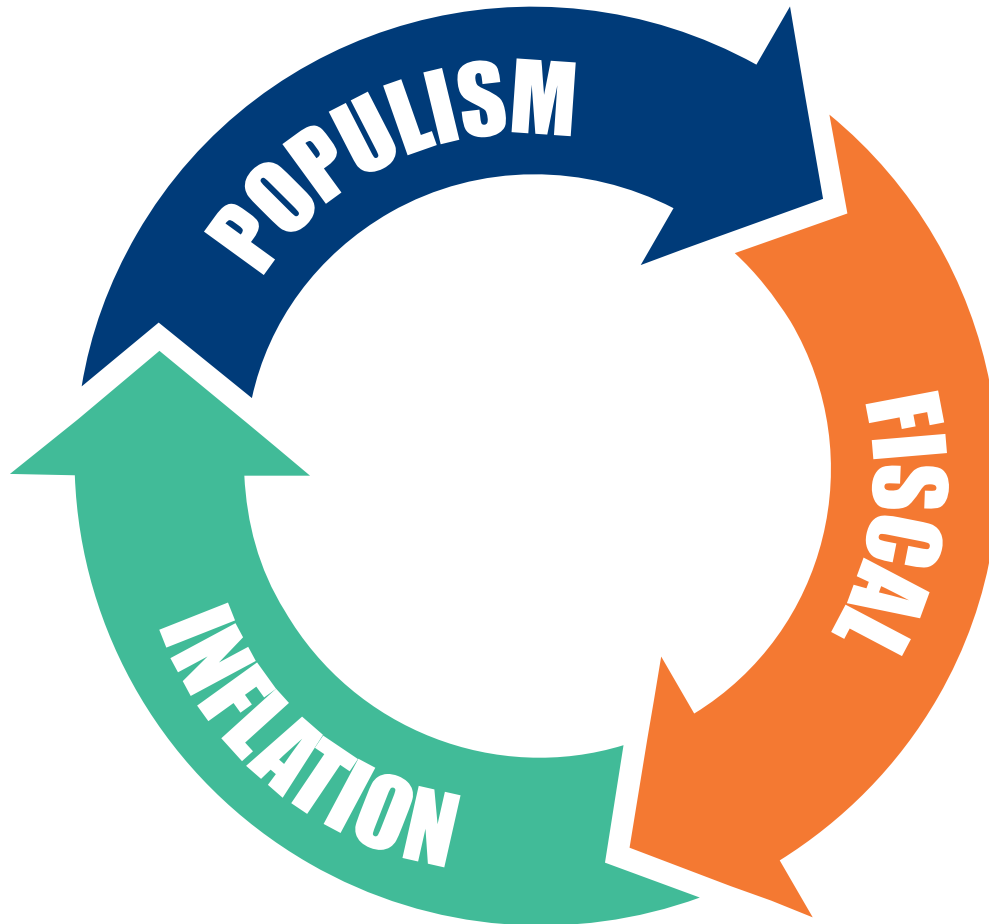


Source: Bloomberg, 31 December 2023.

ECB grappling with stagflation

Fiscal to the rescue

Populism > Fiscal > Inflation



“

Liz Truss unveils £150bn UK energy plan but limits support to six months

Price guarantee will keep average household bills at £2,500 over next two years

Financial Times, September 2022

”

“

Germany approves €100bn fund to modernise its armed forces

Historic Bundestag vote reflects fundamental shift in defence and security policy triggered by Russia's war in Ukraine

Financial Times, June 2022

”

The era of crises = more government

Summary/consequences

Russian invasion of Ukraine has accelerated the process of divergence/deglobalisation

Fragmentation of financial markets and international payments system (SWIFT)

Fracturing of global commodity markets

Balkanisation of trade in goods and services

Less cooperation between nations

US PRESIDENTIAL ELECTION

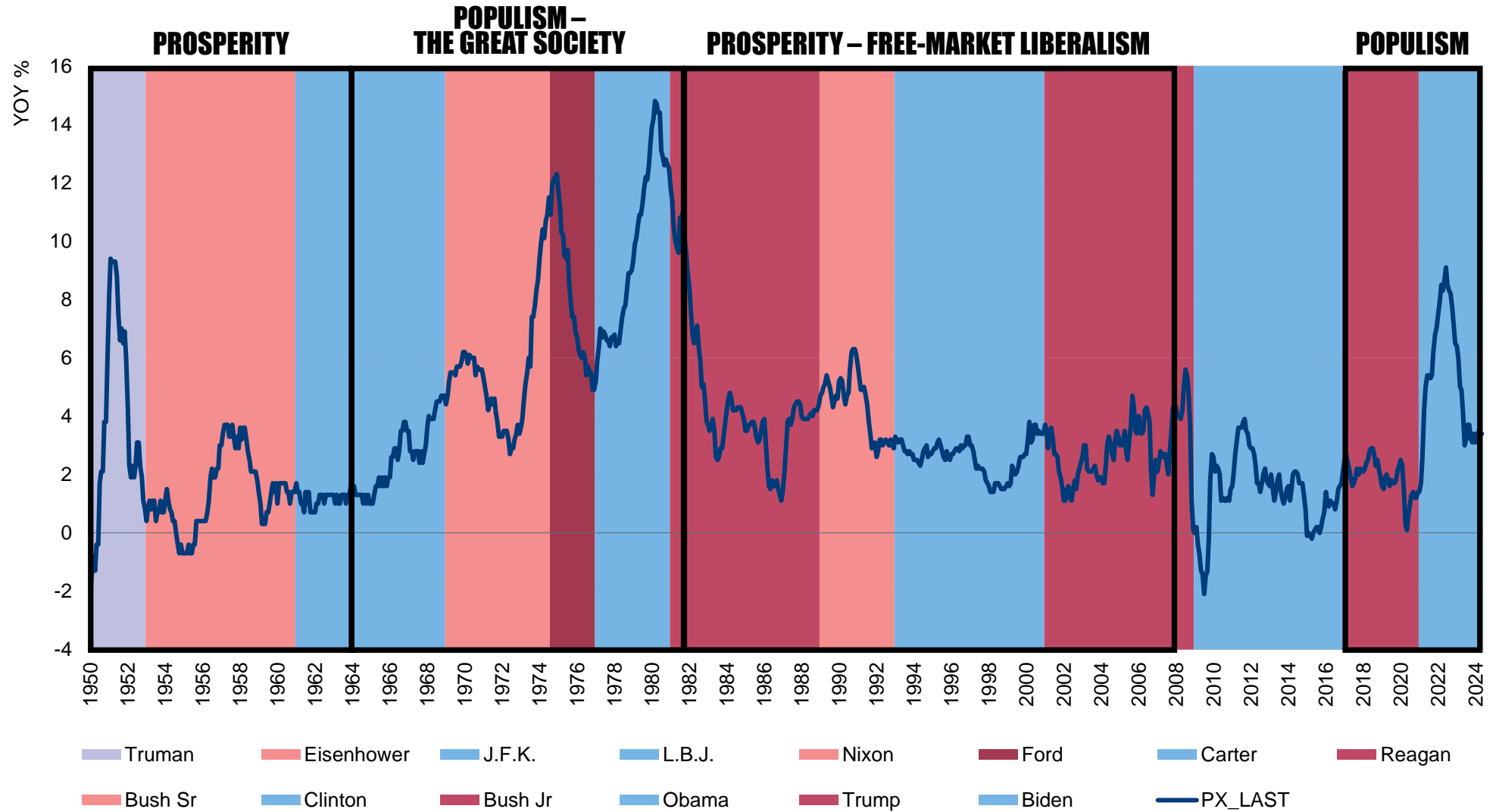
What typically matters for market outcomes post elections is how much the market has worried about the outcome

We're all Keynesians now



The role of government

The populism – prosperity cycle



Source: Bloomberg, 31 May 2024.

From supply-side economics to demand-side economics

IMPLICATIONS

Implications

1

From 'Just in Time' to 'Just in Case'

2

Commodity / resource security

3

Supply chain disruption

4

Onshoring / Protecting and developing strategic industries

5

Increased defence spending

6

More fiscal spending

ALL OF WHICH IS INFLATIONARY

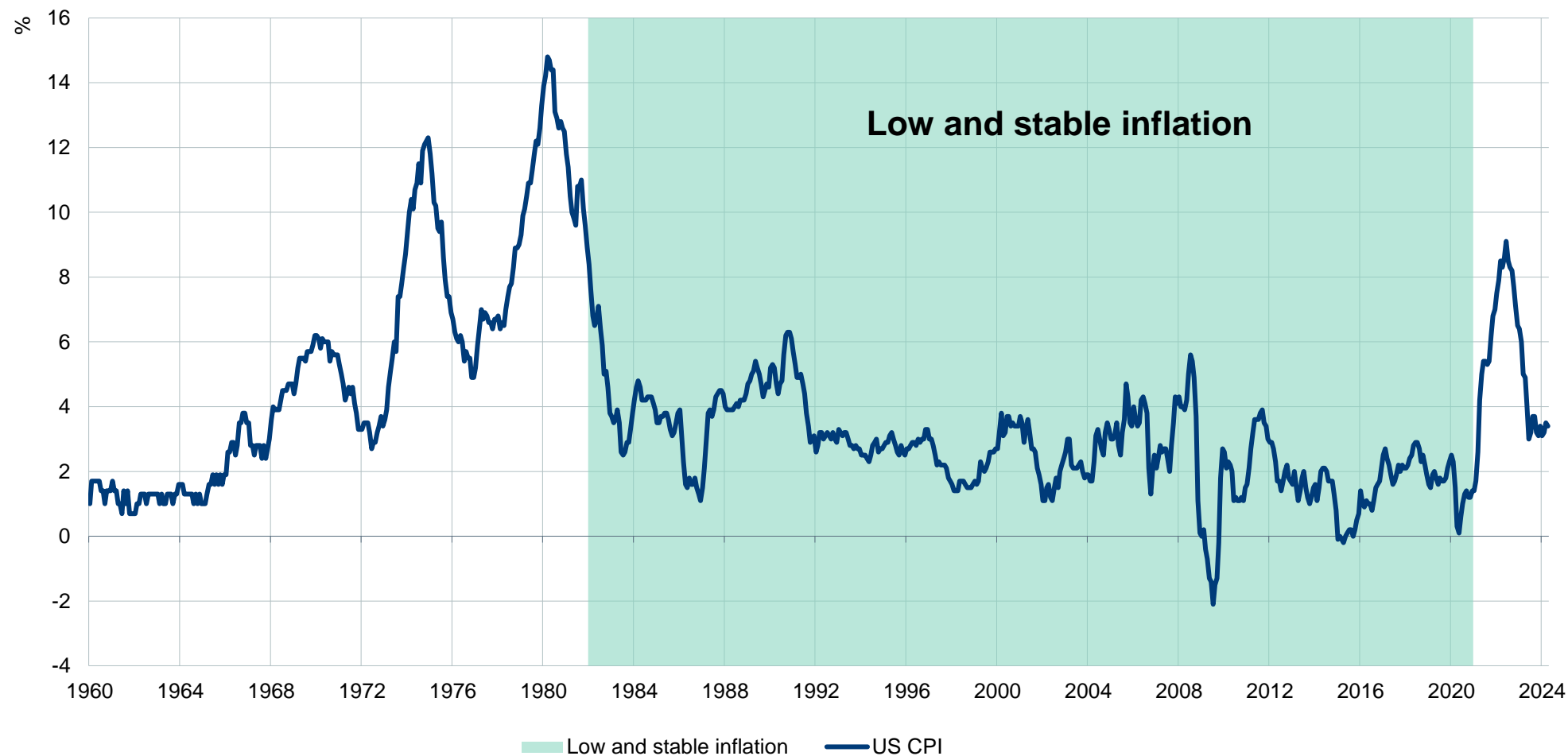


Inflation is likely to be higher and more volatile in the years ahead

REGIME CHANGE

40 years of disinflation over?

US CPI NSA – YoY%

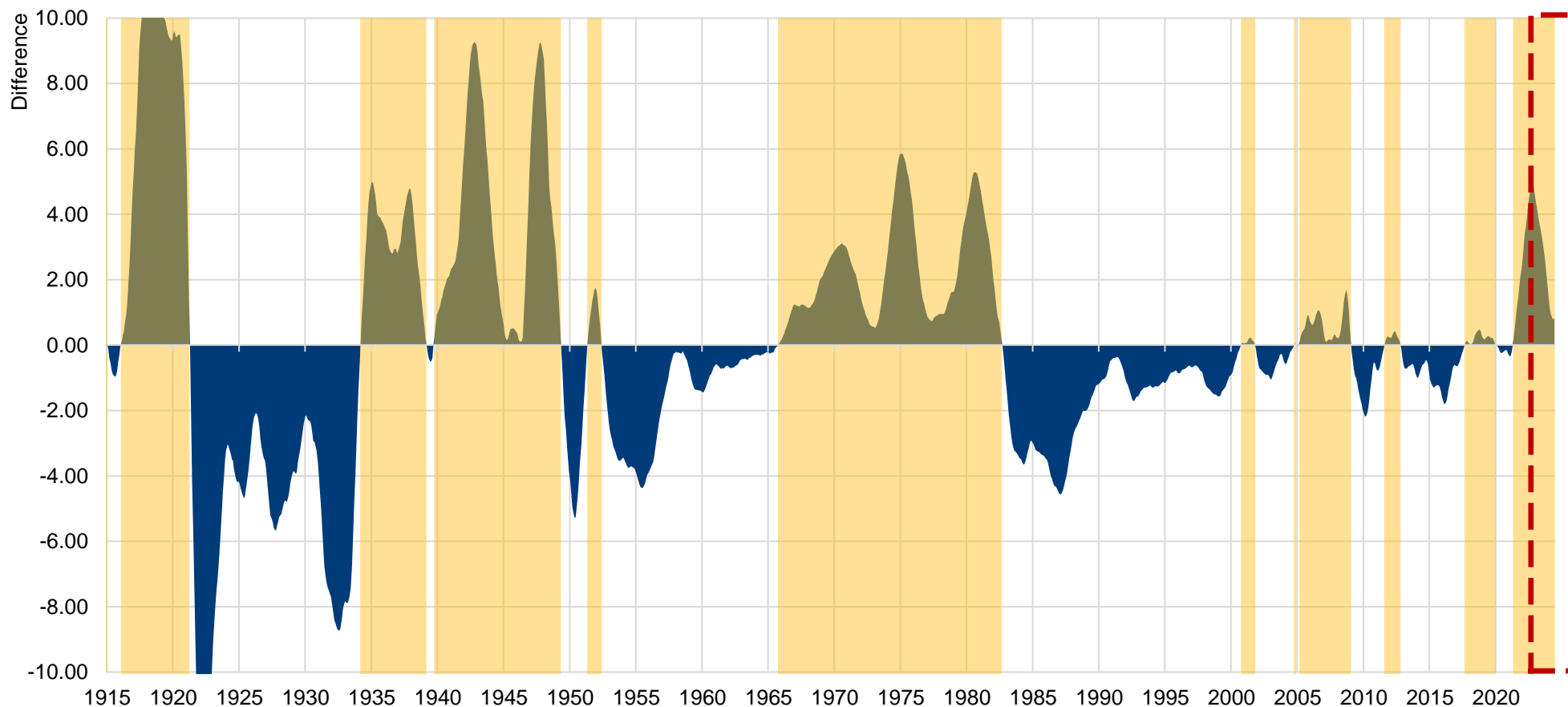


Source: Bloomberg, 30 April 2024.

A longer read of history

The US economy has oscillated between periods of structurally accelerating and structurally decelerating inflation

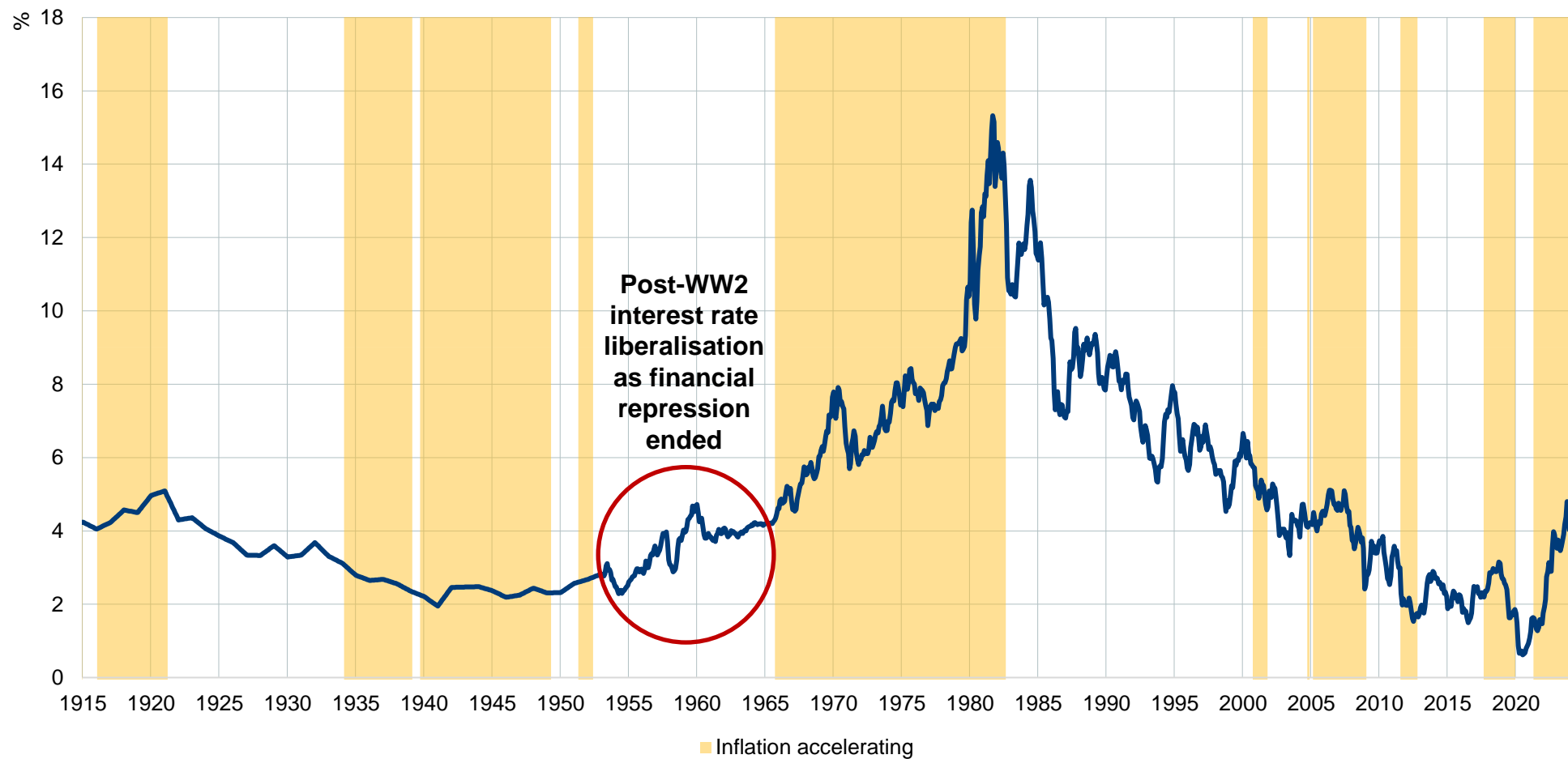
Structural US inflation regimes



Source: Bloomberg, 1 June 2024.

Back to an inflationary regime?

US 10Y yield & inflation regimes



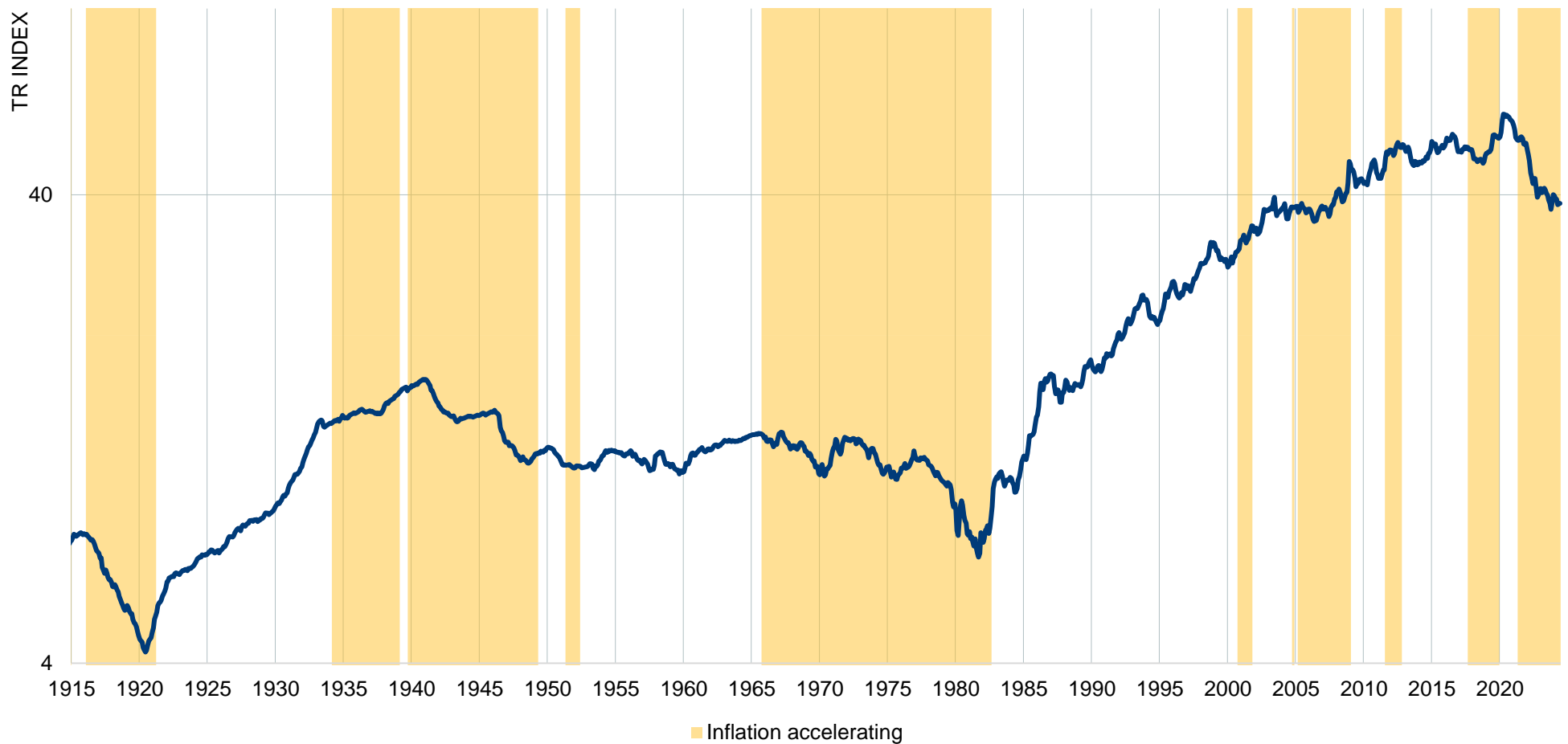
Source: Bloomberg, 1 June 2024.

Long-term interest rate cycles are a feature of history

Fixed Income

Structural bull markets have historically taken place during disinflationary periods

US 10Y constant duration treasury TR (deflated by US CPI) & inflation regimes



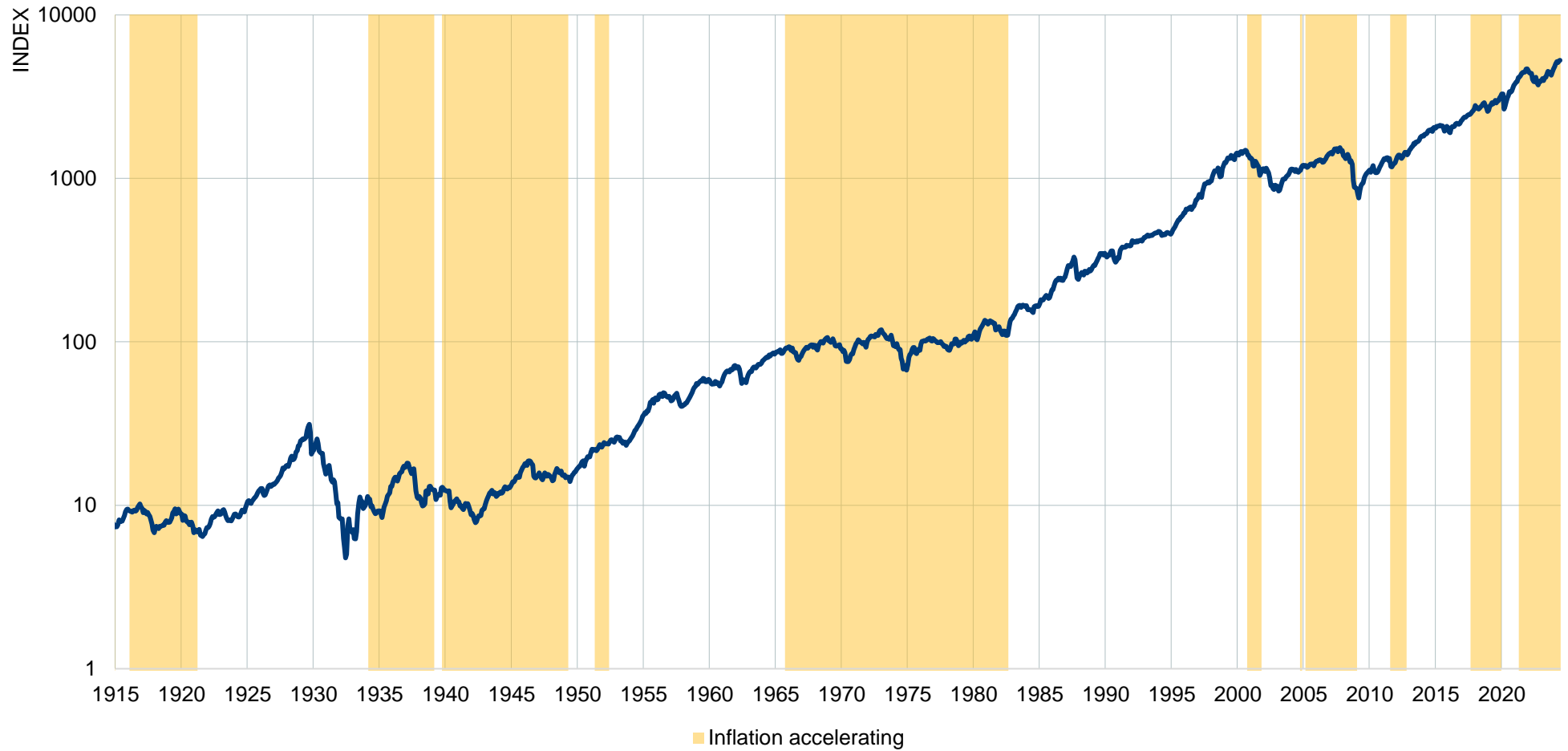
Source: Bloomberg, 1 June 2024.

Long-term interest rate cycles are a feature of history

Equities

Structural bull markets have historically taken place during disinflationary periods

S&P 500 & inflation regimes

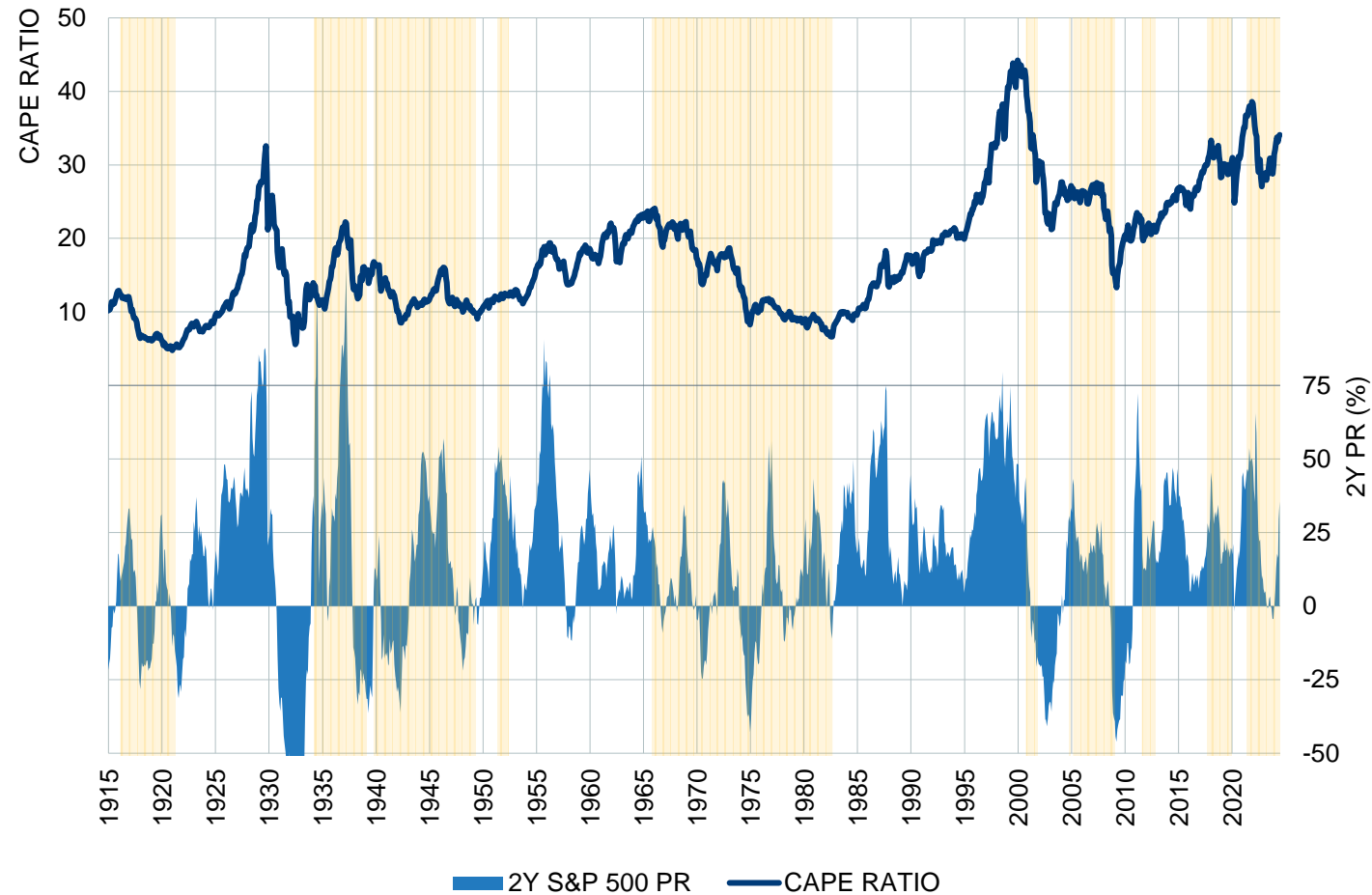


Source: Bloomberg, 1 June 2024.

Equities

Inflation kills bull markets

S&P 500 vs. inflation regimes

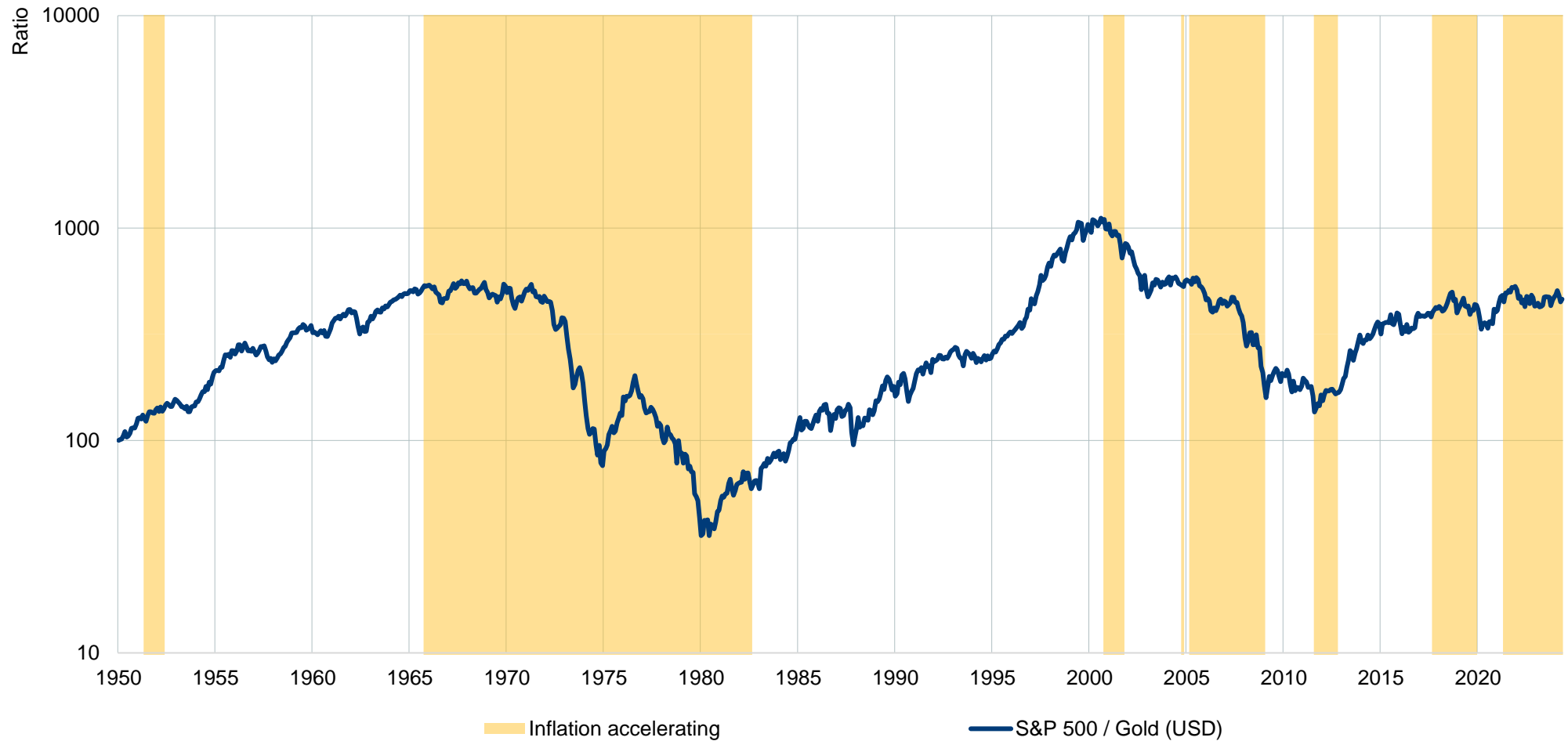


- Inflationary periods have seen deeper and more frequent bear markets versus disinflationary periods
- Since WW2 there are 10 occasions when the 2Y PR has fallen below 0%
- Only one of these (1958) occurred outside of a inflationary period

Commodities

Gold has outperformed the broad equity market during inflationary periods

S&P 500 / Gold (USD) & inflation regimes



Source: Bloomberg, 1 June 2024.

KEY TAKEAWAYS

Key takeaways

1

Geopolitical risk is here to stay

2

Deglobalisation is just getting started

3

‘Populism > Fiscal > Inflation’ cycle in play

4

Entered an inflationary regime in 2021

5

Major consequences for markets

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