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Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

By the Confluence Macroeconomic Team

December 16, 2024

The 2025 Geopolitical Outlook

(Note: This the final* BWGR *of 2024; the next report will be published on January 13, 2025.)

Each December, we at Confluence publish our annual Geopolitical Outlook to give readers a sense of the issues that will likely dominate the international landscape in the coming year. We don't necessarily make predictions in this document. Rather, we aim to alert readers to the probable key issues in the coming year or even beyond. The likely developments we identify aren't meant to be an exhaustive list. We instead focus on the major big-picture conditions that we believe will deeply affect policy and markets going forward. We list the issues in order of importance.

Issue #1: The Next Evolution of American Hegemony

Hegemons — those big, dominant countries that provide global order — have two primary roles. First, they provide global security, which requires them to have the world's most potent military and the ability to project power globally. Such power projection reduces global conflicts (it tends to keep wars regionalized) and protects the global sea lanes for trade. Second, hegemons provide a financial infrastructure that facilitates global trade and payment. As the hegemon provides these global public goods, it must also balance the associated costs and benefits to its citizens. Hegemony creates domestic winners and losers, and hegemonic governments must carefully balance these factors to maintain their superpower role. In 2025, we think it will become increasingly clear that US hegemony has evolved into a new, more nationalist form in order to reduce the costs imposed on the US working class.

European and US Hegemony. Historically, European hegemons were colonial powers. Colonies provided the European hegemons with land for military bases, allowing them to project power globally. Colonies also provided a source of captive demand that allowed the home nation to "dump" its excess productive capacity, facilitating the social balancing needed to maintain domestic support. In contrast, the US is unique in history in that it has provided the hegemonic public goods without colonies. To acquire the global footprint to project power, the US built an extensive alliance system. Washington provided ample economic and security benefits to encourage nations to ally with the US. However, the lack of colonies has complicated America's ability to balance domestic and hegemonic interests. Below is a timeline of the steps the US has taken on its hegemonic journey since World War II:

1. When the US accepted the role of global hegemon after the war, the overt security goal was to contain communism. As advocated by diplomat George Kennan in his famous "long telegram," US leaders worked to stop the spread of communism and simply "wait out" the communists, based on the idea that Marxism as an economic system was unsustainable. The narrative given to the US public was that the threat of communism made the burden of containment and hegemony worthwhile.

In reality, US leaders knew they also had to tamp down longstanding tensions in Europe, the Middle East, and Asia that had dragged the US into two world wars:

- ***Europe*** had been the fount of two world wars because of the intractable "German problem." Germany was too big and vulnerable to be secure in Europe and tended to be aggressive toward its neighbors. The US solution was to effectively disarm the European powers, making them dependent on US security. This resolved the German problem, but the cost to the US was excessive.
- Similarly, ***Japan*** had become a major industrial power despite having almost no natural resources, making it vulnerable to blockades. This prompted Imperial Japan to use military aggression to secure vital resources. The US solved this problem by also disarming Japan and guaranteeing the country access to critical commodities. This not only reduced Japan's aggression, but it also convinced its neighbors that they no longer had to fear Japan.
- In the ***Middle East***, the colonial powers had created pseudo-states whose borders were created without regard to ethnic, religious, or cultural affinities. In fact, groups were often separated by borders to undermine their power. Although the US realized these states were prone to instability, it enforced the existing borders to prevent persistent regional conflicts. Why? It became apparent that the area was rich in petroleum resources and the US was determined to keep them in the hands of the free world.

2. At the Bretton Woods conference on the global postwar financial architecture, Harry Dexter White forced the non-communist world into a gold/dollar hybrid reserve asset/reserve payment model. The dollar was officially linked to gold, and all other currencies in the system had fixed exchange rates against the dollar. White's goal was to preserve some semblance of a gold standard and maintain the US's current account surplus. Also included in the Bretton Woods system were widespread capital controls.
3. In the immediate postwar years, it became clear that the Europeans could not service their dollar-denominated war debts or buy the imports they needed within White's system. The US addressed this problem with an ad hoc response — the Marshall Plan. The US gave Europe massive grants and loans, providing them the dollars to service debt and conduct trade. Although the plan was wildly successful, it revealed a deep flaw of Bretton Woods — if one country is providing the reserve currency and reserve asset, rising global trade would force the reserve-currency nation to run ever-larger trade deficits to supply the currency.[1] The risk was that foreign nations could lose faith in the reserve-currency nation, triggering a crisis. At the same time, if the reserve-currency nation ran a trade surplus, it would contract the global money supply.
4. Although a crisis was avoided for nearly two decades through various patches (currency swaps, moral suasion to discourage nations from demanding gold, etc.), by the early 1970s, the US was facing the unpleasant choice of either policy austerity or closing the gold window. President Nixon chose the latter, ending the Bretton Woods system. The gold standard era also ended, as did

[1] More formally known as the Triffin Dilemma.

fixed exchange rates. Essentially, the dollar/gold standard was replaced with a dollar/Treasury standard.

5. After nearly a decade of financial market stress and high inflation, Federal Reserve Chair Paul Volcker returned confidence into the dollar/Treasury system through a punishing period of monetary austerity. The dollar soared against other currencies and US inflation fell.
   - After the Volcker shock, free world central banks steadily adopted a plan to maintain confidence in fiat currencies. The two elements were central bank independence and a stated inflation target. Monetary policy became independent of the fiscal authorities.
   - At the same time, capital controls were steadily lifted, supporting globalization. Along with globalization, many nations in the West adopted deregulation, which was championed by Prime Minster Thatcher of the UK and President Reagan of the US. The combination of monetary sobriety and supply-side policies tamed inflation.
6. Although the measures deployed in step #5 addressed the inflation problem, the costs of the policy fell heavily on the industrial working classes, especially in the US. The US was able to maintain domestic support for hegemony mostly because of the visceral opposition to communism.
7. In 1989, a stunning development saw the Warsaw Pact nations begin the process of leaving the Soviet security bloc. By 1991, the USSR had dissolved. The West began the process of integrating these nations into the Western trading system. China had already begun market reforms in the late 1970s following the death of Mao. And so, with the unravelling of the communist bloc, China further integrated into the global trading system.
   - A key factor that facilitated this integration was technology, specifically the internet, which allowed firms to geographically separate the planning process from the production process. This development further undermined industrial workers in the West, supporting the offshoring of production to lower cost labor in the newly freed communist bloc.
   - In the wake of the Cold War victory, the US adopted the "Washington Consensus," which stated that it was now evident that there were no alternatives to free market capitalism and democracy. This idea, a facile reading of Francis Fukuyama's *End of History* paper, dominated American foreign economic policy. Free trade and the dismantling of capital controls were strongly encouraged.
8. These policies tended to foster income inequality in the West. In the US, the lower income classes maintained their spending power through borrowing. On the security front, the US supported wars in the Middle East (the First Gulf War) and security operations in the Balkans against Serbia. NATO expanded eastward into the former Warsaw Pact nations. China was allowed entry into the WTO in 2003.
9. On September 11, 2001, al Qaeda terrorists flew commercial aircraft into the World Trade Center in New York and the Pentagon in Washington. In the wake of these attacks, the US invaded Afghanistan, which was harboring the

leader of al Qaeda, Osama bin Laden. The Bush administration later invaded Iraq due to fears that Saddam Hussein was aiding al Qaeda and threatening the US. Both wars became unpopular.

10. As US household debt reached unsustainable levels, the financial system nearly collapsed during the 2008 Great Financial Crisis. Households had heavily borrowed against their homes and when home prices stalled in 2005, the collateral value against these loans fell as well. Homeowners increasingly found themselves "underwater," with mortgages having higher values than the homes that were borrowed against. The financial system aggressively generated these loans to meet the global demand for the reserve asset as globalization and the need for the reserve asset overwhelmed the Treasury market.
11. The steady erosion of economic conditions for the middle class in America, the Great Financial Crisis, and the two Middle East wars soured the American public on hegemony. There was a backlash against the Washington Consensus that culminated in the failure of the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). If these free trade and investment treaties had been enacted, they would have solidified America as the center of global trade. The failure signaled the domestic rejection of the Washington Consensus in the US.
    - This rejection led to a fraying of the American political system, which has been expressed by the election of unconventional presidential candidates Barack Obama and Donald Trump. Both overcame solidly establishment candidates in their primaries and general elections, with Trump being elected to two non-consecutive terms for the first time in 130 years.
    - The American political establishment is rapidly falling out of favor with voters, causing a re-sorting of coalitions within the two-party system, which remains in flux.
    - The rejection of globalization as practiced in the post-Cold War era is leading to support for both trade restrictions and immigration controls.

For regular readers of our geopolitical reports, the above timeline will look familiar. For over a decade, we have been discussing this issue and warning investors that the breakdown of the US global postwar order will have serious implications for markets and asset prices. ***We believe the US has reached a critical point where some sort of resolution to the breakdown of the postwar order is accelerating.*** In a sense, this evolution could represent the third major iteration of US hegemony, with the first being Bretton Woods and the second being the Nixon-to-Volcker transition from a gold to Treasury standard. Although we don't know with certainty what it will look like, some contours are starting to emerge. We expect that whatever resolution emerges, it will have elements of the following:

More Military Burden Sharing. Militarily, the US is going to demand more from its allies in terms of defending themselves. Much of this is due to intergenerational forgetfulness. The Greatest Generation, born before 1928, represent only 0.1% of the population as of 2023. The Silent Generation, born during 1928-45, represent 4.9%. Thus, only 5% of the population has direct experience with World War II. Even the baby boomer generation is down to

20.9%. With approximately 95% of the American population lacking a direct connection to World War II, the rationale behind the structure of the postwar period is fading rapidly. Thus, most Americans don't really understand why the US should be cautious about allowing Europe or Japan to provide their own defense. Therefore, the trend toward foreign powers taking on larger defense burdens will likely grow, and the US will have less influence to dictate policy to our allies.

- This doesn't necessarily mean the US is turning isolationist, but it is a much different foreign policy position than what existed after World War II.
- The US will do more "leading from behind," as President Obama tried to do when the US and its allies ousted Muammar Gaddafi from Libya. The US has provided arms and intelligence to Ukraine but has refrained from contributing to "boots on the ground." This pattern will likely expand, at least until or if the US faces a direct military threat.

More Trade Barriers. The US will also likely "gatekeep" access to the US consumer, which means foreigners will be forced to expend more resources to acquire access to the dollar/Treasury system. This will likely mean forms of capital controls along with tariffs. The BRIC nations have been trying to construct a payment system that doesn't use dollars for payment and Treasurys for the reserve asset. So far, the results have been disappointing.

If we are correct in this assessment, some of the economic and market ramifications are as follows:

- US inflation will likely be higher. Foreign nations will still try to export goods to the US to acquire dollars, but tariffs and other trade barriers will boost the price of those goods, meaning consumers will likely pay more.
- Profit margins could be narrowed in some categories. If a product is mostly supplied from abroad but is also price elastic, then providers may simply not be able to fully pass on the cost of trade interference.
- The US will likely build industrial capacity, which will boost growth through higher investment and lift industrial employment. However, it is unlikely that industrial employment will ever return to earlier levels due to automation.
- How inflation will affect the financial markets is unclear. The usual outcome is for higher long-term interest rates. However, if the Fed is given the task of mitigating the rise in long-duration interest rates, the dollar could weaken. Although the general rule is that higher inflation also weakens equities, financial market deregulation has reduced investment costs to the point where equities might be an inflation hedge. Thus, the demand for stocks could remain strong. Commodities and debasement hedges (gold, crypto) should benefit as well.

This issue deserves a wider treatment, and we intend to do so in 2025. However, we view the election of President Trump as an accelerator of these trends, which is why it is included in our 2025 Outlook.

— BOG

Issue #2: Less Cohesion in the US Bloc, More Cohesion in the China Bloc

We have long discussed how the US-China rivalry is prompting a fracturing of the world into relatively separate geopolitical and economic blocs. We've noted that the evolving US bloc basically consists of today's rich, highly industrialized, technologically advanced liberal democracies and a few closely related emerging markets. The evolving China bloc is largely made up of less developed, authoritarian commodity producers, the most important of which are China, Russia, Iran, and North Korea. We've highlighted how the Biden administration tried to bolster the US's many multilateral and bilateral alliances within the US bloc, while the China bloc was a looser, less coordinated group. In 2025, we think a key trend will be weakening cohesion within the US bloc and increased cohesion among members of the China bloc.

If the US bloc does suffer stress fractures, one likely cause would be the incoming Trump administration's push for Japan, South Korea, and the non-US countries in NATO to hike their resource commitments to defense. Of course, every military alliance argues over burden sharing and has to guard against free-riding. Trump is, therefore, probably right to push the US's allies to spend more on their own defense. The risk is that cutting the US share of allied defense spending too much could reduce US influence and leadership over its allies. That would be especially likely if pressure from the US forces its allies into disruptive fiscal adjustments, or if US pressure is seen as merely "squeezing" its friends for its own purposes. If the US overplays its hand on defense spending, or on its threat to impose big import tariffs even against its friends, the allies could decide to distance themselves from the US, perhaps by cozying up to China and other US adversaries or perhaps by developing their own nuclear weapons.

A more certain development that is already observable is that China, Russia, Iran, and North Korea 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.

Less cohesion in the US bloc and more cohesion in the China bloc will likely set the stage for a further spiraling of tensions between the groups, leading to more global fracturing, more supply chain disruptions, additional upward pressure on inflation and interest rates, and more pressure for increased defense spending outside the US. That should be good for stocks in the industrial, basic materials, and energy sectors, and especially for non-US defense firms and producers of goods and services with dual civilian or military uses.

— *PFH*

Issue #3: China's Economic Growth Slows Further, But Not Its Military

With its extraordinary growth over the last quarter-century, China now has the world's second-biggest economy. While the US gross domestic product (GDP) totaled $27.4 trillion in 2023, China's GDP came to $17.7 trillion. Adjusting for the purchasing power of the yuan (CNY), China's economy is bigger than that of the US, making it a key source of supply, demand, and capital for the global economy. Just as in 2024, we think China's economy will continue to struggle against big, new structural headwinds in 2025, while the government will remain too timid to spark a return to fast growth. China is unlikely to be the engine of global growth that it once was, and its lethargic demand will have negative implications for economic growth, commodity demand, and financial market performance around the world.

The new economic headwinds facing China are now well known and include weak consumer ***demand***, excess capacity and high ***debt***, poor ***demographics***, the ***disincentives*** arising from Communist Party intrusions into the market, and ***decoupling*** by the West. In 2024, it became clear that General Secretary Xi and his government remain ideologically opposed to the kind of consumer stimulus that is probably needed to rekindle fast growth. The stimulus moves it did introduce in 2024 were little more than conventional monetary easing, incentives for consumers to replace appliances, and steps to help provincial and local governments modestly cut their interest payments.

Despite China's slowing economic growth, the government continues its rapid military buildup to challenge the US bloc. According to the latest figures from the respected Stockholm International Peace Research Institute, Chinese defense outlays have risen at an inflation-adjusted average annual rate of 4.5% over the last five years versus a growth rate of just 2.0% for the US. China not only has the world's largest navy now, but it continues to expand it along with its conventional and nuclear missile force.

China's increased cooperation with other authoritarian states and its continued strong investment in its military forces will likely further raise tensions with the US and its allies. China's fast-growing military power and weaponization of its commodity resources against the US will likely prompt even faster global fracturing, investment in the US's domestic mineral resources and manufacturing, and US re-industrialization. That should give an added boost to US large cap and small cap stocks in the Industrials and Materials sectors and Asian and European defense stocks. China's quickly expanding nuclear weapons arsenal is also likely to boost spot uranium prices and uranium miners. *— PFH*

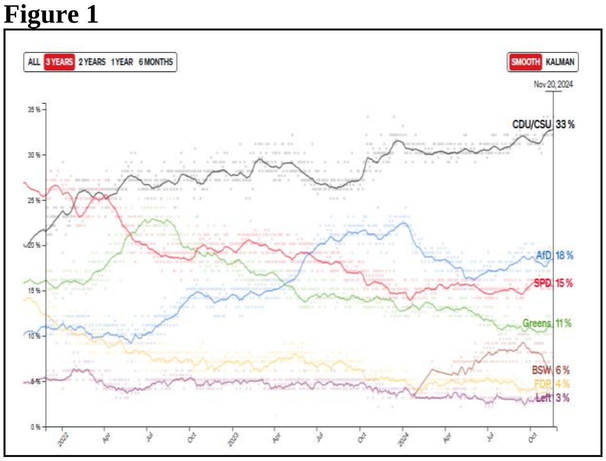
Issue #4: European Politics Shift Further to the Right

As discussed in Issue #1, Europe is facing a populist backlash similar to the US. The recent signs of populist revolt in Europe include Brexit, populist governments in Hungary and Italy, and the near rise of Le Pen in France last year. This is all evidence that, as in the US, Europeans are rebelling against the political establishment.

So far, Germany has avoided having a populist government at the federal level, but that could change when the country holds its general election on February 23. In current polls, Germany's center-right Christian Democratic Union (CDU)/Christian Social Union (CSU) has a large lead over the other parties (see Figure 1, next page). However, none of the major parties have been willing, so far, to partner with the far-right

Alternative for Germany (AfD) party. If the current polling is accurate, a CDU/AfD government would have a majority, but without the AfD, the CDU would need to cobble together a CDU/Social Democratic Party (SDP)/Green coalition, which would probably be unworkable. Germany's proportional representation system requires a party to garner 5% of the vote to gain seats in the legislature. Thus, the Sahra Wagenknecht Alliance (BSW), Free Democratic Party (FDP), and the Left Party are on the brink of exclusion. It's becoming clear that, at some point, the AfD will need to have a place in the government to build a stable coalition.

Figure 1



(Source: Politico)

The centrist parties view the AfD as a neo-fascist party. Its manifesto suggests it is anti-EU, anti-euro, anti-immigrant, and anti-globalist. Most German voters don't support these positions, but there is a large minority that does, and that minority at some point may well force the German political system to accommodate its concerns.

Given Germany's leadership role in the EU and the eurozone, a party that wants to reduce involvement in these bodies would be significant. This is why the mainstream parties have viewed the AfD as an anathema. The February vote could force a political crisis in Germany and the EU just when the US will be increasing pressure on Europe regarding defense and trade. We could see the SPD and CDU try to build another "grand coalition" government, but the SPD has found that earlier versions of this arrangement deeply weakened its own popularity. Another alternative could be that the CDU governs as a minority party and will try to fashion legislation to attract votes from other parties. History suggests, however, that such minority governments have short lifespans. If Germany faces a crisis after the February vote, we expect it would be bearish for the euro (EUR) and European equities. *— BOG*

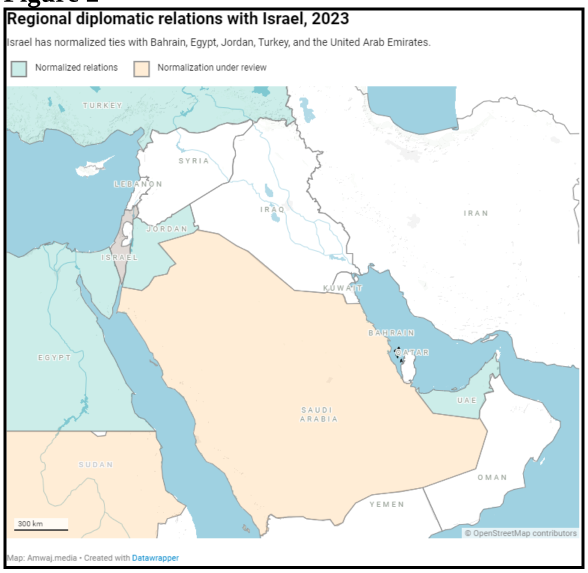
Issue #5: The Middle East Struggles to Regain Peace

As we've written before, the Middle East is riven with geopolitical fault lines that can trigger conflict at any time, often with little to no notice. In his second term, President-elect Trump will likely seek to calm some fault lines, while applying pressure to others. Meanwhile, the major players of the region have agendas of their own. As always, these initiatives will have a combined impact on the price of oil.

Trump's Middle East Goals. We expect that the new administration's Middle East policy will prioritize regional stability and deal-making where possible, especially regarding Iran and the ongoing conflicts in Gaza and Lebanon. Trump wants to cement his legacy as the consummate dealmaker and establish the kind of stability that would let his administration focus on other parts of the world. The three main lines of effort will likely be firm support for Israel, more Abraham Accord-type deals normalizing relations between Israel and other countries in the region (with Saudi Arabia the top priority), and maximum sanction pressure on Iran. It has been said that Trump wants a

Palestinian deal, but he does not care what sort of deal, just so long as it gets done.

Figure 2



(Source: Amwaj Media)

Likely Pushback by Key Players. The Middle East has changed in the four years since Trump's first term ended: Israel has gone on the offensive; Saudi Arabia and other Persian Gulf states have engaged with China to hedge their bets against US withdrawal; Iran has suffered economic stagnation and military humiliation; and Turkey has advanced its position as an intermediary in various relationships. Therefore, while we've seen a range of positive reactions from regional leaders to Trump's election victory (even from Palestinian leaders), we don't expect them to simply conform to Trump's initiatives. For example, Trump has told Israel that he wants the Gaza conflict ended by Inauguration Day. However, Israel's leadership has maintained its commitment to do whatever it takes for however long it takes to achieve its goals. Meanwhile, Iran has expressed a willingness to negotiate, and although it has unilaterally suspended its uranium enrichment activities as a sign of goodwill, it has staunchly stated its right to develop nuclear technology. Moreover, its support of the Russian war effort in Ukraine continues. Saudi Arabia is also holding its ground concerning its own requirements in the Israeli-Palestinian conflict and in its relationship with China. In sum, we expect engagement mixed with firm pushback from regional leaders as they drive their own hard bargains.

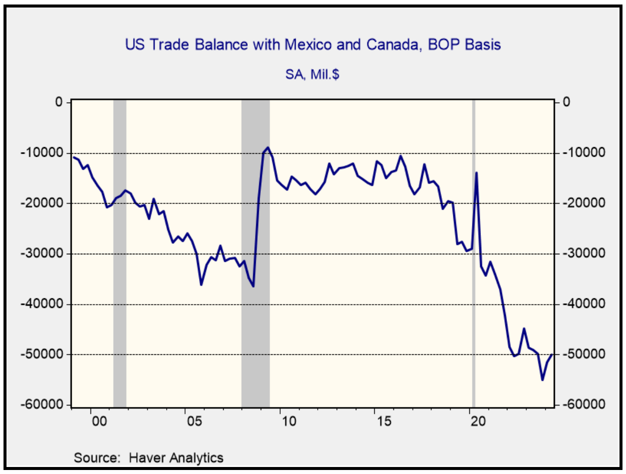
Impact on Oil Prices. We expect regional developments to cause volatility in oil prices in 2025, but we don't expect a sustained rise in prices. Unrest in the Middle East can cause sudden movements in oil prices, but we think factors outside the region will continue to keep a lid on prices. On the supply side, we expect US oil production, which has become the highest in the world, to remain roughly at current levels, while OPEC will continue to seek an opportunity to reverse its earlier production cuts and regain market share. On the demand side, we expect weakness in Chinese oil consumption driven by disappointing economic performance and a strong transition to electric vehicles. — *DO*

Issue #6: Canada and Mexico Adjust to Trump 2.0

As the US's two largest trading partners, Canada and Mexico will face a significant test in 2025. President-elect Trump has threatened to impose 25% import tariffs on both countries unless they curb drug trafficking and illegal immigration into the US. While tensions have since eased, the incident underscores the incoming administration's strained relationship with its North American neighbors and its willingness to use grievances for justification to alter the current trade arrangement.

Since the North American Free Trade Agreement (NAFTA) was modified to become the United States-Mexico-Canada

Agreement (USMCA) in 2018, both Canada and Mexico have expanded their trade surpluses with the US. This change has been especially pronounced for Canada, which shifted from a relatively balanced trade position before the coronavirus pandemic to its largest surplus with the US in nearly 20 years. Meanwhile, Mexico already exports more to the US than China, which has the largest trade surplus with the US.



The widening trade surpluses of Canada and Mexico versus the US have created an uncomfortable situation as the three countries prepare for the 2026 review of the USMCA. Next year, US officials are expected to conduct an internal review of the deal as the three countries start trying to decide whether to extend it for another 16 years. To extend the agreement, each party must submit a written notification of approval on or after the review date. They would have until 2036, when the deal expires, to come to an agreement.

The incoming Trump administration has expressed dissatisfaction with the current terms of the USMCA, but we remain hopeful that a mutually beneficial deal can be reached. Beyond border security concerns, the incoming administration is urging Canada and Mexico to adopt a more stringent approach toward China, aligning with US policy. The US is also likely to push for protections against changes to Mexico's judiciary system. If the sides are unable to avoid a trade dispute, investors are likely to seek refuge in the dollar while selling off the Canadian and Mexican currencies. — *TW*

Odds & Ends

The ***US dollar*** will likely remain strong versus most other currencies, especially if the US applies stiff import tariffs and/or US economic growth remains strong (but yield curve control by the Fed would weaken the greenback). … The ***emerging markets*** could face economic and financial strains due to the strong dollar and continued high interest rates. … ***Russia and Ukraine*** are expected to engage in peace negotiations by year's end, but both sides are likely to become more aggressive in the run-up to these talks.

Ramifications

Our regular readers will note that many of the economic and investment implications presented in this report are consistent with our past forecasts. Our view of US hegemony has evolved, but it and most of the other issues discussed here largely reflect the same rise of nationalist populism, global fracturing, and heightened geopolitical tensions that we've foreseen for some time. In 2025, as in recent years, some investors may be tempted to shut their eyes to this chaos and risk, but we don't think that's a good investment strategy. Rather, we think it's far better to face the world as it is, assess the risks and opportunities, and invest accordingly.

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Confluence Investment Management LLC

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