A Primer On Geopolitics And Investing

Methodology

One of the standard definitions of ‘risk’ in finance is the probability that the actual return on an investment varies from the expected return. Geopolitical risk is no different. It boils down to the deviation from an expected outcome. BCA's Geopolitical Strategy employs this definition to assess the geopolitical landscape, while emphasizing three frameworks:

- **Overstated/Understated Risks**: Risk can be overstated (a ‘red herring’) or understated (a ‘blindside’), thus orienting geopolitical risks relative to investor positioning.

- **Exogenous/Endogenous Risks**: Geopolitical risk can be exogenous to the investment view and driven by events (tail risks or ‘black swan’ events), or it can be endogenous, such as a political assumption underpinning an investment view.

- **Scenario analysis**: All forecasts are probabilistic; scenario analysis assesses the investment implications of various possible outcomes.

**Overstated And Understated Risks**

Geopolitical risk can therefore be either something ‘bad’ (terrorist attack) or something ‘good’ (resolution of the euro area crisis), thus it is relative to market expectations and investor positioning. When the market overstates risk, we refer to it as a red herring (i.e., the euro area crisis). When the market underestimates risk (i.e., emerging market political risks), we refer to it as a blindside. Both types of risks can be devastating to investors.

Investors rely on the media to gain insight into geopolitical and policy risk. There is no Bloomberg terminal for geopolitics. However, the media, often sensationalist and always biased, is not concerned with investor profits, but with selling newspapers and advertising. Many geopolitical risks, therefore, are often overstated or misstated due to the media’s tendency to err on the side of red herrings and sensationalism.¹

Exogenous And Endogenous Risks

One mistake investors often make is that they treat geopolitical risk as separate from the economic/financial analysis that produces their view. Geopolitical risk analysis is thus post-hoc, or perhaps even an optional exercise.

The fashionable term, ‘tail risk,’ captures this approach. Tail risk refers to event risks that emerge from the ‘tails’ of the normal probability distribution curve. These are low probability, high-impact events that throw an investment view off course. Conceptually, these risks are treated as exogenous to the investment view; they waylay investors’ macroeconomic/fundamental analysis with little forewarning.

Geopolitical risk, however, does not usually ‘fall out of the sky.’ It is often endogenous to an investment strategy because investors make unconscious political assumptions when they formulate their market views. The bullish yen view, for example, assumed that there was political support for deflation in Japan due to its demographic characteristics, which limited the BoJ’s ability to reflate aggressively. A bearish view of Europe assumed that the ECB had a Bundesbank DNA that prevented it from doing “whatever it takes” to assuage the sovereign debt crisis. And a view that American policymakers will ultimately agree on the debt ceiling assumes that the electoral process favors compromise.

Geopolitical Strategy treats geopolitical/policy variables as endogenous to investment views, not simply as exogenous ‘tail risks.’ Key political assumptions underpinning major investment views have often not been updated for decades (the Japan example above), or are outright incorrect (the ECB example). Getting these assumptions wrong can be just as costly as missing tail risks.

Scenario Analysis

Geopolitical Strategy views all forecasts as probabilistic. By citing probabilities, we emphasize the inherent uncertainty of social science.

Investment relevant geopolitical analysis uses a three-step process. First, the analysis states the possible outcomes. Second, probabilities of the various outcomes are determined. Third, scenario analysis derives the investment implications of each possible outcome, paying close attention to how the market is currently pricing risk.

The goal is to provide investors with a scenario analysis that highlights three factors:

- **Probabilities** of different outcomes
- **Catalysts** (events, dates, or political/economic variables) that could change those probabilities
- **Implications** for investors
Analytical Framework: Constraints To Action

Geopolitical Strategy emphasizes structural constraints to policy action. We concentrate on what policymakers can do, not what they say they will or want to do.

By focusing on what is possible given existing structural constraints, we reduce the realm of the probable. Constraints can be geopolitical, social, economic, or political. This forms the starting point of our analytical approach, but as we descend lower from the high altitude of structural analysis, we employ whatever method is most appropriate to answer the question at hand.

The goals and methods of geopolitical investment analysis are most similar to those of intelligence analysis. Both have to contend with:

- The real world, not a ceteris paribus theoretical world;
- Incomplete information;
- Limited time in which to make a forecast;
- Scenario analysis in order to gauge the impact of all outcomes, not just the favored forecast.

The key difference is that the principal client for Geopolitical Strategy is not a national government, but our client base in the investment community. In other words, there is no national bias. We adopt an attitude of aloof indifference to the national, normative, ideological, and moral questions of the day.

Multipolarity And Investing: What Does Our World Look Like Today?

A central theme of BCA Geopolitical Strategy is the rise of global multipolarity. Multipolarity implies that the number of states powerful enough to pursue an independent and globally-relevant foreign policy (so-called ‘great powers’) is greater than one (unipolarity) or two (bipolarity). Today, multipolarity is the product of America’s decaying unipolar moment, which lasted for two decades following the Cold War. But multipolarity may be temporary, a transitory state between the post-Cold War era, and either an even greater unipolar hegemony (of perhaps a rising China or a revitalized America) or, more likely, a world of balancing coalitions.

Most International Relations (IR) theorists consider multipolarity to be unstable and more likely to produce military conflict (Chart 1). There are three main reasons:

- During periods of multipolarity, more states can effectively pursue foreign policies that lead to war, thus creating more potential “conflict dyads” in IR parlance;
- Power imbalances between states are more likely if there are more states;
The probability of miscalculation rises due to the number of relevant states making decisions simultaneously.

The “offensive realism” school of IR theory further splits multipolarity into two types: unbalanced and balanced:

- Balanced multipolarity is characterized by a number of (roughly) equally powerful states (along the lines of continental Europe during the 19th century ‘Concert of Europe’ era).

- Contemporary geopolitics, however, approximates unbalanced multipolarity. In *The Tragedy Of Great Power Politics*, the father of offensive realism, John Mearsheimer, reviews 200 years of European history and concludes that unbalanced multipolarity is by far the most volatile geopolitical system (*Table 1*).

When countries are confronted with an unbalanced multipolar system, they are more likely to choose a strategy of “balancing” over “buck-passing.” Buck-passing is a passive strategy that transfers the burden of containing a potential rival to a third power. Balancing, on the other hand, is a more engaged strategy of actively propping up an ally – including fighting wars and stationing troops.

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abroad – against a rising power. At its extreme, balancing produces large alliance blocs, as the immediate years before both World Wars illustrate.³

Thus far, the U.S. has engaged in serial buck-passing rather than active balancing. The reasons why are multiple, from domestic war fatigue to the realization by Washington that it is no longer able to dominate global affairs. President Obama’s doctrine of ‘leading from behind’ effectively involved (and continues to involve) buck-passing to the Europeans on Libya, to Saudi Arabia and Turkey on Syria, to military allies in East Asia on China, and once again, to the Europeans on Russia amid the latest crisis in Crimea. However, these attempts are likely to fail (and have, for the most part, already failed) because the powers that the U.S. is passing-the-buck-to are unwilling or unable to contain the relevant potential regional hegemons by themselves. Furthermore, buck-passing reduces the control that Washington has over what the allies eventually do with the passed buck, leading to unintended consequences that are potentially more dangerous than direct balancing. An example would be a crisis in East Asia created by Japan’s insecurities due to America’s wavering commitment to the region.

Our view is that the buck-passing is eventually going to stop. Crises such as the annexation of Crimea by Russia and a potential military skirmish in East Asia – which we consider to be an understated risk by the markets⁴ – will prompt both the U.S. and its allies to recommit to an active balancing strategy, rather than a buck-passing strategy. When this happens, the world will begin to slowly resemble the geopolitical backdrop of George Orwell’s 1984, bringing to life the famous phrase repeated throughout the novel that “Oceania was at war with Eurasia and in alliance with Eastasia.”⁵

The future is obviously uncertain, but we believe that three trends will emerge out of this multipolar narrative:

³ World War I was preceded by the balancing coalitions of the Triple Entente (France, Russia, and the U.K.) and the Triple Alliance (Austro-Hungary, Germany, and Italy), while World War II was preceded by the balancing coalitions of the Tripartite Pact (Germany, Italy, and Japan), more commonly referred to as the Axis Powers, and the Allies (the Soviet Union, the U.K., and the U.S.).


⁵ Moscow’s attempt to institutionalize its sphere of influence is called the Eurasian Union, ironically harking back to the fictional backdrop of Orwell’s 1984.
The Return Of Europe: European integration, which includes but is not exclusive to the euro’s survival, has its own geopolitical logic in a multipolar world. With the U.S. in relative decline, the Europeans can no longer buck-pass their security responsibilities to Washington. The U.S. has already

proven to have a low appetite for military engagements in Europe’s environs (in Libya, the U.S. “led from behind;” President Obama failed to enforce Washington’s “red line” in Syria; and the U.S. has stood largely pat after Russia’s interventions in Georgia and Ukraine). The rise of emerging economies also means that Europe’s foremost ‘hard power’ tool, its relative economic weight, is in precipitous decline (Chart 2). The only thing that Europe needs for further integration is an enemy, the “other” against whom to focus its integration. On that front, Russian President Vladimir Putin may end up being as critical for the EU’s perseverance in the 21st century as Jean Monnet was in the 20th century.

> **Japan’s Paradigm Shift:** The relative decline of the U.S. and simultaneous rise of China is most immediately relevant for Japan (Chart 3). Tokyo can no longer rely on the overwhelming power disparity between Washington and China for security. It will therefore deepen its ties with the U.S., but also look to rally other China-wary Asian states while pursuing its economic revival policies with an existential zeal. In other words, don’t fight the BoJ (they have more than price stability on their mind)!

> **China-Russia Alliance:** On the other end of the spectrum is the budding ‘Eurasian Axis.’ Russia and China will be pushed into each other’s arms due to the respective balancing strategies of America, Europe, and East Asia. China possesses ample savings, a budding middle class, and an insatiable appetite for commodities. Russia has the investment needs that would be well served by China’s savings pool, and the military and nuclear technology, as well as the commodities that Beijing requires to become a global superpower. Can the two overcome nearly a century of enmity, suspicion, and territorial competition to create a viable balancing coalition to the containment perimeter being built around them? We think they can.7

What does a world of balancing alliances look like for investors?

The danger is that the competing geopolitical blocs may become large enough to undermine economic and financial globalization. A ‘Eurasian bloc’ that includes China with a large pool of savings and a sizeable middle class, combined with Russia and its massive natural resources may not need as much interaction with the rest of the world as its constitutive members require today.

China and Russia certainly have plenty of reasons to consider eroding globalization on some level, particularly as the U.S. and Europe continue to flaunt financial pressure and economic sanctions as geopolitical weapons. Beijing has definitely noted that the U.S. Securities and Exchange Commission reached out to mutual funds and exchange-traded funds that have investments in Russia early in the Ukrainian crisis, warning them of potential geopolitical risk-induced losses; and that White House Spokesman Jay Carney offered his investment advice regarding the ownership of Russian stocks (“I wouldn’t, if I were you, invest in Russian equities right now – unless you’re going short”).

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7 Please see BCA Geopolitical Strategy Special Report titled “The Embrace Of The Dragon And The Bear”, published April 11, 2014, available at gps.bcaresearch.com
If the world does begin to mirror Orwell’s *1984*, why would Beijing further deepen its financial relationship with the West? So that a future Jay Carney can offer his or her asset allocation strategy for Chinese equities?

Getting from today’s world to a world of balanced geopolitical blocs will be a messy process. Free agents (such as India, Pakistan, Iran, Egypt, etc.) will be lured with entreats from both sides, while border zones (South East Asia, Middle East, Eastern Europe, Caucasus and potentially Africa) will become sources of instability. We want to place our bets on countries that will play both sides of the divide (Pakistan and Iran, in particular),\(^8\) while avoiding regions that will provide battlefields for proxy wars, as is the case with Syria and Ukraine.

The world is entering a period of general geopolitical disequilibrium that will likely require higher risk premia across asset classes and will be distinguished by market volatility. This is an era standing in stark contrast to the “Great Moderation,” which was characterized by relative geopolitical and policy stability that ultimately lulled investors into a false sense of confidence regarding non-economic market risks (Chart 4). Economists have proposed many reasons for the low-volatility era between 1985 and 2008, most of which are unsurprisingly rooted in the discipline they study: deregulation of the financial markets, prudent fiscal management, and inflation-anchoring by independent central

banks. However, none of those policies would have been possible without a dramatic reduction in geopolitical tensions and risks, which underpinned macroeconomic stability from the mid-1980s onwards in the first place.

**Bottom Line:** Geopolitics have never ceased to influence the markets. It has simply shifted from being a tailwind to investors – a role it played during the Great Moderation era characterized by American unipolarity – to a headwind today. An unbalanced multipolar world is an unstable world. The fortunes of states will rise and fall by where and how they fit in the upcoming global rebalancing, which will force investors to grapple with geopolitical questions far more than they did during the Great Moderation.

**Monetary Policy: A (Geo)political Perspective**

Inflation has provided a policy anchor for monetary institutions for almost half a century. The post-World War II era was beset with a number of dramatic inflationary episodes (Chart 5), leading to the intellectual consensus that price stability was the *primus inter pares* mandate of central banks. Inflation is a measurable and objective concept, allowing monetary institutions to remain as aloof as possible of political pressures.

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What if inflation is no longer a viable policy anchor?

Several of our colleagues at BCA have written extensively about the global “savings glut.” BCA’s Chief Global Strategist, Chen Zhao, has focused on this theme since 2012, and we recommend clients read his latest piece on the topic.\(^{10}\) Chen makes the point that global aggregate demand has been growing much more slowly than the aggregate supply. There has been an enormous rise in savings as a share of world GDP and a simultaneous decline in global inflation, implying that the growth in savings has primarily accommodated supply-side expansion rather than creating excessive demand and fueling inflation (Chart 6). Furthermore, technological advancements and the deindustrialization of Western economies have diminished the need for capital to fuel economic growth.

The supply-demand imbalance is mirrored by the “slack” in the global economy. Chief Strategist of the Bank Credit Analyst, Peter Berezin posits that inflationary pressures will remain dormant in the developed world for the foreseeable future.\(^{11}\) In the U.S., the average estimate of the long-term equilibrium fed funds rate among FOMC members has fallen steadily (Chart 7), and there is scope for it to fall further. Peter points out that despite a cyclical rebound in investment spending, CAPEX is in fact in a secular decline (Chart 8). Meanwhile, without another household debt binge, the desired savings rate is likely to stay above pre-2008 levels, while wage growth should remain contained and thus unable to create general price inflation (Chart 9).

In this contemporary deflationary context, price stability becomes an incoherent policy target. It is worth remembering that price stability was set as a central bank mandate due to largely political, not just macroeconomic, considerations. As such, it is not a product of hard science, but a mix of economic theory, ideology, and political necessity and could reverse if the same political necessity pushes against it.

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The 1970s were an economic disaster, allowing policymakers such as Ronald Reagan and Margaret Thatcher to campaign on structural reforms that would specifically rein in high levels of inflation. In the current global context that both Chen and Peter describe, inflation vigilance is not going to win votes. Even aging societies of “savers” such as Japan and Germany have bucked the conventional wisdom. In fact, Shinzo Abe has remained a remarkable success story almost two years into his term because he has promised to create inflation, while Angela Merkel just won a re-election on the back of a promise to raise wages across sectors in Germany.

Inflation targeting was also a by-product of the geopolitical context. Before the 1980s, developed economies were isolated from the labor and saving supply pools of more than half of the planet. What is often ignored by economists when discussing the inflationary period of the 1970s is just how isolated global capitalism was, to the point where it is laughable to even use the term ‘global’ (Chart 10). Without global competition to threaten its bargaining power, labor in the developed world forced policymakers to accept wage-indexation and unionization (Chart 11).

The implication of a shift away from inflation targeting is that central banks are becoming increasingly consumed with employment and growth. In this context, it is worth quoting Fed Chair Janet Yellen’s March 31 speech:
CHART 8
CAPEX Is In A Secular Decline...

The relative size of the service sector has been growing

Human capital has become increasingly important relative to physical capital

The relative price of goods has been falling since the early 1980s

CHART 9
...While There Is Still Labor Market Slack

An anemic pick-up, result of base effects

* TOTAL COMPENSATION FOR PRIVATE INDUSTRY.
** FOR TOTAL PRIVATE NONFARM PRODUCTION AND NONSUPERVISORY EMPLOYEES.

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* GOVERNMENT CONSUMPTION EXPENDITURE AND GROSS INVESTMENT ON EDUCATION, PLUS PERSONAL CONSUMPTION EXPENDITURE ON EDUCATION SERVICES.
** SOURCE: CONGRESSIONAL BUDGET OFFICE. INCLUDES PROJECTIONS FOR 2013 TO 2024.
*** REBASED TO Q1 1950 = 100.
By keeping interest rates low, we are trying to make homes more affordable and revive the housing market. We are trying to make it cheaper for businesses to build, expand, and hire. We are trying to lower the costs of buying a car that can carry a worker to a new job and kids to school, and our policies are also spurring the revival of the auto industry. We are trying to help families afford things they need so that greater spending can drive job creation and even more spending, thereby strengthening the recovery... the Federal Reserve is committed to strengthening communities and restoring a healthy economy that benefits all Americans.

The speech is extraordinary in its focus on economic growth and the direct economic well-being of citizens. This should not come as a surprise. The post-2008 years have seen policymakers in the U.S., Europe, and Japan staff their central banks almost exclusively with doves, backing the view that central banks are only independent from political pressure in the very short run. We have used this political analysis to forecast, ahead of the curve, the dovish bias of all three major central banks.12

What will reverse the contemporary deflationary context, considering that CAPEX and wage pressures remain subdued? One possibility would be the global geopolitical context. If multipolarity becomes more threatening and forces active balancing, as we suggested it might, perhaps governments will see the legitimacy of fiscal spending recover, creating an opportunity to boost aggregate demand

at home via countercyclical spending. The erosion of globalization, a potential result of a world split into multipolar blocs, could also impede the aggregate global supply of saving and labor by sequestering it into opposing blocs. At this point, these are just guesses, but we stress that getting the geopolitical context right should be part of the long-term monetary policy forecast.
**Bottom Line:** The erosion of the inflation mandate has three main implications:

Central banks will continue to provide an extraordinarily easy monetary backdrop for a very long time, supporting equities.

While stronger growth will eventually push bond yields higher, the considerable amount of spare capacity and the global saving glut will keep inflationary pressures at bay, allowing central banks to take their time in normalizing interest rates.

With long-term interest rates subdued, high government debt levels will remain sustainable, easing pressure on developed economies to deleverage at a fast pace.

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