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The Cold War Heats Up

Dangerous inflection points ahead

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Summary

- We stand at dangerous inflection points for the Fed, at the G20, and vis-à-vis Iran
- Arguably the Fed is the least worrying of the three given it likes to act as Santa Claus
- By contrast, Clausewitz argues that the US and China power struggle means no trade deal…
- …yet the US uses its soft power even more it will unite its opponents against it
- Moreover, Iran shows that it is prepared to escalate back to the military sphere if needed
- That is mutually-assured destruction of a form, but it also shows the limits of US strategy…
- …or opens the door to huge geopolitical risks ahead

Santa Claus…

Global markets arguably stand on the cusp of dangerous inflection points over the next few weeks.

The first is obvious. **On 19 June the US Federal Reserve will make another rate decision and is expected to continue along the path of its recent dovish U-turn** and open the door to a rate cut as soon as its next scheduled meet on 30-31 July. Obviously, if the Fed is seen as more hawkish than expected and does *not* act as Santa Claus providing gifts of liquidity then markets are likely to react *extremely* badly. However, that is actually the *least* worrying inflection point.

The second is the 28-29 June G20 meeting in Osaka. This appears to be **the last possible juncture for US President Trump and Chinese President Xi Jinping to find the off-ramp from a rapidly escalating trade war**. Indeed, Trump has made clear that if Xi does not agree to meet him, which is still not confirmed, 25% tariffs will be raised on another USD300bn of Chinese goods, essentially hitting all exports, including key consumer items.

Earlier in the year markets were firmly of the view that a US-China trade deal was inevitable and imminent. We took a far more sceptical view and, somewhat belatedly, market sentiment now also seems to reflect a greater probability that Santa will not be delivering a trade deal in June. Naturally, there are concerns over the threat to global economic growth that would flow from such a development.

…and Clausewitz

However, the largest threat is not an escalation of the trade war given we are arguably *already* in a Cold War: it is that we are close to an inflection point where that Cold War starts to heat up.

To understand this threat one needs to **move away from thinking about a central bank Santa Clause and focus instead on Clausewitz**, the brilliant Prussian general and military theorist whose 1832 treatise *'On War'* is still required reading in every military academy today.

Even if you are not familiar with Clausewitz you probably know with .some of his key conclusions, foremost that "War is a continuation of politics by other means."

Clausewitz is relevant to markets today because current US-China tensions are <u>not</u> about trade: they are about **power**. In fact, we can update Clausewitz to today to argue that "*Trade* war is a continuation of politics by other means"(!)

However, what is particularly dangerous about the current backdrop is that numerous episodes in economic history, the 1930s being merely the most recent and best understood, show that trade war can still be a stopping-off point on the way to the real thing.

That is the real inflection point we should be worrying about.

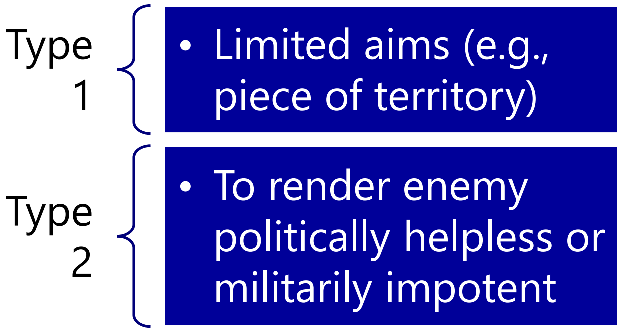
Number 1s and Number 2s

We premise that this US-China stand-off is not about the price of furniture, or employment in the Rust Belt, but about who will hold global hegemony in the 21st century.

That may still be a bridge too far for some but it is *exactly* what both the Americans and the Chinese have been saying: consider President Trump's pledge that the Chinese economy will not be larger than that of the US; and China's November 2017 19th Party Congress, where it pledged to be world number one by 2049. That framing doesn't leave much room for the US and China to find common ground on trade at the upcoming G20.

Indeed, while remaining optimists view the upcoming US-China negotiation as a 'battle' of sorts, they fail to see that the Chinese regard it as a very different kind of fight.

Crucially, Clausewitz argues wars fall into two broad categories: to achieve limited aims; or to disarm the enemy, rendering him "politically helpless or militarily impotent."



Those who don't understand where current trade tensions stem from believe the US has a limited trade war aim - "Sign this deal!" That sounds very rational when the costs of a trade war are so high. In other words, it's a type #1 war.

However, those same optimists do *not* understand that China knows all too well that the economic reforms the US is insisting on as part of a trade deal would dismantle its state-led economic system: from the Chinese Communist Party (CCP) standpoint the regime would then be politically helpless and militarily impotent. In other words, it's actually a type #2 war. Yet it's unclear if the US negotiators are aware that American insistence on market-opening and removal of subsidies, etc., are at root a #2 conflict.

As such, while the CCP feels cornered and is talking about a "Long March"--a national struggle with suffering to achieve victory--in the US there appears little recognition it is about to enter an epic fight. There is no overarching strategy for what the US actually wants to achieve and the price it is prepared to pay to achieve it; nor on the tools it is willing to use to do so.

True, ***parts* of the US establishment now see China as a dangerous economic rival**, as evidenced by the aggressive pushback against Huawei's 5G for example. US legislation is also being proposed to effectively force Chinese firms to delist from US stock exchanges if they cannot improve their accounting standards to a Western level, and there are also calls to restrict US capital flows to China altogether. Yet many US CEOs still see China as an economic opportunity, US banks are looking ahead to Chinese investments, and pension funds are sending more capital east.

As of yet there has thus far been no clear US focus on the vast political differences between itself and China, as was the case in the last Cold War, when the US championed liberty. Instead US-China clashes so far have mostly stayed in the realm of the economic (with dashes of the military). That actually *weakens* the US strategic position in that China can easily better the US with flows of money, and is doing so, but is nowhere close on human rights.

***Parts* of the US establishment are now also starting to see China as an *ideological* rival** and hence are using human rights as a weapon. Criticism of China is becoming louder, especially over Xinjiang and, more recently, Hong Kong. Yet the Trump White House is hardly seen as a champion of traditional Western liberal values.

Indeed, **the US is show a unified strategic vision** for a #2 war, which Clausewitz argues is necessary for victory. By contrast, he states the *defender* has the advantage where they feel the stronger sense of moral and political motivation – which would back China. (Though admittedly, some in China are also cheering on Trump in the hope it prompts market-based reforms, making the overall picture mixed on both sides.)

The key implication is that **the US has much further to go** in order to recognise the scale of the war that it is fighting (#2 not #1) and what it actually wants to achieve in the end; **either that, or the US needs to retreat and become friends with China again** – which is surely a real Santa Claus scenario.

Consequently, what we have seen so far in terms of US actions against China are likely only the first step, and **Clausewitz logic suggests we will see further US disengagement in trade, tech, services, and finance**.

Are markets pricing for this kind of disruption or are they merely worried about more 25% tariffs?

Imbalance of power

So the first risk above and beyond a G20 tariff hike is an escalation into a Cold War where the US disengages from China economically and financially as a #2 struggle. However, this then brings us to **an even larger risk, that of the Cold War heating up**.

There is arguably no real appetite in the US for major military conflict, especially ahead of the 2020 elections. Because the US is war-weary after years of struggle in Iraq and Afghanistan, Washington has so far been relying on its vast economic power to contain its enemies: military power is there more for show than something the US is keen to use beyond a risk-free bombing run or cruise missile attack.

That soft-power-first approach has been clearly evidenced with 25% tariffs and sanctions on China and Huawei, for example; and it can easily be followed up with the cutting off access from the global SWIFT network; or with the cutting of USD swap lines from the Fed. These are awesome financial weapons and clearly remain the primary US tool of its current foreign policy strategy vis-à-vis opponents. We should expect more of them ahead, we would argue.

Crucially, however, **the US is not just at odds with China**. It is also at loggerheads with Russia; and North Korea; and Iran; and perhaps soon Turkey. Even relations with Mexico and the EU are fraying. In short, the list of forces that the US is trying to contain with its economy and currency is growing. In particular, the US does *not* want:

- A nuclear North Korea with intercontinental ballistic missile capability – and the US response has been biting sanctions, the threat of war,…**and then an olive branch from Trump** that appears to have been rejected;
- A nuclear Iran with intercontinental ballistic missile capability – and the US response has been to walk away from the 2015 nuclear deal, biting sanctions, the threat of war,…**and then an olive branch from Trump** that appears to have been rejected;
- An expansionary Russia – and the US response has been biting sanctions (though there is speculation **Trump would like to reconcile with Putin**);
- A Turkey prepared to buy Russian weapons – and the US response has been the threat of tariffs; and
- A more powerful China – and the US response has been tariffs and increasing steps towards economic and financial divorce.

As we saw from initial sharp falls in the Iranian Rial, RUB, CNY, and TRY, as well as in the damage to Huawei, **US tariffs and sanctions can deliver huge blows to other economies**. Indeed, US soft power is also still finding new areas of vulnerability. For example, recent Chinese interference in Hong Kong's autonomy has potentially opened up another weapon the US can use: Hong Kong as a global financial centre and the HKD peg both rely on US goodwill and the availability of the USD – which is at Washington's disposal. And even more worrying, might even the EU and the US soon find themselves at loggerheads over autos, or NATO spending, or Iran?

However, mighty as they are, **so far none of these US economic blows have proved fatal to governments who feel they are in a Clausewitz #2 war with the US rather than Clausewitz #1.** With grim determination the Iranian regime is still in power, as is Kim in Pyongyang, Russia has also shown that it can diversify and survive in the face of US economic pressure, and China shows no sign of blinking.

Moreover, there are increasing signs that states under the US economic hammer are co-operating, which greatly increases their individual and collective strength. The recent Russian-Chinese announcement of dropping the USD for bilateral trade is a symbol of that; so is Turkey buying Russian weapons; so are Chinese-Russian joint military exercises; so is Russian and Chinese economic support for North Korea and Iran; and so is the EU considering ways to help Iran trade with it rather than follow US sanctions.

Clausewitz argued the 'balance of power' is key to military victory. As explored in last year's "The Rise and Fall and Rise of the Great Powers (and the Great Currencies)", **even the mighty US would struggle to counterbalance a combination of China, Russia, North Korea, and Iran** should that coalesce. The 'loss' of Turkey would also be very significant.

Collectively, **such a move away from the USD could potentially start to threaten its global status**. This is not to say that de-dollarisation is a near-term threat: it isn't given our current global architecture and US military power. In fact, there risk is of a further up-leg in USD given the current global backdrop of the US squeezing access to dollars; indeed, one could even link geopolitics back to markets to argue that the reason the Fed is looking to cut now is unrelated to the domestic US economy and far more so to liquidity issues in the offshore dollar market.

Nonetheless, the more the US abuses its privileges within the global financial system, the more appetite rises to supplant it – one day; and at the same time a US #2 strategy based *only* on finance may not be enough to win.

Iran away?

In that key regard we turn to another major risk ahead: a nearer-term strategic push-back against the US paradigm. Clausewitz stressed the dynamic over the static, and **we are in a very dynamic situation in the Straits of Hormuz.**

Dire Straits

9 June saw two oil tankers, one Japanese and one Norwegian, attacked off the coast of Oman. This followed separate attacks on four other oil tankers in the region as well as both drone and missile attacks on Saudi oil pumps and airports. All of these are being blamed by the US, the Saudis, and the UK on either Iran or Iranian proxies.

This has occurred against the backdrop of:

- The US having walked away from the 2015 nuclear deal with Iran struck under the Obama administration;
- Trump having massively increased economic sanctions;
- Tehran having set the EU a deadline of 7 July to subvert US sanctions or else see it also walk away from the deal and start building a nuclear bomb again; and
- Recent talk of the risk of war from the US and Iran.

In short, the situation in the Middle East is extremely volatile and dangerous.

Iran's alleged actions suggest it is desperate enough under US sanctions to escalate from the economic into the military field as a test of US resolve – all the more so in the knowledge that Russia and China, and even North Korea and its nuclear know-how, may all stand behind it in various ways.

Of course, Iran could never hope to win a war with the US. Yet at the same time the US experience in Iraq and Afghanistan has shown it could not "win" cleanly either. The cost in blood and treasure, and the spill-over effects into the oil-rich Middle East, would be destabilising and devastating for years: it goes without saying what the risks to oil prices would be.

Iran is effectively putting a gun to its own head and saying that if it can't export oil, then nobody in the Gulf can either: **it is a form of 'mutually-assured destruction' (MAD).**

Moreover, for a US struggling with an increasingly unfavourable balance of power dynamic, concentrating resources in Iran would greatly underline its efforts to focus on the bigger picture of China. That's a Clausewitz geostrategic error, and even the US military's Central Command has publicly stated that a war with Iran is not in its strategic interests – an odd stance to take for those believing the US is *trying* to start a war. (Which is not to deny that some elements of the Trump administration, like John Bolton, would not back US strikes.)

In short, this is a very high risk strategy for Iran. However, it either surrenders to #2 existential US economic pressure or it ups the ante; and the US either responds to that with military force, at enormous cost to itself and its larger strategy, or it has to back down and lose power and influence**.**

Notably, North Korea already tried nuclear escalation…and found the US was prepared to jaw-jaw rather than war-war. (Which we saw at the time as a strategic imperative necessary to focus on China). However, that period of détente appears close to an end from the Korean side, and the Iranian – and the Russian, and the Chinese.

As such, markets can righty hope the US does not escalate with Iran, and a Kim-is-my-good-friend style solution can be found. However, the clear message which will be sent is that the US has no appetite for a fight…**and *that will only increase the likelihood of other states testing the US further.*** For example, if the G20 fails to produce results for China might it also ask the question "Shall we continue from trade to real war by some means?" as a way to force the US to back down(?)

Of course, if the US were again to blink against Iran, or a hypothetical China stand-off with Taiwan, for example, then we would be taking a major, peaceful step towards the end of US and USD dominance globally.

Potentially, for the US, and worryingly for markets, perhaps the *least* worst strategy is still to lash out at the weakest of the emerging new axis operating against it--which is Iran--in order to show the others what a terrible fate awaits them if they try to defy it…..with all the negative consequences that would then entail. That would send USD, oil, and risk assets surging, while doing untold damage on many fronts in the longer term.

In short, we have a backdrop of an unstable global power dynamic where rising powers are testing the fading US, whose strength is awesome in the economic and market sphere but whose appetite for real blood-loss may no longer be intact – and yet who may have to show otherwise to disprove that point.

As such, dangerous inflection points loom far beyond the Fed, or the G20 meeting.

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