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WHO'S AFRAID OF GEOPOLITICAL RISK?

The future may be unknowable, but the risks from China, Russia and the Middle East aren't.

Let me start with a story.

Joe Biden was annoyed at me. I had just briefed him in great detail on his impending meeting with the Greek prime minister and the difficult reforms we should urge his government to tackle. "Why would I tell him that," Biden scoffed. "Doesn't he know that's what he needs to do?" Biden, who was vice president at the time, didn't care that I was the Treasury's senior official on Europe and steeped in the details of what was ailing the Greek economy. "When you're in politics," he explained not very patiently, "you wake up every morning in a leaky boat and all you ask yourself is how much more water you can afford to take on. I'm not going to come tell him he has to blow another hole in the hull!"

The exchange captures the best framework for analyzing geopolitical risks I know.

After a career in global investments and public policy at the Treasury and White House, I am always frustrated with strategists, investors and corporate executives who review their business risks in excruciating detail, but then throw up their hands at the dark cloud of "geopolitics" that looms ominously over every potential outcome. Yes, we live in a complex world and an international system that is undergoing historic changes. No, it's not possible to predict the future. But if you stare hard at the key decision-makers, you will at least have your eyes on the right moving parts as you assess the balance of risks. And then you can make far more informed decisions about how to deploy capital or shape your global strategy.

Each and every one of them wakes up every day in a more or less leaky boat, and they have to balance the risks before them as best they can. That's where investors and analysts need to focus their attention as they decide whether the Middle East looks like the most intractable of problems. The hostilities are deeply rooted, the space is tight and the arsenals are extensive. Without minimizing the tragedy unfolding there, what makes the problem crucial to the global economy is its impact on the flow of oil. So far, that depends almost entirely on the key decision-makers in Saudi Arabia and Iran, who have opted to protect those flows. Crown Prince Mohammed Bin Salman is preoccupied with the modernization and diversification of his economy and will have to be badly provoked before they abandon that to join the conflict. Of course, if anyone can provoke Saudi Arabia, it's Iran. But the recent escalation of Israeli attacks on Hamas and Hezbollah confirms that Supreme Leader Ali Khamenei isn't looking for a fight either. There has been retaliation against Israel, but nothing to signal he is ready for a wider conflict. That's why for now, oil continues to flow and financial markets see no reason to shift their bets.

Global risks from the Ukraine war look similarly limited for now, even as the terrible human toll mounts and Russia faces extended isolation. Russia's Vladimir Putin makes nuclear threats that capture global headlines, but they look increasingly toothless as Ukrainian forces seize Russian territory or launch drone attacks on Moscow. While the threats of escalation may help Putin shore up support at home, he understands that actual escalation that requires massive mobilization of troops would merely punch another hole in his boat.

As the brutal fighting continues to what is likely to be a stalemate, the real question for global investors becomes whether European leaders make decisive commitments to their own long-term defense. If they succumb to domestic political pressures that resist integration, their political project will falter, their economy will stagnate and their security will fall hostage to Russian power. On the other hand, investors should watch for signs that recent geopolitical shifts may actually encourage greater integration of banks, deeper defense cooperation and a greater commitment to innovation.

The rise in tensions with China is in many ways inevitable as the United States and Europe adapt to the emergence of a great power determined to play a role in shaping the global system. The tensions are aggravated by China's export model that floods other markets with manufactured goods its own people are not ready to buy. The main risks for investors lie in the rising tariffs and trade restrictions that will make global operations and supply chain management more expensive and unpredictable.

The near-term trajectory of the relationship, however, is driven much more by the relative calculations of the Chinese and American presidents. Xi Jinping and Joe Biden have found their own boats to be extremely leaky over the last year, which has made them especially cautious about letting the rivalry get out of hand. This calculus could change in the coming years should China's economy return to healthier growth and allow Xi more space to be more confrontational. A Trump presidency will be more willing to confront the Chinese on trade, but less so on Taiwan or human rights. A Harris presidency may have a more complicated set of tradeoffs to balance.

So don't look away from geopolitical risks, even if they appear overwhelming and unknowable. The future itself may be unknowable, but watching the tradeoffs confronting the key leaders in this unfolding drama will go a long way to helping assess your own risks and rewards. In some sense, we all operate in boats with our own set of leaks to manage.

HOW TO INVEST IN A TRADE WAR

In case you haven't noticed, a fresh chapter of the U.S. trade war with China is upon us. Donald Trump promises massive new tariffs even as the U.S. ends its dependence on China for key imports. Kamala Harris and Joe Biden have settled on a more focused combination of trade barriers and domestic subsidies. But make no mistake that things are going to get rockier from here. The good news is that there are strategies to mitigate the risks to global companies and investors. It requires some fancy footwork and it will be impossible to avoid the rising costs, but a little fancy footwork can go a long way.

First, it's important to understand the heart of the problem. Rising tides of Chinese manufactured exports fuel worries of a fresh shock as the world’s second-largest economy pursues leadership in advanced industries from electric vehicles to machine tools to flat panel displays. Meanwhile, Beijing’s efforts to revive domestic growth continue to prioritize industry over households, making imbalances still worse. While China’s manufactured surplus with the United States has remained flat since before the pandemic, it has risen a little with Europe, a medium amount with Latin America and South Asia, and a lot with Singapore and its ASEAN neighbors.

So far, the data suggests that many emerging markets have benefited from these dynamics as their exports have risen in line with Chinese imports. But this will also make them vulnerable to new tariff barriers as the United States and Europe redouble their efforts to constrain China’s excess capacity when it is repackaged in Malaysia, Thailand or Vietnam.

“Deglobalization” is not quite the right word for these trends. It’s more a re-wiring of the global economy’s interconnections as supply chains naturally adjust to new obstacles. While global trade to GDP has stabilized near 45% ever since the 2008 financial crisis, the number of trade restrictions has risen sharply. It’s not that there is less trade, but trade has simply started eating into corporate profits and investment returns. Given the mounting resentment towards China’s chosen business model which continues to suppress domestic demand, expect even more barriers to pop up. Threats of new measures aimed at Chinese firms that sell to sanctioned Russian counterparts only add to the uncertainty. For nimble investors and corporate executives, the risks are mounting, too. Still, some principles may help mitigate the potential costs as this latest cloud of protectionism descends.

· Avoid Borders! This sounds glib, but there is plainly less risk in businesses that have most of their suppliers and most of their customers in the same country. If your firm inevitably depends on inputs from far and wide, this is an especially good time to review localization strategies that can bring as much supply as possible closer to final demand.

· Services Over Goods: China’s excess supply is in goods. Services are not immune from barriers, but local regulations have actually relaxed for foreign investors in financial services and there is enormous demand for high-quality medical care. Also, foreign firms that establish back-office operations in China for themselves or others can export their services with little fear of interference.

· Everyone’s Friends: There are a few key countries that neither Washington nor Brussels wants to alienate. Despite longstanding trade issues with Brazil, India and South Africa, no Western government wants to do anything that might tilt them toward Beijing, reducing the odds of any new tariffs or barriers popping up in these parts of the world.

· Headwinds into Tailwinds: America’s efforts to keep out Chinese solar panels, batteries and semiconductors are paired with generous subsidies and tax breaks for anyone launching domestic production in these strategic industries. An economist will grumble about why it’s all wasteful and distortionary, but the savvy investor or corporate executive will figure out how to take advantage of this government largesse.

· Margins of Safety: The great value investor Benjamin Graham advised mitigating the risks of any investment by pricing them low enough. One important strategy for navigating trade war uncertainties is to choose firms with

what he called “margins of safety.” This means profitability to absorb higher tariff costs and strong balance sheets to withstand shocks of non-tariff barriers. For companies contemplating expansion or acquisitions, higher hurdle rates will help, too. Sadly, there’s no magic here. For many investors and corporate executives there is no hiding when the world’s largest economies turn protectionist. Tariffs – and retaliation – will inevitably hurt profits. Still, an eye for where the risks are lower may help reduce the costs -- and might even reveal some brighter possibilities amid a darkening outlook.

WHAT COMES AFTER THE SOFT LANDING?

You may have read the news: the Fed started to cut rates, and we can drop the pointless debate over whether it should have begun with 25 or 50 basis points. Much more important now than how the Federal Open Market Committee starts rate cuts is the question of how they stop.

The debate over the soft landing itself seems increasingly pointless as we are pretty much wheels down right now. If I had told you two years ago when inflation peaked at 9.1% that we could get 2.5% with unemployment still at 4.2%, you would have accused me of magical thinking. At least, you would have pointed to the last dozen planes that landed from such a steep trajectory and only came to a stop in a crumpled heap. Of course, there will inevitably be a few bumps yet before we come to a complete stop at our gate, and there will surely be complaints from First Class passengers who were distracted from the in-flight turbulence by free champagne and canapés. The rest of us in steerage will be grateful that the combination of repairing supply chains and moderating excess demand helped restore the cockpit readings to pre-pandemic levels.

But what now?

Pessimists would still have us holding tight to your armrests as they survey the continuing risks of a recession. Falling consumer sentiment and a softening job market have them worried that the plane may yet veer into a ditch. Indeed, the effects of such sharp Fed tightening since early 2022 can still deliver unpleasant surprises to overstretched banks, marginal real estate projects and ephemeral household demand. These Cassandras will argue that faster rate cuts as demand collapses will do nothing to get the craft back on the runway as the Fed will be pushing on a string. The Federal budget debate under a new president and Congress may include more spending and higher taxes to prime the engine but that will take time.

Then there are those who don’t believe that inflationary forces have fully dissipated. They worry the plane’s engine is still running hot and may just burst into flames even as growth slows. A variation of this fear is that the pilot may still not be able to slow the plane as it reaches the end of the runway, requiring a much firmer foot on the brakes that leaves passengers sprawling across the cabin. But what seems more important now is to look beyond this phase of the cycle to the forces that will drive rates and growth higher or lower over the next few years. The latest Fed dot plot has the median Fed governor (and regional bank president) guessing rates will settle between 2.75 and 3.0% with growth at 2.0%.

There is much, however, that can move those estimates in either direction.

Over the next year or two, we have a lot of spending on defense and health care that feels broadly supportive of growth, but also inflationary. There’s also a trade war that includes tariffs and a massive re-design of global supply chains. This feels inflationary, but not necessarily growth-enhancing. On the other side are forces of disinflation that are already appearing in China, as it struggles to recover from its real estate crisis. The massive new investments in technology should boost growth, but the decimation of white-collar and clerical jobs that will come with the deployment of “artificial intelligence” could deliver a serious blow to final demand. On balance, after decades of falling interest rates and inflationary pressures, the Fed looks set for a lengthy battle to keep price increases from rising much above its 2% target. For now, feel grateful that your flight is ending about as well as you might have hoped and your plane will soon taxi gently from the runway to the gate, where you can relax and unbuckle your seat belts. Until, that is, you hear a deafening explosion from that dormant volcano beneath the airport that can no longer suppress the roiling pressures from $33 trillion in government debt and blows everything to smithereens.

Our soft landing was all for naught and the hunt begins for a new metaphor. Magma pressures? Lava flows? Volcanic ash clouds?