



Letter No.48

Geopolitics and stock markets, what are the risks at the dawn of 2022?

"Impossible peace, improbable war" Raymond Aron

The famous word of Raymond Aron, in 1947, then to describe the period of the Cold War preserves all its actuality.

For the sake of brevity and clarity, we will not deal with the thirty or so existing conflicts in the world, from the recent war in Ethiopia to the seven-year war in Yemen, from the Libyan crisis that has persisted for a decade to the renewed tensions between Algeria and Morocco and all the others.

We will focus on the objectives of 3 potential conflicts, China/United States over Taiwan, Iran, and Ukraine, because if one of these three breaks out, financial markets, commodity prices, and currencies would be greatly impacted.

As a preliminary remark, we will make 5 observations:

- *The United States*, even when weakened from within and faced with failures on the international stage, remains *the undisputed leader*, economically, technologically, and militarily.
- *The international system is unstable*: the United States has many partners but no longer wishes to get involved in the resolution of regional conflicts, and so there are multiple sources of instability. From technology to military, China is increasingly challenging American power, and Taiwan is an example, but China has no allies. So, there is a kind of disintegration of the international order.
- *Democracies are weakened*, by a passion for destroying common values, by minorities questioning the truth, by the lack of confidence on the part of a majority, and the stock markets would fall if one of these democracies were to collapse.
- *Authoritarian regimes are not an alternative* and, unless they crush any hint of expression by force, are no longer guaranteed stability. Inflation is their enemy when it erodes purchasing power and triggers social revolts. We have just seen this in Kazakhstan, and it is also evident in Turkey, Hungary, and Brazil, three countries likely to dismiss their populist leaders in the elections, this year or next. Let us not forget that a populist is a man who speaks well of evil (migration, violence...) but who, once in power, does good badly.
- *The "black swans", in geopolitics*: accustomed to the disruptions caused by black swans in the stock market, we have the same view of geopolitics. The unexpected dominates, planning is futile, and adaptation is the first commandment. History is rich in illustrations. The Serbian Princip, who assassinated the archduke heir to the Habsburg crown in 1914, could not have foreseen the consequences of his act - four years of war, more than twenty million deaths, the disappearance of several centuries-old empires, the Romanovs, the Habsburgs, the Ottomans, the Hohenzollerns-. Ten

years later, no one could have anticipated the misdeeds of young corporal Hitler or the seminarian Joseph Djougashvili, the future Stalin.

Therefore, in approaching the three potential flashpoints, we will stick to the facts and try to assess the consequences on the markets.

The Sino-American rivalry and threats to Taiwan:

Let us look at the political environment, the economic context, the stock market framework, and the military context.

The political environment:

There has been a hardening of the regime in China recently, as reflected by various measures, including a reaffirmation of ideology in businesses and families, an education law to teach the love of the nation, a ban on video games for children. Coming up in the autumn is the 20th Congress of the Chinese Communist Party and clearly, the abandonment of the jurisprudence determined by Deng Xiaoping of two terms.

The economic context:

From a domestic perspective, it is a structural slowdown in growth and a multi-faceted real estate crisis, from an international point of view, it is the increased pressure from the West and the general sobering up of the Silk Roads debtors. Since the launch of this project, the Chinese have spent \$120 billion, less than announced, and disillusionment is prevalent, particularly in Africa. It is true that Chinese trade with Africa is \$200 billion compared to \$10 billion when China joined the WTO, but Chinese banks are reluctant to finance and Chinese investments have been reduced from \$11 billion in 2017 to \$3 billion in 2020. From Africa's perspective, trade is unequal, large infrastructure projects and mining investments create little employment, contracts are leonine and debt levels are becoming problematic for some countries. Let us add to this the concern triggered by the deployment of the Chinese military base in Djibouti and the widespread establishment of about sixty Confucius Institutes.

To offer an alternative, the EU is presenting a \$300 billion plan over 6 years to finance infrastructure (transport, digital, climate ...) in emerging countries.

The stock market angle:

A new regulation to curb the foreign listing of technology groups. Didi was listed on the New York Stock Exchange in June of last year at \$14/share, today it is at \$4.9 and will be delisted and transferred to Hong Kong. Many more are expected to follow.

The military angle:

Unlike the USSR yesterday, China has no allies. But it does not matter because it is increasing its military budget, can have an active army of 2 million soldiers, can rely on a high-quality naval force in the South China Sea, and can counter long-range missiles. At the same time, it is strengthening its nuclear arsenal, now estimated at between 250 and 300 warheads compared to 5,800 for the United States, in order to have a second-strike capability, to force the Americans to recognize the mutual vulnerability and to openly raise the possibility of a war against Taiwan.

To summarize these different points, the interference between politics, the economy, and the military is obvious. If it were not for this structural slowdown of the economy and the fear of social conflicts, we would not witness this nationalist surge, this aggressiveness in some regional areas, and this hardening of the regime.

Between China and the United States, the scope of confrontation is wider than it was with the USSR. The Americans, eager to destabilize the Chinese regime, continue to denounce the repression of a million Uighurs in Xinjiang and have just passed a law in the Senate prohibiting the import of products made with the use of forced labor in Xinjiang.

At the same time, the Americans are maintaining prohibitive customs duties on Chinese products sold to the United States, extending sanctions against Chinese companies, and weakening Huawei, the world's leading telecommunications equipment manufacturer, which is suspected of espionage, by dissuading a number of Western countries from signing contracts for the development of 5G. The result for Huawei is a 29% decline in revenue in 2021.

Another example of tension is in trade relations because, in 2021, China did not keep to its commitment, signed in 2020, to increase purchases of American goods and services by \$200 billion: not only have US exports of services not increased, but they have fallen by a third. As for the targets agreed by the Chinese to buy American goods, only 83% for agricultural products have been met, 60% for manufacturing products, and 40% for energy.

In these multiple confrontations, each side raises the stakes and the risk is an undesired incident (e.g. aircraft clashing).

In the South China Sea, China plays the militarization card, the United States the preservation of freedom of navigation card.

In the South Pacific, China, at the risk of angering Australia, is pushing its pawns with the aid given to the Solomon Islands, but the United States is tightening its military ties with Australia and other Asian democracies.

In Hong Kong, Beijing's control is intensifying and 88,000 residents have applied for visas to the United Kingdom.

With regard to Taiwan, Xi is worried about the rise of the independence party, shows his desire for unification, possibly by force of arms, and would like the Americans to give up sacrificing men to defend a territory of 23 million.

But, even though they have withdrawn from Afghanistan and are less present in the Middle East, the Americans have never spent so much on their defense, \$778 billion in 2020. Since the Obama presidency, they have focused on the Pacific and want to be ready to meet the security commitment signed in 1979, to offer Taiwan the means to defend itself without having to send soldiers.

Among the signs of détente, of the continued weaving of economic and commercial links, the recent signing of a multi-year contract for the delivery of liquefied gas by the United States to China (Venture global LNG will deliver the CNOOC), the 7th such agreement in the fourth quarter of 2021, and thus China will receive one-fifth of US gas exports.

Also, the removal of the obligation for foreign car manufacturers to associate with a local partner in China even if it is unlikely to see breaks in partnership with state-owned enterprises.

In conclusion, invading Taiwan would potentially expose China to military retaliation and at the very least to major economic sanctions such as a boycott of semiconductor exports, which China imports to the tune of \$350 billion a year. China produces only 7% of the world's semiconductors and is 15% self-sufficient.

Ukraine:

In 1997, George Kennan, the architect of the USSR containment policy, said that *"expanding NATO would be the most fateful error of American policy in the entire post-cold-war era. Such a decision may be expected to inflame nationalistic, anti-Western and militaristic tendencies in Russian opinion; to restore the atmosphere of the cold-war to East-West relations"*. He was a visionary.

- *There are two interpretations of the Ukrainian crisis:*

That of the West is focused on the illegitimate annexation of Crimea, the unjustified destabilization of Donbass, and the pressure exerted by Russian troops on the country's borders.

That of the Russians dates back to 1990, when, in a moment of Russia's weakness, the West took the opportunity to extend NATO's military grip on Russia's doorstep and its political control by integrating certain countries into the European Union. Russia feels that it has been humiliated, first after the breakup of the USSR, then when Obama spoke of "regional power", and today it considers itself underestimated. When Putin came to power, he had proposed a union of the Slavs, integrating Belarus and Ukraine to form a group of 200 million. The union of the Slavs has not been achieved but, in 22 years Putin has modernized the army and spent more than 4% of GDP on the sector.

These two views are difficult to reconcile because the West wants to preserve Kiev's free will while Vladimir Putin wants to expand his sphere of influence.

- *The evolution of the conflict:*

The conflict in itself dates back to 2014. At the time, Syria had crossed the red line set by the United States through chemical weapons but Obama did not intervene. Putin interpreted this as a weakness of the United States and took advantage of it to invade Crimea.

Since 2014, the conflict has already caused 14,000 deaths, the displacement of 1.5 million people, the occupation of 7% of Ukrainian territory by the Russians, and the granting of Russian passports to 670,000 people. The crisis peaked before Christmas, offering some analysts an easy parallel with the 1962 Cuban crisis or the 1958-1961 Berlin Crisis as Russia massed large troops on the border, 100,000 men (?), and many worried about an invasion of the country.

- *What to expect?*

The fighting on the border has never really stopped since 2014 and if Russia were to enter Ukraine, the latter, a non-NATO member, would not benefit from the assistance clause because no one in Europe wants to die for Kiev. The EU has only one trade agreement with Ukraine. Biden reaffirmed "Putin cannot move on Ukraine," thus would not allow a repeat of the seizure of Crimea in 2014, but ruled out military intervention.

Russia, involved in several fields of operation, has no interest in an additional confrontation after Crimea and Donbass because it would expose itself to economic and diplomatic reprisals. It has more to gain from institutionalizing a bilateral dialogue with the United States.

At a time when the Sino-American rivalry is asserting itself, the challenge for Russia, whose GDP is only one-seventh of that of China, is not to appear as a secondary power. In Putin's eyes, a dialogue, such as the one in Geneva, is more valuable than a costly invasion of Ukraine because it echoes the duopoly of the 40 years after 1945.

December 2021 is 30 years since the end of the USSR. Russia already controls 20% of Georgia, aims to satellite the countries of the former USSR, and in the same logic as Germany after 1933, has its eye on countries with Russian-speaking populations, which is a danger for the Baltic countries, and some analysts wonder if we are not on the eve of a new Munich agreement, with Ukraine taking the place of Czechoslovakia.

Russia does not want Ukraine to be a platform for deploying weapons directed against Russia and complains about arms supplies from NATO members Turkey and the United States. Turkey supplies advanced drones capable of destroying Russian tanks, which have already been tested against Haftar's troops in Libya, against the Kurds in northern Syria, and recently against the "secessionist" Armenians in Nagorno-Karabakh.

The Russians would like to exclude Europe from the scope of the discussions: according to them, during the Minsk meetings, the Germans and the French were too aligned with Kiev and the Western Europe-Russia dialogue never yielded anything. Europe is not out of the game, however, as a meeting of the OSCE, the "Organization for Security and Co-operation in Europe," is taking place and, previously, Biden took care to coordinate with the Europeans before and after the talks with Putin.

Vladimir Putin dreams of resurrecting Yalta, aspires a partition of Europe, demands a withdrawal of US nuclear weapons from Europe, demands a renunciation of NATO expansion, which is deemed unacceptable by NATO Secretary Stoltenberg, but ends with the opposite result with the historically neutral Finland now ready to join NATO.

To denounce the encirclement of Russia is an illusion. It is true that NATO troops were not present in the Baltic states before 2014 and they are now. But 4,500 men, facing 100,000 Russians, remains symbolic.

Russia holds many levers of influence but has understood that it is no longer the master of the game and accepts the existence of the Ukrainian state because the Ukrainian population is mostly pro-Western and becomes more so with every new pressure on its borders.

NATO membership is not the real issue because it requires the acceptance of each of the 30 existing members and, as we know, France and Germany oppose this membership as they are to Georgia's. Moreover, nothing is totally certain in the Russian periphery: if Putin feels compelled to support Belarus, it is to avoid seeing the regime fall. While Russia signed a security agreement with Kazakhstan in December 2021, the latter has bought Turkish drones and armored vehicles and wants to strengthen the economic alliance with Ankara. And the social protest, first against a rise in energy prices, then against the regime and former President Nazarbayev in power from 1989 to 2019, has embarrassed Putin and forced him to intervene.

Russia's economy is too weak to absorb Ukraine and its 44 million population and it needs imports from the EU. An agreement is possible on reactivation of the Intermediate-Range Nuclear Forces Treaty, including the deployment of short- and medium-range missiles in Europe and on communication about military exercises.

From the point of view of the markets, the occupation of part of Ukraine would cause a depreciation of the ruble, pressure on interest rates, an increase in the grain prices as Ukraine is a major producer, a rise in energy prices, especially gas if Nord Stream 2 is frozen and if Russian gas supplies are reduced.

Iran:

- *The decline of American grip:*

Over the past two decades, the United States has lost its leverage over Iran. Bush Senior controlled the situation in the Middle East, Bush Junior, with the consequences of the 2003 war, allowed Iran to dominate Iraq for the first time.

Then Trump was wrong to walk out of the 2015 deal between Obama and Iran. Iran then agreed to limit enrichment to 3.7%; today, it is capable of enriching uranium to 60% and, without a new agreement, would achieve an enrichment rate of 90% within a month.

- *What can we expect?*

Today, neither side wants to lose face. The Iranians seem to be buying time on the road to enrichment, but an agreement by mid-February is conceivable, with, on the one hand, a halt to the development of the nuclear enrichment program and, on the other hand, a lifting of sanctions that could allow the country to emerge from the economic crisis.

There are five recognized nuclear powers in the world, three illicit ones -India, Pakistan, and Israel- and a fourth, North Korea, which is close to joining the club. If Iran were to get the bomb, Saudi Arabia and Turkey would claim the same privilege and the potential damage to the region would be severe.

- *Iran is lucid on both aspects, nuclear and the economy:*

On the one hand, the country knows that it will be difficult for it to have the bomb because Israel and the Sunni powers of the Middle East would not accept it and because China and Russia, friends but nuclear powers, are not in favor of nuclear proliferation. In 2021, the Israelis bombed about thirty Iranian military sites, mainly in Syria. At the risk of being hit by missiles from Hezbollah on Israeli cities, they could do more and destroy Iranian sites.

On the other hand, even in denial, the Iranian authorities cannot ignore the consequences of sanctions, the economic crisis, the brain drain, the discontent, as nearly 40% of the population is below the poverty line and with inflation exceeding 50%, frequent social revolts and leaders suspected of corruption.

China is the only country buying oil from the Iranians, about 0.5 million barrels/day, with the tacit agreement of the United States. China has signed a 25-year partnership agreement.

A visit by Iranian President Ebrahim Raisi to Moscow is scheduled to discuss cooperation between the two countries and extend the agreement by twenty years, but all this is not enough to ensure prosperity. To conclude an agreement would be for the conservative leaders to consolidate their hold on power and that is probably more important than the bomb. On the other hand, a withdrawal of Iranian support to countries in the region or Hezbollah is unlikely and liberalization of foreign investment in Iran is unlikely.

Conclusion:

"Perhaps the supreme virtue, in our century, would be to face inhumanity without losing faith in men."
Raymond Aron, in his introduction to the *Liberté de l'esprit* collection published by Calmann-Lévy.

- *First of all, frustration:* of the three risks analyzed here, the UN Security Council, constantly hampered by the veto of one or more members, achieves nothing and is hardly more operational in the face of the risks of terrorism and cyberattack.
- *Then there is bitterness:* the pandemic has highlighted the shortcomings of the international system. The rapid spread of the virus and the cooperation of laboratories were expressions of the interconnectedness of the world, but states gave in to selfishness, did not want to work together, and were slow to export vaccines to poor countries.
- *Also, lucidity:* of these three points of tension, the United States gives more importance to the preservation of Taiwan's autonomy but the slightest weakness in Ukraine could be interpreted by Beijing as a green light and the Americans know it.

Tensions between democracies and autocracies will remain high as each group is convinced of the weakness of the other and tries to exploit it. In the West as in the East, there is a kind of shift in rhetoric, like an implicit acceptance of the possible use of nuclear weapons and this could mean a setback for world peace.

There is no doubt that American democracy is weakened by the frontal opposition between Republicans and Democrats. We cannot rejoice in the electoral manipulations carried out by the Republican states to reduce access to the vote for minorities. We cannot welcome the persistent worsening of inequalities with 1% of the population holding nearly 19% of the wealth against 11% in Europe. We can only be alarmed by the decrease in life expectancy to 78.8 years compared to 81.1 years in Europe, the increase in mortality by "overdose" or abuse of anxiolytics. With the probable victory of the Republicans in the mid-term elections in the United States, we can only fear a hardening of the American position on these various subjects.

At the same time, on the international stage, Americans have not been replaced. China poses as an alternative model to democracies deemed inefficient, speaks to all countries but essentially pursues economic interests. The US has retreated in Syria and the rest of the Middle East, but neither Russia, Turkey, Saudi Arabia, nor Iran has managed to gain a decisive advantage. Each of these countries is carrying out costly actions but for what lasting benefit?

- Paradoxically, the current tensions in Ukraine have the opposite effect to that sought by Russia because they strengthen the unity of the Western camp and could lead to NATO membership for Finland or even Sweden.
- In this troubled context, we must hope that Europe will emancipate itself:
An undeniable economic force with a single market equivalent in size to China and the United States, it has shown that it is capable of controlling investments and defining standards, for example in telecommunications since Europeans and Americans are working together against the Chinese.

The European Union has made progress at the political level: it is resisting migratory blackmail better than in 2015, recently against Morocco, today against Belarus.

But the EU suffers from not being a state and it will not be, and being a pacifist at heart, it seems far from defining a common defense policy.

- To summarize our 3 points, Putin has nothing to gain from a military invasion of Ukraine, Iran has every interest in an agreement to ease sanctions, China would weaken its already lowered growth prospects by exposing itself to retaliatory sanctions after an invasion of Taiwan.

So, stock markets should be spared from these geopolitical threats.

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