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GLOBAL MACRO RESEARCH

NEW WORLD DISORDER

MAY 2024



AT A TIME OF HEIGHTENED GEOPOLITICAL RISK, THE WORLD'S LEADING SUPERPOWER WILL BE HEADING TO THE POLLS TO CHOOSE A NEW PRESIDENT. IT IS HARD TO REMEMBER A TIME OF GREATER DIVISION, AND THE TWO CANDIDATES WILL HAVE VERY DIFFERENT APPROACHES TO THE WORLD'S PROBLEMS.

EXECUTIVE SUMMARY

The US presidential election in November is a key political event for 2024. If President Biden is re-elected then we should see a continuance of current policies, but a Trump victory would likely bring more dramatic change. A second Trump term would bring the future of key international organisations into focus, and the US would almost certainly slow its efforts to curb carbon emissions, although these are likely to be insufficient anyway. Another major impact will be on global trade, with former President Trump promising a huge increase in trade tariffs – we will cover this important topic in a separate paper. Whoever wins, we are likely to see political divisions deepen further, with confidence in the democratic process continuing to weaken.

We take a deeper look at how the next presidential term could impact the three most prominent geopolitical flashpoints. All of these have potentially significant implications for fiscal spending and inflation:

- 1** **The war in Ukraine:** The conflict in Ukraine has ground to a stalemate, with no significant progress by either side over the last year. Former President Trump has stated that he would end the war within 24 hours, and a frozen conflict may suit Russia, providing time to consolidate. If US aid were to dry up over the medium term, we believe other NATO members would be able to provide sufficient support to sustain the conflict, as a Russian victory would be more costly in the long-term.
- 2** **Middle East conflict:** Israel is battling with Hamas within Gaza, but the plight of Palestinian civilians is eroding international perceptions and support. The regional backdrop is complex, with Iran pursuing a long-term strategy to increase its regional influence. We can see a variety of possible scenarios in the Middle East. Optimistically, Trump could view a grand peace deal as a worthy legacy and be prepared to go all out to achieve it. But there are other more pessimistic scenarios in which Iran becomes more directly involved in the regional conflict.
- 3** **The battle for dominance with China:** A new cold war is building between China and the US. Tensions in the South China Sea are growing, with Taiwan a potential flashpoint given Chinese calls for reunification. We believe a Trump presidency would make an escalation less likely, but Chinese/US relations are likely to deteriorate whoever wins the US election.

Ultimately, we believe a Trump victory would bring significant uncertainty – but that very uncertainty could well reduce the risk of escalation in these key conflicts, as the US response would no longer be as predictable. Iran will likely continue to make use of regional proxies to maintain tensions in the Middle East. This should keep upward pressure on both oil prices and shipping costs. A more serious direct conflict with Iran would run the risk of a significant oil-price shock.

We believe this is one of several factors that will mean inflation remains sticky in the years ahead. This would restrain central bank easing and be a headwind for bond and equity markets. We believe investors need to plan for greater volatility ahead.

THE 2024 US ELECTION WILL DEFINE THE NEXT FOUR YEARS

While there are an unprecedented number of elections occurring around the world in 2024, a key political event is undoubtedly the US election in November. At a domestic policy level, much will depend on the broader vote, with voters electing not just the president but also Congressional candidates for seats in the House of Representatives and the Senate. If the House remains divided, the political stalemate will continue, with cross-party support needed for key legislation. Whatever the makeup of the House, fiscal policy is likely to remain loose, with neither side wanting to tackle the US fiscal deficit.

At an international level, there is the potential for far more radical change depending on the victor. Trade is one area where the president has the ability to act directly, and a Trump victory would likely usher in a new era of trade protectionism. Foreign policy would be another area where US policy could dramatically change – with the US potentially becoming more insular but at the same time less predictable on the world stage.

THE ONE THING WE CAN BE CERTAIN OF WITH A TRUMP VICTORY IS UNCERTAINTY

There is no guarantee that Trump's foreign policy goals would be the same as during his previous term in office, but it is reasonable to expect similar levels of unpredictability. To some degree this may be strategic, a deliberate policy to keep negotiating partners on the back foot. As North Korea has demonstrated over several decades, nobody wants to push a nuclear power too far when you don't know where their red lines are.

However, there are many areas where a second Trump presidency can be presumed to follow the pattern of the first. This would have a significant impact on three key areas:

1. the future of international organisations including the United Nations (UN), North Atlantic Treaty Organization (NATO) and the World Trade Organization (WTO);
2. efforts to slow global climate change, which were in any case likely insufficient; and
3. confidence in the democratic process – whoever wins, it will likely be accompanied by claims of electoral interference, and it is likely that Trump would use a second term to reinforce perceptions amongst parts of his base that the 2020 election result was fraudulent.



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FOREIGN POLICY COULD BE THE FOCUS FOR TRUMP'S LEGACY

Traditionally first-term presidents focus on re-election, and second-term presidents focus on legacy. Although Trump isn't necessarily going to follow tradition, if he does focus on legacy then that will likely have to be based on foreign policy unless the Republicans control both the Senate and Congress.

Trump's foreign-policy style is very personality-based, with an emphasis on striking transactional deals that can be portrayed as successful. There is the potential that this could bring unexpected positive change, like Nixon's resumption of relations with China in 1972. But many of the preconditions are lacking. Today's authoritarian axis of China, Russia, Iran and North Korea looks much more aligned than the communist bloc in the early 1970s, the Sino-Soviet split having happened earlier.

But, if Trump were able to bring Russia, or more controversially Iran, back into the Western democratic fold, that would be a net positive for the world. Although it would be extremely difficult to achieve, if Trump were to want a Nobel peace prize as part of his legacy, a push for peace deals in Europe and the Middle East could become a primary goal.

With this in mind, we analyse how a Trump victory could impact three of the most prominent areas of conflict in the world today. The 2024 National Security Act¹ will provide \$95.3bn in aid across these three areas, so the US remains committed for now. But the post-election outlook is far less certain.



If Trump were to want a Nobel peace prize as part of his legacy, a push for peace deals in Europe and the Middle East could become a primary goal.



¹ Source: https://www.appropriations.senate.gov/imo/media/doc/national_security_act_sxs.pdf

1. THE WAR IN UKRAINE

CURRENT STATUS: STALEMATE

The Russians have gradually stepped up their military industrial base and embarked on shadow conscription in an effort to out-gun and out-man Ukraine. Ukraine has also improved its military industrial base, often, but not always, in partnership with Western countries and arms manufacturers. For now, Ukraine remains dependent on Western supplies of ammunition (particularly artillery shells and air defence) and weapons systems.

Ukraine has had notable success in striking the Russian Black Sea fleet using a mix of Western and Ukrainian manufactured weapons, causing them to rebase from Crimea to Novorossiysk. However, there are serious concerns that in the absence of Western supplies, Ukraine will be gradually pushed back on the ground.

Figure 1: Frontline – April 2024 – no significant changes for over a year²



WHAT DIFFERENCE MIGHT TRUMP MAKE?

Trump has repeatedly stated that he could end the war in Ukraine "within 24 hours" if he were president, with phone calls to Putin and Zelensky threatening to respectively increase or stop military supplies to Ukraine if there is no ceasefire. But it is not clear Putin would be deterred by threats from Trump, as his stated objectives (regime change in Kyiv and direct Russian control of at least the five regions claimed by Russia) are far from fulfilled. It may, however, suit Russia to have the conflict frozen for a time, allowing the Russian military time to consolidate their gains and rebuild their forces. The war could then be restarted at some future date, potentially when the US was distracted by some problem elsewhere.

²Source: Insight. As at 30 April 2024.



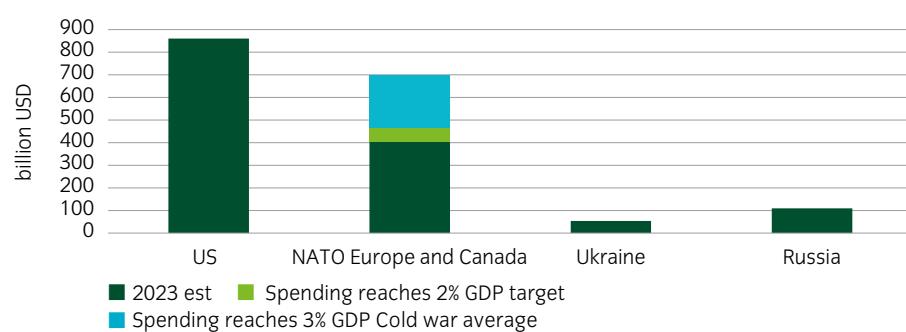


Realistically, a ceasefire under these circumstances with Trump as president would likely see US military aid to Ukraine dry up in the medium term. If Ukraine opted to continue to resist even without US aid, then assistance would be needed from NATO member countries other than the US. There are signs that European countries are gearing up to bear this heavy burden. Investment is being made to expand the production of military supplies from 2025, including an increasing number of joint ventures building production facilities directly in Ukraine.

DON'T UNDERESTIMATE EUROPE'S ABILITY TO PROVIDE THE NECESSARY MILITARY SUPPORT

Military expenditure is already increasing and is going to increase further. While Russian military spending at \$109bn or 5.6% of GDP is the third highest in the world after the US (\$860bn, 2.6% of GDP) and China (\$292bn), it is already dwarfed by the combined military spending of NATO members in Europe and Canada, which stands at an aggregate \$404bn or 1.74% of GDP (see Figure 3). The military spending of European NATO members increased by 11% in 2023 and should reach 2% of GDP overall in 2024 (though not all countries will reach that target). Ukrainian military spending of \$54bn at 31.4% of GDP is, unsurprisingly, the highest proportion in the world.

Figure 2: Military spending³



So even in a scenario where US support fades, the rest of NATO is perfectly capable of supporting Ukraine with considerably more resources than Russia can likely bring to bear. It is simply a matter of logistics in the shorter term, and political will in the long term. We are already seeing the Europeans take the necessary steps to provide for Ukraine's defence in the absence of US support; for example, the Czech-led plan to facilitate the purchase of 800,000 artillery shells in the very near term, and EU and national plans to expand domestic manufacturing capacity over the next few years.

Longer term, if Ukraine were defeated, then Russia would be in a position to threaten EU/NATO states in Central and Eastern Europe as well as the Baltics and Finland. Such an outcome would necessitate significantly higher European defence spending, well above the levels needed to support Ukraine. This is a strong incentive for European NATO members to fund Ukraine in an attempt to prevent a Russian victory. Ultimately, in the longer term, a sustained external threat could well prove the catalyst for the EU to consolidate into a full union.

³Source: NATO, SIPRI, Insight calculations.

2. MIDDLE EAST CONFLICT

CURRENT STATUS: A COMPLEX POLITICAL BACKDROP

The Israel-Hamas war in Gaza is likely to continue until Hamas is significantly reduced as an immediate threat to Israel, most likely towards the end of 2024. Although political differences within Israel are re-emerging, Israelis are united in their determination to destroy Hamas following the horrific attacks of 7 October. The outlook for Gazan civilians caught in the crossfire is grim.

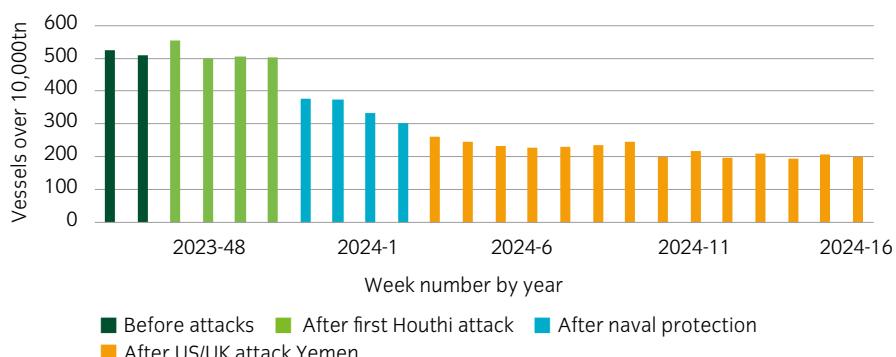
Iran limited its intervention in the initial part of the conflict, largely using proxies. Hezbollah and Israel have exchanged rocket fire over the Lebanese border, there have been ongoing militia attacks on US forces in Iraq and elsewhere, and Houthis have attacked shipping in the Red Sea. This changed on 13 April, when Iran launched over 300 drones and missiles in a direct attack on Israel as retaliation for an Israeli strike on 1 April that killed seven members of the Islamic Revolutionary Guard in Damascus. The attack was efficiently dealt with by Israeli forces and their allies, and little damage was done. Israel responded by attacking a military air base in central Iran, but the reaction from both sides has been muted, suggesting that there is little intent to escalate the conflict further. It appears that Iran is happy to pursue a much longer-term strategy, gradually increasing regional influence to enable attacks on Israel and the US without triggering a direct conflict.

Saudi Arabia and other Western-aligned Middle-Eastern states are faced with a dilemma. The Saudis were close to joining the Abraham Accords in 2023, making peace with Israel for economic (and military) advantage. The leadership of these Sunni states generally want to contain Shi'ite Iran, but their populations feel a stronger pan-Islamic identity with the Palestinian people and support any Islamic resistance forces.

The Democrats in the US also face a dilemma. President Biden supports Israel and its right to defend itself but wants to constrain Israeli actions leading to civilian deaths and suffering, so far with little success. The plight of Palestinian civilians is negatively impacting international perceptions of the US as well as Israel, especially amongst younger segments of the Democratic voter base.

For now the US continues to push back against Iranian proxies. US and allied forces have been attacking the Houthis in an attempt to deter attacks on shipping and restore the number of transits through the Bab el-Mandab Strait, but have struggled to do so (see Figure 3 and 4).

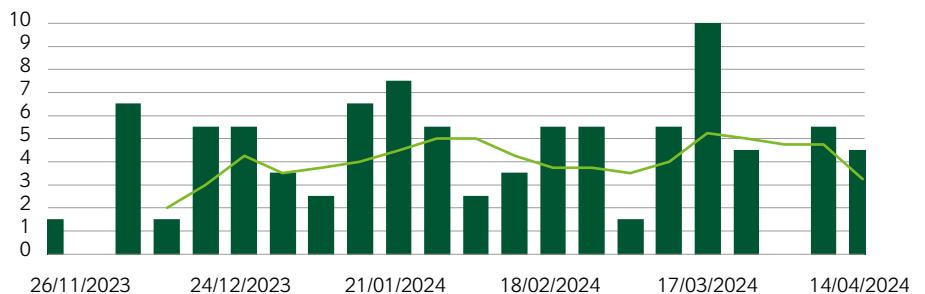
Figure 3: Bab el-Mandeb Strait weekly transits⁴



⁴Source: Lloyds List Intelligence. Vessels over 10,000 tons.



Figure 4: Weekly attacks in the Red Sea⁵



WHAT DIFFERENCE MIGHT TRUMP MAKE?

It appears highly likely that the Israel-Hamas war will be over before the US presidential inauguration in early 2025. The Israel Defence Forces (IDF) may still be operating within Gaza at that point but are likely to have destroyed most of Hamas and the conflict should have shifted to a much lower intensity.

In a scenario where Netanyahu remains the prime minister of Israel, and Trump is re-elected, then the US is far more likely to back an Israeli war on Hezbollah in 2025. An escalation in Hezbollah attacks on Israel in the near term would require Iranian support, and this wouldn't be an easy decision for Iran. But if the Iranians and Hezbollah judge that an Israeli-Hezbollah war is coming anyway, they may choose to launch it at the time of their own choosing, preferably when international opinion of Israel is at a nadir and before Trump is elected.

But there is a more optimistic scenario. A second Trump administration may base its Middle East policy around the twin pillars of blocking Iranian ambitions and establishing a broader peace deal. As unlikely as that may sound in the current climate, Trump may be prepared to do more than previous US administrations to achieve this if he has his eye on a Nobel peace prize and is unable to make progress in Ukraine.

It is possible to envisage a Saudi-Egyptian-Israeli deal based on the Abraham accords (peace for military and economic co-operation) with the Egyptians taking control of Gaza (as was the case pre-1967) and the Saudis, or broader Gulf Cooperation Council (GCC), financing its reconstruction. Trump's added value would be the ability to credibly threaten the withdrawal of military and financial support from the Egyptians and security guarantees from the Saudis to force agreement despite the prospect of domestic protests. Such a deal could only be finalised after fighting stops in Gaza and Lebanon.

A more pessimistic scenario for regional stability centres on Iran. Although Iran seems happy to play the long game, the response function of a Trump administration to its use of proxies would become far less predictable. Iran would never know whether what it regards as a justified attack on occupying US forces would cross one of Trump's hazy red lines and result in a disproportionate response – even seeing Iran attacked directly. This could leave Iran feeling that it needs a stronger deterrent, and the obvious one is a functional nuclear-missile capability. Iran has good relations with China, Russia, North Korea and (usually) Pakistan, all of which are nuclear powers and two of which have vetoes at the UN security council, and they may be prepared to assist Iran in this endeavour.

Iran gaining nuclear weapons is likely inevitable at some point, but a Trump presidency may accelerate it and finally break the dam established by the Treaty on the Non-Proliferation of Nuclear Weapons. Current estimates suggest Iran would need only about a week to produce enough uranium for its first nuclear weapon. This would certainly cross red lines for any Israeli or US administration.

⁵ Source: ACLED, Insight calculations. Four week moving average.

MIDDLE EAST INSTABILITY GENERALLY MEANS HIGHER OIL PRICES AND INFLATION RISK

Should a Trump victory bring an unexpected resolution to the conflict in the form of some grand deal, then we could see a period of outperformance for assets in Israel, Egypt and Saudi Arabia. But if the conflict continues over the medium term, or even worsens, then the primary impact on developed market economies would be via the inflationary impact of higher oil prices, with a smaller risk from increased shipping costs should the Red Sea remain a dangerous transit route.

If an Israel-Hezbollah war were to start, then oil prices would be expected to spike higher. But if the war escalated to direct conflict with Iran, or if Iran were to exit the non-proliferation treaty, there would a risk of a significant oil-price shock (see Figure 5). Such an outcome would be highly inflationary globally and bring back strong echoes of the 1970s. The growth impact would be more severe in Europe and Japan than in North America which has its own oil production and if Trump were elected, he would presumably be actively encouraging US production gains.

Figure 5: Inflation in the 1970s⁶



If the war escalated to direct conflict with Iran, or if Iran were to exit the nonproliferation treaty, there would a risk of a significant oil-price shock.



⁶Source: Bureau of Labor Statistics, Insight Investment. As at 12 February 2024.





3. THE BATTLE FOR DOMINANCE WITH CHINA

A NEW COLD WAR HAS STARTED

The multi-level strategic contest between China and US is gradually turning into a second cold war. Both sides expect the other to be relatively weaker in the future due to inherent weaknesses in their politico-economic structures. This leads to strategic patience with each side happy to avoid war in anticipation of future advantage. Once it becomes clear that one side is on a path of decline relative to the other, that may force a future change in position.

Meanwhile, China continues to expand its regional influence within Asia. At the 2024 annual meeting of the National People's Congress in Beijing, China's Finance Ministry announced a 6.8% increase in its defence budget, to 1.35 trillion yuan (over \$200bn). A key goal for China is the modernisation of its military and naval forces. The Fujian, China's third aircraft carrier, is in its final stages and is expected to become operational well ahead of the 100th anniversary of the People's Liberation Army in 2027.

TAIWAN COULD BE A TRIGGER FOR CONFLICT

China has repeatedly conducted naval exercises in the Taiwan Strait and has opened up two new air routes with flight paths close to outlying islands controlled by Taiwan. This will put Chinese commercial aircraft close to no-fly zones operated by Taiwan's Air Force and makes accidental incursions into Taiwanese airspace more likely. Chinese naval ships and military aircraft now regularly cross the median line of the Taiwan Strait as part of a strategy clearly designed to exert pressure on the Taiwanese government.

President Xi has made clear that reunifying Taiwan with the Chinese mainland is key to his legacy. In his 2024 New Year's address he stated that reunification was "inevitable". But the newly elected president of Taiwan, Lai Ching-te, is fiercely in support of Taiwanese independence, previously being branded a "dangerous separatist" by Beijing. For China, gaining control of Taiwan's production of high-end computer chips would progress the country's strategic goal to move up the global supply chain and become a leader in high-tech goods.

Taiwan is in a constant state of high alert and President Biden has repeatedly stated that the US military would defend the country in the event of a Chinese invasion. In April 2024, the US, Japan, Australia and the Philippines conducted joint maritime exercises – the first time for the four countries to come together – in a huge show of force designed to push back against Chinese militarisation in the South China Sea. The 2024 US National Security Act⁷ provides \$2.58bn to deter a Chinese invasion of Taiwan, although much of this spending will be directed at investment within the US itself, replenishing weapons supplied for the defence of Taiwan and enhancing US cruise-missile capacity.

WHAT DIFFERENCE MIGHT TRUMP MAKE?

Despite President Biden's hawkish rhetoric on Taiwan, the unpredictability of a Trump presidency is again likely to be a key factor in making China less certain about how the US would react, in turn making an invasion less likely. A war between nuclear superpowers would need to be carefully managed to avoid escalation and China would be deeply uncertain about where the red lines would lie. A blockade of Taiwan would be one way that China could significantly ratchet up the pressure without resorting to direct conflict. By stopping container ships from navigating the waters around Taiwan, China could cut off the import and export of goods. As an export-driven economy that imports around 98% of its

⁷ Source: https://www.appropriations.senate.gov/imo/media/doc/national_security_act_sxs.pdf

energy the economic consequences for Taiwan would be severe. But this is also less likely if Trump wins a second term, and a more likely scenario is that China would maintain the status quo and wait for the 2028 election.

But, at the same time, US security guarantees would also become less certain if Trump regains power, and US alliances would almost certainly become more transactional and bilateral. Defence spending in countries like Japan, South Korea and Australia would be expected to rise, reflecting both the uncertainty around US support and in order to show the US that they were “playing fair”, as former President Trump often describes the lack of defence spending by NATO countries. Some countries may react to this change in a different way, seeking closer ties with China instead, or else developing their own nuclear deterrent.

Ultimately, it is not only Taiwan that faces direct conflict with China. China’s claim that it owns virtually the entirety of the South China Sea mean that its perceived boundaries overlap with the territorial claims of several other nations. The US has a mutual defence treaty with the Philippines, which faces ongoing Chinese attempts to block the resupply of marines stationed at Second Thomas Shoal, which China continues to claim sovereignty over despite its claims being dismissed in 2016 by the Permanent Court of Arbitration in the Hague.

NORTH KOREA ALSO REMAINS A WORRY FOR THE US AND SOUTH KOREA

In November 2023, North Korea abandoned the inter-Korean Comprehensive Military Agreement that was struck in 2018 after launching a satellite to monitor US military bases in the region. Kim Jong Un has become increasingly hostile as he seeks to build an even closer relationship with Russia, China and Iran.

US/CHINA RELATIONS ARE LIKELY TO DETERIORATE ANYWAY

The desire to contain China is a bipartisan position in US politics, so whoever wins the election there is likely to be gradual long-term increase in tensions between the two countries. Differences between a Biden and Trump victory will be more about approach and method rather than aims. Trump has been clear that his re-election would bring a significant increase in tariffs on Chinese imports, with 100% tariffs on electric cars and 60% on other goods. This would have major consequences for global trade and US inflation, on which we will expand in a future paper. But the Biden administration is also calling for higher tariffs, including a tripling of tariffs on Chinese steel imports. So both sides are likely to have anti-China rhetoric as part of their election campaigns, and there appears little prospect of any thawing in US/China relations after the election.



The desire to contain China is a bipartisan position in US politics.



CONCLUSION

ECONOMIC IMPLICATIONS

Whoever wins the US election, the world appears likely to be in a state of conflict for some time to come. Defence budgets are on the rise and a Trump victory would only accelerate this trend, bringing greater uncertainty around US defence guarantees and the need to be seen to be making a fair contribution. In aggregate, this is a negative for fiscal balances around the world, but a marginal boost for growth in those countries with meaningful military exports.

If there is no resolution to the conflict in Ukraine, then a Trump victory would likely force greater European political coherence (potentially including the UK). Russia could attempt to foment division in Europe, using its influence in Africa to encourage and fund military coups and fan the flames of conflict, increasing the flow of migrants and refugees from the Sahel.

Commodity prices are a risk. There seems little prospect of a return to lower food prices, and shipping costs are likely to remain elevated due to attacks in the Red Sea. Oil prices are also likely to retain some price premia to reflect geopolitical risk, and the risk of a future oil price shock will continue to lurk in the background – with direct conflict with Iran a likely trigger. These factors are likely to keep upward pressure on inflation.

MARKET IMPLICATIONS

If these factors contribute to a stickier inflation regime ahead, as we expect, it may short circuit central bank easing cycles. This would limit the number of rate cuts we see in the next few years, which would be a headwind for both bond and equity markets, likely raising market volatility. We believe investors need to factor this into their investment strategies, either undertaking strategic hedges, potentially utilising options, or by building robust strategies that use contractual fixed income assets to increase the certainty that objectives will be achieved.

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