



Geopolitical Alpha & Beta

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Framework



Geopolitical Alpha & Beta

- Constraints Framework:

Policymaker preferences are optional and subject to constraints, whereas material constraints are neither optional nor subject to preferences.

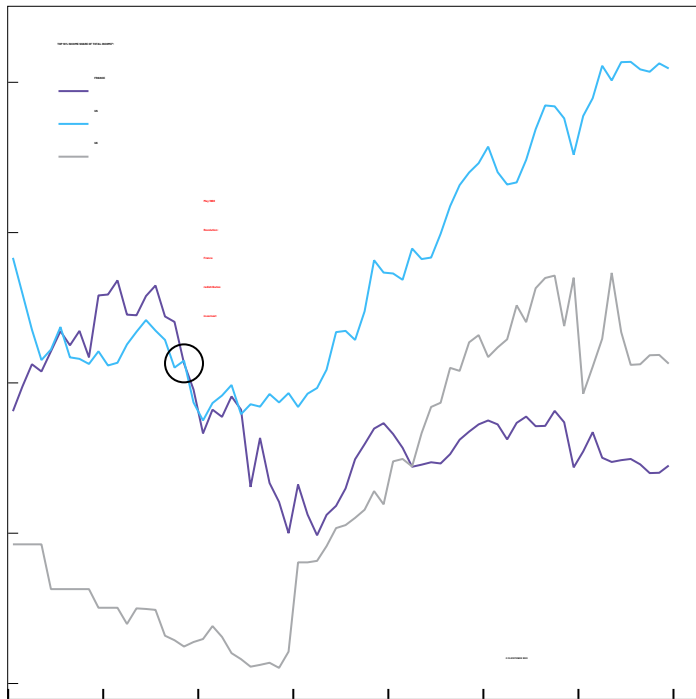
- **Alpha:** Geopolitical alpha is harvested when markets overstate or understate geopolitical risks and opportunities. For example, investors underestimated the policy support likely to be generated in a bipartisan matter following the COVID-19 pandemic, missing a major run-up in risk assets from March 23, 2020, onwards.
- **Beta:** Geopolitical beta is about catching phase shifts and long-term trends. For example, a shift from the Washington Consensus to the Buenos Aires Consensus should – *ceteris paribus* – generate higher inflation and lead to a bond selloff.



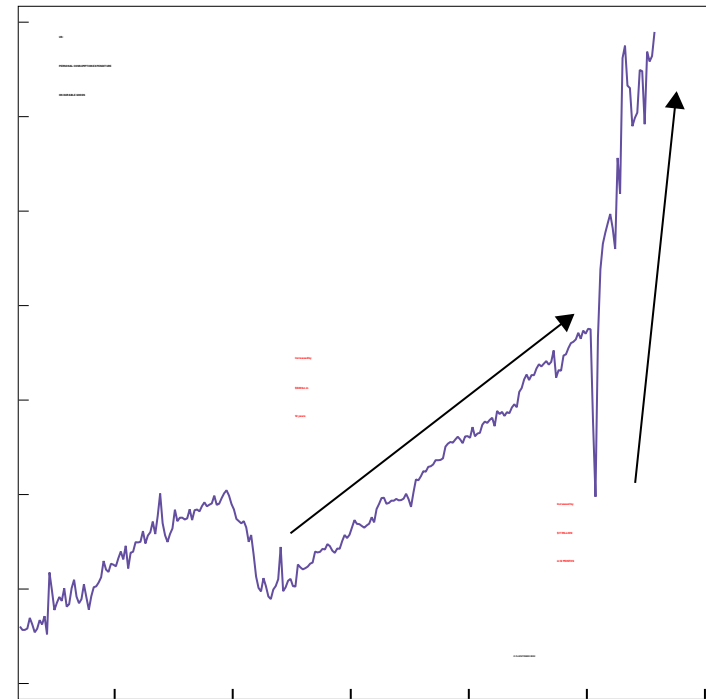
Framework | Alpha & Beta

To generate geopolitical beta, investors must hold long-term views that are informed by their framework. Alpha is generated when events catalyze that framework.

BETA



ALPHA



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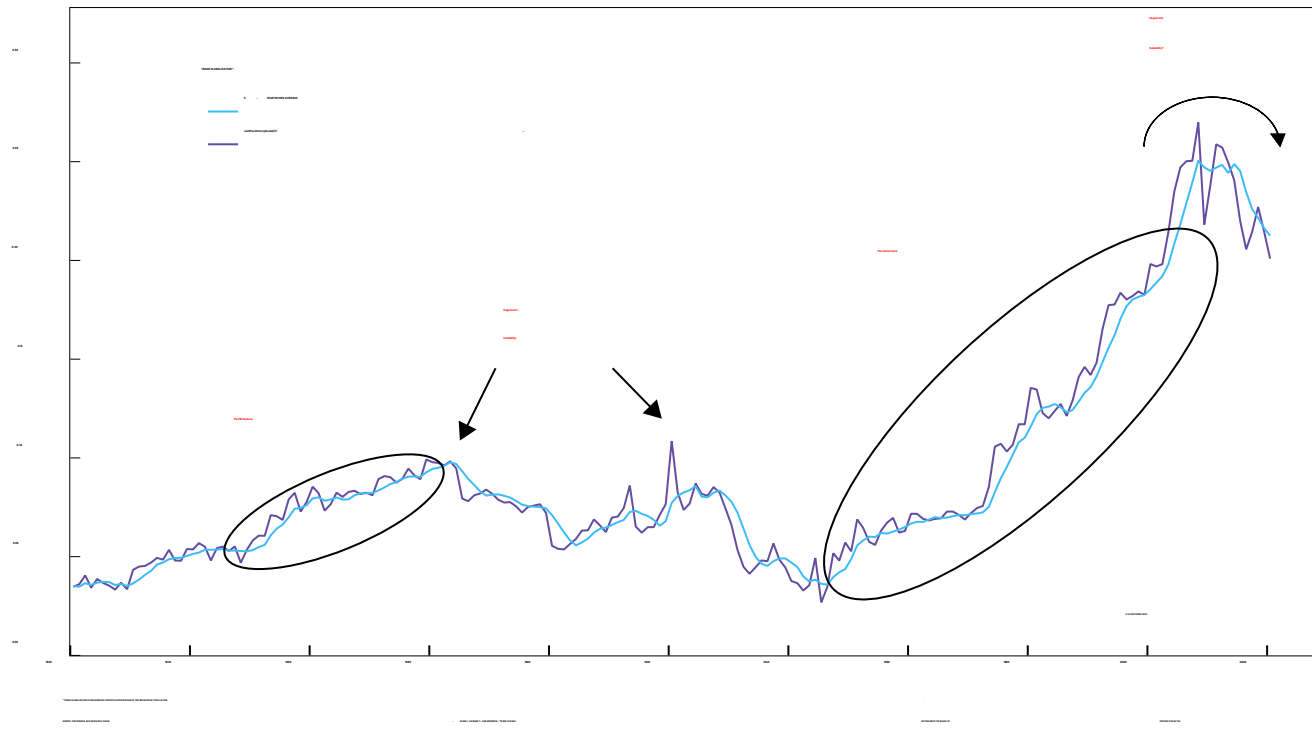
Multipolarity



Geopolitical Context | Globalization Is *Not* the Norm

Globalization is not... normal. It is not self-evident or "given." It is a product of governance, rules, and norms of behavior enforced by a hegemon.

We Are Living Through the Apex of Globalization

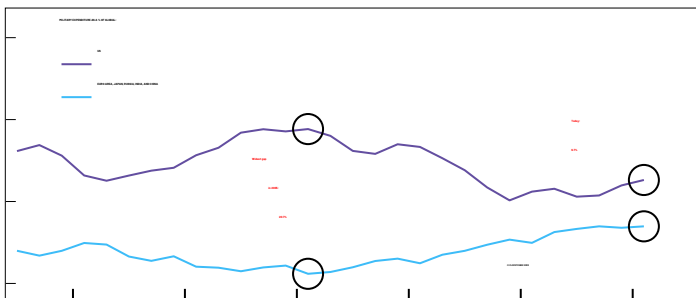
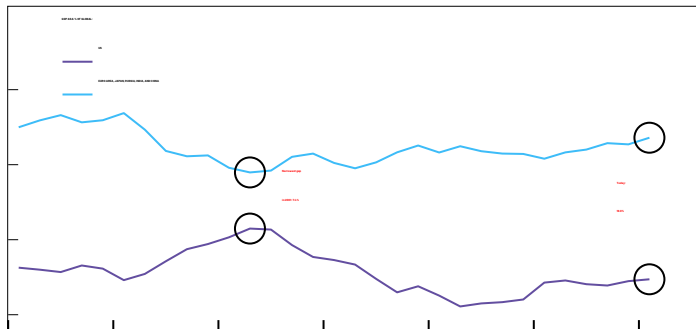




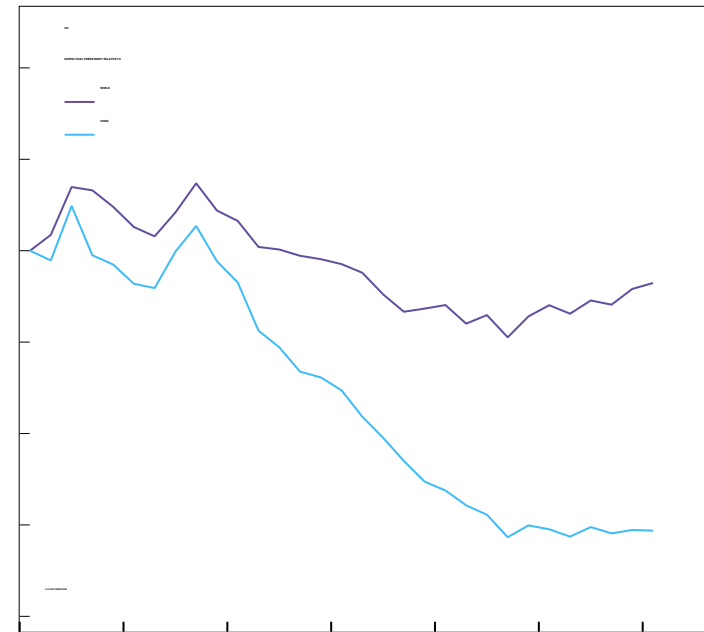
Geopolitical Context | Multipolarity Is the Norm

Multipolarity is not compatible with peak globalization as it crates too much of a disequilibrium. **For the past decade, the world has been multipolar.**

America Has Ignored its Relative Decline...



... For Much of the Past Two Decades to Great Costs

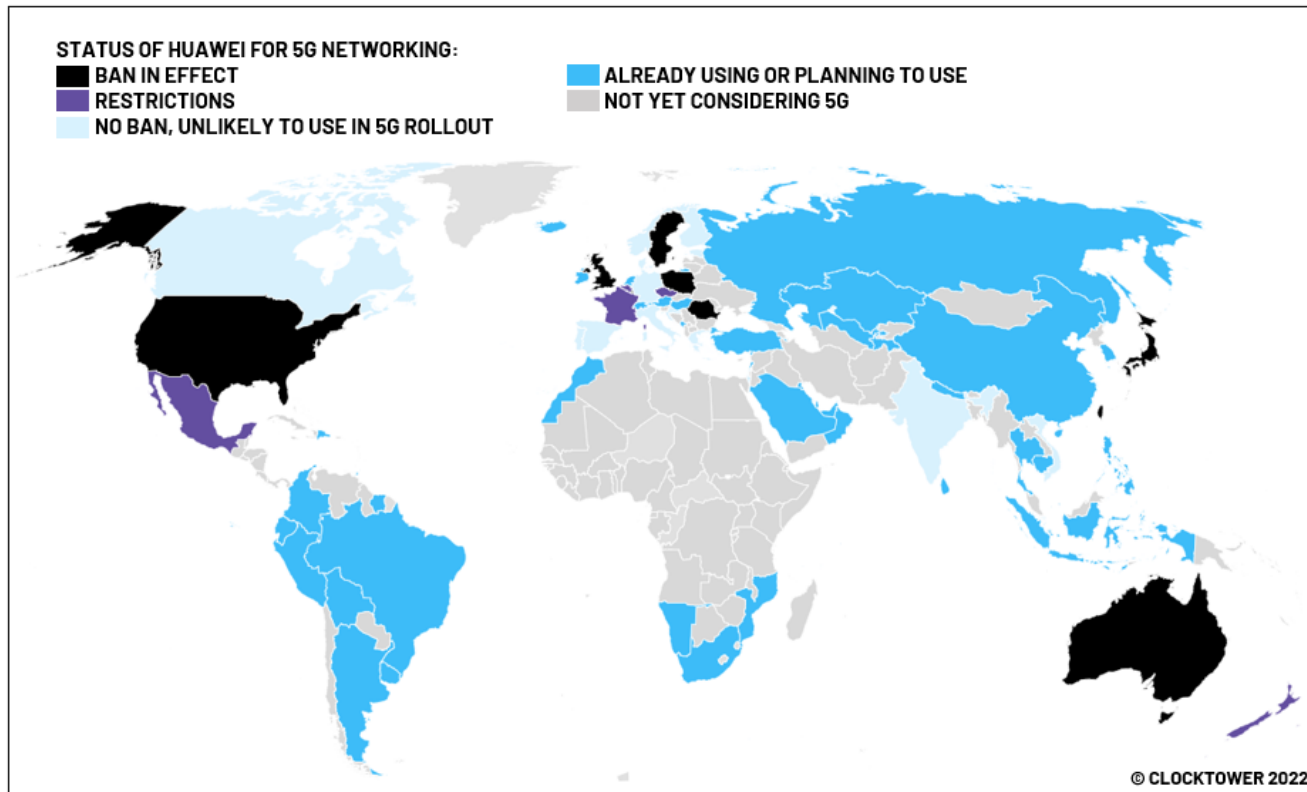




Geopolitical Context | Coalition Against China Failed

Evidence that the world is multipolar can be gleaned from America's experience building a coalition of the willing against China. It failed. Across three different administrations.

George W. Bush Laughs at *Your* Coalition of the Willing



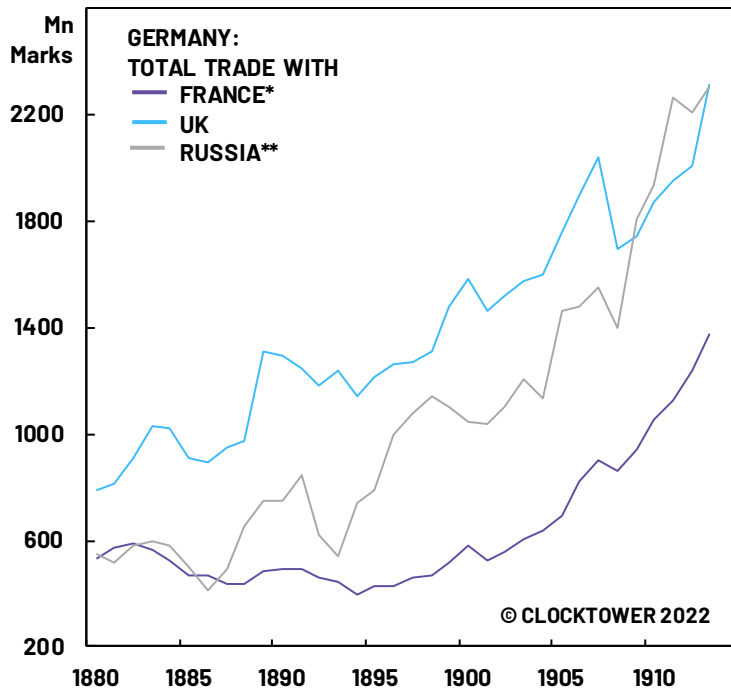
SOURCE: COUNCIL ON FOREIGN RELATIONS.



Geopolitical Context | Multipolarity & Trade

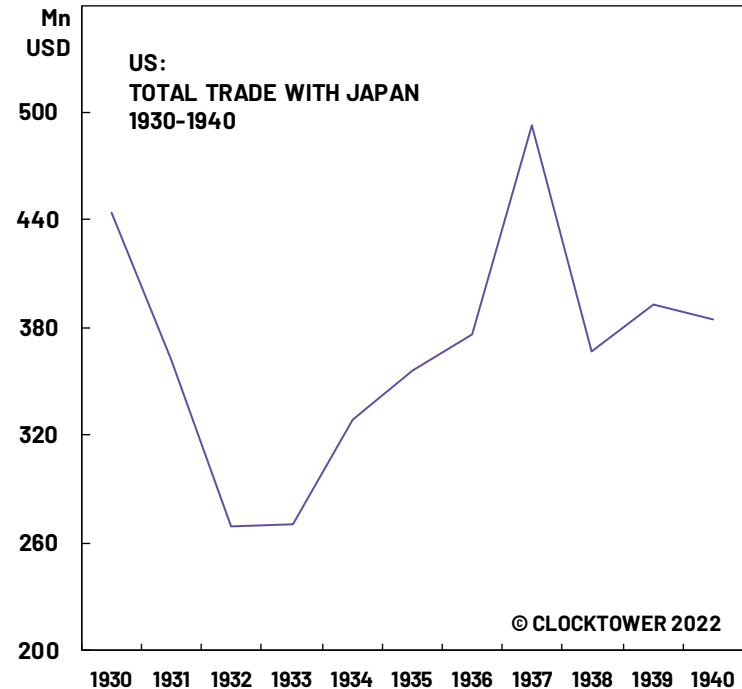
A multipolar global ordering of power does not lead to neatly decoupled economic spheres. Both history and political science teach us that trade between enemies continues.

A Trade War Did Not Precede World War One...



* INCLUDING ALGERIA AND TUNISIA UNTIL 1897.
** INCLUDES FINLAND UNTIL 1897.
SOURCE: B.R. MITCHELL, INTERNATIONAL HISTORICAL STATISTICS, EUROPE, 1750-1988.

... Nor World War Two



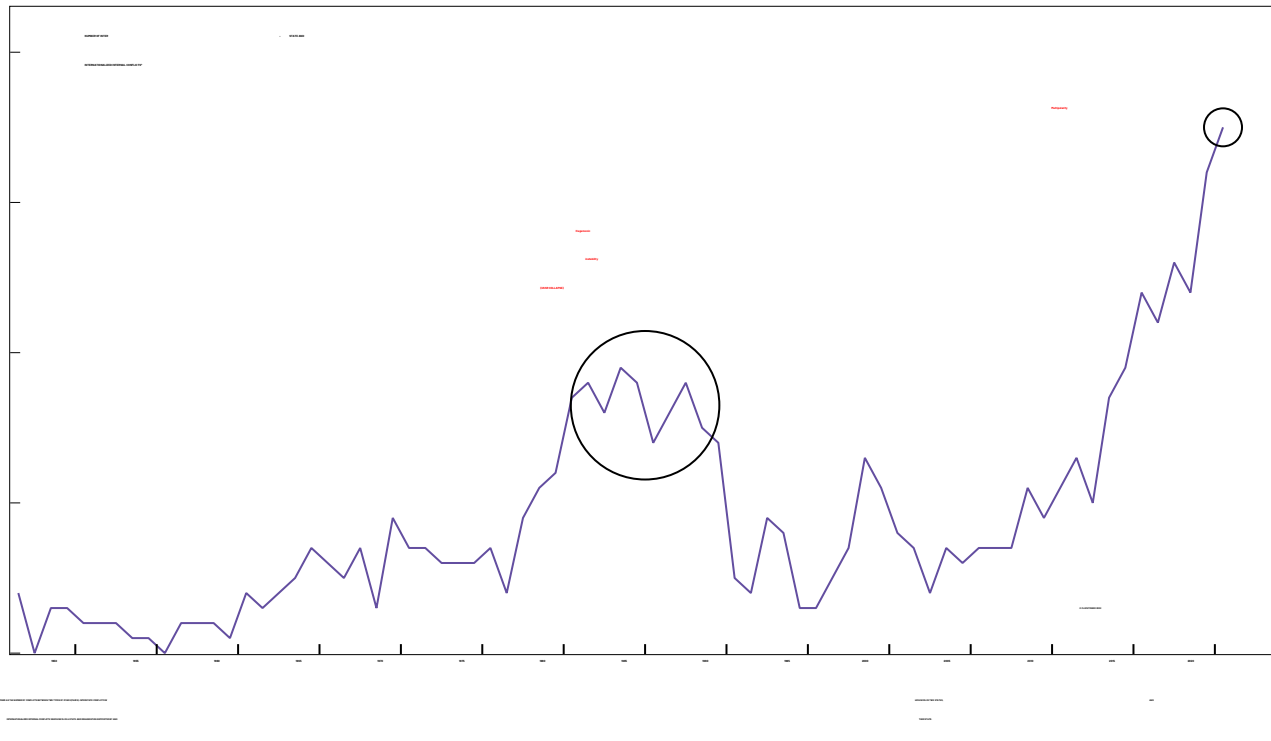
SOURCE: INTERNATIONAL HISTORICAL STATISTICS: THE AMERICAS, 1750-1988. B.R. MITCHELL.



Geopolitical Context | Multipolarity Is Fraught With Risks

Geopolitical conflict is more likely in a multipolar world for a number of reasons, both theory and empirics support this view. This does not mean that every conflict will matter for markets.

Multipolarity Leads to Higher Odds of Conflict



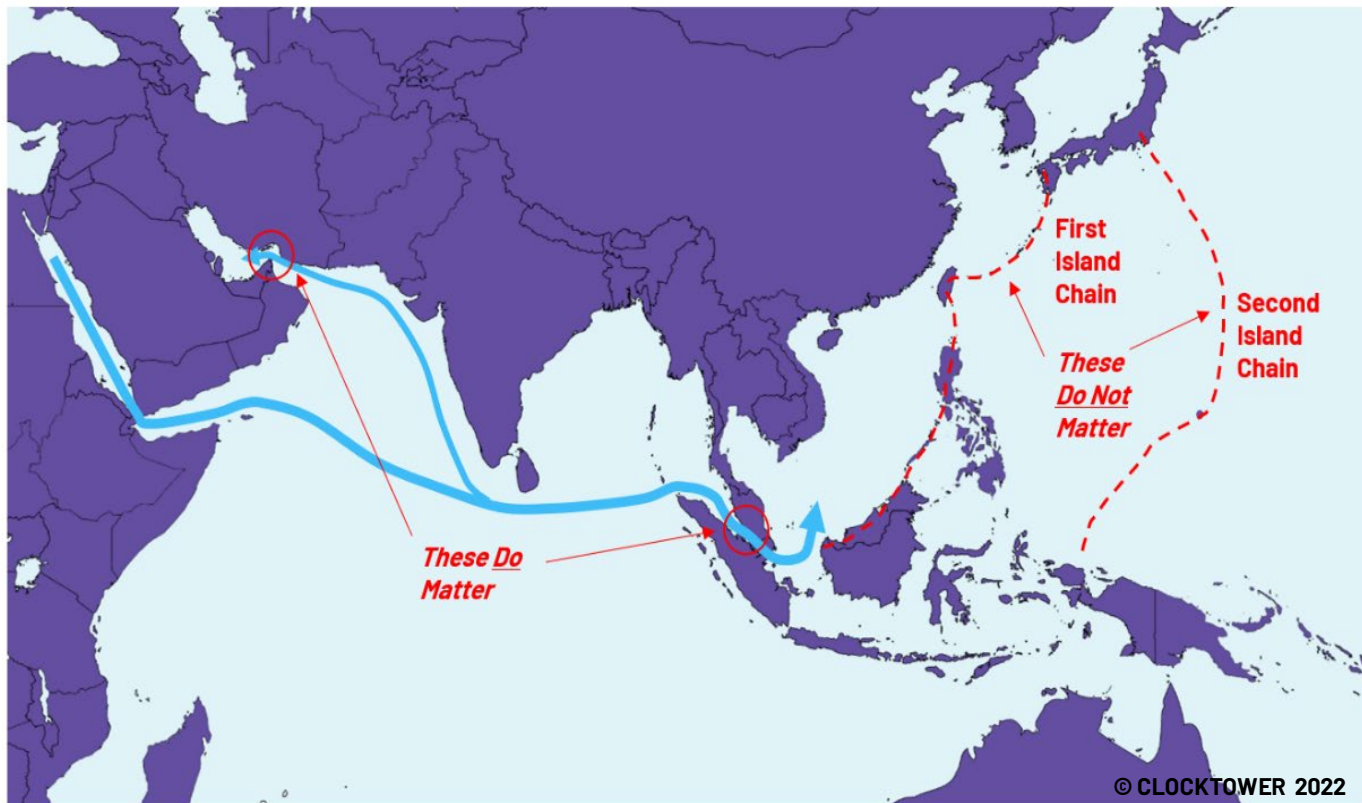
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China-US: Not a Cold War



China-US | China's Trap #1: Geography

Many geopolitical strategists talk of First & Second Island Chains... this is all nonsense. China's geographic fulcrum is half the planet away: The Strait of Hormuz.

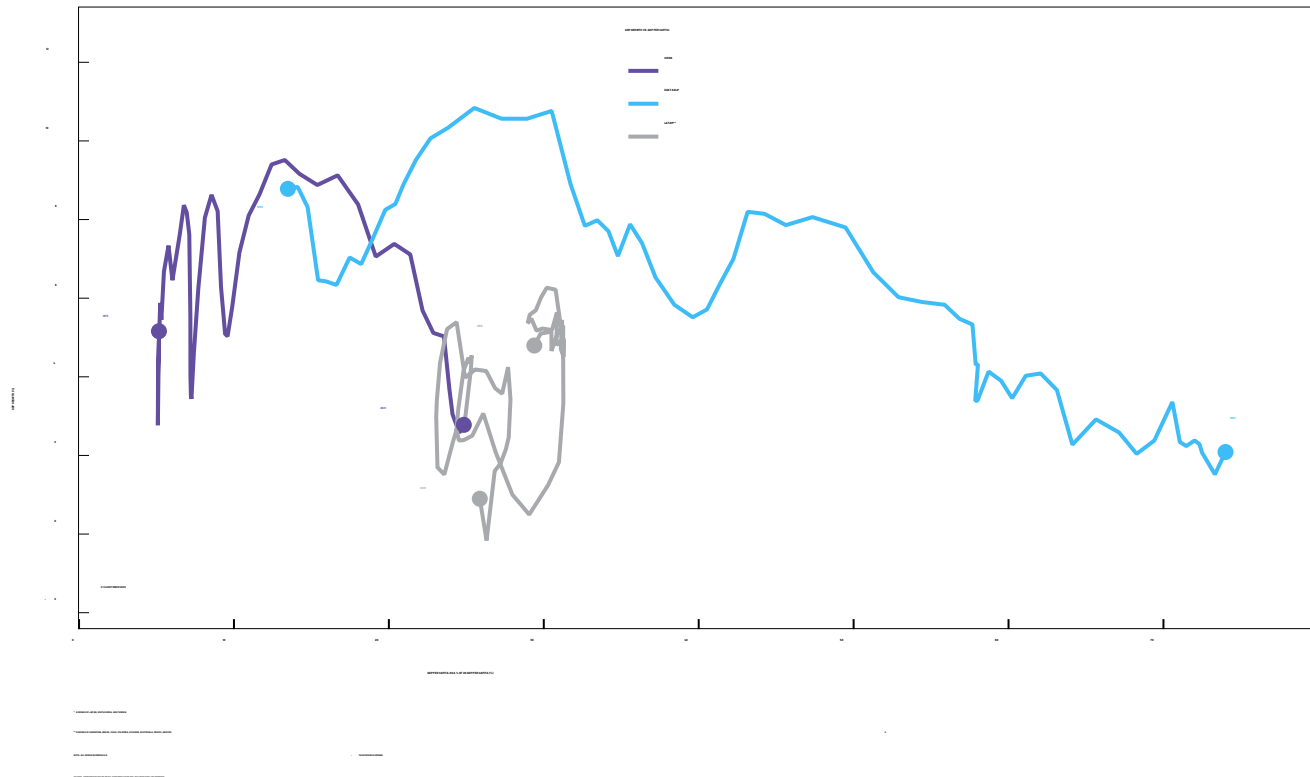




China-US | China's Trap #2: The Middle-Income Trap

China's productivity growth is declining, a dire outcome that will result in the country potentially being trapped in the middle income. China needs to avoid the middle-income trap.

China Is Too Poor to Get Stuck in the Middle-Income Trap

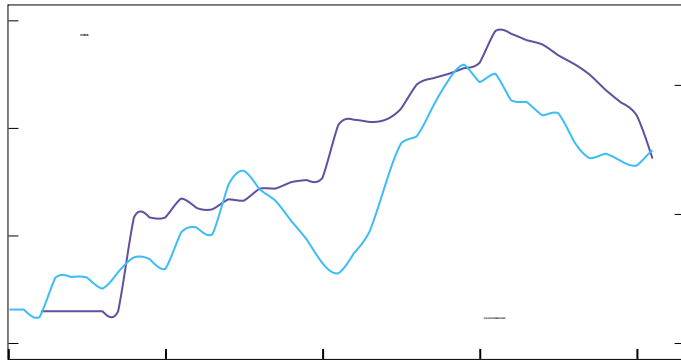
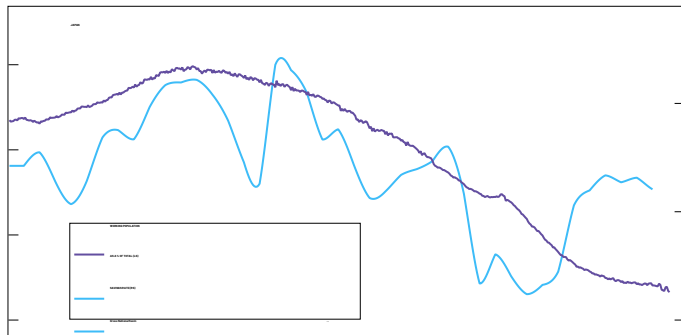




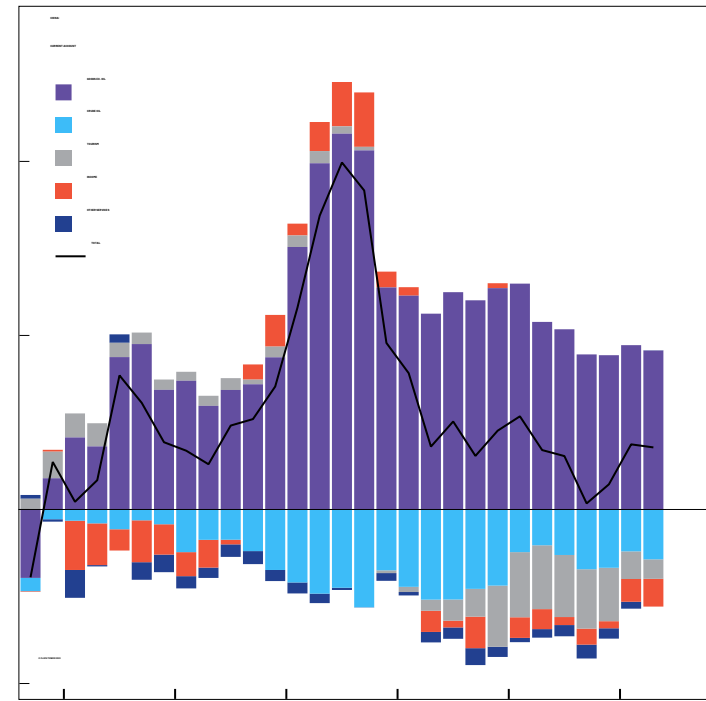
China-US| Trap #3: Demographics Are A Risk to the BoP

If $Y = C + I + G + NX$, and $S = Y - (G + C)$, then $S - I = NX = CA$. Math story put simple: China's demographics will guarantee to tip the country into a CA deficit.

China's Demographics Portend...



... A Risk to its CA Surplus

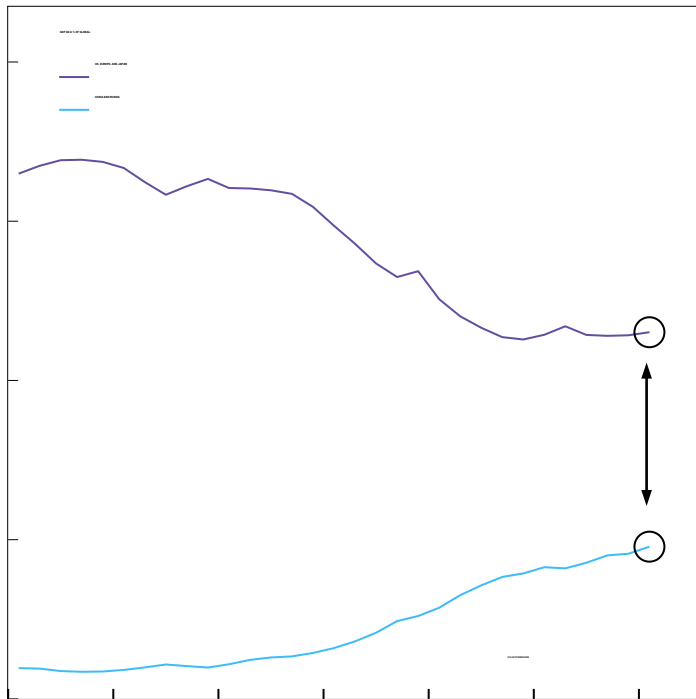




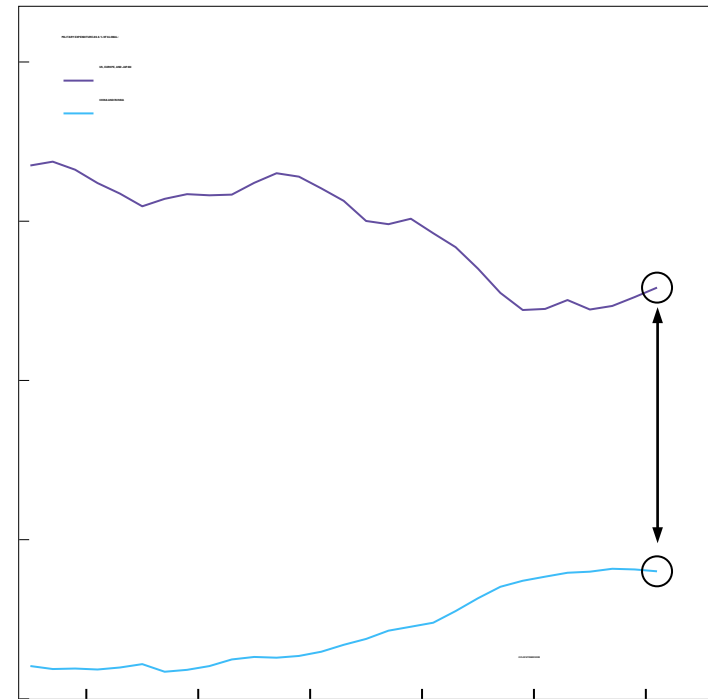
China-US | Will China Usher in A Bipolar World?

If Beijing takes the Russian side and isolates itself from the EU, it may create the conditions for the world to evolve from a multipolar distribution of power to a bipolar one.

The West Has Economic and Military Superiority...



...in A Bipolar World

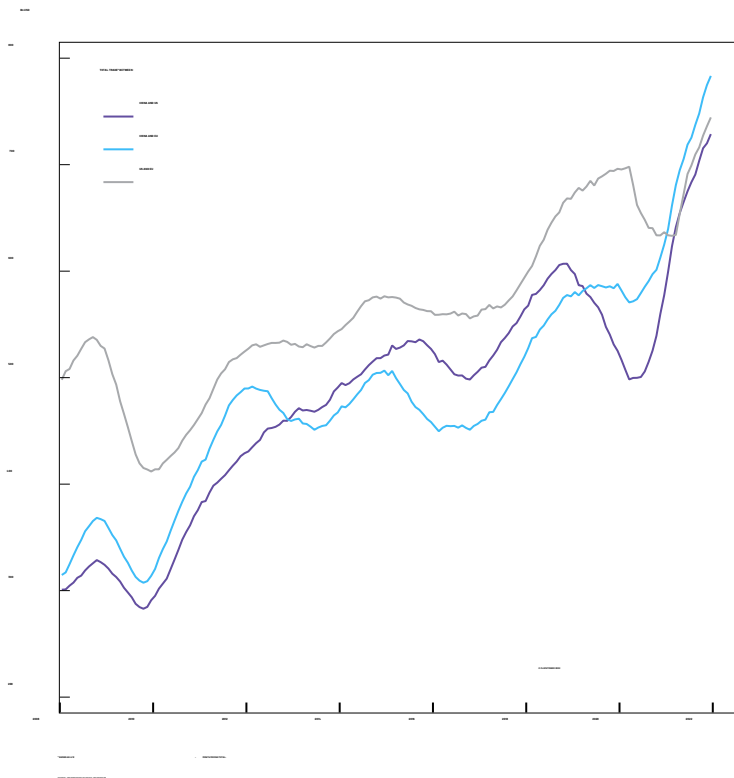




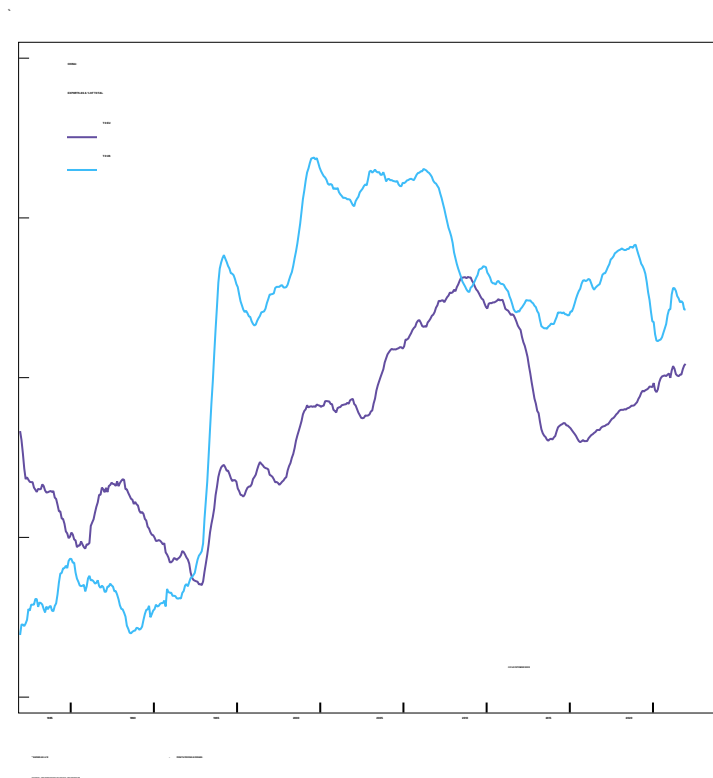
China-US | The Importance of Sino-EU Relationship

The value of bilateral trade between China and the EU is now the world's largest, with China's export dependence on the European market gradually growing to match that of the US.

The Rise of Sino-EU Trade Relationship



EU's Importance to China Has Grown

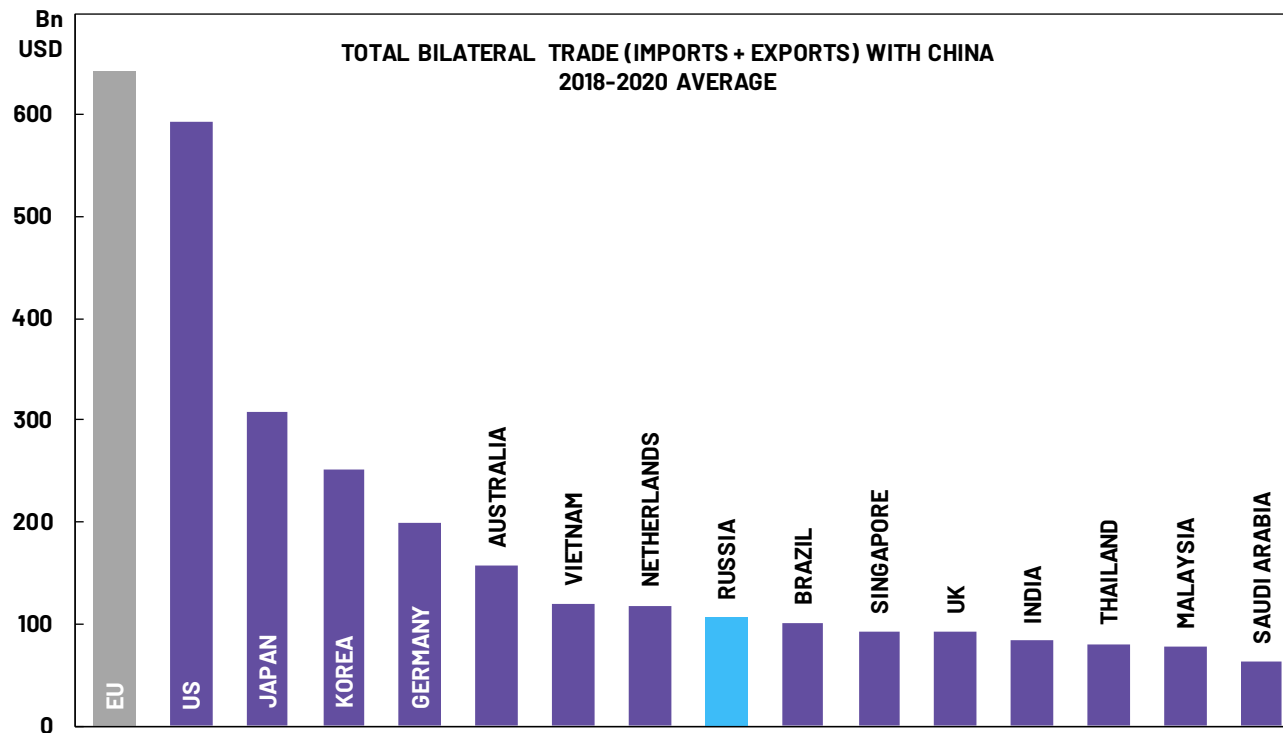




China-US | Less Substance in Sino-Russia Partnership

The substance of the Sino-Russia comprehensive strategic partnership is far less significant than many think, particularly in the West.

Russia Is Not Even in the Top Five Trading Partners of China



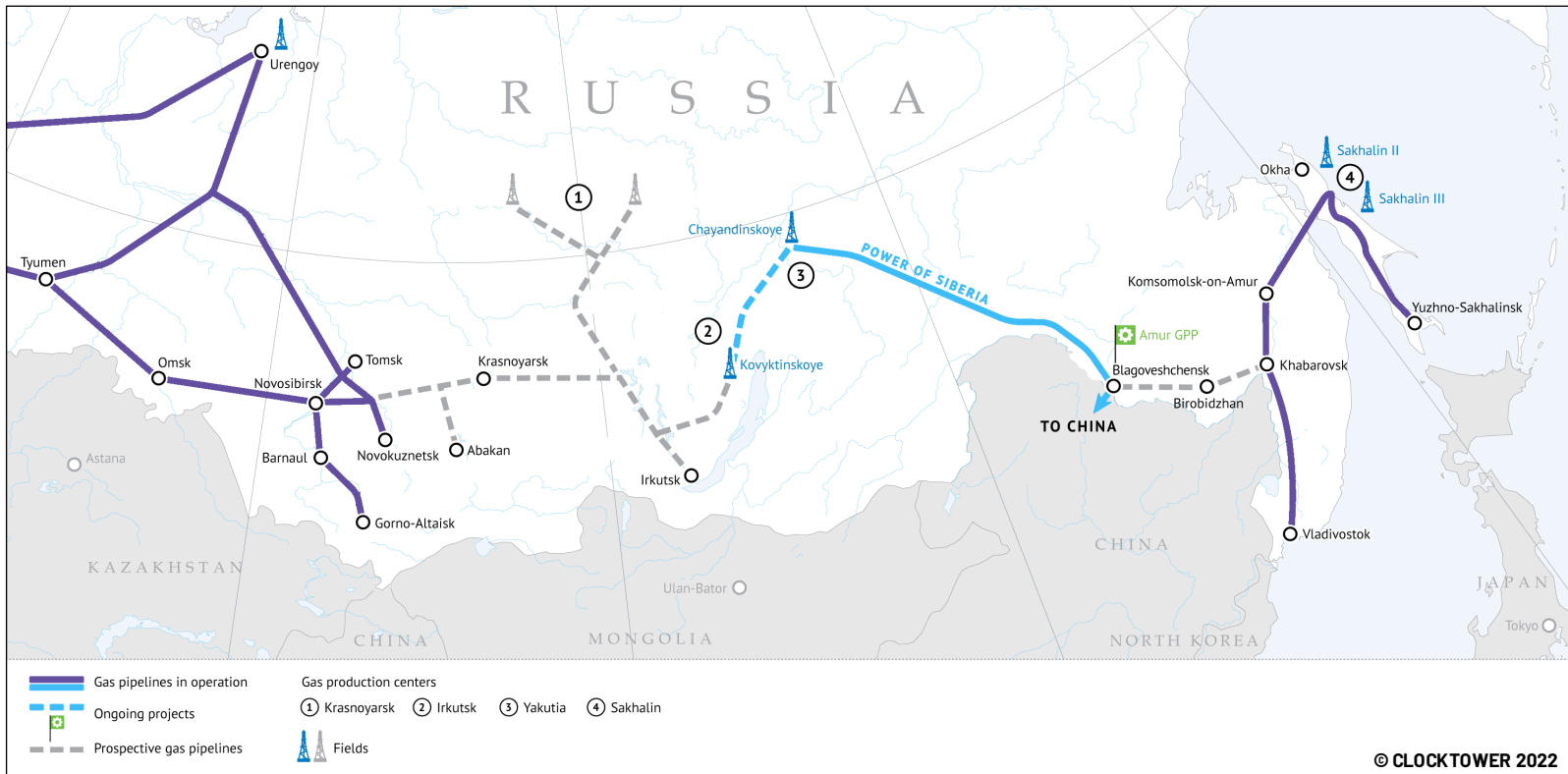
SOURCE: IMF DIRECTION OF TRADE, MACROBOND.
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China-US | Infrastructure Buildout Is Slow

Infrastructural needs for a robust Sino-Russian relationship are huge. They have not been built yet. Getting Yamal Peninsula gas to China would be one of the greatest infra projects ever attempted.

Russia-China Infrastructure Links Are Paltry



SOURCE: GAZPROM.

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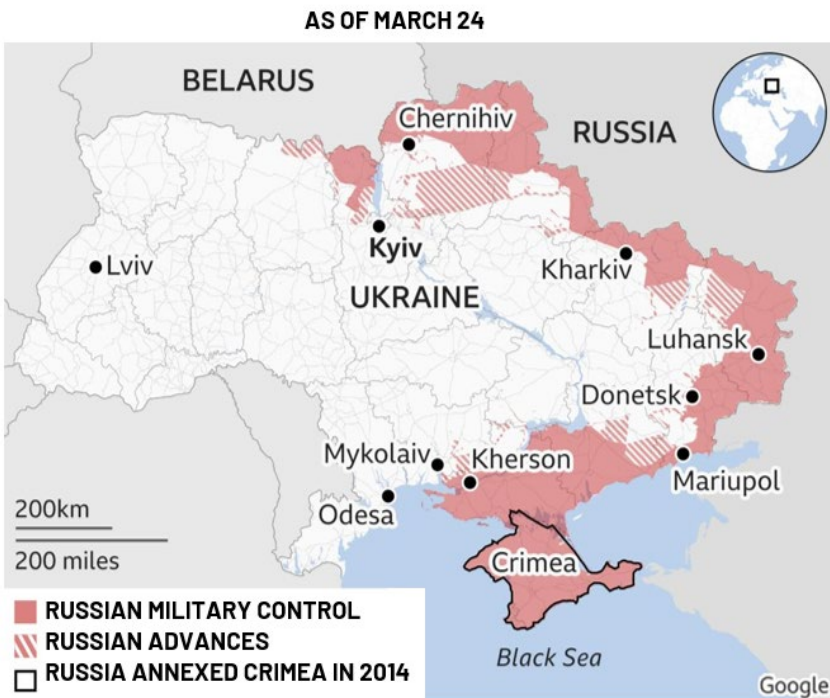
Ukraine: A Symptom of Multipolarity



Ukraine | Russia Is Not Winning

Russian intervention in Ukraine will go down in history as one of the most botched military operations ever. Constraints have overcome preferences.

Russian Preferences...



SOURCE: INSTITUTE FOR THE STUDY OF WAR.
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... Were no Match for Material Constraints



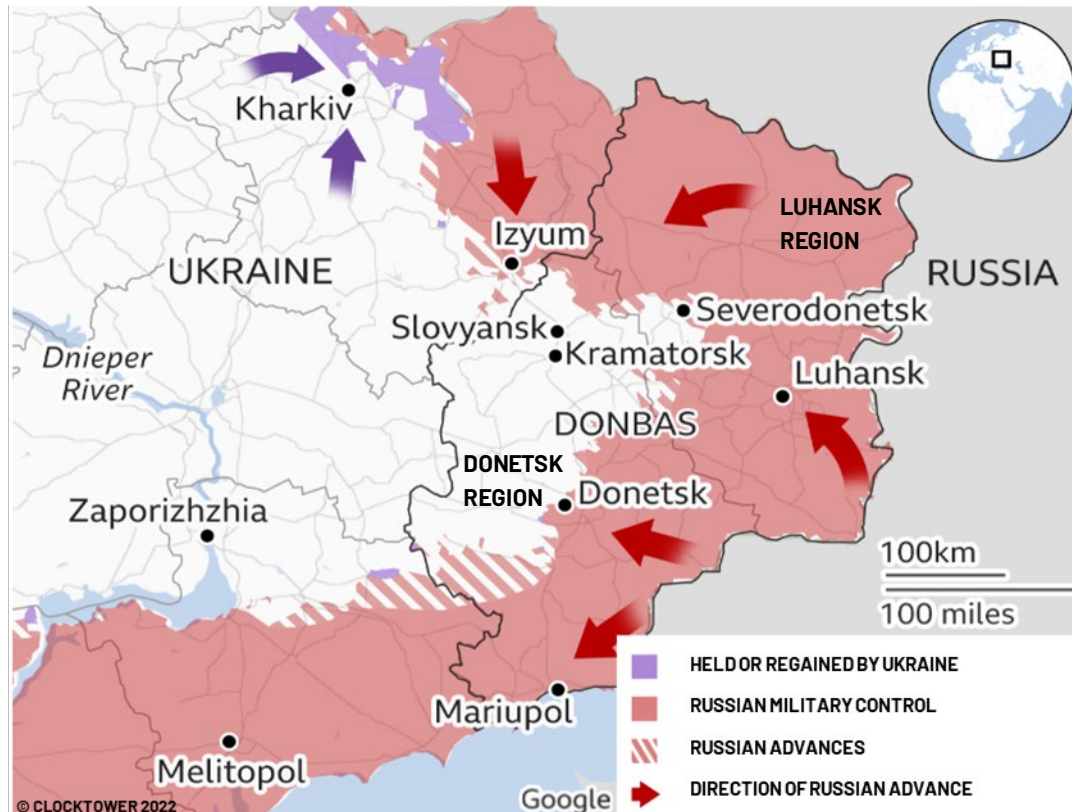
SOURCE: INSTITUTE FOR THE STUDY OF WAR.
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Ukraine | Donbas Remains in Ukrainian Hands...

...which makes it difficult for Moscow to downshift from the conflict.
Investors must watch carefully how Ukrainian troops reposition into Donbas.

Over Half of Donetsk Remains in Ukrainian Control, Will Russia Be Satisfied With Just Donbas?



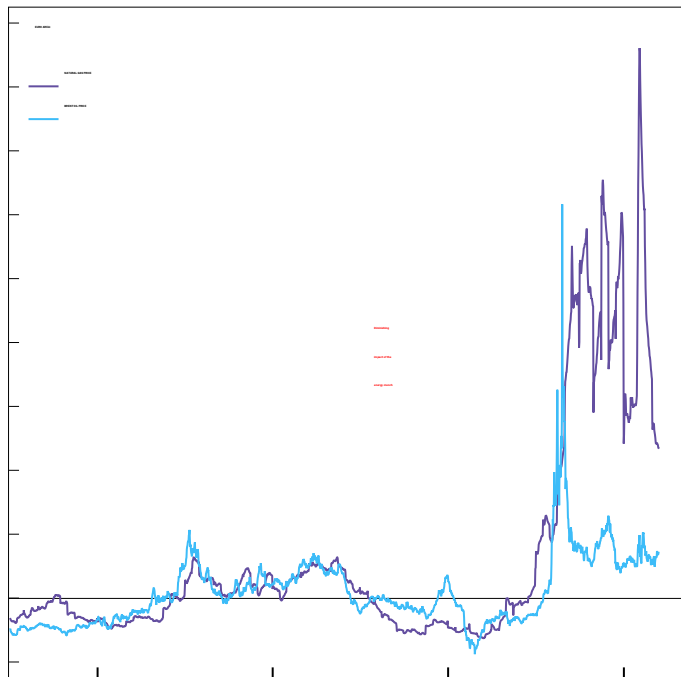
AS OF MAY 26. SOURCE: INSTITUTE FOR THE STUDY OF WAR, BBC.



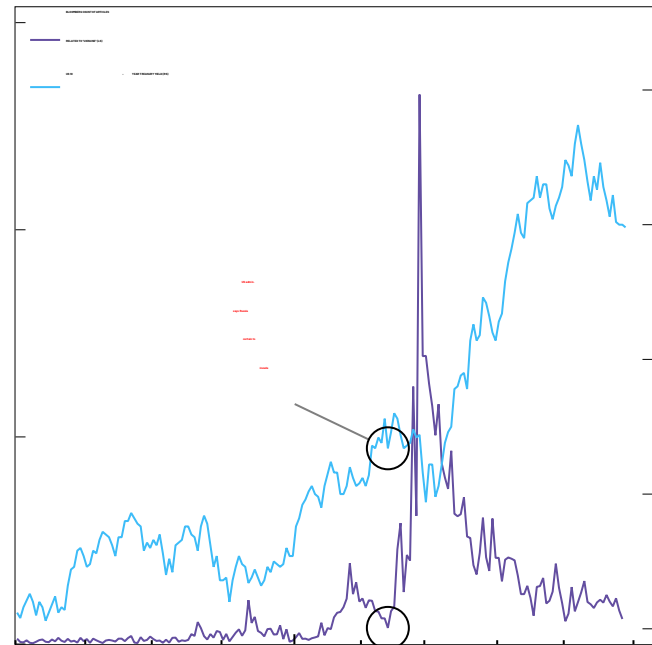
Ukraine | Macro Relevance of Ukraine Is Diminishing

The inflationary impulse from the conflict in Ukraine is beginning to dissipate. If the war remains bogged down in Donbas, **investors should expect macro assets to stop caring, if they have not already.**

Inflationary Impulse from Ukraine Is Diminishing...



... and the Bond Market Never Seemed to Care





Ukraine | How Ukraine Could Become Macro Relevant

Under almost every embargo scenario, Russia actually makes money! Only in the highly unlikely event that volumes fall by 50% but prices stay at ~\$120, would Moscow lose revenue.

Russia Probably Should Either Threaten...



... Or Actually Cut its Exports to the West



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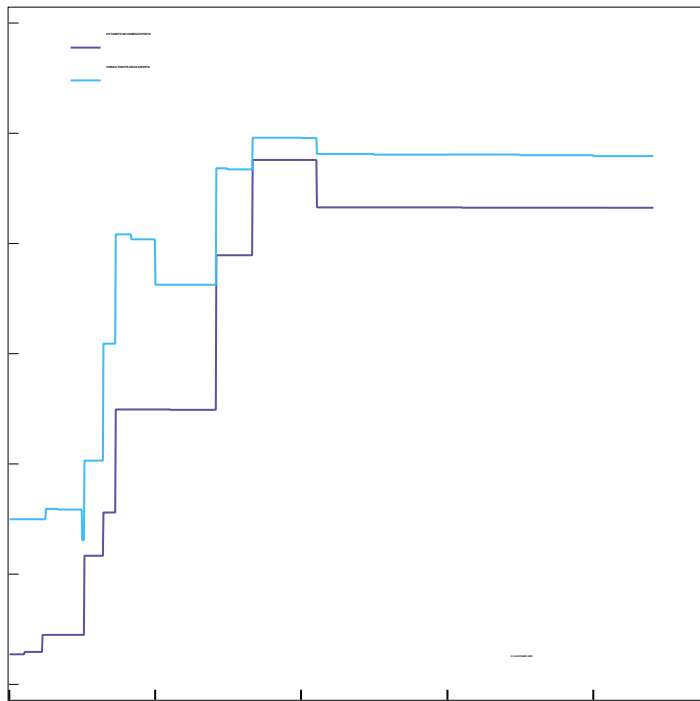
Geopolitics Is Not Transitory



Transitory? | Paradigm Shift #1: *Multipolar World*

While demand is surging, the world is facing several structural supply bottlenecks. The trend of de-globalization and US-China tensions have added to the inefficiency of the global economic system.

The US-China Trade War Produced Inefficiency



Geopolitical Conflict Is Inflationary

PRODUCT CATEGORY	RUSSIA PRODUCTION AS A % OF GLOBAL OUTPUT	LOSS OF EXPORT REVENUE IF A 6-MONTH EMBARGO IS IMPOSED (Bn USD)
PALLADIUM	43.0%	3.2
NATURAL GAS	17.0%	27.8
POTASH	16.0%	1.0
PLATINUM	12.4%	3.3
CRUDE OIL	12.0%	55.0
WHEAT	10.9%	4.0
GOLD	9.0%	9.3
NICKEL	8.3%	1.5
ALUMINUM	6.0%	2.8
COBALT	4.0%	0.1
COPPER	3.5%	2.8

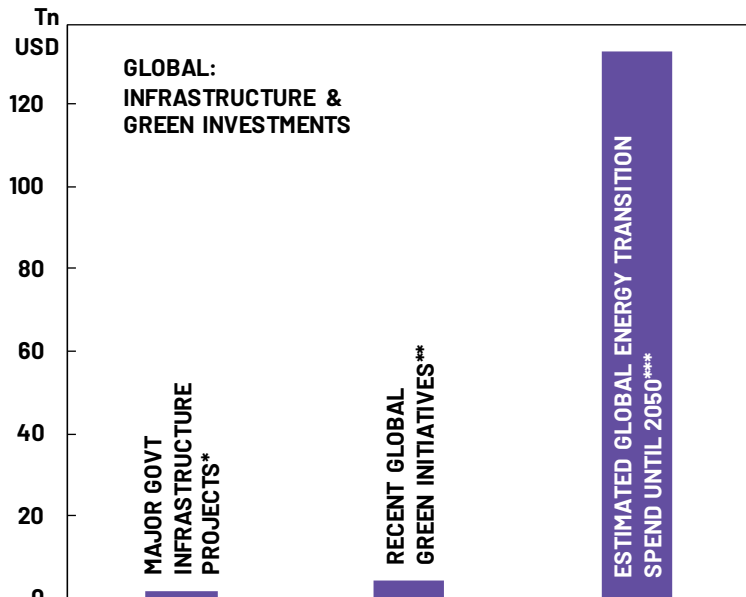
SOURCE: BP STATISTICS, UN, STATISTA, USGS, CLOCKTOWER GROUP CALCULATIONS.



Transitory? | Paradigm Shift #2: *Race to Zero*

The global green transformation has not only unleashed gargantuan investment demand, but also capped traditional energy supply, leading to surging prices in oil and natural gas.

Green Transformation Requires Massive Investment...



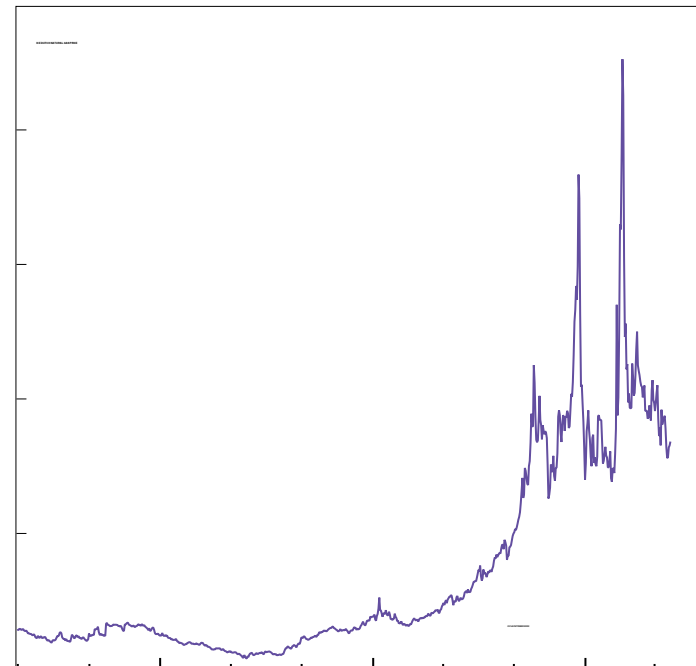
* INCLUDES US INTERSTATE HIGHWAY SYSTEM, SAUDI ARABIA'S NEOM, XIONG'AN NEW AREA, THE APOLLO PROGRAM, THE GREAT WALL OF CHINA, CHINA THREE GORGES DAM, MANHATTAN PROJECT, PANAMA CANAL, SUEZ CANAL, AND US TRANSCONTINENTAL HIGHWAY.

** INCLUDES THE PLEDGED SPENDING BY THE US (\$2 TRILLION UNDER BIDEN ADMINISTRATION), THE EU (\$1-3 TRILLION FROM GREEN NEW DEAL), AND CHINA (AT LEAST \$800 BILLION DURING 14TH FIVE-YEAR PLAN).

*** SOURCE: IRENA ESTIMATES (\$4.4 TRILLION/YEAR FROM 2021 TO 2050). SOURCE: VARIOUS SOURCES, CLOCKTOWER CALCULATIONS.

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... But Constrains Traditional Energy Supply

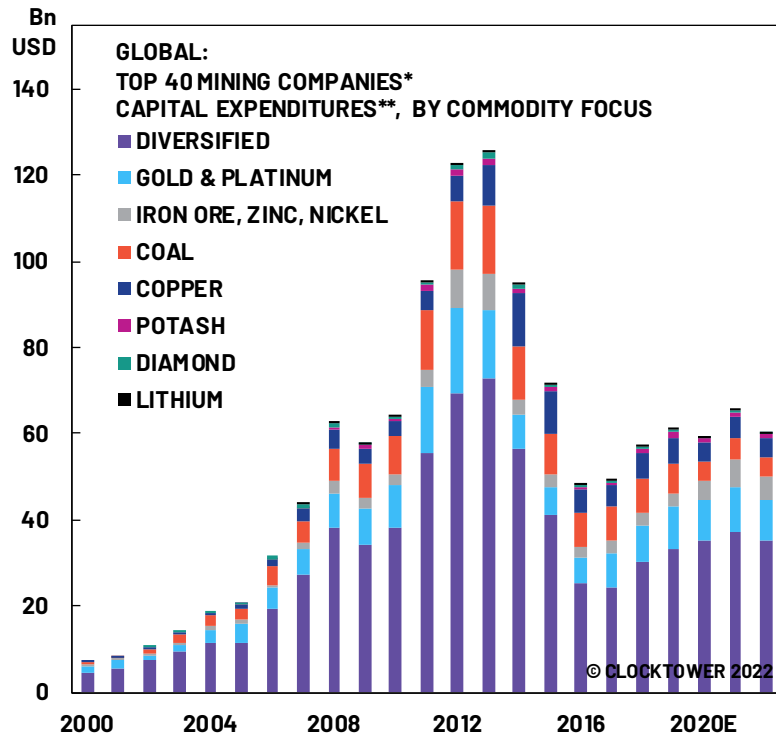




Transitory? | Structural Supply Issue #3: Lack of Capex

The **lack of capex in the last cycle** has significantly constrained the world's ability to ramp up production in the wake of the demand expansion *and* in the wake of the other two structural issues.

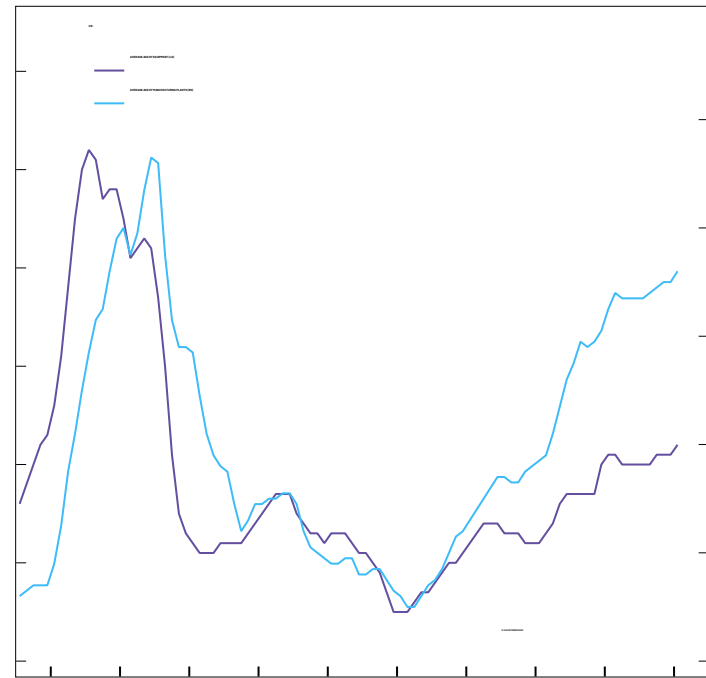
The Last Cycle Was A Capex-Less Cycle



* SOURCE: PWC MINE 2020.

** SOURCE: BLOOMBERG FINANCE L.P. AND CLOCKTOWER CALCULATIONS.

Underinvestment in the US

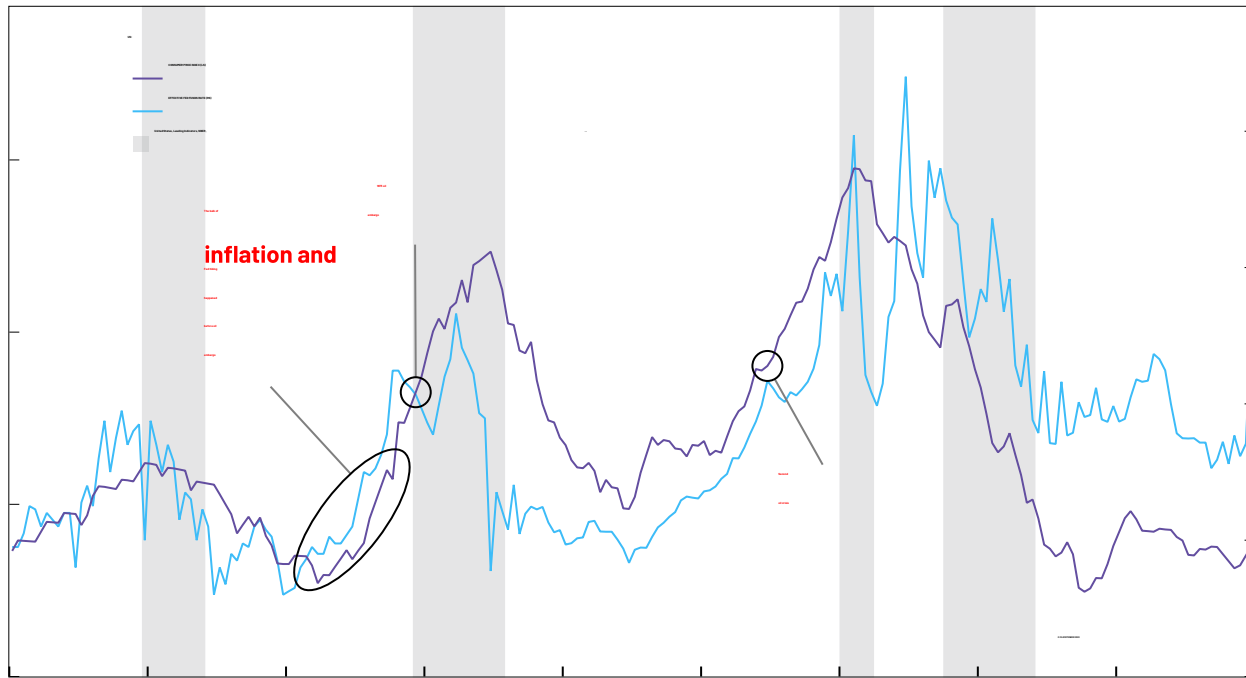




Transitory? | Shades of the 1970s

This all happened once before, in the run up to the 1970s. Inflation surprised to the upside well before the 1973 Yom Kippur War, largely because of BAC-like fiscal and monetary policies of the late 1960s.

It Looks Familiar Because it *Is*

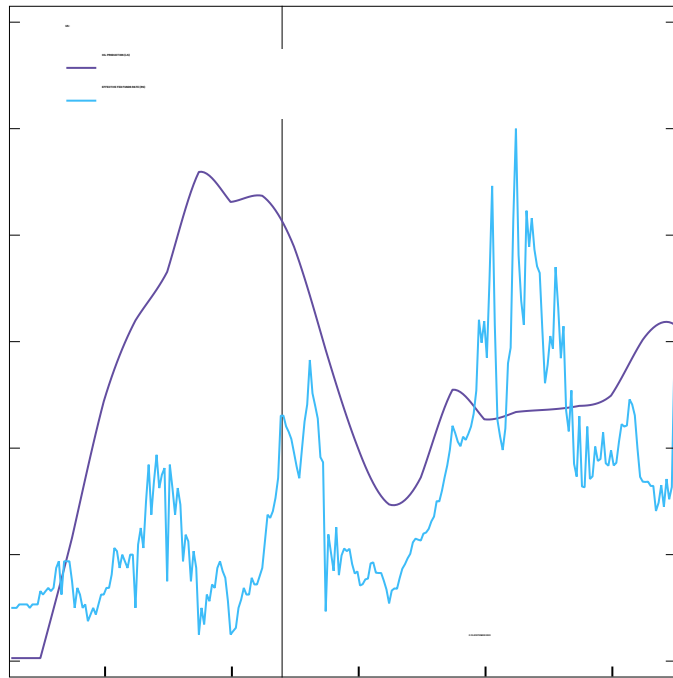




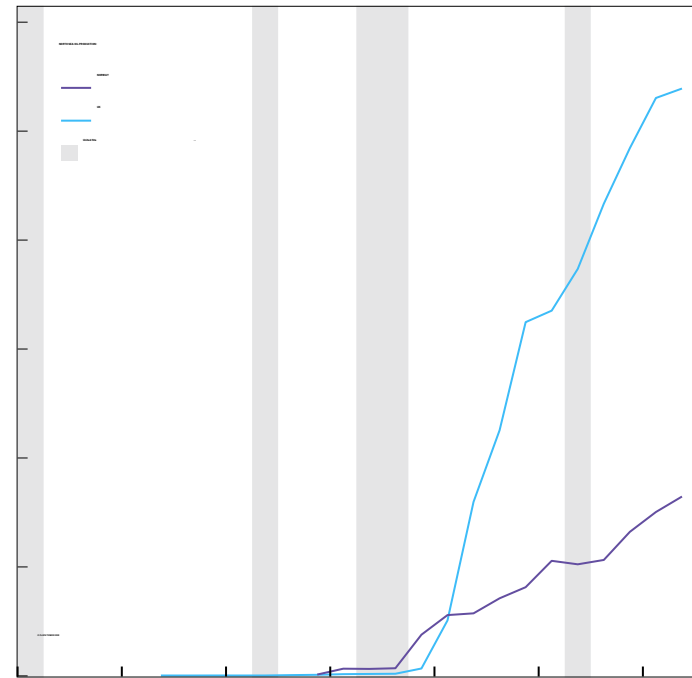
Transitory? | The Fed Hawkishness in 1973 Was a Mistake

The world is setting up to repeat the analogue from 1973, the Fed may have learned its mistakes from that era. **The recession was not necessary as it delayed a capex response to the supply problem.**

The Fed Delayed the Supply...



...Response

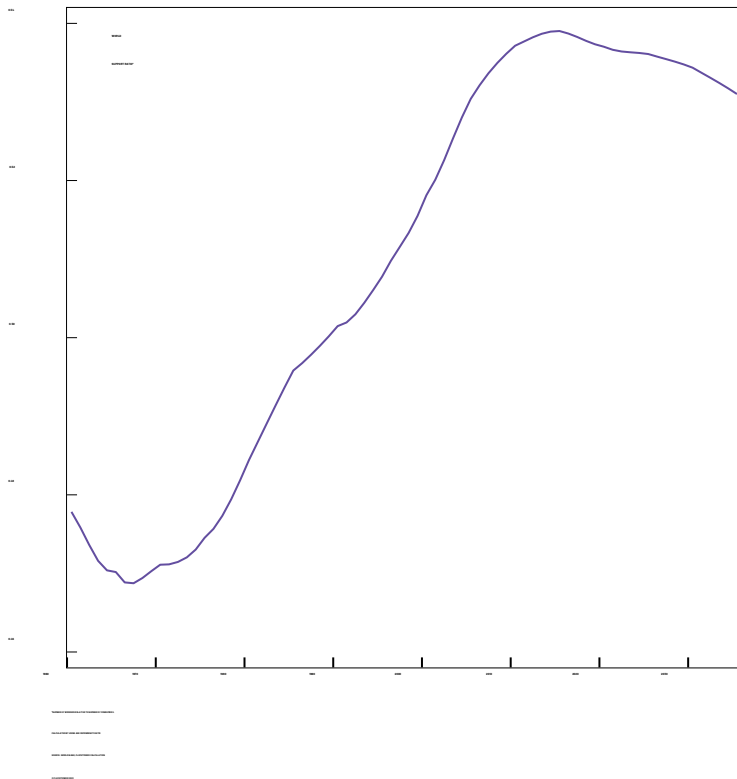




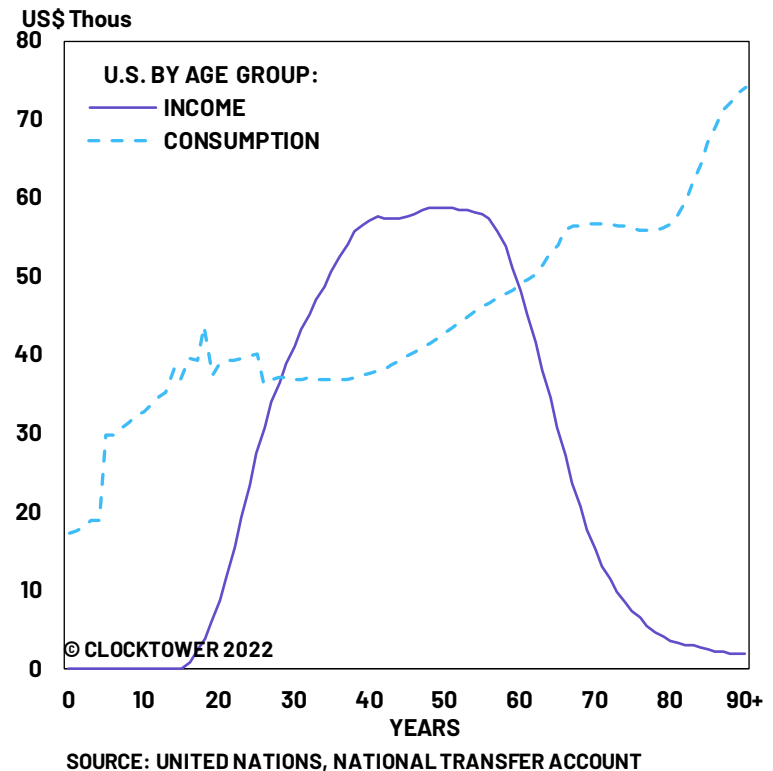
Transitory? | And No, Demographics Are Not Deflationary

Demographics are not deflationary. This is one of the most misunderstood narratives in finance. The G7 labor force growth has peaked. Meanwhile, the ratio of consumers to savers has bottomed.

As World Labor Supply Falls, Wages Will Rise



Retirees Are Not Savers



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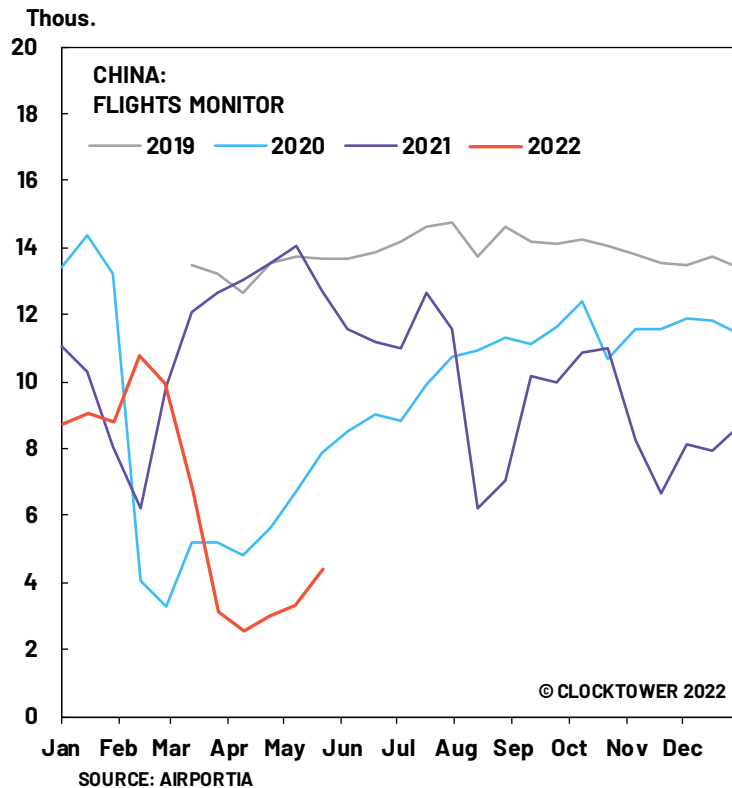
So What?



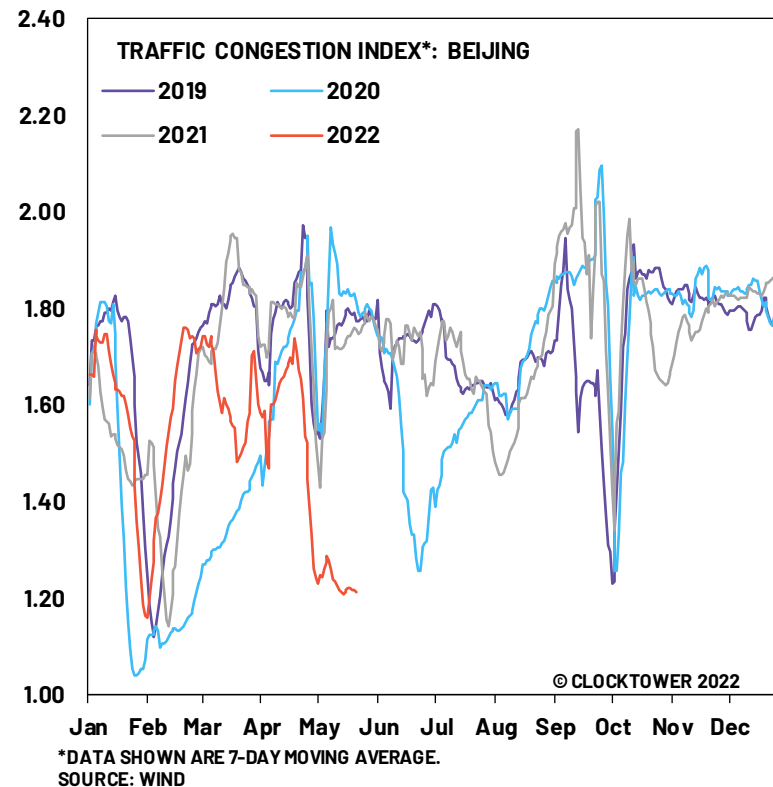
Tactical | The Big Risk for Hydrogen Economy: CHINA

Lockdowns and other forms of restrictions have paralyzed domestic logistics, causing severe supply chain disruptions and growing economic hardship for both businesses and households.

The Airline Industry Has Come to A Halt



Car Traffic Has Fallen Sharply

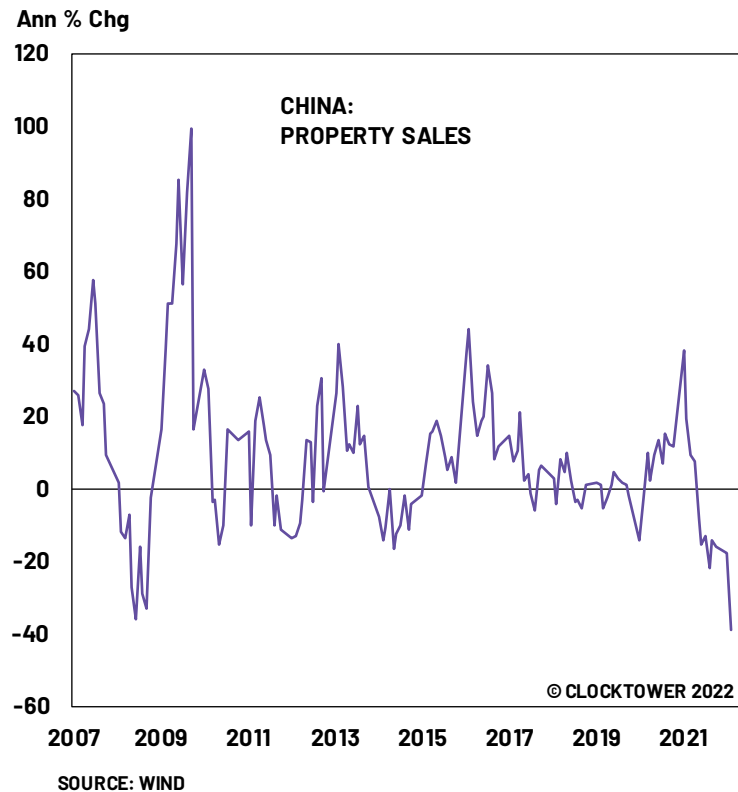




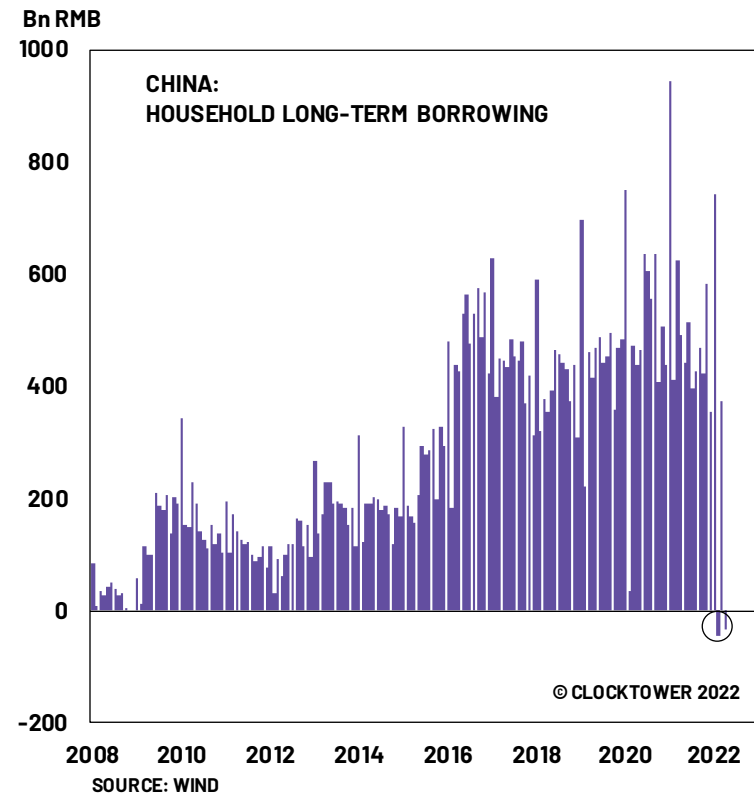
Tactical | Demand Problems Are Entrenched

Given the deleveraging of households and spreading lockdowns, the property sector malaise has increasingly become a demand problem rather than a liquidity problem.

Housing Sales Have Collapsed...



...Due to Households' Deleveraging

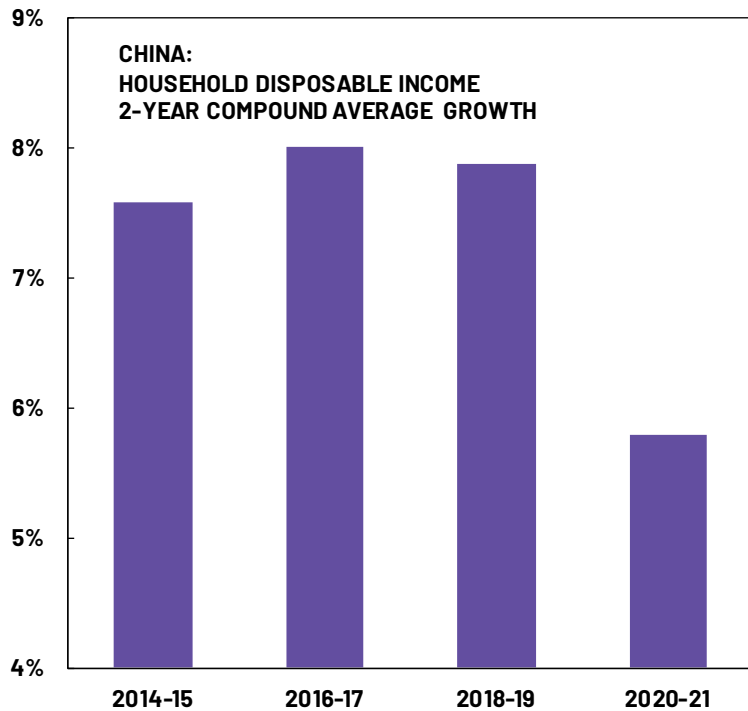




Tactical | Is China About to Have a Balance Sheet Recession?

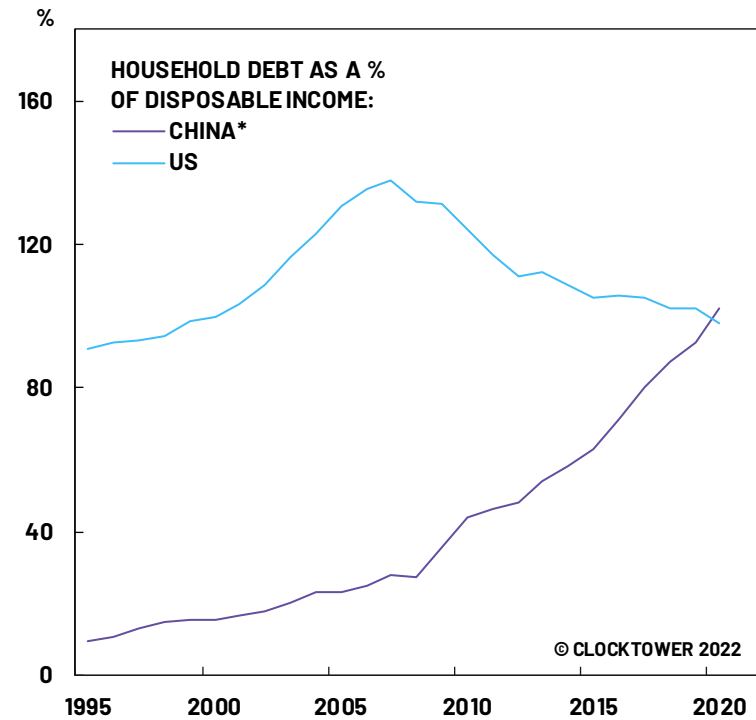
Frequent COVID-19 lockdowns and regulatory crackdown have weighed on household income growth and asset prices, **bringing the risk of a balance sheet recession.**

Households' Income Growth Has Notably Fallen...



SOURCE: WIND, CLOCKTOWER CALCULATIONS.
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...in the Face of Elevated Debt Levels



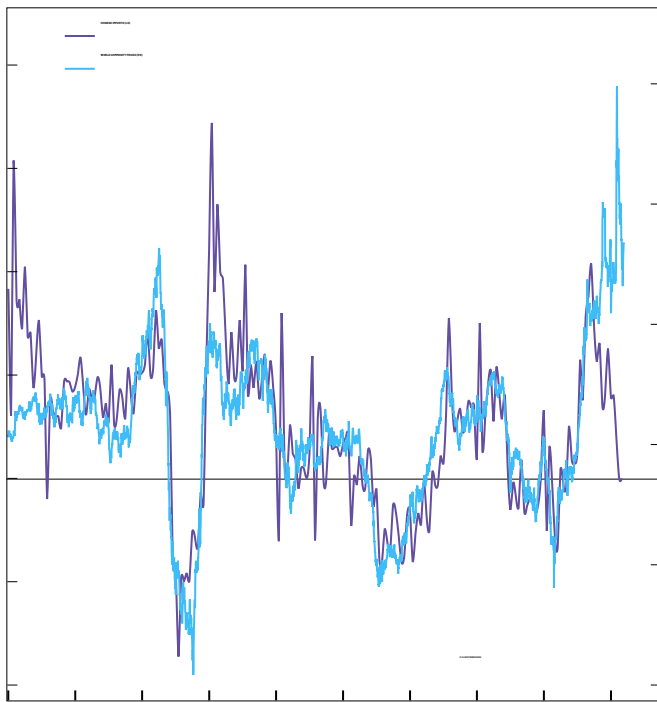
* USES URBAN DISPOSABLE INCOME FOR THE ENTIRE POPULATION. AS SUCH, THE FINAL RESULT MAY UNDERESTIMATE THE HOUSEHOLD LEVERAGE IN CHINA.
SOURCE: WIND, CLOCKTOWER CALCULATIONS.



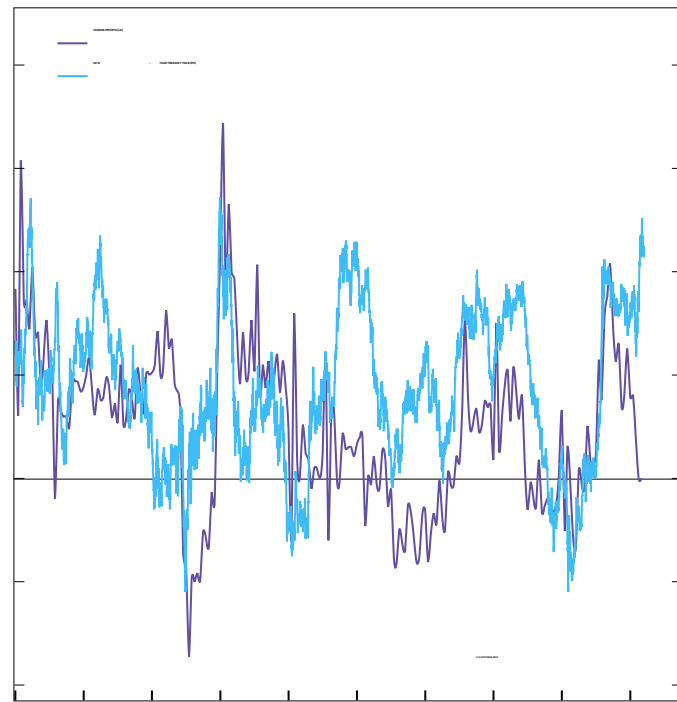
Tactical | Time to Tactically Short Commodities / Long Bonds?

The biggest risk to the Hydrogen Economy is China. It is too soon to tell which way Beijing policymakers lean, greater stimulus or more lockdowns. **Commodities and bond carnage may be overextended.**

Commodities Have Unanchored from China...



...As Have Bond Yields

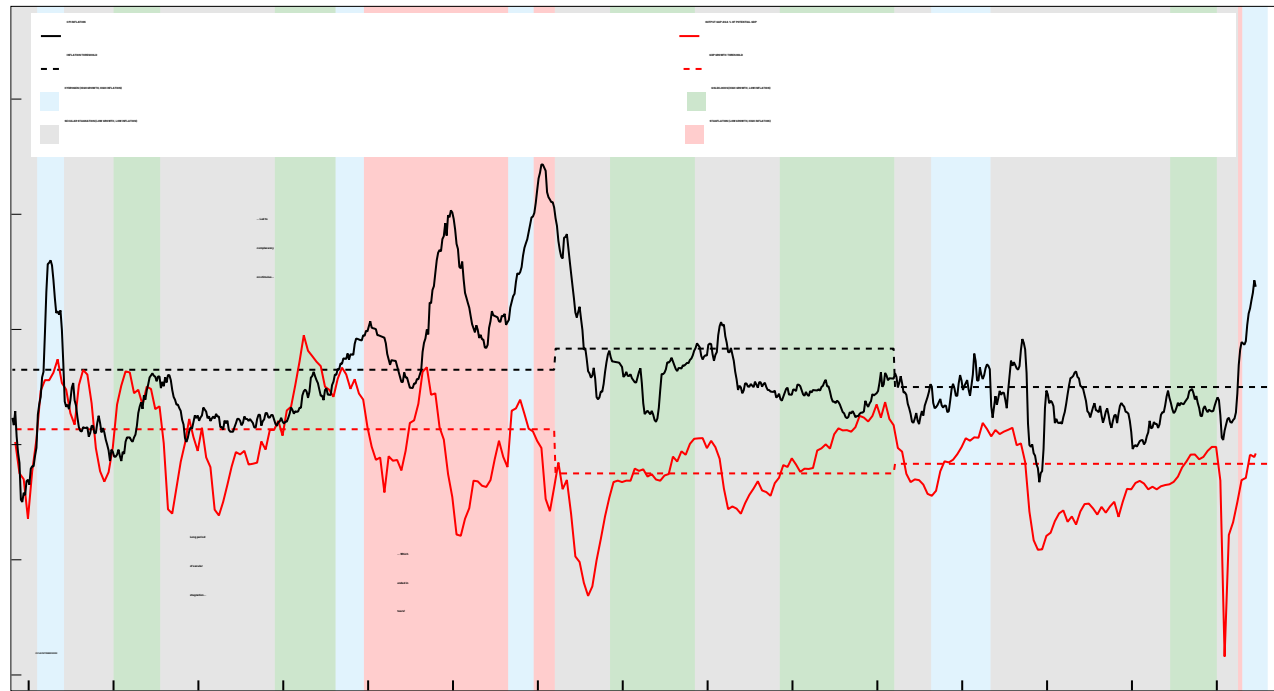




Cyclical View | Hydrogen vs. Stagflation

The market is pricing a Stagflationary context. We think that this is overly bearish given fundamentals. What happens if the Fed pivots from max hawkishness and China stimulates by year end?

The Market Is Pricing In Stagflation, But *Hydrogen* Is Still Our Bet

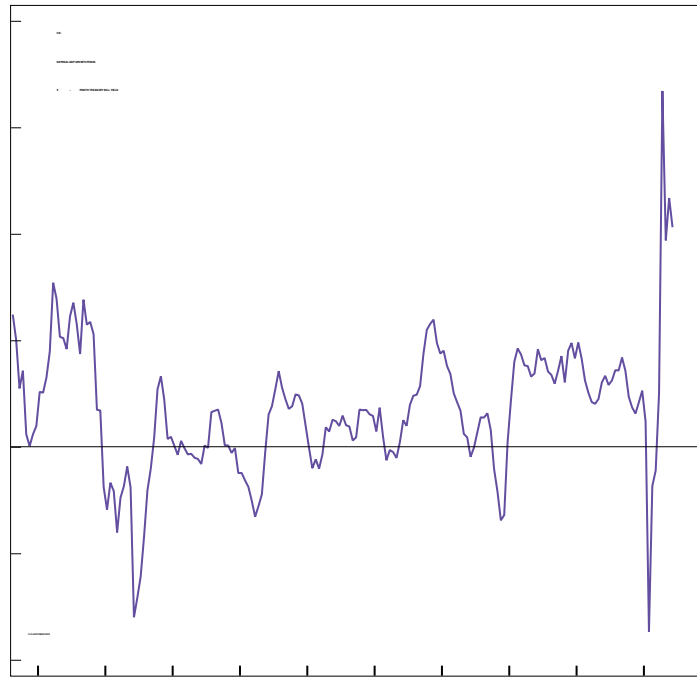




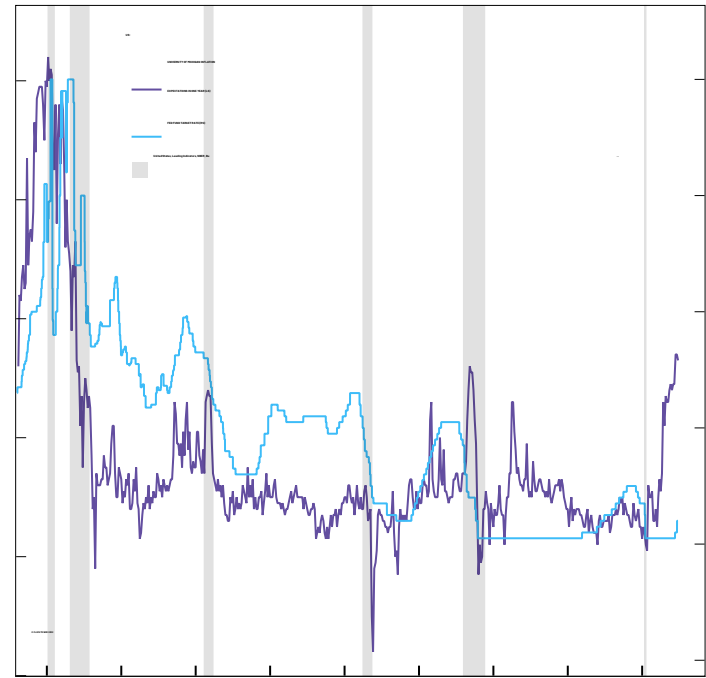
Cyclical View | The Hydrogen Economy Is Here

Since 2019, we have been forecasting that the next recession would usher in the **Hydrogen Economy** due to the policy response. **The pandemic stimulus has given us that high growth, high inflation context.**

The Hydrogen Economy...



... Is Here

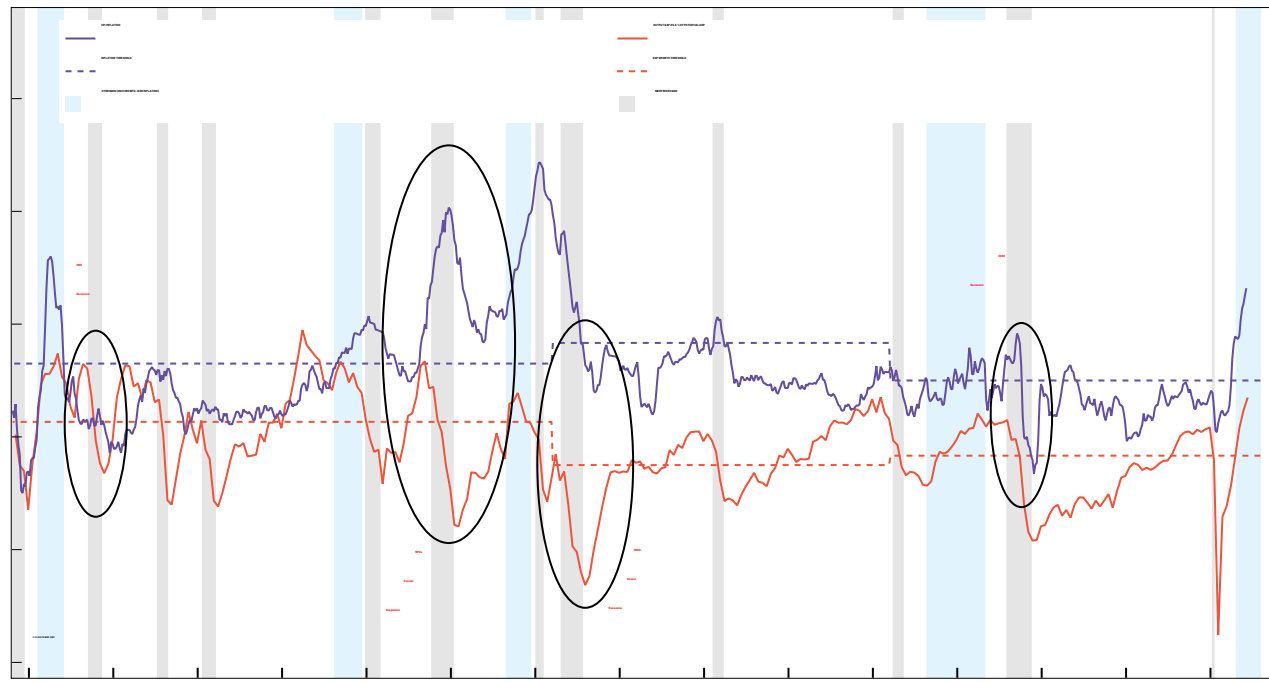




Cyclical View | Hydrogen Cycles Burn Up Quickly

A high growth, high inflation macro context tends to be over quickly. **It burns up before investors can get comfortable and is usually followed by a deep recession.**

The Hydrogen Context Is Rare, Short & Rarely Ends Well!

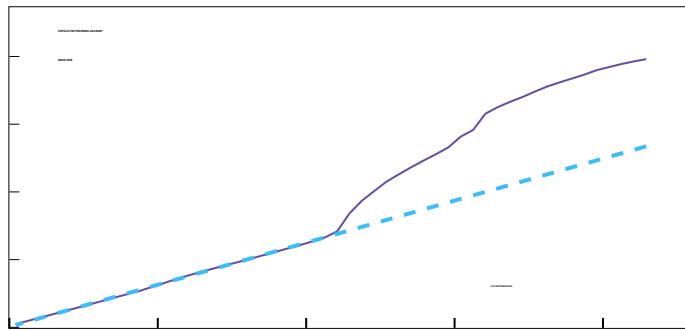
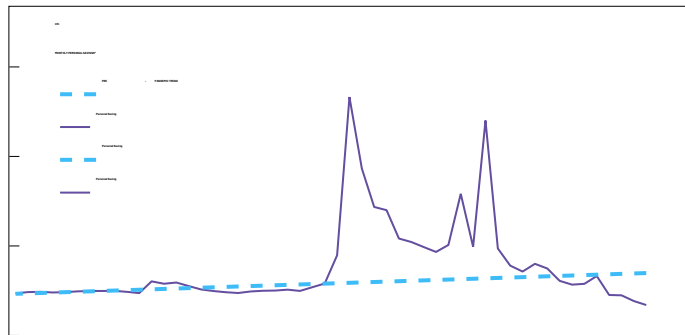




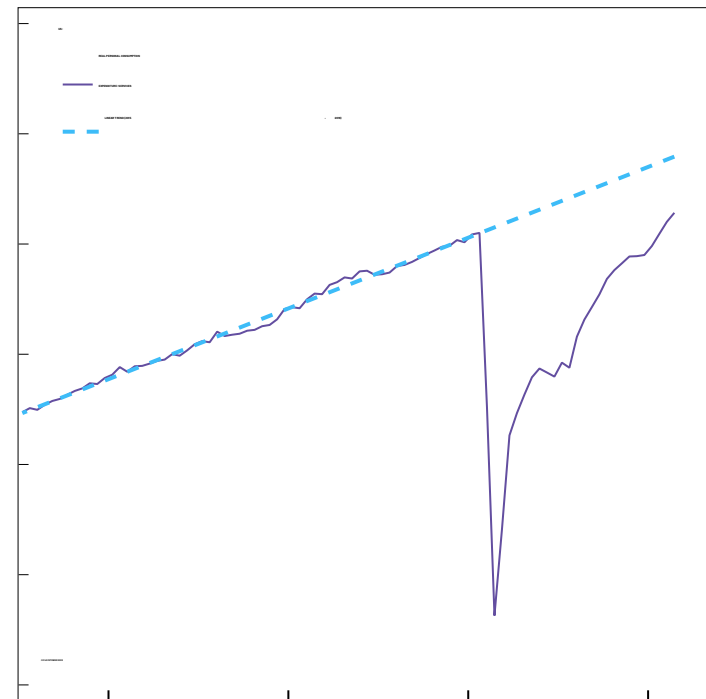
Cyclical View | Is Hydrogen About to Burn Up?

Consumers are flush with savings and expenditure has normalized, but mainly because spending on goods has peaked. **Services still have a lot of catching up to do.**

Consumers Are Flush With Savings



Services Are Ready for Catch Up

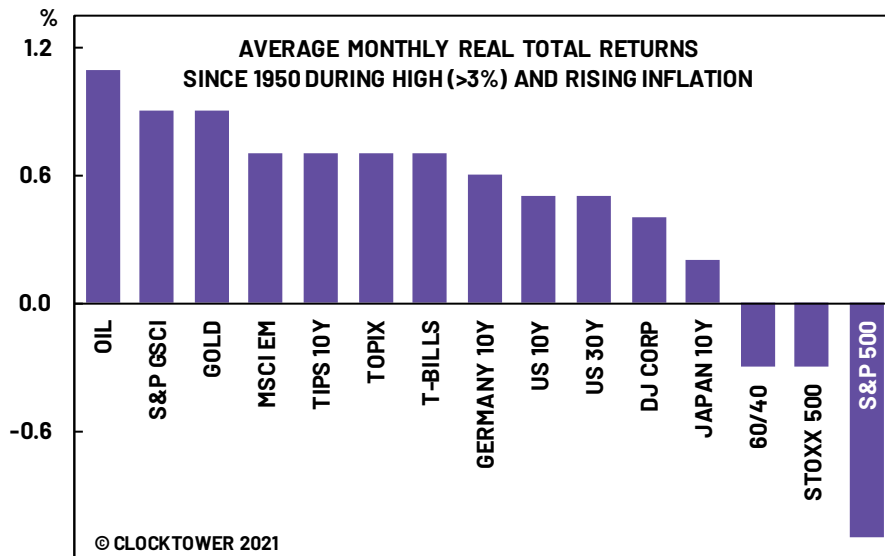




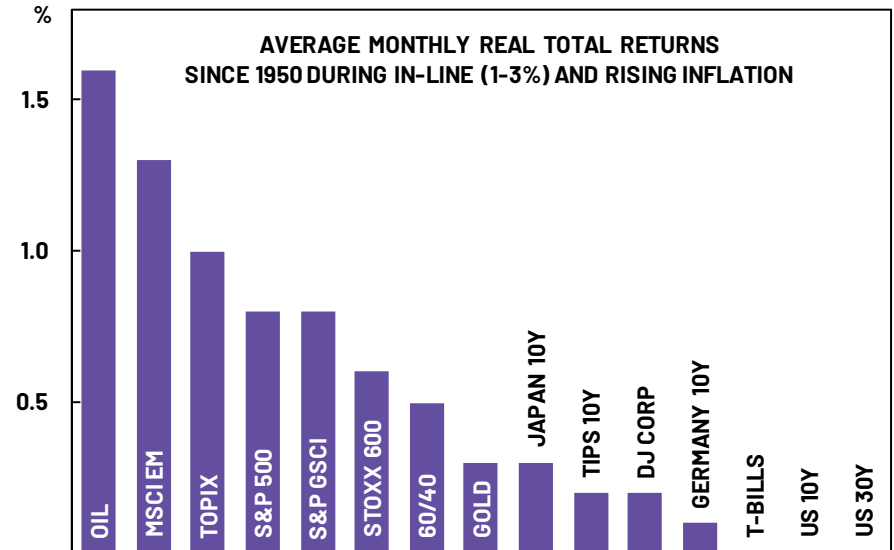
Cyclical View | What Does the Hydrogen Economy Mean?

REGIME	S&P 500 RETURN (%)	CHANGE IN US 10-YEAR YIELD (BPs)	MSCIEM INDEX RETURN (%)	COMMODITY RETURN (%)
HYDROGEN (HIGH GROWTH, HIGH INFLATION)	12.3	10.0	38.2	10.2
GOLDILOCKS (HIGH GROWTH, LOW INFLATION)	16.9	-38.7	46.7	1.1
STAGFLATION (LOW GROWTH, HIGH INFLATION)	2.8	13.6	-0.5	41.9
SECULAR STAGNATION (LOW GROWTH, LOW INFLATION)	9.0	-43.9	8.7	10.3

NOTE: ALL RETURNS SHOWN ANNUALIZED.
SOURCE: CLOCKTOWER CALCULATIONS.



SOURCE: HAVER ANALYTICS, ROBERT SCHILLER, GOLDMAN SACHS INVESTMENT RESEARCH.



SOURCE: HAVER ANALYTICS, ROBERT SCHILLER, GOLDMAN SACHS INVESTMENT RESEARCH.
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Cyclical View | What if the Fed Doesn't Respond?

Equities may still be a buy in a situation where inflation overshoots expectations and the Fed stays behind the curve. **Health care, energy, and some real estate and materials could do well.**

Time to Rotate into Inflation-Proof Sectors

S&P 500 SECTOR UNWEIGHTED PERFORMANCE DURING INFLATIONARY PERIODS								
S&P 500 RELATIVE RETURNS	3/1965-7/1971	1/1973-2/1975	7/1976-1/1981	3/1987-2/1989	6/1998-9/2002	9/2003-8/2006	AVERAGE	MEDIAN
HEALTH CARE	136%	4%	33%	-4%	26%	-11%	31%	15%
ENERGY	-1%	11%	68%	7%	24%	65%	29%	18%
REAL ESTATE	NA	-55%	106%	-12%	6%	25%	14%	6%
MATERIALS	-32%	50%	-19%	26%	1%	11%	6%	6%
CONSUMER DISC.	78%	-43%	3%	-9%	11%	-9%	5%	-3%
FINANCIALS	30%	-5%	-8%	-13%	17%	0%	4%	-3%
INDUSTRIALS	11%	-1%	-2%	-4%	12%	3%	3%	1%
CONSUMER STAP.	7%	-10%	-27%	27%	16%	-4%	2%	2%
I.T.	8%	-3%	13%	-13%	-25%	-14%	-6%	-8%
UTILITIES	-30%	-4%	-13%	0%	-15%	21%	-7%	-9%
TELECOM	NA	-4%	-28%	11%	-47%	7%	-12%	-4%

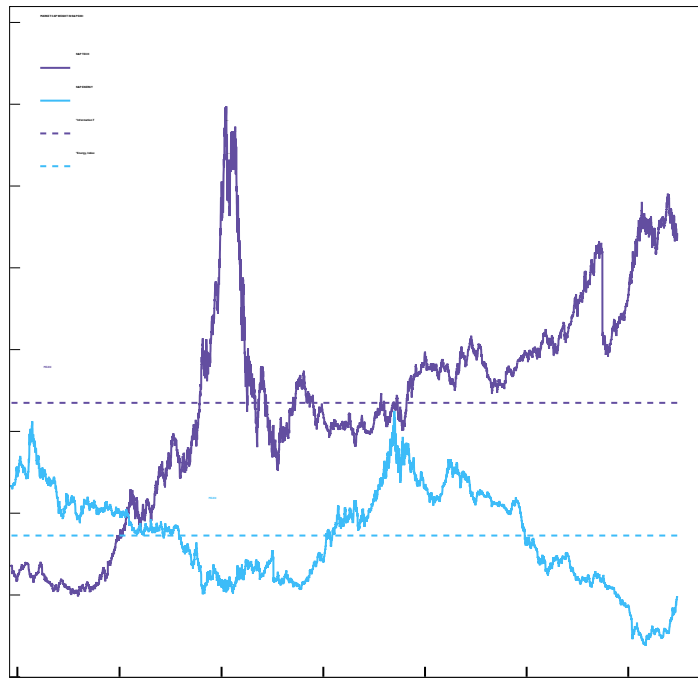
SOURCE: BIENVILLE CAPITAL.



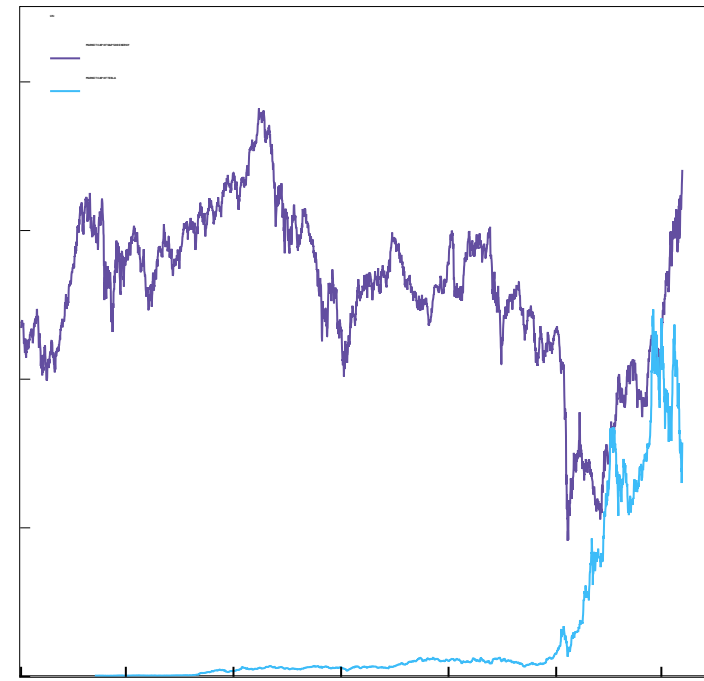
Cyclical View | Tech vs. Energy Divergence Is Ludicrous

Rise in interest rates reflects not just higher inflation, but also the end of our disinflationary era. This phase shift will benefit non-tech sectors, those that will participate in the capex-led cycle.

Tech/ Energy Divergence Has Reached...



...Ludicrous Mode





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