

What Happens Next – Sunday June 6, 2021

Stopping Aging, IRS Audits, and China

Marko Papic

Larry Bernstein:

I'd like to welcome our final speaker today, Marko Papic. He is a partner and chief strategist at Clocktower Group. He's also the author of *Geopolitical Alpha: An Investment Framework for Predicting the Future*. Go ahead, Marko.

Marko Papic:

Much has been said about the paradigm shifts that have caught many investors by surprise. Take, for example, the erosion of the *Washington Consensus* and *laissez-faire* capitalism. Or the purported decline in US relative geopolitical power and the emergence of a messy, multipolar, world. These shifts have brought politics and geopolitics into our purview.

However, that's not why I think there is alpha to be harvested from geopolitics. These are all ontological issues that are part and parcel of being an investor. I think that, by far, the greatest reason why the opportunity for *Geopolitical Alpha* is growing has to do with our own epistemic community. And there are three issues in particular:

- First, the investment industry has become overly professionalized and quantified. As such, it is unprepared, from a human capital perspective, to deal with the messy, non-black&white, world of politics.
- Second, the quality of information at our disposal is fraying. This is in large part the consequence of the collapse of media quality. You can blame social media companies or closing of foreign desks, but this is a reality.
- Third, we don't understand who the experts are. Most investors believe that talking to an ex-policymaker is equivalent to speaking with an expert. But that would be akin to speaking to an astronaut about astrophysics. We lack the culture of recognizing the true experts of geopolitics. It's not the practitioners who are often seeing the trees for the forest and sometimes even mistaking op-eds for analysis.

So let's begin there... With the current conventional wisdom among most "practitioners and ex-practitioners" of geopolitics and the increasingly consensus view that the US and China would decouple. It always amazes me that investors are taking advice about the future of US-China relationship from the very same "experts" who in 2012 were whistling in the dark while obsessing about Islamic terrorism. I'd check the credentials of every Johnny-come-lately by asking them what they focused on, in their geopolitical risk briefings, 10 or even five years ago.

Now, it is the consensus to linearly extrapolate the past decade into the future. By that trajectory, the US and China would be lucky to end in a completely decoupled world resembling the Cold War.

However, I think that the conventional wisdom is missing five factors that constrain US and China from going to war:

1. The Cold War is an anomaly of history. Rarely does the planet neatly decouple into two armed camps. In fact, ahead of both WWI and WWII, enemies traded and invested in one another.
2. Political science theory teaches us that a multipolar ordering of power is unlikely to produce decoupling. Why? Because Allies CHEAT.
3. Empirical evidence supports this. When China put sanctions on Australia against their wine, cotton, barley, timber, and coal exports, it was *American* exporters that filled in the gap. Think about that for a second. Australia has been the tip of the spear of a more assertive US attitude towards China. And yet it lost market share to its purported ally!
4. China is not the Soviet Union. By any measure of imagination. American policymakers seem to not understand this. But they didn't really live under the yoke of the Soviet Union so of course they do not understand the differences (they are not nuanced, by the way... they are dramatic).
5. Ultimately, the US will learn that the best way to contain China is to continue to pry its economy open. Given China's woeful demographics, its current account will eventually fall into a deficit, necessitating the good will of foreign capital for a healthy balance of payments. This is perhaps the ultimate difference with the Soviet Union. The USSR *was* a communist country to the end. It never claimed to be offering a middle-class end point – it claimed to be offering a *proletariat* future. As such, China's ultimate constraint is that its people fully expect to become members of the global middle class.

Investment implications: The world will not violently bifurcate. The decoupling will occur in only some industries. In the meantime, we will rebuild supply chains over a period of the next decade. This rebuild will be gradual. It won't collapse our economy. In fact, it will support the ongoing commodity bull market and be a boon for CAPEX companies. I particularly like semiconductor CAPEX plays.

Larry Bernstein:

Marko, thank you very much.