Market Commentary
October 2024

English Version

All Eyes on Risk: Navigating Geopolitical Uncertainty

Quarterly Call Q4 | 2024

Get guidance on investments, and the major structural factors behind your clients' portfolios.

insigneo

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Introduction

A warm greeting to all of you as we enter the fourth and final quarter of 2024. So far, so good. The US economy and its markets remain on solid footing, buttressed by a resilient US consumer that continues to spend, companies reporting healthy earnings growth, and now, an easing cycle that began with a jumbo 50 basis-point rate cut by the Federal Reserve. However, it is flashing plenty of warning signs, particularly in the labor market. We anticipated this development and encouraged investors to begin underweighting equities back in July. We also advised them to turn more defensively in their portfolios by overweighting utilities, healthcare, and consumer staples at the expense of cyclical sectors. Since we published our Q3 Quarterly on July 8th, US equity markets are essentially flat as of the end of September (e.g., the S&P 500 is up only 3% and the Nasdaq is down 2%), but volatility has increased markedly with the VIX index up over 37%.

What caused markets to inflect this way mid-Summer? The catalyst was the publication of the July US Employment Report that first alerted investors that all was not well in the labor market. To be sure, not all markets were oblivious to this plight. As of the end of September, US 10-year Treasury yields plummeted from a high of 4.7% all the way down to 3.75%, and both oil and copper fell over 20% and 8%, respectively, from their May highs as well. Indeed, equity and credit markets have been more cheerful than government bond and commodity markets. **A useful rule of thumb is that when equity and bond markets send conflicting signals, go with the bond market as there is usually smarter money involved.**

Away from the US, things have looked gloomier throughout the year. The EU's largest economy, Germany, is probably already in recession and China's economy is flailing. Trade flows could decline further in the months ahead, loan growth has fallen to an all-time low, and the housing market continues to implode. Both Europe-

Executive Summary

> The US economy and its markets remain on solid footing - consumer still spending, healthy earnings growth, and the beginning of an easing cycle; however, it is flashing plenty of warning signs, particularly in the labor market.

> Equity and credit markets have been more cheerful than government bond and commodity markets.

> Rule of thumb: when equity and bond markets send conflicting signals, go with the bond market.

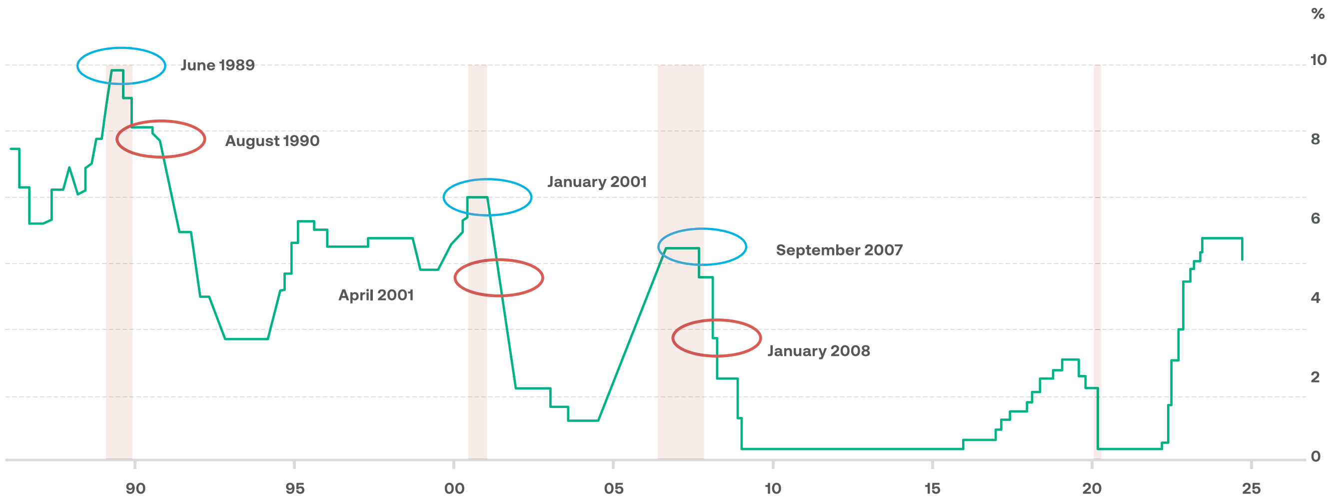
> Chinese Politburo has suddenly gotten serious about stimulating, so tactical opportunity arising for Chinese markets to outperform developed ones over a short-term horizon.

> Generally, geopolitical risk events should be faded after the initial market plunge.

1. Fed Rate Cuts Often Signal That Recession is Around the Corner

Source: Federal Reserve, BCA

— Fed begins to cut rates — US recession begins



an and Chinese markets have largely reflected this fundamental reality. But now that the Politburo has appeared to suddenly get serious about stimulating the economy, can the economy turn around? Indeed, there might be a tactical opportunity arising for Chinese markets to outperform developed ones over a short-term horizon.

Turning back to the US, our views have not changed materially throughout the year so we will simply recap them here briefly as a refresher. So far, the macroeconomic and market landscapes are unfolding largely as we expected due to our concerns surrounding a growth scare emanating from the labor market in the second half of the year. As a reminder, our year-end price target range for the S&P 500 in a non-recessionary scenario was between 5200 and 5400. We published these targets back in January when most of Wall Street was quite bearish and the index traded around 4700. We will stick with those targets for now, implying a 6% to 9% fall into year-end from end of September levels, but still leaving the index in healthy positive territory for the year. It should be noted that we expect annualized returns for the S&P 500 over the next 10-years to be between 8% to 9%. Dating back to 1927, this would be slightly below their historical return of 10%, but well below the 16% annualized returned from the Global Financial Crisis to 2021.

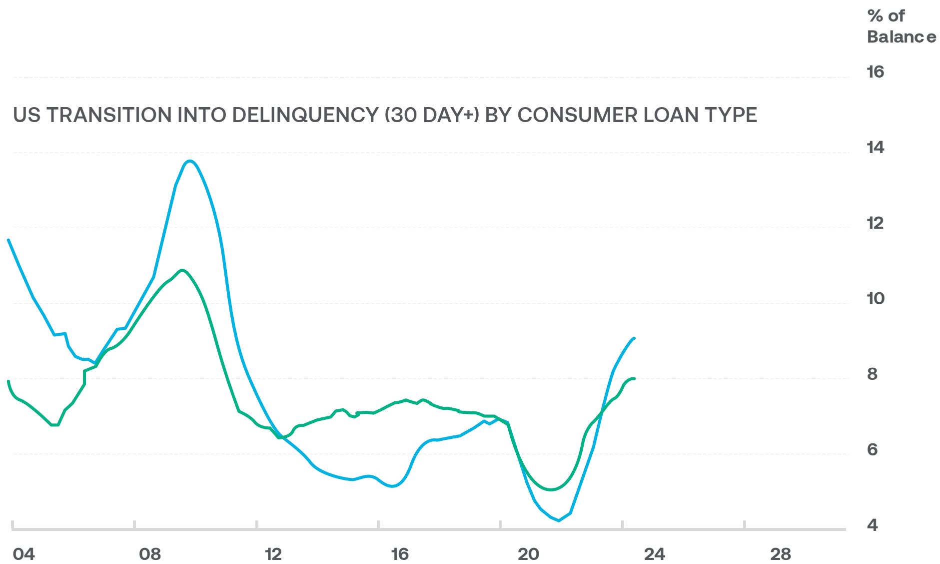
Given the stability of our views this year, we wanted the primary focus of this quarterly to be the numerous geopolitical risks on investors' minds – the US Presidential election, the conflict in the Middle East, the Russo-Ukrainian war, and a few others. How do geopolitical crises affect financial assets? What should investors do when confronted with one? While we will explore some of the contemporary concerns shortly, one major takeaway from our investigations into the history of such events is worth highlighting from the start: **for the savvy, risk-tolerant investor, it is wise to buy after the first shots ring out and markets plunge.**

Macroeconomic & Market Update

September's 50 basis-point interest rate cut by the Fed sparked some enthusiasm in stock markets, echoing similar reactions from January 2001 and September

2. US Consumer Delinquency on the Rise

+30 day delinquency shown as 4-quarter moving average



Source: Federal Reserve Bank of New York

2007. In both of those instances, initial market optimism was followed by significant declines, suggesting that the Fed may have been slow to respond to underlying economic issues, a scenario that could be unfolding once again. Indicators like the Sahm rule, which analyze unemployment trends, are signaling a possible recession later this year or in early 2025. Some commentators are suggesting that the recent rise in the unemployment rate is for a good reason – namely, that more people have joined the labor force. The problem with this view is that the uptick in the unemployment rate is not just due to more people entering the workforce; it is also a sign of slowing labor demand and an increase in job losses. Job openings have dropped close to pre-pandemic levels, and further declines could trigger a cycle of rising unemployment. Additional metrics such as the Conference Board survey, the quits rate, and the hiring rate all point to weakening labor demand. In addition, there is a growing number of people working part-time because they cannot find full-time positions. Moreover, consumer spending in the US is expected to slow as rising household debt and increased delinquency rates on credit cards and auto loans are prompting banks to tighten lending standards and raise interest rates. Finally, the manufacturing sector is showing signs of contraction, with key indicators like the ISM manufacturing index and capital expenditure intentions weakening.

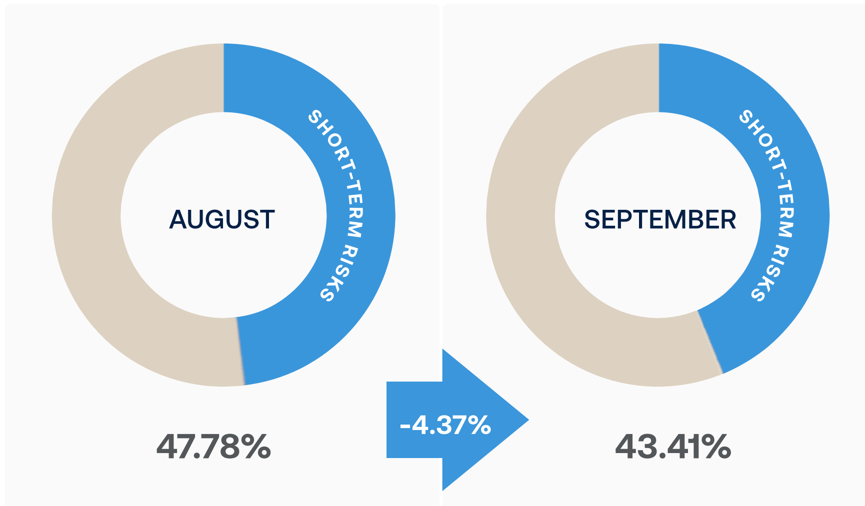
In China, structural issues are hindering economic growth, despite government efforts to stimulate the economy. The effectiveness of monetary easing is limited, as households and businesses are reluctant to borrow and spend, leading to a liquidity trap. Europe faces its own challenges, with consumers hesitant to increase spending despite having financial capacity. The labor market shows signs of slowing, and manufacturing indicators remain weak. Germany, in particular, is struggling with competitiveness due to higher wage growth compared to other Eurozone countries and a reliance on a now-obsolete business model centered on exports to China and cheap Russian energy. Overall, global economic indicators point toward a slowdown, with increasing risks of recession influenced by weakening labor markets, reduced consumer spending, and limited effectiveness of traditional monetary and fiscal policy tools.

Will the Fed save the day? In the long-run, unlikely, in our view. Before the latest meeting, we believed that

3. US Economic Data Resilient – Short-term Risks Falling

Insigneo-Forefront Probit Recessionary Indicator Two Calendar Quarters Forward

OVERALL MACRO LEADING INDICATOR



Source: Insigneo-Forefront Recessionary Indicator

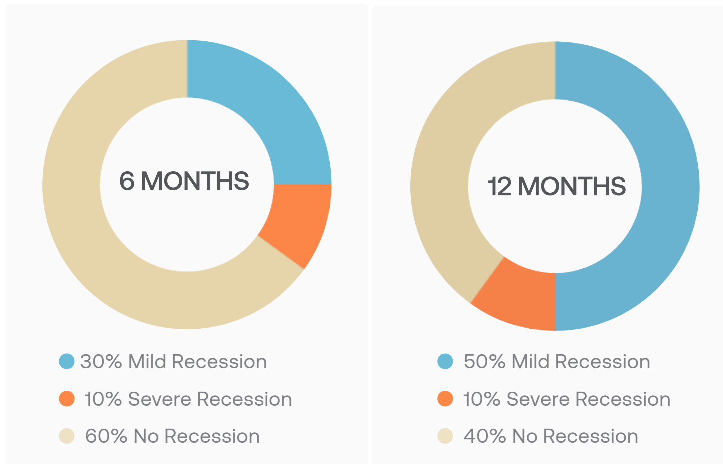
the Fed should have begun easing monetary conditions during the summer when unemployment started to rise noticeably. So, we were glad to see the Fed move aggressively in September. Consequently, we anticipate a reduction in the likelihood of a recession in the near term. Indeed, our proprietary recession indicator, which analyzes over 40 economic time series and has been highly predictive over the past 50 years (though not infallible), reflects this diminished risk. Over a six-month horizon, the indicator has decreased by more than 4% since last month. The primary reason for this decline is the recent release of resilient and positive economic data. For example, industrial production grew in August, and the initial September regional Federal Reserve manufacturing surveys have been encouraging. While August retail sales showed mixed details, the overall figures do not suggest an imminent recession, and housing starts saw a rebound in August.

Despite these positive signs, we are not yet prepared to retract our forecast of a US recession over the next 12 months. Aggressive rate cuts do not significantly change this expectation because monetary policy operates with long and variable lags. Additionally, the 50 basis-point reduction still leaves monetary policy restrictive, as the federal funds rate remains above the Fed's own estimate of the neutral rate. We employ another model that builds upon our earlier probit model by incorporating factors such as monetary and fiscal policy, potential supply shocks, military conflicts, and other geopolitical considerations to provide a comprehensive assessment. This model also indicates that short-term recession risks have decreased, but we continue to foresee a high probability of a mild recession over a 12-month cyclical horizon for the reasons previously discussed.

It is important to highlight that we believe the risks of a severe recession have increased as well. The trade-off to the Fed's assertive rate cut is a higher probability of a second wave of inflation. An economy that overheats in the short term might avoid a recession in the coming months but could face a deeper recession later if the Fed is compelled to implement stricter measures. Because the likelihood of a recession occurring in the next six months has decreased, we might see stocks rise in the short term as investors anticipate a soft landing. However, given that the S&P 500 is at record highs at the end of September, it is our view that it is not an ideal time to initiate new US

4. Subjective Recessionary Probabilities Over 2-Quarters & 4-Quarters Incorporating All Factors

In our Decision Tree, a "Mild Recession" is defined as U-3 Unemployment Rate of 4% ≤ U3 ≤ 6%.



Source: Insigneo

equity market investments at this time. Even in the best-case scenario of a soft economic landing, the index is unlikely to rise significantly from current levels. In the other scenarios, we could see substantial declines. The risk-reward trade-off is simply not compelling for US equity investors as markets seem overly complacent about growth risks.

We want to conclude with some thoughts on China. The recent announcement by China's Politburo has energized financial markets, sparking significant interest in Chinese stocks and related investments. Investors are now wondering whether China's policy shifts mark a meaningful turning point that will support the economy and financial markets. The policy measures have injected a burst of optimism, potentially leading to a period where Chinese equities and related assets outperform global and emerging market stocks due to their low valuations. **As a result, we recommend adjusting the allocation to emerging markets from underweight to neutral within a global equity portfolio. In addition, we would also now upgrade Chinese A-shares to overweight.** However, the absolute performance of emerging market and Chinese stocks will

5. Time to Buy China / Short India

Stock prices in US$: China-A shares vs India (Rebased to 100 as of January 2010)

Source: MSCI Inc., BCA

— "As a result, we recommend **adjusting the allocation to emerging markets from underweight to neutral** within a global equity portfolio."

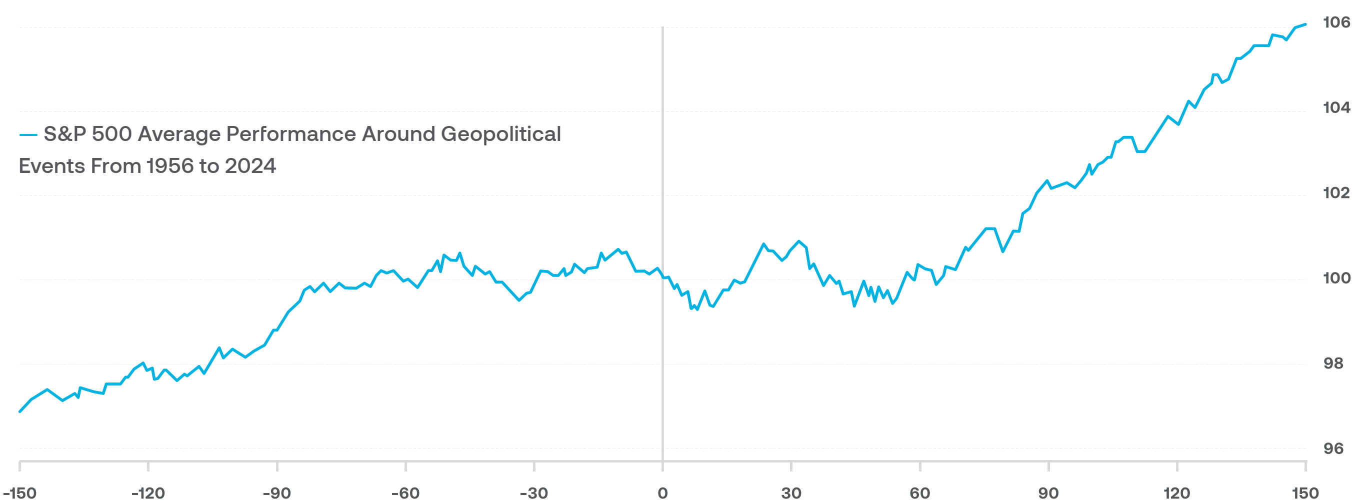
largely depend on the global risk environment. If the current positive market sentiment persists, these stocks could rally further. Yet, we are skeptical about the durability of this beyond the next few months. **Risk-averse investors may want to initiate a relative value trade by going long Chinese A-shares and shorting Indian equities.** As the above chart shows, Indian equities are extremely expensive compared to their Chinese counterparts and some mean reversion is likely. **This is a tactical trade recommendation. Over the long-term, we believe that Indian equity returns should outpace the Chinese bourses.** Despite the recent policy announcements, we doubt that these measures will lead to a significant economic recovery in China within the next six months. Indicators such as credit and fiscal spending impulses suggest that business cycle risks are leaning toward the downside, and a slowdown in Chinese import growth is expected. In conclusion, while the recent policy announcements have improved investor sentiment and could lead to better performance of Chinese stocks in the short term, more substantial measures are likely needed to stimulate a meaningful economic recovery in China.

How Should Investors Manage Geopolitical Risks?

Before we turn to the concerns among the minds of many investors today in the realm of geopolitics, it is worth discussing an appropriate framework for such considerations. To begin, for tactical asset allocation it makes sense for investors to bet against market disruptions caused by geopolitical events when it is sensible to do so. Many investors view geopolitics primarily as risks that prompt caution and a retreat from bullish positions in their investment portfolios. However,

6. Buy After the First Shots Ring Out

Source: Macrobond



historical evidence suggests that while geopolitical events can temporarily boost safe-haven assets these effects are often short-lived.

Risk assets frequently rebound more quickly than anticipated after major geopolitical incidents. If one analyzes all global geopolitical events from the 1956 Hungarian Revolution to the 2024 Iranian missile strikes against Israel and marks the performance of the S&P 500 before and after the event, then the observations are illuminating. After the event, the average decline in the index from peak to trough is -10.62%, but 1-month, 3-months, 6-months, and 12-months later the index is on average positive. In fact, a year later the S&P 500 is up 9.63% on average since 1956 after every geopolitical event since the end of the Second World War. **It follows that investors benefit from staying calm during such times of upheaval.**

There appear to be three main reasons why risk assets tend to show resilience in the face of geopolitical risks:

1. Policy responses: Geopolitical crises often trigger pro-growth policies from governments as they seek to mitigate economic fallout. These policy shifts can serve as catalysts for asset gains.

2. Emergence of constraints: As material limitations become apparent, they narrow the range of likely outcomes initially considered by investors. While initial reactions may focus on a wide array of possible scenarios, over time, the understanding of what is probable becomes clearer.

3. Risk premium collapse: Markets tend to adjust swiftly to ongoing risks, and investors become desensitized faster than expected. As a result, the additional risk premium associated with geopolitical events diminishes, often more rapidly than human sentiment does.

Geopolitical events, therefore, can present opportunities as well as risks. The tendency of media and average investors to overstate geopolitical dangers due to the difficulty in quantifying them creates informational asymmetry. Savvy investors can exploit this by betting against worst-case scenarios, thereby generating significant returns as exaggerated risk premiums fade.

The current situation in the Middle East is illustrative. Despite escalating tensions between Israel and Iran, oil prices did not surge as anticipated. This is attributable to Iran's strategic decisions influenced by material constraints and a market that had become desensitized to ongoing geopolitical risks. Iran has avoided actions that would disrupt global oil supply, partly due to its recent détente with Saudi Arabia and its interests in maintaining regional influence without provoking further conflict. Using a constraint-based framework when analyzing geopolitical risks, allows investors to better assess the probable outcomes rather than the merely possible ones. This approach keeps investors disciplined amid overwhelming news flow and allows them to identify opportunities by considering second- and third-order effects rather than just immediate reactions. ■

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US Election Update – Of Bulls, Bears, and Polls

The US elections will remain the key factor when assessing investment decisions and asset allocation perspectives and will affect the path of the global economy, regardless of who enters the White House.

Both the polls and the betting markets portray a narrow election that will most likely be decided by the voters of the swing states.

Trump's approach seeks to fund the nation's fiscal needs through tariffs, while Harris' strategy focuses on generating revenue through higher taxes.

For these elections, divided government outcomes are expected to be more market neutral, as legislative gridlock would make it difficult for either candidate to pass substantial reforms.

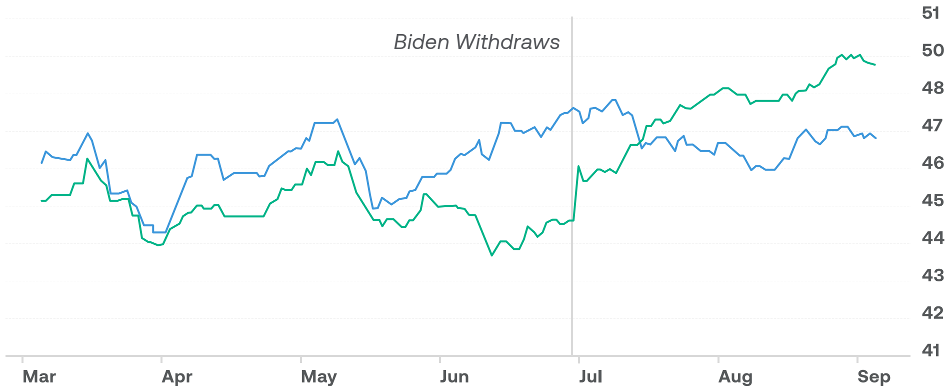
Regardless of the election outcome, fiscal uncertainty will dominate market discussions in the years ahead, posing a significant risk to US leadership on the global economic front.

From now until November 5, and probably until January 2025, the US elections will remain the key factor when assessing investment decisions and asset allocation perspectives. Therefore, we deemed it fit to revisit how the landscape has changed since our last quarterly call, how the changes have affected the market and probable election outcomes, and what we expect in the final stretch until Election Day.

In this atypical election, we had one of the candidates enduring two assassination attempts and the incumbent Democrat candidate abandoning the race while anointing his successor only months before the ballots are cast. Oddly enough, the general landscape has not changed much since we last revisited it. Still, the **elections will affect the path of the global economy, regardless of who enters the White House.**

Even if the polls have been considered flawed and wrong on previous occasions, it is still useful to review them to gauge the political landscape. When President

7. Harris' leadership remains narrow, according to the polls



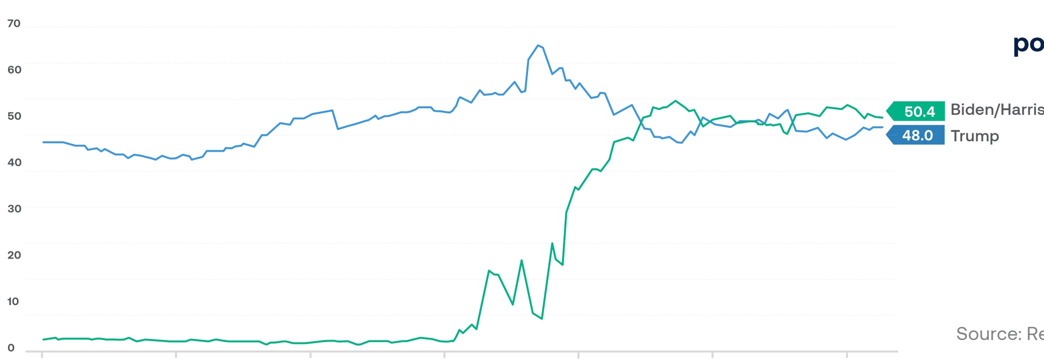
Source: RealClearPolitics Poll Average | Data as of September 25, 2024

Biden was still in the race, the US election seemed like a sure victory for the Republicans, with Donald Trump being consistently ahead of President Biden, with voting intentions for him being the highest right after the first presidential debate. However, the average polls flipped shortly after President Biden stepped away from the presidential race while appointing Vice President Kamala Harris as his successor for the 2024 election. Even if she only accepted her nomination at the end of the Democratic National Convention, she gained momentum from undecisive voters and Democrats who were not content with Biden's candidacy, while appealing more to independent and moderate voters. This momentum, coupled with a strong fundraising campaign, led Harris to close the gap with Donald Trump. As we write this report, Harris is ahead of Trump by two points according to the RealClearPolitics – RCP – Poll Average; however, **Harris' advantage per the polls is still narrow, and the election remains a toss-up.**

Meanwhile, the betting markets initially exhibited a narrower probability of Trump winning the election, with that gap widening in tandem with the observed increase in President Biden's disapproval rating. The increase in Harris' popularity also propelled her betting odds, with her biggest spike occurring when she accepted the Presidential nomination; from then on, the average of the betting markets calculated by RCP has mostly favored Harris. **At the time of this writing, the Harris -Trump spread stood at +2.0, underscoring how close this election should be.**

According to most analysts, this election will be defined by the voters from so-called 'swing states.' Some have

8. Betting markets also portray a toss-up election



Source: RealClearPolitics Poll Average | Data as of September 30, 2024

9. The fiscal impact is still the elephant in the room

(Numbers in $Bn)

Trump Policy Proposal	Total 10yr Budget Impact
Tariffs	
› 60% tariff on imports from China	150
› 10% baseline tariff on all imports	2,000
Subtotal: Tariffs	2,150
Extension of Existing Tax Cuts	
› Extend TCJA individual income tax cuts	-3,820
› Extend TCJA business tax provisions	-586
Subtotal: Extension of Existing Tax Cuts	-4,406
New Tax Cuts	
› Eliminate taxes on Social Security benefits	-1,328
› Eliminate taxes on tips	-122
› Eliminate taxes on overtime	-236
› Lower Corp tax rate to 15%	-623
› Subtotal: New Tax Cuts	-2,309
US Budget Impact (10yr Sum)	**-4,565**

Harris Policy Proposal	Total 10yr Budget Impact
Revenues	
› Increase Corporate Tax Rate 21% to 28%	1,157
› Increase Excise Tax on Net Buybacks 1% to 4%	140
› Increase LT Cap Gains Rate 20% to 28% (Income >$1mln)	217
› Expansion of Net Investment Income Tax	621
› Increase Individual Income Tax Rate Top Marginal Bracket	125
Subtotal: Revenues	2,260
Expenditures	
› Extend TCJA individual income tax cuts (<$400k income)	-1,464
› Expand Child Tax Credit	-1,970
› Expand Earned Income Tax Credit	-140
› Extend Enhanced Premium Tax Credit	-262
› First Time Home Buyer Assistance	-138
› Increase Startup Expense Deduction from $5k to $50k	-23
› Eliminate tax on tips	-122
Subtotal: Expenditures	-4,119
US Budget Impact (10yr Sum)	**-1,859**

Source: Citi Research, Penn Wharton Budget Model, TaxFoundation, Committee for a Responsible Federal Budget.

stated that this electoral process has become a competition for a collection of states, amid what has been deemed a record-low share of undecided voters, This, in turn, has been described as something that could increase Harris' potential voter base.

The latest polls in the swing states at the time of this writing similarly portrayed a tight race – Harris had a one or two-point lead at a maximum over Trump in Michigan and Wisconsin, respectively, while both candidates were virtually tied in Pennsylvania, while Trump carved a six-point lead in Ohio and a slim one-point lead in North Carolina.

Program Discussion

Both campaigns have been more focused on personal attacks than on substantive policy discussions. However, based on the available information from both parties, Harris' economic agenda is projected to continue many of the initiatives from the Biden administration, while Trump's economic agenda emphasizes tax cuts and global tariffs.

Harris' most notable policies include raising the corporate tax rate from 21% to 28%, increasing taxes on capital gains, investment income, and stock buybacks. On the other hand, Trump's key proposals feature a 10% global tariff on all imports with a 60% tariff specifically for China, the extension of tax cuts introduced under the 2017 Tax Cuts and Jobs Act (TCJA), and the introduction of new tax cuts.

In sum, Trump's approach seeks to fund the nation's fiscal needs through tariffs, while Harris' strategy focuses on generating revenue through higher taxes.

Regardless of the proposed path — whether through tax cuts or social programs — both candidates' plans are expected to exert additional pressure on the fragile fiscal picture of the United States. Analysts from Citi

10. A divided government may be the best outcome for financial markets

Baseline Estimates from Fiscal, Tax, and Trade Policy Shifts

	R SWEEP	D SWEEP	TRUMP W/DIVIDED GOVT	HARRIS W/DIVIDED GOVT
EQUITIES				
S&P 500	↑	↓	↓	↓
FX				
Euro	↓	↑	↓	↑
JPY	↓	↑	↓	↑
MXN	↓	↑	↓	↑
USD TWI	↑	↓	↑	↓
RATES				
UST 10Y	↑	↑	↑	↓

Source: Insigneo

estimate that Harris' economic agenda could increase the US fiscal deficit by nearly USD 1.9bn, while Trump's policies could lead to a USD 4.6bn deterioration. As a result, **fiscal concerns are likely to dominate market discussions regardless of the election outcome, especially in cases of a sweep by either party.**

Asset Guidance

We revisited our previous analysis on potential asset price movements across the four election scenarios, and our outlook remains unchanged.

The debate surrounding these four election scenarios revolves primarily around corporate taxes and global tariffs. In this analysis, we will focus on the Republican and Democratic sweep scenarios, as these are the most transformative and likely to drive significant shifts in market dynamics. **In contrast, divided government outcomes are expected to be more market neutral, as legislative gridlock would make it difficult for either candidate to pass substantial reforms.**

On the equity front, Trump's proposal to reduce the corporate tax rate to 15% is expected to boost S&P 500 earnings by 4%, while Harris' plan to raise the corporate rate to 28% would likely reduce earnings by around 5%. According to Citi's analysts, Trump's tax reforms could propel 2026 S&P 500 EPS growth from 12% to 18%, whereas Harris' approach would slow EPS growth from 12% to 5%.

The Democratic sweep is seen as the most negative scenario for equities due to its direct impact on earnings, free cash flow, and corporate balance sheets. In this scenario, large-cap stocks are likely to outperform small-caps, as larger companies typically generate a greater share of their revenue offshore, which would help them mitigate the impact of higher US rates on their effective tax burdens. Even if Harris' corporate tax hike will not resolve the US fiscal gap, it offers a more sustainable solution to the country's current fiscal deficit.

On the fixed income front, even if both scenarios would have a negative impact on US Treasuries (UST), the magnitude would differ by party. Under a Republican sweep, lower corporate taxes are expected to drive yields higher, together with steeper curves due to fiscal concerns. Although reduced tax collection will hurt government revenues, the proposed 10% global tariff is expected to partially offset the fiscal impact. **If the global tariff proposals are implemented, US high yield debt will likely outperform investment grade,** as high yield companies generate more domestic revenue compared to investment grade firms. In addition, a lower corporate tax rate could reduce the incentive for companies to issue debt for tax benefits, which might

— **“…divided government outcomes are expected to be more market neutral,** as legislative gridlock would make it difficult for either candidate to pass substantial reforms.”

result in less debt issuance — a potential positive impact for credit markets.

In a Democratic sweep, higher corporate tax rates could improve the US fiscal outlook, but concerns over mid-term GDP growth — due to potential job and wage declines — offset the positive impact on US Treasuries. Markets anticipate slower growth, which limits inflation expectations and tempers rate increases.

For the dollar, **Trump’s 10% tariff on global trade is expected to strengthen the dollar and weaken EM currencies.** While countries can impose tariffs on US products as retaliation, overall, tariffs are expected to benefit the Greenback. JPM analysts estimate a 4% to 6% USD appreciation under a 10% global tariff scenario. On the EM side, **the Chinese Renminbi and the Mexican Peso are two of the most vulnerable currencies to the Republican policies.** Potentially, the Chinese Renminbi would be the most affected currency, as we might experience a Trade War 2.0 with a 60% tariff on Chinese imports. On the Mexican Peso side, as Mexico became the largest commercial partner of the United States, the 10% tariff will affect 80% of the country’s total exports. Conversely, **a Democratic sweep will act as a headwind to the US dollar,** as a reduction in risk premiums related to global trade tariffs and a less fiscal expansionary scenario weigh on the currency.

Finally, on the commodities front, **gold’s strong fundamentals are expected to remain intact, as the metal continues to serve as a hedge against inflation, geopolitical instability, and fiscal uncertainties.** Oil and energy prices should remain stable despite Trump’s promises to lower them through increased production, mainly due to the lengthy timeline that these changes require. The deregulation process required to boost production would need Congressional approval, followed by significant capital expenditures from energy companies to achieve desired output levels. However, we can argue that Trump could achieve some immediate effects by putting pressure on Iranian oil or by facilitating a potential resolution to the Russia-Ukraine war, which might lead to the reintroduction of Russian gas supplies into the market. Beyond these scenarios, we do not expect significant changes for commodities under a Republican sweep. On the contrary, **under a Democratic sweep, renewable energy assets are likely to outperform driven by Harris’s proposed energy transition initiatives.** Other assets will remain largely unchanged.

The scenarios outlined focus solely on the direct impact of each candidate’s economic agenda without factoring in broader macroeconomic variables such as inflation, unemployment, and overall economic conditions. **Regardless of the election outcome, fiscal uncertainty will dominate market discussions in the years ahead, posing a significant risk to US leadership on the global economic front.** ■

Mauricio Viaud
Senior Investment Strategist
and PM

The Anatomy of Geopolitical Conflict: Hot Spots and Possible Scenarios

The current level of geopolitical risk around the globe has not been this high since the days of the Cold War.

There is a clear dynamic at play between two blocs of nations: The West versus the "Axis of Resistance".

The Middle East, Eastern Europe, and the South China Sea are the three hot spots that if unchecked, could potentially ignite a bigger conflict.

Nuclear, conventional, and irregular warfare are all possibilities of how these conflicts could potentially evolve. We believe that nuclear warfare has the lowest probability of occurring, while irregular warfare has the highest.

The level of geopolitical risk around the globe has not been this elevated since the days of the Cold War. Parting from this premise, we thought it would be useful to explore this risk in more detail, from its various players and hot spots, to possible scenarios.

The Middle East - The Blessing versus the Curse

In a speech last month at the United Nations, Israel's Prime Minister, Benjamin Netanyahu displayed two maps. One was a map of the Middle East showing Iran, Iraq, Syria, and Yemen colored in black. This map, titled "The Curse", highlighted the group of four countries that Mr. Netanyahu referred to as an "...arc of terror". The other one was another map of the Middle East, showing Israel, Jordan, Egypt, Saudi Arabia, Sudan, Bahrain, the United Arab Emirates, and India colored in green. This map, titled "The Blessing" highlighted the group of countries that Mr. Netanyahu described as "Israel and its Arab partners".

The two maps displayed by Mr. Netanyahu highlight the ever-changing picture of the Middle East. In recent years, there has been growing rapprochement between Israel and many countries in the Arab world. This culminated with the Abraham Accords in 2020, where many Arab countries officially recognized Israel as an independent state, leading to increased security and economic cooperation in the region. Since then, the United States, Israel, and Saudi Arabia have been in talks to come to an agreement on what could potentially develop into a unique triumvirate in the region.

It is no surprise that Iran vehemently opposes stronger ties between these three nations. Since its creation, the Islamic Republic of Iran has sought to carve out its own sphere of influence in the Middle East. An under-standing between its three main rivals would desta-bilize its footing in the region, serving to counterbalance a nuclear Iran, backed by Russia and China. A powerful Israeli nation, backed by the United States and cooperating with other Arab nations, is a threat to Iran's influence in the region. As the country's rulers attempt to remain in power, they continue to expand their influence through their many proxies, including Hamas, Hezbollah, and the Houthis in Yemen. Fomenting instability in the Middle East ensures the survival of those in power in Iran.

— "...if either side openly attacks the other in a significant manner, **the situation could quickly spiral out of control."**

Over a year after the attack on October 7th, we stand at one of the most precarious points in recent history in terms of the escalation of war in the Middle East. After having severely degraded Hamas' ability to continue operations as a paramilitary organization, Israel has turned to its northern border with Lebanon, to face another, more powerful Iranian proxy, Hezbollah. Through a series of military operations directed at beheading Hezbollah, Israel has methodically eliminated the leadership of this organization, including the killing of its leader, Hassan Nasrallah himself. Israel appears to be succeeding at destroying the organization's command, control, and communications operations, all necessary to successfully run military operations. Appearing to significantly degrade Hezbollah in a matter of weeks, Israel has made it clear that it can strike at anyone, anywhere, at any time. The question now is, how will Iran respond?

On one hand, Iran does not appear to want conventional and direct conflict with Israel. Not because it lacks the willingness to do so, but because it lacks the capability. Not in terms of the size of its armed forces, but in terms of military sophistication as well as geographic constraints. Barring any direct attack between Israel and Iran, the latter will likely continue fighting through irregular warfare, either through its own military or its many proxies. As a retired senior CIA official smartly put it during a recent television interview "Iran has been known to fight to its last proxy". **If the next iterations of this conflict remain in the realm of irregular warfare, significant escalations are unlikely. However, if either side openly attacks the other in a significant manner, the situation could quickly spiral out of control.**

China – Playing the Long Game

"In China, time is not a linear progression of events but a series of cycles." These were the words of Henry Kissinger, memorialized in his book titled *On China*. Widely regarded as the father of the United States' foreign policy on China, Mr. Kissinger understood the perception of time from the perspective of Chinese culture. As Westerners, we tend to perceive time as a series of short events, driven by the immediacy of results. In contrast, China perceives time as a long, continuous cycle, driven by long term expansions and contractions. Recognizing this difference is key in understanding China's current view of its standing in the world, as well as its possible intentions.

We believe that China currently finds itself in a long-term expansionary cycle that likely began 50 years ago, when

When it re-engaged with other nations. Today, China is a leading provider of low-cost technology to the rest of the world, making it hard to refute that it also finds itself deeply intertwined with the global economy. China is now experiencing another stage in its expansionary cycle, the expansion of its geopolitical influence across the globe.

In a piece titled China's Alternative Order, published in Foreign Affairs, author Elizabeth Economy, Senior Fellow at Stanford's Hoover Institution states that "...China has referred to a 'new security concept' that embraces norms such as common security, system diversity, and multipolarity". In other words, China is attempting to present an alternative to the current system of alliances in the global order. It is attempting to do this through what Ms. Economy refers to as "The Four Pillars", namely the Belt and Road Initiative, the Global Development Initiative, the Global Security Initiative, and most recently, the Global Civilization Initiative. Through these separate, yet linked initiatives, Beijing is attempting to gain support for its new world order by providing economic, developmental, and security aid to many countries around the world, particularly countries in emerging markets that feel left out of the current global economy. China's plan is gaining traction, particularly with countries in the Global South, where Beijing is making meaningful investments in infrastructure, for both commercial and military purposes.

While China continues to build bases around the world, it is also meaningfully expanding its military presence in the South China Sea. The country considers itself the rightful owner of the territories within what it refers to as the Nine-Dash Line and is preparing to defend this territory by building military bases on many islands in the area. Interestingly, Taiwan finds itself inside the Nine-Dash Line. China has long considered Taiwan to be part of its own territory. Now, more than ever, Beijing has an incentive to lay claim to this island nation. First, bringing Taiwan back under its national umbrella would play into China's plan to remain in its expansionary cycle. More importantly, Taiwan is home to the largest producer of semiconductor chips in the world. Control over such a concentrated supply of this crucial link in the semiconductor manufacturing value chain would give China an important economic competitive advantage, as well as a high degree of geopolitical leverage.

Another important dynamic is the continued development of China's navy from one of defense to one of offense, which aligns with China's expansionary cycle on the global stage. Combining military bases across the world with the projection of naval power would give China the global reach that it seeks, at the same time allowing it to pose a credible threat to countries in the West. Much like the Soviet Union attempted to counter Western influence through its regional Eastern Bloc, China is attempting to do the same, this time not through a regional, but a global bloc of nations. **However, China has two things that the Soviet Union never had, economic power and time. More specifically a strategy based on long-term, rather than short-term goals, that can be attained through both military and economic means. This dynamic alone makes China a serious opponent that the West cannot afford to ignore.**

Russia – Attempting to Cling to the Past

It has been over two years since Russian tanks rolled into Ukraine. However, Russia's incursion into its neighbor began a decade ago, after it invaded and annexed Ukraine's Crimean Peninsula. Although Russia initially denied it was behind the invasion of Crimea, it then claimed it was necessary to protect its citizens living in Eastern Ukraine, making a similar claim as pretext for the full-scale invasion of Ukraine a decade later. The real reason for Russia's invasion of Ukraine is up for debate. In our opinion, it involves a multi-faceted answer.

For many years, Russia has been trying drive a wedge within NATO. This was particularly true after many countries once behind the Iron Curtain of the former Soviet Union "switched sides" after the collapse of the U.S.S.R. As Russia's last remaining buffer between itself and NATO, Russia could not afford to see Ukraine become a member of NATO. Both Russia and China have echoed this sentiment as the real reason for Russia's invasion of Ukraine. However, the real reasons may not end there. Vladimir Putin's career reached its apogee in the heart of the Soviet Union during the peak of the Cold War. As a result, his ties to the ideals of the old U.S.S.R. run deep. It would not be surprising if the strategic reason for the invasion was one based on an ideology to bring back the old Soviet Empire, in some form or another. Regardless of the reasons for the invasion, if left unchecked, would the Russian advance stop with the invasion of Ukraine? In our opinion, the answer is no. However, although Russia may have the willingness for further conflict outside of Ukraine, its ability to engage in such a conflict, in a conventional form, is very limited.

For years, Russian military doctrine has been based on the use of large tank battalions, supported by the heavy use of artillery and missiles. This tactic was used during the initial phase of the invasion, but Russia did not expect heavy resistance from Ukraine. However, Ukraine turned out to be a formidable foe, striking back with the use of superior technology supplied by the West to wreak havoc on Russian tanks, as well as artillery and command, control, and communication facilities behind enemy lines.

A treaty or cease-fire could be a possible solution, as Russia's ability to continue a prolonged campaign is questionable. Although Russia continues its saber-rattling regarding the use of nuclear weapons, we believe that this is an unlikely option, given that it knows that such a move would also ensure the destruction of its own country. **However, it is hard to predict what an unpredictable ruler hell-bent on clinging to the past might do if he feels corralled by a lack of options.**

Possible Scenarios: Nuclear, Conventional, and Irregular Warfare

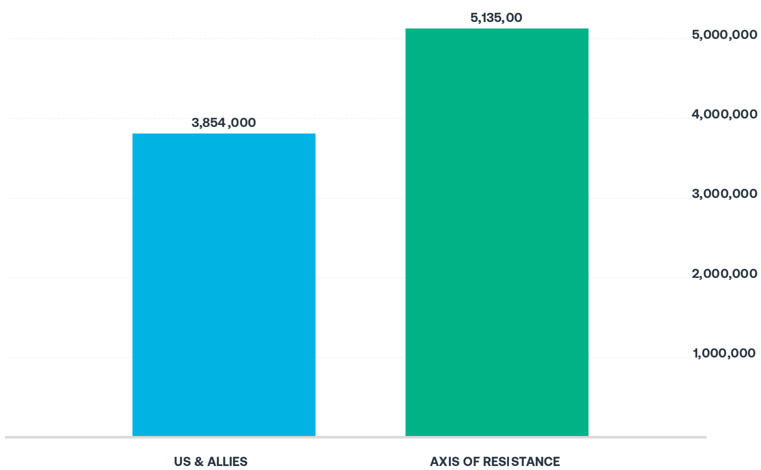
In a world ripe with geopolitical risk, it is prudent to explore the possible scenarios that could evolve over time. Three possible warfare scenarios come to mind: nuclear warfare, conventional warfare, and irregular or asymmetric warfare.

Nuclear war is clearly the most dangerous of these scenarios. Yet although it is not outside the realm of possibilities, we believe that it is one that every country seeks to avoid. Most nations use the threat of nuclear warfare as a deterrence for conventional conflict. The doctrine of Mutually Assured Destruction, or MAD, is in essence what kept the United States and the Soviet Union from engaging in such a conflict. We believe that this is an option that even the most bellicose countries on the globe want to avoid.

Conventional war is a very real possibility. In fact, we are already seeing this type of conflict in Ukraine and the Middle East. However, countries seeking this type of conflict must ensure that they have the ability to carry out a swift war, as well as the will to persevere through a prolonged one. The graphs below compare the United States and its main allies, versus a group of countries termed the "Axis of Resistance", namely China, Russia, Iran, North Korea, Belarus, Venezuela, Cuba, and Syria. The first chart shows the combined standing armies in terms of soldiers of both blocs, where it can be clearly seen that the axis powers have almost a third more soldiers than the allied countries. However, the second chart paints a different picture. This chart shows the combined national defense budgets for both blocs, where we can see that the combined budget for the allied nations is more than three times larger

11. Standing Army

(In terms of soldiers)



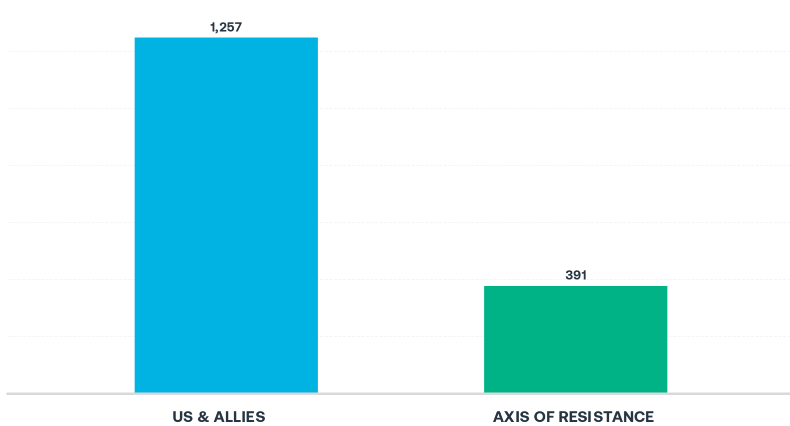
Source: Insigneo, *George S. Takach, Cold War 2.0*;
As of 2023

than that of the axis countries. These two charts tell us that although the axis powers have larger armies, the allied countries have vastly better technology and training. This dynamic has been evident in the Russian-Ukrainian conflict, where, through the use of better weapons and training, Ukraine has been able to stymie a much larger Russian force. This is not to say that conventional warfare is not a possibility, but it suggests that the axis powers are less likely to be willing or able to enter and endure a conventional conflict.

The third option, the use of irregular or asymmetric warfare, is potentially the most likely. In his book *Three Dangerous Men: Russia, China, Iran, and the Rise of Irregular Warfare*, author Seth G. Jones defines irregular warfare as "…activities short of conventional and nuclear warfare…including information operations, cyber operations, support of state and non-state partners, covert action, espionage, and economic coercion". Less costly and easier to implement, this form of warfare is preferred by axis powers. Frankly, it is already being implemented by many players in this bloc, including hacking and disinformation campaigns, state-sponsored terrorism, and economic coercion. Given the experience and advantages that the axis powers have in this realm of warfare, its continuation

12. Defense Budget

(In billons of USD)



Source: Insigneo, *George S. Takach, Cold War 2.0*;
As of 2023

and escalation is the most likely scenario in the near future. However, it is crucial to monitor irregular warfare, as a misstep could easily escalate to the other, more dire types of war.

Nuclear, conventional, and irregular warfare are all possibilities of how these conflicts could potentially evolve. We believe that nuclear warfare has the lowest probability of occurring, while irregular warfare has the highest, as we expect that most countries would prefer to engage in the realm of irregular warfare. However, Eastern Europe is already experiencing a conventional form of conflict, while the Middle East is at risk of escalation. Containment and de-escalation will be key. ■

House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
Global Asset Allocation		
Equities	UNDERWEIGHT	UNDERWEIGHT
Fixed Income	OVERWEIGHT	OVERWEIGHT
Cash	NEUTRAL	NEUTRAL
Regional Breakdown		
US Equities[1]	NEUTRAL	OVERWEIGHT
European Equities	NEUTRAL	NEUTRAL
Japanese Equities	NEUTRAL	NEUTRAL
Emerging Market Equities	NEUTRAL	NEUTRAL
Chinese Equities	OVERWEIGHT	NEUTRAL
US Treasuries[2]	OVERWEIGHT	OVERWEIGHT
Investment Grade Fixed Income	UNDERWEIGHT	UNDERWEIGHT
High Yield Fixed Income	UNDERWEIGHT	UNDERWEIGHT
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	UNDERWEIGHT	OVERWEIGHT
Energy[3]	NEUTRAL	UNDERWEIGHT
Precious Metals	OVERWEIGHT	OVERWEIGHT

[1] Relative to global equities in USD
[2] Relative to aggregate fixed income markets in USD
[3] Relative to an overall commodity allocation

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