

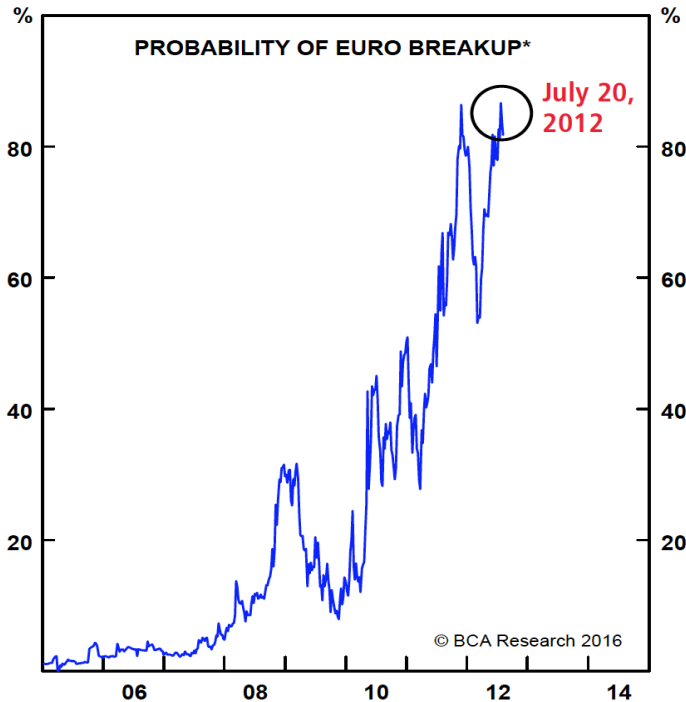
Investing & Geopolitics: Risks & Opportunities In 2017

Marko Papic
Senior Vice President
Geopolitical Strategy

Can Geopolitical Analysis Be Investment Relevant?

Focus on the *constraints* over *preferences*.

Market Misjudged The Geopolitical Imperative For European Integration



* DERIVED FROM ITALY / GERMANY AND SPAIN / GERMANY 5-YEAR YIELD SPREADS.

Market Misjudged Constraints To Putin



* BASED ON USD/NOK EXCHANGE RATE, RUSSIAN RELATIVE TO U.S. CONSUMER PRICE INDEX, AND A TIME TREND.

Five Paradigm Shifts

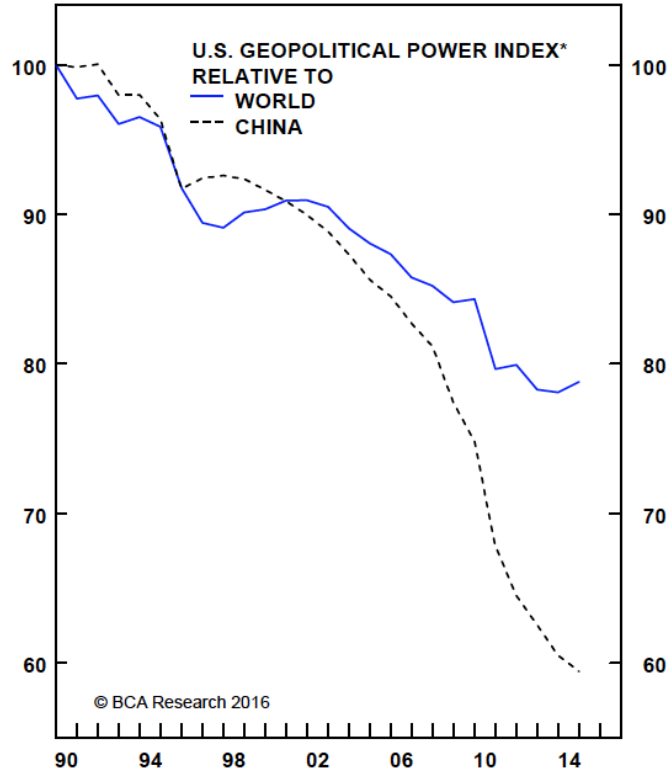
“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so.”

– Mark Twain

- I. From Multipolarity To... Conflict
- II. From Globalization To... Mercantilism
- III. From Legal To... Charismatic Authority
- IV. From *Laissez-Faire* To... *Dirigisme*
- V. From Facts To... Conspiracies

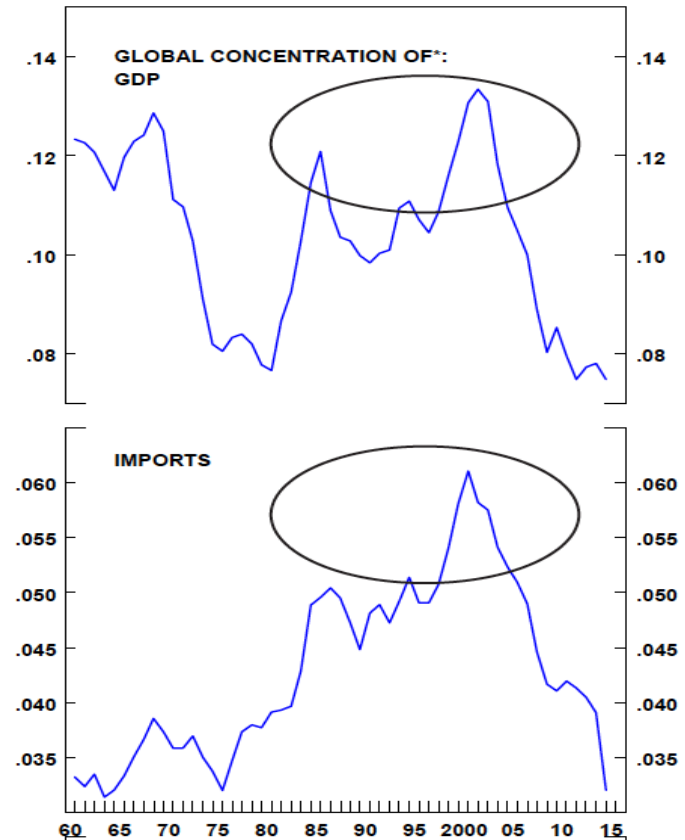
Paradigm I: From Multipolarity To... Conflict

U.S. Power Eroding In A Relative Sense

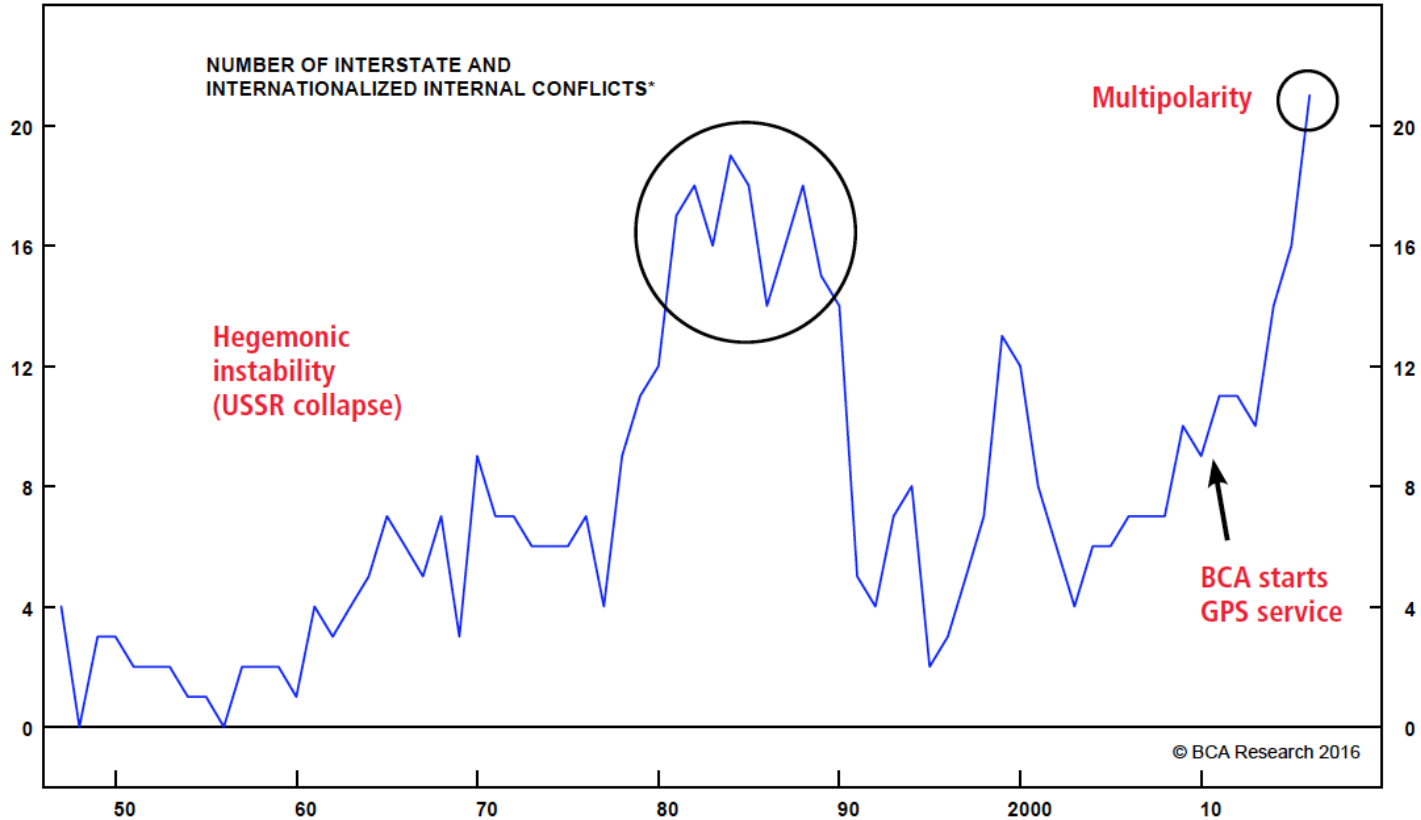


* REBASED TO JAN. 1990 = 100. THE GEOPOLITICAL POWER INDEX MEASURES A COUNTRY'S POWER BASED ON A WEIGHTED AGGREGATION OF ITS ECONOMIC, MILITARY, POLITICAL, TECHNOLOGICAL, AND GEOGRAPHICAL ENDOWMENTS.

The End Of American Hegemony

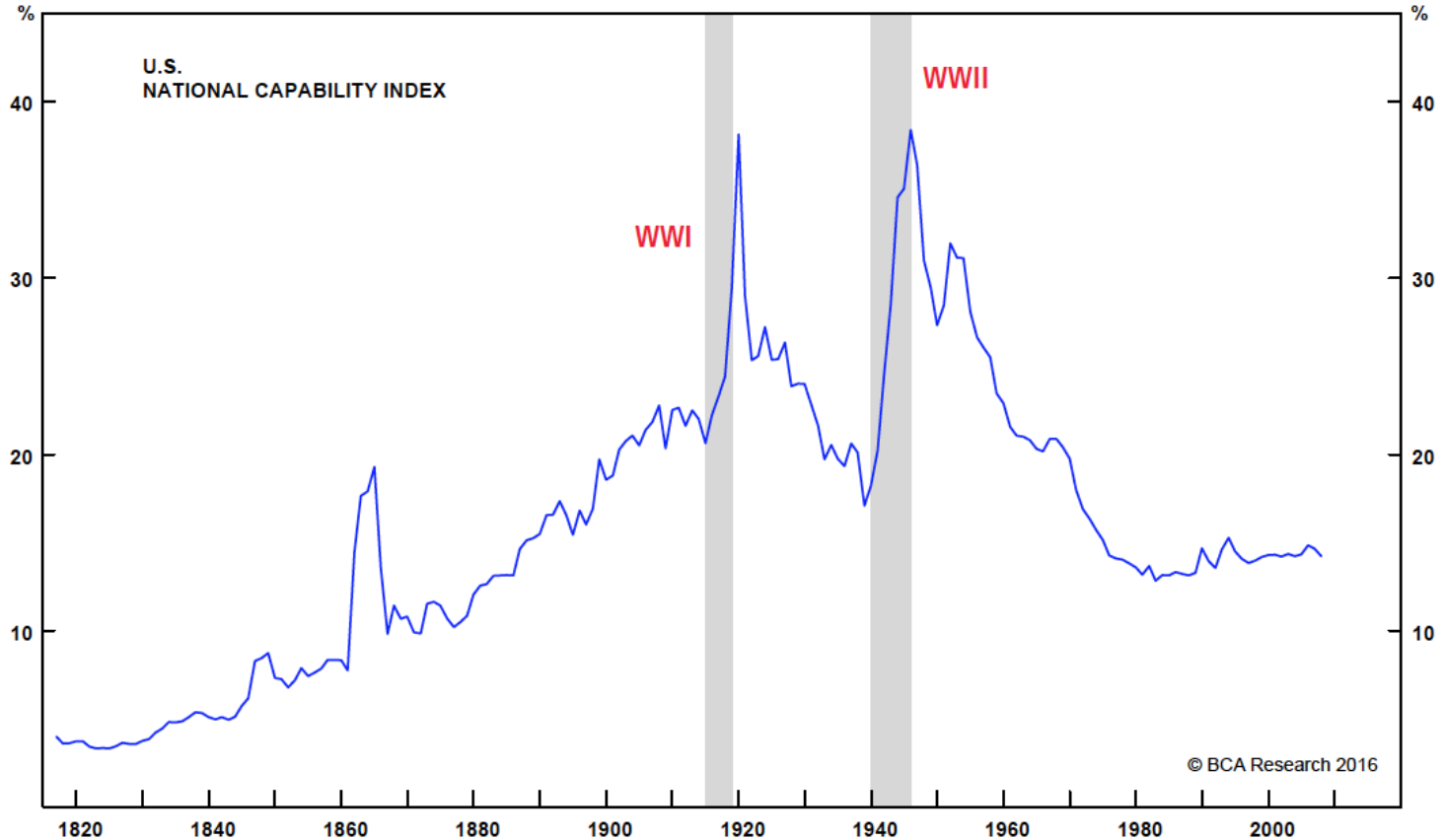


Frequency Of Geopolitical Conflicts Increases Under Multipolarity



* DEFINED AS THE NUMBER OF CONFLICTS BETWEEN TWO TYPES OF DYADS (PAIRS); INTERSTATE CONFLICT WHICH INVOLVES TWO STATES, AND THE INTERNATIONALIZED INTERNAL CONFLICT WHICH INVOLVES A STATE AND AN ORGANIZATION SUPPORTED BY ANOTHER STATE.
 SOURCE: LOTTA HARBOM, ERIK MELANDER AND PETER WALLENSTEEN, DYADIC DIMENSION OF ARMED CONFLICT, 1946-2007. JOURNAL OF PEACE RESEARCH 45(5): 697-710 (2008).

America Is Chaos-Proof



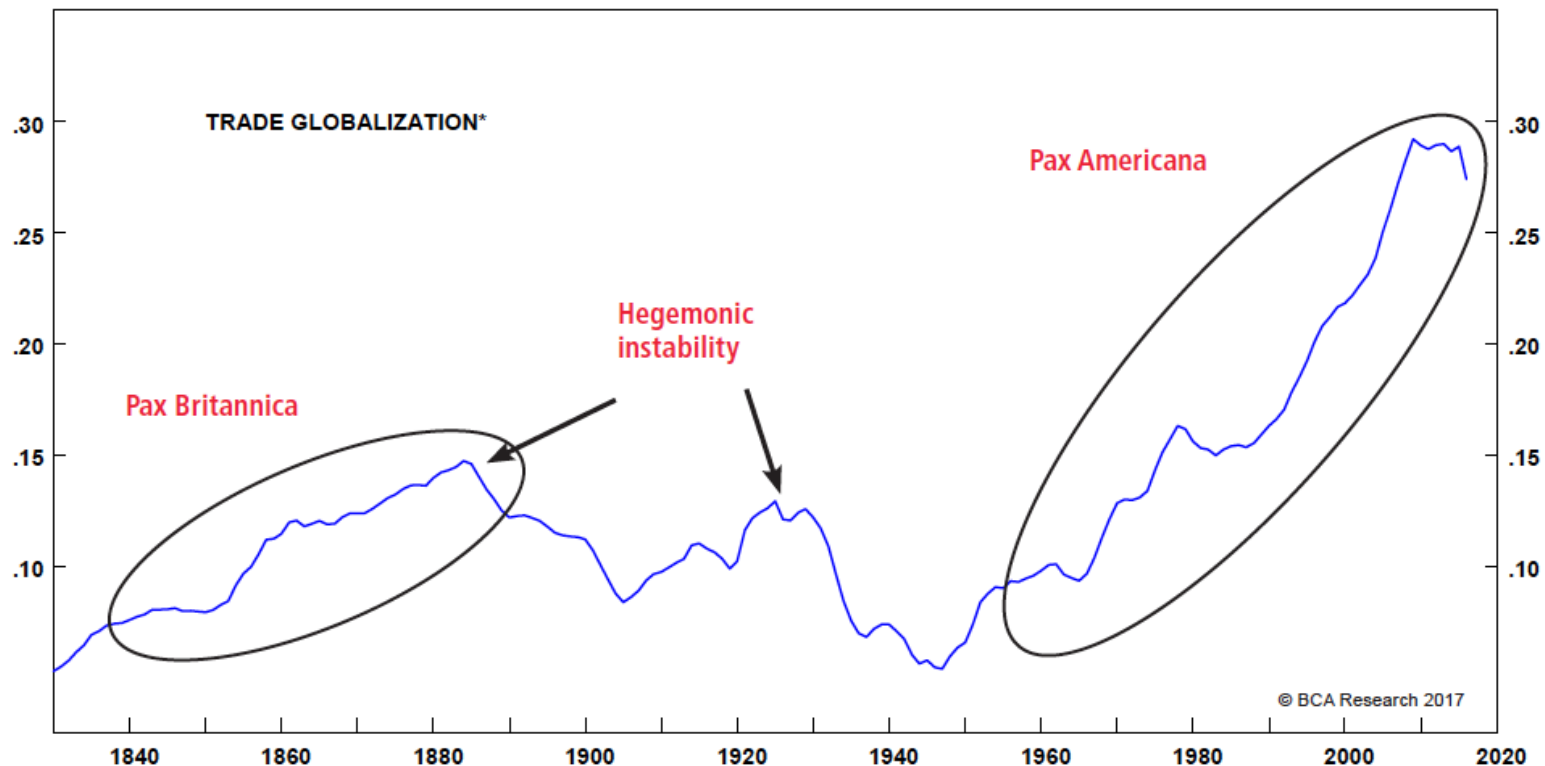
SOURCE: CORRELATES OF WAR DATABASE BY SINGER, BREMER, AND STUCKEY.
THE NATIONAL CAPABILITY INDEX MEASURES THE MATERIAL CAPABILITY OF COUNTRIES IN THE FORM OF IRON AND STEEL PRODUCTION, MILITARY EXPENDITURES AND PERSONNEL, PRIMARY ENERGY CONSUMPTION, AND TOTAL AND URBAN POPULATION.

Investment Relevance Of Paradigm I:

- 1. Multipolarity has lead to an increase in global conflict.**
- 2. Geopolitical risk is positive for safe haven assets and defense equities.**
- 3. The U.S. – the ultimate low-beta, closed economy – has always benefited from global risks and conflict.**

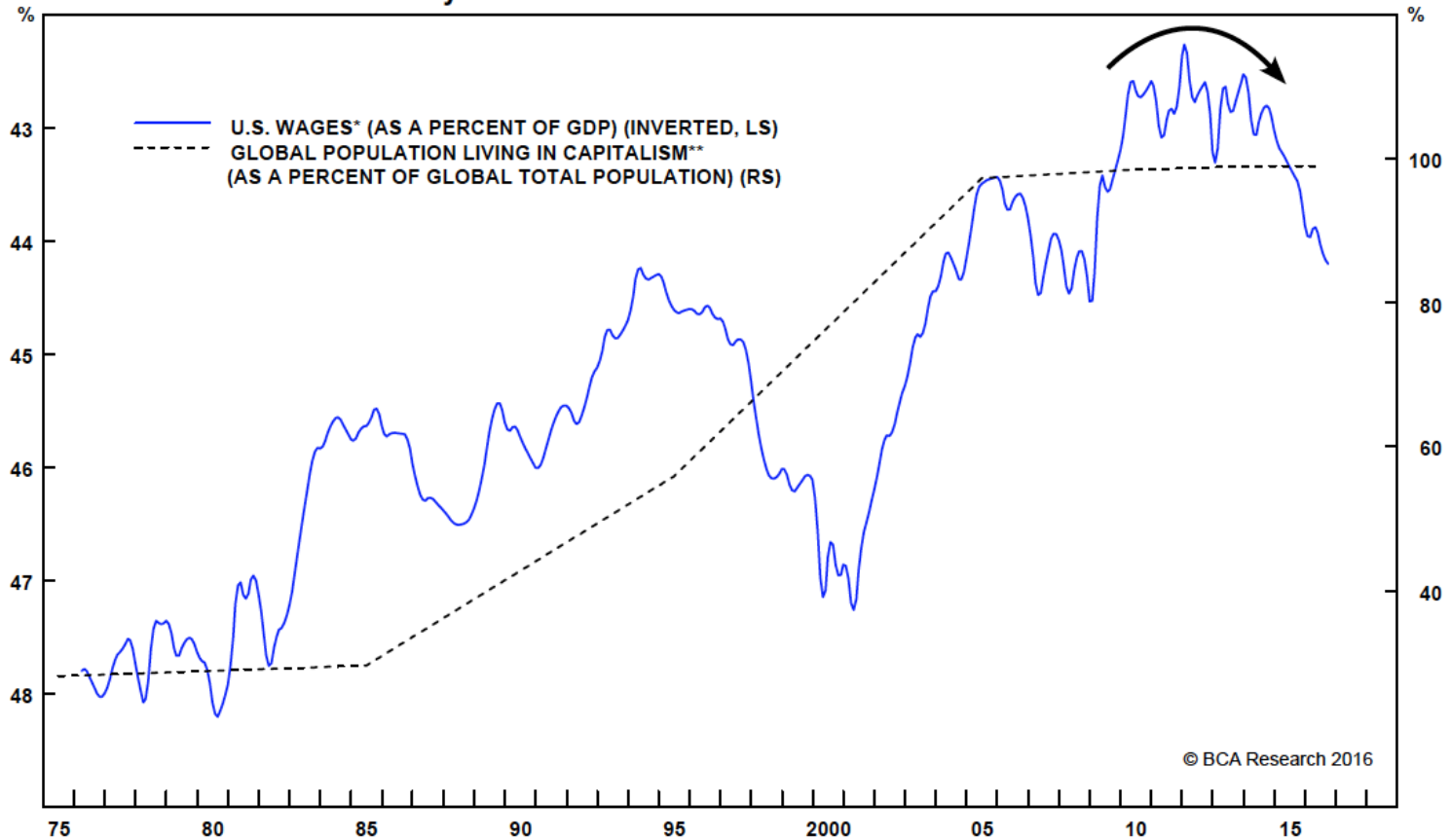
Paradigm II: From Globalization To... Mercantilism

Back To The 1930's?



* TRADE GLOBALIZATION IS MEASURED BY IMPORTS AS PERCENTAGE OF GDP FOR 148 COUNTRIES WEIGHTED BY POPULATION.
SOURCE: BCA CALCULATIONS AND CHASE-DUNN C., KAWANO Y., AND BREWER B., "TRADE GLOBALIZATION SINCE 1795: WAVES OF INTEGRATION IN THE WORLD SYSTEM," AMERICAN SOCIOLOGICAL REVIEW 65 1, 2000.

Globalization: A Deflationary Shock

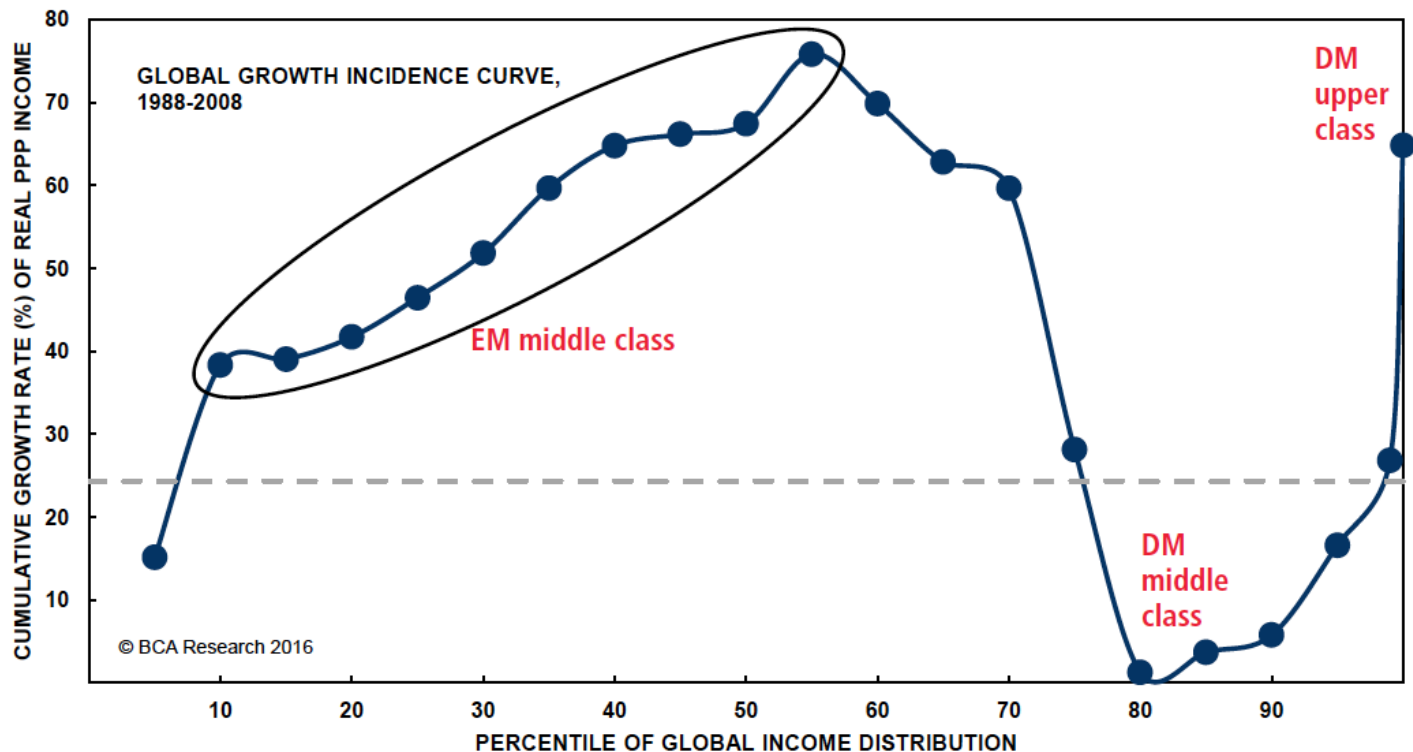


© BCA Research 2016

* SOURCE: BEA.

** PERCENT OF GLOBAL POPULATION LIVING IN COUNTRIES WITH FRASER INSTITUTE ECONOMIC FREEDOM INDEX EQUAL TO OR GREATER THAN FIVE. BASED ON FRASER INSTITUTE AND WORLD BANK DATA.

Globalization: No Friend To DM Middle Class



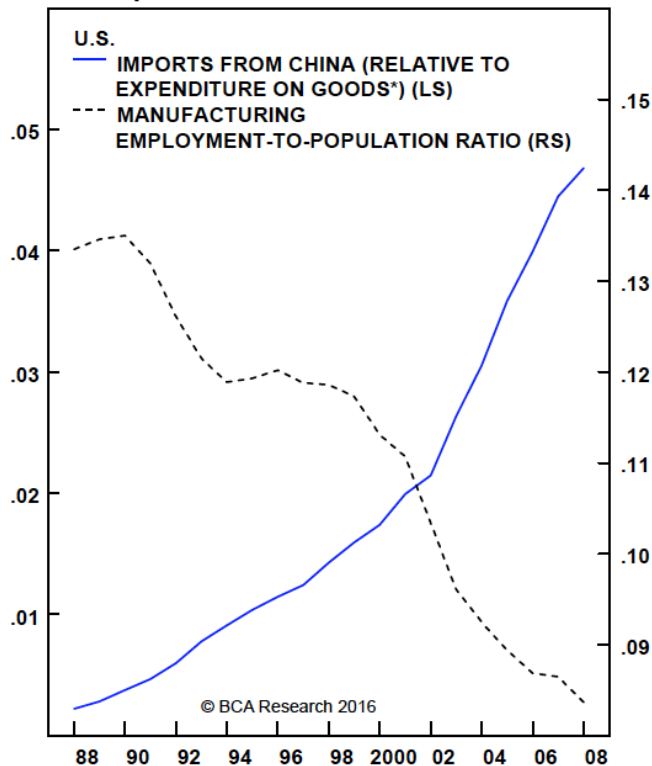
NOTE: Y-AXIS DISPLAYS THE GROWTH RATE OF THE FRACTILE AVERAGE INCOME (IN 2005 PPP USD), WEIGHTED BY POPULATION. GROWTH INCIDENCE EVALUATED AT VENTILE GROUPS (E.G. BOTTOM 5%); TOP VENTILE IS SPLIT INTO TOP 1% AND 4% BETWEEN P95 AND P99. THE HORIZONTAL LINE SHOWS THE GROWTH RATE IN THE MEAN OF 24.34% (1.1% P.A.).

SOURCE: LAKNER AND MILANOVIC (2015)

DATA AVAILABLE AT: [HTTP://GO.WORLDBANK.ORG/NWBUKI3JP0](http://go.worldbank.org/NWBUKI3JP0).

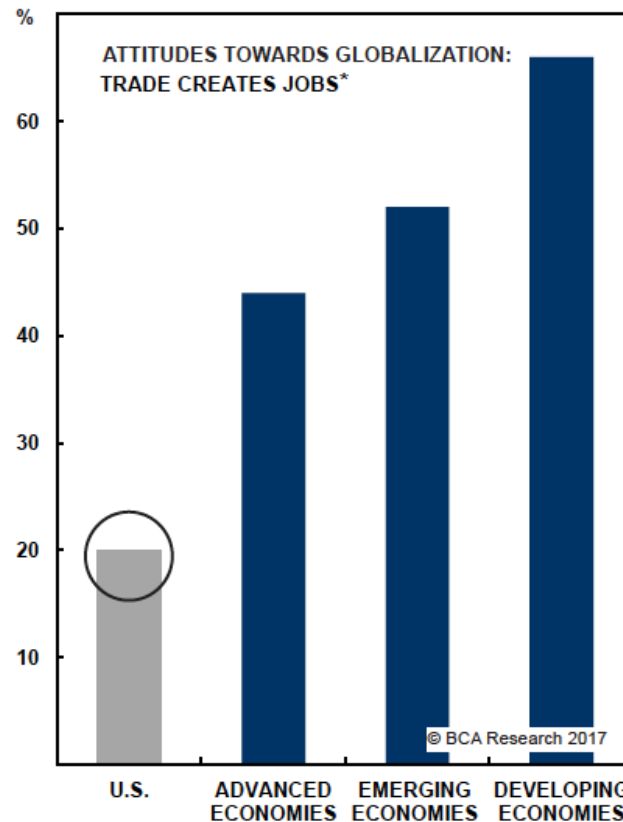
CITATION: GLOBAL INCOME DISTRIBUTION: FROM THE FALL OF THE BERLIN WALL TO THE GREAT RECESSION, CHRISTOPH LAKNER AND BRANKO MILANOVIC, WORLD BANK ECONOMIC REVIEW, ADVANCE ACCESS PUBLISHED SEPTEMBER 26, 2015.

China's Rise Came Partly At The Expense Of U.S. Rust Belt Workers



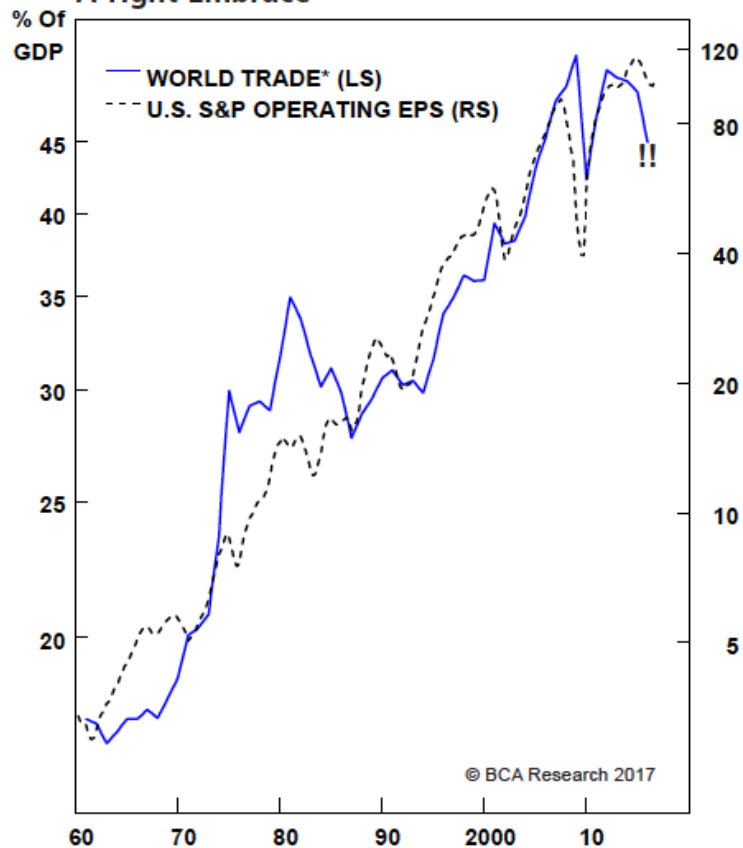
* MEASURED AS U.S. GROSS OUTPUT PLUS NET IMPORTS.
 SOURCE: DAVID AUTOR, DAVID DORN, AND GORDON HANSON, "THE CHINA SYNDROME: LOCAL LABOR MARKET EFFECTS OF IMPORT COMPETITION IN THE UNITED STATES," THE AMERICAN ECONOMIC REVIEW VOL. 103, NO. 6 (2013): PP. 2121-2168.

America Has Soured On Globalization: Jobs



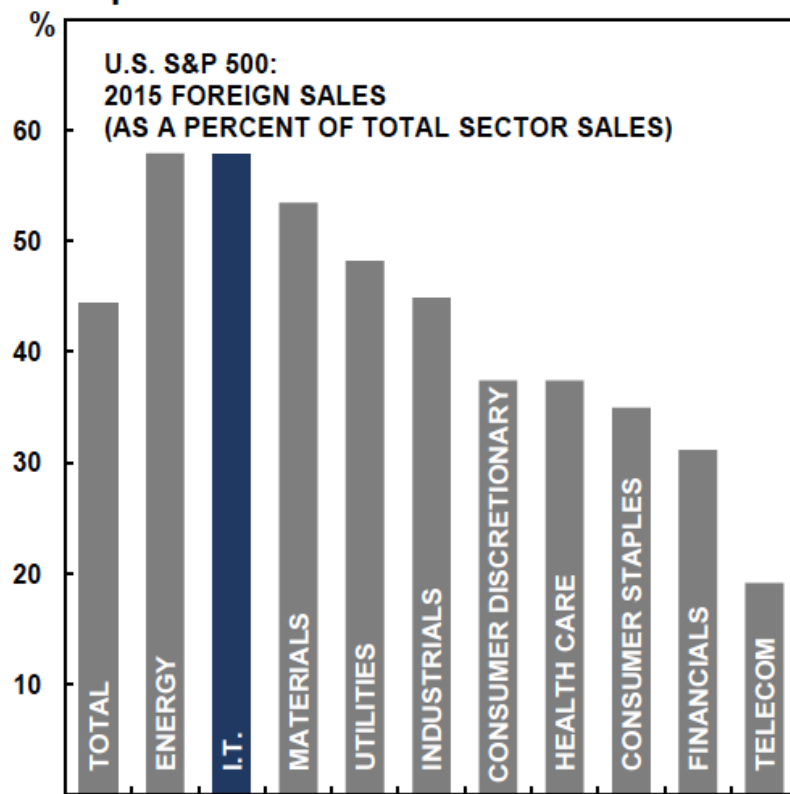
* PERCENTAGE OF RESPONDENTS WHO AGREED WITH EACH STATEMENT.
 SOURCE: SPRING 2014 GLOBAL ATTITUDES SURVEY, PEW RESEARCH.

Globalization And MN|Cs: A Tight Embrace

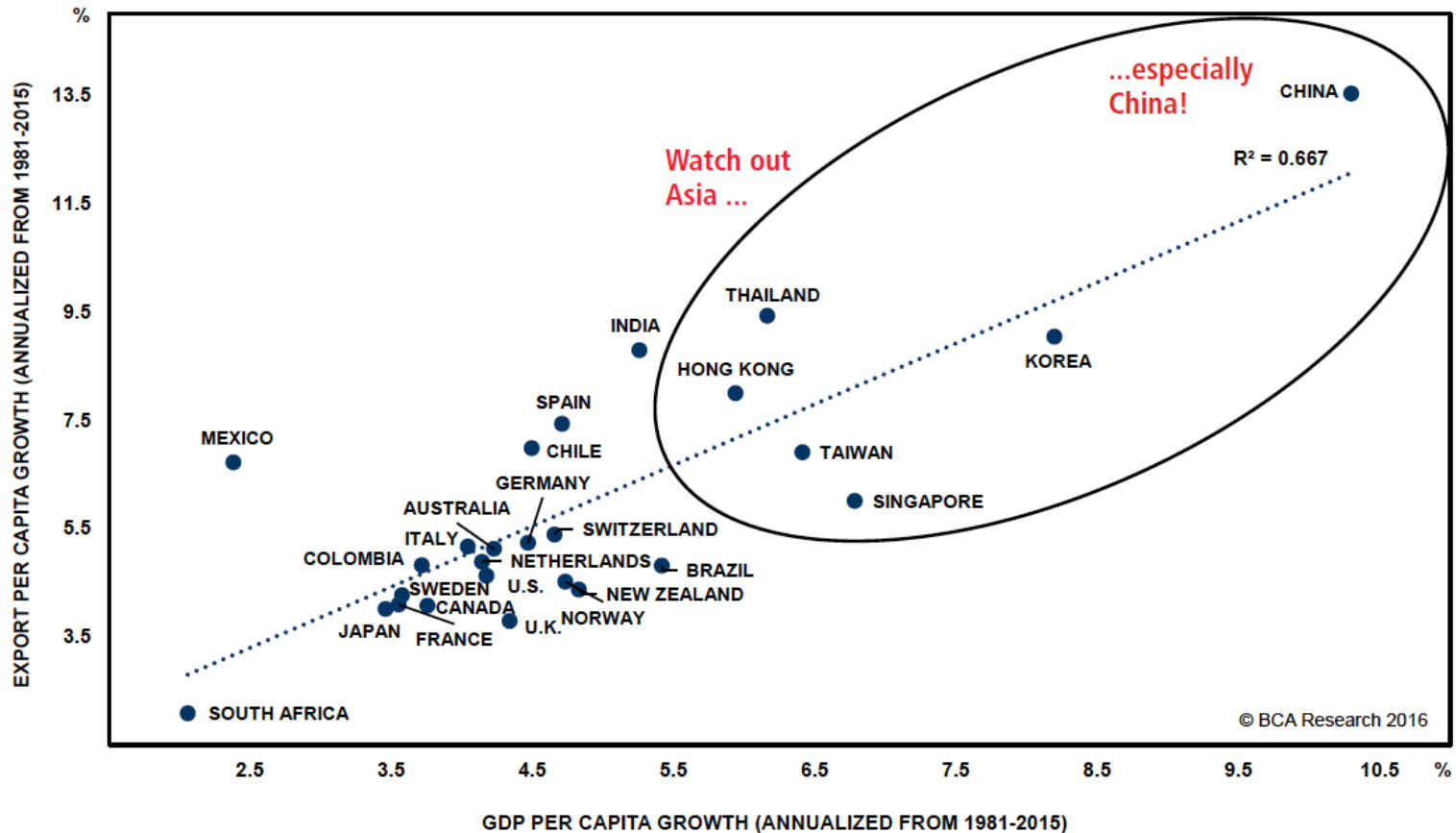


* SOURCE: WORLD BANK.

Tech Stocks Are Heavily Exposed To Globalism



Globalization's Winners Will Be De-Globalization's Losers



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Investment Relevance Of Paradigm II:

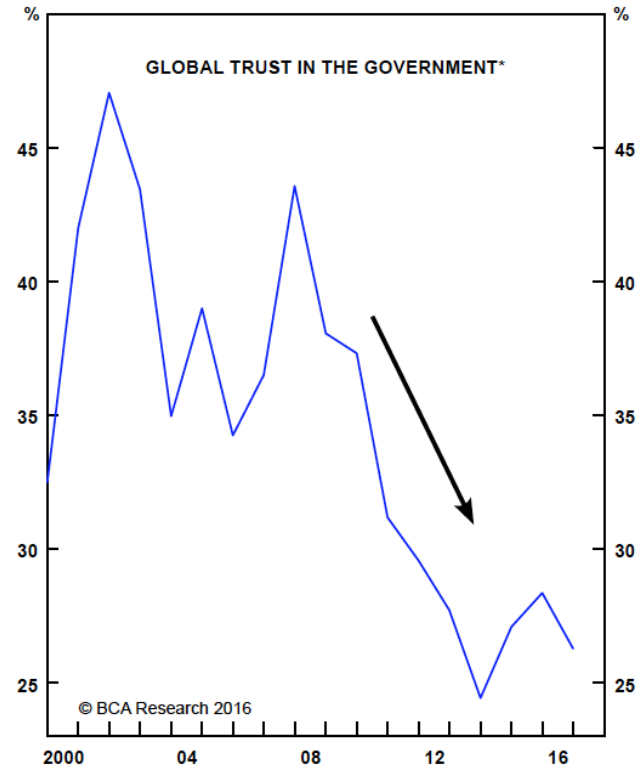
1. **Mercantilism is back: economics, trade, and finance will become tools of statecraft, manipulated by policymakers for *geopolitical gains*.**
2. **Investing in Emerging Markets will require an understanding of geopolitical trends.**
3. **Good for consumer-oriented sectors and economies (DM and small caps), negative for export-dominated sectors and economies (EM and large caps).**
4. **Good for inflation and commodities.**

Paradigm III: From Legal To... Charismatic Authority

In his 1922 “The Three Types of Legitimate Rule,” sociologist Max Weber defines three forms of authority:

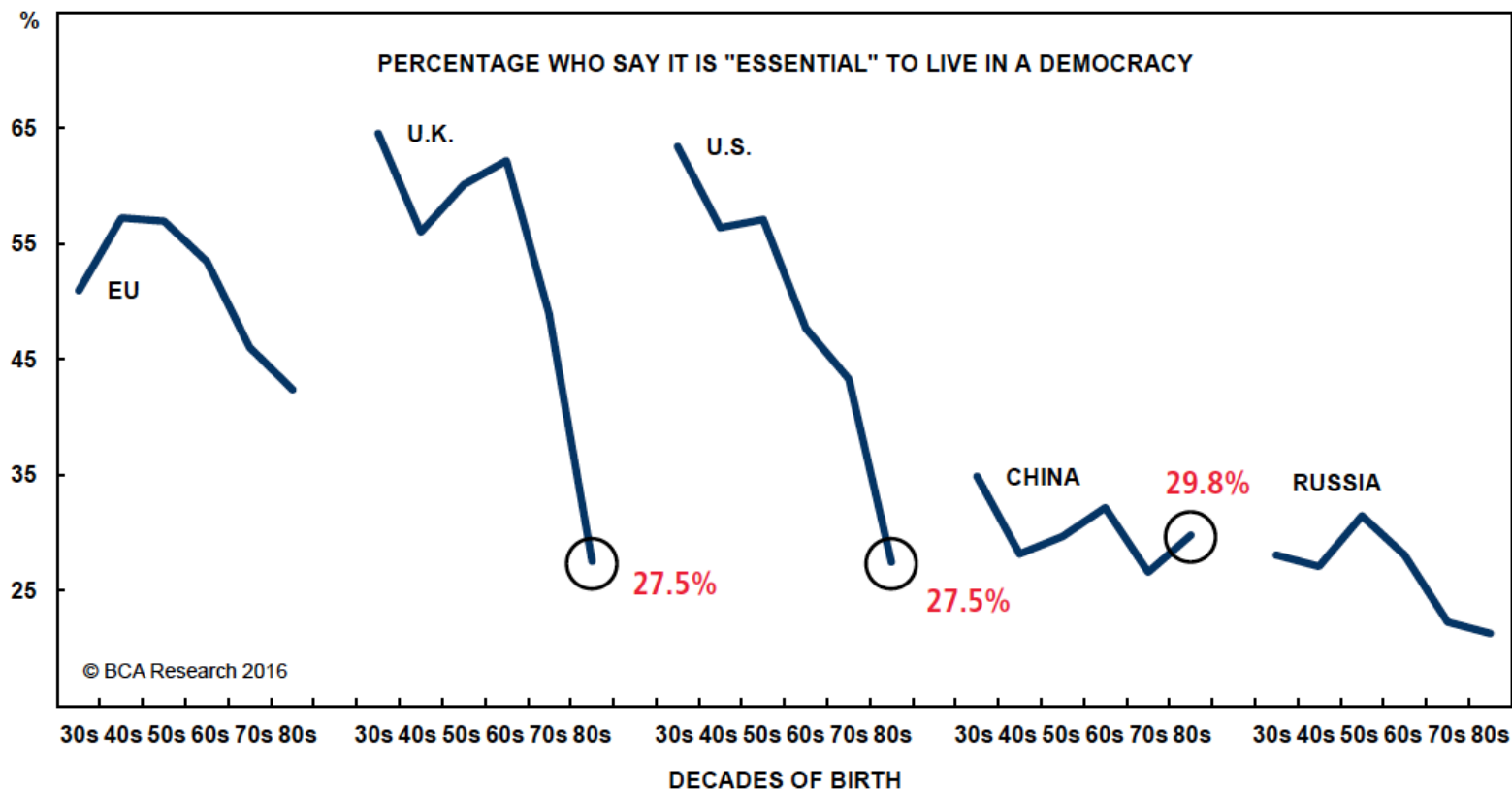
- **Traditional** (monarchies and dynasties)
- **Legal-Rational** (constitutional order)
- **Charismatic** (personality based)

As Institutional Trust Declines,
Voters Turn To Charismatic Leaders



* INCLUDES THE U.S., GERMANY, GREECE, SPAIN, FRANCE, ITALY, THE NETHERLANDS, AND AUSTRIA.
SOURCE: NATIONAL ELECTION STUDIES, PEW RESEARCH, GALLUP, AND THE EU COMMISSION.

Who Needs Democracy When You Have Tinder?

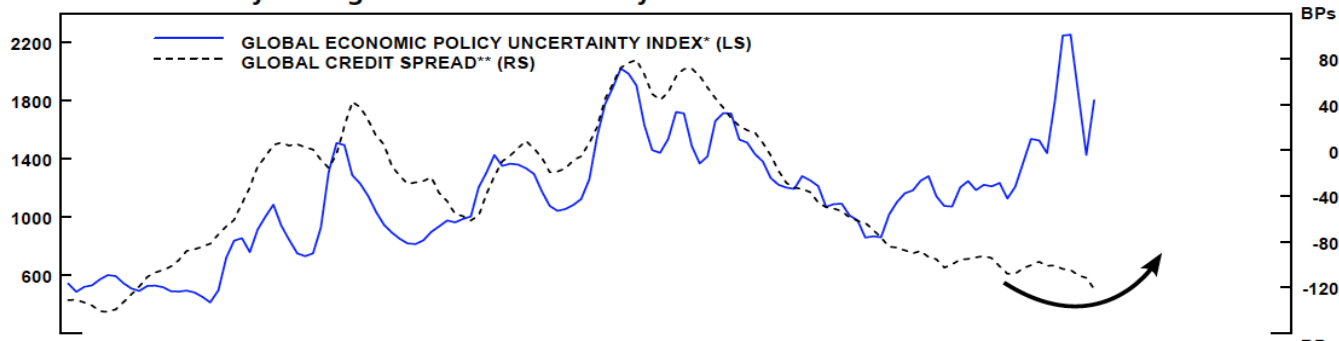


SOURCE: WORLD VALUE SURVEY.

Investment Relevance Of Paradigm III:

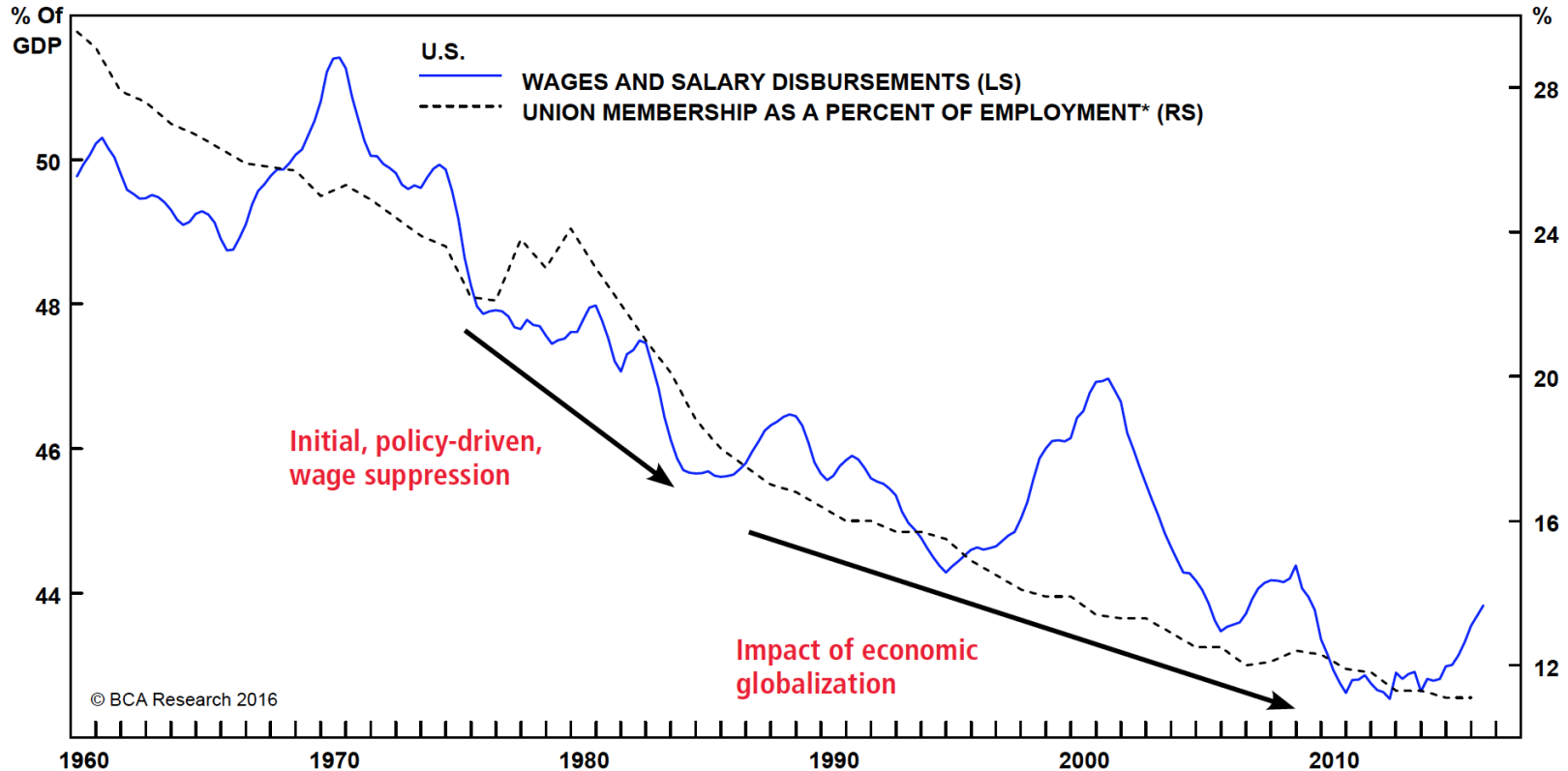
1. It is more difficult to predict the behavior of a charismatic authority, than a legal-rational one.
2. Trump's tweeter feed becomes more important than a bottom-up analysis (just ask Carrier, Ford, and Lockheed-Martin).
3. The bond market is not pricing-in policy uncertainty.

Are Assets Fully Pricing In Global Uncertainty?



Paradigm IV: From *Laissez-Faire* To... *Dirigisme*

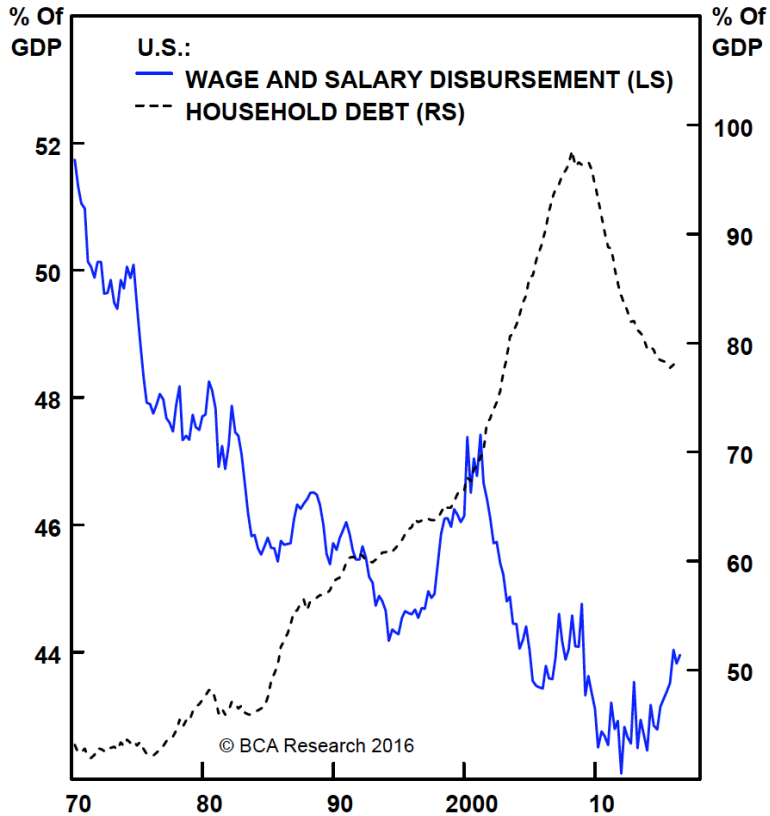
...Leading To Decline Of Labor's Bargaining Power



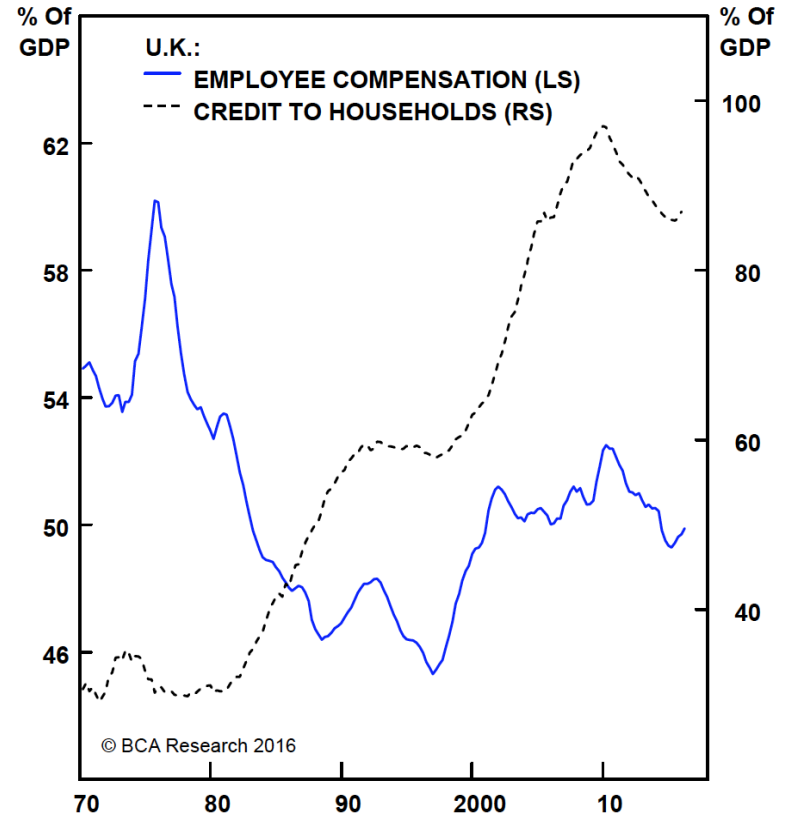
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* SOURCE: BUREAU OF LABOR STATISTICS (BLS).

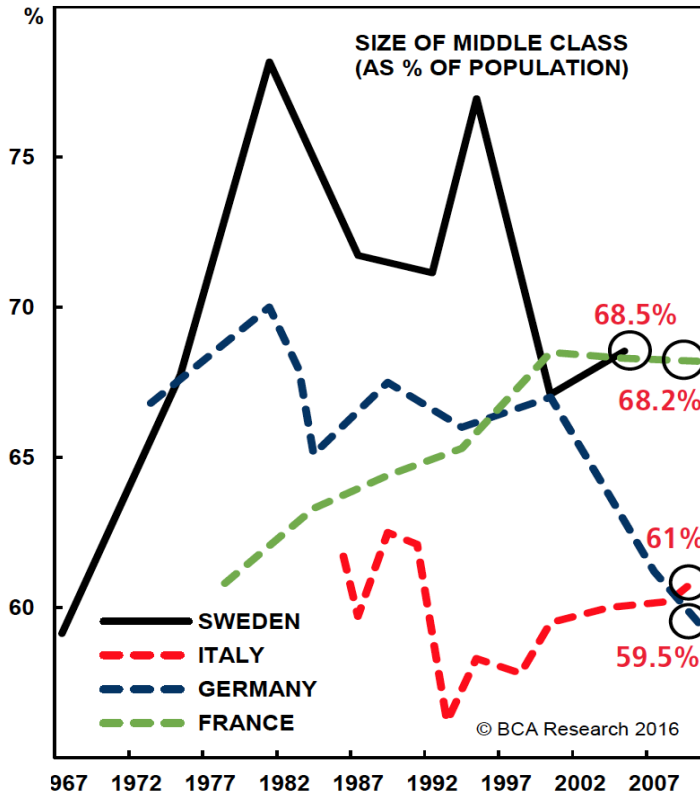
Debt Replaced Income In The U.S...



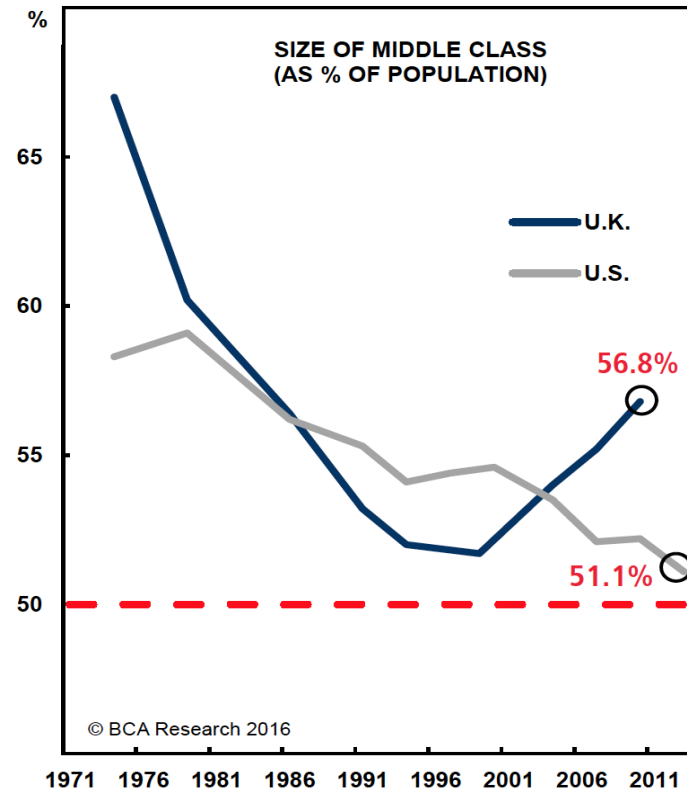
...And In The U.K.



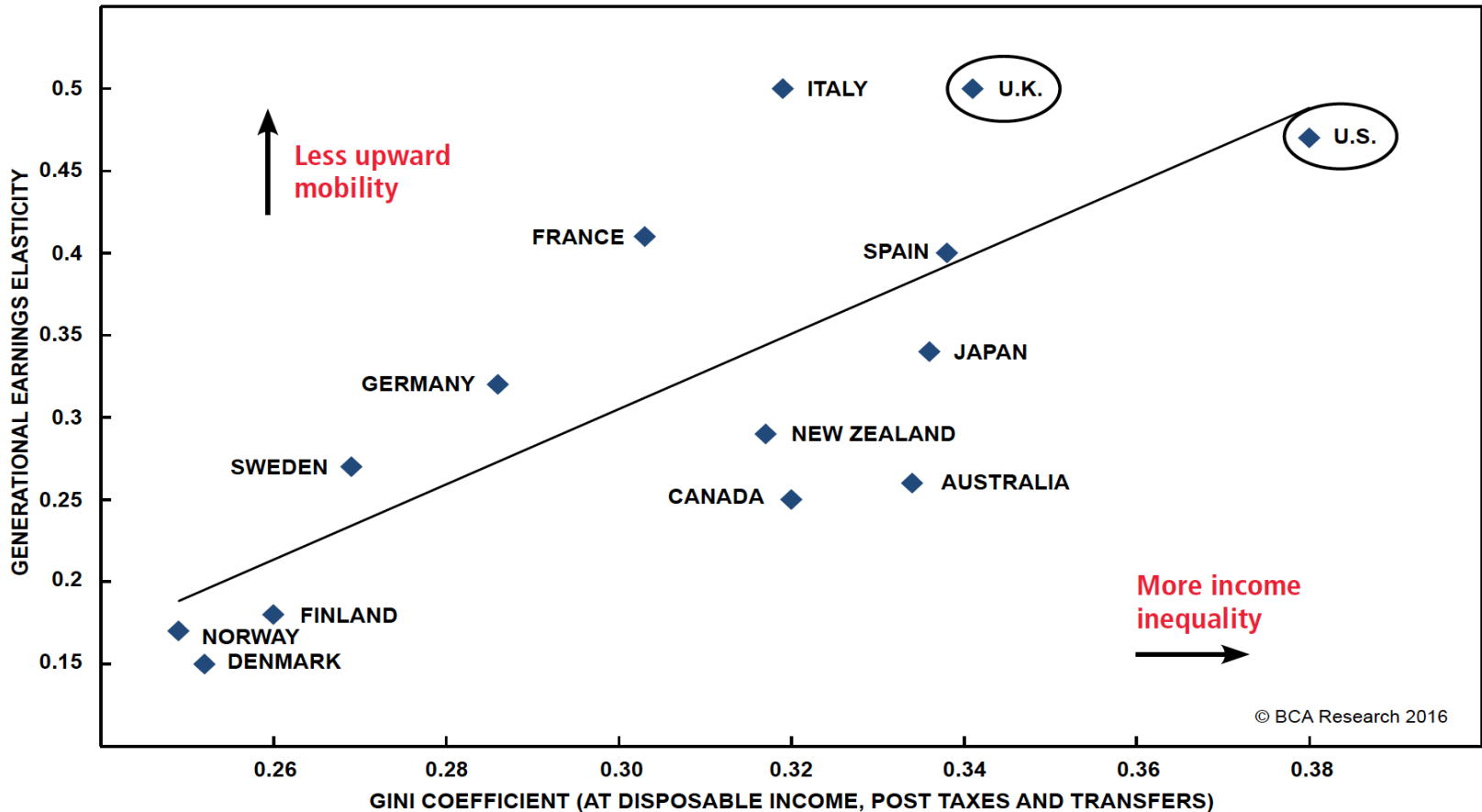
Middle Class Has Thrived In Europe



Middle Class Has Shrunk In Anglo-Saxon World

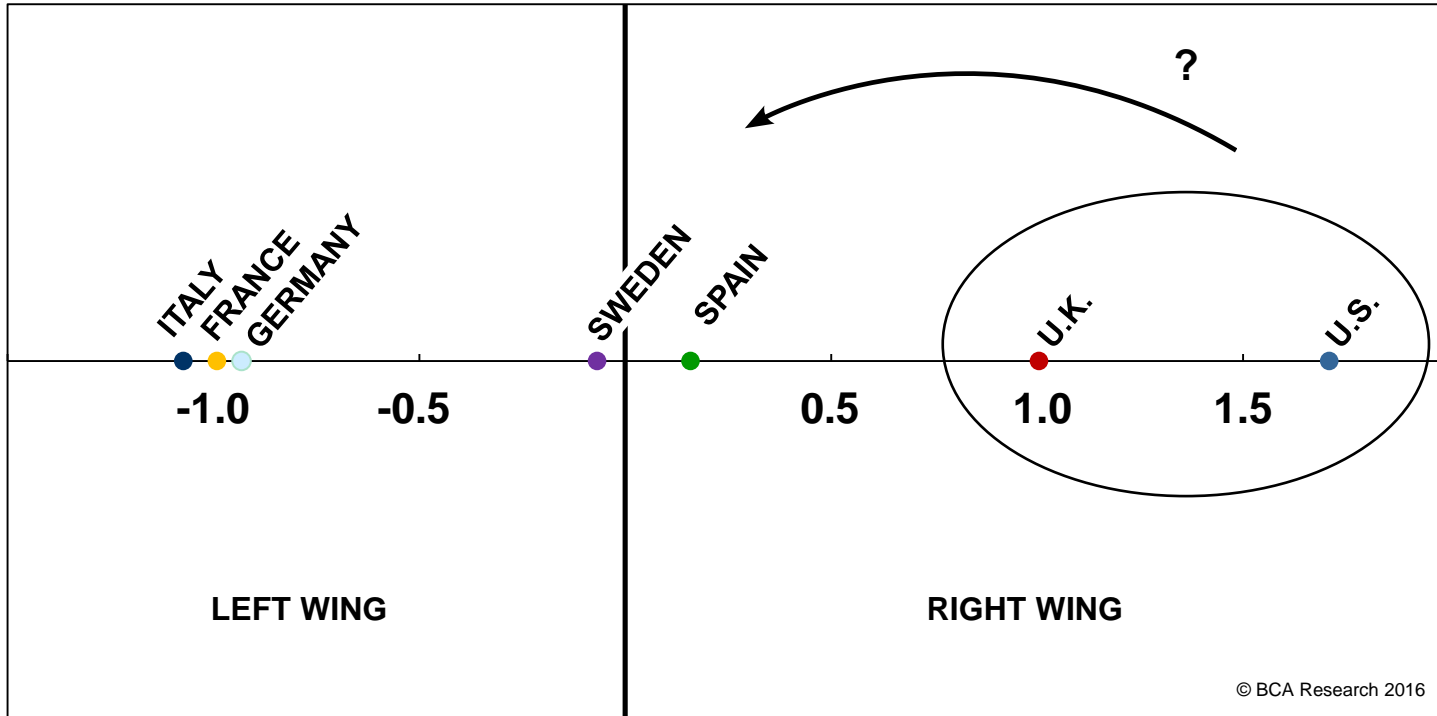


Opportunity And Income: Anglo-Saxons Are Outliers



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Are The U.S. And The U.K. Moving To The LEFT Of The ECONOMIC INDEX?



CALCULATED AS AN EQUAL-WEIGHTED INDEX OF 5 STANDARDIZED COMPONENTS: LABOR PROTECTION INDEX, GOVERNMENT REVENUE AS A PERCENT OF GDP, ALL-IN AVERAGE INCOME TAX RATE AT AVERAGE WAGE, REDISTRIBUTION EFFECT ON GINI COEFFICIENT, AND EASE OF DOING BUSINESS RANKING.

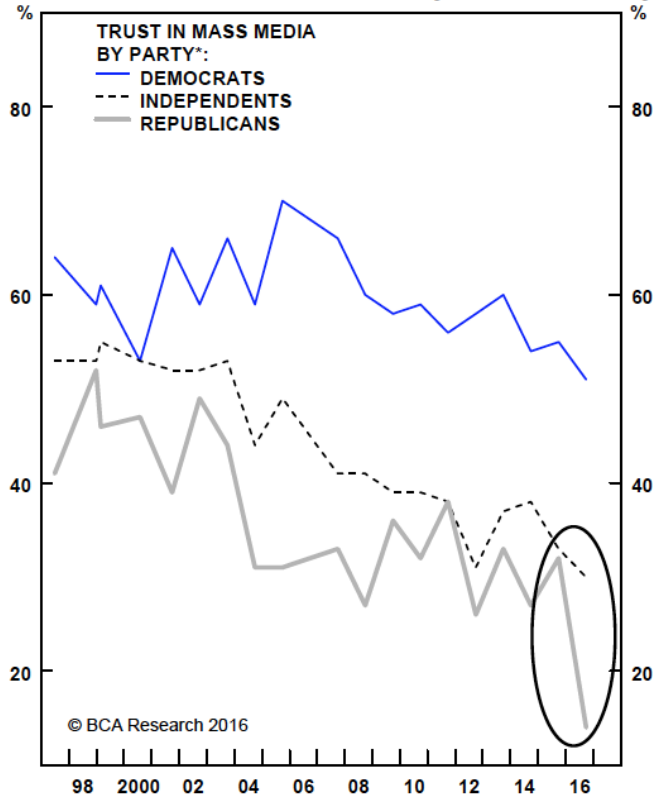
SOURCE: OECD, WORLD BANK, BCA CALCULATIONS.

Investment Relevance Of Paradigm IV:

1. In 2017, the market will be shocked to find itself face-to-face with a marginally more *laissez-faire* Europe and a marginally more *dirigiste* America and Britain.
2. Investors should overweight European assets in a global portfolio.
3. Populist economic policies in the U.S. will favor domestically oriented companies and small caps. Favor S&P 600 over S&P 500.

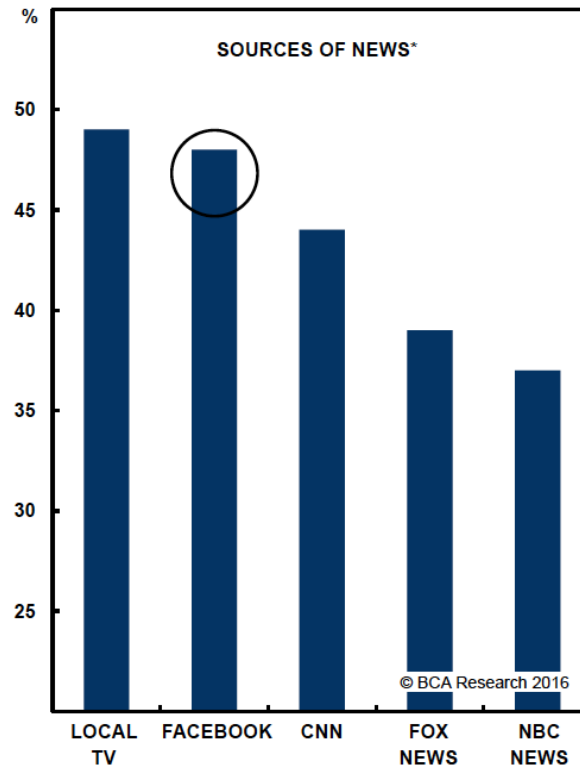
Paradigm V: From Facts To... Conspiracies

"Mainstream Media" Is A Dirty Word For Many



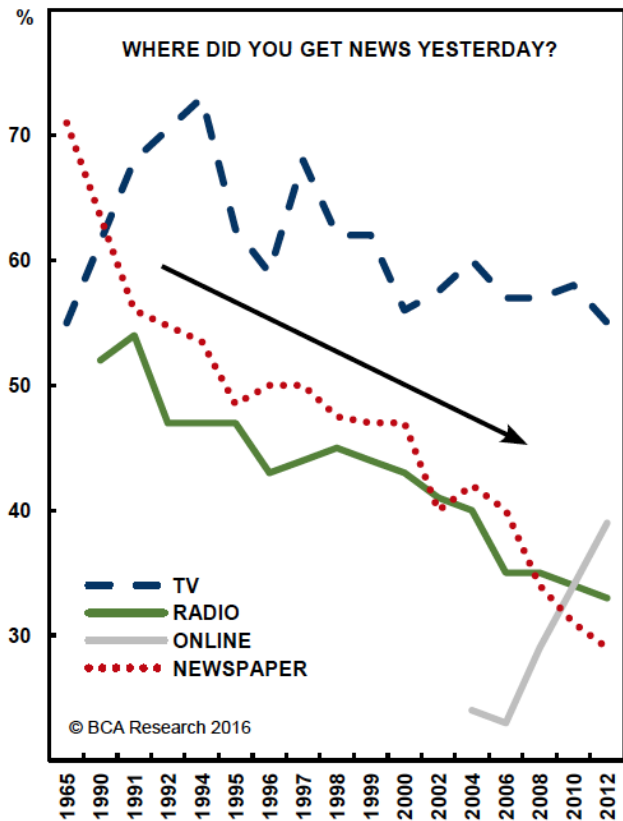
* SOURCE: GALLUP.

Facebook Is The New Cronkite?



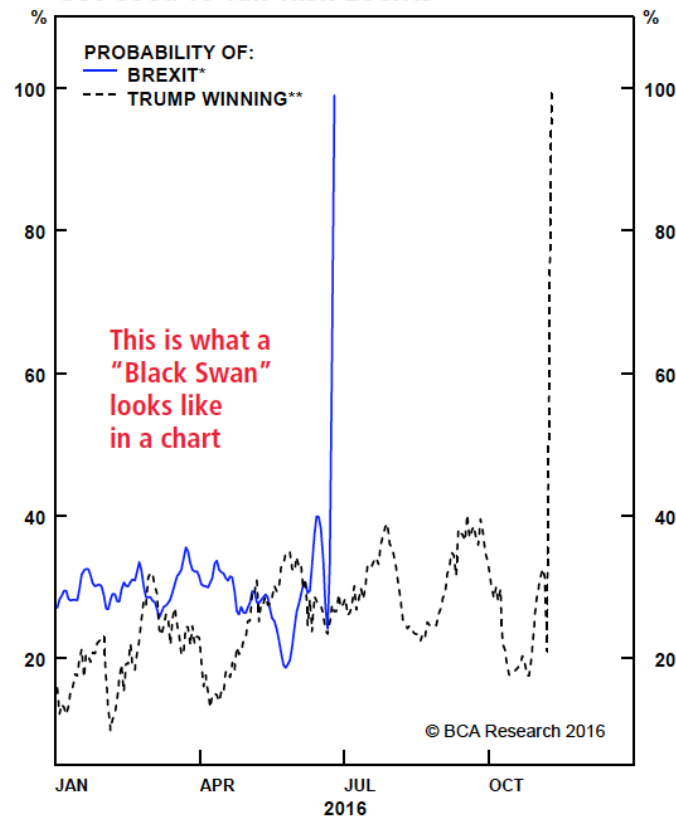
* PERCENTAGE OF WEB USERS SAYING THEY GOT NEWS ABOUT GOVERNMENT AND POLITICS FROM EACH IN THE PAST WEEK.
SOURCE: PEW RESEARCH CENTER, OCTOBER 2014, "POLITICAL POLARIZATION AND MEDIA HABITS".

The Internet Has Killed Journalism



SOURCE: "TRENDS IN NEWS CONSUMPTION: 1991 - 2012," PEW RESEARCH CENTER.

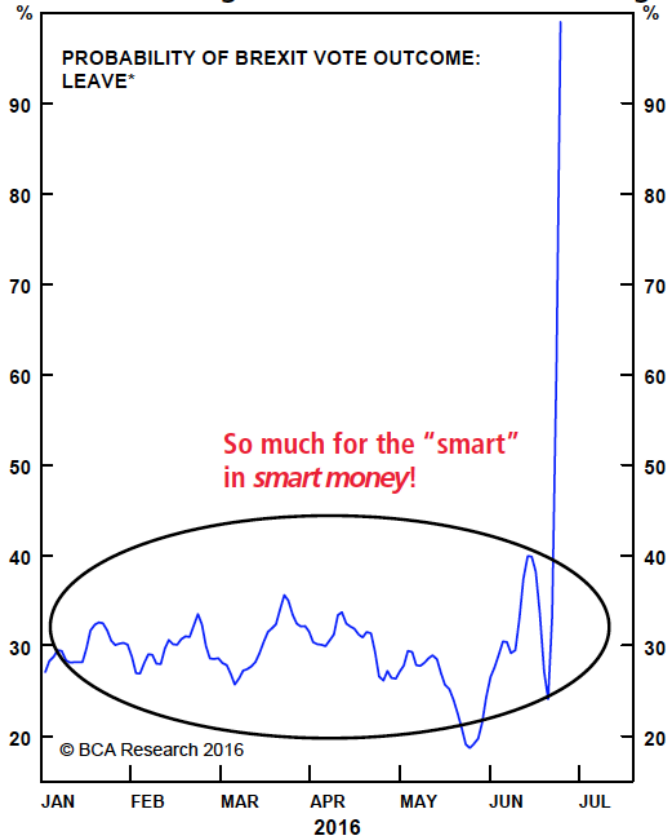
Get Used To Tail-Risk Events



* AVERAGE OF ODDSchecker.COM AND PREDICTIT.COM. DATA.

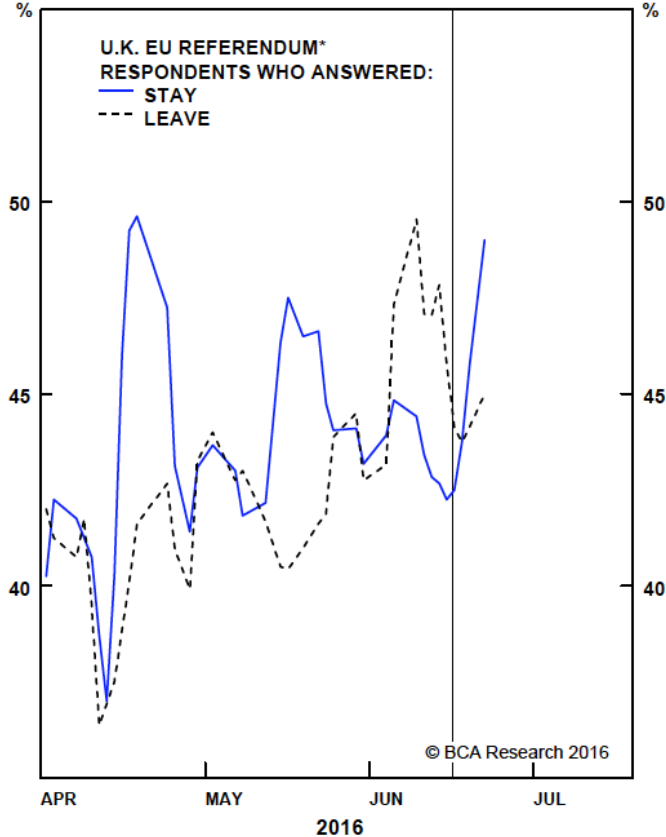
** SOURCE: ODDSchecker.COM.

Online Betting And Pundits Got Brexit Wrong...



* AVERAGE OF ODDSchecker.COM AND PREDICTIT.COM DATA.

... Not The Polls



* SOURCE: DATA AGGREGATED FROM YOUNG, TNS, COMRES, SURVATION, LORD ASHCROFT POLLS, PEW RESEARCH, AND POPULUS.
NOTE: VERTICAL LINE DENOTES THE MURDER OF MP JO COX.

Investment Relevance Of Paradigm V:

- 1. Fundamental analysis of a country's political and geopolitical risk is now an essential tool in the investor toolkit.**
- 2. The polls did not get Brexit and Trump wrong, pundits and media did by understating the probability of anti-establishment outcomes.**
- 3. Investors cannot rely on the media to gauge political and geopolitical risk. And there is no geopolitical Bloomberg terminal.**

Four Investment Themes In 2017

- I. Sino-American Tensions Are *The* Investment Risk In 2017
And Beyond
- II. Europe Is A Massive Red Herring In 2017
- III. Middle East Is No Longer Investment-Relevant
- IV. Russia Is Not A Risk, But Neither Is It An Opportunity

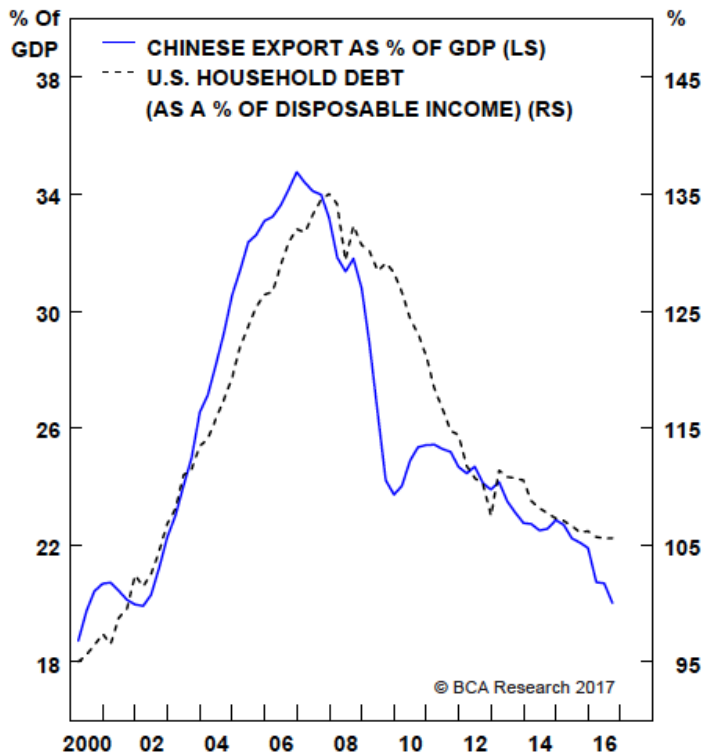
Sino-American Tensions: Yes They *CAN*...

Constraints To Sino-American Conflict:

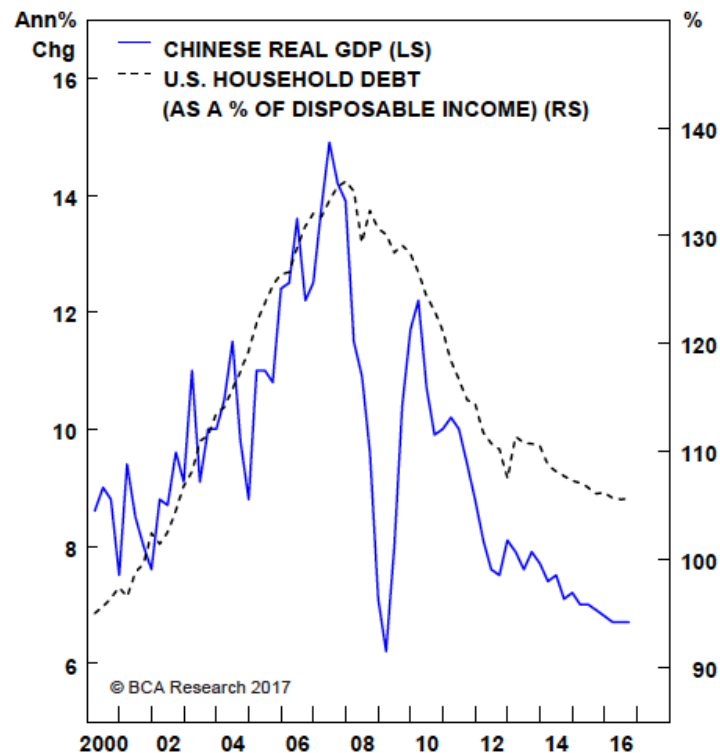
- I. Economic**
- II. Military**
- III. Regional**

Sino-American Tensions: Economic Symbiosis Is Over

Sino-American Symbiosis Is Over: Exports

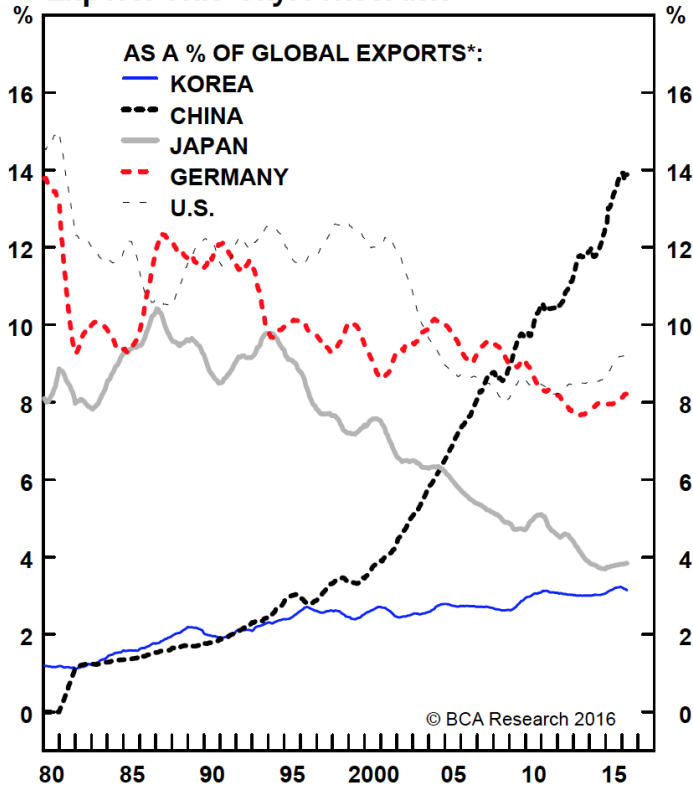


Sino-American Symbiosis Is Over: Growth



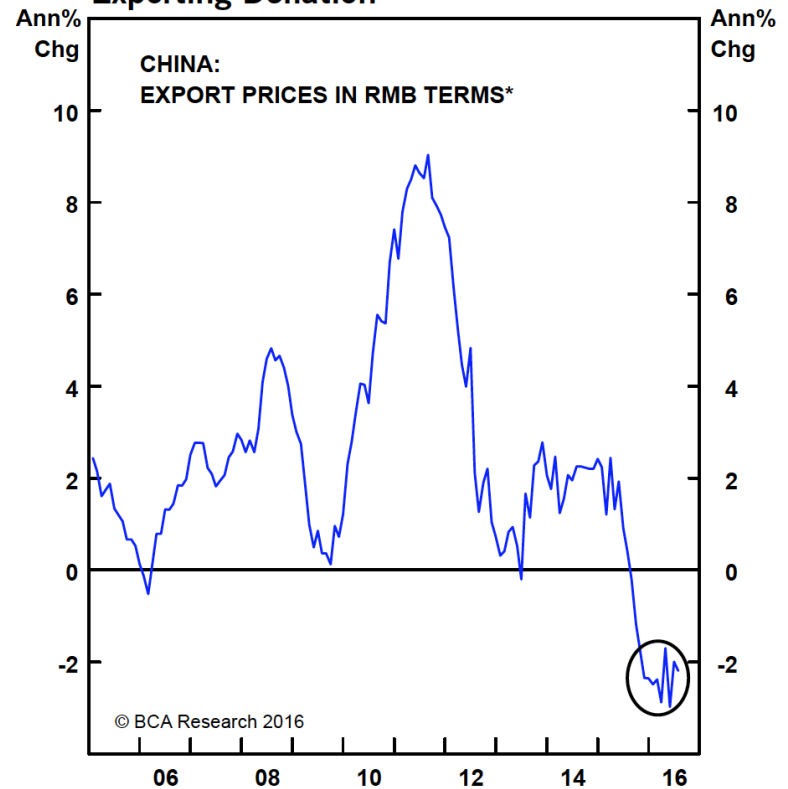
China Is Exporting Deflation

China's Share Of Global Exports Has Skyrocketed...



* SOURCE: IMF DIRECTION OF TRADE STATISTICS.

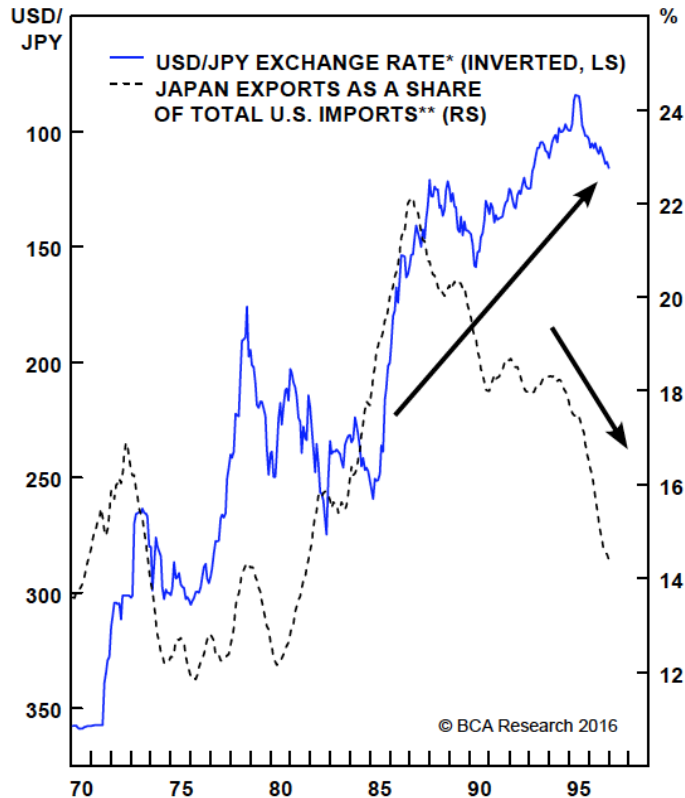
...And Now China Is Exporting Deflation



* HONG KONG RE-EXPORT PRICE AS A PROXY; SOURCE: HONG KONG MONTHLY DIGEST OF STATISTICS.

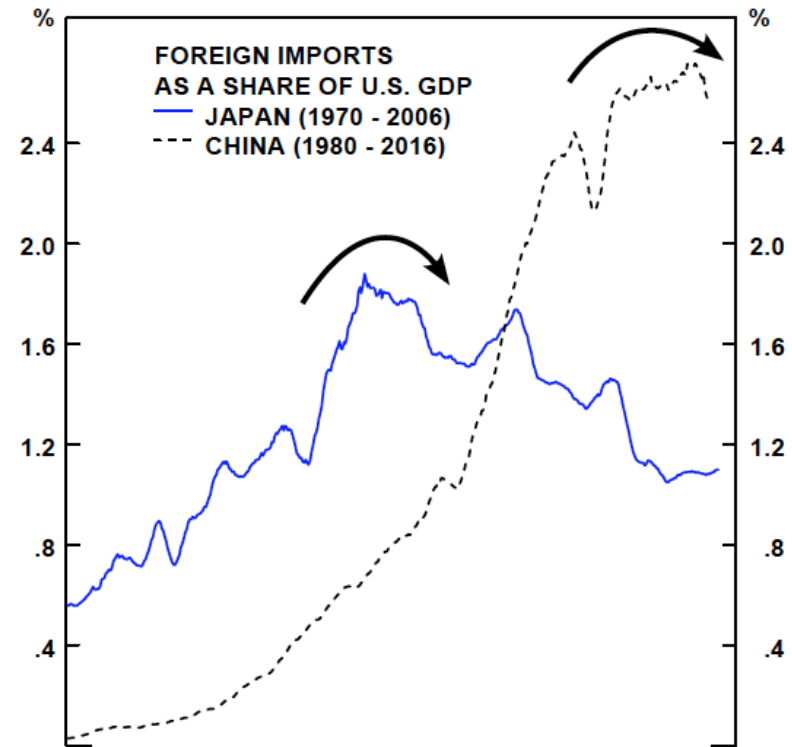
The U.S. Wants A Japanese "End-Game" For China

The U.S. Forced Structural Changes On Japan



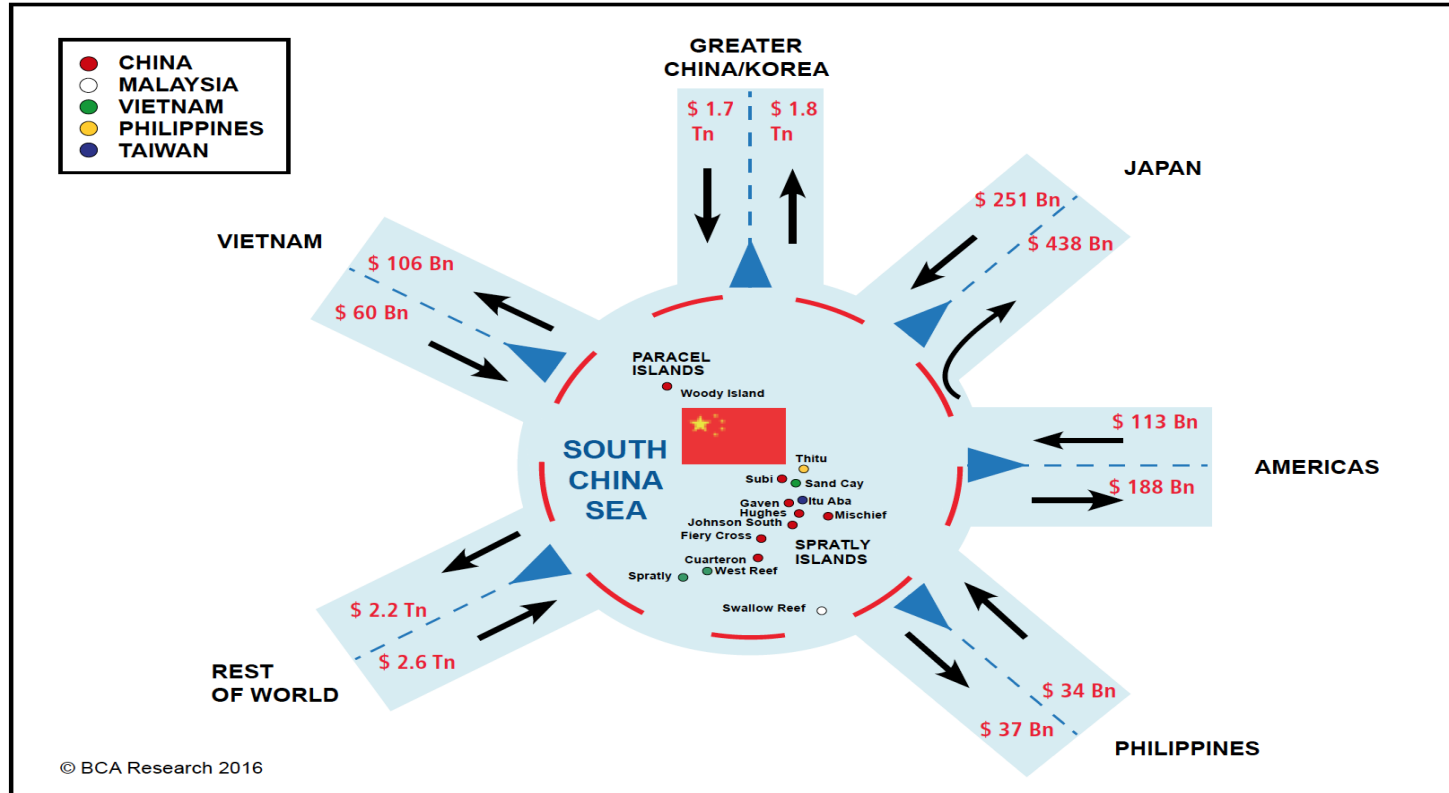
* SOURCE NATIONAL SOURCES AND IMF.
 ** SOURCE: IMF DIRECTION OF TRADE.

The U.S. Will Get Tougher On China Trade



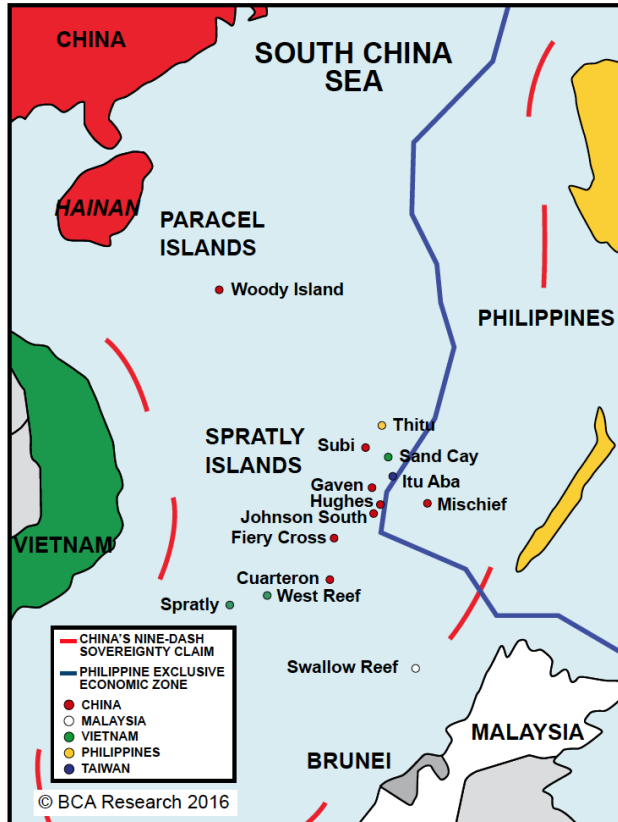
Geography Is Not A Constraint, It Is A Problem

South China Sea As Traffic Roundabout

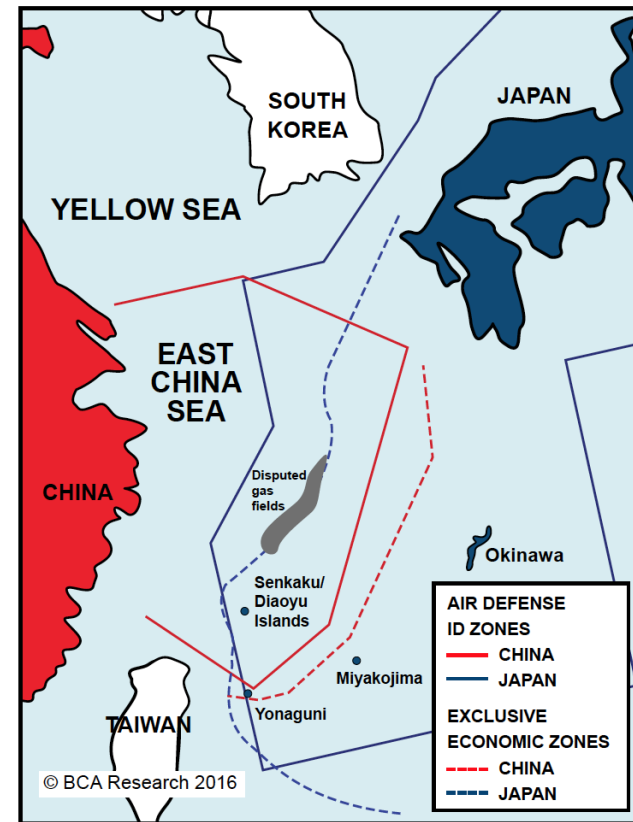


Maritime Nature Of Disputes Makes Conflict *More Likely*

South China Sea: Overlapping Claims

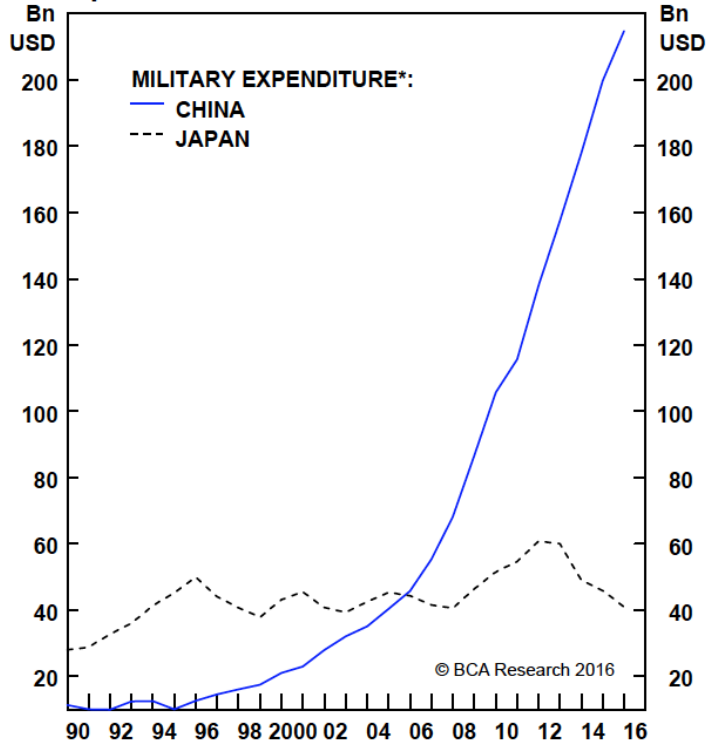


East China Sea: Overlapping Claims



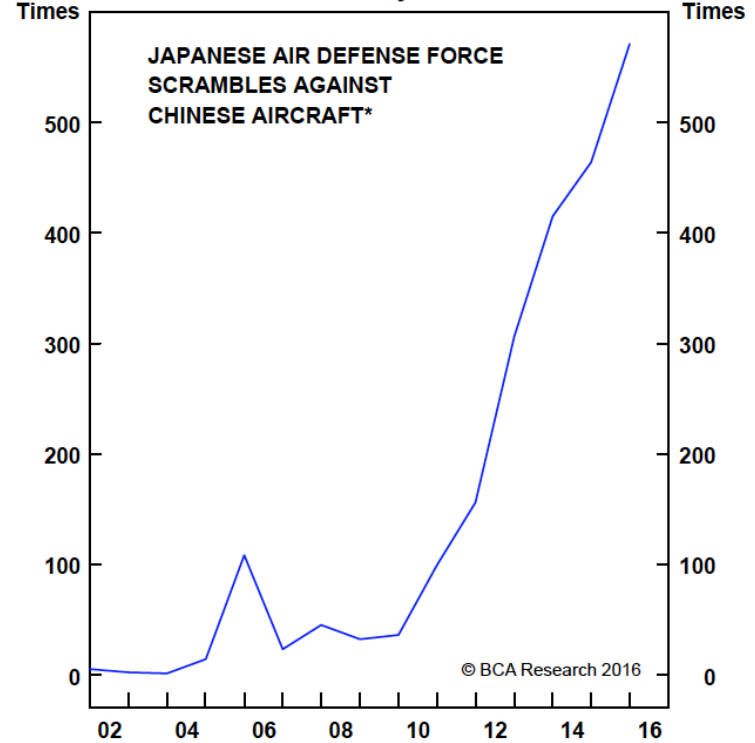
China Lacks Regional Allies

Japan's Secular Decline...



* SHOWN IN CONSTANT 2014 U.S. DOLLARS.
SOURCE: STOCKHOLM INTERNATIONAL PEACE RESEARCH INSTITUTE.

...Is A National Security Concern



* SOURCE: DEFENSE OF JAPAN 2016, JAPANESE MINISTRY OF DEFENSE.

Trump Is Not Constrained On Trade

Trump Faces Few Constraints On Trade

PRESIDENTIAL POWERS OVER TRADE				
STATUTE	NOTABLE PROVISIONS	AUTHORIZATION	PRESIDENTIAL POWERS	CONSTRAINT
U.S. CONSTITUTION	Art. I, Sec. 8; Art. II, Sec. 2	Executive orders, congressional acts, federal court rulings	Prerogative over foreign policy and national security	Weak
TRADING WITH THE ENEMY ACT OF 1917	Section 5b	During time of war (including undeclared)	Regulate all commerce; freeze or seize foreign assets	Weak
TRADE EXPANSION ACT OF 1962	Section 232b	Imports found to impact national security adversely	Impose tariffs or quotas to offset adverse impact	Medium
TRADE ACT OF 1974	Sections 122, 301	Serious U.S. balance of payments deficit; foreign state's actions are unjustifiable, unreasonable, or discriminatory	Impose tariffs up to 15%, and/or import quotas, for 150 days against countries with large balance of payment surpluses	Medium
INTERNATIONAL EMERGENCY ECONOMIC POWERS ACT OF 1977	Section 1701, 1702	National emergency	Regulate all commerce; freeze foreign assets	Weak
NAFTA IMPLEMENTATION ACT OF 1993	Section 201; see also NAFTA Art. 2205	Maintain general level of reciprocal concessions	Proclaim return to Most Favored Nation level of tariffs; proclaim additional duties after consulting Congress	Weak

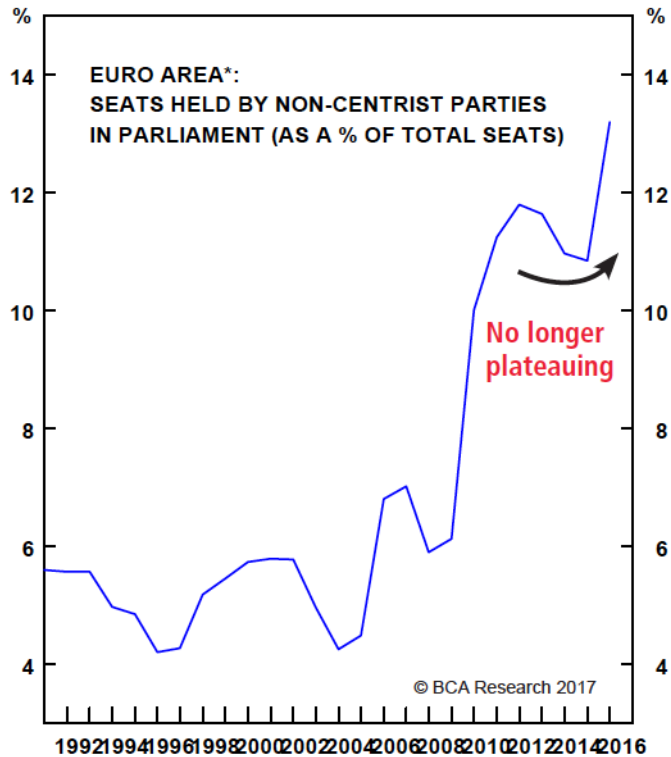
SOURCE: ADAPTED FROM MARCUS NOLAND ET AL, "ASSESSING TRADE AGENDAS IN THE U.S. PRESIDENTIAL CAMPAIGN," *PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS* 16-6 (SEPTEMBER 2016).

Investment Implications Of Sino-American Tensions

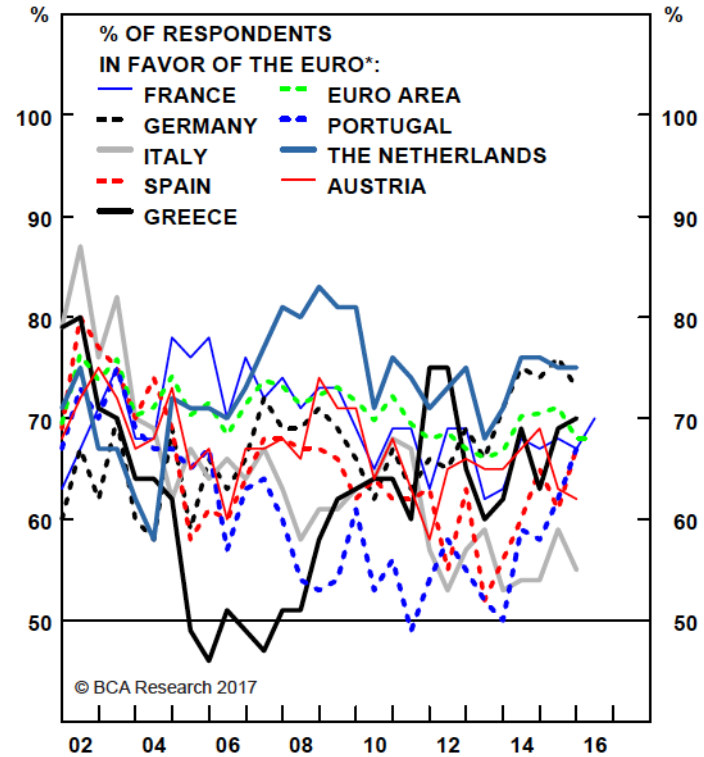
- 1. The market has priced-in the positive policies of the Trump administration (fiscal stimulus, tax reform, deregulation), but trade policy remains un-priced.**
- 2. Trump is unconstrained on trade when it comes to protectionism.**
- 3. The market will be surprised in 2017 by how serious the Trump administration is on trade.**

Europe Is A Red Herring In 2017

Anti-Establishment Parties Are Rising...



...But Euroskepticism Is A Failed Strategy

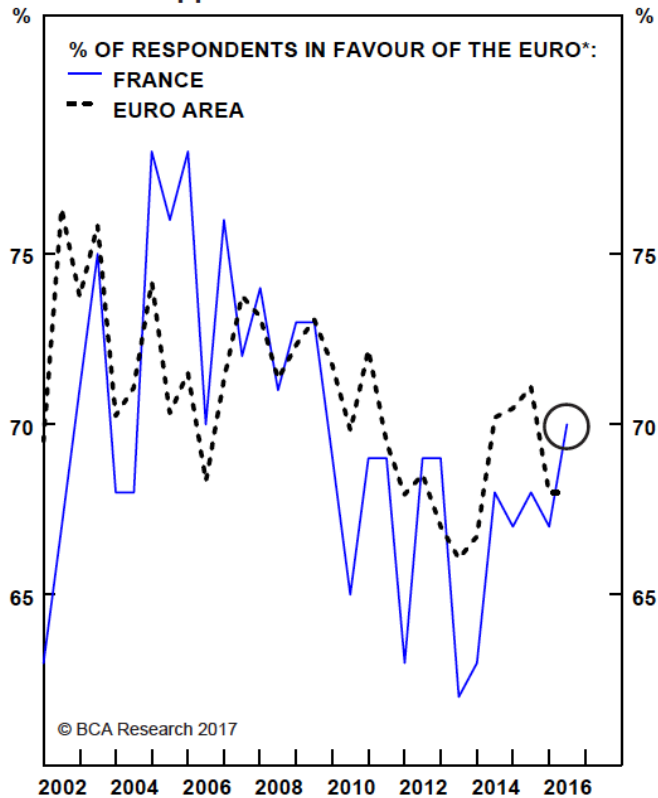


* INCLUDES AUSTRIA, BELGIUM, FINLAND, FRANCE, GERMANY, GREECE, ITALY, THE NETHERLANDS, PORTUGAL, AND SPAIN.

* SOURCE: EUROBAROMETER.

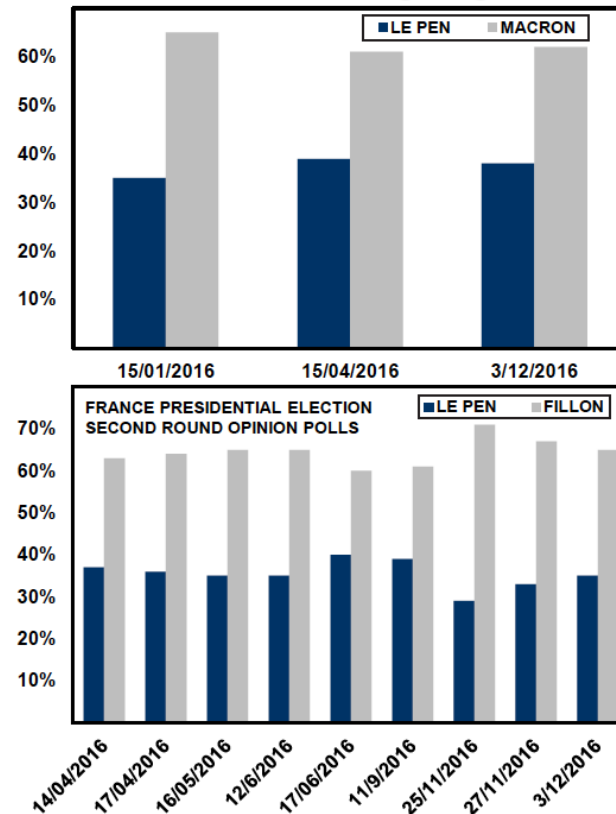
France And Germany Will See The Status-Quo Prevail

French Support The Euro



* SOURCE: EUROBAROMETER.

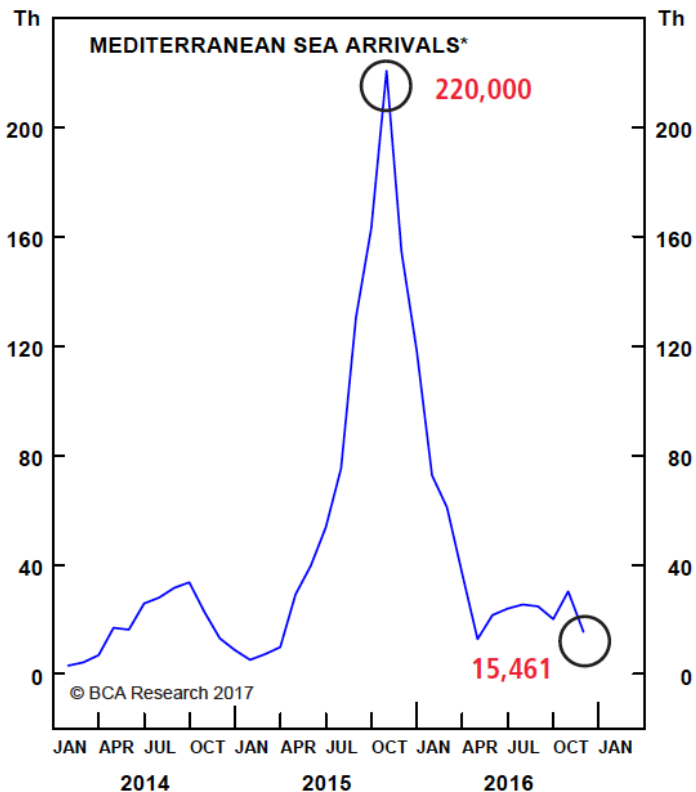
Le Pen Far Short Of Polling Margin Of Error



SOURCE: IFOP, BVA, OXADA, HARRIS INTERACTIVE.

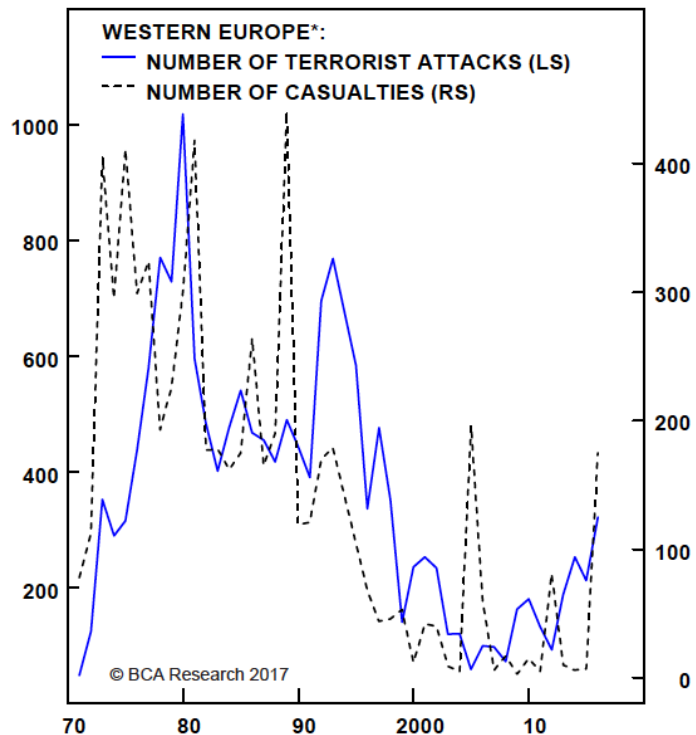
Migration And Terrorism Are Overstated Risks

Migration Crisis Is Abating



* SOURCE: UNHCR.

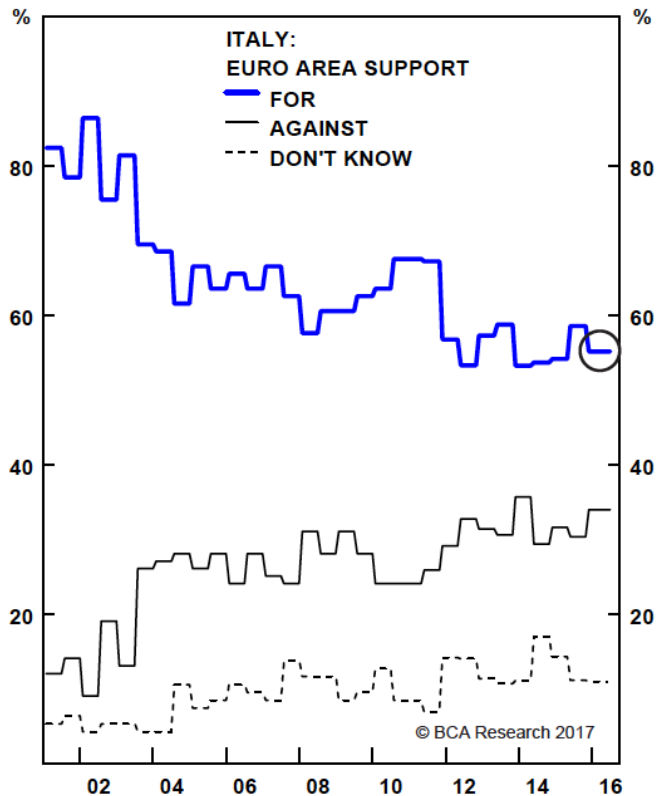
Terrorism Is Not Unprecedented



* SOURCE: GLOBAL TERRORISM DATABASE, UNIVERSITY OF MARYLAND.

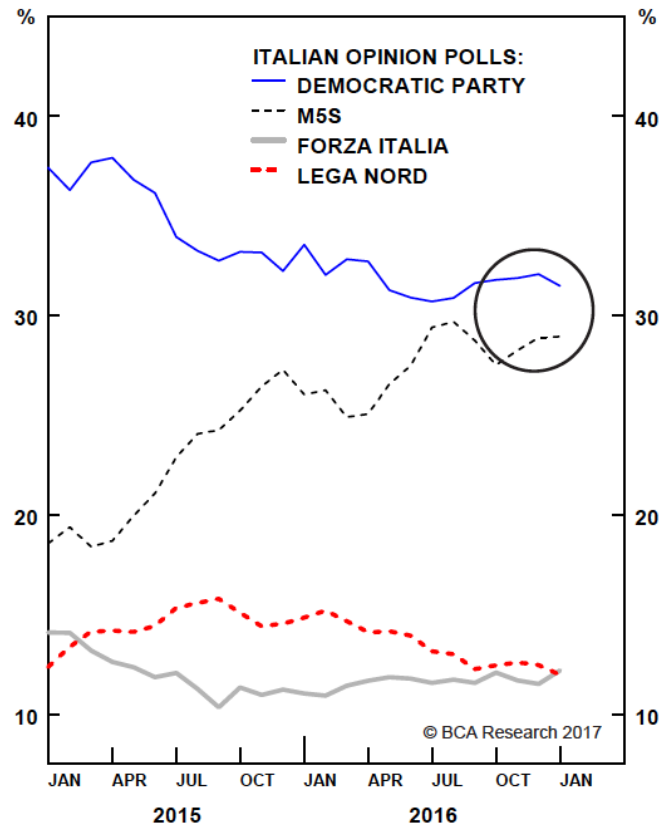
Italy Remains A Risk, But Overstated Nonetheless

Italy & Euro: OK (For Now)

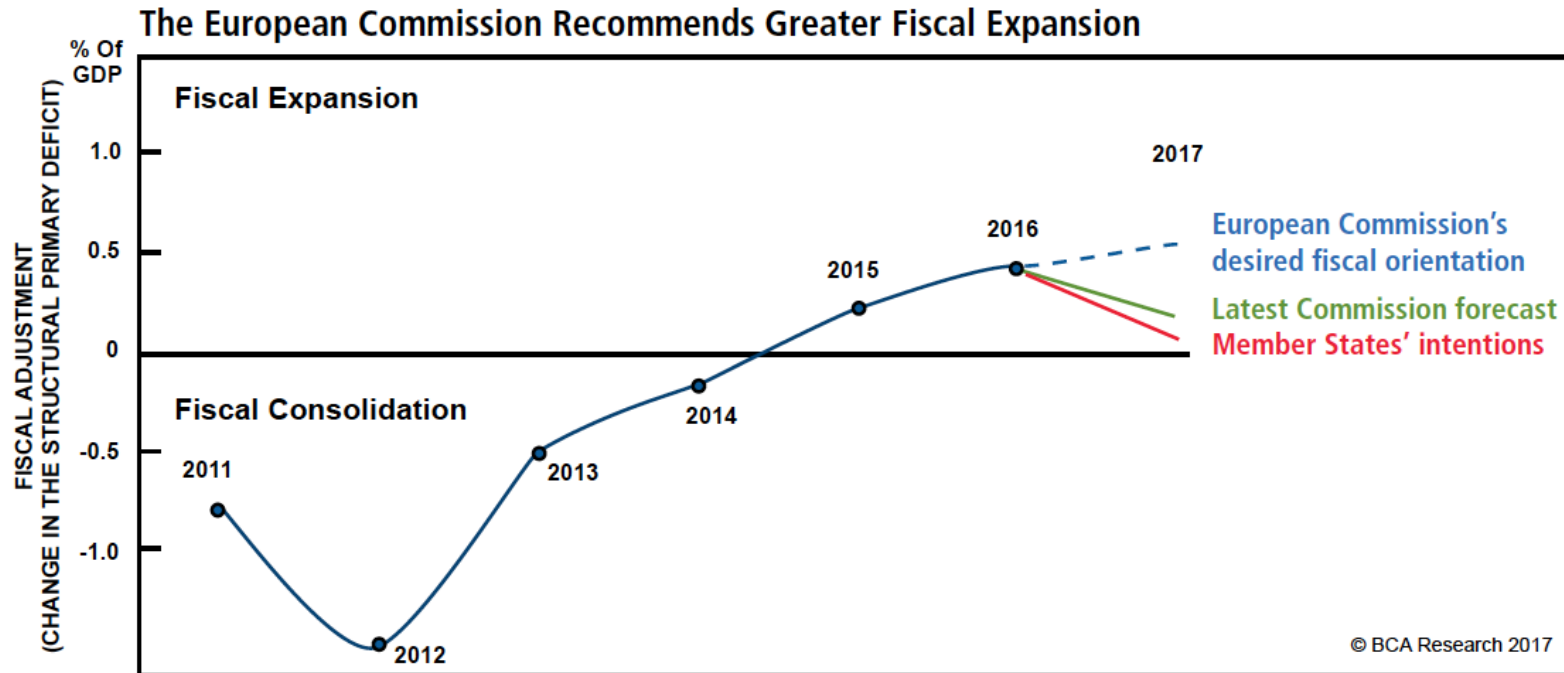


SOURCE: EUROBAROMETER (2015).

Italy: Euroskeptics Peaking?

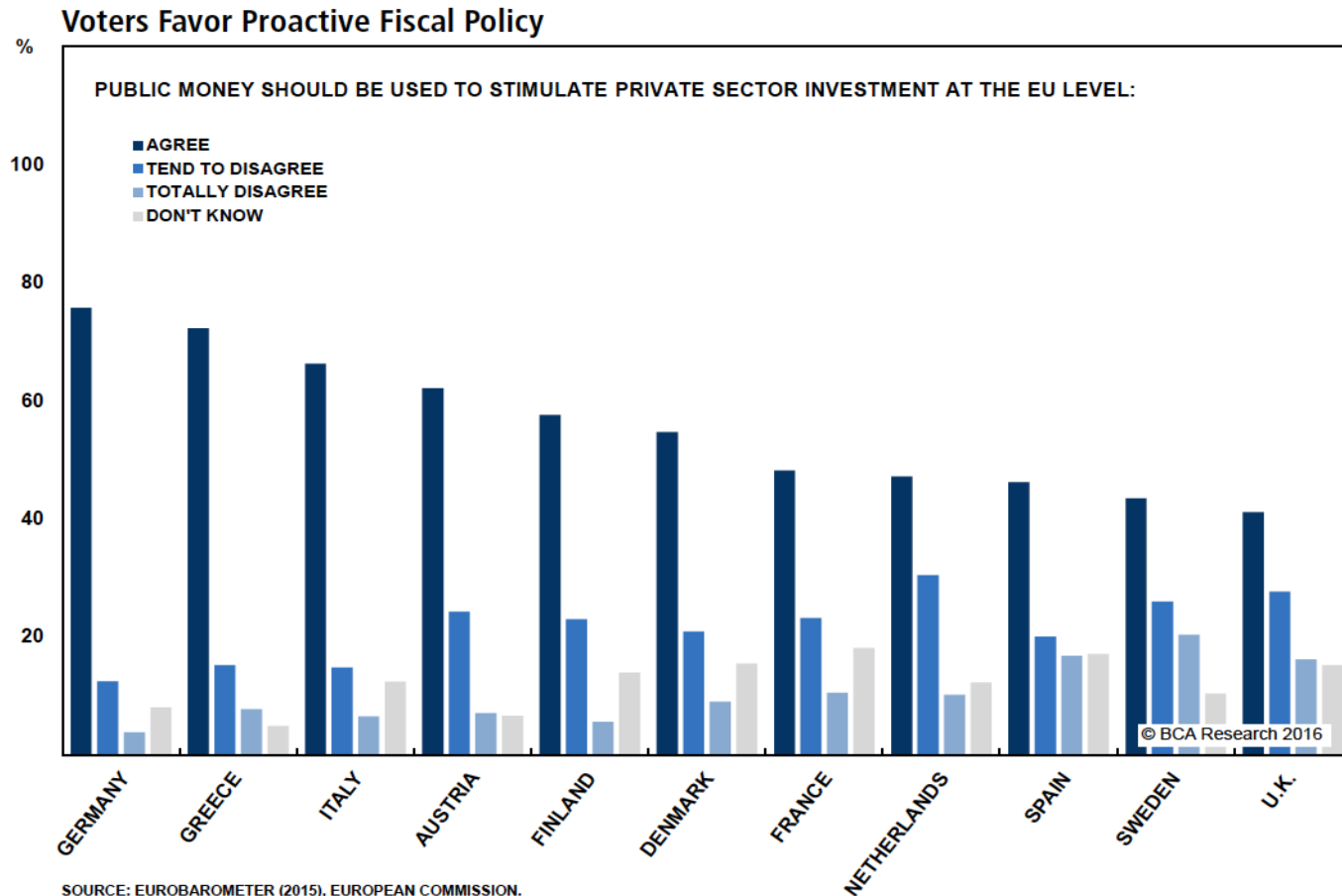


European Goldilocks Scenario – ECB + Fiscal Thrust



SOURCE: "EUROPEAN SEMESTER AUTUMN PACKAGE: WORKING FOR A STRONGER AND MORE INCLUSIVE ECONOMIC RECOVERY," EUROPEAN COMMISSION (NOVEMBER 16, 2016).

Support For Government Stimulus Highest In *Germany!*

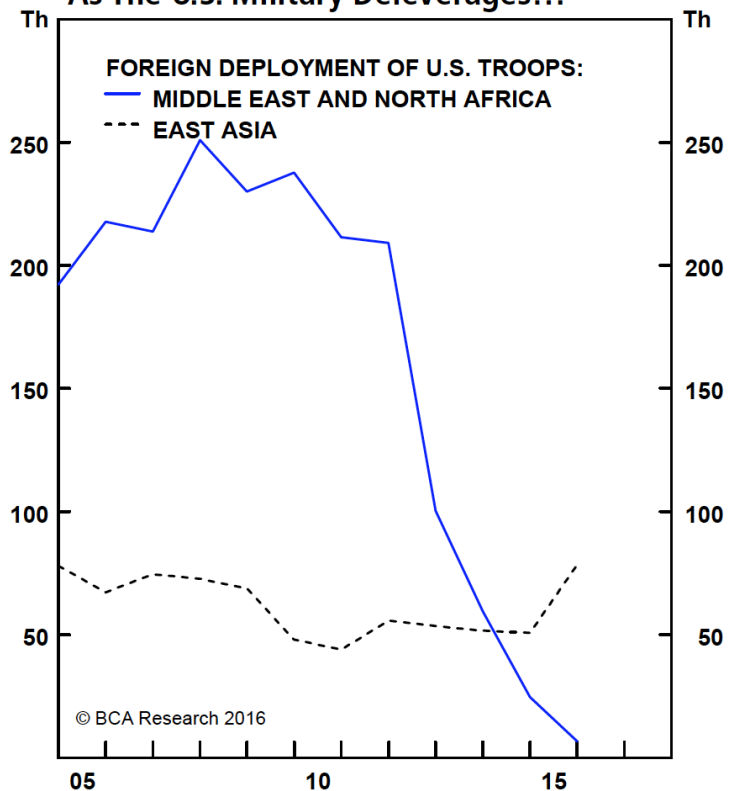


Investment Implications Of European Politics:

- 1. European politics will remain volatile in 2017, but risk of anti-establishment victories remain overstated.**
- 2. A status-quo victory in Germany and a victory for reformers in France would be a major positive.**
- 3. Support for austerity is waning, whereas the ECB has to remain easy due to political risk in Italy. This will combine to give investors a goldilocks scenario.**
- 4. Italy remains a risk.**

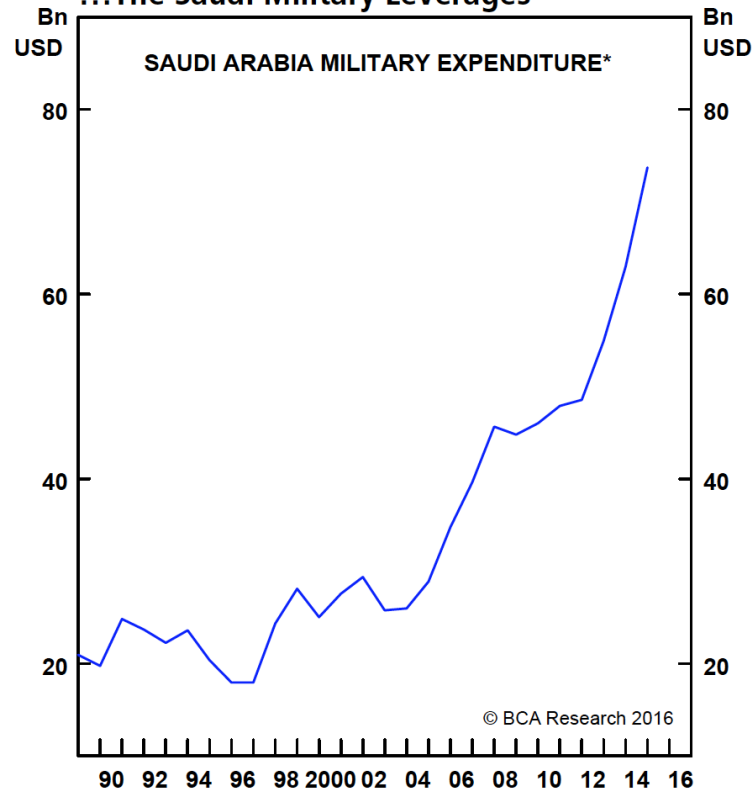
New Era For Oil & Middle East

As The U.S. Military Deleverages...



SOURCE: THE HERITAGE FOUNDATION AND DEFENSE MANPOWER DATA CENTER.

...The Saudi Military Leverages

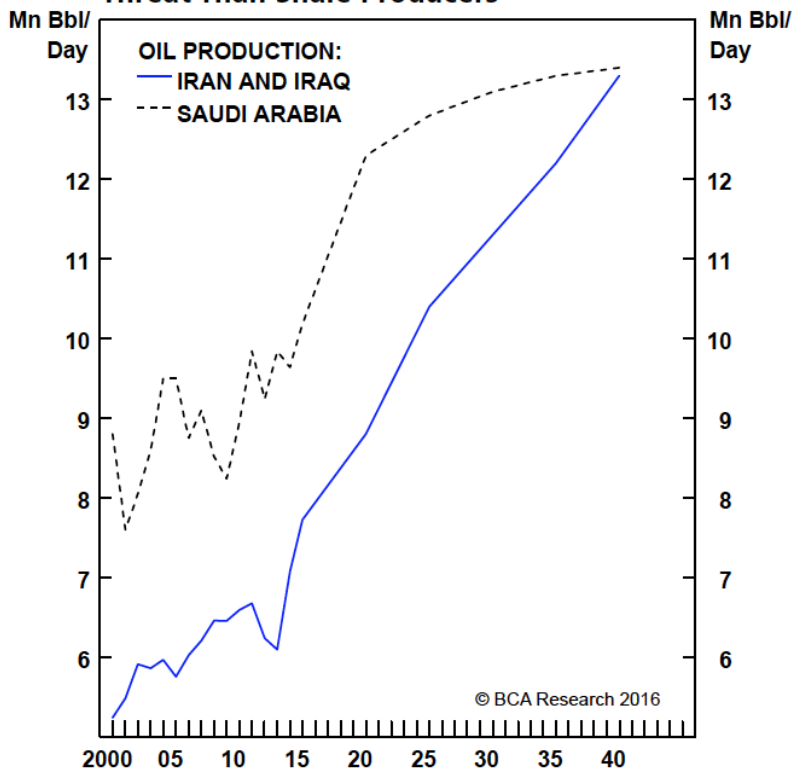


* SHOWN IN CONSTANT 2014 USD.

SOURCE: THE SIPRI MILITARY EXPENDITURE DATABASE.

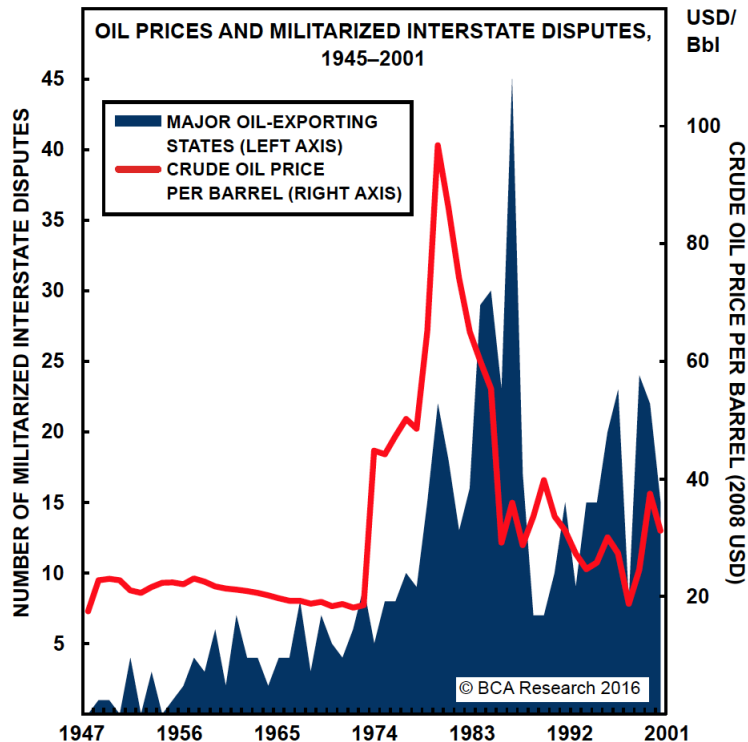
Two Headwinds To Oil Prices

Iran-Iraq Production Is A Bigger Threat Than Shale Producers



SOURCE: WORLD ENERGY OUTLOOK 2015, IEA.

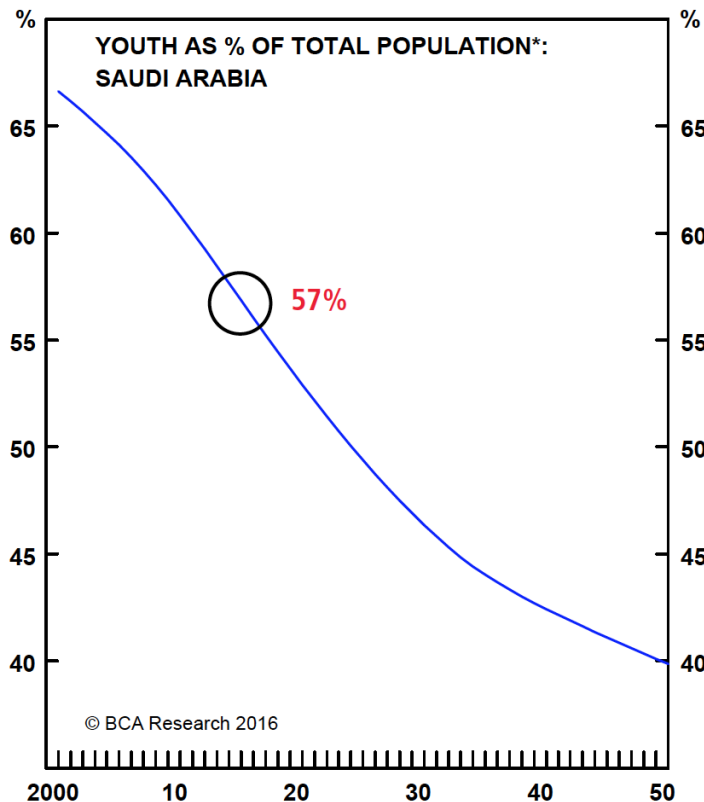
Do Not Worry About Major War



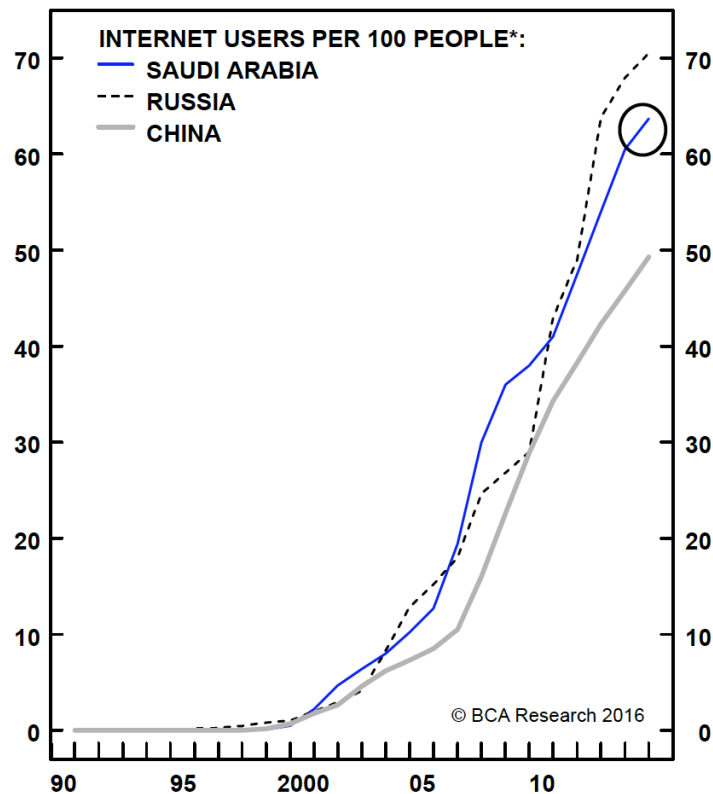
SOURCE: HENDRIX, CULLEN S. "OIL PRICES AND INTERSTATE CONFLICT BEHAVIOR," *PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS*, DATED JULY 2014, AVAILABLE AT IIE.COM., GHOSN, FATEN, GLENN PALMER, AND STUART BREMER, 21:133-154. "THE MID3 DATA SET, 1993-2001: PROCEDURES, CODING RULES, AND DESCRIPTION," *CONFLICT MANAGEMENT AND PEACE SCIENCE*, AVAILABLE AT CORRELATESOFWAR.ORG., AND BRITISH PETROLEUM.

Saudi Arabia Will Focus Inward

Saudi Arabia's Youth Is Large...

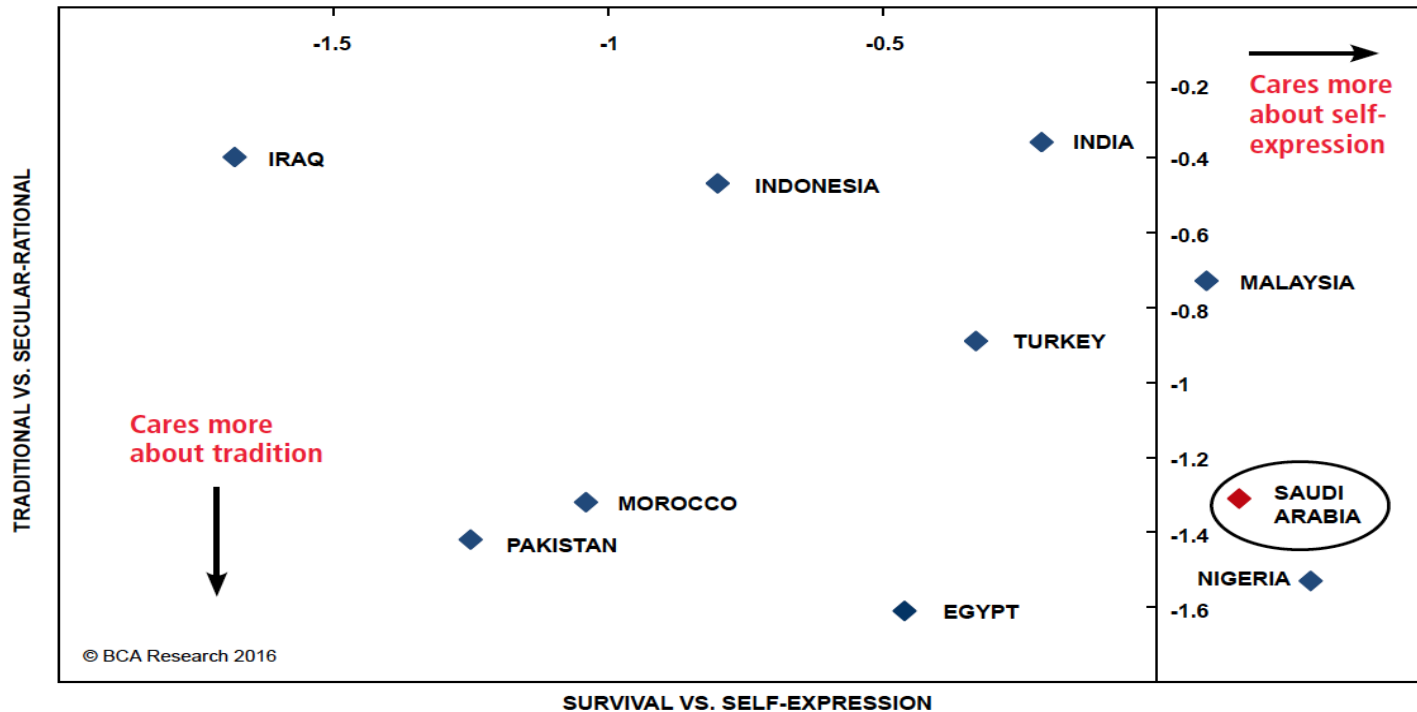


...And Internet Savvy



Saudi Arabia Is More Modern Than You Think

Saudi Arabia: More Modern Than You Think

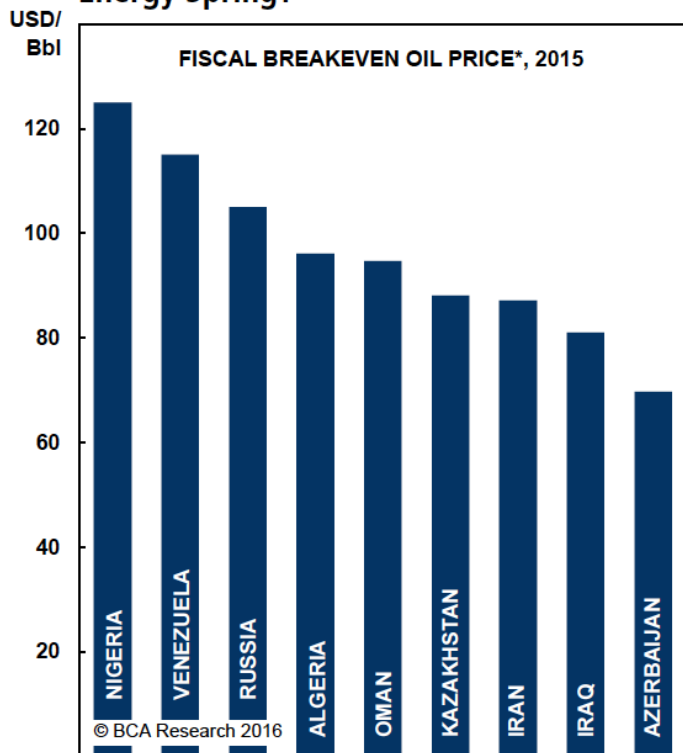


SOURCE: WORLD VALUE SURVEY.ORG; RONALD INGLEHART AND CHRISTIAN WELZEL, "CHANGING MASS PRIORITIES: THE LINK BETWEEN MODERNIZATION AND DEMOCRACY," PERSPECTIVE ON POLITICS JUNE 2010 (VOL 8, NO. 2) PAGE 554.

NOTE: THE TRADITIONAL/SECULAR-RATIONAL VALUES DIMENSION (Y-AXIS) REFLECTS THE CONTRAST BETWEEN SOCIETIES IN WHICH RELIGION IS VERY IMPORTANT AND THOSE IN WHICH IT IS NOT. A LOWER SCORE MEANS MORE TRADITIONAL, A HIGHER SCORE MORE SECULAR. THE SECOND MAJOR DIMENSION OF CROSS-CULTURAL VARIATION IS LINKED WITH THE TRANSITION FROM INDUSTRIAL SOCIETY TO POST-INDUSTRIAL SOCIETIES, WHICH BRINGS ON A POLARIZATION BETWEEN SURVIVAL AND SELF-EXPRESSION VALUES (X-AXIS). THE WEALTH OF POST-INDUSTRIALIZED SOCIETIES ALLOWS THEM TO TAKE SURVIVAL FOR GRANTED. A LOWER SCORE MEANS SOCIETY IS MORE CONCERNED WITH SURVIVAL, A HIGHER SCORE MEANS SOCIETY IS MORE POST-MATERIALIST AND EMPHASIZES SELF-EXPRESSION.

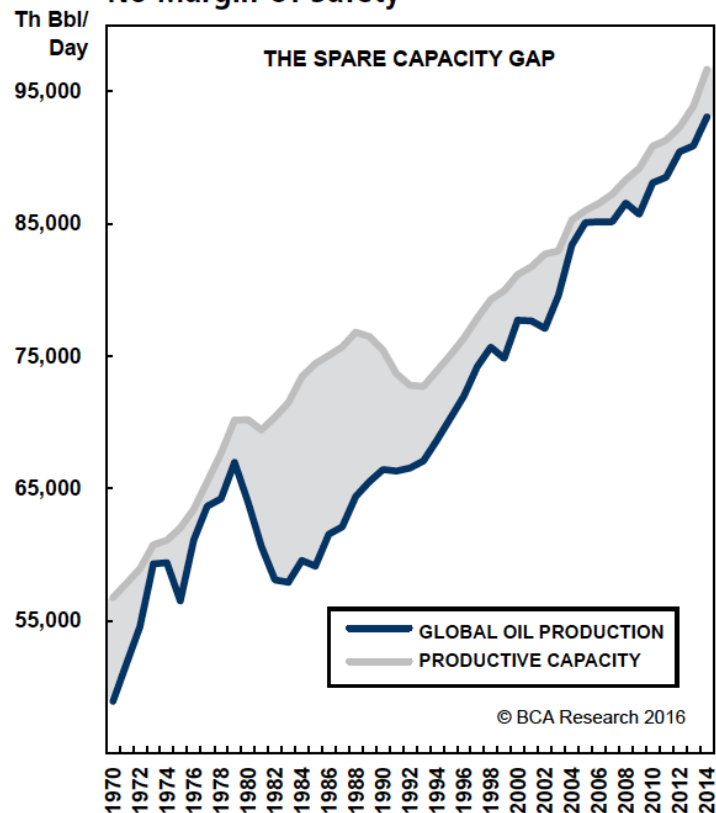
Two Tailwinds To Oil Prices

Energy Spring?

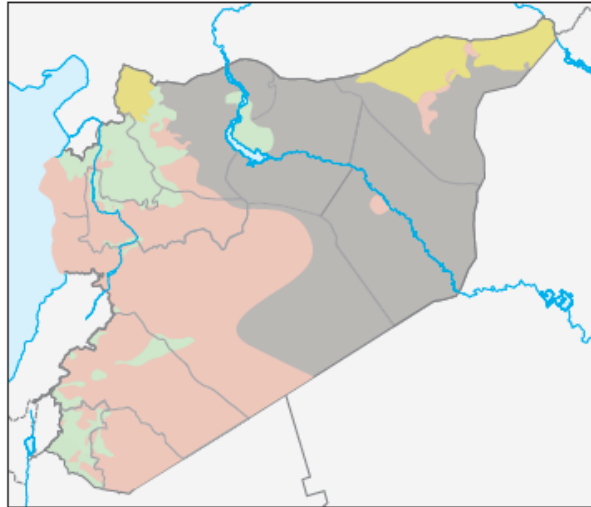


* SOURCE: IMF REGIONAL ECONOMIC OUTLOOK, MIDDLE EAST AND CENTRAL ASIA, OCTOBER 2015 AND DEUTSCHE BANK.

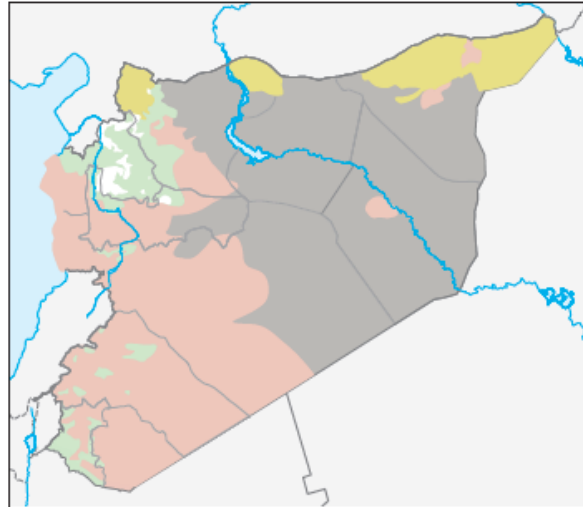
No Margin Of Safety



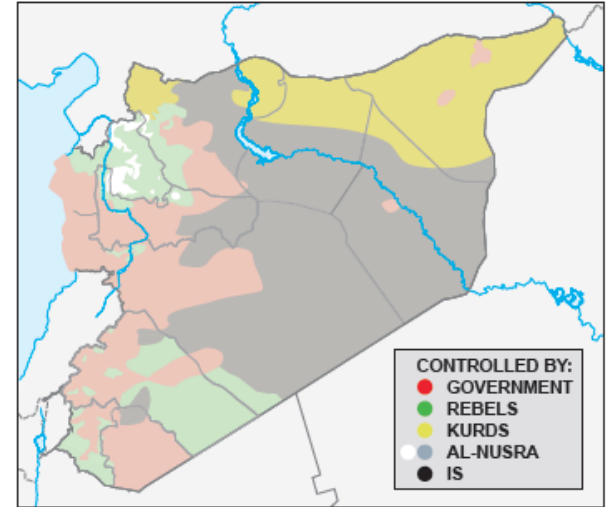
Iraq And Syria: Kurds Are The Real Winners



SUMMER 2014



SPRING 2015



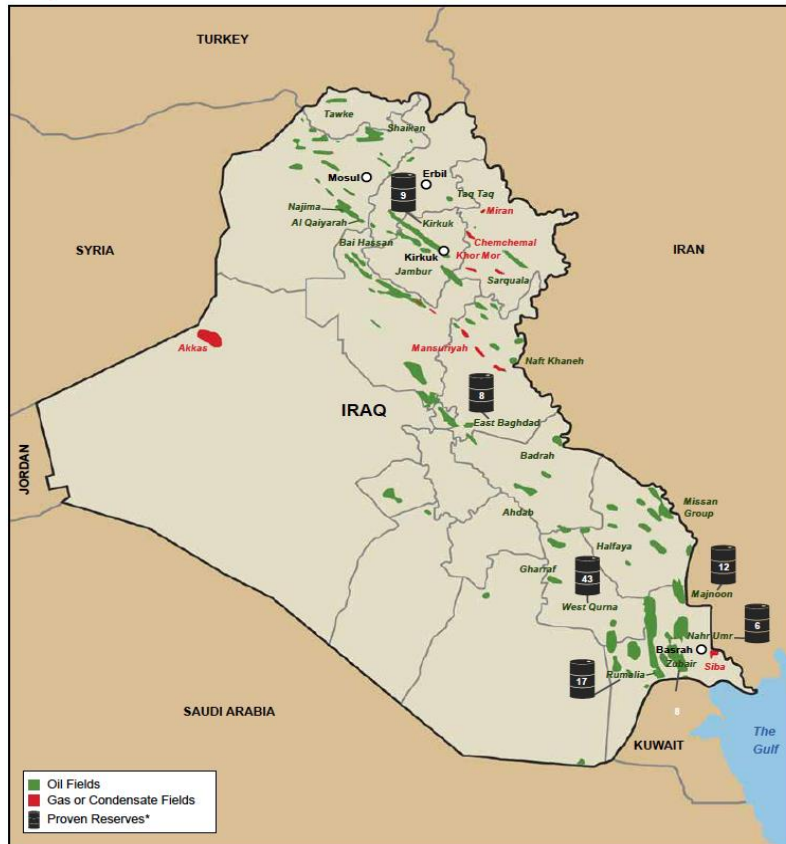
WINTER 2016

SOURCE: ANNA NEWS
[HTTP://ANNA-NEWS.INFO/NODE/40684](http://anna-news.info/node/40684)

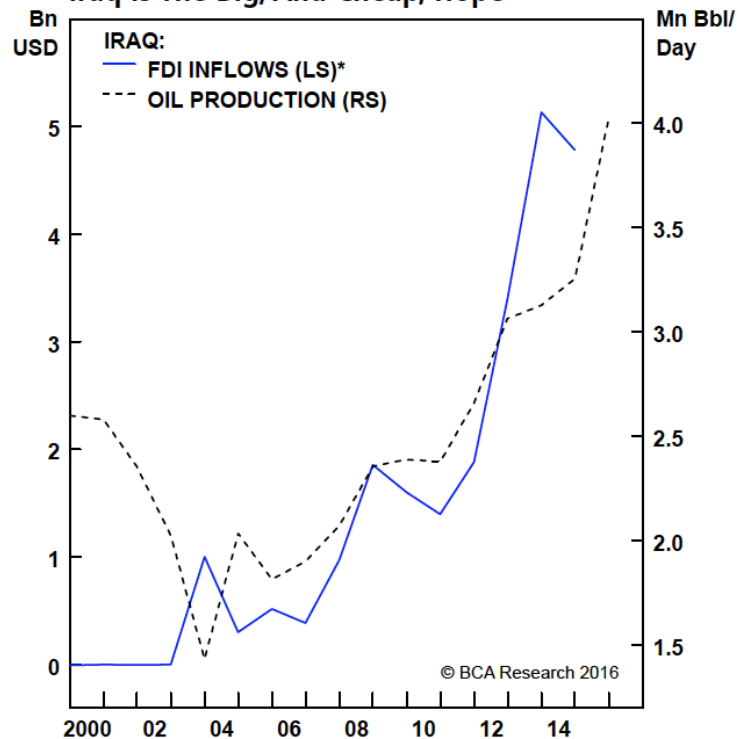
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Kurdish Gains Are Significant For Oil Production

Iraqi Oil Production And Reserves



Iraq Is The Big, And Cheap, Hope

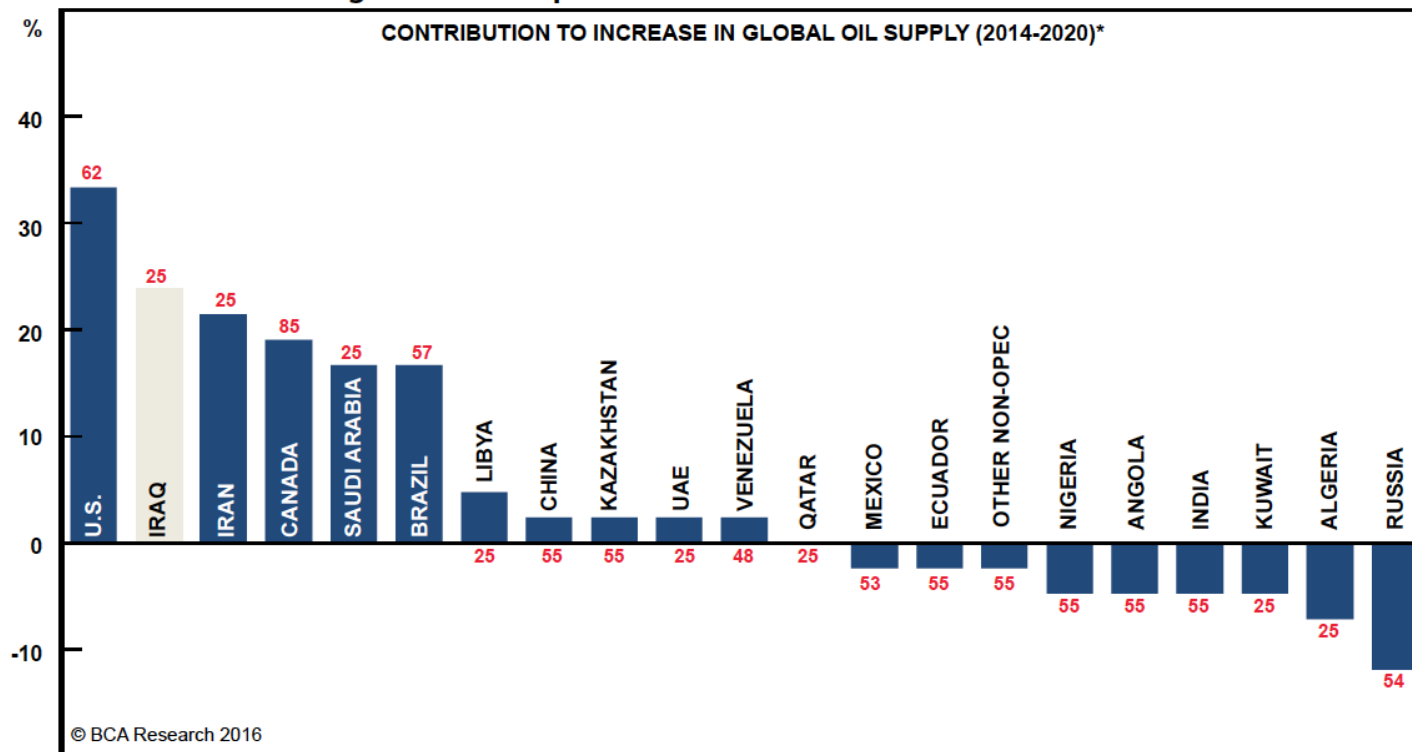


* SOURCE: UNCTAD.

* PROVEN RESERVES OF CRUDE OIL AND NATURAL GAS LIQUIDS, BILLIONS OF BARRELS. TOTAL PROVEN RESERVES AMOUNT TO 143BN BARRELS (2011).SOURCE: EIA; IEA; UNIVERSITY OF TEXAS.

Long-Term: It Is All About Iraq

The World Is Running Out Of Cheap Oil



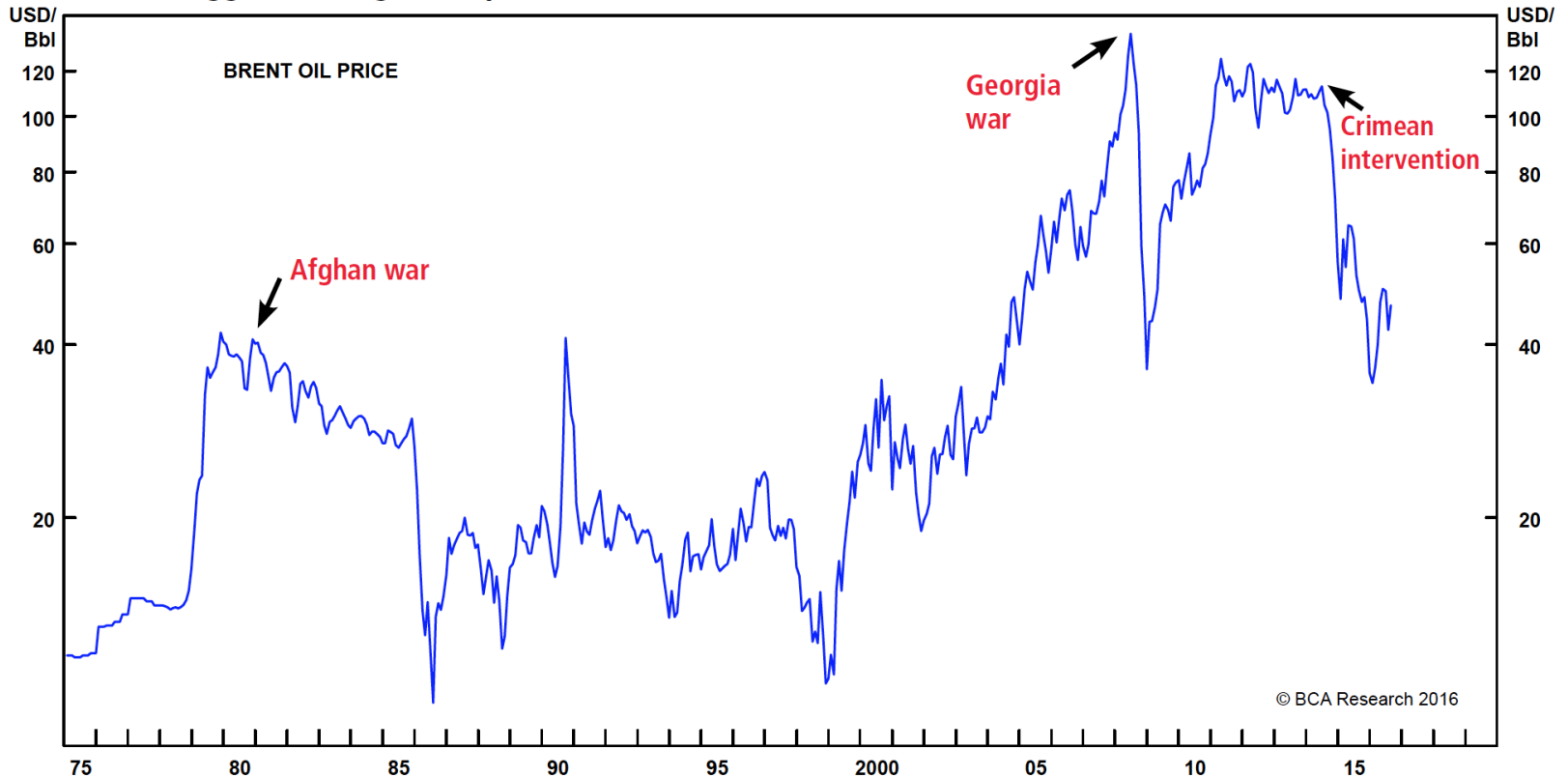
* RED NUMBERS INDICATE AVERAGE BREAKEVEN OF OIL FIELDS.
 SOURCE: WORLD ENERGY OUTLOOK 2015, INTERNATIONAL ENERGY AGENCY
 AND RYSTAD ENERGY.

Investment Relevance Middle East:

- 1. We expect volatility in oil prices.**
- 2. But there is more upside than downside risk from these levels.**
- 3. Do not expect a major conflict in the Middle East.**
- 4. Expect domestically-focused reforms in Saudi Arabia.**
- 5. Iran's geopolitical power will continue to grow (as will its investment relevance as a market).**

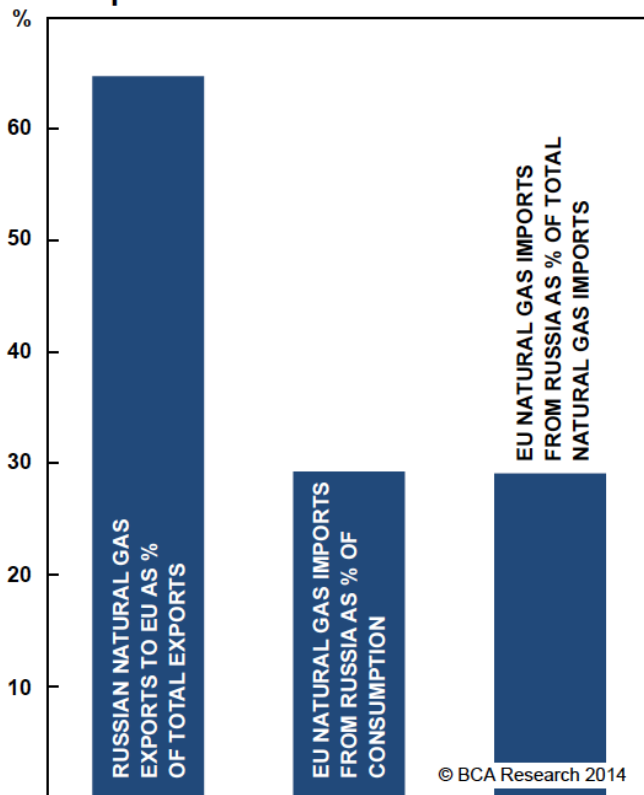
Russia Is All About Oil

Russian Aggression Signals Top Of The Oil Bull Market



Russia Needs The West More Than West Needs It

European Market Is Crucial For Russia



SOURCE: BRITISH PETROLEUM.

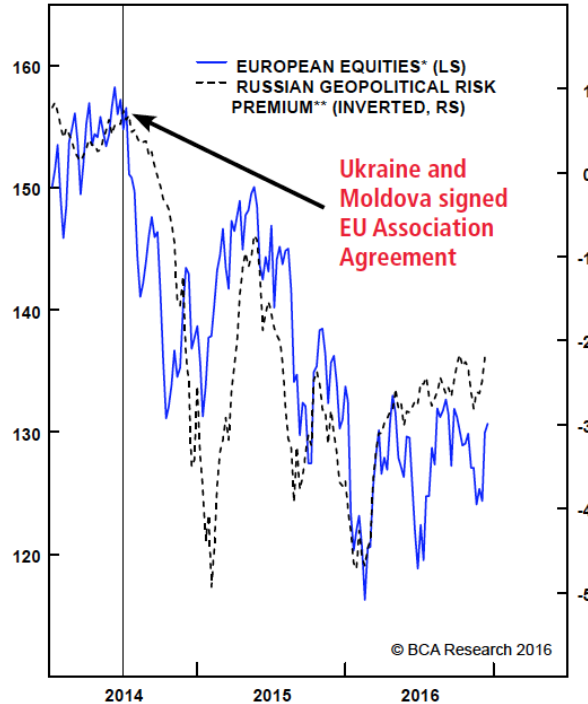
Russia Is Just Not That Important To Germany



SOURCE: EUROSTAT.

Russia-West Thaw Would Be Bullish Europe

Thaw In Russian-West
Cold War Is Bullish Europe

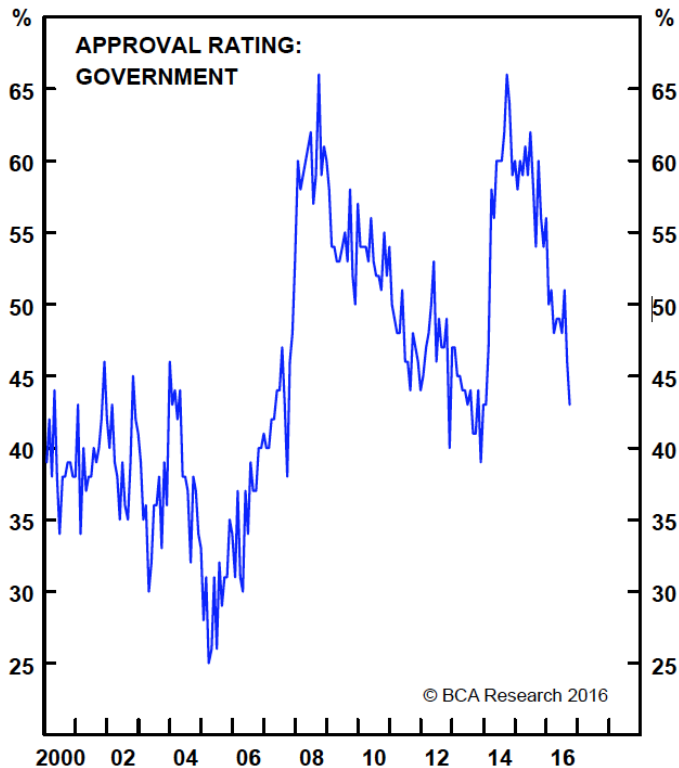


* INCLUDES SPAIN, ITALY, FRANCE, GERMANY, AND NETHERLANDS.
SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).

** BASED ON USD/NOK EXCHANGE RATE, RUSSIAN RELATIVE TO U.S. CONSUMER PRICE INDEX, AND A TIME TREND.

The Risk Is That Putin Needs Geopolitical Crises To Stay In Power

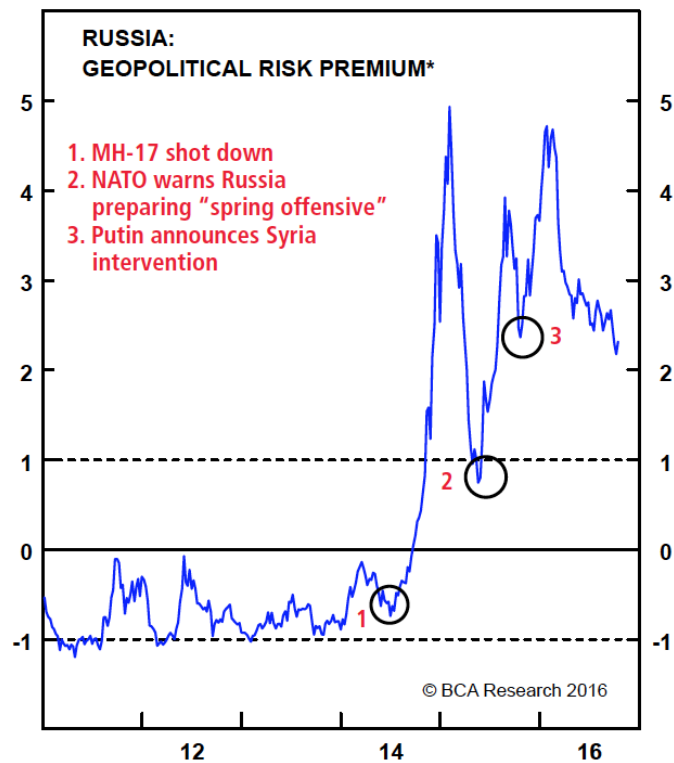
Government Support Dropping Again...



© BCA Research 2016

SOURCE: LEVADA CENTER.

...But Geopolitical Risks Are Subsiding



- 1. MH-17 shot down
- 2. NATO warns Russia preparing "spring offensive"
- 3. Putin announces Syria intervention

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* BASED ON USD/NOK EXCHANGE RATE, RUSSIAN RELATIVE TO U.S. CONSUMER PRICE INDEX, AND A TIME TREND.

Investment Relevance Of Russia In 2017:

- 1. Buy Russia? Sure, but structural reforms are needed for Russia to become a long-term investment opportunity.**
- 2. European equities will benefit from a thaw in relations.**