CROSSROADS

At the Intersection of Geopolitics and Geoeconomics

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Here are some critical issues to watch around the globe over the coming month:

North America

- In the US, months of campaigning came to an end with Democrats breaking the Republicans' grip on power by securing a majority in the House of Representatives, retaking several state legislatures, and winning seven new governorships. The US stock market initially reacted positively to the divided government, however since then it has lost ground. Historically speaking and based on current dynamics we expect the markets to have a more positive tone in the foreseeable future.
- President Trump has said he expects to raise tariffs on $200bn of Chinese goods to 25% from 10% at the beginning of the year. He also declared that he's ready to apply a further round of levies on $267bn worth of imports, including iPhones and laptops, starting next year. If the threat materializes market volatility will increase and trade disputes will evolve to a trade war which will darken the clouds and increase the chances of a recession by the end of 2019.
- The yield on the US 10-year Treasury note declined 11 basis points from early November to 3.07%, while volatility, as measured by the CBOE Volatility Index (VIX), rose to 20.8 from 18%.

Europe

- British Prime Minister Theresa May has negotiated a draft Brexit deal with the European Union. The deal has been met with harsh criticism by both Conservative and Labour members, and it is likely that that those challenging her leadership will grow in strength and number. The pound jumped by 1.1% shortly after the announcement of the agreement, but the modest gains have since been wiped away. If the Agreement is not approved by the UK Parliament, we expect further pressure on the pound and UK equities which will make both more attractive.
- Italy failed to meet a deadline to resubmit its budget plans to the European Commission. If Italy does not address its deficit spending, the Commission may consider launching an EDP--a disciplinary process that can lead to financial penalties. Despite not surpassing the maximum deficit spending of 3% of GDP, the Italian government falls well short of 60% of public debt to GDP while its spending proposals and tax cuts undermine the Eurocrats authority. Deputy Prime Minister Luigi Di Maio has said that Italy is open to lowering its deficit spending. Italian bond yields have edged down since the start of the month, as 10-year paper has seen a 7-basis-point drop to 3.41%. Its spread over the equivalent German bond yield — a widely watched measure of eurozone risk sentiment — is down 5 basis points at 306 basis points. When the matter is seen in combination with Brexit it represents a conundrum that could start the unraveling of the Euro endeavor, especially if a trade war with China erupts and US leadership becomes an AWOL (let's not forget that it was the US Treasury Department and the US Fed that provided the moral suasion and the ammunition needed between 2009-2013 to keep the Euro together).
- Global equities were lower for the month amid continued concerns over slowing global economic growth and the chaotic Brexit process playing out between the United Kingdom and the European Union. If the EU turmoil continues, European markets will fail experiencing an anticipated turnaround and the Euro will become even more susceptible to downward pressure despite the fact that as things are right now, it is the greenback that faces the downward pressure.

Asia-Pacific

- For the first time in APEC's 25-year history, Papua New Guinea (PNG) was forced to end the summit with leaders failing to agree on a communique. It was reported that four Chinese officials were removed from the office of the Prime Minister of PNG. However, the Chinese government has denied these claims. In contrast, the US, Australia, and Japan released a joint statement declaring together they will identify infrastructure projects for development and financing. Given US policy trajectory of "America first" we see little room of cooperation which will undermine further international trade.
- The EU has flirted with placing sanctions on Cambodian garments. The EU would remove Cambodia from the Everything But Arms (EBA)

preferential system. The EU is the largest importer of Cambodian textiles, and the clothing industry is the largest employer in Cambodia. The World Bank has warned that these sanctions would have major ramifications on the Cambodian economy.

- India is set to miss its fiscal deficit target for the year ending March 2019 due to a shortfall in revenues and lower-than-targeted disinvestment proceeds. India's 2019 fiscal deficit target has been pegged at 3.3% of GDP. Indian credit agencies have estimated that the actual deficit will be 3.5% of GDP. Given the bank tremors in India we cannot exclude the possibility of a Lehman day in India and thus recommend caution regarding exposure to India.

Middle East

- Early elections in Israel seem like a possibility as Israeli Prime Minister Benjamin Netanyahu's coalition has been strained. Naftali Bennet, the head of the Jewish Home Party, has said that the coalition cannot continue to exist. Mr. Bennet had been gunning to be made defense minister, but Prime Minister Netanyahu has taken on the role for himself – a move which, along with other disregard for coalition partners, is straining the coalition. Despite this contention, financial stocks climbed in Israel, as the benchmark TA-35 index and TA-125 index finished 1.5% and 1.3% higher, respectively. Bond prices fell, with the TEl-Bond 20 and TEl-Bond 60 indexes closing down 0.3%. All of this in a two day period falling a surprise rate hike by the Bank of Israel.
- Pressure has increased on Saudi Arabia as several countries have stated their intention to end arms sales to the country. US President Trump disagreed with the broad consensus among the intelligence community that Crown Prince Mohammed bin Salman was involved in the murder of Washington Post reporter Jamal Khashoggi. However, the US Senate has planned a vote to revoke support Saudi Arabia in its war in Yemen. Saudi stocks have declined this month with the Tadawul All-Share Index falling by 2.2%. The yield on Saudi Arabia's $5 billion bonds climbed to a record high 4.6 percent. We would not be surprised if tensions with Iran intensify that could result their proxy war to escalate significantly, especially if the Kingdom's finances deteriorate.
- The sanctions against Iran have officially gone into effect. The Trump administration threatened to penalize buyers of Iranian oil as part of its stated goal to reduce Iran's petroleum exports to zero. It blacklisted 50 Iranian banks and subsidiaries, more than 200 people and ships, Iran's national airline and more than 65 Iranian aircraft. However, the sanctions regime will likely be undermined by exemptions allotted for at least a six-month period. Iran's biggest petroleum customers, like China and India, will not be penalized during this six month period. Oil prices continued their slide due to oversupply (originated mainly from the US) as well as some concerns about slowing demand. We expect oil prices to stabilize and be significantly higher 8-12 months from now.

South America

- With his administration set to take office on January 1st, Brazilian President-elect Jair Bolsonaro has begun making announcements regarding his cabinet selections. Much to the delight of investors, Bolsonaro announced that University of Chicago-educated Paulo Guedes will head Brazil's new "super ministry" which will merge the finance, industry, trade, and planning ministries. With high pressure to produce results quickly, Guedes has stated that his agenda will include selling various state companies, deregulating industries, and cutting taxes to attract investment and create jobs. Inclined to believe that Bolsonaro will support Guede's agenda, Brazilian markets have rallied significantly. The Brazilian real fell 2.9% earlier this month and stocks lost 0.8% before rallying after the election. If we could risk a prediction , we would say that the Brazilian economy and markets should do better in 2019.
- Mexico's President-elect Andrés Manuel López Obrador, commonly referred to as AMLO, takes power later this month after a landslide victory earlier this year. At the beginning of the month, AMLO announced his intentions to scrap a $13bn airport project, citing opposition from the Mexican people and several environmentalist groups. This move signaled to investors that Obrador intends to follow through with his nationalist agenda regardless of the consequences to financial markets. The peso is currently at its weakest point in 5 months and 10-year bond yields have reached their highest in decades. For at least the first few months of his presidency we recommend caution regarding Mexican exposure.
- The IMF completed its second review of Argentina's fiscal and monetary policy and is expected to soon disburse $7.6 billion of the $56.3 billion financing

deal. The deal will be the IMF's largest ever and is intended to help stabilize economic activity. According to the IMF, the framework already put in place for the deal in October has been effective in stabilizing financial markets (after extreme volatility in August and September) and will continue to enhance Argentina's resilience to external shocks. If the situation continues improving, then president Macri's chances of re-election in 2019 will improve significantly and assuming that the world is not in a recession, then S. American markets will look more attractive.

Sub-Saharan Africa

- On November 19th, the IMF released a statement regarding the constraints to South Africa's economic recovery due to growing state debt and capital outflows as a result of global trade tensions. In order to attract investment and restore confidence, the IMF recommended that South Africa must address increasing costs in taxes, regulation, and lack of competition. If South Africa does not cut borrowing and avoid a debt trap, it may be forced to turn to the IMF for help. Trade tensions between the US and China have resulted in a weakened South African rand as well as weakened 10-year bonds which rose 3 basis points to 8.99% in less than a week. In equities, the All Share index and blue-chip Top40 index fell 0.65% and 0.70% respectively in a single day period. Given those uncertainties, we recommend some caution regarding exposure to S. Africa.
- Inflation in Zimbabwe reached its highest point since 2008, despite President Emmerson Mnangagwa's efforts to revive the economy. A severe dollar shortage has contributed to major surges in food and clothing prices. Zimbabwean officials reported earlier this month that an Australian energy firm had discovered vast oil and gas deposits, raising hopes of economic recovery through exploitation of oil deposits. So far, however, the company states that while they have seen encouraging indications, no actual discoveries have been made. Despite rising prices, and an all but destroyed currency, the stock market in Zimbabwe continues to rise.

Suggested Readings

The Crisis Next Time

Carmen Reinhart and Vincent Reinhart

The Next Capitalist Revolution

The Economist

Will Taiwan Be the First Domino to Fall to China?

Yi-Zheng Lian