



Geopolitical risks revisited

Heading into 2017, expectations over heightened geopolitical risks may have been overdone. However, the recent onset of a crisis of Qatar, which perhaps has broader regional implications, might just be a first warning that geopolitical risks are still ever present and could easily resurface with a vengeance later this year.

This year started with lots of uncertainties around the Trump presidency: potential US trade wars with Mexico and China, handling of North Korea, Iran and Russia and support for NATO. In Europe, there were concerns about elections in the Netherlands, France, Italy, and Germany and the rise of populist parties threatening the sustainability of the eurozone.

As the year progressed, markets became increasingly sanguine over these risks – perhaps helped therein by clement global financing conditions, but also evidence of a global synchronised deflation/growth trend which helped counter concerns on the geopolitical front. Dutch and French elections ultimately produced market friendly results. Emmanuel

Market Insight



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Macron's win in France was significant and represented a push back from the populism as reflected in the Trump/Brexit victories, reinvigorating Europe in the process. The Trump presidency seemed eager to offer moderation/concessions on the trade front with China in exchange for cooperation over North Korea. Perhaps economic logic set in even over negotiations with Mexico over the North American Free Trade Agreement and the Trump administration seemed willing to deal/work with the Putin regime. Even on NATO, rhetoric appeared eager to stress the US' continuing support for the Trans-Atlantic Alliance.

Despite the somewhat more sanguine market outlook, geopolitical risk has a habit of resurfacing when least expected. The recent onset of a crisis of Qatar, which could potentially have broader regional implications, might just be a first warning that geopolitical risks are still ever present.

The Middle East

Recent events in Qatar affirmed an unstable and perhaps toxic mix in our minds playing out across this region. It might be that the crisis in Qatar can be confined to the Gulf countries, with careful management by forces of moderation (Kuwait and Oman in this case). However, the fact that this crisis came just weeks after Trump's visit to the region, where he seemed to give Saudi Arabia the nod of support for pushing ahead to forge closer cooperation around some Muslim country led defence organisation, was maybe no coincidence.

The Saudi/UAE/Egypt/Bahraini move against Qatar might be the first step in forcing increased unity and defence cooperation across the Sunni Muslim states in the region. But any such Sunni-dominated entity will surely worry Iran, and other non-Arab states in the region, perhaps even Turkey therein. Some might fear that this is a prelude to a looming Saudi-Iranian military tussle in the region. Furthermore, there is a school of thought that plays this to the script of the 'Clash of Civilisations' thesis known to resonate with Steve Bannon in the Trump team, and another that suggests with oil prices in structural decline Saudi Arabia may be looking to exchange its domination over the oil market with military and geopolitical dominance in the region, which likely inevitably means countering/eroding the risks from Iran. Clearly, we feel this does not bode well for regional peace and stability. But as the crisis in Qatar has proven, the risk of regional powers (Iran, Saudi Arabia, Russia, Egypt and Turkey) being dragged in, and perhaps then even the US, and Europe/NATO – the recent crisis in Syria has underscored how conflict in the Middle East may have big ramifications (security and migration) beyond the region – is not insignificant. We would argue that the current vacuum in leadership/uncertainty over US policy, and the Trump administration's flux in support of long-standing allies (e.g. NATO and Qatar) adds further risk and uncertainty. The risks for the crisis in Qatar being mismanaged and getting out of control are clear-cut.

Iran and Israel

It's not possible to talk about the Middle East without touching on US/Israel – Iranian relations. The Obama administration had a clear policy of engagement with Iran, reflected in the nuclear deal and partially facilitated through US support for Qatar. The Trump administration seem intent on turning this on its head with a reorientation back to supporting Saudi Arabia (and again affirming the relationship with Israel as paramount) and a row back from the Iran nuclear deal, with talk of new sanctions being codified by the US Congress. This adds another complexity to the mix, but the risk is that we see a resumption of proxy wars/conflict being played out across the region with Iran, including in Syria, Lebanon, Bahrain, and also perhaps now in Qatar. The recent alleged ISIS attack in Tehran seems to just make this more likely. As noted above, there are chances of a Saudi-Iran conflict, which could drag in the US and Israel.

Turkey

Turkey has been dragged into the Qatar crisis via close links between President Erdogan and the Emir of Qatar, and their common position over support for the Muslim

Brotherhood, Hamas, et al. Turkey has offered assistance with food supplies and hinted of military support by agreeing on legislation to allow up to 5,000 Turkish troops to be deployed to Qatar. Turkey has aligned with Iran and Russia, in support of Qatar. This raises obvious strains in the Turkish relationship with the US and other NATO partners. This latter relationship is already under threat as a result of EU/US criticism of democratic trends in Turkey, post-Gezi and after the failed coup last year. Turkey's deepening ties with Moscow (purchase of high end S440 air defence missiles) raises particular hackles in Western capitals, given Turkey has the second largest standing army in NATO and has been a mainstay in Western security for 70-odd years.

Turkey is also fighting to counter Kurdish movements at home (PKK) and in Syria (YPG) and is now also facing the unwelcome (from a Turkish perspective) prospect of a referendum on independence for the Kurdistan Regional Government. The risks are that we could see increased Turkish military intervention in Syria and Iraq which has the potential to pit it against NATO allies, but also Iran and Russia. Again the risk of escalation is not insignificant.

North Korea /China – US

It seems that despite Trump's initial belligerent statements, a pre-emptive US strike against North Korea is very unlikely. Any such attack would be uncertain of success, and the probability of retaliatory strikes is very high, potentially leading to casualties in South Korea and beyond. The encouraging thing is that US policy under Trump seems to be evolving back towards that under previous US presidents which is based on using sanctions to slow North Korea's pursuit of long range nuclear strike capability to reach the US.

Encouragingly, the Trump administration seems more willing to work with China to pressurise North Korea to slow its nuclear ballistic missile programme. The Trump administration has used the stick against China – with the threat of trade restrictions unless it takes action itself against North Korea. The hope is that China will take action and this will cement US-China ties as a result, averting the threat of a Sino-US trade war. The problem seems to be that the Chinese administration is split on how to deal with North Korea, with the military seemingly unwilling to act, while the more pragmatic economic lobby is more willing to give some concessions to the US.

We believe some in the Chinese administration do not think the Trump administration is serious, with a colleague recently hearing the line in Beijing that the Chinese government thinks it can offer Trump 'breadcrumbs and sell these as golden balls'. There is a sense that the Trump administration is so weak at home that any concession from China will be grabbed with both hands and sold as a huge success. Perhaps over the next month the US and Chinese sides will meet to gauge Chinese 'progress' in reining North Korea in while the US military/strategic conclusion is unlikely to amount to much. The question is then will the US political leadership opt to raise pressure on China to act on North Korea by taking some pre-emptive trade measures. We don't think this scenario is currently priced by markets or expected, but if delivered alongside current Chinese policy tightening (against the credit bubble) it could all prove quite disruptive. Clearly we could add in herein simmering Sino-US tensions over the South China Sea, which also could easily come to the fore and, with the risk of miscalculation from an inexperienced and as yet not yet fully staffed US administration, could so easily escalate.

Russia – NATO relations

The hope that the Trump presidency would quickly move to improve relations with Russia, for example secure sanctions moderation, were soon dashed amid the on-set of the Flynn-gate scandal. Russia is toxic in DC at the moment and there seems to be little hope that the Trump presidency can deliver any meaningful improvement in the relationship with Russia without throwing yet more media, political and legal spotlight on itself.

Momentum in Congress at present seems to be to tighten the sanctions regime around Russia by codifying existing sanctions maintained by Executive Order, through legislation, piggy backing off new Iranian sanctions legislation. If codified, and likely extended, it will be

very hard to lift sanctions - they are likely to last for decades. The question then is how Russia responds to the realisation that its hopes of sanctions moderation and normalisation in the relationship with the US are unlikely to be delivered on.

Given that Putin seems to be working on a strategic geopolitical play to rebuild/re-assert Russia's superpower status, do we see Moscow push its agenda, by further external military interventions, perhaps in Ukraine, Central Asia, Transcaucasia or the Middle East? The prospect of this is perhaps made more likely by the looming Russian presidential election due in March 2018, the weak state of the Russian economy and deteriorating prospects for oil prices, still the mainstay of the Russian economy. Recent demonstrations in Moscow around housing redevelopment plans might make the Putin administration more willing to look for foreign adventures, and especially while the West is still seen as weak, divided and unable to act in a unified way.

On closer inspection, the current Russian – Ukraine stand-off in Eastern Ukraine is simply unsustainable in our view. The underlying problems of Russian strategic (territorial or at the least forcing it back under Russia's sphere of influence) claim over Ukraine, and Ukraine's desired Western orientation have not been resolved. We have a large Russian force deployed in Donetsk People's Republic/Luhansk People's Republic and Western Russia, and an increasingly capable Ukrainian military force being built to counter this. In effect there are two armed camps of hundreds of thousands of troops on either side, with hundreds of tank/artillery pieces, aircraft and missiles rained against each other. Ukraine's military doctrine has, meanwhile, been changed to being set against Russia, as against the West, and its parliament recently declared its intent to join NATO. It seems hard to imagine that this build up ends without a major conflict and a distinct winner and a loser – albeit timing that conflict is difficult, and likely it is still a medium to longer term threat. But as the annexation of Crimea, and Russian military intervention in Ukraine proved, these things are hard to predict. The facts are that little political attempts are being made to close the gaps and as time passes Ukraine seems to be drifting further apart from Russia, which is inevitably going to grate in Moscow. The Trump White House at least, if not the administration, seems naïve in terms of its Russia/Ukraine views, as reflected in its attempted reach out (back door channels) to marginal Ukrainian oligarchs/politicians as a means to seek some peace deal.

Europe

In our view, an early positive from the US administration is its focus on the weak state of NATO and its overdependence on the US – albeit the Trump presidency seems more focused on the financial implications of this for the US budget than necessarily concern over the defence of Europe. With the Trump presidency sending out mixed messages as to its allegiance to NATO, the realisation is dawning that other NATO members need to step up to the plate and bear more of the burden. NATO members (perhaps aside from Turkey) seem clear as to the risks – particularly from a resurgent and more aggressive Russia. There is even talk of an EU defence capability – helped perhaps by the UK's potential (depending on the impact of the recent election) looming Brexit.

On Brexit, the rise of populism and anti-immigrant feeling, we had been worried about centrifugal forces bringing the end of the EU enlargement project. As I think EU enlargement has been one of the greatest success stories of the EU – in helping promote peace, stability, security and prosperity across emerging Europe, from Estonia to Albania and Turkey – its end would weaken the anchor for reform from accession states, and pose huge security risks across the entire continent. We would argue that the absence of an EU enlargement anchor could create serious risks of conflict in the Balkans, Ukraine and Turkey. There are numerous obvious hotspots, including Bosnia-Herzegovina, Kosovo and Macedonia/Albania, Ukraine, et al. But perhaps the recent victories of more centrist Europhiles, like Macron, and likely Merkel/Schultz in Germany in September, suggests that EU enlargement is not at an end. Let's hope.

We cannot end without commenting on the surprise UK election result. In our view, the

result leaves the prospect of “soft Brexit”, or even Remain, through a second referendum more likely. This suggests the UK will remain more, not less, engaged with Europe, which surely has to be better for the peace, stability and security of Europe. That said, UK politics are now deeply uncertain, and we could yet see political drift, weak coalition, repeat elections, and failed Brexit, whatever that might mean – albeit it could well be bad for the UK and Europe.

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