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The 2030 Outlook

Over the next several weeks we will look into the more distant future, to the year 2030. We will explore the long-term strategic alternative world development scenarios as laid out by the National Intelligence Council (NIC) and present our views regarding the developments. The NIC forecasts the likely paths that are either currently underway or are forecast to occur in the future. The NIC projects four possible global political and economic states based on these expected trends.

The NIC is the analytic arm of the Director of National Intelligence office. It provides data and analysis for all the intelligence agencies and operates as the Intelligence Council's main source for long-term strategic analysis. The NIC is represented by all 16 civilian and military intelligence agencies and also taps experts from academia and the private sector. The organization is designed to serve as an unbiased source of information for policy design, whether it conforms to the current foreign policy or not. In the most recent global long-term outlook report, the NIC has provided four alternate states of the world for 2030 which could result based on the interplay of council-defined megatrends, smaller trends and "known unknown" game-changers. We note that these should not be seen as predictions for the future, but potential possibilities that are likely to happen given the set of current circumstances. The NIC report is designed to make the intelligence agencies and

policymakers aware of a wide range of possible outcomes. We believe that our readership would benefit by understanding the possible scenarios that the government judges to be likely. The NIC reports often affect U.S. foreign policy in the long-run and thus we deem it useful in analyzing global geopolitical and economic trends.

We will first turn our attention to the NIC report, exploring the methodology that the report utilizes, briefly describing the megatrends in place and then give a list of the four most likely outcomes. We will then analyze the most likely worst-case scenario in-depth and present our own view on the direction and likelihood of these conditions. We will focus on the U.S. role and how the country and its global partners might react to the changing economic and geopolitical environment. As always, we will conclude with the long-term impact on the financial markets.

The 2030 Report

In addition to the input from the aforementioned government intelligence agencies, the NIC has sought out the views of international leaders and think tanks, leading academics and corporate players to determine the current and emerging trends. It ranks the trends according to their probability and impact. The NIC forecasts that there are developments in play that are likely to happen under any scenario, and that there are possible game-changers that, although are less likely to happen, would change geopolitics significantly if they occurred. Game-changers should be perceived as low probability, high impact events.

The Megatrends

Four megatrends were distinguished to be underway or emerging over the next couple of decades. These trends are best described as highly probable. The first is individual empowerment, including poverty reduction, better accessibility to education and widening of the global middle class. Basically, an increasing number of people will improve their living standards. The second megatrend is the slow loss of an obvious global superpower. Under this scenario, networks and coalitions are important in balancing the resulting multipolar world. Geopolitical uncertainty will increase with this trend. The third megatrend is the global demographic shift that will affect economic growth, slowing growth in the “aging” countries and boosting it in the “young” countries. The fourth megatrend is the significant growth in demand for natural resources, including food, water and energy, as the global population surges. This trend would also increase international and regional tensions.

The NIC also points out a handful of smaller and less certain trends; we will not list all of them, instead we will name a few that we deem more important. Global economic growth continues to be slow and crisis-prone. The NIC expects global growth to moderate, with the developed world slowing the most due to demographic changes. Even Chinese growth is expected to slow to approximately 3% rate from the current 8%. Another interesting game-changer is the impact of emerging technologies and their impact on global productivity. Technology has enabled companies to introduce significant improvements in productivity over the past decade and may aid future solutions for the growing population, urbanization and climate change issues. At the same time, growth in the use of technology could also heighten social unrest,

as human labor becomes increasingly automated.

The Alternative Worlds

This week we will take a look at the most plausible worst-case scenario, the case of the Stalled Engines, as the NIC calls it. Under this scenario, the probability of global conflict increases as the U.S. slowly relinquishes its status as the world superpower. Over the next couple of weeks, we will look at the other three possible outcomes. The second scenario, Fusion, the most plausible best-case scenario, predicts that the U.S. and China are able to collaborate on a range of global issues, leading to geopolitical stability. The third scenario, the “Gini-out-of-the-bottle,” sees instability rising due to increasing inequalities both internationally and within countries. The fourth possible outcome, the Non-state World, is the scenario in which non-state actors aided by emerging technologies take control of the global geopolitical dynamics.

The Most Likely Worst-Case Scenario

The NIC proposes that under the Stalled Engines scenario there would be no obvious global superpower, resulting in a realignment of relative influence internationally and within countries. The U.S. role in international dynamics remains a major uncertainty. We will turn our attention to the U.S.’s changed role and the general global conditions that are likely to develop within this power vacuum. The central question to the continued superpower responsibility is the U.S.’s ability and willingness to remain the global hegemon. The U.S. has played the role by getting involved in non-strategic interests to ensure international safety. For example, a very important precondition to globalization and the ensuing international economic growth

was the assurance of safe international sea lanes.

Since WWII, the most successful emerging economies have adopted export promotion as a development strategy. Though successful, the program is dependent upon the U.S. consumer. The U.S., for most of the post-war period, was willing to distort its economy to allow for the absorption of foreign exports as one element of winning the Cold War. There have been benefits to being the provider of the reserve currency and the importer of last resort. Foreign economies provide low cost goods to the U.S. in exchange for dollars which keeps inflation low. However, this foreign competition has dramatically reduced employment in the tradable goods sector of the U.S. economy, leading to significant job losses. In addition, as the world economy has expanded, the U.S. has been forced to resort to debt financing to support the level of consumption required to supply the global reserve currency. This has made the U.S. economy dangerously addicted to debt. This says nothing about the military costs of being the global superpower.

After 65 years of playing this role on the global stage, there are increasing signs that the U.S. won't be able or willing to do so much longer. Massive fiscal deficits call into question the expenditures required to maintain a global military. High unemployment undermines the support for free trade. The appeal of reducing America's military commitments and openness to trade is rising.

The recent foreign policy direction has indicated an increased interest in becoming neo-isolationist and allowing the world to remilitarize. Although U.S. involvement is important shorter term because of the need for security, in the longer term if the U.S.

decides to withdraw as the superpower, then the power vacuum will allow a multitude of regional economic, political and religious power struggles to re-emerge. The NIC predicts that under this scenario by 2030 only a limited free trade zone would remain.

The current administration has been gradually developing a new foreign policy. What we are seeing develop could be graciously described as "offshore rebalancing," or harshly portrayed as "neo-isolationism." Essentially, the administration is trying to build a foreign policy for a superpower that is facing growing budget constraints and groaning under the costs of global leadership.

The perfect foreign policy for the U.S. would allow the country to continue its outsized influence at significantly lower costs. This means that the U.S. more judiciously allocates its influence into regions that are of strategic importance and allows other areas to be dominated by regional hegemon or balanced between two or more powers, with the U.S. holding the balance of power between the competing states.

Offshore rebalancing suggests that the U.S. only becomes actively involved in conflicts that affect America's direct interests. In other conflicts, the U.S. may provide a supporting role but leave the active fighting to others.

Burden shifting allows the U.S. to spend less on defense and more on deficit reduction and social programs. There are clear risks involved; allies can run policies we don't agree with or create messes that require U.S. attention. Managing such a world is much more difficult than simply retreating into isolationism or maintaining the current policy.

This process will be slow and riddled with uncertainty for the U.S. and the world. As one power becomes less active on the international scene, other players will surely look to strategically increase their influence. As the U.S. turns inward, the most likely candidate to take on more responsibilities would be China. Indeed, the report suggests that China will take over as the world's largest economy several years before 2030.

China has indicated its interest in having more influence in the near abroad, and we believe that the country will continue to challenge its neighbors, especially over natural resource rights. The recent South China Sea island dispute demonstrates the country's willingness to engage in conflict and throw its weight around. We believe China will become more important internationally, but to ensure its continued growth it will have to resolve several issues, including more efficient capital allocation mechanisms and more effective social programs.

Under this scenario, the Eurozone would also turn more isolationist, as would most of the developed countries. For the Eurozone in particular, the worry remains that the disagreements on policy between countries would ultimately lead to the unraveling of the monetary union.

At the same time, several peripheral powers would vie for regional dominance. The Middle East will remain a hotbed for conflict, but the Sub-Saharan region will also likely see increasing conflicts. The power vacuum will allow numerous local powers to fight for influence, and the large global powers are unlikely to get involved, unless the issue and region is strategic for them. The U.S. is likely to become less dependent on foreign oil on the back of

domestic shale discoveries and innovation in production technology.

Ramifications

The steady change in U.S. foreign policy, which appears to be shifting from superpower dominance to offshore rebalancing and burden shifting, is an epic change in policy and could have unexpected effects on global stability. The U.S., along with other developed countries, will likely turn inward and protectionist, with the aging demographics pulling down growth. At the same time, emerging markets are likely to increase their share of the global economy at an unprecedented rate. Emerging markets are forecast to contribute about three-quarters of global economic growth by 2030.

Still, the U.S. has several advantages over emerging and other developed powers. Although the U.S. population is aging, its demographics are more favorable than other developed countries, due to high immigration and its ability to integrate those immigrants. The level of innovation also remains high. The U.S. continues to enjoy the rule of law and remains a destination for capital flight during times of international stress.

The question of U.S. dominance being raised by a government agency indicates that the U.S.'s exit from the global center stage is a real possibility. We believe that the U.S. will remain a major power, but that it is becoming more willing to remove itself from non-strategic battles and focus on domestic issues. If so, the global economy is likely to become more volatile and the geopolitics unstable in this global power vacuum.

What does a long-term investor do in such a market? Invest as if in a secular bear market, meaning a mix of fixed income and equities is in order. In addition, an allocation to commodities is prudent as well.

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