Geopolitical expert, Professor Alan Dupont, shares his view on the likely results of the current power struggles between the US, China and Russia and the implications for investors.

Investors often question whether geopolitics needs to be on their radar. People ask me: “When was the last time a geopolitical event shook the markets?”. In more certain times, that would have been a fair question. But in my 40 years of observing risk, I have never seen a period of more geopolitical uncertainty than in the last 18 months.

Geopolitical shocks are shaking the very foundations of the established international order: the UK’s surprise Brexit decision, the equally unanticipated election of Donald Trump as the 45th American President, and the widespread rejection of ‘politics as usual’ in the democratic West. These and other disruptive events are ushering in a period of great change that I call the “new world disorder”. Investors must consider this new geopolitical landscape because it has enormous consequences for market stability and investment decision making.

What investors need to understand is:

1. Are these disruptive trends fleeting, or do they presage a long-term, cyclical shift in geopolitical and economic power?

To answer this question, we need to take a step back and see our current situation in its historical context. In the 1960s, political theorist George Modelski asserted that geopolitical super cycles occur every 100-120 years. At the end of each super cycle, the dominant state starts to weaken, confronts challengers, its basis fragments and often, the world is plunged into wars and conflict. We can see these cycles in play over the last 500 years. Every century or thereabouts, global leaders have been threatened by emerging challengers, with the resulting conflict eventually coalescing into a new, more stable global system, often under different leadership.

Until recently, our post-1945 world system was founded on Pax Americana and underpinned by the US military. In 1990, President George Herbert Bush talked of “…a new world order where the rule of law, not the rule of the jungle, governs the conduct of nations.” I believe the world order President Bush was describing is unravelling. Western values are being contested by new players: rising, or resurgent, states; and non-state actors, including transnational criminals. We can see evidence of this right across the political spectrum: at one end, the rise of identity politics, populism and nativism in the developed world; and at the other, in Islamic State’s ambition to destroy the old order completely and begin anew with a global caliphate.

If, as it appears, we are currently in the midst of a transition between super cycles, then we can expect major macro system change for at least a decade to come. In the new world disorder, the rules we have taken for granted throughout our lives – the capitalist system, free markets and the rule of law – may no longer hold. Already, the global institutions (United Nations, World Bank and IMF) set up by the victors of World War II are weakening.

I believe this transition period is likely to be long lasting (10-30 years) and characterised by conflict, disruption and elevated levels of geopolitical volatility. Investors can expect to see the rate of geopolitical change accelerate, increasing the likelihood of breakdowns in the macro system until a new world order emerges. What we have been experiencing for the last 18 months is the new paradigm.
2. What will the new world order look like when the system finally stabilises?

With so many factors in flux, this is a thorny question. What I can state with certainty is that the world will not go back to the way it was. There may be some elements of continuity, but not many.

To get a glimpse of a possible future, it is illustrative to look at potential challengers for world power, their likelihood of success and the systems they favour.

Assertive China

China has much invested in the old system, needing stability and open markets to deploy its excess capital. However, President Xi Jinping is happy to change the rules that don’t suit him – witness China’s activity in the South China Sea and its Silk Road initiative.

In an integrated play for trade and energy security, China is seeking to wrest control of the Malacca Strait from the US Seventh Fleet by aggressively militarising a number of reefs in the Spratly Islands. The rest of the world takes a dim view of this bellicose build-up in the world’s most important sea, which carries more than 40% of world trade and 50% of energy trade. It could easily become an arena for escalating conflict, with major implications for financial markets, unless Xi is able to position the development in a sufficiently diplomatic light.

China is also targeting 64 countries and 15 Chinese provinces for transport, energy and trade projects through its massive Belt and Road connectivity initiative. If successful, the visionary program will develop Central Asia for China’s benefit and bring neighbouring countries into its orbit. Notably, with Chinese-controlled ports being developed in strategic locations, such as Pakistan, the new Silk Road will also secure alternative sea access should energy and trade supply be disrupted in the Malacca Strait by any future conflict.

Unstable North Korea

China may be the antagonist in one potential conflict, but it is also the only power capable of defusing another – that of North Korea’s nuclear weapon’s program. Under Kim Jong-un, the rogue state has made major advances in its missile technology. By 2020, North Korea will have 100 nuclear warheads and an ICBM capable of reaching continental US. Not only will this be unacceptable to a belligerent Trump, it creates the real possibility that South Korea and Japan will develop their own nuclear programs.

Avoiding conflict will require a political solution, brokered by China on whom North Korea depends for trade and energy. It’s a Hobbesian choice for China, which relies on North Korea as a buffer state with South Korea. But the situation is reaching a critical point, requiring a game changing event. We must hope it resolves via negotiations not war.

Disruptive America

Pax Americana is dead and is being buried by Trump. But Trump is not responsible for its demise. His skill has been to identify and ride the crashing wave of systemic discontent surging across the US. What differentiates this presidency from previous administrations, is that, rather than being invested in protecting the old order, Trump is collaborating in pulling it down.

The US will survive Trump – it will eventually endure and strengthen because of its resilience and underlying strengths. But its reign of world dominance is over.

Aggressive Russia

Russian President Vladimir Putin’s revanchism has been clear for some time. Putin has taken every opportunity to shake up the old order, shocking Europe with his annexation of Crimea and destabilisation of Ukraine. Resentful of US unilateralism and Europe’s attempt to enlarge NATO, Putin will continue to assert himself on the world stage. He will use Trump’s NATO attacks to try to reset Russia-US relations. His marriage of convenience with China may fall apart over competition for power and influence in Central Asia where Russia has long held sway.

Weakened Europe

With Brexit, not Frexit, the European Union (EU) has not fragmented, but anti-EU sentiment remains in many countries. The question is how quickly this massive trading bloc will recover. With internal challenges far greater than those confronting the US, the likelihood is that Europe’s decline will be more difficult to reverse.

India in the wings

As compared to authoritarian China, India is taking longer than many expected to emerge as a global power. But India’s time will come. After 25 years of economic liberalisation, India has some world-class sectors. Now its outward-looking leader is tackling corruption and criminality and putting in place the infrastructure needed to realise India’s promise. Down the track, India will join the US, China and Russia as a force to be reckoned with.
Implications for investors

China will not rule the world, but neither will the US nor Russia. We are going back to a more traditional multipolar system. In the current transitive state, disruptive transnational forces and emerging technologies will continue to accelerate geopolitical and economic change, causing greater uncertainty and volatility in the market.

Given the complexity of the macro system and the law of unintended consequences, making investment decisions in a silo won’t work. Smart investors will integrate geopolitical considerations into a holistic approach to risk management. Good risk strategies won’t necessarily future proof a portfolio or fund, but knowledge is always better than ignorance.

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