



# AROUND THE WORLD IN 8 PAGES...

3<sup>rd</sup> QUARTER 2018

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## ABOUT OUR '8 PAGES' SERIES:

The Librarium Associates monthly 'Around The World In 8 Pages..' series is a quarterly publication created by our team focused on geopolitical and macro economic trends and developments around the World during the last 3 months. As long term thinkers we draw on the lessons of history as a guide to understanding the present and charting the probable paths ahead. There are no crystal balls but in the words of A.W. Pinero: **"The future is only the past again, entered through another gate."** It's our mission to glean valuable insights from history and apply them as a foundation for understanding the journey ahead.

We are constantly engaged in active horizon scanning while adhering to our belief that students of the lessons of history and permanent features such as geographic realities can provide superior insights.

From these broad scenarios we work to identify investable trends and specific opportunities. We find that such a broad approach provides an 'early alarm' system for risk management and an indicator of attractive price/value situations across asset classes.

The intention of our research and the basic premise of this publication is to present rational perspectives based upon a diligent analysis of historical data. Through organizing the data logically, information is created. Through understanding and developing perspectives on the information, knowledge is generated. With knowledge, one can then start to make informed decisions.

The most practical way to imagine the future is to question the expected, this is best done making use of what we call 'critical thinking' – Critical thinking is the careful, deliberate determination of whether one should accept, reject or suspend judgment about a claim and the degree of confidence with which one accepts or rejects it. Critical thinking employs not only logic but a broad intellectual criteria such as the one outlined above. Critical thinking requires extensive experience in identifying the extent of one's own ignorance in a wide variety of subjects which is often captured in the following sentence: I thought I knew, but I merely believed.

As J.F. Kennedy put it: **"Belief in myths allows the comfort of opinion without the discomfort of thought."** Our aim is always to avoid this trap of the mind, when one attempts to look into the future one is better off exhibiting a more intellectually humble approach and challenge one's beliefs and opinions by asking the question: What if we took the opposite view? This leads to a more balanced set of insights in our view.

The insights and opinions offered in this document are meant as a summary of events and our views – not a conclusive or exhaustive overview or for that matter a specific investment recommendation.

We hope it will offer some food for thought and that it can form the basis of conversations between our clients, interested parties and ourselves.

Sincerely yours,

Mr. S.H. Sorensen  
Senior Associate



# PRE-DEPARTURE BRIEFING:

Napoleon stated that; **"The power of all nations are inherent in their geography."** Combined with slow moving and relatively 'solid' data such as demographic trends, geography forms the foundation for our approach to understanding the world we inhabit. Then you can apply a lens of historical context and an understanding of human and group psychology. With these tools one can distil broad insights on national and global trends and the probable paths forward.

In our opinion too much is made of traditional data, GDP % growth per quarter etc. are simply the short term effects of these underlying forces and should not be considered as the foundation for understanding but merely as a limited and 'noisy' symptom. We look for long-term patterns and potential breaks from the expected linear paths of most observers. As Niccolò Machiavelli puts it in 'The Prince'; **"One change always leaves the toothing for another."**

On our whirlwind tour Around the World in 8 Pages we will not offer traditional broad bland descriptions of quarter over quarter economic data but we will offer variant perceptions on the World's key regions as well as individual nations. We will delve into specific trends or events that caught our eye as significant during the last quarter.

As always we hope to inspire our readers to explore the World further by themselves, to ask questions and let people find the answers, to awake a sense of curiosity and a quest for further understanding. We welcome your observations and feedback and hope to meet up with you for a cup of coffee or a glass of wine in the future and mull it all over together. It has been our experience that real learning resides at the intersection of differing informed opinions expressed respectfully between learners.

In this report we have the benefit of two esteemed & well traveled co-sherpa's who will help us navigate the journey and who will share their wisdom & perspectives on this wonderful planet we all inhabit. You can meet them on the following pages. **Let's begin the voyage together...**

**"Not all who wander are lost." – Tolkien**

## A DAY IN THE OFFICE...



The World is no different from any other object in that we can make more sense of it by viewing it from different angles. In our quest for insights we cover global macro economic trends and geopolitical events seeking variant perceptions in order to discern future paths and probabilities of likely outcomes.

—Mr. Sune Hojgaard Sorensen  
Senior Associate  
Librarium Associates Ltd.



George Magnus is an independent economist and commentator, and Research Associate at the China Centre, Oxford University, and at the School of Oriental and African Studies, London.

George was the Chief Economist, and then Senior Economic Adviser at UBS Investment Bank from 1995–2012. He had a front row seat and key managerial position for multiple episodes of boom and bust in both advanced economies and emerging markets, including notably the Great Financial Crisis of 2008. George famously anticipated it in 2006–2007 with a series of research papers in which he warned of an impending Minsky Moment. Whilst at UBS, he served for four years as the Chair of the Investment Committee of the pension and life assurance fund. For four years until 2016, he served finally as an external senior adviser with clients of the investment bank.

He had previously worked as the Chief Economist at SG Warburg (1987–1995), and before that in a senior capacity before the 'Big Bang' at Laurie Milbank/Chase Securities, and before that, at Bank of America in London and San Francisco.

George is closely followed nowadays for his insights and observations about the global economy in general, and China and demographics, in particular. His China focus derives from a long period of observation and study that goes back to his first visit in 1994. He also opines regularly on demographic trends around the world, as well as on key issues nowadays such as Brexit, and the US and the world economy. He is a regular contributor to the Financial Times, Prospect Magazine, BBC TV and radio, Bloomberg TV and other outlets.

His written work and a blog can be found on his website at [www.georgemagnus.com](http://www.georgemagnus.com)

Converse with George on Twitter:  
[@georgemagnus1](https://twitter.com/georgemagnus1)

Meet our first Sherpa,  
the indomitable Mr.  
George Magnus, who will  
share some insights on  
China's Belt & Road  
Initiative from his new  
book.

George's current book, **RED FLAGS: WHY XI'S CHINA IS IN JEOPARDY** was published in September 2018 by Yale University Press. His earlier books are *The Age of Aging* (2008), which investigated the effects of the unique experience of demographic change on the global economy; and *Uprising: will emerging markets shape or shake the world economy?* (2011) which examined the rise of China and other major emerging markets, and questioned controversially the widely accepted narrative that China was destined to rule the world



Chase Taylor is a global macro strategist and macro trader at Pinecone Macro. Chase runs Pinecone Macro Research, LLC – a research service he launched this fall that provides insights into his investment analysis. Chase does not come from Wall Street or business school, but the military. He prides himself on being a self-taught macro practitioner.

Chase started in the Air Force working on B-1 Bombers' avionics systems. He spent most of his career as a geospatial intelligence analyst working on strategic and tactical intelligence problem sets. He has also worked in acquisitions at a research laboratory specializing in rocket propulsion.

Chase combines the analytical techniques he learned in the intelligence community with a special focus on history and nature to create a unique framework for macro analysis. **HE SPECIALIZES IN ANALYZING A FUTURE MOST INVESTORS DISCOUNT AS EXTREMELY UNLIKELY TO FIND HIDDEN OPPORTUNITIES.** He combines technical analysis, fundamental understanding, and the power of narratives and reflexivity to uncover asymmetric investments.

**Learn more** about Chase's work and subscribe to his excellent free newsletter here:  
**[WWW.PINCONEMACRO.COM](http://WWW.PINCONEMACRO.COM)**

For active investors you can also explore his various interactive service packages.

Lastly go strike up a conversation with Chase on Twitter: **@Pineconemacro**.

Meet our second Sherpa, the talented Mr. Chase Taylor, who will be guiding us through the dynamic yet elusive nation state of **PAKISTAN**.



**THE PATH OF THE WARRIOR POET...**



## THE VIEW FROM NORTH AMERICA: THE US:

In the CIA manual on 'Tradecraft & structured analytic techniques' there is a very useful segment titled; 'Devil's Advocacy' that provides a great framework for both investment and geopolitical analysis. The definition is "Devil's Advocacy – Challenging a single, strongly held view or consensus by building the best possible case for an alternative explanation."

We commenced the work on this outlook amongst much talk of all comers 'bending the knee' for the almighty King US Dollar, highflying US Stock markets with US companies with trillion USD valuations, a powerful US economy, EM crisis, the usual EU fragility & the supposedly overpowering & one-way-only effects of the US's muscular new policy towards China - which most observers agree will seriously damage China's rise. With such typical linear thinking prevailing and most observers seeing the US as set to continue to outperform on all fronts it seems prudent for us to engage in an exercise of 'Devil's Advocacy' & look at some counter arguments to some of the core tenets of this US centric world view.

As to Mr. Robertson Davies' observation; "The eye sees only what the mind is prepared to comprehend." Ideally such an exercise can open our eyes to some of the indicators that a tipping point is up ahead, and help us identify where some of the pillars are becoming porous.

**First let's look at the prevailing narratives on some of the fundamental pillars underpinning the US - economically and geopolitically before we play Devil's Advocate to tease out some contrarian nuances:**

**GEOGRAPHY:** Since the fall of the Soviet Union the world's dominant power – in economic & military terms – has resided in North America with the US. A nation of continental scale, surrounded on both sides by oceans – the Atlantic & the Pacific – and with two smaller friendly and largely complementary nations to its north and south. Rich in resources, namely a large scale & highly productive agricultural hub connected to the Gulf of Mexico by an easily navigational river system for access to global markets & urban centers on the two coasts. Secondly with innovative solutions (Horizontal drilling & fracking) it has become a major producer of energy – oil & gas – which makes its position in the world optimal across all key areas of geographical assessment.

As we wrote in our 2017 Q4 ATWI8P outlook: "Geographically this continent sized 'island' empire is a natural self-contained bastion that has served its dominant nation state - The US - and largely its two adjunct junior partners very well. With no enemies nor competitors on its door-step, with a river transportation system in it's midst flowing in optimal directions for harnessing its agricultural and industrial potential. It has largely been left to pursue it's "Manifest Destiny" since the completion of the Louisiana Purchase and the US triumph at the battle of San Jacinto. Left unscathed and in an unrivalled position of strength by the last two major global conflicts the US has spend the last 70 years in the ascendancy, becoming the world's dominant power center in the process."

Geography is as close to permanent as you can get in the affairs of man and the US has been dealt the best hand by far.

**"DEVIL'S  
ADVOCACY:  
DEFINITION:  
CHALLENGING A  
SINGLE,  
STRONGLY HELD  
VIEW OR  
CONSENSUS BY  
BUILDING THE  
BEST POSSIBLE  
CASE FOR AN  
ALTERNATIVE  
EXPLANATION."**

- The CIA Tradecraft & Structured Analysis Manual.

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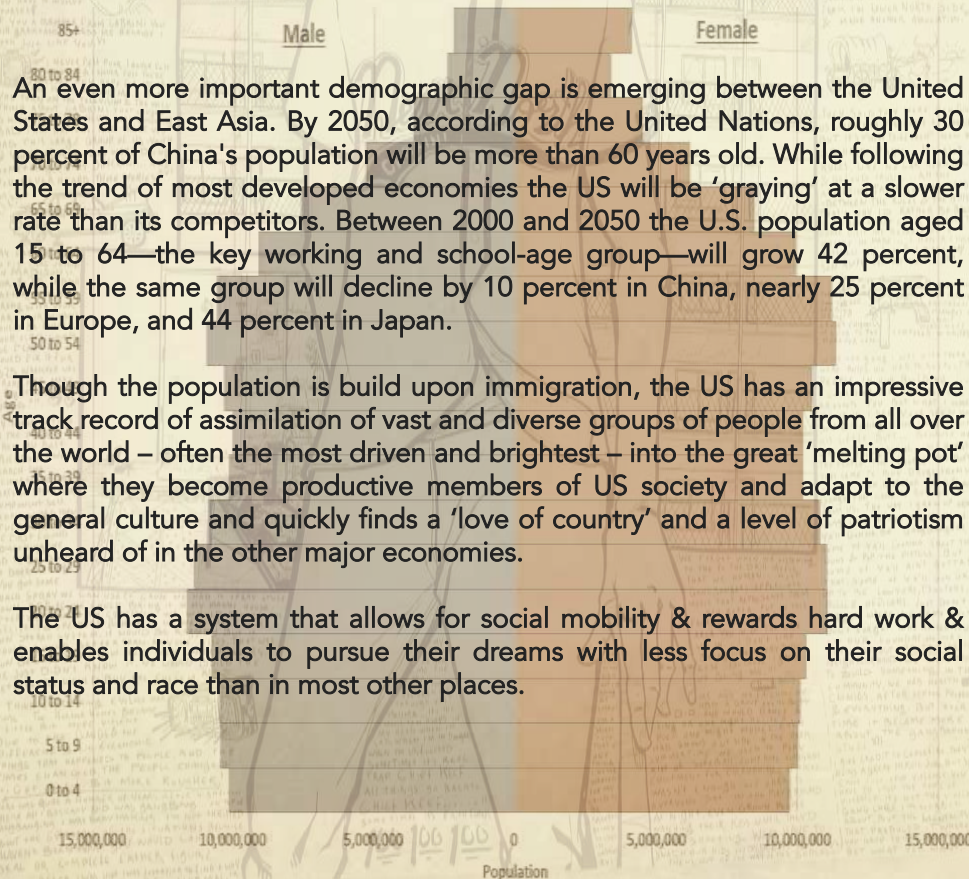


## DEMOGRAPHICS:

**A basic picture of America's demographic future:** The operative word is "more" - according to the US Census Bureau - by 2050, about 100 million more people will inhabit this vast country, bringing the total U.S. population above 400 million.

With a fertility rate 50 percent higher than Russia, Germany, or Japan, and well above that of China, Italy, Singapore, South Korea, and virtually all of Eastern Europe, the US has become an outlier among its traditional competitors, all of whose populations are stagnant and seem destined to eventually decline.

Thirty years ago, Russia constituted the core of a vast Soviet empire that was considerably more populous than the United States. Today, Russia's low birthrate and high mortality rate suggest that its population will drop by 30 percent by 2050, to less than one third that of the US.



An even more important demographic gap is emerging between the United States and East Asia. By 2050, according to the United Nations, roughly 30 percent of China's population will be more than 60 years old. While following the trend of most developed economies the US will be 'graying' at a slower rate than its competitors. Between 2000 and 2050 the U.S. population aged 15 to 64—the key working and school-age group—will grow 42 percent, while the same group will decline by 10 percent in China, nearly 25 percent in Europe, and 44 percent in Japan.

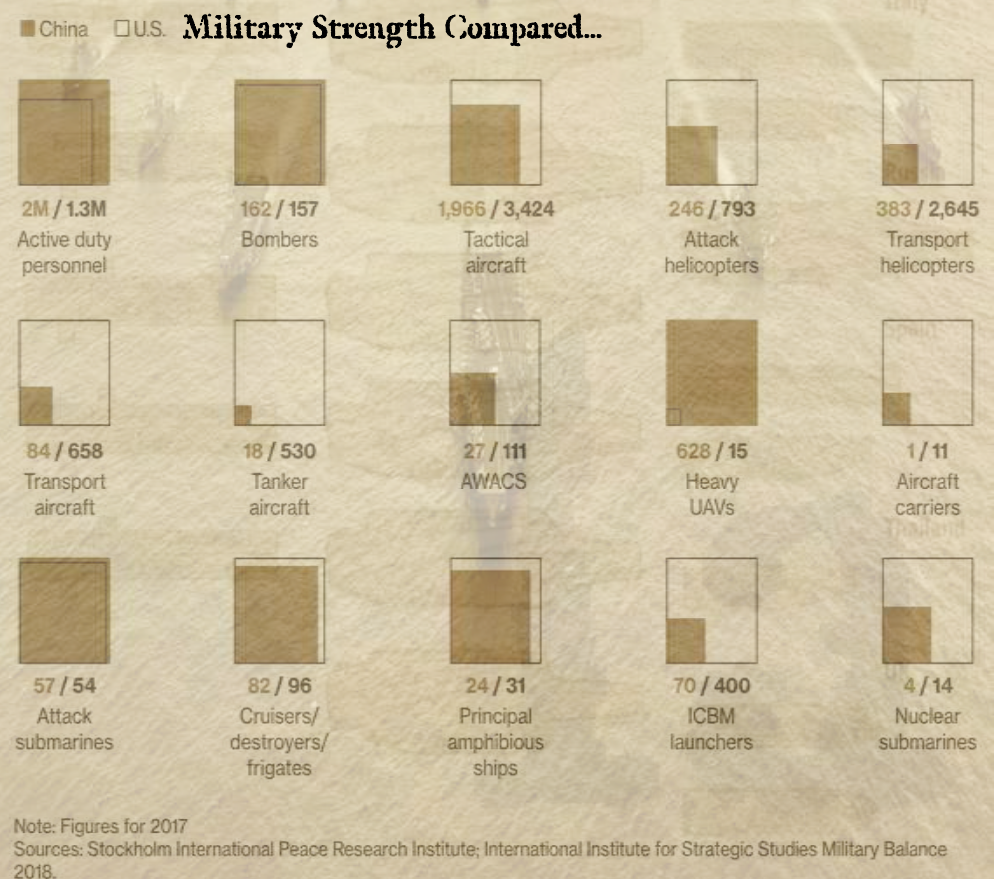
Though the population is built upon immigration, the US has an impressive track record of assimilation of vast and diverse groups of people from all over the world – often the most driven and brightest – into the great 'melting pot' where they become productive members of US society and adapt to the general culture and quickly finds a 'love of country' and a level of patriotism unheard of in the other major economies.

The US has a system that allows for social mobility & rewards hard work & enables individuals to pursue their dreams with less focus on their social status and race than in most other places.

## MILITARY:

This from a Brookings Institute article titled; 'America's awesome military' along with the illustration below on the competitive advantage of the US Vs. China, captures the prevailing views on the US military vis-à-vis the rest of the world:

**"The United States has the best military in the world today, by far. US forces have few, if any, weaknesses, and in many areas—from naval warfare to precision-strike capabilities, to airpower, to intelligence and reconnaissance, to special operations – they play in a totally different league from the militaries of other countries. Nor is this situation likely to change anytime soon, as US defense spending is three times as large as that of the United States' closest competitor, China, and accounts for about one-third of all global military expenditures – with another third coming from U.S. allies and partners."**





## ECONOMY:

The US has the largest economy in the world at \$20.4 trillion, according to data from the IMF, which shows the US economy increased from around \$19.4 trillion the year before.

A comprehensive study by the Swiss Business School showed the US improving three positions to return to the top spot, overtaking more nimble players like Hong Kong, Singapore and the Netherlands, and even leaving Switzerland behind. The US economy's comeback was mainly driven by economic performance, government efficiency, capital provision and digital infrastructure, said the authors of the study.

The 2018 survey now has found the US to be especially attractive because of its dynamic economic development, easy access to financing and a business-friendly environment in general. The world's largest economy excels in economic diversification, direct investment, venture capital and digital infrastructure.

The US economy is often said to be self-contained as it feeds of its powerful consumer base, that never seems to tire or run out of funds. It's manufacturing and chemicals businesses has access to some of the cheapest energy & raw material inputs from the fast growing oil & gas industry, and the defense and aerospace sectors are secure in the knowledge that they can expect ever growing government contracts from the worlds largest military and their allies who are a somewhat captive buyer.

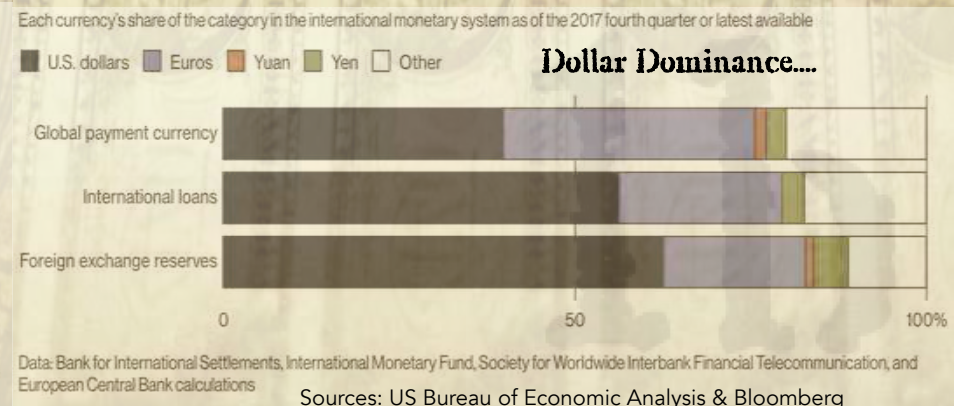
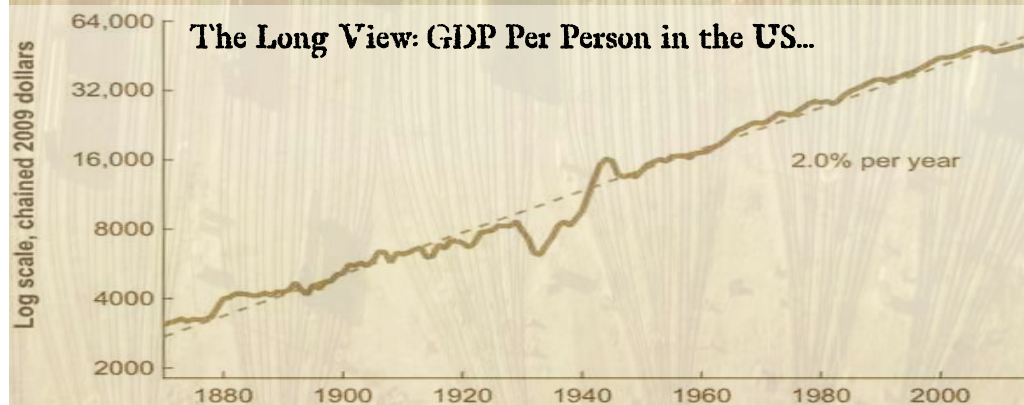
With globally dominant financial, services and technology sectors – all of which traditionally are some of the most profitable – the US is well positioned and its companies are without peers in many fields & with access to the worlds deepest capital markets and a giant home market they come at the world from a position of great strength.

## FINANCIAL MARKETS:

The global economic system is based on public institutions and systems installed and controlled by the US and it has the world's reserve currency - the USD – which is also the major trading currency of the world in which all commodities are traded. Its private financial sector is dominant in all aspects of global finance and the US markets are the deepest, broadest and most liquid.

According to a recent McKinsey study: **"The US accounts for the largest share of the global financial stock (37 percent). The total US financial stock is now \$44 trillion, more than double its size 10 years ago, a growth rate of 8.6 percent a year since 1993, in line with the overall global rate of 8.4 percent. The size of the US financial stock relative to GDP has increased from 179 percent in 1980 to 397 percent in 2003 due to growth in private debt and equity securities. The US exemplifies the dominance of market-based financing and private securities in its role as the hub in the global capital market. Due to its size, liquidity, and economic health, the US attracts the lion's share of cross-border equity flows, and foreigners hold an increasing share of its financial stock."**

In short, as to the illustrations below, the US(D) is dominant in all corners of the world and across all financial markets. If push comes to shove the US can outmuscle all comers with its devastating financial arsenal. While the US is prone to speculative bubbles its financial sector was quick to repair it's balance sheets after the Great Financial Crisis and it is the 'Shaquille O'Neal in a world of dwarfs' – the cleanest shirt in the hamper – and even when it has problems, they can rely on the all powerful FED to step in and backstop any issues with unlimited resources that quickly makes any problems the problem of the rest of the world. In a world based on comparative credibility, it's always the host with the most.





# PLAYING DEVILS ADVOCATE...

## IS THE US REALLY IN SUCH AN UNASSAILABLE POSITION?

“We must not copy foreign experience and chase after leading countries. But we must outstrip them and occupy leading positions ourselves. Long-distance, contactless actions against the enemy are becoming the main means of achieving combat and operational goals. All this is supplemented by military means of a concealed character, including carrying out actions of **informational conflict** and the actions of special-operations forces.” – V. Gerasimov

**GEOGRAPHY:** While the US remains secure in its perfectly positioned domain, reality is that over the last 3 decades the world has become ‘smaller’ and more claustrophobic as non-traditional actors such as **terrorist** cells – as most devastatingly expressed on that cruel September day in 2001 – operate in ways that negates the comfort of ocean-sized ‘moats’ & friendly neighbors.

As our reality is increasingly online and digital, **cyber attacks** and **information warfare** has come to the forefront, bringing “**the strange, extra-dimensional landscape of cyberwar’s battlefield with it. This is the confounding geography of cyber warfare. (...) The physics of cyberspace are wholly different from every other war domain. In those physics, we are reminded that distance is no defense. Every barbarian is already at every gate. And the network of entanglement in that ether, which unified and elevated the world for the past 25 years, can over a few hours, bring it to a crashing halt.**”

Via social media, information warfare has been put on steroids and whichever way you want to view the 2016 US election and subsequent elections in Europe and other parts of the world, it is undeniable that populations have been affected & for anyone who spends a couple of hours online it is clear that a crystallization of the fragmented reality of the US population has taken place. As people spend more and more time online it’s a reality, that they become more prone to outside interference & propaganda. **If you can drive wedges deeply enough, you can undermine the sense of shared values that forms the very foundation of democracy. A divided people is easier to manipulate and control.** With today’s digital reality it can be done from anywhere in the world and oceans are no barrier.

Lastly the effects of **global warming** are having adverse effects in recent years, with coastal areas exposed and creeping fresh water issues starting to effect agriculture. The US is still holds the prime real estate and with Canada forms one of the richest areas in terms of fresh water supply.



**DEMOGRAPHICS:** Demographics is placed on the advantage side of the US competitiveness ledger. A broad view of the macro demographic trends, taking into account only population growth and age-profile, appears to support this claim. Yet this ignores other US trends that could strike a blow at worker productivity, undermining the potential economic advantage. Economists, always ready with a handy formula, has a way to roughly calculate GDP growth: labor force growth X productivity growth. This means that to keep an economy growing, either the labor force or productivity need to expand (or there must be an expansion of one to compensate for any contraction of the other). Obviously the population's age-profile matters too. It's best to have the bulk of a population be of working age. That way there are fewer nonworking, and therefore unproductive, children and elderly putting a burden on the economy.

As discussed earlier, compared to its major economic competitors, the basic contours of US demographics appear favorable, providing the labor force component of the GDP growth formula.

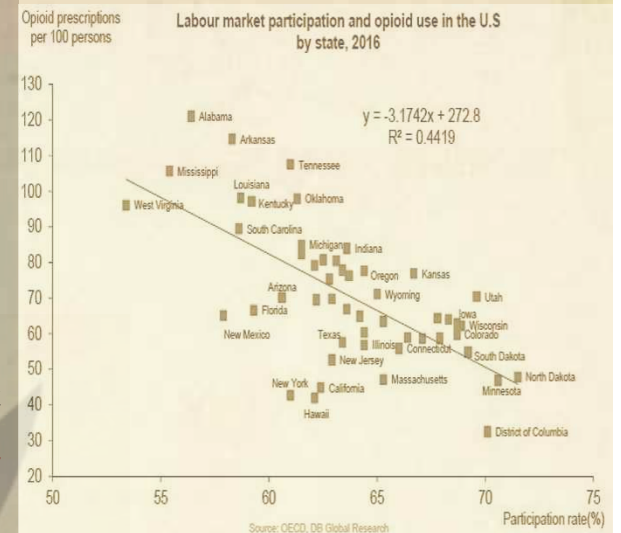
But when you bring out the 'Macro-scope,' a more complete picture of the US labor force comes into focus and it is not so encouraging. What matters more than raw working-age population numbers is the share of the working-age population that is actually working or seeking work, otherwise known as the labor force participation rate. Here the US compares less well, especially for men. People in employment do indeed work longer hours and take fewer vacations than employed Europeans. However, **US men in their late thirties are more likely to completely leave the work force behind, their labor force participation rate is lower than their counterparts' in nearly every European country.**

Productivity growth, the other component of the GDP growth equation, is proving elusive as well. Productivity improves when fewer inputs are needed per unit of output. Smart, capable, vigorous workers (productive human capital) help drive productivity higher. In other words, it's not just the size of the labor force, but the quality of the labor force that counts. In the 2000s, the productivity growth of the U.S. labor force was more or less on par with that of the Japanese and European labor forces. That is changing. The US population is losing its edge on educational attainment. According to the OECD, Americans aged 55 to 64 are among the best-educated in their age group in the developed world in terms of high school and college completion. **Americans aged 24 to 35 are solidly in the middle-of-the-pack & with a big fall-off in STEM educated people. Uniquely among nations, the group entering the US labor force is no more educated than the group currently retiring.**

Health trends are also worse in the US. Around 1950, Americans, and particularly American white women, were among the longest-living and healthiest in the world. Now it's flipped. A recently released report by the Institute of Medicine found that, compared against sixteen other "peer" countries, Americans have among the worst life expectancy and health at every age and income level. According to demographer S. Jay Olshansky, the US could be the first rich country to experience average life expectancy, which at present is reserved to former Soviet countries and Sub-Saharan Africa. **The least educated white Americans are already experiencing a drop in life expectancy, and at a rate that is astounding demographers, with poor dietary habits and alcohol and drug related illness and deaths skyrocketing in recent years.**

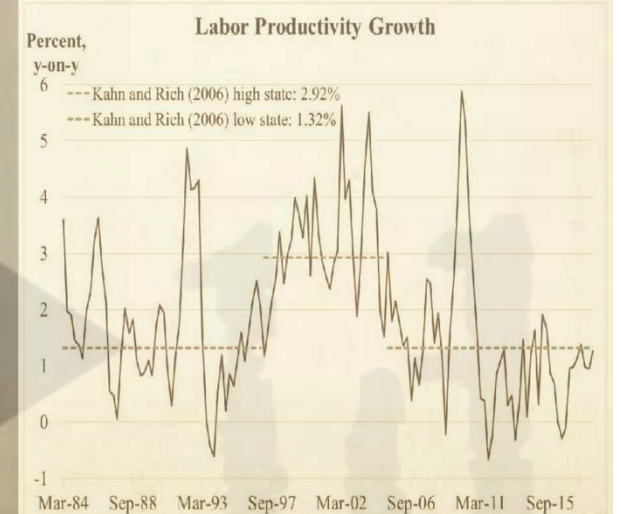
When you add these trends together, it appears that these factors could well take the edge off the perceived US demographic advantage, unless major changes in education and healthcare are implemented promptly.

## The opioid crisis has had a negative impact on labor force participation across the US...



## US productivity growth has been low..

Last observation 2018/Q2



Sources: DB & Kahn & Rich + FRB of NY



**MILITARY:** While there can be no doubt that the US has by far the most formidable military on the planet, alone in its ability to project awe inspiring acts of force anywhere in the world on a sustained basis. Its personnel is unrivalled in competency, and crucially they are battle tested both in terms of actual combat but also the all important supply lines and systems.

However there are some areas that needs to be looked at – the most obvious one is the flip side of these areas of strength – the pure size and costs involved are just as outsized compared to the rest of the world. The never ending wars in the Middle East that the US has been entangled in for over 2 decades, has provided combat experience but also great costs and sacrifice. **The height of strategic wisdom is to avoid all conflicts and entanglements from which there are no realistic exits.** According the Congressional Budget Office the war in Afghanistan alone has cost in excess of \$1 trillion so far with the two wars in Iraq costing over \$2 trillion. With over 6000 US personnel losing their lives and over 50,000 injured, the costs have been high and there is no real end in sight, even if the combat operations have been dialed back.

With **US debts and government deficits** reaching unsustainable levels, and foreigners – such as China – not willing to go on financing the US's spending, something will have to give. With skyrocketing entitlements including those for military personnel, and the need for better education and updated infrastructure becoming pressing issues, it's hard to see how the US can continue to spend such outsized amounts on its military. Hard choices will have to be made and engaging in large-scale conflicts seems to be extremely risky beyond the battlefield. **Grand strategy is what a state can do or should do consistent with the fact that its resources are not unlimited and that the appetite of its people is not unlimited – on current conjecture the US may be hitting the outer limits on both of those fronts soon.**

China has rightly been identified as the main 'strategic rival' by the current administration. But China is not a foe like the ones the US has faced in its campaigns in the Middle East or even like the Soviet Union during the Cold War. It is of different scale and complexity. While too much is being made of China's supposed ability to conjure 100 year plans and play 4 dimensional games of 'Go' it is important to note their completely different timelines and approach to conflict. This from Sun Tzu does sum up the actual actions of China well:

**"To fight and conquer in all your battles is not supreme excellence; supreme excellence consists in breaking the enemy's resistance without fighting. Therefore the skilful leader subdues the enemy's troops without any fighting; he captures their cities without laying siege to them; he overthrows their kingdom without lengthy operations in the field. This is the method of attacking by strategem."**

Or as Robert D. Kaplan stated earlier this year: **"...China is fighting a war with the US in the South China Sea. It's just that the Americans don't completely realize it, because the Chinese method of war is to win without ever having to fight. The last thing the Chinese want to do is have a shooting match with the US Navy, because they will lose. They may not lose in a generation, at the rate they're going, but they will lose now. So, it's a series of little micro-steps: take an island here, build a runway there, do nothing for 6 months, then send an oil rig into disputed waters. After there are international complaints, withdraw the oilrig and take another island. It's a very subtle strategy where any reaction makes it seem like you're over-reacting"**

This kind of approach along with the informational and cyber warfare we mentioned in the 'Geography' segment, makes it difficult for the US to play to its strengths and unleash it's large scale military solutions and just like it has faced in the Middle East and in Vietnam it finds itself chasing shadows in a modern version of guerilla warfare that negates its overwhelming & advanced military hardware.

It is also worth noting that China appears to have taken a page out of the US Cold War book of strategies, and has developed a high powered push to become the leader innovation and technology space, which is akin to the 'arms race' in that it forces the opposition to try to match spending and efforts in order not to be left behind – Xi stated in 2016; **"If science and technology (S&T) flourish, the nation will flourish, and if science and technology are strong, the country will be strong."** And he went on to extol indigenous S&T innovation as key to modernizing China's military & ensuring its national security. Many actions since then shows that China is delivering on this front, while the US has a significant lead in many areas –the gap is narrowing and just as the US is faced with financial constraints, China appears set to partly reinvent the battlefield.

Lastly, a recent DoD study of the US 'manufacturing and supply chain resiliency' showed it to be not very resilient, with major flaws in both areas as much of the US's military equipment relies on supplies of strategic minerals such as rare earth elements – which is a market China controls and examples of concerning incidents of hardware based espionage via micro-electronics has hit the headlines recently, which is another area where China is a dominant player. While these aspects are not major roadblocks for the US, they do represent potential bottlenecks and are examples of the real issues facing the US & it's military.

Beyond this, **Russia** is a dark horse with significant and aggressive military and intelligence assets, not to mention the only nuclear arsenal that measures up to the US, at least in scale. While Russia is inherently weak it has shown a willingness to challenge the US in the unconventional theatres and perhaps the biggest risk is an implosion in it's leadership, leading to chaos and an array of deeply concerning and challenging realities for the US to deal with.

The US is still clearly in control in the traditional military sphere but challengers – large and small – are making inroads and especially in the non-conventional spaces, like information and cyber warfare they are proving very adept at negating the US's numerical advantages.

**"It is hubris to suggest our potential adversaries are not as capable or even more capable of far-reaching and deeply embedded innovation." – Lieutenant General Shanahan, Director of Defense Intelligence and lead for Pentagon's AI focused Project Maven.**



**ECONOMY:** As we write this, the US reported GDP growth that increased at a stellar annual pace of 4.1% in Q2, to much fanfare and Twitterly & the 'mission accomplished banner' was dusted off by the Administration as they celebrated the highest GDP growth results since 2014. They did not let the fact that the Q1 number was revised down from 2.9% to 2.3% spoil the party. The President predicted bravely; "...that this is the start of a long-term trend, and these numbers are very very sustainable and are going to go a lot higher." While that certainly would be something to celebrate there are reasons to be doubtful, first let's look the dynamics behind these numbers; 3 one-off drivers seems to have been behind it – tax cuts, a surge in government spending & a rush to ship exports out of the country before the trade tariffs kicked in (Looking at you Mr. Soybeans). **You could argue that all 3 of these drivers are high-risk policies that will in due time turn from catalyst to a drag on the economy.**

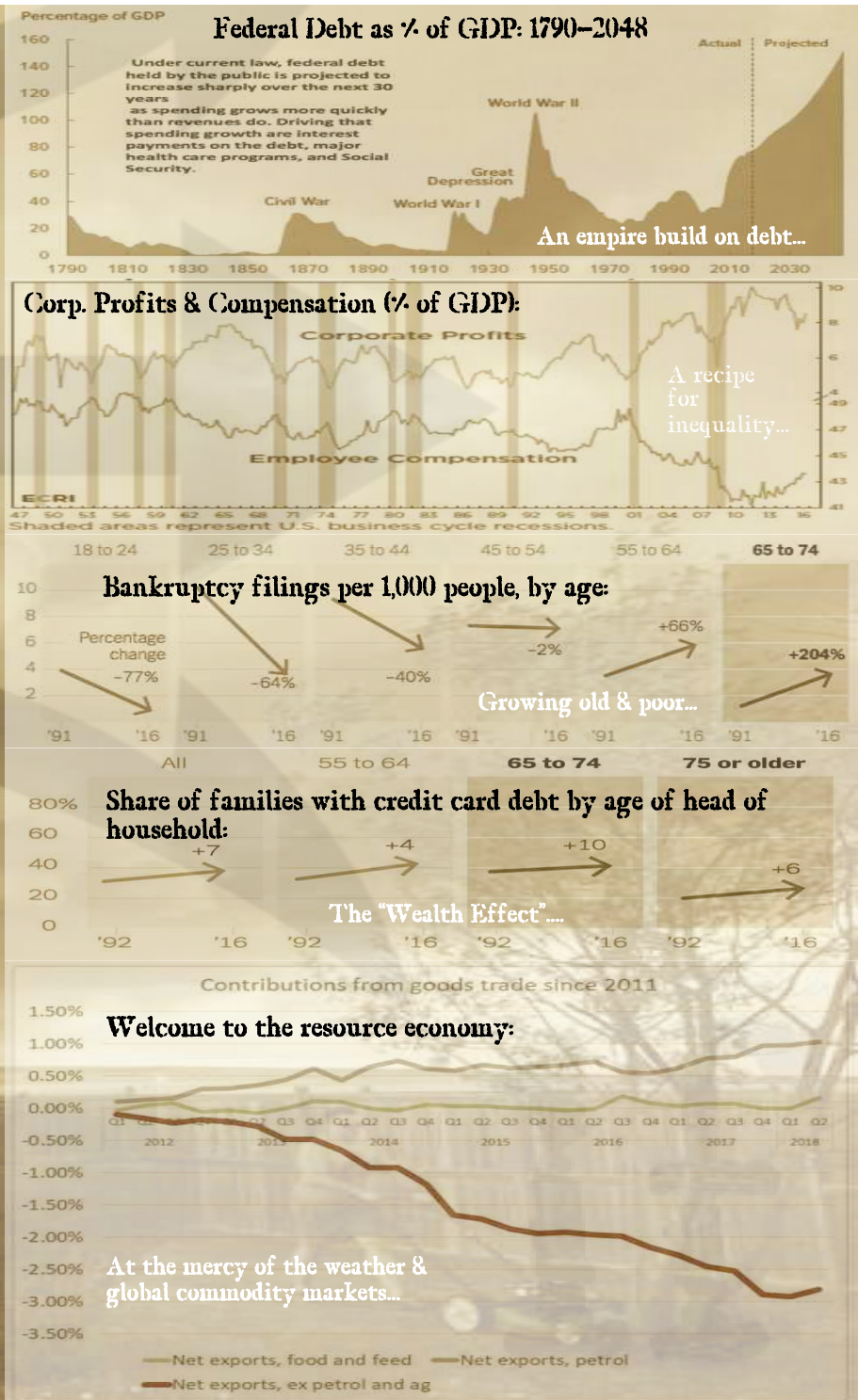
Now let's look at those insatiable consumers for signs of potential retail fatigue. While corporate profits have been faring very well over the last 40 years the wages of the average worker has gone the other way, and the mirage of increased spending power has come via the easy access to consumer credit. This illusion has 'helped' alleviate rising inequality and enabled a larger swath of the population to participate in the wonder of so-called retail-therapy. In the US credit has become the easy answer to all ailments – declining growth & rising inequality; if you can't afford an education, a house, new car or an exotic holiday the government, with a little help from the ever eager credit merchants can lend you the key to the American Dream in the form of that extra loan, ReFi of the ReFi or 5<sup>th</sup> credit card you need & deserve. **You can only go on spending your future earnings on things you don't really need today for so long.**

Once the music stops it all comes tumbling down. While the housing market has been licking it's wounds from '07, car and student loans are at unsustainable levels & the so-called deleveraging of the US consumer appears to have been limited to defaulting on the mortgage, with **40% of working-class adults unable to raise \$400 for an emergency according to a FED survey**, real actual savings appear illusive. While wages has been rising, it might be too little too late as a storm is brewing in the pension and healthcare spheres, with over 100 million working age individuals who do not own assets in Retirement Accounts or participate in a DB pension & most public pensions desperately underfunded. Bankruptcy filings by people between the ages of 65 -74 was up 204% between 1991 and 2016 and more and more retirees live in mobile homes as they can't afford rising rents & have sold their homes to access the funds for living costs. **You can go on 'eating the seed corn' for only so long.**

Corporate debt is at record highs and the quality is sinking fast with a build up in so-called '**Zombie Companies**' – while the business news are full of coverage of fast moving companies like the FAANGs, most are less dynamic and the labor force as discussed is not providing the productivity boost needed to offset the headwinds. The recent corporate tax cuts have given a temporary sugar high but the effects are likely to be temporary and most of the funds coming back in are being deployed for financial engineering not actual engineering. Another worrying long term trend is rising industrial concentration, which leads to an imbalance between corporations and workers. Workers in many industries have fewer choices of employer, and when industries are monopolistic or oligopolistic in nature, they gain significant market power vs. their employees. Despite the US economy growing many times bigger in the last 3 decades, we have seen the number of listed companies fall by half and many industries now have only a few big players and/or Private Equity has taken them over and inserted them in their portfolios, where the same dynamics play out but even more ferociously.

Lastly let's look at the change in the composition of the US economy – so while it is consumer and services focused at home, in terms of exports (an increasingly challenged area) it has become a resource economy dependent on the weather for it's agricultural exports and at the mercy of the global energy & chemical markets for its energy and petro-chemical exports. Recently several interesting reviews of the financing that powers the so-called Shale Revolution has cast a stark light on this supposed 'wonder story' that paints it as less of an entrepreneurial victory and more of an unsustainable high-risk game of financial shenanigans, subsidized by artificially low interest rates and excessive liquidity in search of yields. As we 'go to print' we find that the US oil & gas sector had the highest number of corporate downgrades in Q3 2018 according to S&P. **Only time will tell if it's more of an elaborate structure build on shifting sands or if it can be the bedrock of the US economy for decades to come.**

Sources: CBO, ECRI, NYT & B. Setser





**FINANCIAL MARKETS:** When reviewing 'Demographics' and the 'Economy' we have already touched upon some of the areas that could affect the financial markets adversely. But let's take a look at the debt/treasury markets and then the USD & a brief look at the stock markets.

The **Treasury markets** is poised for some conflict - A deluge of debt supply is set to inundate the \$15.3 trillion Treasury market, just as borrowing costs are set to rise. Not only is the US budget deficit primed to swell to roughly \$1 trillion by the fiscal year 2019 and past that in subsequent years, but the interest owed by the government is also forecast to triple in the coming decade to nearly a trillion dollars a year, according to the CBO. This is all set to take place as the FED is scaling back its debt purchases, any drop-off in investor demand for the burgeoning supply of U.S. Treasuries could mean tens of billions of dollars in additional interest which in turn would crowd out the entitlements & military requirements we highlighted earlier.

The recent tax cuts, along with increased spending for Social Security and Medicare as the baby boomer generation retires, are already set to boost the public debt burden by \$10 trillion over the next decade, CBO estimates show. By that time, net interest costs will reach \$915 billion. (That's up from a record \$523 billion in interest paid in the year ended Sept. 30.) The federal government could soon pay more in interest on its debt than it spends on the military, Medicaid and children's programs. Something has to give & the currency is the least painful option for the politicians.

So perhaps the almighty **King Dollar** is heading for an 'emperors new clothes' moment at some stage. What is for sure, as the current US administration has been deploying the USD as a weapon & generally gone about antagonizing everyone beside Kim Jung-un, The rest of the world – allies & competitors alike – are getting restless (allies) or is felling empowered and thrust onto the stage (Competitors) and what was a whisper for so-called 'De-Dollarization' a year ago has become louder and clearer by the day. As stated in several of our reports we do not see a ready made alternative to the USD in it's role as the world's reserve currency & while there inroads being made for global trade denominated in other currencies, the commodity markets are still predominantly priced in USD as is most of the world's credit. However it is striking how quickly this drive has moved from the fringe to the mainstream – now it's everywhere from Bloomberg opinion pieces, to BIS & IMF White Papers & into the presentations of policy makers from China, Russia & the EU. The recent pull back from the JCPOA by the US is a case in point which appears to have united all these diverging parties in, at least a vocal if not practical, protest.

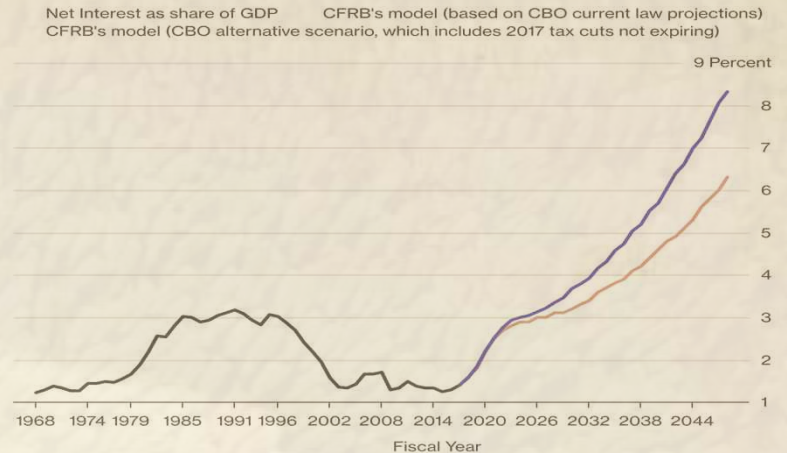
As I often point out; **Change is a process not an event.** And the game to relinquish the USD's 'Exorbitant privilege' is clearly afoot. As all fiat currencies carry their own specific problems a gradual change to a multi-currency reality is most likely, perhaps with the introduction of a digital SDR for reserve & trade denominations initially. What is clear is that the world is well aware of the fact that it has been a hostage to the USD and the erosion of the status of the USD is underway – for some like Russia, China, Turkey & Iran who are under sanctions from the US the drive for change is more urgent. From a financial market perspective it means that the world will be an increasingly reluctant buyer of what the US have to sell, even if for now the alternative options are limited. Most likely it will take major crisis to be the catalyst for significant change & the 'winner(s)' of this crisis will be the one(s) who dictates the terms & the direction of the changes. Is it imminent? Most likely not. Is it inevitable? Yes – father time is undefeated, even when it comes to the grandest of empires.

More broadly the US markets – especially the key companies on the major US indexes has seen incredible levels of inflows – the whole world has piled into the FAANGs & other story stocks & PE & VC funds have more money than they know what to do with. Public and Private market valuations are in nosebleed territory, while in recent months the rest of the world's – especially EMs – has slumped or outright collapsed in comparison. Foreign holdings of US securities recently hit a record of \$18.4 trillion, much of it further concentrated in a few positions. When everyone is on the same side of the boat its time to get concerned and switch places. In the last year Congress has passed a gargantuan tax cut and spending increase that, according to DB, represents the largest stimulus to the US economy outside of a recession since the 1960s. It sets the federal debt, already at the highest relative to GDP since the 1940s, on an even steeper trajectory and stimulates an already hot economy and financial markets even further. Think about it even if the US house is the 'best house on a bad block' - are investors being probably rewarded to justify the myriad of risks we have identified?

**"VOLATILITY IS ALWAYS THE FAILURE OF MEDIUM...THE CRUMBLING OF A REALITY WE THOUGHT WE KNEW TO A NEW TRUTH." – Mr. C.R. Cole**

## US Interest Costs set to Soar...

Payments on U.S. debt to reach over 6% of GDP by 2048



## US Stocks have widened their lead over all major indexes...



As of Oct. 2



## THE US: THE SUM OF IT ALL...

In summary if the areas that was highlighted by this game of 'Devil's Advocacy' are indeed, even partly the reality, and yet the US is actually still the 'cleanest shirt in the hamper' then the world is surely in a much worse state than most observers recognize today.

While financial markets appear overbought due to structural reasons and the record levels of liquidity floating around the system, they are great market structures with a rule of law & efficient market making mechanisms well beyond anything you can find anywhere else in the world. Geographically the US is blessed. Demographically it has some man made issues that are only being further damaged by flawed policies and under investment in education and healthcare.

While the economy is indeed the sum of all these parts, it is leveraged beyond repair and it will lead to real problems that will spread out across all the other areas eventually and in unpredictable ways. This is true of most of the world's major nations at this stage.

Lastly, an area that I purposely did not touch upon is society and the effects of inequality – they could turn out to be the wildcard. The US is a deeply divided country currently with the fabric of society torn almost to the point of splitting in two. Political partisanship is at level where constructive long term governing becomes near on impossible, even for a great nation with some of the most intelligently designed 'wheels of governance'.

The rhetoric is disheartening and unproductive - as the pendulum of a two-party system swings further and further to the sides, spending precious little time in the middle, seeing a constructive path forwards becomes increasingly difficult.

From my readings it was always clear to me that the real risks to the US was internal, not external. As to Abraham Lincoln's observation:

**"At what point, then is the approach of danger to be expected? I answer, if it ever reach us it must spring up amongst us; it cannot come from abroad. If destruction be our lot we must ourselves be its author and finisher. As a nation of freemen we must live through all time, or die by suicide."**

Time spend on social media gives me the impression we are not so far from such an escalation into the unknown, my time spend with people from all walks of life - when traveling this great nation gives me hope that large scale calamity can be avoided and from the darkness the sun will rise again and be a beacon to the world.

## SOUTH AMERICA: SPOTLIGHT SECTION: BOLIVIA: ABOUT TO GET LIT?

Sir John Templeton, the renowned investor, stated that; **"If you want to have a better performance than the crowd, you must do things differently from the crowd."** He went on to say that; **"People are always asking me where is the outlook good, but that's the wrong question. The right question is; Where is the outlook most miserable?"** When investing in general these are sage advice and when investing in Emerging Markets or Frontier Markets they are extremely apt.

Currently most EMs are regarded as 'miserable' so that in itself tells us that it's a great place to look for opportunities to deploy some of the profits that can be harvested from the rich valuations currently on offer on the US markets, enabling you to deploy that strong USD where you can get some real 'bang for your buck.'

**Getting off the beaten track** and taking a look at some of the less heralded places, like Bolivia, can be a good exercise that may create some interesting investment opportunities for those who have the patience and risk tolerance required. With the growing demand for Lithium and major players, like China, Japan, South Korea & Germany pursuing supply deals around the world most of the easier places have been targeted with Chile providing the gold standard of supply and operations and Australia moving forward as well. Places like Argentina and Bolivia – while rich in potential supply – has been embraced less enthusiastically for obvious and good reasons. Both nations have a complicated history with investors – large and small – and Bolivia's populist President Evo Morales has been an outspoken proponent for national control of natural resources who has a mixed record of governing and has antagonized several large corporations with FDI in the country.

The Bolivian economy has had a historic pattern of a single-commodity focus, from silver to tin to coca to natural gas and now potentially to lithium. Political instability and a difficult topography have constrained efforts to modernize the agricultural sector. Relatively low population growth coupled with historic low life expectancy has kept the labor supply in flux and prevented industries from flourishing. Several run-ins with rampant inflation and corruption have thwarted development in the past. Around 2000 the fundamentals of its economy showed improvement, leading major credit rating agencies to upgrade Bolivia's economic rating in 2010. The mining industry, especially the extraction of natural gas and zinc, currently dominates Bolivia's export economy. Between 2006 and 2014, GDP per capita has doubled and the extreme poverty rate passed from 38 to 18%. Moreover, the Gini coefficient measuring inequalities declined from 0,60 to 0,47. A discovery in 1997 confirmed a tenfold gain in Bolivia's known natural gas reserves. Finding markets to utilize this resource, both domestically and internationally, has been slowed by a lack of infrastructure and conflicts over the state's role in controlling natural resources. Gold and silver production has increased dramatically over the past decade. Additionally, Bolivia has increased zinc production, extracting more than 100,000 tons each year. Other metals excavated include antimony, Iron & tungsten.

Bolivia's Lithium resources are estimated to be at the level of 9 million tons (USGS), highest in the world as per individual country and 22% of the world's total. This is significantly more than the second- and third-placed Chile and Argentina, which hold 18% and 16% of the global total resources respectively. The Bolivian government claims that it has 70% of the world's lithium reserves and the most optimistic estimation claims there is 140 million tons of lithium in Salar de Uyuni.

With elections due in 2019 new leadership may come in and take a more pragmatic approach and build on the broader foundations established since 2000. Bolivia secured a \$1.3 billion investment from Germany's ACI Systems GmbH in its lithium project in April – the country's biggest step yet toward realizing Morales' lithium goals. In 19 months' time, ACI Systems GmbH is scheduled to begin working with Bolivia to manufacture and market lithium batteries. Until now, a lack of expertise and market opportunities have hindered Bolivia's venture into the lithium industry. **Change could be on the horizon for Bolivia in 2019 and beyond – investors should take note.**



## **A LOOK AT EUROPE FROM 10,000 FEET** (or 3,048 meters to go with the more appropriate metrics system):

Europe is a mess. It has always been a mess and it will continue to be a mess. A big wonderful mess of humanity clawing its way to a better standard of living, with several big slide backs along the way. But so is everywhere else. It has many different paths ahead of it, some good and some terrible, most likely the path will be down the middle, grey and bland like a rainy autumn day in a suburb of Brussels.

There will be some drama, some decisions made by committee & a cynical population will mull along with a low level of enthusiasm for everything except for a night out on the town or a Champions League game of football (Soccer) involving their preferred team. People will write in capital letters on Twitter & in the British tabloids and US business news agencies; about 'xit' this and 'xit' that nation every 6-8 months and nothing much will transpire besides more meetings in bland European destinations, where plenty of black coffee and open sandwiches will be served.

Inequality will still be lower than in the other major economic blocks of the world, people will be better educated and have access to reasonable healthcare, the politicians will be pretty dull bureaucrats with a taste for good wine and long lunches. Companies will be less profitable than elsewhere but more stable, besides the banking sector which will continue to be either weighed down with politically driven Non Performing Loans (NPLs) or they occasionally get tempted to follow the sirens song and run off to the next grand casino the 'smart guys' on Wall Street rigs up for them or on some exotic emerging market foray.

The weather will be grey in the north and there will be too many tourists in the south. The food will be good in the south and bland in the north. The music will mainly be horrible. The populations will become older and grey but societies will overall be more efficient, besides France where they will be on strike.

Occasionally people will be unhappy and fearful, political opportunists from both extremes of the political spectrum will try to take advantage with soaring rhetoric and grand promises of a better tomorrow, which will be more like the 'good old days' if only they can get into power. Occasionally they will gain a brief position of power and their empty promises and false slogans will run into the real world constraints of governing and the hard realities that promises made will remain just that, and soon people will tire of their rhetorical spiel and the bond market of their unsustainable budget proposals.

**Immigration will be a problem and a solution.** The focus on the problems will be disproportionate & shrill. The young will continue to pursue education and employment in the urban areas around the continent with the most dynamic economies & cultural experiences. They will continue to be multi-lingual and with a global mindset, well aware that the world is interconnected & dreaming of the opportunities it represents. The less educated will be challenged by global realities and an increasingly automated manufacturing industry.

The European Union will continue to do some good things and may even make organic changes to its more cumbersome bureaucratic nonsense. It will be a target for national politicians, who needs to redirect blame for failures, some of the blame will be justified, mostly it will be more complex. It will continue be a useful safety valve to enable the populace to let off steam without the kind of calamities of the not so ancient past.

53.0000° N, 9.0000° E

**"Few people are bold enough to meet an evil in the face.  
How many suffer with the tooth-ache till the nerve decays,  
rather than encounter the momentary aggravation of tooth  
drawing?" - R. Hildreth**



Collectively Europe will have to pick up more of the burden of its defense, it will be a complicated process, but one that will eventually leave it in a better position and it will provide opportunities for the local defense sector. It will force the nations of Europe to reassess their place in the world and the challenges it faces.

**Russia** will be a complicated neighbor, both deeply interconnected and yet so far apart. And while the current regime appears suboptimal, with its hardnosed brand of 'Realpolitik' and hooligan manners, an implosion of order followed by chaos would be an even larger threat.

To the south, geographical realities are that Europe's southern border does not start at the Mediterranean coast, but somewhere in the middle of the Saharan Desert - so it has been for centuries and so it will continue to be - a body of water is a conduit for movement of goods and people, not a barrier. As much of that territory is in various stages of unraveling and parts are in all out freefall into chaos, it will be a continuous source of uncertainty & challenges.

People will always seek to improve the conditions for their family and try to escape real danger. As such Europe will have to face this reality and start the long path of unwinding a long and troubled history in the **MENA** region, 'lines in the sand' drawn up by pompous Europeans of yesteryear will need to be reassessed with the local populations in the driving seat, economic opportunities will need to be created so that viable societies can be established, where positive developments are taking place, real long term support must be provided. The borderlands on all sides will continue to be problematic but also full of opportunity.

On the global stage Europe and its business community will continue to be pragmatic and do deals with all comers, that will increasingly open up the world for commerce while still paying more attention to things like the environment & consumer protections than what is currently the case within the other major blocks of the global economy. Europe will continue to produce high quality goods & its people will continue to be consumers of the world's goods at a high level.

Europeans will continue to live local lives in a larger European and global context and increasingly the nation state will be less and less important to most beyond the arena of sports. For historic reasons this will be less pronounced in the East - Especially Poland & Hungary - & it will cause some ongoing schisms. People from all over the world will continue to come and visit its great cities and natural wonders and be frustrated with the slow service and rude waiters but the food, the wine and the culture will go some way to make up for it.

**Europe is not going anywhere fast**, but that is natural for this relatively small ancient overpopulated landmass. That is properly for the best anyway. Historically when Europeans has 'gone anywhere fast' it has normally led to major genocide and appropriation of parts of the world and their treasures and on occasion some major steps in the evolution of 'the wheels of commerce' and 'the structures of everyday life.'

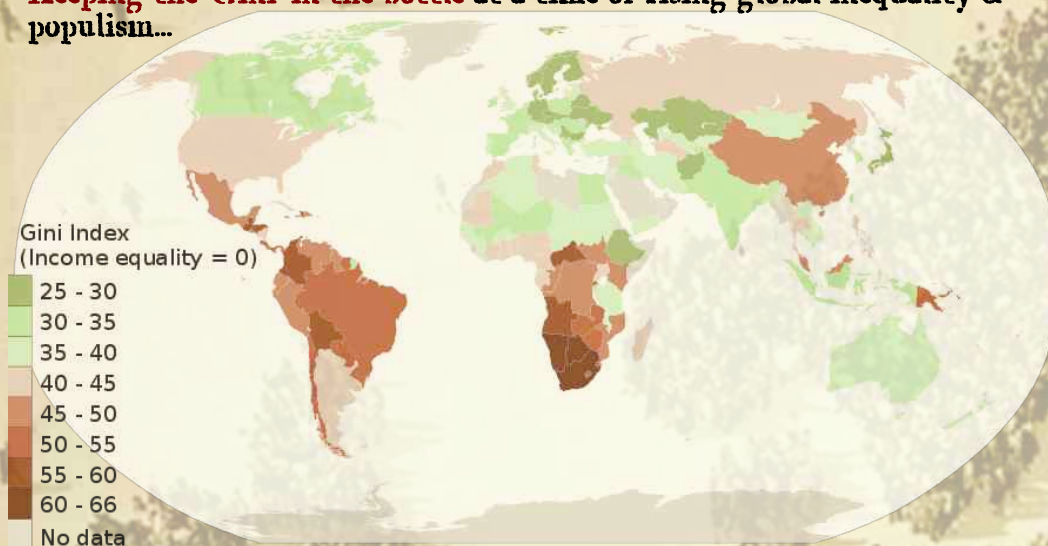
Investors should see Europe for what it is - a mixed basket(case on occasion) with diverse opportunities and a mature set of economies with 'long term greedy' businesses, a slow moving bureaucracy, the rule of law, not man, innovative yet practical, a little something for everyone's tastes can be found - and act accordingly.

**"If Europe were once united in the sharing of its common inheritance, there would be no limit to the prosperity and glory which its three or four hundred million people would enjoy... We must build a kind of United States of Europe."** - Winston Churchill



## VISUAL ADDENDUM TO PAGE 3: EUROPE:

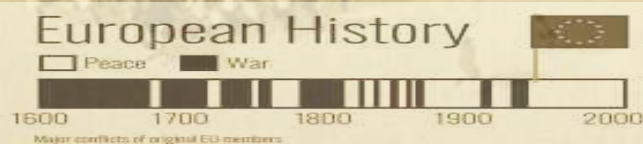
**Keeping the 'Gini' in the bottle at a time of rising global inequality & populism...**



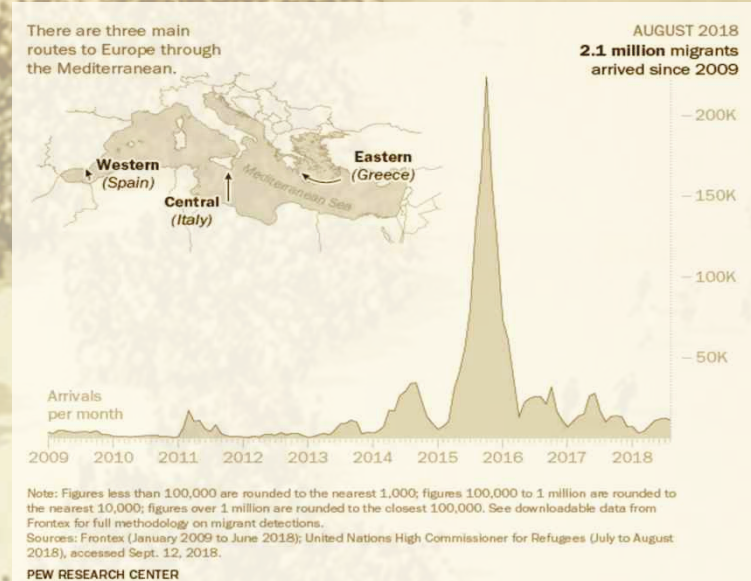
**Grey Europe...Ageing like a good bottle of wine or heading for a retirement bottleneck?**



**Moving away from its 'normal state' & finding a foundation for peace or just the interlude?**

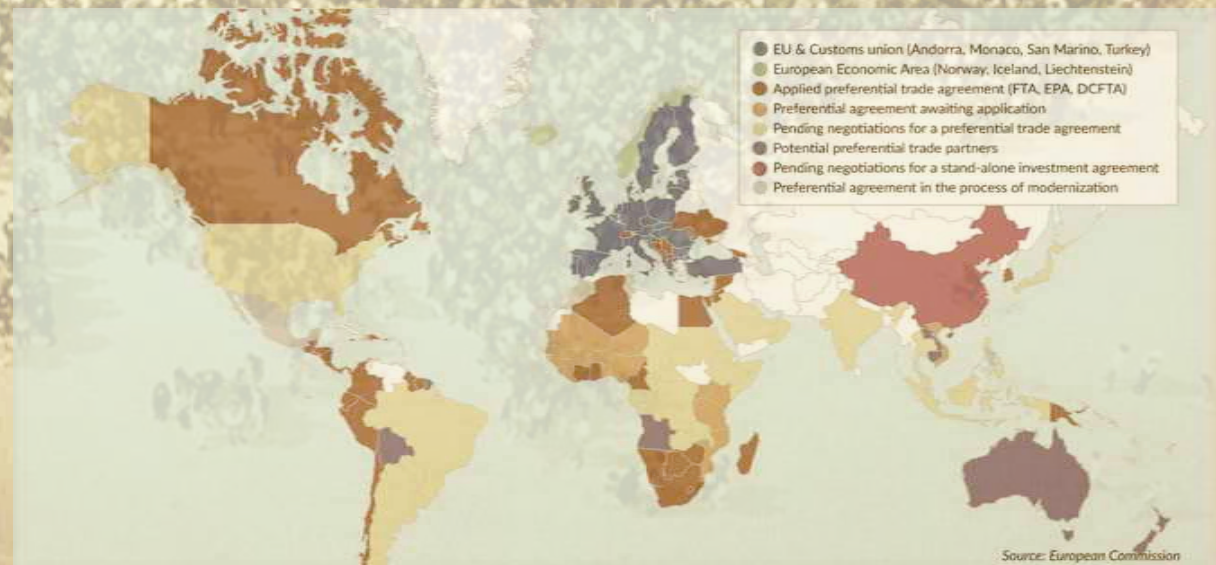


**Welcome to Club Med...**



**"You have to understand that no one puts their children on a tiny boat unless the water is safer than the land." – Warsan Shire, poet, author, immigrant.**

**EU Trade Agreements – Moving along with its ambition to secure free-trade agreements with the whole world...**





## THE UK: TIME TO GET REAL...

In our ATWI8P report from Q4 2017 we wrote the following:

**"The UK increasingly resembles a remix of Monty Python, Mr. Bean & Fawlty Towers skids. The vague mission to "take back control" is well and truly off course, with the politics looking more and more desperate and downright incompetent.**

**The business community and the City must be pulling out their hair as the politicians flail from one blunder to another. (...) We are being told that "Brexit means Brexit" but not much else, the process resembles a faith-based initiative where voters was given wildly unrealistic expectations of the utopia ahead. The clash with the granular realities has been a crude awakening as negotiations started in earnest.**

**Many Britons backed Brexit because they wanted to cut immigration and regain sovereignty, but they did not vote to make themselves poorer and for their children and grandchildren to be worse off. The UK GDP growth is expected to be amongst the lowest in Europe and across the rest of the advanced economies in 2018.**

**In the seminal 'Extraordinary Popular Delusions & the Madness of Crowds by C. Mackay he states: "People, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, one by one." As realities are dawning on an incredulous public, serious questions about the path chosen on that infamous day in June 2016 are surfacing. There are some signs that 'one by one' larger swaths of the public are seeking clarity and a different path as for the politicians they still seem to be engaged in a comical panto rendition of 'Game of Thrones' and flailing from one disaster to the next."**

We followed up on that in our ATWI8P report in Q1 2018 with the following observations:

**"The UK is like a rudderless vessel drifting around at sea with the crew in a drunken argument below deck, while the captain and the officers have locked themselves in the captain's cabin arguing over who's fault it all is and trying to chart a path forward using a map drawn by someone who has never left the shore.**

**In the past we highlighted the fact that the Northern Ireland issue could not just be swept under the carpet just because it was inconvenient, and as to our expectations the issue is back in the headlines in Q1 with no realistic proposal in sight. In the words of Ayn Rand: "You can avoid reality, but you cannot avoid the consequences of avoiding reality." This issue will not go away and will bring significant practical, political & economic challenges. It is also worth keeping an eye on the issue of Gibraltar, which remains dry tinder for a flare up."**

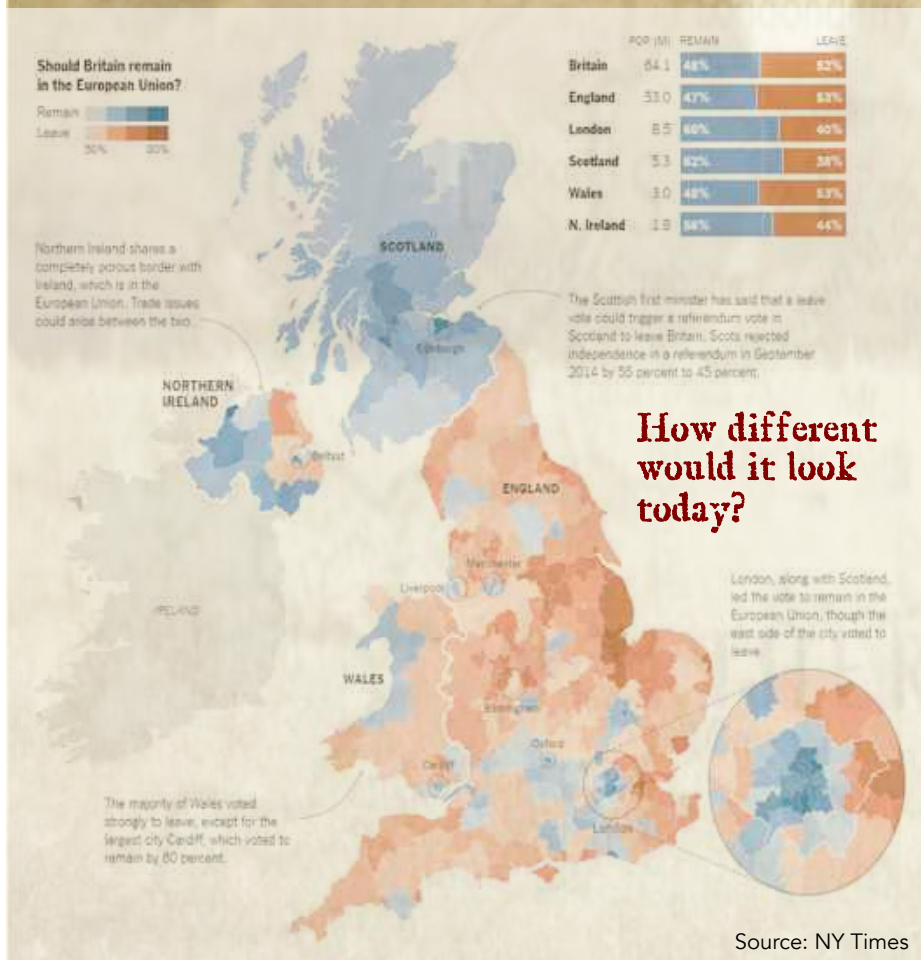
**As we enter Q4 of 2018 it is perhaps most telling that all these observations could be made again today – nothing has really been achieved and as Prime Minister May recoils from another European misadventure in Salzburg and returns home to her mutinous gaggle of aloof cohorts we seem to be heading over the cliff without a parachute. As I write this the SNP has issued a statement that it supports a 2<sup>nd</sup> vote & that it would seek an independence vote if the Brexit deal is enacted against the wishes of the majority of Scottish voters. Complex matters & yet the leadership is still mainly sloganeering.**

**There is an incredible vacuum of able leadership in both the major parties that borders almost on the incomprehensible, considering the history of this great nation. If ever there was a time for a visionary, driven, pragmatic leader to form a competent group and establish a new party, surely now is the most opportune time for the dramatic change required to shake the place from its stupor and build real broad support for a vision that addresses the concerns for the future expressed in the June 2016 vote while balancing realities of the world we inhabit & Britain's role in it. As Investors we see weakness in the GBP as an opportunity to buy global companies in select sectors on the LSE at a discount, the same goes for RE/CRE in London & the major university towns like Cambridge & Oxford.**



## VISUAL ADDENDUM TO PAGE 4: EUROPE: THE UK:

### How Britain voted in the 2016 EU Referendum:



**How different would it look today?**

**"There is an overwhelming perception that the Brexit negotiations are not turning out well. In our most recent tracker 73% of the public thought the negotiations were going badly, including majorities of both Remainers & Leavers, and both Tory & Labour supporters. Only 22% of people now think that it is likely that a deal will be struck in time for Britain to leave the EU in March 2019." - Sept. 2018 YouGov Survey**



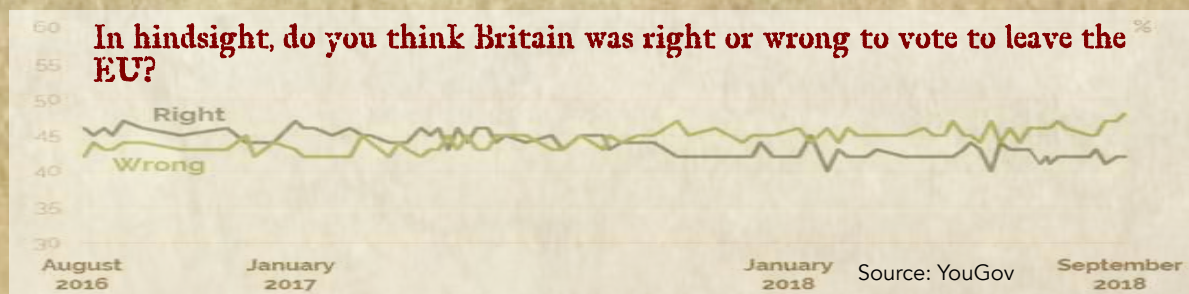
**"The informal Salzburg summit has driven home the bitter truth behind the Brexit saga. It has become un-negotiable. Mrs. May now has a constitutional duty to admit that truth. There is no positive outcome that is equally acceptable to the EU and to the UK.**

**"The British people, who voted in a narrow majority to leave the EU, were misinformed & misled in fundamentally devious ways by the Brexiters." President Macron stated this baldly and he is right. The Leavers had no idea what they were getting the country into and the overwhelming majority of the voters would have been incapable of outlining how they saw things developing during and after the negotiations on exiting.**

**They did not know the difference between a "hard" or a "soft" Brexit. They had no information about the relative merits and demerits of the "EEA model" as opposed to the "Canada model" or the "no deal model" or indeed any other exit model. In short, the electorate was sold a myth.**

**They were sold that myth by a handful of ideologues and careerists who had no clearer idea than the voters themselves about what Brexit actually involved."**

**- Professor J. Howorth of the University of Bath.**





## THE VIEW FROM THE MENA REGION: IRAQ

A look at **THE WATER ISSUE** - Seen through the situation in Iraq, which provides a telling example of all the related dynamics for the entire region.

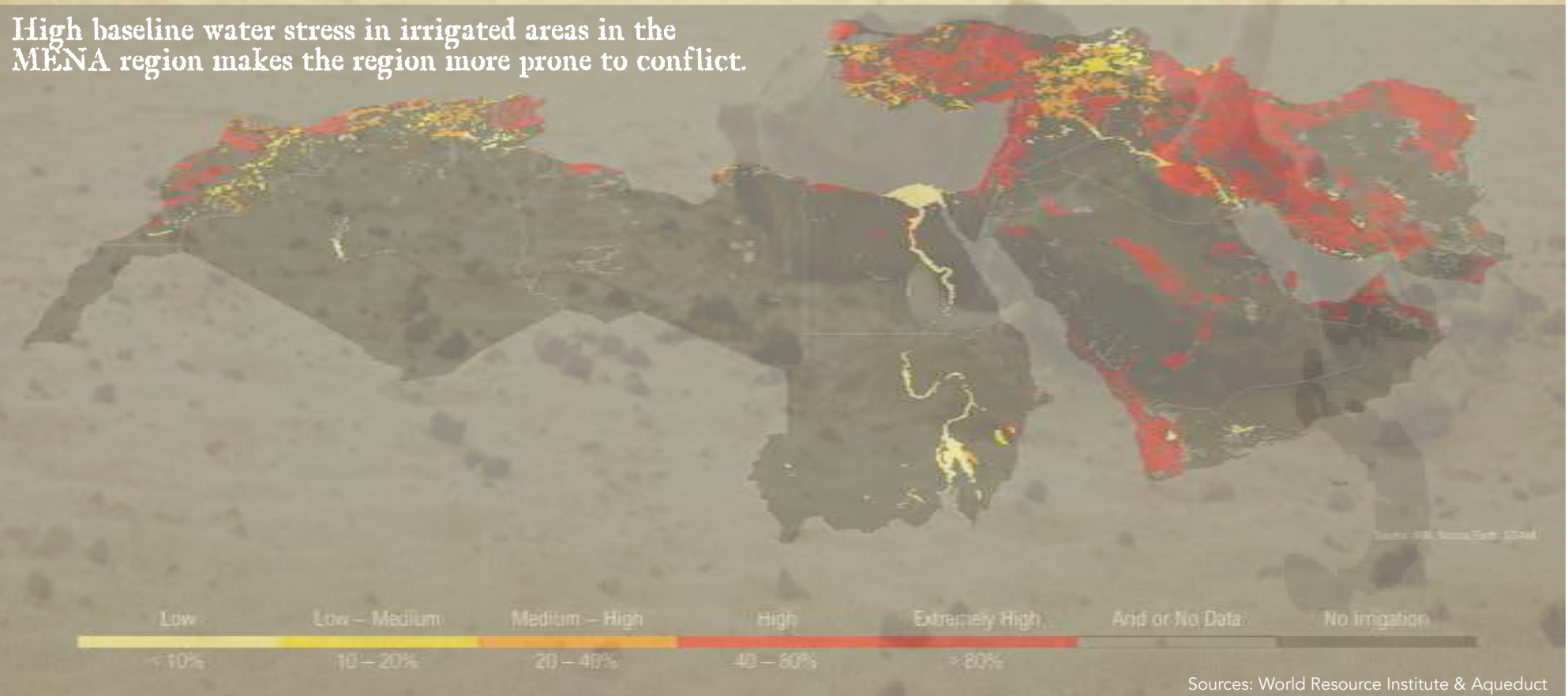
It is hard to imagine life without access to sufficient quantities of fresh water, but in some parts of the world, particularly the Middle East, that is becoming more than a theoretically disturbing possibility, as climate change, mass migration, environmental degradation, drought and political instability - among other issues - make the use and management of diminishing water resources an increasing challenge.

The Middle East & North Africa is the most water-scarce region in the world with 60% of the population having little or no access to sustainable drinkable water and over 70% of the region's GDP being exposed to high or very high water stress.

Water scarcity in the region involves multiple factors such as climate change leading to droughts and floods, low water quality, and poor water management in the context of fragility, conflict, and violence. This is one of the reasons why a WEF report from 2015, stated that the water crisis is "the greatest threat to the region, as it is the source of political instability and unemployment." In 2016, the World Bank estimated that MENA will lose 6-14% of its GDP because of water scarcity caused by climate change by 2050.

### MENA - IRRIGATION & WATER STRESS OVERVIEW

High baseline water stress in irrigated areas in the MENA region makes the region more prone to conflict.





## Iraq - The land between two rivers & a rock & a hard place...

The southern city of Basra was once known as the "Venice of the East" because of its freshwater canals, and Iraq itself is still known as the "Land Between the Two Rivers" - the Tigris and the Euphrates - which have nourished civilizations since antiquity.

**In reality Iraq is a water-strapped country.** Nearly two-thirds of its surface water originates outside its borders, leaving it vulnerable to the actions of upstream neighbors Turkey and Iran. The so-called Fertile Crescent has been steadily drying since 1931, with a significant decline in vegetation since 2008 and steep declines in groundwater between 2008 and today. Iraq has been suffering from drought since the 1970s but between 2007 and '09, 40% of its cropland experienced reduced crop coverage and livestock was decimated. During that same period large parts of the rural population abandoned their land seeking access to drinking water and a better livelihood in the urban centers, which was already struggling to manage services for their existing populations. The situation in 2018 is far more serious due to rising temperatures & population growth in Iraq.

The problems, however, are only likely to deteriorate further. Considering its lingering security challenges and political instability, Iraq won't be able to solve the current water crisis on its own, and its neighbors are unlikely to be forthcoming with much assistance.

**In life you get what you have the leverage to negotiate for and Iraq has little leverage, and what they do have is slipping away quickly, like sand between the fingers. Water and economic development are inseparable as is water and a functioning nation state. Water is ultimately very political in Iraq & across the region, just like its oil.**

For several years now, the region, and particularly Iraq, has been suffering from a dire water crisis, compounded by the decrease in water quantities from rivers flowing from upstream to downstream countries. Iraq has been severely affected by this; as there are no alternative sources of water commensurate with consumption. These factors are at the heart of the region's conflicts and are liable to explode at any time; especially after recent climatic and environmental changes; the scarcity of water in dams and rivers, and the lack of rainfall at a time of increasing demand stemming from increased consumption.

Upstream dams in Turkey, Syria and Iran have shrunk the rivers and their tributaries, seasonal rainfall has dropped and infrastructure has fallen into disrepair. The result is an acute lack of freshwater that has allowed a salty tide from the nearby Arabian Gulf to advance north from the Shatt Al Arab waterway - the confluence of the Tigris and the Euphrates that Basra residents depend on - and seep into once-lush farmland.

The sharing of water between the three countries (Iraq, Syria and Turkey) has been the subject of international treaties and protocols since 1920 - following Iraq and Syria's exit from the Ottoman Empire - including the "Lausanne Peace Treaty" signed between Turkey and the allies on 24 July 1923. The straight lines drawn in the sand by the British and French had little consideration for religious realities nor for 'trivial' matters such as viable fresh water supplies and the resulting ability to grow food for the populations of these newly minted nation states. Consider that the region has seen an explosion in its population since those days, and you have a completely dysfunctional framework of agreements & perhaps even borders.

Not that anyone is really following any agreements, whether its due to them being obsolete in nature or because in a tough neighborhood, Iraq has been weak and at various stages in complete disarray, with wars under Saddam Hussein against Iran and Kuwait, then the US-led invasions, 2006's sectarian tensions and the war against the Islamic State. This ongoing barrage has left all sectors of their economy severely damaged & the government in a weak negotiation position. Both Iran and Turkey have in recent years rerouted cross-border water sources they share with Iraq. Turkey started filling the Ilisu Dam - one of 22 dams and 19 power plants being built as part of their ambitious hydroelectric project - in March, earlier than the expected June 1 date agreed, which would have allowed more to flow before the agricultural growing season. Since then the level of water flowing into Iraq from Turkey has gone down by 50 per cent, the head of the Mosul dam said earlier this month. Turkey - having had to rely on its oil rich, but ironically water scarce, neighbors for its energy needs - believes that its water resources will provide it with a national wealth equivalent to that of the oil producing countries in the region. This is what former Turkish President Suleiman Demirel said at the opening ceremony of the Ataturk Dam: **"The waters of the Euphrates and Tigris are Turkish, and the sources of this water are Turkish resources."**



**A smoldering environmental disaster providing the spark to set the social tensions ablaze yet again...**

The unprecedented salinity, along with the lack of water and nearby oil operations, has eliminated 87% of the province's 20,000 square kilometers of arable land. The salinity has killed fish and cattle, and caused a dozen bird species to disappear from the area, the country is only able to farm 3-4 million hectares - about a third of its cultivable land - because of water shortages, soil salinity and political instability, according to the UN's Food and Agriculture Organization.

The increasingly erratic rainfall patterns across the region, has hit the country's agricultural and farming sectors hard. The prolonged reduction of water levels in rivers slashes electricity generation from hydroelectric dams, which, in turn, affects the water supply for agriculture and eventually forces the country to import more food than it already does. This poses a threat to food security, and results in an increase in the areas under desertification and salinity.

Iraq's Ministry of Water Resources, states that a particularly dry season and adverse regional water policies have left "Iraq with only enough water to irrigate half of its farmland this summer." Consequently, the government has now banned the plantation of summer crops, including corn and paddy rice cultivation. According to official estimates, one in five Iraqis are farmers. The depleting water levels in rivers have led to a big slash to both their production and income. A large number of people have migrated from rural areas to the cities as a result of the water shortages. The urban areas are imploding and unemployment is on the rise, Iraq's population growth, which has trebled over the last four decades - from about 10 million in 1980 to almost 37.5 million in 2016 – Which makes Iraq's current population growth rate about 15%, which is one of the highest in the world, is only set to exasperate these issues. **A hungry man with few economic opportunities is an angry man without much to lose, this is not a recipe for stability as history has provided proof of many times.**

The frustrations are real and the solutions appear insurmountable, even for a nation with a well functioning governance structure, which Iraq is as far from being as is possible. Much like its stagnating rivers and canals, Iraqi society has become a victim of a never-ending cycle of corruption with all its ills and secondary effects. There is no nation in the MENA region that is not affected by water scarcity with all the different issues Iraq is experiencing percolating just below the surface. Pay attention to Iraq and especially the Basra region for an indicator, as it's where the stresses are most pronounced currently.

**"They see that Iraq is dying, strangled by these parties that have been looting us for 15 years but who are more interested in serving Iranian interests than our interests. We either save the country or it will be lost."** – Ali, Protester in Basra

**"We are peaceful, but each of us sits on a warehouse of weapons. In 15 years 1 million Iraqis have been martyred. Had we held demonstrations early on and lost a thousand people we would be in a better place now."** – Haitham, protester in Basra



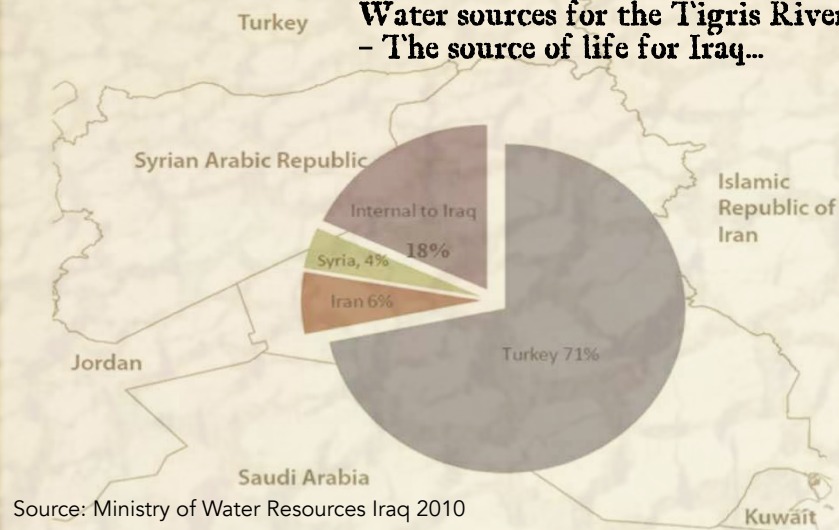
# VISUAL ADDENDUM TO PAGE 5: MENA & SUB-SAHARAN AFRICA: IRAQ

## Water-Related Diplomacy Between Iraq and Turkey

Because Iraq is a downstream country, Turkey has control over its water supply. The issue has created diplomatic tensions between the two countries throughout the past century.

	Event	Implication
1923	The Treaty of Lausanne breaks the Ottoman Empire's territory into separate countries; a few months later, Turkey becomes a republic	The treaty's terms stipulate that the newly established Syria, Iraq and Turkey form a commission to discuss water issues and require Iraq to inform Iraq of any planned infrastructure along the river. Political boundaries constrain water management politics in the Levant
1926	Iraq, Syria and Turkey sign their first nonbinding water-sharing agreement	The agreement states that Turkey, Syria and Iraq must equitably share the water of the Euphrates River but lacks reliable monitoring and enforcement mechanisms
1946	Iraqi King Faisal II and Turkish President Ismet Inonu sign a treaty regulating relations, including a protocol on the use of the Euphrates and Tigris rivers	Turkey begins to share some water-related data with Iraq
1953	Turkey establishes the General Directorate of State Hydraulic Works to administer dam construction	Turkey begins dam construction across the country, building some 673 large dams and 657 small dams by 2018
1970s	Turkey and Syria use water from the Euphrates River for large-scale irrigation projects	Political tension mounts between Turkey and Syria
1975	Turkey launches the Southeastern Anatolia Project, which includes 22 dams, 19 hydroelectric power plants and several irrigation projects	Some projects stoke tension between Turkey and Iraq, including the Keban Dam
1980	Iraq and Turkey establish the Joint Technical Committee on Regional Waters	Ankara and Baghdad further discuss the vague 1946 protocol, and Iraq complains about receiving less downstream water
1983-1990	Turkey builds the Ataturk Dam	Turkey agrees to maintain minimum flow to Iraq, but Iraq claims the volume is insufficient. The dam's filling causes alarm in Iraq
1990	Turkey and Iraq sign bilateral water-sharing agreement	Agreement is vague and downstream demands continue to increase and outpace even the loose agreement
2000	Iraq threatens to bring Turkey before an international tribunal for not obtaining its agreement before building dams that affect the Iraqi water supply	Because no international law requires Turkey to obtain Iraq's permission to dam any rivers, Ankara tries to smooth over its relationship with Iraq without changing its behavior
2004	The Iraqi Ministry of Water Resources raises its yearly budget from \$1 million to \$150 million	Iraq intends to build more efficient water infrastructure and encourage better domestic irrigation techniques with the expanded budget
2006	Turkey begins construction of the Ilisu Dam on the Tigris River	The dam will eventually produce 2% of Turkey's electricity, but the effect filling its reservoir, at 11 billion cubic meters, will have downstream on Iraq complicates Turkey's ability to fund the project with international investment
2014	As the Islamic State takes over portions of Iraq, it claims control of several strategic dams, including the Mosul Dam	Concern in the international community grows over the jihadist group's ability to use water as a tool to control and terrorize the Iraqi population
2018	Turkey begins filling the Ilisu Dam	Iraq's government complains that by filling the dam prior to the Turkish elections, Ankara is politicizing the process, which, Baghdad contends, could restrict its downstream water supply in the future

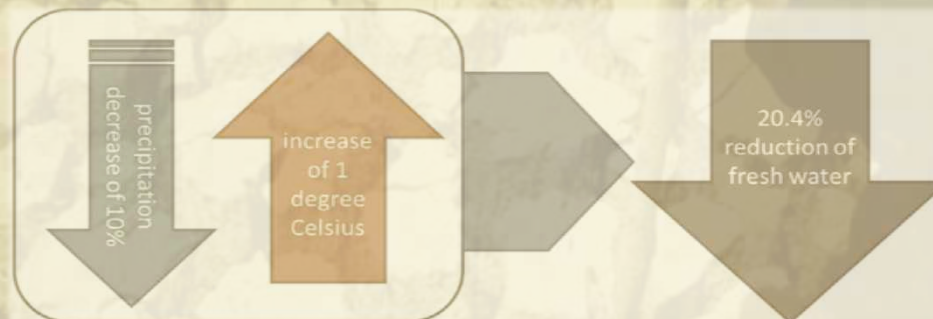
## Water sources for the Tigris River - The source of life for Iraq...



Source: Ministry of Water Resources Iraq 2010

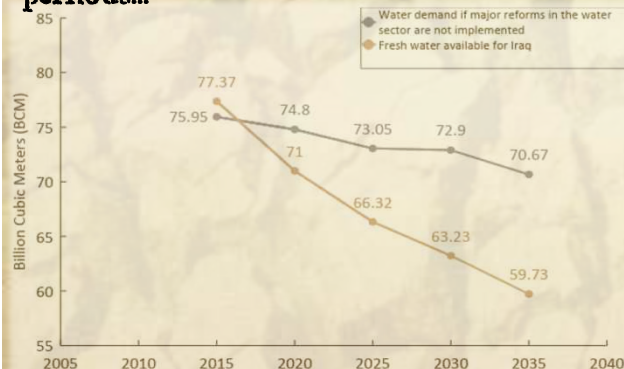
THE IRAQI MARSHES HAD BEEN REDUCED TO 10% OF THEIR HISTORIC SIZE BY THE YEAR 2000. THESE MARSHES WAS CRUCIAL COMPONENT OF IRRIGATION FOR FARMING AND PROVIDED UP TO 60% OF THE FISH CONSUMED IN IRAQ.

The devastating impact of global warming...  
(Impact of ambient temp. increase on reduction of freshwater.)



BASRA'S WATER CONTAINS 40,000 MILLIGRAMS OF TOTAL DISSOLVED SOLIDS - A MEASURE OF SALINITY - THE ACCEPTABLE LEVEL IS 2,400 -2,600.

Even with major reforms the path forward is perilous...



UP TO 98% OF IRAQ'S WATER ORIGINATES FROM NEIGHBORING COUNTRIES.

## Getting Salty...Iraq Soil Salinity

SEVERELY SALINE OF IRRIGATED AREAS	4%
MEDIUM SALINE	50%
SLIGHTLY SALINE	20%
TOTAL EFFECTED AREAS	74%

ONLY 1/3 OF IRAQ'S ARABLE LAND CAN BE FARMED NOW BECAUSE OF WATER SHORTAGES & SOIL SALINITY.

Sources: Iraq Energy Institute & Stratfor

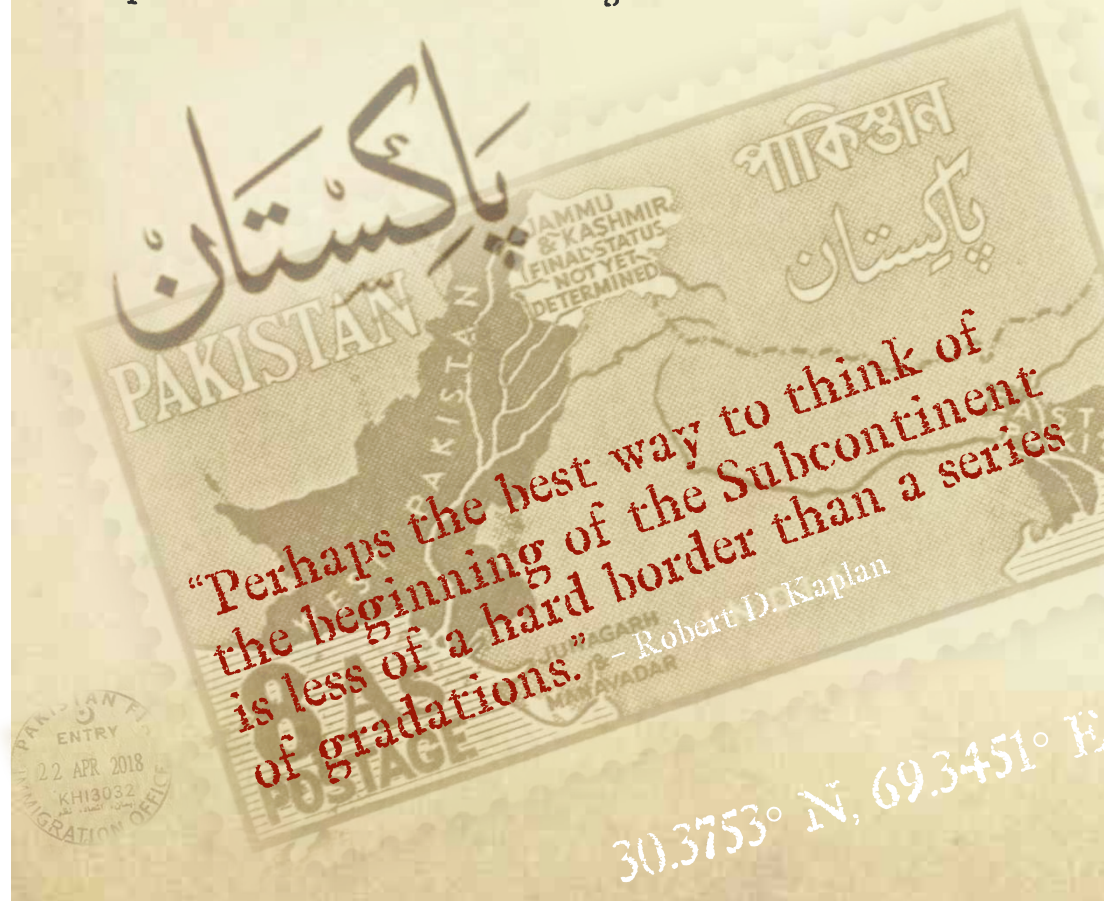
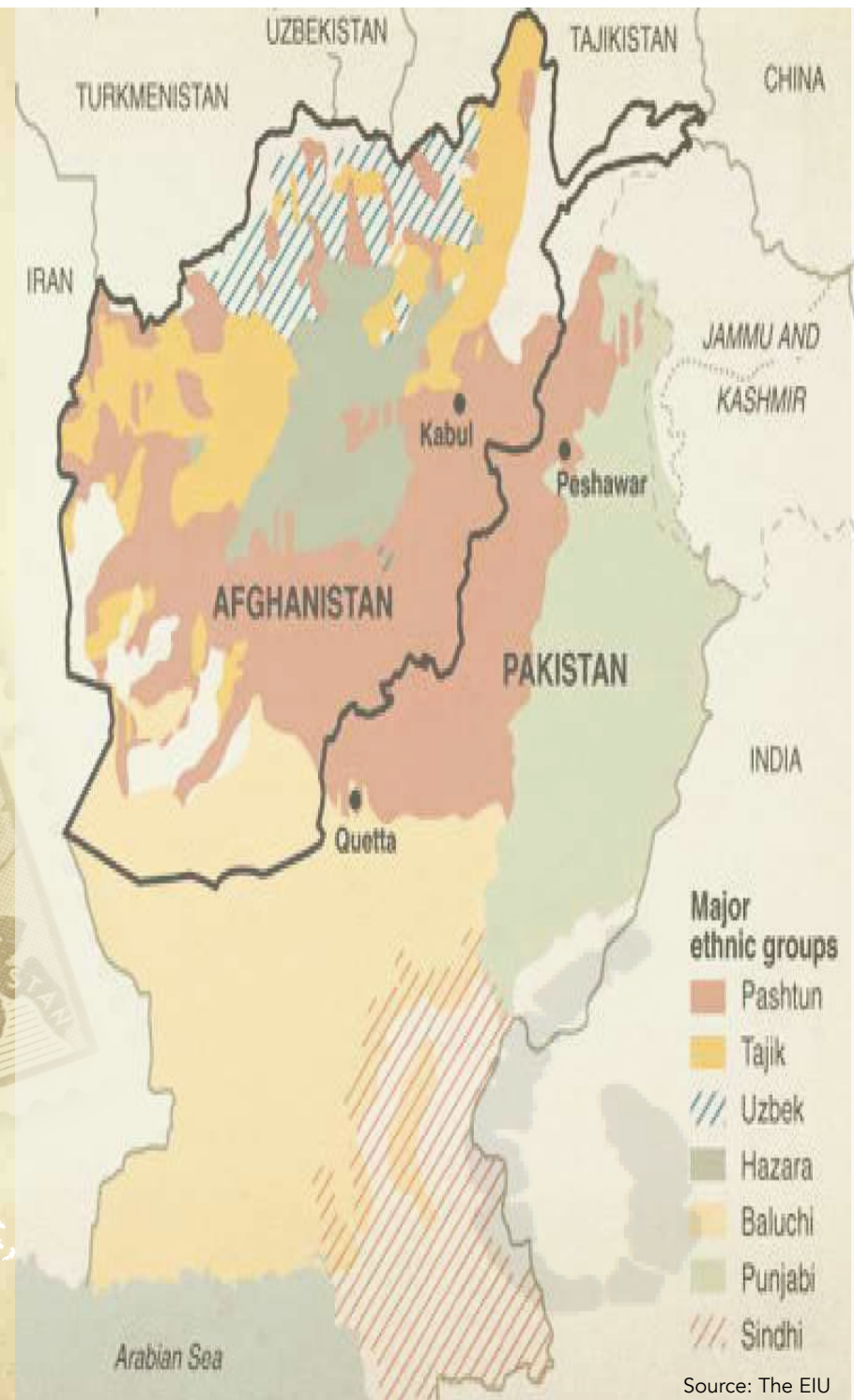


## THE VIEW FROM ASIA: PAKISTAN

The following insights are provided by our guest Sherpa, Mr. Chase Taylor, Founder of Pinecone Macro Research.

### PAKISTAN: LAND OF THE PURE

Pakistan as we know it began in 1947 as an independent homeland for India's Muslim population in South Asia. The country is home to over 200 million people, making Pakistan the sixth largest country in the world. The country is home to a multitude of ethnicities, all with their own language and culture. Ethnic and religious differences color much of Pakistan politics and culture and are important, but this analysis will focus on macro themes. Just know that no picture of Pakistan is complete without a solid understanding of those issues.





## The Economy: A rollercoaster ride with plenty of contrasts and potential.

Pakistan is South Asia's second-largest economy in a region that was the world's wealthiest for much of history. The country has been growing around 5%, which sounds solid but considering its population growth, it needs to grow faster. The country is growing at its fastest pace in a decade, but are in yet another debt crisis. Pakistan has one of the fastest growing middle classes in the world and this cohort is key to the future success of the country. The middle class could number 160 million by 2030.

Pakistan has had to devalue its currency four times this year. Currently the currency is down about 15% against the dollar in 2018. The emerging market (EM) country is currently in a debt, current account, and balance of payments nightmare. Like many EM nations, Pakistan took on too much foreign currency debt, but there are also systemic issues such as tax avoidance. Pakistan has over 200 million citizens and about 1% of them pay taxes. New Prime Minister Imran Khan has promised to tax the country's elite and fight corruption. Can he make good on these promises?

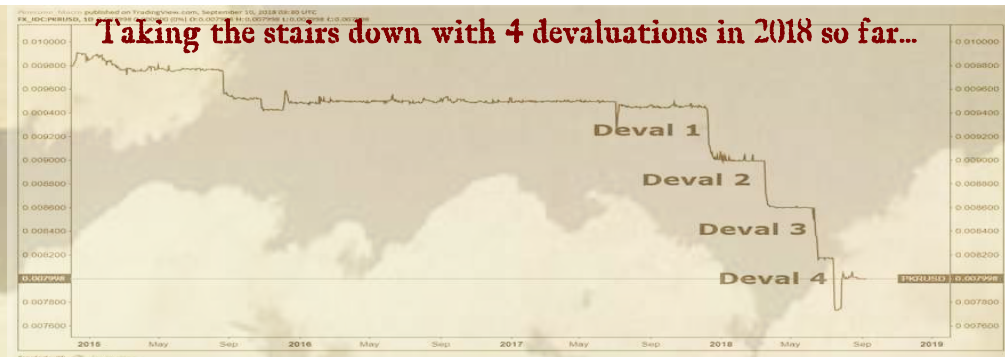
The current account gap has been spiraling over the past year with a \$3.7b trade deficit and external debt over 30% of GDP, which is a six year high. Pakistan has to work to increase tax collection and exports. The combination of a higher dollar and oil has been pressuring Islamabad despite the growth rate of the economy. Oil is currently threatening to break out of a 6 month rectangle pattern that could see a 10% push higher which would add pressure to Pakistan's finances.

Islamabad is likely to look to the Saudis, Chinese, and IMF for more bailout money. The IMF gave them \$6.6 billion in emergency cash less than two years ago and has bailed out Pakistan over a dozen times since 1980. Pakistan has already borrowed at least \$5 billion from China over the past year.

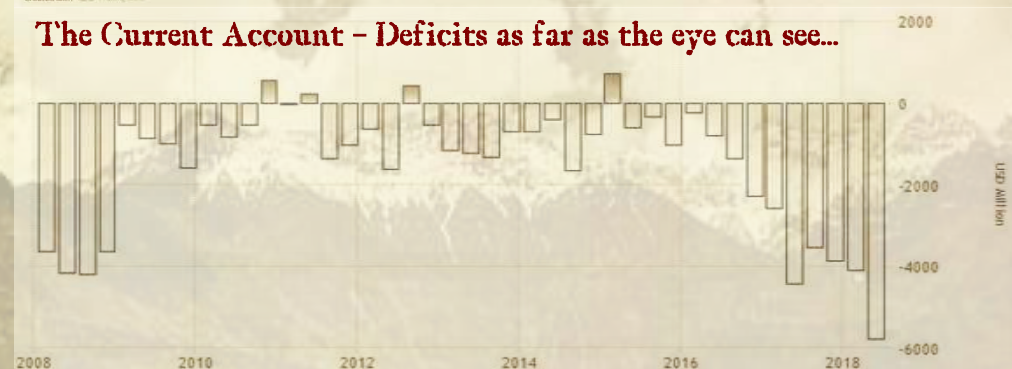
Islamabad must remove roadblocks for business. If Pakistan wishes to industrialize, they have to create conditions favorable for industrial companies. Pakistan ranked 147th out of 190 countries and regions in the World Bank's Ease of Doing Business 2018. Needless to say if dramatically improved, growth could ease serial debt issues.

Sources: TradingView, TradingEconomics & Bloomberg

## Taking the stairs down with 4 devaluations in 2018 so far...



## The Current Account - Deficits as far as the eye can see...



## The FX Reserves - A rapidly deflating safety cushion...



The USD reserves - The trend is NOT your friend...

Source: Bloomberg

Bloomberg



## A look at the current politics – Can Khan deliver?

It is easy to forget that Pakistan had its first successful democratic transition this century. Functioning democracy is still a new reality in Pakistan.

Imran Khan just capped a 20 year quest to become the prime minister. He was elected amid swirling rumors of military interference as Khan was considered to be the candidate of the military, who have largely run Pakistan politics (the parts that matter) for many years. Khan used overwhelming young and urban support looking to shake up the corrupt status quo. So far Khan has strayed from much of his populist rhetoric and has attempted to mend relationships with the US and India.

Khan has taken symbolic steps to change the ways of government. He sold a fleet of luxury government cars and helicopters (although he has controversially used one) and stripped officials of full meals at meetings. Rounding errors, but red meat to his populist base.

Khan's new finance minister Asad Umar has come clean about the budget and said the deficit may be as wide as 7.2% of GDP, much higher than the previous government admitted. Umar also said the government may need more than the widely reported \$12B to fund their external funding gap. As an analyst looking at developing countries, I value a government that can look at a situation with realism and clarity. So far Umar is taking a sober approach and investors should appreciate that. Umar turned a humble fertilizer company into a large conglomerate and is a respected businessman. Umar should give international investors hope.

## Navigating a difficult neighborhood...

**India** shares a 1,900 mile border with Pakistan and has been a bitter foe since Pakistan was created. The two nuclear powers have had wars, skirmishes (including fighting on a glacier at 22,000 feet), and share a tense relationship today.

Imran Khan has made significant attempts to engage in talks to ease tensions. However after India recently rejected talks, Khan lashed out and called India "arrogant." Chances are India and Pakistan will indeed hold talks – but only after elections in India next year. I am optimistic the two nations can make significant progress next year.

The roots of tension are from the British Empire folding and leaving the subcontinent after two exhausting world wars. The Brits left quickly and India and Pakistan's creation led to an extraordinary movement of people. Millions of Muslims fled India for Pakistan as millions of Hindus and Sikhs made their way to India. It was absolute chaos, full of panic, fear, and violence. Estimates suggest 15 million people were displaced and 1 million died in the violence that ensued. Pakistan only received 17% of the financial reserves of the pre-independent government. Pakistan has been playing catch up ever since.

I will only briefly discuss the complex issue of **Kashmir**. If India controlled Kashmir, Pakistan would lose their border with China and perhaps the power of their relationship with Beijing. This would also give India more access to Afghanistan and central Asia. If Pakistan controlled Kashmir, it would dramatically improve their water security which is a leverage point for India. Pakistan fully depends on water from the Indus River which runs through India controlled Kashmir. There is much more to Kashmir of course, but I wanted to highlight the strategic interests.

If you have ever wondered why Pakistan is so involved in **Afghanistan**, it is simply a vital part of potential war strategy, if India were to ever invade and march on Islamabad. It is a 250 mile, flat route into Islamabad, and the Pakistan military may need to retreat into the Pashtun/tribal regions of eastern Afghanistan. For this reason and others, Pakistan helped create and support the Taliban when it was cool (think American support during the Soviet war). Pakistan views their access and control of this region as a national security staple.



## China – The 'all weather friend' with big plans for a shared future...

Pakistan was the first country to establish formal diplomatic relations with the People's Republic of China and even helped facilitate Nixon's famous state visit to China.

Pakistan recently joined the Shanghai Cooperation Organization, which is a security organization founded in 2001 by China and Russia that will likely be in increasingly adversarial relations with NATO in the future. China hopes the membership of Pakistan and India will help resolve the differences between the two nations. Considering the recent moves by Pakistan showing a desire to repair relations with India, perhaps the new SCO membership will be transformative. Imran Khan made it known to India that "if India takes one step, Pakistan will take two." For now he must wait.

## CPEC – Crucial infrastructure, Trojan horse or a bit of both?

The \$62B China-Pakistan Economic Corridor (CPEC) is possibly the most important part of China's Belt and Road Initiative (BRI). CPEC includes ports, roads, rails, and power plants. Pakistan has a small industrial base and counts on agriculture for much of the country's output. Having reliable power is a prerequisite for a powerful industrial economy and with CPEC's focus on power (90% of funding), it could unleash an industrialization of Islamabad's economy. Lost in the big picture view of CPEC, is a fiber optic project that connects Pakistan to China with state of the art communication technology. Not only does this connect the two countries but it also connects with the Europe-Asia Terrestrial Cable Network. Unlike much of CPEC, the fiber optic project has already been completed.

In addition to CPEC and other economic partnerships between the countries, China is also cooperating heavily in defense. China is building eight new submarines for Pakistan. China has also recently launched remote sensing satellites for Pakistan and is building them JF-17 fighter jets, which will be the backbone of the Pakistan Air Force.

The Gwadar port is the face of CPEC, if not BRI. There are over a thousand workers already working at a large container terminal at the port. Pakistan does not envision an old fishing village with a shiny new port to push containers through, but a powerhouse industrial port city with LNG terminals, refineries, mills, and more. Despite this, the port has been called "unviable" in Foreign Affairs and compared to Sri Lanka's Hambantota port which has been a bust. Gwadar is also located in Baluchistan, a region that houses some fiercely independent Baluchis who occasionally use violence against the government. This port is a strategic imperative for China as it allows Beijing to bypass the Strait of Malacca which is an important chokepoint that could threaten Chinese economic growth.

Imran Khan has set up a committee to look over CPEC to sort out possible negotiations with China over issues Pakistan has with the deal. Officials have discussed taking things slower and extending timelines. Considering the ugly debt and balance of payment situation the country is facing, this may be a good idea for Islamabad. So far China seems open to renegotiating the deals, but have highlighted that once the infrastructure comes online, it will have an outsized positive economic impact.

This is a part of a larger story for China as Malaysia, Sri Lanka, and Myanmar are also fighting back on some of the BRI deals.

## The US – Best of 'frenemies'?

Pakistan is important to the US because of its strategic location in South Asia.

The US has depended on supply routes into Afghanistan from Pakistan to support the multi decade war effort. The war is currently a point of contention between Washington and Islamabad and the US has pulled aid over support for militants in Afghanistan.

The Pakistan Inter-Services Intelligence (ISI) has a long history of supporting the Taliban in Afghanistan. Pakistan was also added onto a global terrorist financing monitoring list this summer thanks to US pressure.

When Pakistan mentioned going to the IMF for another bailout, the US was very critical of the idea of China getting their loans made whole thanks to an IMF bailout.

Secretary of State Mike Pompeo who was the loudest critic, just assured Pakistan that Washington would not try and block the request on his visit to Islamabad in early September.

Pakistani Information Minister Fawad Chaudhry said the two countries "set many things straight" and reinvigorated ties on Pompeo's visit.



## THE OUTLOOK - A SEARCH FOR BALANCE...

Pakistan above all needs to create more balance.

The country is in desperate need of economic, political, and geopolitical balance.

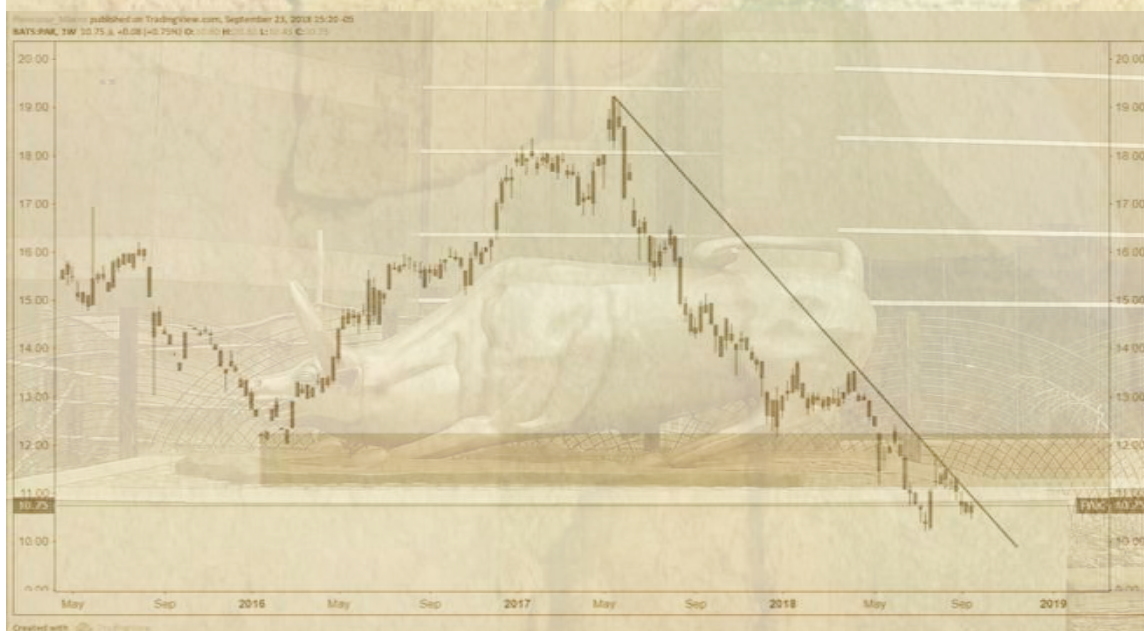
Pakistan has been growing at 5% since independence and has gone without a recession for decades, but has had over a dozen debt crises as well as constitutional crises. Balance of payments needs more – well – balance. External debts and FX reserves have to be managed more effectively. Trade must be managed in a sustainable manner.

There is little balance among important institutions in the country. The military holds key security and diplomatic power; countries like China are weary to negotiate important matters with even prime ministers for fear they cannot make lasting decisions. This young democracy must shift power from military to civilian institutions, and those institutions must deserve the shift.

Geopolitically Pakistan has long tried to balance complicated relationships with China, India, the US, and Saudi Arabia. These relationships hold a messy web of competing strategic interests, buffers, and counterweights which make balance challenging.

Saudi Arabia is set to become a large strategic investor in CPEC in what could become a grand economic partnership. Details will be worked out in early October. This creates a significant partnership between China, KSA, and Pakistan. This may be the boost Islamabad needs to go from debt crisis to a strong balanced economy via CPEC enabled industrialization and urbanization. This also moves KSA closer to China's sphere of influence.

China, India, and the US all need Pakistan's support against terrorism. Fighting terror may be the key to geopolitical balance. Progress against terrorists that threaten US, India, and Chinese interests in exchange for financial concessions could open significant doors. This must be done without giving up essential counterweights of course. If Pakistan can help end the Afghan war to get the US out and find a more concrete solution with India in Kashmir, the potential exists to rebalance ties with the world's powers in ways that benefit Pakistan.



**As an investor** I want to see progress made on the issues of balance I mentioned above and I want to see Khan keep some promises. Pakistan has a future that could be incredibly bright with a strong growing middle class, fading ethnic nationalism, newfound infrastructural strength, democracy finding its legs, and possible breakthroughs in strategic relationships in the region and in Eurasia at large. Keep an eye on these signposts and keep an eye on macro fundamentals such as the exchange rate, policy rates, and of course equity prices.

Using Global X MSCI (\$PAK) as my proxy, I am looking for the price to exit its down trend and clear the shaded area. As a technical analyst if I can marry that price action with an impressive fundamental/potential backdrop, I would be very interested in owning Pakistani assets. This country and this region hold enormous potential and carry strong tailwinds, unlike much of the developed world.



## VISUAL ADDENDUM TO PAGE 6: ASIA: PAKISTAN

### Reshaping Pakistan with Chinese investments

Projects within the framework of Belt and Road and the China-Pakistan Economic Corridor



**Security Assets dedicated by Pakistan to the protection of CPEC:**

**New Special Security Division: 9,000 Army soldiers & 6,000 Paramilitary forces personnel.**

**2,600 Police Officers. (Sindh province)**

**4,200 Police Officers (Khyber Pakhtunkwa province)**

**Special Protection Unit: 10,000 personnel (Punjab province)**

From 'Monsoon' by R.D. Kaplan: "...it struck me that whether Gwadar developed or not depended signally on how the government in Islamabad behaved. If it did not make a grand bargain with the Baluch of the scope that would isolate embittered men like the ones I met, then indeed the mega-project near the Iranian border could become another lost city in the sand, beset by local rebellion. (...) if it did make such a bargain (...) then the traditional fishing village that I saw could well give way to a pulsing Rotterdam of the Arabian sea, with tentacles reaching northward to Samarkand. BUT NOTHING WAS DESTINY."

Source: MERICS



The following is an exclusive extract from the latest book by our guest sherpa: **Mr. George Magnus**, titled '**RED FLAGS - WHY XI'S CHINA IS IN JEOPARDY**,' which is out in all good bookstores by the end of October & is a **MUST READ**.

CHINA

### **XI JINPING'S BELT AND ROAD: WIN-WIN, OR NATIONAL SELF INTEREST?**

Over 40 years ago, Mao Zedong assured an audience that the East Wind would prevail over the West Wind. He meant that the winds of change were shifting away from the 'imperialists' towards countries reclaiming or rebuilding their independence. President Xi Jinping's language today is different, but he too shares the view that the tide is now flowing to the East, and that China will dominate Asia, be prominent elsewhere, and set out its stall as an example for others to line up behind.

The centrepiece of this thinking is the so-called Belt and Road Initiative (BRI), a concept that Xi articulated first in 2013, and that has become, in effect, China's foreign policy. Most people know about the ancient caravan trails linking the old Chinese imperial capital of Xi'an to the Mediterranean. Xi's BRI is the modern day re-incarnation, including not just the 'Silk Road Economic Belt' across Eurasia, but also the 'Maritime Silk Road' connecting coastal China to the Indian Ocean and the Mediterranean. But what is the BRI exactly, and how should we think about it and its implications?

### **WHAT IS THE BRI?**

The **first** thing to note is that the BRI is actually geographically incoherent. Originally, it was about 65 states between the Ural Mountains and the Bering Straits, south of the Caucasus Mountains and east of the Bosphorus Strait and the Suez Canal, spanning most of Eurasia. But the BRI now extends, at least commercially, into Western Europe, Africa and Latin America. China has even outlined plans for a 'Polar Silk Road' in the Arctic, seeking access to Russia's back yard to take advantage of the thawing of Arctic ice caps to halve the shipping time to, say, Rotterdam, and exploit hydrocarbon and mineral resources.

**Second**, and least controversially, the BRI is a massive connectivity project comprising trade, policy co-ordination, financial links, people to people ties, but above all, networks of infrastructure projects involving the construction of transportation systems such as railways, highways, bridges and airports, energy facilities such as power plants and pipelines, and telecommunications capabilities.

For example, high speed rail links Jakarta to the textile hub of Bandung in central Java, China to Laos and Thailand, Addis Ababa to Djibouti, and Belgrade to Budapest. China has financed, or built, or taken control of major port facilities, for example Gwadar in Pakistan, Colombo Port City in Sri Lanka, and the Greek port of Piraeus. Other major projects include the construction of power stations in Pakistan along the China-Pakistan Economic Corridor, Vietnam, and Mongolia, and the rail network system linking the Pacific seaports of Eastern China and the Russian Far East to Europe, known as the New Eurasian Continental Bridge.

**Third**, a lot of numbers have been banded about to put a value on the BRI, most of which are inaccurate or double-count projects that pre-date the BRI. Some range up to \$5 trillion but Chinese officials have put a more modest tag on it, pledging to commit \$1 trillion over several years. Since nearly all of China's BRI involvement entails financing rather than direct investment, and the financial flows have been averaging about \$120 billion a year since 2015, China's more modest sums out to 2020 or 2025 seem more plausible. Just for perspective, the Asian Development Bank estimated in 2017 that 45 Asian nations needed to build about \$26 trillion of infrastructure by 2030, or annual expenditure of about \$1.7 trillion. Even a continuation of these flows from Chinese development banks, however, let alone any rise, is dependent on what happens to the credit capacity of their sovereign clients, and the state of the economy and the lending market at home, which is, of course many times bigger.



## BRI BENEFITS AND COSTS...

Because China is the hub of a huge regional and global production system, it needs to engage and participate globally in ways that protect and shape the environment in which Chinese business and trade function. It relies heavily on imported energy, raw material and food for its economy and citizens, and it depends on important supply chains for trade. It has also built up extensive investments abroad, and millions of Chinese either work, study or travel abroad. Breakneck economic development, moreover, has generated major inequality problems between rural and urban populations, and between poorer western and central provinces on the one hand, and the richer coastal provinces on the other. The BRI is designed to address all these issues.

It is also intended to help reboot Chinese manufacturing industries, and spur the development of newer industries, such as advanced manufacturing, high speed rail, telecommunications, and green energy, as well as promote Chinese brands.

The BRI is also expected to relieve the pressure on sluggish heavy industries suffering from excess capacity, notably coal and steel. Affected firms might export that excess output to BRI countries directly, or by moving the physical capacity itself into other countries. It is planned, for example, to migrate 20 million tonnes of Hebei province's large surplus steel capacity (as well as cement and plate glass) to Southeast Asia, Africa and Western Asia by 2023.

Yet, not all recipients of Chinese financing describe their involvement in the 'win-win' narrative that China professes. Unquestionably, many countries, especially poorer ones, benefit from new infrastructure construction and financing, but these may precisely be the sort of countries that may not be able economically, or politically, to absorb the sheer scale of China's excess capacity, keep corruption at bay, or do anything about below investment grade credit ratings in order to get access to additional important sources of finance, such as co-financing from official development agencies.

While Chinese financing for infrastructure is unquestionably welcomed in many places, more and more Chinese BRI projects are running into trouble. According to a study by the Washington consulting firm, RWR Advisory Group, 234 of a total of 1,674 projects in 66 BRI countries have run into either financial or political trouble in the last 5 years. The Centre for Global Development estimates that 23 nations are facing financial stress. Concerns over poor administration, weak governance, and Chinese political heavy-handedness have become widespread.

Recently, the Malaysian Prime Minister, Mahathir Mohamad, announced on a visit to China that he was cancelling two major Chinese-financed infrastructure projects. These projects, worth about \$23 billion, were deemed unaffordable and also figured in corruption investigations in Kuala Lumpur, centred around the previous Prime Minister. Mahathir also spoke, however, about 'a new version of colonialism', implicating implicitly his rather embarrassed hosts.

Pakistan, Nepal, Bangladesh and Myanmar are also among countries that have cancelled projects because of financial difficulties, or political interference. African countries acknowledge China as their biggest trade partner, but some are also uncomfortable about a China that extracts commodities and profits, runs persistent trade surpluses, and provides cheap exports and its own workers, both displacing local goods and workers. The Nairobi-Mombasa and Addis Ababa-Djibouti rail links are thought to have been chronically overpriced, and fiscally burdensome. The Bagamoyo port and special economic zone development north of Dar-Es-Salaam is expected to cost about \$10 billion, or about a fifth of Tanzania's GDP.

**Unsustainable debt problems** could easily result in appeals for financial assistance, as they have, for example, in Pakistan, and in colonial-type 'payment-in-kind' arrangements, including controlling stakes. Sri Lanka, for example, spends four-fifths of government revenues to service debt incurred to build over-capacity in new highways, a new international airport, now labeled the 'world's emptiest airport', and the deep-water port of Hambantota. Financially unviable, the port was in effect handed over to China in 2017, along with 15,000 acres of surrounding land.



## WORLD GAME-CHANGER?

If the economics of the BRI are nuanced, the geopolitics are crystal clear.

China has clear designs over the South China Sea, which carries about 30 per cent of global sea-borne trade, and comprises enormous fishing grounds that yield about 12 per cent of the world's annual catch. Six of China's largest 10 ports are on the East China Sea. These commercial interests have to be protected and it is consequently natural for China to aspire to be not just a naval, but also a maritime power. China wants to build warships and submarines to equip its navy, and is expanding its navy faster than any other country. But it also wants a whole range of military land, sea and even space-based assets, a coast guard, extensive port infrastructure, merchant shipping and fishing fleets, and a shipbuilding industry.

The quest to incorporate Taiwan into the Mainland aside, China wants to keep the US Pacific fleet as far away from China as possible with an immediate focus on the so-called 'first island chain', comprising islands off Russia's peninsula of Kamchatka down past Japan to Taiwan, and then to the Philippines and Malay peninsula. Eventually, we could imagine, China could seek to extend its naval influence further and perhaps as far away as Indonesia or even Australia.

The assertion of sovereignty over the seas, islands, rocks and reefs that fall inside the so-called 9-dash line, often to the chagrin of China's Asian neighbours, has resulted in substantial dredging projects to reclaim land on around a half dozen or so reefs and turn them into sea-based runways, ports and anti-aircraft and anti-missile battery systems.

China's maritime interests are not, of course, restricted to the South and East China Seas. The construction of and access to ports on the Arabian Sea and Indian Ocean, notably Gwadar in the Pakistani province of Baluchistan, gives China commercial and naval proximity to Oman and the Persian Gulf, which are a mere 240 miles away. This means China doesn't have to ship oil all the way around India, across the Indian Ocean and through the Straits of Malacca in South east Asia and then north to its eastern coast. The 550 mile long Straits of Malacca, which are 1.5 miles wide at the narrowest point and through which 80 per cent of China's sea-traded oil comes, are potentially a choke point on a 7,500 mile journey from the Gulf to say, Shanghai. Gwadar, moreover, offers the Chinese Indian Ocean fleet a perfectly situated naval base.

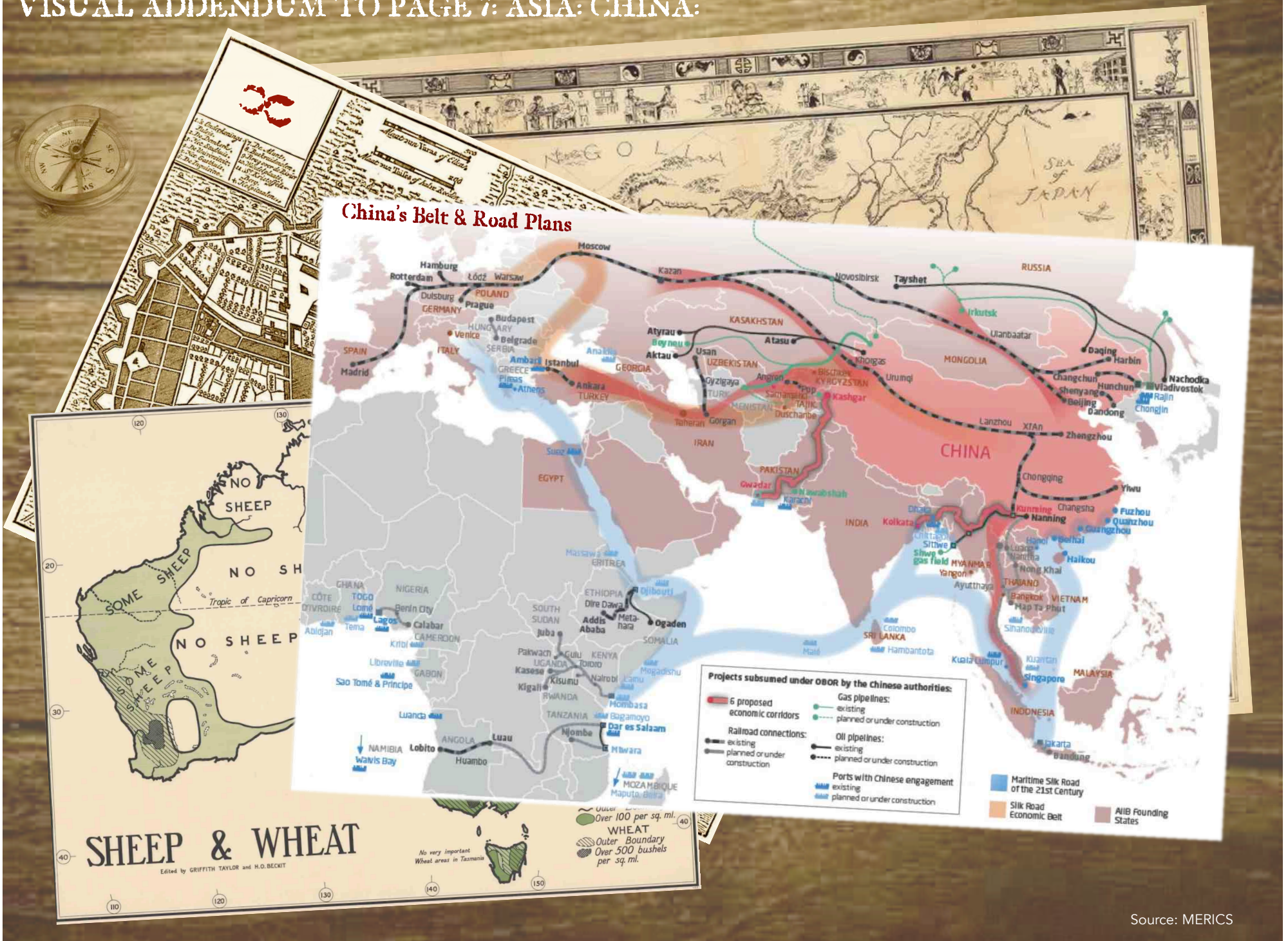
In China's narrative, the BRI may be a sort of 21st century reincarnation of ancient trading routes, but it has no historical precedent other than in rhetoric. The ambition to encircle India by land and sea is new. There never was a financial and resource exchange system for power, transportation and infrastructure development in central Asia, the Middle East, parts of Europe and Africa. And the formation of trade and security relationships designed to keep the US away from, or at least stifle its reach within Asia, is very modern.

China's approach to global engagement has unquestionably changed. Deng Xiaoping's urge for China to keep a low profile - 'hide your capacities, bide your time', - has given way to a new sense of entitlement, capability and ambition, and even a demand for deference and respect from others.

From our western bunker, the spectacle of a rising China with a seemingly unassailable and all powerful Xi Jinping at its head seems irresistible. It is as the Chinese narrative would have us think. Yet, we should remember that Henry Ford is reported to have said, 'When everything seems to be going against you, remember that the airplane takes off against the wind, not with it'. Just because the Communist Party and others say the BRI will change the world order and global economy, doesn't mean it will be so. The US, India, Japan, the EU and Australia, and many others may yet have something to say about this.



# VISUAL ADDENDUM TO PAGE 7: ASIA: CHINA:





## REFLECTIONS ON THE JOURNEY AS WE PREPARE TO DISMOUNT...

**REFLECTIONS FROM THE JOURNEY:** The geopolitical tectonic plates are grinding against each other and the friction is becoming more palpable as each day passes. The US is increasingly tied up in internal partisanship & petty score settling. The rest of the world is getting restless (Allies) or is feeling emboldened & thrust onto the stage (Competitors) & in this whole chaotic whirlwind, the roles are getting mixed up and more ambivalent. The reality of Lord Palmers observation: **"We have no eternal allies and we have no perpetual enemies. Only our interests are eternal and perpetual."** has well and truly set in. As the cogs of history turns, it will be time to watch out for those seemingly benign secondary effects that spring out of nowhere and lights a fire underneath it all. At times of change, it is the risks that mainly draw attention. But opportunity is also inherent.

**"TURNING AND TURNING IN THE WIDENING GYRE. THE FALCON CANNOT HEAR THE FALCONER; THINGS FALL APART; THE CENTRE CANNOT HOLD; MERE ANARCHY IS LOOSED UPON THE WORLD. THE BLOOD-DIMMED TIDE IS LOOSED, AND EVERYWHERE THE CEREMONY OF INNOCENCE IS DROWNED; THE BEST LACK ALL CONVICTION, WHILE THE WORST ARE FULL OF PASSIONATE INTENSITY."**  
- W.B. YEATS 1919.

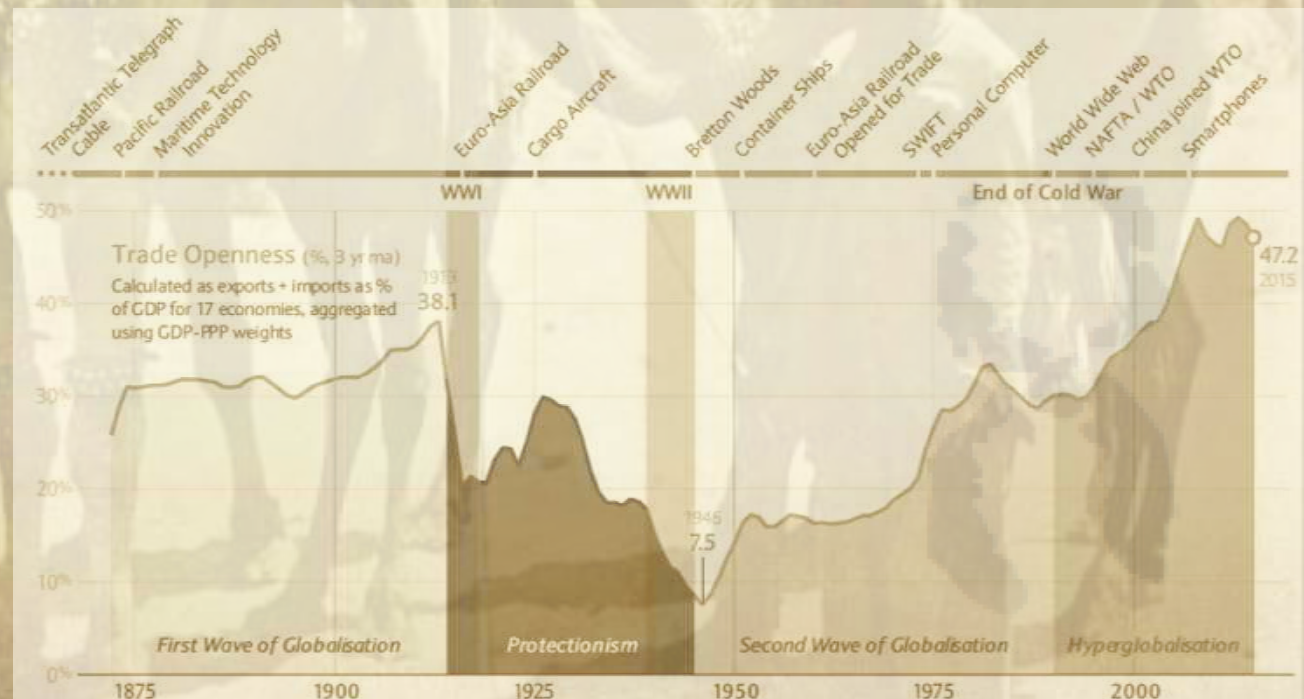
**"Our hands rest purposely on history's door and it depends on us to push it in the right direction."** - James B. Mattis.

## SOME GUIDANCE FROM THE THINKERS OF THE PAST:

**"Global war, as well as global peace, means that all fronts and all areas are interrelated. No matter how remote they are from each other, success or failure in one will have an immediate and determining effect on the others."**  
- N. Spykman

**"The remedy is for people to stop watching the ticker, listening to the radio, drinking bootleg gin, and dancing to jazz; forget the "new economics" and prosperity founded upon spending & gambling, and return to the old economics and prosperity based upon savings and working."**  
- T.W. Lamont, 1930

**Has the trend of ever growing trade & globalization reached a 'permanently high plateau' or has it become extended & set for a reverse?**





## SOURCES & INSPIRATION...

In the words of Sir Isaac Newton: **"If I have seen further it is by standing on the shoulders of Giants."** On this page we humbly show appreciation to those great individuals, source materials & books that provided us with the foundation for the insights shared in this report.

### SOME WRITTEN FOOD FOR THOUGHT FROM Q3:

Demographic turning points for the United States: Population projections for 2020 to 2060. – US Census Bureau.

Too little too late: Bankruptcy booms among older Americans. – NYT

The US Defense Budget in FY2019: Underlying Trends. – Anthony H. Cordesman CSIS.

The Demographics of Wealth 2018 Series: The bigger they are, the harder they fall: The decline of the white working class. – St. Louis FED

The Rise of Zombie Firms: Causes & Consequences. – BIS

Assessing & strengthening the manufacturing & defense industrial base & supply chain resiliency of the US. – DoD

War with China: Thinking through the unthinkable. – RAND Corp.

How Mediterranean migration paths to Europe have changed since 2009 – PEW Research.

Towards sustainable water resources management in Iraq. – Iraq Energy Institute

A decade after the global financial crisis: What has (and hasn't) changed? –McKinsey Global Institute.

Librarium Focus Series: Cyber Security Sector – Global Trends. –Librarium Associates.

The Big Hack: How China used a tiny chip to infiltrate Amazon & Apple – Bloomberg Businessweek

### GO FIND AND READ/REREAD:

THE TIMELESS & VERY RELEVANT BOOK:

THE RAVEN OF ZURICH: THE MEMOIRS OF FELIX SOMARY.

### LOOK OUT FOR:

GEORGE MAGNUS' NEW BOOK:

RED FLAGS: WHY XI'S CHINA IS IN JEOPARDY.

### A FINAL BIT OF WISDOM...

"I don't seek out others who will confirm my way of thinking, but rather strive to widen my point of view, so that I can attempt some conception of the entire interest of a country that is entirely independent of my own position."

– Mr. Felix Somary AKA The Raven of Zurich



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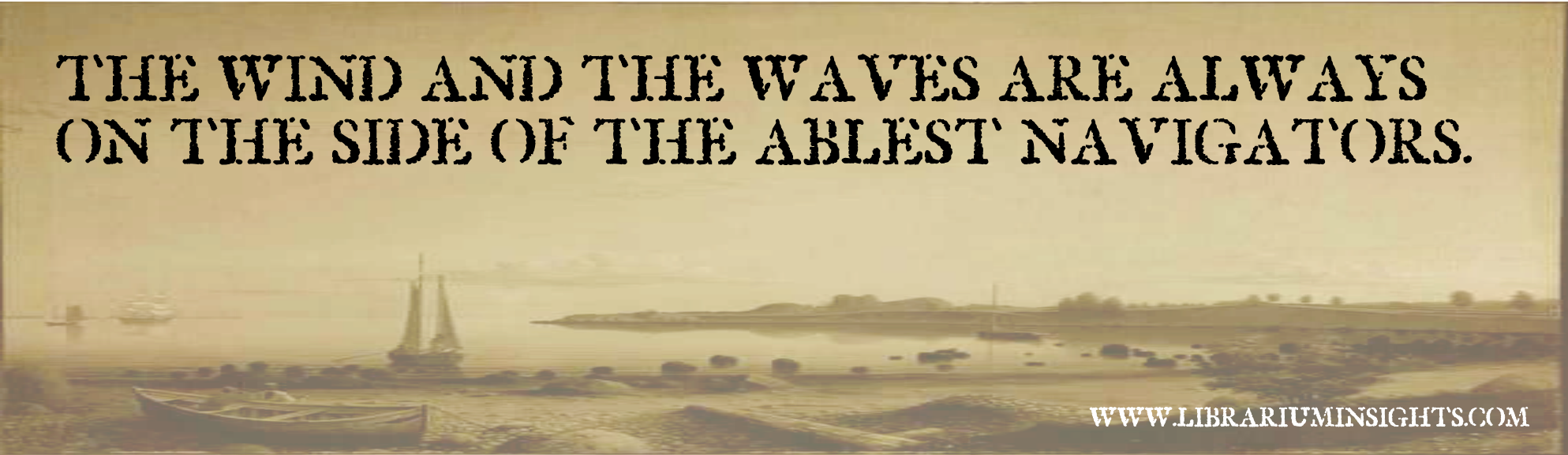
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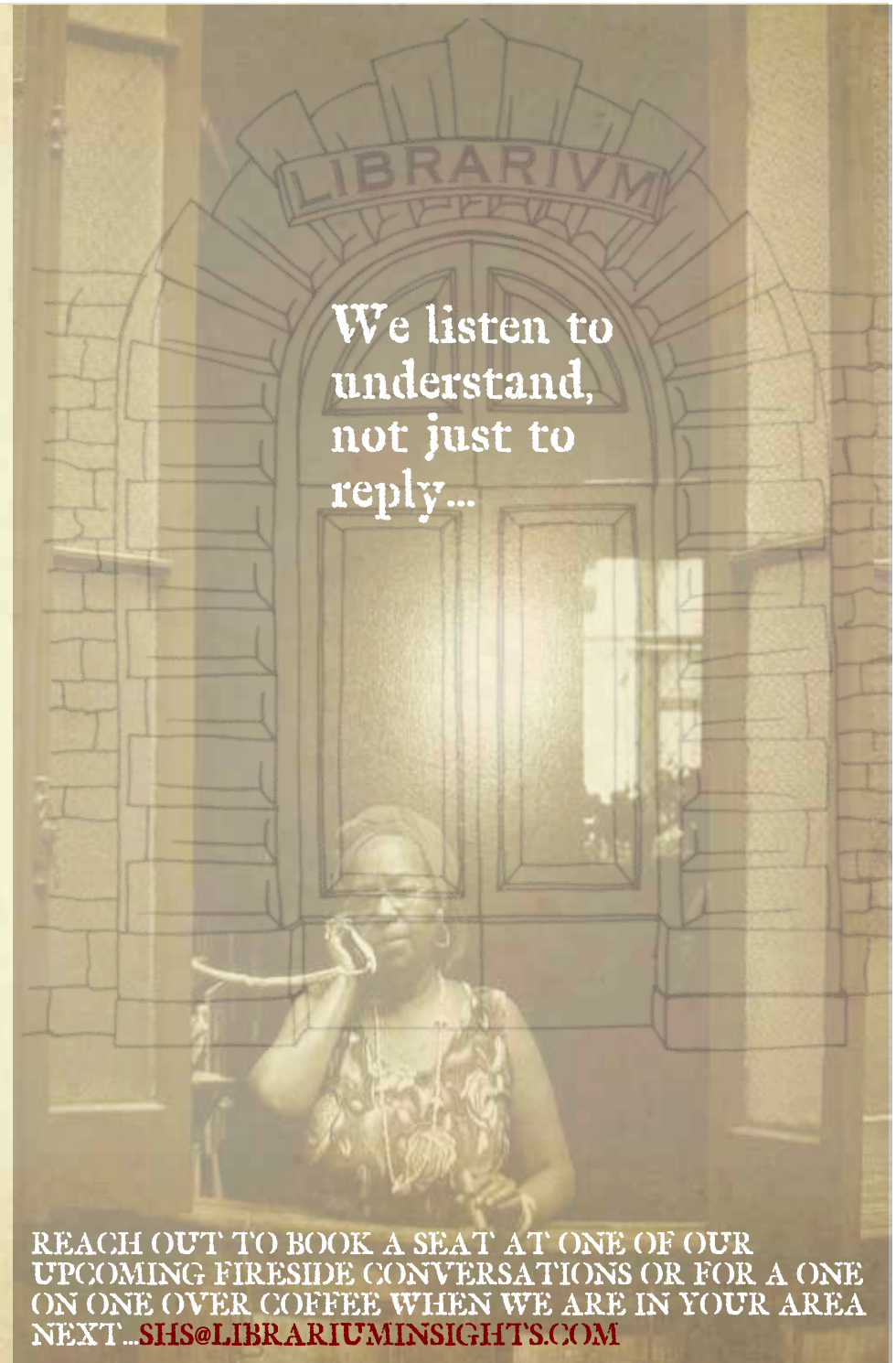
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