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April 2015

Multipolarity And Investing: Opportunities & Risks

Presentation to:
Washington Association Of Money Managers

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Geopolitical Strategy

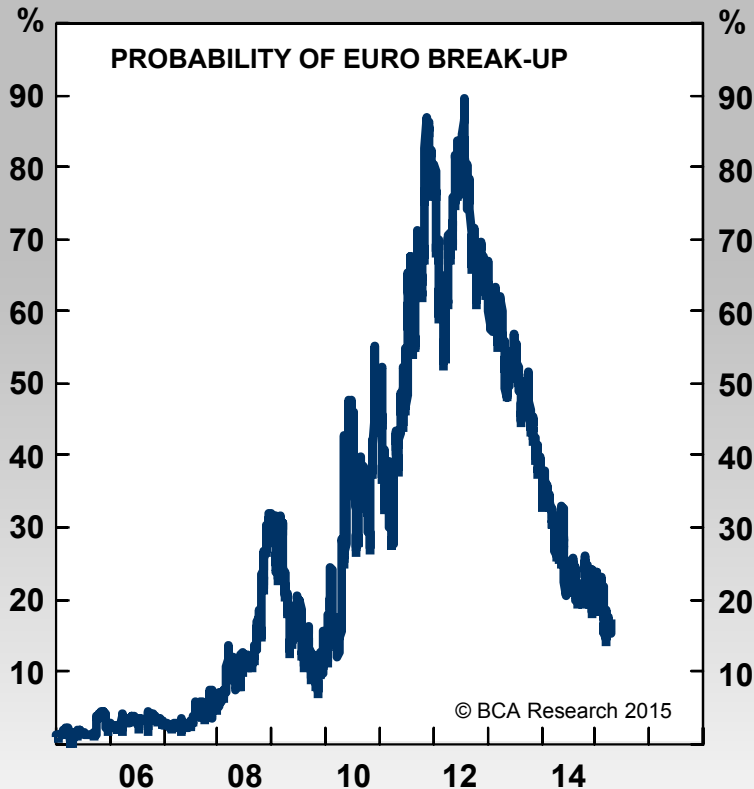
A Word On Methodology

For (geo)political analysis to be investment-relevant, it has to...

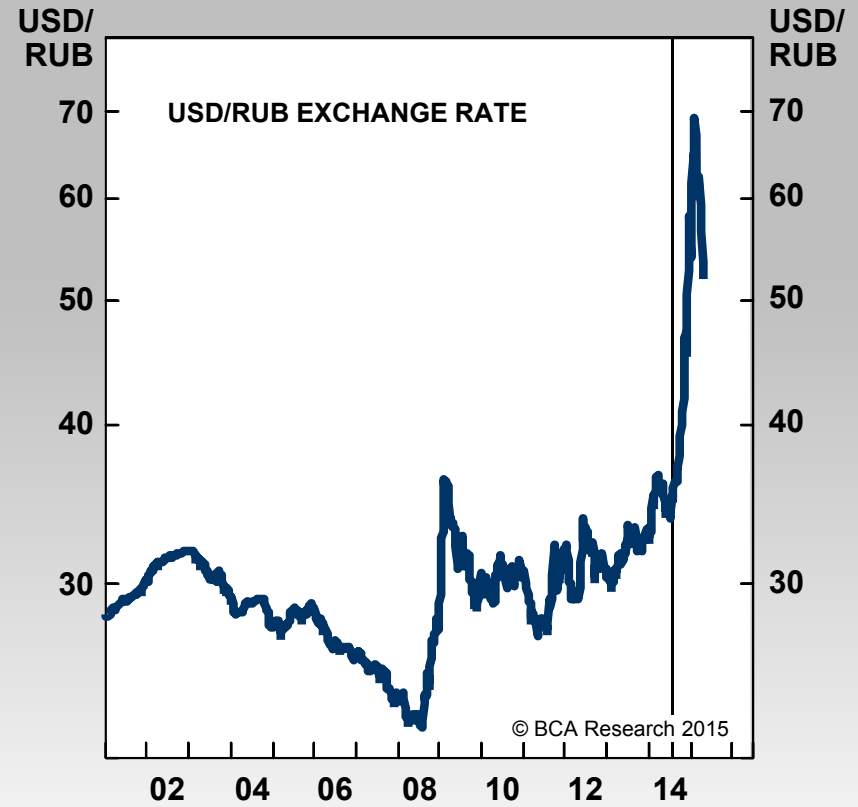
1. Examine policymaker **CONSTRAINTS**, not their **PREFERENCES**
2. Maintain risk-neutrality
3. Reveal endogenous (geo)political assumptions, not fixate on exogenous 'tail risks,' or as Mark Twain said:

*“It ain't what you don't know that gets you into trouble.
It's what you know for sure that just ain't so.”*

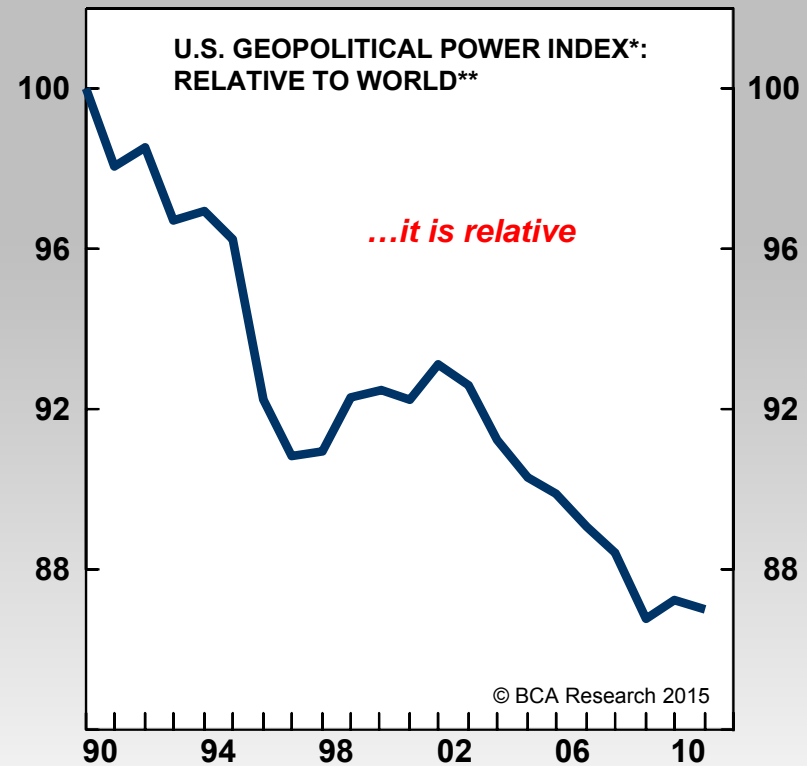
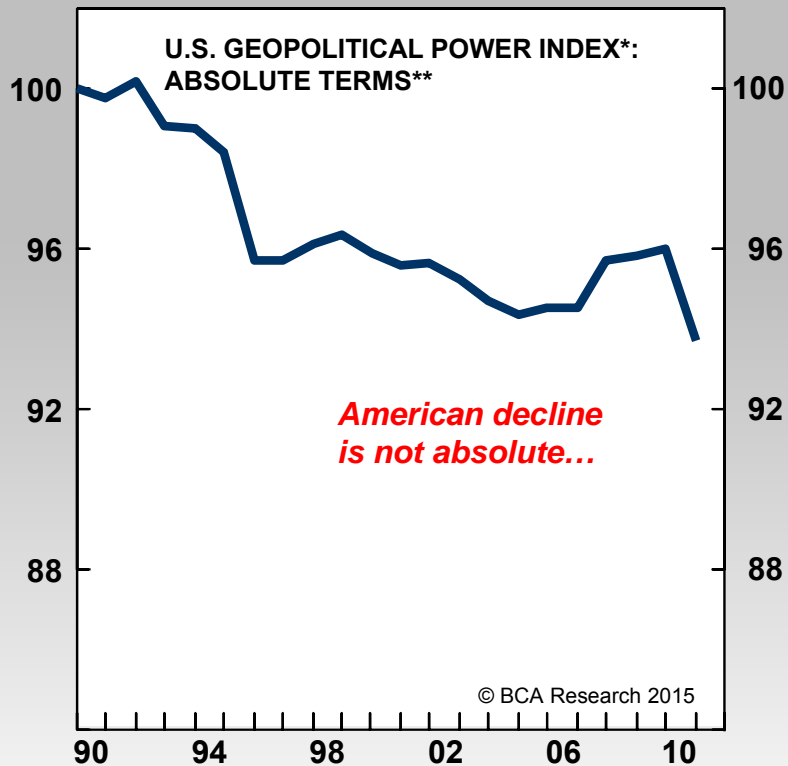
The Market Is A Poor Judge Of GPS Constraint Paradigm



DERIVED FROM ITALY / GERMANY AND SPAIN / GERMANY 5-YEAR YIELD SPREADS.



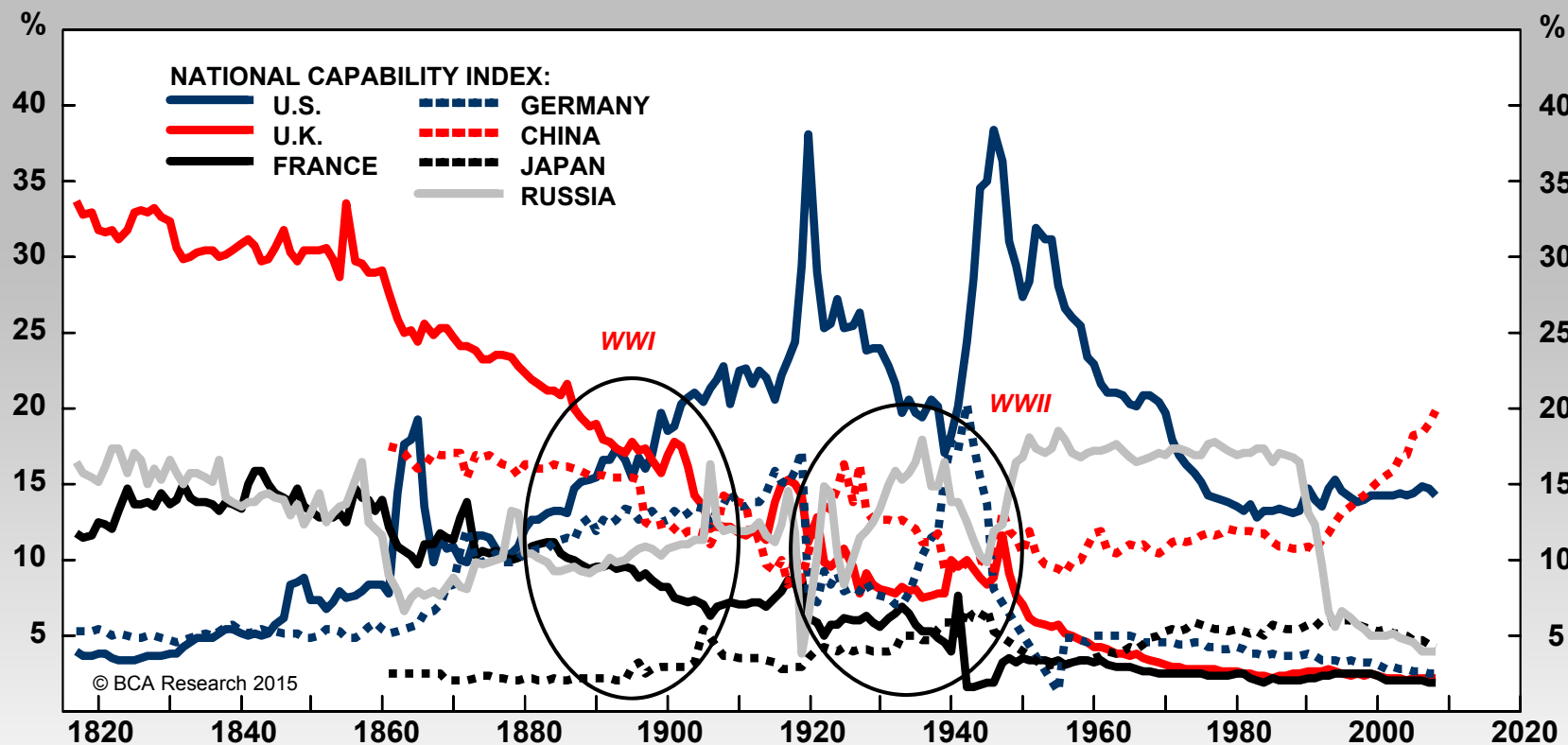
Welcome To Multipolarity



* THE GEOPOLITICAL POWER INDEX MEASURES A COUNTRY'S POWER BASED ON A WEIGHTED AGGREGATION OF ITS ECONOMIC, MILITARY, POLITICAL, TECHNOLOGICAL, AND GEOGRAPHICAL ENDOWMENTS. SOURCE: BCA CALCULATIONS.
 ** SHOWN REBASED TO 1990 = 100.

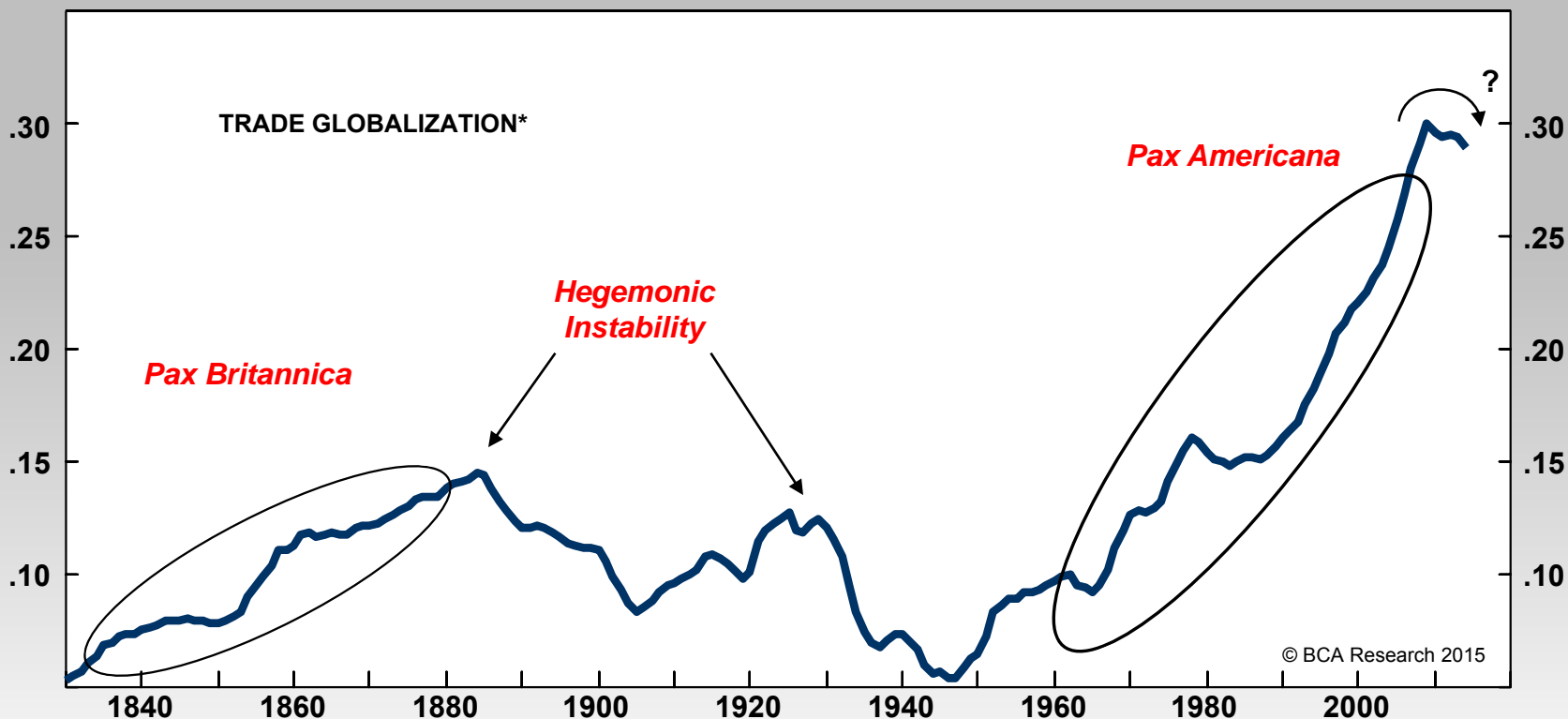
* THE GEOPOLITICAL POWER INDEX MEASURES A COUNTRY'S POWER BASED ON A WEIGHTED AGGREGATION OF ITS ECONOMIC, MILITARY, POLITICAL, TECHNOLOGICAL, AND GEOGRAPHICAL ENDOWMENTS. SOURCE: BCA CALCULATIONS.
 ** SHOWN REBASED TO 1990 = 100.

Multipolarity Is Messy And Dangerous



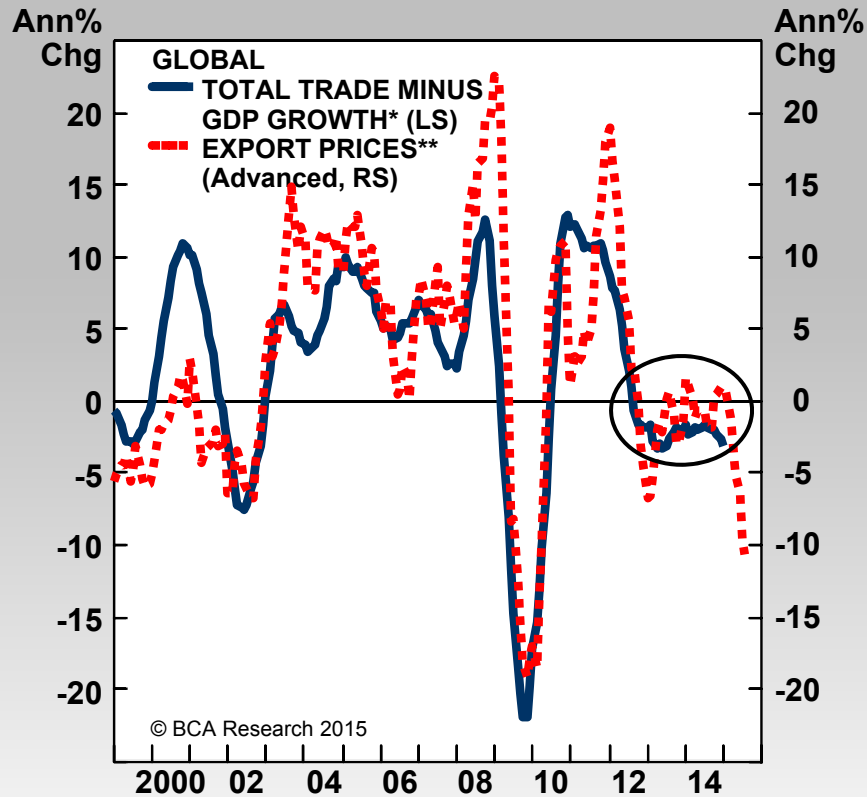
SOURCE: CORRELATES OF WAR DATABASE BY SINGER, BREMER, AND STUCKEY.
 THE NATIONAL CAPABILITY INDEX MEASURES THE MATERIAL CAPABILITY OF COUNTRIES IN THE FORM OF IRON AND STEEL PRODUCTION, MILITARY EXPENDITURES AND PERSONNEL, PRIMARY ENERGY CONSUMPTION, AND TOTAL AND URBAN POPULATION.

Multipolarity Will Erode Globalization

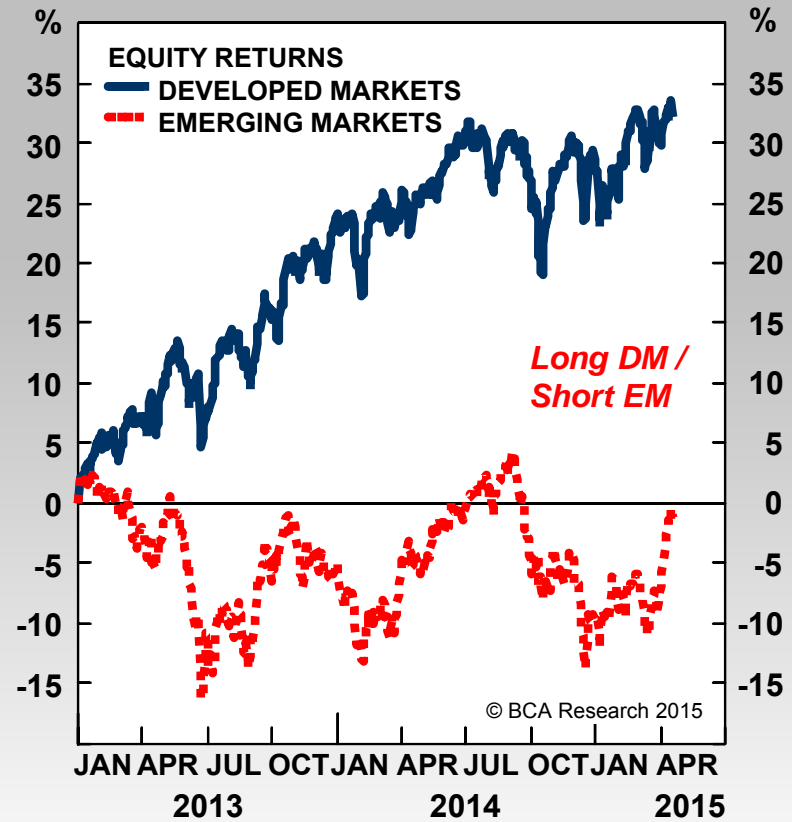


* TRADE GLOBALIZATION IS MEASURED BY IMPORTS AS PERCENTAGE OF GDP FOR 148 COUNTRIES WEIGHTED BY POPULATION.
SOURCE: BCA CALCULATIONS AND CHASE-DUNN C, KAWANO Y, AND BREWER B, "TRADE GLOBALIZATION SINCE 1975: WAVES OF INTEGRATION IN THE WORLD SYSTEM," AMERICAN SOCIOLOGICAL REVIEW 65 1, 2000.

Investment Conclusions

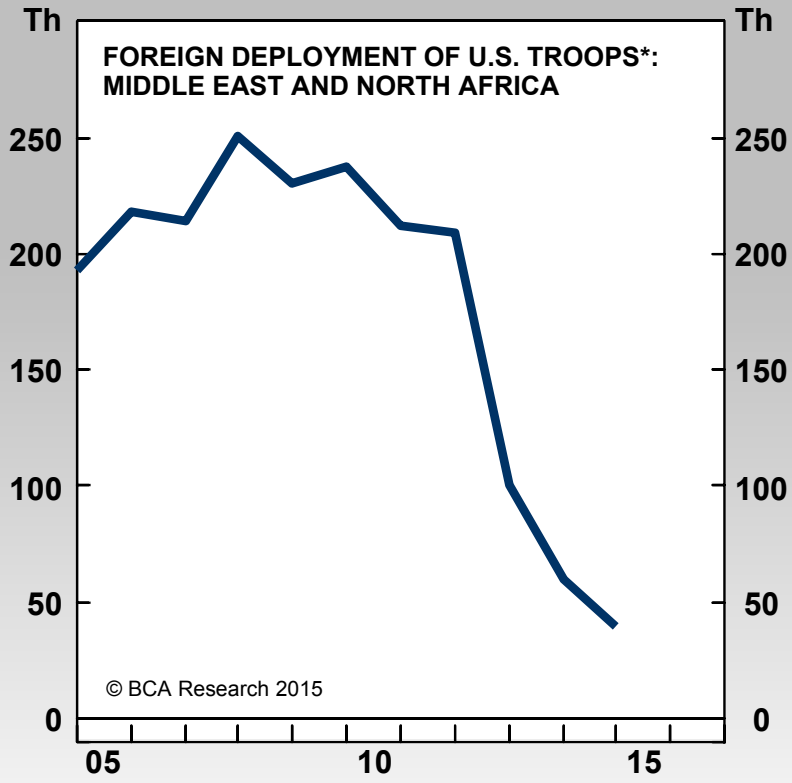


* SOURCE: IMF.
 ** SHOWN SMOOTHED. SOURCE: NETHERLANDS BUREAU FOR ECONOMIC POLICY ANALYSIS.

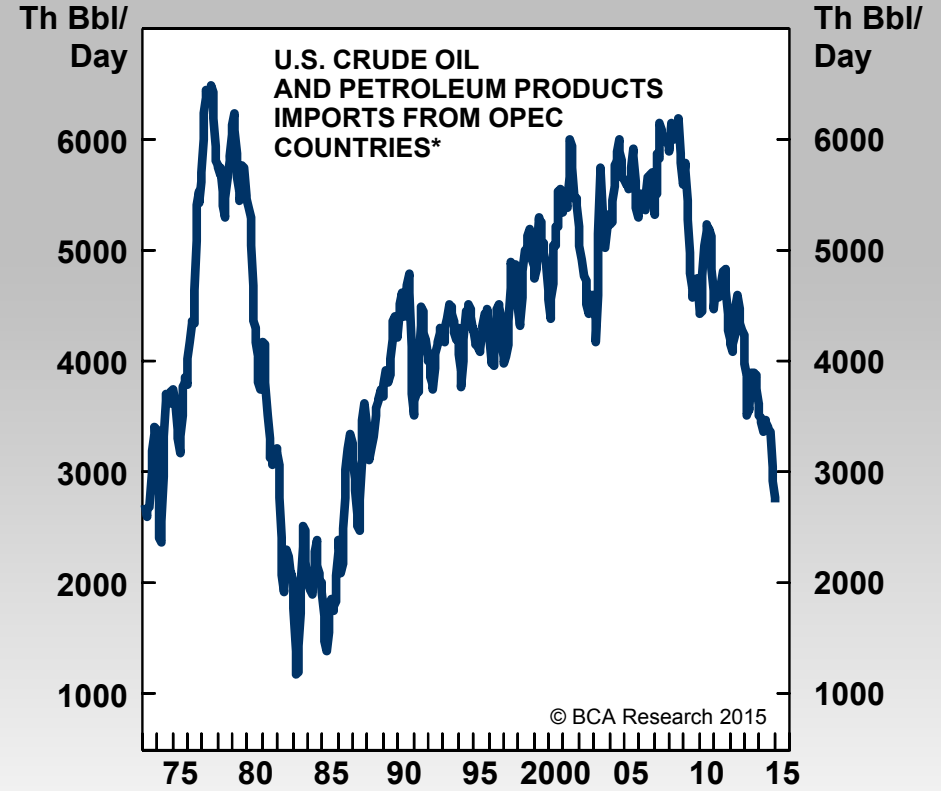


SHOWN REBASED TO JAN. 2013 = 1, IN COMMON-CURRENCY TERMS.
 SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION).

Middle East: Geopolitical Disequilibrium



* SOURCE: THE HERITAGE FOUNDATION AND DEFENSE MANPOWER DATA CENTER.



* SHOWN AS 3-MONTH MOVING AVERAGE.

Iran And Saudi Arabia Are Fighting For Regional Hegemony

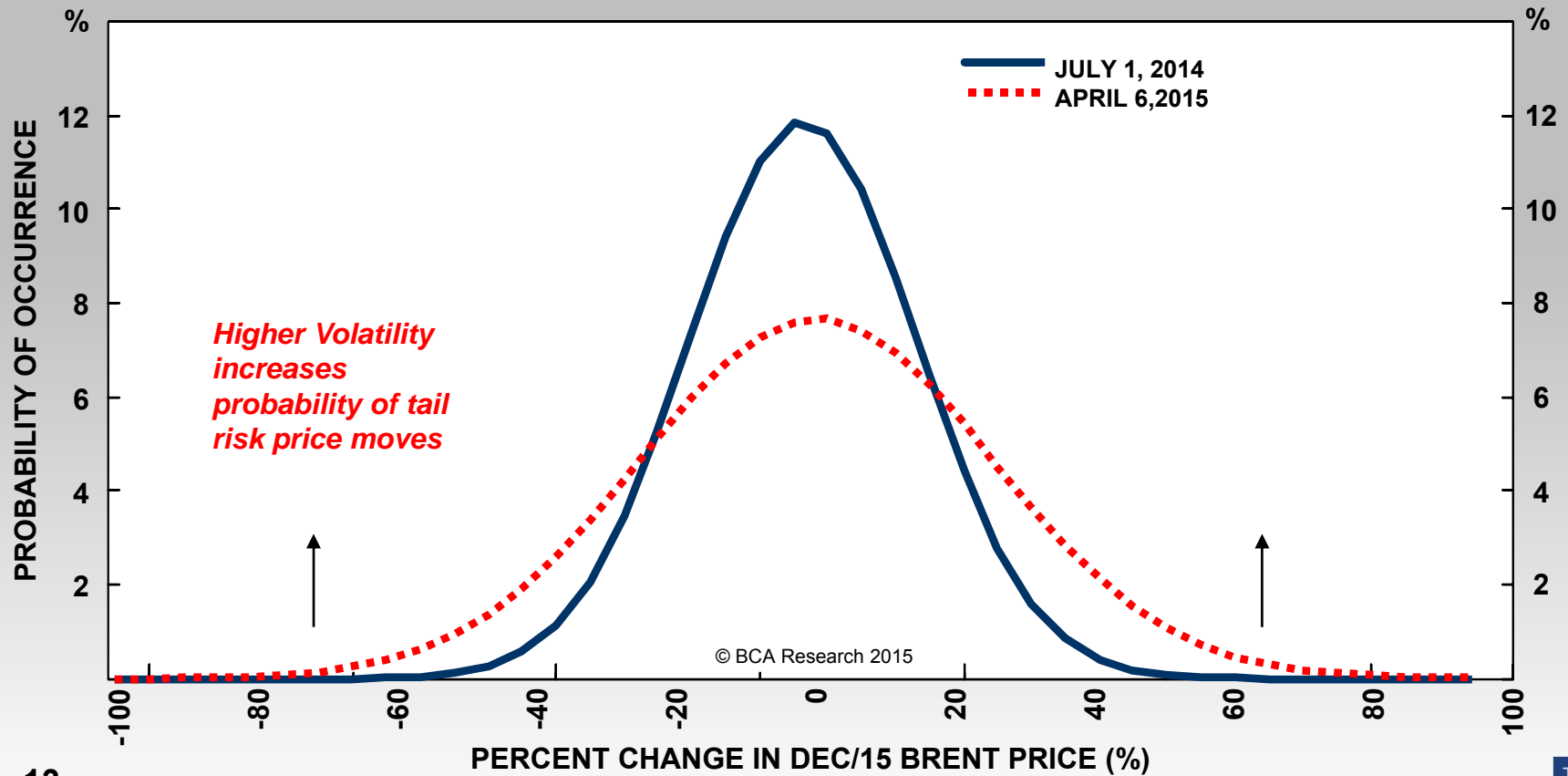


Energy Markets: Paradigm Shift

GEOPOLITICAL EVENT	PROBABILITY	IMPACT ON OIL PRICES	DURATION
DEATH OF OPEC	N/A - event is ongoing	MAJOR HEADWIND	Long - Or as long as Saudi Arabia pursues this strategy
IRAN - P5+1 NEGOTIATIONS	65% that June deadline produces an agreement	MEDIUM HEADWIND	Long - End of sanctions will release about 800,000 bbl/day of Iranian production in mid-2016. However, opening of Iran will allow it to eventually boost production to about 4.1 million bbl/day.
IRAQ STABILIZED BY IRAN	40% that Iran successfully stabilizes Iraq	MAJOR HEADWIND	Long - FDI flows in, boosting Iraqi production beyond 6 million bbl/day.
SAUDI ARABIA INVADES YEMEN	50%	MINOR TAILWIND	Short/Medium - Not clear how this would lead to a sustained spike in geopolitical risk premium.
SAUDI ARABIA INVADES IRAQ	25%	MEDIUM TAILWIND	Long - Iran and Saudi Arabia square off against one another within the borders of the world's fourth largest oil producer.
UNCOORDINATED SUPPLY CUT BY A MAJOR PRODUCER	25%	TAILWIND - MAGNITUDE DEPENDS ON WHICH PRODUCER	Depends on which producer and for how long - We are most concerned about Nigeria, Libya, Venezuela, Algeria, and Russia in that order. Low oil revenues lead to heightened domestic political risk, which in turn leads to supply cuts. This happened in Libya in November, with oil production down 370,000 bbl/day since then.
COORDINATED SUPPLY CUT BY A NON-OPEC MEMBER	15%	MAJOR TAILWIND	Medium - Russia, or another major producer, throws in the towel and cuts production due to the pain of lost revenue.
ISRAEL ATTACKS IRAN	< 5%	MAJOR TAILWIND	Short - Sustainability of rally depends on Iranian retaliation, which is unlikely to involve closing the Strait of Hormuz.
IRAN CLOSES STRAIT OF HORMUZ	< 1%	MAJOR TAILWIND	Short - Iran has no reason to do this now that it is close to rapprochement with the West. If it did, however, it would have to face off against the U.S. Navy.

RED - HEADWIND; GREEN - TAILWIND; NOTE: ALL PROBABILITIES ARE SUBJECTIVE.

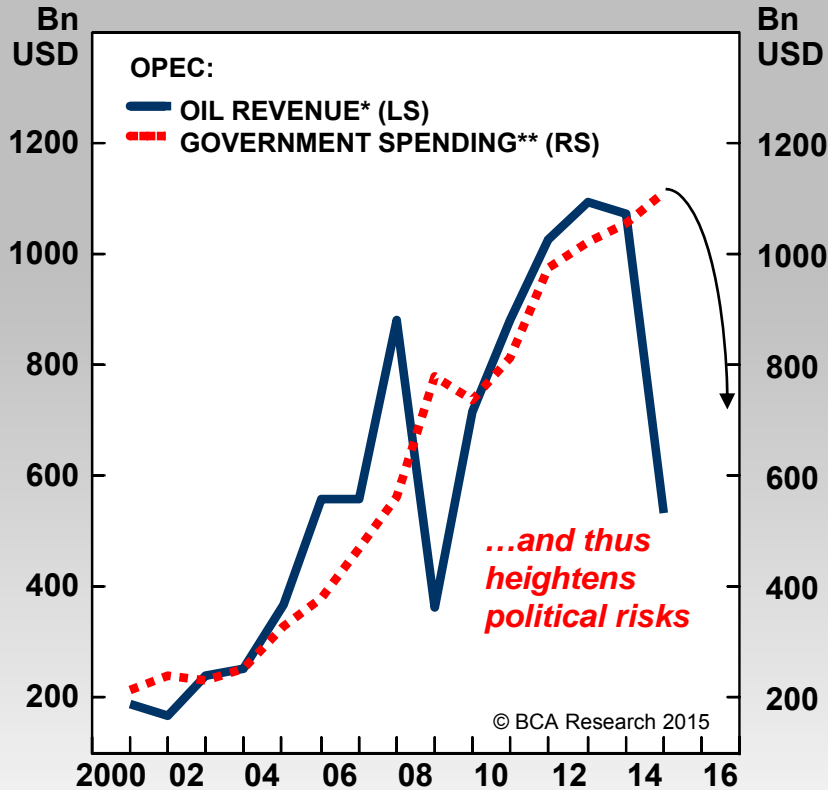
Energy Markets: Oil Price Volatility



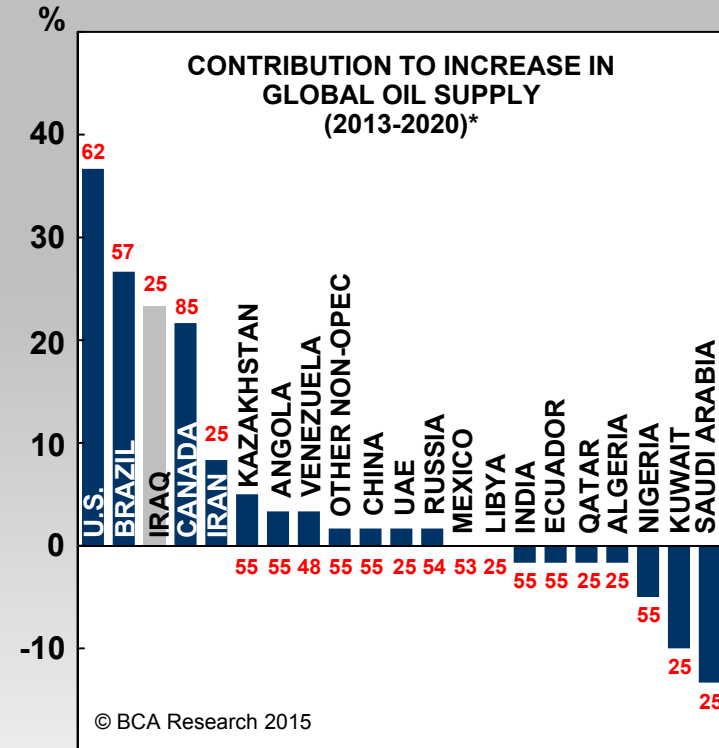
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THIS CHART SHOWS THE EVOLUTION OF THE PROBABILITY DISTRIBUTION FOR RETURNS DERIVED FROM IMPLIED OPTION VOLATILITIES FOR DEC/15 BRENT CRUDE OIL OPTIONS. IN MID-2014, VOLATILITY WAS NEAR-HISTORICAL LOWS, AND THE EXPECTED RETURNS FOR DEC/15 BRENT FELL IN A NARROW RANGE. IN NOVEMBER 2014, OPEC ANNOUNCED IT NO LONGER WOULD ADJUST ITS PRODUCTION TO ACCOMMODATE NON-OPEC PRODUCTION. THIS MOVE WOULD INCREASE RISK IN THE MARKETS ON THE DOWNSIDE DUE TO UNRESTRAINED PRODUCTION, AND ON THE UPSIDE, DUE TO THE HIGHER LIKELIHOOD LOW PRICES WOULD DESTABILIZE FINANCIALLY DISTRESSED OIL EXPORTERS.

Why We Are Not Oil Bears (Yet)

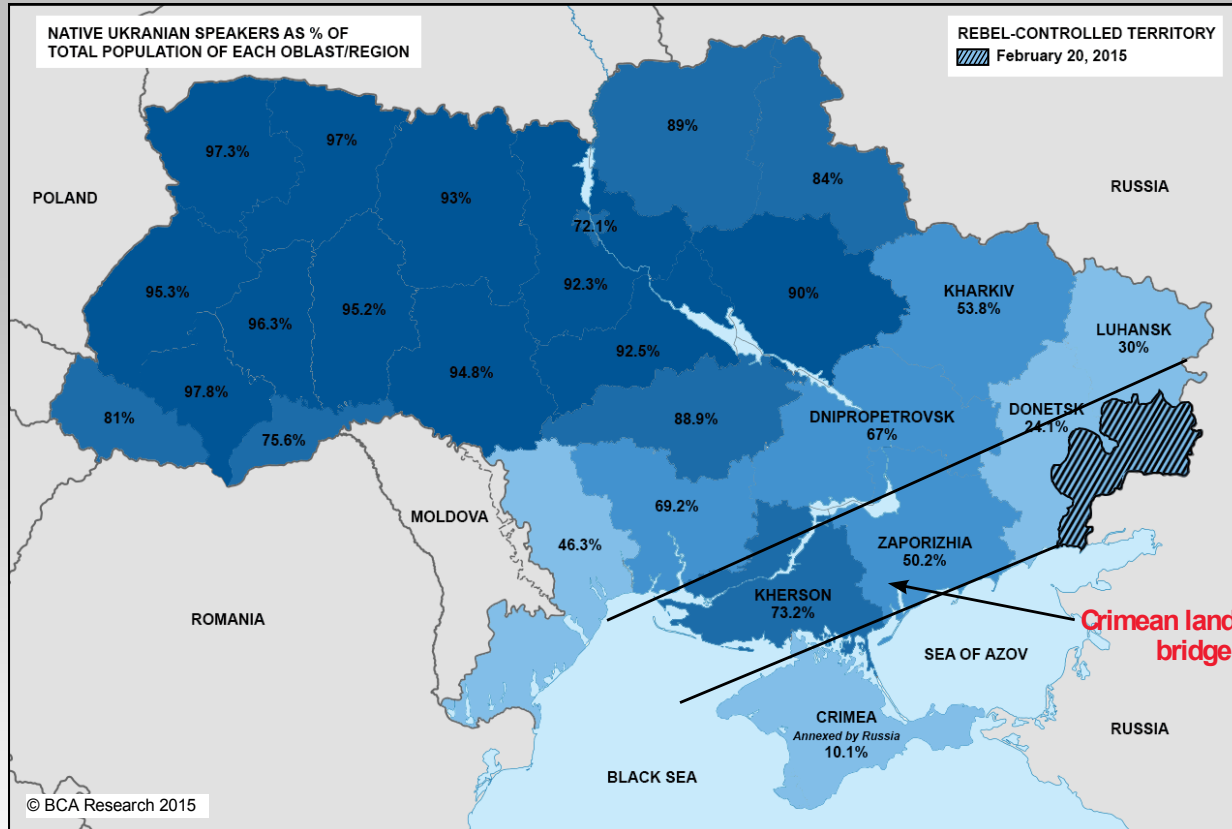


* TOTAL OPEC OUTPUT MULTIPLIED BY BRENT PRICE.
 ** TOTAL GOVERNMENT SPENDING OF 12 MEMBERS.
 SOURCE: IMF, WEO OCTOBER 2014.



* RED NUMBERS INDICATE AVERAGE BREAKEVEN OF OIL FIELDS.
 SOURCE: WORLD ENERGY OUTLOOK 2013/2014, INTERNATIONAL ENERGY AGENCY AND RYSTAD ENERGY.

Russia-West Tensions: Constraints To Cold War



SOURCE: THE BBC, STATE STATISTICS COMMITTEE OF UKRAINE AND UKRAINE NATIONAL SECURITY & DEFENCE COUNCIL.

Russia-West Tensions: Opportunities In Deescalation

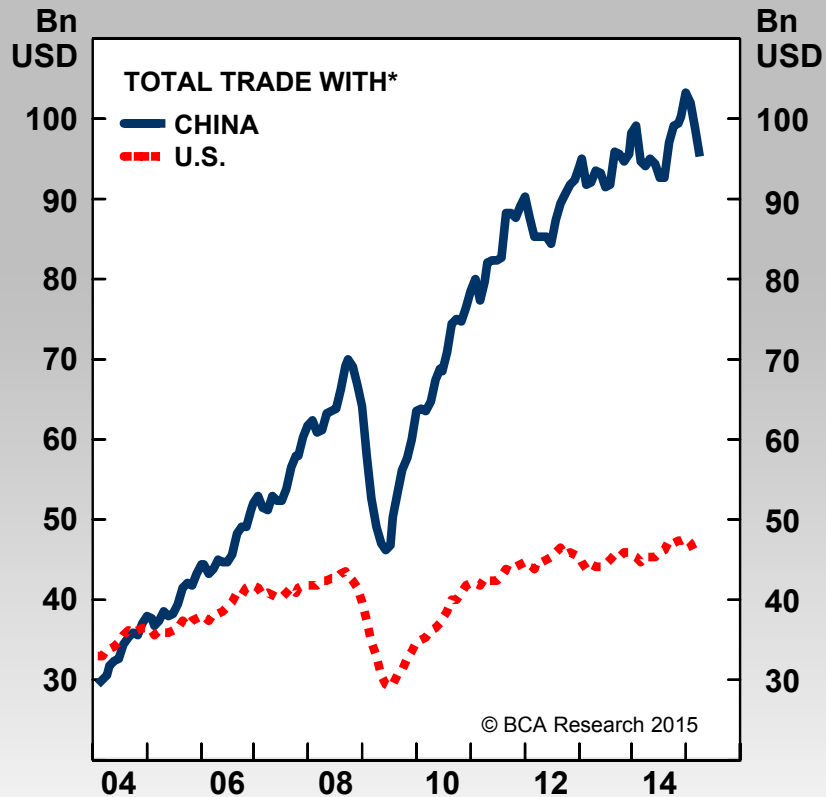


* BASED ON USD/NOK EXCHANGE RATE, RUSSIAN RELATIVE TO U.S. CONSUMER PRICE INDEX, AND A TIME TREND.
NOTE: VERTICAL LINE DENOTES MH-17 CRASH.

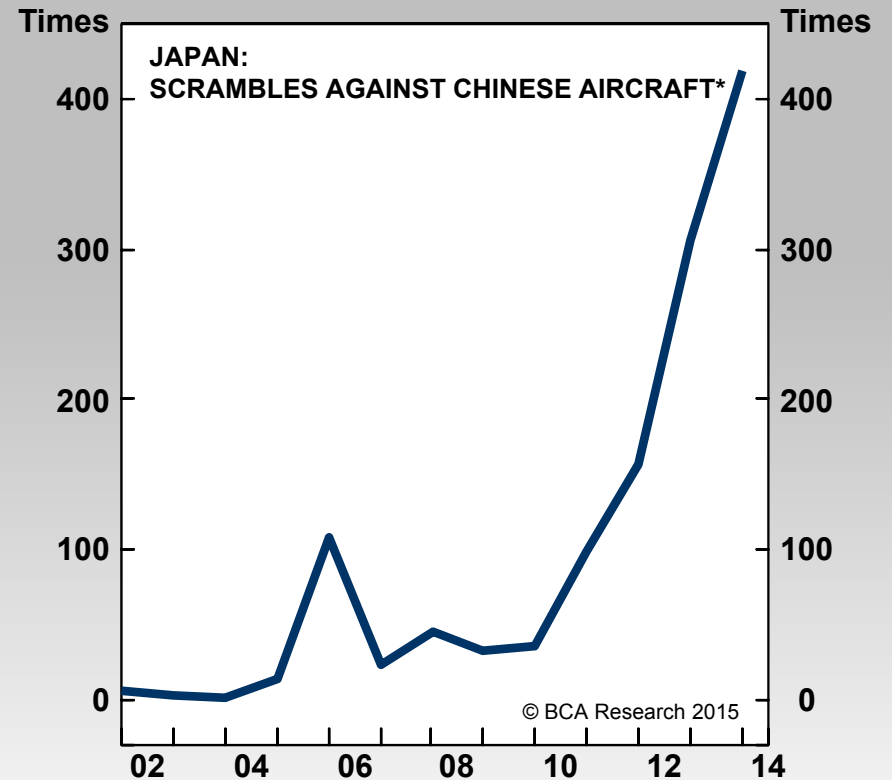


* SOURCE: THOMSON / IBES.
** PERCENTAGE PREMIUM / DISCOUNT RELATIVE TO EM BENCHMARK.

East Asia: The Forgotten Risk

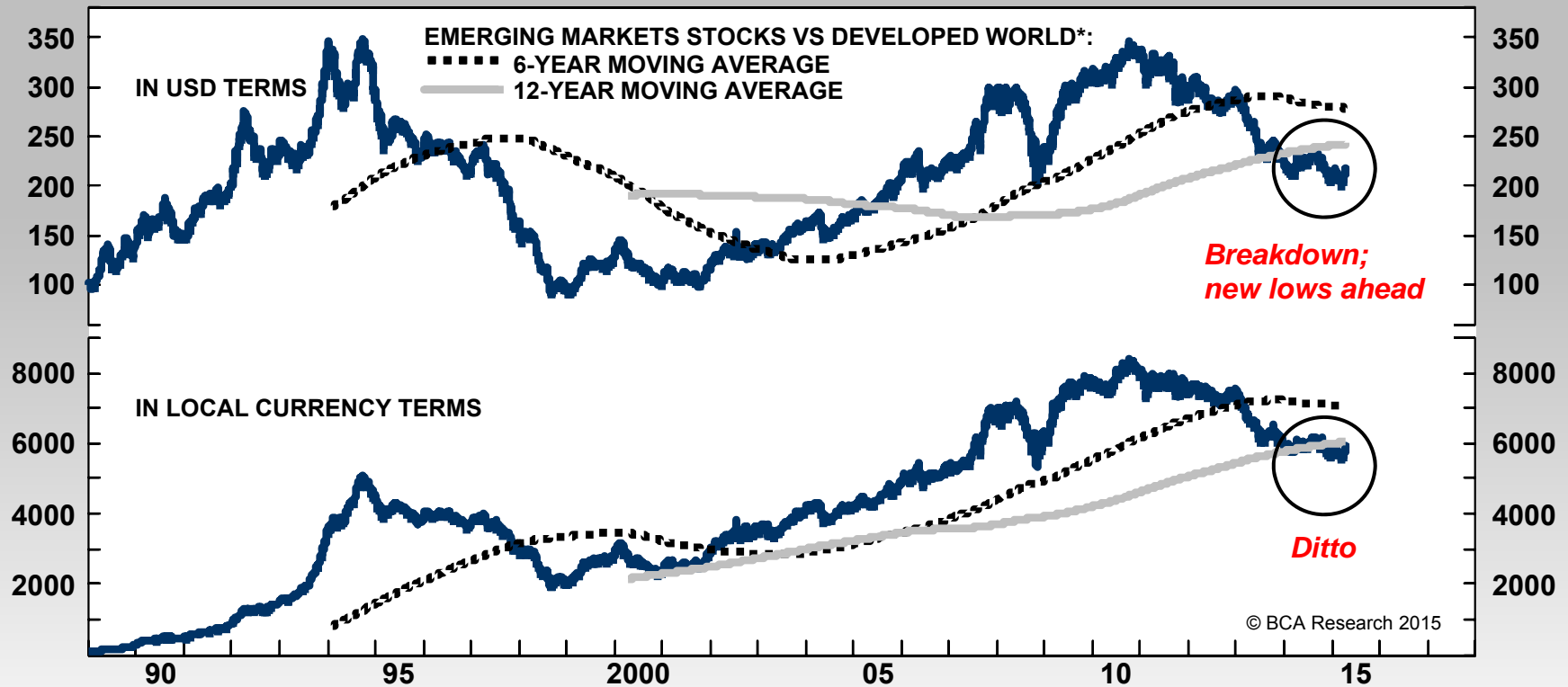


* INCLUDES JAPAN, SOUTH KOREA, INDONESIA, SINGAPORE, PHILIPPINES, VIETNAM, MALAYSIA, AND TAIWAN.



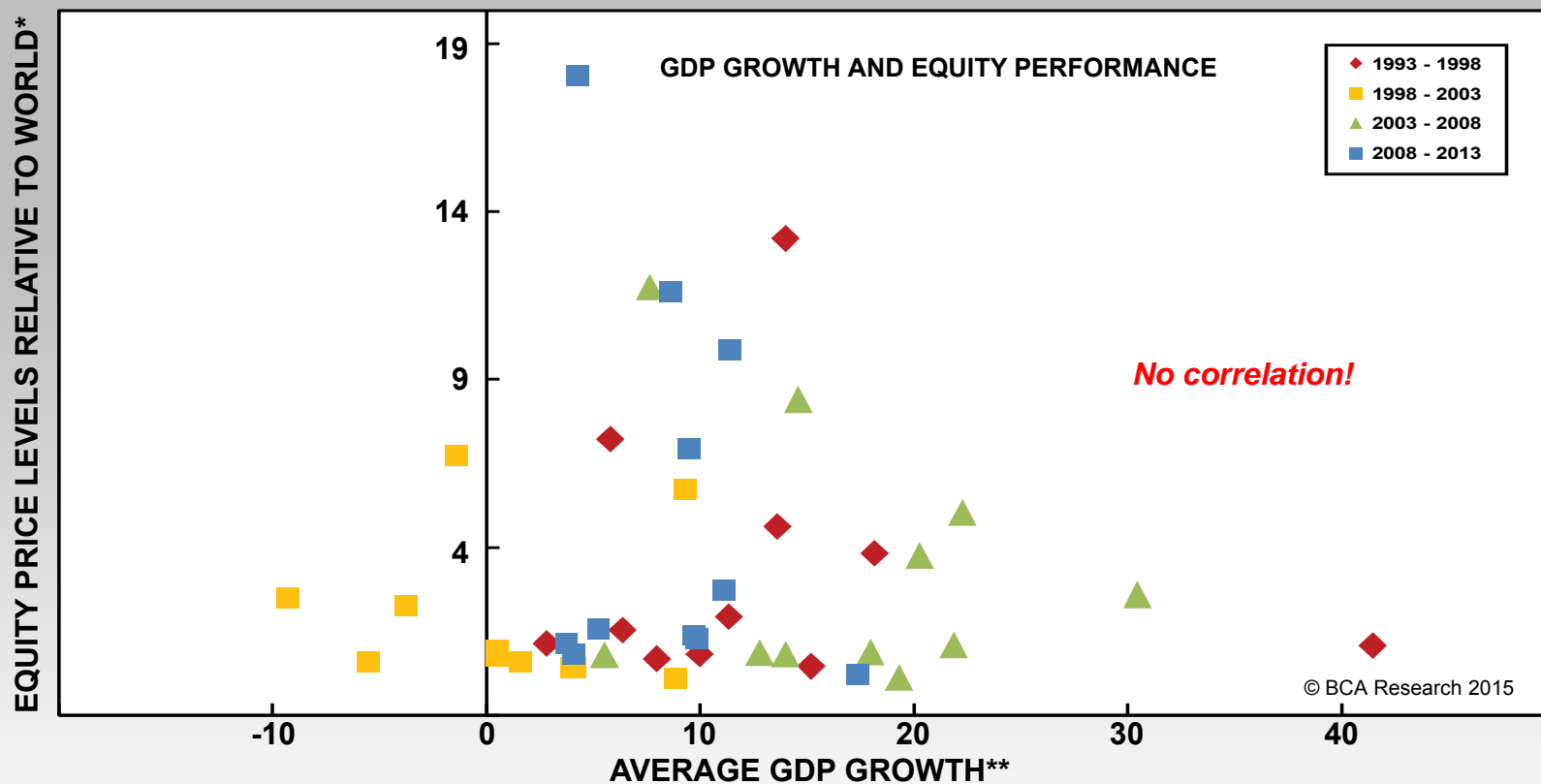
* SOURCE: RESPONSES TO NEW THREATS AND CONTINGENCIES, JAPANESE MINISTRY OF DEFENSE.

EM: Bloodbath



* BOTH SERIES ARE REBASED TO JANUARY 1989 AT 100; SOURCE: MSCI INC. (SEE COPYRIGHT DECLARATION)

Growth Will Not Rescue EM



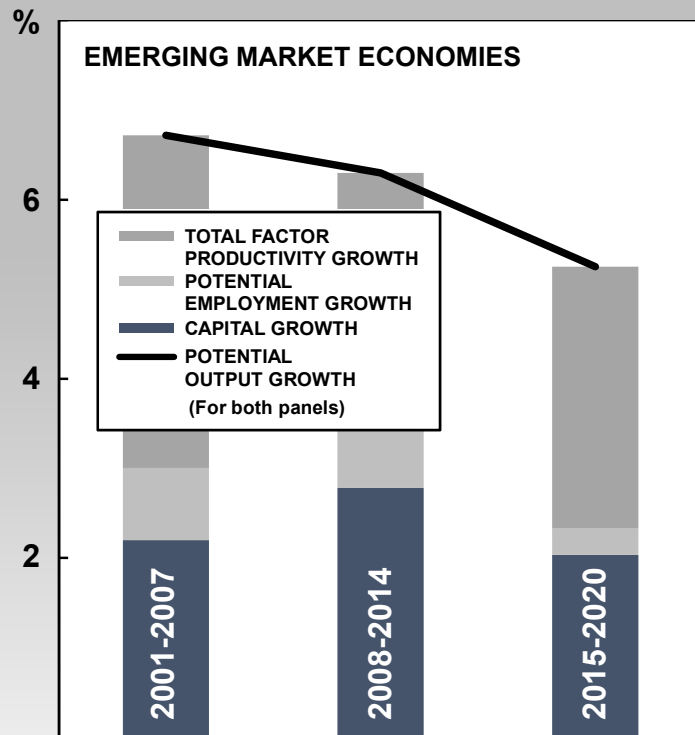
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* SHOWN IN COMMON-CURRENCY TERMS. SOURCE: MSCI (SEE COPYRIGHT DECLARATION).

** SOURCE: IMF WORLD ECONOMIC OUTLOOK.

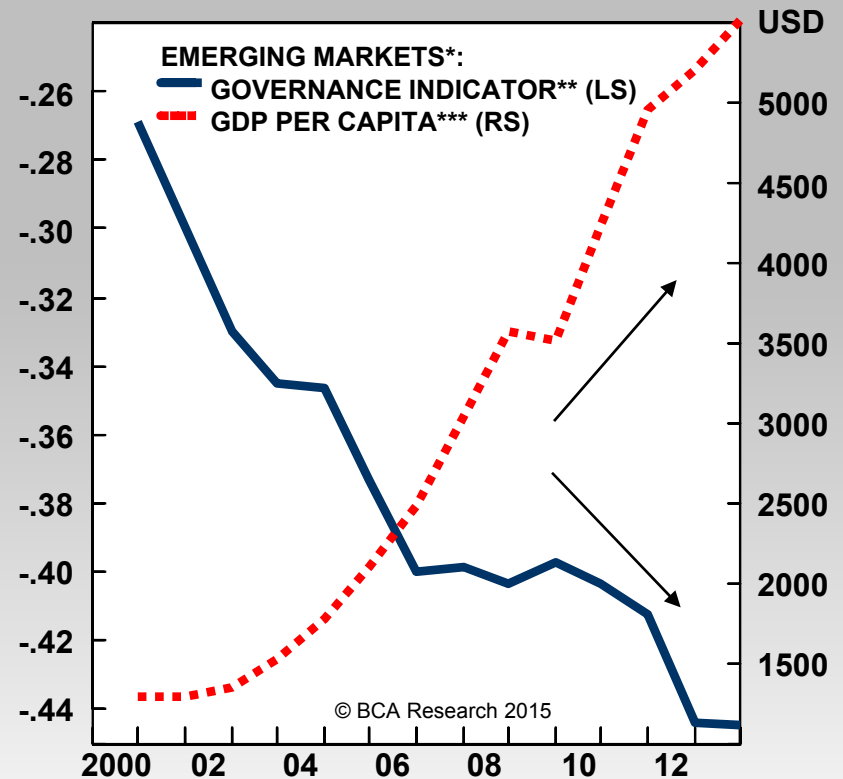
NOTE: DATA POINTS REPRESENT CHINA, BRAZIL, INDIA, RUSSIA, SOUTH AFRICA, SOUTH KOREA, TAIWAN, MALAYSIA, CHILE, MEXICO, AND SINGAPORE IN FOUR TIME PERIODS.

EM Needs Structural Reforms



SOURCE: IMF.

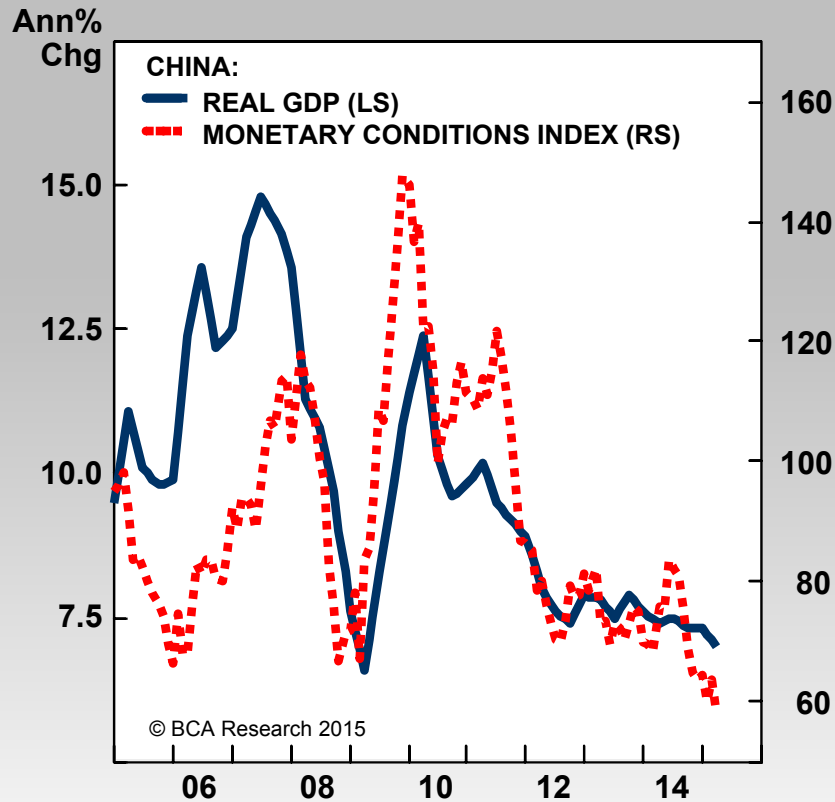
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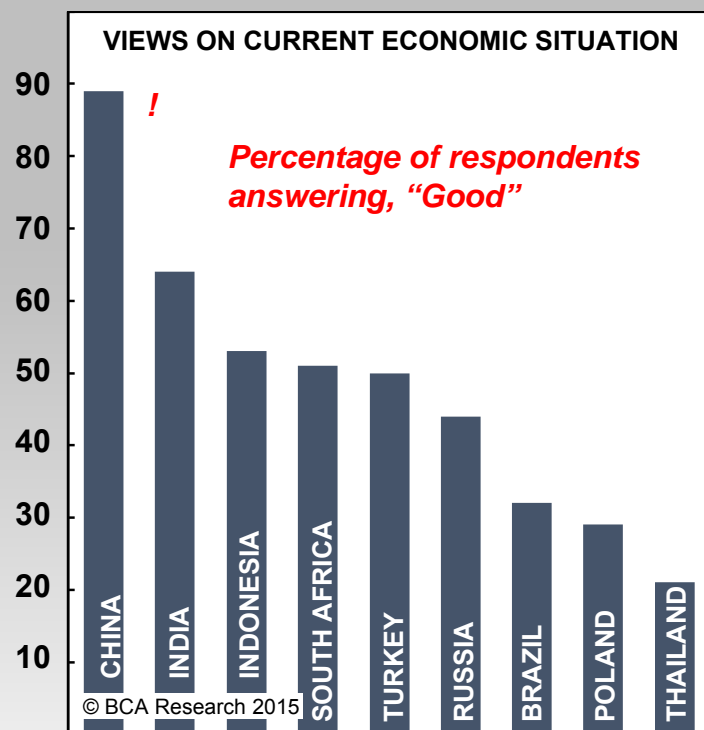
* INCLUDES CHINA, BRAZIL, RUSSIA, INDIA, MEXICO, INDONESIA, TURKEY, MALAYSIA, THE PHILIPPINES, THAILAND, AND SOUTH AFRICA.
 ** INDICATOR IS AN EQUALLY-WEIGHTED AVERAGE OF THE FOLLOWING MEASURES: GOVERNMENT EFFECTIVENESS, VOICE AND ACCOUNTABILITY, POLITICAL STABILITY AND VIOLENCE, RULE OF LAW, AND CONTROL OF CORRUPTION. SOURCE: WORLD BANK AND BCA RESEARCH.
 *** WEIGHTED BY POPULATION.

China: Growth Over Reforms

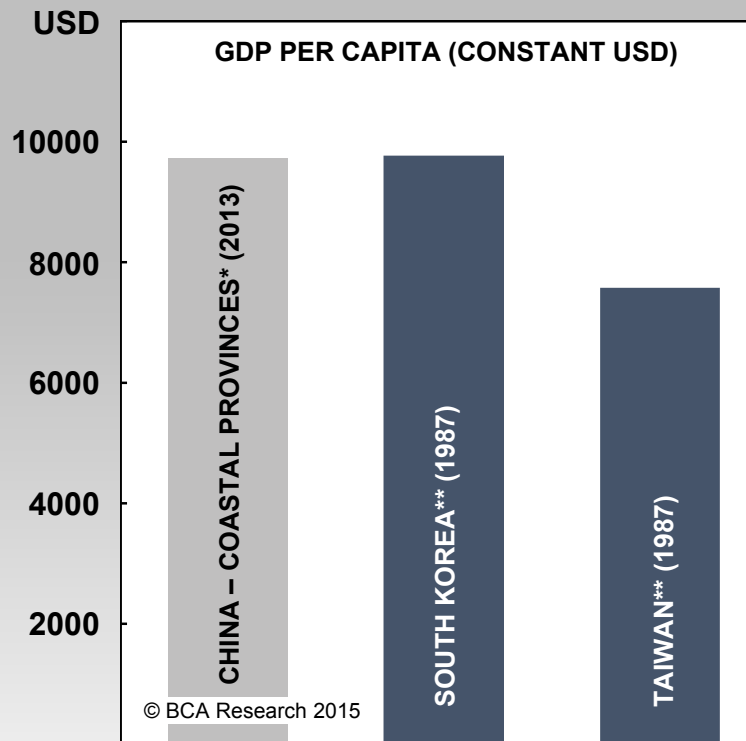


* SOURCE: NATIONAL BUREAU OF STATISTICS OF CHINA.

China: Can China Reform?

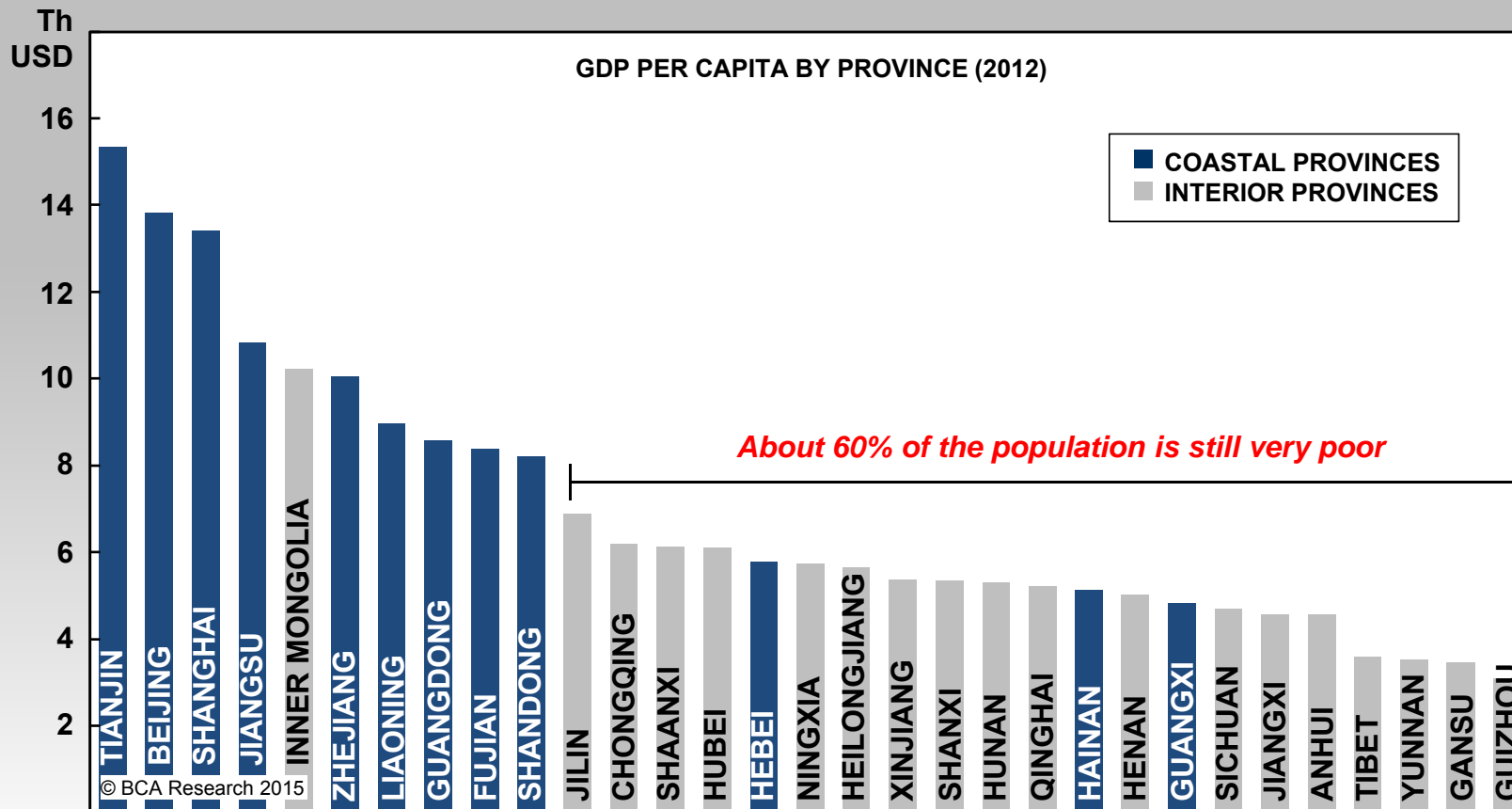


SOURCE: "GLOBAL PUBLIC DOWNBEAT ABOUT ECONOMY," PEW RESEARCH CENTER, SEPTEMBER 2014.

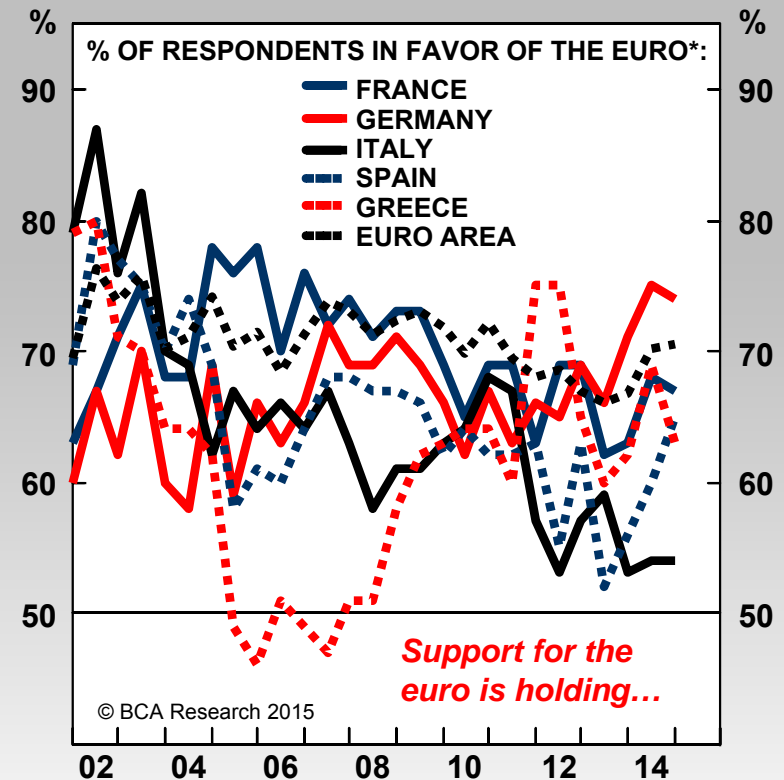
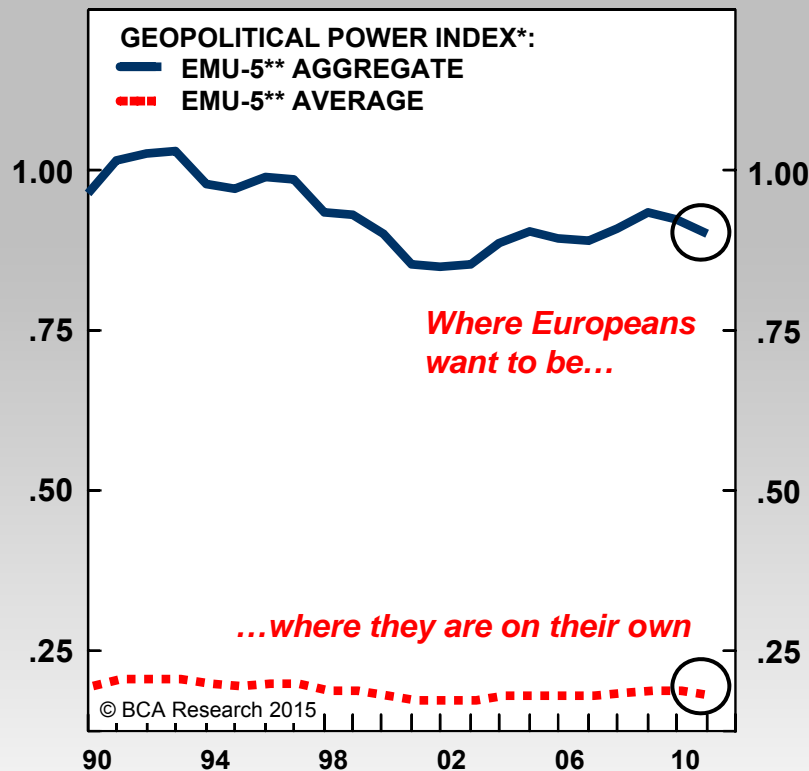


* SHOWN AS POPULATION WEIGHTED GDP PER CAPITA. SOURCE: CEIC.
 ** SOURCE: IMF WEO (2014) AND WORLD BANK.

China: One Country, Two Economies



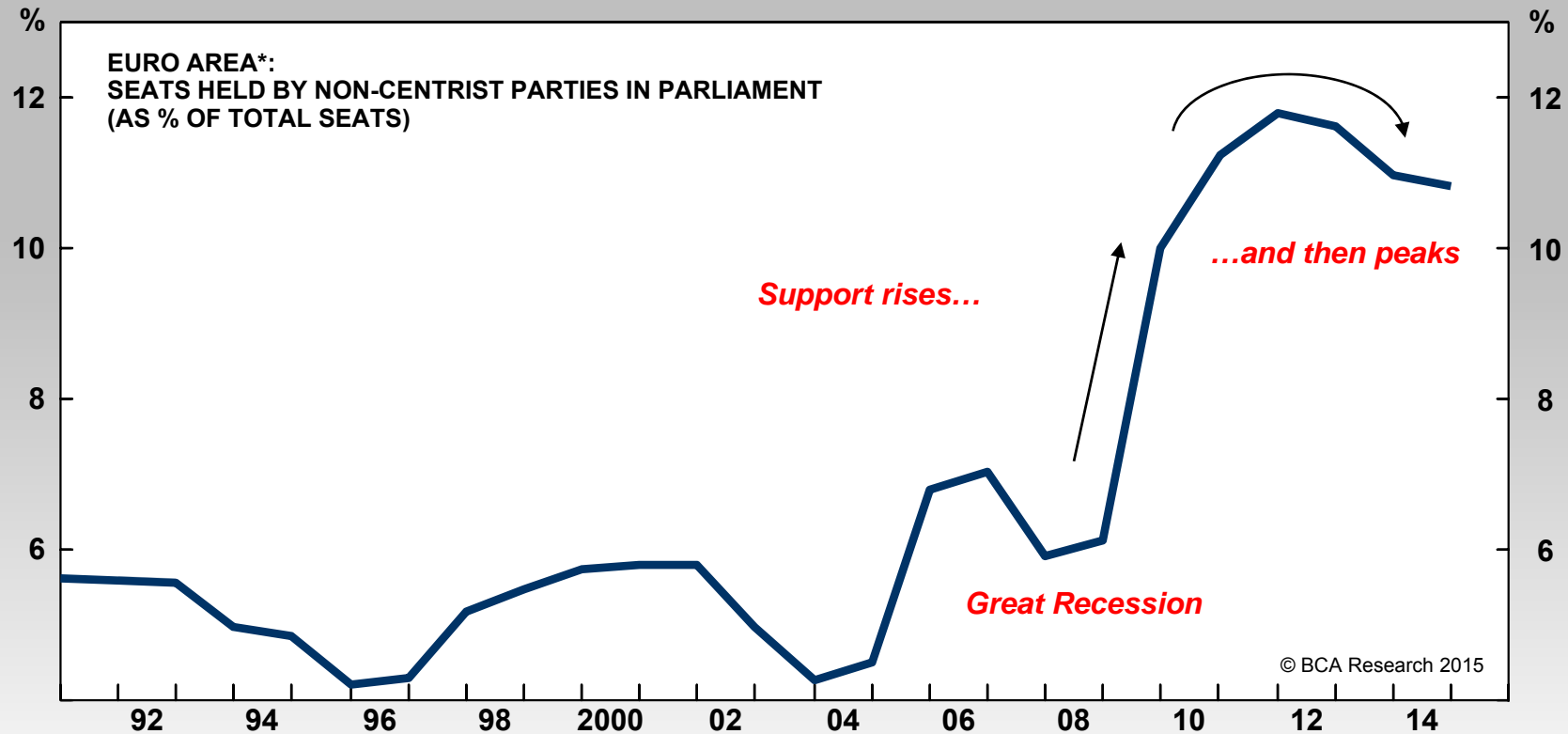
Europe: The Euro Is Geopolitics



* THE GEOPOLITICAL POWER INDEX MEASURES A COUNTRY'S POWER BASED ON A WEIGHTED AGGREGATION OF ITS ECONOMIC, MILITARY, POLITICAL, TECHNOLOGICAL, AND GEOGRAPHICAL ENDOWMENTS. SOURCE: BCA CALCULATIONS.
 ** INCLUDES FRANCE, GERMANY, ITALY, SPAIN, AND THE NETHERLANDS.

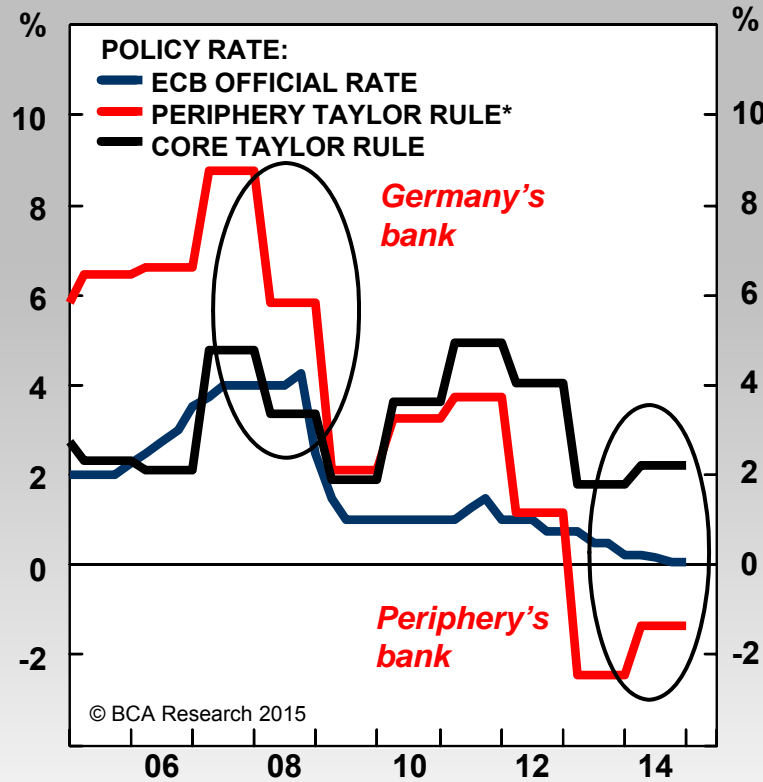
* SOURCE: EU COMMISSION.

Europe: Populism Is Overstated

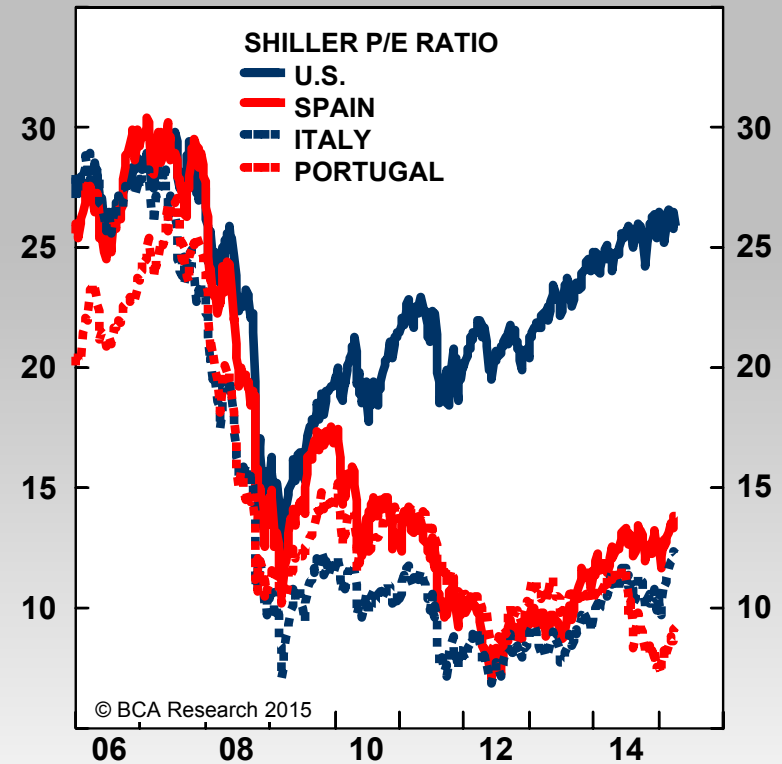


* INCLUDES AUSTRIA, BELGIUM, FINLAND, FRANCE, GERMANY, GREECE, ITALY, THE NETHERLANDS, PORTUGAL, AND SPAIN.

Europe: Two Trade Ideas

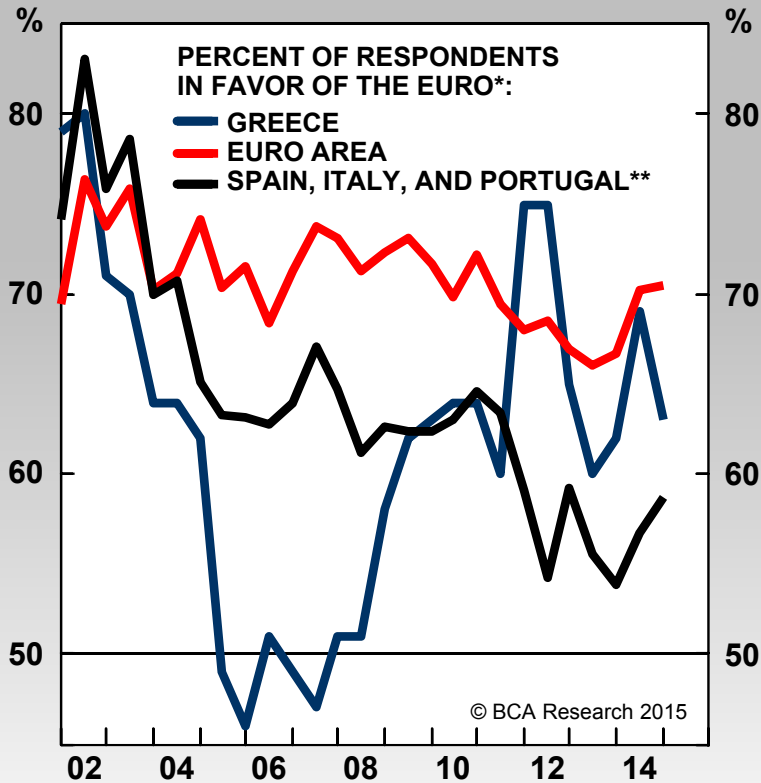


* TAYLOR RULE INCLUDES INFLATION AND THE UNEMPLOYMENT GAP. FOR ADDITIONAL DETAILS PLEASE SEE: NECHIO, FERNANDA, "MONETARY POLICY WHEN ONCE SIZE DOES NOT FIT ALL," FRBSF ECONOMIC LETTER (JUNE 2011).



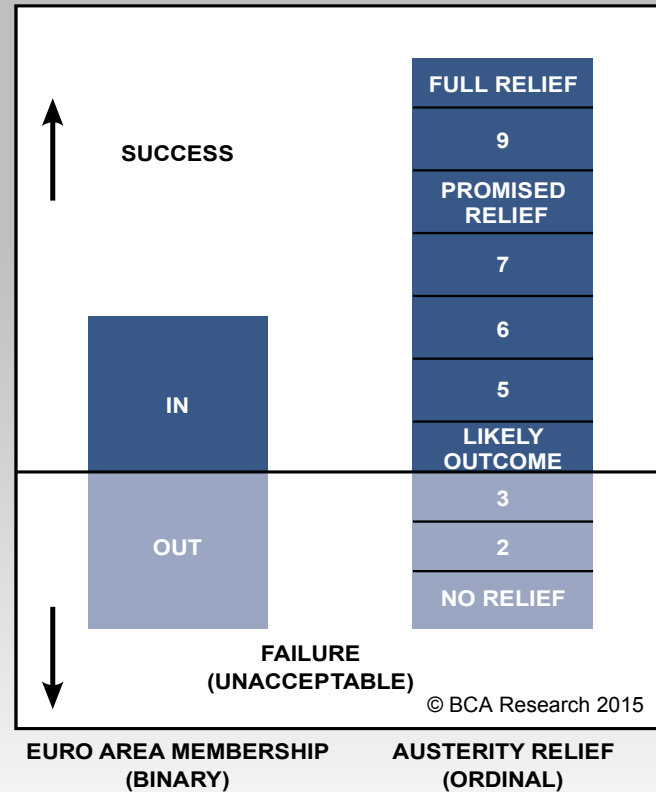
NOTE: BASED ON DATA FROM MSCI INC. (SEE COPYRIGHT DECLARATION).

Can Greece Ruin The Euro-Party?

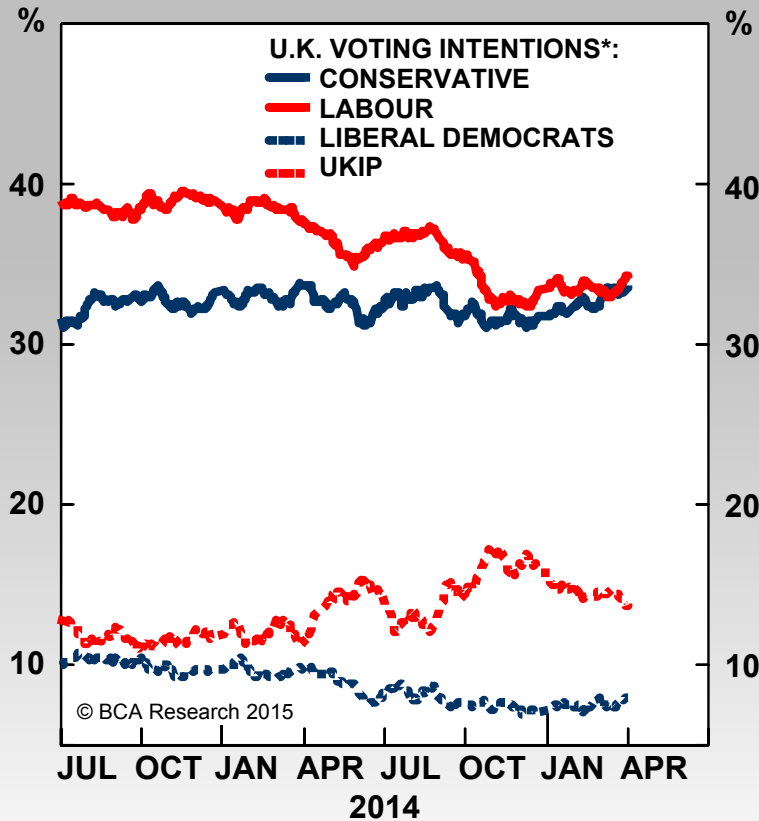


* SOURCE: EU COMMISSION.

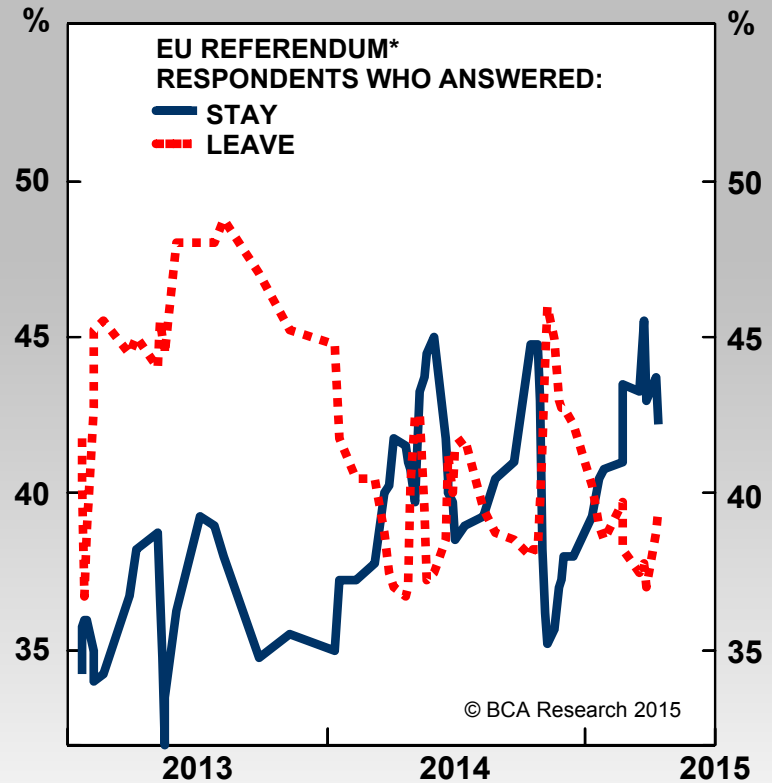
** POPULATION-WEIGHTED AVERAGE.



What About The U.K.?

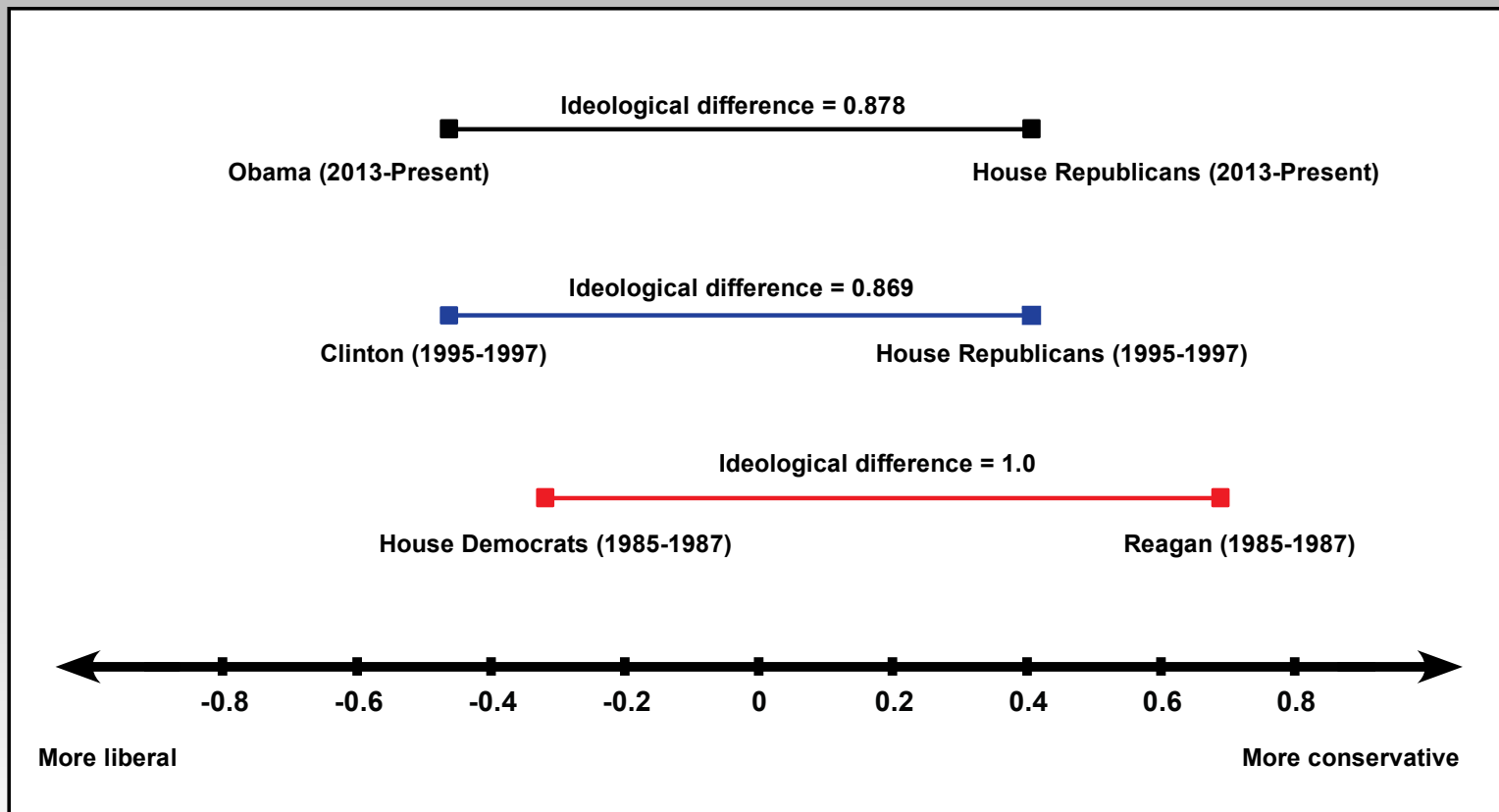


* SOURCE: U.K. POLLING REPORTS. SHOWN AS 15-DAY MOVING AVERAGE.



* SOURCE: DATA AGGREGATED FROM YOUNG, TNS, COMRES, SURVATION, LORD ASHCROFT POLLS, PEW RESEARCH, AND POPULUS. SHOWN AS 4 WEEK MOVING AVERAGE.

U.S.: Polarization In Context



Q&A