

Putin's Invasion

From today's The Morning:

By German Lopez

Good morning. Russia's war in Ukraine is especially dangerous after decades of relative peace worldwide.

A fading peace

Russia's invasion of Ukraine could mark a troubling shift: the end of a relatively peaceful global era.

Though it has not always felt like it, the world has since the 1990s endured less war than any other period in recorded history. Wars and resulting deaths plummeted with the conclusion of the Cold War in 1991 — and the subsequent end of direct and proxy conflicts between the world's great powers.

“The end of the Cold War was the greatest thing to happen to peace in a long time,” said Jeremy Shapiro, the research director at the European Council on Foreign Relations.

But the world has since changed. After emerging from the Cold War as the lone superpower, the U.S. grew weaker, bogged down by failed wars in Iraq and Afghanistan. Meanwhile, Russia and China evolved into more formidable powers; they are now better positioned to challenge a world shaped by American norms and rules.

Invading Ukraine is the biggest example of Russian President Vladimir Putin's willingness to challenge a U.S.-led order. Another is Russia's intervention in the Syrian civil war. China has its own interests — in controlling Taiwan and increasing influence in East and Southeast Asia.

The strengthening alliance between Russia and China in recent years also suggests they are sketching new lines of global competition. And in response to these threats, other potential great powers, like Europe, are rebuilding their own militaries.

Peace, experts said, has not looked this fragile in decades.

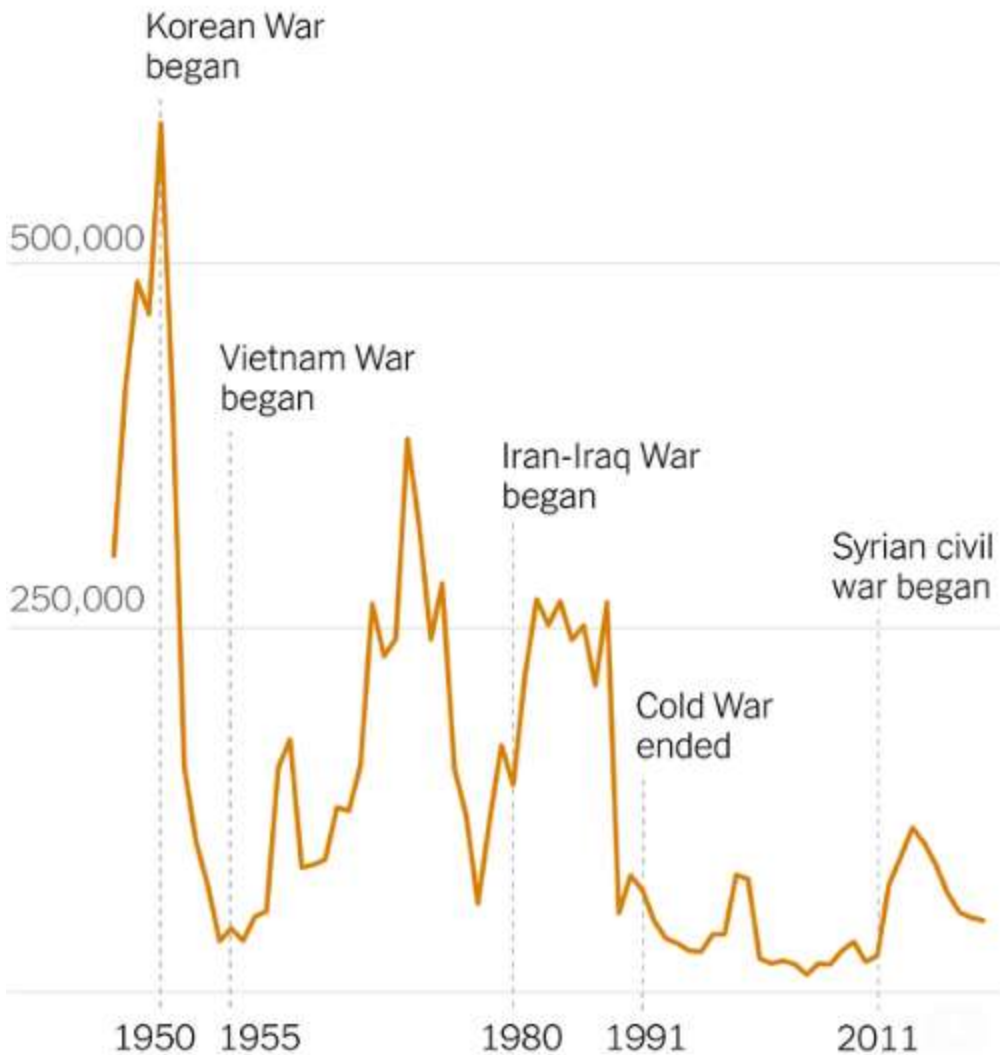
How conflict receded

For much of human history, war was the norm. Between the 16th and 18th centuries, great powers battled each other most years. And in the 19th and 20th centuries, they fought in conflicts that culminated in two world wars that killed more than 100 million people and displaced tens of millions more.

But after the Cold War, the rate of new conflicts fell more than half, according to Bear Braumoeller, an international security expert at Ohio State University. The conflicts that did occur were on a smaller scale. Deaths from war plummeted. (Part of that decrease was also thanks to militaries getting better at treating wounded soldiers.)

The drop was unprecedented, William Wohlforth, an international relations expert at Dartmouth College, told me. “We can't find another period with a shift in conflict trends that compares,” he said.

Global deaths in war



Data from 1946 to 2020. Labeled conflicts do not account for all deaths. | Source: Our World in Data

Several ingredients factored into this peace. There was a lack of great power competition; no country could seriously challenge the United States. Nuclear weapons also continued to deter nations from warring against each other, given the potentially apocalyptic consequences. An increasingly integrated global economy made any war a risk to everyone's continued growth. And peacekeeping institutions, like the U.N. and the E.U., created outlets for countries to try to settle disputes and enforce antiwar rules (although not always successfully).

Another element: Great power is no longer synonymous with an appetite for conquest. U.S. officials in the nation's century as a superpower have viewed attempts to take over other countries as a direct route to sinking the world order they had built and led. America's own acts of aggression — in Vietnam, Panama, Iraq and elsewhere — were aimed at upholding that order, however flawed the justifications.

Rising challengers

Russia and China never liked the idea of a U.S.-led world order. For decades, both have called for a new structure in which they get a bigger, or even dominant, say over how the world works.

Russia (**Putin?**) has its own imperial ambitions in Eastern Europe, and it views NATO's expansion toward its western doorstep as an existential threat.

China has benefited economically from the liberal order and globalization. But its leaders also want to oppress domestic dissidents, the democratic government in Taiwan, protesters in Hong Kong and predominantly Muslim Uighurs, among others, without outside interference.

These are longstanding goals for Russia and China, but they now have a greater ability to act on their beliefs. Putin has cemented his rule after more than two decades in power, and in that time he moved to modernize Russia's military (though the stalemate in Ukraine has exposed major weaknesses). China has grown its economy to a point that it may soon rival the United States', and it is expanding its military power and regional influence as well.

That could lead to more great power competition — potentially through a new wave of proxy wars between these countries and the West or, worse, direct conflict.

But any great shift in the world order hinges largely on what China does, as the only real rival to the U.S. Given the risks of war, China could continue to pursue its interests with economic or diplomatic levers over military force, said Stacie Goddard, an international security expert at Wellesley College.

China also has repeatedly called for respecting every nation's sovereignty. There are good reasons to be skeptical of that pledge, including China's interests in Taiwan and its continued support for Russia after the invasion of Ukraine. But if China means it, the war in Ukraine could end up looking less like a sign of what is to come and more like a deadly last gasp from the Cold War era.

State of the War

- President Biden denounced Russia's invasion and declared that Putin "cannot remain in power." But a White House official downplayed the possibility that Biden had called for the Russian president to step down.
- While Biden was traveling in Poland, two rocket strikes hit Lviv in western Ukraine, not far from the Polish border. The strikes undercut earlier signals that Russia had narrowed its ambitions.
- Western officials, however, have picked up chatter among senior Russian commanders about giving up on capturing Kyiv and other key areas in Ukraine, according to two people with access to intelligence.
- Ukrainian forces have mounted a counteroffensive in the Kyiv suburbs to block Russia's route to the capital, destroying tanks and killing Russian troops.

From The Octavian Report:

Why Russia is Losing: Gen. David Petraeus on the War in Ukraine

Jonathan Tepperman

Mar 23

With the war in Ukraine now almost a month old, the fighting has entered an ugly stalemate. Russia's once-vaunted military has bogged down in the face of Ukraine's fierce resistance. With the possible exception of Mariupol (a city of 400,000 that has been destroyed), Russia has failed to capture any major cities, and with Ukraine launching counterattacks and ambushes, the Russians are suffering as many as a [thousand](#) casualties per day. As the invaders grow more desperate, they've begun the mass bombardment of civilian areas, causing a predictably high number of deaths; indeed, inflicting pain on civilians may be part of President Vladimir Putin's strategy. Given all these developments, I decided that now was the time to hear from one of America's most-decorated military leaders, the man who literally wrote the book on winning over civilians during wartime. **Gen. David Petraeus** led the 101st Airborne during the 2003 invasion of Iraq, before overseeing the drafting of the U.S. Army's counterinsurgency manual and commanding all coalition forces in Iraq from 2007 to 2008. Petraeus then ran U.S. Central Command, led coalition forces in Afghanistan, and served as CIA director under President Barack Obama. We discussed the reasons for Russia's surprisingly bad performance in Ukraine, how the conflict is likely to play out, and the parallels between that war and the ones in Iraq and Afghanistan.

Octavian Report: Why has the Russian military performed so much worse than expected?

David Petraeus: There are numerous reasons. First, Russia is facing very capable Ukrainian forces and a citizenry that are fighting for their survival, have the home-field advantage, and are fiercely determined to defend their country. Second, the Russians have been surprisingly unprofessional in numerous ways, from tactical tasks to overall operational concepts. Third, the vast majority of the Ukrainian population hates the Russians, and that hatred is growing every time a civilian building gets hit and civilians are killed. Not only are the Russians not winning hearts and minds, they are alienating hearts and minds, and that is helping to galvanize the entire Ukrainian nation.

The Russians have also been surprisingly poor at performing basic tasks like employing armor, infantry, engineers, artillery, and mortars to achieve combined-arms effects. They seem quite inadequate at maintaining their vehicles and weapons systems, and they have abandoned some of them when they've broken down. They don't appear to perform sufficient preventive maintenance and are also generally struggling to provide sufficient logistics support to their forces.

The Russian military also lacks one of the key strengths of U.S. and Western militaries, which is a strong, professional noncommissioned officer corps. To make matters worse, the Russian military uses a fairly substantial percentage of conscripts. It's very hard to determine how many of them are in Ukraine, but in the Russian military overall, around 20-25 percent of all troops are conscripts. And there are particularly large numbers of conscripts performing logistics tasks—including driving trucks and fuel tankers and maintenance vehicles. That might explain some of Russia's problems in these areas.

Early on, the Russians also struggled to move off-road. The ground was not frozen the way they had hoped it would be, so their wheeled vehicles got stuck in the mud very quickly, and even their tracked vehicles had problems. With spring rains not far off, the traffic issues could get even worse (though it has been relatively dry in recent days).

Beyond that, the Russians have fielded less impressive equipment and soldier kit than expected, given how much money they reportedly spent on their military over the last 10 years or so. Their communications have proven unsecure and vulnerable to jamming—one reason that generals and other commanders have had to move

to the front to find out what's going on, leaving them vulnerable to snipers. The Russians' precision munitions don't seem very precise. That's presumably why they weren't able to make Ukraine's runways inoperable in the first hour of the war, the way the United States did in Iraq in 2003, making it impossible for the Iraqi Air Force to take off. In fact, the Ukrainian Air Force is still flying. Meanwhile, the Russian Air Force has been unimpressive in providing their troops on the ground with true close air support just beyond the front line of their forces. Instead, they're generally been carrying out attacks that are disconnected from ground maneuvers.

You can also see the lack of precision munitions in the sheer frequency with which the Russians are hitting civilian infrastructure—unless they truly meant to hit those targets, which would be barbaric and criminal.

The Russians also have problems doing very basic tasks, like staying spread out and dispersed and seeking concealment when stopped for any period of time. A vehicle column should never close up and stop in the open on a major highway where it can be spotted by a drone and hit by artillery, as happened last week. The 40-mile Russian traffic jam we saw outside of Kyiv—that was sheer incompetence. And it took them days just to get that column under tree cover.

On top of all those shortcomings, the whole Russian campaign was clearly based on wildly mistaken assumptions about how quickly they could take Kyiv and how quickly they could topple the government and replace it with a pro-Russia regime.

I should note that it does appear that the Russians are now making some adjustments in response to their appreciation for Ukrainian strengths and weaknesses—for example flying more bombing missions at night, when Ukrainian air defenses are less effective, and digging into defensive positions outside cities and pounding them with rockets, missiles, artillery, and bombs, rather than trying prematurely to seize them. But it makes one wonder what those forces were doing during the months of supposed training before the invasion was launched.

OR: Russia seems unable to send more men or equipment to Ukraine. Why is that?

Petraeus: The Russians do appear to be scrambling to replace their casualties and equipment losses, which seem to have been much higher than they expected—their killed-in-action numbers already nearly double our losses in 20 years in Iraq. They are scouring the eastern military district and Georgia, Chechnya, and Syria for additional troops, foreign partners, and mercenaries. They are also reportedly extending the one-year tour of duty for their current cohort of conscripts—which would have ended in April—and are bringing on the next cohort early. All that bodes ill for Russia; at some point, its units will take so many losses that they are no longer combat-effective (that is, they will be unable to accomplish their mission without being reconstituted with new personnel and equipment). Russia will also need to rotate its forces out of combat at some point and replace them with others units, as the United States did over the years in Iraq and Afghanistan. And it's not clear how they're going to manage that.

OR: Why did the West overestimate Russia's military?

Petraeus: I think it's because we were unduly impressed by reports of Putin's investment in the modernization of Russia's forces. And we'd not seen them try to conduct large-scale operations against a determined, capable enemy. Over the last 30 years, most of Russia's military operations have been against the forces of small countries such as Georgia—an important brigade of which was in Iraq and under my command when the Russians attacked in 2008. Or they've fought against extremists and insurgents—like in Chechnya, where Russian forces ultimately destroyed Grozny and many other built-up areas—and in Syria, where Russian forces largely provided bombing support for Syrian forces and Hezbollah, destroying and largely depopulating Aleppo

in the process. What Russia is trying to do in Ukraine is incomparably more challenging. Remember that Ukraine is about the size of Texas, but before the invasion it had about 13 million more people. And Kyiv covers 320 square miles, 20 more than New York City.

OR: What do you think of the wisdom of a NATO no-fly zone for Ukraine?

Petraeus: I understand the desire of those advocating for one. But however it is configured and named, it would inevitably require U.S. aircraft to enforce it by confronting—and likely shooting down—Russian aircraft. It would also likely require taking out Russian air-defense assets on the ground. And those actions could result in an escalation of the conflict that could be quite worrisome. It is for those reasons that NATO Secretary General Jens Stoltenberg and President Joe Biden, among other NATO leaders, are understandably unwilling to commit to such a mission.

OR: Are you worried that Washington may nonetheless feel pressured into imposing a no-fly zone?

Petraeus: It seems pretty clear that President Biden is not willing to reconsider his decision. In the absence of that, what Ukraine really seems to need right now is more air-defense assets, ideally ones that can not only shoot down aircraft flying higher than Stingers can engage but also take out missiles and rockets. Reportedly, additional air-defense assets are now on their way to Ukraine. I would love to see additional aircraft provided, if that could be done quietly and relatively clandestinely.

OR: How should NATO respond if Russia uses weapons of mass destruction in Ukraine?

Petraeus: Severely. But NATO should not publicly detail precisely what its response would be, since that response is impossible to decide on in advance given the myriad possible contexts.

OR: How, if at all, should the Biden administration increase its military support for Ukraine?

Petraeus: More air defense assets—and from all NATO nations, not just the United States. And many more than the 100 Switchblade “suicide drones” being provided, including ones with larger warheads that can wreak havoc on vehicles. The Switchblades could be a game-changer if provided swiftly and in sufficient numbers.

OR: How real is the threat that Putin will retaliate against the West for its support of Ukraine? We’re seeing more and more stories about Western fears of Putin lashing out, but those strike me as a bit far-fetched.

Petraeus: It’s very hard to say. The chances are certainly greater than zero at this point, but still quite low, as the last thing Putin needs is a fight on another front and even greater NATO unity. Nonetheless, given Russia’s nuclear arsenal and Putin’s saber-rattling a couple of weeks ago, this danger has to give pause to those sitting in the situation rooms of NATO nations.

OR: What else can NATO and the United States do to respond to Russia?

Petraeus: We haven’t yet discussed the unprecedented economic sanctions that have been imposed and the enormous financial actions that have been taken, nor the withdrawal of hundreds of Western companies from Russia. These have all been generated very swiftly, and more such actions are being taken every day. They could, over time, prove the decisive element in the strategic battle of attrition between Moscow and Kyiv, even as the physical battlefield has settled into a bloody stalemate.

OR: What are the parallels between the Russian war in Ukraine and the U.S. wars in Iraq and Afghanistan, and what should those parallels teach us?

Petraeus: Clearly each of those wars demonstrates the importance of leadership at every level, especially at the top. But the contexts of each of the wars is unique and very different. That makes it very difficult to say, for example, whether an Afghan version of President Volodymyr Zelensky could have galvanized and led the Afghan forces and people in mounting a coherent, determined defense against the Taliban without U.S. air power—and, critically, without the thousands of western contractors who, until the U.S. withdrawal, were maintaining the sophisticated U.S. planes and helicopters we provided to the Afghan Air Force.

Ukraine also reaffirms what we revalidated in Iraq and Afghanistan: that hearts and minds do matter. We were applauded when we invaded Iraq and toppled the murderous kleptocratic regime of Saddam Hussein. And even in the toughest days that followed, the vast majority of the Iraqi population was at least tolerant of the Western presence—and became supportive again when the Surge [President George W. Bush’s 2007 troop increase] restored security and pulled the country back from a Sunni-Shia civil war. The same was largely true in Afghanistan, where the Taliban regime was not loved and where many of the people celebrated their toppling by playing music, shaving their beards, and sending their girls to school.

In contrast, I can’t imagine the extraordinary challenges the Russians face in Ukraine: invading a country where virtually everyone hates you and many of the adults are trying to kill you. With every additional civilian life lost, the Russians only make their task more difficult.

OR: How linear and consistent is fighting in a war? Will Ukraine be a continual slogging battle of attrition until one side is ground down, or will one side’s military capabilities and/or will to fight simply crack at some point, causing a relatively sudden phase change? If the latter, what are the precursors to look for?

Petraeus: It’s always hard to tell when an enemy is about to crack. If Russia’s reported losses of troops, weapons systems, and vehicles are not wildly inflated, however, there may already be a number of Russian units that are combat ineffective, and there have to be others on the edge of becoming ineffective. That points to challenges overall in the weeks ahead, particularly for those Russian units under pressure, such as those around Kyiv and Kharkiv. Units elsewhere are likely are in somewhat better shape and will continue to fight, unless logistics shortfalls undermine their ability to do so.

At the end of the day, though, the real battle is the one between the leaders of Ukraine and Russia. And I suspect that the losses, damage, destruction, and displacement of people will ultimately lead both President Zelensky and President Putin to make compromises that, before the invasion, would not have been acceptable to either. The question is how long that will take.

From a BCA Research Special Report on Friday:

The Geopolitical Consequences Of The Ukraine War

Two weeks ago our Global Investment Strategy service wrote a report called “The Economic And Financial Consequences Of The War In Ukraine,” (which we shared) arguing that while the war’s impact on commodity markets and financial conditions would be significant, the global economy would continue to grow and equity prices would rise over the coming 12 months.

This companion special report will consider the geopolitical consequences of the Ukraine war. The primary consequence is that “Great Power Struggle” will intensify, as the return of war to Europe will force even the

most pacific countries like Germany and Japan to pursue their national security with fewer illusions about the capacity for global cooperation. Globalization will continue to decay into “Hypo-Globalization” or regionalism, as the US severs ties with Russia and China and encourages its allies to do the same.

Specifically, Germany will ultimately cleave to the West, China will ultimately cleave to Russia, a new shatter-belt will emerge from East Europe to the Middle East to East Asia

Global Versus Regional Wars

Russia’s invasion of Ukraine is a continuation of a regional war that started in 2014. The war has been contained within Ukraine since 2014 and the latest expansion of the war is also contained so far.

The war broke out because ~~Russia~~ Putin views a western-allied Ukraine as an intolerable threat to ~~its national~~ his security. Its historic grand strategy (In our view this framing is unhelpful in understanding why Putin's Russia invaded Ukraine, although the Geopolitical consequences contained in this report are the likely result.) calls for buffer space against western military forces. Moscow feared that time would only deepen Ukraine’s bonds with the West, making military intervention difficult now but impossible in the future. As long as Russia fails to neutralize Ukraine in a military-strategic sense, the war will continue. President Putin cannot accept defeat or the current stalemate and will likely intensify the war until he can declare victory, at least on the goal of “de-militarization” of Ukraine.

So far Ukraine’s battlefield successes and military support from NATO make a Russian victory unlikely, portending further war. If Ukraine and Russia provide each other with acceptable security guarantees, an early ceasefire is possible. But up to now Ukraine is unwilling to accept de-militarization and the loss of Crimea and the Donbass, which are core Russian demands (**Map 1**).

Russia’s invasion of Ukraine has caused a spike in the global geopolitical risk The spike confirms that geopolitical risk is on a secular upward trend. The trough occurred after the fall of the Soviet Union when the world enjoyed relative peace and prosperity. The new trend began with the September 11, 2001 terrorist attacks and the US’s preemptive invasion of Iraq. This war initiated a fateful sequence in which the US became divided and distracted, Russia and China seized the opportunity to rebuild their spheres of influence, and international stability began to decline.

Now Russia’s invasion of Ukraine presents an opportunity for the US and its allies to rediscover their core national interests and the importance of collective security. This implies increasing strategic pressure not only on Russia but also on China and their ragtag group of allies, including Iran, Pakistan, and North Korea. The world will become even less stable in this context.

Still, Russia will not expand the Ukraine war to other states unless it faces regime collapse and grows desperate. The war is manifestly a stretch for Russia’s military capabilities and a larger war would weaken rather than strengthen Russia’s national security. NATO utterly overwhelms Russia’s military capacity, even if we are exceedingly generous and assume that China offers full military support along with the rest of the Shanghai Cooperation Organization (**Chart 2**). As things stand Russia still has the hope of reducing Ukraine without

MAP 1
Russian Invasion Of Ukraine, 2022



SOURCE: EVAN CENTANNI AND DJORDJE DJUKIC, WWW.POLGEONOW.COM

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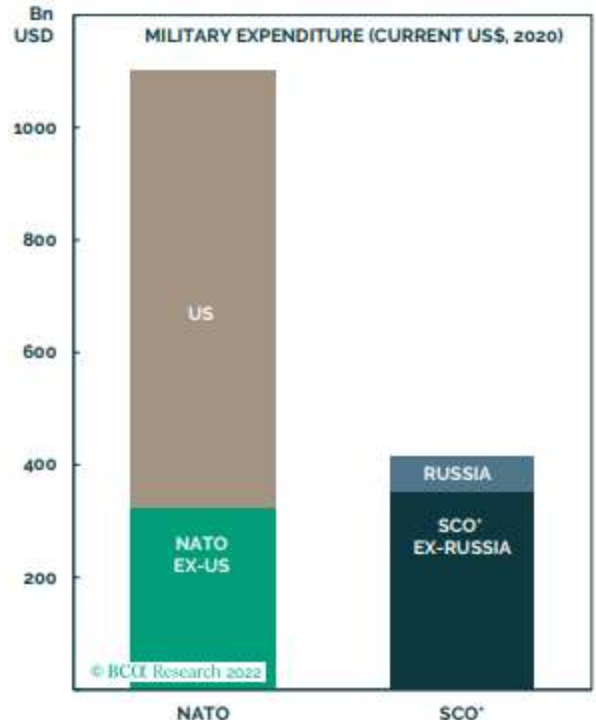
destroying its economic foundation, i.e. commodity exports. ...

None of the great powers are willing or forced to wage war with Russia directly. The US and UK are the most removed and hence most aggressive in arming Ukraine but they are still avoiding direct involvement: they have repeatedly renounced any intention of committing troops or imposing a no-fly zone over Ukraine and they are still limiting the quality of their defense aid for fear of Russian reprisals. The EU is even more keen to avoid a larger war. Germany and France are still attempting to maintain basic level of economic integration with Russia. China is not likely to enter the war on Russia's behalf – it will assist Russia as far as it can without breaking economic relations with Europe.

The war's limitations are positive for global investors but only marginally. The law that governs the history of war is the law of unintended consequences. Investors should absolutely worry about unintended consequences, even as they strive to be clear-headed about Russia's limited means and ends.

If Russia fails or grows desperate, if it makes mistakes or miscalculates, if the US is unresponsive and aggressive, or if

CHART 2
Russian War Aims Limited



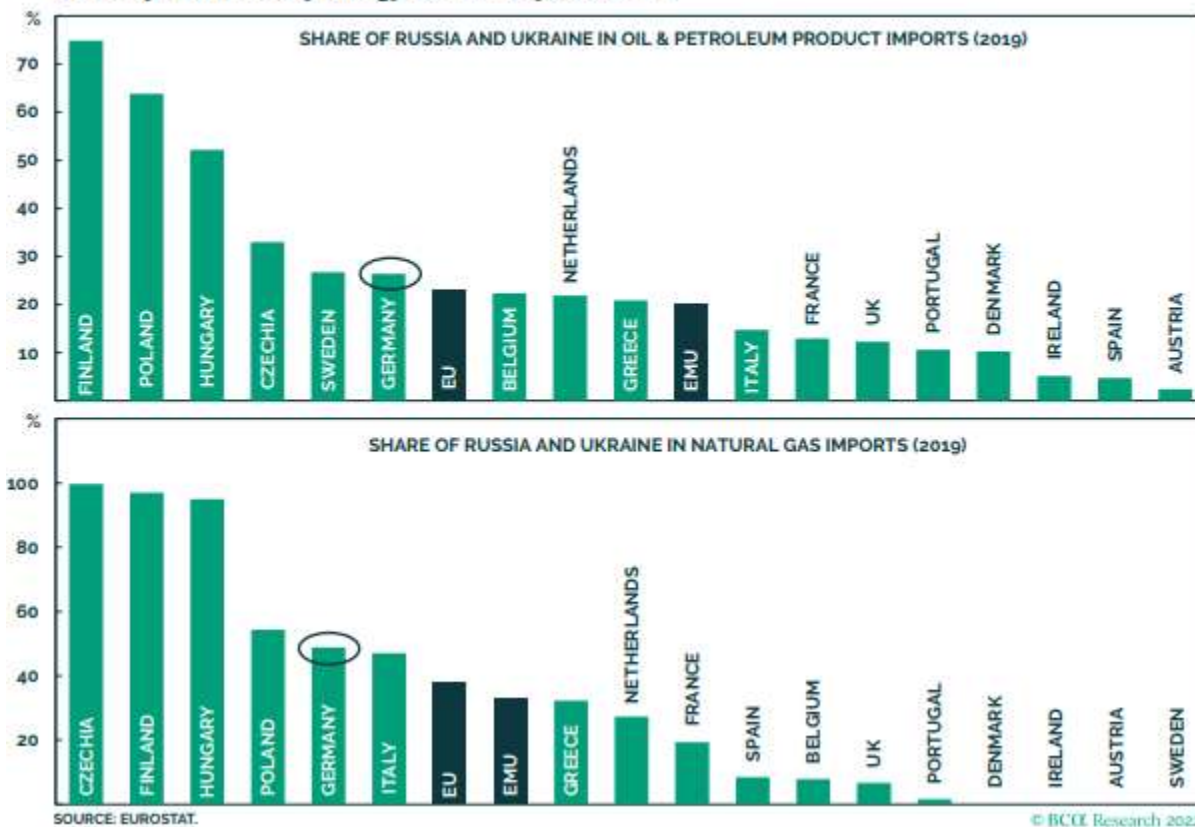
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* SHANGHAI COOPERATION ORGANIZATION. INCLUDES FOUR OBSERVER STATES: AFGHANISTAN, IRAN, BELARUS, AND MONGOLIA. SOURCE: WORLD BANK AND SIPRI.

lesser powers attempt to provoke greater American or European security guarantees, then the war could spiral out of control. This risk should keep every investor alive to the need to maintain a reasonable allocation to safe-haven assets.

If not, the end-game is likely a deliberate or de facto partition of Ukraine, with Russia succeeding in stripping Crimea and the Donbass from Ukraine, destroying most of its formal military capacity, and possibly installing a pro-Russian government in Kyiv. Western Ukraine will become the seat of a government in exile as well as the source of arms and materiel for the militant insurgency that will burn in eastern Ukraine. Over the course of this year Russia is likely to redouble its efforts to achieve its aims – a summer or fall campaign is likely to try to break Ukraine’s resistance. But if and when commodity revenues dry up or Russia’s economic burden becomes unbearable, then it will most likely opt for ceasefire and use Ukrainian military losses as proof of its success in de-militarizing the country.

CHART 4
Germany Will Diversify Energy But Not Boycott Russia



Why Germany Will Play Both Sides But Ultimately Cleave To The West

A critical factor in limiting the war to Ukraine is Europe’s continued energy trade with Russia. If either Russia or Europe cuts off energy flows then it will cause an economic crash that will destabilize the societies and increase the risk of military miscalculation.

German Chancellor Olaf Scholz once again rejected a European boycott of Russian energy on March 23, while US President Joe Biden visited and urged Europe to intensify sanctions. Scholz argued that no sanctions can be adopted that would hurt European consumers more than the Kremlin. Scholz’s comments related to oil as well as natural gas, although Europe has greater ability to boycott oil, implying that further oil supply tightening should be expected.

Germany is not the only European power that will refuse an outright boycott of Russian energy. Russia's closest neighbors are highly reliant on Russian oil and gas (**Chart 4**). It only takes a single member to veto EU sanctions. While several western private companies are eschewing business with Russia, other companies will pick up the slack and charge a premium to trade in Russian goods.

Germany's insistence on maintaining a basic level of economic integration with Russia stems from its national interest.

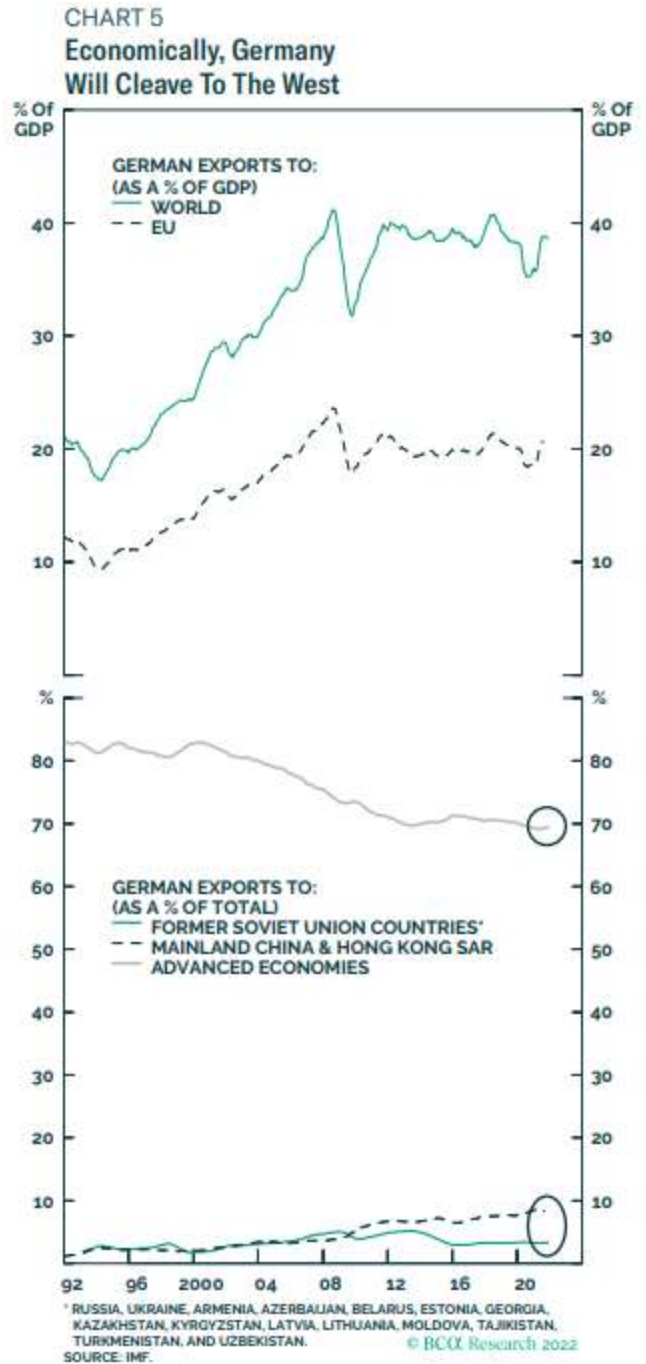
During the last Cold War, Germany got dismembered. Germany's whole history consists of a quest for unification and continental European empire. Modern Germany is as close to that goal as possible. What could shatter this achievement would be a severe recession that would divide the European Union, or a war in Europe that would put Germans on the front lines. An expansion of the US sanction regime to cover all of Russia and China would initiate a new cold war and Germany's economic model would collapse due to restrictions on both the import and export side.

Germany's strategy has been to maintain security through its alliance with America while retaining independence and prosperity through economic engagement with Russia and China. The Russia side of that equation has been curtailed since 2014 and will now be sharply curtailed. Germany has also been increasing military spending, in a historic shift that echoes Japan's strategic reawakening over the past decade in face of Chinese security competition.

But Germany will be extremely wary of doing anything to accelerate the process of economic disengagement with China. China does not pose a clear and present military threat to Germany, though its attempt to move up the manufacturing value chain poses an economic threat over time. As long as China does not provide outright military support for Russia's efforts in Ukraine, and does not adopt Russia's belligerence against neighboring democracies like Taiwan, Germany will avoid imposing sanctions.

This stance will not be a major problem with the US under the Biden administration, which is prioritizing solidarity with the allies, but it could become a major problem in a future Republican administration, which will seek to ramp up the strategic pressure on China.

Ultimately, however, Germany will cleave to the West. Germany is undertaking a revolution in fiscal policy to increase domestic demand and reduce export dependency.



Meanwhile its export-driven economy is primarily geared toward other developed markets, which rake up 70% of German exports (78% of which go to other EU members). China and the former Soviet Union pale in comparison, at 8% and 3% respectively (**Chart 5**).

From a national security perspective Germany will also be forced to cleave to the United States. NATO vastly outweighs Russia in the military balance. But Russia vastly outweighs Germany. The poor performance of Russia's military in Ukraine will not console the Germans given Russian instability, belligerence, and nuclear status. Germany has no choice but to rely on the US and NATO for national security.

If the US conflict with China escalates to the point that the US demands Germany carry a greater economic cost, then Germany will eventually be forced to yield. But this shift will not occur if driven by American whim – it will only occur if driven by Chinese aggression and alliance with Russia. Which brings us to our next point: China will also strive to retain its economic relationship with Germany and Europe.

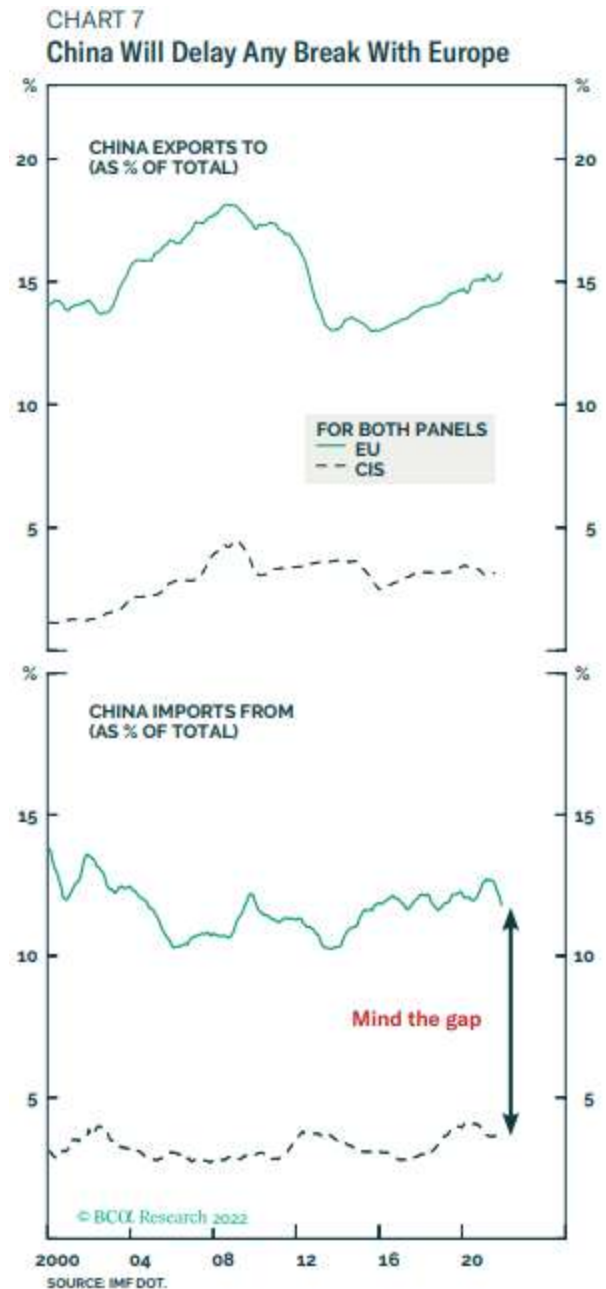
Why China Will Play Both Sides But Ultimately Cleave To Russia

The US ... will continue to penalize China's economy. Washington aims to erode the foundations of China's military and technological might so that it cannot create a regional empire and someday challenge the US globally. Chinese cooperation with other US rivals will provide more occasions for the US to punish China. For example, Presidents Biden and Xi Jinping talked on March 18 and Biden formally threatened China with punitive measures if Beijing provides Russia with military aid or helps Russia bypass US sanctions. Since China will help Russia bypass sanctions, US sanctions on China are likely this year, sooner or later.

Europe thus becomes all the more important to China as a strategic partner, an export market, and a source of high-quality imports and technology. China needs to retain close relations as long as possible to avoid a catastrophic economic adjustment. Europe is three times larger of an export market for China than Russia and the former Soviet Union (**Chart 7**).

When push comes to shove, however, China cannot afford to reject Russia. Russia's decision to break ties with Europe reflects the Putin regime's assessment that the country cannot preserve its national security against the West without allying with China. Ultimately Russia offers many of the strategic benefits that China needs. Most obviously, if China is ever forced into a military confrontation with the West, say over the status of Taiwan, it will need Russian assistance, just as Russia needs its assistance today.

China's single greatest vulnerability is its reliance on oil imported from the Persian Gulf, which is susceptible to



American naval interdiction in the event of conflict. Russia and Central Asia form the second largest source of food, energy, and metals for China (**Chart 8**). Russia provides an overland route to the supply security that China craves.

Russia also wields immense influence in Central Asia and significant influence in the Middle East. These are the critical regions for China's Eurasian strategy, symbolized in the Belt and Road Initiative. Chinese investment in the former Soviet Union has lagged its investment in the Middle East and the rest of Asia but the Ukraine war will change that. China will have an historic opportunity to invest in the former Soviet Union, on favorable terms, to secure strategic access all the way to the Middle East.

China will always prioritize its East Asian neighbors as investment destinations but it will also need alternatives as the US will inevitably seek to upgrade relations with Southeast Asia.

Another reason China must accept Russia's overtures is that China is aware that it would be strategically isolated if the West pulled off a "Reverse Kissinger" maneuver and allied with Russia. This option seems far-fetched today but when President Putin dies or is overthrown it will become a fear for the Chinese. There has never been deep trust between the Chinese and Russians and the future Russian elite may reject the idea of vassalage to China. Therefore just as Russia needs China today, China will need Russia in the future.

Why The Middle East Will Rumble Again

The Middle East is destabilizing once again and Russia's invasion of Ukraine will reinforce this trajectory. Most directly, the reduction in grain exports from Russia and Ukraine will have a disproportionate impact on food supplies and prices in countries like Pakistan, Turkey, Egypt, Libya, and Lebanon (**Chart 10**).

A new shatter-belt will take shape not only in Russia's and China's neighborhood, as they seek to establish spheres of influence, but also in the Middle East, which becomes more important to Europe as Europe diversifies away from Russia.

Part of the strategic purpose of Russia's invasion is to gain greater naval access to the Black Sea and Mediterranean, and hence to expand its ability to project power across the Middle East and North Africa. This is both for general strategic purposes and to gain greater leverage over Europe via its non-Russian energy and supply sources.

The critical strategic factor in the Middle East is the US-Iran relationship. If the two sides arrange a strategic détente, then Iranian oil reserves will be developed, the risk of Iraqi civil war will decline, and the risk of

CHART 8
China Cannot
Reject Russia

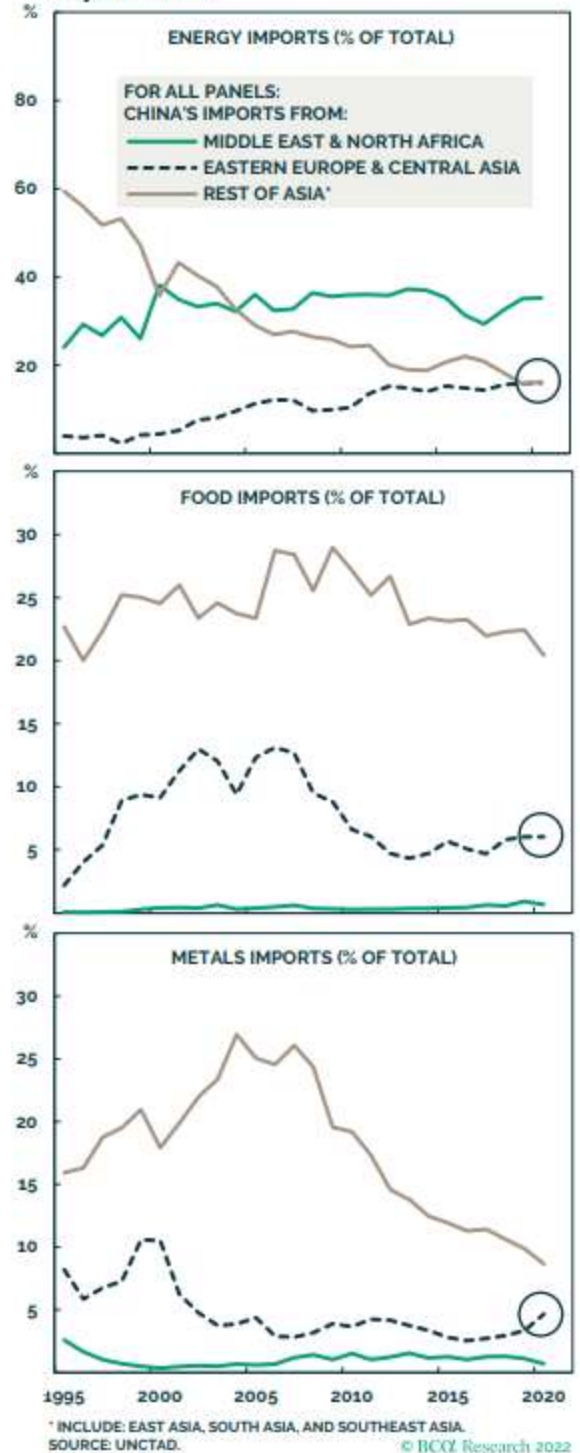
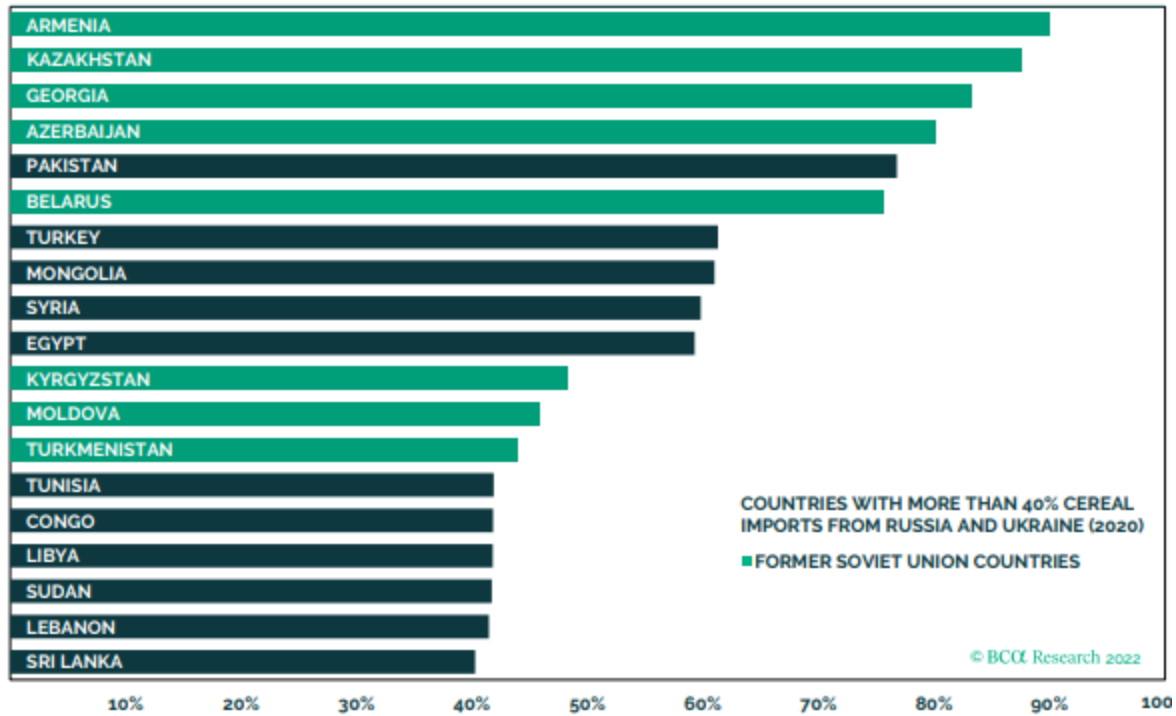


CHART 10
A New Shatter-Belt Emerging



SOURCE: UNCTAD.

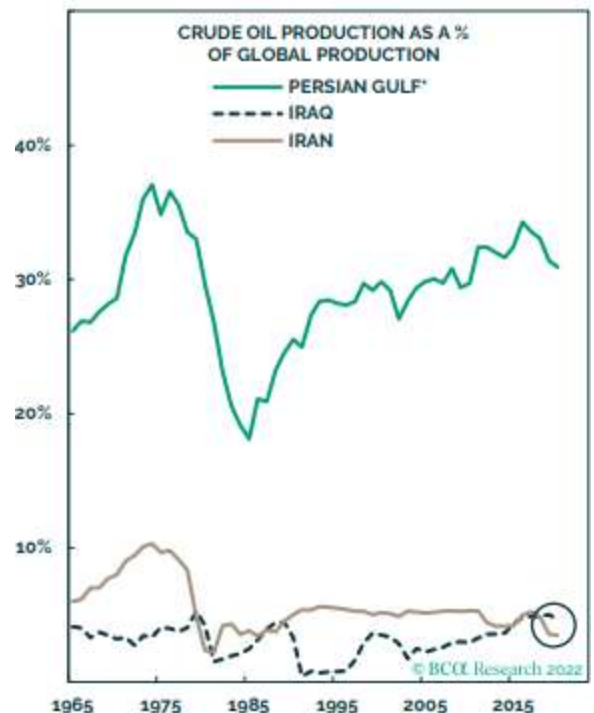
general war in the Middle East will decline. This would be an important reduction of oil supply risk in the short and medium term (**Chart 11**). But our base case is the opposite: we expect either no deal, or a flimsy deal that does not truly reduce regional tensions.

A US-Iran nuclear deal might come together soon – we cannot rule it out. The Biden administration is willing to lift sanctions if Iran freezes its nuclear program and pledges to reduce its militant activities in the region. Biden has reportedly even provided Russia with guarantees that it can continue trading with Iran. Theoretically the US and Russia can cooperate to prevent Iran from getting nuclear weapons. Russia’s pound of flesh is that Ukraine be neutralized as a national security threat. However, any US-Iran deal will be a short-term, stop-gap measure that will fall short of a strategic détente.

Iran is an impregnable mountain fortress and has a distinct national interest in obtaining deliverable nuclear weapons. Iran will not give up the pursuit of nuclear weapons because it cannot rely on other powers for its security. Iran obviously cannot rely on the United States, as any security guarantees could be overturned with the next party change in the White House. Tehran cannot rely on the US to prevent Israel from attacking it.

Therefore Iran must pursue its own national survival and security through the same means as the North Koreans. It must avoid the predicaments of Ukraine, Libya, and Iraq, which never obtained nuclear weaponization and were ultimately invaded.

CHART 11
Middle East Still Unstable, Still Essential



* INCLUDES IRAN, IRAQ, KUWAIT, OMAN, QATAR, SAUDI ARABIA, AND UNITED ARAB EMIRATES.
SOURCE: BP STATISTICAL REVIEW OF WORLD ENERGY 2021.

Insofar as Iran wants to avoid isolation, it needs to ally with Russia and China, it cannot embark on a foreign policy revolution of engagement with the West. The Russians and Chinese are unreliable but at least they have an interest in undermining the United States. The more the US is undermined, the more of a chance Iran has to make progress toward nuclear weapons without being subject to a future US attack.

Of course, the US and Israel have declared that nuclear weaponization is a red line. Israel is willing to attack Iran whereas Japan was not willing to attack North Korea – and where there is a will there is a way. But Iran may also believe that Israel would be unsuccessful. It would be an extremely difficult operation. The US has not shown willingness to attack states to prevent them from going nuclear. A split between the US and Israel would be an excellent foreign policy achievement for Tehran.

The US may desire to pivot away from the Middle East to focus on containing Russia and China. But the Middle East is critical territory for that same containment policy. If the US abandons the region, it will become less stable until a new security order emerges. If the US stays involved in the region, it will be to contain Iran aggressively or prevent it from acquiring nuclear weapons by force. Whatever happens, the region faces instability in the coming decade and the world faces oil supply disruptions as a result. Iran has significant leverage due to its ability to shutter the Strait of Hormuz, the world's premier oil chokepoint (**Chart 12**).

Why A Fourth Taiwan Strait Crisis Looms

There is a valid analogy between Ukraine and Taiwan: both receive western military support, hence both pose a fundamental threat to the national security of Russia and China. Yet both lack a mutual defense treaty that obligates the US alliance to come to their defense. This predicament led to war in Ukraine and the odds of an eventual war in Taiwan will go up for the same reason.

In the past, China could not prevent the US from arming Taiwan. But it is increasingly gaining the ability to take Taiwan by force and deter the US from military intervention. The US is slated to deliver at least \$8.6 billion worth of arms by 2026, a substantial increase in arms sales reminiscent of the 1990s, when the Third Taiwan Strait Crisis occurred (**Chart 13**).

The US will learn from Russian aggression that it needs to improve its vigilance and deterrence against China over Taiwan. China will view this American response as

CHART 12
Iran's Other Nuclear Option

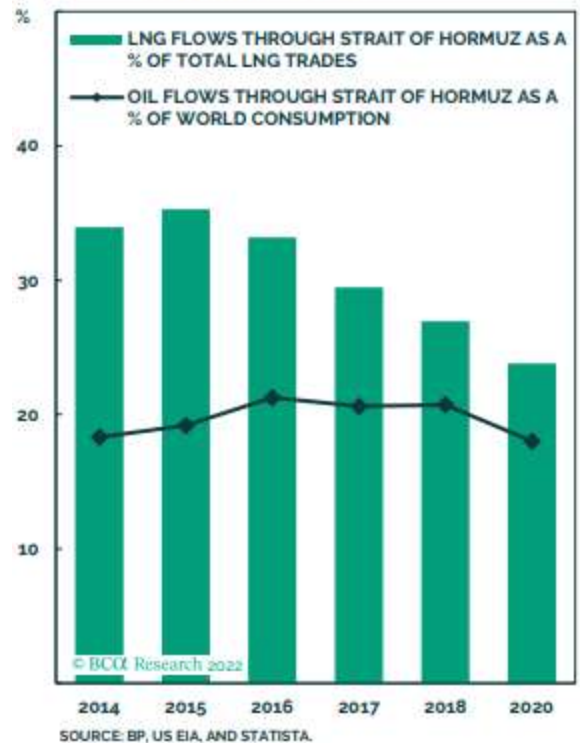
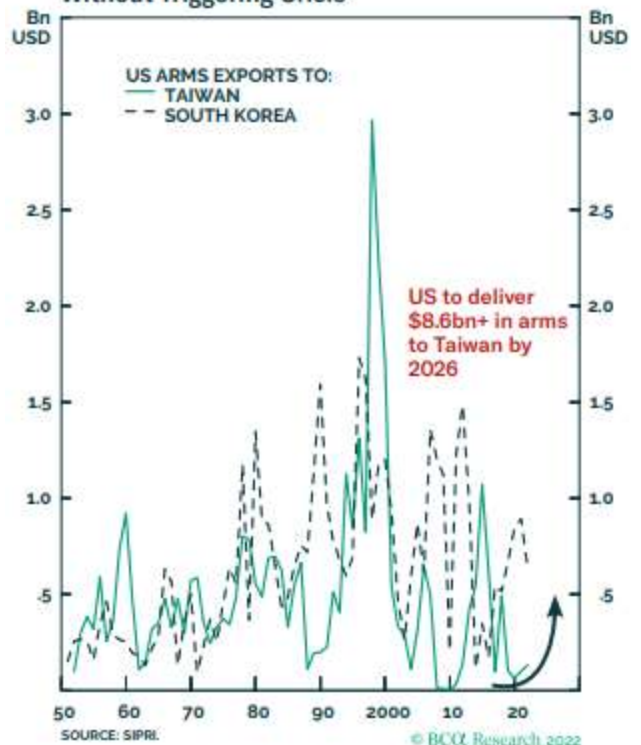


CHART 13
US Cannot Deter China
Without Triggering Crisis



disproportionate and unfair given that China did nothing to Ukraine.

China is probably just capable of defeating Taiwan in a war but Beijing has powerful economic and political incentives not to take such an enormous risk today, on Russia's time frame. However, if the 2022-24 election cycle in Taiwan returns the nominally pro-independence Democratic Progressive Party to power, then China may begin to conclude that peaceful reunification will be politically unachievable. Already it is clear from the steady course of Taiwanese opinion since the Great Recession that China is failing to absorb Taiwan through economic attraction (**Chart 14**). As China's trend economic growth falters, it will face greater sociopolitical instability at home and an even less compelling case for Taiwan to accept absorption. This will be a very dangerous strategic environment.

Taiwan is the epicenter of the US-China strategic competition, which is the primary geopolitical competition of the century because China has stronger economic foundations than Russia. China will become even more of a threat to the US if fortified by Russian alliance – and China's fears over US support for Taiwan necessitate that alliance.

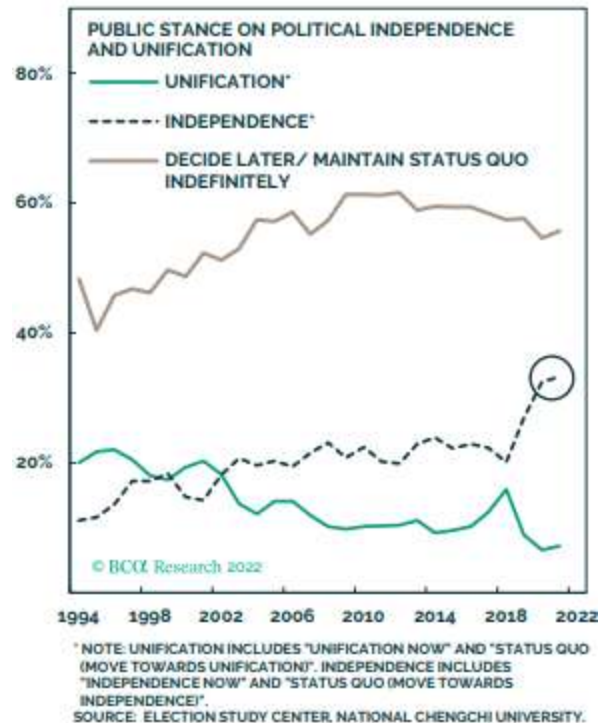
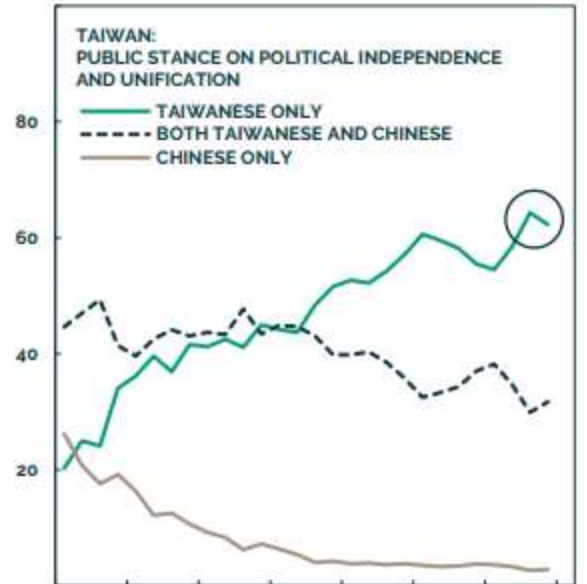
The US

None of the headline geopolitical risks outlined above – NATO-Russia war, Israeli-Iranian war, or Sino-Taiwanese war – would be as great of risks if the United States could be relied on to play a stable and predictable role as the world's leading power. The problem is that the US is divided internally, which has led to erratic and at times belligerent foreign policy, thus feeding the paranoia of US rivals and encouraging self-interested and hawkish foreign policies, and hence global instability.

It seems likely that US political polarization will remain at historic peaks over the 2022-24 election cycle. The Ukraine war will probably feed polarization by adding to the Democratic Party's woes. Inflation and energy prices have already generated high odds that Republicans will retake control of Congress. But midterm churn is standard political clockwork in the US. The bigger risk is stagflation or even recession, which could produce another diametric reversal of White House policy over a mere four-year period.

Former President Donald Trump is favored to be the Republican presidential nominee in 2024 – he is anathema to the left wing and unorthodox and aggressive in his foreign and trade policies. If he is reelected, it will be destabilizing both at home and abroad. But even if Trump is not the candidate, the US is flirting with disaster due to polarization and uncertainties regarding the constitution and electoral system.

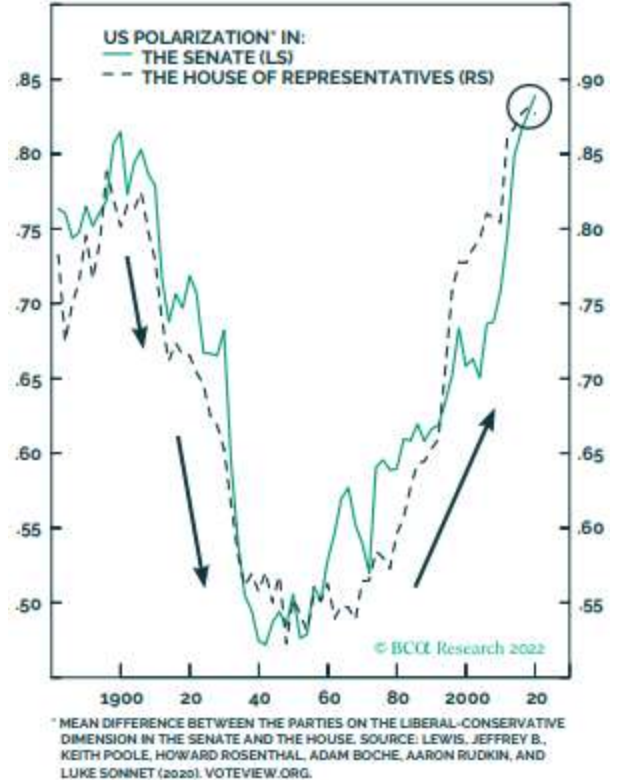
CHART 14
Taiwanese Opinion Hard To Reconcile With Mainland Rule



US polarization is rooted in ethnic, ideological, regional, and economic disparities that have congealed into pseudo-tribalism. The potential for domestic terrorism of whatever stripe is high. ... In the event of a series of negative economic shocks and/or constitutional breakdown, US political instability could get much worse than what was witnessed in 2020-21, when the country saw large-scale social unrest, a contested election, and a rebellion at the Capitol.

Yet we would take the other side of the bet. US polarization will likely peak in the coming decade, if it has not peaked already. The US has been extremely polarized since the election of 1800, but polarization collapsed during World War I, the Great Depression, and World War II. True, it rose during the Cold War, but it only really ignited during the Reagan revolution and economic boom of the 1980s, when wealth inequality soared and the Soviet Union collapsed (**Chart 16**). The return of proactive fiscal policy and serious national security threats will likely drive polarization down going forward.

CHART 16
Yet US Polarization Is Peaking ...
Aided By Foreign Threats



Investment Takeaways

- The good news is that the war in Ukraine is unlikely to spread to the rest of Europe and engender World War III. The bad news is that the risk of such a war has not been higher for decades. ...
- Europe and China will strive to maintain their economic relationship, which will delay a total breakdown in East-West relations. However, Germany and Europe will ultimately cleave to the US, while China will ultimately cleave to Russia, and the pace of transition into a new bifurcated world will accelerate depending on events.
- If the energy shock escalates to the point of triggering a European or global economic crash, the pace of strategic confrontation will accelerate.
- The global peace that emerged in 1945 is encountering very significant strains comparable to the most precarious moments of the Cold War. The Cold War period was not peaceful everywhere but the US and USSR avoided World War III. They did so on the basis of the peace settlement of 1945.
- The reason the 1945 peace regime is decaying is because the US, the preponderant power, is capable of achieving global hegemony, which is threatening to other great powers. The US combines the greatest share of wealth and military power and no single power can resist it. Yet a number of powers are capable of challenging and undermining it, namely China, but also Russia in a military sense, as well as lesser powers. The US is internally divided and struggling to maintain its power and prestige.
- The result is a return to the normal, anarchic structure of international relations throughout history. Several powerful states are competing for national security in a world that lacks overarching law. Great Power struggle is here to stay. Investors must adjust their portfolios to keep them in tune with foreign policies – in addition to monetary and fiscal policies. ...