

The geopolitical outlook for 2024

By Angelo Katsoras

Introduction

Heading into the New Year, the world will be grappling with a number of geopolitical issues. These include the current conflicts in Ukraine and the Middle East and upcoming elections in the United States, Taiwan, India, and Mexico. The ongoing rivalry between the United States and China, growing government intervention in the economy, mounting debt, and higher interest rates add to these challenges.

November 2024 U.S. elections

Setting aside the pronounced partisan divide that characterizes the U.S. political landscape, what is most unusual about this election is that polls show that most Americans are not in favour of,¹ or have reservations,² about the potential candidacies of former President Trump and President Biden.

As for Nikki Haley or Ron DeSantis winning the Republican primary against Donald Trump, their slim chances depend on how well they do in Iowa and New Hampshire. Following strong performances, one of them might be able to persuade all the other candidates to drop out of the race early, leaving only one person to go head-to-head with Donald Trump.

U.S. presidential elections are often closely contested affairs, and the losing side may find it difficult to accept the outcome. This time around, this risk is exacerbated by what some people call the criminalization of political differences, where the partisans of each political party accuse the other side of corruption while ignoring their own transgressions.

If a Republican wins the presidential election, certain green policies would be reversed by executive order and later by legislation if they were to gain control of both houses of Congress. Also, Ukraine would come under greater pressure to negotiate with the Russians (more on this later).

Despite the significant differences between Democrats and Republicans, they are aligned in certain key areas. For example, neither Biden nor Trump would make significant spending cuts unless forced to do so. They also share a protectionist stance on trade, particularly when it comes to China. The U.S.-China tech war, which really began in 2019, when Trump banned the sale of high-end chips to Huawei, was escalated by Biden in 2022 when he severely restricted the sale of advanced semiconductors to all Chinese companies.

Russia-Ukraine war

Ukraine will increasingly be fighting two battles in 2024. On the one hand, it will keep trying to break the stalemate on the ground and advance on heavily entrenched Russian defences. On the other, it will strive to convince the West to continue its financial and military support. These challenges are compounded by the West's inability in the short term to ramp up military production of certain weapons, particularly artillery shells. The war between Israel and Hamas has tightened the supply of certain weapons even more.

While we believe that further aid to Ukraine will eventually be approved by both the United States and the European Union, we also predict that Ukraine will face increased Western pressure to adopt a more defensive posture in the war and enter into negotiations with Russia.

Any settlement would likely result in a "frozen conflict" rather than a formal peace, with Russia retaining control of occupied territories. The prospects of relations between the West and Russia being restored and of sanctions being lifted would be virtually non-existent. Europe would continue to shift supply chains, especially in the energy sector, away from Russia, while Moscow would keep on redirecting trade flows away from Europe, including building infrastructure to sell oil and gas to China and other Asian countries.

¹ "NBC News poll: Nearly 70% of GOP voters stand behind Trump amid indictment and investigations," NBC, April 23, 2023

² "Poll: Overwhelming majorities express concerns about Biden, Trump ahead of 2024 race," NBC, September 24, 2023

Israel-Hamas war

The prevailing view is that the Israel-Hamas conflict will remain confined to the Gaza Strip and will not spread elsewhere. However, there is a significant risk that the longer the conflict lasts, the more it will destabilize the region and spill over into other countries, such as Lebanon.

While we deem it unlikely that Iran will get involved in the war directly, it may escalate the conflict via proxies. This could entail heightened artillery exchanges with Hezbollah in Lebanon and increased threats to shipping. Iran-backed Houthi fighters in Yemen have already launched several attacks on commercial vessels in the Red Sea with ballistic missiles and armed drones.

The risk of conflict escalation is further highlighted by the more than 85 missile and drone attacks on American bases in Iraq and Syria since October 7, reportedly resulting in minor injuries to several dozen U.S. troops. A strong U.S. response would be inevitable if soldiers are killed in future attacks. This, in turn, could trigger a cycle of increasingly harsh responses and counter-responses.

China's challenges

China faces many economic challenges in 2024. Manufacturing activity is contracting, the housing sector (which accounts for about one-fifth of the economy) continues to struggle, and foreign investment has turned negative for the first time since records began in 1998.

While it enjoys significant advantages in key areas such as green energy and electric vehicles, China also faces the challenge of significant overcapacity in these same areas. A recent article in the New York Times illustrated the magnitude of this problem very well: "China has already built enough solar panel factories to supply the entire world's needs. It has built enough auto factories to make every car sold in China, Europe and the United States. And by the end of 2024, China will have built in just five years as many petrochemical factories as all of those now running in Europe plus Japan and South Korea."³

China will undoubtedly seek to export its excess capacity. However, this is likely to heighten trade tensions with many major countries and potentially trigger another wave of tariffs.

China-U.S. tensions

While many analysts breathed a sigh of relief that the recent face-to-face meeting between leaders Biden and Xi appeared to lower the temperature between the two superpowers, it has not fundamentally changed the dynamic between them. In 2024, tensions between China and the United States will continue to be driven by a combination of factors, including a great power rivalry, radically different economic/governance models and, most importantly, lack of trust. This makes it almost inevitable that U.S. and Chinese companies that are heavily dependent on each other's markets in sectors deemed strategic will eventually lose market share.

For example, America will continue to use export controls to limit China's development of advanced semiconductors and artificial intelligence. Similarly, China is likely to use export controls on certain minerals and green technology for the same purpose.

In a nutshell, the United States suspects that China's ambition is to acquire U.S. technology and become the world's leading geopolitical power. Conversely, China perceives the United States as seeking not only to expand its access to the Chinese market but also to contain China's rise as a global power. Since both are at least partially right, this rivalry is not likely to end any time soon.

Taiwan

Taiwan's presidential election on January 13 will be one of the most closely watched in 2024. The ruling Democratic Progressive Party (DPP) and the opposition Kuomintang (KMT) present very different strategies for dealing with China. The DPP advocates strengthening ties with America and its allies while building a military deterrent. Conversely, the KMT pledges to focus on reducing tensions by reopening a dialogue with China. Currently, the incumbent DPP is ahead in the polls.

If the DPP manages to win, we believe that, unless Taiwan declares independence, China's strategy of increasing pressure will be limited to staging aggressive military exercises, targeting selective Taiwanese business operations on the mainland, and imposing trade sanctions.

³ "More Semiconductors, Less Housing: China's New Economic Plan," New York Times, November 6, 2023

Finally, it is important to recognize that, regardless of the outcome of the election, the Taiwan issue will remain unresolved in the near future. It will therefore remain a key factor driving the gradual shift of semiconductor supply chains away from Taiwan.

Europe

In 2024, Europe will continue to be burdened by some of the highest gas and electricity prices in the world, a weak economy, and overly burdensome regulations. This places European companies at a significant competitive disadvantage to their international peers and increases the likelihood that more companies will move their operations overseas.

Germany is a case in point. According to the German Institute for Economic Research, the gap between German companies investing abroad and foreign investment in Germany was at an all-time high in 2022. That year, Germany saw a significant outflow of more than €135 billion in foreign direct investment, while attracting a meager €10.5 billion in return. Given that Germany is Europe's leading economy, its struggles cast a shadow over Europe's economic outlook.

On the political front, these economic difficulties will translate into the continued erosion of support for current European governments. The Conservative government in the UK, which is currently trailing the opposition Labor Party by more than 20 points, is a prime candidate to be voted out of power. A general election is widely expected in the fall of 2024. At the same time, we foresee that support for traditional mainstream parties in continental Europe will continue to decline in favour of parties on the far left and right of the political spectrum.

India

Indian Prime Minister Modi's first two terms have seen significant economic reforms and infrastructure improvements that have boosted the country's growth. Its economy has grown from the tenth to the fifth largest in the world over this period.⁴

The likelihood of Modi being re-elected and of his BJP party holding on to both chambers of parliament is high. The upcoming elections will be spread over six weeks across April and May in order to manage the logistics of mobilizing the world's largest electorate of about 900 million voters.

India's growing economy, China's economic missteps (i.e., increasing government control of private sector companies), and geopolitical tensions are among the driving forces making India an important part of America's and the West's plans to gradually wean global supply chains from China.

Finally, given India's strategic role as a geopolitical counterweight to China and its rapidly expanding market amid a slowing global economy, it has simply become too important to get angry. This means, among other things, that India can violate sanctions against Russia without fearing major repercussions.

Mexico

In 2024, Mexico will continue to benefit from the growing trend of nearshoring supply chains and being part of the USMCA trade agreement. This includes access to tax breaks under the Biden administration's green energy legislation.

However, investors will be watching Mexico's elections in June 2024 closely. President Obrador and his MORENA party have endorsed Claudia Sheinbaum, the former mayor of Mexico City, to succeed him. Sheinbaum, a virtual shoo-in to win, has pledged to continue Obrador's policies. It remains to be seen whether this will extend to some of his more controversial positions. While Obrador has welcomed foreign investment in the industrial sector, he has obstructed the operations of certain foreign companies in sectors such as energy and mining, which led even to the forced cancellation of contracts in some cases.

Security is also a major concern. U.S. officials have said that large swaths of Mexican territory are controlled by drug cartels rather than the government. These cartels ship massive amounts of drugs to the north. In 2022, there were well over 100,000 overdoses in the United States.

In 2019, U.S. President Trump canceled plans to designate Mexican drug cartels as terrorist organizations after speaking with Mexican President Obrador, who was very concerned about impacting the flow of goods across the border. However, if a Republican wins the presidency this time around, overwhelming support among Republicans makes it highly likely that this

⁴ "Narendra Modi's expected re-election will inspire fear and hope," Economist, November 13, 2023

measure will be implemented by executive order. This would give law enforcement agencies and prosecutors even more power to examine corporate records and freeze assets.

Local content rules and subsidies will keep altering the global economy

In a global landscape where local content rules and subsidies increasingly empower governments to become larger allocators of capital, the importance of efficiency and comparative advantage will continue to be overshadowed by national security concerns. In this environment, there is a growing tendency to exclude products from key sectors manufactured by geopolitical rivals, rather than focusing on creating superior products.

Will the trend of subsidizing key sectors collide with higher interest rates and debt?

Countries are stepping up their industrial policy interventions at a time when debt levels are rising. The IMF estimated that the total gross public debt of the world's advanced economies as a share of GDP was 113% in 2022, up from 81% in 2000. Much higher interest rates have in turn led to a sharp rise in debt servicing costs.

This raises the question of when the ability to provide substantial subsidies to key sectors, combined with a reluctance to cut popular social programs, will collide with the challenges of higher interest rates and mounting debt.

With its slower economy, higher operating costs and lack of a common treasury, the EU is more likely than the United States and China to be the first to feel the effects of this impending collision. France is a case in point. Soon after announcing a substantial boost in defence spending last year, the government faced extensive protests when it implemented minor cuts to the national pension system. We believe that this was just the first of many other similar situations to come.

The United States is also not immune to debt-related worries. Its fiscal situation is complicated by the inability of Democrats and Republicans to reach a compromise that would raise taxes and cut spending to at least slow the rate of debt growth. Indeed, this impasse is increasingly being cited by credit agencies as one of the factors influencing their ratings of U.S. debt.

Bottom line

The confluence of various geopolitical factors, including wars, elections in key countries, a great power rivalry, and increasing government intervention in the economy, means that it is more important than ever for investors to consider these issues when making investment decisions.



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