Global Economic Viewpoint

Geopolitics are here to stay

21 November 2023

Economics
Global

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Elections and geopolitics in focus in 2024

One of the 5 themes we discussed in our Global Macro Year Ahead was geopolitics. Over the past decade, there was a shift in geopolitical trends with the world shifting away from the efficiency-gains approach of globalization, into a (geopolitical) risk management approach to supply chains. Also, over 60% of world GDP is going into elections next year, leading to heightened policy uncertainty amid increasing political polarization. Finally, with ongoing conflicts in the Middle East and war in Ukraine stagflationary risks become more prominent.

US elections: Heading for a rematch

Next November, the US will vote to elect its next president, 34 Senate seats and all 435 seats in the House of Representatives. No matter the outcome, we expect trade policy will remain focused on slowing China's progress towards developing advanced technology and manufacturing. Election dynamics create questions about the Fed outlook as history suggests the Fed is reluctant to change policy direction ahead of an election but will sustain hikes or cuts if they were started in advance. Outcomes driving a looser fiscal stance are likely to lead to higher rates and a steeper curve. US election year has tended to see a pickup in FX realized volatility and some support for the DXY.

The US election and policy risks towards Asia

Our base case is for US trade and investment policy to Asia to remain largely unchanged regardless of the result of the 2024 elections. Relations with China will continue to show moments of tensions followed by subsequent periods of de-escalation. This pattern has been consistent in the past two US administrations from both parties. Regardless of the geopolitical situation, we think the RMB can weaken on a trade-weighted basis.

Reshoring and nearshoring are a reality

The ongoing tensions in US-China relations are evident in how US outward FDI flows have shifted since 2018. Also, the share of China in US imports is declining while the share of Mexico increases. While there is a bullish case for the Mexican peso on the back of nearshoring in the medium term, we expect the combination of elections in the US and Mexico to pressure MXN in the short term. We still see MXN as overvalued.

EMEA: of war and peace

We believe a local conflict in the Middle East and its short-term consequences are already priced in but a regional escalation with multiple fronts could further pressure assets. Lebanon appears vulnerable but the International Monetary Fund could provide a safety net for Jordan, and Tunisia and Egypt could muddle through 2024. A potential Saudi-Israel normalization deal could also be impacted. Finally, most key risks are already priced in regarding the Russia-Ukraine war, but market importance may increase again in case of any major escalation. Any de-escalation should help normalizing trade/financing.

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Geopolitics are here to stay

Elections and geopolitics in focus in 2024

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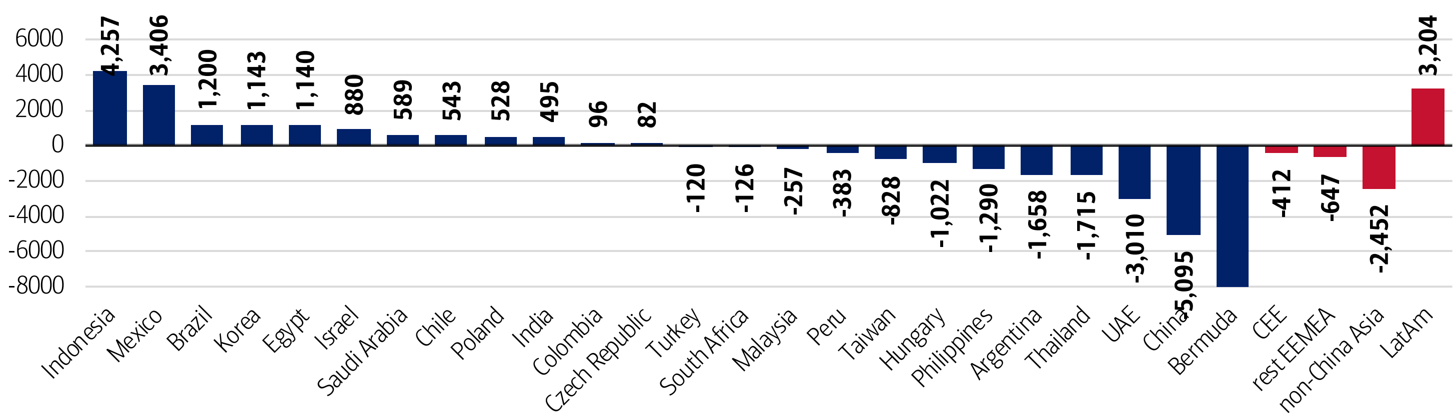
Over the past decade, there has been a shift in geopolitical trends. In a sense, the world has shifted away from the efficiency-gains approach of globalization into a (geopolitical) risk management approach to supply chains. Looking at outward FDI from the US speaks by itself, with FDI clearly shifting away from China into ASEAN and LatAm (Exhibit 1).

Next year, the US elections will be a key focus for global observers. In fact, over 60% of world GDP is going into elections next year, be it national, parliamentary, or local (Exhibit 2). As a result, we expect heightened policy uncertainty amid increasing political polarization. However, regardless of results, we believe geopolitics are here to stay.

More recently, the onset of the Israel-Hamas war and the risks of regional escalation have brought geopolitical risks to the forefront, as the war in Ukraine did in 2022. Stagflationary risks become more prominent in the current environment, so we warn investors about still present inflationary risks (see Don't take disinflation for granted).

Exhibit 1: Since President Trump was elected, US investment has clearly shifted out of China into ASEAN and LatAm
Change in FDI outflows from USA, 2017-2021 (USD millions)



Source: BofA Global Research, Haver
Note: 2021 vs 2017 change in USDmn. Includes reinvestment of retained profits in FDI.

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Exhibit 2: US elections could have spillover effects for other countries.
Elections around the globe in the upcoming months

Date	Country	Event	Economic and market Implications
22-Nov-23	Netherlands	General elections	Focus will be on the performance of far-right parties and their weight in the next parliament, perhaps even ruling coalition. Potential confrontational attitude towards the European Union could raise market perceived risk on EU/Euro area cohesion.
Jan- Feb 24	Egypt	Presidential elections	We expect potential economic reform to proceed post the likely re-election of President Sisi.
Dec 2023	Serbia	Parliamentary Elections	An important test of support to the incumbent's economic policies and potential geopolitical normalization with Kosovo.
13-Jan-24	Taiwan	Presidential elections	A victory of the ruling Democratic Progressive Party (DPP) would likely be seen as "status quo" and a continuation of existing economic policies, while any other outcome might potentially bring more changes. The market is likely to focus on the geopolitical implications of the election outcome, as the "Pan Green" camp (DPP) has a more hawkish stance towards mainland China than the "Pan Blue" camp consisting of the Kuomintang (KMT), Taiwan People's Party (TPP) and independent candidate Terry Guo.
Jan 2024	Pakistan	Parliamentary Elections	Key elections as a stable new cabinet is needed for drastic policy adjustments required for debt sustainability going forward. No visibility of elections outcome as of yet, as PTI participation/result remains the key factor of uncertainty.
4-Feb-24	El Salvador	General and presidential elections	In a controversial move, challenging rulings from the previous constitutional court, President Bukele is running for reelection, for another 5-year term. The concentration of political power in El Salvador has created concerns about checks-and-balances, but at the same time has given the government more effectiveness to make difficult decisions (such as fiscal consolidation). Polls say Bukele is highly likely to be reelected. He is the president with the highest approval rate in LatAm.

14-Feb-24	Indonesia	General elections, first round presidential elections	Domestic capex cycle is likely to remain weak as corporates remain on a "wait-and-see" mode. 3 candidates are vying for presidency. If none secures at least 50% of the votes, elections will head into round 2 in Jun, in which case uncertainties will drag on and pose further growth headwinds. Market expects secound-round Ganjar-Prabowo; Anies win most negative for IDR.
25-Feb-24	Senegal	Presidential elections	President Macky Sall not contesting 3rd term, has endorsed the current Prime Minister while a united opposition could pose a strong challenge. No clear outright winner. Post elections important for stability, staying on IMF course and start of hydrocarbons 2H 24.
17-Mar-24	Russia	Presidential elections	Given tight control over domestic political space, the outcome appears to be quite predictable. Main market impact is in the potential changes in the geopolitical stance post-elections.
10-Apr-24	South Korea	Legislative elections	Given that the opposition party (Democratic Party of Korea) holds majority of seats in general assembly (56.4%, vs. 37.3% for the ruling party, People Power Party), the legislative election in 2024 would be crucial in determining President Yoon's ability to push forward his agenda as it enters the third year in his five-year term.
May 24	India	General elections	Modi is up for a third term as the prime ministerial candidate. While state polls have shown falling share of Modi's party (BJP) at the national level, he enjoys considerable popularity. Markets are pricing policy continuity. It remains to be seen if the current government turns populist in the upcoming budget, but BJP has generally refrained from such dole outs and has sided by prudent fiscal consolidation. Political continuity may trigger equity inflows but hedge with topside INR volatility covering elections.
May 24	South Africa	General elections	Watershed election if the governing ANC were to fail to get 50% share of vote. ANC win is continuity and no catalyst for reforms. ANC loss could produce unstable coalitions and uncertain economic policies and outlook.
5-May-24	Panama	General & presidential election	In Panama, presidential elections rarely have an impact on asset prices. This is because the political equilibrium is very market friendly. Since the consolidation of democracy in the early 90s, only three parties have governed Panama: PRD (current ruling party), Cambio Democratico, and Partido Panameñista. The 2024 elections are unlikely to affect markets either, in our view.
19-May-24	DomRep	General & presidential election	All polls show DomRep's presidential election will be a three-race horse between the incumbent president, Luis Abinader; Abel Martinez, the candidate of PLD (party that ruled for 16 consecutive years before Abinader); and Leonel Fernandez, who has already been president three times. These three candidates are market-friendly, with moderate nuances in their policy preferences.
2-Jun-24	Mexico	General elections, presidential election	Mexico will elect a new president, a new federal congress and many local positions. Polls show AMLO's Morena keeping both the presidency and a majority in congress. Morena's presidential candidate is likely to be Claudia Sheinbaum (former governor of Mexico City, leading in polls), while the main opposition candidate is Xóchitl Gálvez, leading a coalition of parties. Sheinbaum is mostly seen as a continuation to AMLO. She has said she would support nearshoring if workers are paid fairly, and also Mexico's transition to renewable energy. There is likely to be volatility in markets ahead of the elections, which also coincide with the US.
Summer 24	Sri Lanka	Presidential elections	Important test of sustainability of reform agenda in line with IMF program going forward. Most political forces tend to support IMF engagement, but policy priorities may shift post elections.
6/9 June-24	European Union	European Parliament elections	The parliamentarian majority stemming from 2024 EU elections will appoint the top roles for key EU institutions, namely the EU Commission President and the President of the EU Council. Markets will closely watch if the "status-quo majority" (the grand coalition between EU people's Party (EPP), the Socialists and Democrats (S&D) and Renew Europe (RE)) will be challenged by a new coalition more skewed toward right-wing parties. As for policy areas, the composition of the new EU Parliament will matter for the EU policy stance in key areas like green transition, climate/environment, and migration. It will also matter for the position of EU in the Ukraine-Russia war. Note that the re-design of the new EU fiscal rulebook should happen by year-end. If no agreement now, EU elections could further delay any reform ambitions.
9-Jun-24	Belgium	Federal elections	Focus will be on the performance of far-right parties and their weight in the next parliament, perhaps even ruling coalition. Potential confrontational attitude towards the European Union could raise market perceived risk on EU/Euro area cohesion.
26-Jun-24	Indonesia	Second round presidential elections, if needed	Neither scenario ideal for IDR outlook – Ganjar market friendly but Prabowo now backed by Jokowi.
Autumn-24	Austria	Legislative elections	Focus will be on the performance of far-right party and its weight in the next parliament, perhaps even ruling coalition. Potential confrontational attitude towards the European Union could raise market perceived risk on EU/Euro area cohesion.
Oct 24	Tunisia	Presidential elections, date to be confirmed	We do not expect President Saied re-election to affect the weak economic reform momentum, but there may be more grounds for a revised IMF program post-elections.
26-Oct-24	Georgia	Parliamentary Elections	Opposition will run campaign on the promise to accelerate pro-EU policy reforms. Previous elections saw some fiscal easing ahead of the vote.
27-Oct-24	Uruguay	General & presidential elections	Polls show a competitive election between the center right coaliton and Frente Amplio left coalition. Parties are seen as moderate compared to other LatAm countries. The government has advanced in pension reform and green hydrogen investments.
5-Nov-24	USA	General & presidential elections	The US will vote to elect its next president, 34 Senate seats and all 435 seats in the House of Representatives. The outcome of the elections could affect several key issues for domestic and global growth.
Dec 24	Ghana	General elections	Elections tightly contested between two main parties but no ideological differences. Risks are overspending in an election year and missing IMF program targets.
Aug-Nov 2024	Australia	Federal Election	Labor will seek a re-election but the opposition will focus on increased cost of living and the rental crisis. We expect a rump up in fiscal spending in 2H 2024. Headlines suggest spending on housing supply as well as cutting infrastructure projects to lower inflation and labor costs.
2024	Venezuela	Presidential elections, date to be confirmed	The government and the opposition signed agreements in October to hold free presidential elections in 2H24, with international observers. Following the agreements, the US Treasury authorized transactions in Venezuela's oil and gas sector through April 2024 and lifted restrictions on secondary trading of Venezuela sovereign bonds and PDVSA (Petroleos de Venezuela) bonds. Corina Machando was elected presidential candidate with 93% of the votes in the opposition primaries. President Maduro argues that opposition primaries were fraudulent, and Machado is currently banned from holding public office.
2025	UK	General Elections, no later than January 2025	A UK general election must be held by January 2025 and is widely expected in Autumn 2024. The ruling Conservative Party are currently behind in the polls. We see a risk of fiscal stimulus ahead of the election.

Source: BofA Global Research, government websites, and local news outlets.

Notes: Does not include local elections. There will be local elections in Brazil (October 2024) and Türkiye (2024). While Ukraine presidential elections are scheduled for March 2024, they may be delayed due to martial law.

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US elections: Heading for a rematch

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Next year's US elections are one of many that will have important implications for global growth. On November 5th, 2024, the US will vote to elect its next president, 34 Senate seats and all 435 seats in the House of Representatives. It is still early days, and the situation remains fluid for all major elections. The first Republican Caucus will be held in Iowa on January 15, and the first Democratic Primary will be held on February 3 in South Carolina. Here is a quick rundown of the elections:

- The likely nominees for the presidential election based on current polling are former President Trump for the Republican party and President Biden for the Democratic party. Current polls suggest that the election would be close with general ballot polls giving a slight edge to former President Trump.

- In the Senate, 23 Democratic and 11 Republican seats are up for election. Of the 23 seats controlled by the Democrats, the Cook political report judges three to be toss-ups: Sinema (AZ), Brown (OH), Manchin (WV). Sinema is technically an Independent but she is not caucusing with Republicans and has cast most votes in line with Democrats. Manchin, meanwhile, has said he will not run for reelection, which likely means the seat will be won by the eventual Republican nominee. Of the 11 Republican seats, none are currently viewed as toss ups. Therefore, the two seat majority Democrats hold in the Senate may be at risk.

- Then in the House, the Cook political Report currently believes 14 Republican and 8 Democratic held seats are toss up races. This means that which party wins control over the House could also be a very close call.

The outcome of the elections could affect several key issues for domestic and global growth. It is too early to say with certainty what the implications will be, but we offer broad strokes of what we would expect around key economic and policy issues under different election outcomes (Exhibit 3). For example, we expect fiscal policy would be relatively looser either under a Republican or Democratic sweep, although for different reasons. A divided government would lead to gridlock and likely neutral policy. In our view, there is also potential for increased brinkmanship under a divided government with a Democratic president (the current situation).

No matter the outcome, we expect trade policy will remain focused on slowing China's progress towards developing advanced technology and manufacturing. Yet, the method to accomplish that goal will likely differ. If Trump is elected, then tariffs are likely to be back in play. If Biden is reelected, then policy will likely be quieter but no less restrictive.

Exhibit 3: The outcome of the election has different implications for key policy issues
Hypothetical US election scenarios

Key Issue	Republican Sweep	Democratic Sweep	Divided Government, Republican President	Divided Government, Democratic President
Fiscal policy	Looser (tax cuts)	Looser (spending increases)	Neutral (Gridlock)	Neutral (Gridlock)
Trade policy	Increased use of tariffs and tech restrictions	Tech restrictions	Increased use of tariffs	Ongoing restrictions tied to technology
Monetary policy/Fed	New chair, more political pressure	Possible, still independent Fed	New chair, political pressure	Possible, still independent Fed
Climate policy	Reversal of climate agenda	Expansion of climate agenda	No change (Gridlock)	No change (Gridlock)
Foreign Policy	Increased risk of isolationism	Increased engagement with US allies	Increased risk of isolationism	Increased engagement with US allies

Source: BofA Global Research

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In our view, a tough stance on China will continue to be popular policy for any president. Given this, the ongoing trends in reshoring, nearshoring and friendshoring are likely to continue as the US looks to gradually decouple from China. Other issues like climate and foreign policy are also likely to differ depending on the outcome of the election, which could have spillover effects for other countries.

Election dynamics can impact Fed policy due to independence concerns

Election dynamics create questions about the Fed policy outlook & Fed leadership.

Fed policy outlook: Fed leadership has stressed independence is paramount. Fed leaders are therefore likely reluctant to shift monetary policy ahead of an election for fear of being politicized. History suggests the Fed is reluctant to change policy direction ahead of an election but will sustain hikes or cuts if they were started in advance (Exhibit 4). We interpret this to suggest the last opportunity for the Fed to shift stance to be the June FOMC; if the Fed hasn't started another round of hike or cuts by mid-year we suspect they will be "locked" with a very high bar to deviate through November.

Fed leadership: Fed leadership will turn over after the election. Powell's term ends May 23 2026 and the term of the Vice Chair for Supervision, Michael Barr, ends on July 19 2026. We suspect a Republican president would seek to replace both Powell and Barr in favor of individuals preferring lighter bank regulations. A Democrat could possibly replace current leadership but might be torn between a desire to have policy continuity and Fed independence. New Fed leadership with a Democratic president is a toss-up.

Rates impact: the potential for a Fed to have policy "locked" ahead of the election might push the Fed to cut marginally sooner than they otherwise would have. A Fed that could cut somewhat sooner supports our view to be long belly rates and in 5s30s steepeners.

Any election outcome that appears to be a D or R sweep will favor additional fiscal easing & have the following rate market impact: higher rates given fewer Fed cuts, steeper nominal 2s10s & 5s30s curves due to more UST supply, and SOFR swap spread tightening due to a worsening UST supply / demand backdrop.

Exhibit 4: Change in Fed policy rate based on business days prior to election (% points)

Fed typically does not change policy direction once 100 business days from election

Biz Days Before Election	'76	'80	'84	'88	'92	'96	'00	'04	'08	'12	'16	'20
-250	0.12	-1.75	0.5	3.12	-1.75	-0.5	1	0.75	-3.5	0	0.25	-1.5
-200	0.25	-0.25	0.5	0.5	-1	-0.25	1	0.75	-2.5	0	0	-1.5
-150	0.25	2.25	-0.5	-0.5	-1	0	0.5	0.75	-1.25	0	0	0
-100	-0.5	4.25	-0.5	-0.5	-0.75	0	0	0.75	-1	0	0	0
-50	-0.13	3.75	-1.75	-1.75	-0.25	0	0	0.25	-1	0	0	0
-25	-0.13	1.75	0	0	0	0	0	0	-1	0	0	0
-5	0	0	0	0	0	0	0	0	-0.5	0	0	0

Bloomberg; Positive value = Fed had hiked leading into election date, Negative value = Fed had cut leading into election date

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US Presidential Cycle year 4 favors higher DXY, FX vol, SPX and to an extent oil

The Presidential Cycle is a well-publicized theory in equity markets, founded by Yale Hirsh. It suggests fiscal decisions made in year 1-2 take time to be made and realized making year 3 the "boom" year. Year 4 is a period of residual strength with fiscal / investment decisions tweaked to shore up economic confidence ahead of another election. In year 4 the S&P 500 was higher 75% of the time with an average change of 7.49% and median of 10.66% (Out of 24 observations since 1928 (Exhibit 5)).

The DXY and to some extent oil tended to benefit in year 4

We extend this cycle to FICC and found a higher DXY and to an extent oil (Exhibit 5). Of 12 observations since 1973, the DXY was higher 75% of the time for an average change of 3.93% and median of 4.64%. The best months were January, October and July (Exhibit 6). Of 10 observations, oil was higher 67% of the time. However average and median change conflict. Since 1963, the US 10y yield did not exhibit a year 4 tendency.

Exhibit 5: Presidential Cycle Year 4

Year 4 is supportive of higher S&P 500 and US dollar index (DXY). To some extent, higher oil too.

Security	Average change	Median Change	Up Ratio	# of Observations
S&P 500	7.49%	10.66%	75%	24
DXY	3.93%	4.64%	75%	12
US 10Y yield	-7 bp	-1 bp	47%	15
Oil	-2.75%	1.49%	67%	10

*SPX 1928-11/2023, DXY 1973-11/2023, US10Y 1963-11/2023, Oil 1983-11/2023 CL1 front month roll-adjusted T-5

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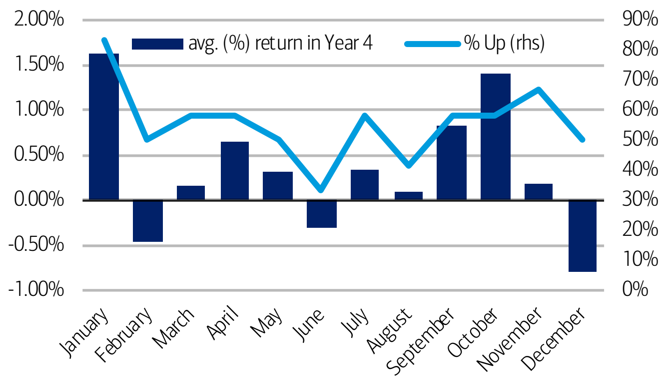
Exhibit 6: Average change in DXY during year 4 of Presidential cycles

During year 4 of the Presidential cycle, the DXY was strongest in January up 83% of the time for an average change of 1.63%.



Source: BofA Global Research, Bloomberg

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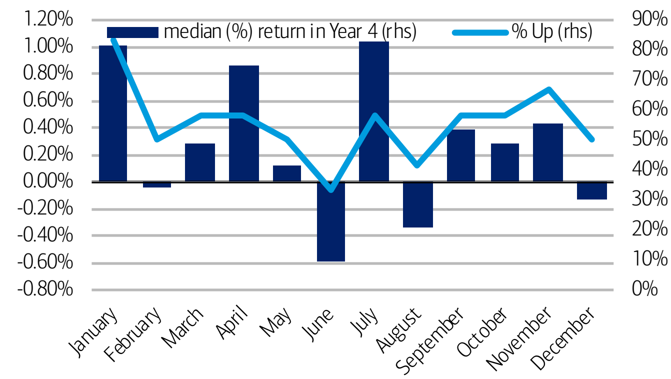
Exhibit 7: Median change in DXY during year 4 of Presidential cycles

During year 4 of the Presidential cycle, the DXY was strongest in January up 83% of the time with a median change of 1.01%



Source: BofA Global Research, Bloomberg

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US Presidential cycle (year 4) seasonals are bullish FX vol into next year.

US presidential elections are an important market catalyst for global investors as they present policy uncertainty. In our view, rising policy uncertainty tends to peak in Year 4 of the US Presidential cycle, which corresponds to 2024 this time around. In our analysis we find that there is a seasonal pickup in FX realized volatility in election years with Year 4 seeing the highest FX vol seasonality for USD pairs in G10. In that vein, the mid-term Year 2 has the second-highest average level of FX volatility since 2000.

We looked at realized FX vol by US presidential years in USD/G10 (using monthly data). Averaging across G10 pairs, Year 4 has historically seen the highest realized volatility in the US Presidential cycle since the introduction of flexible exchange rates in 1973 (Exhibit 8) as well as in the more recent data since 2000 (Exhibit 9). Since 1973 year 4 had higher volatility than year 3 for all individual pairs and since 2000 for 8 of 10 pairs.

Exhibit 8: Year 4 saw higher vol for all USD-G10 pairs since 1973

Realized vol by year of US presidential cycle since 1973

	Year1	Year2	Year3	Year4
DXY	8.3%	8.1%	7.7%	8.2%
GBPUSD	9.6%	7.9%	8.9%	10.5%
USDJPY	10.1%	12.0%	8.9%	9.6%
AUDUSD	10.2%	10.3%	9.0%	11.7%
USDCAD	5.9%	5.5%	6.1%	6.5%
NZDUSD	11.3%	10.5%	11.0%	11.5%
EURUSD	8.9%	9.4%	9.1%	9.9%
USDCHF	11.4%	10.6%	10.6%	10.7%
USDSEK	10.7%	10.4%	9.3%	10.5%
USDNOK	9.8%	10.8%	10.0%	10.7%
Average	9.6%	9.6%	9.1%	10.0%

Source: BofA Global Research, Bloomberg

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Exhibit 9: Year 4 was the most volatile year in the cycle on average

Realized vol by year of US presidential cycle since 2000

	Year1	Year2	Year3	Year4
DXY	6.8%	7.7%	7.4%	8.1%
GBPUSD	7.5%	8.1%	8.4%	9.4%
USDJPY	8.6%	9.1%	7.4%	10.6%
AUDUSD	11.1%	11.0%	11.1%	13.6%
USDCAD	8.3%	7.1%	8.8%	8.4%
NZDUSD	12.9%	12.3%	12.2%	13.0%
EURUSD	8.2%	9.0%	8.8%	10.0%
USDCHF	8.3%	9.4%	10.2%	10.2%
USDSEK	10.1%	10.7%	10.4%	11.0%
USDNOK	8.7%	12.2%	11.6%	12.8%
Average	9.1%	9.7%	9.6%	10.7%

Source: BofA Global Research, Bloomberg

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The US election and policy risks towards Asia

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As we have alluded to in the section above, our base case for is US trade and investment policy to Asia to remain largely unchanged regardless of the result of the 2024 Presidential election. Relations with China will continue to ebb-and-flow with moments of tensions followed by subsequence periods of de-escalation. This pattern has been consistent in the past two US presidential administrations from both parties.

Expecting Taiwan relations to be a constant – but stable – source of contention

One of contention between US and China in the near-term is how to response to the election in Taiwan in January 2024. The most recent development of a potential coalition between two opposition parties muddles our base case for the presidential race. Our base for the election is the continuation of the status quo in Taiwan where relations between mainland China and Taiwan would remain tense with periodic increase in tensions. However, all these actions would fall short of outright conflict as neither side have an incentive to escalate beyond signaling, in our view. Currently, the FX market is pricing in little risk premium to USDTWD around the timing of the election in January 2024 suggesting FX market is looking through the risk (see What's the market pricing for Taiwan's January 2024 election?).

Our base case, regardless of the upcoming administration, the US government will remain committed to the current 'One China' policy and operating within the constraints outlined by the Taiwan Relations Act.

The ongoing use of US technology in China is a source of policy uncertainty

Regardless of the winner of the 2024 US presidential election, we expect the ongoing trend of technological restrictions to China, especially around semiconductor technology, to continue. However, so far, the US policy stance towards on the use of US advance chips and software for plants in China has avoided the most hawkish scenario. As of October 2023, the US has granted licenses to Korean and Taiwanese chipmakers to continue servicing their China-based plants with US technology and software. A Republican victory to the upcoming presidential election may change this stance and bring about a faster technological decoupling not only between the US and China, also on to the entire the technology supply chain in Asia with adverse effects also impacting Korean, Taiwanese, and Japanese chipmakers.

Treatment of Asian investors under the IRA under the next US administration

Under the incentives provided by The Inflation Reduction Act of 2022 (IRA), Korean companies have heavily invested in manufacturing capacity in the US to produce electric vehicles. Among some Korean companies, there are concern whether favorable tax treatment would end. This would impact future investment flow from Korea and Taiwan, especially as semiconductors and industrials are making meaningful investments in US industrial capacity.

US investment flow to China is also subject to policy risk

Another policy risk that may arise from the change in US administration is the implementation of the so-called "reverse CFIUS". On August 9, 2023, President Biden signed an executive order (EO) which limits the scope of US investment into certain sectors of the Chinese economy which are deemed sensitive and contrary to US national interest. This topic of 'reverse CFIUS' was discussed for months before the final EO was signed. Relative to previous expectation, the final language of the EO was less hawkish and the final implementation rules impacted mostly primary market and non-trade securities and largely did not impact the trading of secondary market securities. A change in US administration may change this outlook which will serve to disturb financial flows between the US and China system in a more forceful and volatile way.

RMB to weaken

The base case expectations for geopolitics in Asia in 2024 is a tense, but stable, situation. The recent increased contacts between high-level US and Chinese officials paints a more optimistic backdrop for US-China relations in 2024. The tail-risk scenario would be US-China relations to resume a path of deterioration, in which case, investors should buy geopolitical protection in the form of USDCNH and USDTWD top-side. For the CNY, our base line forecast is for USDCNY to reach at a peak of 7.40 in 4Q23 because of wide interest rate differentials against the US and the artificial support the PBoC has provide the RMB in 2H23 which we think will be unwind. Regardless of the geopolitical situation, we think the RMB can weaken on a trade weighted basis.

Reshoring and nearshoring are a reality

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US Congress spurs US manufacturing

The manufacturing section has been buoyant in the US since the post-pandemic recovery started taking ground in the later part of 2020. Originally spurred by the rotation from goods to services, manufacturing jobs skyrocketed, surpassing pre-pandemic levels as early as March 2021. Additionally, construction spending in the manufacturing sector almost tripled since early 2021, leaving behind half a decade at relatively stable levels (Exhibit 10).

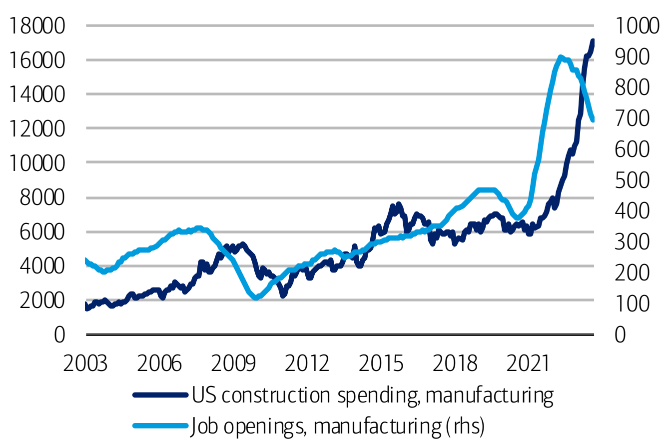
These facts and reshoring are two sides of the same coin, and geopolitics go a long way in explaining these ongoing dynamics. Additionally, fiscal policies have certainly boosted the US manufacturing sector: the CHIPS Act, the Inflation Reduction Act, and the Infrastructure Investment and Jobs Act are all geared towards incentivizing the expansion of the manufacturing sector in the US, including semiconductor production.

Nearshoring is Mexico's lifetime opportunity

The ongoing tensions in US-China relations are evident in how US outward FDI flows have shifted since the beginning of the Trump administration. Since 2017, US investment has clearly shifted out of China into ASEAN and LatAm, with Indonesia and Mexico standing out (Exhibit 1).

The geographical proximity of Mexico to the US makes it a natural candidate for nearshoring, i.e. relocating production based on risk-management considerations, in this

Exhibit 10: US manufacturing skyrocketed
Construction spending (USD mn) job openings (thousands, 12mma)



Source: BofA Global Research, Haver

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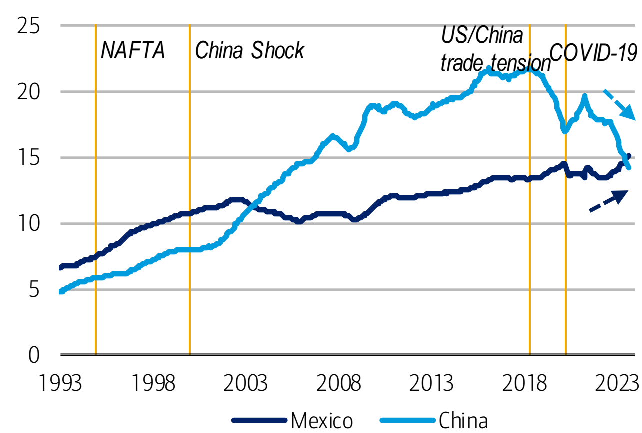
Exhibit 11: China's loss has been Mexico's gain in US imports
Share in US total imports, 12mma (%)



Source: BofA Global Research, Haver, US Census Bureau

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case closer to North America. In our view, nearshoring can be Mexico's lifetime opportunity amid what can be seen as a structural shift in US-China relations, which we expect to fundamentally persist regardless of the outcome of US elections.

In this context, we can already see nearshoring in the macro data. Since the US imposed tariffs on China in 2018, the share of China in US imports has declined by over 6 percentage points. Simultaneously, and most markedly since the pandemic, the share of Mexico in US imports has risen by about 2 percentage points, with Mexico overtaking China as the US' main trading partner (Exhibit 11). Most recently, Mexico's construction sector has increased by 47% yoy in real terms as of August 2023, largely driven by nearshoring (see Investment is booming).

In this context, we may be witnessing the reversal of the "China shock". Still, many challenges remain for Mexico. Most notably, Mexico needs to invest more in infrastructure, energy, education, and the rule of law to fully reap the fruits of nearshoring. The upcoming elections in Mexico will shed some light on what to expect.

While there is a bullish case for the Mexican peso (MXN) on the back of nearshoring in the medium term, we expect the combination of elections in the US and Mexico to put pressure on MXN in the relatively short term. We still see MXN as overvalued, largely driven by carry and vulnerable to risk-off shocks. In a highly volatile environment, usually a very characteristic trait of electoral periods, we believe carry may not save the Super Peso.

EEMEA: of war and peace

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Middle East regional geopolitical risk premium may be on the rise

Regional geopolitical tensions have been important to monitor due to the tail risks to the global economy. Geopolitically induced spikes in crude oil, for instance due to escalated and widened regional conflicts, can be among the most challenging exogenous shocks for markets due to their stagflationary impact. Global growth could be impacted, but at the same time inflation expectations could actually increase, especially if there was some expectation of the shock persisting.

Saudi energy policy suggests potential support for oil prices

Saudi energy policy against the backdrop of regional tensions suggest oil prices are likely to remain elevated. Large OPEC (Organization of the Petroleum Exporting Countries) spare capacity could allow for a gradual, controlled, offsetting increase in its market share in response to a potential drop in Iranian oil exports. (Press reports suggest potential tightening of enforcement of US secondary sanctions on Iran). OPEC decisions are likely to finely balance its members' funding needs, the impact on oil demand, and internal cohesion considerations. Our analysis of Saudi fiscal breakeven oil price suggests general government funding requirements are met around US$95/bbl (see Saudi Arabia – eyeing US$100/bbl oil).

Potential Middle East escalation carries large regional macro impact

The regional economic fallout of the Israel/Hamas war could be meaningful across strong or distressed credits. Gulf countries are likely to be supported by high oil prices but the proposed India-Middle East-Europe Economic Corridor (IMEC) is likely to be put on ice. Lebanon appears vulnerable but the International Monetary Fund (IMF) could provide a safety net for Jordan. Tunisia and Egypt could muddle through 2024 but uncertainty prevails beyond that. (MENA – booms and busts).

Any potential involvement of Hezbollah in the conflict could imply further large economic losses for Lebanon. Unlike the July 2006 Hezbollah-Israel conflict, Lebanon's economic outlook is already weak, its domestic political challenges are unresolved, and current ties with the Gulf states could suggest no substantial infusion of reconstruction funds. Any broadening of the conflict could affect offshore hydrocarbon exploration and recovery of eurobonds (see Lebanon - between change and the status quo).

Gulf countries are likely to be supported by high oil prices but the proposed India-Middle East-Europe Economic Corridor (IMEC) is likely to be put on ice. The conflict could also impact a potential Saudi-Israel normalization deal that was being negotiated by the US. We covered economic implications of Arab normalization deals in our note Tectonic shifts in the Middle East.

The large population of Palestinian descent could make Jordan vulnerable to social instability if the conflict widens. This could likely hamper economic reform momentum, with regional instability potentially impacting tourism and energy flows and widening external financing needs. Still, we think international support is likely to remain robust to ensure stability.

The conflict has mixed implications for Egypt, in our view. On one hand, it is likely to weigh on external funding requirements through likely lower tourism receipts and loss of gas exports in a prolonged conflict. On the other hand, we think regional instability is likely to result in greater economic support to Egypt from the international community, including through an upsized IMF program. Additional international support could likely delay credit concerns to 2025, but a sustained reform momentum is necessary given the peak in external debt amortizations in 2024 and 2025.

Israel economy is resilient, but impact will be larger than previous conflicts

Security concerns and ongoing military operations dominate the economic outlook in the country. 360K reservists that have been drafted amounts to 8% of Israel's labor force. As economic activity slows down due to security conditions and sentiment, policymakers are taking fiscal and monetary steps to support the economy. At start of the conflict Israeli assets came under pressure; CDS widened 90bp and ILS weakened c.6% and rates sold-off. We believe that a local conflict and its short-term consequences in the economy are already priced in, however a regional escalation with multiple fronts could imply further pressure on assets and require more financial support for the economy, increasing the fiscal burden.

The Israeli economy has been very resilient in previous conflicts and its structural improvement over the years made it stronger through its higher current account surplus based on high-tech service exports, high savings and a strong household asset portfolio which is well diversified. The strong fundamentals of the economy imply a potential bounce back in Israel assets when the military conflict ceases, even if the political conflict continues for a longer period. We see the medium-term outlook dominated by uncertainty surrounding regional politics.

Russia/Ukraine: largely priced in by now...

As the Russia-Ukraine war is approaching a third year, most of the key market risks from this conflict could already be well priced in by now. As such, in the absence of any major developments, the market importance of this conflict could likely continue to fade in 2024. Thus, the energy market has likely largely adjusted to the new geographies of Russian exports as well as to their reduction overall.

After a big shock in 2022, the global food market should have also adjusted to the disruptions of supplies from the Black Sea region, even despite the recent suspension of the grain deal. Thus, the high importance of the grain deal in 2022 was mainly due to massive stocks after a record 2021 harvest in Ukraine. However, according to USDA estimates, most of them have already been depleted, as total grains output in Ukraine is set to decline by some 1/3 versus 2021 peaks. Meanwhile, the country has developed new logistics capable of maintaining exports even without Black Sea shipments. On top of that, grain shipments from Russia continued to grow, supported by rising output.

Apart from commodity supplies, we note that the conflict will likely play an important role in US/EU politics, as required financing of the war effort may draw additional political attention. Thus, Ukraine has budgeted over US$40bn in external financial assistance in 2024, which is lower than in 2023 but is yet to be secured.

... but watch out for any changes

Therefore, we think that market importance of the conflict may increase again in case of any major escalation, which could start to impact existing or new logistical routes out of either country. On the contrary, any potential secession of hostilities for any reason may also become a major driver for the market as the market may start to price in an eventual unwinding of some of the earlier disruptions and normalized trade/financing.

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