A Lame Duck And Geopolitical Tensions

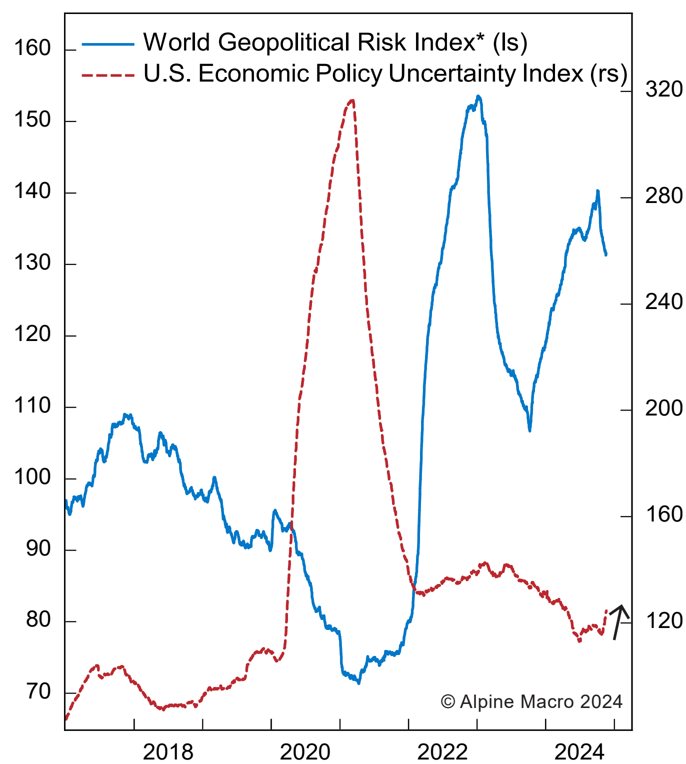
- A lame-duck Biden administration heightens geopolitical uncertainty.
- Escalation in Ukraine is a higher risk, but truce talks are likely next year.
- Middle East tensions endure; monitor Israel-Hezbollah truce prospects and Iranian nuclear developments.
- China-U.S. tensions should remain subdued as Beijing waits for Trump's policies.
- Stay long on gold and aerospace & defense assets as both short- and long-term geopolitical hedges.

In This Report

Our expectation has long been that geopolitics would grow more volatile around the election, particularly in the lame-duck period. A demoralized Biden administration, on its way out, will struggle to manage geopolitical challenges, creating opportunities for U.S. rivals to exploit policy uncertainty[1].

The escalation in the Russia-Ukraine conflict and ongoing clashes between Israel and Iranian proxies, particularly Hezbollah, exemplify these risks. **Chart 1** illustrates how geopolitical risks remain very elevated, while U.S. policy uncertainty is ticking up.

Chart 1 Geopolitical Risks Are High, While U.S. Policy Uncertainty Ticks Up



*Source: Matteo Iacoviello

1 Alpine Macro *Geopolitical Strategy* "United States: Trump's Comeback - Brace For Headlines, Expect Policy Surprises" (November 7, 2024) and "United States: An Increasingly Wild Election Season" (July 17, 2024).

Russia-Ukraine: Ceasefire Likely In 2025

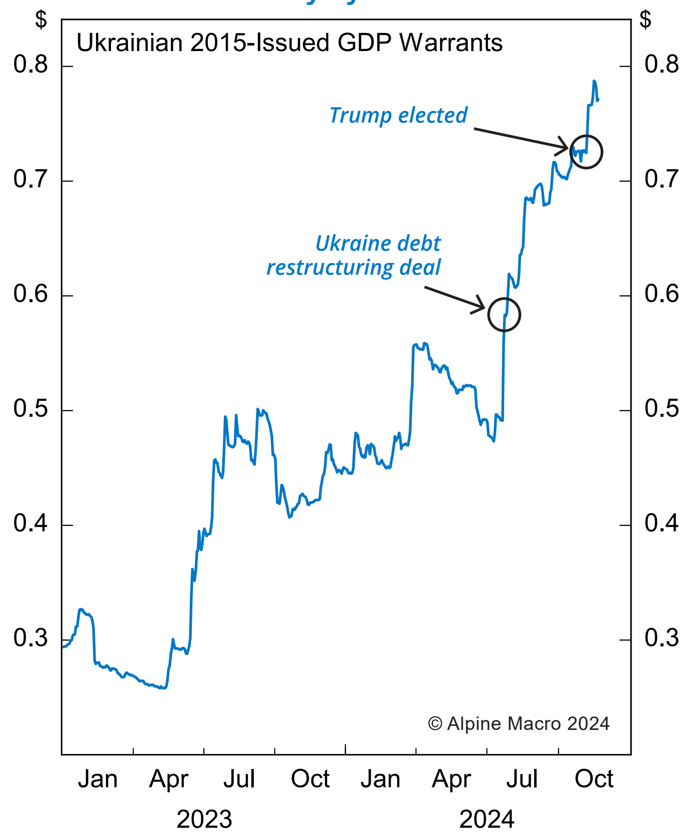
Markets reacted negatively this week to news out of Ukraine. The Biden administration has allowed Ukraine to use U.S. ATACMS missiles to strike targets inside Russian sovereign territory for the first time. Russia views this as an escalation and has signaled a change in its nuclear doctrine, implying it may use nuclear weapons against countries (and their allies) that attack Russian territory with conventional weapons.

This move is surprising, as the Biden administration is nearing the end of its term and has long resisted allowing Ukraine to strike deep within Russia, fearing nuclear escalation. Outgoing administrations typically avoid major policy shifts, making this decision — less than two months before leaving office — questionable. Critics see it as an attempt to “lock-in” the Trump administration’s policy options, compelling continued support for Ukraine.

There are plausible alternative explanations. First, North Korea’s entry into the Russia-Ukraine war marked an escalation by Russia, which is also intensifying its offensives, possibly in anticipation of gaining leverage ahead of U.S.-led peace talks next year. The ATACMS could be Biden’s response. The second explanation, and this is borne by the fact that Trump himself has not spoken (yet) against this policy move by Biden, is that this policy shift has (at least some) tacit agreement from the incoming Trump administration.

Why might Trump support this escalation? It could increase pressure on Moscow, giving Trump leverage in brokering peace between Ukraine and Russia

Chart 2 Trump’s Election Priced-In Positively By Ukrainian Warrants



Source: Bloomberg Finance L.P.

next year. Trump’s *modus operandi* to “escalate to deescalate” aligns with this move.

As we argued earlier this year[2], regardless of the election outcome, the U.S. and NATO would likely pressure Ukraine toward a truce or long-term ceasefire. Ukraine is running out of manpower, its defenses are gradually being eroded, and reclaiming lost territory seems unachievable.

Trump’s starting negotiating position is to enforce a truce, freeze front lines along current control, and block Ukraine’s NATO membership for 20 years.

2 Alpine Macro *Geopolitical Strategy* "The Russia-Ukraine War: Lurching Toward An Uneasy Truce?" (October 11, 2024) and "The 2024 Geopolitical Risk Outlook" (December 6, 2023).

While Ukraine objects, it has little choice, especially as European support may waver.

Why would Russia agree? First, Putin can frame keeping the currently occupied territories as a “win” to bolster domestic political support. Second, the war’s economic and human costs strain Russia's stability. Third, refusal risks further U.S. military support for Ukraine under Trump – which Trump’s advisors have threatened. Thus, Putin has shown interest in a potential deal.

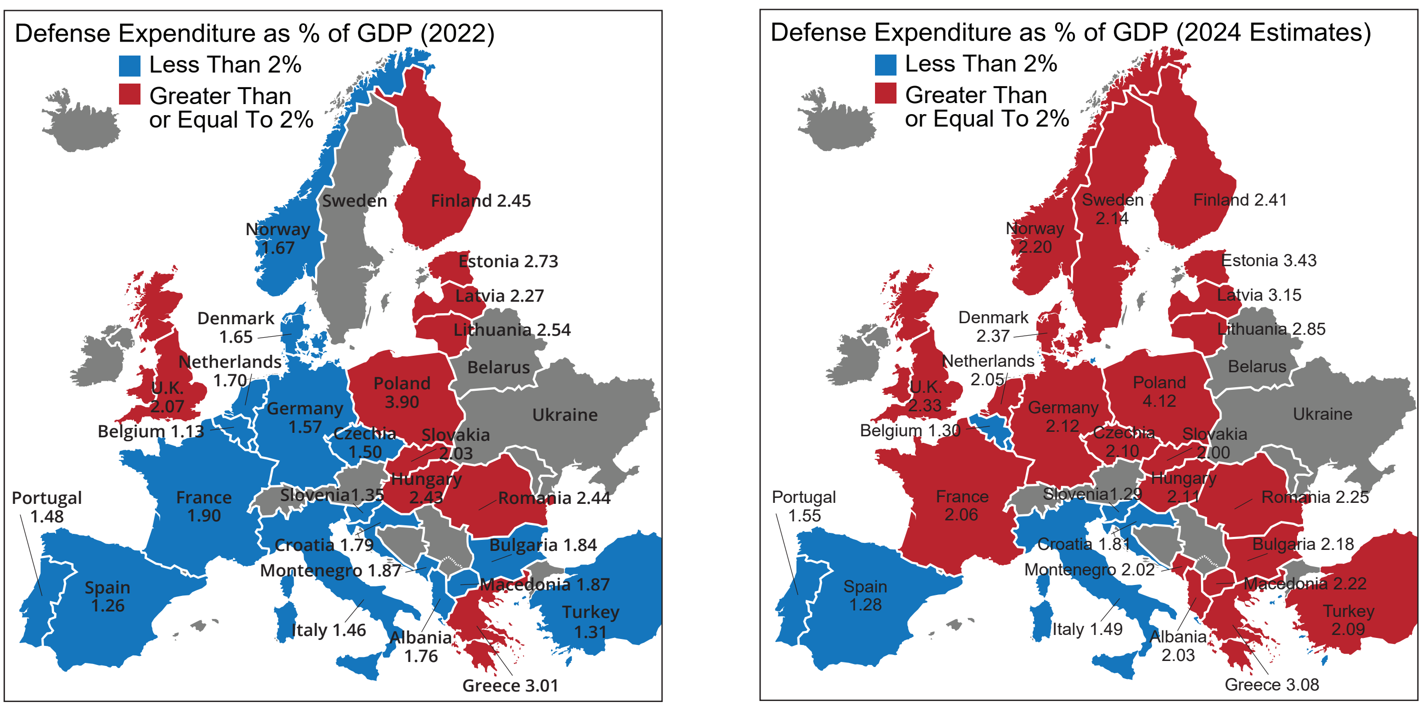
In short, we anticipate a ceasefire in 2025. **Chart 2** illustrates recent Ukrainian GDP-related warrant movements, with local markets reflecting similar expectations of some end of open hostilities.

Claims that Trump will abandon Ukraine remain misplaced. Many of his national security advisors (Mike Waltz, Marco Rubio, etc.) are pro-Ukraine, and Trump has stated that this year securing an independent Ukraine aligns with U.S. interests.

While many analysts will lament that Ukraine will not recover its occupied territories, it has no realistic chance of doing so militarily, unless NATO were to directly intervene vs. Russia (i.e., which it will not do). Similarly, Trump’s idea of not allowing Ukraine in NATO for 20 years would not be a major concession to Russia: Ukraine is far from enacting the kinds of political and governance reforms needed for NATO accession anytime soon.

A ceasefire would trigger efforts to rearm Ukraine against future Russian aggression, with Europe likely taking the lead. The U.S.' reluctance to fund Ukraine is real. European NATO members are also increasing defense spending and will continue to arm

Map 1 Europe Is Rearming



Note: U.S. and Canada at 3.49 and 1.38 not included in the illustration; NATO states are committed to spending 2% of GDP on defense
Source: NATO

Note: U.S. and Canada at 3.38 and 1.37 not included in the illustration; NATO states are committed to spending 2% of GDP on defense

Table 1 Escalation Scenarios In The Middle East

Outcomes	Scenarios	Probabilities				Market Impact
		Current	Apr. 14, '24-Aug. 16, '24	Dec. 22, '23-Apr. 13, '24	Oct. 19, '23-Dec. 21, '23	
Major Escalation (60%)	1. Major Regional Escalation, But No Sustained Israel-Iran War	**30%**	30%	20%	10%	Markets Start To Price-In Geopolitical Risks
	2. A Sustained Israel-Iran Direct Conflict	**30%**	30%	20%	20%	Sustained Global Risk-Off, Oil Price Shock (i.e., back to the 1970s scenario)
No Material Escalation (30%)	3. Gaza Strip War, With No Major Regional Escalation	**30%**	40%	60%	70%	Market Neutral Outcomes + Occasional Headline Risk Volatility (i.e., status quo)
Long-Term Truce (10%)	4. Lasting truce	**10%**	-	-	-	Marginally Lower Energy Prices, Positive For Regional Assets

themselves. The war in Ukraine has driven remarkable growth in European defense spending (**Map 1**), with most European members now meeting the 2% of GDP military spending goal. Trump's pressure on Europe, while undiplomatic, could further bolster military expenditures. There is talk of raising NATO's European members' military expenditure, and the largest 15 European members would have to almost double their defense spending to $720bn, if they were to replace U.S. military spending[3]. While this is an exceedingly high estimate, higher European defense spending is likely.

While diplomacy could begin by early spring, the conflict's resolution remains uncertain. We foresee a ceasefire at some point, but no peace dividend for markets, as Russia will remain heavily sanctioned while occupying Ukrainian territory.

3 Bloomberg "Europe May Need $720 Billion in Defense Funds, Analysts Say" (November 19, 2024).

Towards A Middle East Peace? Maybe, But Not So Fast…

Will peace break out in the Middle East? Possibly, but we think the situation remains as tense as before, despite various ongoing negotiations. We would want to see a ceasefire between Israel and Hezbollah, and further steps by Iran towards backing down, especially when it comes to nuclear proliferation, before altering our Middle East conflict scenarios, and the expectation of a conflict escalating in the region (**Table 1**).

Iran and its allies, especially Hezbollah, have suffered significant setbacks against Israel. With the Trump administration taking office soon, Iran may feel incentivized to back down. While Trump appears to be pressuring Israel to settle or limit conflicts before he assumes office, he is also expected to adopt a very hawkish stance vs. Iran, and potentially give Israel more latitude than the Biden administration. At a minimum, Trump is likely to reinstate "maximum pressure" policies to curb Iran's nuclear ambitions and regional influence, while possibly threatening Tehran militarily.

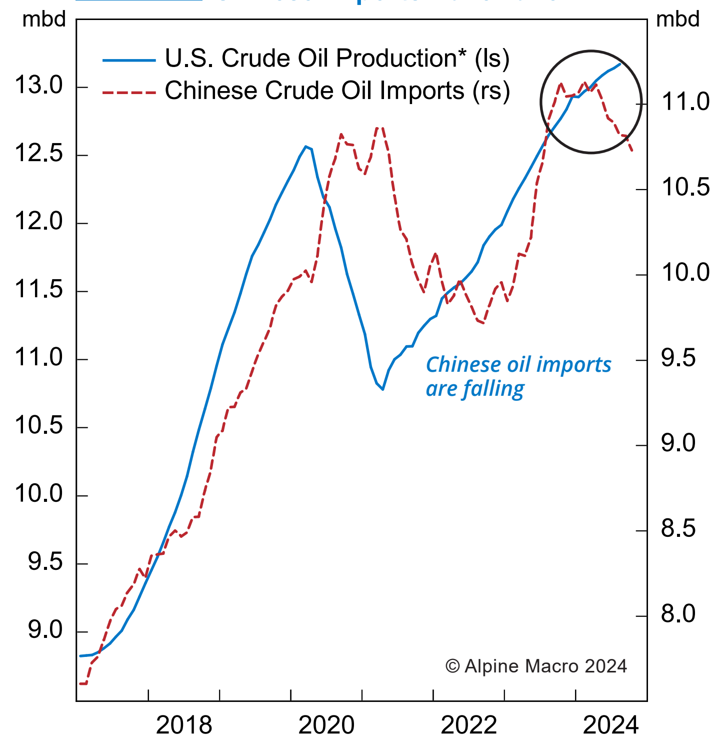
Ongoing indirect talks between Hezbollah and Israel are said to be advanced. Hezbollah and the Lebanese government have apparently agreed to terms put forward by the Biden administration. However, it remains unclear if these are acceptable to the Netanyahu government. A truce hinges on whether Israel trusts compliance will be enforced and if it retains the ability to strike Hezbollah if it rearms — a point of ongoing contention.

Iran has also signaled that it is willing to allow IAEA nuclear inspectors back in the country and to freeze its uranium enrichment at 60%. Iran's proposal comes as the IAEA is preparing to condemn Iran for its continued nuclear proliferation, opening the door to snapback sanctions both by the U.S. and the European powers. IAEA wants Iran to reduce its stockpile of 60% enriched uranium, but Iran seems unlikely to agree to that, as well as to more extensive inspections.

Unless Iran complies with the IAEA terms, which for now seems unlikely, it means that the possibility of either Iranian proliferation or of strikes against its nuclear facilities by Israel, and possibly the U.S., will remain elevated.

Israel may act against Iran before Trump takes office, disregarding lame-duck Biden's efforts to prevent escalation. If IAEA talks fail, could Iran gamble by attempting to cross the nuclear threshold, hoping to deter strikes? Such a move might backfire, inviting an Israeli (or possibly American) response. We estimate the chance of a major escalation, that would spike the oil prices, namely a sustained Israel-Iran conflict still at 30%.

Chart 3 U.S. Oil Production Has Increased, Chinese Imports Have Fallen



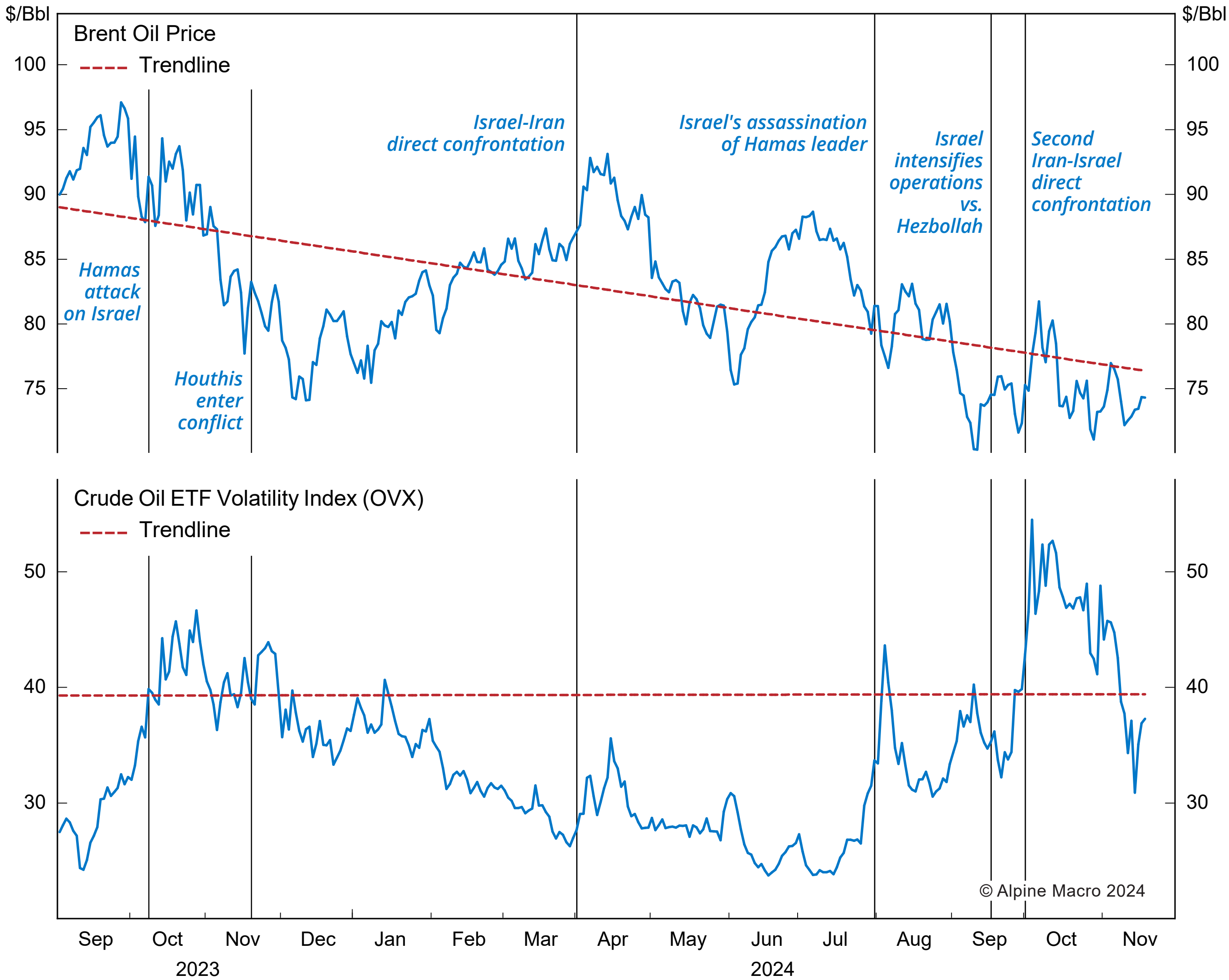
*Source: EIA
Note: Both series are shown as 12-month moving average

However, absent escalation, oil prices are on a downward trend[4], driven by lower Chinese demand and increased U.S. production (**Chart 3**). So far, as the conflict in the Middle East has been contained, and with the exception of geopolitically-driven episodic spikes in oil price and volatility (which washed out of markets in a matter of days/weeks), the overall price trend has been downward – while oil price volatility has stayed roughly flat (**Chart 4**). For now, markets are not pricing in the escalation risk.

With Trump soon to implement "drill, baby, drill" policies, increased U.S. production will likely pressure oil prices further, even if Iran faces renewed

4 Alpine Macro *Global Strategy* "Recession Fears, Market Indicators And Investment Bets" (August 26, 2024).

Chart 4 Oil Prices Have Trended Down, Despite The Middle East Conflicts



sanctions. A separate oil price headwind could happen if OPEC producers might then try to compete for market share if U.S. output surges.

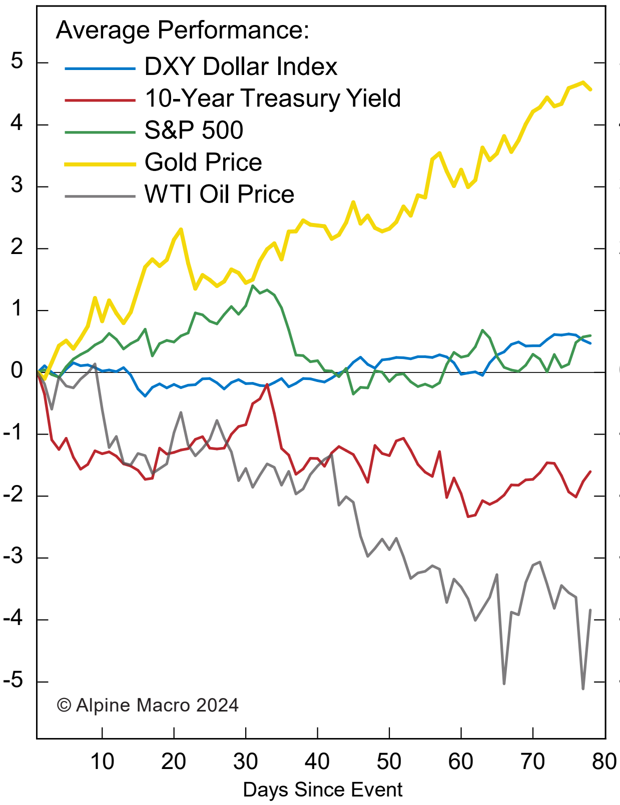
Lower oil prices would not only have economic implications (e.g., positive for lower inflation in DMs and for European growth), but would also put economic pressure on a number of U.S. rivals, including Iran and Russia.

U.S.-China: A Waiting Game

Several clients have asked whether strategic or economic conflict escalation between the U.S. and China is likely during the period between the election and Trump's January 20 inauguration. We think this is quite unlikely during the lame-duck period.

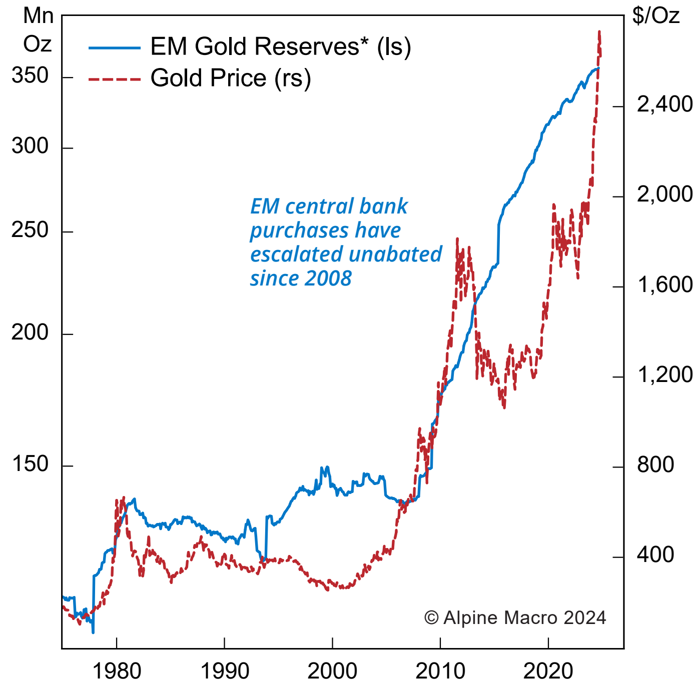
First, China is likely to take a wait-and-see approach to how the Trump administration positions itself. Second, Beijing is preoccupied with its domestic

Chart 5 Gold Is The Best Geopolitical Safe-Haven Asset



Note: Based on 56 major geopolitical events since 1973, with values rebased to 0 on the event date

Chart 6 EMs Are Accumulating Gold



*Source: IMF

economic problems, very likely limiting its willingness to act confrontationally. Third, the Biden administration is unlikely to alter its China policies in its final two months.

Once in office, Trump is expected to pursue higher tariffs on China, likely below 60%. Tariffs will likely be used strategically to: 1) support select domestic industries, 2) leverage foreign market access for U.S. goods and services, and lastly 3) raise revenue. Commerce Secretary nominee Howard Lutnick recently hinted at such policies, though debate continues over how tariffs will apply to rivals (e.g., China) versus allies and other trade surplus nations. Lutnick seems to indicate a tough but targeted approach.

The Biden administration's "small yard, high fence" approach to selective decoupling in strategic industries (e.g., advanced tech, manufacturing) will likely expand under Trump into a "bigger yard, higher fence" model. Full economic decoupling is unlikely given deep U.S.-China economic ties, though it will be a risk, especially if the U.S. and China engage in tit-for-tat measures.

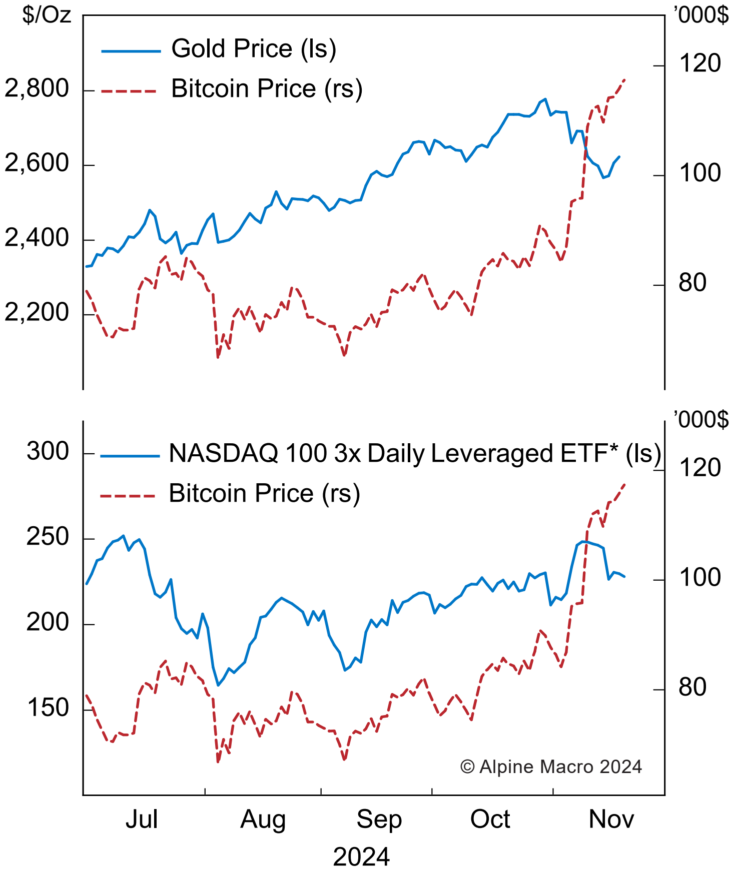
That said, Trump's transactional approach to policymaking leaves room for compromises and a potential trade or economic deal/*détente* with China.

Bottom line: U.S.-China relations are in limbo before January 20, 2025.

Market Implications

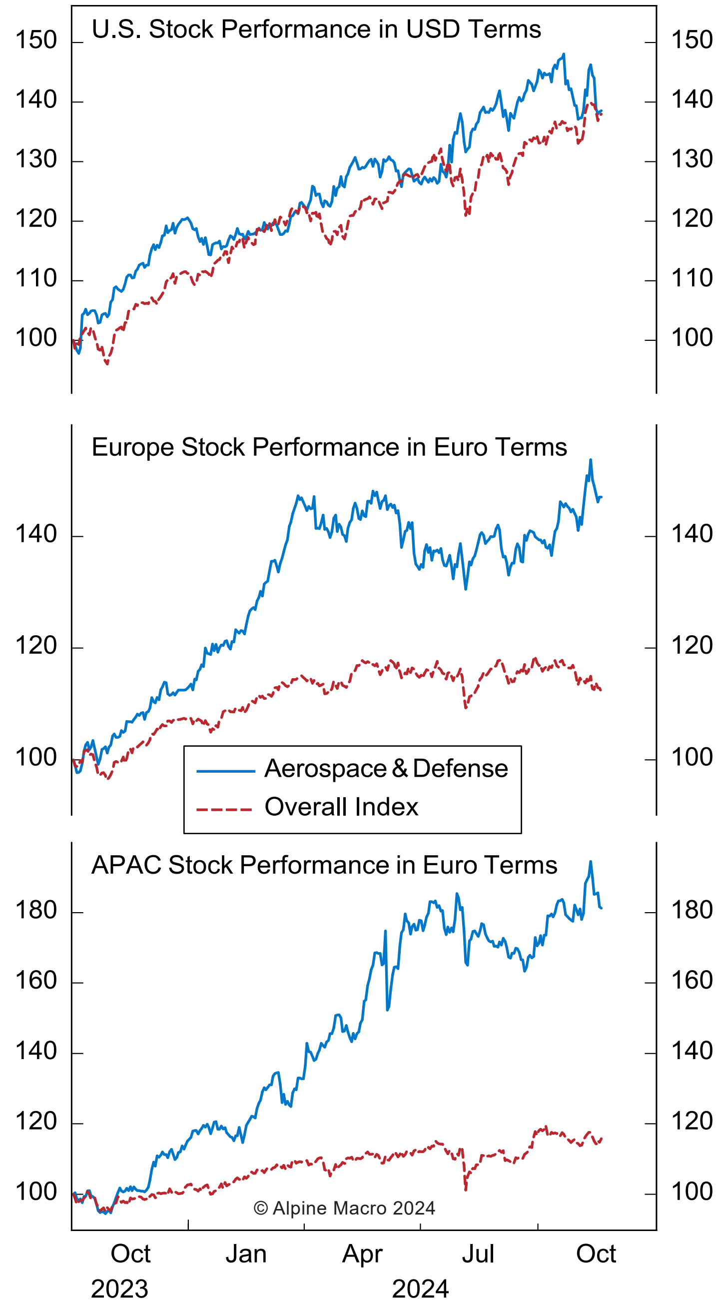
How should investors position themselves during the lame-duck period? Alpine Macro has written

Chart 7 Gold And Bitcoin



*Source Bloomberg Finance L.P.

Chart 8 Aerospace & Defense Stocks Since The Hamas-Israel War



Note: All series are rebased to Oct 2023=100

in detail about the implications of a next Trump administration[5].

This report, however, looks at the geopolitical environment during the lame-duck period, which suggest two investment ideas, which we have long advocated.

Staying long gold is prudent. Gold remains the best short-term safe-haven asset for geopolitical shocks, with relevance heightened over the next two months amid ongoing geopolitical uncertainty (**Chart 5**). Longer-term, major emerging markets will continue accumulating gold as a hedge against Western economic pressure (**Chart 6**), while most major

5 Alpine Macro *Equity Strategy* "Equity Trump Trades 2.0" (November 20, 2024), *Emerging Markets & China Strategy* "Trump's Sweep And Beijing's Playbook" (November 12, 2024), *Global Strategy* "Trump Trade, Fed Policy And Investment Strategy" (November 11, 2024), *Global Fixed Income & Currency Strategy* "A Clean Sweep?" (November 8,2024), and *U.S. Bond Strategy* "Higher Yields But Lower Bond Volatility?" (November 7, 2024).

economies are also cutting rates — so the long-term gold prospects align with the short term.

Gold, though not cheap, has become more affordable since the election, with expectations of higher growth and fewer FOMC rate cuts weighing on its price. It is also cheaper relative to Bitcoin, likely due to expectations of a more crypto-friendly regulatory environment under Trump. Chart 7 shows Bitcoin's post-election rise relative to gold and its decoupling from a leveraged Nasdaq measure, reflecting these regulatory expectations.

Aerospace & defense equities should continue outperforming benchmarks globally (Chart 8). The U.S., Europe, and Asia are rearming, with the Trump administration likely to increase procurement spending while pushing allies to do the same. Geopolitical tensions during the lame-duck period, as well as longer-term expectations of a more strained global environment, should sustain this sector.

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A Unique Mind On The Markets