

A Second Cold War Has Begun

Retrieved Wednesday 9th of August 2017 07:39:11 PM

A bizarre version of democracy drives modern [geopolitics](#). The number of nations supporting an international policy determines its legitimacy instead of morality or any legal basis.

As a result, invasions, sanctions and economic agreements are pursued based on the support of countries who need not have anything to do with them. The theatrics at the UN show the key question is always whether the country proposing something can garner the support they need, not whether the proposed action is legitimate.

That creates a wheeling and dealing environment, just like in a democracy. Tiny African nations frequently back initiatives they are unaffected by. Spain and Bulgaria's support for the invasion of Iraq was secured how, I wonder? (Syria opposed the invasion...)

Apply this state of affairs to the situation between President Donald Trump and North Korea. Trump recently told the press that a threat from North Korea would be met with "fire, fury and frankly power". The American stockmarket dropped on his remarks.

North Korea promptly replied with its own nonsense. The country declared it will pre-empt any American pre-emptive attack with its own pre-emptive pre-emptive attack. The island of Guam and its bomber base are top of the list of targets.

The only problem is that the two buffoons in charge might not be bluffing.

Trump obviously has the military capabilities at his disposal to unleash fire, fury and, frankly, power. But until recently, Kim Jong Un's bite was ill defined. Can his missiles reach American soil? Or are the hostages of South Korea and Japan enough?

A report from the Japanese Defence Ministry argues North Korea may have a miniature nuclear war that fits into the intercontinental ballistic missiles (ICBMs) they've been testing. The Washington Post added that it can confirm North Korea has produced such a war according to the US Defense Intelligence Agency. Kim's arsenal of them is at an estimated 60, depending on who you ask.

Going back to the mechanics of modern geopolitics, can Trump strike North Korea? Does he have the support of enough nations?

There's no way of knowing how many small nation acolytes Trump could collect. Not to mention how they might be bought. But the major powers are likely to take sides too.

Japan seems especially concerned with North Korea. Perhaps because of its proximity. But more likely because certain political leaders want to put an end to Japan's pacifist ways and acquire arms. To do that, they need an enemy. Korea just happens to be the traditional option going back hundreds of years.

America's traditional allies in Canada, the UK and Australia are toeing the American line verbally. They would most likely back a war at least politically.

But no seems to be considering South Korea's point of view here. It has by far the most to lose. But adding a nuclear war-equipped ICBM doesn't change the military maths much given the proximity of the countries. North Korea's military is enough of a threat without long-range missiles.

Could this be a black swan?

The short answer is that a war with North Korea won't be a black swan because you're already worried about it. A black swan is unexpected. But yes, a war could trigger a crisis in financial markets.

The big risks are, obviously, from North Korea's ability to cause damage to South Korea and Japan. London and the east coast of the US may be within range of North Korea's ICBMs too, but my analysis won't protect you from a nuclear war landing in your back garden unless you're willing to move to Cape Town.

South Korea and Japan are not among the UK's major trading partners. But both nations are a disproportionately large operator in financial markets, which are of course a major part of the UK economy.

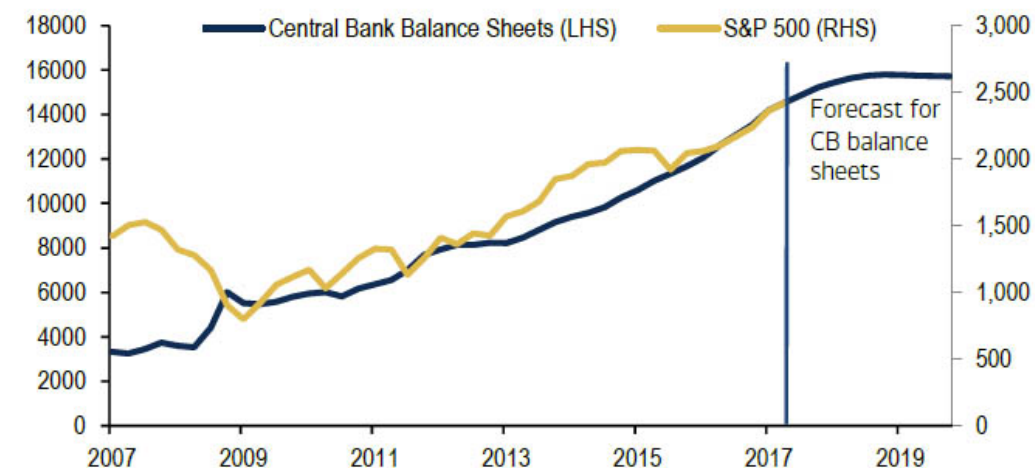
It's clear that the outbreak of war would cause stockmarkets to fall and government bonds in uninvolved nations to surge in a bid for safety. You're better off owning German government debt than that of America's ally, the UK government, in that scenario.

But the key question is when such a war turns into a buying opportunity. An academic study about stockmarket performance in the wake of wars found that they reduce returns by about 4% per year. But stocks can still go up. And the initial drop on the beginning of a war is a great place to buy.

The end of central bank stimulus

Fear is pulsing through the markets. Analyst after analyst at investment banks around the world are pointing out that only [central bank](#) money printing has kept the stockmarket afloat. And central bank money printing is set to decline in 2018. Therefore, the stockmarket is doomed.

Chart 1: Will equity prices follow the slowdown in central bank balance sheet growth?



Note: Central bank balance sheets include the Fed, BOE, ECB, and BOJ.

Source: BofAML Global Research, Bloomberg, Federal Reserve Board, Bank of England, European Central Bank, Bank of Japan

This analysis has things precisely backwards. Central bankers printed money precisely to [goose the stockmarket](#). It's not a side-effect, it's the intended "wealth effect".

That theory says pumping up the stockmarket will make people feel richer and buy more, improving the economy. This is about as stupid as tricking people into borrowing and buying more with low interest rates. But with that method exhausted at 0% interest rates, central bankers came up with theory B to justify their hammer looking for a nail philosophy.

Anyway, if central bankers are printing money precisely to goose the stockmarket, then worrying about the effect of an end to [quantitative easing](#) (QE) on the stockmarket is missing the point. The moment the stockmarket dips, they print more money.

The stockmarket drives QE.

Indeed, just forecasting central bank policy based on their predicted amounts of money printing is misguided. They will print the amount of money needed to float the stockmarket, regardless of what they publish as their estimated amounts.

Worrying about a crash in the stockmarket because of a lack of QE completely misses the reason QE comes into being – to prevent a falling stockmarket.

Economists join the stockmarket analysts with a slightly more enlightened question: how will the central banks "unwind" all their stimulus?

But no has answered the "why" yet. Why would central banks unwind their stimulus if it's the only thing keeping things afloat? Why will they willingly call an end to the stability they've created? It may be false stability, but it still feels stable.

For central bankers to decrease QE and increase interest rates in the face of a stockmarket crash would mean a complete change of their position and belief set. They'd have to admit they're clueless and declare they're willing to allow a repeat of the 2008 crash.

Unlikely.

At the slightest sign of trouble, central bankers will return to their QE ways.

Until next time,

Nick Hubble
Capital %26 Conflict