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Investing in the age of Geopolitics

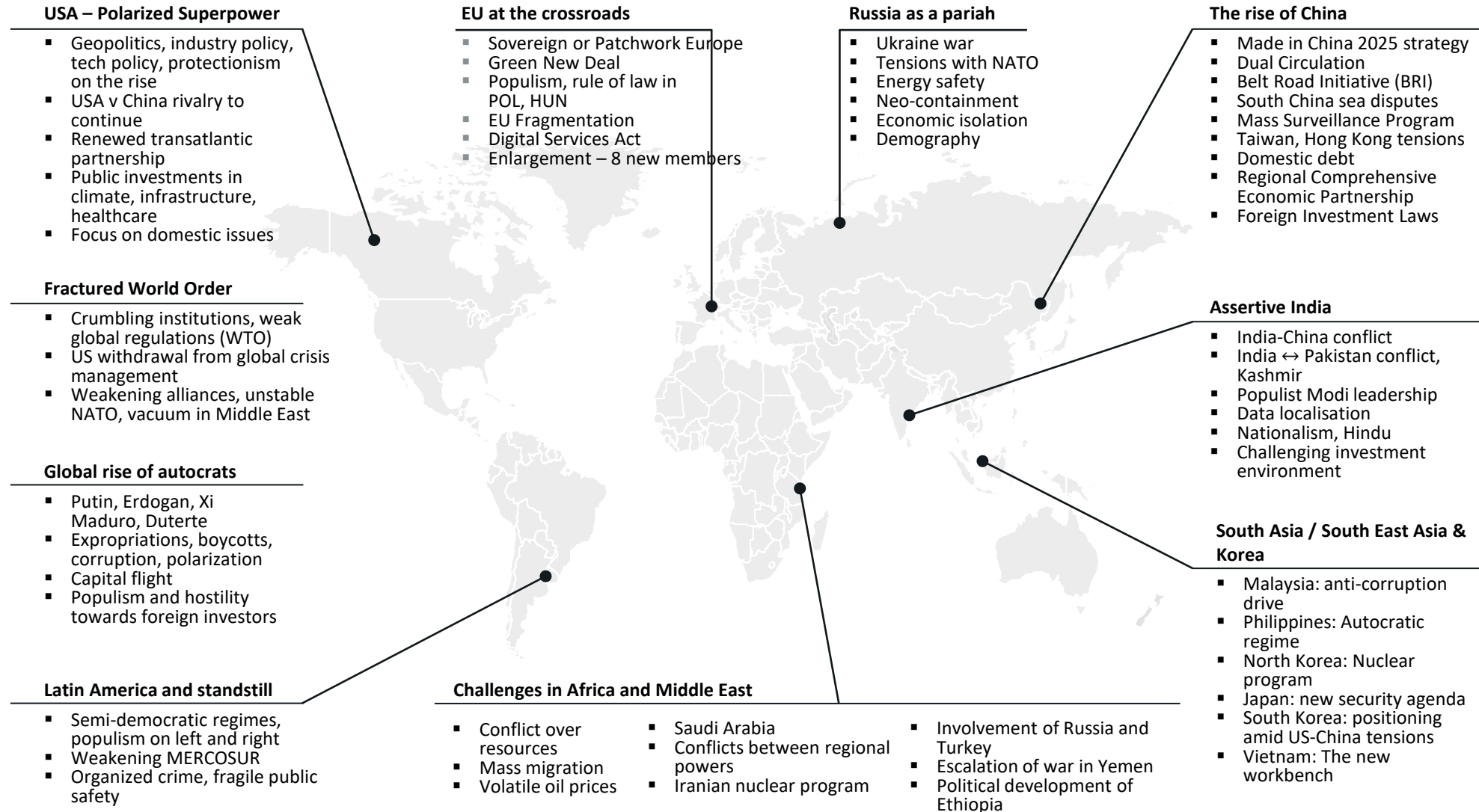
Recommendations for the strategic asset allocation

Think Tank Active Investing

Hamburg, September 25 2023

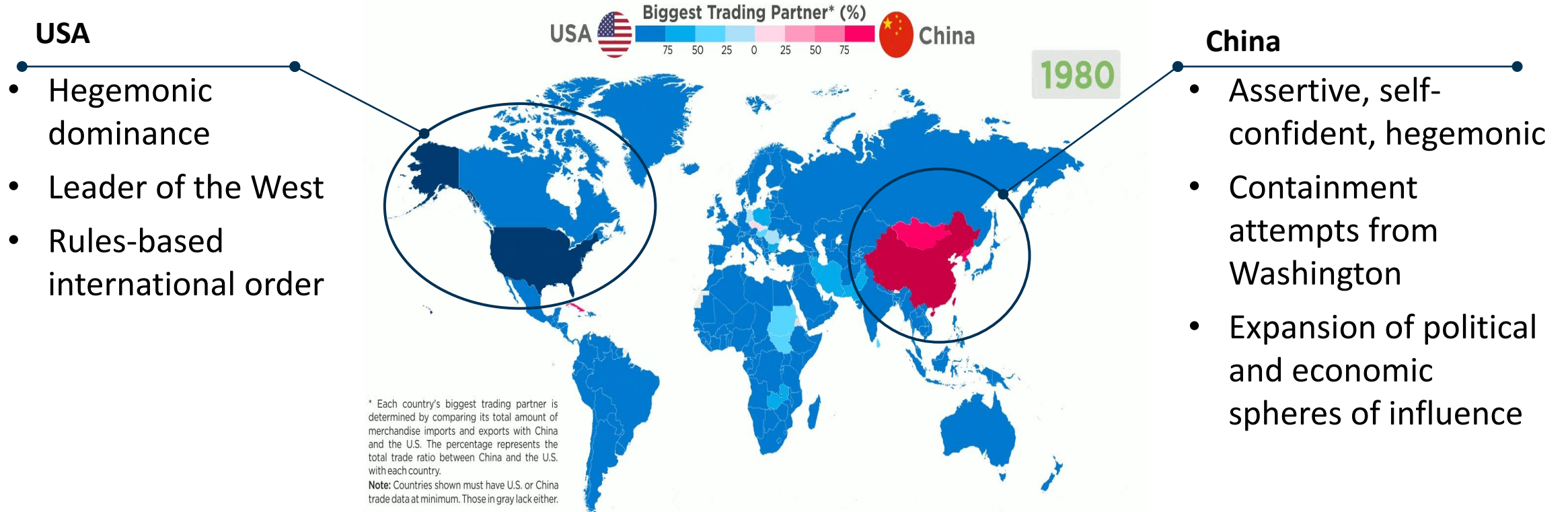
Jan Friedrich Kallmorgen | Berlin Global Advisors

Governments, companies & investors need to deal with a new world: Geopolitics replaces Globalization...



...with U.S. v China to be the central conflict of the 21st century

Thucydides Trap?



System conflict between the USA and China prioritizes national security over economic interdependence.

...leading to global bloc building & fragmentation...

Western Alliances

G7



- USA
- Japan
- Germany
- France
- Italy
- UK
- Canada
- EU

NATO



- USA
- Canada
- Sweden (tbc)
- 29 European Nations

AUKUS

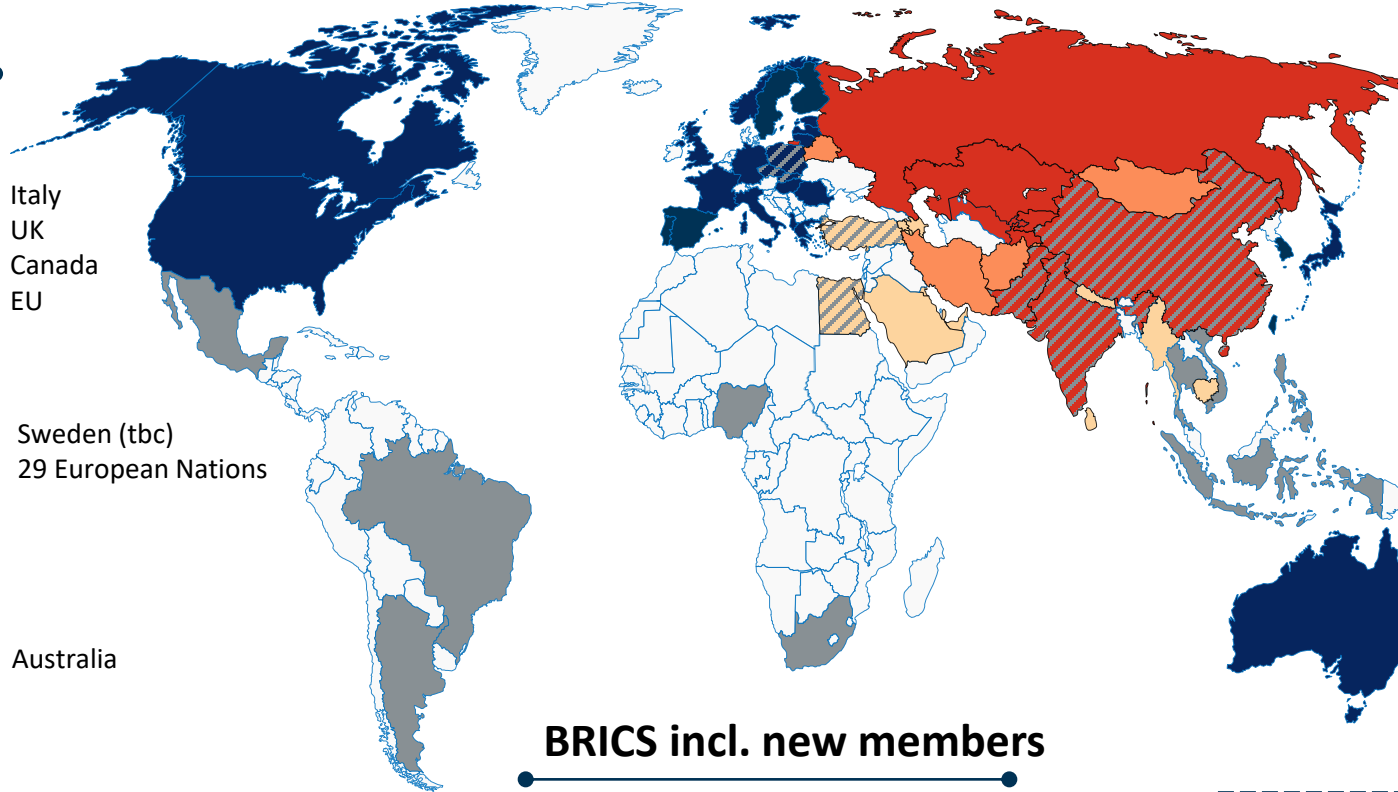


- USA
- UK
- Australia

Quad



- USA
- Japan
- Australia
- India



BRICS incl. new members

- Brazil
- Russia
- India
- China
- South Africa
- Iran
- Saudi Arabia
- Egypt
- UAE
- Ethiopia
- Argentina

Eurasian Partnerships

SCO



Member states (8)

- China
- Russland
- Kasachstan
- Kirgistan
- Pakistan
- India
- Tajikistan
- Uzbekistan

+

4 Observer States +13 Dialogue Partners

CSTO

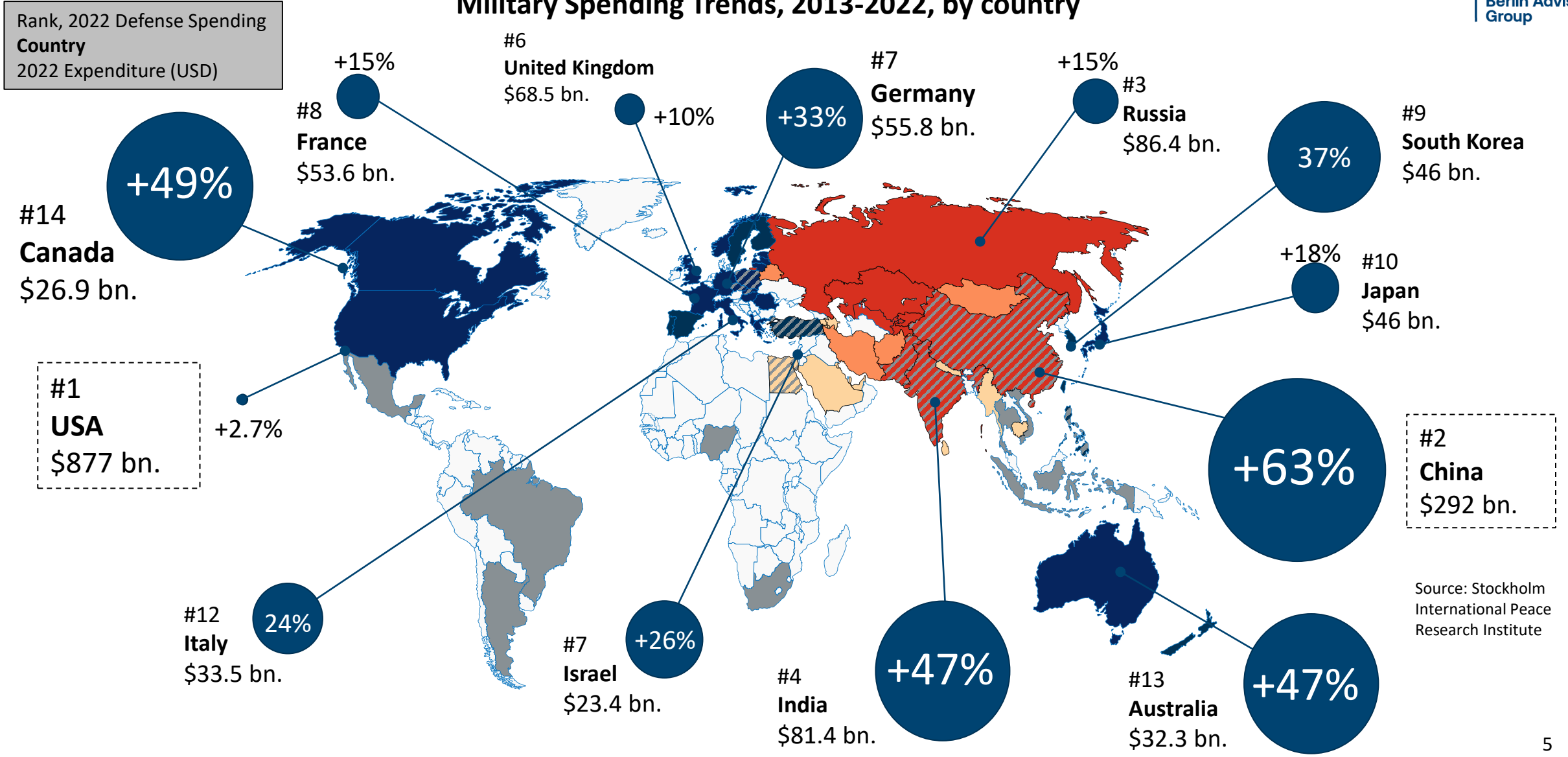


- Russland
- Armenia
- Kazakhstan
- Belarus
- Kirgistan
- Tajikistan



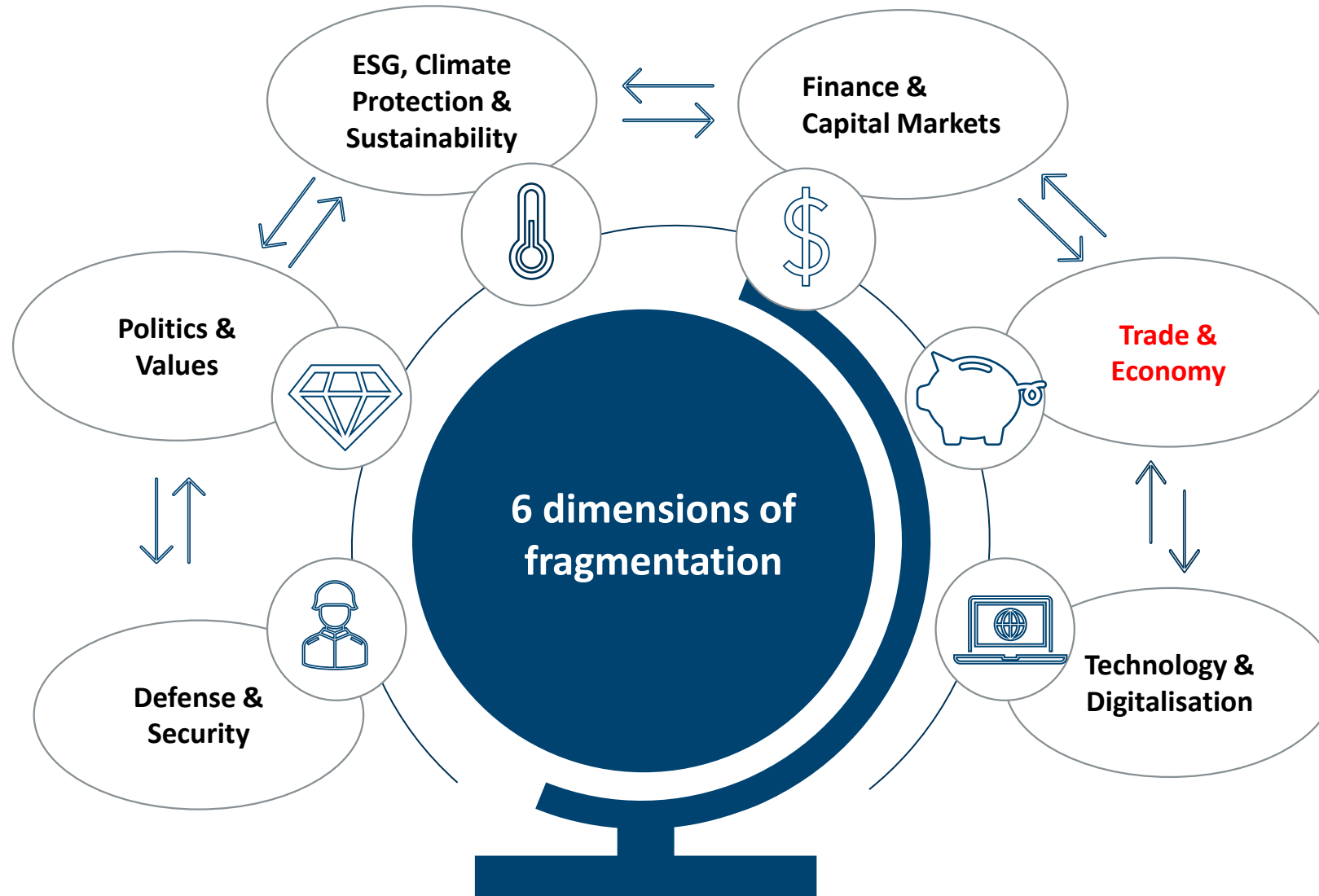
...and the World to stock up weapons and defense spending...

Military Spending Trends, 2013-2022, by country



Source: Stockholm International Peace Research Institute

Compartmentalizing Geopolitics in different dimensions helps





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Deep Dive: Key Risks 2023/24

Russia's war in the Ukraine – 3 Scenarios



“Putin most likely calculates that time works in his favor and that prolonging the war — including with potential pauses in the fighting — may be his best remaining pathway to eventually securing Russian strategic interests in Ukraine, even if it takes several years.”

U.S. Director of National Intelligence Avril Haines, 4. April 2023

Scenario 1: Prolonged Stalemate

- Ukraine has begun counter-offensive in June 2023
- No side achieves a decisive breakthrough on the battlefield
- Positional warfare ensues for the foreseeable future
- No sanctions easing, energy supply disruption between Europe and Russia continues
- Key uncertainty: can both sides secure their weapons supply

Likelihood: 60%

Scenario 2: Russia loses ground – forced to negotiate

- Successful Ukrainian counteroffensive in the summer and military attrition on both sides
- Ukraine achieves operational control over territories around the Crimean Peninsula, forcing Putin to negotiate with Ukraine
- Putin accepts Western security concessions for a ceasefire before Crimea
- Long-term roadmap for easing sanctions becomes conceivable following a ceasefire
- European energy policy further decouples
- Main uncertainty: Will Putin be willing to engage in negotiations?

Likelihood: 25%

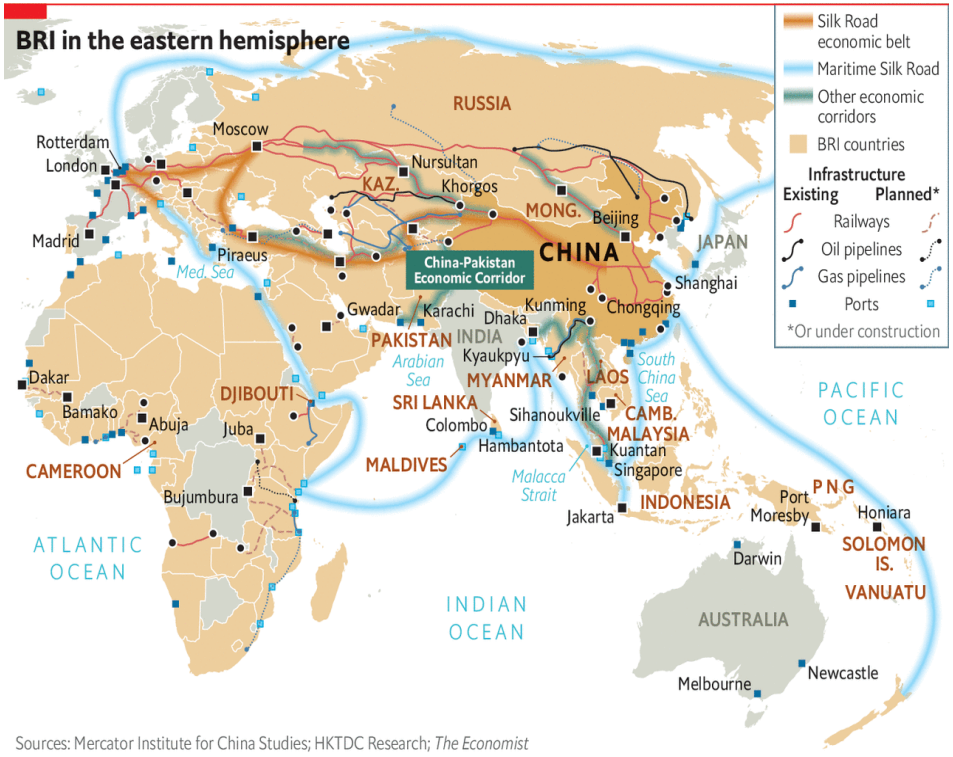
Scenario 3: Prolonged War/ Military Escalation

- Successful Ukrainian counteroffensive, Russian forces continue to lose ground; Putin escalates
- Domestic instability increases further after Prigozhin's move; Putin's power significantly undermined
- Use of tactical nuclear weapons, escalation around Zaporizhzhia
- Main uncertainty: Can a Russia-NATO escalation be avoided?

Likelihood : 15%

The new China: A cyber dictatorship aspiring for global dominance

China seeks to expand its economic sphere of influence...



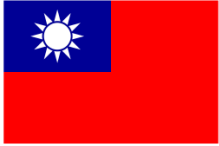
Sources: Mercator Institute for China Studies; HKTDC Research; The Economist

...and secure a security-related sphere of influence in the Pacific.



Source: Economist

Taiwan: Scenarios 2023 - 2027

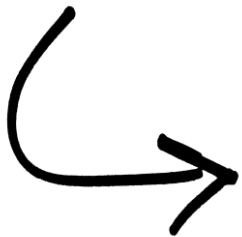


The PRC is aspiring for “**peaceful national reunification**” with Taiwan but does not renounce the use of force. President Biden has signaled that the US will send forces to Taiwan if invaded.

60% likelihood

Baseline scenario: Boa Constrictor

For the upcoming term, the PRC is going to **focus on non-violent political actions**, such as the gradual **political and economic isolation** of Taiwan, psychological warfare through the deployment of **military capabilities**, or the **intervention in Taiwan’s internal politics**



These measures will likely fall short of what the U.S. could interpret as overly “coercive” and is unlikely to lead to a larger military conflict but will trigger non-military responses by the U.S. and its allies along a “**corridor of tension**”

30% likelihood

Escalation Scenario I: Control

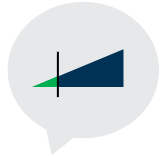
Extension of legal and regulatory Authority by the PRC to **bring Taiwan under its control**. The PRC calibrate its actions limiting/preventing **direct military engagement with the U.S.**, rendering it politically difficult for the U.S. and its allies to mount a robust response.

10% likelihood

Escalation Scenario II: Invasion

Currently, a **scenario suggesting a full-scale invasion of Taiwan** has a low likelihood. It could be triggered by a **unilateral declaration of independence by Taiwan**, the PRC’s perception of military superiority or domestic political dislocations threatening the stability of the current leadership of the PRC.

Taiwan conflict: Implications for Global Trade



Baseline Scenario

- **US:** Tightening export controls and expanding tariffs / export controls on national and economic security grounds.
- **China:** Denying and / or complicating market access, dislocation of Chinese outbound supply chains, seeking to sanction-proof domestic economy.



Escalation Scenario I

- **US:** Strategic industry-specific sanctions, e.g. disrupting the supply of semiconductors to China and the Chinese military-industrial complex.
- **China:** Risk of blocking exports of rare earths, reinforcement of the control of vital transport routes for strategic materials.



Escalation Scenario II

- **US:** Freezing reserves of the People's Bank of China (PBOC), cutting off China's banks from SWIFT, trade of embargo with China.
- **China:** Possibility of stopping to service debt held by sanctioning parties, nationalize FDI, freeze portfolio investment of foreign investors.



America counters China with Geoeconomics

Washington's **geoeconomic instruments / National Security Strategy:**

- **Invest** in competitiveness, innovation, and resilience
- **Align** efforts with US allies and partners
- **Compete** with the PRC to defend US national interests



↳ **US industrial policy contains carrots and sticks:**

Carrots – Boost key domestic industrial sectors and strengthen US supply chain resilience, such as:

- Bipartisan Infrastructure Bill
- Chips and Science Act
- Inflation Reduction Act

Sticks – Hinder adversaries' development in key industrial sectors, such as:

- Export Controls
 - Entity List
 - End-Use Screening
- Outbound Investment Screening

Cold War II? America's China containment strategy



*„On export controls, given the foundational nature of certain technologies, such as advanced logic and memory chips, **we must maintain as large of a lead as possible.**“*

National Security Advisor, Jake Sullivan

- Biden's team is expanding Trump's trade controls to maintain an advantage over China.
- Investment programs like the IRA and Chips Act are also geopolitical industry policy instruments to make the U.S. more competitive and resilient against China
- Restricting China's access to US technologies aims to limit China's military modernization, preserve the US technological leadership, and respond to China's human rights violations.
- National Security interests beat business interests when it comes to China – this trend will only increase with the upcoming U.S. elections – expect a “race of the hawks”
- At the same time, Washington beefs up key international institutions like NATO or the Worldbank and accommodates the “Global South” at G20 level, i.e. EU-US-Saudi Arabia-India infrastructure alliance.



But watch the elephant in the Room ...50% chance Trump comes back



*"I'll meet with Putin. I'll meet with Zelensky. They both have weaknesses and they both have strengths. And **within 24 hours, that war will be settled. It'll be over**"*

- 45th US President Donald Trump, 11. Mai 2023

Foreign Affairs

Ukraine Scenario 1: Reduced Support

- Higher chances of success for Moscow
- Europe at risk and needs to provide more support. US NATO Membership in question
- Signal to China about US credibility

Ukraine Scenario 2: Continued Support

- Prolonged trench warfare
- For example, in 2017, Trump allowed the sale of weapons to Ukraine (when Obama refused)

• China

- Benefits from the decline of US soft power / alternative world order
- Shift of US military resources from Ukraine to the Indo-Pacific region
- US-China trade war escalation

• EU

- US security guarantees questioned
- EU-US trade war
- EU needs to provide stronger financial support to Ukraine

Energy and Climate

- Energy strategy: "drill, baby, drill!"
- US withdrawal from the Paris Climate Agreement
- Abolition of the Environmental Protection Agency (EPA)
- Rise in oil prices for the EU
- Relaxation of regulations to promote fossil fuel production

Internal Affairs

- Further debate on the US debt ceiling
- No civil war, but increased political polarization in the US
- ESG: "Woke" vs anti-woke: Spilt in U.S. business community and finance

The EU is also pursuing a geoeconomic strategy

“Today, the United States and the European Union are taking new steps to deepen our economic relationship as we build the clean energy economies of the future and address shared economic and national security challenges.” - Joint Statement by President Biden and President von der Leyen, March 10, 2023



↳ The EU’s industrial strategy follows a similar structure to US industrial policy measures – although with greater focus on supply chain resilience and characterised by higher economic dependence on China.

Targets for Europe’s geoeconomic strategy include...

- a. Strengthening the resilience of the single market
- b. Dealing with the EU’s strategic dependencies
- c. Accelerating the green and digital transitions

...and are implemented through e.g.:

- a. Next Generation EU
- b. Green Deal Industrial Plan
 - i. Critical Raw Materials Act
 - ii. Net-Zero Industry Act
- c. European CHIPS Act
- d. Reform of the electricity market design

In the middle: EU-China Relations

Motivation

Brussels wants to keep China as a market but is forced to react to the PRC's increasing **authoritarian assertiveness**, as well as Beijing's ties with Moscow – not least due to pressure from the US.

Xi wants to **challenge rules-based globalization**, while preventing US-EU alignment against China. While European business are still welcome in China, it is **highly regulated** by the Communist Party.

Strategy

The EU is increasingly emphasizing the rivalrous nature of Sino-European relations.

Given their **economic dependence** on both the US and China, Brussels strikes a balance to wait out the conflict without incurring too much economic damage.

However, **de-risking** and building up supply chain resilience is painful but **increasingly inevitable**.

China's economic leverage over Europe is forcing European businesses to **conform to Chinese economic policy**.

Thereby Beijing is expanding resilience and its influence on European economies.



Policies

- EU Net Zero Industrial Plan aimed at reducing critical raw material supply dependencies
- Generous state support for tech and net-zero products through the (IPCEI)
- National alignment with US export controls
- Moderate Inbound investment screening
- Potential adoption of outbound investment screening measures in 2024

- Heavy subsidization of its enterprises
- Sweeping industrial policy
- Strategic use of foreign policy to advance economic goals
- Weaponization of economic linkages to pressure third countries





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Consequences for Trade and Supply Chains

Friendshoring Supply Chains



*“Favoring the **friend-shoring of supply chains to a large number of trusted countries**, so we can continue to securely extend market access, will lower the risks to our economy as well as to our trusted trade partners.”*

- U.S. Treasury Secretary Janet Yellen, 22. April 2022



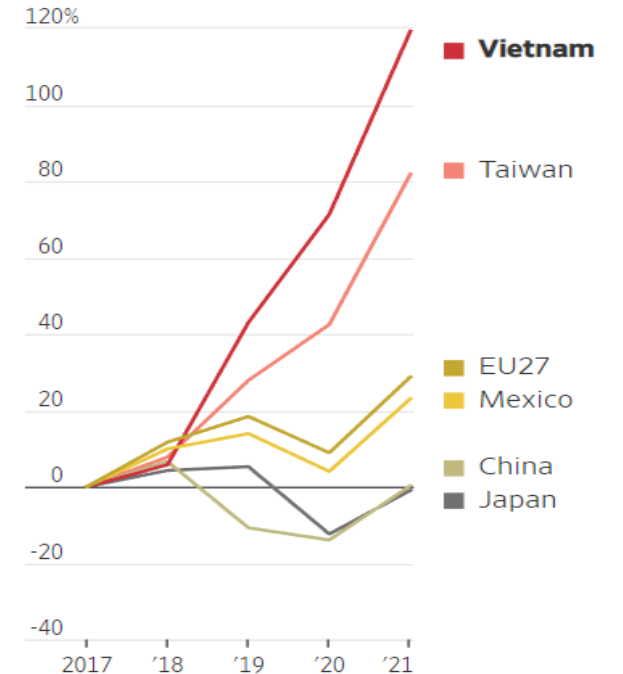
Governments are increasingly promoting trade and investments with countries considered politically and economically friendly...

...to reduce economic dependencies on political rivals...

...and to strengthen political and economic alliances.

US-Import Trends

Value of goods imported into the USA;
Change since 2017

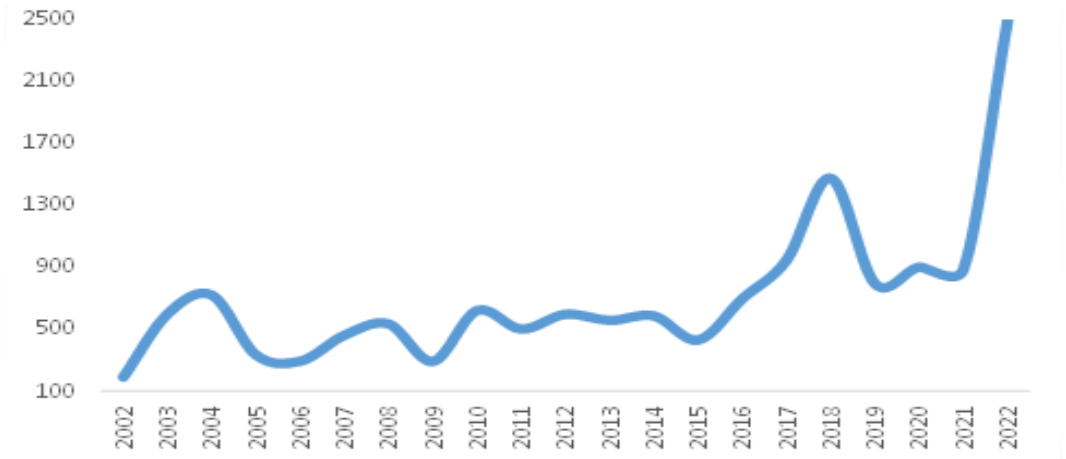


Source: Census Bureau; Moody Analytics

Increasing trade restrictions on rivals

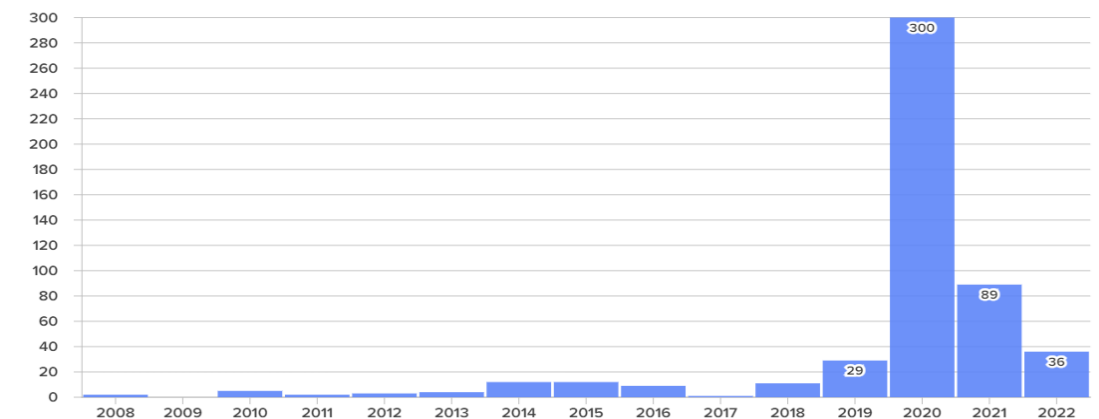
- States are increasingly using trade restrictions to weaken geopolitical rivals.
- Increase in **sanctions**...
 - Especially in the USA, sanctions have become an increasingly used tool of foreign policy.
 - With the Russian invasion of Ukraine, an attempt is being made for the first time to cut off a geopolitical superpower from global markets.
- ...and more recently, **export controls**.
 - Washington is increasingly using export controls to prevent Chinese companies (e.g., Huawei, ZTE) from accessing critical goods.
 - Export controls to restrict semiconductor precursors to China in October 2022 have far-reaching consequences for the Chinese tech industry.

New US Sanctions Designations Per Year



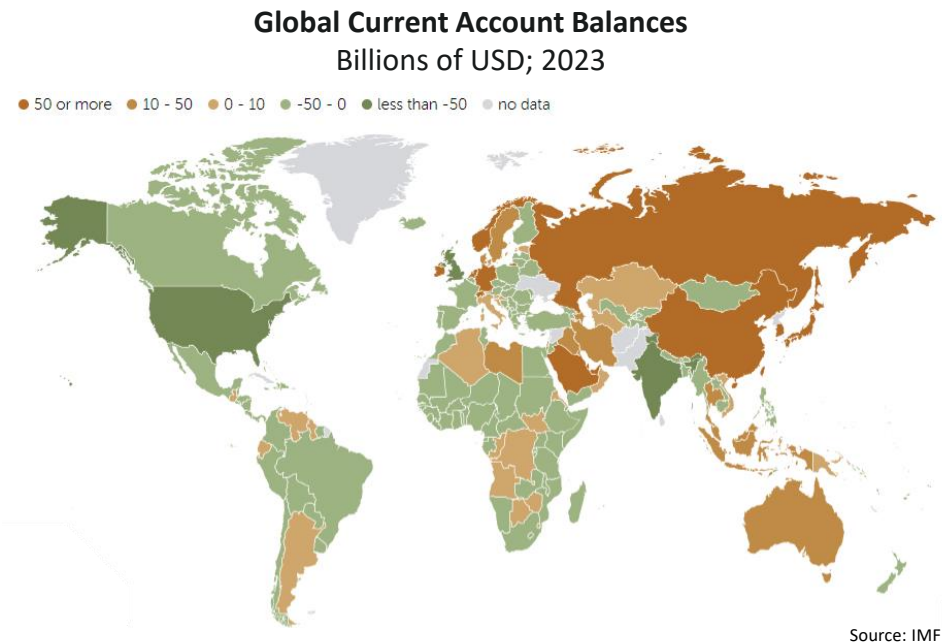
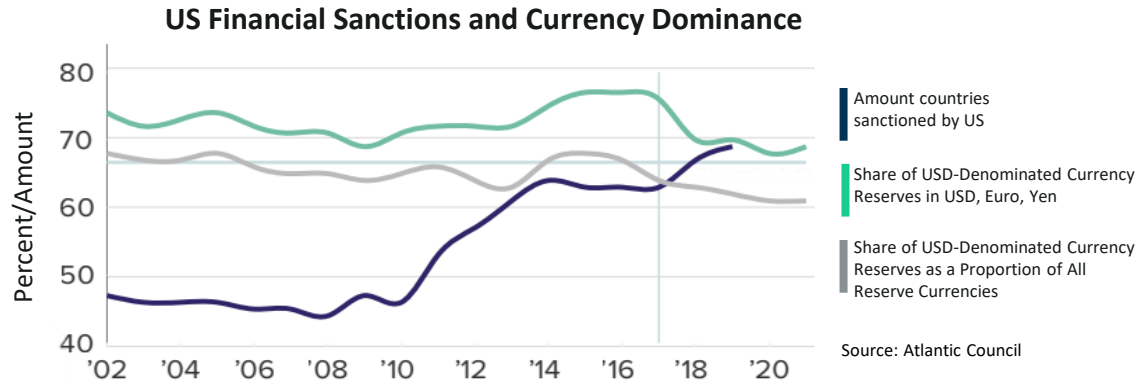
Quelle: Gibson Dunn

Designation of Companies for US Export Controls Per Year



Quelle: Atlantic Council

...and *weaponized* interdependence of global financial flows.



- **Dollar dominance persists...**

- Despite increasing U.S. financial sanctions, the U.S. dollar remains the dominant reserve and financial transaction currency (with the Euro in second place).
- Liquid markets, reliable financial institutions, economic openness, and its role as a geopolitical security guarantor strengthen the international role of the USD.

- **...as current account balances prevent comprehensive localization.**

- Current account deficits in the USA/UK/India and surpluses in China/Russia/Saudi Arabia prevent a complete financial decoupling of geopolitical blocs.



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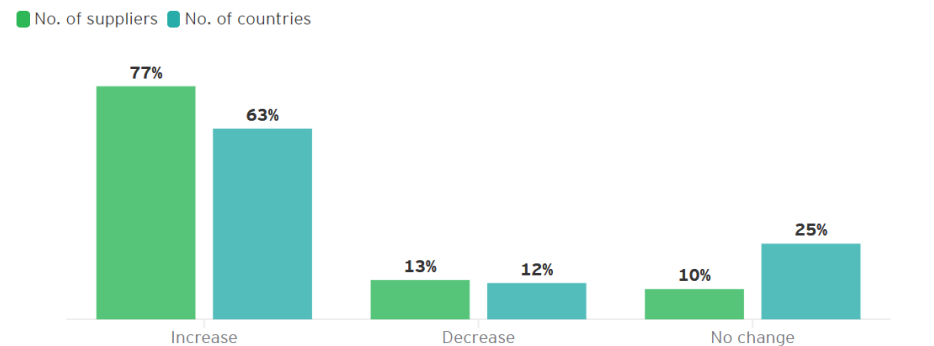
Consequences for Companies

Companies are pursuing supply chain restructuring...

- An EY survey revealed that 55% of all surveyed companies have engaged in near or re-shoring in the past 24 months.
- According to the survey, 61% of companies also stated that they changed their supplier base in the last 24 months.
- As a diversification measure, 57% reported that they established new branches in one or more additional countries in the last 24 months
 - 53% plan to do so in the next 24 months.

Impact of Supplier Diversification

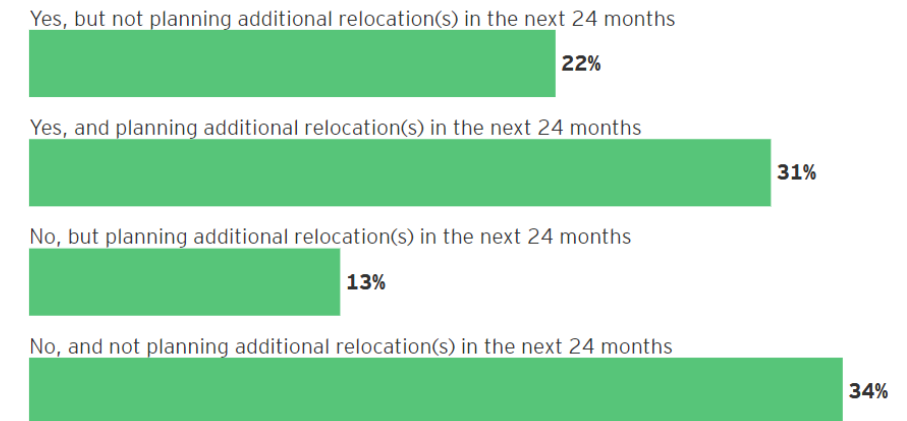
Companies worldwide that have made significant changes to their supplier base (or plan to do so in the next 24 months). How do these measures change the total number of suppliers and the number of countries?



Source: EY

Measures for Resilience

Has your company relocated some of its operations from one country to one or more other countries in the last 24 months (e.g., nearshoring or re-shoring)?



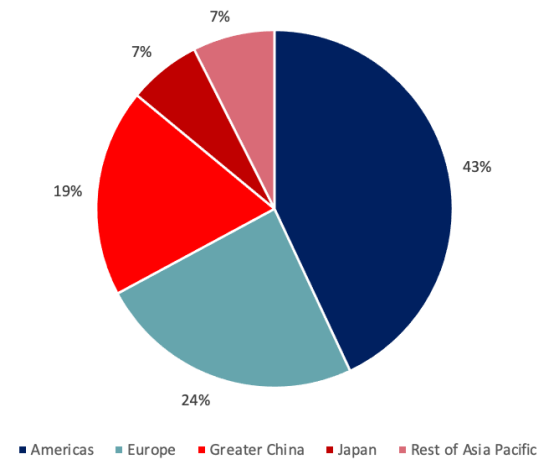
Source: EY

...and look to mitigate their China risk through diversification or localization.

Diversification – Apple Case Study

- In November, "Zero-Covid" protests disrupted the critical Apple production facility in Zhengzhou, exposing a concentration risk for Apple.
- In response, Apple is pursuing **strategic realignment**: 25% of production is to be outsourced to Vietnam and/or India.

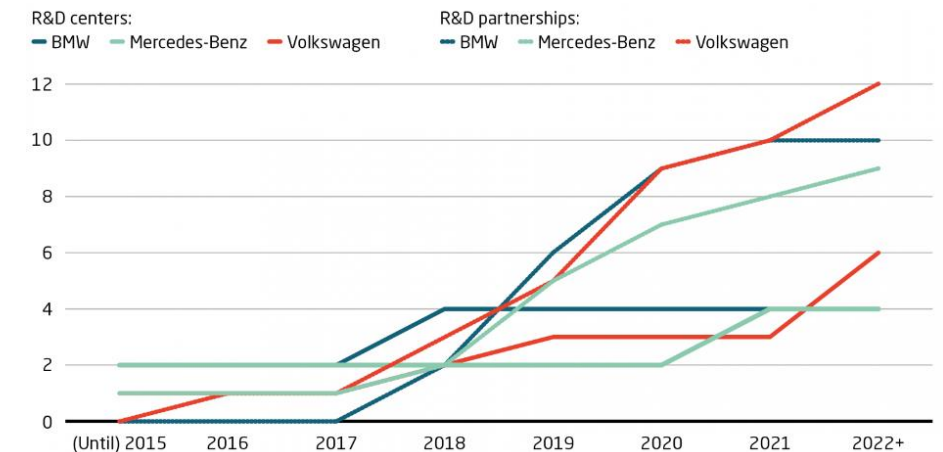
Apple: Revenue by Region



Localisation – Volkswagen Case Study

- Volkswagen's market share in China, their largest market, decreased from 20% in 2019 to 16% in 2022. The company concluded that VW did not fully understand the Chinese consumers in terms of their needs and desires.
- Therefore, VW has announced a localizing "second home market strategy" to strengthen their development capabilities **"in China, for China."**

Research and development centers of German automobile manufacturers in China; (cumulative)



Source: Merics



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Consequences for the strategic asset allocation

Look at geopolitical positives for business...

- **Russia's war in the Ukraine** has - despite the ruthlessness, tragedy and losses - some positive effects:
 - Closer transatlantic cooperation in security, energy, finance, technology, industry policies
 - A boost for new energy technologies such as hydrogen, CSS, new nuclear, fusion
- **The middle powers** like India, Saudi Arabia, Brazil, Argentina, Turkey or Indonesia will **benefit** from the new geopolitical situation, will receive increased FDI and will become more attractive markets
- The **EU** and the **US** will invest billions of public money in sectors such as **artificial intelligence, semiconductors, biotech, military** and **cyber**. **Companies in these sectors stand to benefit.**
- Similarly, there is a significant need for investment in **the transformation of energy systems** and the creation of a **robust infrastructure** from **rail transport** and **ports** to **space / satellite communications**.
- These investments will only be able to be financed in part from public funds and will require creative **public-private solutions with very attractive opportunities for strategically thinking CEOs and investors.**

... invest in national security opportunities...

We recommend investing in those companies / sectors that are structurally (geo-) politically driven as they are critical for national security and for maintaining / creating an edge for the West over global rivals. These include:

- Artificial intelligence & quantum computing
- Semiconductors and equipment
- Defense / Military / Cyber
- New Energy: Hydrogene, Nuclear Fusion
- Water & Food Security
- Telecommunications, spaces /satellite

These sectors will benefit from massive public funding in G7 / NATO countries.

Portfolio companies should thus have sophisticated government relations to work closely with political leaders in G7 / NATO countries and **public institutions** such as the World Bank/IFC, EBRD, ASB, KfW, etc.

...and hedge your bets

Companies in which you invest should engage in **360 geopolitical risks management and** implement strategies to hedge against risks, i.e:

- Headquarters in NATO / G7 countries.
- Decisive reduction of exposure to the Chinese market
- Focus on development of new growth markets, i.e. India, Southeast Asia, Africa.
- Friendshoring / NATOization of supply chains.
- Diversification of critical raw materials sources / replacement through innovation.
- HR: Leadership and key positions have been vetted for political reliability
- Funding: > 5% shareholding from G7/ NATO-allied investors / sovereign wealth funds only



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Thank you for your attention

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