

Geopolitical and Geoeconomic Report

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For much of the past few years, we have treated geopolitics as if it were an external disturbance that, sooner or later, would be absorbed by the markets. A war pushed oil higher, a sanction altered certain trade routes, China responded to the United States and, after a few weeks of volatility, the economy went back to imposing its own logic. That separation is becoming increasingly difficult to maintain.

The current situation has a particular feature. The main sources of tension are acting on variables that were already under pressure before the latest shock appeared. The Middle East is affecting an energy market that Europe has still not managed to make structurally cheaper. The war in Ukraine is forcing higher defense spending in economies with limited fiscal room. The rivalry with China coincides with enormous needs for minerals, semiconductors and industrial capacity. The United States is facing all of this with federal debt above \$40 trillion* and long-term rates back at levels that almost no one was contemplating only a few years ago.

Geopolitics is not creating all of these problems. It is finding them already there. And that changes things quite a bit.

THE MIDDLE EAST REMAINS THE IMMEDIATE RISK

The oil market is functioning, but it is doing so in a way that can hardly be described as normal. Traffic through the Strait of Hormuz remains well below prewar levels. Over the last weekend, 17 cargo vessels crossed, compared with roughly 125 large commercial vessels a day before the conflict. Saudi Arabia has managed to recover part of its exports from Gulf terminals, while producers have improvised transfer and loading arrangements that keep barrels moving. This reassures the market because it shows that supply has not disappeared.

The problem is the cost of keeping it moving.

Every additional ship-to-ship transfer, every rerouted voyage, every extra day at sea and every insurance policy that includes a war premium ultimately gets added to the cost of a barrel. The same is true for freight. Spot container rates between China and the U.S. East Coast have multiplied since February and are back near levels comparable with the worst of the post-COVID disruptions.

Hormuz does not have to close to generate inflation. It is enough for it to stop functioning the way it used to.

Brent has corrected toward \$100 a barrel on expectations of diplomatic progress between Washington and Tehran. The move makes sense. The market discounts future barrels, not only the ones moving today. But four sessions of falling oil prices do not solve a physical problem that remains open. The Houthis still have the ability to put pressure on the Red Sea alternative, and an attack on Saudi Arabia's East-West pipeline has once again shown that diverting crude away from Hormuz does not automatically remove the risk. It simply moves it a few hundred miles.

China has also entered the equation more decisively. Beijing has asked Iran to restrain Houthi attacks on Saudi facilities. I do not think this is a minor point. China buys energy from every major actor in the region and needs to make sure that none of them can block the others. Its interest is not to defend Saudi Arabia against Iran. Its interest is to keep the oil flowing.

That is probably the most rational position of all.

UKRAINE IS NO LONGER JUST A WAR

The war continues without a visible political exit, and attacks on energy infrastructure have once again become a regular part of the military campaign. Russia strikes Ukrainian facilities while Ukraine continues to hit Russian refineries, storage sites and other energy assets. This kind of warfare has a different effect from destroying an armored vehicle. A refinery taken offline reduces productive capacity, alters exports, forces flows to be rerouted and ultimately affects fiscal revenues.

Russia is beginning to acknowledge the cost in its own accounts. The government now expects a deficit of as much as 3% of GDP, well above what was initially budgeted. For a wartime economy that is not an extraordinary figure, but it does show how far the conflict has moved beyond being financed only by windfall energy revenues.

Europe has a different problem. It is being forced to increase military spending while trying to finance an energy transition, modernize infrastructure and sustain welfare states designed for a much younger population.

Germany can afford to do considerably more than others. France has less room. The French spread over the German Bund has reached levels not seen since 2012. It is a signal that should not be dramatized, but it should be ignored even less. The euro was designed on the assumption that markets would eventually converge in their perception of risk. From time to time they remember that France, Germany, Italy and Spain share a currency, but they do not share a balance sheet.

A Europe that needs to spend more on defense will do so precisely as the marginal cost of issuing debt becomes important again. For a decade, that barely mattered. With rates near zero, debt could almost be discussed as an accounting issue. It has a price again.

THE MACROECONOMIC PROBLEM IS BECOMING RATHER UNCOMFORTABLE

Last week, the Federal Reserve raised the federal funds target range to 3.75%-4.00%. Warsh's message was fairly clear. The economy continues to grow at a solid pace, investment remains strong, the labor market is holding up and inflation is still too high.

The Fed's new projections put 2026 PCE inflation at 3.7% and core PCE at 3.4%. More interestingly, the median projected policy rate for year-end has risen from June. The market has had to abandon rather quickly that comfortable debate over when rate cuts would begin.

The ECB reached a similar conclusion a few days earlier. It raised rates by 25 basis points and took the deposit facility to 2.50%. It expects average inflation of 3% this year, 2.5% in 2027 and still 2.1% in 2028. At the same time, it has revised its growth forecasts slightly higher because the European economy has held up better than expected.

That is a rather unpleasant combination for a central bank.

If the economy were collapsing, the decision would be straightforward. Policymakers could tolerate somewhat more inflation for a time and cut rates to avoid a deep recession. If inflation had disappeared, there would not be much mystery either. The problem comes when growth holds up well enough for demand to keep putting pressure on prices while oil, gas, transportation and tariffs add inflation from the supply side.

The United States also has an additional component that Europe does not share on the same scale. Investment associated with artificial intelligence is creating extraordinary demand for capital, electricity, semiconductors, networks and construction. For years we have talked about AI as a future source of productivity and therefore as potentially disinflationary. It probably will be. First it has to be built.

And building it costs a great deal of money.

CHINA AND THE UNITED STATES HEAD INTO A MEETING THAT MATTERS MORE THAN USUAL

Xi Jinping arrived in the United States yesterday and is meeting Donald Trump today. It would be a mistake to expect one meeting to resolve a rivalry rooted in technology, military power and trade. It can, however, determine how far both countries are willing to go to prevent that rivalry from turning back into an open trade war.

Energy, agriculture, rare earths, semiconductors, sanctions and Taiwan will all be on the table in one form or another.

Rare earths are probably the clearest example of how the relationship between economics and national security has changed. The United States can restrict Chinese access to certain chips, but China still holds a dominant position in the processing of critical minerals that U.S. industry needs for technology, automobiles and defense. Both sides have leverage. Neither can use it without hurting itself.

The immediate question is whether energy trade flows between the two countries restart, whether China expands its agricultural purchases and what happens to restrictions on critical minerals. I would not expect a reconciliation. An extension of managed confrontation would probably be enough for markets to welcome it.

The November 3 midterms add another source of uncertainty, particularly in the Senate. Republicans enter the election with 50 seats versus 46 Democrats and four independents, while The Cook Political Report currently rates seven races as toss-ups, including Alaska, Iowa, Maine, Michigan, New Hampshire, Ohio and Texas. Polling shows very narrow margins in several of those states. In Michigan, for example, the RealClearPolitics average puts Abdul El-Sayed (D) about two points ahead of Mike Rogers (R), while in New Hampshire the race between Chris Pappas and John Sununu is also separated by only a couple of points. Trump's deteriorating approval rating adds pressure on Republican candidates. The latest Reuters/Ipsos poll puts his approval at 32% and gives Democrats an eight-point lead in the generic congressional ballot, 43% to 35%, although a national figure cannot be mechanically translated into individual Senate races. For markets, the real issue is less who wins any one state than whether the result changes control of the Senate, because that would affect the White House's ability to secure ap-

pointments, pass fiscal legislation, shape financial regulation and advance part of its economic agenda during the final two years of the term.

EQUITIES, THE INDEX IS SAYING LESS THAN IT SEEMS

The Nasdaq is at record highs while oil and long-term yields have retreated from last week's peaks. At first glance, it looks as though the market has decided to ignore geopolitics.

That is not exactly what is happening. Beneath the indexes, dispersion is enormous. Semiconductors have again led the gains, and enthusiasm around artificial intelligence is supporting valuations that, with long-term rates near 5%, would be difficult to justify in many other sectors. As long as earnings keep growing, the market is willing to pay those multiples. The problem will come if part of today's capex takes too long to turn into profits. Technology therefore still has a story of its own.

So does defense. Europe has entered a spending cycle that does not depend on whether the war in Ukraine ends tomorrow or three years from now. The increase in inventories, ammunition, air defense, drones, electronics and industrial capacity now reflects a broader strategic decision. For European defense companies, the tailwind remains favorable.

Energy behaves in a much more binary way. Serious diplomatic progress with Iran would quickly strip some of the premium out of oil and hurt producers. A renewed disruption of Hormuz would do exactly the opposite. I do not think it makes much sense to forecast Brent to the nearest five dollars while a meaningful share of global supply depends on political decisions that can change overnight.

European industrial and transportation companies are in a worse position. Expensive energy, higher logistics costs and less comfortable financing squeeze margins. Airlines are probably one of the clearest examples because fuel sits directly in the cost structure and offers very little scope for substitution in the short term.

Banks require more care. Higher rates can support net interest margins for a while. When tightening begins to damage credit, real estate or sovereign debt, what initially helped earnings turns into balance-sheet risk. The recent reaction of European banks to lower oil prices gives a fairly good sense of where that boundary lies.

DEBT IS BECOMING A REAL MARKET AGAIN

For me, this remains the most delicate part. The 10-year Treasury has recently traded around 5%. With federal debt above \$40 trillion and a deficit close to 6% of GDP, it is no longer enough to ask what the Fed will do. The question is how much an investor demands to finance a government for ten or thirty years when that government will continue issuing enormous amounts of paper.

The two-year note will continue to respond primarily to Warsh and the FOMC. The thirty-year bond has more problems on its plate. Future inflation, the deficit, issuance, foreign demand, the term premium and fiscal credibility are beginning to matter much more. If the Fed keeps short-term rates high, the front end remains under pressure. If the Treasury keeps issuing large amounts of debt while investors demand more compensation, the long end has little reason to relax very much either.

That can produce an odd situation a few years from now. The Fed could be cutting rates while mortgages remain expensive because the long end of the Treasury curve does not follow.

Anyone who thinks lower Fed Funds automatically means a return to cheap money should spend a little more time looking at the curve.

In Europe, France will probably be the sovereign market that tells us the most about how much fiscal risk investors are willing to tolerate. Italy still has more debt, but France now combines fiscal deterioration, political uncertainty and a market that for years treated it almost as a substitute for the Bund.

COMMODITIES, WHERE GEOPOLITICS IS STILL EASIER TO SEE

Oil remains the most immediate indicator because it directly reflects the risk of supply disruption. If talks between the United States and Iran advance, some of the premium now embedded in Brent should disappear. If they fail and attacks on routes or infrastructure resume, \$100 is unlikely to be a particularly solid ceiling.

European gas deserves almost as much attention. Europe replaced part of its Russian gas with LNG and discovered that diversifying away from one supplier does not mean eliminating geopolitical risk. Qatar, maritime transport and regasification terminals have become part of European energy security.

Gold tells a different story. Geopolitical tension and concern over public debt support demand, while high real rates work in the opposite direction. The fact that gold remains strong despite high rates says quite a lot about the demand for protection.

Copper and critical minerals may have the longer-term story. European rearmament, power grids, artificial intelligence, data centers, electric vehicles and industrial reshoring are competing for the same resources. If the West wants to reduce strategic dependencies, it will have to build redundant capacity. Redundancy is excellent for security. It is rather less attractive for costs.

WHAT COULD CHANGE THIS SCENARIO IN THE NEXT FEW DAYS

The first test comes tomorrow with the OECD's new forecasts. I will be particularly interested in how much of the energy shock it has already incorporated into inflation and how much it subtracts from European growth.

I do not expect a historic agreement from the Trump-Xi meeting. I would look for something more modest and probably more useful: signals on tariffs, energy, rare earths and how long the trade truce can last.

Next week, the United States will publish JOLTS, the final revision to second-quarter GDP and August PCE. The last of these matters particularly after the Fed's rate increase. If core inflation remains around current levels, the market will have a harder time arguing that September was a one-off increase.

The jobs report comes after that.

And oil will continue to set the tone throughout.

If I had to reduce this report to one variable, something I generally dislike doing, I would watch Brent and the 10-year Treasury together. A simultaneous decline in both would ease inflation, monetary policy pressure and valuations. A joint rise would recreate precisely the combination that can do the most damage to Western economies: expensive energy and expensive capital at the same time.

Companies can live with one of the two for quite a long time.

With both, considerably less so.

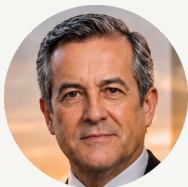
NOTES

* European notation

** U.S. notation

SOURCES

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