Grey G CAPITAL RESEARCH
greygcapital.com

June 1, 2019

June 2019 Summary Report

Macroeconomic Risks and Geopolitical Dynamics

June 1, 2019

OVERVIEW

This report reviews developments through the end of May and offers projections for the month of June forward.

One month ago, we advised there was a higher-than-expected probability of a breakdown in US-China trade negotiations. The US-China geopolitical situation and market indices have since deteriorated substantially, with **US equities down nearly 7% in May** (S&P 500).

This month's report covers US-China dynamics in depth to help clients consider how **recent short-term cyclical moves fit within medium- and long-term cyclical patterns**. We have consistently been warning of a deterioration in US-China relations and provide detail on that long-term cyclical trend here. However, we do not currently see China as the primary source of short-term macroeconomic or financial risk. In fact, we assess **a near 60% probability that some type of China-US trade war truce will be declared near the end of June**.

In our opinion, the **short-term nexus of market risk has shifted to inflationary expectations related to tariff policy**. This is particularly important in terms of how inflationary concerns might lead to **a delay in Fed policy action that disappoints market expectations** - at a time when US GDP growth projections are less than half of Q1 2019 (Q1 revised: 3.1%; Q2 estimates: 1.2-1.5%).

This deterioration in macroeconomic fundamentals matches our warnings in previous months' reports, and we project **a further drop in June consumption data related to May's market decline**. As this incoming negative data is digested by the markets (June data is reported in July), any delay in Fed action could be especially damaging.

The announcement at the end of May of **US tariffs on goods from Mexico** has the potential to further contribute to inflationary expectations. We see this move as part of a **strategic shift by the Trump administration to boost GDP growth**

numbers by reducing the US's recent record trade deficit with Mexico. We've highlighted this GDP-data-boosting trade strategy as a driver of tensions with China in multiple reports (a strategy that has recently reduced the deficit with China to its lowest level in five years). We are **optimistic that a shift to a focus on Mexico will be accompanied by a shift in strategies with China**.

Any trade strategy shift with China will likely be characterized by a **headline-making temporary move away from the application of tariffs** on broad categories of Chinese goods. We expect the **primary driver of such a temporary respite to be Xi-Trump personal relationship dynamics,** with the long-term trajectory of US-China relations fundamentally unchanged.

Inflationary concerns may be dampened and market sentiment boosted in the short- to medium-term by such a shift. The risk of the market reacting negatively to the next cyclical shift downward in US-China relations, however, remains a significant medium- to long-term threat.

The primary current short- to medium-term geopolitical threat we forecast is a 30% probability of a US military strike on Iran. We consider this probability higher than current market expectations, and beyond direct oil sector impacts **our principal concern is further deterioration in geopolitical and market sentiment from even a limited conflict**.

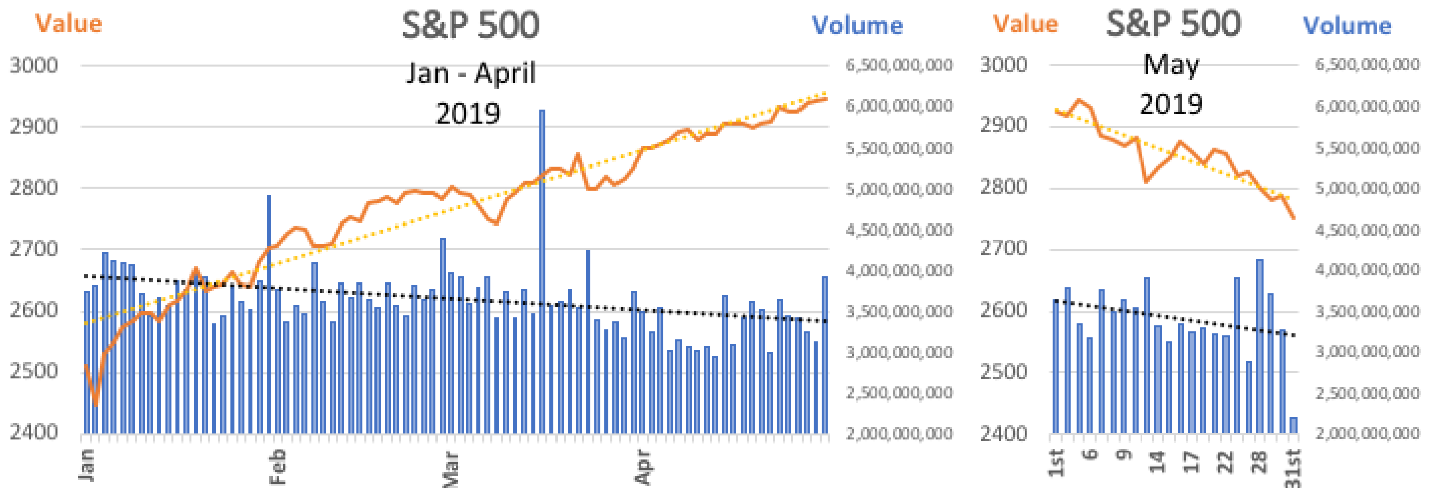
In mid-May, the Federal Reserve released its **Financial Stability Report, highlighting risks related to expansion of corporate debt**. That report also assesses the relative stability of the US financial system and the adequacy of financial sector capital buffers for downturn scenarios. Our analysis of the Fed's report here focuses on how its data highlights the extent to which **capital markets have experienced a dramatic and sustained long-term expansion.** Our concern is how market and macro data may be indicating **a long-term cyclical capital shift that is underappreciated and a major market and macroeconomic threat**.

The **rapid inversion of the US yield curve at the end of May** is reviewed within the context of these broader financial dynamics.

Section 1 covers a **market review**, including yield curve inversion analysis.
Section 2 covers the dynamics of **US-China trade negotiations**.
Section 3 covers the Fed Stability Report and **long-term cyclical dynamics**.
Section 4 closes with an analysis of **other geopolitical risks, including Iran.**

MARKETS SUMMARY

In the first four months of 2019, US equity markets enjoyed a powerful upward trend, increasing over 20% by April 30th from early January lows. The month of May saw a sharp retrenchment of these gains, with the S&P 500 down nearly 7% by May 31st from its May 1st intra-day high.



This May drop has most commonly been attributed to worries about global growth associated with renewed China-US trade tensions. The timing of the market's decline has reinforced this trade-focused explanation: it began on Monday, May 6th, following a weekend Twitter message from President Trump warning tariffs on Chinese goods were set to increase if Chinese negotiators didn't change their approach.

After multiple quarters of negotiations, as May progressed the prospect of a US-China trade deal seemed to collapse along with market upward momentum.

AN ALTERNATIVE EXPLANATION

Readers of the Grey G Capital Research summary report published at the onset of May will recognize not only that this breakdown in negotiations was foreseeable but also that **the macroeconomic story is more nuanced**. As we have noted before, reductions in Chinese imports have been a key component in an improved US trade balance and have thus been a positive contributor to US GDP growth data short-term.

The argument that these tariffs will undermine global economic growth by substantially reducing growth in the world's two largest economic engines seems questionable in the short- to medium-term. Rather than direct GDP effects, we attribute the dramatic US market response to US-China trade news as **profit taking in the face of an uncertain environment**, alongside the possible **impact of tariffs on inflation and thus Federal Reserve policy**.

Beyond short-term business cycle concerns, **Fed rate cuts are absolutely critical**

to continued expansion of the current long-term capital cycle. The market's "over-reaction" of not only May but also Q4 2018 may be **indicative of sentiment shifts related to a growing appreciation of longer-term threats.**

Or Just Profit Taking?

A less severe interpretation recognizes that **ongoing US-China tensions are likely to heavily impact the profits of major US firms engaged in China**. Profits are likely to be hit not only due to targeting of US corporations' in-country operations by the Chinese government and consumers; an increase in costs associated with internal supply chains with China is another likely hit to US corporate earnings. The need to restructure global supply chains is also becoming more apparent as the long-term downward trajectory of US-China relations solidifies, entailing further disruption to operations and capital re-allocation.

In terms of direct GDP impact, however, **there appears a disconnect between the overall reduction in Chinese, US, and global GDP versus market responses**.

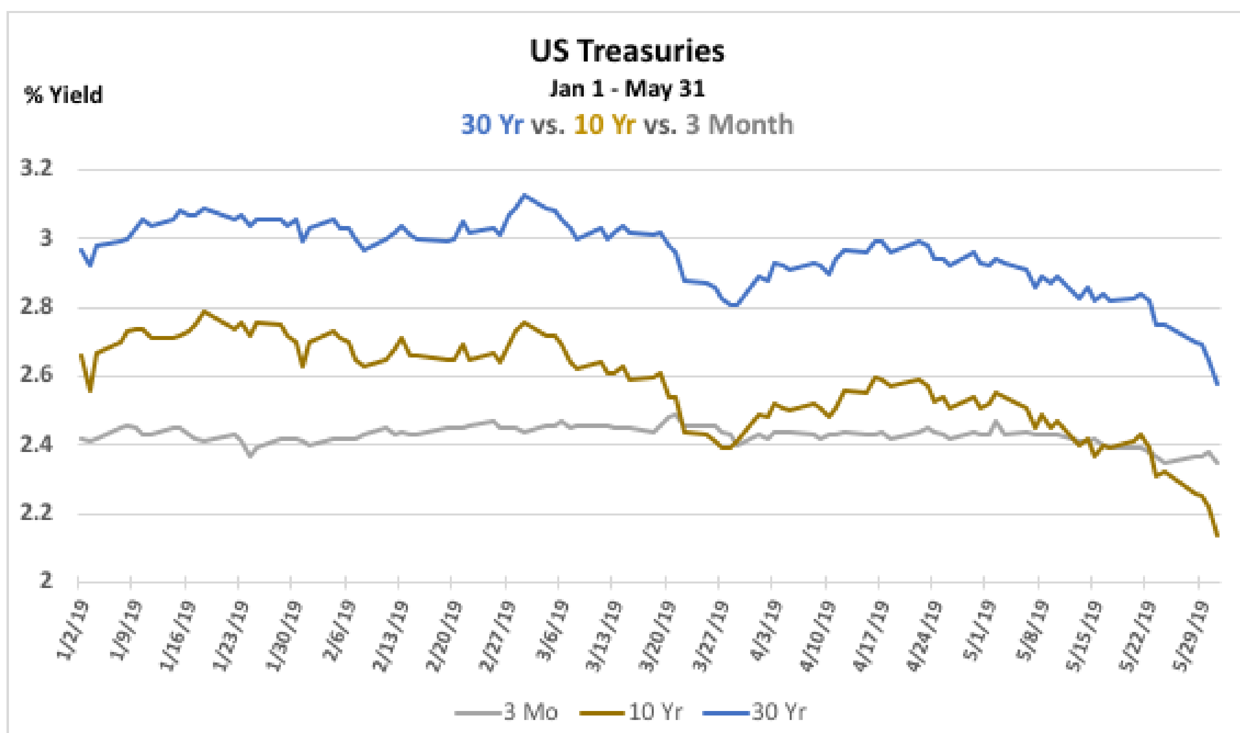
Chinese Stock Market Resiliency

The performance of the Chinese stock market in May also belies the narrative that continued trade friction between the United States and China is set to dramatically reduce Chinese GDP growth and thus overall global growth. Since May 1st, **Chinese markets have traded in a relatively narrow band and declined only marginally.** The CSI 300 China index of major stocks on the Shanghai and Shenzhen exchanges remains up nearly 20% from early January lows.

CSI 300 China Index
Past 6 months

YIELD CURVE INVERSION

Accompanying the recent US equity market downturn and trade negotiation frictions, there have been **dramatic inflows into long-term US Treasury bonds in May**. This has driven a widely reported "inversion" of the US Treasury yield curve. The graph below highlights how demand for 10-year Treasury bonds has driven its yield lower than the return on 3-month Treasury bills.



Bond Yield Comparison (May 31)

Japan 10 Year: -0.096%
Germany 10 Year: -0.207%
Switzerland 10 Year: -0.468%

UK 10 Year: 0.888%
United States 10 Year: 2.133%
China 10 Year: 3.297%
United States 30 Year: 3.58%

IS THIS INVERSION UNUSUAL OR DIFFERENT?

This "inversion" of the yield curve has worried many analysts given its juxtaposition with conventional narratives of otherwise strong headline economic data. As seen in the above graph, the end of May is **not the first time in 2019 that the yield curve has inverted** - it inverted in late March (though to a much lesser extent) and also briefly in late 2018. Given how these **previous inversions saw subsequent equity gains** - plus a less-than-perfect record of yield curve inversions as reliable predictors of recessions - there is contentious debate regarding the implications of recent yield curve dynamics.

Previous yield curve inversions have often resulted from a rapid increase in short-term interest rates per Fed tightening. In those scenarios, inversions appeared to indicate that the Fed had "overshot" on rate hikes and a subsequent rate cut was pending. This subsequent rate cut tended to entail a short-term boost to equity markets, implying that a **yield curve inversion could actually have positive short-term market implications.**

Recent inversions - of which the end of May has been the most severe - are perhaps different in that they are driven not by a rapid increase of the short end of the yield curve (as per the case with rapid Fed rate increases). **Substantial reductions in yields at the long end of the curve have driven inversion** even as short-end rates have remained relatively stable.

Securing Modest Long Term Returns

At Grey G Capital Research, we consider this recent rapid yield curve inversion in the most fundamental of terms: this is a result of capital rushing into long term US Treasuries. The simplest explanation behind this rush is that holders of the reallocated capital were eager to **secure guaranteed returns in the low single digits because of a perceived lack of better prospects elsewhere long term**.

The **unusually high guaranteed returns offered by US bonds relative to other major economy bonds** - as highlighted in the Bond Yield Comparison table above - have been recognized as a unique opportunity. This may not only be an indicator of a shift towards "risk-off" psychology and expectations of future lower interest rates. It is also an **indicator of low market expectations for future returns** in equity assets and higher-risk fixed income securities.

In conjunction with trends in commodities futures curves, we consider this inversion a warning sign of long-term cyclical risks. Short-term, however, we anticipate **there may be opportunities associated with a short-term cyclical reversal**. A scenario might not only be short-term gains related to a momentum shift and growing expectations of a rate cut; a sentiment shift related to prospects for a US-China trade deal are another possible driver.

These short-term cyclical factors and fluctuations should be understood within their long-term cyclical context.

Prior to a review of this long-term cyclical context as it relates to the Fed's May Financial Stability Report, this month's report will give an overview of the US-China trade negotiation dynamic.

TRADE NEGOTIATION DYNAMICS WITH CHINA

NATIONAL SECURITY VS. MARKET PERCEPTIONS

The Grey G Capital Research framework focuses not only on the impact of long-term capital trends. We identify significant **divergences between the policy direction of the national security community vs. prevailing market expectations**.

This is a key driver of our consistent warning that **the probability of a sustained positive outcome from US-China trade negotiations is far lower than markets appear to expect**.

Despite this divergence, we anticipate a near 60% probability of a temporary truce in the trade war near the end of June. This represents an expectation of **a cyclical pause, as Presidents Trump and Xi seek to solidify the strength of their personal relationship.**

AN AGGRESSIVE CHALLENGE TO PARTY POWER

On the surface, the Trump administration's aggressive pressing for major structural changes in the Chinese economy can be seen as an effort to "level the playing field" for US businesses. At a deeper level, **ambitious US efforts for Chinese structural changes are a direct challenge to the Chinese economic development model and the power base of the Chinese Communist Party**.

They are recognized as such in China, which is the key reason Party rhetoric in the state-controlled media turned strongly nationalist at the end of May.

The Trump administration's initial negotiating position has **demanded far more than the elimination of tariff and non-tariff barriers in return for access to the US market**. Firm, enforceable commitments that protect US firms from intellectual property and technology transfer have been another component. We expect these demands to remain and likely be incorporated in any eventual deal.

However, in addition to these fairly conventional trade demands the Trump administration also appears to have been pressing for specific enforceable trade-balance targets as well as an opening of the Chinese internet to American firms and information providers (which would potentially undermine Party control of information). US negotiators have further been **driving for structural changes in industrial subsidies that would fundamentally shift the structure of China's state-centric development model.**

REALISTICALLY NEGOTIATING IN GOOD FAITH?

We appreciate these demands from a political perspective in terms of chipping away at the power of the Communist Party. **The willingness of Chinese negotiators to even allow these terms to have been included in draft agreements represents an interesting shift** and may indicate support even within the Party for reforms that would undermine Party control. From a more practical perspective, drawn-out negotiations have likely represented a stalling tactic aimed at identifying American priorities while **buying time for Chinese policymakers to encourage a structural economic shift away from vulnerability to US pressure**.

Regardless of motivation, **we see little prospect for a successful trade deal that both threatens the Party's monopoly on information and undermines the extensive spoils system it runs under the guise of central planning**.

PARTY CONTROL IS CHINA'S TOP PRIORITY

The critical role that central planning and central credit allocation continue to play in Chinese economic development is often missed by observers focused on the 70% of Chinese GDP that is generated by the private sector. Despite the crucial role private businesses and market signals play in driving the Chinese consumer sector and innovation, **Party cadres continue to control the "commanding heights" of the Chinese economy behind the scenes**. This includes having Party members in key leadership positions in the private sector (ex. Huawei; Alibaba).

State-owned banks dominate the financial sector and are Party planners' tool to **funnel capital at preferential rates to key industries and allies**. State-owned enterprises also dominate the non-financial "commanding heights" of the economy (transportation, infrastructure construction, power and natural resources, etc.), serving as the backbone of Chinese economic growth.

This **state subsidization of vast sectors of the Chinese economy** not only skews the production cost of Chinese goods in a way that can make for unfair competition with US businesses; it also **is a critical foundation of Chinese Communist Party power.** The Party's ability to pick winners and losers is combined with the Party's ability to place loyal cadres in jobs within the mammoth state-owned sector. This represents **a vast spoils system that is as important to continued Party dominance of China as is the Party's control of the military and government security forces**.

UNDERMINING THE PARTY IS US TOP PRIORITY

Targeting this economic foundation of Chinese Communist Party power is indicative of not only trade-related tensions; this reflects an **increasing realization in national security circles that the Chinese Communist Party in command of a powerful Chinese economy and modern military poses the most formidable long-term national security threat to the United States**. This realization has accelerated recently as the Party has consolidated power in China and deployed systems that are fundamentally at odds with central tenets of American democracy.

The development of increasingly sophisticated systems of population monitoring and control as well as mass internment of populations in Xinjiang have virtually eliminated earlier hopes that the Party was a benign force on its way peacefully into the dustbin of history. In particular, the combination of artificial intelligence with large amounts of data on citizens to assign "social credit" scores and isolate networks of potential political challenge represents **a fundamental threat to democratic ideals that has been widely underappreciated**.

MAJOR DIVERGENCE FROM MARKET EXPECTATIONS

This trajectory of thought within national security circles is at sharp odds with economic arrangements that have integrated China into the world economy. **Talk of the need to "decouple" from China economically is a common theme in national security discussions**, with major economic, political, and financial implications that thus far seem to have been underappreciated in markets.

Opportunity at G20 Summit in Osaka

Amidst this backdrop, we nonetheless assign a **60% probability of a trade truce near the end of June**. This is based on our expectation that Presidents Xi and Trump will wish to demonstrate the strength of their personal relationship at the June 28-29 G20 Summit in Osaka, Japan. This builds on what we see as a **70% probability that the two Presidents will meet at the summit in Osaka.**

Failure of Xi to attend the G20 so close to home would be highly unusual, and President Trump has indicated he will attend. A failure of the two to meet there would be a clear signal that their interpersonal relationship was weak and imply a loss of face for both men. We assess an **80% probability that should their meeting be of substantial length it will result at minimum in a temporary truce in the application of US-China tariffs**. We do not expect a resolution of the most complex issues as outlined above, but each leader has an incentive to give and receive "face" through some kind of declaration that steps both nations back from a precipice in bilateral relations.

A Shift in Strategy

These short-term cyclical swings present opportunities, but **for an outcome more substantive than a truce the Trump administration will have to scale back its trade-related ambitions.** Such a shift has practical economic benefits since high tariffs on Chinese goods have the potential to add to inflationary concerns and undermine Fed policy flexibility. Fed action will be critical to maintaining a healthy economy and markets - a key driver of Trump 2020 re-election prospects.

We see **a strategic US roadmap in place for China trade negotiations** that is focused on securing a **short-term agreement** to boost Trump 2020 re-election prospects, then a **subsequent resurgence of pressure** on China. The contours of this road map are the current hard line giving way to a temporary truce, with expectations that during that truce an agreement will be negotiated which focuses on tariff and non-tariff barriers alongside intellectual property and technology transfers.

In this scenario, state industrial subsidies are put aside for future discussion, and are addressed through more **targeted trade policy such as countervailing duties**.

This strategy does not fundamentally change the trajectory of US-China relations but allows short-term developments that encourage positive market sentiment and an environment conducive to Fed rate cuts. A shift to focus on the bilateral trade deficit with Mexico could allow a continued boost to GDP data.

Shifting Risks towards a Period of Market Vulnerability

The **primary risk we see with such a strategy is a failure to reach an agreement during this truce**. This could be driven by a refusal of the Trump administration to shift away from its comprehensive "all-or-nothing" strategy. It could also be driven by a Chinese Communist Party assessment that denying Trump this success would have follow on effects that could undermine his re-election prospects, thus eliminating a longer-term Party threat. We see a concerning scenario developing where expectations of a deal in the fall are disappointed at the same time macroeconomic data deteriorates, with major potential market implications.

Financial Stability and Long-Term Capital Cycle Issues

Deciphering Unusual Data Trends

Our highlighting of the possibility for tariffs to add to inflationary expectations in a way that could hamper Fed policy contrasts sharply with what have recently been **very low inflation levels in the American economy**. This is certainly positive in terms of encouraging Federal Reserve flexibility for stimulus. But it should be recognized that **current low inflation levels contrast sharply with what would be forecast from traditional economic theory**. Helping to decipher confusing data trends is a key insight of Grey G Capital Research's focus on long-term capital cycle dynamics.

With low levels of unemployment traditionally associated with higher inflation, and a major increase in tariffs on goods from the US's single largest import partner (China) implying budding inflation as well, **low inflation numbers have perplexed many analysts.**

Possible Constraints on Policy Action

In considering the likelihood of Fed policy makers to aggressively pursue pro-cyclical policies, it should be noted that **caution with inflationary expectations is integral to the mandate of the Federal Reserve**. Given exceptionally low levels of unemployment (the other central pillar of the Fed's mandate), we have strong **concerns that Fed policymakers will be inclined to err on the side of caution** in the face of low macroeconomic performance indicators.

The potential for this to contrast with market expectations and lead to significant market dislocation is our primary concern, particularly within the context of what we feel is **an underappreciated long-term capital cycle dynamic**. Our concern is that current low inflation in the face of what should be multiple inflationary pressures represents **a possible indicator of a cyclical turn in a long-term capital cycle.**

Deep Long-Term Cyclical Pressures

To better demonstrate what we mean by long-term capital cycle, the tables on the following page are built from data in the Fed's May Financial Stability report (note: 1997 values are approximations based on discounting current data by the Fed's stated average growth rate from 1997-2018).

These tables represent **a "balance sheet" perspective on the US economy and financial system**, allowing both an assessment of where the balance sheet has expanded most rapidly as well as a clearer perspective on financial and macroeconomic vulnerabilities.

Dramatic Increases in Asset Values

ASSETS	Value ($ Trillions) CURRENT	Value ($ Trillions) 1997	Percent of GDP CURRENT	Percent of GDP 1997	Share of Total CURRENT	Share of Total 1997
Residential Real Estate	33.9	11.6	162%	127%	31%	40%
Equities	30.5	6.8	146%	74%	28%	23%
Commercial Real Estate	18.4	4.7	88%	51%	17%	16%
Treasury Securities	15.6	3.7	75%	40%	14%	13%
Investment-grade Corporate Bonds	5.7	1.1	27%	12%	5%	4%
Cropland	2.5	0.8	12%	9%	2%	3%
High-Yield and Unrated Corporate Bonds	1.3	0.4	6%	4%	1%	1%
Leveraged Loans*	1.1	0.1	5%	1%	1%	0%
TOTAL ASSETS	109.0	29.1	522%	317%		

Tripling of Business and Consumer Debt

OUTSTANDING CREDIT	Value ($ Trillions) CURRENT	Value ($ Trillions) 1997	Percent of GDP CURRENT	Percent of GDP 1997	Share of Total CURRENT	Share of Total 1997
Total Business Credit	15.2	5.0	73%	55%	49%	48%
Corporate Business Credit	*9.8*	*3.7*	*47%*	*40%*	*32%*	*35%*
-- Bonds and Commercial Paper	6.2	2.1	30%	22%	20%	20%
-- Bank Lending	1.5	0.8	7%	9%	5%	8%
-- Leveraged Loans	1.1	0.1	5%	1%	4%	1%
Noncorporate Business Credit	*5.5*	*1.4*	*26%*	*15%*	*18%*	*13%*
Commercial Real Estate	2.4	0.7	11%	8%	8%	7%
Total Household Credit	15.6	5.4	75%	58%	51%	52%
Mortgages	*10.3*	*3.4*	*49%*	*37%*	*33%*	*33%*
Consumer Credit	*4.0*	*1.4*	*19%*	*16%*	*13%*	*14%*
-- Student Loans	1.6	0.2	8%	3%	5%	2%
-- Auto Loans	1.2	0.4	6%	5%	4%	4%
-- Credit Cards	1.1	0.5	5%	6%	3%	5%
TOTAL NON-FINANCIAL PRIVATE CREDIT	30.9	10.4	148%	113%		

Dramatic Growth in Size of Financial Sector

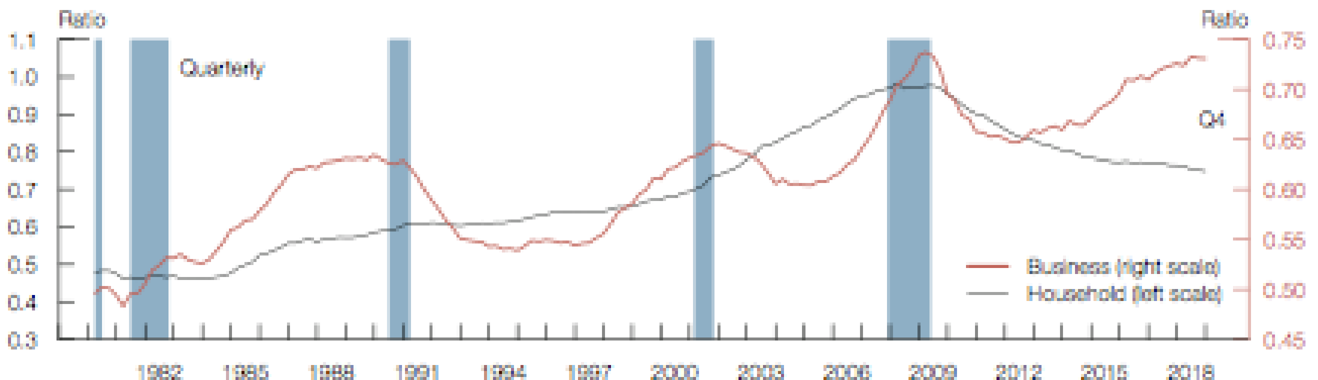
FINANCIAL SECTOR SIZE BY ASSETS	Value ($ Trillions) CURRENT	Value ($ Trillions) 1997	Percent of GDP CURRENT	Percent of GDP 1997	Share of Total CURRENT	Share of Total 1997
Banks and Credit Unions	19.2	6.2	92%	68%	35%	47%
Mutual Funds	14.7	2.4	70%	26%	27%	18%
Insurance Companies	9.9	3.3	47%	36%	18%	25%
Life	7.4	2.5	36%	27%	14%	18%
Property and Casualty	2.4	0.8	12%	9%	4%	6%
Hedge Funds*	7.7	0.1	37%	1%	14%	1%
Broker-Dealers	3.4	1.3	16%	14%	6%	10%
TOTAL FINANCIAL SECTOR	54.7	13.3	262%	145%		

SECURITIZATION	Value ($ Trillions) CURRENT	Value ($ Trillions) 1997	Percent of GDP CURRENT	Percent of GDP 1997
Agency	9.1	2.8	44%	14%
Non-Agency**	1.2	0.6	6%	3%
TOTAL SECURITIZATION	10.2	3.5	49%	17%

Fed Focus on Corporate Debt Risks

In assessing financial systemic vulnerabilities, the **Fed report highlights corporate debt levels as a potential cyclical risk**, framing them within the context of recent history (red line, graph below). Though household and business debt currently are each the equivalent of approximately 75% of current US GDP (US GDP $20.9 billion, nominal terms), the **reduction in household debt relative to the high levels leading up to the Great Financial Crisis** is cited as a source of confidence in the Fed's analysis.

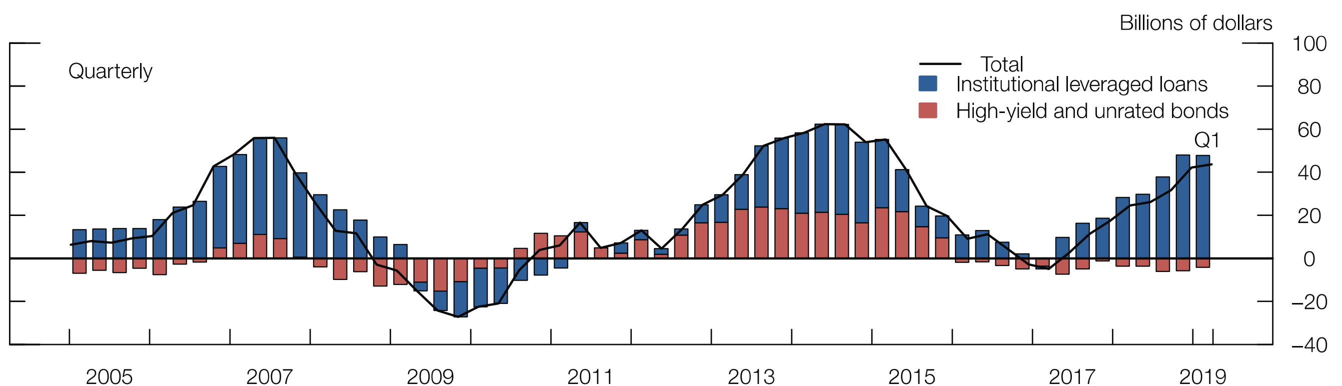
2-2. Business- and Household-Sector Credit-to-GDP Ratios



Source: Federal Reserve Board staff calculations based on Bureau of Economic Analysis, national income and product accounts, and Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

High levels of corporate debt are assessed as a vulnerability due not only to high levels relative to historical norms but **recent increases in lending to higher risk corporate borrowers.**

2-4. Net Issuance of Risky Business Debt



Source: Mergent, Fixed Income Securities Database (FISD); S&P Global, Leveraged Commentary & Data.

Roadmap for a Business Cycle Shift

Regarding a business cycle shift, our focus is a **scenario of a deteriorating economic environment leading to widespread downgrades of currently borderline investment grade debt**. Such downgrades would entail rapid liquidation from portfolios as institutional investors seek to avoid the increased capital requirements per the debt's new high-risk status. Such a **liquidation might affect bond market liquidity and entail severe price pressures**.

Continued low credit spreads on high-yield bonds are encouraging in this context.

Convergence of Business Cycle and Long-Term Capital Cycle Trends

Our focus regarding market and macroeconomic risk extends beyond these short- and medium-term dynamics as associated with common business cycle pressures. We suspect **long-term cyclical dynamics are driving inflation and macroeconomic data that has been significantly weaker than headline unemployment and growth numbers would imply.**

As highlighted in the above summary tables, the "balance sheet" of the US economy has seen a near tripling of total nonfinancial private credit. At the same time, **total assets have grown in 20 years from near $30 trillion to $110 trillion - from 320% to over 520% of GDP.** During this period, the total financial sector has quadrupled in size.

We see these trends as part of **a cyclical increase in the capital base of the US economy** - a sustained long-term trend within which short term recessionary and business cycles have fit. Our concern is that pressures associated with a turn in this long-term capital cycle **might dramatically increase the size and impact of what would normally be associated with a normal turn in the business cycle**.

In particular, equity assets have grown from near $7 trillion to over $30 trillion in the last two decades - from 75% to 145% of GDP. This far surpasses the current value of US investment grade and high yield bonds ($5.7 trillion and $1.3 trillion, respectively). Though Real Estate continues to be the principal asset on balance sheets in the US economy (Residential: $ 33.9 trillion; Commercial: $18.4), we consider **the potential for volatility in equities the primary macroeconomic threat in the US economy.**

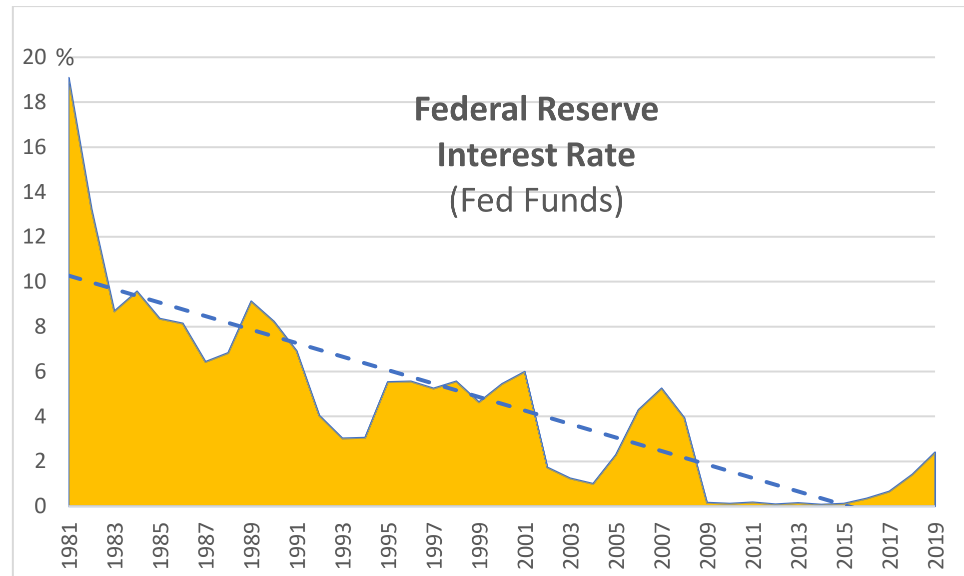
This contrasts with the framework presented in the Fed's Financial Stability Report, which considered equity valuations only slightly elevated using the traditional metric of P/E ratios.

1-8. Forward Price-to-Earnings Ratio of S&P 500 Firms

Source: Federal Reserve Board staff calculations using Refinitiv (formerly Thomson Reuters), IBES Estimates.

Policy Options to Extend Capital Cycle

In this long-term context, we re-introduce a graph from previous monthly reports that highlights Fed policy history. The **Fed policy trend towards looser monetary policy tracks what we see as the evolution of the current capital cycle**, which actually began its expansion trend in the early 1980s. Equity market participants will note that this time frame also marks the onset of the current secular bull market in US equities.



While market participants are focused on short-term Fed policy shifts, the **limited capacity for the Fed to extend this current long-term capital cycle** is a primary concern in our analysis.

There is certainly **room for Fed rate cuts and extraordinary policy measures to add renewed momentum to this capital expansion**, but we believe the scale of the challenge is vastly underappreciated.

Geopolitical Risks

As stated in the initial overview, our assessment is that the principal short- to medium-term source of **geopolitical risk has shifted from NE Asia to Iran**. We find the **probability of a US military strike on Iran significantly higher than what appears to be expected** (we currently assess a 30% probability).

Drive for Regime Change in Iran

This assessment is based not only on May moves by Iran's Persian Gulf neighbors to ensure a stable oil supply in case of conflict, as well as the recent positioning of significant US military assets in theatre. Unlike brinksmanship as used effectively (thus far) by the Trump administration with North Korea, **the Trump administration appears to be pursuing a path with Iran that fundamentally entails either regime change or military conflict.**

The heart of that strategy seems to be isolating the hardline elements of the Iranian regime, specifically Iran's Revolutionary Guard Corps and its aligned theocratic elements. **The US assesses the IRGC as the primary driver of objectionable Iranian activities abroad**, including the promotion of international conflicts involving Shia militias; anti-Israel and Hezbollah operations; global assassinations and terrorist activities; and the acquisition of nuclear strike capabilities.

It is our assessment **the Trump administration intends to squeeze the Iranian regime relentlessly as a means to destroy the Revolutionary Guard**. This represents a fundamental attack on the nature and power of the current regime, so that regime change should be fundamentally understood as the goal. Though we do not expect an invasion to secure regime change, we nonetheless see **a high probability of some kind of military strike focused on neutering the IRGC**.

We expect this strike to be cited as in response to one of two triggers:

Backing the IRGC into a Corner

The scale of the **economic war being waged on Iran is intended to create popular discontent that leads to protests aimed at regime change**. In addition to sustained activities to encourage popular protest, we expect the US to implement **military strikes should any popular uprising be met with government force**.

Faced with a trajectory of deteriorating economic conditions and popular discontent, **IRGC elements may feel encouraged to preemptively strike out**. In such a scenario, we find a high probability for at least a limited strike on IRGC power-projection capabilities. A more powerful "decapitating" strike that targets IRGC assets and Iranian missile and nuclear facilities for total destruction seems possible as well.

Such limited military action could be expected to result in some dislocation to the global oil market. As noted, arrangements have already been made by Gulf producers aligned with the US to boost production, and we expect any strike to focus on minimizing Iranian capacity to threaten shipping in the Persian Gulf. **Oil market dislocation would likely be driven primarily by psychological factors**

related to escalation, as Iranian petroleum products are already effectively isolated from much of the global market.

Geopolitical Escalation

Our assessment of the probability of a strike relates to the **US attacking the IRGC in a limited manner, not full-scale declaration of war with Iran or striking at the broader Iranian military other than air power projection**. The full macroeconomic impact of such a conflict beyond what is outlined above will be determined by the extent to which the broader Iranian regime and potential allies decide escalation is appropriate. This is a critical threat, but we do not think it will halt US action.

Of particular concern is whether Russia or China might decide that an American strike on Iran represents an overreach that should be addressed by a more confrontational approach. This has the potential to enhance two tail-end risks we see facing the world economy.

The principal tail-end risk we see in such a scenario is the **risk of increased Russian activity in Venezuela as a strategic pushback**. As noted in earlier reports this year, we believe further Russian action in Venezuela has the potential to dramatically increase US-Russia tension and at its most extreme disrupt the global oil market.

A second tail-end risk in such a scenario could be a **hardening of negotiating tactics from China and/or North Korea**. We find, however, it unlikely that the Iran dynamic will fundamentally shift Chinese negotiating plans or attitudes. Regarding North Korea, part of the reason we believe a limited strike on Iran is more likely than perceived is in part its utility in sending a strong message to the North Korean regime. We suspect any action on Iran will be followed with overtures to North Korea to minimize negative repercussions.

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Further discussion or comments on points covered in this research summary are welcomed by the report's editor and principal author, Mark Reedy. Contact: reedy@greygcapital.com

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