6 January 2023
Investment Solutions & Sustainability
Global

CREDIT SUISSE

Credit Suisse Economics

War and Peace

CONTRIBUTORS

Zoltan Pozsar
212 538 3779
zoltan.pozsar@credit-suisse.com

In 2019, James Sweeney, then chief economist at Credit Suisse, popped into my office and said "*you know this pandemic and lockdowns… this is where your world [funding] and my world [global industrial production] intersect, because supply chains are payment chains in reverse*". I thrive on memes, and after James' blitz visit, we quickly wrote Covid-19 and Global Dollar Funding, a piece that explained why the pandemic would lead to a major funding crisis…

In 2022, Pippa Malmgren became my source of macro stimulus. Her meme that "*World War III has already started, but it's different from "traditional" world wars: it is a hot war in cold places* [like Svalbard, underwater, cyberspace, and space], *and a cold war in hot places* [like islands in the Pacific, the DRC, and the Sahel]" inspired me to write four "war" dispatches last year: War and Interest Rates, War and Industrial Policy, War and Commodity Encumbrance, and finally, War and Currency Statecraft. In these, I identified six fronts (meaning "hot wars") in "macro-land" (a "cold place") where Great Powers were going "at it" in 2022:

the G7's financial blockade of Russia, Russia's energy blockade of the EU, the U.S.'s technology blockade of China, China's naval blockade of Taiwan, the U.S.'s "blockade" of the EU's EV sector with the Inflation Reduction Act, and China's "pincer movement" around all of OPEC+ with the growing trend of invoicing oil and gas sales in renminbi. Those were six geopolitical events in one single year, that is, a geopolitical curveball to deal with every two months.

I don't think 2023 will be different: in a number of regions in Europe and Asia, the threat of a hot war is real; the BRICS are set to expand with new members ("BRICSpansion"), which means more de-dollarization of EM trade flows; CBDCs are spreading like kudzu, with Türkiye the latest country to launch one; and with the launch of every new CBDC, the potential of Project mBridge to diminish the role of the dollar in FX transactions and trade invoicing will rise as it interweaves BRICS (and soon BRICS+) central banks into a global network to rival the global network of correspondent banks on which the dollar system runs.

War – in one form or another – was a theme that defined macro not only last year, but basically every year since 2019: trade war with China; the war on Covid-19; war finance to deal with lockdowns; war on inflation, as we overdid war finance; and war then spread to engulf Ukraine, finance, commodities, chips, and straits as discussed above. Monetary and fiscal responses were just that – responses to mother nature and geopolitics – and with geopolitics getting more complicated, not less, investors should remain mindful of the threat of non-linear risks in 2023.

In my previous dispatch, I noted that investors are not particularly well trained to deal with geopolitical risk, because for generations geopolitics didn't matter – anyone who traded securities or ran a portfolio since the end of World War II, did so in the cocoon of a unipolar world order, under the cover of *Pax Americana*.

But as I argued here, the unipolar world order is being challenged, and as I argue on the front page of today's dispatch, war has been and will likely remain a theme until the quest for world order (that is, "control") is settled. When Henry Kissinger writes about how to avoid another world war (see here), and Niall Ferguson writes about the risk of Cold War II spilling into World War III in an op-ed on *Bloomberg* (see here), you know that something is definitely up…

Henry Kissinger's year-end essay and Niall Ferguson's new year essay are not the types of essays that you normally read alongside sell-side outlook pieces, which suggests that this ain't your parents' "global macro environment", and it ain't your grandparents' either. We have to go way back in history for direction…

During the Great Financial Crisis (GFC), events forced us to abandon using the term "post-WWII" in the context of recessions and business cycles. Of course, that was because the GFC threatened to unleash a second Great Depression, which was a "pre-WWII" event that rendered "post-WWII" comparisons irrelevant, and turned Kindleberger's Manias, Panics and Crashes and, via Paul McCulley, Minsky's Stabilizing an Unstable Economy into required reading. Similarly, in light of the events of 2022, it seems prudent for investors to abandon the idea that the post-WWII world order will remain stable, or at least won't be challenged. Pre-WWII parallels are once again relevant, with a new reading list: Mackinder's The Geopolitical Pivot of History, Brzezinski's The Grand Chessboard, and Herman's Freedom's Forge. The last one is about two industrialists who oversaw the production of the "arsenal of democracy" that underwrote *Pax Americana*, which, to use Ferguson's term, is challenged today by the "arsenal of autocracy".

In my "war" dispatches, I stressed four themes:

1. War is inflationary.
2. War means industry.
3. War encumbers commodities.
4. War cuts new financial channels.

In today's dispatch, I will add a fifth theme:

5. War upsets all four prices of money.

As many have learned from Perry Mehrling, money has four prices (par, interest, foreign exchange, and the price level), and as Niall Ferguson noted in his essay, "*we forgot that war is history's favorite driver of inflation*". In my first three "war" dispatches, I talked mostly about inflation: "war is inflationary", so is the embrace of industrial policy at full employment, and so is commodity encumbrance.

For the first three prices of money (that is, par, interest, and FX) to be stable, the fourth price has to be absolutely stable. It's simple: if the price level is stable, *i.e.*, inflation is 2%, the Fed can "casually" manage business cycles and clean up crisis situations using QE. With stable prices, there is a fairly narrow range in which policy rates will move up or down, and hikes have a predictable pace (typically 25-bp increments). But if inflation is above target and off the charts, all bets are off. That's been the story of 2022: no hikes; hikes; string of hikes; string of 25 bps; string of 50 bps; string of 75 bps; string of 75 bps first with forward guidance, and then without. Instable fourth price = instable second price, and instable second price means an instable first price and an instable third price.

In my field, "polycrisis" means that all four prices of money are having a crisis: the collapse of stable coins is a crisis of par; an unprecedented pace of hikes with a (still) uncertain level for the terminal rate is a crisis of policy rates (OIS); the volatility in the price of crypto, DM, and EM currencies are crises of FX; and, as discussed above, all these crises are due to a crisis of the price level – that is a crisis of inflation – which, in turn, has been driven by mother nature and geopolitics. In the domain of the second price (interest rates), spreads around OIS have been fairly quiet to date: only credit spreads had blowouts, but not swap spreads. But with Treasuries, I see a conceptual problem brewing…

Just as "war" is becoming more entrenched as a macro theme (see above), the Fed continues to do QT, and so it does the precise opposite of "war finance". In Commodity Chokepoints and QT, I noted that the Fed would have to restart QE sometime during the summer of 2023, and according to page six of this report, "*the amount of government debt that will need to be absorbed by the private sector in [2023] is larger than at any time outside of world wars*". I can't disagree…

Yes there is $2 trillion in the o/n RRP facility to absorb the Treasuries to come, but Treasuries will have to cheapen a lot relative to OIS (tighter swap spreads) to bring in RV funds, which won't run positions larger than $25 billion each so they won't have to report their positions; banks are unlikely buyers too, as they hold lots of underwater bonds in HTM books, and with their reserves down, they are closer to tapping the funding market than funding the Treasury through AFS books; FX-hedged buyers are unlikely buyers too, as they got priced out, and the BoJ will soon "feed" them duration at home; and as Brad Setser showed, geopolitical events last year have fundamentally re-shaped global financial flows and reduced large FX reserve managers' appetite for U.S. Treasury debt too…

So if the "classic" marginal buyers won't buy, who will?

If there is a sell-off in equities, credit, and EM, risk sellers would buy Treasuries, but if there will not be a sell-off, the lack of "classic" marginal Treasury buyers means that Treasuries will be at risk of tailing at auctions, which, in turn, would drive sell-offs in equities, credit, and EM. Thus, my sense is that this is a "checkmate-like" situation: the Fed won't be a pivot and the terminal rate may have to go higher still (see here), neither of which augurs well for either risk assets (sell-off, then into Treasuries) or Treasuries (rates sell-off, then risk sell-off, then into Treasuries). "*Hot wars in cold places and cold wars in hot places*" need "war finance", not QT. There is a solution to the poor demand for Treasuries, which is QE under the "guise" of yield curve control, which my instinct says will come by the end of 2023 to control where U.S. Treasuries trade versus OIS.

The put is dead, long live the put!

The put under risk assets is dead: Powell didn't mention stocks at Jackson Hole. The put under government bonds is about to be born: the "baby" conceived already in a CGFS report, titled, Market Dysfunction and Central Bank Tools. The report says that if government bond markets become dysfunctional, central banks should provide a backstop. I assume that tailing Treasury auctions will qualify, as will any large increase in the deficit that will have to be funded "on the fly". But don't expect the put under government debt to prop up risk assets: unlike QE in the context of low interest rates and a risk asset put, the coming QE will be in the context of Treasury market disfunction. That is, the coming QE will aim to police swap spreads at high levels of interest rates, not to depress yields to inflate risk assets. The next round of QE will aim to "keep the wheels on the cart" amid high inflation, growing geopolitical tension, and an ugly financial divorce between the West and the global East and South.

In closing the fifth and final "chapter" of my "war" series, consider this quote from Tolstoy: "*The most difficult subjects can be explained to the most slow-witted man if he has not formed any idea of them already; but the simplest thing cannot be made clear to the most intelligent man if he is firmly persuaded that he knows already – without a shadow of doubt – what is laid before him.*"

Finance is about discounting the future, and in finance you can't get personal.

But my message to readers is that war is deeply personal, and it naturally forces you to take sides. But taking sides can't blind your objectivity and judgement when it comes to your portfolio. Don't be Tolstoy's "*intelligent man*" who "*knows*" that today's world order is the only possible world order because Francis Fukuyama said so, and, similarly, that U.S. dollar hegemony is the end of financial history.

So keep an open mind, or get financially repressed…

I intended my "war" dispatches as a series of dispatches that would provide clients of Credit Suisse with a "framework" to navigate the Great Power conflict that I think will define the macro and investment landscape this decade. Great Power conflict is not a "joke". It is quite real. President Xi refers to it as a "struggle", a word which he used 22 times at the latest congress of the CPP.

In the West, we tend not to think of what's coming this decade as a "struggle", but we should. To that end, I'd suggest reading my "war" dispatches in this order:

1. War and Peace ("war upsets all four prices of money")
2. War and Interest Rates ("war is inflationary")
3. War and Industrial Policy ("war means industry")
4. War and Commodity Encumbrance ("war encumbers commodities")
5. War and Currency Statecraft ("war cuts new financial channels")

What does all this mean for one's portfolio and the price of various instruments:

1. 60/40 won't cut it anymore and should be 20/40/20/20 instead, with the weights representing cash, stocks, bonds, and commodities.
2. Cash, while the curve remains inverted, is "king". It provides a nice yield, has no duration risk, and, as Warren Buffet said, it has an option value.
3. Commodities should include three types of gold: yellow, black, and white. Yellow gold is gold bars. Black gold is oil. White gold is lithium for EVs.
4. Commodities should also include a range of other stuff like copper, cobalt, *et cetera*, and the general theme driving commodities is that…
5. …after years of underinvestment, supply became extraordinarily tight, just as we re-arm, re-shore, re-stock, and re-wire the grid (see here).
6. The U.S. dollar won't be de-throned overnight…
7. …but on the margin, de-dollarization and digitization (CBDCs) by BRICS+ central banks will reduce dollar dominance and demand for Treasuries.
8. The dollar's strength or weakness should be thought of in the context of the four prices of money (that is, par, interest, FX, and the price level):
9. The U.S. dollar will remain "FX" strong versus other DM currencies…
10. …but will be become "price level" weak (that is, outright devalue) versus commodities and "FX" weak versus most BRICs currencies…

…which will guarantee plenty of volatility in all four prices of money this decade.

Good luck in 2023 and beyond…

Additional Important Information

This material has been prepared by the Investment Strategy Department personnel of Credit Suisse identified in this material as "Contributors" and not by Credit Suisse's Research Department. The information contained in this document has been provided as general market commentary only and does not constitute any form of personal advice, legal, tax or other regulated financial advice or service. It is intended only to provide observations and views of the Investment Strategy Department, which may be different from, or inconsistent with, the observations and views of Credit Suisse Research Department analysts, other Credit Suisse departments, or the proprietary positions of Credit Suisse. Observations and views expressed herein may be changed by the Investment Strategy Department at any time without notice. Credit Suisse accepts no liability for losses arising from the use or reliance on of this material. This material is not for distribution to retail clients and is directed exclusively at Credit Suisse's institutional clients.

FOR IMPORTANT DISCLOSURES on companies covered in Credit Suisse Global Markets Division research reports, please see http://www.credit-suisse.com/researchdisclosures. To obtain a copy of the most recent Credit Suisse research on any company mentioned please contact your sales representative or go to http://www.credit-suisse.com/researchandanalytics.

This material does not purport to contain all of the information that an interested party may desire and, in fact, provides only a limited view of a particular market. It is not investment research, or a research recommendation for regulatory purposes, as it does not constitute substantive research or analysis. This material is provided for informational purposes only and does not constitute an invitation or offer to subscribe for or purchase any of the products or services mentioned.

The information provided is not intended to provide a sufficient basis on which to make an investment decision and is not a personal recommendation or investment advice. While it has been obtained from or based upon sources believed by the trader or sales personnel to be reliable, each of the trader or sales personnel and Credit Suisse does not represent or warrant its accuracy or completeness and is not responsible for losses or damages arising from the use or reliance on of this material.

Where distribution of this material is subject to the rules of the U.S. Commodity Futures Trading Commission ("CFTC"), it is a "solicitation" of derivatives business only as that term is used within CFTC Rule 1.71 and 23.605 promulgated under the U.S. Commodity Exchange Act (the "CFTC Rules") where applicable, but is not a binding offer to buy/sell any financial instrument. The views of the author may differ from others at Credit Suisse Group (including Credit Suisse Research).

Credit Suisse is acting solely as an arm's length contractual counterparty and not as a financial adviser (or in any other advisory capacity including tax, legal, accounting or otherwise) or in a fiduciary capacity. Any information provided does not constitute advice or a recommendation to enter into or conclude any transaction. Before entering into any transaction, you should ensure that you fully understand the potential risks and rewards and independently determine that it is appropriate for you given your objectives, experience, financial and operational resources, and other relevant circumstances. You should consult with such advisers (including, without limitation, tax advisers, legal advisers and accountants) as you deem necessary.

Credit Suisse Securities (Europe) Limited ("CSSEL") and Credit Suisse International ("CSI") are authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority ("FCA") and the Prudential Regulation Authority under UK laws, which differ from Australian Laws. CSSEL and CSI do not hold an Australian Financial Services Licence ("AFSL") and are exempt from the requirement to hold an AFSL under the Corporations Act (Cth) 2001 ("Corporations Act") in respect of the financial services provided to Australian wholesale clients (within the meaning of section 761G of the Corporations Act) (hereinafter referred to as "Financial Services"). This material is not for distribution to retail clients and is directed exclusively at Credit Suisse's professional clients and eligible counterparties as defined by the FCA, and wholesale clients as defined under section 761G of the Corporations Act. Credit Suisse (Hong Kong) Limited ("CSHK") is licensed and regulated by the Securities and Futures Commission of Hong Kong under the laws of Hong Kong, which differ from Australian laws. CSHKL does not hold an AFSL and is exempt from the requirement to hold an AFSL under the Corporations Act in respect of providing Financial Services. Credit Suisse Equities (Australia) Limited (ABN 35 068 232 708) ("CSEAL") is an AFSL holder in Australia (AFSL 237237). In Australia, this material may only be distributed to Wholesale investors as defined in the Corporations Act. CSEAL is not an authorised deposit taking institution and products described herein do not represent deposits or other liabilities of Credit Suisse AG, Sydney Branch. Credit Suisse AG, Sydney Branch does not guarantee any particular rate of return on, or the performance of any products described.

This material is distributed in the European Union by Credit Suisse Bank (Europe), S.A. regulated by the Comision Nacional del Mercado de Valores.

If this material is issued and distributed in the U.S., it is by Credit Suisse Securities (USA) LLC ("CSSU"), a member of NYSE, FINRA, SIPC and the NFA, and CSSU accepts responsibility for its contents. Clients should contact sales coverage and execute transactions through a Credit Suisse subsidiary or affiliate in their home jurisdiction unless governing law permits otherwise. Investment banking services in the United States are provided by Credit Suisse Securities (USA) LLC, an affiliate of Credit Suisse Group. CSSU is regulated by the United States Securities and Exchange Commission under United States laws, which differ from Australian laws. CSSU does not hold an AFSL and is exempt from the requirement to hold an AFSL under the Corporations Act in respect of providing Financial Services. Credit Suisse Asset Management LLC (CSAM) is authorised by the Securities and Exchange Commission under US laws, which differ from Australian laws. CSAM does not hold an AFSL and is exempt from the requirement to hold an AFSL under the Corporations Act in respect of providing Financial Services.

If this material is issued and distributed in Japan, it is issued and distributed in Japan by Credit Suisse Securities (Japan) Limited, Financial Instruments Firm, Director-General of Kanto Local Finance Bureau (Kinsho) No. 66, a member of Japan Securities Dealers Association, The Financial Futures Association of Japan, Japan Investment Advisers Association, Type II Financial Instruments Firms Association. This report has been prepared and issued for distribution in Japan to Credit Suisse's clients, including institutional investors.