LE DIVORCE
INVESTMENT THEMES FOR THE POST-TRANSATLANTIC WORLD

Bottom Line:
1 – After the war, Europeans needed access to U.S. markets and American protection of its trade routes and oil supplies
2 – Germany trades more with China than with the U.S., and the *Belt and Road* initiative has opened new land routes
3 – Russia and Iran could supply all of Europe's energy and the rise of EVs will reduce Europe's oil dependency
4 - The Transatlantic divorce reinforces the case for higher yields and a weaker USD

The term "Transatlantic Alliance" is a bit of misnomer for "alliance" implies equals. The transatlantic relation is one of inequality. In the charitable (European) view, Europe is to Uncle Sam what Athens was to imperial Rom, a respected source of inspiration and culture. In the realistic (American) view, Europe is to the U.S. what Robin is to Batman, a mostly useless sidekick to the one true superhero.

Despite this original ambiguity, the Transatlantic alliance has certainly achieved its goals: Europe is peaceful, wealthy, and open to American multinationals. **The U.S. no longer sees the value of its alliance with this cluster of whining, declining mid-size powers.** A financially-strapped, energy independent superpower should re-orient resources domestically and pivot its strategic focus towards the continent that matters – Asia. D. Trump's isolationism and disdain for Europe is the explicit continuation of the implicit policies of the two prior American administrations. Since U.S. foreign policy is now publicly conducted on Twitter, I will not spend much time covering the U.S. perspective.

This report will focus on the other side of pond and argue that the feeling is, or at least should be, mutual: **Europe no longer needs an alliance that has repeatedly hurt her economic interests**. Most of the European elite still bows to the altar of Atlantism but **the tectonic plates of popular opinion, trade routes, and energy dependency have already split the two sides of the Atlantic.**

The alliance still hangs by the force of habit, the vested interests of bureaucracies, and institutional inertia. Like a loving wife afflicted by the Stockholm syndrome, the Franco-German establishment hopes that Europe's overbearing husband will change its abusive ways and that the next elections will re-kindle the flame of old romance.

Politicians can delude themselves with chimeras, especially when they are protected from the *vox populi* by a thick layer of treaties and bureaucracies. But investors do not have this luxury. The last part of this report will focus on the investment implications of the slow disintegration of the Transatlantic alliance.

A progressive Transatlantic divorce would reinforce the two secular trends that I keep coming back to: a weaker U.S. Dollar and higher, much higher bond yields. The last part of this report will discuss more granular themes at the country and sector level, as well as the secular outlook for European assets. Breaking-up a long and sometimes happy marriage is difficult, so there will be some pain over the medium-term. But over the long-term, leaving an abusive relationship is liberating. At least, that is the life lesson from the otherwise unmemorable 2003 romantic comedy, *Le Divorce*.

Nobody does clichés like Hollywood Romcom directors

A Very Brief History of the Transatlantic Alliance

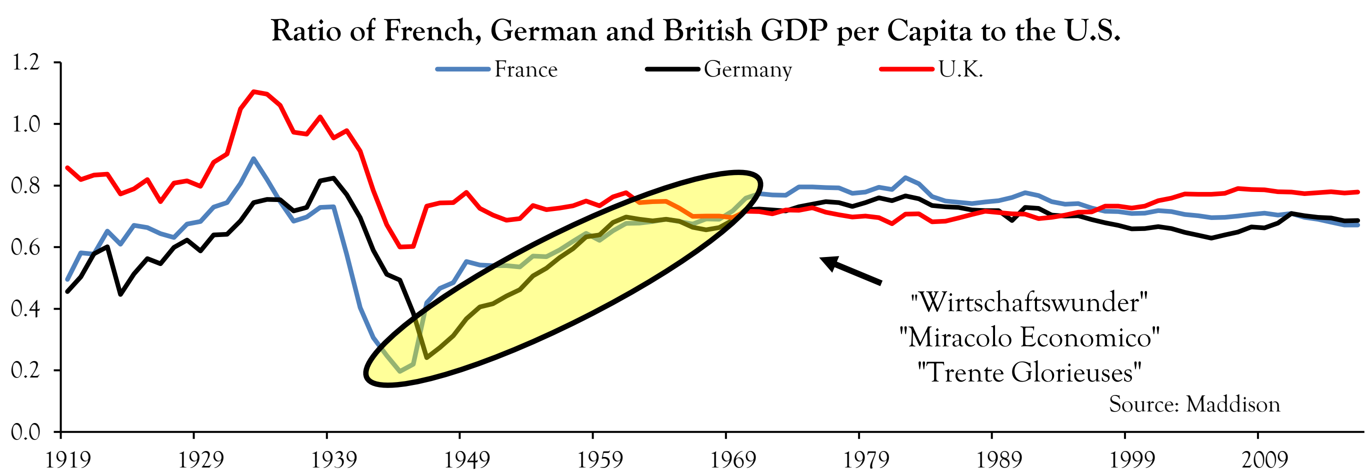
The Transatlantic alliance was born out of European despair. After destroying most its continent and large chunks of the world, European nations had little choice but to turn to the only power that was still standing. In 1948, Western Europe needed America's dollars, markets, raw materials, technical expertise, and military might. Despite the historical strength of Communist Parties in France and Italy, Europeans had little appetite for a Soviet alliance after the Berlin blockade of 1948-1949.

Fortunately for Western Europe, its financial need and strategic despair overlapped with the U.S. economic interests and nascent imperial confidence. The European Recovery Program of 1948, or Marshall plan, handed over $13 billion in loans and gifts to the U.K., France, Italy, Germany, Ireland, Benelux countries, Scandinavia, Portugal, Switzerland, Austria, Greece, and Turkey. Even Communist Yugoslavia got its bit of Uncle Sam's money. German finance minister L. Erhard and Austrian economists criticized the top-down nature of the aid, but the Marshall plan certainly beat the alternative – the Soviet Union actually charged reparations from former axis powers.

The Transatlantic alliance became the pillar of the U.S.-led international order and post-war institutions: the 1947 General Agreement on Tariffs and Trade promoted free trade between its members, the 1944 Bretton Woods agreement organized the global monetary system around the U.S. dollar, and the 1949 North Atlantic Treaty Organization integrated what was left of Europe's armies under American control. The 1950 Schuman declaration paved the way for the foundation of the European Economic Community in 1958, with the blessing and financial support of the Europe's economic and military patron.

Western Europe experienced a miraculous recovery under the U.S.-underwritten international order. Germany's per capita income rose from 22% of the U.S. in 1944 to 77% during the post-War *wirtschaftswunder*. This newly-found prosperity occasionally led European powers to attempt more autonomous policies. The United Kingdom tried to re-assert its imperial might during the Suez crisis, and C. De Gaulle tried to lure K. Adenauer into an independent military alliance.

In both instances, **American economic pressure swiftly killed these neo-imperial ambitions in the bud**. Europe still needed U.S. dollars to settle its trade, American consumers to buy its products, U.S. ships to guard its trade routes, and access to U.S.-controlled oil tankers to power to its economy. The weakening of this economic dependency is the underlying reason for the recent weakening of the Transatlantic alliance. To which we shall now turn.



Growing Apart, Economically

In diplomatic meetings, the Transatlantic alliance is usually framed around shared values and history. The U.S. and England have a special relationship because of a shared a language, free market ideology, and terrible cuisine. Every Franco-American summit features a teary speech about America's first ally, the Lafayette Escadrille, and the white crosses of the Coleville Normandy cemetery. The memories of the "*ich bin ein Berliner*" and the "tear down this wall" speeches are so vivid that B. Obama effectively launched his [2008 Presidential bid] in Berlin.

Shared values and a common history make for nice cocktail speeches, but alliances are maintained by common economic and strategic interests. As explained in the brief historical introduction, **Europeans accepted the fundamental inequality of Transatlantic alliance because it provided four main benefits**.

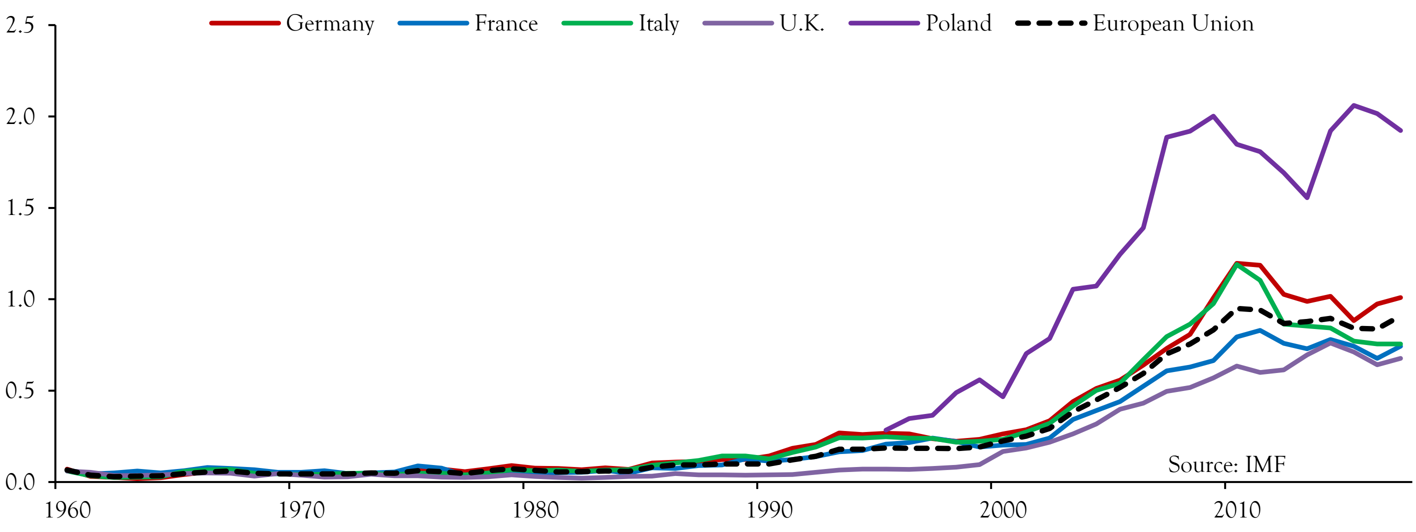
- Protection against the Red Army
- Access to the American market for European exporters
- Policing of the world major trade routes by the U.S. Navy
- A source of U.S. dollar to pay for energy imports

I will not waste any time of the first argument, which was settled when the Berlin wall fell a generation ago. Only a delusional or bad faith analyst would suggest that a country of 144 million with a GDP of $1.5 trillion can threaten an ensemble of 508 million with a GDP of $18 trillion.

Per the second point, the importance of access to the American market has greatly diminished since the days when the U.S. consumer was the only game in town. Poland trades twice as much with China as it does the U.S. **China has overtaken the U.S. as the biggest non-European trade partner for Germany**. Italy would be in the same position had it not been for the recent rise in the U.S. dollar[1].

China is of course just the most striking example of the diversification of trading partners brought by globalization. A last statistic illustrates the relative decline of Transatlantic trade: **trade with the U.S. accounts for just 6% of Europe's total trade, against 10% in 1960**.

Goods Trade with China as a % of the U.S. in Major European Countries



[1] Since trade flows are computed in U.S. dollar, the dollar value of Euro or CNY-denominated trade has dropped since 2014, even though physical flows have increased.

The shrinkage of Europe's American dependency will accelerate due historical changes in trade routes.

According to the World Shipping Council, around 80 % of global trade by volume is currently carried out over maritime trading routes. The Asia-North Europe and the Asia-Mediterranean are the second and third busiest trade routes, with 13.7 million and 6.7 million containers shipped annually, respectively. Most of these containers follow the path highlighted in blue in the chart below, a 35-day journey that crosses the Taiwan straits, the South China Sea, the strait of Malacca, the Gulf of Aden, the Suez Canal, and the strait of Gibraltar. This route is especially crucial for oil tankers: about 17 million barrels of oil crosses the Strait of Hormuz every day, against just 850,000 oil barrels across the Panama Canal.

Control of the oil tanker route eventually allowed allied powers to recover from their early defeats in World War 2. The United States protected this route with a pearl necklace of military bases and navy fleets. This supremacy has not been challenged since the Royal Navy retreated from the Suez Canal in 1956. **The U.S.-controlled Europe-Middle East-Asia sea route was the pillar of the 20th century world order and the ultimate justification of the Transatlantic alliance** for three reasons:

- Absence of an alternative sea route
- Prohibitive cost of land-based trade routes
- Europe's dependency on imports of middle eastern fossil fuels

This triple geopolitical constraint on European prosperity is progressively relaxing and may cease to exist by the middle of this century.

First and least importantly, the South China sea – Indian Ocean – Suez Canal route is no longer the fastest way to send cargo ships from Northeast Asia to Europe. The melting of the Arctic icecap is progressively opening the Northern Sea Route (NSR). As shown by the red line at left, a voyage from Shanghai to Rotterdam via the NSR shaves roughly 30 percent of the distance off a similar trip via the Suez Canal, and it also avoids pirate-infested waters.

Figure 4.1: Major container ports in East Asia that are within reach of the Arctic Routes

For now, trade volume on the Northern Sea Route is a statistical error: just 18 ships crossed the Northern Sea Route last year, down from a peak of 71 in 2013. However, time and global warming play in the NSR's favor: a 984-foot liquefied natural gas tanker crossed the NSR without the aid of specialized ice-breaking vessels for the first time last year. The Copenhagen Business School estimates that the Arctic liner shipping will become economically feasible around 2040 if the ice cover continues to diminish at the present rate.

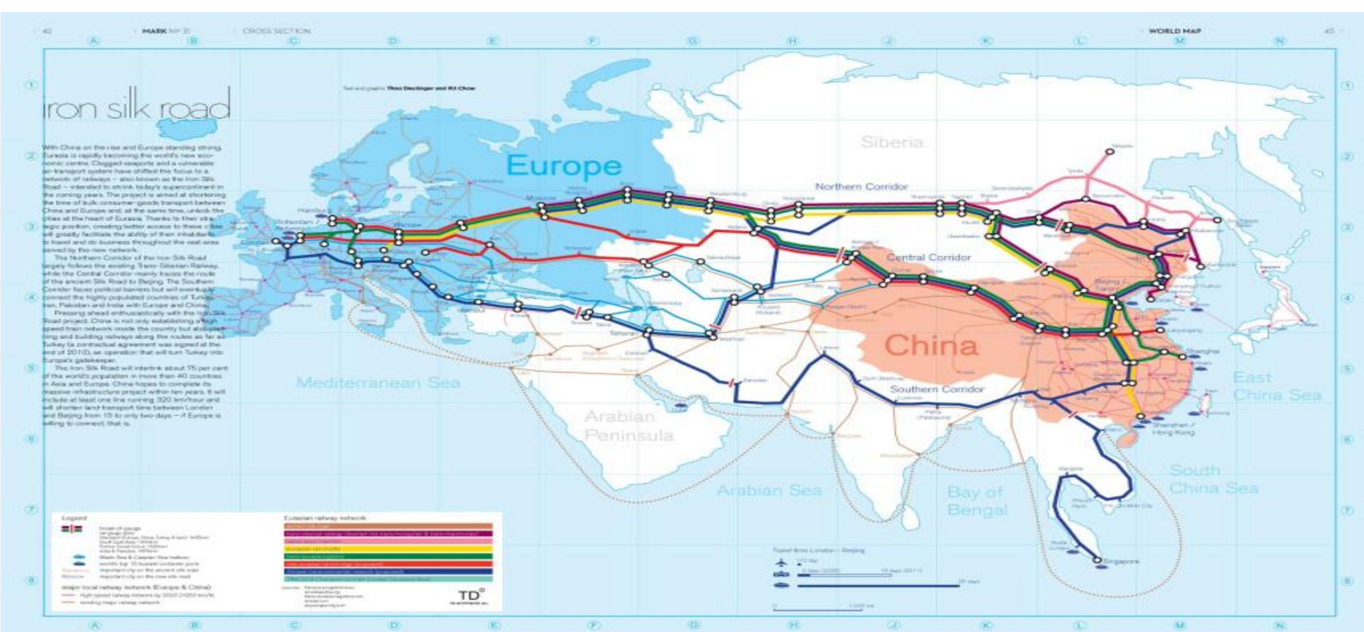
Second and more importantly, the *One Belt, One Road* initiative aims to connect 75% of the world's population in 40 countries within a decade. China hopes to reduce the traveling time from London to Beijing to two days with at least one 320 km/hour high speed train. Note that the journey currently takes 18 days on the newly-inaugurated Yiwu-London route. Adventurous readers with three weeks to kill can book their tickets here.

Describing the multiple and sometimes contradictory initiatives associated with the *One Belt, One Road* project far exceeds the scope of this modest paper. T. Miller's richly-documented China's Asian Dream takes a cautiously optimistic view of the project. Granted, travel by land is structurally less efficient than by sea: the quote for a 40-foot container was $2,500 when the Yiwu-London rail line was opened with great fanfare in January. Shipping the same container would have cost just $1,500!

Even with generous Chinese subsidies, many of the freight trains that cross the Eurasian steppes and deserts are empty. Many *OBOR* initiatives simply re-package existing projects to generate CCP-pleasing sensational headlines. The only certain beneficiaries of the *OBOR* initiative are the corrupt officials who sold expensive concessions to Chinese state-owned enterprises. China's grand strategy is dangerously dependent on a handful of autocratic regimes that may never repay the loans so generously handed by the Export-Import Bank and other China-controlled financial vehicles. Last but not least, many of the *OBOR* "partner countries" resent this Chinese takeover of their trade, infrastructure, and natural resources.

Only time will tell how much of the *One Belt, One Road* initiatives are economically sustainable. Given the project's size, it will most certainly leave a parade of white elephants across the Eurasian steppes, a flood of questionable money in dictators' pockets, and a mountain of bad loans on Chinese banks' balance sheets. But from a geopolitical perspective, the *OBOR* initiative already matters in two ways:

- It exists: it may not be very economical yet, but China and Europe can already trade directly, bypassing U.S. navy-controlled oceans and straits. **This will matter enormously in the not-so-crazy hypothesis of a conflict in the South China Sea or a nuclear escalation in the Persian Gulf**.
- China is fully committed to the project. The viability of every imperial project ultimately depends on the willingness of its core to finance its outward expansion. The autocratic and stable nature of the Chinese political system is an asset for such a long-term, costly, imperial vision.

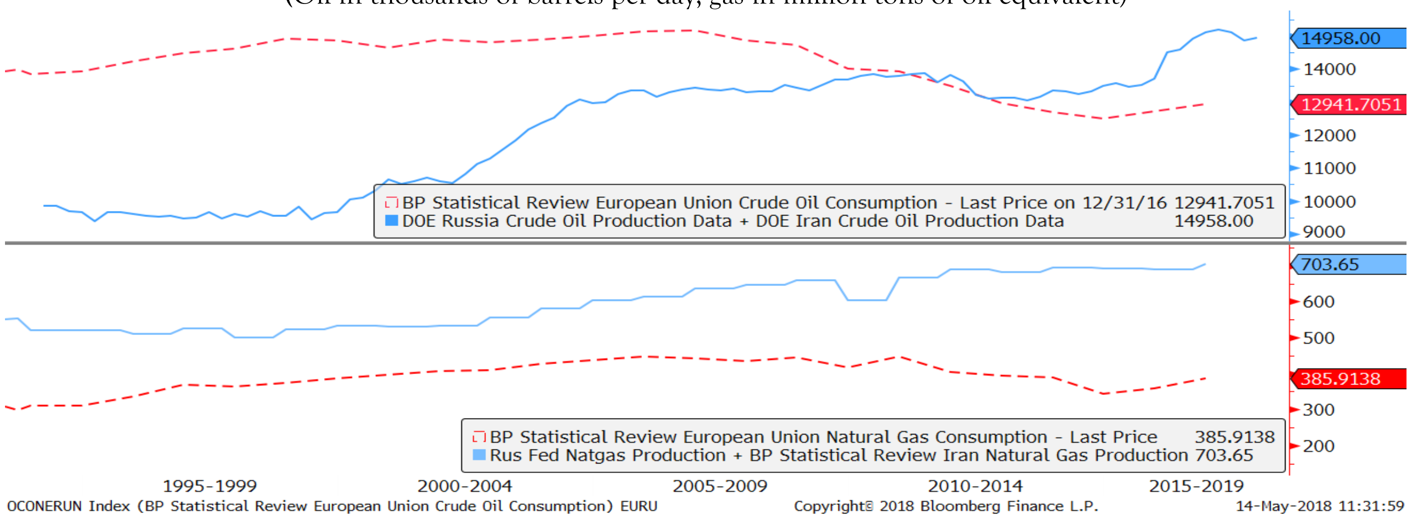


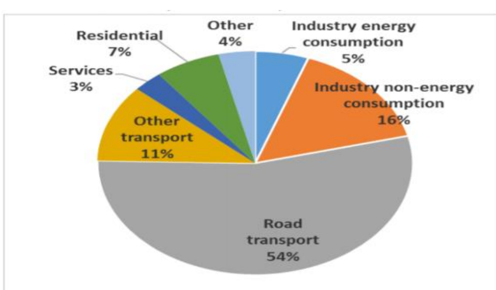
Source: Eurasia News

The third and most crucial economic pillar of the Transatlantic alliance was Europe's dependency on middle eastern fossil fuels. The chart below may be a gross simplification of a complex geopolitical reality, but it brutally summarizes the new fundamentals of European energy politics. **Europe consumes 12.9 million barrels of oil a day, down from 15.7 million barrels forty years ago. Russia produces about 10.5 million, and Iran another 4.4 million**. On the gas front, Russian and Iranian is twice as large as Europe's consumption.

A hypothetical European D. Trump would take one look at this chart and flip a century of European diplomacy on its head. Dropping the sanctions on Gazprom could double Russian energy imports overnight. Twisting the arms of small Eastern European countries could speed up the completion Nord Stream 2 to 2019. Giving Iran access to the Southern Gas Corridor could break the U.S. economic choke on the region, just in time for the first deliveries of Caspian Sea LNG to Europe via Trans-Anatolian Natural Gas Pipeline in June.

Europe's Oil & Gas Consumption versus Russia and Iran Production
(Oil in thousands of barrels per day, gas in million tons of oil equivalent)





Source: Eurostat Energy Balances

The rise of **hybrid and electrical vehicles (EVs) is another secular nail in the coffin of Europe's dependency on U.S.-protected Middle eastern energy imports**. According to Eurostat Energy Balances, road transport accounts for 54% of European energy consumption. The Swedish government recently made headlines with a law mandating a 70% reduction in transportation greenhouse gas emission by 2030 (the picture below illustrates this joyful moment) and every European government is coming up with a laundry list of incentives to increase the adoption of EVs or hybrid vehicles.

The rise of EVs is especially meaningful for countries which derive most of their electricity from non-fossil fuels. For example, nuclear energy accounts for about 75% of France's electricity consumption while wind power supplies about 45% of Denmark's electricity consumption.

In conclusion, **the economic fundamentals of the Transatlantic alliance (access to the U.S. consumer, protection of the trade route East of Suez, and dependency on middle eastern energy imports) are all already unravelling. Politics will eventually follow**. To which we shall turn now.

Growing Apart, Politically

As explained in the first part, the Transatlantic alliance was founded on an original inequality: the U.S. had the dollars, the trade routes, and the military might that Europeans craved. As a result, Transatlantic relations were always unbalanced. But the American hegemon tended to avoid explicit predation on its junior partners and focus on mutually beneficial initiatives.

This dynamic changed after the great financial crisis. On the one hand, the shale boom had greatly reduced the strategic value of the U.S. post-war system of alliances. On the other hand, the recession led to a domestic re-orientation of the U.S. public budget. The result was **an increasing lack of concern for European interests, and a greater willingness to use imperial force to extract wealth from allies**.

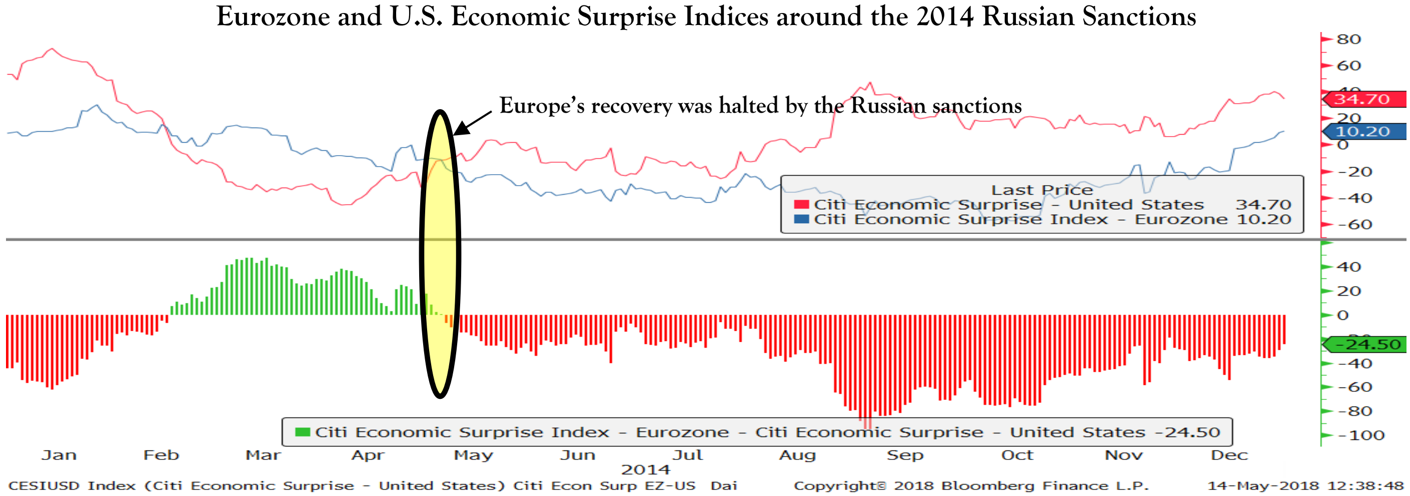
Bank	Fine, in billions
Bank of America	$76
JPMorgan Chase	$44
Citigroup	$19
Deutsche Bank	**$14**
Wells Fargo	$12
RBS	**$10**
BNP Paribas	**$9**
Credit Suisse	**$9**
Morgan Stanley	$9
Goldman Sachs	$8
UBS	**$7**

According to Keefe, Bruyette and Woods, U.S. regulators raised a staggering $243 billion in banking fines since 2008. European banks contributed about $55 billion, or a quarter of the total. The initial set of fines focused the lending abuses that took place prior to the 2008 crisis and tended to be indiscriminate. However, the recent years have witnessed the "weaponization of finance": foreign (or in this case European[2]) banks operating in the U.S. were fined for actions taken outside of U.S. jurisdictions. Under this new extraterritorial model, **European banks have effectively become an auxiliary of the U.S. Department of State**.

European regulators have retaliated by fining large U.S. tech groups for violations of competition laws and tax evasion, but the amounts levied are comparatively negligible.

The United States is ready to sacrifice any number of European jobs to send a message to its strategic competitors. The 2014 Russian sanctions mostly hurt European exporters, to the benefit of domestic Russian production and Chinese manufacturers. The pain was real: most European economic indicators plunged in the second half of 2014. The steel and aluminum tariffs are another example of the U.S. disregard for its European allies. NAFTA members should not be affected and China successfully got an [exemption by threatening U.S. agricultural exports](): German steel producers may end up as the sole victim of Trump's protectionist gesticulations. Similarly, the U.S. denunciation of the JCPOA and threat of sanctions against companies doing business in Iran will predominantly affect Europe, and France in particular: large Iranian investments and contracts by Airbus, PSA Citroen, and Total could be cancelled.

Eurozone and U.S. Economic Surprise Indices around the 2014 Russian Sanctions



[2] I cannot recall any large fine levied against Asian banks

By and large, the European establishment has been a passive victim of this unilateral display of imperial power. E. Macron tried to "tame the beast" with prodigal and somewhat awkward public displays of affection for D. Trump while A. Merkel has refused to indulge the vanity of the U.S. President. Neither leader could move the needle on the three most important objectives of European diplomacy: the Paris accord, free trade, and the Iranian nuclear deal.

D. Trump and E. Macron's dandruff summit
(under the auspices of G. Washington)

The French and German political establishment have chosen to ride the storm. They believe that D. Trump, whose election they never anticipated, will go just go away if they burry their heads in the sand. Anyway, the midterms are coming, the Mueller probe may force the resignation of the leader of the free world, and Democrats will surely win the next Presidential election.

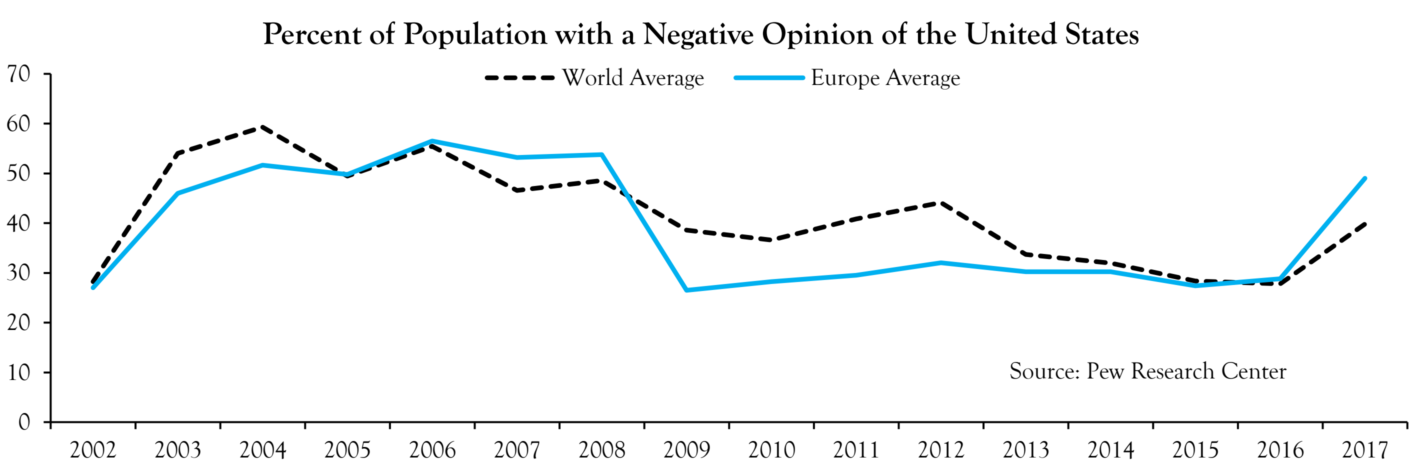
Maybe.

But the Transatlantic marriage is not threatened by the mood swings of POTUS45, but by **a secular divergence in economic and geopolitical interests**.

The Atlantic alliance has been the core of the European *doxa* for three generations and its ideology has permeated trade groups, lobbies, and think tanks. Institutions that were created by and for the promotion of American interests in Europe defend the Transatlantic alliance with the ferociousness of a bureaucrat fearing for his pension.

However, popular opinion will adjust to this new reality much more quickly – in fact, it already has. According to the last survey by the Pew Research Center, the countries with the most negative view of the U.S. President are Sweden (92%), Spain (90%), Germany (87%), and France (86%). Only Mexico distrusts D. Trump more (93%). For comparison, just 67% of Tunisians, 57% of Senegalese, and 35% of Russians have a negative opinion of the 45th President. This European dis-satisfaction with Uncle Sam is not just a matter of person: 49% of Europeans have a negative opinion of the United States as a whole. In a major historical turn, **Europeans' perception of the U.S. has become more negative than the world average**.

Anti-Americanism has become a rising force in all recent European elections. Explicitly anti-American candidates gathered 49.6% of the vote at the first round of the 2017 French presidential election. Anti-Americanism and Russophilia are a rare common point in the *M5S-Lega Nord* coalition that is about to govern Italy. J. Corbyn has unleashed a wave of hatred against England's former colony un-matched since the Boston Tea Party. In Eastern Europe, the leaders of "illiberal democracies" openly reject the Western values that have shaped the Transatlantic alliance.



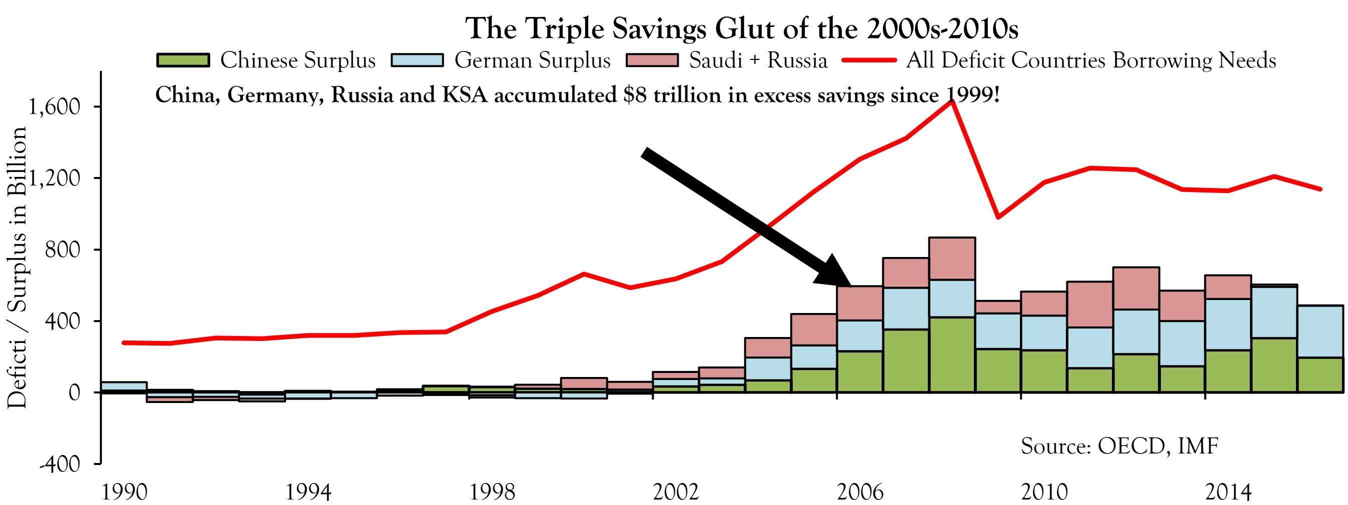
Market Implications

A progressive unwinding of the Transatlantic alliance would reinforce the two secular trends that I keep coming back to: a weaker U.S. Dollar and higher, much higher bond yields. The Transatlantic alliance has been the pillar of the post-war order: the two largest economies in the world, accounting for more than half of the world's GDP (until recently), a majority of U.N. security council, 57% of IMF voting quotas were committed to free-trade, rule-based decision forums and collective security. The Transatlantic alliance made the world safer, more predictable, and more open to trade. As a result, the cost of capital fell steadily as the global pool of savings increased and geopolitical risk premia shrank. The expansion of global trade resulted in a steady demand for the U.S. dollar, which kept its value despite soaring deficits, even after the collapse of the Bretton Woods system.

There is no ready-made coalition that can match the awesome power of the transatlantic alliance. The BRICs economies account for just half of the combined GDP of Europe and the United States, and these disparate countries do not share the tight Transatlantic institutional framework and cooperation mechanisms. Hence, the dissolution of the Transatlantic alliance will lead to a power vacuum, or "G-zero", a term coined by I. Bremmer to reflect the collapse of global leadership. A world without a single leader may not necessarily be a bad thing: as we discussed earlier, the Transatlantic alliance has turned into an unhappy marriage, which only holds because of the weight of habit and institutional inertia. But a leaderless world will certainly less predictable: the risk-free rate should increase to compensate for the inherent instability of a multipolar world. It is highly telling that the 10-year Treasury yield hit its secular low of 1.35% on the night of the Brexit vote, the first successful popular revolt against the post-War Transatlantic institutions.

The unravelling of the Transatlantic alliance will contribute the secular rise in Treasury yields and the fall of the U.S. dollar via a reduction of European (mostly German) surpluses. At $595 billion annually, the European trade surplus is the by far the world's largest macro-economic imbalance. The European trade surplus is a byproduct of the Transatlantic alliance: the original *quid pro quo* of the Marshall plan opened U.S. markets to European exporters, in exchange for Europeans' acceptance of the U.S. Dollar as the sole global reserve currency. The arrangement was mutually beneficial, at least initially: Europeans got to rebuild their economies. Americans got to buy German cars, French perfume, and Italian vacations that they did not pay for, since European surpluses were reinvested in dollar-denominated debt.

Much of the media attention focuses on American attempts to renegotiate this deal, via protectionist threats and reduced military spending in Europe. But **Europe may no longer be in a position to accumulate such large surpluses anyway**: as I explained in Four German Singularities, Germany's pending retirement bomb will drastically reduce the country's excess savings, and force a domestic re-orientation of its economy. As I explained in Higher for Longer, Much Higher for Much Longer, this German savings squeeze is occurring just as the two other big global savings gluts (the Chinese surpluses and the Petrodollar glut) are being drained at the same time.

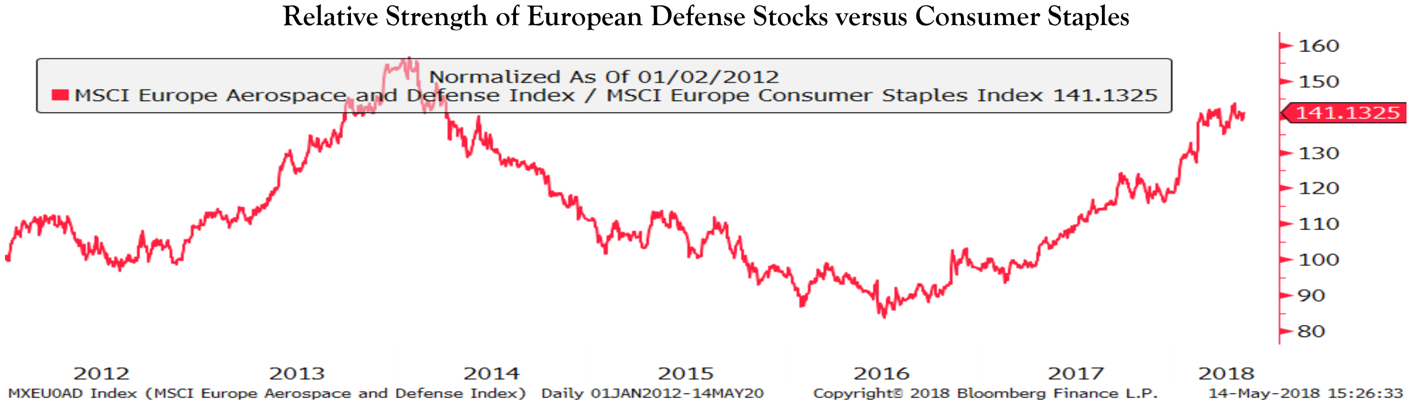


The unravelling of the Transatlantic alliance will reduce the demand for USD-denominated assets. What about European assets? I think the answer is more ambiguous. There will surely be some short-term pain. Modern Europe was built on the backbone of the Transatlantic alliance since the Marshall plan was signed 70 years ago: its governments have relied on the U.S. military umbrella, while its economies have focused on competitive export niches to serve the U.S. market.

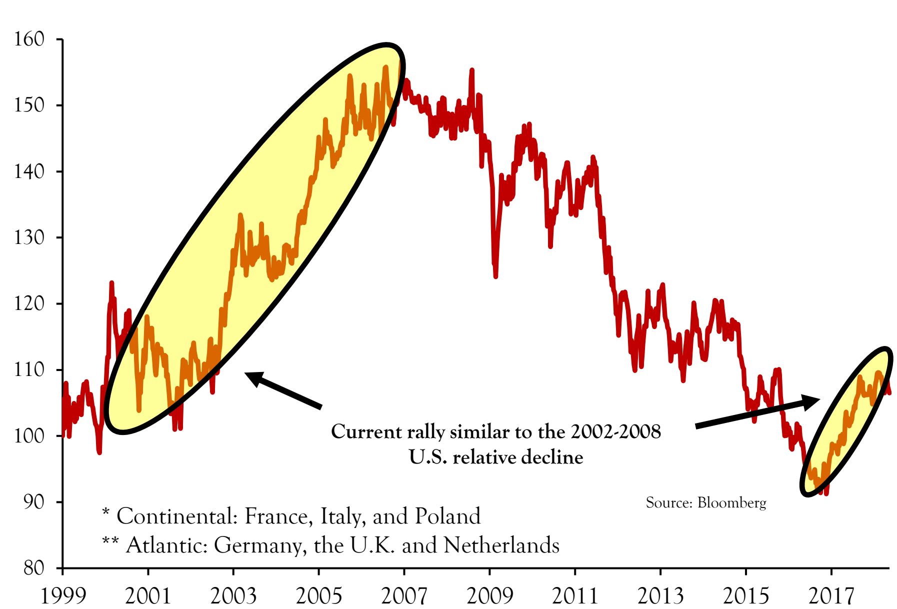
The Transatlantic alliance trade can be summarized by **the relative performance of the European defense sector versus consumer staples stocks**. European consumer stocks, such as Nestle, Danone, Unilever, l'Oreal, and Inbev Anheuser Busch, are essentially American multinationals that happen to be incorporated in Europe. They were built to please post-war American suburban consumers, who demanded easily-recognizable standardized products. These companies rely on the global infrastructure provided by the Transatlantic alliance: their complex logistic chains require free trade, their voracious appetite for mergers and acquisitions needs open capital accounts, and their financial leverage is supported by cheap money.

On the contrary, **European defense stocks would be the most obvious beneficiary of the unravelling of the Transatlantic alliance**. The Euro area spends just 1.4% of its GDP on defense. Raising this figure to the 2% NATO objective would require $78 billion in additional annual spending. For comparison, the market capitalization of the MSCI Europe Defense Index is just $257 billion. Not surprisingly, European defense stocks have risen almost continuously against European consumer staples stocks in the past two years. Not surprisingly, their ascent started on the night of the Brexit vote.

Relative Strength of European Defense Stocks versus Consumer Staples



Relative Strength of Continental* versus Atlantic European Markets**



At the country level, the British and Dutch economies are the most integrated with the U.S. The German export powerhouse also relies on U.S. imports for 3.5% of its GDP. These three countries built their prosperity on the backbone of the Transatlantic alliance.

Conversely, France is less reliant on exports due to its large government sector and its lack of competitiveness, while Italy and Poland tend to look East rather than West.

Unsurprisingly, Europe's "continental" markets have greatly outperformed the "Atlantic" powerhouses since the U.S. election. Expect more of the same in a post-Transatlantic alliance world.