



**PREDICTIONS FOR THE NEW YEAR
PART 2: POLICY AND GEOPOLITICS**

In the history of time, individual freedoms are exceedingly rare. Equality is not a construct found in the natural order of things. Nature, “red in tooth and claw”, is a stratifying force abetted by continual competition, and only the fittest survive. As parents are apt to tell their progeny: life is not fair. Democracy is a long experiment in individual freedoms. With an elaborate system of checks and balances, the Founding Fathers took great pains to mitigate the natural tendency towards stratification in hopes of collaborating into a more prosperous and equitable future. Nevertheless, entropy defines all systems. For the first time in nearly a century, the societal costs of unfettered free markets have created an existential crisis for democracy. By virtue of the monetary regime of the last four decades, the competitive forces inherent to free-market economies that drive optimal outcomes have indelibly eroded democratic ideals of equality. As such, in recent history, the natural tendency towards the dominion of force, of autocratic rule, has reasserted itself.

At the end of the Cold War, the political scientist Francis Fukuyama argued in *The End of History and the Last Man* that the collapse of the Soviet Union was the last obstacle to clear on the way to a globalized world of liberal democracy and market economies. Today, we are headlong into a retreat from any semblance of this global order with autocratic regimes governing well over half the world’s population. A choice will have to be made in the West to preserve the causes of individual freedoms and human rights at the cost of a potentially bifurcated global economic system; or ultimately, democracies will have to adapt in order to compete and survive. The resolution of these competing regimes will not only affect the fate of the global economy but the very trajectory of humankind itself.

Unfettered free markets have worked against democratic ideals of equality for the last 40 years. Central bank driven inequality has seen to it that fewer and fewer citizens of the democracies of the world feel the system is fair. The rise of populism has signaled deepening divisions and a desire for change. In the decade ahead, politics will be increasingly beholden to the demands of a divided people. With liberal democracies in strife, aspiring strongmen in autocratic regimes around the globe have consolidated their power.

The pandemic has accelerated the building pressures of inequality and pushed them into the political fore. Governments around the world, after 40 years, have responded with historic fiscal largesse. This is no surprise. Since time incarnate societies have fluctuated in their trust in entities that allocate capital: at times trusting the free market; and at others, trusting government. We are witnessing a seachange in economic policy in America in this vein. Even in the current milieu of growing distrust in government, there will be more demands to concentrate power and capital allocation in the seat of the federal government.

Markets rhyme, history repeats: there is no better era than the “roaring twenties” to illustrate regime shifts of this kind. Much like the decade preceding our current predicament, the 1920s was a period of swift economic transformation in America driven by the dramatic availability of investment capital. Pastoral ideals of prairie life had given way to cosmopolitan displays of liberation and newfound prosperity. F. Scott Fitzgerald assigned this period the moniker “the Jazz Age”, an evocative shorthand for American notions of freedom and abundance. Between 1920 and 1929, the US GDP doubled in a chapter of unbridled free-market capitalism. This new wealth bred a massive acceleration in innovation: the US Patent Office issued patent number 1 million in 1911 and by 1926, it issued its second million. Although productivity soared due to electrification and the efficiencies of innovation, wages stagnated and the affluence of the age became increasingly concentrated in fewer and fewer coffers.

Often accompanying an acceleration of market growth is a wanton increase in speculation. Wall Street eventually became the scene of activity of this sort and wealthy business tycoons were not the only participants - school teachers, dishwashers, and the rest of the hoi polloi began dumping much of their savings into the stock market. As a result, the market underwent a rapid expansion with valuations quadrupling over the decade. In 1929 the Federal Reserve raised interest rates in an attempt to combat these market excesses. Rate hikes caused interest-sensitive sectors to implode. The stock market collapsed and left a liquidity crisis in its wake. Consumers found themselves unable to repay loans and businesses no longer had the capital to finance their operations.

The economic collapse that ensued is the defining calamity of the 20th century. Although FDR was pressured by fiscal conservatives of his own party, in the 1930's he would implement a fiscal regime change in response to overwhelming political pressure from the plights of the people. To address the economic crisis born of the free market, the federal government was restructured and emboldened in order to more effectively allocate capital and become stewards of the economy. In the longer term, it established a new normal of government intervention and financial oversight with programs such as the national retirement plan, unemployment insurance, disability benefits, minimum wages, public housing, and mortgage protection.

It is through this lens of the past that we look to the future. From where we sit we expect to see continued political pressure on the federal government to allocate capital and address the current plights of the people: inflation and inequality. As we detailed in ([Part 1](#)) of this newsletter, the Federal Reserve does not have the proper tools to address inflation. As we continue transitioning to a regime of unprecedented fiscal policy that will doubtlessly put secular upward pressures on prices, we will see significant political and geopolitical fallout.

REPUBLICANS WILL SWEEP THE MIDTERMS IN THE U.S., INFLATION WILL BE THE POLITICAL BLUDGEON & POPULISM WILL PREVAIL

Due to the Fed's inability to contain inflation in the immediate term, there will be considerable political pressure to address the issue. Republicans will doubtlessly use inflation as the political bludgeon in the upcoming midterm elections. The GOP establishment and media have already begun rattling off the indictments of the Democratic caucus's largesse during the Covid crisis, scapegoating the stimulus as the driver of price inflation. As President Biden's approval rating continues to careen out of positive territory (chart below), this will be a compelling narrative that will captivate middle America as we approach the midterm elections. Republicans will likely regain control of both bodies of Congress, but ironically, we foresee that this will actually result in less legislative deadlock and more policy response.



Although cultural antagonisms between Democrats and Republicans have rarely been more antagonistic, both parties have actually drifted economically left in the last two decades. In the last election cycle, populist leanings in coalitions on the right were given voice by Donald Trump, an outsider himself to the political establishment, who promised to make whole those who had experienced the most significant loss of status over recent decades. Blue-collar voters, particularly in key swing states in the rust belt, became galvanized behind Trump’s rhetoric of welfare programs, infrastructure spending, and protectionism. Trump, a keen marketer if nothing else, mirrored a mounting disillusionment with an ever-greater concentration of economic and political resources within a segment of society. With messages of nationalism and visceral contempt of a broken system, Trump flew in the face of the preferences of his own party that had coalesced around the fiscal conservatism of the Tea Party in recent decades. This cultural pathos of the downtrodden is often associated with political regimes on the left, particularly socialism, as we see echoed in Bernie Sanders. This is not your father’s Republican Party. We will doubtlessly see continued adoption of these populist leanings on the right as inflation continues to rise, punishing those very same voters in swing states that have already experienced outsized economic dislocation.

Despite the tough talk about the inflationary effects of fiscal policy, the Republican Party will have little recourse to address their campaign promises of price stabilization without resorting to fiscal stimulus to alleviate inflationary pain in the immediate term. Joe Biden has a long record of reaching across the aisle and taking the middle road on policy issues and politically he will be mandated to cooperate to combat inflation. Ironically, with a Republican legislature and Democratic president who wants to protect his legacy as a member of congress for 30 years, we will see more cooperation and more fiscal stimulus. It would take little more than a GOP baptism and branding to push

it through. Although this will provide temporary relief, more fiscal spending will only help perpetuate secular inflation and interest rate normalization.

INVEST IN WHAT THE GOVERNMENT IS INVESTING IN:

As we have laid out, we foresee an increasing concentration of financial oversight and direction from the US government, as well as more fiscal spending. Given this, we recommend sitting at the source of the coming liquidity and investing in the sectors that the federal government will be allocating capital towards in the coming years.

LEGACY ENERGY WILL OUTPERFORM

The rising price of crude has the knock-on effect of inflating the costs of all goods and services in the immediate term. As political pressure continues to mount to address inflation, we will see legislation to increase the supply of domestically produced hydrocarbons, especially with a Republican congress. We have an abundance of untapped natural resources here in the US, and it will be an obvious and effective way to address the issues of the day. Incentives are mounting to disentangle ourselves from trade relationships with warmongering autocrats in oil-rich countries. As globalism wanes, populist strains in America will feed into the desire to produce domestically. Democrats will have to concede and forgo longer-term plans for an energy revolution to satisfy the calls to address inflation in the immediate term. Demand is only going to increase as the economy fully reopens. There will be a policy shift that reduces regulation on US producers and provides fiscal support for domestic energy operations to produce more crude, which will in turn increase the profit margins for legacy energy companies. US shale comes online quickly and is production heavy on the front end - look for the space to lead the way.

DEFENSE SECTOR WILL OUTPERFORM

History is replete with examples of rising inflation generating social unrest, violence, and in extreme examples even the dissolution of governments. Inflation creates conflict that tends to spill out onto a global scale. If prices become unmanageable in more developed countries, we can expect to see more global conflict. Prices are currently some 3% higher than they were when anti-government rebellions sprung up in northern Africa a decade ago.



Tensions have already increased with the recent brinksmanship of expanding autocratic regimes, as they attempt to claw back territories that have previously declared independence. With a likely Republican congress, we can expect to see an increase in military spending in an attempt to discourage what has become increasingly blatant disregard for global order. We expect that the defense sector will see an inflow of government capital over the coming years.

REAL ESTATE WILL OUTPERFORM

Real estate has been the key source of wealth creation and upward mobility in America for the last 40 years. It is increasingly unaffordable, out of reach, and is historically under-owned by younger generations and lower-income families. Over this time the construction of entry-level homes has declined more than 84%. House building has been accelerating in recent years but has run into significant setbacks as lumber scarcity and labor shortages plagued the industry during the Covid crisis. As we navigate our way through this year and get beyond the pandemic, the housing supply shortage is going to be one of the largest obstacles to inclusive economic growth and equitable outcomes here in the US. This is a politically neutral issue and a natural sector to stimulate. We will see fiscal support in this sector and federal programs such as first-time homebuyer tax credits, builder, and supply-side tax credits.

AS MILLENNIALS BECOME THE MAJORITY ELECTORATE, THEY WILL REINFORCE FISCAL POLICY AS A SECULAR TREND

Baby Boomers have largely been the beneficiaries of 40 years of asset appreciation driven by monetary policy. Meanwhile, the millennial cohort has suffered at the hands of poor wage growth, low homeownership relative to historic norms, and massive amounts of debt, especially student debt. The system hasn't worked for this cohort. They have

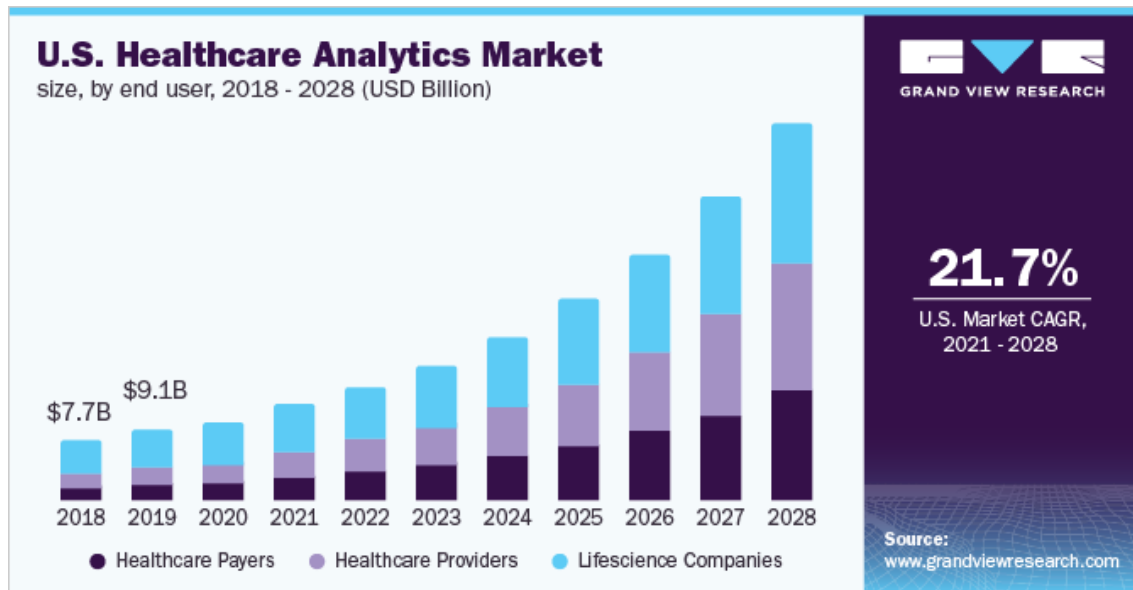
experienced two recessions and now inflation is further widening what is already generational inequality. This generation will become fore-of-mind in policy and legislation moving forward. As this cohort matures into the majority electorate, we see a fiscal support to come to help this generation catch up in the decades to come. This will give secular legs to the fiscal transition that has already begun to take place in the last several years.

HEALTHCARE SECTOR IS DUE FOR A DATA REVOLUTION

Rising healthcare costs have been instrumental in keeping the millennial cohort from being able to achieve the financial stability afforded to the generations prior. By the end of this decade, Medicare programs will no longer be able to pay out healthcare benefits. There are more beneficiaries than ever before, folks are living longer, and congress released medicare reserves to help fund the Covid relief. Insolvency is looming. Administrations tend to pay lip service to solving this problem, but of course, it's politically unpalatable to cut benefits or raise taxes. Additionally, Inflation and rising healthcare premiums will *further* erode the reach of these funds. This is at the expense of all future generations. There will need to be a technology-driven revolution with increased access to healthcare data to help drive down cost in order to forgo what will sure to be a looming crisis for generations to come.

The pandemic brought what were already broad inefficiencies in the US healthcare system into extreme focus. This is one of the few sectors yet to be disrupted by leveraging insights from data and it is facing further structural damage if costs cannot be lowered in the immediate term. The US has strict privacy policies guarding against healthcare data collection. However, in other segments of American life, we willingly offer up personal data of all kinds to "planet Palo Alto" at zero cost every other day of the week. HIPAA is a legal tautology ("we keep your health information private to ensure that your health information is properly protected") with little regard for actual healthcare outcomes to patients. The law is shrouded in ambiguity and has largely turned our healthcare workers into administrators.

In addition to the reduction of cost, waste, and bureaucracy by simply eliminating HIPAA, allowing for a democratization of healthcare data would dramatically lower costs, improve outcomes, and make way for a healthcare revolution. Most diagnosis and prescription is a *decision tree*—imagine the efficiencies if entire modalities of healthcare practice were delegated to data analysis. Additionally, it would extend the reach of potentially groundbreaking research. We already have a competitive advantage in Biotech here in the US, this is an extraordinary growth opportunity in the next decade as the graph below lays out.



Understandably, the healthcare system has been focused on the very short term due to the pandemic, but the solvency problem is undoubtedly a looming crisis. In order for there to be any sane solution to systematic problems in US healthcare, many of the systems that western democracies adopt to safeguard personal privacy will have to be unwound in order to ensure longevity in the future. These are competitive tailwinds already enjoyed by autocratic powers that have tools available in the form of data collection, which have increased exponentially over the last 20 years, to optimize for long term societal economic outcomes,

AS INFLATION STICKS, WE WILL SEE INCONSISTENCY IN LEADERSHIP IN THE US, WHICH WILL BE GEOPOLITICALLY DISADVANTAGEOUS AGAINST THE RISE OF AUTOCRACY

No matter if it is inherited or temporary, inflation does a number on a president's political favor as Jimmy Carter quickly found out 40 years ago. The last time we experienced Inflation in the US, markets went sideways and we experienced a slew of one-term presidencies. Nixon, Ford, and Carter were all waylaid by inflation. We will likely experience similar political outcomes in the next decade as we struggle to contain structural inflation. Strong and consistent leadership is a mainstay of coherent and effective policy: the success of the New Deal has much to do with the fact that FDR was a three-term president. Coherency in policy-making is necessary to encourage long-term structural changes. Additionally, the checks, balances, and term limits that are inherent to our democratic process have reinforced a system of short-sighted policy. The US will continue to struggle to make important long-term investments to steer optimal policy decisions needed to compete in a bifurcated global economy. This gives autocratic

regimes, particularly China, a competitive advantage for they do not have to operate with the increasingly existential inefficiencies inherent to our democratic institutions.

AS MODERN DEMOCRACIES DECLINE, AUTOCRATIC REGIMES WILL CONTINUE TO CAUSE GLOBAL CONFLICT: CHINA WILL INVADE TAIWAN

Consistency of leadership and a prioritization of the whole of society over the rights of the individual allows China to compete on a national scale much more effectively. They can achieve this because they forgo the personal liberties that are inherent to liberal democracy. Personal freedoms can only survive by virtue of the embedded structural inefficiencies that serve to protect individual rights from the tyranny of the state. Given the increasing populism, internal problems driven by inequality, and the likely inconsistency in leadership we mentioned prior, the window for democratic influence and leadership on the global order is closing.

The PRC has managed to simultaneously maintain centralized control of the economy at the seat of government and enjoyed the rapid growth of free enterprise. If they were to continue on the course of the last 40 years, China would be set to become the largest economy in the world in the next decade. In spite of this, China has made moves recently to upset this global order, bifurcating the global economy that they have largely been the beneficiaries. In a consequential 5,000 word joint statement with Russia produced around the time of the opening ceremony of the Winter Olympics in Beijing, China vowed to stand side by side with Russia in an alliance against America and the West. A few weeks later, 130,000 Russian troops were amassed at the border of Ukraine, an act of aggression that would have proven too costly without the support of the world's second-largest economy. The document details an ideological solidarity and military alliance to fight the “pernicious influence” of democratic values.

The invasion of Ukraine by Russia is a catastrophe in its own right, but why would China willingly fly in the face of the globalism that has driven their exponential growth to support Putin’s nostalgia for Russian imperialism? It is a natural conclusion of this Faustian bargain that **China has its own designs and needs the support of Russia’s formidable military to invade Taiwan.** In upsetting the international order, The PRC will doubtlessly need access to a commodity-rich Russian economy to bolster itself in a newly bifurcated global economy. Unfortunately, we see this as just the beginning for autocratic power grabs. The dual-threat of military action from Russia and China creates a significant deterrence for US intervention in conflict in the Asian theater.

It has been a long time since the West has had to worry about this. Will we have the stomach to once again burden the potential cost of elevating the ideals of liberal democracy? If not, in the space of a decade, we will likely not have the means to

influence the fate of the global order. If Russia and China continue to get away with aggression of this sort in the coming years, the credibility of the United States's support for liberal democracy will struggle, and this American chapter of history will likely come to a close. The window is closing.



Cem Karsan

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A handwritten signature in black ink that reads "Cem Karsan". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

As always, these longer-term macro views only represent a small portion of the factor inputs used in our models for predictive distributions for underlying market moves and implied volatility. Our models are focused on capturing daily moves and in the immortal words of Bruce Lee are always focused on not being dogmatic, instead being flexible,

“...formless, shapeless, like water.”



CONTACT US: If you have any questions, concerns, or need any information please feel free to reach out to us at any time by contacting ir@KAlvolatility.com

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