

There's no question the world was a more dangerous place at the height of the cold war. Looking back on the Cuban missile crisis, President John F. Kennedy said he considered the chance of war between the Americans and Soviets — an existential geopolitical risk if there ever was one — was "between one in three and even". There's no meaningful risk of war between any of the world's key state actors today: while there's scenario planning for how Nato would react if Russia were to suddenly invade Poland or the Baltics, or if a military escalation between the United States and China in the South China Sea were to spiral out of control, these are the stuff of war gamers preparing for worst case scenarios, not serious considerations for markets to worry about in the near future.

And yet the geopolitical risk environment is far more volatile today than it has been in decades, as we plunge deeper into the geopolitical creative destruction that is the g-zero. A lack of global leadership, a spike in political polarization, a less favorable growth environment, and growth in the power of disruptive non-state actors (and a consequent weakening of the authority of a wide range of central governments) combine to create an expanding series of "fat tail" risks. These are concerns that normally would be negligible but suddenly have become plausible in the near term. Not black swans, which are truly unpredictable risks (let's say, the sudden demise of Russian President Vladimir Putin and its impact — the sort of event that requires general resilience rather than specific mitigation plans), but rather grey swans — risks usually safely ignored that suddenly require more serious consideration.

We've given some thought to **what is — and what isn't — a serious fat tail in today's geopolitical environment**. Unlike our "top risks" at the beginning of the year, these aren't risks we consider likely to transpire over the coming year. Rather they're quite unlikely, but still much more likely than they should be. And to things balance off, we'll end with some "red herring" fat tails: risks you'd think are a fat tail, but don't pass the threshold.

## 5 fat tails

**1 — Brexit.** By far the biggest of the fat tails, with a historic UK referendum on membership in the European Union coming up in less than two months. It's nearly a coin flip. The polls remain locked up, with the latest (by Yougov) supporting Brexit by a 51%-49% margin. In favor of continued Union: undecided voters at this point are reasonably high at some 10% of the population, and late breaking uncertainty tends to support the status quo in what becomes a contest between known and unknown concerns. Further, the pro-Brexit forces are politically divided within the United Kingdom and haven't (and aren't likely to) come up with coherent economic arguments for their cause. But continued association with Europe is likely to look worse, not better, come end-June given both expanded security risks and a likely seasonal uptick in the refugees crisis. And the most committed voters are found in the anti-Europe bloc, so if there's any trouble with turnout (Cameron's inability to effectively drive the news cycle, or even poor weather), the Brexit forces have an advantage.

A British exit means years of difficult negotiations with the Europeans, accompanied with consequent market uncertainty, as European governments work to ensure European Union withdrawal doesn't create support for copycat referenda and a broader EU dissolution. It would likely be accompanied by **immediate talk of a second referendum**, with the Europeans would then have to debate the merits of, but that will do nothing to reduce market unease. Either way it **will weaken negotiations on the transatlantic trade and**

**investment partnership (TTIP), already unpopular** among most Europeans (and Americans). And will create stronger support for an "every nation for itself" approach among European sovereigns to deal with emerging challenges on the continent. **It'd be a serious economic hit for the Brits, a meaningful one for the Europeans, and a critical unwind of the most important alliance underpinning an already-strained US-led global economic, political, and security architecture.**

**2 — 9/11 in Europe.** Most likely would be **Belgium, France, or Germany**. Tens of thousands of European fighters returning from a brutal and diminished Islamic caliphate; large indigenous and disenfranchised Muslim communities increasingly susceptible to radicalization; improved (and encrypted) technologies for recruitment and communication; and a stretched and uncoordinated group of European intelligence agencies create even worse conditions for a large-scale terrorist attack than prior to 9/11 in the united states.

Core European states remain much more resilient than those on the front lines of refugee flows, and accordingly the populist backlash in the event of an attack in these countries, which are the most at risk (France, Belgium, France), would not lead to the emergence of a Le Pen-style "front national" or similar government. But a catastrophic "successful" terrorist attack on the continent would dramatically expand domestic support for unprecedented intrusive security measures and end nascent EU coordination on refugees. It would also crowd-out efforts at improved fiscal coordination and technocratic economic governance.

**3 — WikiLeaks x10...** involving a developing country government. The Panama papers made for extraordinary headlines, but a few weeks later the story is all but forgotten. In part because it mostly revealed politically-embarrassing but legal efforts by political leaders to protect their assets; for those where true corruption was at play, the details provided in the leak weren't sufficient to pose a challenge to their continued rule. But in a world where forced transparency is growing exponentially and individuals with unfettered access to information see no other way to effect change (or themselves become a meaningful part of the food chain), it's impossible to imagine the risks from such leaks not expanding dramatically.

The most harmful in the near term would be a WikiLeaks-type event; one in which classified government information involving who did what to whom (around spying and jailing programs, even assassinations) became public. Developing states with weak institutions, consolidated power, and a profound need for secrecy would be most affected. Broad internal purges would be the minimum reaction following such a leak, destabilizing the government (for example in Russia, china, and Saudi Arabia). In a worst case scenario, it could lead to disruptions in key interstate relations and/or spillovers in domestic violence, leading to regime change (in weaker frontier states: Venezuela or sub-Saharan African autocracies, for example).

**4 — Saudi instability.** The story for the past months has been **Mohammed Bin Salman**, the 31-year-old deputy crown prince. His **Saudi "vision 2030"** is a dramatic departure from business as usual in Saudi Arabia: announcements of true economic diversification, transparency for Saudi Aramco and other key state enterprises, social change, and educational reform. It's as necessary and overdue as it is discomfiting to many Saudi elites. And it comes alongside a host of poorly-managed geopolitical challenges, including wars in neighboring Yemen and Iraq and a growing internal security threat within the kingdom itself, none of which the Saudis are handling well.

**The long-term concern is if the reforms are implemented and ultimately don't succeed. The nearer fat tail risk is that the effort, alongside Bin Salman's efforts to become king, lead to a coup attempt.** That leads to internal factions like the national guard, military, and police in an open fight against each other, with massive capital flight alongside and a Shia-dominant eastern Arabia province that sees the uncertainty as its opportunity to assert autonomy (with help from Tehran). Saudi-Iranian tensions spike in this environment, possibly leading to direct fighting between the two countries (indeed, the middle east is the one place in the world where the present state of play makes interstate conflict between major powers, both in the region and among neighbors, plausible). **If you're worried about where state-sponsored cyber warfare could really hit markets, this should be your concern.**

**5 — Turkey.** President Recep Tayyip Erdogan has done his level best to consolidate power and transform Turkey into a country where political and military institutions are directly accountable to him individually. But if the Turkish leader aspires to have the internal strength of Vladimir Putin or Xi Jinping, Turkey's institutions are both too strong and too resilient to allow it. That creates insecurity for the Turkish leader; exacerbated by the country finding itself in the most challenging geopolitical environment of any major economy in the world today.

The biggest fat tail risk comes from a combination of these two factors. The **Syrian war expands**, particularly as a Russia- and Iran- supported Bashar al-Assad moves to retake Aleppo. Refugee flows to Turkey expand dramatically, just when the EU-Turkey refugee deal (and the political and economic support afforded to Erdogan alongside it) falls apart. Security risks for Turkey from across the border and from Kurdish separatists within Turkey expand, while Erdogan's domestic support base erodes. Erdogan would feel pressed to take security measures in his own hands in that scenario, pressing into Syria and creating his own buffer zone. That would sharply tax Turkey's relations with both the European Union and Nato, while Russian president Putin would feel the need to escalate his own interventions. The **biggest danger** in that scenario: **Erdogan using anti-Kurdish military actions for political ends, intersecting with the Kurds' hope everywhere in the region that now is their moment to achieve their own state...**leading to a much wider conflict.

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If this were a full “top risks”-length report, we could add **some smaller fat tails** to the mix: spillover from Islamic state expansion across North Africa, with growing terrorism and state-shaking instability in Morocco, Tunisia, and Egypt. A much more negative outcome in Brazil if a new president Michel Temer gets caught up into the lava jato case, along with an expanded group of the new slate of politicians in charge. Or the coming Venezuela implosion getting seriously bloody. Easier to hedge, but nonetheless worth a mention.

## Not fat tails

**1 — dissent in China.** We continue to see all sorts of reported anecdotes around business people criticizing the communist party; growing pressure against outspoken media and Ngos; and most recently an anonymous letter being circulated around the country telling Xi Jinping and his family to “watch out”. And there's good reason: endemic corruption, environmental degradation, growing industrial layoffs and the abuse of power. But the communist party has gotten increasingly effective in dealing with it. Xi effectively

blames local officials; they payoff many of the disenchanted, and China operates the most extensive internal security monitoring and repressive force in the world, numbering over 600,000. Even when broader unrest in one place, it never gets networked around the country and thus doesn't represent a threat to the top leadership. Add to this Xi's real popularity given the scale of his anti-corruption campaign, and, for the near term at least, there's not much to see here.

**2 — The South China Sea.** The military posturing continues. The Chinese and the Americans make claims and counterclaims, but its jaw-jaw, not war-war. The Chinese denying a US carrier a visit to Hong Kong is a debating point, not a military one. There are all sorts of opportunities for an accident, but nobody is making dangerous moves that could precipitate a real crisis. Why? No leaders in the region have Putin-like impetuosity or Erdogan-style insecurity, making climb-downs easier and a focus on long term economic gains the top priority. We suspect we'll see more tensions in the region over the coming months, particularly as the Chinese see more opportunity for setting military precedent at the tail end of the Obama administration (and, even sooner, when the international tribunal makes a final decision about the Philippines arbitration case, likely next month). But if push comes to shove, shove will be met with reassurances that no harm was meant.

**3 — Russia on the march.** Having taken a bunch of territory, president Vladimir Putin is now content to wait Ukraine out... and has little interest in reopening hostilities vis-à-vis the Europeans. Putin is not exactly comfortable at home given his country's economic decline; but there's no imminent opposition, or threat to his rule. Putin's risk-acceptant posture on national security, and willingness to use hard power, makes accidents much more likely (à la the downing of mh17, or even a direct incident between Russian and Nato militaries); but Putin's interventions remain limited both militarily and in their political goals. There's no fat tail risk to the sovereignty of a Nato state.

**4 — President Trump.** Yes, he can win the nomination — our best estimate given polls of remaining primary contests show Donald Trump reaching 1229 delegates before Pennsylvania uncommitted delegates are accounted for, 1264 once you include them (he needs 1237 for the nomination). But even against a seriously-unpopular Hillary Clinton, Trump's negatives would be by far the highest of any nominee since modern polling began. And the much heralded high republican primary turnout is worth a mention: Trump's percentages have increased in recent ballots in part because the gop numbers overall have shrunk dramatically as the race has turned to a more narrowly-attractive Trump vs. Cruz. If it's Hillary vs. Trump, we'll see truly-unprecedented news coverage. And breathless concern about what could happen to the country if he were to win--which, by the way, is another reason trump doesn't deserve "fat tail" status: far more market indifference to an actual trump presidency than a significant shift of leader in other major economies. Just 'cause people are worried about it, doesn't mean we should be listening.