

East Asian Kerfuffle

Ieodo is a manmade platform affixed to an undersea rock (named Socotra) in the Yellow Sea. For a map and an aerial photo see Cumberland's website, www.cumber.com. The direct link is:



The platform is Korean, and the facility is an oceanographic research station. South Korea built the platform and claims jurisdiction, but China claims jurisdiction, too. International maritime law stipulates that undersea structures are not nationally territorial while above-sea-level structures are subject to claims.

Ieodo is situated in the area where South Korea, China, and Japan are engaged in asserting claims over Air Defense Identification Zones (ADIZ). The airspace zones claimed by the three countries overlap. And now there is an occasional scrambling of military aircraft when planes enter the zones. Civilian aircraft and unarmed military or research aircraft face the choice of lengthening routes to bypass the zones or acknowledging them by advance filing of flight plans with the respective governments.

And those governments face similar choices. Do they respect the zone of another country with which they disagree and file their own flight plans? Or do they ignore the claim of another country, which they contest, and thereby add to the risk of confrontation? Thus we have a geopolitical test of wills at work in East Asia.

The initial US response to competing claims was to support Japan and fly two B-52s into the zone the Chinese claim, without notifying China. That move ratcheted up the Chinese response, and the Chinese scrambled fighter escorts. The incident triggered more responses and drew Korea into the kerfuffle.

The latest news suggests that Japan is willing to engage in discussions with China and Korea. This may lead to a negotiated settlement, but that is doubtful. Meanwhile, North Korea's petulant young leader is again starting to activate his nuclear ambitions. It seems that he cannot stand not being the center of attention in the region. America's VP, Joe Biden, serves as the US envoy to all of the regional players, and it is his task to ratchet down the regional tensions.

We see the analysis of Night Watch (December 5) as instructive.

"When world powers disagree on an issue they tend to spotlight minor points, such as treatment of journalists. While that is important, it does not threaten conflict in the same way as scrambling fighter jets in an air defense identification zone, which China has done. The Chinese made no compromises to the US Vice President about their declaration of an air defense identification zone. The Vice President said he was very direct with the Chinese, but North Korea and economic issues appear to have been more prominent in the talks, based on the press coverage. The Chinese seldom admit mistakes, almost never issue retractions and would never compromise on a national sovereignty issue for the US or any other nation. The Biden visit was mostly for show. Nothing serious appears to have been accomplished, which should surprise no one."

Markets are dismissing the risks involved in the East Asia situation, as can be seen from various market reactions that are sending stock prices higher. Geopolitical risk premia are very hard to measure before some event triggers a change in

pricing. Right now, it would appear there is no risk premium in the markets when it comes to the East Asian kerfuffle, even though the three largest economies (by GDP) in the world (the US, China, and Japan) are engaged in it.

The ADIZ dispute also covers the geography of the Senkaku Islands (as named by Japan). The Chinese claim them as well and call them the Diaoyu Islands. The ADIZ controversy started over this disputed claim, and the delineation of the zones brought in South Korea. Much has been publicized about this, so we will not repeat all that here.

A few final thoughts, and then we will get to some market strategy. The world's dominant currency used in trade is the US dollar. China's currency, the yuan, has just surpassed others to become number two in global trade. China is slowly evolving its global role and aiming at world reserve-currency status. It is starting to issue yuan-denominated debt. It is opening up its financial markets. We will soon witness 50 Chinese initial public offerings (IPOs) that are approved for release. Make no mistake, China is now a major world player. When it comes to the production of goods (not services), it has surpassed the US and other economies and is now the world's largest manufacturer.

The demographics in all three places are influencing the behaviors and outcomes of the kerfuffle. The US has permitted limited immigration – not enough in our view, but some. Japan has a closed society, little immigration, and a rapidly aging population. China has recently changed its policy towards demographics and permitted more than one child. The emphasis on demographic policy in China led to an overabundance of men relative to women. The oligarchs in Beijing know they have too many young men now. Some of them think that large numbers of young men in military uniform serving in a more disciplined way would benefit their society. Others in the oligarchy disagree. Political disagreements in China do not evidence themselves in the same way that they do in boisterous

democracies like the US, Japan, or Korea.

History shows that functioning democracies like the US, Japan, and South Korea are adept at defending themselves when external threats and pressures intensify to the point that defense is required. The same democracies are less likely to engage in military adventurism and to wage war with each other if they perceive that the war is avoidable. Those democracies will wage war in other regions and with non-democracies. The US actions in Iraq and Afghanistan are examples.

China is not a functioning democracy like the US or Japan. The decision-making hierarchy in China is more capable of moving in a militaristic direction that could intensify geopolitical risk. On the other hand, China also wants to open up and become a market-based capitalistic system. How to do both without sacrificing either is the policy dilemma for China and a diplomatic challenge for Japan and the US.

Meanwhile, the Japanese regime is very intense and nationalistic when it comes to the preservation of its geographical view. The Japanese-Chinese enmity is ancient and deeply rooted. Remember that Japan, since WWII, has favored unilateral disarmament. Japan's technological capability, which allows for current state-of-the-art military technology, is widely recognized. Japan, for example, could have functioning nuclear weapons very quickly if it wished. It also has the skills and capability to ratchet up its military prowess. But Japan faces the population issue. It would have to use the most advanced technologies to assert itself militarily, given the fact that its population is both aging and shrinking.

Contrast that with China's abundance of young men and its evolving military force. Japan has fewer men and women to serve in the uniformed services, but it has capacity to quickly upgrade to a more intensely technological and modernized military. The US has demographics that fall

somewhere in the middle and the highest form of technological capability, but the US is currently led by a weakened president whose Defense Department is in the throes of the budget fight.

Let's not forget South Korea, which maintains constant vigilance with regard to its northern cousin. South Korea is always in some state of readiness for war.

What does this mean for markets?

Four reserve currencies matter worldwide. They are the euro, the pound, the yen, and the US dollar. Two of the countries that preside over them are involved in this dispute, and China is aspiring to world reserve currency status. While the Eurozone and UK are primarily observers in the dispute, each has its own financial and economic problems. There is rising geopolitical risk when the three largest economies in the world are involved and two (soon to be three) key world reserve currencies are involved.

For investors today, the fraught political situation requires vigilance and a contingency plan. We would not sell securities in anticipation of a future additional military confrontation. We would however carefully observe all actions taking place in this East Asian kerfuffle. We would act very quickly were there a ratcheting up of additional activities. We are now going to see fighter planes of one party flying very close to unarmed or armed aircraft of another. There will be a test of wills, skills, and the ability to patrol airspace. These tests will be negotiated with swiftness and technological capacity that many of us in the civilian arena can only read about and attempt to understand.

Our current market position of overweighting Japan, looking for the yen to weaken, and looking for the Japanese stock market to rise is the best course to stay on. We are on that course. Our portfolios at Cumberland Advisors in the

international arena are positioned accordingly and have been for some time. As of today, there is no change.

In the US, the stock market reflects an upward bias as long as the Federal Reserve's policy continues along the present lines. We do not expect Chair Yellen, the new Fed Board of Governors, or the Federal Open Market Committee to make any abrupt, shock-inducing policy changes. It is not in the Fed's best interest or the nation's best interest to do so, and policy makers know it. The onset of predictable Fed tapering is not a policy shock if it is transparent and undertaken gradually.

The unknown element here is China. We do not know how far Chinese leadership is willing to go to assert their claims. We will get mixed messages purposefully sent to us by the leaders in Beijing. Remember, it is the mixed message that puts the other side on a risk-aversion course. North Korea, for its part, is unpredictable.

Who'd a thunk it? Ieodo and Socotra Rock are now the center of an East Asian kerfuffle.

This writer's personal note: The word *kerfuffle* derives from a wonderful 19th century British (Scot, really) term for a dispute, altercation, brouhaha, or disturbance: *carfuffle*. A kerfuffle may lead to serious beatings, or it may lead to some shouting and then a "standing down." The term is defined in the modern version of Merriam-Webster, which cites its origin (as currently spelled) in the post-World War II period. I checked an older version of Webster's Unabridged, and the word *kerfuffle* did not appear.

Oh joy! Oh, joy! We have a writer's delight! We have used a new word. Were Shaye Kotok, my deceased mother, who was a serious and respected English teacher, still alive, I suspect she would be smiling. Mom, I thought of you today.