

Cumberland Advisors Market Commentary – Year-End & 2020 Forecast Note #8 – 52 Targets

We may not like the direction of the world, but our task as investment advisors is to set aside personal and political views when we make buy-sell-hold decisions for client portfolios that we manage.



As we proceed into 2020, our US ETF portfolio will continue to be overweight the defense and aerospace subsector of America's industrial companies via a single ETF. It is liquid and trades well and will likely remain a core position in the portfolios.

The world continues to be a dangerous place, and the likelihood of that danger's increasing seemed high to me and to all of us at Cumberland as I wrapped up an initial draft of this commentary on New Year's Day. That likelihood is demonstrably higher now, after the assassination of Iran's General Qasem Soleimani. The US's assassination of Soleimani is regarded by many a destabilizing event. Ilan Goldenberg, director of the Middle East Security Program at the Center for a New American Security, has penned a thorough analysis of likely next moves in the US-Iran conflict. See "Will Iran's Response to the Soleimani Strike Lead to War? What Tehran Is Likely to Do Next," *Foreign Affairs*, Jan. 3, 2020, <https://www.foreignaffairs.com/articles/iran/2020-01-03/will-irans-response-soleimani-strike-lead-war>

Clearly Iran is at the top of the agenda and the headlines today, and North Korea is not far behind. Just as clearly, the Middle East is coming to a boiling point in several regions and countries. Our focus cannot, however, be limited to what

comes next with Iran or what comes next with North Korea.

We must not forget the South China Sea, either; this is a major intersection of China-US competitiveness. And the regional players in the controversy include Vietnam, Philippines, and, hugely, Japan. And don't forget the divisive issue of Taiwan. The demonstrations in Hong Kong may make the TV news, but intensification in the South China Sea military arena is occurring every day.

Nor can we take our eyes off South America and the disruption occurring from Venezuela's bankrupt state and the emigration of millions of people who are leaving if they can. In other South American countries, regimes are behaving in ways that exacerbate risk. Argentina is one of them. Brazil is another, and political turmoil in Chile is disturbing in that Chile was viewed as a stable and reliable player in an uncertain neighborhood.

Let's not forget the Eastern European scene with Russia's activities and Ukraine and particularly the Russian naval base in Sevastopol, Crimea. (See this page to get a sense of Crimean geopolitics: <https://www.google.com/search?q=crimea+ruussia>.) And we must focus on the changes in the Mediterranean with Syria and Turkey and the development of the enlarged Russian naval base at the Syrian city of Tartus. For some recent history there see <https://www.globalsecurity.org/military/world/syria/tartous.htm>. Remember, the US has abandoned a reliable ally (the Kurds) and sent a message to the entire region that we renege on our promises and don't keep our word about defending allies.

In the midst of all of this worldwide change, the Trump administration is lurching toward a policy shift away from US "global policeman" status. Trump has replaced globalism and diplomacy with nativism, protectionism, and growing isolationism. This is a major policy shift with generational

implications. Trump's continued belligerent and erratic style has undermined our traditional alliances. In our view he has exacerbated the danger in a world that is lurching toward more hostility.

Now, I know that Trump supporters feel differently and will defend him as the first president to stand up for what is, in their view, an America-centric posture in preference to a multidimensional diplomatic world view. That is a policy debate that may surface in the 2020 election cycle. We believe it will take a serious international event to bring it to the top of the list of priorities. We recall how US hostages in Iran changed the outcome of the Carter presidency. We also recall how the Kissinger-designed and Nixon-led US China initiative was not enough to save Richard Nixon during his second term. As for the Trump political initiative versus the House impeachment attempt, we expect that initiative to continue and strengthen into Trump's second term if he is re-elected, while the House remains under Democratic control.

It is a failure of American politics if the policy debate of globalism versus isolationism doesn't happen, given the many pressing issues, and if our country can't rise above the partisanship divide. Our national politics have eroded to this extreme.

We note that the US defense budget is expanding and is being funded through ever-increasing debt and without restraint. The budget process has placed deficit spending on a trajectory to rise above \$1 trillion a year, with increased emphasis on defense spending. R&D spending in the US defense budget is at an all-time high. And, lest we forget, the capex spending of the American tech sector now totals about the same as R&D spending in the US defense budget, and a substantial chunk of that FAANMGS capex is defense-related and should not be ignored. So think about defense R&D and FAANMGS capex as an integrated expenditure. Compare that with BAT (Baidu, Alibaba, Tencent) defense-related spending to get a sense of how large

this US-China defense competition is and the how the trajectory trends only toward more intense competition. Hat tip to Adam Virgadamo of Morgan Stanley for detailing this issue in a Sunday morning note in early December.

In sum, we're overweight the defense-aerospace sector and are likely to be that way for a while.

What used to be "speak softly and carry a big stick" (see https://en.wikipedia.org/wiki/Big_Stick_ideology) has now become "tweet loudly and erratically." But the stick is still big, and it remains, for better or worse, in the hands of whomever the nation elects as its commander-in-chief.

As we put a wrap on this commentary tonight, President Trump has just warned Iran by tweet that the US has "targeted 52 Iranian sites" should the country strike "any Americans, or American assets."

In closing, we will point readers to 11 Brookings experts' brief but impactful analyses of President Trump's decision to have Iran's General Soleimani killed:

<https://www.brookings.edu/blog/order-from-chaos/2020/01/03/around-the-halls-experts-react-to-the-killing-of-iranian-commander-qassem-soleimani/>

David R. Kotok

Chairman and Chief Investment Officer

Email | Bio

Read the rest of the series, 1-7, of "**Year-End & 2020 Forecast Notes**" by David R. Kotok at this link:

<https://www.cumber.com/cumberland-advisors-market-commentaries-year-end-2020-forecast-notes-by-david-r-kotok/>

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Cumberland Advisors Market Commentary – Defense Expenditures

Most Americans have never heard of the Stockholm International Peace Research Institute, www.sipri.org. A few minutes surfing

their website might just inspire you to add it to your list of independent research sources.



You can check out the role of the military in Venezuela and how it is supporting Maduro as a result of the financial support the military has enjoyed. This mutually beneficial relationship helps to explain the difficulty of regime change in that country.

One can also check out many other informative research pieces.

Try the report “Trends in World Military Expenditure, 2018” (<https://www.sipri.org/publications/2019/sipri-fact-sheets/trends-world-military-expenditure-2018>). Take a look at Table 1 on page two for a summary of the 40 highest military expenditures, listed by country. The US tops the list. China is second. The economic data in this report helps to identify some macro themes. Worldwide military spending is estimated at about 2.1% of global output (GDP). America accounts for more than one-third of the world’s military expenditures. France spends more than Germany does. South Korea spends more than Brazil or Italy or Australia or Canada does. Macro data helps put things into perspective when that data is combined with geography.

One takeaway for us is critical.

We know the world is a dangerous place, and it seems that it is becoming more so. Traditional diplomacy seems to be failing. The latest North Korean missile firing is an example of this failure as Dictator Kim has demonstrated after two summits with President Trump. Let me be clear. Kim is a really bad guy. This next comment is about tactics and strategies and not in any way offered to protect or defend a strongman/dictator. Whether its Kim or Maduro or others, ruthless despotic dictators are the enemy, always and every

time.

Note that a physical “walking out” of a meeting can occur only once in diplomacy and then the rules of engagement are forever changed. Ending a meeting without a joint statement used to be the way to message the world and the other side about discontent. No dictator/strongman leader can tolerate a direct insult since it raises risk to him from those at his home government who want to remove him or kill him. This is particularly so with dictators and strongmen who do not need to face elections.

So all the negotiations needed to deal with dictators and strongmen have now changed. The second summit with Kim was a victim of a real estate negotiating tactic. I’ve seen that tactic personally and used it on occasion. Negotiations can be tough and hard. So, you get up in the middle of a meeting to send a message that you are serious. You walk out. You also leave a channel open to resume if that is what you want to do. But in a business transaction, you do not have to proceed. That is why merger talks and transactional negotiations get broken off and then resumed.

In diplomacy, the reopening of a negotiation can happen but the methods used now have to be changed. The change occurs in the back channels and we do not see them in the public domain.

One side cannot take any risk or insult by the other side. Once you walk out the first time, you need to rewrite the rules. Unlike a real estate transaction, the “walking out” card can be played only one time. We shall see how the US deals with that principle in its global geopolitics. Negotiations between Trump and Xi are now subject to these new rules. The world’s two largest economies are also the world’s two largest military expenditures listed in the SIPRI report.

Meanwhile, the aggregate of military expenditures worldwide is heading higher and doing so from a record level.

We also know that the technology of war is intensifying at lightning speed. Check out: <https://www.sipri.org/media/press-release/2019/emerging-technologies-pose-challenges-control-biological-weapons-new-sipri-report> . Destructive capacity grows and is now expanded into the cyber realm. Here is another report to digest: <https://www.sipri.org/research/armament-and-disarmament/emerging-military-and-security-technologies/cybersecurity> . Nothing appears on the horizon to stem this accelerating trend.

At Cumberland, we continue to hold the defense sector ETF in our US ETF accounts. We rebalance it on weakness.

David R. Kotok

Chairman and Chief Investment Officer

Email | Bio

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