New York Life Investments

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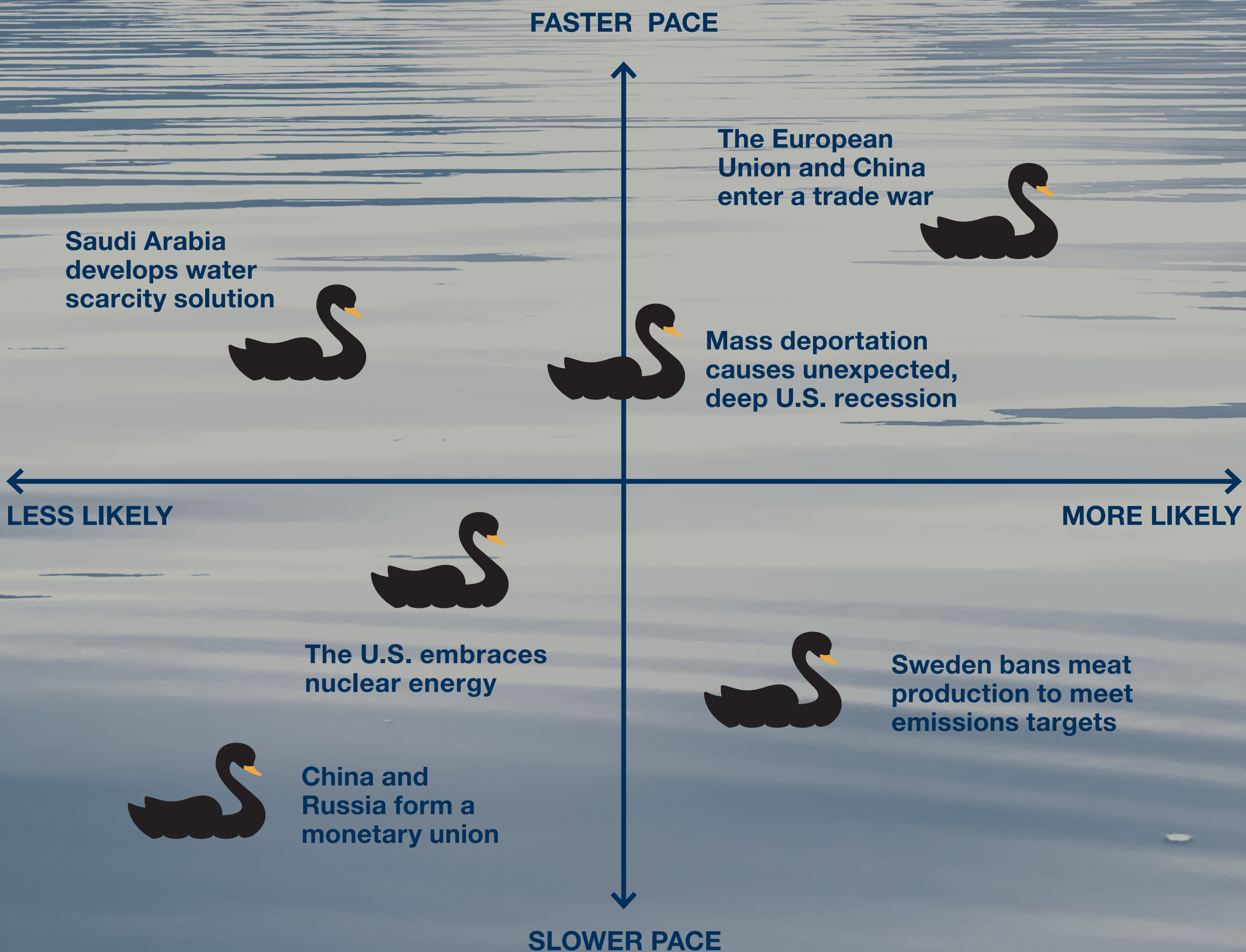
Swan lake: the risks that would most disrupt consensus in 2024

Our top picks in evaluating the unpredictable



Opinions of the New York Life Investments Global Market Strategy team, January 2024.

Introduction

A *black swan* is a high-impact, unpredictable event that disrupts investor consensus. Investor attention around them may ebb and flow, but these events always can, at any time and with no warning, upend entrenched economic narratives and reset market expectations.

In the past several years, shocks previously considered unlikely or impossible have come to fruition, with heavy impacts on economic growth, market behavior, and human life. For investors, it's important to be aware not only of any event's primary impacts, but also of the non-linear ways a shock can filter through the economy and markets. Global economic structures and international relations are changing, with sometimes long-dated and unpredictable repercussions.

Accordingly, we believe it is appropriate and perhaps necessary to consider not only the upside and downside scenarios to our base case views, but also "black swan" events that, though incredibly unlikely, could upend the 2024 outlook.

We prioritize key risks by considering the likelihood, severity, and speed of their impact. Then, we build scenarios to determine how that impact would be felt — and what, if any, action investors could take to mitigate or capitalize on it. While not in our base case for 2024, we believe the risks outlined here, if they occurred, would do the most to disrupt investment allocations.

China and Russia form a monetary union

LIKELIHOOD: LOWER | SPEED: SLOWER

Adversity makes strange bedfellows. For different reasons, both China and Russia would like to counterbalance the U.S. and EU, making a deeper strategic partnership between the two countries possible. Recently, U.S. and EU sanctions on Chinese firms and the severing of a growing number of East-West business partnerships have already brought China and Russia closer together.

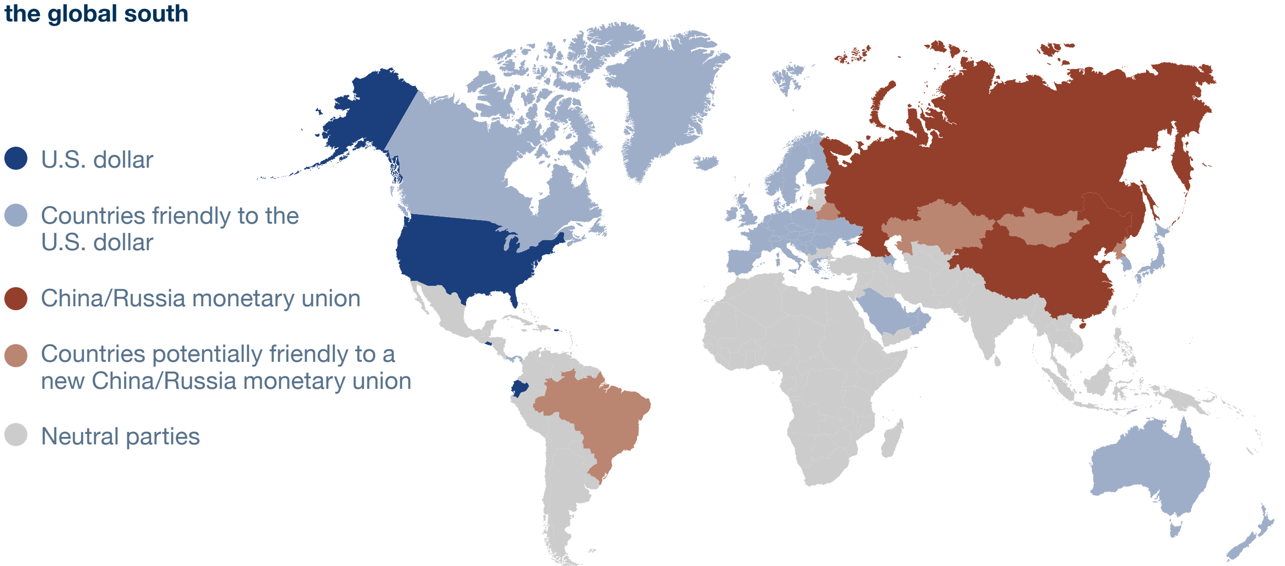
In what would mark a new era of global economics, China and Russia could form a monetary union, starting with a common currency for international financial transactions akin to the European Currency Unit (ECU) that preceded the euro. This new currency, designed to coexist with the renminbi and the ruble, would aim to enhance economic and policy coordination between the two countries. If successful, this experiment may pave the way for a full currency merger and possible expansion accounting for 21% of global GDP.

The primary drivers for this union stem from a shared desire to counter Western sanctions and reduce dependency on the USD. Financial sanctions on Russia have already been painful; further dollar weaponization may make China-Russia collaboration more likely. The booming bilateral trade between the two nations and their economic synergies—Russian energy and Chinese technology—further bolster the case for integration. Geopolitically, the two countries share a border and similar governance systems, and both maintain low inflation and healthy current accounts. Russia and China's cooperation in Middle East relationships and leadership of the BRICS[1] cohort suggest both Putin and Jinping are aware they cannot individually counter the expanding influence of the U.S. and the West.

Investment implications

A new global currency would likely have strong financial market and geopolitical implications. U.S. yields may take the hit: China would likely need to sell substantial amounts of its Treasury holdings to restructure its reserves in support of a currency union with Russia. Gold may help to back such a currency; a structural increase in demand could support its price and reduce volatility. An increasingly polarized world would likely necessitate adaptability for the largest multinational corporations, as distinct business and trade regions could drive up operational costs. Western-based companies may benefit from reshoring, with consumers bearing higher prices. Global investors would likely see these divisions reflected in new equity and bond index organization, prompting a re-calibration of geographic risk assessment.

A China-Russia monetary union would be a dramatic shift in global finance, especially for neutral parties in the global south



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Sweden bans meat production to meet emissions targets

LIKELIHOOD: MEDIUM | **SPEED: SLOWER**

Almost every country has made bold commitments to reduce carbon emissions. But deadlines are looming, and many countries are likely to fall short of these goals. Faced with rigid economic structures around traditional fuels and limited physical resources to expand renewable energy capacity, we expect countries will look for cost-effective ways to slash emissions to meet 2030 targets.

Enter: meat production. Though the key culprit is beef, the production of dairy and key proteins flies under the radar as a powerful polluter, responsible for 14.5% of all global greenhouse gas emissions and 60% of those from global food production. In 2024, a country like Sweden could act on this data by announcing a substantial meat tax, potentially as a step toward a complete ban on all domestically produced, live animal-sourced meat by a key emissions target date like 2030.

But would such a drastic step as a ban be necessary? Per The Good Food Institute, plant-based alternatives to chicken, pork, and beef can reduce greenhouse gas emissions by 86%, 92%, and 99%, respectively. Lab-cultivated alternatives to these proteins can cut emissions by up to 92%.

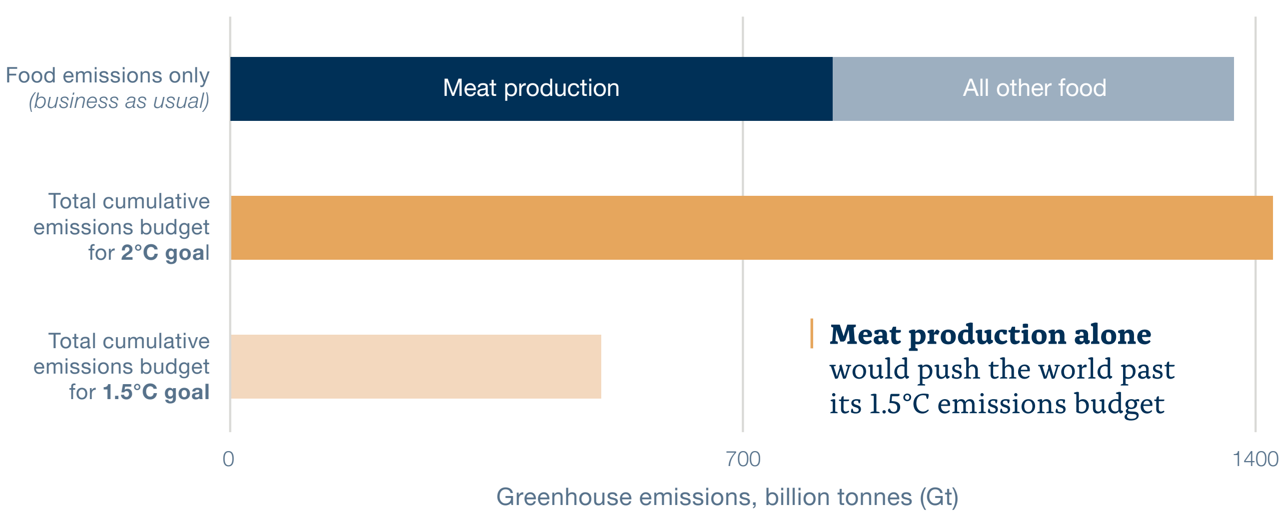
Whether it takes the form of a tax or a total ban, Sweden is primed to make such a bold statement in the realm of climate policy. It has a legally binding target for carbon neutrality by 2045 and a cultural readiness for transformative change. Sweden's unwavering national support for combating climate change was evident during the 2022 European energy crisis, despite the urgent need to prevent blackouts and ensure household heat through winter.

Investment implications

While the impact of Sweden's policy on global meat prices would likely be limited due to its small share in overall production, such a bold policy example could pave the way for a surge in public and private equity investments in plant-based and lab-grown meat technologies. New use could be made of the swathes of farmland currently dedicated to livestock and growing livestock feed, potentially transforming the bio-infrastructure landscape. Food industry giants, traditionally known for their farmed meat products, are already diversifying into the alternative meat space, suggesting that consumers are primed for climate-friendly shifts in food production.

Food emissions alone could exceed the carbon limit required to maintain 1.5°C climate change targets

Billion Tonnes (Gt)



Sources: New York Life Investments, Our World In Data, Michael Clark et al. (2020): Global food system emissions could preclude achieving the 1.5°C and 2°C climate change targets, *Science*. Chart shows estimated emissions from 2020 to 2100. Goals are defined as having a 67% chance of succeeding from 2020 onwards.

The U.S. embraces nuclear energy

LIKELIHOOD: MEDIUM | **SPEED: MEDIUM**

At the end of 2022, the state of California extended the life of the Diablo Canyon nuclear plant to 2030, canceling a decision to retire it in 2025. The energy community considered this a stunning reversal as California, the birthplace of the U.S. anti-nuclear movement, decided to maintain its only remaining set of reactors amid struggles to run its power grid with fewer fossil fuel plants.

California's choice reflects one facing the United States as a whole: to lean in or away from nuclear. Nuclear power accounts for nearly 20% of the country's electricity and about half of its carbon-free electricity, but for many years the U.S. abandoned nuclear energy due to environmental and safety concerns. If technological advancement reduces cost and safety concerns, then the use of smaller, more efficient nuclear power plants may be on the horizon, revolutionizing the industry and igniting a boom in nuclear plant construction.

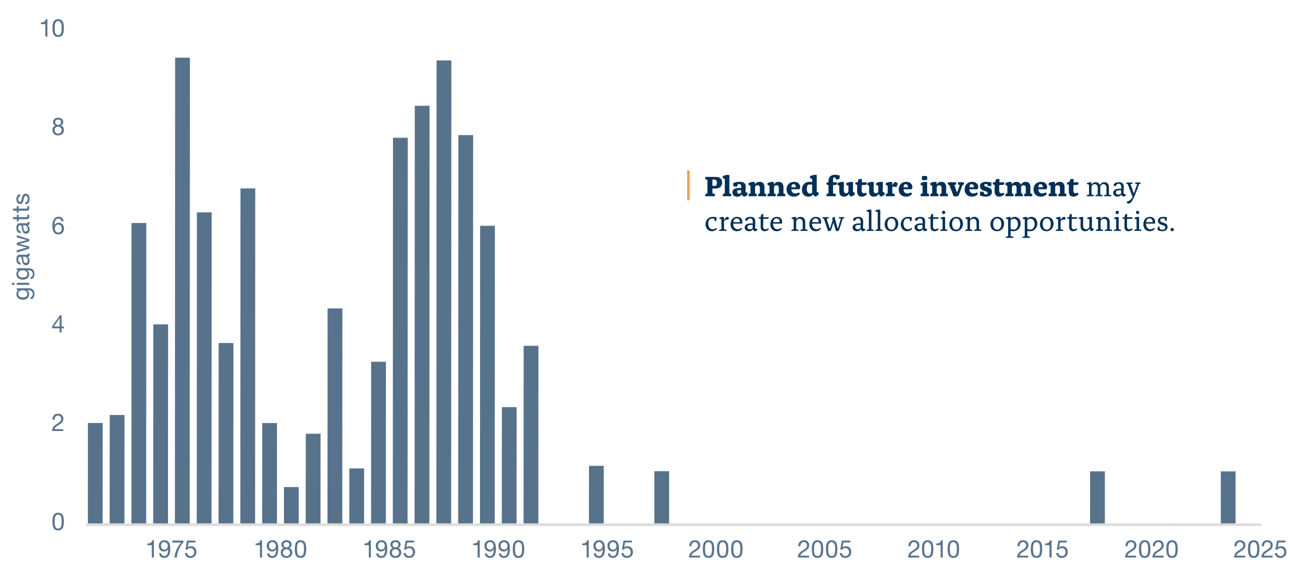
Technology is likely what makes a nuclear renaissance *possible*, but a shift in attitude may be required to make it more *likely*. What could prompt this shift? Decreasing the reliability of traditional power plants—either due to weather events or cyber attacks—could have an influence. Increasing concern about the cost and safety of traditional power plants may also play a role. The rising visibility of climate change is already influencing investment, which may contribute to change. Twenty-two countries, including the U.S. and existing nuclear energy powerhouse France, committed to tripling their nuclear capacity by 2050 at the 2023 United Nations Climate Change Conference. The U.S. Department of Energy provided substantial funding in October 2020 towards the development of advanced reactors, the first of which is expected to be operational by the end of 2024.

Investment implications

An increase in the importance of nuclear energy—after a long period of underinvestment—could drive a meaningful uptick in attention to the sector: materials, infrastructure, nuclear energy companies, battery companies, uranium processing, nuclear waste management, and nuclear safety technology providers. Additionally, oil-importing countries could benefit from falling costs, assuming global oil production continues but prices fall due to decreased demand. A key hiccup will be Russia's dominance of uranium mining, processing, and nuclear services; many of these functions have been excluded from Western sanctions on Russia and could open the door to selective economic cooperation.

The U.S. has dramatically underinvested in nuclear energy

U.S. nuclear power capacity additions, by year of initial operation



Sources: New York Life Investments, U.S. Energy Information Administration, Macrobond, January 2024.

Saudi Arabia develops water scarcity solution

LIKELIHOOD: LOWER | SPEED: MEDIUM

Water is quickly becoming the world's most precious resource. For Saudi Arabia, which depends heavily on oil today and will suffer heavily for water tomorrow, addressing water scarcity is now a strategic imperative. Of course, water scarcity extends far beyond Saudi Arabia; a large portion of the global population faces water scarcity due to uneven distribution, overuse, and climate change, while pollution severely impacts the quality and safety of water supplies. Many countries have been investing in cost-effective desalination to improve water access, but Saudi Arabia has been leading the charge. If these investments pay off, it could position the Saudis as a leader in desalination and change global political and financial relationships regarding the world's most precious resource.

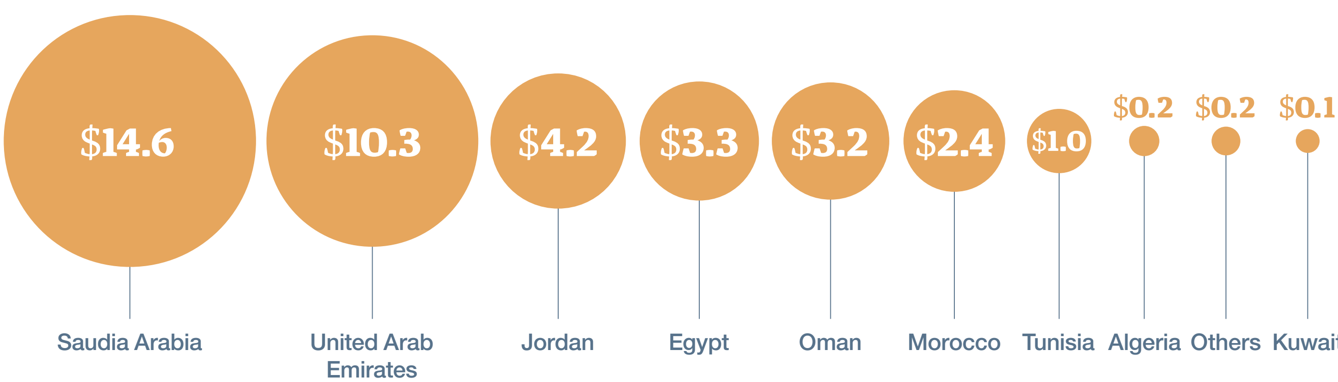
A major breakthrough needed to make desalination cost-effective is utilizing brine discharge, a byproduct of desalination. Researchers are working on transforming brine into construction materials. This development would not only address environmental concerns but also add economic value to the desalination process. Moreover, advancements in renewable energy enable the decoupling of desalination processes from their historical dependence on hydrocarbons, making them more sustainable and economically viable.

Investment implications

A desalination breakthrough in Saudi Arabia could lead to a reduction in geopolitical risks associated with water scarcity. By relying on seawater rather than river water, tensions between countries over shared water resources could diminish. Saudi Arabia's importance in the Middle East and global economies would likely rise. Choices related to the licensing and copying of technology could impact geopolitical relations and intellectual property law. Blue bonds, which finance marine and water-based projects, could see a surge in demand. Finally, countries less exposed to water insecurity, such as Canada and the Nordic states, may become more attractive to investors, reflecting a global shift in investment priorities towards nations with stable and sustainable water resources.

Saudi Arabia is the global leader in desalination investments

Total cost of water desalination plant projects in the Middle East and North Africa, USD billions



Sources: New York Life Investments, 4th MENA Desalination Projects Report 2023, Macrobond, January 2024. Others include Libya, Qatar, and Bahrain.

The European Union and China enter a trade war

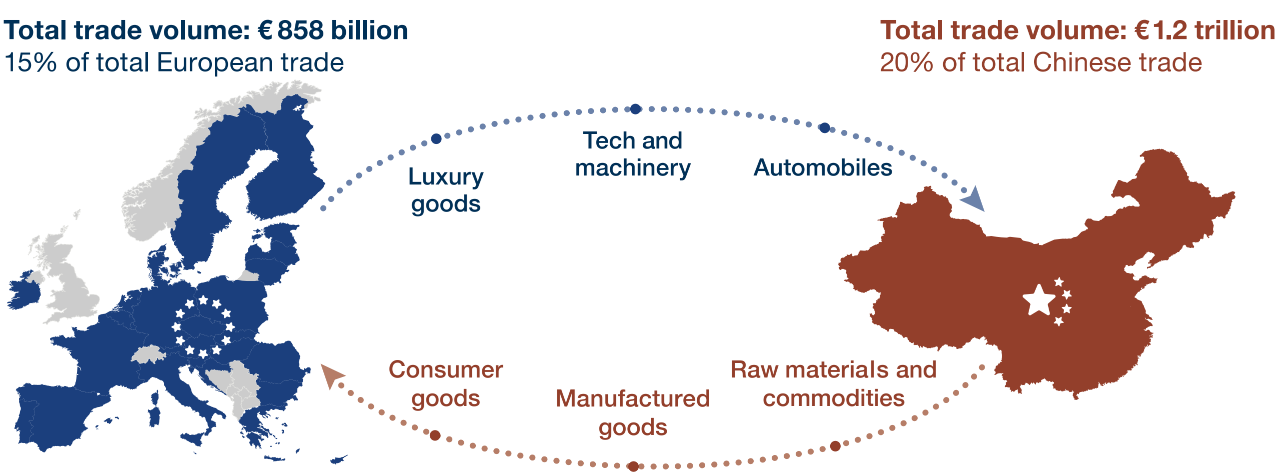
LIKELIHOOD: HIGHER | **SPEED: FASTER**

Think trade wars are behind us? Think again. China's rapid emergence as an electric vehicle (EV) exporting powerhouse challenges the established order in the global auto industry, and two of its largest trading partners *and competitors*—Germany and Italy—are taking note. China leverages three key cost advantages in the auto industry: lower labor costs, government subsidies, and favorable shipping costs. European car companies view these practices as unfair and have been pushing the European Union to impose tariffs on Chinese cars and possibly steel. Similar to how China responded to U.S. tariffs in 2019, China could respond with punitive tariffs, igniting an EU-China trade war. An EU decision to impose tariffs could be influenced by multiple factors: rising scrutiny and public sentiment against China's trade practices, the results of the European Commission's anti-subsidy investigations into Chinese EVs and steel, and the potential election of a more China-hawkish European Commission President in June 2024. Globally, an increase in protectionism and growing comfort among governments to resort to protectionist sanctions as a means of economic defense may increase the likelihood of further trade disputes.

Investment implications

The first casualty of an EU-China trade war would likely be the auto industry; cars would become more expensive. Producers of inputs and manufacturing of automobiles would also be impacted. Emerging markets with heavy industrial, manufacturing, and electronics capabilities might benefit from increased demand if supply chains shift away from China. Looking beyond the auto industry: Chinese demand plays a major role in Europe's luxury goods sector, leaving it vulnerable to a trade war and potential restrictions on Chinese tourism to the EU. Also consider the spillover of this fractured relationship: an EU-Mercosur[2] trade deal has been on the table for some time now, with both sides continuing to point to issues with the agreement. But an EU-China trade war could increase the value of South American markets to European companies, leading Europe to offer concessions and, thereby, increasing the likelihood of the EU-Mercosur trade deal.

An EU-China trade war could disrupt one of the world's largest trade relationships



During the 2018-2019 U.S.-China trade war, U.S. tariffs affected around 18% of its imports, equivalent to 2.6% of its GDP, while China's retaliation impacted 11% of its imports, equivalent to 3.6% of its GDP.

Sources: New York Life Investments, Eurostat, China General Administration of Customs (GAC), China National Bureau of Statistics (NBS), China Customs Statistics Information Center (CCS), Macrobond, January 2024. Total trade volume = imports plus exports. Europe is represented by the EU27 countries. Latest data available as of 2022.

Mass deportation causes unexpected, deep U.S. recession

LIKELIHOOD: MEDIUM | SPEED: MEDIUM

In the United States, the debate over immigration has intensified. During an election year, these debates could culminate in either political party promising tighter immigration policies aimed at both new and existing undocumented immigrants. In an extreme scenario, mass deportations could occur, and the resulting economic shock would be meaningful. The American Action Forum estimates mass deportation would have a Great Recession-like impact on the economy, with a potential $1.6 trillion reduction in GDP, or 5.7%, and an estimated cost to the government of $400 billion.

Why the hit to growth? The U.S. currently hosts about 8 million undocumented workers. Their deportation would be unlikely to translate to an equivalent number of jobs for American citizens. Differences in skill and education levels limit quick or perfect substitution in the labor market. The resulting sudden reduction in the U.S. labor supply would put upward pressure on wages, contributing to higher inflation and interest rates. Consumption would decline, too. Roughly 96% of working-age undocumented immigrants in the U.S. are employed, so removing their contributions to consumer spending, taxes, and other state benefits would have a noticeable impact.

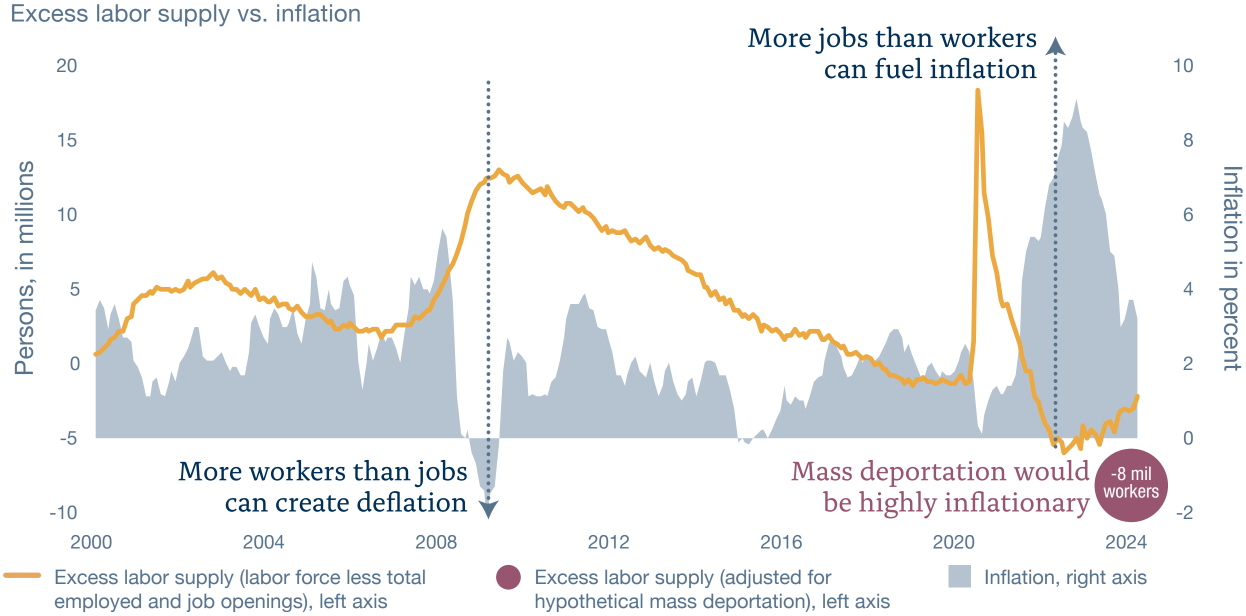
Arizona's experience during the Financial Crisis offers a recent example of this dynamic. Strict immigration laws intended to replace undocumented workers with U.S.-born workers resulted in less than 10% of such jobs being filled by citizens. Arizona's economic recovery lagged behind its neighbors, particularly in construction employment, underscoring the complex dynamics of immigration and sector-specific employment.

Investment implications

A severe U.S. recession would clearly impact global financial markets and asset allocation decisions. States excelling in agriculture and manufacturing may be hardest hit, impacting local economies and municipal coffers. A second wave of prohibitively expensive labor—so soon after the COVID-19 shock—could lead to meaningful investment in automation. What's less clear are the political ramifications, such as the global trend towards populism. Would political affiliations change? Would other countries condemn the U.S. action, or repeat it? Relationships with migrants' countries of origin would likely fray meaningfully, potentially increasing the influence of other global powers such as China.

Major changes in worker supply impact key economic variables

Excess labor supply vs. inflation



Sources: New York Life Investments Multi-Asset Solutions, U.S. Bureau of Labor Statistics (BLS), Macrobond, January 2024. Inflation is represented by the Consumer Price Index (CPI). The CPI is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Other Risks

By their very nature, black swans are unforeseen. We therefore acknowledge that there are countless risks we did not, or cannot, identify. Still, there are a few themes that bear watching—plenty of swans lurking in all areas of the lake.

Risk	Why not included
International conflict over seabed mining	The risk of conflict increases as resource scarcity rises, but we don't see this risk playing out in the near term. Seabed mining is currently highly regulated, and the high cost and technical complexity required make it challenging for many countries.
War breaks out between China and Taiwan	Given China's current strategic intentions surrounding Taiwan, this is a persistent risk. We covered this risk in last year's report.
The U.S. dollar loses its global reserve status	Replacing the dollar likely requires both geopolitical and technological shifts. We have written extensively about this in other forums.
An uncertain or contested 2024 election in the U.S. fuels global instability	Event risks such as elections bear close monitoring. We are tracking the election and its potential impacts separately in our Macro Pulse.
The U.S. suffers a liquidity crisis or falls into a deep recession	Unfortunately, we believe this risk is likely enough that it cannot be considered a black swan event. We've covered what deep and shallow recessions could feel like and what defenses the economy has this cycle against a deep recession in our quarterly outlooks.

Next steps for investors

The question for investors is not whether black swans could be a force for market change, but whether that force is relevant to their portfolio decisions today.

In some cases, the answer is an unambiguous yes. Agile portfolios with appropriate risk tolerance can take advantage of shifts—temporary or structural—brought on by market shocks. For these portfolios, monitoring dislocations can be an achievable and meaningful driver of excess investment return. Focused analysis can reduce the impact and severity of adverse events and enhance the potential for upside growth.

For other investors, day-to-day conversations about geopolitical risk are little more than a drain on time and resources, with no realizable benefit to their investment process or return generation.

For this reason, we encourage investors to focus on action—not distraction—when it comes to black swans. Consider reviewing our piece, "Geopolitical Risks and Portfolio Resiliency" for steps to incorporate disruptive events effectively and appropriately into your investment process.

To read the piece and other relevant content, visit our Global Markets page by clicking here.

Global Market Strategy at New York Life Investments

Our team of market strategists connects macroeconomics to asset allocation. Leveraging proprietary research alongside the breadth and depth of the New York Life Investments platform, we provide actionable insight into market-driving events, structural themes, and portfolio construction to empower investment decision-making.

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1. BRICS is an acronym for an association of five major emerging national economies: Brazil, Russia, India, China, and South Africa.

2. The EU-Mercosur trade deal is a proposed agreement aiming to reduce trade barriers between the European Union and the Mercosur countries (Brazil, Argentina, Uruguay, and Paraguay).

All investments are subject to market risk, including possible loss of principal. Diversification cannot assure a profit or protect against loss in a declining market.

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