

MACROCOSM

Some Thoughts on North Korea's Nukes

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Kim Jong-un is no madman. He wants a seat at the top table of mutual assured destruction.

Many clients have asked us to comment on North Korea's apparently successful test of an inter-continental ballistic missile, suggesting rapid attainment of a capability to strike the United States with a nuclear weapon. We are not in the business of pretending we have special inside insights on geopolitics, or of stirring people up with doomsday scenarios. We'll do what we always do – share our best ideas based only on our knowledge of history and feasible possibilities, and our belief that affairs are guided by the incentives facing the players in a game theory setting, and that markets react as uncertainties emerge and are resolved.

- Looking ahead across infinite time, nuclear weapons are a game of Russian roulette that we must eventually lose – it's just a question of when. And each year the number of bullets in the cylinder increases. The weapons improve and miniaturize over time, in line with their own version of [Moore's Law](#). As they proliferate, the risk of further proliferation increases in line with [Metcalf's Law](#).
- [Even a conventional thinker like Warren Buffett has to admit](#), "My

Update to strategic view

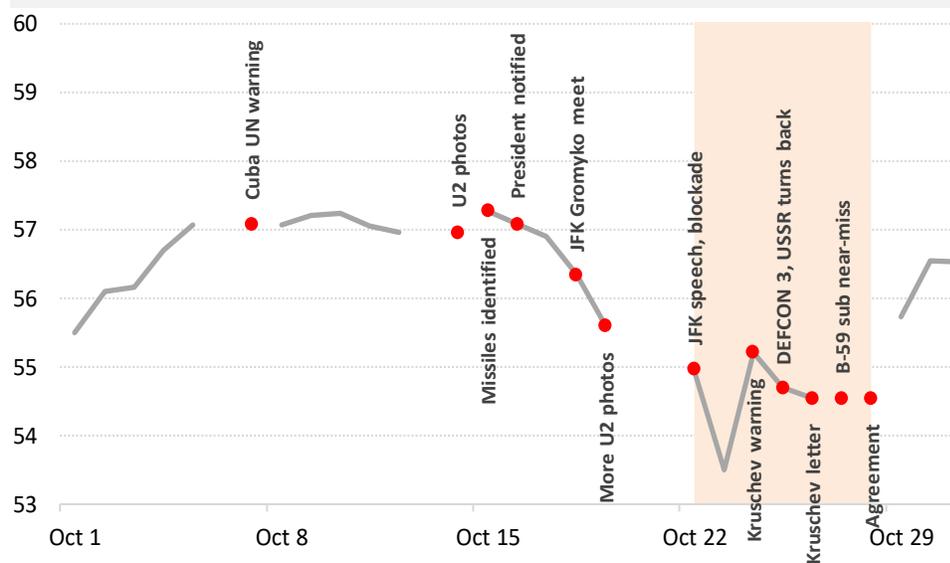
EMERGING MARKETS MACRO, ASIA MACRO, US MACRO:

While the acquisition of nuclear weapons capabilities by North Korea is not a positive, it is no different in kind from the threat the world has faced for 72 years. Last week when North Korea tested an ICBM, markets barely moved, and indeed long-term sovereign yields backed up in the opposite of a flight to safety. Historically markets have reacted only mildly to geopolitical threats such as the 1962 Cuban missile crisis, with the worst of the reaction in advance, and the bottom reached before the resolution, when the military response is first understood. We think the Kim regime is rationally interested in self-preservation, and seeks a place at the top table of mutual assured destruction. China has no power and little motive to denuclearize North Korea, an ally. If a crisis eventually emerges, we expect it will follow the usual pattern, leading to a buyable dip.

[\[Strategy dashboard\]](#)

S&P 500 weekday closing price during 1962 Cuban missile crisis

● Key events ■ Public phase



Source: Bloomberg, Wikipedia, TrendMacro calculations

biggest worry is nuclear...attack of some sort... That will happen some day in our future... It'll happen sometime when it isn't on our minds..."

- Buffett is talking about an attack "by a government or by a rogue." But the greatest risk is in the frail physical and human systems of command and control over the weapons. The public is generally unaware that [many accidents have already happened](#). That they have not led to detonations, and the resulting chance of mistaken retaliation, is miraculous.
- As to "a rogue" – that is, a terrorist – there is no evidence that nuclear weapons are in such hands.
- *The matter before us today is the possession of nuclear weapons by a state: the Democratic People's Republic of Korea. While it is a uniquely small, impoverished and autocratic state, North Korea is nevertheless a state, and indeed a quite stable one.*
- *Nuclear weapons have now been possessed by states for 72 years. These include states run by mass-murdering totalitarian regimes such as those of Joseph Stalin and Mao Zedong. Yet after Nagasaki, nuclear weapons have never been used. It must be the case that, for states, democratic and totalitarian alike, the game-theoretic solution of [mutual assured destruction](#) is quite effective.*
- Not only have there been no system accidents of command and control. There have been no political accidents, either.
- The popular imagination is fascinated by the idea that history is replete with political accidents that led to unnecessary wars. For example, most people seem to believe that World War One was a march of folly, with the guns of August, 1914, triggered by the assassination of an obscure archduke in the Baltics. That popular expression "march of folly" comes from the title of [a celebrated book](#) by historian Barbara Tuchman, and people who haven't read it assume it is about the accidents that caused Europe to sleep-walk into World War One. But the book doesn't even mention the matter. Tuchman's [The Guns of August](#) – which is entirely about World War one – shows that Germany was fully prepared for expansionary war, and only needed an excuse to start it.
- *Indeed, in the closest the world has ever come to nuclear war – the Cuban missile crisis of October 1962 – the game theory of mutual assured destruction prevailed, and the structure of command and control succeeded, barely, in preventing accidents.*
- In a little-known incident on Saturday, October 27, 1962, just one day before President John F. Kennedy and Soviet Premier Nikita Khrushchev negotiated an end to the crisis, Soviet submarine B-59 had been deeply submerged for many days near the border of the US blockade of Cuba, out of radio contact, running out of fuel, air conditioning off, and carbon dioxide scrubbers failing. When US Navy ships began detonating small depth-charges nearby to scare it off, the groggy captain wrongly assumed that war had begun and initiated the process to launch nuclear torpedoes. Ordinarily, launch could proceed once the captain had obtained the agreement of the "political officer" (there was one aboard every Soviet sub). But the commander of the flotilla, [Vasili Arkhipov](#), just happened to be aboard this particular submarine, so his vote was required as well –

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and he voted “no.” That single syllable probably prevented a nuclear war between the superpowers. But the system *did* work.

- *We go through all this because, as we consider how resilient markets seem to be in the face of geopolitical crises, it would seem that the bet is generally on the idea that incentives are well-aligned to avoid mutual assured destruction.* Or as Captain Mandrake said in [Dr. Strangelove](#), “let’s face it we... we don’t want to start a nuclear war unless we really have to, do we?”
- In the Cuban missile crisis, US stocks traded down about 4% between the time that the CIA interpreted photographs from U-2 spy planes as evidence of Soviet nuclear missiles in Cuba, and President Kennedy gave an address to the nation announcing the presence of the missiles and the imposition of a blockade. *So ruling out sheer coincidence, it would seem that the stock market had been trading on geopolitical information not generally available to the public* (please see the chart on the first page).
- *Kennedy’s speech was on Monday night, October 22. Stocks traded down another 3% the next day, and that marked the low for the incident. Not bad for what was almost a nuclear war.*
- As with the first Gulf War and the invasion of Iraq, the market downside all occurred in advance, and at the very outset of hostilities. Once things were underway, stocks recovered.
- The terror attacks of September 11, 2001, followed a similar pattern, in which markets declined until it was clear what the US military response would be.
- *The news last week of North Korea’s ICBM test got pretty much no market reaction at all. If anything, the most notable market event of last week was the back-up in sovereign yields world-wide, which would suggest the opposite of a flight to safety.*

For some future crisis with North Korea to follow the same historical pattern as other geopolitical crises, we would have to assume that it will follow the usual game-theoretic incentives against mutual assured destruction.

- *To start, this would seem to need to presume that supreme leader Kim Jong-un is rational.*
- He is surely evil – but that doesn’t mean he isn’t rational any more than his silly haircut does. He has maintained power for almost seven years, since the death of his father “the Dear Leader” Kim Jong-il in December 2011. He, in turn, maintained power for 17 years, and *his* father Kim Il-sung had maintained it for 45 years, the third-longest reign for a non-royal leader in the 20th century. The three of them have done it despite poverty and isolation, in a domestic political environment of toxic intrigue, and expertly playing the superpowers of the world against each other. *These guys know what they are doing.*
- *What are Kim Jong-un’s incentives?* We don’t pretend to really know, but we think it’s a good bet that maintaining the Kim dynasty’s power is seen as Job One. Squeezed between China and US-clients South Korea and Japan, it makes sense for Kim to want to avail himself of the protection of mutual assured

destruction. His small stockpile of nuclear weapons – some of which may be safely stowed away on submarines – already makes him untouchable. The ICBM capability locks it in, and adds to his prestige.

- North Korea is not Iran. It would seem to be seeking security, not *jihad*. Kim wants 47 virgins in *this* life, not the next one. A man who wants to stay alive and cling to power is a man we can deal with.
- Why does China tolerate this? It's an American political conceit of the moment to imagine that something like [Coase's Theorem](#) is in operation here, putting China in the least-cost position to denuclearize North Korea. But least-cost isn't necessarily cheap enough. That submarine with just a single North Korean nuke is as much a risk to China as it is to South Korea.
- And why do we presume that China wants to denuclearize its ally North Korea in the first place? The US doesn't want to denuclearize *its* allies – the UK, France and Israel. China may like having a nuclear ally on its border, having lived for years with three non-allied neighbors – Russia, Pakistan and India.

All in all, we tend to conclude that the threat of North Korea's nuclear weapons isn't different in kind than the threat we've faced successfully for 72 years.

- The good news is that Kim Jong-un is rational, and probably has rational aims for North Korea's nuclear weapons.
- Those aims are to make North Korea a full player in the game of mutual assured destruction, in order to assure its security and that of the Kim regime.
- We don't rule out a crisis at some point. We doubt the US would be stupid enough to attack North Korea in an attempt to decapitate its nuclear capability and overthrow the Kim regime. But North Korea might precipitate a crisis, using some kind of nuclear demonstration or threat to drive explicit security guarantees.
- Should such a day arrive, doubtless markets will have to build in risk premia as the threat emerges and takes shape.
- If the crisis takes the form of a nuclear attack by North Korea, then all bets are off. Once a mushroom cloud appears on the horizon, history will change and will never change back. But based on history as we know it, that's not how the crisis will take shape. It will be a threat, not an event. It will be designed to catalyze a political outcome, and that outcome will likely emerge quickly.
- Obviously, if this kind of thing happens, we'll wait and see – and we reserve the right to make whatever investment call we think is appropriate under the circumstances. But if we had to lock it in now, we'd say "buy the dip." Hey, if we're wrong, the trade will never settle anyway.

Bottom line

While the acquisition of nuclear weapons capabilities by North Korea is not a positive, it is no different in kind from the threat the world has faced for

72 years. Last week when North Korea tested an ICBM, markets barely moved, and indeed long-term sovereign yields backed up in the opposite of a flight to safety. Historically, markets have reacted only mildly to geopolitical threats such as the 1962 Cuban missile crisis, with the worst of the reaction in advance, and the bottom reached before the resolution, when the military response is first understood. We think the Kim regime is rationally interested in self-preservation, and seeks a place at the top table of mutual assured destruction. China has no power and little motive to denuclearize North Korea, an ally. If a crisis eventually emerges, we expect it will follow the usual pattern, leading to a buyable dip. ▶