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The Carlyle Compass

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Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. This week's edition features guest author Jeff Currie, Chief Strategy Officer of Energy Pathways at Carlyle.

A Structural Capital Rotation is Underway

Security is now clearly paramount to any investment thesis. As the US retreats from international cooperation, the world is getting more dangerous and more expensive. Trade routes are attacked, supply chains are weaponized, and wars of conquest are becoming more common and closer to home. At the same time, capital costs are rising, liquidity is draining, and taxes (via tariffs) are rising. In response, the dollar has weakened, commodities rallied and asset heavy sectors, such as defense, have benefited tremendously. We believe this is just the beginning of a much larger capital rotation out of the asset light sectors and into asset heavy sectors that are the backbone of global supply chains and slanted towards Europe.

As we highlighted in [The New Joule Order](#), the global framework that was set in place at the end of WWII has been under increasing pressure for decades and is now breaking down. If the dollar (bonds) was the heart of the old-world order and oil (barrels) was the blood in the veins, then the US military is the muscle (bombs). These three orders—bonds, bombs and barrels—were the legs supporting the global framework for four generations and all three are under increasing pressure, particularly in the past month. The dollar is now the weakest since 2022 and oil has rallied back to \$75/bbl. The risks of oil hitting \$100/bbl hasn't been this high since the Russian invasion of Ukraine.

Geopolitical Tensions Have Rarely Been Higher

The situation between Iran and Israel has now entered a new phase given that the IAEA declared Iran was not complying with its non-proliferation obligations for the first time in almost 20 years. This revelation is what prompted Israel's attack on Iran last Friday and their following declaration, backed up by the US, that they wouldn't stop until these proliferation risks had been diminished. As this is now existential to the current Iranian leadership, the risks of them doing something extreme in retaliation have also increased significantly.

The key question is whether the Iranians attack critical energy infrastructure in the region or block the Straits of Hormuz. While such disruptions are not in our base cases, the probability of these events has rarely been higher. The main reason for this is Iran knows from the experiences in 2022 that high oil prices and inflationary pressures in the US can create substantial domestic pressures on the US president. This comes at a time when the events in Los Angeles have made the US particularly vulnerable to such domestic pressures. In other words, all these events are interconnected which is being reflected in higher gold prices that are flirting with new highs.

Europe Is a Big Benefactor

At first it may seem strange that the dollar is weakening and the Euro is rallying given Europe is the region most exposed and vulnerable to this retreat and needs to invest immediately into defense. This strength in Europe is being driven by the excess fiscal and physical industrial capacity that can be immediately tapped with release of the German debt brake. For the past decade, European capital has flooded into the US, supporting US tech investment and enabling the US deficit. Halting, if not reversing, that flow is the most likely way for Europe to finance its own strategic needs.

In addition, Europe is in the strongest global position in terms of debt/GDP, income and wealth equality, and consumer surplus. Europe's bond markets are signalling a level of confidence in its domestic affairs that was historically only reserved for America, with its exorbitant privilege. Investing in European defense, infrastructure and energy is a big theme and is already likely to rival U.S. AI investment, which has totaled around \$500 billion of capex since November 2022. In contrast, Europe has already announced more than €1.5 trillion in new investments into strategic defense-related sectors.

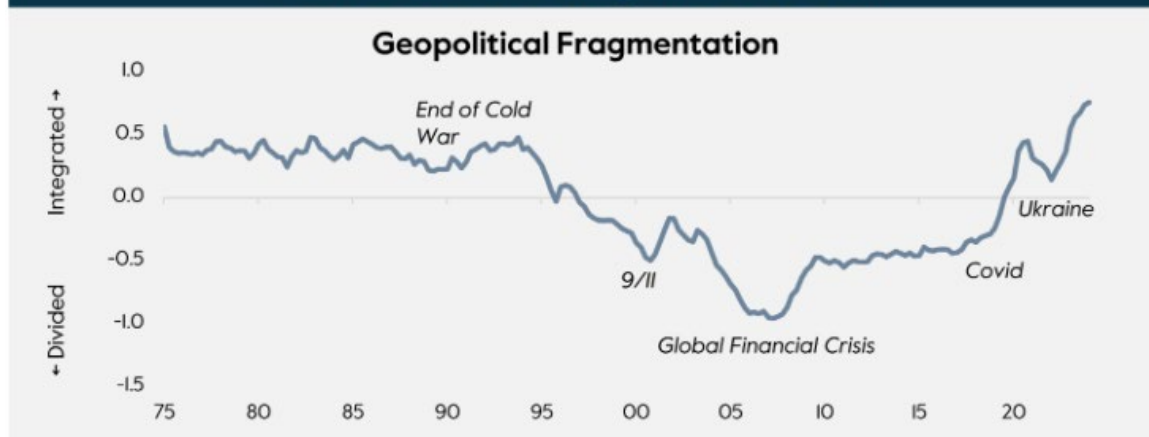
The US maintained a dominant military whilst simultaneously deindustrializing. Europe, by contrast, retained its industrial base, and yet put relatively little emphasis on defense. Today's geopolitical shift is driving an urgent expansion in defense manufacturing, infrastructure and energy, all of which are likely to result in a capital rotation back to asset heavy. This capital rotation process towards asset heavy Europe is already underway—since ChatGPT was announced in November 2022 the DAX has outperformed the US by 20%.

Geopolitical Fragmentation and Asset Rotation

With the global order rapidly reshaping, this current capital rotation is likely the beginning of a much larger sustainable trend in capital allocation. This is not a new phenomenon. Rotations in the allocation of capital between asset light and asset heavy, and eventually between American and European, companies have occurred during these shifts—Dotcom to BRICS (2002-2004), BRICS to US Tech (2014-2015). We believe we are in one of these rotations towards Europe given the valuations discounts in Europe and the region's stronger fundamental backdrop and fiscal capacity for defense.

Global Fragmentation Drives Asset Rotations

The world is more politically, economically and financially divided than during the Cold War



Macro political and economic watersheds mark asset rotations



Source: Carlyle Analysis; Jesús Fernández-Villaverde, Tomohide Mineyama, Dongho Song, 2024, Are We Fragmented Yet? Goldman Sachs. There is no guarantee that any projections will be achieved or that any historical trends will continue. Certain statements made on this slide are opinions and beliefs of Carlyle and should not be relied upon as a promise or representation as to past or future performance.

Desperation Is the Mother of Innovation

Security and fear drive innovation, and strategic industries have historically been the largest benefactors from defense spending. Just in the modern era, motorways, the internet, mobile telephony, nuclear energy and even solar panels have all been driven by military budgets. Israel and South Korea lead the world in R&D spending as a share of GDP—and also have some of the most dangerous borders.

Europe dominated telecommunications in the 1990s and 2000s because of Cold War-era investments in telecommunications. Finland and South Korea recognized the need for mobile communications along their highly vulnerable borders, which dovetailed with consumer and industrial benefits. Thus, Nokia and Samsung became national telecommunications champions with GSM and LTE. As security concerns faded over the 1990s, so did R&D and so eventually did Nokia. Europe has the ability—but for the past 34 years, it has simply lacked motivation.

Private capital commands a “complexity” premium. Venture capital and private equity evolved in the US in part as a solution to complex investment problems around defense spending. There was a need for patient capital that could invest not just money but also expertise and networks. This was especially suited to firms in cutting-edge—and thus high risk/high reward—strategic industries. Both the American military and private capital were thus midwives to Silicon Valley, the internet and AI.

The European Security Renaissance Is Not Optional

For Europe this is existential. Long standing trends have brought Europe to this moment, not particular presidents in foreign capitals. It is hard to overstate the security dilemma this now poses for Europe and the growth implications for the European economy and strategic investing. It is not a coincidence that Poland is the best performing economy in Europe right now and that Ukraine has developed extremely effective and complex supply chains. As America pulls back, Russia pushes forward; Europe is waking up to these realities.

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