Confluence INVESTMENT MANAGEMENT

Bi-Weekly Geopolitical Report

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Parsing the World's New Geopolitical Blocs

For more than a decade, we at Confluence have been tracking and writing about the waning commitment of the U.S. to its role as global hegemon. We've shown how U.S. retrenchment and protectionism have helped erode globalization. Factors like deregulation, falling transportation costs, improved technology, and easing geopolitical tensions following the end of the Cold War may have promoted political and economic integration for decades. Now, however, governments across the globe are erecting barriers to trade, investment, and migration, leaving authoritarian strongmen emboldened to assert themselves. The latest example of that has been Russian President Putin's invasion of Ukraine.

Amid these developments, we've argued the world will fracture into at least two main political and economic blocs: a U.S.-led bloc consisting mostly of liberal democracies and a China-led bloc of mostly authoritarian states. This report discusses which nations are likely to join each bloc, which will merely lean toward one bloc or the other, and which may try to stay neutral. Based on our predicted makeup of each bloc, we describe their differing political, economic, and financial characteristics. As always, the analysis also includes ramifications for investors.

What Will Determine Bloc Membership?
Our analysis identified 13 different geopolitical, economic, and cultural criteria that will likely affect how these countries' leaders will decide which bloc to ally with. Most of our criteria reflect the formal relationships of each country as they stand today, such as their membership in mutual defense treaties like the North Atlantic Treaty Organization (NATO) or the Shanghai Cooperation Organization (CSO), intelligence-sharing arrangements like the "Five Eyes" group, and free-trade deals such as the U.S.-Mexico-Canada (USMCA) agreement or the European Union (EU). We chose these criteria based on the idea that such deep, long-lasting relationships offer a certain comfort level between countries that will be hard to abandon.

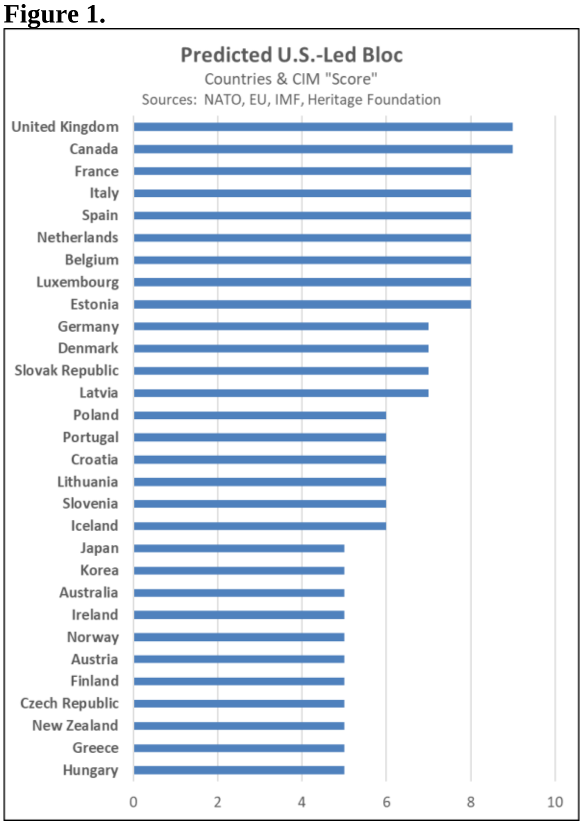
Other criteria that we chose reflect a country's own political, cultural, and economic idiosyncrasies, for example, their score in the Heritage Foundation Index of Economic Freedom or whether they are considered "advanced" by the International Monetary Fund (IMF). Our thesis is that countries scoring similarly on these criteria will have a stronger affinity for each other. Finally, since we think economic and trade interests will be a key consideration for aligning with a bloc, we also include criteria that address a country's relative economic dependence on exports to the U.S. versus exports to China.

For each of our criteria, we systematically applied points to almost 200 different countries for which we had data. In the tables and figures below, countries with higher positive scores are assumed to align with the U.S. bloc. Countries with big negative scores are assumed to align with China. We assumed the rest would be indifferent or lean toward one or the other bloc. A few countries, such as Cuba and North Korea, had such little data available that we could not score them, but we think they would join the China-led bloc. We also excluded a number of very small countries, like some Caribbean island-states, for ease of calculation and data presentation. We suspect those countries would lean toward the U.S. bloc.

Our Prediction of Bloc Membership

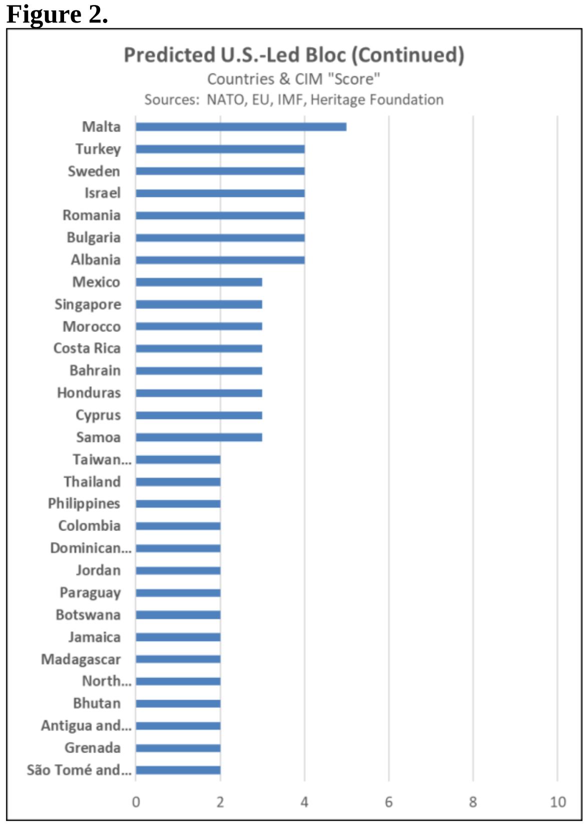
Based on the methodology described above, we identified 60 countries that scored +2 or more, which we considered a sign that they would likely align with the U.S.-led bloc (see Figures 1 and 2).

Figure 1.



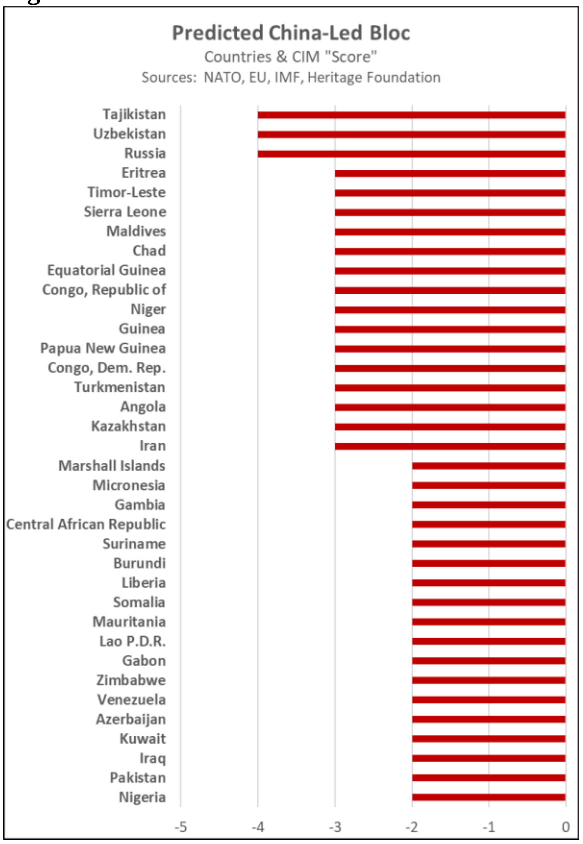
We think this prediction of the U.S. bloc makes intuitive sense. At 60 members, it accounts for almost one-third of all countries, consistent with the U.S.'s long tenure as a global hegemon and its history of actively building military and economic partnerships. The very high scores for the U.K. and Canada also make sense as they are often seen as the U.S.'s closest allies. The relatively low scores for countries like Japan and Australia reflect their location in the Asia-Pacific region and their high dependence on trade with China. Nevertheless, those countries are likely to stay solidly in the U.S.-led bloc.

Figure 2.



In contrast to the U.S. bloc, our analysis identified only 37 countries that scored -2 or less, which we considered a sign that they would join the Chinese bloc. As shown in Figure 3 on the next page, most of the countries we put in the China-led bloc are relatively poor, less developed, and less democratic. Russia and several other former Soviet republics are among the most likely to join the Chinese bloc, while most of the other members are big commodity exporters to China.

Figure 3.



Perhaps the most interesting groups are those that our analysis suggests will merely lean to one side or the other or remain neutral. Of the nations that don't clearly fall into either the U.S. bloc or the China bloc, our scoring suggests about one-third would lean toward China (see Figure 4 on next page). That's mostly because of these countries' lower scores in the Index of Economic Freedom. We assume that government leaders in these less-free states will gravitate toward the authoritarian political and economic system of China. Among the most notable countries in this group, India leans toward the Chinese bloc because of its participation in the SCO, while Saudi Arabia and South Africa also lean toward China because they are so dependent on exports to China.

Of the countries that don't fall cleanly into the U.S. or Chinese blocs, we score another one-third or so as leaning toward the U.S. (see Figure 5, next page). Most of these countries lean toward the U.S. because they have a similarly high level of economic freedom and/or they rely more on exports to the U.S. than exports to China. The key countries in this group include Switzerland, Chile, Peru, several Latin American countries, and several Caribbean islands.

The remaining one-third or so of the unaligned states would appear to be truly neutral or indifferent (see Figure 6, page 5). Most of these countries are smaller, less developed states in Africa, Latin America, the Caribbean, or the South Pacific. The only large economies in this group are Indonesia and the United Arab Emirates, both of which rely heavily on exports to China but are seeing those exports grow relatively slowly. Even though most of these countries have only small economies, the U.S. and China may try hard to influence them and bring them into their blocs because of their geographic position. A good example is the Solomon Islands, which has recently signed a security deal allowing the Chinese navy to dock there. The deal also lets China send troops to the Solomons in certain instances of unrest. Importantly, the Solomons sit just 1,300 miles northeast of U.S.-allied Australia, so the U.S. and Australia have been working feverishly to reverse the decision.

Comparing the Blocs

If our predictions are at all accurate, the U.S.-led bloc would look vastly different than the China-led bloc. For example, the U.S. bloc would have far fewer people, mostly because it would exclude such populous countries as China itself and China-leaning India (see Figure 7, page 6). Based on demographic data from 2016 to 2021, the U.S. bloc's population is also only growing about 0.6% per year, versus the Chinese bloc's growth rate of 1.0%.

On the other hand, the U.S. bloc would account for almost two-thirds of global GDP, owing to the big, highly productive countries in the group. The U.S. bloc would also be much richer. Adjusted for currency purchasing powers, the U.S. bloc's GDP per capita in 2021 stood at more than $40,000 per year versus only $15,000 in the China bloc (see figures 8 and 9, page 6).

Figure 4.

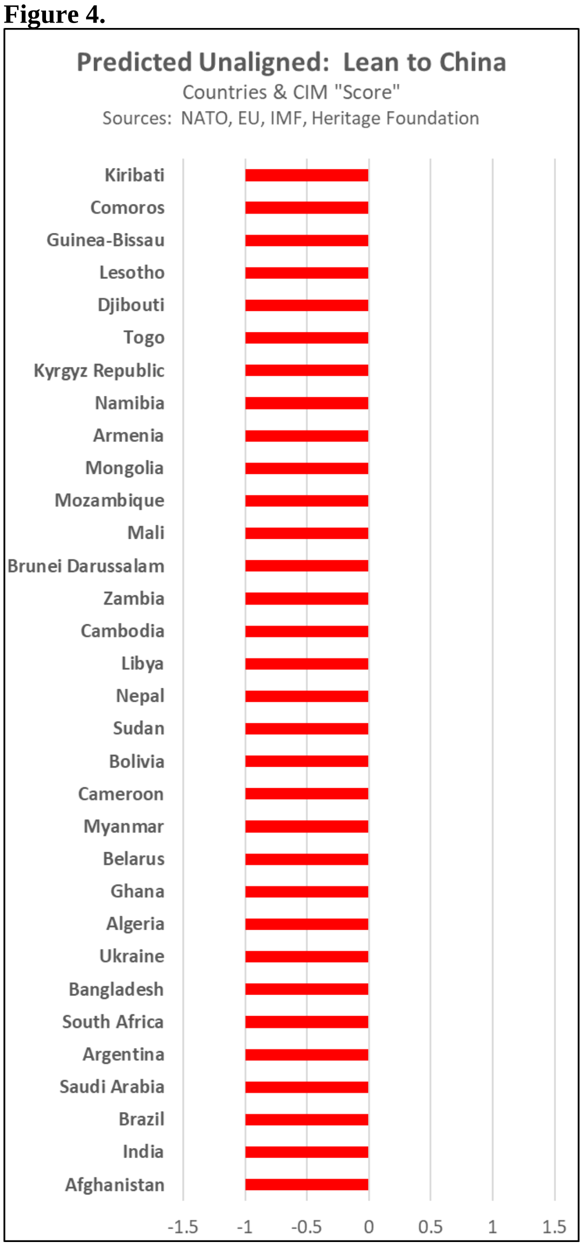
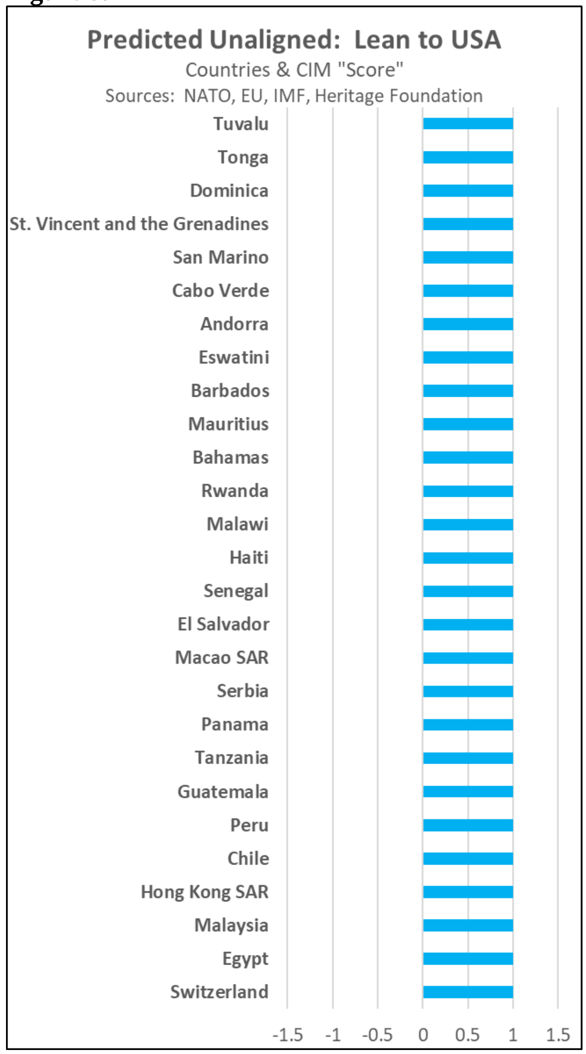


Figure 5.



As one might expect, the rich countries allied with the U.S. have long been a target for China and other poor countries seeking to develop through export promotion. As shown in Figure 10 on page 7, China relied on the U.S. bloc for more than half its merchandise trade from 2015 through 2019 (the last full year before the distorting impact of the coronavirus pandemic). In fact, 59.8% of China's goods exports went to the U.S. bloc during that period. Because China relies heavily on technologically advanced capital goods from U.S.-allied countries like Germany, and because it relies on basic materials from U.S.-allied countries like Australia, 65.6% of China's imports came from the U.S. bloc in 2015-2019.

Figure 6.

Interestingly, the U.S. also relies heavily on its own bloc for its international trade. Specializing in the export of both commodities and complex, expensive capital goods like airliners, the U.S. sends 72.3% of its goods exports to other countries in its own bloc and only 9.2% to China and the rest of that bloc. To solidify its position as global hegemon, the U.S. has traditionally also run trade deficits with both blocs. Approximately 62.5% of U.S. goods imports come from other countries in the U.S.-led bloc, while 22.8% come from China and the rest of its bloc (see Figure 11 on page 7).

It's clear that the U.S. bloc is the holy grail for exporters in terms of market size. A similar thing could be said for foreign investment, although the relevant data is much harder to come by. A fracturing of the global economy that limits trade and investment between blocs would therefore be especially painful for China and its allies. At the same time, new restrictions on trade and investment would also be painful for the U.S. bloc, where firms have long sought to take advantage of the Chinese bloc's relatively faster economic growth.

A Word About Commodity Markets

Our analysis also highlights how commodity supply chains could be disrupted as the world fractures into blocs. The global market for crude oil is a key example. Based on data for specific countries in the *BP Statistical Review of World Energy*, the U.S. bloc has a voracious appetite for energy, accounting for 52.6% of global consumption in 2020 but producing just 32.7% of output (see Figure 12, page 7). The China bloc only consumed about half as much as the U.S. bloc, but it produced more than the entire U.S. bloc, in large part because it includes oil giants like Russia, Iraq, Iran, and China itself. In Figure 12, the heavy black bars show a similar story for proved reserves. The U.S. bloc only held 15.1% of the world's crude reserves in 2020, mostly in Canada and the U.S, while the China bloc held more than half of all reserves. Including China-leaning countries, the nations affiliated with China hold about three-fourths of the world's oil reserves.

Figure 7.

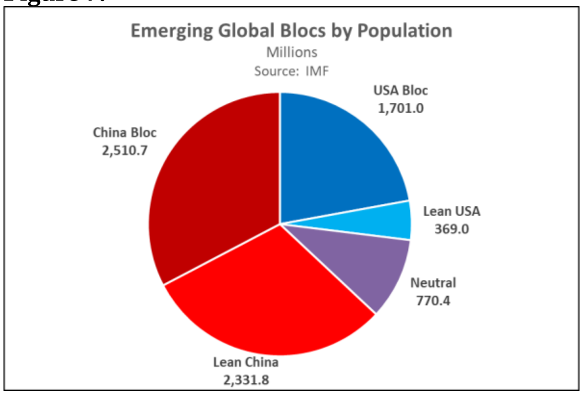


Figure 8.

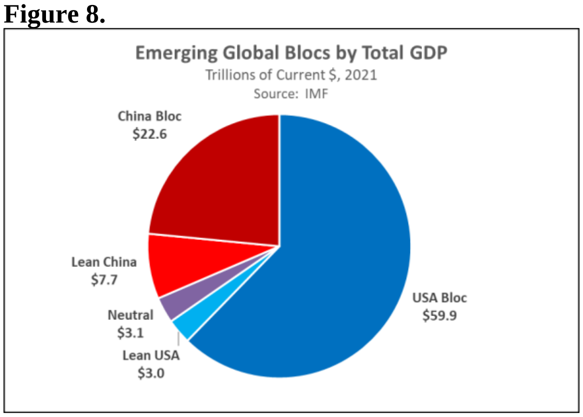
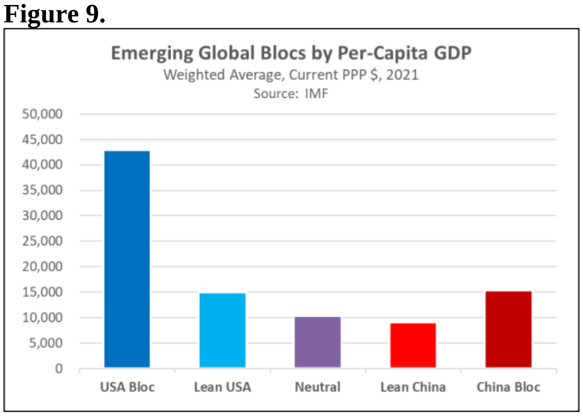


Figure 9.



Global natural gas supplies show a similar pattern. The U.S.-led bloc alone accounts for 49.9% of world consumption but only 40.0% of production. It also holds relatively little of the world's gas reserves. In contrast, the rival China bloc produces almost as much as the U.S. bloc but consumes far less, leaving a big surplus for export. At the same time, the China-led bloc holds the lion's share of world gas reserves.

Because of this disparity, with the affluent U.S. bloc using most global commodities, while the China bloc holds most of the supply, another potential point of contention as the world fractures is that the U.S. bloc could find itself in heated competition for the Chinese bloc's natural resources. The Chinese bloc will be in a position to use its resources as leverage in geopolitical crises or in trade and investment negotiations. One example of this is how Russia recently throttled back its gas exports to Europe in order to forestall greater NATO support in the defense of Ukraine.

Ramifications

To reiterate, this analysis is not meant to be a hard-and-fast prediction of how deglobalization will proceed or how the world will necessarily look in the coming decade or two. It's merely an attempt to understand the general contours of the evolving world and the implications of those contours. Changing political, economic, social, and financial circumstances may mean that the evolving blocs will look quite different than laid out here. Because of French President Macron's push for Europe to build its own "strategic autonomy," for example, the European Union or the Eurozone could potentially break into its own bloc. All the same, we think this analysis provides a useful first cut at understanding how the world is fracturing. Compared with the golden age of globalization over the last three decades, the evolving blocs of the future will have many more trade, investment, and migration barriers between them. The best concrete examples of these barriers include the various Trump administration import tariffs (many sustained by President Biden) and new [restrictions on U.S. investors wanting to hold Chinese stocks](). Following the Western countries' [freezing of Russian foreign reserves]() after Russia's invasion of Ukraine, we also expect to see countries in the Chinese bloc pulling their financial investments out of the U.S. grouping.

Figure 10.

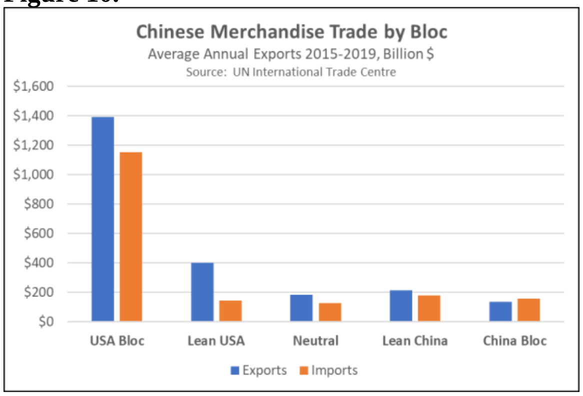
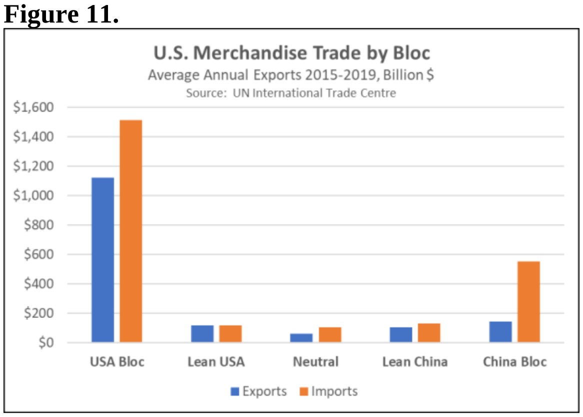


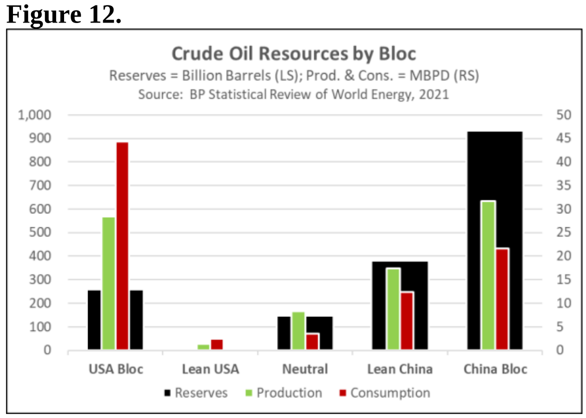
Figure 11.



For U.S. companies and investors, we think a key ramification of this analysis is that any likely U.S.-led bloc would be dominated by rich, democratic countries that respect private property rights and free markets. That may sound like the same fault lines that divided countries during the Cold War. However, [as Tufts University professor Michael Beckley wrote in *Foreign Affairs* recently](), the most important characteristic of the U.S. bloc will be democracy, with deviations from free-market capitalism tolerated as necessary (e.g., protectionist trade barriers, industrial policies to build up new industries, etc.). During the Cold War, the priority was free-market capitalism, with deviations from democracy being frequently tolerated (e.g., alliances with dictators, etc.).

At one level, U.S. firms and investors should be encouraged that they're likely to retain trade and investment opportunities with the world's richest countries. U.S. investors may lose access to many of the countries that have long been seen as offering the fastest economic growth, but that may not be as big of a loss as some might think. For instance, China has often failed to meet its market-opening commitments. Some Western firms have found the Chinese market to be lucrative, but others have found actual market access to be disappointing, even as China took control of its technology "by hook or by crook." On top of that, China and many of its affiliated countries are also now facing steep slowdowns in population growth and economic advancement. In sum, we think a new U.S.-led bloc as described here might still offer good opportunities for stock investors.

Figure 12.



The global commodity markets could see the most disruptions from the evolving bloc system. The concentration of key resources in the China-led bloc could translate into supply shortages within the U.S.-led bloc, especially if the Chinese-affiliated countries deliberately withhold access in order to create geopolitical or economic leverage. At the same time, the Western countries' move to freeze Russian foreign reserves in response to the Russia-Ukraine war will probably encourage many countries in the China-led bloc, or those leaning in that direction, to shift some of their reserves to non-Western currencies and commodities. That could eventually put downward pressure on the dollar and other Western currencies, even as it drives commodity prices higher. In sum, the evolving bloc system probably adds to the extraordinarily bullish scenario we see for commodities in the coming years.

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Confluence Investment Management LLC

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