

May 15, 2023

## Opportunities and Risks in a Tripolar Nuclear World

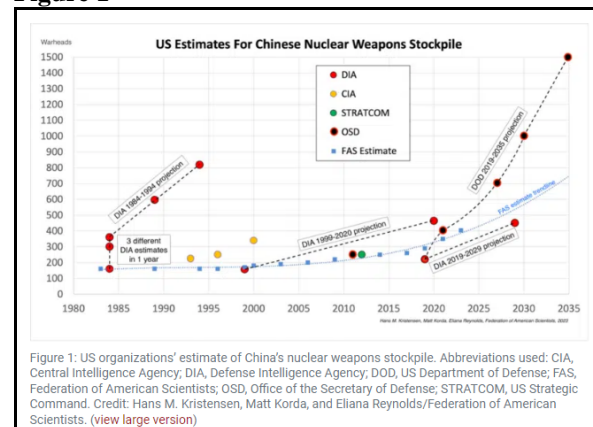
Some 30 years into China’s development boom, it’s no longer controversial to say that tomorrow’s global investment environment will be shaped by Beijing’s effort to displace the United States as the world’s dominant country. China remains focused on building its various sources of power, whether they be political, economic, technological, or military. We have examined those sources of power and their implications for investors in various publications. This report dives deeper into one aspect of China’s growing military power: its new effort to expand its arsenal of strategic nuclear weapons and the means to deliver them against the U.S.

China’s nuclear buildup will result in a scarier, less stable world. Many investors and investment managers will be tempted to close their eyes to this uncomfortable risk. Here at Confluence, we think it’s better to understand this important trend and incorporate the resulting opportunities and risks into our investment strategies. It may seem strange to mention *opportunities* in relation to a potential nuclear arms race, but history shows that riches are often made during times of war or international tension. Although nuclear war is unthinkable and unwinnable, preparation for a conflict will require investment and economic allocation. Portfolios should take this spending into account. In discussing the investment implications of China’s nuclear buildup, we therefore identify both the opportunities and the risks that may arise.

## The New Chinese Buildup

Ever since China developed its first atomic bomb in 1964 and its first hydrogen bomb in 1967, the country has publicly maintained a “no first use” policy regarding its nuclear weapons. [China has also maintained a “minimum deterrence” policy, under which it kept its arsenal just big enough and survivable enough to present a credible threat that it could retaliate with a nuclear strike against any country that tried to attack it.](#) Since the 1980s, Western analysts have generally estimated that China’s nuclear arsenal consisted of only a few hundred warheads, even as those same analysts sometimes forecasted big increases in the future (see Figure 1). The U.S. Department of Defense, the Federation of American Scientists (FAS), and the Bulletin of the Atomic Scientists (BAS) all estimate that China’s nuclear arsenal currently consists of about 400 weapons.

**Figure 1**



(Source: *Bulletin of the Atomic Scientists*)

Western analysts believe the Chinese have a somewhat larger number of launchers for their weapons, including stationary in-ground missile silos, road- and rail-mobile

carriers, submarines, and bombers. These systems can launch a wide variety of short, medium, and long-range missiles, including inter-continental ballistic missiles (ICBMs) that can carry multiple independently targeted reentry vehicles (MIRVs) and can strike the U.S. from Chinese territory (see Figures 2 and 3). [The Chinese are also developing hypersonic missiles designed to get past U.S. missile defenses.](#) The Defense Department, FAS, and BAS believe China now has about 475 nuclear launchers.

**Figure 2**

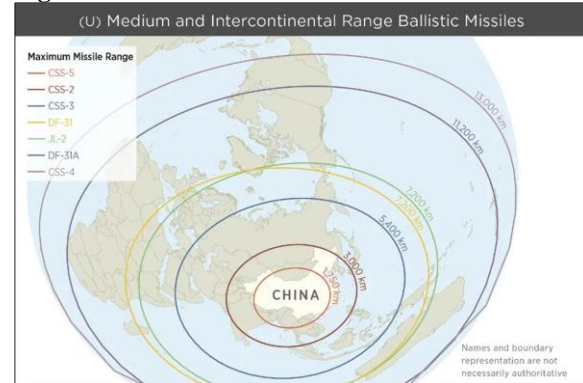


*Chinese Jin-class missile submarine.*  
(Source: USNI News)

In mid-2021, Western analysts began to see signs that Beijing was planning a dramatic expansion of its nuclear force. Satellite imagery and other intelligence showed that China is now building several new solid-fuel ICBM silo fields in the isolated western parts of the country. The Department of Defense estimates that at least 300 silos are under construction. [When completed, these silos will put China far ahead of the U.S. in ground-based ICBM launchers.](#) If each of the 300 silos eventually houses a MIRVed missile with 10 warheads, they alone would have almost twice the 1,550 deployed nuclear weapons that the U.S. currently has in its silos, bomber aircraft, and submarines. [The Defense Department forecasts that China will have more nuclear warheads than the U.S. deploys by 2035.](#) Considering China's entire "triad" of ground-, air-, and sea-launched missiles, some analysts fear

China could ultimately plan to deploy several thousand nuclear weapons.

**Figure 3**



(Source: U.S. Department of Defense)

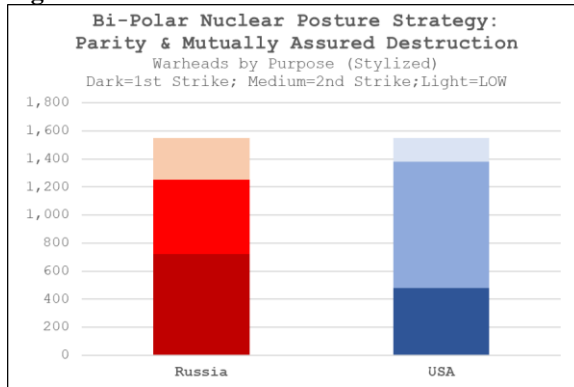
### The Cold War's Stable Bipolar World

While there are already many friction points between the U.S. and China, we believe Beijing's program to expand its nuclear arsenal will be even more destabilizing. It would be impossible to explain all the critical aspects of nuclear strategy in this report, but to understand the implications of China's nuclear buildup, it may help to describe the relatively stable "bipolar" nuclear standoff between the U.S. and the Soviet Union during the Cold War.

During the decades-long standoff between the U.S. and the Soviet Union, nuclear stability was built on *parity* (similar numbers of nuclear weapons on each side) and *mutually assured destruction* (MAD, or the certainty that if one side launched a nuclear attack on the other, it would itself be destroyed by a retaliatory strike). Cold War arms control treaties, embodied today by the New START agreement, have left the U.S. and Russia with parity at a maximum of 1,550 deployed nuclear weapons each. The U.S. and Russian arsenals are also still designed for MAD. Some of each side's arsenal is set to "launch on warning" (LOW), i.e., ready to be launched as soon as incoming missiles are detected, but before they hit. A large part of each arsenal is

designated for a “first strike” against the adversary. A final portion is designed to survive a first strike and be available for a “second strike” to retaliate (see Figure 4).

Figure 4



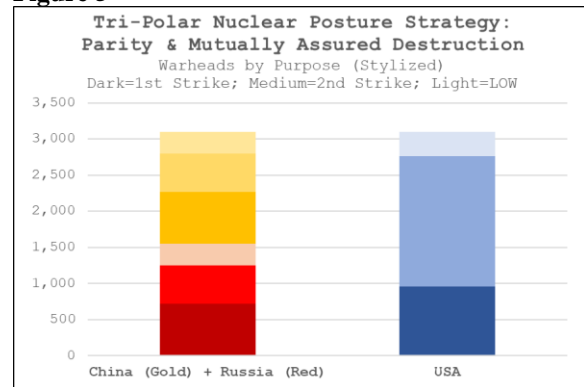
To understand the relative stability of the bipolar Cold War world, it may be useful to compare it to a stable two-body system in interplanetary physics. When any two celestial bodies are within each other’s gravitational pull, scientists can readily predict the motion of the two bodies in space so long as they know each body’s initial position, mass, and velocity. Armed with that data, for example, scientists could predict the relative positions, at any given time, of two asteroids, planets, or stars that are orbiting around each other. As we show in the next section, China’s evolution as the world’s third major nuclear power creates a much more unpredictable situation than a binary planet or star system.

**Today’s Unstable Tripolar World**

As China expands its nuclear arsenal to match or surpass that of the U.S., the new tripolar nuclear world will be much less amenable to parity and MAD. The problem is that the U.S., China, and Russia will now all need to deter and potentially defend against *two* major nuclear powers, which may or may not be cooperating. If one nation, such as the U.S., tries to keep parity with *both* of its major adversaries, it would

end up with more weapons than either individual adversary (see Figure 5). Not only would that violate parity, but it also might tempt the U.S. into thinking it could attack one of the adversaries, such as China, without being destroyed itself. In this situation, both China and Russia might fear the prospect of being a “poor second” with insufficient forces to survive a U.S. attack. Until they could catch up with the U.S. arsenal, they would each have an incentive to launch a nuclear first strike in time of crisis.

Figure 5



Since China is drawing Russia closer into its evolving geopolitical camp, the two nations might also cooperate against the U.S. For example, Russia might agree to attack the U.S. in retaliation for its attack on China. Adding to the uncertainty, it’s important to remember that China-Russia tensions were very high through much of the Cold War. Their relationship was tainted by ideological differences and territorial disputes that brought them to the brink of war in 1969. Adding to that, Russian leaders are probably chafing at their new junior position in the China-led bloc. Russia therefore might take advantage of the situation to attack both China and the U.S. once they have used up their arsenals and are reeling from nuclear exchanges.

Finally, there are implications for countries allied with the three major nuclear powers, especially smaller nuclear states and those states that could probably develop nuclear weapons quickly if they decided to do so. Any allied nation that is protected by a major power's "extended deterrence" or "nuclear umbrella" (such as Japan, Australia, or South Korea) will look warily at the growing precariousness of their patron. If they begin to question their patron's ability and will to defend them, they might switch their allegiance to one of the other major nuclear powers. Or, they might be tempted to develop or increase their own nuclear arsenal, expanding the scope for an accidental or deliberate nuclear conflict. [According to opinion polls, voters in South Korea have already swung toward supporting the development of an indigenous nuclear force.](#) Of course, this risk could prompt the U.S. to expand its nuclear force even further to reassure its allies.

In this new, evolving tripolar world, each major nuclear power has an incentive to rapidly grow its strategic nuclear arsenal and attack its adversary first. Each also has an incentive to cooperate with another major nuclear power or take advantage of any conflict between the other two. Extending the previous section's comparison with interplanetary physics, this new world can be likened to a "three-body problem." When three celestial bodies are in proximity with each other, scientists have discovered that there is no way to predict their motions or their future positions in space, even if you know their respective initial positions, masses, and velocities. Scientists therefore refer to the three-body system as "chaotic." Indeed, this new nuclear world is likely to be much more chaotic than the relatively stable, highly globalized world of the three decades after the Cold War. If this newly

chaotic environment prompts further nuclear proliferation, the world would become even more unstable.

### **Analysis and Investment Implications**

To understand all the implications of China's new nuclear buildup, note that the country faces no significant threat to its sovereignty. Its northern border with Russia is peaceful, and the border at the edge of its western deserts faces the weak, relatively friendly states of Central Asia. Its mountainous borders to the southwest and south are generally impenetrable, and even though China has territorial disputes with India in the Himalayas, it already has a sizable nuclear advantage over that country. China's remaining frontiers consist of its southeastern and eastern coasts, which are well defended by its world-leading navy and conventional missile force. China can therefore have only one motive for the rapid buildup of its nuclear force: to boost its global influence and power. With growing confidence that it will be listened to, China will likely become even more assertive on the world stage, exacerbating tensions with the West and furthering the global fracturing that is already in play.

A country's nuclear deterrent is all about fear. The purpose of a nuclear force is 1) to signal that a potential adversary would face unacceptable costs if it attacked or failed to submit to the nuclear power's vital interests, and 2) to scare potential adversaries into backing down and submitting to the nuclear power's aims (for China, the key aim is to reunify Taiwan with the mainland, by force if necessary). In this sense, a nuclear deterrent force is "used" every single day by shaping the behavior of potential adversaries and reassuring allies. [The U.S. explicitly sends such signals when it deploys B-52 bombers or nuclear missile submarines near rogue states like Russia or North Korea.](#)

Russia has explicitly engaged in such nuclear saber-rattling against the West during its invasion of Ukraine.

Huge numbers of nuclear weapons and the growing incentive to use them could result in nuclear war and fatal damage to the countries involved or even to global civilization. More immediately, as discussed above, the new tripolar nuclear world will likely be marked by a prolonged, large-scale nuclear arms race. Since the New START treaty is already weakened by accusations that Russia has violated it, the agreement might finally be abandoned, freeing the U.S. and Russia to dramatically expand their arsenals along with China. As each side tries to keep up with the other two powers, parity will never be reached, and MAD will be questioned. When coupled with potential innovations such as adding artificial intelligence to strategic operations, that will create the incentive to increase nuclear and conventional forces even further.

For investors, the overriding opportunity created by the new tripolar nuclear world is simply a further spiraling of tensions between the U.S. and China. Continued tensions will likely prompt a further broad arms race covering both conventional and nuclear forces, so we think defense industry firms will benefit from higher military

budgets, stronger margins, and more stable revenue streams. **Defense stocks** are therefore likely to perform well. We also anticipate that the continuing tensions will buoy **general commodity** prices over the longer term after this year's expected recession has ended. In particular, we are looking for new or existing ways to take advantage of increased demand for the **uranium** used in nuclear weapons (and in emissions-free electricity generation).

Of course, the key risk in this new world is that the nuclear buildup and proliferation could lead to nuclear warfare. But that risk isn't really operable for investors, since such an event would probably devastate every conceivable asset. We think a much more actionable risk in the new tripolar world is that global fracturing will worsen and lead to less efficient supply chains, higher costs, higher inflation, and elevated interest rates. Corporate profit rates will likely become constrained compared with the recent past, but companies will eventually adjust, and **general stock** returns will likely remain relatively attractive. The main casualty is likely to be **bonds**, which may enter a prolonged bear market.

Patrick Fearon-Hernandez, CFA  
May 15, 2023

*This report was prepared by Patrick Fearon-Hernandez of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

### Confluence Investment Management LLC

Confluence Investment Management LLC is an independent Registered Investment Advisor located in St. Louis, Missouri. The firm provides professional portfolio management and advisory services to institutional and individual clients. Confluence's investment philosophy is based upon independent, fundamental research that integrates the firm's evaluation of market cycles, macroeconomics, and geopolitical analysis with a value-driven, company-specific approach. The firm's portfolio management philosophy begins by assessing risk and follows through by positioning client portfolios to achieve stated income and growth objectives. The Confluence team is comprised of experienced investment professionals who are dedicated to an exceptional level of client service and communication.