Confluence Investment Management

Bi-Weekly Geopolitical Report

By the Confluence Macroeconomic Team

July 14, 2025

Mid-Year Geopolitical Outlook: Searching for the Endgames

As the first half of 2025 draws to a close, we typically update our geopolitical outlook for the remainder of the year. This report is less a series of predictions as it is a list of potential geopolitical issues that we believe will dominate the international landscape for the rest of 2025. The report is not designed to be exhaustive. Rather, it focuses on the "big picture" conditions that we think will affect policy and markets going forward. Our issues are listed in order of importance.

Issue #1: US-China Tensions Remain
Halfway through 2025, global security and economic prospects continue to turn on the growing rivalry between the United States (the reigning global hegemon) and China (the rising power most willing and able to challenge the US's global position in the coming years). News reports in the first half of the year focused mostly on trade policy disputes between the US and other nations, including China, after President Trump imposed his big import tariffs. Investors followed suit but finally seemed to become numb to the to-and-fro of Trump's program. Looking ahead, investors may now begin to focus on other aspects of US-China relations that have worsened this year, such as technology and security conflicts that could potentially undermine investor confidence.

US-China Trade Issues. To recap, Trump imposed a range of tariffs and other trade barriers targeting China early in 2025, including import duties to punish Beijing for its failure to help cut the US supply of fentanyl, high tariffs to protect favored US industries such as autos and steel, and "reciprocal" tariffs designed to cut China's gaping trade surplus with the US. Trump also pressured US allies to cooperate in blocking Chinese exports. In turn, Beijing retaliated with its own tariffs on US goods and limits on Chinese exports of critical magnets made from rare-earth minerals. That prompted Trump to counter-retaliate with additional tariffs and embargoes on US technology exports to China. However, China's actions exposed how much economic leverage Beijing has gained from its near monopoly on rare-earths, prompting cooling-off deals at Geneva and London over the spring. As of this writing, the specific contours of the new US and Chinese tariffs and other trade policies remain in flux, but any final deal will likely slow US-China trade going forward.

US-China Technology Competition. As Washington and Beijing sparred over trade, China has continued to make progress in its headlong effort to catch and even surpass the US in key technologies of the future. Among the most important examples are the recent reports that show Chinese artificial-intelligence models are rapidly taking market share from the US in Europe, the Middle East, and Asia. Even though China's best models continue to modestly underperform US models, foreign firms are eager to adopt them due to their extremely low price and open sourcing. (We discuss AI in further detail below.) Separately, Chinese electric vehicles continue to gain share in non-US markets, based on both quality and price. Even if investors haven't focused much on China's tech gains amid today's trade fights, they should remember that such gains will likely spur further pushback from the US, including potential new bans on US tech exports to China.

US-China Military Competition. Finally, Beijing also continued to develop its military capacity versus the US during the first half of the year. The Chinese navy continued to conduct provocative maneuvers in the waters close to Japan and the Philippines. Perhaps most notable, China simultaneously deployed two of its operational aircraft carriers to the Western Pacific Ocean for the first time, demonstrating its ability to conduct large-scale operations in blocking positions between the US and its allies in Japan, South Korea, Taiwan, and the Philippines. Finally, state media indicated that China's modern new aircraft carrier, the *Fujian*, will be commissioned by the end of 2025. These developments will also likely lead to further US-China tensions.

In sum, we think US-China tensions will keep spiraling over the rest of 2025, even if the two sides strike a trade deal. New US trade barriers will irritate China over time, while China's rising tech and military prowess will prompt pushback from the US. That will raise the risk of further trade or tech restrictions and confidence-busting military tensions. The result will likely be further headwinds for Chinese stocks and US equities of firms dependent on Chinese production or imports. In contrast, this tense environment will likely be positive for gold and other precious metals.

– PFH

Issue #2: Russia-Ukraine War Continues

As we've noted ever since Russia launched its all-out invasion of Ukraine in early 2022, the key geopolitical issue for investors is Moscow's potential future aggression against the rest of Europe. Driven by deep anger over Russia's loss of status and power after the Cold War, President Putin and his government of ex-KGB and ex-military officials were probably always destined to threaten Central and Western Europe, despite naïve assertions by some observers that Russian aggression stems from, or is excused by, the expansion of the North Atlantic Treaty Organization to the east starting in 1999. If NATO's expansion hadn't happened, the unallied former Warsaw Pact nations of Eastern Europe almost certainly would have been a tempting re-acquisition target for the Kremlin, and Putin and his government would have found some way to justify aggression against them. Looking forward to the rest of 2025, the important thing is that Ukrainian resistance is likely to keep the Russians pinned down for at least a while yet.

At the start of 2025, some observers considered Russia and Ukraine to be in a military stalemate. However, by the spring, the Russian military appeared to regain some momentum by pushing Kyiv's forces almost entirely out of their salient on Russian territory and starting to make inroads in Ukrainian territory again. Now that the Trump administration has reduced US political and military support for Ukraine, it would not be a surprise if Russian forces continue to make gains. The Kremlin probably doesn't have the troops and equipment to push Kyiv's forces into wholesale retreat, even with the help of allies such as China, Iran, and North Korea. All the same, it appears that Russia has the momentum to gain more Ukrainian territory in the second half of 2025.

For investors, the impact of Russia's renewed gains will mostly be felt in the politics of Western Europe. As we've long argued, Russia's aggression has finally scared Western European leaders into a crash program to rebuild their countries' defenses. The European Union has set up a special fund to spur joint arms procurement and relaxed its fiscal rules to let member nations spend more on defense. EU and non-EU countries in Europe are rapidly boosting their defense budgets, and President Trump is pressuring the US's allies in NATO and across Asia to hike their defense spending by multiples as high as 5% of gross domestic product. We continue to believe these efforts will support robust returns for European and Asian defense firms. As described in more detail below, the associated fiscal stimulus could even accelerate broader economic growth in those countries, buttressing the positive impact of a weaker US dollar on European stocks.

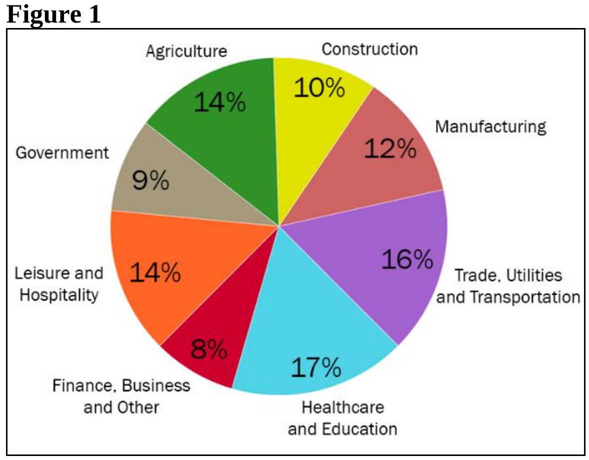
– PFH

Issue #3: Fallout From Israel-Iran War

The Israel-Iran war in June will likely have a lasting impact on the balance of power within the Middle East. The region has four main geopolitical powers that continuously strive against each other for influence: Turkey, Iran, Saudi Arabia, and Israel. As our report on the region's many fault lines explains, the rivalries among these countries have long roots, some "only" a century old and others from antiquity. The relative fortunes of these contenders have fluctuated through time, and, in this latest chapter, Iran has suffered a major setback. With an already deeply distressed economy, the country has now sustained significant damage to its air defense network, ballistic missile force, and nuclear weapons program (although the extent of that damage remains unclear). We think the other regional players will quickly seek ways to take advantage of those losses and gain influence.

In our view, Turkey is best positioned to take advantage of the new situation. The country has the 18th largest economy in the world and the largest in the Middle East. It has continued to grow in recent years and possesses greater diversity across sectors than other countries in the region that depend more heavily on petroleum output (see Figure 1). Its geopolitical position recently benefited from the fall of the Assad regime in Syria at the hands of a rebel group closely allied to and arguably under the control of Turkey. One man, President Recep Tayyip Erdoğan, has ruled Turkey this entire century. He has shown himself to be strong-willed, decisive, and intent on expanding Turkish regional influence wherever possible. We expect him to seize Iran's loss for Turkey's gain.

Figure 1



Recent sectoral contributions to Turkey's GDP. (Source: IELTS)

The two remaining questions looming over this conflict are whether there will be regime change in Iran and how the conflict will affect the price of oil. We consider outright regime change in Iran to be possible but unlikely. Regimes are hard to overthrow, and there does not seem to be an appetite for that level of uncertainty among neighboring countries or global powers with the capability to do so. Rather, we think Iran will subtly transform its governing structures to move away from its ideologically driven foreign policy. Similar to the way China transformed its economic system and relations with the rest of the world while remaining Communist, this regime will be forced to make changes that shift away from the policies that bankrupted its economy and rendered it a pariah state. This will take time, but we may see the initial signs of a course change before the end of the year. This opens the door for possible "deals" between the Trump administration and the Iranian regime, such as a reduction of sanctions on the Iranian economy in exchange for nuclear program concessions.

As to the price of oil, the global market has shown a surprising ability in recent years to take Middle Eastern conflict in stride, with the price of oil remaining relatively stable. There is always the possibility of an extreme event such as an Iranian attempt to close the Strait of Hormuz, through which 20% of global petroleum consumption flows; however, especially with the diversification of supply witnessed in recent years from places such as the US and Guyana, it seems increasingly likely that oil prices will ride out Middle Eastern turmoil.

– DO

Issue #4: US Mulls Capital Controls

In March, our *Bi-Weekly Geopolitical Report* titled "The Bessent Gambit" outlined the problems facing the new administration and its plan to address them. Essentially, the US has excess debt in both the private and public sector. Since the Great Financial Crisis, private sector debt (the sum of household and non-financial corporate debt) has stabilized. In fact, household debt relative to GDP has declined. On the other hand, public sector debt to GDP remains elevated. In our report, we noted that this excessive debt accumulation was mostly due to the dollar's status as the world's reserve currency, meaning that most international trade and transactions are denominated in dollars. To participate in the global economy, nations are incentivized to acquire dollars, and a reliable method to gather greenbacks is to run a trade surplus with the US. When other nations want to hold dollars for future transactions, they will hold US assets, primarily debt instruments.

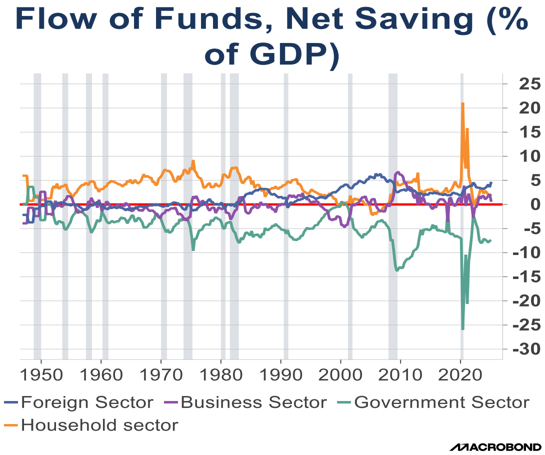
The Economics of Savings and Deficits. To better understand the mechanics of this process, we used the savings identity from macroeconomics. This identity shows that private sector net saving (investment less saving) plus public sector net saving (government spending less taxes) plus foreign net saving (exports less imports) must equal zero. At present, the US is open to both trade and financial flows, so the identity looks like this:

$$(I-S) + (G-Tx) + (X-M) = (I-S) + (G-Tx) + (X-M)$$

In this equation, the left side in blue represents the rest of the world. To acquire dollars, foreign nations need to run a trade surplus, requiring either a public or private sector saving balance. In other words, either S>I or Tx>G. If either of these sectors have a negative balance (or excessive saving), a trade surplus results. On the US side, if foreigners create conditions where M>X, then G must exceed Tx or I is greater than S. What this means is that the US debt situation is due, in part, to the dollar's reserve status, which creates demand for dollars. If the US runs either public or private sector deficits, it creates debt which is, in part, absorbed by foreigners.

We can observe this process in US net sector saving data, as shown in Figure 2.

Figure 2



In the early 1980s, the Volcker shock signaled that the US would implement austerity. This gave foreign investors confidence that the US would protect the value of US Treasury debt. Soon after, foreign saving began to be a steady feature of the US economy. These foreign flows forced domestic net saving to accommodate by either reducing saving or actually dissaving. Most of the time, the government sector dissaves. But when the US ran a fiscal surplus in the late 1990s, business dissaved, which triggered the tech bubble. When the US ran a 3.5% public deficit in 2006-07, household and business dissaving triggered a housing bubble. These foreign inflows can be destabilizing. And, as we noted in our report, another negative is that the trade deficit has led to US deindustrialization.

The Biden and Trump Strategies. The Biden administration tried to address this issue by maintaining a large fiscal deficit to implement industrial policy. Biden used subsidies to expand investment in favored sectors. The Trump administration is trying a more direct approach. By raising tariffs, the administration is attempting to reduce the trade deficit (and the inflows of foreign saving) by taxing imports, which, if successful, could lift Tx relative to G. However, tariffs can be hard to implement as trade policy is devilishly difficult. Different goods usually carry different tariff schedules. There is often a problem of transshipments, where a higher tariffed nation exports goods to a lower tariffed nation to avoid some or all of the tariff that would have resulted from a direct shipment. And, of course, from time immemorial, tariffs lead to smuggling.

Another Possible Strategy. An even more direct approach would be to tax the item that foreigners want for their saving: US assets, especially Treasurys. If a foreign nation sells goods to the US and acquires dollars, but then finds it has to pay a tax to hold US assets, the attractiveness of the dollar declines. It's simpler to enforce. By implementing capital controls, the US would make it difficult to acquire assets that result from running a trade surplus with the US.

There are no solutions…only tradeoffs.
– Thomas Sowell

Where Do We Go From Here? Persistent foreign saving inflows have led to clear problems. The US has too much debt and too little factory capacity. The resulting social problems that emerged in parts of the US economy are obvious. However, these inflows have had positive effects as well. The main benefit has been lower borrowing costs, closely matched with low inflation.

Referring to the savings identity, the goal of US policymakers is to change the behavior of foreigners. We want other nations to stop engaging in policies designed to build domestic saving and instead absorb their saving via higher investment or fiscal deficits. If the US is successful in reducing these inflows, we would expect upward pressure on both inflation and interest rates. If the monetary authority takes steps to prevent interest rates from rising, the dollar would bear the brunt of the adjustment and weaken significantly.

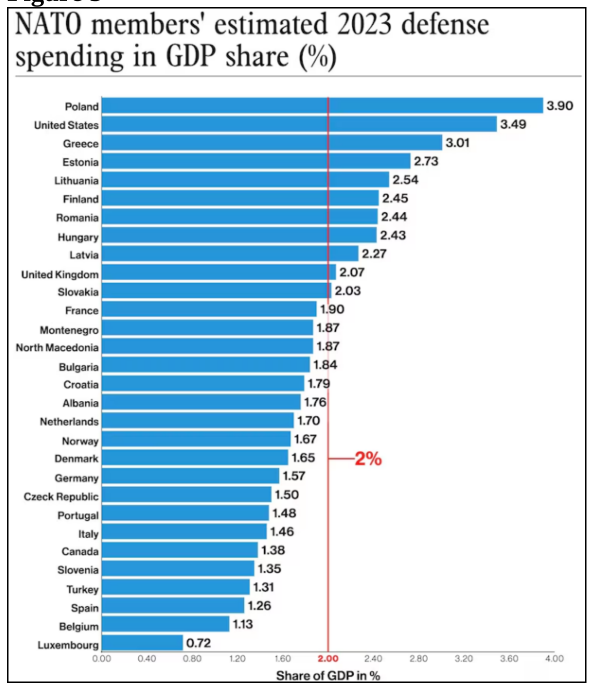
– BOG

Issue #5: Prospects for Lasting Economic Change in Europe

Changes in Europe's geopolitical landscape are shifting the security imperatives of most European nations, and these new imperatives have big economic implications. Before the Russian invasion of Ukraine in 2022 and the return of Donald Trump to the White House this year, two key assumptions guided European security thinking: 1) there were no serious external military threats, and 2) the US would uphold its longstanding commitment to defend Europe should a threat arise. Both those assumptions have now been shaken. The invasion of Ukraine not only demonstrated Russia's willingness to initiate major war on the continent, but it also laid bare Europe's utter lack of military preparedness to defend itself without US assistance should Russia choose to continue its aggression westward. Meanwhile, under President Trump's leadership, the US is openly questioning its commitment to Europe unless Europe significantly boosts its share of the allied defense burden. We believe the resulting sense of insecurity is helping improve European economic policy and prospects.

Europe Responds to Russia and Trump. As European leaders recognized the threat from Russia and pressure from Trump, they've responded with a commitment to rearm. Most NATO countries have now pledged to meet Trump's demand to raise defense spending to 5% of GDP by 2035, in a historic shift aimed at convincing Trump to maintain US defense commitments. This compares to the non-US allies' current average defense burden of about 2%, implying they will more than double their spending over the coming decade (see Figure 3).

Figure 3



(Source: NATO)

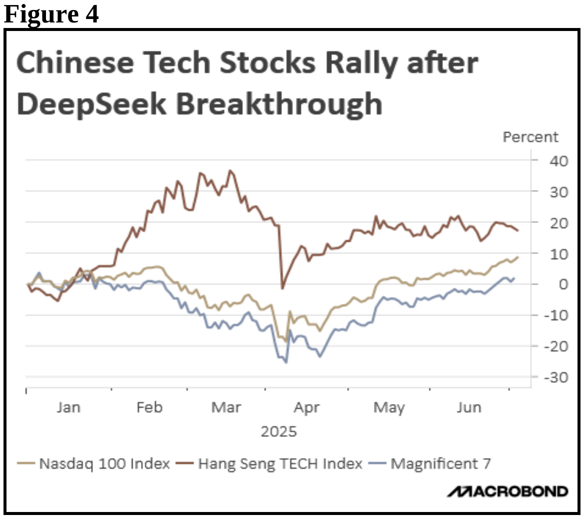
This reawakening in the realm of defense seems to have spurred a broader movement in Europe to regain lost economic competitiveness. Germany is leading the way with a plan to boost its defense budget by 70% by 2029, a faster rate than either the United Kingdom or France. As our recent report introducing Germany's new chancellor, Friedrich Merz, explains, this defense effort forms just one part of Germany's multi-pronged program to rejuvenate its flagging economy. Germany's program also includes initiatives to cut business regulation, lower taxes, and boost public spending on infrastructure and technology. We are seeing similar initiatives in other European countries. Taken together, this amounts to a massive, long-term stimulus plan for the European economy, led by security concerns but branching out into a broader program of rejuvenation. We expect Europe's defense and broader industrial stocks to benefit the most, but spillover effects will likely boost the entire European economy relative to its typical performance since the end of the Cold War.

We already see the political actions necessary to spur this change, and we think the economic impact could start to become noticeable as soon as the end of 2025.

– DO

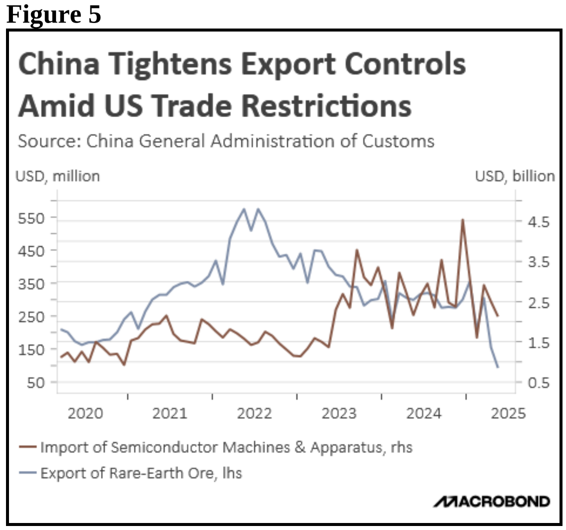
Issue #6: AI Investing Gets Second Wind
While trade wars dominate headlines, the true contest for global supremacy in the 21st century is unfolding in AI labs and semiconductor fabrication plants. The stakes became clear on January 20, coinciding with the US presidential inauguration, when China's DeepSeek AI model revealed not just incremental progress but transformative leaps in Chinese AI's algorithmic efficiency, directly challenging the US's long-assumed technological dominance. By mid-March, the Hang Seng TECH Index had soared 36%, leaving the NASDAQ 100 and the US's Magnificent 7 tech giants in the dust (see Figure 4). This impressive rise, settling at a robust 17% gain, painted a vivid picture of the sluggish recovery of US tech stocks. This divergence represents more than a temporary market anomaly; it also serves as a reminder of how China's advancing AI capabilities are reshaping global investment flows and changing expectations about the future of tech leadership.

Figure 4



Mutual US-China Interdependence. The fierce geopolitical competition between the US and China conceals an uncomfortable interdependence. China's grip on 98% of rare-earths processing gives it strategic leverage over the very foundations of modern technology. Yet, the US retains its advantage through a 40% market share in critical chip design tools and its leading AI research institutions. The recent, carefully choreographed relaxation of US and Chinese export controls shows that, despite all the posturing, the two global powers recognize that a complete tech decoupling would cripple the AI aspirations of both nations (see Figure 5).

Figure 5



But US-China Competition Persists. However, the rivalry continues to intensify along increasingly dangerous fault lines. China has begun weaponizing its manufacturing dominance, requesting trade secrets in exchange for access to critical minerals. At the same time, the US is expanding its semiconductor alliance network, recently incorporating Gulf states into its orbit, while crafting AI standards deliberately designed to isolate China. The world is rapidly dividing into two distinct technological orders, compelling nations to make stark choices between rival digital ecosystems.

The US Advantage Under Threat. The current US tech advantage, while real, is under increasing pressure. The recent lopsided Senate defeat of a proposed moratorium on state-level AI regulation exposed a critical lack of consensus in the US on how to streamline domestic AI development. Compounding this issue, growing local opposition to data centers and semiconductor fabs, driven by environmental concerns and NIMBYism, threatens to impede US capacity expansion even as China accelerates its AI progress. This internal friction and regulatory inertia, contrasted with China's ability to rapidly execute massive infrastructure projects, suggests that the US's edge may be slipping.

Prospects for the US. Despite these internal challenges, we think the US will maintain its technological edge at least in the medium term. This is mostly because of the US's big ecosystem advantages, geopolitical power, and existing leadership in critical technologies. However, the longer-term trajectory is uncertain. China's command of essential resources and its streamlined regulatory environment could enable faster, more decisive advancements in AI. Should China continue making incremental improvements, global capital flows may gradually shift eastward, potentially strengthening Chinese equity markets while weakening the dollar's reserve status.

China's success may ultimately hinge on whether the US can maintain cohesion among its allies. The US network of technology partnerships could prove decisive in preserving Western dominance as allied nations may remain reluctant to fully embrace Chinese technology even if it achieves technical superiority. For investors, this suggests maintaining core exposure to US tech leaders while carefully monitoring developments in export controls and potential opportunities in non-restricted Chinese tech sectors. The coming decade will test whether democratic innovation systems can outpace authoritarian efficiency in what has become the defining technological competition of our era — a contest that will determine not only which nation leads in AI, but also which vision of technological governance prevails on the global stage.

– TW

Summary

Together, the issues outlined here paint a picture of increased and sustained uncertainty in geopolitics. The US-China rivalry and other international tensions have made the global investment environment riskier than what was typically the case in the post-Cold War era of globalization.

We continue to believe that investors must face these facts head-on, look for ways to manage the risks, and consider whether the new environment might offer intriguing investment opportunities. For example, we believe President Trump's dramatic policy changes and aggressive stance toward allies is contributing to a weaker dollar, which has historically helped propel outsized returns for foreign stocks versus US stocks. Moreover, today's global tensions continue to encourage central banks in China and elsewhere to ramp up their gold purchases, buoying prices for the yellow metal. In our view, the investment implications discussed here illustrate how important it is for investors to keep track of the global geopolitical landscape.

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This report was prepared by Patrick Fearon-Hernandez, Thomas Wash, Daniel Ortwerth, and Bill O'Grady 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.

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