Confluence Investment Management

Bi-Weekly Geopolitical Report

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Agricultural Commodities in the Evolving Geopolitical Blocs

As regular readers of this report will know, Confluence has long predicted that as the United States steps back from its traditional role as global hegemon, the world will become much less globalized and countries will coalesce into at least two rival geopolitical and economic blocs—one led by the U.S. and one led by China. In our report from May 9, 2022, we described the results of our recent study that aimed to predict which countries will end up in each of the evolving blocs. Following that, in our report from June 6, 2022, we showed how key mineral commodities are unevenly distributed among the evolving blocs, and what that might mean for geopolitics and investment strategy.

In this report, we dive even deeper into the differences between the evolving blocs by looking closely at the international trade in key agricultural commodities within and between the groups. We explore what those differences and relationships might mean for geopolitics going forward, especially regarding the rivalry between the U.S. and China. We conclude with a discussion of the implications for investors.

Oil Seeds

Our June report found that some key mineral commodities are unevenly distributed between the blocs and will likely be weaponized as inter-bloc tensions rise. For example, crude oil and natural gas reserves and production are concentrated in the China-led bloc, giving Beijing leverage over the U.S.-led bloc by threatening to cut off those supplies. In today's study, we focus on the level of production and inter-bloc dependence for a range of agricultural commodities, starting with soybeans, the world's biggest export crop by value.

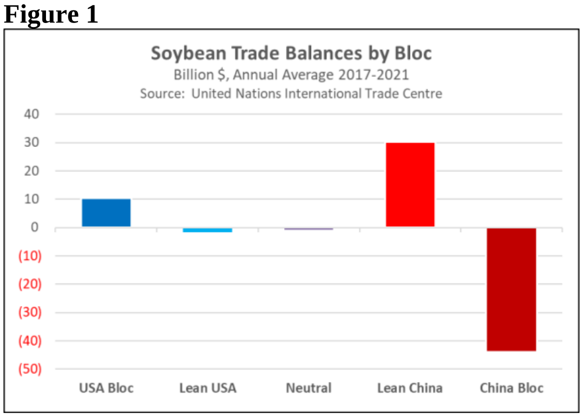
We based this part of our analysis on the UN International Trade Centre's detailed data on global exports and imports. Our first step was to calculate each bloc's total trade balance for the world's most important farm goods. Intra-bloc trade surpluses and deficits cancel each other out, so an overall bloc trade surplus for a given product indicates the group, as a whole, exports more to all the other blocs than it imports from them, and vice versa. This analysis illustrates just how interdependent the China and U.S. blocs became in the heyday of globalization and free trade from the 1980s until just a few years ago. [Please see our aforementioned May 9 report for a list of the countries we project to end up in each bloc.]

As shown in Figure 1 (on the following page), we calculate that the countries in the U.S.-led bloc collectively had an average annual trade surplus of $10.4 billion in soybeans from 2017 through 2021. The U.S. alone had an average annual soybean surplus of $21.8 billion in those years, while Paraguay had an average surplus amounting to $2.2 billion and Canada's was $1.8 billion. However, those and other countries' smaller surpluses were partially offset by soybean trade deficits elsewhere in the U.S.-led bloc. The figures suggest that trade between surplus and deficit countries in the same bloc can be quite important.

However, trade between blocs can be important as well. For example, the China-led bloc had a massive average soybean deficit of $43.9 billion from 2017 to 2021, almost all of which came from China itself. The large soybean surplus of the "China-leaning" bloc suggests it was the main source of China's soybean imports. Indeed, the UN data show that Brazil, of the China-leaning bloc, was China's top source for soybeans in those years.

Soybeans are a major source of edible oil for humans, but they are also used as an affordable protein-rich feed for livestock. They therefore play an important part in the world's food supply. Going forward, we think China's high dependence on imported soybeans means it will exert heavy political and economic pressure on Brazil and the other China-leaning countries to maintain or strengthen their orientation toward Beijing. By the same token, we suspect that the U.S. and its bloc members will eventually try to pry those countries out of China's orbit and make them closer allies with the U.S.

Figure 1



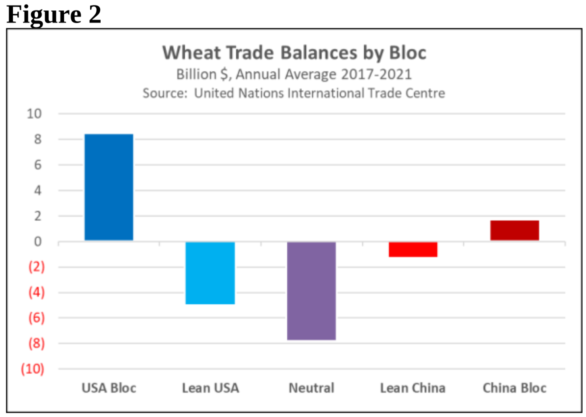
Grains

We next focus on wheat and corn, which the UN suggests are the world's second- and third-most valuable export crops. The global trade profiles of these commodities are dramatically different than that of soybeans.

Wheat. According to the UN data, the U.S. bloc collectively had a healthy trade surplus in wheat averaging $8.5 billion dollars per year over the last five years. Not only was the surplus sizable, but it was also well diversified with Canada, the U.S., Australia, France, and Romania all registering average wheat surpluses of $1.0 billion or more per year. Those surpluses were partly absorbed by deficits in other member countries. Italy and Turkey had the biggest wheat deficits in the bloc, averaging $1.9 billion per year.

- Figure 2 suggests that most of the U.S.-led bloc's net wheat surplus went to countries in the "U.S.-leaning" and "Neutral" blocs, while wheat exports and imports were collectively in balance in the China-affiliated blocs.
- Most people probably think of wheat as primarily a human food, but it also can be processed into protein-rich animal feed, making it another key food grain. However, given the China bloc's trade surplus in wheat, we suspect the crop and its producers won't be drawn into the U.S.-China rivalry nearly as much as soybeans and their producers will.

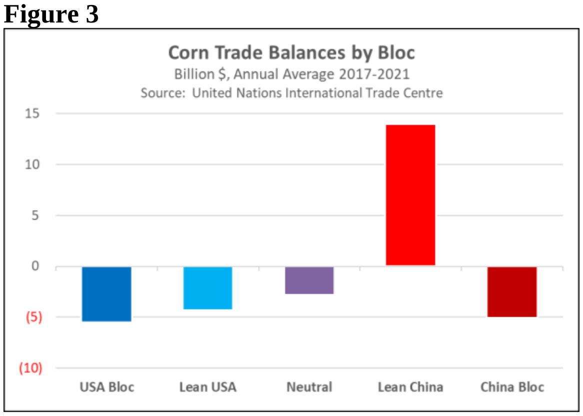
Figure 2



Corn. The global trade patterns in corn are entirely different from those of soybeans or wheat. The most notable aspect is that only one bloc—the China-leaning group—has a net trade surplus in corn. The China-leaning camp has a towering corn surplus, mostly reflecting the large surpluses of $5.8 billion in Argentina, $4.9 billion in Brazil, and $4.4 billion in Ukraine (the numbers cover 2017 through 2021, before the current war).

- Some countries in the other blocs also had big surpluses in corn, like the U.S. surplus of $11.5 billion. However, those surpluses were offset by deficits in many other countries, such as the shortfalls of $2.6 billion in China, $3.3 billion in Mexico, and $3.6 billion in Japan.
- Like soybeans, corn is an important source of feed for farm animals. Since the China-leaning bloc is in such a strong position to provide soybeans and corn to China as it boosts its production of pork and other animal proteins, we think Beijing will be especially keen to keep those countries on its side. We suspect China will try especially hard to curry favor with countries like Brazil and Argentina. On the other hand, the U.S. may try to peel those countries away from Beijing's orbit through a range of economic, political, or military incentives.

Figure 3



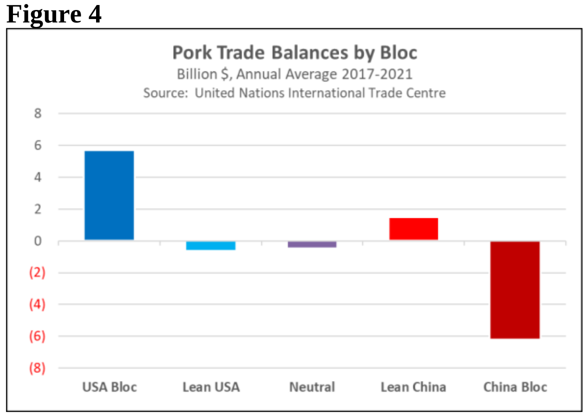
Meats

The UN data show a similarly complex situation for the global trade in fresh and frozen pork and beef, two of the world's most important sources of animal protein. Illustrating the complexities of the overall agricultural trade, the inter-bloc differences in the pork and beef market are significantly different than those of the soybean, wheat, and corn markets.

Pork. Based on the UN data, the U.S.-led bloc, as a whole, has a large trade surplus in fresh and frozen pork amounting to $5.7 billion per year (see Figure 4). In recent years, the U.S. itself has had an average annual pork surplus of $4.0 billion, but its overall bloc surplus is driven more by European countries, including Spain, with an average pork surplus of $5.0 billion, Germany at $2.9 billion, and Denmark at $2.7 billion. Those and other, smaller surpluses in the bloc are partially absorbed by the pork deficits in other U.S.-led bloc countries. In contrast, the China-led bloc had a massive pork deficit amounting to $6.2 billion per year, almost all of which was from China itself.

- The enormous surplus for the U.S.-led bloc and the big deficit for the China-led bloc would suggest that China and its allies depend on the U.S. and its allies for most of their pork imports.
- Indeed, the UN's country-by-country figures confirm that countries in the U.S.-led and U.S.-leaning blocs made up 18 of China's top 20 sources of pork imports in 2021. China's only two top-20 pork sources outside of these blocs were Brazil and Argentina, which we assign to the China-leaning bloc.

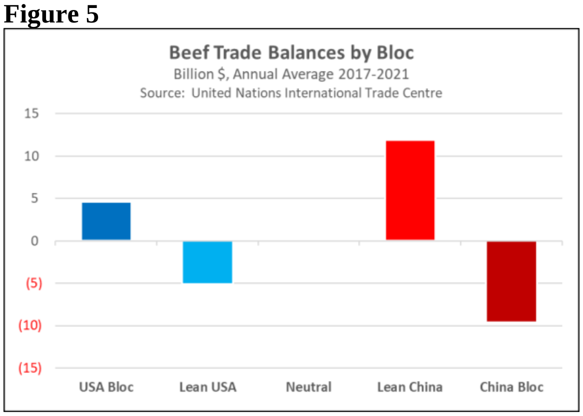
Figure 4



Beef. Finally, the large global trade in fresh and frozen beef shows a completely unique set of relationships. Our analysis shows the U.S.-led bloc has a sizable, well-diversified trade surplus in beef, driven mostly by average surpluses of $6.8 billion in Australia, $2.3 billion in New Zealand, and $2.2 billion in Ireland (the U.S. and Canada both have beef surpluses of a bit less than $1.5 billion per year). The China-leaning bloc has an even bigger beef surplus of $11.9 billion, mostly reflecting the average annual surpluses of $6.3 billion in Brazil, $3.3 billion in India, and $2.3 billion in Argentina.

- Interestingly, the U.S.-led bloc's big beef surplus is almost exactly the same size as the U.S.-leaning bloc's beef deficit, and the China-leaning bloc's big surplus is a bit bigger than the China-led bloc's deficit. At first glance, this might suggest that these surplus blocs are exporting beef mostly to their closely allied blocs.
- In reality, China is the #1 or #2 beef market for many countries in the U.S.-led bloc, including Australia, New Zealand, Canada, and the U.S. itself. The same can be said for Brazil and Argentina in the China-leaning bloc. Surprisingly, much of India's beef surplus represents sales to U.S.-leaning countries, such as Egypt and Malaysia.

Figure 5



Analysis

This analysis underscores just how complex the world's agricultural trade is. There is no single pattern of trade that applies to all exporters or importers, or to all products. The relationships between countries and blocs can differ dramatically. Nevertheless, we can say that some countries and blocs have developed strong dependencies on other countries and blocs as the U.S. promoted global security and trade, import and export barriers fell, and the world became globalized.

With almost 20% of the world's population but only about 7% of its arable land, China has long faced challenges in maintaining food security. It currently produces roughly 60% of its annual food needs (for an intriguing look at China's food security issues, check out this podcast). China is now especially dependent on the China-leaning bloc's soybeans and corn, and its pork and beef to a lesser extent. The key producers of those goods in the China-leaning bloc are Brazil and Argentina.

- As the U.S. and China increasingly wage economic war on each other, the China-leaning countries, and Brazil and Argentina, in particular, will likely be coveted by each side, enhancing their political and economic leverage.
- By the same token, Brazil and Argentina would likely suffer from easing U.S.-China tensions or weaker Chinese economic growth.

Meanwhile, the rich, highly productive countries of the U.S.-led bloc enjoy more diversified markets, especially within their bloc. Still, the big net exporters in the group sometimes rely on China and its bloc for a lot of their foreign sales. This suggests that political frictions over maintaining or cutting back inter-bloc trade will likely be contentious even within each group. For example, if leaders in the U.S.-led bloc want to restrict agriculture exports to the China-led bloc, they will likely face strong pushback from farming constituencies.

Investment Ramifications

As noted in our previous studies, the fracturing of the world into relatively separate geopolitical and economic blocs will disrupt supply chains and boost security risks around the world. We believe the result will likely be increased investment to relocate production facilities, higher costs, higher interest rates, and weaker corporate profits. Those factors will likely present headwinds for equities and bonds going forward.

When it comes to commodities, the outlook is more varied. As discussed in our report from June 6, the inter-bloc dependencies for some mineral commodities will tempt U.S. and Chinese leaders to weaponize them. The threat of mineral commodity supplies being cut off for geopolitical reasons will tend to boost the prices of those goods over time. In contrast with mineral commodities, the China bloc is glaringly dependent on food imports from other blocs. That suggests the U.S. bloc will be tempted to rein in its exports of soybeans, corn, pork, beef, and other foods sent to the China bloc, perhaps via embargos or export tariffs. The U.S. bloc will also try to curry favor with Brazil and Argentina, perhaps by opening its market further to their agricultural goods. Therefore, in contrast with mineral commodities, the U.S.-China rivalry could produce excess supplies of agricultural goods in the U.S. and other blocs, pushing down their prices. Because of the evolving geopolitical trends, we have long argued that investors should consider broadening their investment mix to include commodities. This analysis shows that investor focus over time should probably favor mineral commodities over agricultural commodities.

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