Funcas Intelligence

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Early-2026 Recalibration

EU Defense Plans

Middle Power Adjustments

Capital and Investment Shifts to Asia

The Debt Leverage Debate

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Funcas Intelligence (FI) is a publication directed towards a broad base of international and Spanish readers. Funcas Intelligence´s focus is to identify and assess the game changers and relevant events of the global economy and the financial sector with potential impact for Spain.

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Contents

The Debt Leverage Debate

Foreign holdings of U.S. Treasuries may look like geopolitical leverage, but once distinguishing between private investors and foreign official institutions, the debt weapon narrative largely dissolves. U.S. financial dependence on Europe and Asia is real in scale, yet it is systemic, reciprocal, and too costly to weaponize to serve as an effective tool of coercion.

Early-2026 Recalibration

Fed pauses after December cuts, ECB prepares the ground, while markets test the "soft landing" narrative*

→ The Federal Reserve held rates steady at its January meeting after three consecutive cuts into year-end (2025), while the ECB maintained its policy stance but signaled increasing confidence in the disinflation process.

→ Financial markets entered 2026 with strong momentum, yet January-February volatility has revealed a more selective and fragile risk environment.

United States: A pause after three cuts, with financial conditions doing part of the easing

The Fed's January hold confirms a shift from active recalibration to cautious monitoring, as markets debate how much easing is still to come. At its late-January meeting, the Federal Reserve kept the federal funds target range unchanged at 3.50%–3.75%, following the cumulative 75 bps of cuts delivered between September and December 2025. The statement reinforced the now-familiar message of data dependence, highlighting continued progress on inflation while acknowledging signs of moderation in labour-market momentum.

The Federal Reserve kept the federal funds target range unchanged at 3.50%–3.75%, following cumulative cuts delivered between September and December 2025

Headline inflation has moved closer to target, with core measures trending downward but still slightly above 2%. Growth indicators for Q4 2025 and early Q1 2026 suggest a cooling but not contracting economy. Consumer spending remains resilient, though more uneven, and business investment has softened. As for hiring data, these point to gradual normalization rather than abrupt deterioration.

Interest rate markets initially priced a high probability of further cuts by mid-2026. However, stronger-than-expected January payroll data and stable services activity have led to some repricing. Two-year Treasury yields, which had fallen into the low-3% range at year-end, have moved higher (3.5–3.6 %) during February, reflecting reduced urgency for immediate additional easing.

Beyond policy rates, the broader financial environment has loosened meaningfully compared with mid-2025. Equity valuations remain elevated, credit spreads tight by historical standards, and mortgage rates have declined relative to their 2024 peaks. As in late 2025, the effective stance of policy may be more accommodative than headline rates suggest, potentially limiting the

As in late 2025, the effective stance of policy may be more accommodative than headline rates suggest, potentially limiting the Fed's room for aggressive further cuts

Fed's room for aggressive further cuts unless macro data deteriorate more visibly.

Euro Area: Holding steady, but with easing bias strengthening

The ECB's next move is more likely to be a cut than a hike as inflation hovers around target

The ECB maintains its pause, yet communication suggests that the next move is more likely to be a cut than a hike. At its January meeting, the European Central Bank kept its key rates unchanged, holding the deposit facility at 2.00%. The Governing Council reiterated that inflation is "around target," with both headline and core measures hovering close to 2%. Wage growth remains firm but shows tentative signs of peaking, while credit conditions continue to weigh on investment.

Recent activity data point to weak but positive growth in the euro area. Services have stabilized, and there are early indications that manufacturing contraction may be bottoming out, particularly in Germany. However, fiscal consolidation pressures in several member states and still-tight bank lending standards argue for caution.

Markets have interpreted recent ECB communication as preparing the ground for a potential cut in Q2 2026, conditional on further confirmation that inflation will remain sustainably at target. The divergence that dominated much of 2025 (Fed easing *vs*. ECB pause) is now narrowing, as the Fed pauses and the ECB edges closer to renewed accommodation.

The euro has traded in a relatively stable range (1.16-1.18) against the dollar in early 2026, with currency dynamics increasingly influenced by relative growth expectations and political risk premia rather than rate differentials alone.

Global markets: Strong start, rising dispersion, and February reality checks

January opened with strong risk appetite. U.S. equities extended their late-2025 rally, with broadening participation beyond mega-cap technology. European equities also benefited from lower energy-price volatility and expectations of more accommodative financial conditions later in the year.

The "soft landing plus lower yields" consensus remains intact but is less one-directional than at year-end

However, February has brought more nuanced price action. Volatility has picked up across rates and equity markets as investors reassess the timing and magnitude of further central bank easing. The "soft landing plus lower yields" consensus remains intact but is less one-directional than at year-end.

In fixed income, curves have modestly steepened in both the U.S. and parts of Europe as long-end yields stabilized while short-end expectations adjusted. Credit markets remain resilient, though issuance has accelerated, raising questions about valuation discipline if growth momentum slows further.

Commodities have shown mixed performance. Energy prices have remained contained despite geopolitical tensions, while precious metals continue to benefit from portfolio hedging demand and ongoing central-bank purchases. The U.S. dollar, after weakening into late 2025, has stabilized in early 2026 amid reduced expectations of rapid Fed easing.

Overall, markets appear to be transitioning from liquidity-driven optimism to a more earnings- and data-sensitive phase. Sector rotation has intensified, with investors favouring quality balance sheets and defensively positioned cyclicals over high-duration growth exposures.

A fragile but evolving equilibrium

The early-2026 backdrop resembles a recalibration rather than a regime shift. Inflation is no longer the dominant threat, but neither is it fully vanquished. Growth is moderating, yet recession risks remain contained for now. Central banks are moving from active adjustment to conditional fine-tuning.

For the Fed, the challenge is to avoid easing too quickly into still-robust financial conditions. For the ECB, it is to ensure that any renewed cuts reinforce, rather than undermine, credibility on price stability and fiscal discipline within the euro area.

Markets continue to price a benign macro path (gradual disinflation, moderate growth, and incremental easing) but this equilibrium remains exposed to confidence shocks, whether from geopolitics, fiscal tensions, or pockets of credit stress.

As 2026 unfolds, the key question is no longer whether the tightening cycle has ended. It is whether central banks can manage the next phase, normalization without complacency, in a world where policy credibility, financial stability, and geopolitical fragmentation remain tightly intertwined.

The key question is no longer whether the tightening cycle has ended, but whether central banks can manage normalization without complacency

Notes

* This article was written prior to the escalation of conflict in Iran. Any resulting disruption to commodity markets, particularly oil, could introduce additional upside risks to inflation, with potential implications for the path of monetary policy at both the Fed and the ECB.

EU Defense Plans

Assessing EU Rearmament Plans and Dependence on the United States

→ The EU's fragmented financial architecture, coupled with divergent national threat perceptions and interests, creates a "rearmament paradox" in which immediate security needs often undermine the development of the EU's sovereign defense industrial base.

→ Unless the EU integrates its capital markets, coordinates procurement, and scales its defense industry, rearmament may entrench dependence on the United States rather than reduce it.

Introduction

Russia's invasion of Ukraine in 2022 and growing uncertainty about long-term U.S. security guarantees have transformed European defense into a central strategic priority.

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EU member states have announced sizable increases in military expenditure, and new initiatives, such as the European Defence Industrial Strategy and Security Action for Europe (SAFE) loan instruments, aim to reinforce industrial capacity and reduce fragmentation. However, three overarching EU policy objectives — increasing defense spending, achieving rapid rearmament, and building European strategic autonomy — are potentially contradictory.

A "rearmament paradox" has emerged in which immediate European security needs reinforce its dependence on the United States and often undermine the development of the EU's sovereign defense industrial base.

Defense spending

North Atlantic Treaty Organization (NATO) defense spending increased significantly between 2022 and 2025, with 32 states surpassing the 2% GDP benchmark in 2025.

At the June 2025 NATO Summit in the Hague, leaders agreed to establish a new benchmark of 5% of GDP by 2035, including 3.5% for core military expenditures and 1.5% for defense-related resilience.[1] This shift, at the urging of President Donald J. Trump, reflects an acknowledgment that the 2% floor was insufficient to address the threats facing the region and that Europe could no longer count on U.S. security commitments.

Spending increases, however, do not automatically translate into domestic industrial expansion or real rearmament. Instead, rapid spending increases

Rapid spending increases boost short-term readiness but deepen long-term dependency translate into import-heavy procurement, which solves short-term readiness but worsens long-term dependency.

The EU's reliance on fragmented, non-collaborative acquisition prevents the necessary industrial expansion and efficiency, leaving the industry reliant on short-term, tailored products.[2] Moreover, the rearmament process is uneven and leans heavily on external suppliers to deliver critical defense capabilities, such as air defense, intelligence, surveillance and reconnaissance (ISR), and long-range fires.[3] These purchases improve readiness but entrench technological dependence and undermine strategic autonomy.

EU financial architecture and defense industry

EU defense industry fragmentation is not merely organizational; it is also financial and regulatory

EU defense industry fragmentation is not merely organizational; it is also financial and regulatory.[4]

The EU Commission has repeatedly emphasized that the bloc's capital markets remain fragmented and limit scale financing.[5] Fragmented capital markets slow industrial scaling, forcing states to import when urgency rises.

Fragmented capital markets also increase borrowing costs for defense SMEs relative to U.S. firms operating in deeper markets.

Europe lacks defense-focused venture capital and public equity markets with the depth of the U.S., limiting scale-up capacity. In turn, limited access to deep equity markets constrains SME growth. Moreover, defense-sector SMEs, which are key to innovation, face greater obstacles to accessing capital than other sectors.[6]

Defense manufacturing requires long-term financing and predictable demand. Yet EU procurement remains nationally structured, episodic, and politically sensitive.[7] Nationally structured, short-cycle procurement reduces predictability, discouraging long-term private investment. Procurement complexity and divergent national requirements also reduce economies of scale.

Lastly, regulatory divergence and political resistance reduce the likelihood of mergers that would create scale champions.

The result is insufficient scaling capacity, which contributes to an inability to meet surging demand and increased reliance on imports. Without deeper capital market integration, rearmament risks reinforcing dependency rather than reducing it.

U.S. dependence

U.S. dependence is not accidental; it is structurally produced by urgency and fragmentation. As European defense spending increased, it purchased more U.S. equipment. U.S. Foreign Military Sales (FMS) accounted for 51% of military equipment spending by European NATO countries from 2022 to 2024, up 13% from 2019 to 2021.[8]

Europe relies on U.S. defense production for certain sectors. Nearly half of the fighter jets used in Europe are produced in the United States, while U.S. missile defense systems remain the most widely deployed on the continent.[9]

Many European systems also rely on U.S. components, including satellite infrastructure, software and operating systems, secure communications architecture, and other high-end technologies critical to modern warfare.[10]

U.S. reliance makes sense when it is based on alliances or rational decision-making, such as NATO interoperability requirements, economies of scale in advanced platforms, and the logic of burden sharing.

However, in other cases, it can reduce sovereignty. U.S. reliance can lead to dependence on U.S.-controlled software updates; export-control vulnerabilities, like the International Traffic in Arms Regulations (ITAR); or strategic chokepoints, such as satellites. It can also lead to supply chain lock-in effects, where the EU is tied to U.S. technology and supply chains for many years, making it expensive to switch to domestic alternatives.[11]

U.S. dependence can reduce EU sovereignty when it constrains independent operational decision-making or limits the EU's ability to sustain military operations without U.S. authorization or industrial support.

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Financing rearmament

Germany is expected to spend over €108 billion on security and defense in 2026, up from €87 billion in 2025.[12] However, it remains constrained by its constitutional debt brake, despite amending its constitution last year to exempt some military and intelligence spending.

France and Italy have strategic ambitions and strong defense industries but face high public debt. Sustained increases risk market pressure and political resistance. For example, less than 20% of Italians surveyed viewed security and defense as a top priority, the lowest in the EU.[13]

In Poland and the Baltics, high threat perception drives rapid increases in spending. Fiscal sustainability is secondary to the urgency of deterrence. Poland, Lithuania, and Latvia were the only three countries on a definitive path to meet NATO's 3.5% core expenditure target as of August 2025.[14]

Spain's rearmament trajectory has been slower, reflecting a lower level of threat perception and domestic political opposition from members of the current government coalition. Spain has insisted it would only need to spend 2.1% of GDP to meet NATO's core military requirements.[15]

EU defense spending reflects a distributive conflict problem - the constraints facing EU member states include diverging national threat perceptions, domestic and electoral politics, and defense-industrial lobbying. Countries with high threat perceptions prioritize rapid rearmament and deterrence over long-term fiscal sustainability or debt limits. Voters also tend to prioritize social

EU defense spending reflects a distributive conflict driven by diverging threat perceptions, domestic politics, and defense-industrial lobbying welfare, health care, and education over defense. And support for defense spending generally splits on party lines, conservatives are generally more in favour than those on the left. Lastly, defense industry lobbying influences fiscal policy by steering government contracts and securing funding for long-term programs that are hard to stop once started.

Joint borrowing

The SAFE instrument, adopted in May 2025, allows the European Commission to raise €150 billion on capital markets to finance long-term loans. It aims to support industrial-scale operations and joint procurement to address fragmented markets and reduce reliance on non-European suppliers. In January, the first wave of funding valued at approximately €38 billion was approved for eight member states, including €10.5 billion for Spain.[16]

The EU's experience with NextGenerationEU funds demonstrated that joint borrowing could mobilize large-scale financing while lowering borrowing costs for high-debt states. Some member states have since advocated for joint European debt to fund a massive surge in defense spending, though other states oppose debt mutualization for defense and other purposes, arguing that the joint debt deal during the COVID-19 pandemic was exceptional.[17] Despite some advancement with the SAFE instrument, mutualizing debt for defense spending is thus not likely to move forward anytime soon.

Financial institutions

The European Investment Bank (EIB) has expanded its support for security-related investments. It removed the dual-use mandate to allow "pure military" investments and reached €4 billion in expenditures in 2025, with another €4 billion planned for 2026.[18] This marks a normalization of defense as a legitimate investment sector. ESG exclusions have softened, and institutional investors increasingly treat defense as strategic infrastructure. Regulatory shifts have also reduced the reputational risk that previously constrained private bank lending to the sector.[19]

Without coordinated demand, financial deepening will not automatically translate into strategic autonomy

However, capital alone is insufficient. Investors require long-term contracts, predictable procurement cycles, regulatory clarity, and cross-border standardization. Without coordinated demand, financial deepening will not automatically translate into strategic autonomy.

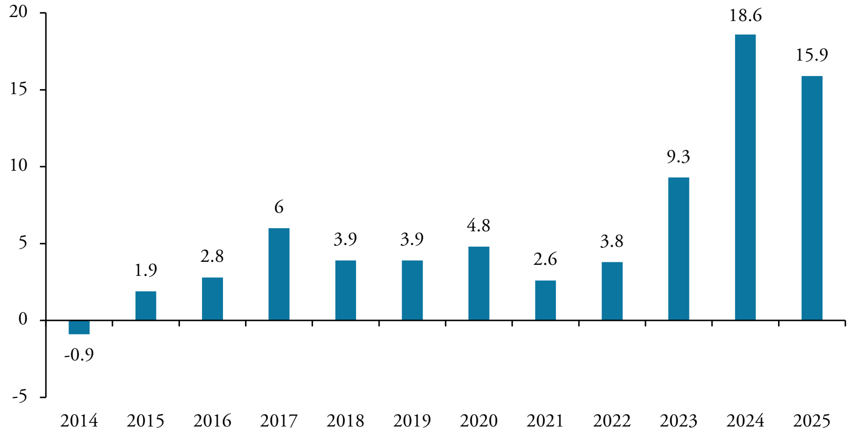
Conclusion

Strategic autonomy is not just about spending more on defense. It is a matter of restructuring the foundations of Europe's defense economy.

Absent deeper financial, industrial, and fiscal integration and joint financing, EU rearmament risks reinforcing structural dependence even as spending increases

Europe's rearmament drive exposes a structural paradox - the urgency of deterrence pushes EU member states toward U.S. imports. At the same time, strategic autonomy requires industrial scaling that depends on deeper financial and fiscal integration. Absent deeper financial, industrial, and fiscal integration and joint financing, higher defense spending risks reinforcing structural dependence rather than overcoming it.

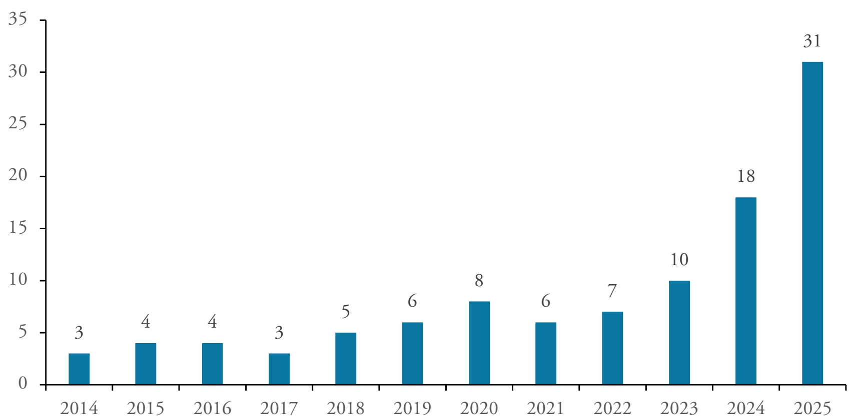
EXHIBIT 1.0 – DEFENSE EXPENDITURE GROWTH IN NATO EUROPE AND CANADA, 2014–2025 (PERCENTAGE)



Note: Data as of June 3, 2025, based on 2021 prices and exchange rates. Figures for 2024 and 2025 are estimates.

Source: NATO Defence Expenditure Report, 2025.

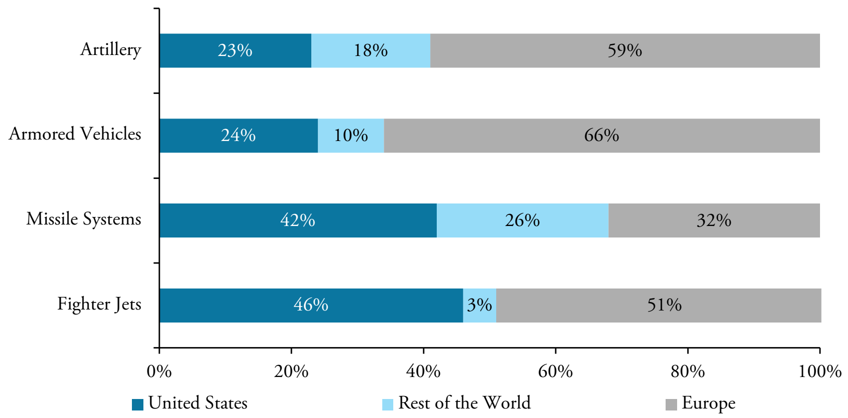
EXHIBIT 2.0 – NUMBER OF NATO MEMBERS MEETING THE 2.0% SPENDING THRESHOLD, 2014-2025



Note: Data as of June 3, 2025, based on 2021 prices and exchange rates. Figures for 2024 and 2025 are estimates.

Source: NATO Defence Expenditure Report, 2025.

EXHIBIT 3.0 – EQUIPMENT USED BY EU27, BRITISH, AND NORWEGIAN MILITARIES BY SOURCE OF PRODUCTION



Note: Percentages represent the share of military equipment produced by the United States, Europe, and the rest of the world. Missile systems refer to surface-to-air missile systems. Armored vehicles include mounted battle tanks and personnel carriers. Artillery includes self-propelled guns and mortars.

Source: International Institute for Strategic Studies, *The Guardian*.

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Middle Power Adjustments

Evaluating Canada's Increased Engagement with China

→ Canada's renewed engagement with China is a calculated diversification strategy amid enduring U.S. dominance, though U.S. structural dependence constrains Canada's strategic autonomy.

→ Canada's approach demonstrates that economic and geopolitical diversification within limits is possible — offering useful lessons for Europe.

Introduction

The global economy can best be described as asymmetrically multipolar, with economic diffusion but no systemic power parity. Trade and production are diversifying across regions, yet finance, security alliances, and high-value technological ecosystems remain heavily centered on the United States.

Canadian policymakers have increasingly faced a strategic dilemma in recent years- how to preserve economic prosperity while remaining deeply integrated with the United States and increasingly exposed to China

At the January World Economic Forum in Davos, Canadian Prime Minister Mark Carney made international headlines when he argued that middle powers must "step up" in an era increasingly defined by the U.S.-China rivalry.[1] For Canada, this is not a rhetorical position but a necessity. Canadian policymakers have increasingly faced a strategic dilemma in recent years - how to preserve economic prosperity while remaining deeply integrated with the United States and increasingly exposed to China.

Canada is pursuing a new China policy that reflects this middle-power adjustment. Its approach is to diversify its economic and geopolitical ties, elevating China to a strategic partner, while it manages a strained bilateral relationship with the United States.

Canada has also adopted a more hawkish approach in its negotiations with the U.S. while the EU, except for its coordinated response to Trump's renewed threats to acquire Greenland, has been more dovish

Canada has also adopted a more hawkish approach in its negotiations with the United States. At the same time, the EU, except for its coordinated response to Trump's renewed threats to acquire Greenland, has taken a more dovish stance.

The paper demonstrates the limits of Canada's diversification strategy under enduring U.S. centrality as structural dependence constrains strategic autonomy. It also gives the EU an idea of what can be learned from Canada's stronger negotiating approach.

Conceptual framework

The discussion about Canada-China relations often conflates key strategic concepts.

Diversification is an economic risk-management strategy that reduces concentration risk across trade, investment, or supply chains. Measurable indicators include trade share ratios, foreign direct investment (FDI) flows, and sectoral exposure. By contrast, hedging is simultaneous engagement in and balancing of activities to secure economic benefits while mitigating security threats.

Strategic autonomy is the capacity to act independently, without excessive reliance on any single partner and without vulnerability to coercion. On the other hand, realignment is a systemic shift in geopolitical orientation, including institutional and security commitments or agreements.

The evidence thus far shows the limits of Canada's diversification strategy as structural dependence constrains strategic autonomy.

There is limited proof of realignment. Canada remains a member of the U.S.-Mexico-Canada Agreement (USMCA), its NATO commitments are unchanged, and its relationships with the other members of the Five Eyes (Australia, New Zealand, the United Kingdom, and the United States) are intact. Canada also has not reoriented its security alignment with the United States. There has also been no shift in structural dependency. It continues to have significant U.S. export concentration.

Canada has also not achieved strategic autonomy. It continues to depend on U.S. market access, dollar liquidity, and integrated supply chains.

Based on this framework, Canada's approach to China reflects economic diversification within a hedging strategy. Its engagement functions primarily as risk management rather than a realignment or geopolitical pivot.

Canada's engagement with China functions primarily as risk management rather than a realignment or geopolitical pivot

Canada's China policy

Bilateral tensions intensified in late 2018 after Canada arrested a Huawei executive, and China retaliated by arresting two Canadian citizens.[2] In 2022, Ottawa's Indo-Pacific Strategy labeled China an "increasingly disruptive global power."[3]

After taking office in March 2025, Carney warned of new threats to Canada's security and sovereignty from an "assertive China."[4] However, relations improved after Carney met with Chinese President Xi Jinping in October 2025. Then, in January, Carney visited China, becoming the first Canadian prime minister to do so since 2017. During the visit, Carney stated that Ottawa and Beijing were forging a new strategic partnership.[5]

One of the key pillars of Canada's new China policy is expanded trade. Canada hopes to increase exports by 50% by 2030.[6] Both sides also committed to resolving long-standing trade barriers, including reducing tariffs on Chinese electric vehicles and Canadian canola seeds.[7]

Canada has relaxed investment rules in non-sensitive sectors, such as energy, agriculture, and consumer goods.[8] It also seeks to expand two-way investments and trade in clean and conventional energy and accelerate Chinese investment opportunities in Canada.[9]

Canada selectively expands economic ties with China while it protects its national and economic security

At the same time, Canada has established guardrails to protect its national interests. Carney ruled out deepening ties with China in artificial intelligence, critical minerals, and defense.[10] This duality reflects hedging: Canada selectively expands economic ties with China while it protects its national and economic security.

Constraints and risks

Canada's China strategy, however, faces many domestic and international challenges.

Domestic Constraints

Pew Research Center surveys show that only 34% of Canadians have a favorable view of China.[11] Concerns include human rights, foreign interference, and past bullying tactics.

Regionally, some provinces, such as Alberta and Saskatchewan, stand to benefit from reduced tariffs on canola.[12] However, the automotive sector in Ottawa would face increased competition from Chinese imports.[13]

The Canadian Vehicle Manufacturers' Association has also warned that engaging with China on EVs would undermine local manufacturing and pose data security concerns.[14]

U.S. and Chinese Risks

Canada faces the risk of U.S. retaliation for its increased engagement with China. Trump has already imposed tariffs on lumber, autos, steel, and aluminum, and threatened to impose an additional 100% tariff on Canadian goods after Carney announced a "strategic partnership" if Canada agreed to a trade deal with China.[15] Notwithstanding the late February Supreme Court ruling that invalidated some of Trump's tariffs, he is likely to continue threatening and imposing tariffs to influence the actions of foreign governments.

Canada's economic integration with the United States, via the USMCA, is a constraint and a source of vulnerability. Integrated automotive supply chains, energy interdependence, and regulatory alignment with the United States limit Canada's ability to quickly reorient away from the United States. Moreover, the USMCA sunset clause review in June provides the United States with leverage. Trump is reportedly considering scrapping the three-country trade agreement and pursuing bilateral deals instead.[16] It could also demand that Canada curb its engagement with China in exchange for continued U.S. market access.

Canadian diversification reduces vulnerability to the U.S. but introduces exposure to Chinese coercion

China has also demonstrated a willingness to employ coercion. In 2019, Beijing increased tariffs on Canadian canola and restricted Canadian imports of seed, pork, and beef products amid diplomatic tensions.[17] Thus, Canadian diversification reduces marginal vulnerability to the United States, but its increased engagement with China also introduces exposure to Chinese economic strong-arming tactics.

China's perspective

Beijing may welcome limited Canadian diversification away from U.S. overdependence, but it is unlikely to offer concessions that meaningfully alter Canada's structural constraints. Its incentives favor symbolic engagement and selective economic access, not a structural underwriting of Canadian autonomy from the United States.

Beijing may welcome limited Canadian diversification away from U.S. overdependence, but it is unlikely to offer concessions that meaningfully alter Canada's structural constraints

China lacks the economic incentive to rebalance Canada away from the United States on a structural level. Canada is marginal in China's global trade portfolio. It would also be very unlikely for China to provide Canada with preferential market access, financial backstopping, or security guarantees. It does not offer such support to U.S. treaty allies.

These dynamics underscore the asymmetric dependence in the Canada-China relationship.

Implications

The United States remains central to global finance, technology ecosystems, and high-value supply chains. However, trade diversification is observable at the margins. Supply chain "friend-shoring" and "China+1" strategies reflect economic risk management rather than systemic decoupling.

The global system is not fragmenting; rather, it is becoming asymmetrically multipolar, with middle powers cautiously hedging under U.S. dominance.

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Canada's experience illustrates this dynamic: confrontation with Washington, such as tariff disputes, can coexist with robust engagement elsewhere. Diversification, therefore, reduces marginal vulnerability, but not core dependency.

Lessons for the European Union

The EU has historically taken a more accommodating stance toward the United States and China. In 2025, it was weak in its trade negotiations with the United States but showed more resolve earlier this year in response to Trump's renewed calls to acquire Greenland.

It is worth noting that the EU differs from Canada in several respects. The EU's single market rivals the United States and China in economic size. However, unlike Canada's centralized trade authority, the EU must maintain cohesion among 27 member states. The EU's export dependence on the United States is significant, but far lower proportionally than Canada's reliance on the United States.

Certain Canadian lessons are transferable to the EU. For example, Canada shows that a firmer posture is possible under certain conditions. The bloc

Canada shows that a firmer posture is possible under certain conditions

would need to maintain internal cohesion, coordinate industrial and trade policy instruments, maintain credible security guarantees independent of U.S. fluctuations, and have the resolve to absorb short-term economic retaliation.

In addition, the EU could engage China in non-sensitive sectors while protecting critical technologies. It could also reduce exposure to the United States without seeking to break or replace transatlantic ties.

There are also non-transferable lessons. Canada has a narrower maneuvering space. It is more vulnerable to U.S. retaliation due to its geographic proximity and trade concentration. In this regard, the EU enjoys greater structural leverage. Although Canada is deeply reliant on the United States for regional defense, it faces no serious external threats. On the other hand, the EU relies on the U.S. security umbrella for strategic deterrence and faces real threats from Russia.

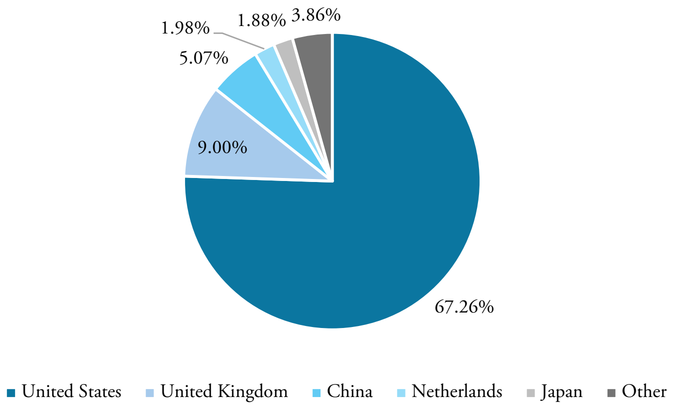
Conclusion

Canada exemplifies pragmatic hedging under asymmetric power conditions. Its engagement with China is best understood as economic risk management within a framework of enduring U.S. centrality. Diversification reduces vulnerability at the margins but does not constitute realignment.

Canada's case shows that diversification can mitigate marginal risks, but it is not a solution to structural dependence on the United States

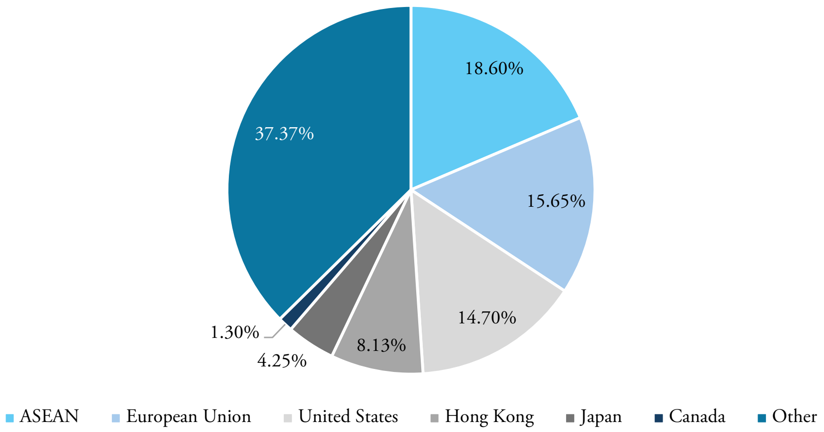
Canada's case shows that diversification can mitigate marginal risks, but it is not a solution to structural dependence on the United States. The EU could adapt as the U.S. economic gravitational pull weakens. However, its goal of achieving strategic autonomy would require confronting U.S. pressure when necessary and managing China engagement in coordination and with discipline.

EXHIBIT 4.0 – TOP CANADIAN EXPORT MARKETS BY PERCENTAGE, OCTOBER 2025



Source: Statistics Canada.

EXHIBIT 5.0 – TOP CHINESE EXPORT MARKETS BY PERCENTAGE, 2024



Source: UN Comtrade Database.

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Capital and Investment Shifts to Asia

Where the Money is Going and Why

→ The moderate movement of capital from U.S. markets toward select Asian economies reflects an incremental reweighting rather than systemic transformation.

→ The reallocation also signals the rise of distinct Asian investment clusters in manufacturing, technology, and capital intermediation that are steadily attracting marginal global flows.

Introduction

Since the passage of the "Big Beautiful Bill" in July 2025, a moderate reallocation of capital has moved from U.S. markets to select Asian —including portfolio flows to Japan and financial centers such as Singapore and Hong Kong, supply-chain FDI into manufacturing bases such as Vietnam and Malaysia, and innovation and startup investment in ecosystems such as Singapore and India.

Since the passage of the "Big Beautiful Bill" in July 2025, a moderate reallocation of capital has moved from U.S. markets to select Asian economies

This shift does not represent a systemic challenge to U.S. financial dominance. Rather, it reflects tactical portfolio rotation, supply-chain diversification, and the strengthening of specific Asian innovation and manufacturing clusters.

The relevant question is not whether U.S. financial centrality is eroding, but where capital moving toward Asia is concentrating, and what structural forces are driving those allocations.

This paper examines the sectoral, geographic, and institutional destinations of capital flows into Asia and distinguishes between cyclical rotation and longer-term structural repositioning.

Distinguishing the drivers

In assessing current capital and investment shifts, it is important to distinguish between temporary market ebbs and permanent shifts in financial gravity. Some drivers, such as interest-rate expectations, are cyclical, while others, such as supply-chain reconfiguration, are structural.

Cyclical drivers can be considered tactical rotation. Recent shifts to Asia have been partially fueled by monetary policy expectations (rate normalization in Japan *vs.* easing in the West), relative equity valuations, and currency fluctuations.

On the other hand, structural drivers can be considered a regime change. The long-term pivot is anchored in fundamental demographic momentum, industrial clustering (particularly in semiconductors and AI), and a "China Plus One" supply chain strategy that seeks to hedge geopolitical risks through diversification.

Evidence of shifts to Asia

Investment operates across distinct time horizons, with different levels of volatility and distinct drivers

Investment operates across three distinct time horizons, with different levels of volatility and distinct drivers.

Financial portfolio rebalancing

Portfolio rebalancing toward Asia partly reflects expectations of U.S. monetary easing, relative valuation gaps, dollar cycle positioning, and strengthening economic resilience in key markets.[1]

Japan has seen renewed interest from foreign investors following corporate governance reforms and improved shareholder returns.[2] Singapore and Hong Kong continue to function as regional wealth-management hubs, with Asia-Pacific now accounting for a rapidly growing share of global high-net-worth assets.[3] Singapore has become the fourth-largest global startup ecosystem, offering a stable, low-friction environment for wealth management and institutional flows. And in February, hedge funds recorded their largest net purchases of Asian stocks since 2016.[4]

These flows primarily reflect cyclical positioning and relative valuations rather than permanent structural change.

Portfolio flows remain highly sensitive to global liquidity conditions. Cross-border portfolio flows tend to reverse when U.S. rates rise, or global risk sentiment deteriorates.[5]

Supply chain FDI relocation

Unlike portfolio flows, FDI reflects multi-year commitments tied to production networks and labor markets. FDI relocation is driven by labor-cost differentials, demographic expansion, trade diversification, tariff risk management, and industrial policy competition.

Geopolitical hedging and "China+1" strategies are risk-management approaches that diversify supply chains away from China, often into Southeast Asia or India, while maintaining a presence there.[6] This approach aims to mitigate risks from U.S.-China trade tensions, rising costs, and disruptions.

Vietnam and Malaysia have benefited from these supply-chain diversification strategies.[7] Vietnam is emerging as a premier manufacturing destination, with FDI inflows approaching $40 billion in 2025.[8] Malaysia is successfully positioning itself as a hub for semiconductor diversification.[9]

These adjustments are not easily reversible. Once manufacturing ecosystems cluster, network effects reinforce location decisions. FDI shifts, therefore, signal durable changes in the geography of production.

Innovation and startup ecosystems

A third layer involves where startups incorporate, raise capital, and build technology platforms. Startup location decisions reflect regulatory predictability, talent pools, access to regional consumer markets, and government incentives.

Singapore has emerged as a regional venture capital hub, supported by strong rule-of-law institutions and tax clarity.[10] India's startup ecosystem is now among the world's largest by number of unicorns.[11] And South Korea and Taiwan continue to be the global leaders in advanced semiconductors, controlling most cutting-edge chip production and high-end memory.[12]

These ecosystems exhibit medium- to long-term stickiness. However, they remain sensitive to global venture capital cycles, placing this layer between the liquid portfolio flows and the structural FDI.

Interplay
The three categories reinforce each other and accelerate the shift of capital towards Asia. The FDI provides the physical infrastructure and demand; the startup ecosystem provides technological efficiency and Industry 4.0 growth; and the portfolio flows provide the broad-based liquidity and valuation support.

However, these layers operate on different time horizons and are driven by different incentives. Portfolio flows can reverse quickly in response to global liquidity tightening without necessarily disrupting embedded manufacturing capacity or innovation clusters. Venture capital cycles may slow as FDI continues to expand. This reflects a partial overlap rather than self-sustaining momentum.

Durability of current shifts
The most compelling evidence of sustained reallocation is visible in production geography rather than in equity fund flows. Portfolio reallocations may normalize if U.S. valuations compress or growth reaccelerates. FDI and supply-chain restructuring, by contrast, reflect multi-year corporate planning decisions.

Investment clusters
Capital is not shifting to Asia uniformly; rather, it is concentrating into three specific functional clusters within Asia's diverse landscape, each driven by distinct economic advantages.

Capital is not shifting to Asia uniformly; rather, it is concentrating into specific functional clusters within Asia's diverse landscape, each driven by distinct economic advantages

Advanced technology hubs: Taiwan, South Korea, Japan
These economies specialize in semiconductors, advanced manufacturing, robotics, and AI hardware. They benefit from industrial depth and supply-chain clustering.

Financial and governance hubs: Singapore, Hong Kong
These hubs serve as centers of capital intermediation. Institutional quality, legal predictability, and wealth management ecosystems are primary drivers.

Demographic and supply-chain growth hubs: Vietnam, Malaysia, India
These countries attract FDI due to labor-force expansion and integration into global manufacturing networks.

Although capital has reallocated toward selected Asian markets, the scale remains insufficient to challenge U.S. financial dominance materially

Implications for the West

Although capital has reallocated toward selected Asian markets, the scale remains insufficient to challenge U.S. financial dominance materially. No Asian currency yet offers comparable depth, liquidity, and legal infrastructure, and the structural foundation of continued U.S. centrality remains strong.

The dollar continues to anchor global reserves. The U.S. dollar remains dominant in global reserves, accounting for approximately 57% of foreign exchange reserves.[13] U.S. capital markets also retain unmatched depth and liquidity. The Treasury market functions as the global risk-free benchmark; legal predictability and property-rights enforcement remain strong; and the United States continues to anchor global technology ecosystems, particularly in AI.

Current movements represent diversification at the margin rather than systemic displacement.

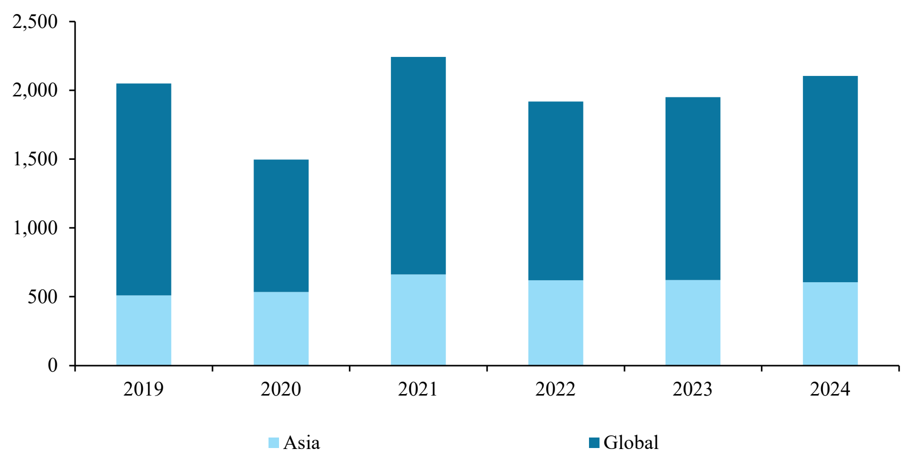
Conclusion

Capital is reallocating to Asia in measurable but differentiated ways. Portfolio flows reflect cyclical positioning; supply-chain FDI signals for longer-term industrial diversification; and innovation ecosystems are deepening in selected technology hubs.

The central development is not the decline of U.S. dominance, but the strengthening of distinct Asian investment clusters that are attracting marginal capital flows

The evidence points to incremental reweighting rather than systemic transformation. The central development is not the decline of U.S. dominance, but the strengthening of distinct Asian investment clusters that are attracting marginal capital flows.

EXHIBIT 6.0 – FDI INFLOWS TO ASIA AND GLOBALLY, 2019-2024, USD BILLION



Source: UN Trade and Development.

EXHIBIT 7.0 – TIME HORIZON, VOLATILITY, AND DRIVERS OF DIFFERENT KINDS OF CAPITAL

	Time Horizon	Volatility	Drivers
Portfolio flows	High	High	Rates, valuations
Supply chain FDI	Low	Low	Supply chains, labor, policy
Startup ecosystems	Medium/Long	Mixed	Ecosystems, regulation, talent

Source: Funcas.

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The Debt Leverage Debate

Assessing U.S. Financial Dependence on Europe and Asia

→ Foreign holdings of U.S. Treasuries may look like geopolitical leverage, but once distinguishing between private investors and foreign official institutions, the debt weapon narrative largely dissolves.

→ U.S. financial dependence on Europe and Asia is real in scale, yet it is systemic, reciprocal, and too costly to weaponize to serve as an effective tool of coercion.

Introduction

Foreign holdings of U.S. Treasuries are often portrayed as a source of geopolitical leverage by their European and Asian creditors. While foreign investors hold one-third of marketable U.S. Treasuries, the coercive debt leverage narrative weakens once one distinguishes between private investors and official institutions.[1] U.S. financial dependence is real in scale, but it is systemic, reciprocal, and costly to weaponize.

Exposure does not equal coercion

Public and private foreign investors hold substantial shares in U.S. Treasuries, corporate bonds, equities, and dollar-denominated financial instruments. Total foreign holdings of U.S. securities exceed $35 trillion as of mid-2025.[2]

Yet exposure is mutual. Large-scale liquidation of Treasuries would depress bond prices and weaken the dollar, but it would simultaneously impose capital losses on the seller and disrupt its own financial system.[3] Interdependence, therefore, creates shared vulnerability rather than unilateral power.

Interdependence creates shared vulnerability rather than unilateral power

Private *vs.* official holders

The most critical mistake in the debt-leverage argument is the failure to distinguish between the types of owners. Headline figures often lump all foreign holders together, but the motivations and constraints of a private pension fund are different from those of a central bank.

Private investors, whether based in Madrid, Tokyo, or New York, behave the same way regardless of nationality. They respond to incentives like relative returns, safety, and liquidity. And governments cannot easily compel these private actors to sell their U.S. assets. Doing so would violate fiduciary mandates and cause massive self-inflicted financial losses.

High levels of foreign private ownership do not meaningfully increase U.S. political vulnerability

The relevant issue regarding potential coercion involves debt held by foreign official institutions, such as central banks and sovereign wealth funds

Consequently, high levels of foreign private ownership do not meaningfully increase U.S. political vulnerability.

Foreign official holdings and China

The relevant issue regarding potential coercion involves debt held by foreign official institutions, such as central banks and sovereign wealth funds.

Japan is the largest single foreign holder of U.S. Treasuries, but as a treaty ally, its position is not generally framed in adversarial terms. European official holdings are fragmented and largely aligned with U.S. interests, making them highly unlikely to be used coercively.

Among official holders, China stands out for the sheer scale of its holdings, its centralized strategic control, and its geopolitical rivalry with the United States. As of December 2025, it was the third-largest foreign holder of U.S. debt. China reached an all-time high of $1.32 trillion in U.S. Treasuries in 2013, then steadily reduced its holdings to $683 billion by December 2025.[4] This reduction has diluted China's capacity to disrupt the bond market through unilateral action.

A large-scale sell-off by China would also be economically self-defeating. Depressed Treasury prices would generate losses on China's remaining holdings, while dollar depreciation could complicate exchange-rate management and affect export competitiveness. Moreover, U.S. Treasuries function as core collateral in global dollar funding markets, limiting the feasibility of abrupt liquidation. Past episodes of Chinese reserve adjustment were largely absorbed by other investors, including U.S. households, mutual funds, and the Federal Reserve.[5]

Greater diversification of reserves toward gold or euro-denominated assets could exert marginal long-term effects on Treasury demand. Still, such adjustments tend to be incremental and market-absorbed rather than disruptive.

Structural fragilities in global bond markets

More price-sensitive actors, including hedge funds, households, and foreign bond holders have partially replaced traditional institutional investors

While deliberate debt weaponization appears unlikely, a recent OECD report suggests that sovereign and corporate bond markets have become structurally more fragile.[6] Global bond markets now exceed $100 trillion and have undergone significant changes in their investor base.[7] More price-sensitive actors, including hedge funds, households, and foreign bond holders have partially replaced traditional institutional investors.

At the same time, governments are increasingly shifting from longer-term borrowing to more short-term financing needs. In 2025, government refinancing needs reached record levels, accounting for roughly 80% of gross borrowing.[8] These developments may reduce the shock-absorption capacity of debt markets. Such vulnerabilities, however, are systemic rather than geopolitical. They reflect leverage, refinancing pressures, and evolving market structure, not the strategic leverage of foreign creditors over the United States.

Conclusion

U.S. financial dependence on Europe and Asia is substantial, but it is embedded in dense networks of mutual interdependence. Private investors act according to market logic, while official holders face strong economic constraints that limit the credibility of coercive threats.

Financial interdependence creates exposure, but not geopolitical leverage. The greater risk to financial stability is not deliberate debt weaponization, but in the broader structural fragilities of an increasingly leveraged and price-sensitive global bond market.

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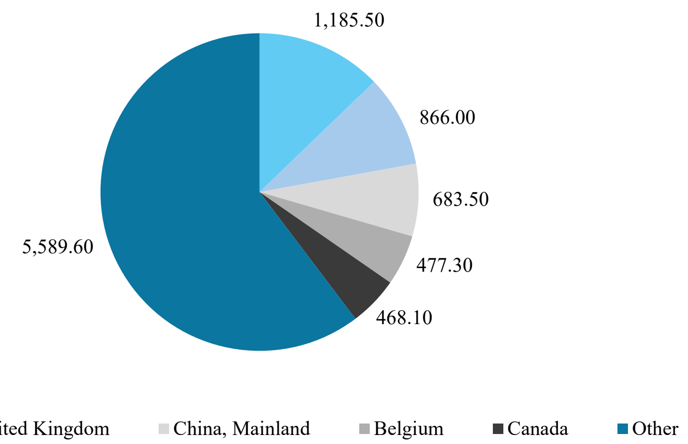
EXHIBIT 8.0 – ESTIMATED OWNERSHIP OF U.S. TREASURY SECURITIES, 2020-2024

Month, Year	Total Debt	Foreign Holdings	Foreign Holdings as a Share of Total Debt
December 2020	$20.9 trillion	$7.3 trillion	30%
December 2021	$22.6 trillion	$7.7 trillion	30%
December 2022	$23.8 trillion	$7.3 trillion	31%
December 2023	$26.2 trillion	$7.9 trillion	34%
December 2024	$28.1 trillion	$8.5 trillion	30%

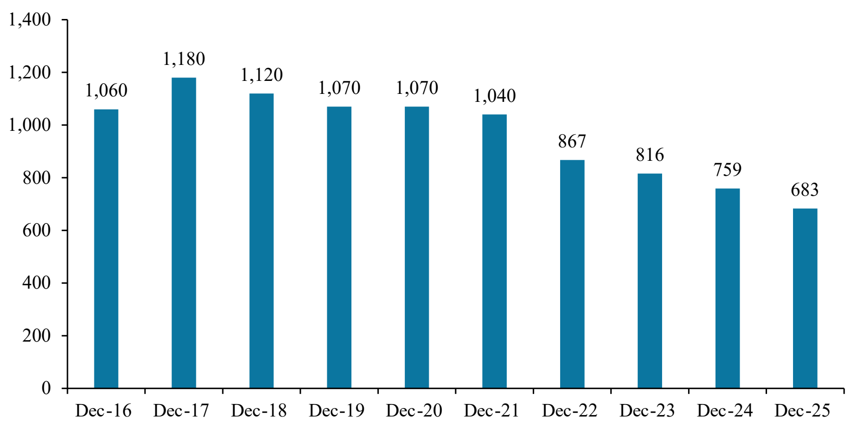
Note: Table includes marketable Treasury securities held by the public. Data current as of May 14, 2025.
Source: Board of Governors of the Federal Reserve System.

EXHIBIT 9.0 – FOREIGN OWNERSHIP OF U.S. TREASURY SECURITIES, DECEMBER 2025, USD BILLION



Source: U.S. Department of the Treasury.

EXHIBIT 10.0 – U.S. TREASURIES HELD BY CHINA, 2016-2025, USD BILLION



Source: U.S. Department of the Treasury.

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Notes

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