DEGLOBALISATION: IMPLICATIONS FOR INVESTORS

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This research has been commission by the Investment Management Corporation of Ontario (IMCO) through Oxford Economics, a leader in global forecasting and quantitative analysis.

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PREFACE

IMCO is focused exclusively on providing comprehensive investment solutions, including timely insights on global economic trends, to public-sector clients in Ontario.

One trend that we have observed is a shift away from globalisation towards deglobalisation. It is too early to tell whether these observations are simply a 'blip' or whether we are going through a regime change. But, given the potential implications for our clients and their portfolios, we engaged Oxford Economics, a leader in global forecasting and quantitative analysis, to develop this research paper which examines key globalisation, and deglobalization, trends.

We are pleased to share the enclosed research paper, which is a part of our recently launched research program to create clear and relevant context on issues facing the markets. This research program also includes a series of research papers on topics related to inflation, real interest rates, productivity, and growth.

One observation in the enclosed paper is that, on its own, deglobalization is not necessarily bad. In fact, if it makes our economy more efficient, it may be a natural development, in the same way that globalisation was in the past. However, we are concerned if deglobalisation is driven by nationalistic or insular economic policies.

We would expect a policy-led deglobalization to result in:

- An increasingly fragmented world, characterized by lower returns, higher volatility, and reduced correlation of business cycles across countries;
- Increase in dispersion among markets, with larger impact on economies that have been past beneficiaries of globalisation, such as export-oriented emerging economies;
- Reduction in the global capacity to produce certain goods and services, potentially resulting in domestic inflationary pressures; and
- Increased uncertainty and heightened risk aversion during a period of adjustment.

These risks have been exacerbated by the COVID-19 Pandemic currently ravaging economies around the world. The natural reaction of many countries to protect their citizens by restricting exports of medical equipment and supplies has also clearly demonstrated that the outsourcing of production in pursuit of efficiency and cost savings has also undermined the security of production in a crisis.

There is no crystal ball that accurately predicts the future and the views expressed on the following pages represent one potential version of the future. As a result, our clients' portfolios are not optimized for a specific market environment or potential path of future returns. Instead, we strive to help our clients build diversified portfolios that include strategies intended to work in different potential market environments.

EXECUTIVE SUMMARY

- Over the last 200 years, the world economy has experienced two major waves of globalisation, which were characterised by increased flows of trade, capital, people and information. Recent events suggest that this cycle may have reached a turning point.
- Since the global financial crisis, the ratio of global trade to output has started drifting lower. This represents a stark reversal of the long-standing trend of trade growth consistently outpacing GDP growth.
- To the extent that old economic models of exporting globally make less sense, a decline in cross-border flows may be a natural and efficient outcome. What would be more troublesome is a scenario where the open, global economy unravels as a result of nationalistic and insular economic policies. Unfortunately, the prevalence of such policies is growing around the world.
- This type of 'policy' deglobalisation would have adverse consequences for the world economy. Although there may be some short-term gains for certain groups, such as lower-skilled workers in developed economies, the net impact on the global economy would be negative.
- From an investment perspective, there would likely be few 'winners' in this increasingly fragmented world, and we would expect it to be characterised by lower returns and higher volatility, with greater dispersion in asset returns. Reduced correlations would make it even more important to diversify investments, both globally and across asset classes.
- Of course, the impact would not be the same on all economies. At a national level, economies that have been past beneficiaries of globalisation, such as export-oriented emerging markets, would be more vulnerable to the fallout from a reversal of these trends. European stocks would also be exposed given the high dependency on foreign revenues of listed companies.
- Deglobalisation would also reduce economies' capacity to produce certain goods and services. This negative supply-side shock would place upward pressure on prices, potentially resulting in domestic inflationary pressures. This could leave bond markets vulnerable. Lower economic growth could compound the upward pressure on bond yields as government finances come under pressure.
- As the world economy adjusts, increased uncertainty and heightened risk aversion should be positive for traditional safe-haven currencies. Longer term, the USD at least should continue to benefit from the US economy being relatively insulated from negative developments in global trade given its large domestic market.
- Navigating the challenges posed by deglobalisation may require a fundamental rethink of existing frameworks for investing. But market disruption can bring new opportunities for adaptable investors that are able to understand and respond to these shifts.

GLOBALISATION	POLICY-LED DEGLOBALISATION	IMPLICATIONS FOR INVESTMENT
Outsourcing of manufacturing production	Reshoring of production due to protectionism	Lower earnings multiples for multinational firms; Providers of labour-saving technologies likely to benefit from increased demand
Lower cost of capital	Higher cost of capital	Lower earnings multiples, upward pressure on corporate bond spreads
Export-oriented economies grow rapidly	Countries with large domestic markets more insulated	Refocus portfolios away from markets reliant on global trade
Downward pressure on global prices	Domestic inflation more responsive to domestic resource constraints	Potential upward pressure on bond yields and uncorrelated volatility in national markets
Increased correlation of business cycles across countries	Reduced correlation of business cycles across countries	Benefits of diversification (across geographies and asset classes) are amplified

1. HAS GLOBALISATION STALLED?

FOR MANY YEARS THE WORLD ECONOMY WAS BECOMING MORE INTEGRATED

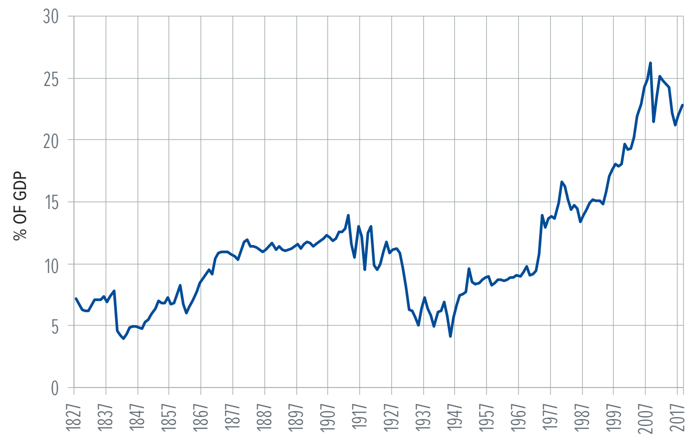
The process of globalisation refers to the economic integration of countries through the movement of goods, services, capital, people and information across borders. The global economy has experienced two major waves of globalisation over the past 200 years, with each wave being driven by radical reductions in technological and policy barriers to international transactions.

The growth of trade relative to incomes first took off in the second half of the 19th century, driven by transport-technology advances and a reduction in tariffs. This first wave of globalisation started slowing by the late 1800s and came to an abrupt halt with the outbreak of World War I in 1914, which disrupted global trade flows and devastated Europe. The challenges of rebuilding Europe's economies in the aftermath of World War I were further compounded by the imposition of trade and exchange restrictions that continued until the end of World War II.

The end of World War II ushered in a new wave of globalisation with the advent of the General Agreement on Tariffs and Trade (GATT) and later the World Trade Organisation (WTO).

This second globalisation wave continued until the global financial crisis (GFC) of 2007-08. Particularly notable was the period from the late 1990s, which is often referred to as the era of "hyper-globalisation" due to the especially rapid surge in world trade that occurred. This period was characterised by the integration of China into world trade and a surge in flows of foreign direct investment (FDI) as manufacturing production became increasingly fragmented across borders, aided by advances in global communications technology.

Global: Ratio of trade to GDP



Source: Fouquin and Hugot (CEPII 2016), World Bank, Oxford Economics

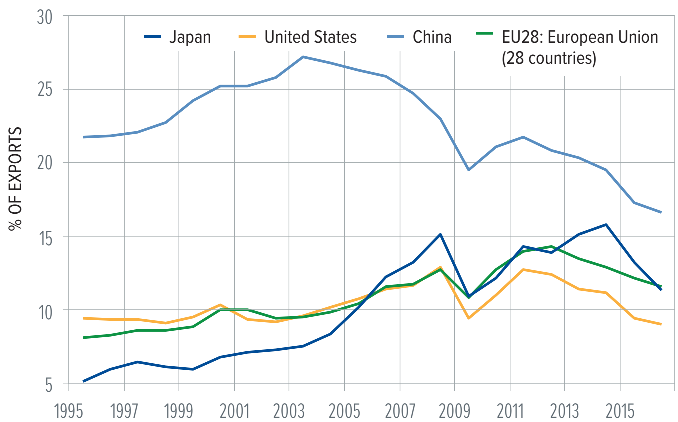
BUT WE MAY NOW BE ENTERING A PERIOD OF REVERSAL

This second wave of globalisation was disrupted by the onset of the GFC, as world trade collapsed more rapidly than output. Although trade flows had bounced back to previous levels by 2010, growth in global trade subsequently downshifted, with the ratio of trade to output drifting lower in recent years. This represents a stark reversal of the long-standing trend of trade growth consistently outpacing GDP growth.

Whether this shift is permanent or transient is still an open question. A number of cyclical factors have weighed on trade growth, including the slower recovery of (trade-intensive) investment compared to (less trade-intensive) consumption around the world. But there are also structural factors at play, including the slowing Chinese economy (previously trade's growth engine) and some evidence that the pace of expansion of global supply chains may have slowed in the mid-2000s due to shifting factors influencing the attractiveness of offshore production facilities.

Evidence that firms are shortening or otherwise reshaping their global supply chains includes a recent plateau (or decline) in the foreign value-added content of exports for many major economies. This shift has been especially pronounced in China, where the foreign value-added content in exports has been declining for several years, reflecting the country's substantial investments and technological upgrades aimed at expanding its production capacity and increasing domestic sourcing of intermediate inputs.

Foreign value-added content in exports



Source: Oxford Economics/OECD

CREEPING PROTECTIONISM THREATENS TO RESTRICT TRADE

Compounding the impact of these factors has been a rise in protectionist measures as anti-globalisation sentiment has influenced the political debate in the US, Europe and elsewhere. According to the WTO, the rate at which new trade-restrictive measures are being put in place by its members is running at a historically high level[1], underscoring the phenomenon of "creeping protectionism" that emerged after the GFC. This is illustrated by the recent renegotiation of NAFTA, which was pursued with import reduction and supply chain repatriation as the main objectives of the US Administration. Moreover, as evidenced by Brexit and the US-China trade dispute, a marked reversal of trade liberalisation remains a risk as calls in some countries for stronger measures to protect their domestic markets may yet be translated into action.

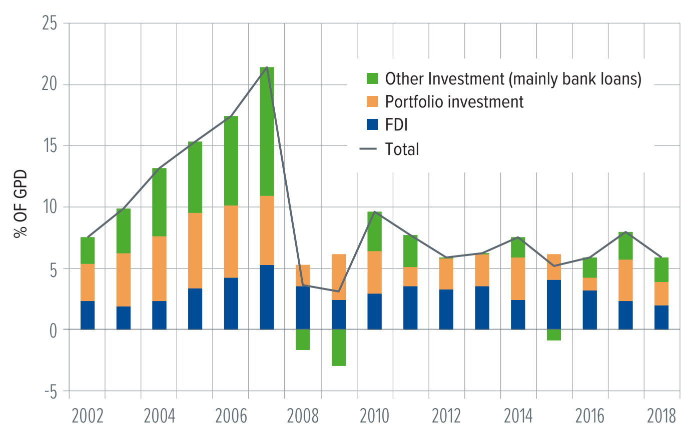
That said, it must also be recognised that there has also been some important progress recently on trade liberalisation. For example, several big new trade accords have been finalised, including the Canada-EU Comprehensive Economic and Trade Agreement (CETA), Trans-Pacific Partnership agreement (TPP-11), the African Continental Free Trade Area (AfCFTA) and the EU-Japan Economic Partnership Agreement. China's Belt and Road Initiative is another example of efforts to strengthen international connectivity.

CROSS-BORDER FINANCIAL FLOWS HAVE SLOWED ABRUPTLY, AND ARE NOT RECOVERING

Evidence that globalization may have reached an inflection point is also apparent in the collapse of cross-border capital flows. Global capital flows contracted sharply during the GFC and have since recovered to only about 25% of their pre-crisis peak.

Drilling down to the underlying composition of these capital flows reveals that this post-crisis "financial deglobalisation" was driven primarily by reduced international bank lending, whereas FDI and international portfolio flows have so far proved more resilient (notwithstanding US threats to impose restrictions on bilateral investment ties with China). This cross-border bank deleveraging likely reflected the impact of both tighter regulatory policies and unconventional monetary policies, which have interacted to encourage a home bias to bank lending while also incentivising corporate borrowers to shift their borrowing toward the bond markets.

Global: Cross-border flows of capital



Source: UNCTAD/IMF

HAS THE NATURE OF GLOBALISATION CHANGED?

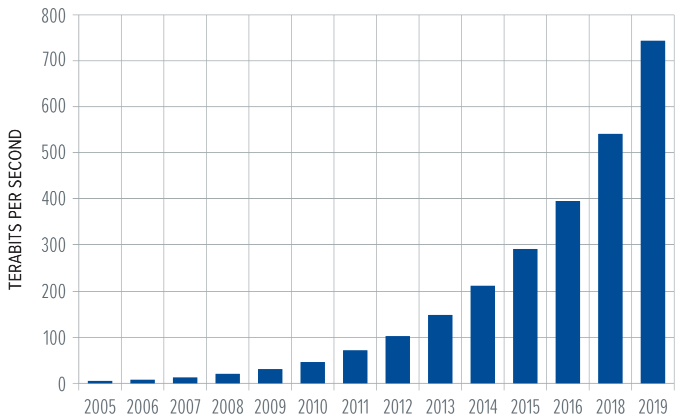
While global flows of trade and capital have levelled off or declined in recent years, there have been few signs to date of any slowdown in international data flows, which have continued to surge forward. Indeed, the volume of data flows, measured in terabits per second, multiplied by a factor of 40 in a decade to reach an estimated 740 terabits per second in 2018.

Network connectivity continues to transform commerce, communication, education, and much more. These data flows are often associated with the services sector, but business activities across a broad spectrum of activities benefit from digital connectivity. For example, data transfers can enable manufacturers to coordinate R&D activities across multiple locations, control geographically dispersed production processes and track products as they are transported to customers. As this

[1] https://www.wto.org/english/tratop_e/tpr_e/tpr_e.htm

new digital era unfolds, some have argued that globalisation is not in retreat, but rather it has entered a new phase where digitisation transforms business models and links consumers and suppliers across the world.

Global: Used cross-border bandwidth



Source: TeleGeography, McKinsey Global Institute analysis

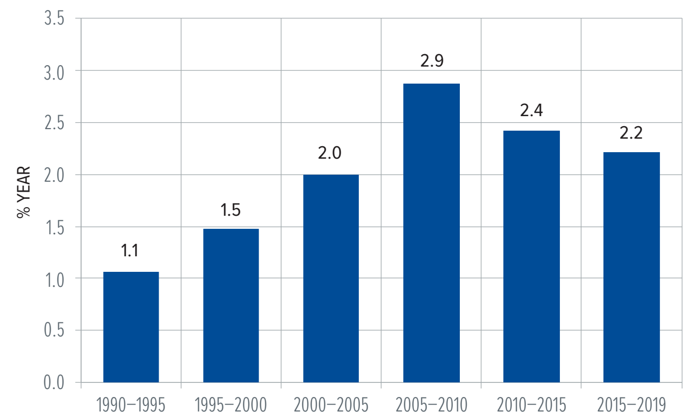
Yet this optimistic view of globalisation's future is also under threat as a growing number of countries introduce barriers that make it more expensive and time consuming, if not illegal, to transfer data overseas. Some, such as China and Russia, already restrict the transfer of most types of data. Other governments are also imposing various barriers to cross-border data flows, the most prominent being the EU's recently introduced General Data Protection Regulation (GDPR), which permits data transfers only to countries deemed as providing adequate data protection.

While these policies are often adopted to address legitimate underlying concerns, such as privacy and cybersecurity, sometimes the motivation is purely mercantilist. The lack of international consensus and cooperation on policies to regulate the digital world could lead to the emergence of national digital borders, inhibiting flows of data and information, with negative consequences for trade, supply chains, and cross-border investment.

ANTI-IMMIGRATION SENTIMENT HAS INCREASED

Although the number of international migrants worldwide has continued to grow, tolerance for migration has clearly ebbed amongst the world's wealthier nations. For example, measures to tackle illegal immigration to the United States were a hallmark promise of President Trump's election campaign; and support for populist candidates has also risen in Europe, where refugees and illegal immigration have risen sharply due to instability in the Middle East.

Growth in the number of international migrants



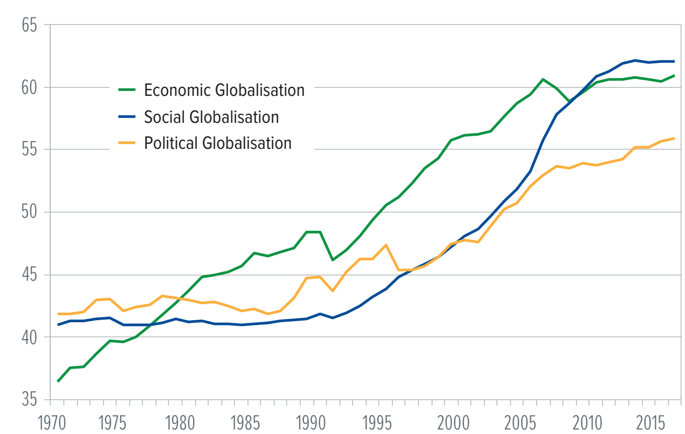
Source: United Nations World Migration Report 2020

SLOWING GLOBALISATION CONFIRMED BY INDICES

Globalisation is a multi-faceted concept encompassing economic, social and political aspects that go beyond just trade and capital flows. In order to capture these broad aspects of international integration, summary indicators have been developed that attempt to measure globalisation's progress using a weighted average of different indicators. The most widely used amongst these is the KOF Globalisation Index, which includes sub-indices measuring the economic (trade and financial), social (information, cultural and interpersonal) and political dimensions of globalisation.

Their results confirm that economic and social aspects of globalisation have on average hardly advanced over the past decade, notwithstanding continued growth in certain indicators such as information flows. Only political globalisation has continued to increase, reflecting ongoing cooperation through international organisations and treaties.

KOF Globalisation Index*



*De facto indices, measuring actual international flows and activities.
Source: KOF Swiss Economic Institute

IS DEGLOBALISATION NECESSARILY "BAD"?

In the same way that the concept of globalisation is multi-dimensional, deglobalisation may also proceed along different pathways with varying implications. To the extent that old economic models of producing in one region and exporting globally make less sense, deglobalisation may be natural and efficient. It may be that less complex and more localised supply chains work better for some industries.

As an example, in the fashion industry it is increasingly important to reduce lead times for getting new fashion product into stores in order to satisfy consumer demand at its peak.

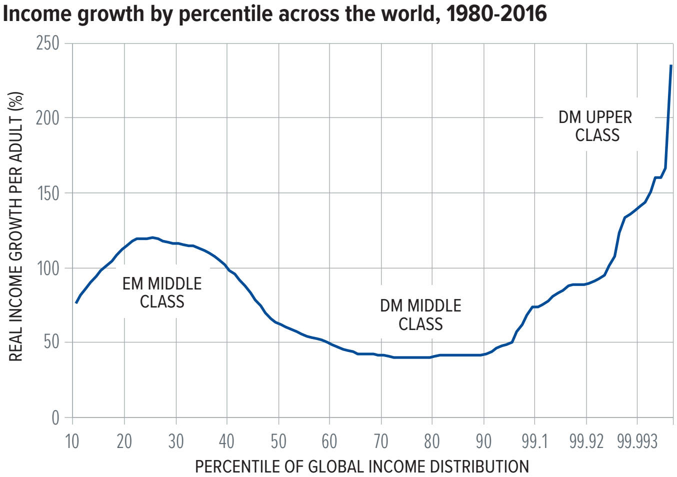
Likewise, the adoption of new technologies (such as robotics and 3D printing) may also make it increasingly cost-effective for production to be located near to the final consumer. Of course, a side effect of increased use of automation is that de-globalization may not bring with it the return of the jobs that were originally lost as a result of globalisation.

What would be more troublesome is a scenario where the open, global economy unravels as a result of economic policies that are insular and prioritise the domestic market over trade. Such an outcome may hinge on political developments and a key concern here is the rise of populism and anti-globalisation sentiment, which have the potential to hasten a shift towards such comparative isolationism.

THERE IS GROWING RESISTANCE TO GLOBALISATION AMONGST THE PUBLIC

It is perhaps not surprising that the political discourse on trade in many developed nations has now shifted from extolling the economic benefits of globalisation to focussing on concerns about job losses, falling real wages, deindustrialisation, and inequality. While globalization has helped to narrow the gap between the poorest and richest nations of the world, it has also contributed to job displacement, particularly amongst low-wage earners in industrialised economies.

Income growth by percentile across the world, 1980-2016



Source: World Inequality Report, 2018

[2] https://www.automation.com/pdf_articles/oxford/RiseOfTheRobotsFinal240619_Digital.pdf

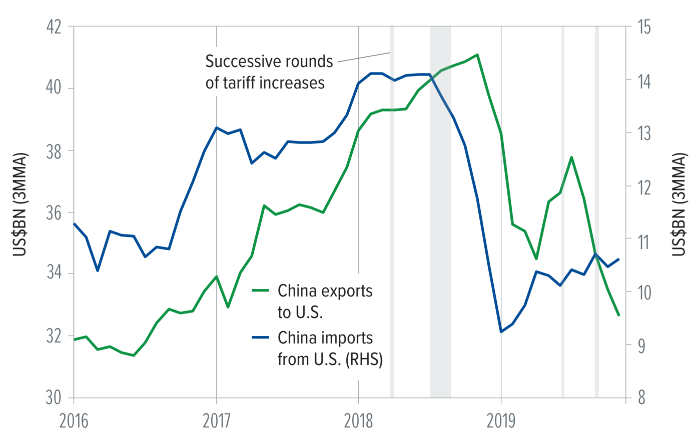
Of course, trade is not the only factor driving job displacements in these economies. The global stock of robots multiplied three-fold over the past two decades and our estimates suggest that each new industrial robot eliminates 1.6 manufacturing jobs on average and almost twice that in low-skilled regions[2]. Combined with lack of effective policies to assist trade-displaced workers, this has helped to fuel the political ascendancy of parties on the right (e.g. Trump, Farage and Le Pen) but also new parties on the left such as Spain's Podemos, and populist hybrids such as Italy's Five Star Movement.

This political backdrop means that we may at best face a long pause in activist policies aimed at trade liberalisation. In this environment, it is also plausible that previous trade liberalisation measures may be gradually eroded as countries backslide on their commitments. With populist movements around the world fuelling economic nationalism and a tendency toward increased unilateralism, there is also the potential for more intense conflicts over trade and financial regulation, as well as increasing hostility to migration. The US-China trade war and the Brexit vote provide the most palpable recent examples of this populist backlash against globalisation.

AN ESCALATION OF TRADE TENSIONS REMAINS A KEY RISK

While the UK's departure from the EU is still underway, the US and China have been in a trade war for around two years, a period long enough to yield important lessons about how such disputes affect trade flows. From early 2018 to September 2019, the average Chinese tariff on US goods has risen by 13ppts (8% to 21%) and the average US tariff on Chinese goods by 18ppts (3% to 21%). The impact on trade volumes has been large. From 2018 peaks, US exports to China have fallen 25% and Chinese sales to the US are down 20%. Considering the rise in demand in each market, trade volume falls have been around double the tariff rise (an 'elasticity' of around two).

US & China: Bilateral trade

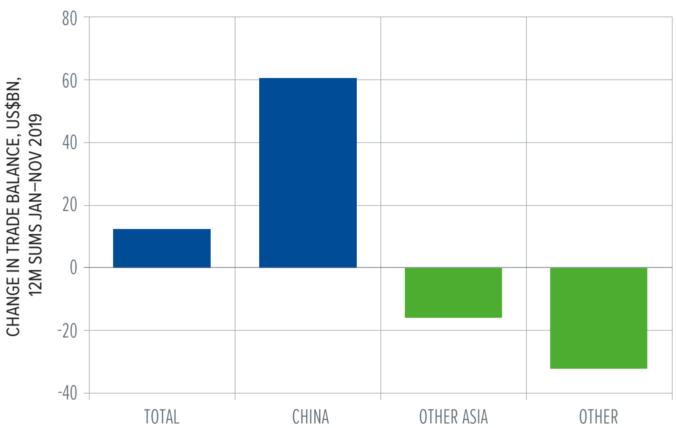


Source: Oxford Economics/Haver Analytics

The US-China bilateral trade deficit has been cut by the trade war: in 2019 it fell by US$60bn or around 15% (on an annual basis).

But the overall US trade deficit hasn't changed much – rather, its composition has shifted with a narrower deficit with China offset by wider deficits with the rest of Asia and other parts of the world. In other words, supply chains have started to shift, with suppliers from the rest of the world displacing Chinese goods in the US market. The longer these high tariffs stay in place, the harder it may therefore prove to get rid of them as new supply chains form and political constituencies in their favour are created. And with many of the targeted Chinese goods being intermediates, there is a growing risk of significant economic 'decoupling'.

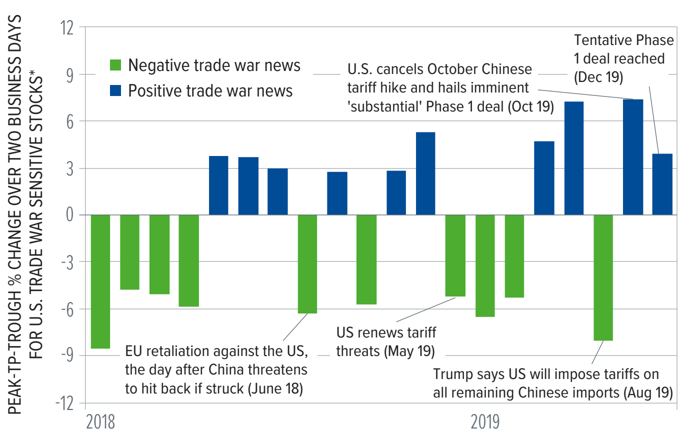
US: Trade deficits



Source: Oxford Economics/Haver Analytics

While the recent Phase 1 deal between the US and China has been accompanied by a wave of optimism, historical evidence and more recent experience suggest caution. Over the course of the trade war, we have frequently seen a de-escalation in trade tensions followed by a re-escalation. And our analysis of trade-war sensitive stocks supports the view that markets have reacted strongly to the ebb and flow of these tensions. With China unlikely to yield to the US's more fundamental requests to reform its industrial policies or to abandon its quest for global technological leadership, the potential for a renewed escalation of trade tensions remains.

Timeline of major trade war news and US stocks



Source: Oxford Economics/Haver Analytics
*Top 10 positive and top 10 negative trade war news events. Average response for basket of trade war sensitive US stocks, weighted by sensitivity of individual stocks to trade war news.

Moreover, trade policy tensions are not confined to the US-China dispute. The US is also threatening high tariffs on EU goods and has ongoing disputes with India and Vietnam, amongst others. Among other bilateral trade disputes, Japan and South Korea are also locked in an ongoing economic conflict. Against this background, further escalation into a full-blown trade war is therefore still a realistic possibility. This would undoubtedly have severe near-term repercussions for international trade flows, and it could also encourage a weakening of countries' WTO commitments, leading to an unravelling of the multilateral system of world trade with serious longer-term consequences. Indeed, the WTO is already in trouble, with the US blocking the appointment of judges to its appellate court.

THE COVID-19 CRISIS ADDS FUEL TO NATIONALIST POLICIES

The coronavirus pandemic is also likely to have long-term negative implications for globalisation as it demonstrates how outsourcing of production in pursuit of efficiency and cost savings has undermined the security of production. The crisis will likely force all of us to rethink our supply-chain strategies, with a view to shortening and/or diversifying supply chains to improve reliability.

For certain sensitive industries such as pharmaceuticals and medical equipment, governments may even force producers to ensure there is adequate domestic productive capacity to guarantee ongoing stability of entire supply chain needed in a time of crisis. Policy support for domestic agricultural production may also be strengthened, given concerns around food security in some countries. More generally, the crisis will only add fuel to nationalist sentiment and re-energise protectionist trade policy agendas.

TARIFFS COULD ALSO BE RAISED TO SUPPORT CLIMATE CHANGE POLICIES

Another policy development that is likely to drive deglobalisation is the introduction of new regulations to reduce carbon emissions, which will make geographically dispersed supply chains more costly. Indeed, shipping is viewed as one of the world's most polluting activities and is now firmly in the sights of policymakers.

More broadly, reducing greenhouse gas emissions consistent with the goals of the Paris Agreement will require unprecedented efforts across all sectors of the economy and from all countries. But efforts at international policy coordination are bedevilled by an enormous free rider problem. The obvious solution to the free rider problem is the imposition of tariffs and the adoption of carbon border taxes against countries that renege on the Paris Agreement.

With the US scheduled to leave the Paris Agreement this year and the EU on the verge of formalising plans to be carbon neutral by 2050 this has already set up an obvious point of friction. The EU, for example, has already signaled its intention to seek greater protections in terms of standards to facilitate the European Green Deal.

2. IMPLICATIONS OF A DEGLOBALISING WORLD

While deglobalisation may take the form of an orderly transition characterised by shifting economic drivers and consumer tastes, the implications for investors are likely to be most severe in a scenario characterised by a more pernicious, forced adjustment as a result of nationalistic policies and increased protectionism. We focus here on the implications of such 'policy' deglobalisation.

This paradigm shift would be associated with a structural break in a number of trends that had defined the previous era of globalisation. As summarised in the table below, this could also have important implications for investment strategies. This chapter discusses these trends in more detail.

BENEFICIARIES OF GLOBAL INTEGRATION MAY BE MOST VULNERABLE

Deglobalisation in the sense of reduced openness and a forced retreat from internationalisation would be expected to have a negative impact on the global economy. This reflects a widespread consensus among economists on the overall net benefits of open trade, albeit with the need to cushion the negative impact it has on certain groups in society. Although there may be some short-term gains from deglobalization for certain groups, such as lower-skilled workers in developed economies, there would be greater losses for other groups. By unravelling the long-term benefits of closer trade and investment links, retreating into protectionism also has the potential to unsettle global financial markets.

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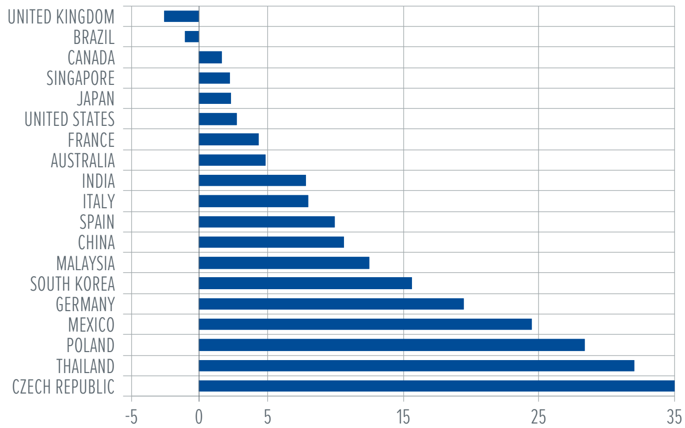
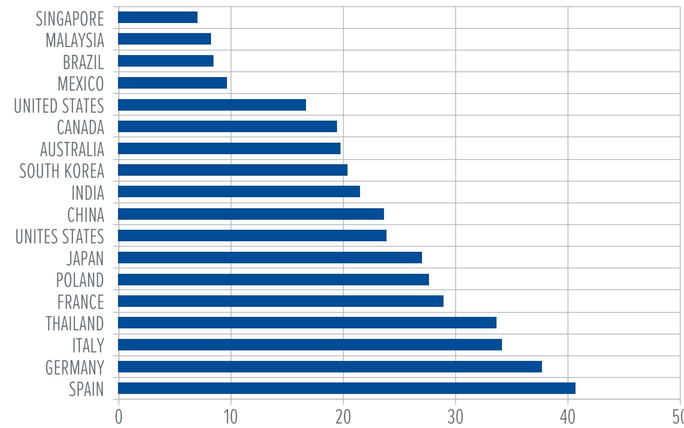
Change in exports of goods (% GDP), 1985-2018)



Source: Oxford Economics/Haver Analytics

Change in KOF Economic Globalisation scores (1986 to 2017)



Source: KOF globalisation index, 2019

At a national level, it would be reasonable to expect that economies that have been past beneficiaries of globalisation, building their economies on export-driven growth, would be more vulnerable to the fallout from a reversal of these trends. One may therefore expect small, open economies that have experienced a large rise in their export/GDP ratio in recent decades to be most exposed. On this measure, Mexico and other emerging markets in Asia and Eastern Europe that benefitted from the offshoring trend appear most at risk. This potential vulnerability to deglobalisation is supported by research from the IMF[3] indicating that middle-income countries with typically lower levels of globalisation tend to gain more from increasing their levels of international economic integration compared to higher-income countries that are already highly globalised. In other words, there are diminishing marginal returns to globalisation.

The economic measure of globalisation provided by the KOF Globalisation Index generally support these conclusions, underscoring how emerging markets have become increasingly integrated into the world economy over the past two decades. Although the economies of developed Europe rank highly, this is heavily influenced by the 'regionalisation' of trade and financial links across the expanding European Union. Conversely, China's scores on this measure are dampened by its capital and exchange control regime.

That said, the net impact of all these changes on individual economies will depend on a variety of factors, including domestic policy responses and the behaviour of the corporate sector. For example, deglobalisation pressures could hasten China's internalisation of supply chains as well as the rebalancing of its economy away from investment and exports towards consumption. This is already creating global winners and losers as the composition of China's imports shifts toward consumer goods.

The negative repercussions of deglobalisation could also extend beyond economies that have successfully grown their export sectors. If mature economies become more inward-looking, this could undermine the development prospects of poorer countries hoping to pursue export-led industrialisation strategies. This applies to many parts of Africa, which face the challenge of creating jobs for a large population of low-skilled workers.

BUSINESS CYCLES WILL LIKELY BECOME LESS SYNCHRONISED

In a more fragmented world, economic and financial cycles will likely be less correlated globally. Trade flows would likely become more regional in nature as supply chains shorten and in general cross-border trade and investment would be lower. Reduced cross border capital flows could also impact access to credit for certain sectors, as well as liquidity and volatility in some markets.

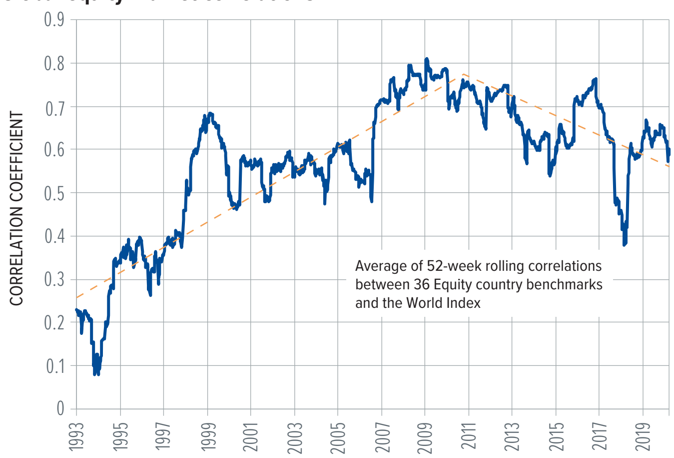
These shifts will have associated costs for companies (and investors) as they adjust to the new environment and face reduced growth opportunities. As power shifts away from multilateral organisations and governments subscribe less to global rules and regulations, global corporations will need to deal with growing complexity in differing domestic regulations across regions and countries. With less strict rule enforcement, intellectual property rights may also be harder to enforce. And as local knowledge requirements become more onerous, it may even be reasonable to question whether the multinational model will remain an appropriate corporate structure for international commerce or whether a move toward a more decentralised organisational structure will prove more effective.

[3] IMF (2018), "The Distribution of Gains from Globalization", Working Paper WP/18/54

DIVERSIFICATION WILL BECOME INCREASINGLY IMPORTANT

From an investment perspective, deglobalisation may mean that national markets are less vulnerable to external shocks, but this would be at the cost of increased vulnerability to domestic economic conditions.

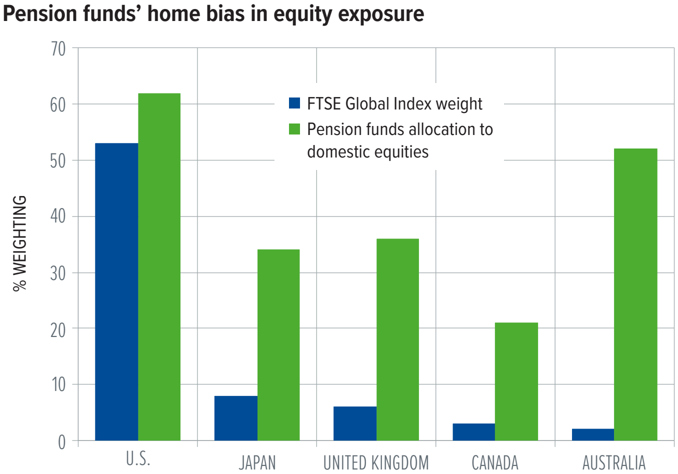
Global equity market correlations



Source: Thomson Reuters Datastream, Oxford Economics

One may expect markets in such an environment to be characterised by lower returns, higher volatility, and greater dispersion in returns. Indeed, there is evidence that correlations between equity markets have been trending lower recently, after a period of heightened co-movement during the post-crisis period. Reduced correlations between markets increase the benefit of diversifying investments globally (as well as diversifying across asset classes) to achieve better risk-adjusted returns. This is an important consideration as domestic biases in investment portfolios are pervasive across major markets, despite the well-documented diversification benefits of including foreign securities in a diversified portfolio. For example, Canadian equities account for around 3% of the global equity market, yet many Canadian pension funds allocate a significantly larger portion of their equity portfolios to domestic stocks.

Pension funds' home bias in equity exposure



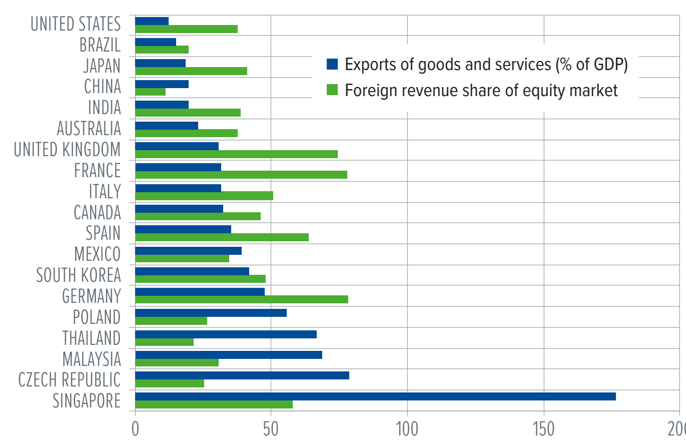
Source: FTSE Russell (2019). "Appraising home bias exposure"

CONSIDER THE FOREIGN REVENUE EXPOSURE OF EQUITY MARKETS

With multinationals facing higher costs in a deglobalisation scenario, domestically-focussed stocks may be expected to outperform. When constructing an equity portfolio, one should therefore consider the economic exposure of the constituent companies. Market capitalisation based indexes classify companies based on their country or region of domicile, but this does not necessarily reflect the sources of their revenues.

Although open economies are typically also characterised by equity markets with relatively high exposure to foreign demand, there are exceptions (reflecting that listed companies are not necessarily representative of the national economy). For example, the foreign-revenue shares of equities in many smaller emerging markets are considerably lower than the corresponding shares of exports in economic output. Conversely, it is also notable that the US is a fairly closed economy, but its equity market is much more exposed to fluctuations in foreign demand. However, Europe appears exposed to a more protectionist world given the high foreign exposure of listed companies combined with the long-standing fragility of domestic demand in the region.

Total exports (% of GDP) and foreign revenue share of equities



Source: Oxford Economics/Haver Analytics

DOMESTIC-ORIENTED STOCKS WILL DELIVER MORE RELIABLE RETURNS

Any market disruption can offer investment opportunities as some firms outperform others, but the challenge will be to understand, identify and exploit those opportunities as they unfold.

In general, sectors with domestically-oriented income flows (e.g. construction and utilities) should be more insulated from earning downgrades, as well as strong brands with limited substitutes. Likewise, small-cap equities also tend to be less exposed to foreign demand. Conversely, valuations of export-oriented companies (or those heavily dependent on global value chains) with large equity multiples may suffer the most as earnings expectations are downgraded with the onset of deglobalisation. As the cost of capital rises, companies with higher leverage may also underperform.

In an environment characterised by uncertainty and paradigm shifts, firms with agile operations will be best placed to adapt to new economic realities. It will also be important to consider who may be able to fill any new gaps in demand. For example, the US-China trade war has demonstrated that tariffs can result in significant trade diversion effects, benefitting third-party countries. Investors could therefore seek to play regional divergences arising from protectionist policies.

REGIONALISATION OF TRADE HAS NEGATIVE IMPLICATIONS FOR SHIPPING

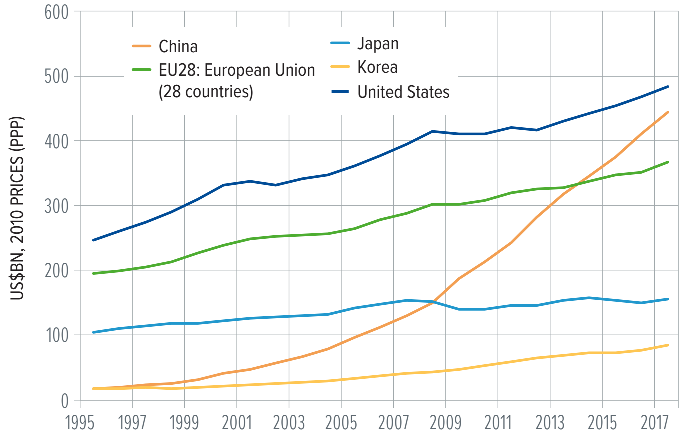
As supply chains shorten, companies involved in long-distance shipping could be expected to suffer. Regionalisation of trade would benefit shipping firms that operate shorter routes, while also tending to favour rail and auto-haulage companies that may be better placed to serve localised supply chains.

TECHNOLOGY'S CENTRE OF GRAVITY WILL SHIFT EAST

The digital revolution will present myriad opportunities for investment in new technologies and this will not change in a deglobalisation scenario. Indeed, demand for industrial automation, robotics and other new technologies will only increase as production moves closer to the final consumer. But the implications of deglobalisation for developments in the sector are nuanced.

The US-China trade war is already creating regional fragmentation in the tech sector and encouraging the development of China's own high-tech ecosystem. In a deglobalisation scenario, these shifts would only hasten, leading to a US-China technological 'decoupling'.

Gross domestic spending on R&D



Source: OECD Science, Technology and R&D Statistics

The digital economy and innovation-driven development have now moved to the forefront of China's efforts to develop the Belt and Road Initiative. Chinese R&D investment has grown remarkably over the past two decades and it now ranks as the second-largest in the world for R&D spending. China is already making headway in achieving global leadership in 5G, Artificial Intelligence, quantum computing and in other digital and disruptive technologies. Asia may therefore host a larger share of the future's high-growth tech companies, while former US tech giants come under increasing pressure. And as China spreads its digital norms and standards, this could result in the formation of an East-West "Silicon Curtain" with the Internet bifurcating into Chinese-led and US-led versions, as predicted by former Google CEO Eric Schmidt[4]. Indeed, the Chinese telecoms giant Huawei has recently proposed the construction of a new global internet infrastructure, which it is looking to export to other countries.

HIGHER INFLATION MAY LEAVE FIXED INCOME VULNERABLE

On the inflation front, globalisation has for many years had a steady disinflationary impact on the world economy, as the integration of lower-cost producers into the world economy has acted like an increase in potential supply for advanced economies. If this effect diminishes, it could imply a negative supply-side shock to advanced economies, implying more inflationary pressure and increased sensitivity of domestic wages to domestic labour market conditions. That said, the inflation outlook will also depend upon other factors including exchange rate movements and the disinflationary effects of weaker aggregate demand. Moreover, it is questionable whether the inflationary impacts of deglobalisation would be sufficient to offset the medium-term deflationary tailwinds from technology's dampening effect on prices, as well as the influence of ageing populations. Still, domestic inflation rates should become more responsive to national resource constraints and there would be reduced synchronisation of producer price inflation across countries.

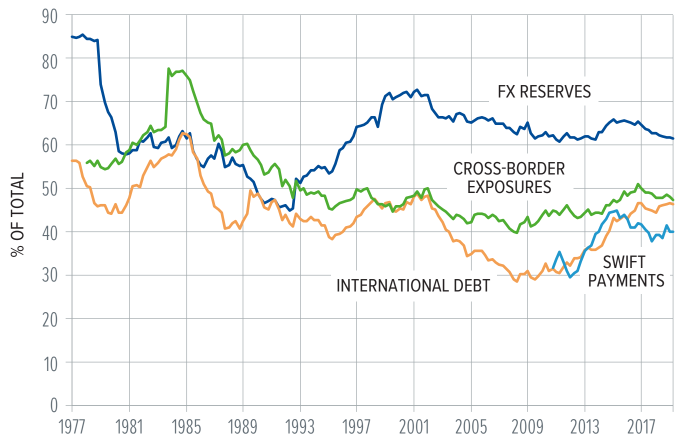
[4] https://www.cnbc.com/2018/09/20/eric-schmidt-ex-google-ceo-predicts-internet-split-china.html

With deglobalisation representing a negative supply-side shock to the economy, bond markets would be vulnerable to potentially higher domestic inflationary pressures. Lower economic growth could compound the upward pressure on bond yields as government finances come under pressure. While it is true that there has been little evidence to date of any upward pressure on bond yields despite the inversion of the globalisation trend in recent years, this may just reflect the lasting support to bonds from the 'quantitative easing' and expansionary monetary policies pursued by the world's major central banks.

SAFE-HAVEN CURRENCIES ARE LIKELY TO BENEFIT IN THE NEAR TERM

As the world economy adjusts, increased uncertainty and heightened risk aversion should be positive for safe-haven currencies such as USD and JPY. Conversely, those currencies most exposed to trade conflicts and the negative implications of deglobalisation (e.g. CNY, EUR) would likely weaken. Longer term, the USD at least should continue to benefit from the US economy being relatively insulated from negative developments in global trade.

US: Dollar financial usage



Source: Oxford Economics/Haver Analytics

That said, the decline of US economic hegemony could also open the possibility of a world less dominated by the US dollar. The dollar's share of cross-border payments and lending, international debt issues, and FX reserves remains high at 40%-60%, underscoring its role as the world's main reserve currency. Potential rivals are far behind, especially the Chinese renminbi, which as a non-convertible currency accounts for just 1-2% of transactions. But the Chinese government has been taking a number of steps to increase the international use of the renminbi, efforts which could accelerate with economic decoupling from the US and efforts to bind together diverse countries in a "New Silk Road Economic Order". Assuming a far greater degree of convertibility, the RMB's international usage would no doubt rise over time, although history suggests that it could take decades for US dollar dominance to be supplanted.

THE RETURN OF CAPITAL CONTROLS?

International finance has so far escaped relatively unscathed from the deglobalisation pressures affecting trade. In fact, the persistently low level of interest rates has resulted in a substantial increase in the volume of cross-border carry trades as investors seek higher yielding assets. Nevertheless, a trade war scenario could see policymakers seeking to restrict domestic institutions from investing in foreign entities. Indeed, there have already been suggestions that the US could introduce additional restrictions on investment relations with China, such as limits on federal employee retirement fund investments. The imposition of restrictions on capital flows would open a new front in a global trade war, with the potential for rapid escalation. Widespread capital controls would have a much more serious impact on investor returns as they would not only further undermine global economic growth prospects but also reduce opportunities for portfolio diversification.

INVESTORS WILL NEED TO REMAIN FLEXIBLE

Navigating the challenges posed by this reconfiguration of the world economic system may require a fundamental rethink of investors' existing frameworks for investing. While this new environment will likely be characterised by increased volatility and greater dispersion in asset returns, market disruption can also bring new opportunities for adaptable investors that are able to understand and respond to these shifts.