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Investing in a deglobalised world

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KEY TAKE-AWAYS

- Although the global flow of information has improved in the dozen years since the Global Financial Crisis, the rise of political nationalism, trade protectionism and local sourcing has led to a slowdown in the pattern of globalisation seen since the 1970s. Growth has been disrupted.
- It is debatable whether this trend will continue or merely take a different form of globalisation (such as being focused more in the IT sector), but there will surely be winners and losers over the medium term.
- Countries with large internal markets, low production costs and adaptable economic systems are likely to do well, while those with small, open economies could come under stress. Large, global companies may see their costs rise as they are forced to shift production back home.

It has been well documented and commented upon that, since the Global Financial Crisis (GFC) of 2008, the globe has experienced a slowdown in cross-border goods trade and financial flows, as well as capital markets integration. This trend has been termed "deglobalisation", as it is a reversal of major factors that have historically been a major engine of growth since the 1970s when the West re-opened its markets to China. This has been compounded by pressure for "political deglobalisation" in the form of rising populism, local sourcing, protectionism and increasing objections to immigration in many developed markets - manifesting, for example, in the 2016 election of President Trump in the US, Brexit in the UK, the US-China trade war and the Russia-Saudi Arabia spat over oil production.

Most recently, the unprecedented national economic lockdowns, bans on international travel and resulting curbs in trade used in the fight against the spread of COVID-19 represent further serious challenges to globalisation. In their competition for scarce virus-fighting materials and uncoordinated approaches to dealing with the pandemic, many governments around the world have demonstrated some degree of nationalism while foregoing cooperation with others. Supply chains have been disrupted, supply curtailed and workers laid off, highlighting the consequences of a less globalised world. And while we know these are temporary measures, now that precedents have been set it could be easier for these measures to be implemented again in future.

The deglobalisation debate

As one cause of this backlash against globalisation (aggravated by the unprecedently slow recovery from the GFC), experts point to the failure of governments to help spread its benefits wider over the past few decades. Emerging markets (and China in particular) have experienced substantial improvements in their living standards, helping accelerate the expansion of their middle classes as manufacturing jobs shifted to their shores. Equally, in developed markets large multinational companies and their (generally wealthy) shareholders and executives benefited from rising revenues and profit margins, as did the well-educated thanks to the creation of more highly skilled jobs. And while the middle- and disadvantaged classes did benefit from cheaper goods, critically, they suffered from the loss of millions of manufacturing and other lower-skilled jobs overseas, as well as long-term disinflationary pressure on their wages, which have not risen in real terms for well over a decade.

Contrary to this trend, however, the flow of information around the world has actually accelerated since the GFC, facilitated by ever-advancing technology. Think, for example, of how South Africans can now buy from Alibaba online, or transact in bitcoin. Our societies, markets and economies are now closely interlinked all over the world, thanks in good part to this information flow, and many believe these connections cannot be reversed, just as the advance of technology cannot be stopped. Free societies will not tolerate the blocking of the internet, for example, or a reversal of the choice consumers enjoy among so many platforms. In fact, many observers say that future progress in global integration will largely be IT-led, and that the fiercest competition will be in this sector (witness the US government's ban on ZTE and Huawei and its corruption fine on Ericsson, or the EU's antitrust probe into Amazon and fine of Qualcomm for anti-competitive microchip pricing). So in this sense, globalisation marches on.

There is also debate over whether deglobalisation is a permanent and inexorable path, merely a temporary disruption (or correction), or if we are perhaps in an evolutionary period that will result in a new form of globalisation. Whatever the case may be, as long-term investors we need to consider this trend in our strategic investment thinking. How is this impacting our investments ideas? Who are likely to be the biggest winners and losers from deglobalisation? And what should individual investors do?

Investor considerations: Possible winners

In terms of countries or regions, we would look East for the most winners. Many analysts contend that Southeast Asia will receive the most new investment as a result of the US-China trade war. Some US multinationals are already moving their supply chains from China to other cheap destinations to Southeast Asian countries, as well as Mexico and India, creating more jobs and economic growth. In the 2019 Agility Emerging Markets Logistics Index, Indonesia, Malaysia, Vietnam, Thailand and the Philippines all performed strongly (according to a survey from Trade Intelligence magazine, October 2019).

Smaller frontier markets could also accelerate their development by taking advantage of the opportunity to supplant Chinese suppliers. Should they be able to invest wisely and quickly enough, Bangladesh, Vietnam, Sri Lanka, Kuwait and Morocco, among others, could possibly step at least partly into the gap over the medium term. At a company level, new gaps in competition created by trading bans could be favourable for agile companies. For example, Samsung and Ericsson would have greater chances of doing more business with the US government and its contractors now that Huawei and ZTE have been banned from that lucrative trade.

Going forward, Asia (and the Chinese economy in particular) is likely to play an increasingly important role in global economic and financial cycles as it further opens up and its consumers have greater buying power. According to the American Enterprise Institute, between 2014-2018 China committed to investments of more than US$1 trillion in about 1,700 projects across 130 nations. More than half of this was related to its well-known Belt and Road Initiative, with a focus on infrastructure. However, China is equally focused on creating a broader, integrated market based on Chinese digital standards (in June 2019 the Philippines partnered with Huawei for the rollout of its 5G telecoms network, for example). Chinese companies have also been moving up the value chain and accelerating their investments in the Southeast Asian region, India, Russia and Africa in recent years. Meanwhile, its investments in the US and Europe have slowed. Additionally, China has been opening trade in the renminbi and lifting foreign ownership restrictions on financial companies. Could a new form of globalisation be China-led, with the

Chinese government and companies overtaking the US as the largest global investor?

Other beneficiaries of deglobalisation are likely to be countries with big consumer bases that are largely self-sufficient and do not depend on exports, like the US, China and India. In this same vein, companies that have strong domestic revenue bases should also gain ground on their more international competitors.

Will the US and Europe benefit from having jobs repatriated? Although more local jobs will be created, companies will certainly try to substitute humans with the latest AI-driven technology, robots and other cheaper alternatives. Also, with more trade barriers and less competition and efficiency in manufacturing, developed market consumers are likely to have to pay more for both imported and locally made goods. In both these cases, those with lower skills and salaries would be the biggest losers. Governments will need to support re-training programs to minimise the extent to which such workers are locked out of the labour market in the short term, although over the longer term there has been no real evidence that the implementation of technology produces permanent reductions in employment, despite the many fears that this will be the case.

From an investor's perspective, a more divided world could create more opportunities for investment diversification. Just as globalisation has driven a stronger correlation between countries' financial markets and economic growth cycles over the past four decades, a disrupted world could lead to more diverging cycles in different countries. This could materialise even among emerging markets, giving South Africans greater prospects for more highly diversified portfolios.

Investor considerations: Possible losers

Conversely, the losers from deglobalisation would be countries with smaller, more open economies that depend on exports and external financing – mainly emerging markets such as South Africa (although SA relies on limited quantities of offshore debt), African countries in general, and many Latin American economies.

In the shorter term, these countries will have to hone their negotiating skills to secure favourable trade terms with a variety of trade partners. At the same time, should the European Union (EU) be forced to take sides with the US over China in a trade war, EU countries (and especially Germany) would also be hit hard, given that China is its largest supplier of foreign goods and second-largest export destination. Note that very few countries followed the US in its ban of Huawei and ZTE in 2019 – not even the UK.

Equally, large multinational companies forced to move their supply chains to more expensive locations, or even back to their home market, would likely suffer from lower profit margins. Not only have they benefited from especially low labour and input costs, but also from advantages like favourable tax treatment and less regulation and red tape. If these advantages were to disappear, investors may require a shift in mindset, as it has been these companies (particularly the technology giants) that have experienced the fastest growth in the globalisation wave and investors have relied upon most for strong returns.

From the broadest perspective, it is the likely negative growth implications of deglobalisation for the world in aggregate that investors should probably be most concerned about. Economic theory and history are very clear in demonstrating that trade is growth-enhancing (a global win-win); while as we saw from the 1930s, protectionism and beggar-thy-neighbour policies have the opposite effect. Mainstream economists forecast slower global growth if protectionist-type policies are widely implemented and this would, all other things remaining the same, likely result in lower corporate profit growth and lower equity returns over time. Slower economic growth, in turn, could lead to lower inflation and therefore lower prevailing interest rates as well.

Asia may offer best investment opportunities

So how does this sum up? Should the deglobalisation trend continue in a similar form as we have seen in the past few years, South African investors looking for the best returns may need to re-think their traditional Western focus and consider gradually reducing some of their exposure to the US and EU, while diversifying into more emerging markets and companies in Asia. Here they could find winning corporates that adapt quickly and successfully to changing trading conditions and governments that help to facilitate this. There could also be more opportunities for diversification in the de-syncing of market cycles, and in an opening Chinese market.

Yet it is also possible that advancing technology and more liberal approaches could eventually win the day in the West, and deglobalisation could be reversed. This latter development would depend on governments implementing more progressive and generous policies helping those located in disadvantaged regions and working in uncompetitive industries to adapt successfully to such a rapidly changing world. This would undoubtedly take time and money to be achieved, and in the meantime the East is almost certain to continue its rise. Whatever the case, China and other Asian countries will necessarily demand more investor attention in the coming years. ■

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