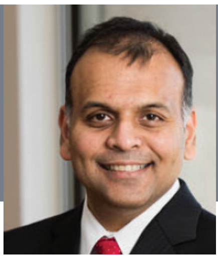

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Is the end of globalisation the end of global investing?

There are increasing concerns that the period of globalisation is drawing to a close and that countries are moving away from trade liberalisation toward increased trade protectionism, which could have far-reaching consequences for economies, companies and investors. In this note, Global Equities Portfolio Manager Amit Lodha shares his insights on challenges to globalisation, its implications for investors in global equities and opportunities for active investors in a deglobalising world.

In his book 'The Levelling: What's Next After Globalization', Michael O'Sullivan argues the case for the end of globalisation and how a new world order will be established in finance, economics and geopolitics. He eloquently suggests that today is analogous to a period in the late 1980s when many people focused on the fall of communism itself and few saw that a bigger trend – that is, globalisation – was about to take hold. The two major ballot box surprises, Brexit and the election of Donald Trump as the US President, suggest that we are in the process of a similar paradigm shift where the sun is setting on the globalisation-driven world order of the last 40 years and we are in the noisy and disorderly period of the transition to, and the birth of, a new order.

The challenges to globalisation

- **Geopolitics:** As the world becomes more multi-polar and less interconnected, it is evolving into a US-led Americas, Europe and a China-centric Asia. Restriction in trade (through tariffs) could be the precursor to a cold war between the US and China.
- **Record high indebtedness,** the dominant imprint of central banks, which will lead to some tough choices, as rising wealth inequality meets record growth in wealth.
- **Political volatility** (post Brexit vote/Trump's election) has risen; economic and market volatility will certainly follow.
- **Multi-century lows in interest rates** are creating a basic breakdown in the contract of law between the borrower and the lender (as apparent from the recent Berlin Senate voting to freeze rent for five years, even though most agree it is unconstitutional and illegal).
- **Technology and technology-related companies,** which just recently were going to be the solution to all our problems, are now increasingly regarded as the problem (privacy and the impact of, and race for, artificial intelligence).

A world in transition and what it means for investors

The idea with this note is not to go into great detail on solutions to the problems above, but to really tackle the smaller, more mundane issues of how the death of globalisation will impact global investors like us – simply, how should our investment framework evolve as we navigate the rough seas of this period of change?

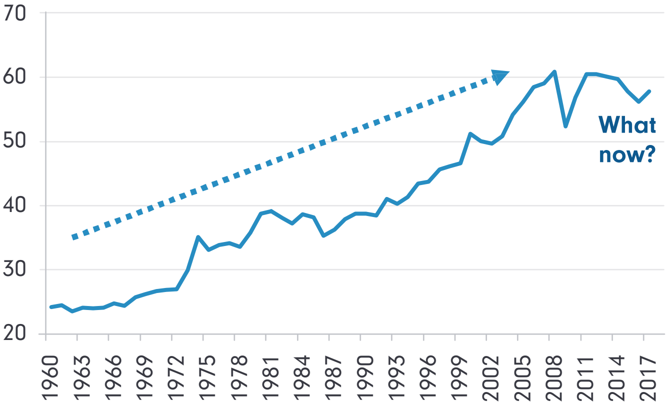
To give you the (possibly glass-half-full) conclusion, the end of globalisation could actually be positive for active investors, investing on a global basis. The very-near-term outlook is unambiguously bleak. The hallmarks of globalisation over the past 40 years have been greater integration of economies, markets, nations and cultures. While globalisation has been on the upswing since the 1700s with the rise of the East India companies, it really went into its blow-off peak over the last 18 years with the creation of the European single market, the signing of the North American Free Trade Agreement and the entry of China into the World Trade Organisation (in 2001). However, now it is increasingly being seen as a threat.

The following table captures the effects of globalisation versus deglobalisation.

Globalisation	Deglobalisation
Lower cost of capital	Higher cost of capital
Efficient global production value chains	Inefficiencies leading to slower growth, falling margins and cash flow
Falling pricing power of labour versus capital	Higher pricing power of labour versus capital
Larger addressable market for multinationals	Smaller addressable market for multinationals
Efficient capital allocation	Inefficient capital allocation as capital intensity will rise

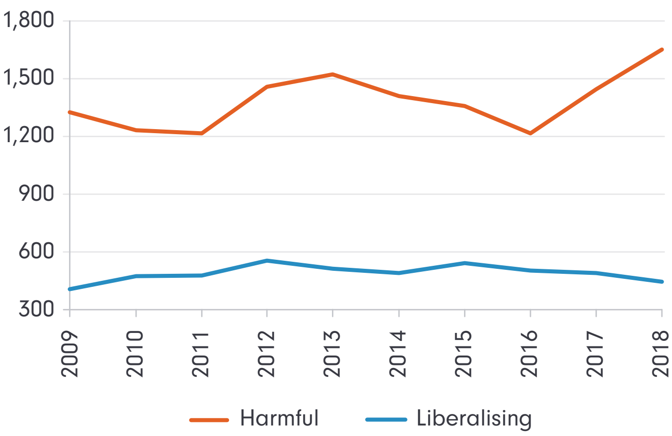
In the context of this transition, how do we incorporate the macro into the micro?

Chart 1: Is deglobalisation a threat to international trade?
World trade as a percentage of GDP (1960–2017)



Source: The World Bank, June 2019. Annual World Trade Data (1960 – 2017) as a percentage of GDP.

Chart 2: Discriminatory trade measures on the rise
New trade interventions every year



Source: Global Trade Alert, June 2019. Number of State Trade Measures in each calendar year as recorded.

A new paradigm

The changes we are seeing have a number of implications. Our suggested framework is to deal with them one at a time.

Diversification

Over the last two decades, the case for international diversification (and hence global investing) has been weaker as, with increasing interconnectivity, economies and markets have been more correlated. We have talked about the four-sided coin toss previously – US interest rates, the US dollar, the oil price and economic growth in China being the drivers of the macro investing cycle, globally.

In a world **with** borders, it could be argued that economic and market correlations should reduce, increasing the desirability of global investing as the probability of finding uncorrelated investments globally increases. In a small way, this is already apparent in the split global internet space. While US technology names Amazon, Alphabet and Facebook will be impacted by slower global economic growth, as a result of the US-China trade wars, the direct impact to their revenue and business is limited as they have never been allowed to participate in the growth of the Chinese internet economy in the first place. Similarly, the Chinese internet companies like Alibaba, Tencent and Baidu face limited direct impact from tariffs as they don't operate in the Western world markets. Technology again seems to have predicted the future direction of travel of other industries.

Country selection

Over the last 10 years, we have talked about how we are agnostic to country selection and focus only on the stock selection. However, in a tri-polar world, one will really need to consider how the new global alignment structures work.

Take Australia and India, for example. Australia has a very strong trade balance (through commodities) with China, yet its value systems and political positioning are closer to the US and it was in fact one of the first Western nations to also follow the US in banning ZTE/Huawei. (The UK, incidentally, has so far refused to align with the US on Huawei.) Chinese buyers have been big participants in Australia's real estate market and their further withdrawal (in a US-China cold war scenario) could further hurt the prospects of that sector.

India through its more recent history (remember the Non-Aligned movement) has tried to follow true non-alignment. However, given its borders with China, it will increasingly have to make a conscious choice, as while it has the potential to provide a fourth vector to the geopolitical order, now is not its time. Yet given its domestic growth story, if it can get policy framework right, it has the potential to offer the global investor companies with strong domestic growth drivers, uncorrelated to what is happening in the global geopolitics.

More broadly, we are less worried about financial barriers rising against the free flow of money. Yes, there are likely to be temporary financial crises (like the Asian financial crisis); however, over the long arc of history, money has always found a way to flow and maybe it gets a little less efficient versus what it is now, but we don't expect it to come in the way of the ability to own companies around the world.

From a prudential risk management perspective, however, the one thing that will rise in importance will be the liquidity management of the portfolio (for example, a higher portfolio level cash holding to compensate for reduced efficiencies of moving money freely). The debate relating to the future of crypto-currencies and its ability to buck the deglobalisation trend is unending. Although the ability for capital to move swiftly, anonymously and without oversight makes it an interesting asset class, it has also raised concerns among regulators, particularly in an era of deglobalisation where every transaction outside your control represents a lost tax revenue. Facebook's cryptocurrency project, Libra, has also raised a few alarm bells on how Facebook's crypto plans would hand over much of the control of monetary policy from central banks to private companies. It is also my view that currency markets, especially the US dollar (which has been the global reserve currency through most of this period), will be our best early warning indicator if the trend towards deglobalisation gathers pace.

Sector selection

The last 10 years have been unambiguously about the growth in importance of technology across the world. Seven out of the top 10 most valuable companies in the world today are in the tech-related sectors.[1] And we expect this pace of change to only accelerate, causing further disruption across our sectoral map. There are, however, some important questions that we will need to wrestle with, which require a guided international response:

- Privacy norms, data storage and collection internationally
- Dealing with the impact of advances in artificial intelligence, especially the ethical aspects
- Bio-engineering and the ethics around human gene manipulation
- Cyber terrorism and cyber security

If the West decides to deal with perceived monopoly power, it could be handicapping innovation precisely at this moment where it needs to compete with Chinese businesses working in the interest of the nation state. The Huawei ban and the 5G conundrum is but the first shot across the bow (in our view) with many more to come across technology and other areas of proprietary technology should the technology trade war worsen.

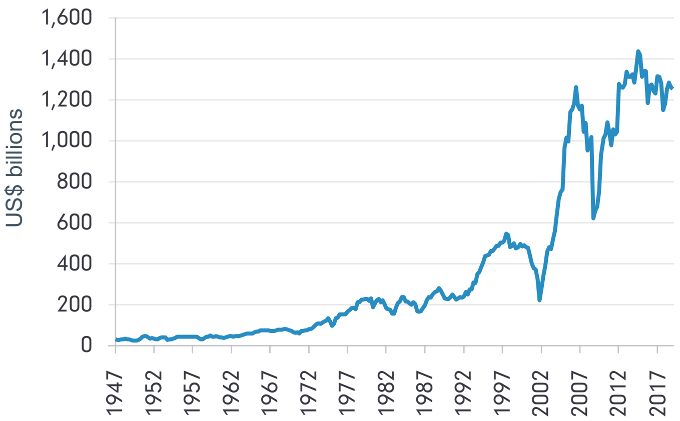
No one likes bloodshed – but if there is an arsonist in your house, you have got to do what you have got to do to defend your family.

Corporate margins

It could be argued that global multinationals (which incidentally are the biggest weights in any index you might passively invest in) have been the biggest beneficiaries of globalisation due to the ability of locating their supply chains in the geographies with the most productive and efficient labour, abundant resources, low taxation or supportive infrastructure. Moving supply chains from China to Mexico or Vietnam or India, or even back onshore to the US, will undoubtedly lead to higher costs and falling margins. Also, as more labour returns onshore to an already tight employment market in most advanced economies (especially the US), the rising domestic wage inflation is likely to put further pressure on margins.

Chart 3: Is deglobalisation a potential challenge to corporate profits?

US non-financial corporate profits



Source: US Bureau of Economic Analysis, Federal Reserve Bank of St Louis, 30 May 2019. Non-financial corporate business: Profits before tax.

Chart 4: Can this trend persist in the deglobalised world?

Relative Russell Growth Index/Russell Value Index

Bloomberg, 26 June 2019. Quarterly Relative Russell 1000 Growth/ Russell 1000 Value Indices have been used.

The opportunity for active management

For every loser there is a winner. In a war (trade or otherwise), the neutral party – the 'Switzerland' – is the one who gains, the one who can deal with both sides. A similar analogy applies to corporations that could do well under this trade war scenario.

Ericsson is a good past example of this. When Donald Trump banned ZTE, it marked a seismic shift in industry pricing power in a four-player industry made up of two Europeans (Nokia and Ericsson) and two Chinese players (ZTE and Huawei). And Ericsson has seen gains in market share in both the East and West – it has one-third of China Mobile's 5G orders and a very high market share in Verizon and AT&T's 5G rollout.

A more recent example with similar characteristics has been Samsung Electronics. What Trump did for Ericsson with his short-term ban on ZTE, we think he has done for Samsung with his ban on Huawei. Samsung was losing its number two position in mobile phones to Chinese competitors like Huawei, OPPO, Vivo and Xiaomi. With the ban on Huawei, especially the threat that it can no longer use Google's open source Android code, we expect Samsung to regain market share in the Android market (70% of the global smartphone market are non-Apple users). Further, with its vertically integrated non-Chinese supply chain (Apple iPhones are in fact produced in Samsung factories, with Samsung components), Samsung again stands to gain as it is well-positioned for this multi-polar world.

Active management is simply skating to where the puck will be, rather than where it is; that, to us, is the simple definition of alpha generation and in a volatile world (versus what we have seen in financial markets over the last 10 years), hopefully this provides more opportunities for alpha generation.

A world with more nuance?

Large versus small – While Ericsson and Samsung are examples of large multinationals that will do well because of these trade wars on balance, the answer is a lot more nuanced for other multinationals and large corporations. In fact, with increased uncertainty around where to set up factories given tariffs, limited access to foreign markets (due to borders going up), the growth prospects of many multinationals, especially those with a US domicile, suddenly look poorer, especially if they lose access (over time) to one-sixth of the world's population.

Relatively speaking, the domestic corporation focused on selling health care services or consumer staples to its own citizenry with no global aspirations could do better as we navigate this changing market. This, though, is more an argument of who hurts less rather than who benefits more but could drive some multiple expansion in favour of domestically focused mid/small cap stocks versus the large multinationals (analogous to the period post the bursting of the tech bubble in 2001).

Growth versus value versus income – High valuations are an outcome of the market's embedded expectations of high future expected growth. However, in a world where global growth is slowing due to all headwinds of deglobalisation that we covered above, it could be that these expectations may not come through. As we learnt in prior recessionary periods like 2001 and 2008, in high-growth companies it is the fall in these expectations and hence the high multiple which causes most of the losses.

On the other hand, companies with steady income dynamics (like telecom companies serving the local customer, local coffee shops, restaurants, auto part retailers, home builders) will be less impacted by these changes and could see a relative rerating. In this environment, our answer to the growth versus value conundrum is 'reasonable growth with income characteristics at decent valuations'.

Conclusions

It is not a given that our scenario of a deglobalised world above will come through (currency markets, especially the US dollar, will be your best early warning indicators). There is hope that a trade resolution can be reached, and neighbours can learn to co- exist. However, as long-term investors, we must consider this risk scenario and incorporate it into our stock picking. To us this means:

- Mid/small versus large multinational corporates
- Domestic growth versus international growth
- Growth at reasonable value with income characteristics (versus the high quality, high growth which is susceptible to disappointment of high expectations)
- Low-debt, cash-rich companies in favour of high debt (as cost of capital rises)
- Management teams with the competence and wherewithal to adapt, be flexible and make the right investments
- A search for the 'Switzerland' in every industry and value chain
- And, just in case, a little bit of gold.

In investing, it is as important to ask the right questions as it is to know where to look for the answers. As paradigms change, a contrarian and open-minded approach should serve us all well.