The future of globalization

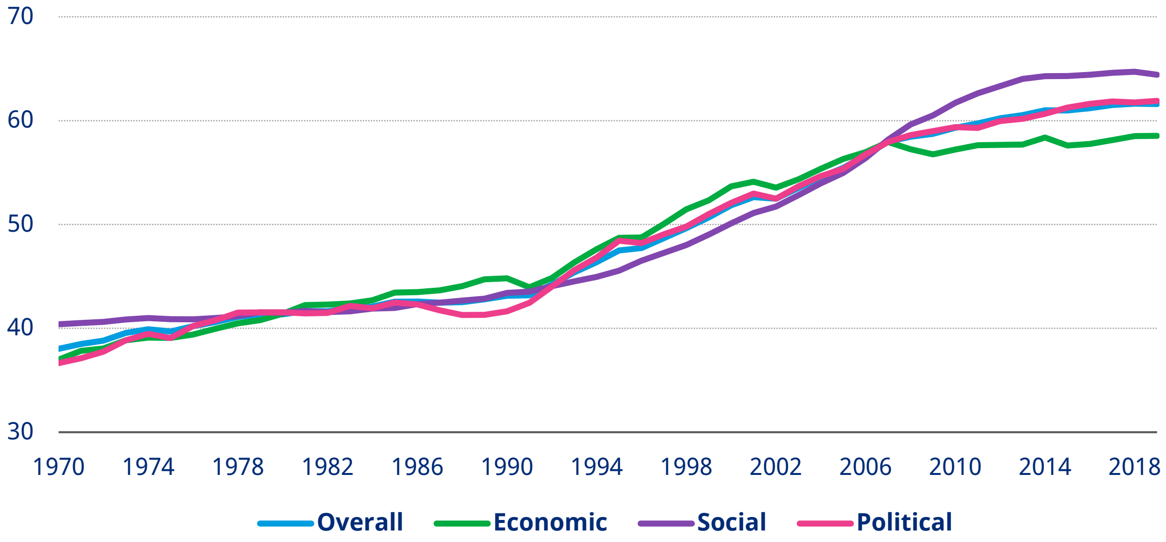
How globalization has shaped the world

Globalization describes the integration of the world across various dimensions such as trade, financial flows and culture[1]. Having started in the nineteenth century, this mega trend accelerated in the 1980s as technology gains helped minimize the impact of distance and natural barriers[2].

The world economy has been shaped by the effects of increased globalization over the past four decades as it relates to increased labor competition, cross-border economies of scale and the shared benefits of the internet-driven technological revolution. The fall of the USSR and the increased opening of China further added to these effects.

However, trends generally peak and fall and globalization may be no exception. Deglobalization is a term used to describe the process of globalization going in reverse. This became a hot topic in 2017 given the trade war between the US and China that has still not been resolved. Since then, a number of events have conspired to keep this potential trend reversal in the news. Most notably, the Covid-19 related shocks to international supply chains, the conflict in Ukraine and a shift in corporate focus from prioritizing efficiency to operational resilience have necessitated a re-examination of the future of globalization and the possible effects on investment portfolios.

Figure 1. Globalization has slowed but not retreated[3]



[1] For a more comprehensive definition, see Peterson Institute (2022): 'Globalization is the word used to describe the growing interdependence of the world's economies, cultures, and populations, brought about by cross-border trade in goods and services, technology, and flows of investment, people, and information'

[2] It could be argued that the true start of globalization was Columbus's voyage to the Americas in the 15th century with trade and financial flows even occurring long before then. For simplicity, we chose the 19th century as the official start of globalization in earnest as this is where global exports started to exceed 5% of global GDP with the supply chain integration of the 1980s heralding the latest phase of globalization. For more information, refer to 'A brief history of globalization' by the World Economic Forum (2019).

[3] Gygli, Savina, Florian Haelg, Niklas Potrafke and Jan-Egbert Sturm (2019): The KOF Globalization Index – Revisited, Review of International Organizations, 14(3), 543-574 external page https://link.springer.com/article/10.1007/s11558-019-09344-2 (accessed in September 2022). The KOF globalization index is a composite of individual variables with the aim to track trends in the economic, social and political dimensions of globalization. It is used in order to monitor changes in the level of globalization of 122 countries over a long period.

Factionalization rather than deglobalization?[4]

Lingering resentments over globalization are as old as the phenomenon itself, despite the net economic benefits[5]. A large constituency has always been suspicious of globalization; developed markets saw manufacturing bases shift across the globe while emerging markets' financial stability was undermined by contagion as connectedness increased. Backlashes against globalization include isolationist trade policy in the late 1920s, Cold War trade embargos, Japanese-American trade tensions in the 1980's, Ross Perot's 'giant sucking sound' campaign in the 1990s, Brexit, and the trade war between China and the US. Skepticism towards globalization was not only driven by economic anxieties, cultural alienation also played a major role, especially in the case of Brexit. Many people feel that their traditional ways of life are being upended by undemocratic globalism imposed by rootless elites out of touch with ordinary people.

This building resentment and different responses to both the Covid-19 pandemic and the conflict in Ukraine have highlighted the potential for a new reality as the world appears to be aligning on several axes and spheres of influence (blocs).

We believe that the world is not going through outright deglobalization, rather it is becoming increasingly fractured. In other words, countries are more reluctant to trade and share with countries dissimilar to themselves in certain aspects[6] but more than willing to interact cross-border with their allies. This return to Cold War-style spheres of influence could lead to a less integrated world. However, deeper trade ties within these blocs may partially offset reduced global connectivity.

How could globalization evolve?

The evolution of trade and financial markets will have three key characteristics, in our view:

1. **We believe that trade integration will continue within blocs and "reshoring" is likely overhyped, at least for now.** Foreign trade is increasingly scrutinized in many countries. However, there are signs of strong blocs emerging that are willing to trade among themselves. At the end of 2020, the Regional Comprehensive Economic Partnership ('RCEP'), an Asia-centric trade agreement, was signed. It is the largest trade agreement ever and is poised to substantially increase trade within the Indo-Pacific region. Additionally, China is increasing its presence across Asia, Africa, Latin American and emerging European economies via its "Belt and Road"

[4] We started talking about the concept without always using the specific term in our Themes and Opportunities going back to 2019 (T&O 2019 – The Four Elements – tectonic frictions in the global world order and T&O 2018 – political fragmentation)

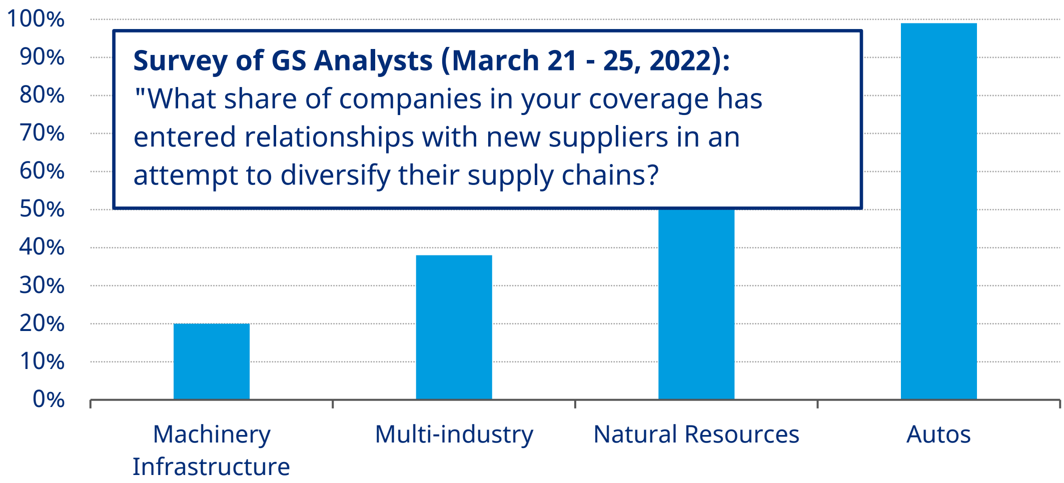
[5] The benefits of globalization include increased competition, larger economies of scale, increased labor mobility, increased capital flows and higher quality goods, all leading to higher living standards.

[6] Such as political ideology, national approach to governance as well as national strategic misalignments

initiative.[7] Within Western economies, energy policy is shifting substantially as a result of sanctions against Russia.[8]

That said, even in the face of trade skepticism and some anecdotal evidence of reshoring (bringing jobs and production back to domestic economies), there is no meaningful evidence of this happening on a grand scale yet. The distance of trade flows has remained constant over the last ten years and even increased slightly during the pandemic.[9] This is partly because labor costs still matter, putting any first-mover who brings production home and increases costs at a disadvantage, especially while the global labor market remains tight. Existing infrastructure and proximity to other suppliers and segments of the supply chain also matter. Companies, however, are making gradual changes such as reducing single-country dependency by shifting some production from China to countries like Vietnam, Turkey and Mexico. Some companies are building several supply chains to cut single points of failure. Where reshoring occurs, it is often driven by the ability to deploy industrial technology. Some sectors associated with countries' national security will be more susceptible to seeing their supply chains realigned in spite of higher costs — think of technology, food or defense — while items such as clothing or furniture will likely continue to be predominantly sourced globally.

Figure 2. Supply chain diversification trends



Source: Goldman Sachs Global Investment Research as at April 28, 2022

2. **Following the energy shock triggered by the pandemic reopening effect and exacerbated by the Ukraine conflict, countries have been forced to re-evaluate their commodity sourcing.** In the future, a reliable, stable commodity supply may matter more than price, assuming the price difference is small. Indeed, the

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[7] A broad initiative adopted by China's government in 2013 that includes but is not confined to infrastructure construction and finance to connect China with the rest of the world to facilitate trade.

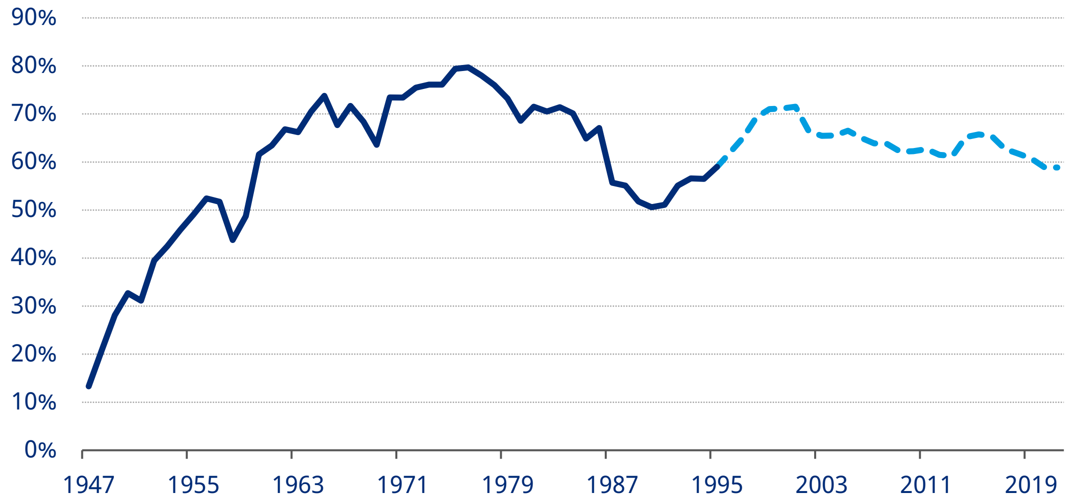
[8] 'Friend-shoring' is a buzzword to describe the trend towards trade supply chain integration among allies.

[9] Harvard Business Review (2022): Trade regionalization – more hype than reality?

rejigging of energy (and broader commodity) supply chains has begun. Europe and the UK have already started to source gas from the US, and India has been buying Russian oil at a discount. Other Asian countries may try over the years to secure long-term access to Russian supplies at an attractive price. The focus on energy security will likely lead to a shift in supply chains. The US and Canada are positioned well to help supply Europe and the UK, while Russia could become the energy hub of Asia and countries less aligned with the West. A reshuffling in commodity supply chains will be a multi-year process and lead to greater inefficiency as it will be harder and more costly to get commodities where they are needed.

3. **The US dollar and western assets could face more competition.** The US dollar had been the unchallenged reserve currency since World War II. China's growing economy over the last few decades has challenged US economic supremacy and increased interest in holding Chinese renminbi and gold. Moreover, the US's use of financial sanctions in the name of national security interests may cause countries and investors less aligned with the US to diversify their foreign currency holdings away from the US dollar. This could dent the dollar's place as the world's undisputed reserve currency. However, the US dollar's legacy role as an international reserve currency, the sheer size of the US economy and trust in US institutions by allied countries make an outright de-dollarization unlikely in the decades ahead, in our view.

Figure 3. US dollar share of global foreign exchange reserves, %



Source: Goldman Sachs Global Investment Research (2022), Eichengreen et al. (September 2020), IMF. Note: Dark blue line is sourced from Eichengreen (2020), and light blue dashed figures are sourced from the IMF.

Positioning portfolios for evolving spheres of global integration

The realignment of trading blocs is likely to play out over a long time and there is material uncertainty around how each will ultimately do so. How can investors with a long time horizon (10 – 20 years) position their portfolios to seize opportunities and mitigate risks? As there are no single asset solutions for mega-trends such as these, we offer three broad considerations for making your portfolio robust.

1. **Allow for a more fractured world while allocating globally**
   The re-plumbing of the global investment landscape comes with opportunities and risks – tail risks, in particular – as many investors who have seen their Russian holdings written down in 2022 can attest. Also at risk are sectors that are sensitive from a national security perspective and governments can change the 'national interest' definition at a whim. At Mercer, our advice remains to invest globally. No matter how globalization evolves, actively managed global mandates can pivot towards those companies and regions that are likely to benefit from prevailing economic trends.

   Meanwhile, Mercer's equity guiding principles encourage equity investors to consider incorporating **specialist exposures**, including thematic exposures that may include "winners" from a shifting global order. Examples of opportunities include domestically oriented businesses that may gain an advantage over multi-national companies in a shift towards regionalized blocs. Passive and some active large-cap global equity portfolios may be dominated by a handful of multi-nationals, so accessing domestic companies that are addressing supply chain implications of this shift may diversify this risk. Innovation in areas such as robotics and other technology, which can be used to re-orient supply chains domestically, may also play a greater role. This is an **alpha opportunity for managers** and could help offset the negative impact that potentially declining profit margins, as a consequence of the world becoming less integrated, could have on expected returns.

   We also believe investors should have a strategic allocation to **emerging markets equities, which includes a substantial exposure to China**. The evolution of globalization may affect China in different ways. On the one hand, a slowdown in globalization is a headwind for China's exporters. On the other hand, more regional integration in Asia could offset this to a degree. Also, China's economy has become more consumption-oriented over the last decade, a trend we expect to continue. If the world is factionalizing, it may be harder to get full exposure to China's opportunity set via global companies listed in developed markets. The delisting of some Chinese stocks[10] in the US or regulatory nationalism leading to different technology ecosystems across regions highlight the importance of accessing the Chinese market directly in a more factionalized world. Investors need to be comfortable with geopolitical risks in a factionalizing world. The Taiwan situation remains a wildcard. While we believe that the long-term portfolio impact of geopolitics tends to be limited in most cases, major events such as the Ukraine conflict can lead to sanctions, investment bans and capital controls. Such risks need to be weighed against more benign scenarios in which China exposure would represent a positive, long-term return driver, in addition to a rich source of alpha

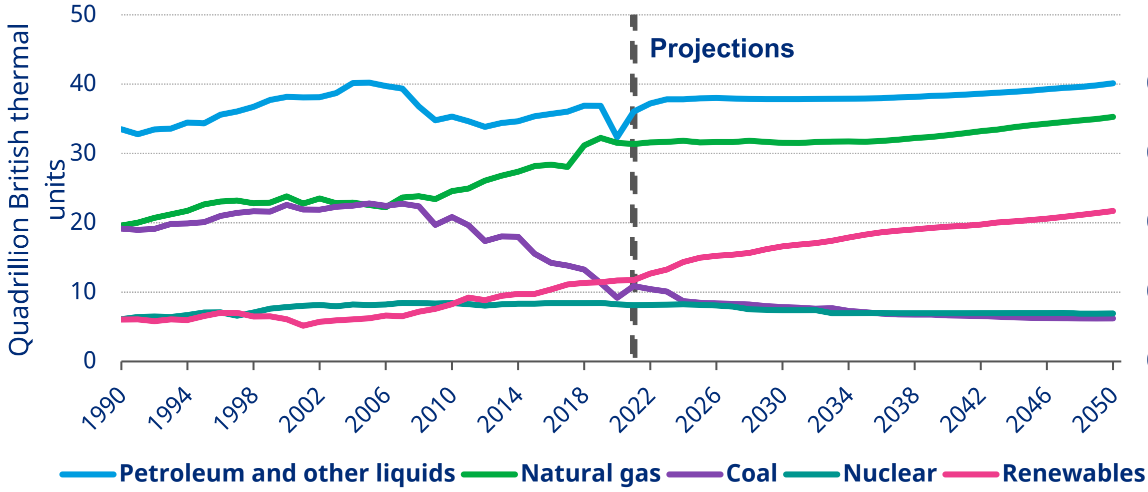
[10] A deal between US and Chinese regulators was reached in August that aims to prevent such delistings. Nevertheless, companies have already been delisting amid regulatory uncertainty and there are doubts whether the deal will actually work in practice.

and portfolio diversification. The inherent allocation of emerging market equities to **EM ex China** also provides exposure to countries such as Mexico, India, Turkey and Malaysia that are set to benefit from diversifying supply chains and increased intra-bloc trading.

Last but not least, long-term capital assumptions should be reviewed. Factionalization could impact productivity, potentially leading to lower returns and higher inflation assumptions, although technology and innovation may offset some of the negative effects of the world potentially becoming less integrated. Acknowledging that we do not have a crystal ball that will allow us to predict the scope and scale of such tectonic shifts with precision, portfolios should subject themselves to scenario testing to ensure they are resilient to different globalization pathways.

2. **Consider commodities a strategic part of your portfolio**
In a commodity-constrained world, **private or publicly listed exposure to broad natural resources** could be considered a strategic allocation in portfolios for three reasons. First, demand is set to increase as the global population is expected to grow and peak about mid-century. Further, the expansion of middle classes is expected to be an additional demand driver. Second, even if technology continues to drive efficiency gains in commodity extraction and processing, the benefits may become more marginal compared to the start of the industrial era. Third, the combination of under-investment in the oil and gas sector over the last decade (due to the ESG drive and capital discipline), limitations on mining in many countries as well as a potential transformation in commodity supply chains due to rising resource nationalism may result in more frequent commodity supply shocks. A strategic allocation to natural resources could therefore position portfolios to benefit from shifts in global integration and the potential for commodity market instability. On the energy front, the investor’s ESG beliefs will inform the balance between oil and gas and renewables and energy efficiency. Oil and gas is expected to remain the bulk of the energy mix for decades to come while renewables and energy efficiency is expected to see strong growth. Furthermore, exposure to some segments of the natural resource spectrum such as metals should position portfolios for the expected demand increase as the energy mix diversifies. Natural resources should also give investors exposure to diversified sources of food, including innovation in food that could mitigate risks and capitalize on opportunities associated with shifts towards blocs and increased awareness of food security by many countries.

Figure 4. Historical and projected energy consumption by source



Source: US Energy Information Administration (EIA), Annual Energy Outlook 2022 (AEO2022). Data as of June 2022.

3. **Allow for the possibility of the US dollar facing more competition**
   Outright de-dollarization seems unlikely but we believe that the US dollar and other western safe-haven assets will face more competition if emerging market surpluses are not recycled into western countries. This could become a simultaneous headwind for western assets and a tailwind for emerging market assets. Allocations to **locally domiciled emerging market equities and bonds** are a natural hedge against some diversification away from the US dollar. **Gold** may also help in this context as a potential beneficiary if emerging market central banks continue to use it to diversify their reserves.

Conclusion

We do not believe the world is de-globalizing per se, rather fracturing into blocs, not just between countries but within countries. Countries are more reluctant to trade and share with countries dissimilar to themselves in certain aspects but more than willing to trade cross-border with their allies.

This may lead to both opportunities and risks for investors. Mercer encourages the proactive consideration of risks and opportunities. This can be done by ensuring global allocations are positioned for a more factionalized world; natural resources are considered as a hedge against commodity instability; and emerging market domiciled securities, as well as gold allocations, are considered as a hedge against increased efforts to diversify US dollar holdings.

Across all asset classes, active management remains as important as ever, given the opportunities and risks these shifts will represent, driving various layers of dispersion at the economic and market level. As these shifts cannot all be incorporated at the portfolio construction level, they may require a more opportunistic, granular response.

Portfolio construction itself should subject itself to a review of forward-looking capital market assumptions in light of these trends. Portfolios should also undergo scenario analysis to test their resilience to the different paths that the transformation of globalization could take.

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