China, Deglobalization and Global Fragmentation:

What it all Means for Institutional Investors

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A mere century ago, many economies around the world were fairly insular as transportation was time consuming, expensive and cumbersome. However, as transportation and technology improved, trade surged, and nations became more interdependent. As a result, the term "globalization" was coined, and some believed that the trend toward interconnectivity might continue inexorably into the future. However, in recent years, and due to a host of issues including shifting geopolitical alliances and the rise of populism, there has been some speculation that economic interdependence might slow or even reverse itself.

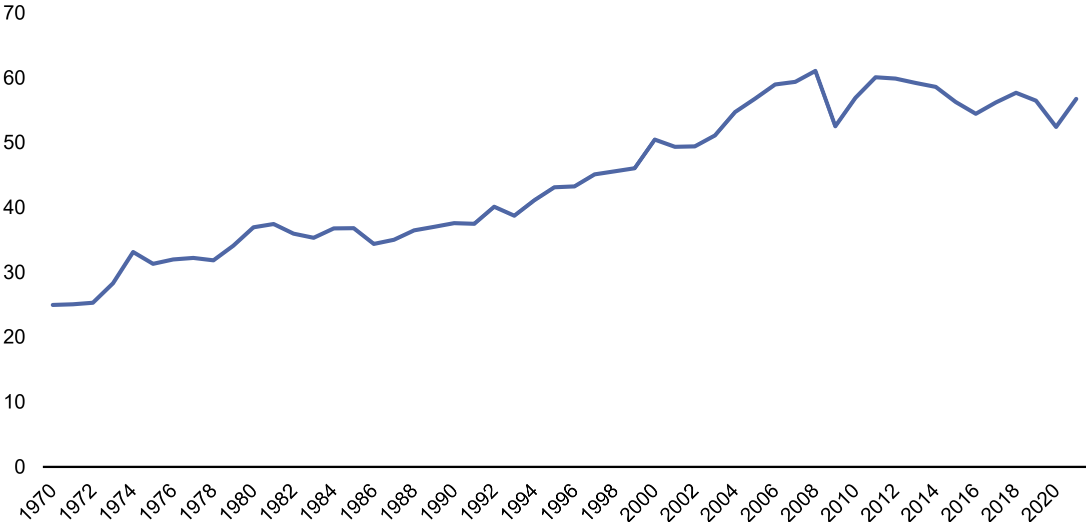
We will explore various datasets to determine if we are indeed seeing clear evidence of a reversal in globalization. We also discuss the potential implications for multi-asset class portfolios.

Globalization: Onward and Upward, or Plateauing?

According to the World Bank, in 2001, when China joined the World Trade Organization (WTO), global trade as percentage of global gross domestic product (GDP) stood at 49%. That number rose sharply to 61% in 2008 and then retreated in the following decade to 57% (in 2021). Some argued that the decline in that ratio could be a harbinger of things to come regarding global interconnectivity and trade.

However, we posit that the trajectory we are on regarding globalization cannot be precisely determined by any one ratio. In fact, there are a number of issues that should be considered when evaluating trends in globalization. As suggested above, shifting geopolitical alliances and the rise of populism, both individually and collectively, could have a myriad of implications for globalization over time. Those trends are also likely to determine future winners and losers with respect to individual sectors and industries.

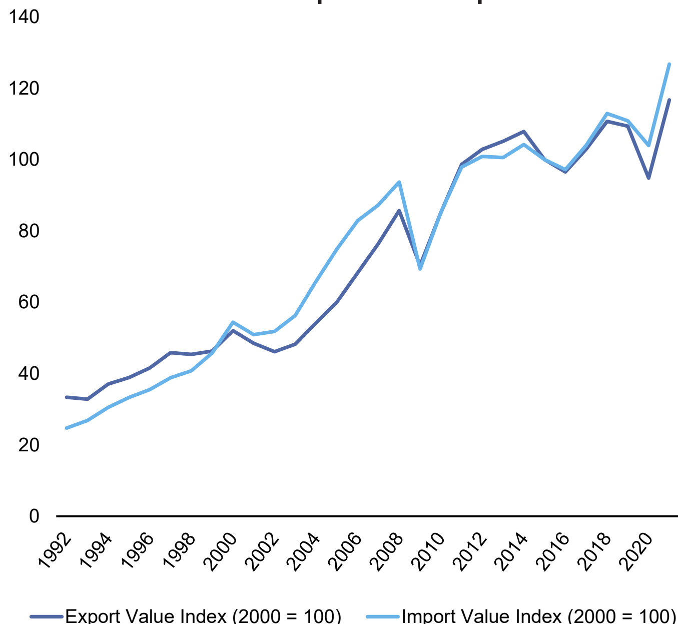
Exhibit 1: World Trade % of GDP



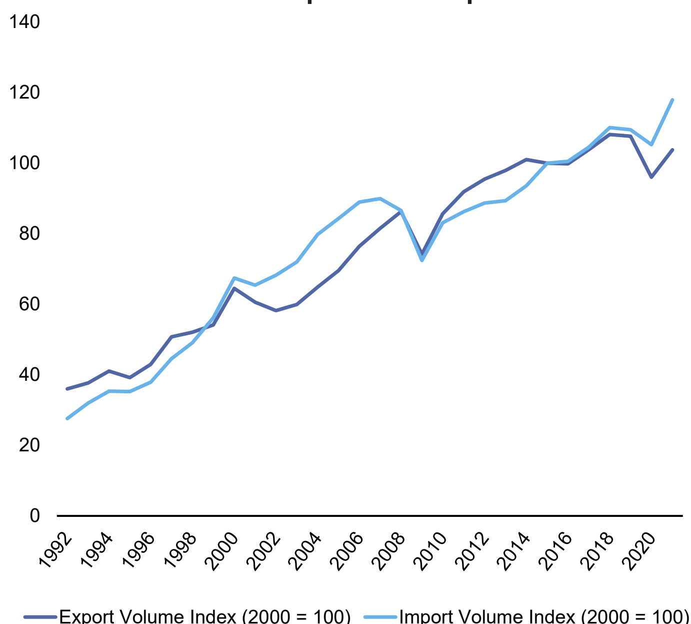
Source: World Development Indicators.

Other Datasets to Consider

Exhibits 2a and 2b show U.S. exports and imports (which includes both goods and services), both from a value and volume standpoint. This is important to consider because the United States is a vast economy and import and export data provides a good glimpse into the movement of goods and services throughout the world.

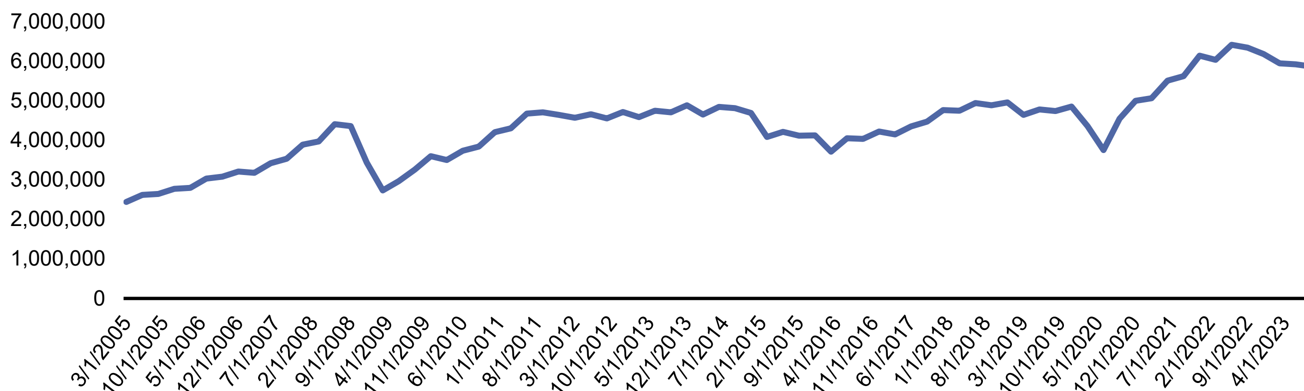


Source: World Bank.



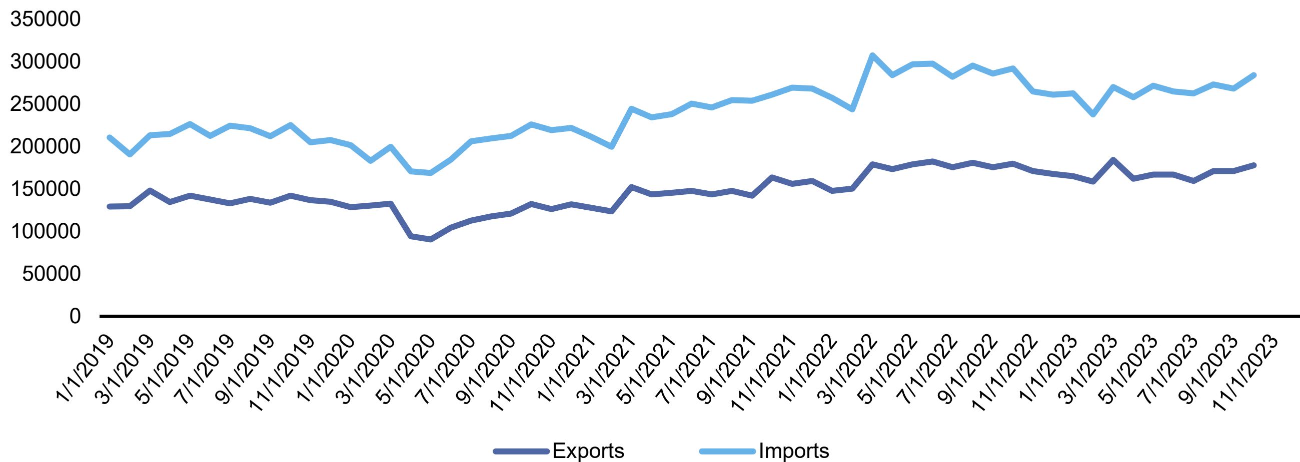
Source: World Bank.

That data points to a slowing pace of growth in exports and imports in the post global financial crisis (GFC) era. Breaking down the information shown in Exhibit 3, during the COVID-19 pandemic an increase in demand for goods led to an increase in trade in 2021 and 2022, which has since slowed. The trend is more closely observed and appreciated when looking at the more granular monthly export and import data as shown in Exhibit 4 on the following page. A similar trend of slowing growth since the global financial crisis is observed in Exhibit 3, which depicts world merchandise export data. Each of these datasets point to a slowdown in growth, but they do not point to an outright decline in global trade. Neither does the recent uptick during the pandemic suggest a long-term trend.



Source: World Trade Organization.

Exhibit 4: U.S. Exports and Imports ($, Monthly)



Source: World Trade Organization.

We believe that the headline number of total imports and exports actually masks the changing dynamics of trade relations between countries. For example, trade tensions with China and ensuing tariffs on Chinese imports had a notable impact on the composition of U.S. imports. In fact, Exhibit 5 breaks down the imports by partner share. China continues to be a major trading partner, constituting 18.5% of imports in 2021, down from a high of 21.9% in 2017. But while imports from China have declined, imports from India, South Korea and Vietnam have risen from 7% in 2017 to 9.7% in 2021. Similarly, Japan and Canada constituted 37.2% of imports in 1991, but now account for only 17.2% of imports. However, some of that slack was made up by China and Mexico, which have become larger destinations for U.S. exports as shown in Exhibit 6 on the following page.

Exhibit 5: U.S. Imports — Partner Share (%)

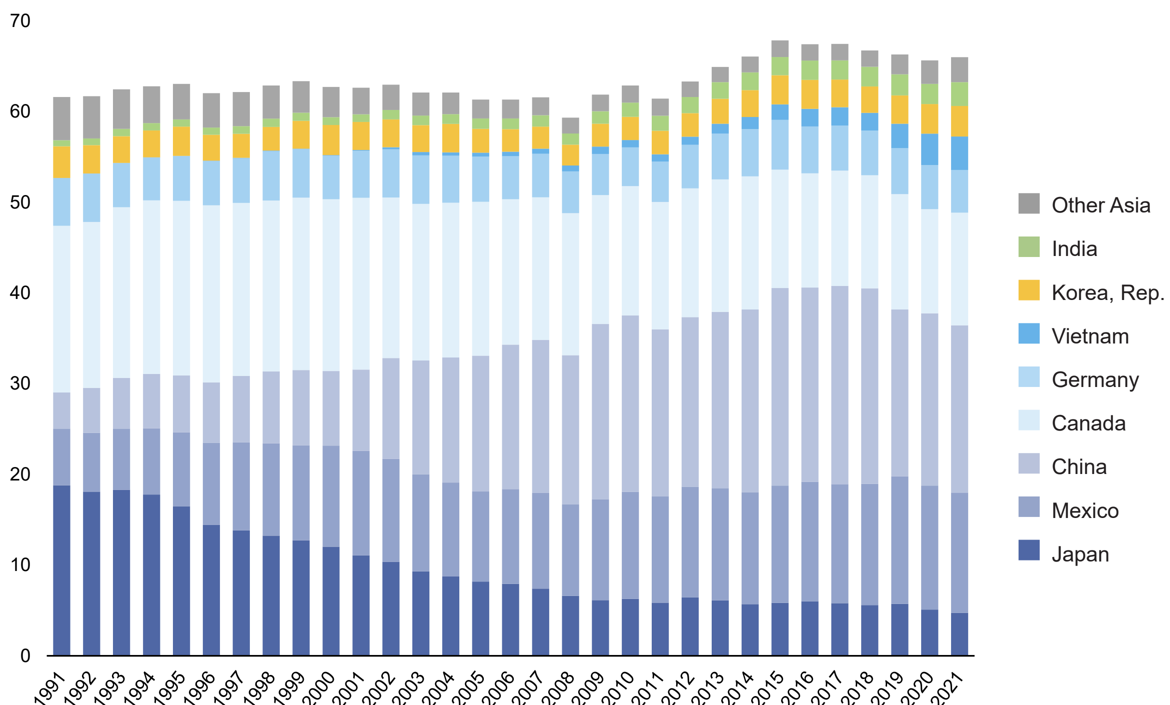
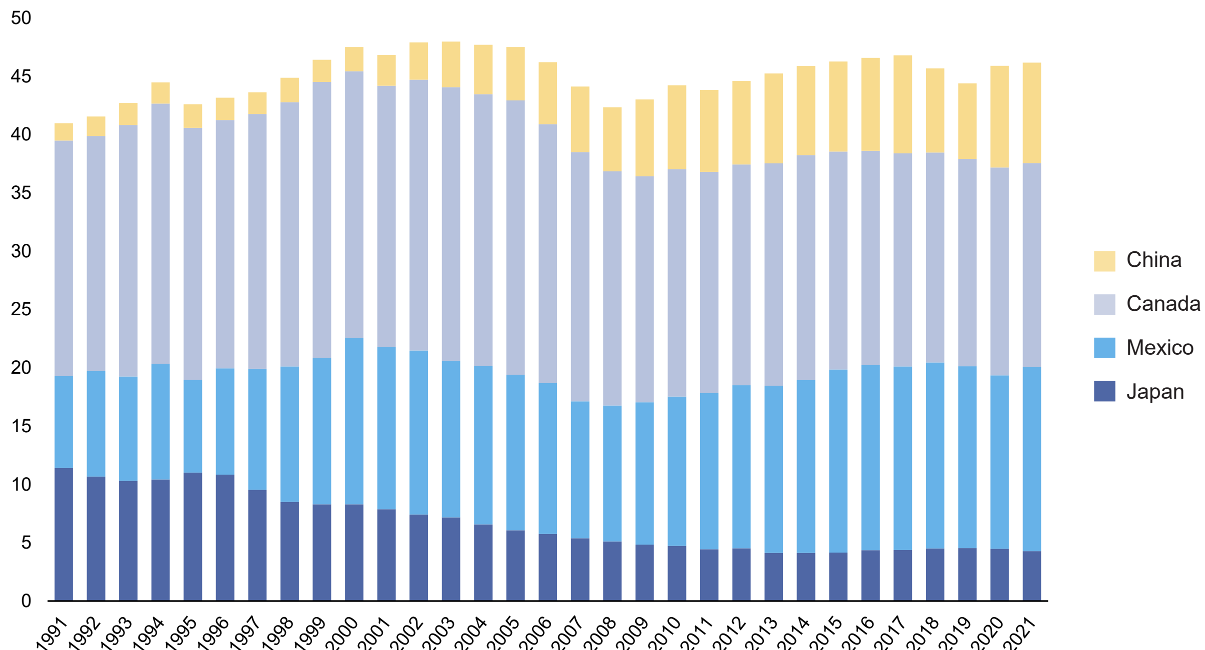


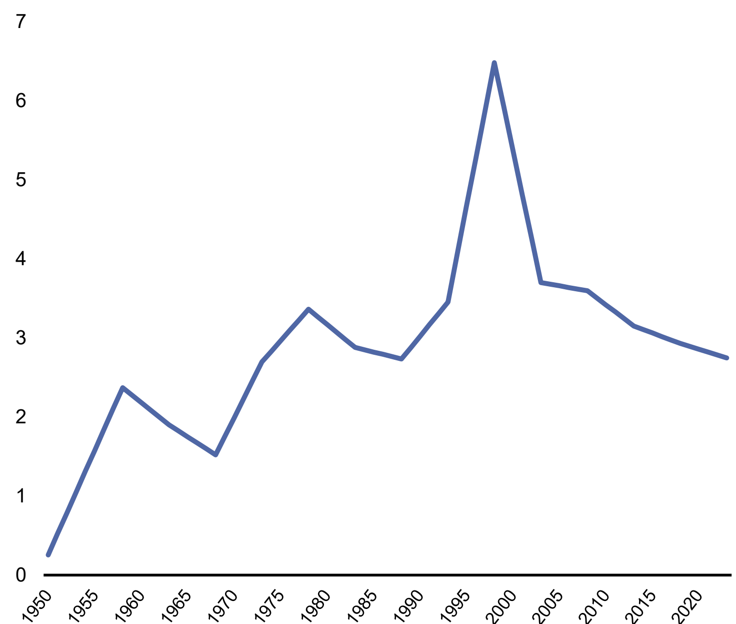
Exhibit 6: U.S. Exports — Partner Share (%)



Foreign direct investment, which refers to an ownership stake in a foreign company by an investor/company/government from another country, is another way of measuring interconnectedness between countries. According to the United Nations Conference on Trade and Development (UNCTAD's) Global Investment Trends Monitor, global foreign direct investment flows in 2023 are estimated at $1.37 trillion, implying an increase of 3% over 2022. When looking at data for the U.S., FDI inflows have risen from $104 billion in 2005 to $285 billion in 2022, while FDI outflows have risen from $15.4 billion in 2005 to $373 billion in 2022. While short-term headwinds may be experienced during periods of rising interest rates or slower economic growth, the data points to a continued flow of capital across borders over the long-term.

Lastly, net migration, which measures the number of immigrants minus the number of emigrants, including citizens and noncitizens, is a good measure of the flow of labor across countries as it signifies global integration. For the U.S., the net migration rate per 1000 persons peaked at 6.5 in 1998, and has recently declined to about 2.8, which still points to a net positive inflow of labor as shown in Exhibit 7 below. All of this suggests that we are not seeing outright deglobalization or a return to an insular world at this point in time.

Exhibit 7: U.S. Net Migration (Per 1000 Population)



Source: United Nations - World Population Prospects.

Impact of Rapidly Changing Geopolitics

Again, we see nothing in terms of data that would suggest that outright deglobalization is in the cards. Let's take a closer look at the Russian invasion of Ukraine and its impact for some clues.

In 2022, when Russia invaded Ukraine, the European Union (EU) enacted sanctions on Russia, which curtailed that nation's imports and exports. As a result, per Eurostat data, the value of EU imports from Russia fell by 81% between February 2022 and September 2023. Meanwhile, Russia's share of natural gas imports fell from 39% in the third quarter of 2021 to 12% in third quarter of 2023. However, the void was at least partly filled as natural gas imports from the U.S. rose from 9% (in the third quarter of 2021) to 23% (in third quarter of 2023). In short, this showcases that even over a very short period of time, the supply chain for natural gas in the EU was reconfigured from being Russian-centric to U.S.-centric and that trade didn't shut down, it merely shifted.

Further Observations Regarding Deglobalization/Global Fragmentation

We believe that globalization evolves over time in reaction to lower labor costs, capital investments that create leading edge infrastructure, availability of natural resources, trade agreements, policy initiatives, political agenda, regulatory landscape and geopolitical stability. We also believe that export partners and capital flow destinations are constantly evolving, particularly during periods of rising populism and increased polarization such as we are seeing today across much of the globe. We do not expect the global economic interconnectedness to reverse per se. Instead, we would argue that we are transitioning to a system where geopolitical alignments and national interests will play a greater role in defining trade policy and multi-lateral trade agreements. We are also cautious about the impact these changing trends might have on goods prices and corporate profits. While we haven't necessarily seen a jump in goods inflation, even as these shifts are happening, we should expect to see more shocks to inflation expectations as the supply chains continue to evolve.

Our view (of deglobalization) is one where past relationships are not necessarily indicative of what might happen in the future. We posit that in the future, securing supply chains will be paramount, and lead to a realignment of global trade and capital flows in-line with international policy ideology. We expect to see countries emphasize regional economic trade pacts as a way to align with their foreign policy priorities. We do not believe that we will see a sustained slowdown in global trade over the long-term, but instead expect to see slower near-term growth than in the past as building and reconfiguring diversified supply chains and aligning trade policies with domestic populist views takes precedence.

Further:

- We conclude that global trade data points to continued integration of international economies on trade and capital.
- We observe that geopolitical fragmentation is leading to winners and losers within this ecosystem, leading us to believe that the reconfiguration of global supply chains and global trade is an evolution from the current system of extreme cooperation to one that focuses on self-reliance and geopolitical partnerships. This is also leading to more regional trade and economic cooperation that aligns with common foreign policy interests.
- We do not believe that a drastic reversal in globalization or interconnectedness across international economies will occur, but rather a reconfiguration of how global trade is conducted, that will be predicated by regional alignment and policy priorities, and that will have implications for investors across the globe.

Implications for Institutional Investors

As the global trade landscape evolves to focus on national interest and diversified supply chains, we expect past trade relationships to be tested. Multi-asset class investors need to reevaluate their strategic long-term allocations in response to the changing dynamics. A country that might have had the tailwind of trade could be facing greater scrutiny today leading to increased cost of doing business tomorrow, and raising the equity risk premium that investors expect to be compensated for upon making investments in the country. This needs to flow into capital market return expectations as well as risk expectations. This has implications for long-term return expectations for multi-asset portfolios.

From an asset allocation standpoint, it would be a mistake to assume that the capital returns of the past will continue indefinitely into the future. New winners will come forth and companies that greatly benefited from economies of scale will be forced to deal with an increased cost of doing business. As always, investors should look beyond data and through the lens of changing dynamics and therefore reallocate to areas of the economy that are seeing greater capital flows. Secular decline within a certain sector or country's equity also has implications for the broad benchmark composition, which needs to be considered as well. For example, a shift away from China as a manufacturing hub leads to a shift towards other low-cost origin countries such as Vietnam and India. Similarly, a shift away from Russia for energy needs has meant greater opportunity for U.S. based energy exporters. Similarly, a company that was a beneficiary of global trade might find itself losing out to competitors in other low-cost countries that have either built out their infrastructure or have a better trade relationship with exporters. These shifts call for increased due diligence towards active management strategies that are allocating globally.

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Investors should also consider the shifts in supply chains and its potential impact on regional inflation when considering investments within a region. For example, the sudden shift away from Russian energy imports led to higher energy costs and therefore higher inflation in the Eurozone region. While the shifts we are pointing to tend to be long-term in nature, investors should also be cognizant of any potential impact on inflation expectations. Within the U.S., lower cost manufacturing imports from China have contributed to lower levels of core goods inflation in the last two decades. We expect this to change as manufacturing sources move away from the low-cost provider. This could lead to higher levels of inflation than the very low levels observed in the decade preceding the pandemic.

Finally, within multi-asset portfolios, institutional investors should pay greater attention when choosing active managers as keen insights into the macro landscape will increase the importance of careful security selection. If deglobalization contributes to higher sustained inflation and interest rates than has been the case over the last 15 years, it would likely have a meaningful impact on asset valuation levels, discount rate assumptions and the cost of debt for institutional investors. While there are no immediate steps to be taken, we are closely monitoring these deglobalization trends to understand any impact on return expectations, risk expectations, and longer-term inflation and interest rate levels.

STAY TUNED

In the second quarter, we plan to issue another InvestEd to discuss:

- ► The significance of regional economic partnerships, trade blocs and geopolitical realignments and their potential impact on inflation.
- ► The potential implications of those partnerships and realignments for institutional investors.

To learn more or discuss in greater detail, please contact your PFMAM relationship manager.

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