Investment Strategy

The Equity Thematician | June 30 2019

A deglobalising world and our ‘Yellow brick road’

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- Globalisation of the past decades has helped economies prosper and also expanded the investment universe; it has also resulted in rising social exclusion in developed markets, and led to a populist backlash pushing for protectionist policies.
- Protectionist policies have the power to reverse globalisation, to some extent. At an aggregate level, this is unequivocally bad for risk assets. Within the global investment universe, there are assets that will suffer less, or even profit, from the current phase of deglobalisation.
- We identify eight investment themes for a deglobalising world. Together these investment themes will go under the banner of “Yellow brick road” investing and will constitute our roadmap for thematic investments for the years to come. *The Equity Thematician* will publish follow-up reports on each of these themes.

What

Globalisation has been with us for a considerable period of time and the modern era globalisation has promoted an increase in trade of goods and services, greater competition, economies of scale and increased mobility of capital and labour. Trade openness in the past has not only brought new products to new markets, but also resulted in lower costs of manufacturing. This has also been facilitated by a global trend of reduction in capital controls and a steady rise in migration. Of course, globalisation also presented challenges. Social discontent has risen in the developed world where parts of the population, especially the middle income class, have not benefitted (rather were hurt) by the new globalisation. This has resulted in a rise of protectionist and nationalist instincts.

So what

US-China trade and tech war, re-drafting of NAFTA, Brexit, rise of Eurosceptic parties etc. are manifestations of increasing protectionism, in our view. Data suggests faltering trade in goods and services, fading cross-border capital flows and cross-border capital lending as well as decreasing migration. There is more. Some argue that the recent rise of protectionist and nationalist attitudes by the US and China might even induce the reversal of global data flows. This would be quite a dramatic development. In fact, the explosive growth in data flows has been the most important and revolutionary phenomenon of globalisation in the recent past. Indeed technology which has in the past facilitated rapid globalisation has turned the war-ground for the current episode of trade war between the US and China. In short, now with the rise of protectionism challenging free trade and with economies becoming less open, benefits of globalisation enjoyed in the recent past decades might well reverse. This would inevitably have profound implications for economies, corporates and therefore investors.

Now what

A deglobalising world presents risks but also opportunities for investors, we identify eight investment themes (macro, micro, country and sector ideas). In framing our investment thesis, we draw inspiration from the novel *The Wonderful Wizard of Oz*, in which little girl Dorothy follows the ‘Yellow brick road’ to meet the Wizard of Oz and to eventually realise two things: first, there is no place like home and second, all the power is within you.

Did you know?

- Real growth in global per capita GDP was 56% between 1 million BC and 1500AD, 386% between 1500AD and 1900AD and 856% between 1900AD and 2000AD. As the world became more interconnected, it became more prosperous (*Peterson Institute for International Economics: Globalization Facts and Consequences*).
- Since 1955, the volume of world trade has grown much faster than the world economy as a whole, and for many countries it has been the engine of growth.
- Services trade is underestimated. According to McKinsey, trade in services, properly accounted for, may in fact already be more valuable than trade in goods (*McKinsey: Five major shifts show how globalization is changing*).
- Between 1998 and 2017, growth in per capita income of emerging market middle income class was 10x the growth in per capita income of the developed world middle income class.

The obscure origins of globalisation and its inclusive marvels

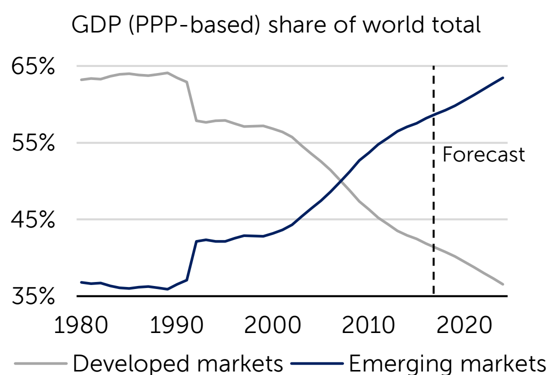
When was it that globalisation began? Was it 1800 (when the transport revolution of the North Atlantic resulted in commodity price convergence across the World) or 1498 (when Vasco da Gama circumnavigated Africa) or 1492 (when Columbus discovered the Americas) or even earlier that globalisation began?[1]

What was it *Pax Mongolica* or *Pax Romana* or *Pax Sinica* or *Pax Britannica* or *Pax Ottomana* or *Pax Americana* that drove globalisation?

Whenever and whatever, globalisation has been with us for a considerable period of time and the modern era globalisation (which in our opinion has persisted since 1980) has helped in increased trade of goods and services (therefore greater choice for the end consumer), greater competition (lower prices), economies of scale (more efficient production) and increased mobility of capital and labour. Trade openness in the past has not only brought new products to new markets, but also resulted in lower costs of manufacturing. Global integration has also been facilitated by reduction in capital controls and a steady rise in migration. Of course, globalisation also presented challenges.

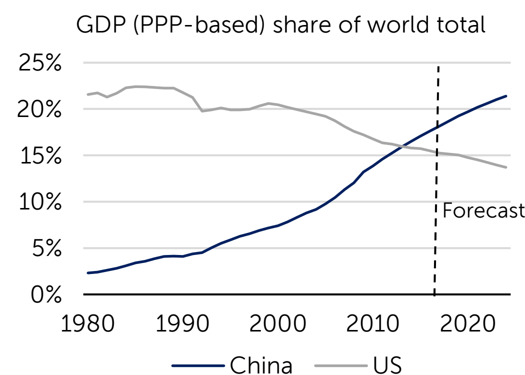
Globalisation has made the emerging market economies an integral and significant part of the global economy. They have effectively used their cheaper resource costs to export higher value added goods globally primarily to the developed world. In doing so, emerging market economies have also significantly used the technology of the developed world. Thanks to much higher growth rates, the emerging markets share of global output has gone up massively, at the expense of developed markets. Over the last forty years, this process has been particularly impressive when measured in Purchasing Power Parity (PPP) terms (for discussion on PPP and why it matters, see the box on the following page). Quite strikingly, in 1980, DM contributed 65% to global GDP (and EM contributed the remaining 35%); on IMF estimates by 2021, the share of EM in global GDP is expected to touch 65% (with DM share dropping to 35%) – an exact reversal in positions compared to 1980 (exhibit 1). This trend of relative economic weight moving away from DM to EM can be seen no better than in the case of the US and China (exhibit 2).

Exhibit 1: Economic dominance shifted from DM to EM...



Source: IMF WEO Database (April 2019) and ADCB Asset Management

Exhibit 2: ... with US losing and China gaining over the past forty years



Source: IMF WEO Database (April 2019) and ADCB Asset Management

> "No generation has had the opportunity, as we now have, to build a global economy that leaves no-one behind. It is a wonderful opportunity, but also a profound responsibility."
>
> Bill Clinton, former US President

[1] When Did Globalization Begin?, Kevin H. O'Rourke, Jeffrey G. Williamson, NBER Working Paper No. 7632, Issued in April 2000

Purchasing Power Parity (PPP) versus nominal exchange rate, and why it matters

GDP is measured in PPP terms when it takes into account the domestic purchasing power of local currencies in different countries rather than the international purchasing power at the prevailing nominal exchange rates. The purchasing power of, say, the Chinese renminbi is much higher in China than in the US (where it would need to be exchanged in US dollars at the prevailing nominal exchange rate). This is true for most emerging markets, which means that their PPP-based GDP is higher than their GDP based on nominal exchange rates.

Critically, over the long-term, nominal exchange rates should converge to the PPP-rates, since those rates imply the true purchasing power of (emerging) currencies. Hence, the appropriateness of using PPP rates when evaluating the potential global economic power of emerging markets.

However, there is more to this. In spite of the increased share of GDP of emerging markets, effective economic power is still to a large extent being retained by the US, as the holder of the world's sole dominant reserve currency, the US dollar (and one would add that the "minor" reserve currencies are not emerging market currencies, but belong to other developed markets). This economic power is better reflected by the global shares of GDP in (the prevailing) nominal exchange rates, where the growth in the emerging markets' share, whilst still impressive, has been more contained.

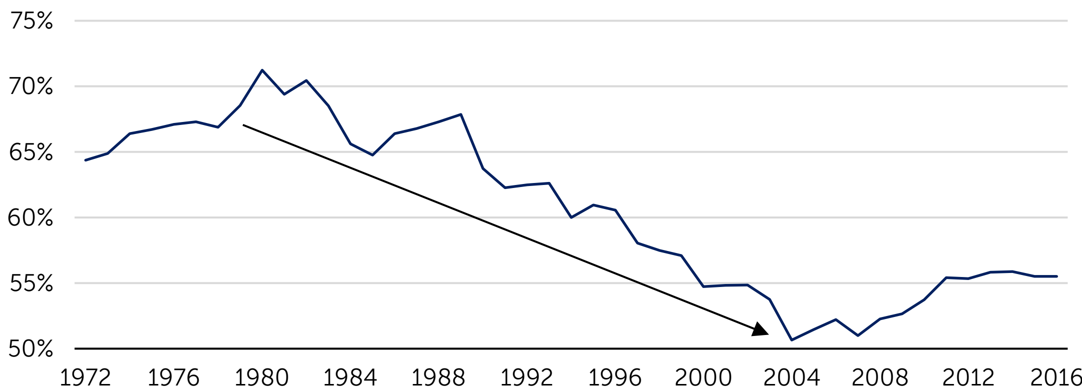
The distinction is very important because the US has recently been very aggressive in using that economic power by introducing economic sanctions on a myriad of countries for different political reasons. This so-called "weaponisation of the dollar" is a development that will need to be closely followed. In the short-term, it could lead to dollar shortage, driving up spreads and the dollar nominal exchange, widening rather than reducing the gap between developed markets and emerging markets. In the long run, however, it could lead to (not only) emerging markets looking for alternatives to the US dollar. Also for that reason, and pending of course all sorts of less predictable geopolitical events, from a long-term perspective (the true scope of all our *The Equity Thematician* publications) it makes most sense to look at the PPP-exchange rate, rather than the nominal-exchange rate.

The obscure consequences of globalisation

Across countries globalisation is a win-win proposition...

It is important to stress that in the aggregate globalisation is a win-win proposition. By forcing more efficient capital allocation, in particular the production of certain goods and services where such production is cheaper for similar quality levels, global output will grow faster compared to the situation where such production is trapped within the confines of specific countries. Relocation of production and goods to countries where such production is cheaper of course means that it is being relocated to countries with lower wages, i.e. lower GDP per capita. This can be clearly seen by exhibit 3 showing a marked decline of the average GDP per capita of the countries exporting to the United States.

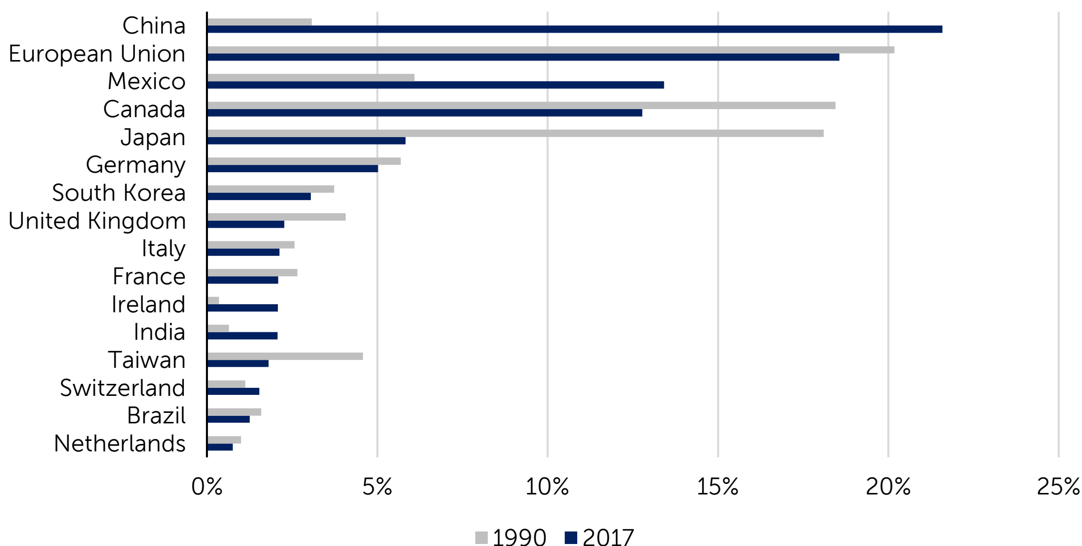
Exhibit 3: US trade has moved away from countries with similar level of development (wages) to countries with lower level of development (wages)



Source: IMF, Maddison GDP per capita report and ADCB Asset Management

Exhibit 4 puts names to the countries involved. One can clearly see that during the recent period of globalisation, China and other emerging markets exports have mostly risen as a share of total exports to the US, whilst the share of developed markets exports to the US has come down.

Exhibit 4: China and other emerging markets have increased their share in US imports



Source: IMF, Maddison GDP per capita report and ADCB Asset Management

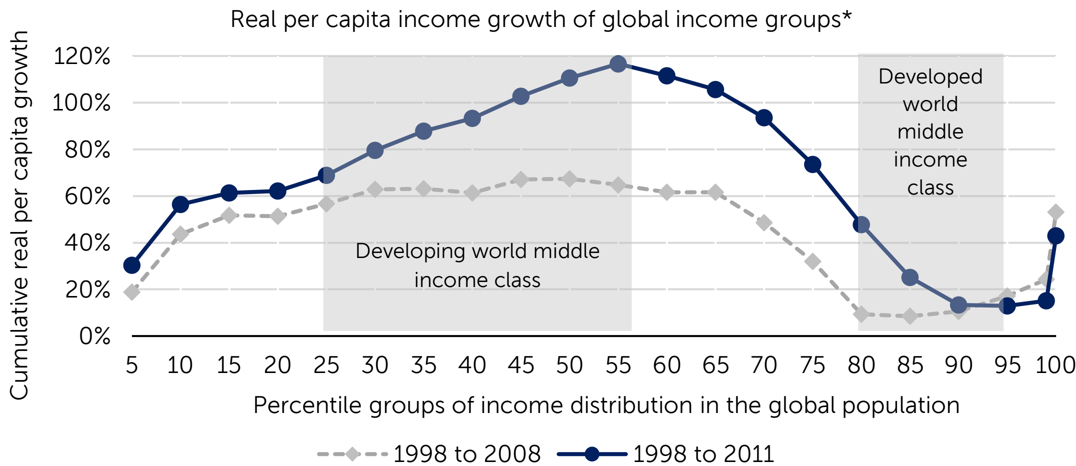
Again, it is important to stress that, for trade as for global GDP, we are talking about shares, *not* about absolute levels. Since the 1980s global trade and global GDP levels have grown. GDP has grown in all countries. Also, all countries have been allowed to specialise in those sectors where they are more competitive, read cheaper. It is this international specialisation that has benefitted all countries.

...but something went wrong

Within countries, however, and in particular *within* developed markets, the picture is less clear cut. Whilst, returning to the above examples of exhibits 3 and 4, globalisation has allowed the US to become better and better in the high end segment of value creation, the outsourcing of "easier" jobs has inevitably led to depression of the wages of lower skilled workers. Thus whilst globalisation has lifted millions of people out of poverty, many workers in developed markets have seen their income stagnating all whilst the house prices and the asset prices in their own countries have continued to rise at very high rates[2].

Exhibit 5 shows how globalisation has helped increase the income of the middle income class in emerging markets at the cost of the middle income class in the developed world. As mentioned, particularly disturbing to the (shrinking) developed markets middle income class has been the fact that simultaneously the income of the upper income class(es) globally (i.e. both in the developed and in the emerging world) has risen sharply, which has gone together with a significant rise of house and asset prices. This phenomenon has damaged social cohesion in developing countries, leading to a rise in populism, and protectionist rhetoric gaining traction. It has happened both in the US and in the UK, where the traditional mainstream parties, both on the left side and on the right side of the political spectrum have been subverting conventional wisdom, and mainstream policies. It has happened also in the European continent, where anti-establishment parties are making electoral gains at the expense of the traditional mainstream parties. At this stage the phenomenon appears to be less marked in Canada, Australia, New Zealand, Japan and Korea.

Exhibit 5: Not all middle income groups are made equal



Source: Milanović, B. *Inégalités mondiales : le destin des classes moyennes, les ultra-riches et l'égalité des chances*, https://www.editionsladecouverte.fr/catalogue/index- In__galit__s_mondiales-9782348040450.html (accessed on 6 March 2019)., OECD and ADCB Asset Management | Note: *top ventile is split into top 1% and 4% between P95 and P99.

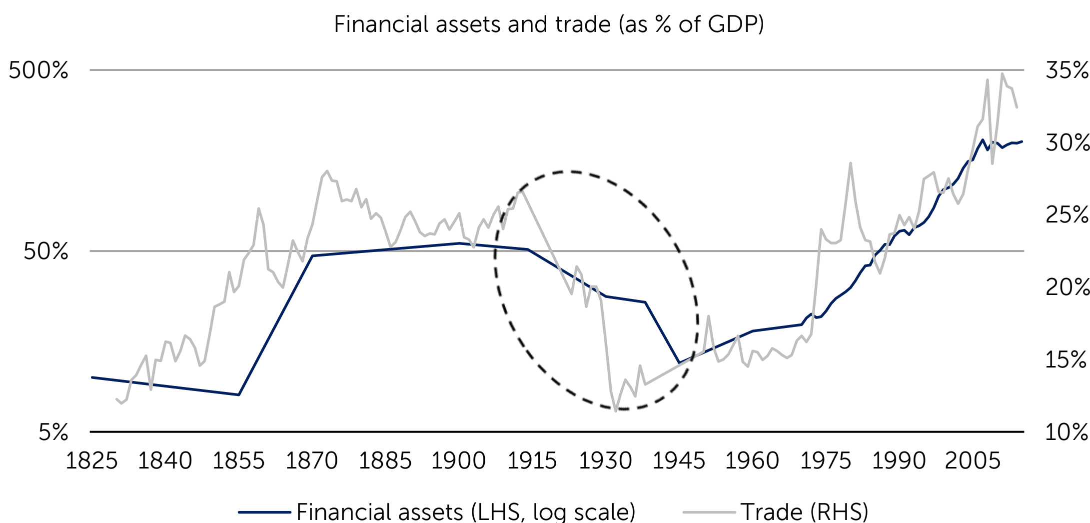
> "The whole of the global economy is based on supplying the cravings of two percent of the world's population."
>
> Bill Bryson, American-British author

[2] Indeed, as has been pointed out by Greenwald, Lettau and Ludvigson, *Origins of Stock Market Fluctuations*, NBER, 2016, the main driver of the rise in US equity prices over the last 40 years has been the persistent shift away of income from labor to capital, rather than increased productivity or reduced risk aversion.

Deglobalisation and the implications for investors

Precisely because in the developed markets, the rewards of globalisation have gone to the owners of the capital at the expense of the working middle class, we should not be surprised that the growth of financial assets has gone hand-in-hand with the rise of globalisation. In fact, exhibit 6 shows that this has been a constant over the last two centuries. The rise in financial assets reflects the redistribution away of income from the working (middle income) class to the owners of capital. And since populism challenges that redistribution, we would argue that it has the potential of reversing the globalisation. This is what happened hundred years ago with World War-I and the Great Depression. It was not until after the end of the World War-II that the anti-globalisation movement started to abate.

Exhibit 6: Globalisation is not irreversible



Sources: Federico and Tena-Junguito (2017); Lane and Milesi-Ferretti (2017); Obstfeld and Taylor (2004); Federal Reserve flow of funds accounts; IMF, Balance of Payments Statistics; World Bank; US Department of the Treasury; McKinsey Global Institute analysis; BIS calculations and ADCB Asset Management

> "I think there's a lot of merit in an international economy and global markets, but they're not sufficient because markets don't look after social needs."
>
> George Soros, Chairman of Soros Fund Management

Manifestations of the anti-globalisation trend

US China trade and tech war, re-drafting of NAFTA, Brexit, rise of Eurosceptic parties etc. are manifestations of increasing isolationism. Complicating this is the fact that technology (information and communication) which has in the past facilitated rapid globalisation has turned the war-ground for the current episode of trade war between the US and China.

When considering technology, we think investors should exercise caution when identifying winners and losers in a trade-war context. For instance, the "information technology" (IT) sector as defined by the index provider MSCI includes technology hardware & equipment, semiconductors & semiconductor equipment and software & services. Whilst we think the former two are vulnerable to trade disruptions, we think software & services are more resilient (see our report *The Equity Strategist: Our pivot to the service sector, a safe harbour, 28 March 2019*). Furthermore, most investors still tend to associate the consumer-facing technology platforms (likes of Facebook, Amazon, Netflix, Google, Baidu, Alibaba, Tencent etc.) with the broader IT sector. Benchmarks, however, transform. Today, it is simply wrong to consider these companies "technology" companies. In fact, they are today, classified by MSCI as "communication services". They are a lot more resilient to trade disruptions and the investment case for the sector is based on a relatively strong consumption trends across the globe.

Charts below make a point that some of the drivers – like the growth of cross-border trade and cross-border capital flows – that have helped in the progress of globalisation over the past decades are now showing signs of abating. Growth in merchandise trade has fallen since 2011 (exhibit 7). Whilst 2016 and 2017 saw some acceleration, trade growth did fade again in 2018. Looking at the more recent data, some of the trade between US and China has been front loaded because of the increasing tariff threats. This might provide support in the near-term.

Outsourcing – which has helped in massive expansion of the trade in recent decades – might have logically run its course. Services trade too has come under pressure (exhibit 8).

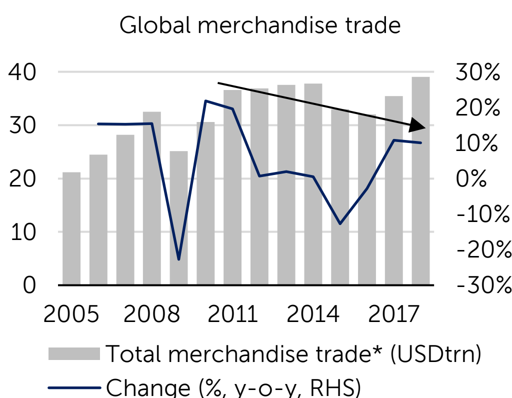
Foreign direct investment (FDI) trends have weakened too – at least the exponential rise we saw in the global FDI over past forty years is unlikely to repeat in the future (exhibit 9).

Cross-border bank lending has been on a constant decline since the global financial crisis of 2008/09 (exhibit 10).

The rise in protectionist instincts has also started to affect the migration trends globally. For instance, according to FT, as of early 2019, net migration from EU to UK fell 70% since Brexit vote.

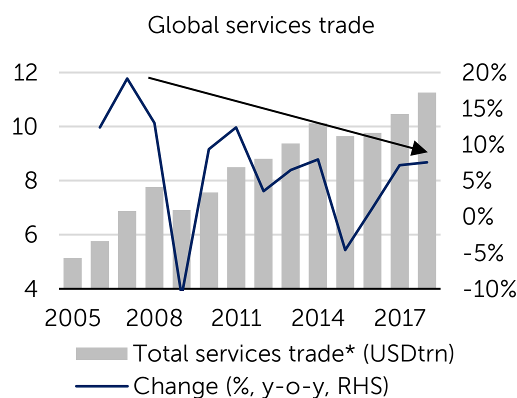
Also, as we pointed out on the first page of this paper, with data becoming increasingly valuable, the rise in protectionism might even result in a fall in cross-border data flows as the focus shifts towards the issues of data privacy and security policies, foreign surveillance, national security risks and developing national digital economies.

Exhibit 7: Goods trade is under pressure…



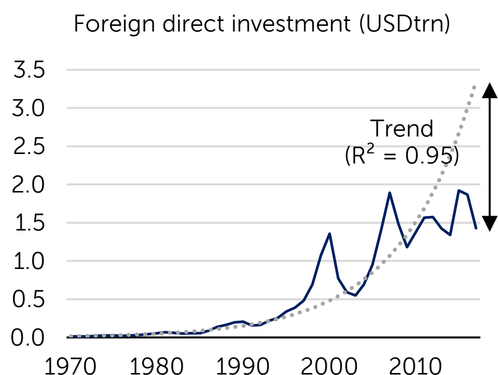
Source: UNCTAD and ADCB Asset Management | Note: *trade is defined as sum of imports and exports

Exhibit 8: …as is the trade in services



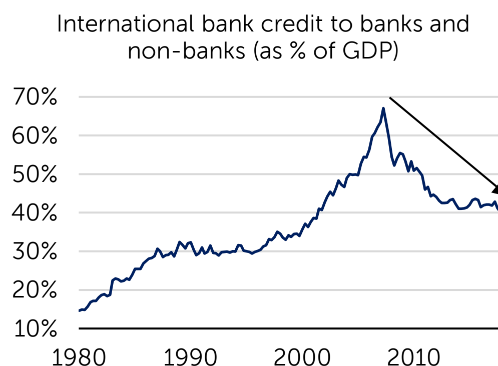
Source: UNCTAD and ADCB Asset Management | Note: *trade is defined as sum of imports and exports

Exhibit 9: Global FDI is growing well below historical trend



Source: UNCTAD and ADCB Asset Management

Exhibit 10: Cross border lending* has been falling



Source: BIS and ADCB Asset Management | Note: *international bank credit to banks and non-banks

Implications

Very broadly, as we argued in our report *The Equity Thematician: Bracing for lower long-term equity returns, February 2019*, trade openness in the past has resulted in lower costs of manufacturing. This has also been facilitated by a global trend of reduction in capital controls and a steady rise in migration. Now with the rise of protectionism challenging free trade and with economies becoming less open, the benefits of globalisation to capital returns might well reverse. Logically, this should feed into weaker equity market returns over the long-term (think next ten years). Of course, we don't mean to say that the equity returns over the next ten years will be negative, but in our view, they are likely to be moderate compared to the double digit annual returns of the 2010s.

However, all global international frameworks have their winners and losers. A less globalised world would be no exception. Therefore, identifying the appropriate strategy becomes rather important. Our 'Yellow brick road' investing (discussed in detail below) is our strategy to help investors during these testing times for globalisation.

Admittedly, we do not have empirical evidence from the past – not least because these events are not very frequent, at least in the modern history – to identify the winners and losers of deglobalisation. Moreover, this entire anti-globalisation still remains very fluid and hard to predict on how the future could shape up. For instance, these deglobalisation trends could eventually translate into a different form with a strong prospect for "regional agglomeration"[3] and therefore, it might become very hard to identify the exact winners and losers. On the flip side, however, anything that disrupts also provides opportunities. From an investing point of view, success depends on identifying opportunities – a combination of embracing winners and avoiding losers; our 'Yellow brick road' strategy entails both.

[3] We borrow this phrase from Professor Richard Kneller (Globalisation and Economic Policy Center (GEP), School of Economics, University of Nottingham) who uses it to describe the realignment of global supply chains to be more concentrated on a particular region than the entire globe.

'Yellow brick road' investing: our basic thoughts on deglobalisation

Little Dorothy Gale, the fictional protagonist of Lyman Frank Baum's 1900 novel *The Wonderful Wizard of Oz*, travels the 'Yellow brick road', meets the wizard and returns home from the mysterious land with two key lessons: 'there is no place like home' and 'all the power you need is within you'. From our perspective (please allow us to be philosophical here), yellow brick road is the path of realisation, which is more important than the final destination itself!

The key message is that deglobalisation is bad for overall global capital markets: the world is (becoming) not so nice (anymore)! The deterioration is structural, not cyclical. It will become increasingly less profitable to chase cyclical upturns. More important even, it will make more sense to focus on those economies, sectors and stocks that are less reliant on the world.

Philisophy#1: there is no place like home: focus on domestically oriented companies

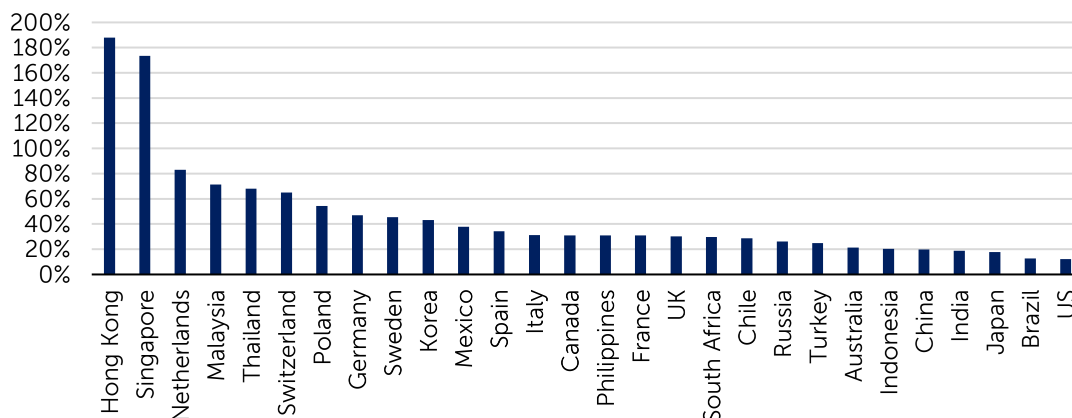
Philosophy#2: All the power is within you: focus on self-help stories

Putting philosophy into practice, we prefer

1. economies that are more reliant on domestic demand to those that depend on exports
2. countries that have self-sufficient economic models over those that are reliant on external support
3. equity markets whose index composition is more titled towards domestic consumption than to global consumption/trade
4. services sector over manufacturing sector (see our report *The Equity Strategist: Our pivot to the service sector, a safe harbour, 28 March 2019*)
5. small and mid-cap stocks over large caps
6. companies with low cross-border revenue-asset mismatch
7. companies that have high internal growth rates[4]
8. defense stocks as countries adopt more isolated and nationalist approach.

Following charts (exhibits 11-16) provide some information/intelligence regarding the macro and micro composition of various countries/regions.

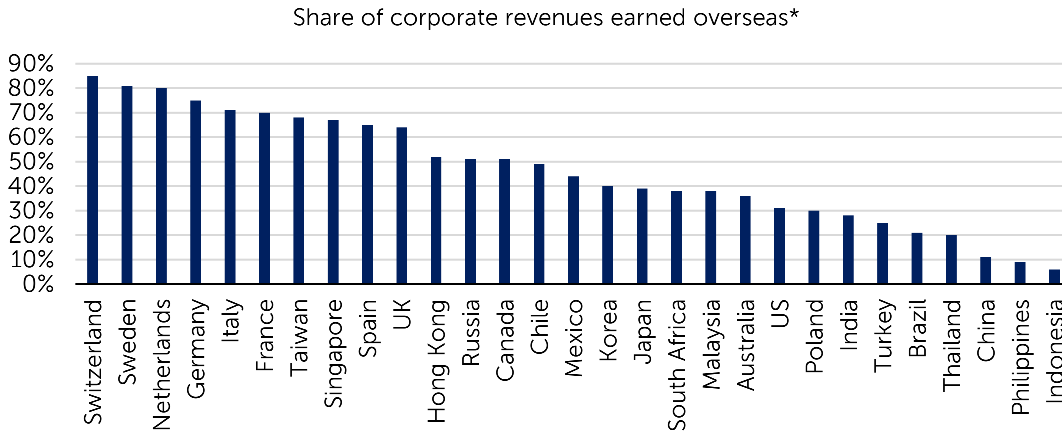
Exhibit 11: Some Asian and European economies are more reliant on trade*



Source: World Bank and ADCB Asset Management | Note: *Data based on 2017 annual numbers. Trade in some cases could be concentrated within the region (for instance within Europe) and therefore might not be as vulnerable as the headline numbers would suggest.

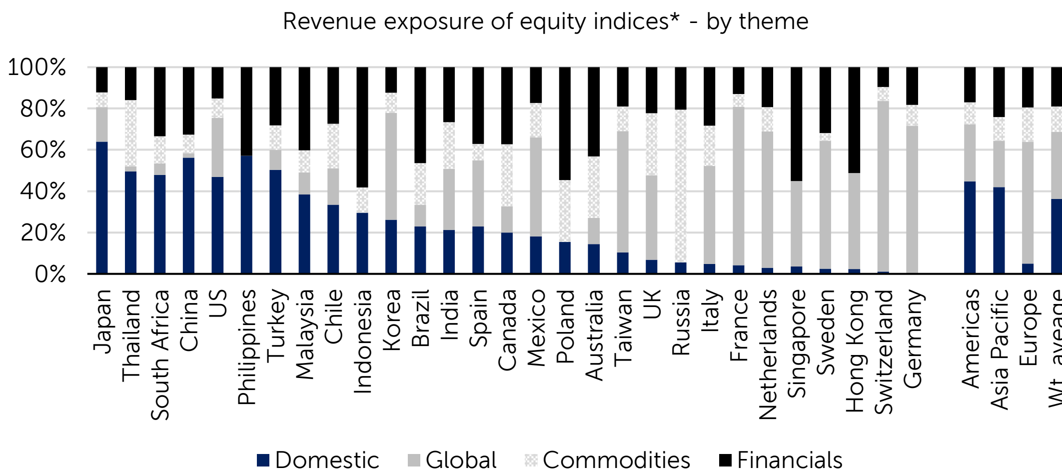
[4] Maximum growth rate a firm can achieve without resorting to external financing and is calculated as 'Internal growth rate = return on equity * retention ratio'.

Exhibit 12: European equity markets are more reliant on overseas revenues



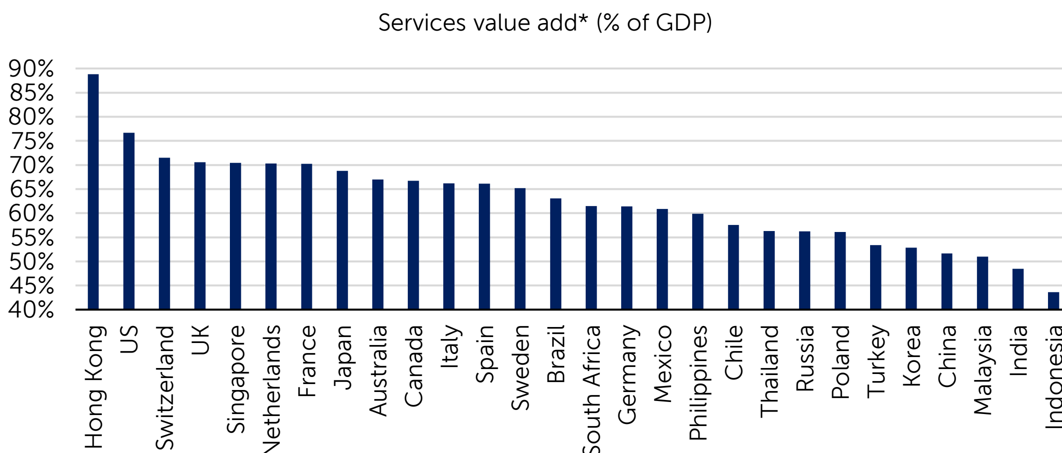
Source: MSCI, HSBC and ADCB Asset Management | Note: *Data based on 2017 annual numbers.

Exhibit 13: Equity markets in Americas and Asia are more domestically oriented



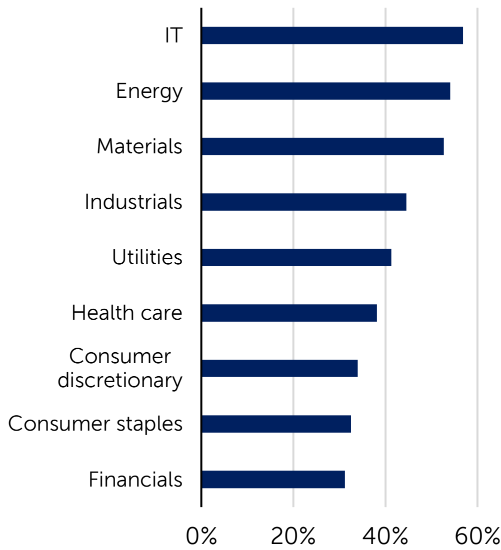
Source: MSCI, HSBC and ADCB Asset Management | Note: *Data based on 2017 annual numbers.

Exhibit 14: Developed markets are more service-oriented and emerging markets are more manufacturing-oriented



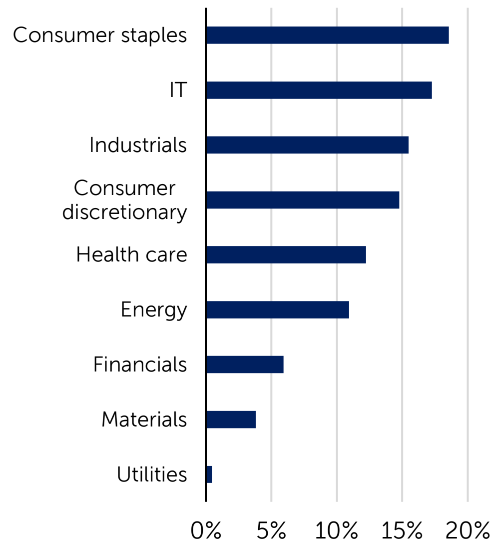
Source: World Bank and ADCB Asset Management | Note: *Data based on 2017 annual numbers.

Exhibit 15: In the US, foreign sales are most important for IT sector…



Source: S&P Dow Jones Indices LLC from data provided by S&P Global Market Intelligence and ADCB Asset Management | Note: *data as of July 2018

Exhibit 16: …but for the market overall, overseas sales in consumer staples segment is more important



Source: S&P Dow Jones Indices LLC from data provided by S&P Global Market Intelligence and ADCB Asset Management | Note: *data as of July 2018

Conclusion

This paper highlights our key orientation posts as we navigate through the 'brave new world of deglobalisation'. For now, that means a preference for large economies that are less reliant on trade, and those equity markets that are more geared to services and domestic demand.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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