

The Impact of Deglobalisation?

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When Henry Kissinger asked Zhou Enlai about the significance of the French Revolution, Enlai reputedly replied, “It’s too early to tell.”

In 1972, the year of Richard Nixon’s meeting with Zhou the size of the Chinese economy was \$113bn (IMF, PPP) and the country was a backwater. Today, similar estimates put the size of the economy at close to \$20 trillion.

Raising living standards was a clear policy objective for the Chinese leadership from Deng Xiaoping onwards. It is a remarkable story and a stark contrast to Russia which has struggled to raise the living standards of its population in the same period, if indeed, it ever was a policy goal for Russia.

It can be hard to grasp the significance of events as we live through them but looking back it is surprising how quickly in the 1970s and early 1980s “Made in Japan” was supplanted by “Made in Hong Kong,” and then by “Made in China.” What is often called globalisation has proceeded more quickly and deeply than we realise.

At the start of the period a lot came together all at once: international capital controls were abolished paving the way for the globalisation of financial markets, China opened the world to a billion or so of low-paid workers paving the way for a large expansion in cheap traded goods and Paul Volcker, at the Federal Reserve, raised US interest rates to a peak of 20.61% in June 1981 precipitating a vicious recession as the price of paving the way for the thirty years of disinflation, falling interest rates and growth that followed.

That period probably ended in 2008 with the global financial crisis. The open international cooperation that underpinned the pre-crisis economy has since morphed into aggressive competition and, tragically, open conflict. The twin behemoths that stride the world economy, the US and China, are increasingly belligerent with respect to each other despite the deep linkages forged by forty years of economic integration.

Of course, if the trends that characterised much of our working lives go into reverse, it begs the question of what will be the impact of this historic reversal and, for us as investors, what will be the impact on investments. What should investors do?

To take the three points above in reverse:

- 1) Right now, investors are, rightly, focussed on energy prices as the key component of the explosive rises in inflation rates. Food prices are likely to follow as energy price rises feed into the cost of production.

However, scarcity drives innovation. It seems probable that the energy supply squeeze fostered by the Kremlin can be substituted quickly by a combination of new and old tech as energy investment is accelerated. Nonetheless, given the experience of the Volcker years investors should recognise that monetary policy is too loose, and they should prepare for both higher inflation and higher interest rates.

- 2) Even before relations between the US and China began to deteriorate, the Chinese advantage in labour costs had largely evaporated. China is no longer the “low-cost” place to invest. It is no longer the exporter of “deflation.”

It does, however, retain comparative advantage in scale. One of our Asian managers reported to us recently that even though companies like Apple wanted to reduce their dependence on Chinese manufacturing there was simply nowhere else in the world they could find the necessary capacity.

Therefore, despite escalating tensions, US-China decoupling is much easier said than done. China needs foreign demand and investment, and the US needs the manufacturing capacity available in China. So-called “reshoring” is also much easier said than done and both have an incentive to cooperate. (For example, China has relaxed audit rules this week on Chinese overseas listings to retain access to US markets).

However, even as energy cost pressures ease, labour cost inflation is likely to prove stickier. Centres of high capacity, low-cost manufacturing are hard to find now that China has “emerged” into a mature economy.

3) The abolition of capital controls and the deregulation of financial markets in the early 1980s provided the funding to permit “globalisation” to proceed. Global trade and global payments systems are two halves of the same coin.

China has accumulated large international reserves but as Russia has found out, reserve accumulation (the financial accounting difference between exports and imports) is a doubled-edged sword if, as they are, mainly in US dollars, US dollar denominated assets and/or in US depositaries e.g. Fort Knox.

The end of globalisation as we have come to understand it means that the forces that led to persistently low and declining inflation rates alongside low and falling interest rates have now gone into reverse. If the supply-side problems referred to above persist, we are likely to see a return to the kind of cost-push inflation that has been absent since the 1970s.

Forty years of declining interest rates have floated many boats, but as the cost of capital rises investors will have to be more discerning. Inflation will erode cash deposits; a higher cost of capital will expose inefficient firms. Fractured global financial markets will place a premium on security, governance, and enforceable property rights.

Finally, given the drumbeat of environmental, ecological and climate change, markets will reward experimentation, innovation, and effective commercialisation.

It is very unfashionable to say so, but those characteristics are very much more typical of the United States than say, China. Perhaps the end of globalisation will also end the talk of the “China century” and affirm that the death of Uncle Sam, as Mark Twain didn’t say, has “been greatly exaggerated.”

Investing in the next decade will be very different to the last and our unconstrained approach should allow us to take advantage of the opportunities whilst also managing risks through our Stabilisers.

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