End of Globalization?

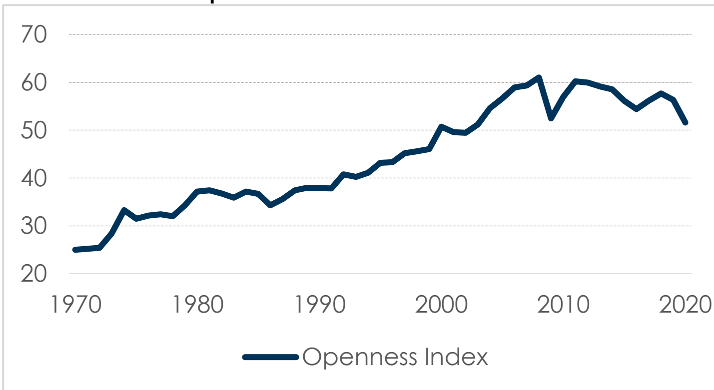
June 2022

- **Decades of globalization have led to the developed world relying more on foreign nations, sometimes with competing interests.**
- **The pandemic and recent geopolitical events have shifted attention to the challenges inherent in an increasingly connected world.**
- **As nations - and companies - reconsider their cross-border relationships, how does this impact investors?**

Overview

For decades, companies have embraced technological advances to improve the efficiency of supply chains and distribution channels across the globe. In the decades following World War II, trade continued to account for a growing percentage of the world economy. This secular uptrend plateaued after the 2008 GFC and declined more notably following 2020's COVID-related production disruptions. The Russia-Ukraine war and recent COVID lockdowns in China have further exacerbated this problem, prompting some policymakers and corporations alike to shift toward deglobalization.

Trade Openness Has Flattened in Recent Years



Source:The World Bank:

** The trade openness index is the sum of world exports and imports divided by world GDP.*

A Perfect Storm

China is the U.S.'s largest source of foreign trade, representing over $500 billion of imports (18% of total) and $151 billion of exports (6% of total) in 2021. Despite this mutual reliance, the relationship between the world's two largest economies has become increasingly strained – first by higher tariffs and trade barriers instituted under President Trump, then by the pandemic.

The economic impact of the pandemic could not have been much worse for global supply chains. Corporations that had not previously considered the importance of supplier diversification suddenly scrambled to identify new trading and distribution partners outside of China. Product shortages, shipping delays and rising costs have now continued into a third year, highlighting the severity of these disruptions.

China's "Zero COVID" strategy has led to multiple provincial lockdowns in 2022, further prolonging supply chain issues. As a result, this year's global economic growth is expected to be cut nearly in half from the previous year.

Economists expected the supply-demand imbalance to largely resolve itself by the end of this year. Instead, the disruption has been further hampered by unexpected geopolitical events, namely Russia's invasion of Ukraine. Russia accounted for 45% of Europe's natural gas imports in 2021, and both Russia and Ukraine are major exporters of products like wheat, metals and fertilizers. The increase in energy prices over the past two years has been the largest since the 1973 oil crisis, and food commodities have seen their largest increases since 2008.

The Shores of Supply

Rapidly rising prices have stoked long-dormant inflationary pressures and, in turn, the desire to become less reliant on other nations for food and energy needs. Establishing alternative supply chains could take the form of moving production facilities and supply lines back to one's own country (onshoring), to a region closer in proximity (nearshoring), or to a country with which relations are more favorable (friendshoring).

So far, the U.S. has seen no material increase in construction of domestic manufacturing facilities. Evidence from the American Chamber of Commerce in China showed just 7% of firms shifting activity from China and less than half of these planning to move to the U.S. Recreating supply chains closer to home with comparable supplies, quality and networks, if possible, could take years.

The situation in Ukraine has also forced many investors and companies to divest from Russian interests. Continued growth of ESG or values-based investing could lead to divestment elsewhere as companies or suppliers are deemed unsuitable, whether for ethical or environmental reasons. Pressure to reduce carbon emissions could lead to more localized production, and increased investor scrutiny could have impacts globally and down the supply chain.

What would Deglobalization Mean for Investors?

Many of the world's largest companies depend upon lower-cost suppliers to maintain healthy profit margins. If more production is shifted to higher-cost domestic sources, this could result in more local investment and jobs but higher prices passed along to the consumer (inflation).

Globalization was a process that evolved over many decades, and the progress will not be undone quickly. However, any degree of deglobalization or reduction in trade could have negative implications for investors, in the form of less competition and innovation, leading to higher inflation and/or reduced profitability, and potentially-heightened geopolitical risks.

Deglobalization would likely impact countries, sectors and businesses in different ways, and it is far too early to begin measuring the effect recent events may have on the future world economy.

It is therefore crucial that investors maintain globally-diversified portfolios, with meaningful allocations to domestic and international companies across publicly-traded and privately-held assets. Actively managed strategies further enhance the probability of allocating to the winners and avoiding the losers.

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