Investing Amid the Crosscurrents of Nationalism and Globalization

By Joseph Quinlan
Investing Amid the Crosscurrents of Nationalism and Globalization

By Joseph Quinlan

Rarely has the global investment backdrop been as tumultuous and fluid as it is today. Even with the inauguration of Joseph Biden as 46th U.S. president, and the collective belief that the United States is back and ready to embrace a more multilateral world, it’s not business as usual. A “return to normalcy,” as promised by President Biden, is not in the cards. There is no going back.

Why do we believe this? Because the world has fundamentally changed. China is no longer interested in biding its time, evidenced by Beijing’s more muscular foreign policy and its dual circulation economic strategies for self-sufficiency.1 In Europe, the vision of strategic autonomy is gaining traction as the continent looks inward to safeguard its economic future and well-being. Biden’s “Buy American” plan mirrors the isolationist impulses of both China and Europe. It also reflects the fact that the president will be more focused on fixing problems at home as opposed to expending a lot of energy overseas.

Meanwhile, owing to the pandemic and the resulting global recession, the World Bank forecasts that up to 150 million people in the emerging markets could be pushed into extreme poverty—defined as living on less than $1.90 a day—in 2021.2 And if all of the above were not enough, companies are scrambling to rethink the risks to their global supply chains; consumers the world over are embracing new forms of shopping and work experiences; and the pandemic—induced explosion in the digital economy has disrupted one global sector after another and accelerated trends and themes already in place. As noted by Satya Nadella, chief executive officer at Microsoft, “We’ve seen two years’ worth of digital transformation in two months.”3

History has shown that major crises often lead to fundamental shifts in economic activity and social behavior, and this time will be no different. Notably, in the post-pandemic world, investors will need to navigate between the shifting contours of globalization and the rise of nationalism.

RECONFIGURING GLOBALIZATION

There is no arguing that the rise in populism, the spread of protectionism, and the decimating effects of the pandemic have dealt a blow to a more integrated global economy. Nor is there much contention that even before the pandemic waylaid the world economy, global trade as a share of gross domestic product (GDP) was stagnating; cross-border foreign direct investment (FDI) was slowing; and trade-governing bodies such as the World Trade Organization (WTO) were being exposed as ineffective, notably by the U.S.–Chinese trade war, which has frayed the fabric of globalization. Yet despite these headwinds, the demise of globalization—the unfettered flow of cross-border movement of goods, services, capital, data, and people—has been greatly exaggerated.

Many factors suggest that globalization’s obituary be placed on hold for now. First, a multilaterally minded Biden administration may yet reboot globalization and opt to strengthen the pillars of global integration that the Trump administration demolished. Biden’s cabinet is filled with globally minded policymakers who are welcoming of greater global integration, not less. The Biden administration is intent on working with U.S. allies and more amenable to joining multilateral constructs such as the Paris Climate Agreement, which suggests more globalization, not less, over the next four years.

Second, for all the chatter about “onshoring” and “reshoring,” and all the talk of firms decamping en masse from China, there is little evidence thus far to suggest a wholesale change in this direction. Indeed, according to a survey conducted by the US–China Business Council, very few U.S. firms have moved or plan to move out of China.4 The reason: China’s market is just too large and lucrative for U.S. firms not to be there. Meanwhile, FDI into China totaled $76 billion in the first half of 2020, a 4-percent year-over-year decline, which was much lower than expected and counter to the everyone–is–bolting–China narrative. In contrast, FDI into the United States plunged a stunning 61 percent over the same period.

Third, U.S. multinationals are not about to give up on being multinational any time soon; they can’t afford to. The future earnings growth of many firms depends on accessing foreign markets and overseas resources because the U.S. economy accounts for only one-quarter of world GDP and less than 5 percent of the world population. In other words,
when it comes to global supply and demand, there is a great deal of both beyond U.S. shores. The activities of multinationals (i.e., cross-border investment, technology transfers, employment, trade, etc.) will remain the glue of globalization.

Fourth, although export restrictions have increased over the past year—the International Monetary Fund counted 120 such restrictions last year—the pandemic—induced decline in global trade has not been as severe as first predicted by the WTO.\(^5\) When the pandemic started, the WTO forecast global trade to plummet by 13–32 percent; in October 2020, however, the organization upgraded its forecast, anticipating a drop in global trade of just 9.2 percent in 2020, followed by a solid rebound in 2021 of 7.2 percent.

Finally, investors need to reframe how they think about globalization. They must think less about trade and investment in goods and more about trade in services as well as growth in digital and virtual cross-border activities. The next phase of globalization outlook is about software, not hardware; experiences, not physical assets; clouds and codes, not colas; and intangibles as opposed to tangibles. As noted by Erik van der Marel, a senior economist at the European Center for International Political Economy, a new type of globalization is emerging, one based on “digital services, research and development, data, ideas and other intangibles.”\(^6\)

These activities are setting the tone for the global economy. Indeed, services trade now represents 20–25 percent of total trade and is growing faster than cross-border trade in goods.\(^7\)

The world already was going digital before the coronavirus (COVID-19) struck, but the pandemic, like other shocks in history, has hastened the pace of change. Despite disputes over cross-border data flows, the greater the digitalization of the global economy, the greater the level of cross-border digital trade in a host of sectors including insurance and pension services, financial services, and telecommunications, computer, and information services. The future of globalization includes more trade in the so-called “other business services” that run the gamut from research and development services, legal and accounting services, management consulting, and public relations services. It also includes more exports of architectural, engineering, scientific, and other technical services, as well as waste treatment services, operating-lease services, and exports of personal, cultural, and recreational services.

In the end, trade in goods has slowed as global digital trade has accelerated. Globalization is not dead—it’s slowly being reconfigured. Adding momentum to this dynamic is the switch from physical retail toward e-commerce, the explosion in remote working and remote learning, and soaring demand for remote and online healthcare services. Most of these activities take place at the local level, but they will go global gradually as the world economy continues to move online. Keep in mind that more than 2 billion people—more than 40 percent of the world’s population—never have logged on to the internet. In other words, a tremendous upside remains for the growth of the global digital economy and the continuation of globalization.

That said, however, the kryptonite of globalization is nationalism, which, like the digital economy, is also on the rise.

**THE RISE OF NATIONALISM AND THE SHIFT IN THE COMMANDING HEIGHTS**

It’s back—and with a vengeance. It, in this case, is big government and the spike in public sector activism (aka nationalism) in the United States and abroad. In a seismic U-turn, the pendulum for control of the commanding heights—the most important elements of the economy—is swinging back to the state and away from the markets. This historic shift is bipartisan in the United States, meaning that regardless how the Republicans and Democrats get on in Washington under the Biden administration, the role of government in the United States is set to expand over the medium term. It’s also becoming enlarged in Europe and Japan, while the state is already centrally encased in China. Lenin is back.

The most important elements of the economy were dubbed the “commanding heights” by Vladimir Ilyich Lenin in 1922, and ever since then the pendulum of control for the heights has swung between the state and the marketplace.

The Roaring Twenties favored big business until the economy and stock market cratered in 1929; then the pendulum swung toward big government during the 1930s and 1940s, and big government became firmly entrenched in the decades following the end of World War II.

By the end of the 1970s, however, against a backdrop of stagnation, rising inflation, and spreading economic malaise, control of the commanding heights pivoted decisively to the free market, jump‐started by the anti‐government, pro‐market revolution of Ronald Reagan and Margaret Thatcher. In the ensuing decades, government around the world—in both the developed and developing nations—relinquished its grip on the commanding heights to the markets. Politics followed economics. Market‐friendly policies became the norm—think greater levels of deregulation and privatization, liberalization of trade and investments, reduced capital controls and financial reform, and greater global integration of heretofore closed economies such as India, China, and the former communist states of eastern Europe.

All the above helped create a golden era of globalization—the world became “flat” owing to unfettered cross-border flows of trade, capital, investment, and people. It was a propitious time for U.S. multinationals, which planted investment roots...
all over the world in order to gain access to new foreign markets and to leverage the resources (workers, technology, and raw materials) of other states. The upshot: a golden era for multinationals, accompanied with a long-term boost to corporate earnings. The markets or the private sector controlled the commanding heights, until it didn’t.

**BIG SHOCKS CAN EQUAL BIG GOVERNMENT**

The pendulum began to swing back to the state in the aftermath of the Global Financial Crisis of 2008–2009. The crisis was blamed on too much financial leverage and too little regulatory oversight; it was compounded by widening income inequality and rising unemployment rates among unskilled workers. These dynamics took on political dimensions, culminating with Brexit, the United Kingdom’s decision to leave the European Union, and the populist ascent of Donald Trump in 2016.

Even before the pandemic of 2020, in other words, the tide was turning against the markets—and it turned even more sharply toward more government once COVID-19 struck. How couldn’t it? Nothing demands more of government than a once-in-a-century public–health crisis together with a deep recession. Government policy response—both fiscal and monetary—has been unprecedented, totaling 44.4 percent of GDP in the United States, 45 percent of GDP in Europe, and a staggering 60 percent of GDP in Japan. Policy-makers around the world moved fast and went large in addressing the pandemic of 2020. As a result, rarely has the footprint of government been so large, and rarely in the past few decades has the government exerted so much control of the commanding heights.

But all crises spur government action. As noted in the Wall Street Journal:  

*The Great Depression produced both a bigger social safety net and a host of new government programs,* World War II led to the creation of a unified Defense Department and the Cold War spawned an interstate highway system. In just the past two decades, the 9/11 terrorist attacks produced new consolidated agencies to handle homeland security and national intelligence, and the 2008 financial meltdown led to a broad range of new actions by the Federal Reserve that are being replicated and expanded now.8

The legacy of the coronavirus pandemic will be no different from previous seismic shocks: an expanded role of the state at the potential risk of greater economic inefficiencies. Even when the pandemic subsides, Wall Street will have to pay special attention to Washington—and to governments around the world.

The idea and acceptance of big government is going global. Whether in France, Japan, or India, governments are becoming more involved in imposing conditions on which goods, services, and technologies can be bought or sold, and which foreign partners are deemed trustworthy. The fostering of “national champions,” demands that supply chains be redesigned and brought home, greater scrutiny of foreign investment deals, the creation of indigenous data firewalls, financial subsidies that encourage in-country mergers—many of these policies are, in general, anathema to the private sector and could lead over the long term to a number of unfavorable unintended consequences.

As control of the commanding heights shifts toward the state, the macro risks to the private sector could manifest in slower or stagnated economic growth, lower return on invested capital, higher taxes, less offshoring and greater margin pressure as a result, and higher inflation and therefore interest rates. Nothing just mentioned—in most cases—is favorable for corporate profits or valuations.

Neither are rising U.S.–Chinese tensions that have triggered tit-for-tat trade sanctions between the two parties and stoked fears that the world’s two largest economies could decouple. Bilateral relations between these economic giants are now at their lowest level since China opened to the world in the late 1970s. As The Economist warned in early 2020, “the planet’s biggest break–up is under way,” a split that will “reshape the world economy” in the process.9

That’s hardly a propitious omen for global earnings given that over the past few decades China has emerged as one of the largest and most dynamic consumer markets in the world, underpinning the profits of global automakers, food and beverage firms, technology leaders, financial leaders, aerospace firms, airlines, and many other companies. General Motors now sells more vehicles in China than in the United States; the same holds true for Germany’s premier automakers such as BMW and Mercedes Benz. Pick virtually any sector—luxury goods, fitness apparel, fast food—and there is a good chance China is the top market in the world owing to its burgeoning middle-class consumer base. Among total consumer spending of the developing nations in 2019, China accounted for a staggering 27 percent of the total, or $5.3 trillion. That figure is equivalent to the combined annual consumer spending of Germany, Japan, and India ($5.5 trillion). On a comparable basis, total consumer spending in India, according to figures from the International Monetary Fund, totaled $1.7 trillion in 2019, a fraction of China’s spending heft.

How U.S.–Chinese relations evolve under the Biden administration remains to be seen. More certain is this: The world is entering an era of more intense competition between the great powers, which begets more nationalism and more state involvement in the economy. In the United States, for instance, the threat of China has sparked rising bipartisan support for a U.S. industrial policy in such key sectors as aerospace, electronics, rare earth minerals, telecom, agriculture, health care, and other sectors.
deemed vital to national security. And right behind the United States are France, Germany, Japan, South Korea, and many other nations, now more determined than ever before to promote economic sovereignty and self-reliance via safeguards on strategic assets, critical infrastructure, and emerging technologies.

Investors increasingly will have to weigh the effects of a more visible hand (the state) in the economy versus the invisible hand (the markets), and the underlying effects on future corporate earnings and profit growth. That said, let’s be clear: State intervention during the pandemic has been largely effective in bringing the global economy back from the abyss and providing support for the capital markets. Investors have welcomed and benefited from massive government action. But history shows that the bigger the government presence in the economy, the greater the odds of misallocated resources and market distortions over the long term. Future market returns increasingly will be influenced by the rise of nationalism and the delicate balance of control of the commanding heights.

THE BOTTOM LINE
What does all of this mean for investors? It means that there are plenty of risks and rewards when it comes to asset allocation and the construction of portfolios. Successful investing requires that one see the forest for the trees—and recognize and navigate the multiple crosscurrents of the global economy.

Globalization is not over—it’s morphing into more service-led activities, a bull- ish prospect for many of the world’s leading technology companies, ranging from hardware to content. Global supply chains are being rethought by firms but not radically overhauled. The latter is too expensive, and there’s more talk than action when it comes to decamping from China. The Middle Kingdom, as China is sometimes called, is one of the largest and most dynamic economies in the world. Investors should be leveraged to western firms with a strong footprint in China, as well as leading Chinese firms in technology, logistics, and health sciences. Ditto for the tech-driven economies of Taiwan and South Korea. Japan also looks attractive given the country’s lead in automation and robotics.

Meanwhile, the proactive and aggressive policy response to the pandemic has swung the pendulum of the commanding heights back to the public sector. Near-term, that is positive for equities and for future corporate earnings. Unprecedented policy measures staunch the unprecedented swoon in global growth in the second quarter of 2020 and provided the floor for the subsequent rebound in global equities and global economic growth. At some point down the road, however, market concerns will shift and leaders will begin to ponder the long-term effects on growth and productivity of big government and its echo, nationalism.

But for now, nationalism is back, which means the assets under the control of competent and transparent governments deserve a premium relative to those under the control of weaker governments lacking direction and coherence. Governance—both at the corporate and country levels—matters, and it is set to become a larger factor in determining asset prices.

The post-pandemic world is coming into view, and it is replete with promising investment opportunities for investors skilled in seeing the big picture.

Joseph Quinlan is head of CIO Market Strategy, Chief Investment Office for Merrill and Bank of America Private Bank.

ENDNOTES
1. The concept of “dual circulation” reflects China’s goal of reducing its dependence on global trade for growth, while boosting/ elevating domestic-led growth.
7. Ibid.

Opinions and forecasts are as of January 28, 2021, and subject to change. Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results. Bank of America, Merrill, their affiliates, and advisors do not provide legal, tax, or accounting advice. Clients should consult their legal and/or tax advisors before making any financial decisions. The Chief Investment Office (CIO) provides thought leadership on wealth management, investment strategy and global markets: portfolio management solutions; due diligence; and solutions oversight and data analytics. CIO viewpoints are developed for Bank of America Private Bank, a division of Bank of America, N.A., (“Bank of America”) and Merrill Lynch, Pierce, Fenner & Smith Incorporated (“MLPF&S” or “Merrill”), a registered broker-dealer, registered investment adviser, Member SIPC and a wholly owned subsidiary of Bank of America Corporation (“Bank Corp.”). This information should not be construed as investment advice and is subject to change. It is provided for informational purposes only and is not intended to be either a specific offer by Bank of America, Merrill or any affiliate to sell or provide, or a specific invitation for a consumer to apply for any particular retail financial product or service that may be available. Asset allocation and diversification do not ensure a profit or protect against loss in declining markets. Investments have varying degrees of risk. Some of the risks involved with equity securities include the possibility that the value of the stocks may fluctuate in response to events specific to the companies or markets, as well as economic, political or social events in the U.S. or abroad. Investments in foreign securities (including ADRs) involve special risks, including foreign currency risk and the possibility of substantial volatility due to adverse political, economic or other developments. These risks are magnified for investments made in emerging markets. Investments in certain industry or sector may pose additional risk due to lack of diversification and sector concentration.

Investment products:
Are Not FDIC Insured  |  Are Not Bank Guaranteed  |  May Lose Value © 2021 Bank of America Corporation. All rights reserved. MAP3415171 - 01/2021