Headed down a rabbit hole?

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Sophus Capital℠
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Chinese President Xi Jinping recently traveled to the World Economic Forum in Davos and championed the benefits of globalization while highlighting the risks of protectionism. Meanwhile, populists in Britain and the U.S.—stalwart nations of global free trade—have been busy talking up the scourge of globalization. It's an upside-down world only Lewis Carroll would understand.

Indeed, globalization is in the cross-hairs of many politicians these days. Threats of tariffs and protectionism abound, and, if enacted, they could pose a drag on global economic growth. Nobody correctly predicted the political outcomes of the past year, and certainly nobody knows how nationalism will manifest itself in future trade policies. Yet there is a feeling that more sensible minds will prevail and globalization is, ultimately, unyielding. Moreover, any setbacks and subsequent market volatility might provide opportunities for active managers who can capitalize when stock prices disconnect from fundamentals.

History as our guide

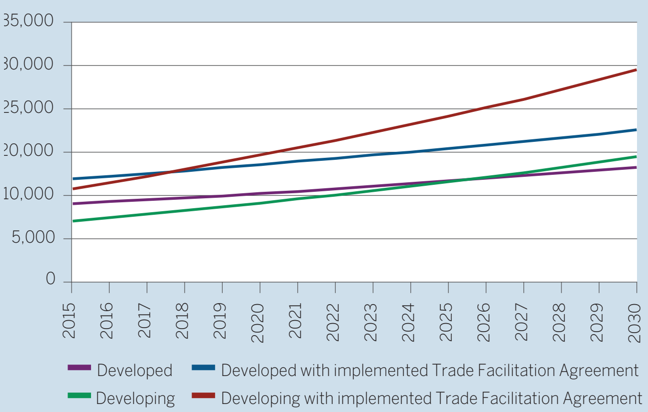
Mike Reynal, chief investment officer of Sophus Capital, fully acknowledges that there are very real risks to globalization today. But as an equity manager with a global perspective, he still believes in trade liberalization and its ability to lift both developing and developed countries. He points to statistics from the World Trade Organization that show a longer-term trend of rising international trade following the conclusion of WWII between 1950 up until the Global Financial Crisis. There may be setbacks along the way, and cross-border capital flows may still be below peak levels from a decade ago, but Reynal believes that the slowing pace of trade liberalization and rising protectionism rhetoric is unlikely to completely reverse globalization.

He reminds us that globalization is driven by four key factors: cross-border capital flows, trade, migration, and the free-flow of ideas and communication. Capital flows and trade may have hit a speed bump, but migration and the exchange of ideas and knowledge continue unabated. In fact, the era of digital globalization (the vehicle of increased knowledge-sharing) is still in its infancy, and the Sophus Capital team believes that the amalgamation of cross-border ideas is an unassailable historical force that will continue to propagate globalization in the future.

This exchange of knowledge—delivered by rising cross-border data flows—may verify the notion that globalization is indeed inexorable. A 2016 report from McKinsey Global Institute asserts that in contrast to slowing international trade in recent years, digital flows are showing no signs of abating. Cross-border bandwidth "has grown 45 times larger since 2005," and "is projected to grow by another nine times in the next five years," according to the report. All of this is boosting participation in the global economy and suggests that globalization is not reversing.[1]

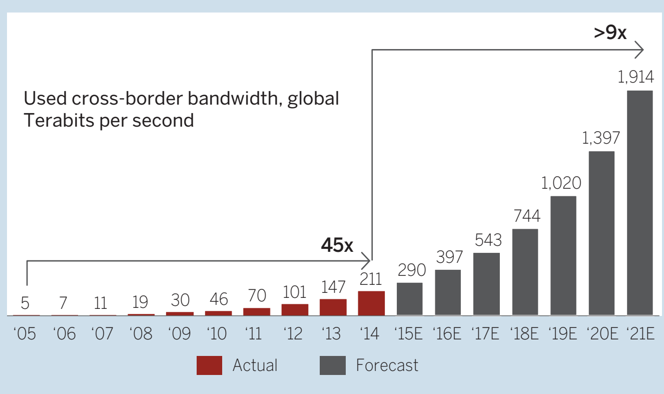
A recent IMF publication appears to concur, summarizing that we may be in a new era of heightened political resistance, but that any "drag from politics seems

Projected exports 2015-30, by country group
(billion constant 2007 US$)



Source: Fontagné *et al*. (2015)

Cross-border bandwidth has grown 45 times larger over the past decade and may grow another nine times larger by 2021



Sources: TeleGeography, Global Bandwith Forecast Service, McKinsey Global Institute analysis

[1] McKinsey Global Institute March 2016, *Digital Globalization: The New Era of Global Flows*

weaker than the thrust from technology. Absent some truly cataclysmic shock—something akin to a world war or a depression—the best bet is that globalization will march on."[2]

Risks remain

Reynal also likes to cite 19th century economist David Ricardo, an unabashed proponent of free trade and developer of the theory of comparative advantage, which suggests that individuals or nations are better off when they trade for products or services that can be created more cost-effectively elsewhere than at home. This free flow of goods and services has been the avenue to rising standards of living, he argues, and it has improved access to a wider array of goods and services available at a lower price for all participants.

Yet, in recent years, globalization has also resulted in uneven economic growth among nations, as well as disruptions across various sectors of the economy. This is the reality, and it may be fueling the recent rise of populism and nationalist rhetoric. There has been heightened talk of protectionism, and, surprisingly, much of it is emanating from the West. This includes rumblings from the new U.S. administration of a 45% tariff on Chinese goods, or a boarder adjustment or "mirror" tax for goods produced in Mexico. "No doubt about it, if enacted, these types of protectionist measures could create short-term pain for global investors," admits Reynal. The Organization for Economic Co-operation and Development (OECD) estimates that a 10% increase in trade costs could lower Global GDP by 1% in the medium-term. Or, put another way, the OECD estimates that each dollar of increased protection leads to a drop of 66 cents in gross GDP.[3]

Consider the controversy surrounding the U.S. announcement that it would impose new tariffs on Canadian softwood lumber imports. Will this be met by retaliatory Canadian tariffs? Will this raise the cost of homebuilding domestically? And, will it trickle down to slow or reverse job growth in the industry? This is but one small, real-world example that bears watching.

"Once protectionism grabs hold, it runs the risk of spawning new tariffs, weakening consumer confidence, and elevating geopolitical tensions," warns Reynal. "Consumer costs would likely rise. Supply chains could be disrupted, potentially leading to job losses in a feedback cycle. And the stock market, a proven discounting mechanism, would certainly presume lower earnings."

The takeaway

That's just one possible dystopian economic future, but the likelihood of such a bleak scenario where economic liberalism is derailed is a long-shot, according to Reynal. There's simply too much to be lost on all fronts. In China, for example, the Central Authority must hold up its half of the tacit agreement whereby Beijing continues on a path to economic liberalization (albeit not always as quickly as hoped) in return for stability, peace and control. The U.S. and other developed economies are also unlikely to launch into full protectionism at the risk of hampering economic growth.

In times like these, it's incumbent upon investors to retain their longer-term focus and commitment as to why they are allocating to emerging markets. That may be to capture potential higher rates of growth, to diversify return streams, or even to diminish their inherent home-country bias. Moreover, emerging markets often tend to over-react to macroeconomic developments in the short term, and this can provide opportunities for active managers.

"A new era of trade wars or higher tariffs could undermine globalization if policy-makers fail to grasp the full risks to global growth. Still, we believe cooler heads will prevail," says Reynal.

Plus, protectionism is not exactly new, Reynal reminds us. And it's not only about headline tariffs. Protectionism is also about "local content" rules, licensing, rules of origin, labor and immigration, environmental rules, domestic sourcing requirements, and myriad other issues. "As emerging markets investors, we've been dealing with these challenges for more than 16 years, so we take the latest 'threats' in stride and are confident that we will continue to find ways to uncover opportunities in fast-growing and exciting developing markets," he adds.◆

[2] IMF Finance and Development, December 2016 Vol. 53, No. 4, *Globalization* Resets
[3] OECD, ILO, World Bank and WTO, November 2010, *Benefits of Trade for Employment and Growth*

Sophus Capital is an independent Victory Capital investment franchise with deep experience navigating emerging markets over multiple cycles. Sophus Capital employs both fundamental analysis and quantitative screening to identify companies that the team believes can sustain above-average earnings. The team has been utilizing its investment philosophy and process for more than 16 years.

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