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Limits of globalization

Market Comment, December 2018

Given the sharp rise in volatility in the financial markets in 2018, an obvious question arises: What is the underlying reason for the increase in uncertainty that is driving this phenomenon? Could globalization finally be coming up against its limits?

Since the end of the Cold War and the opening-up of previously closed Communist parts of the world, the phenomenon of globalization has been the primary driver of huge increases in company profits and therefore also massive stock market gains. Western companies were able to acquire hundreds of millions of new clients in the emerging markets. In the next phase, these companies were able to produce their goods in these countries at much lower wage costs – which in turn triggered a further huge rise in corporate earnings and equity prices. Things have become more complicated in the third phase: Thanks to their increased economic strength, Russia and China have begun the catch-up process – both militarily and technologically. The latter has now started to demand the transfer of US technological expertise to Chinese companies as a price for access to the Chinese market. Ever since Russia's expansion into the Ukrainian Crimea and China's occupation of islands close to Singapore on Asia's key oceanic trade route, we have seen how friendly coexistence has given way to less friendly rivalry over global supremacy in technological, military, and therefore also political affairs.

This means greater volatility for all asset classes for two reasons. Firstly, the growth of the global economy is increasingly being disrupted by political developments. 2018, which began with the Trump Administration's initiation of trade hostilities, is the obvious example, but it will not be the last. Secondly, it has become more difficult to cut costs further by outsourcing production to low-wage countries due to the surge in nationalism all around the world, particularly at a time when an increasing number of competitive rivals are springing up in China and other Asian countries. The so-called "peace dividend" from equities that we have seen over the last few peaceful decades is therefore dwindling. All asset classes, particularly equities, must now factor an additional risk premium into prices for the disruption of globalization. Little wonder that the valuations of all equity markets have declined sharply in 2018 when viewed in terms of price/earnings ratios.

> "We can expect a slowdown of globalization over the next few years, with the possibility of weaker economic and earnings growth as a result."
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> Gérard Piasko, Chief Investment Officer

The limits of globalization are the issue here – a decline in the peace dividend (i.e. lower valuations) due to political uncertainty. Trump's policies are emblematic of this development. The acceptance of Brexit by UK voters in the 2016 referendum was the first sign of this in Europe, and the recent protests against Macron are the latest manifestation, driven by a sense of social injustice among the French population. The electoral success of more extreme politicians in countries as different as Italy, Poland, Hungary, Mexico and Brazil also highlights the extent to which globalization is under attack. Perhaps globalization really has progressed too rapidly and brought higher-than-expected social costs. Either way, broad swathes of national populations all around the world are increasingly looking for politicians who will pursue a more nationalist agenda. The central parties aligned with globalization, are being voted out of office, and politics is becoming more polarized accordingly. A slowdown in globalization for a number of years would be no surprise – and such a development should lead to a decline in global economic growth.

Furthermore, it would also appear that a slowdown in globalization is actually necessary in order to usher in greater political stability in many countries. The stand-off between Italy and the EU, for example, shows that supranational bureaucracies as in Brussels are becoming ever less popular with national electorates. And national is precisely what democracies are: There is now an almost irreconcilable contradiction between national democratic sovereignty on the one hand, and increasing globalization and global economic integration on the other. Greater economic integration and reform – such as through the joint issuance of EU bonds – would mean relinquishing national democratic sovereignty. Yet this is precisely what populations all across Europe are rejecting in view of declining levels of prosperity among the middle classes, the rising social costs of immigration, and high taxes. The dramatic slump in the popularity of French President Macron, a champion of EU integration, is a textbook example of how a national population can rebel against a government that legislates without consulting large segments of the electorate. In a similar way, the US population does not appear to be in favour of further globalization to the benefit of China. The political establishment in the US (including the Democrats) has become increasingly convinced that China has been abusing the principles of the World Trade Organisation for too long – whether by forcing US companies with Chinese customers to transfer their technological expertise to China, or through its disregard of the intellectual property rights of Western companies and brands. For many in the West, the rise in economic inequality is viewed as a consequence of outsourced production to low-wage countries and the immigration of workers from these countries. This can have the effect of hastening the economic decline of the middle class, which is so important to the stability of Western democracies. The result? A dangerous polarization of politics. The protests in Paris are the latest warning signal of where this trend is heading, and they are unlikely to be the last.

In summary, we can expect to see something of a reorientation – and perhaps also a slowdown – of globalization over the next few years. A resurgence of globalization probably requires greater engagement on the part of the middle classes, which have been confronted by a decline in prosperity. After all, it is the middle classes that really matter when it comes to the political and social stability of Western democracies – and these same middle classes can quickly be swayed by extremist politicians, as we have seen in recent centuries in France and Germany. Neither the protests in Paris nor the various other current political tendencies should be underestimated. For investments, and particularly equities, all this means increased volatility due to greater political uncertainty and the likelihood of lower global economic and earnings growth. Future financial market returns are thus likely to be lower than in previous years.

Gérard Piasko

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Editorial deadline: 17 December 2018

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