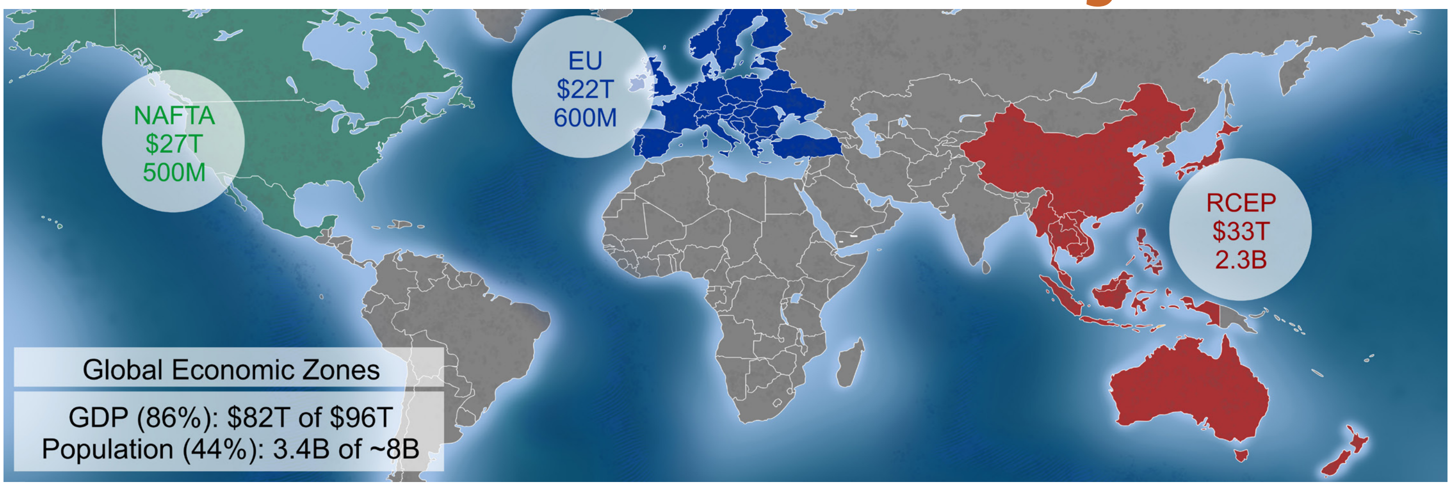
ASPIRIANT

Insight

August 2022 Wealth Management Commentary Achieve more.

Nationalization: The Tidal Power Surge



Ken Cummings

Spheres of Influence

Powerful geopolitical developments underway with respect to nations, alliances, trade and economies are creating a strong tidal effect on today's markets. Three dominant economic zones around the world, which collectively account for about 86% of global Gross Domestic Product (GDP) and 44% of the world's population, vie with each other for a larger piece of the global prosperity pie:

- The United States, Mexico and Canada (USMCA) agreement, which replaced the North American Free Trade Act (NAFTA) a couple of years ago
- The European Union (EU)
- The Regional Comprehensive Economic Partnership (RCEP)

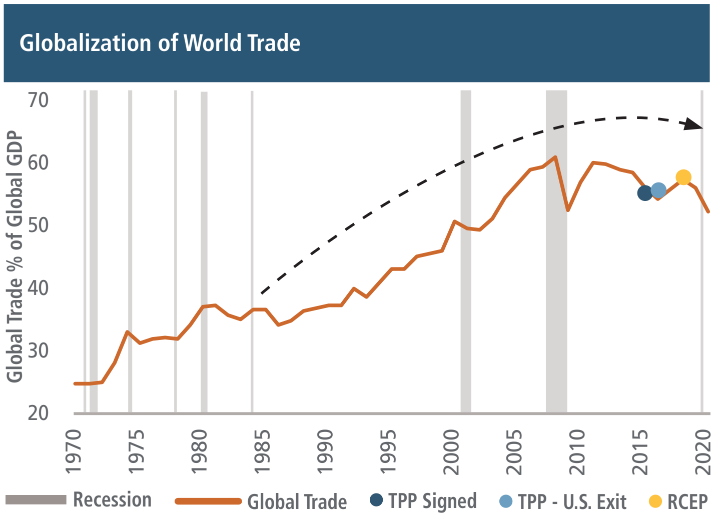
Each zone, or alliance, offers preferred trading status and benefits to its members, such as low or no tariffs, standardized rules of trade and intellectual property rights. Importantly, most countries belong to several trading organizations, not just the three shown on our map. But we highlight these spheres of influence due to their sheer size and presence on the world stage.

Lesser known of the three is the RCEP, which became effective this January. That agreement was partly a response by some member countries to the U.S.'s withdrawal from the Trans-Pacific Partnership (TPP) in 2017. Compared to the other two economic zones, the RCEP is several trillion dollars bigger in terms of GDP and more than 1.5 billion people larger. It includes 15 member states, including some with geopolitical clout in their own right, such as China, Japan and Australia. So, the RCEP clearly has some heft, and we suspect we'll be hearing more about it in years ahead.

Implication of receding globalization

Figure 1 on the following page measures the total amount of goods and services traded across countries relative to the total amount of goods and services produced, which is global GDP. Therefore, the line serves as a proxy for how much countries and companies have been globalizing over the past 50 years. Between the mid-1980's and early-2010's, countries and companies rapidly globalized business, trade, manufacturing and supply chains. Increasing globalization leads to lower prices of goods and services as companies scale the costs of their inputs, labor and capital. In other words, it is deflationary. However, in recent years, the pace of globalization slowed, possibly due to the diminishing returns of additional outsourcing and offshoring. You can see that with the cresting of the line since the mid-2000's.

Figure 1



Data as of 6/30/2022. Source: Aspiriant analysis. Data from World Bank, National Bureau of Economic Research (NBER). TPP defined as Trans-Pacific Partnership Agreement. RCEP defined as Regional Comprehensive Economic Partnership. Recessions defined by NBER.

Figure 2

Globalization	Advancing	Retreating
Countries		
Economic Growth	Faster	Slower
Inflation	Lower	Higher
Political Climate (Inequality)		
Within 1 Country	Worsening	Improving
Across All Countries	Improving	Worsening
Companies		
Sales Growth	Faster	Slower
Costs		
Employees	Lower	Higher
Inputs (Energy & Materials)	Lower	Higher
Capital (Dept & Equity)	Lower	Higher
Profit Margins	Expanding	Compressing
Investors		
Valuations	Expanding	Compressing
Equity Returns	Above Average	Below Average

Source: Aspiriant analysis.

Moreover, supply chain disruptions, including those caused by conflict, have prompted countries and companies to reconsider how best to ensure the availability of food, water, energy and resources. Understandably, most countries prioritize the security and stability of their people and economies. However, this nationalism comes at a price since a slower pace of globalization likely leads to slower economic growth and higher inflation.

Importantly, the countries and economies of the world are far too integrated today to completely deglobalize. So, onshoring, reshoring or friend-shoring are unlikely to occur en masse. However, we expect to continue seeing discrete examples of nationalism related to energy independence (especially in Europe), critical component manufacturing (such as the recent passing of the Chips and Science Act), and environmental, social and governance advocacy (like McDonald's leaving Russia after it invaded Ukraine).

In the grand scheme of global commerce, these decisions will occur on the margin. However, at a minimum, we expect the level of globalization to, at-best, crest and, at worst, recede. In either case, the deflationary undercurrents that have offset prevailing inflationary pressures in the past may finally give way.

The Globalization table (Figure 2) presents the profound changes that could occur if globalization crests or recedes. The first column displays how advancing globalization affects countries, companies and investors across several dimensions. The second column presents the implications in an environment of retreating globalization.

The dashed boxes highlight some of the most critical elements. For countries, lower levels of globalization would likely lead to slower growth and higher inflation, perhaps even stagflation. No doubt, the political climate would change as inequality within and across countries change. Among other factors, companies would experience a slower pace of revenue growth and lower profits. As a result, investors would likely experience a period of below-average investment returns as valuation multiples compress to reflect the new environment.

This is a meaty topic with far-reaching consequences, which we will continue to monitor and explain. Understanding the transformation and developing insights will prove critical to successfully navigating market volatility.

John Allen, CFA
Chief Investment Officer, Partner

Marc Castellani, CFA
Managing Director – Investment Strategy & Research, Partner