The Incredible Shrinking Earth: Have We Reached Peak Globalization?

Introduction

Advancements in technology have allowed capital and labor to be divided across the world within a global economy. Globalization has been an incredibly powerful economic force, and the extent to which global markets have become integrated has had a profound impact on the way the world operates. As with any tectonic shift of this magnitude, there have been winners and losers. Society as a whole may be "better off," but there are industries and geographies (along with their workers and investors) that are no doubt "worse off," having effectively been left behind. In many ways, to understand the current state of global politics (and the potential impact on the markets), one must understand the winners and losers of globalization.

In this quarter's *Strategy Insights,* we take a deeper look into the history and impact of globalization while also analyzing current global trends.

The History of Globalization

As it became possible to separate the production process from the ultimate source of demand, businesses began to take advantage of the cost differential between markets by moving productive capital investment to its cheapest source. In doing so, the industry composition of regions across the world began to change, especially between developed and emerging economies.

Since the early 2000s, China and India's share of world GDP doubled from about 12% to 24% while certain developed market sectors have not kept pace. U.S. manufacturing is one such example of this phenomenon. As global trade grew, manufacturing employment in the United States began to fall, rapidly decreasing right around the time China entered the World Trade Organization (WTO) in 2001.

Further Assessing the Impact of Globalization

In our view, the largest financial market impact of globalization came in the form of a secular trend toward lower real interest rates and inflation.

> *The labor force and technology shocks that drove production to China and India dramatically increased potential global output. In the process, wealth and income were transferred from relatively low saving rate developed markets such as the United States to countries with very high saving rates, in particular China. As a result, global aggregate demand lagged the growth of potential output, putting downward pressure on inflation while global savings rose relative to investment. Consequently, there has been downward pressure on real interest rates. - First Quarter 2015 Strategy Insights*

From an economic perspective, it seems the most influential "losers" in this scenario have been low and middle class wage earners. Breaking down U.S. wage growth trends in a bit more detail shows that since 1979 the cumulative change in real hourly wages for low income workers has declined 5%, while for middle income workers it has risen 6%, and for the highest earners it has grown a much more robust 41%.

This may offer the clearest explanation of how certain macro-economic trends have led to a paradigm shift in global politics. Whether it be the election of President Donald Trump, the Brexit vote, or separatist momentum building in Europe, many believe the pendulum has swung too far in one direction (toward global integration). As such, investors may be well served to understand the implications of the pendulum swinging back in the opposite direction—and toward the rising anti-globalization movement.

Trends in Economic Nationalism and Potential Investment Implications

At this still early stage we will refrain from making any policy predictions because any specific policy forecast regarding taxes or trade would be at best a guess, not a fully informed probability distribution. However, we do think it is fair to say that investors should be prepared for more U.S.-centric policy proposals. With that in mind, we have devised a playbook that positions investors for such a scenario.

Market Volatility

For now, tax cuts and deregulation are the market's focus. We think these agenda items have the potential to be economic game changers, but the market is not currently discounting certain policy risks. As a result, market volatility has been extremely low, and put options on the S&P 500® have not been this cheap since before the financial crisis. There have been 196 trading days without a correction of 5% (the average is 50 days), and consistent with our view that economic momentum may start to slow in the second quarter, investors may want to think about ways to add protection to their portfolios. Markets may certainly drift higher, but insurance is historically cheap. Conversely, gaining upside exposure through call option purchases is also a way to gain market exposure with a smaller risk outlay.

Developed over Emerging Markets

If President Trump succeeds in his policy agenda, which we believe will be important to maintain U.S. market momentum, rates and the dollar will likely move higher. If there are major delays or outright policy failures, we will likely see market turbulence across the board. Both scenarios may prove difficult for emerging market relative performance.

Currency Hedge International Exposure

Although the dollar likely will not appreciate to the extent we saw toward the end of 2016, we find it hard to make the case that it will weaken dramatically versus other major currencies. Although some in the administration have tried to talk down the dollar lately, actual policy proposals are dollar-bullish—policies on trade, the potential for border adjustability, and possible interest rate hikes, to name a few.

It is certainly possible, in our view, that the market is underwhelmed by the ultimate impact of new policy actions (or such actions are delayed). In this case it is likely the dollar weakens, but for now we would err on the side of hedging international exposures back to the dollar for a portion of one's international exposure.

Exposure to Small Caps

We still like large-cap companies over small-cap in 2017, given relative valuation and volatility considerations. That said, we believe small-cap companies may enjoy an outsized benefit from changes in regulation and tax policy while also being more insulated from the risks associated with a rising dollar and from trade policy.

Tax Policy Beneficiaries

Tax policy details are still limited, but our view is that some form of repatriation is likely. Therefore, as informed by performance during the 2005 repatriation tax holiday, companies with a large amount of unremitted cash as a percent of their market capitalization are likely to benefit.

Consumer Staples, Consumer Discretionary, and Energy would likely experience the largest negative impact from an earnings-per-share perspective if a border tax is included in final tax legislation.

Not Just a U.S. Phenomenon

Whether it's Brexit, the upcoming European election season, or general skepticism regarding the viability of the Euro area common currency union, we see plenty of evidence that populist trends are gaining momentum in certain international regions.

Our base case is that populist parties will not take control in any Eurozone country in 2017, although we respect the probability, especially over the long term. Regardless of populist momentum, the key criteria for a successful currency union never really existed in Europe, and still do not, so we can envision a scenario in which countries naturally choose to exit the Eurozone over time. This is a long-term risk, and perhaps seems a bit extreme, but we believe the probability is high enough that it is a risk worth highlighting when thinking about the possible implications of anti-globalization trends on international investment allocations.

State of the Outlook—Reviewing Several First-Quarter 2017 Outlook Calls

Optimism can be a powerful force in the markets, and we believe positive "animal spirits" may be the biggest wildcard during first-half 2017, with investors digesting and interpreting policy changes and beginning to predict winners and losers.

- No question that optimism has ruled the day. The S&P 500 is up another 6% thus far in 2017, credit spreads continue to tighten, and many investors have focused on the pro-growth elements of the administration's policy agenda. Our view is that this may continue as we move through the second quarter. Under the surface, however, the market may not be as "risk-on" as some may think. For example, large cap is outperforming small cap, growth is outperforming value, and sector performance would indicate to us some trepidation as it relates to the reflation story (cyclical sectors such as Energy, Financials, Industrials, and Materials all underperforming).

  For now, we think momentum carries us higher, but our business cycle work indicates a moderation of economic data as we push toward midyear, possibly causing investors to rethink what is possible from a growth perspective in 2017. The market has also begun to price in winners and losers, as seen by the sharp drop in stock correlations. We think this could provide for a better environment for active managers.

The Institute for Supply Management™ (ISM) Manufacturing Index is likely to have peaked at the end of 2016, with some renewed pressure likely heading into early 2017. Growth is unlikely to accelerate significantly in the coming quarters.

- Our view here is that we were early, but a slowdown is still likely. Our economic activity indicators forecast a moderation of the ISM Manufacturing PMI, which we feel is an important leading economic indicator. From an overall growth perspective, according to the Atlanta Fed GDPNow index, first-quarter GDP is tracking at 1.0%. This slow growth trend is unchanged from what we have seen in recent years, and our view continues to be that any material impact on growth from changes in policy is unlikely to be a 2017 event. We are now starting to see the first signs of a peak in leading indicators, with the Markit PMI data for March retreating to levels not seen since the fall of 2016, while other regional manufacturing surveys also appear to have peaked in February.

Over the longer term (that is, five years and beyond), we still think equity market returns will be below historical averages.

- This is a valuation argument, and it will not change until we see current valuations adjust. This can happen by prices falling or growth accelerating, or by a combination of the two. Our view is that over the completion of this cycle, it is likely that declining prices will be more influential in the ultimate valuation adjustment.

We favor U.S. equities, Financials, Health Care, and Consumer Discretionary sectors, large cap over small cap, and value over growth.

- By and large, this positioning has been constructive thus far in 2017. The Health Care and Consumer Discretionary sectors have outperformed the S&P 500 year to date. The Information Technology sector has led the way, an area of the market also highlighted as an outperformer in our business cycle analysis. Sectors we liked less in our outlook included Consumer Staples, Telecommunication Services, and Materials. Year to date, Materials and Telecommunication Services have underperformed the S&P 500, with Telecommunication Services one of only two negative sectors.

  Large caps have also significantly outperformed small cap, and although we feel small cap companies will ultimately reap greater rewards from tax cuts and deregulation, in 2017 we still believe large cap stocks will outperform. Although U.S. equities have outperformed developed international, emerging markets have outperformed domestic equities. Also, growth has outperformed value, with technology stocks driving that performance. We missed the mark in those areas in the first quarter, but we still favor domestic equities over emerging markets and value over growth going forward.

  We believe that Financials can ultimately lead value higher (although this may become a longer-term perspective given the flattening of the yield curve and range-bound longer-term interest rates), and emerging markets are still vulnerable to appreciation in the U.S. dollar and higher interest rates. We also do not think growth will materially accelerate in emerging markets this year, ultimately weighing on equity markets in those regions.

Our view is that benchmark neutral duration in fixed income portfolios best balances our belief that although interest rates are likely to gradually move higher over time, the visibility for growth and inflation is even more unclear and may somewhat temper the rise in yields.

- We continue to hold this view, and intermediate duration bonds have outperformed shorter duration holdings year to date. We expect the yield curve to flatten as the Federal Reserve raises rates, which is in alignment with our neutral duration positioning. In all of the last nine tightening cycles, the yield curve has flattened.

Our current conviction regarding high yield is not pound-the-table positive or negative. We are coming off an extremely good year for high yield, so we believe returns are likely to moderate some in 2017. That said, conditions are in place for the asset class to generate respectable returns.

- We still hold this view. While high yield has remained solid thus far in 2017, returns are slightly trailing 2016 returns during the same period (even after the major selloff in high yield we saw during January 2016). We continue to believe that the economy will expand at a modest pace, and investors will still have an appetite for higher yielding assets throughout the year. Risks to high yield are stretched valuations (spreads have continued to tighten in 2017) and competition from higher quality income-generating assets as yields rise.

Also, leveraged loans may be a more attractive area in the higher yielding fixed income universe. Leveraged loans are higher in the capital structure (less risk in that sense) and a diversifier against rising rates. Leveraged loans also typically have coupon floors of 1% (based on LIBOR); as rates rise, investors would benefit from higher floating rate coupons.

Appendix: Asset Allocation Playbook

The table on page 6 is the first iteration of Hawthorn's asset allocation views summarized in one complete, concise format for your reference/use. The asset class views depicted in the table apply to an intermediate-term horizon (that is, over the next 12–18 months). This summary of our individual asset class views depicts absolute direction and strength of conviction but is entirely independent of unique client needs, objectives, and constraints, as well as any portfolio construction considerations. We hope you find this a useful tool, and we plan to include it and update it in future issues of the *Strategy Insights*. As a disclaimer, we reserve the right to change, modify, or otherwise alter these views at any time based on shifting market and economic conditions.

Jeffrey D. Mills
Hawthorn Investment Strategist and
Senior Investment Advisor

Hawthorn Asset Allocation Playbook (as of 3/31/17)

Asset Class	Sub Asset Class	Favorability: −			Neutral			+	Points of View
Equities				●					
U.S.	Large Cap					●			Relative valuation and vulnerability to overall market volatility cause us to favor mid and large over small, especially when considering the magnitude of small cap outperformance in 2016. That said, if we start to see tangible momentum on the policy front, small-cap companies may enjoy an outsized benefit from changes in tax rates and regulation.
	Mid Cap					●			
	Small Cap			●					
Non-U.S.	Intl. Large/Mid Cap				●				Even though developed international valuation multiples are about flat year over year and appear relatively more attractive versus domestic equities, we see more potential risks and disruptions and relatively fewer positive growth catalysts in the coming year.
	Intl. Small Cap			●					
	Emerging Markets		●						Fundamental pressures stemming from protectionism, stronger dollar, higher U.S. rates; potential headwinds to commodity prices.
Fixed Income				●					
U.S.	Short Muni Fixed Income			●					With the possibility of longer-term rates remaining range-bound, we favor intermediate duration fixed income. To date, core fixed income has outperformed short, and we believe this trend will persist for the balance of 2017.
	Core Muni Fixed Income				●				
	U.S. High Yield			●					Overall credit conditions remain favorable, but credit spreads are tight, leaving high yield less room to outperform.
	U.S. Leveraged Loans				●				Perhaps more attractive than high yield given their place higher in the capital structure and protection from rising rates.
	U.S. TIPS				●				A reasonable hedge if inflation overshoots current expectations; however, that is not our base case forecast.
Non-U.S.	Global Bond				●				Sovereign credit looks about fairly valued currently with the primary sources of return likely to come from countervailing global trends in currencies and interest rates, hence our neutral stance.
	Unconstrained Bond						●		Flexibility provides for diversification if rates should steadily rise (a primary risk to fixed income in this market).
	Emerging Market Bond			●					Spreads look too tight currently (that is, fundamentals in the region suggest wider spreads), and we expect this to occur in 2017. Relative yield advantage makes EM debt marginally more attractive than EM equities.
Alternatives						●			
Private	Private Real Estate						●		With the pendulum swinging more recently toward short-termism, we think this creates an opportunity at the opposite end of the spectrum for patient, long-term investors. At a time when the expected returns on traditional asset classes are likely to be below historical norms, the illiquidity premium has become increasingly valuable.
	Private Debt					●			
	Private Equity							●	
Hedge Funds	Equity Long/Short					●			Can generate outperformance in a market where the overall risk/reward balance may be skewed toward risk. Equity market correlations are falling, and the removal of extreme monetary policy accommodation which compressed the cost of capital across the quality spectrum should help swing the performance pendulum back in favor of certain hedge fund strategies. However, should the market move steadily higher with little volatility, these allocation will likely underperform.
	Event Driven					●			
	Relative Value					●			
	Directional					●			
Cash						●			
Tactical Allocations						●			
Tactical	Master Limited Partnerships					●			Massive headwind from oil price drop is gone; valuation not nearly as stretched versus other yield-oriented areas of the market.
	Infrastructure				●				Still like the long-term theme, but valuation is a headwind.
	Currency Hedged Europe				●				The dollar may not appreciate to the extent it did in 2016; still hard to make the case that it will weaken dramatically, in our view.
	Structured Note (Drawdown)						●		Ability to earn a coupon while waiting for a more attractive entry point into equities can be an attractive strategy, especially versus cash.

Source: Hawthorn

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