GlobalData. TS Lombard

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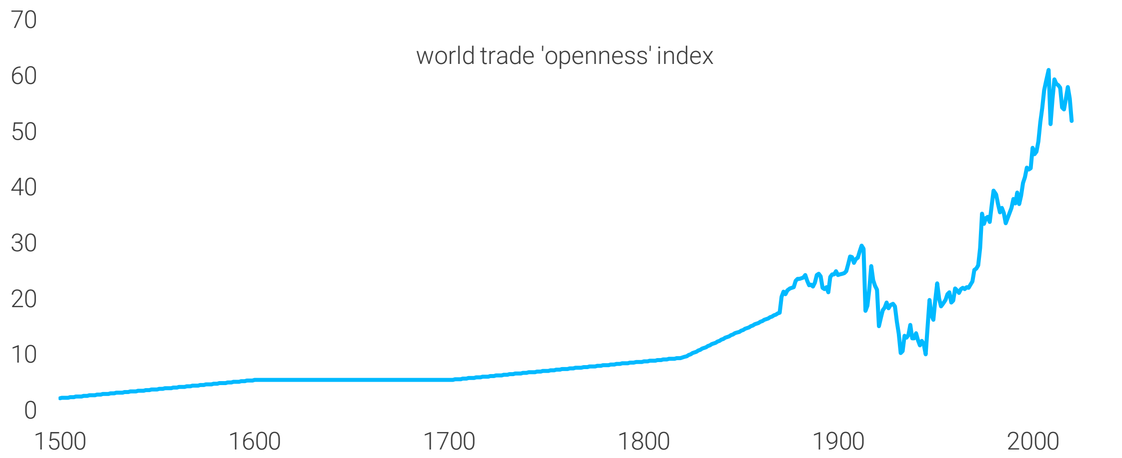
Macro Picture

DEGLOBALIZATION IS REAL

Dario Perkins

Deglobalization is real and gaining traction, despite the resilience of global trade over the past three years. With bilateral trade patterns starting to shift, and both the US and China using strategic industrial policy with a fair amount of success, there is no way back to the neoliberalism of the last 40 years. This will have important macro and market implications.

Chart 1: Globalization has peaked, but deglobalization is only just getting started



Source: OurWorldinData, TS Lombard

DEGLOBALIZATION HYPE

Deglobalization has become a consensus theme since the start of the pandemic. Not only did COVID-19 expose inherent vulnerabilities in long cross-border supply chains, but we have seen big geopolitical shifts that are accelerating the trend towards reshoring and friendshoring. There is even speculation the US dollar will lose some of its dominance as the world's reserve currency.

FACT OR CONJECTURE?

While the data on global trade do not (yet) reflect this new reality, we see clear evidence that deglobalization is real and gaining traction. Pre-COVID tariffs remain in place and bilateral trade patterns have started to shift. But the bigger story is that both the US (with "Bidenomics") and China (EV subsidies) are now using strategic industrial policy with a fair amount of success.

WINNERS AND LOSERS

Deglobalization has long been an important part of our new macro supercycle thesis. It is the result of a deeper political shift away from the neoliberalism that has defined the last 40 years. Naturally, this process will have important implications for financial markets and the economy. But despite all the gloom among macro commentators, it is not nearly as disastrous as it seems.

DEGLOBALIZATION IS REAL

Talk of "deglobalization" is not new – it dates back to at least the Trump trade war with China (2018-20), if not the UK's vote to leave the EU, or the widely acknowledged "slowbalization" of the world economy (which started after the 2008 global financial crisis). It is also an idea that is now turning mainstream, as part of an emerging consensus about how the macro environment will look different in the 2020s. (As the Jackson Hole chatter makes clear.) There are three reasons why deglobalization has gone mainstream. First, the experience of the pandemic illustrated the risks inherent in long, complex international supply chains. As companies look to build greater resilience, their focus is shifting from "just in case" inventory management to "just in time" supply networks. Second, and more important, the events of the past three years have compounded existing geopolitical fractures. Trade relations between China and the US have continued to sour, and there is now an irrevocable split between NATO and Russia (including a number of developing countries that are sympathetic to Russia). This splintering of geopolitical alliances can only accelerate the trend towards friendshoring and reshoring (particularly for strategically important resources), which is destined to create deeper fragmentation of international trade and finance. Third, there is the role of the US dollar. Suddenly it is not just the conspiracy theorists on Twitter who are predicting a permanent dilution of the US currency's international dominance.

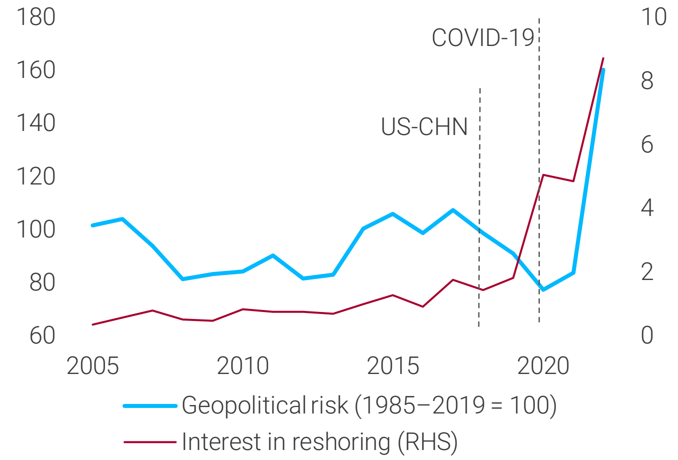
Critics point out that deglobalization remains a forecast rather than an economic reality. When we look at actual data – rather than conjecture – we see that world trade is holding up remarkably well (and the dollar remains as dominant as ever). Yet it is important to remember that powerful temporary forces, particularly the COVID boom in consumer durables, have been flattering the performance of world trade. Once we go deeper, we see a number of trends that are more in line with the (gradual) deglobalization thesis. The most compelling evidence comes from the US, particularly the country's bilateral relationship with China. Successive US governments have sought to curb Chinese imports and there is now compelling evidence that these policies are working (even after allowing for trade divergence via other low-cost Asian producers like Vietnam). The bigger story, however, is the re-deployment of "strategic industrial policy". Recent trends highlight two notable successes: the US desire to rebuild its domestic industrial base (where "Bidenomics" is delivering a compelling investment boom) and China's shift into the EV market (where Chinese exporters are suddenly outcompeting traditional auto producers). With Europe caught in the middle and under pressure to match the trade nationalism of its peers, the apparent success of Bidenomics-style trade subsidies sets an important precedent for the post-COVID era. It also signals a fundamental departure from the neoliberalism of hyperglobalization.

Gradual deglobalization has long been a part of our new macrocycle thesis. Looking through the noise and distortions of the past three years, we see broad confirmation that our thesis remains in play. Understandably, there is a great deal of concern among investors about what this means for financial markets. Since globalization was associated with rapid improvements in efficiency, a collapse in worker power, historically high profit margins and Goldilocks conditions for financial markets, it seems natural that deglobalization could reverse these trends. And to the extent any reconfiguration of international trade patterns will render parts of the existing capital stock obsolete, it is obvious that deglobalization must involve a degree of wealth destruction (since equity holders have a claim on that existing capital stock). Yet, for the broader macro economy, we think the pessimism about deglobalization is overdone. On balance, investment and GDP growth are likely to be stronger in the 2020s, while AI/robotics should help curb some of the potential inflationary consequences of domestic labour shortages and lost productivity. The prevailing tendency of interest rates and inflation is likely to be higher than in the 2010s, but there is no reason to fear persistent stagflationary outcomes. We should also remember that deglobalization will bring new investment opportunities, particularly in commodities and for certain EMs. Some economies in Asia, Latin America and Eastern Europe will be net beneficiaries.

1. DEGLOBALIZATION HYPE

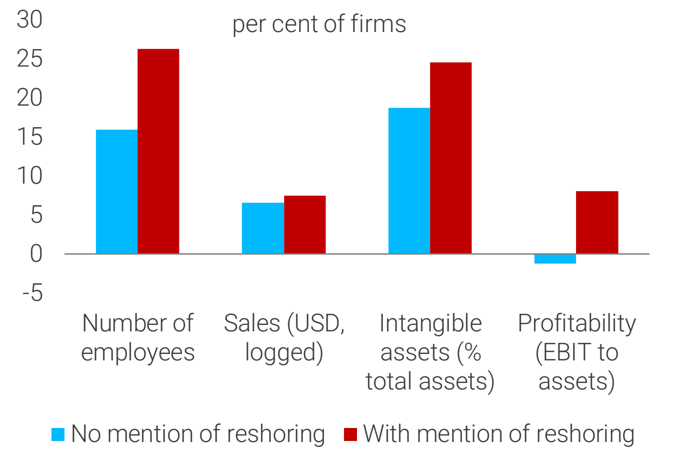
There is nothing new about the concept of deglobalization. But an idea that started to gain traction with the economic populism of the 2010s – already an era of so-called slowbalization – is now a central tenet of the consensus view about how the world economy might look different in the coming decades. There are good reasons for this shift, particularly after a pandemic that exposed the vulnerabilities inherent in long international supply chains and amid a war in Ukraine that has inflamed existing geopolitical tensions (creating a genuine national security rationale for restricting trade, particularly in strategically important resources like new green-energy supplies and semi-conductors). But beyond all the media chatter about reshoring and friendshoring, what evidence is there to suggest the global economy is genuinely starting to "fracture"? Is the era of hyperglobalization truly over? And if it is, what is likely to replace it? What does this mean for the global economy and future market returns? Who loses? And who gains?

Chart 2: Geopolitics and reshoring



Source: IMF, interest based on corporate earnings transcripts

Chart 3: Corporate interest in reshoring

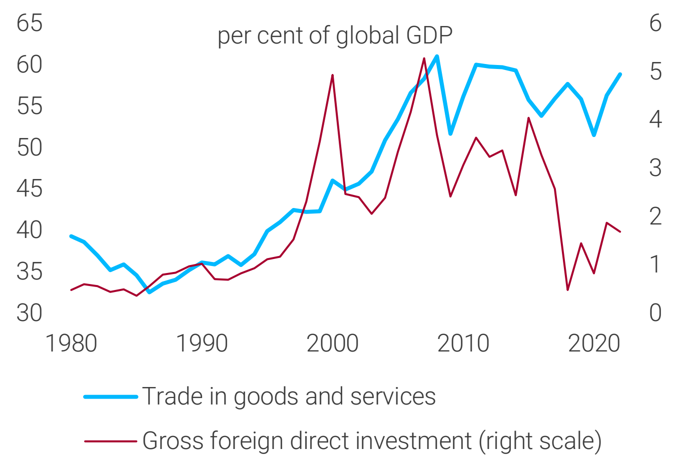


Source: IMF, interest based on corporate earnings transcripts

Origins of deglobalization

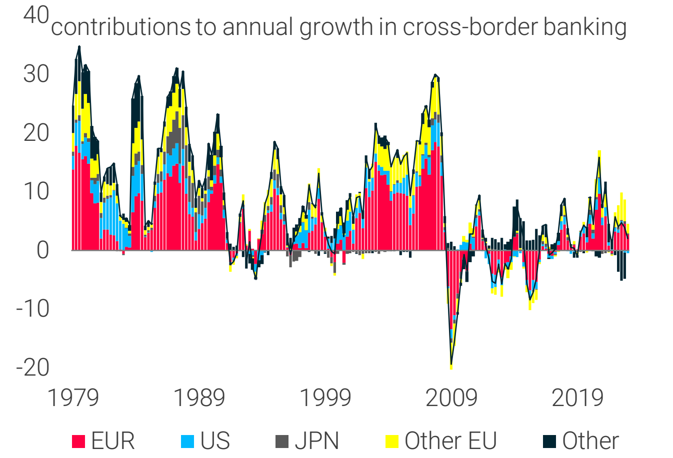
The 2010s were a difficult decade for global trade. After a long period of stagnation (so-called slowbalization), the emergence of economic populism (notably Brexit in the UK and Trump in the US) suggested the political climate was starting to shift against the hyperglobalization that had characterised the second half of the 20th century. Perhaps the prevailing neoliberal order had exaggerated the benefits of unfettered free trade or, more likely, had failed to recognize that some parts of society were losing out, particularly "middle-income" households in the United States and Europe (especially if they worked in manufacturing). The trade war between the US and China, which started in 2018, was further confirmation that the old Washington consensus – "free trade is always good", to quote the West Wing's Toby Ziegler – was breaking down. Policymakers had forgotten the lessons of history. As we pointed out back in 2019, the persistent weakness of the post-GFC economy had produced a macro and political environment not unlike the Long Depression of the late 19th century, which was also an era of stagnant wages, acute polarization and rising inequality. In the end, those same trends triggered a powerful political backlash, one that gave us the world's first wave of state intervention and protectionism.

Chart 4: Slowbalization since 2008



Source: IMF

Chart 5: Finance dried up for globalization after 08



Source: BIS, TS Lombard estimates

Deglobalization goes mainstream

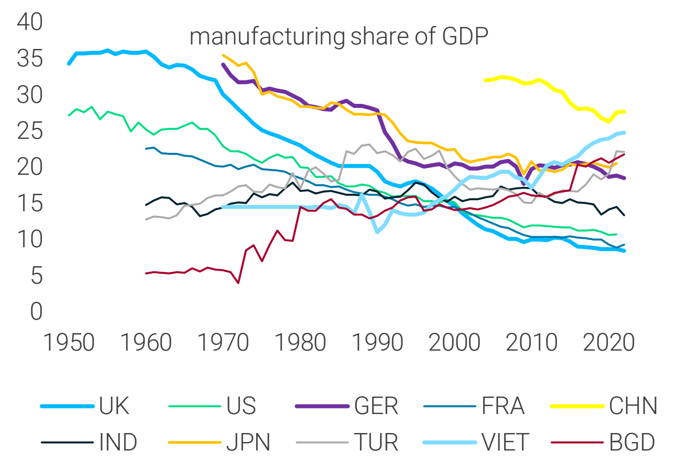
While deglobalization is not a new theme for investors, the events of the past three years have propelled the idea into mainstream thinking about how the global economy is likely to change during the 2020s. Three developments have been particularly important:

(i) Supply-chain vulnerabilities: Companies made massive efficiency improvements from the 1980s onwards, as they learned to manage their supply chains better, thanks to new technologies, automation and digital information. But at the same time companies prioritized cost efficiencies over resilience, with supply chains becoming longer and more complex, leaving them vulnerable to disruption. COVID-19 exposed the vulnerabilities of this system. The best example is what happened in the auto industry, where many manufacturers had to halt production of cars because they could not secure enough semiconductors. Over time, this experience could lead to a major rethink in the way large manufacturers source their inputs – for example, by reducing the complexity of their supply chains or securing multiple suppliers. It might accelerate international "reshoring" or create a new era in which "just in case" procurement replaces the existing "just in time" regime. A recent NBER paper shows that the optimal supply-chain configuration depends on the nature of the risks the global economy is facing. If systemic threats – such as those caused by pandemics or climate change – become more frequent, even "just in case" supply lines may not be sufficient. Companies will need "just in worst case' supply chains, incorporating even greater resilience, which will further reduce efficiency.

(ii) Geopolitical tensions and strategic rivalries: The war in Ukraine has intensified existing geopolitical tensions, with strategic rivalries now forming more clearly around regional trading blocks. China, Russia and their allies are on one side, while the US, Europe and their allies are on the other. Companies that already had a private incentive to shorten their supply chains in response to the pandemic could now be compelled to do so by protectionist politics, which will mean a greater emphasis on reshoring and "friendshoring". We know from history that geopolitical alliances have always had a powerful bearing on financial linkages, trade patterns and FDI – for example, trade relationships shifted around the two World Wars, during the Cold War between the US and Russia and around the collapse of communism. This new "wartime economy" will also lead to greater state intervention, particularly in terms of strategic investments (i.e., "industrial policy"), public R&D and countries seeking to secure strategic resources (such as semiconductors). Policymakers are more likely to deploy food and energy protectionism – a trend that is already emerging.

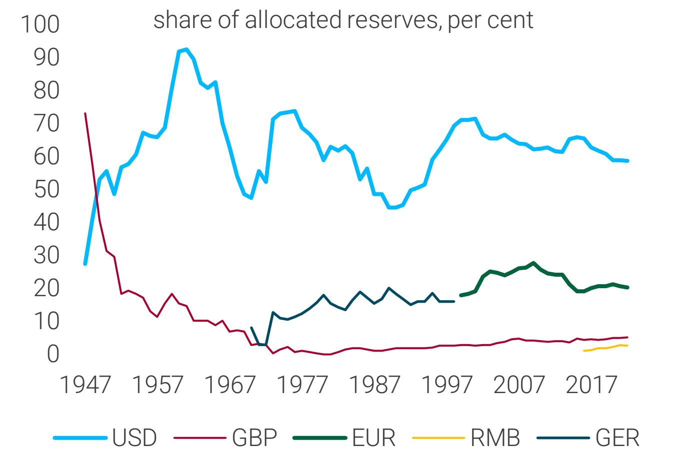
(iii) Weaponization of the US dollar: Shifting geopolitical allegiances and changing global trade patterns could also have implications for the US dollar as the world's reserve currency. Indeed, the recent sanctions on Russia's foreign assets (including its exclusion from the SWIFT system) have continued the trend of "weaponizing" the international monetary system to punish countries that have acted against the interests of the wider NATO community. At the margin, these actions have clearly strengthened the incentive for some parts of the world – particularly countries that do not necessarily share the Western ideology of liberal democracy – to diversify out of the US currency as a matter of national security and financial sovereignty. Again, history suggests we should take these risks seriously. Academic research shows that geopolitics has always had a critical bearing on how central banks have chosen to allocate their FX reserves. And there is currently no shortage of media reports suggesting that some countries are already looking for USD alternatives (including RMB and hard commodities such as gold). The most recent example has been speculation about a new BRICs currency, which could be used for cross-border payments between Brazil, Russia, India, China and South Africa. But there is even talk, particularly in China, about extending this to a much larger group of EMs. Talk of Bretton Woods III is now a mainstream idea rather than a conspiracy theory.

Chart 6: Many DMs lost their manufacturing base



Source: World Bank, TS Lombard

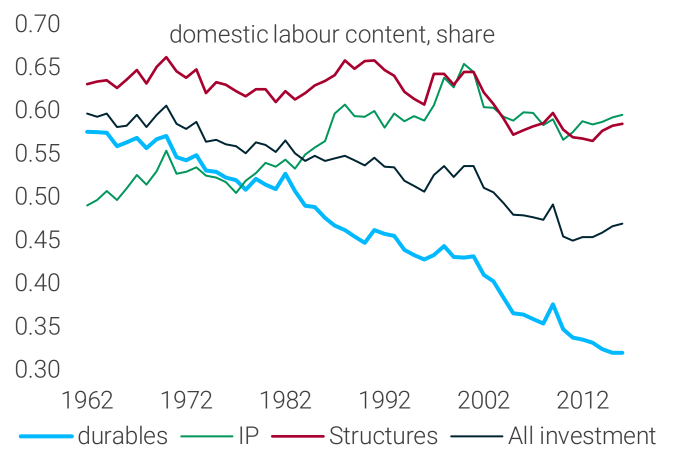
Chart 7: USD still dominant



Source: IMF, TS Lombard

While we see no immediate threat of the US dollar being "dethroned" – the US currency has crucial advantages over all its rivals in terms of liquidity, the depth of US capital markets, network effects and the importance of US demand as a source of global economic activity (see here for more) – we certainly have a lot of sympathy for the deglobalization thesis. The "fracturing" of the global economy into regional trading blocs has been an important theme in our research for some time, long before it became the consensus narrative. In fact, there have been three stages in this deglobalization trend. The first was a shift in public attitudes that started in around 2015. The focus then was on jobs and wages. Then, with the start of the pandemic, worries about the resilience of supply chains provided another rationale for deglobalization. But the most important shift was geopolitical, starting with the Russian invasion of Ukraine (which also exacerbated America's strategic rivalry with China). It is important to emphasize, however, that we see a broader story here: a deeper political shift – the rejection of neoliberalism – that is set to deliver a critical inflection point in the long, multi-decade macro supercycle. Not everyone agrees with us, however. Indeed, there are many economists – particularly enthusiasts of the old Washington consensus – who believe deglobalization is still just a forecast rather than an economic reality. In Section 2, we investigate those claims and show that they are somewhat short-sighted.

Chart 8: US deindustrialization



Source: EmployAmerica.org

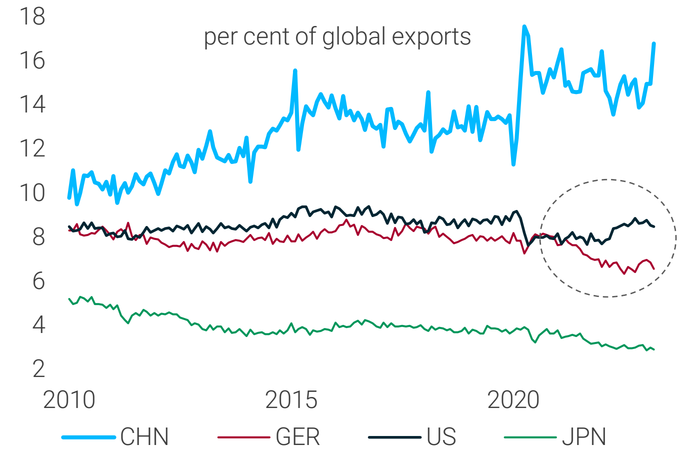
Chart 9: COVID trade boom turns to bust

Source: CPB, TS Lombard

2. FACT OR CONJECTURE?

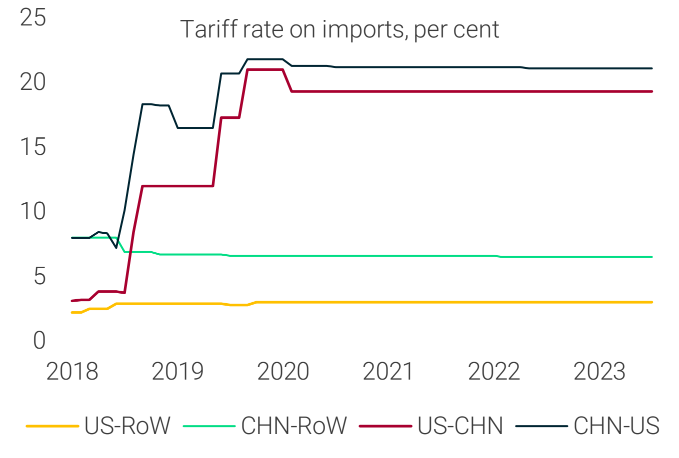
While deglobalization is now a popular thesis, some economists like to argue that it is still a forecast rather than an economic reality. In fact, despite the pandemic and the war in Ukraine, world trade has been remarkably buoyant and there is still no concrete evidence to suggest the role of the US dollar has diminished – quite the opposite, given the relentless strength of America's currency (which suggests there is still plenty of global appetite for the greenback). Yet it is important to remember that the buoyancy of global trade over the past three years is largely the result of unusual and heavily distorted spending patterns – namely, the COVID-induced boom in consumer durables. Looking more deeply at the data, including at bilateral trade links, we find clear evidence to suggest that the deglobalization thesis is very much on track and likely to continue. But the most important trend is the sudden deployment of strategic industrial policy, particularly in the US ("Bidenomics") and China. The apparent success of these policies is only going to increase their attractiveness elsewhere, leading to a classic tit-for-tat spiral in economic nationalism. Europe, which is under acute pressure from its terms of trade shock (i.e. imported energy prices) and China's sudden penetration of its auto industry, is likely to join this scrap.

Chart 10: China and US gaining market share



Source: IMF, TS Lombard estimates

Chart 11: Pre-COVID protectionism still in place

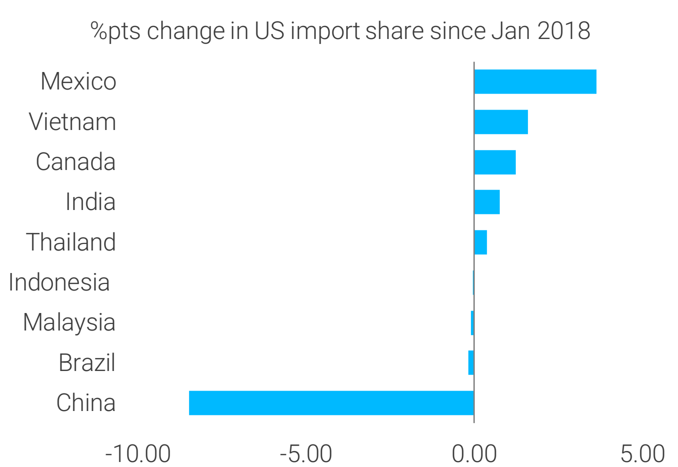


Source: Bruegel institute

The deglobalization hoax?

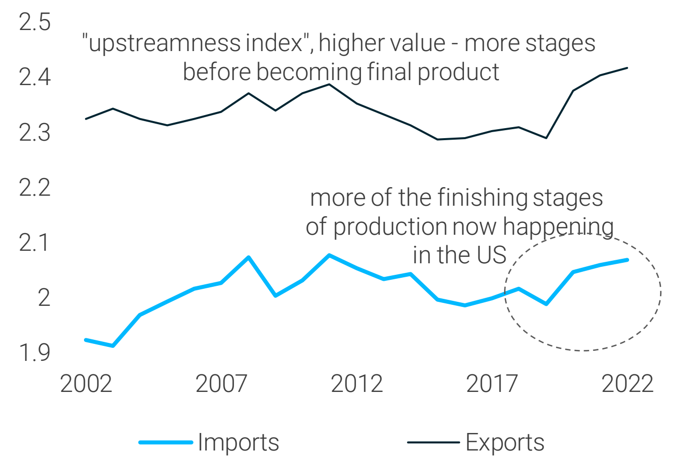
It seems odd that deglobalization should have become a mainstream idea just as world trade hit historical highs. According to the Dutch CPB institute, global export jumped more than 20% between April 2020 and December 2022, rising to levels well beyond the norms of the slowbalization era. And a recent analysis from Pinelope Goldberg and Tristan Reed confirms that globalization – measured in physical trade, capital flows and migration – has proved surprisingly resilient. Yet there are several reasons we should not take this resilience for granted. First, a large part of the bounce in global trade was simply a recovery from the initial collapse in trade at the start of the pandemic. Second, COVID itself caused massive distortions in global spending patterns. With households spending a larger share of their income on goods, the pandemic environment was inherently advantageous to manufacturing and trade. Since then, spending patterns have started to return to normal and we are seeing a powerful bullwhip recession in manufacturing. This is likely to deliver a deep contraction in international trade from the second half of 2023, putting the supposed “resilience” of globalization in an entirely different light.

Chart 12: Bilateral US trade has shifted



Source: Datastream, TS Lombard

Chart 13: Early evidence of US reshoring

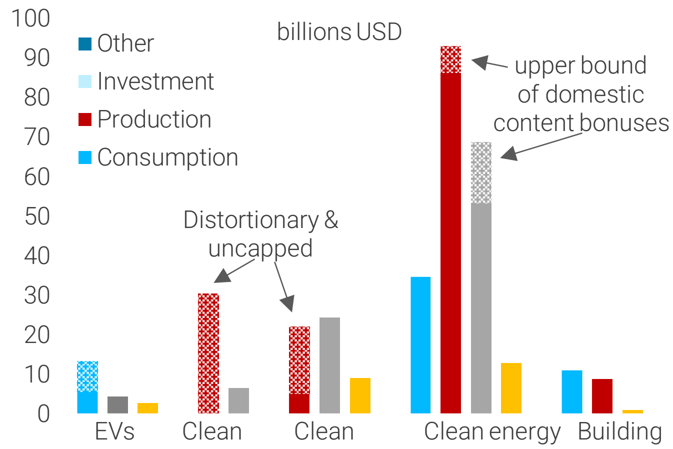


Source: Laura Alfaro and David Chor (presented at Jackson Hole 2023)

US tariffs are 'working'

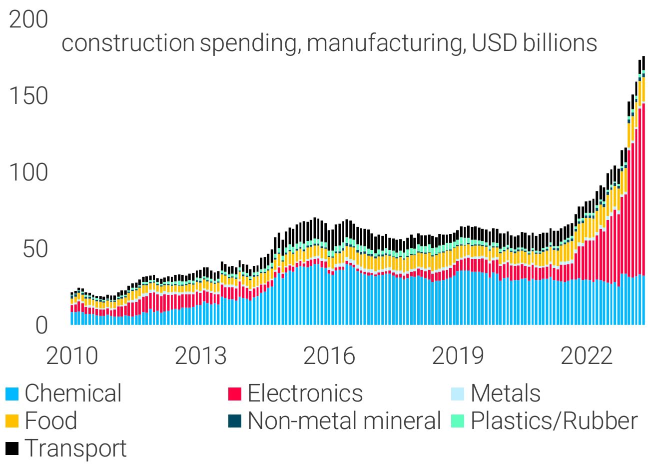
The bigger worry for the advocates of globalization – as Goldberg and Reed acknowledge – is that trade data always lag developments in trade policy, which, in turn, lags shifts in political attitudes towards free trade. And in the political arena, there is overwhelming evidence that the deglobalization narrative is now gaining traction. Not only have the tariffs that the US and China introduced before the pandemic remained in place (Chart 11), but they are also now having a discernible impact on bilateral trade between the two nations. Chart 12 shows that there have been particularly large shifts in the composition of US imports, with China's share plunging by almost 10 percentage points since the start of the trade war in 2018. Of course, some economists believe this is just a classic case of "trade division" – other low-cost Asian economies such as Vietnam have taken China's place, probably with Chinese exports rerouted precisely to avoid US tariffs. If that were true, US "dependence" on China would be undiminished. But like Noah Smith, we do not believe the evidence supports this conclusion. Exports from these other countries have not been large enough to offset the "lost" US-China trade (e.g. China's exports to Mexico have risen only modestly) and even if Chinese companies have set up new plants in places like Vietnam, over time we should expect China's contribution ("value added") to fade.

Chart 14: Bidenomics



Source: Bruegel Institute

Chart 15: US manufacturing renaissance



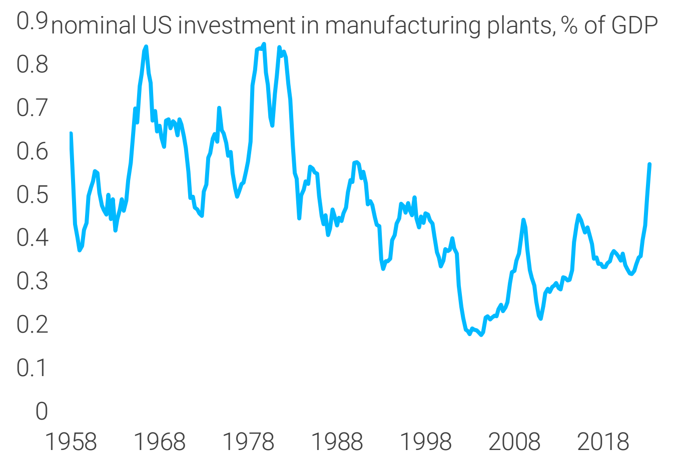
Source: BEA, TS Lombard

More detailed analysis – from Laura Alfaro and David Chor (presented at this month's Jackson Hole symposium) – supports our findings. Alfaro and Chor show that the reallocation of US imports from China to Vietnam and Mexico has happened across a wide range of products. While Vietnam has gained in electronics, apparel and textiles, Mexico has done particularly well in auto parts, glass, iron and steel. The researchers confirm that US tariffs have played an important role in diverting bilateral trade flows, but they also find compelling – though early – evidence of reshoring/friendshoring. Alfaro and Chow reach this conclusion by looking at the participation of the US in global value chains, showing that the production-line positioning of US imports has started to shift to more "upstream" activities, which means more of the "finishing stages" of production are now happening domestically rather than overseas. They cross-check this finding with data on FDI and corporate earnings calls, which also support the reshoring thesis. Given that successive administrations have been obsessed with reducing their perceived "dependency" on Chinese imports – which is why many of the tariffs introduced under President Trump have remained in place with President Biden – the authorities will no doubt interpret these data as evidence that their protectionist pivot is "working". Meanwhile the US has managed to preserve its share of global exports, which, after an early COVID dip, has returned to pre-pandemic levels.

The Bidenomics effect

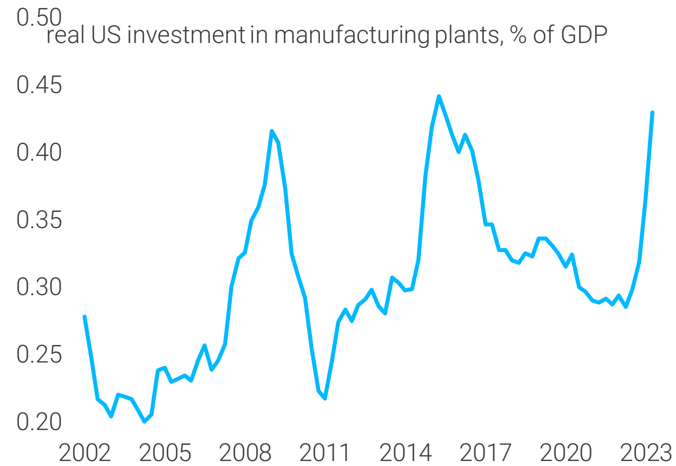
The US determination to suppress Chinese imports through hefty tariffs supports the deglobalization thesis – at least on a bilateral basis – but it is not necessarily a sign of policy "success", particularly if it means consumers are paying higher prices for goods imported from other parts of the world. But the potentially bigger story for deglobalization is that we are also seeing an important shift in attitudes towards "strategic industrial policy", not least the deployment of fiscal subsidies to boost domestic manufacturing and encourage reshoring. The highest-profile example of this is "Bidenomics". US policy was spearheaded by two laws passed 12 months ago — the Inflation Reduction Act and the Chips and Science Act — along with the Infrastructure Investment and Jobs Act, passed in late 2021. Combined, the government is offering hundreds of billions of dollars in subsidies, grants and loans to spur new investment in broadband networks, semiconductors, electric vehicles (EVs) and batteries – with a deliberate bias towards domestic suppliers. And because many of these tax incentives are uncapped, the overall scale of this programme could end up being much larger than anyone expected.

Chart 16: Nominal capex to 1980s levels



Source: BEA, TS Lombard

Chart 17: The US capex boom is real



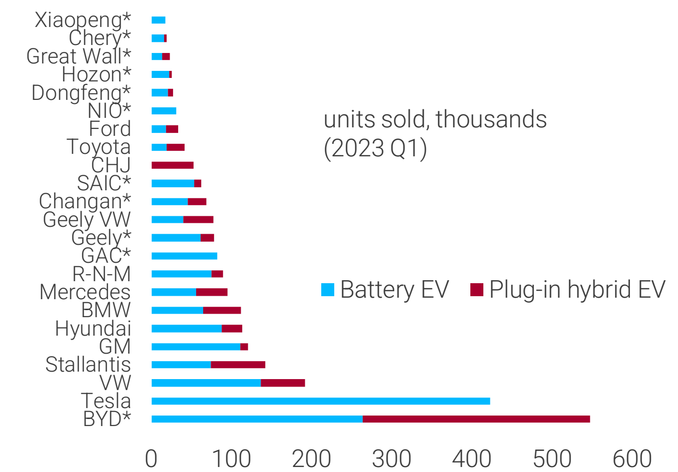
Source: BEA, TS Lombard

Chart 16 shows Bidenomics is already having a powerful impact on US investment in manufacturing capacity, which has surged during the first 12 months of the programme. In nominal terms, the share of US GDP devoted to investment in manufacturing plants has risen to its highest levels since the late 1980s (mainly thanks to buoyant construction activity in the electronics sector). While part of this trend is simply the result of higher prices, we are also seeing a notable acceleration in investment *volumes*. Even if the overall macro impact of these policies is uncertain – it is not clear, for example, how many jobs Bidenomics will create (independent estimates from Princeton University's Repeat project put the number at 2.2-2.9 million by 2035) – the US authorities can already point to genuine and tangible evidence of "successes" from their policy initiative. This sets an important precedent, especially in the context of a US economy that is enjoying a much better COVID recovery (with a superior growth/inflation tradeoff) than many other parts of the world). And it is not just the US that seems to be enjoying the benefits of activist industrial policy. China's exports, too, have performed well since the pandemic, mainly because the country has offset its lost US exports by capturing Europe's car industry.

China's EV dominance

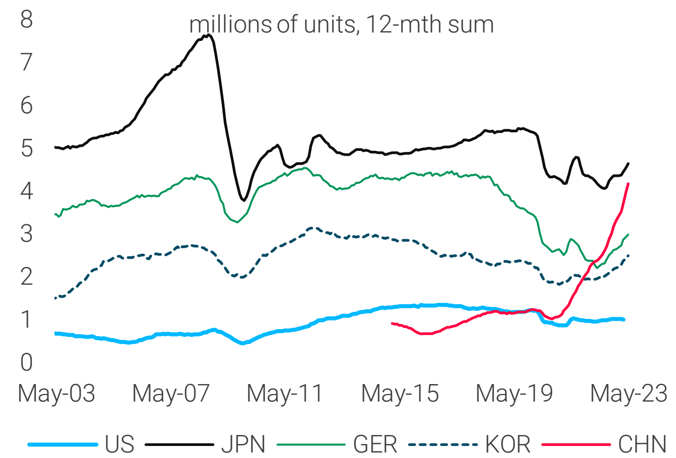
Although China's share of US imports is down significantly since 2018, its overall footprint in global trade has increased (Chart 10). Much of this improvement seems to have come at the expense of Europe and Japan, with Germany hit particularly hard. Europe's trade deficit with China is now even larger than America's (Chart 21). The main reason for this is that China is enjoying a powerful boom in EV production, something that has taken European auto manufacturers by surprise. Charts 19 and 20 show that Chinese auto sales have surged since the start of 2021, with Chinese exports making powerful inroads into a range of foreign markets – including Canada, the euro area and (most notably) the UK. Like the US, China has been using generous state subsidies to encourage EV production, combined with protectionist measures, which have ensured that most of the benefits have been captured domestically rather than leaking into the rest of the world. To qualify for subsidies, cars had to be domestically made and to have batteries produced by Chinese companies, giving national champions like Contemporary Amperex Technology and BYD an advantage over previous market leaders. It turns out that Chinese auto manufacturers had already positioned themselves well to take advantage of the global shift into EV –this fascinating tweet thread shows how this has played out in the UK.

Chart 18: China now dominates EV market



Source: FT, TS Lombard. * Chinese companies

Chart 19: China's EV surge during COVID



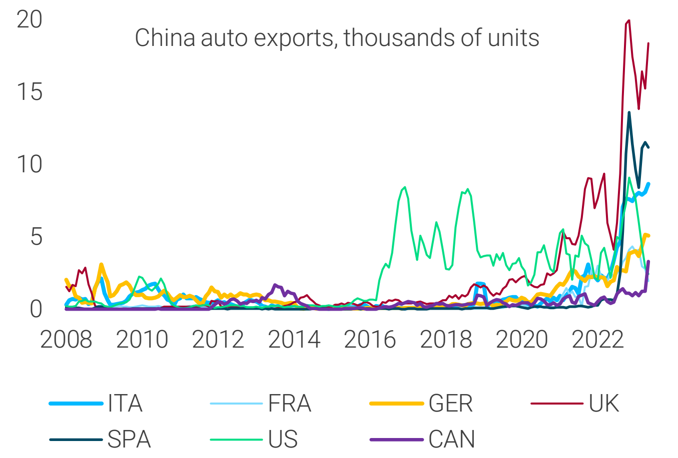
Source: CEIC, TS Lombard

Global subsidies race

This apparent success of industrial policy – both in the US and in China – is the most important development in international trade right now. It is the clearest path to the continued fragmentation of global supply chains and the regionalization of international trade. The immediate question is how Europe will respond. Aggregate global trade is set to deteriorate over the next 12 months, and China is suddenly capturing one of its most important industries. Energy is still significantly more expensive than it was before the Ukraine war, and manufacturing powerhouses like Germany are facing a serious economic slump. But across the Atlantic, advocates of Bidenomics seem to have found a solution, with a compelling narrative about how strategic industrial policy can boost national output and create jobs – at a time when policymakers in Europe are struggling to come up with a "plan". Is it surprising that there are now plenty of European politicians pushing for a stronger EU response to Bidenomics?

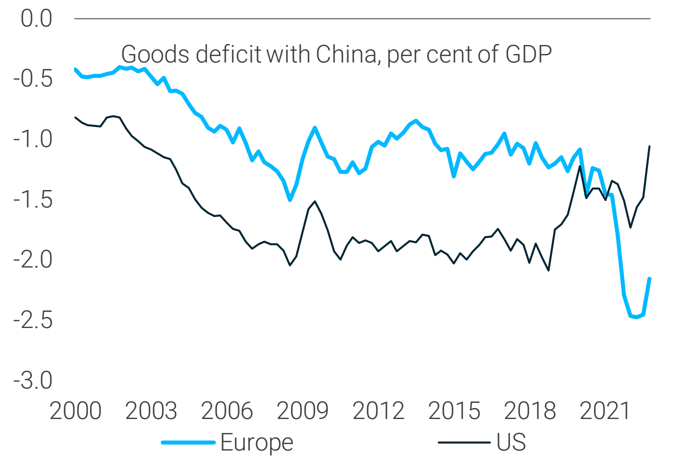
To be fair, the EU is already trying to bolster its domestic investment, particularly in green energy. But it has been doing so in a way that does not involve US- or Chinese-style industrial nationalism. While the US regime offers subsidies worth $7,500 an electric car, for example, the average in the EU was already €6,000 per vehicle in 2022. Under the €800bn NextGenerationEU Covid-19 recovery programme, member states must commit almost 40% of spending to the green transition. But until recently, there was resistance in Europe to encouraging "national champions" because it would undermine the Single Market. Now those incentives have started to shift. Last year, the European Commission relaxed its strict state-aid rules, giving member states more leeway to help their companies get through the turbulence triggered by Russia's invasion of Ukraine. And this was expanded in March 2023 to pave the way for more investment in Europe's clean tech industry. These dynamics are not surprising: the thing about strategic industrial policies like Bidenomics is that they tend to spread. We are entering an era of tit-for-tat strategic industrial policy or an international "subsidies war" in which the superpowers will try to rebuild domestic industry by running fiscal deficits and adopting a more interventionist state model. This signals a profound shift for the global economy – and a clear rejection of neoliberalism.

Chart 20: China penetrates global markets



Source: CEIC, TS Lombard

Chart 21: Now Europe has the China problem



Source: IMF, TS Lombard estimates

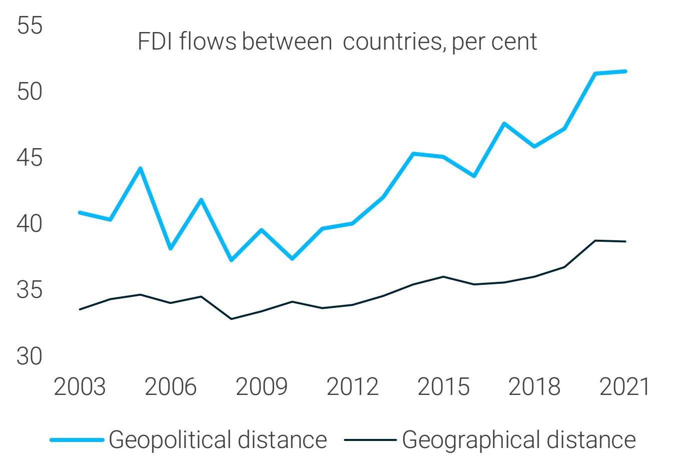
3. WINNERS AND LOSERS

Even as international trade has looked resilient over the past three years, we have seen an important shift in economic thinking. It started in the US with Bidenomics, but the basic plan – to rejuvenate domestic industrial hubs, reorient (or "de-risk") global supply chains and transition to new clean energy sources – is clearly attractive to many other parts of the world. Europe, facing pressure to protect its domestic car industry from Chinese EVs and find an alternative to Russian natural gas, has no option but to respond. And we are already seeing similar trends in Japan and South Korea, which have also introduced subsidies for their tech and clean energy sectors, in order to attract new investment or prevent more companies from shifting to the US. All of this supports our thesis for continued (but gradual) deglobalization, with the start of a new era of strategic industrial rivalries and fiscal interventionism. Naturally, there is a great deal of pessimism about what this means for the global economy – and for asset markets in particular. But we think the bearishness is overdone. In many ways the 2020s could produce a better macro environment than the 2010s. And it will certainly bring new investment opportunities.

The gains from globalization

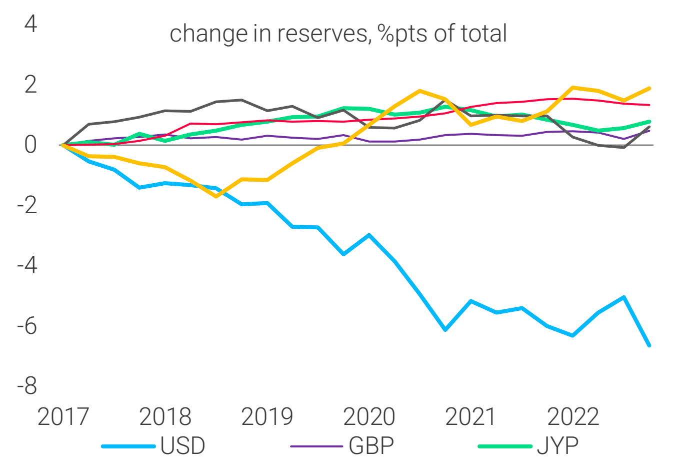
It is widely agreed – except perhaps among central bankers (who think they control inflation…) – that globalization reduced consumer prices, raised productivity, boosted corporate profits and contributed to the Goldilocks-style conditions that were so helpful for financial markets. Perhaps the most import aspect of this came from the doubling of the global labour force that resulted from the entry of China, India and Eastern Europe into international markets. Most of these extra workers were unskilled and brought little capital with them, so the effect was to lower the ratios of skilled labour and physical capital to unskilled labour. This drove down the wages of unskilled labour and increased the rate of profit on capital. Naturally, the production of goods and services that were intensive in the use of unskilled workers shifted to the emerging economies. But the effects did not stop there. New technologies allowed businesses to push the division of labour even further. Products that were designed in the US could now be assembled in China, using parts from surrounding countries and, perhaps, with a call centre in India providing after-sales services and assistance. This unbundling of the production process into its constituent tasks allowed businesses to maximize efficiency, while destroying workers' bargaining power.

Chart 22: FDI already shows friendshoring



Source: IMF

Chart 23: Signs of USD dilution?



Source: IMF, TS Lombard

The impact of deglobalization

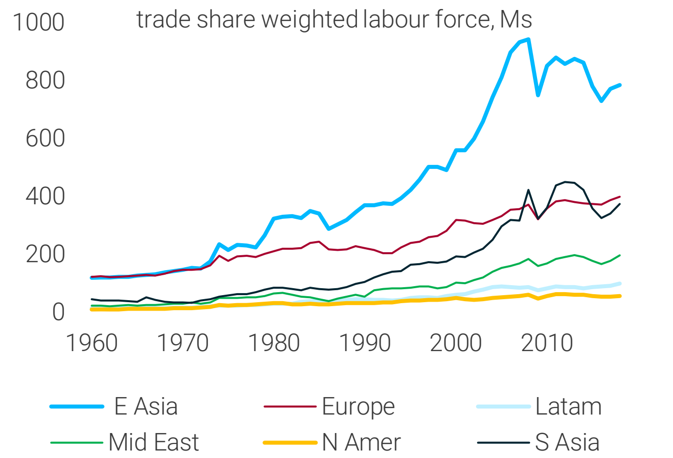
If deglobalization is set to reverse these trends, we should probably expect a new era of higher inflation, slower productivity, lower profits (as labour shortages boost wages) and a more difficult (potentially more stagflationary) environment for asset markets. On one level, of course, these dynamics seem inevitable. Deglobalization would certainly make part of the existing capital stock redundant and equity holders – who have a claim on this existing capital stock – would suffer losses. This is wealth destruction, concentrated among those large multinational companies (and their shareholders) that were responsible for our existing supply networks. (Currently, up to 40% of the value of US trade occurs between multinational corporations and their foreign affiliates.) Economic efficiency would deteriorate, too, which would probably mean higher prices for consumers. Decades of continuous deflation in global goods price would probably come to an end. But the issue here is about the speed of deglobalization and the degree to which we will ultimately roll back our existing supply structures. We suspect deglobalization will remain a relatively gradual process, and we are not looking – even as a potential endgame – at the complete reversal of the old regime. Remember, even if economic self-sufficiency is a plausible objective for the US, it would be impossible for most other developed nations. Ultimately, we are looking at a scenario where countries will try to strategically "de-risk" and shorten their supply chains to increase resiliency, but they won't be able to exclude China from global markets.

Recent research from the ECB has tried to model the impact of deglobalization, based on various scenarios about the sectors and countries that could be involved in the supply-chain "de-risking" effort – i.e. whether deglobalization is concentrated only in "strategically relevant" industries or spreads more broadly to all international trade in intermediate goods. While the effects of full deglobalization would be large, reducing national income and raising consumer prices, the impact would be more manageable if it were focused on strategically important sectors like semiconductors and certain metals (especially if the new trade restrictions do not apply to "friendly" nations). But even in a situation where there is completely free trade within the new geopolitical trading blocs, overall levels of imports and exports would still contract substantially – a marked acceleration in the deglobalization trend. And countries that are big exporters of intermediate goods, such as Korea, Ireland and the Benelux, would suffer disproportionately.

Shift in 'prevailing tendencies'

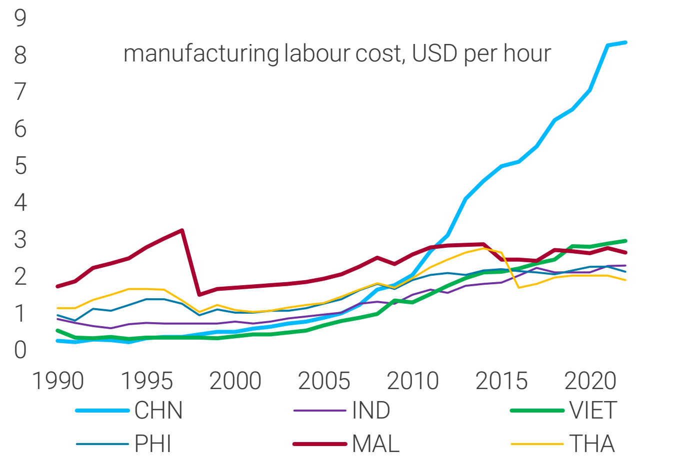
Our focus on this new macro regime has always been about how it will alter prevailing tendencies in inflation and interest rates, not deliver an era of stubbornly high inflation. We see 2% inflation becoming a sort of floor on inflation rather than a ceiling (whereas in the 2010s, central banks were always trying to hit their targets from below). This is a profoundly important shift for financial markets – as we have explained elsewhere – but it is much more subtle than many investors realize. Moreover, despite all the worries about perma-stagflation, we think gradual deglobalization could contribute to higher – not lower – economic growth. One of the peculiarities of destroying the capital stock and rebuilding it is that the process is additive to GDP: we are going to see much stronger investment (both public and private) than we had in the 2010s. And a high-pressure economy, which will redistribute spending power from large multinational companies to workers, is also likely to deliver higher wages, which will boost aggregate consumption, particularly compared with the old regime of stagnant real wages. That is not to say, of course, that there will not be profound challenges. Labour shortages, already a

Chart 24: The global labour shock after the 90s



Source: United Nations, TS Lombard

Chart 25: Chinese labour no longer so cheap?



Source: The Economist

feature of the post-COVID economy, will linger and productivity could suffer. But new digital technologies and automation offer a way to overcome these issues. When US or European companies reshore their supply chains, they will use AI and robotics to replace foreign workers. They will not be trying to retrain millions of new manufacturing workers. Automation becomes particularly important in a world where demographics are already turning (net) inflationary.

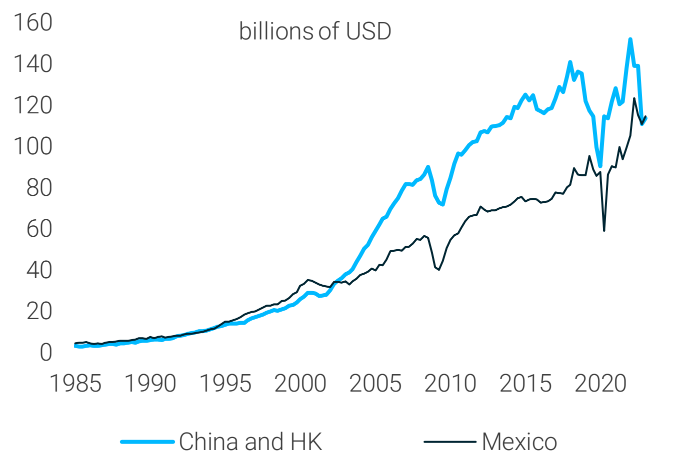
Positives from Industrial policy?

Even the consensus view on industrial policy seems too pessimistic. For decades, economists have warned against these interventions on the basis that they seem to have no discernible benefits from the economy. "Governments shouldn't pick winners" was the neoliberal rallying cry, backed by a body of empirical evidence that found a negative correlation between incidences of industrial policy and wider economic performance. Yet several recent pieces of research have raised doubts about the validity of those conclusions, pointing out that the prevailing consensus had not measured industrial policy accurately and that there was a good chance the pessimistic results were the result of an identification problem. As Juhász, Lane and Rodrik (2023) point out, a better approach is to look for indices of industrial policy that were not specific economic interventions, such as those that were the result of military conflict. When we do this, we find lots of examples of government interventions that raised productivity, delivered large "multiplier" effects on output, and even generated a persistent technological edge. Classic examples include the Napoleonic blockade of Britain, government R&D during WW2 and the US-Soviet space race.

Net winners

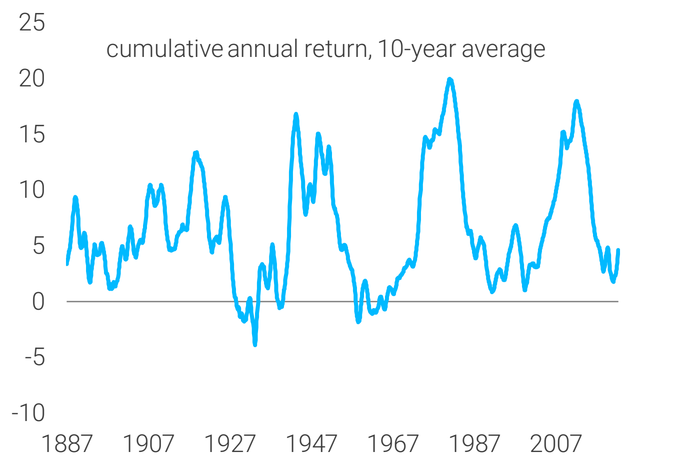
While everyone is focused on the losers, the process of gradual deglobalization will also create new investment opportunities. One obvious implication is that it should boost commodity prices. Any attempt to reconfigure supply chains and invest in new manufacturing plants will inevitably create enormous demand for energy, metals and other raw materials. When you combine this theme with the world's attempt to decarbonize the global economy (plus the physical effects of climate change itself – increasingly extreme weather and more frequent supply dislocations) it is easy to see the conditions for a new commodity supercycle, especially once we have passed the current recession scare. There will be some countries – especially EMs – that will be beneficiaries from this process. Yet the real winners from deglobalization could be those countries that were not already integrated into global supply chains and will gain from the

Chart 26: Mexico is back?



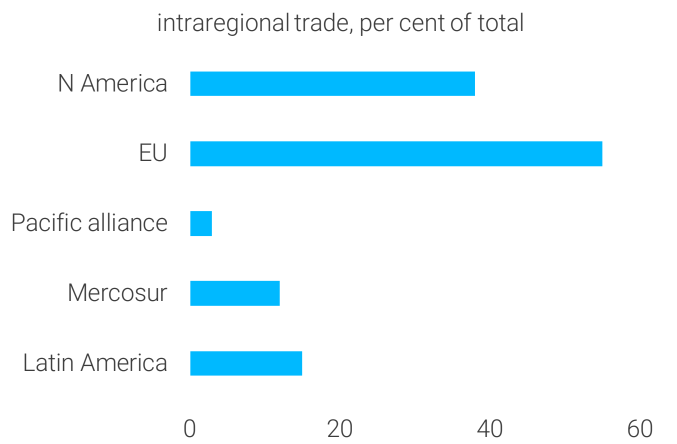
Source: US trade data, TS Lombard

Chart 27: Time for another commodity supercycle



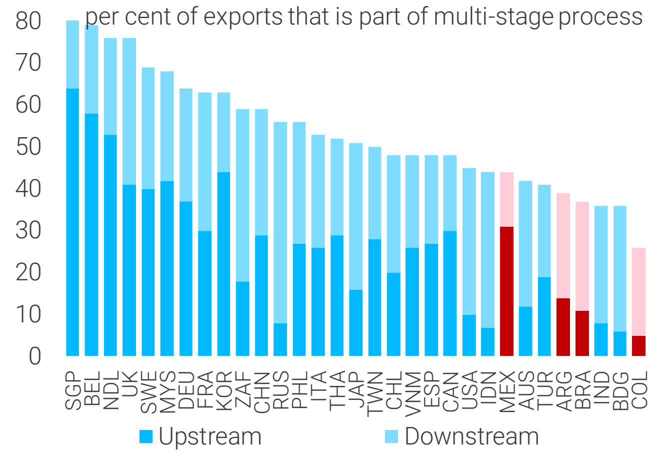
Source: AQR Capital Management, TS Lombard reconfiguration. Notable examples include Vietnam, Indonesia and Taiwan as part of Asia's regional trading bloc, India, and Latam – Mexico, Brazil and Chile – as part of US friendshoring.

Chart 28: Latam wasn't part of globalization story



Source: IMF

Chart 29: Latam not integrated into supply chains



Source: United Nations, TS Lombard

Opportunities in Latam?

One of the most interesting aspects of deglobalization is how it could impact Latin America (via both the commodity channel and the reconfiguration of supply chains). Intraregional trade links have been scarce compared with other parts of the world; and countries like Brazil, Argentina and Mexico were famously "closed" to existing trade networks while suffering competitive losses from the emergence of China. Mexico is a prime example. Following a series of domestic crises during the 1970s and 1980s, Mexico restored its macro stability from the mid-1990s onwards and was even seeing some clear benefits from having joined NAFTA. As John Authers points out, a thriving industry of maquiladoras emerged –assembly plants on the border that would take parts from the US, put them together into final products and send them back again – which acted as a catalyst for growth. But once China joined the WTO, Mexico was priced out of US markets by cheap Chinese labour. Now, Mexico's real GDP per capita has fallen below that of China. A new configuration of global trade would offer an opportunity to reverse these trends – particularly as China's labour is no longer as competitive as it was (Chart 25). US companies, and even their Chinese competitors, are already looking to the cheap and well-connected labour available at the Mexican border. The question is whether the domestic authorities will provide the right set of policies to embrace this opportunity – something that also applies to the broader Latam region.

More generally, our EM specialists think it is helpful to divide the winners into three main groups, depending on the type of exposure they have to the new global trading system. So, for example:

(i) EM critical mineral suppliers: Chile and Peru for copper, Chile and Argentina (perhaps Bolivia) for Lithium, Indonesia for Nickel and South Africa for platinum. Longer term, Brazil could become a big exporter of green hydrogen.

(ii) Critical input suppliers (e.g. semiconductors, pharma): South East Asia and India, but potentially Mexico (with a more investor-friendly administration) and Costa Rica too.

(iii) Other manufacturing gains (from friendshoring): South East Asia, India and Mexico.

Bottom line

Public opinion started to shift against globalization during the second half of the 2010s. Originally this change of attitude was about lost jobs, stagnant real wages and rising inequality. Then, at the start of the pandemic, worries emerged about the resilience of long international supply chains. But the most important shift has undoubtedly been geopolitical, following Russia's invasion of Ukraine, which also exacerbated the strategic rivalry between the US and China. While sceptics like to point to the resilience of global trade as evidence that the whole deglobalization narrative is overblown, we find the evidence less reassuring, particularly when we look through the obvious pandemic distortions (and there is always a lag between trade policy and its impact on the global economy). We see two crucial developments that suggest the deglobalization thesis is very much real and gaining traction. First, the trade restrictions that were implemented before COVID-19 have remained in place and are having a discernible impact on bilateral trade patterns. Second – and seemingly more important – we are seeing the return of strategic industrial policies in what is a clear rejection of the neoliberalism that has set the tone of global macro for much of the past 40 years. Both the US and China are now using strategic industrial policy with a fair amount of success. The US is seeing a clear industrial renaissance ("Bidenomics") and China is making serious inroads into global EV production, mainly at the expense of Europe. It seems inevitable that these sorts of policies will catch on, spreading to other jurisdictions, including the EU. Indeed, we may end up with an all-out (highly protectionist) "subsidy war", which would confirm our long-held view that the global economy has started to fracture. Naturally there is a lot of concern among investors about what this means for financial markets and the economy. But this pessimism seems overdone. We think the global economy will emerge stronger during the 2020s, while deglobalization will also bring new investment opportunities.

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