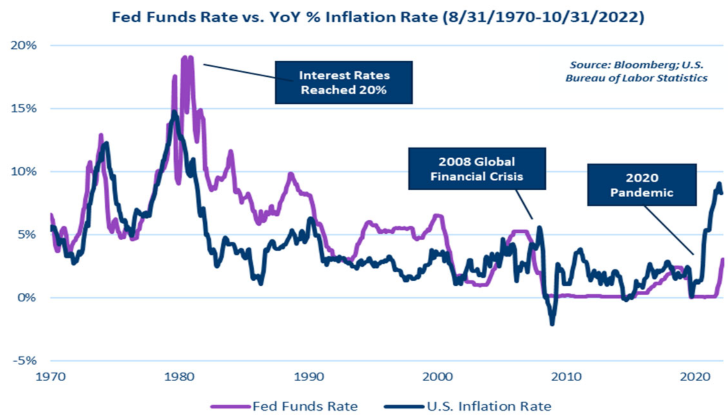
Investing, In A Less Connected World

<u>The "World is Flat" period that has ended</u>

The period described by Thomas Friedman in his 2005 book titled, "The World is Flat", was first initiated by the fall of the Berlin Wall in 1989, signaling the fall of communism and allowing populations from Eastern Europe to join the economic mainstream. It was also marked by a relative lack of geopolitical conflict between national actors as the Cold War thawed over the following years. In its wake, the world witnessed a rise of multiple Emerging Market economies, especially China, which moved to a more export driven economy.

What followed was an unprecedented jump in trade, sometimes referred to as "hyper globalization". From 1989 to 2008, world exports as a share of GDP rose from 19% to 31%, and it seemed that globalization was an unstoppable force (Figure 1). This led to strong global growth combined with a steady decline in interest rates for multiple decades, while inflation was held in check given the inherently disinflationary nature of globalization.

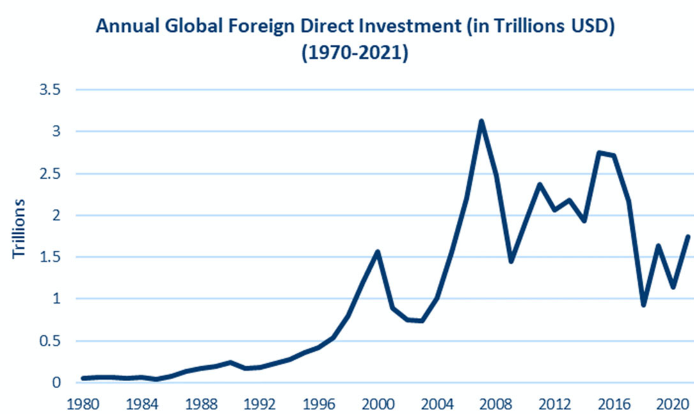
Interest rates and inflation fell gradually for multiple decades (Figure 2), and for investors, this resulted in meaningful appreciation of risk assets of all kinds, particularly equities. Markets generally did not differentiate between high quality and low quality companies (often times it favored the latter) and longer duration investments (those with cash flows expected far in the future) benefitted significantly. There Is No Alternative (TINA) to owning equities was the right strategy. Interest rates were low, bond yields had fallen, and investors were effectively incentivized to pour their money into the stock market, which moved up with historically low levels of volatility. These conditions also promoted a never failing "buy the dip" strategy in which investors could buy any risk asset when its value had fallen, assuming a fast rebound and future profits.



While globalization benefited markets and economies across the world, serious social disruptions began to emerge from this evolution. These included the loss of developed market manufacturing jobs, decreased social mobility, and rising economic inequality due to the concentration of wealth among those holding financial assets around the world.

<u>The New "Less Flat" World</u>

For some time, exports as a share of GDP have flattened and are now seemingly trending lower. Other metrics show similar trends amongst global foreign direct investments (Figure 3), which have also fallen sharply.



The prospect of a "Less Flat" world gained momentum in 2016 with the emergence of nationalism (America First, Brexit) and growing societal discontent within many developed markets. More recently, these trends were further exacerbated by the global pandemic, which introduced a need to re-evaluate global supply chains, particularly those that originate in increasingly "unfriendly" places. Supply chains are now more likely to move onshore or into friendly regional blocs. This is not only driven by the disruption witnessed throughout the pandemic, but also by nationalistic trade policies and an increasingly unstable global regulatory environment. As such, one of the key structural drivers of this period of low inflation (globalization reducing costs) is no longer in place.

Central banks have now been put in the position of being a source of market volatility, rather than the dampener they had been in the prior period. They are compelled to aggressively fight inflation through raising policy rates and slowing economies. According to the International Monetary Fund, three quarters of the global institutions the fund tracks have raised interest rates since July 2021. The last time so many major nations abruptly hiked rates was in the 1980s[1]. The fact that so many central banks are now facing off against rapid inflation increases the chance for market dislocations.

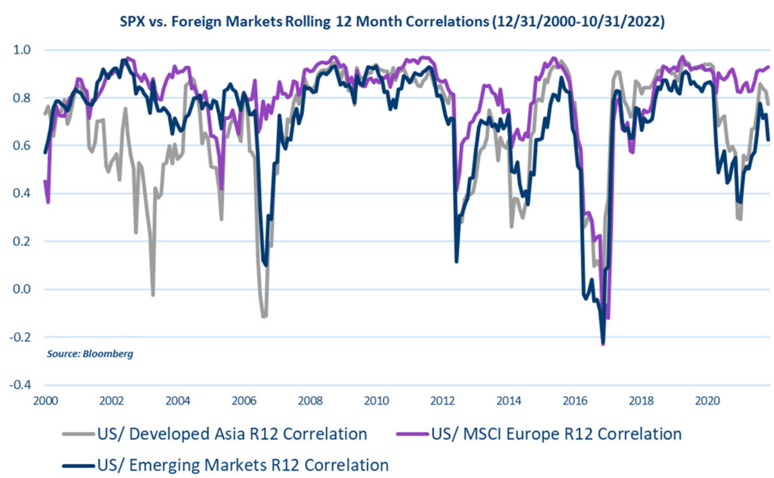
Also, countries are becoming more protectionist on economic policy from a security perspective. Russia's invasion of Ukraine in 2022 represents a material change that is not to be ignored. It has had major impacts on energy and food supplies globally, which is forcing capabilities to be rebuilt elsewhere. The impact of rising Taiwan-China and US-China tensions has significant economic implications and is particularly acute in technology, namely semiconductors, which have become omnipresent in our daily lives. Given the perceived risks associated with relying on Chinese components, these supply chains need to be rebuilt domestically (or at least in "friendly" locales). In many countries, it can be argued that the period of globalization contributed to the polarization of politics. Offshoring of jobs, immigration, and economic policy have become hot button issues around the globe. As such, changes in governmental leadership are more likely to be more frequent, and result in significant policy change, clouding the long-term investment outlook.

<u>Investment Implications</u>

If the world is becoming de-globalized, the benefits of a diversified portfolio may become even more important.

Global Decoupling of Markets Creates International Opportunities

Historically, global markets have moved largely in tandem with shorter periods of lower correlation, only enhanced by years of growing globalization (Figure 4). Today, markets remain reasonably correlated over concerns of a global recession, however looking forward, we see scope for a global decoupling of markets and persistently lower correlation driven by the divergence in economic and monetary policies and rising political risks around the world.

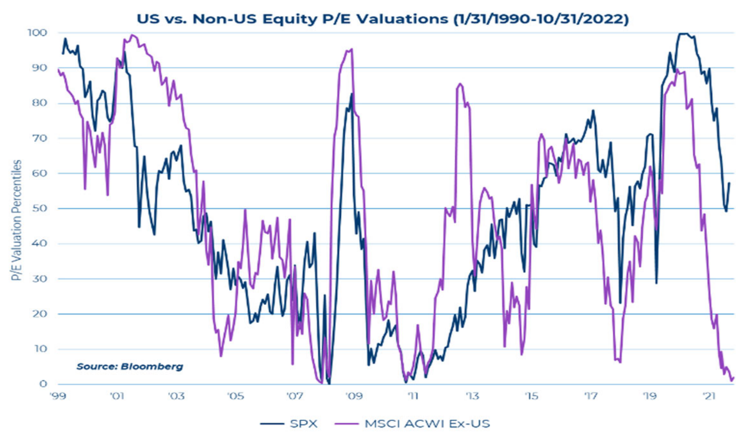


This represents a point in time unlike anything the international community has experienced in decades and creates a unique opportunity for investors to benefit from diversification. In prior years, diversification offered fewer benefits because the broadly rising bull market lifted most assets. In this potentially more fragmented world where some economies are more vulnerable than others (i.e. weaker central banks, higher recession potential, greater external supply chain reliance), diversification can become even more valuable, though it will require close monitoring and a nimble approach.

[1] Jeanna Smialek and Eshe Nelson, "Global Central Banks Ramp up Inflation Fight," The New York Times (The New York Times, July 17, 2022), https://www.nytimes.com/2022/07/17/business/economy/global-central-banks-inflation.html.

The risk of geographic portfolio diversification has always been that each country brings to the table a unique set of political and regulatory challenges. That risk has become increasingly relevant in portfolio decisions given geo-political concerns (i.e. Russia-Ukraine war, US-China tension) and an unstable regulatory environment. With China in particular, we have to re-underwrite the prospects of investing in the region given recent events and the re-election of President Xi. More broadly, manager selection must be focused on teams with an on-the-ground presence to help navigate local dynamics and make them more micro informed. At BBR, we have historically prioritized this dynamic in our search for international managers and have found it both crucial and effective in reducing risk.

Within equities, non-US developed markets are more attractive on both an absolute and relative basis while US large caps remain expensive (Figure 5). For example, we have found compelling investments in Asia where valuations (P/E) are cheaper relative to historical levels and US markets. As of 9/30, the US is trading at a P/E of 17.6x and MSCI Asia Pacific is at 11.1x. We are also finding non-US opportunities in areas such as corporate credit in Europe where spreads are widening and a stressed/distressed opportunity set is quickly developing.



We believe that the political and geopolitical risks associated with investing abroad can be exacerbated when investing in illiquid markets. For that reason, we have historically only invested in the liquid markets of developing countries, including China, because we believe the ability to make manager changes (adds/trims/exits) is key in a less stable, more volatile world.

The Domestic Opportunity

The opportunity, however, is not just limited to international investments. There are also equally compelling opportunities to invest in domestic beneficiaries of this global shift, including U.S. domestic infrastructure and manufacturing. There have already been a number of government policies that have catalyzed domestic investment. President Biden signed a $1trn infrastructure bill into law in November 2021 aimed at a range of public and private infrastructure. Additionally, the Senate passed the $52bn CHIPS Act in 2022 to invest in domestic semiconductor manufacturing.

While the world's economy will remain connected in many respects, it is likely the marginal dollar of investment will be directed to areas that aim to address complex issues that have been exposed over the last few years. This includes solving issues around supply chain concentration and more localized sourcing of key components. We believe trends toward onshoring or nearshoring are on the verge of further acceleration.

This changing perspective has created a wide array of investment opportunities for US managers, especially those focused on sectors such as infrastructure or manufacturing, and generally via less liquid, real assets and private equity funds. For instance, within our private equity strategy, we have managers investing in areas of the market like mid-band spectrum, which is benefitting from exponential growth in mobile broadband services, or the evolution of power infrastructure, which has seen an acceleration in activity driven by public policy (i.e. infrastructure spending bill) and supply dynamics. On the real assets side, we've gotten access to niche investments like barges, specifically vessels covered by the Jones Act of 1920, which requires goods shipped between U.S. ports to be transported on ships that are built, owned, and operated by United States citizens or permanent residents. The positioning of these managers in this changing global environment should set them up well to generate attractive returns for investors.

A Changing Playbook

If in the prior "World is Flat" period investors could successfully buy the dip and generate a profit, this new normal may require a different playbook. Simple exposure to traditional equity was a clear driver of performance in a time of peak globalization, however it can no longer be expected to generate such meaningful contributions in this higher risk environment. Therefore, the concept of There Is No Alternative ("TINA") that dominated markets for over a decade is now potentially being displaced by There Are Real Alternatives ("TARA") to traditional equity.

This changing dynamic towards a TARA driven market lends itself well to the hallmark of BBR's investment approach, which is investing in diversified portfolio of niche focused specialist managers who seek to take advantage of a more volatile market and outperform in the long term.

We turn to alternative investments (both domestically and abroad) that are well positioned to offer equal, if not superior, performance in the medium term. For instance, managers who specialize in stressed and distressed credit are currently operating in an optimal environment for their strategies given the broader market dislocation that has caused extreme spread widening. They offer the potential to generate equity like returns in this type of environment.

Comparable returns to equities can also be achieved by investing in fixed income markets today, but it requires discipline around real returns and risk, both from duration and credit perspectives. We have found it advantageous to invest in managers with the flexibility to allocate across fixed income asset classes depending on the market environment and fluctuate duration/credit risk accordingly. It is possible, perhaps even likely, that fixed income becomes compelling before equities in a scenario where inflation cools down, but we hit an economic and earnings recession.

Conclusion

The world is currently facing a once-in-40 years policy shift, moving from globalization to de-globalization. Viewed carefully, change can reveal opportunity. A de-globalized, less predictable world plays right into what have always been our strengths; comfort with the unconventional and uncorrelated, clear eyed objectivity when navigating storms, rigor rather than emotion in decision making, and uncovering opportunities that others might miss.

Important Disclosure Information