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Capital at risk.

Deglobalisation:

Private markets investing in a diverging world

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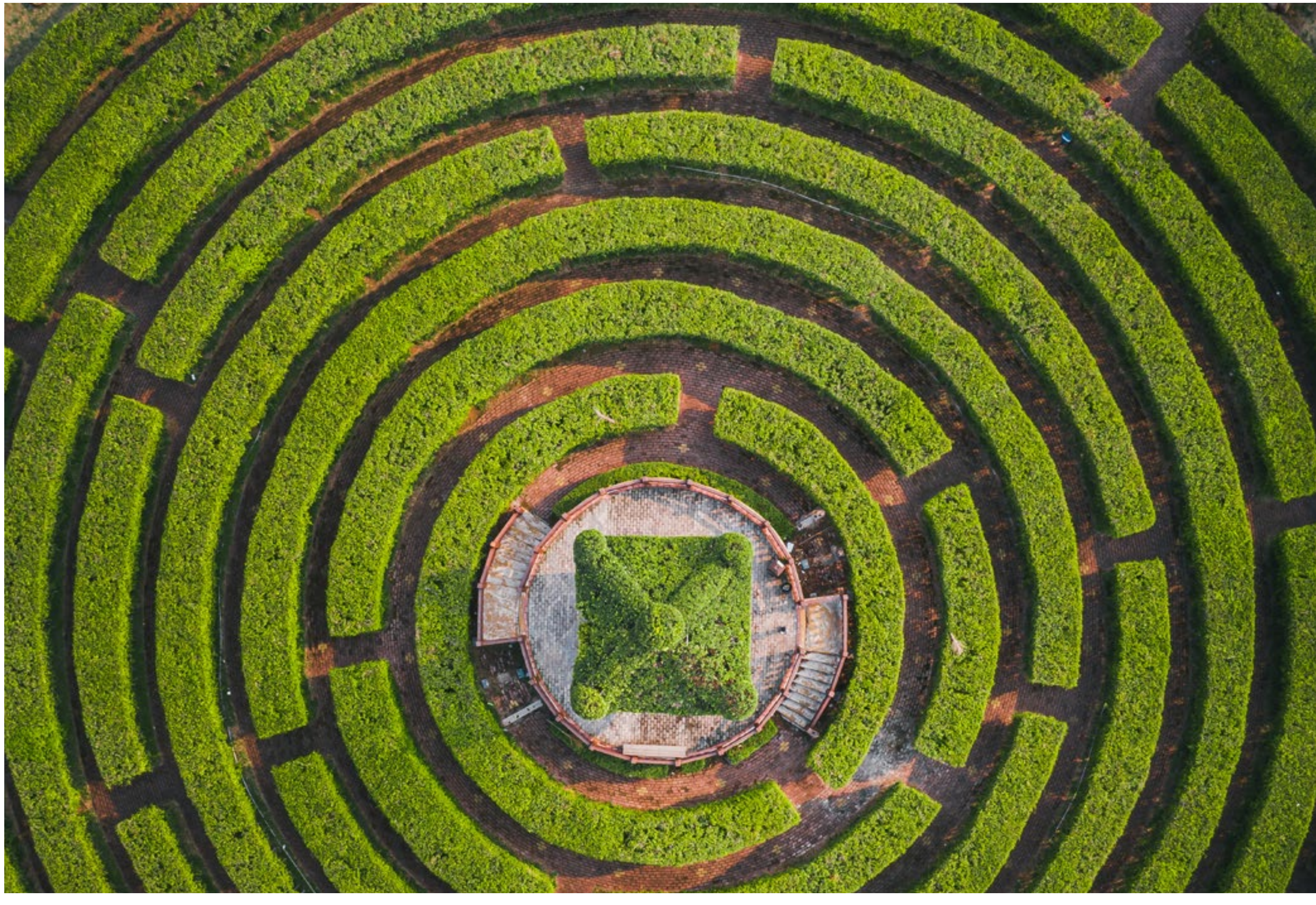


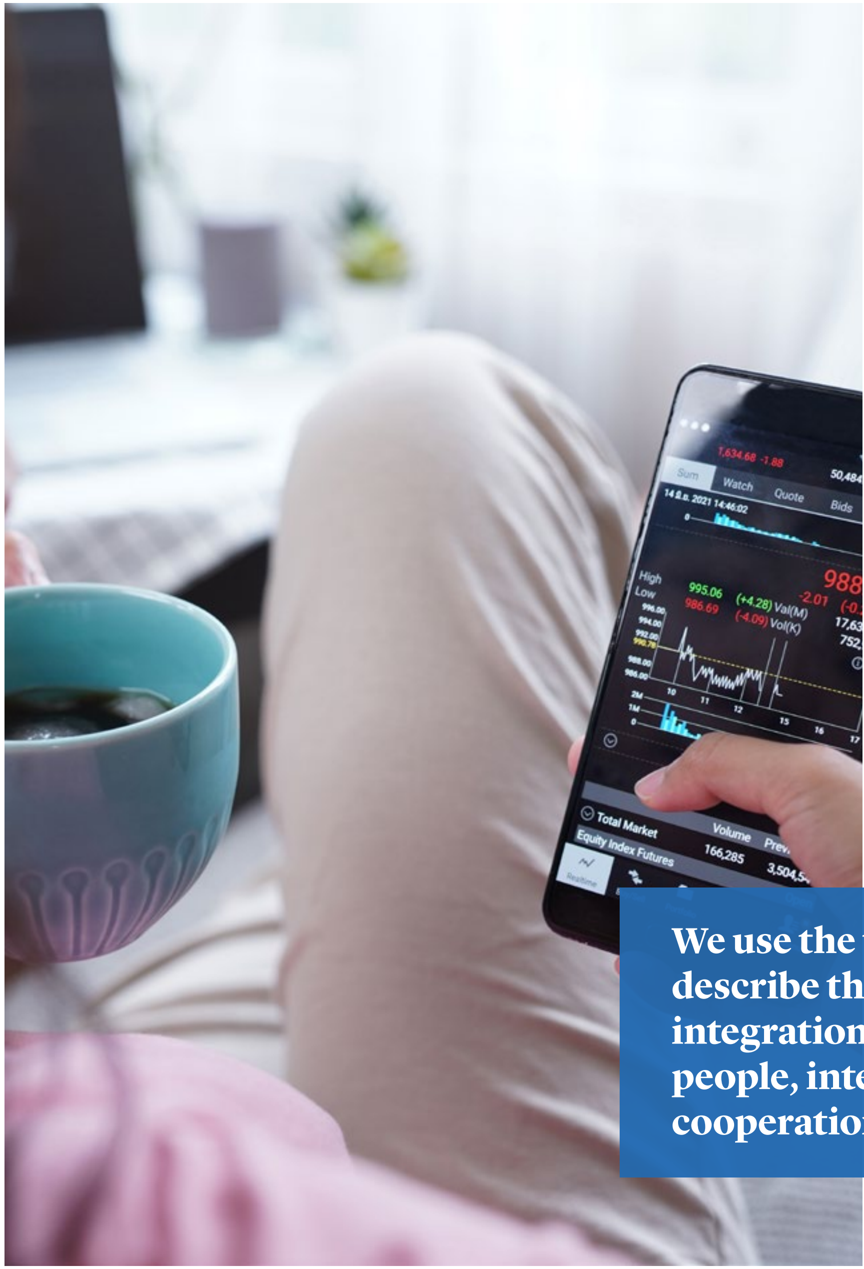
Key Takeaways:

We assess the impact of deglobalisation across private market asset classes, through the lens of goods, resources, capital, people and security.

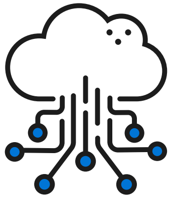
We expect deglobalisation to be inflationary and a headwind for long-term economic growth.

In our view, industrial real estate, domestic manufacturing, consumer non-cyclicals, defence and clean energy are examples of better-positioned sectors, benefiting from structural tailwinds. Consumer cyclicals and sectors reliant on international trade and travel are more at risk.

Investors may wish to assess exposure to deglobalisation risks and, should they see fit, rotate towards better positioned sectors while improving resilience against tail-risk events.



The multi-faceted nature of deglobalisation



In 2024, we published our report on the future of private markets. We identified deglobalisation as one of the four megatrends shaping portfolios (the other three being demographics, digitalisation and decarbonisation).

We use the term 'deglobalisation' to describe the weakening in global integration of trade, capital flows, people, intellectual property and cooperation. It can manifest itself through several channels. Some of the trends emerged recently due to the pandemic and the Russia/Ukraine conflict, the effects of which could fade in the medium term as the world adjusts to a new normal. Others are more entrenched, such as the geopolitical tension between China and the US, which has escalated over the past decade and is unlikely to diminish soon.

There is a huge amount of uncertainty with respect to the direction of travel and magnitude of the various impacts from deglobalisation. Things can also change very quickly, for example if there is new political leadership. Investors would need to consider their conviction on the likely persistence of the different trends and how it aligns with their investment horizon.

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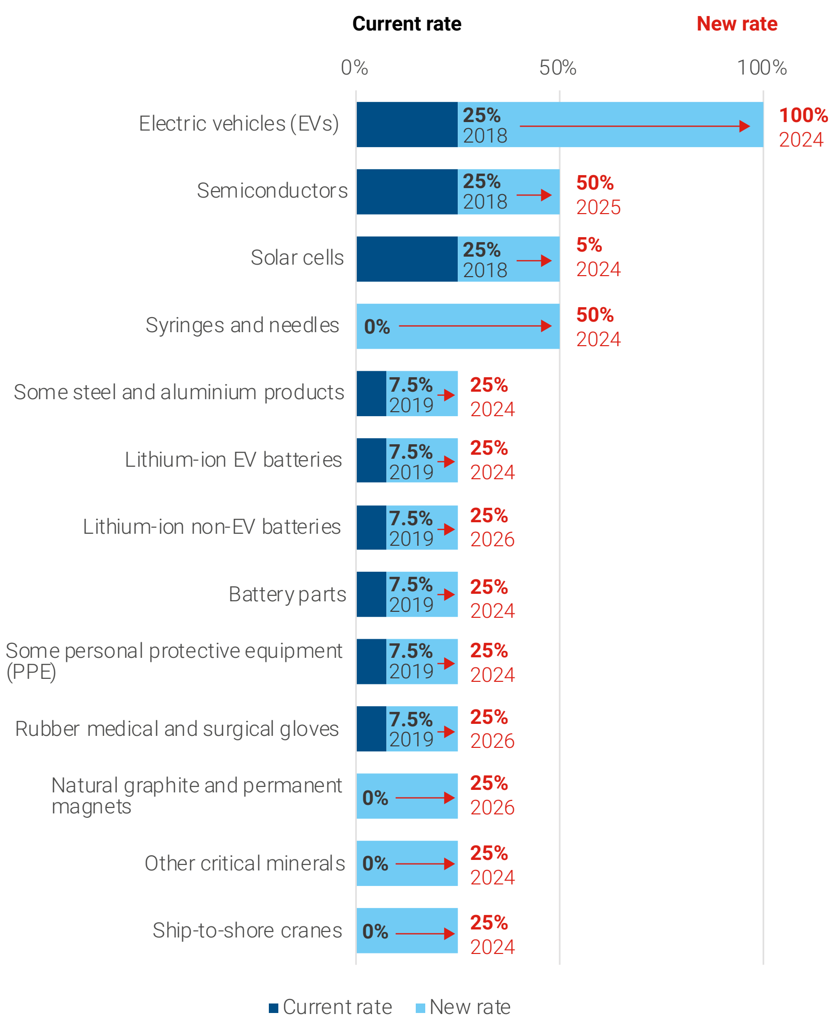
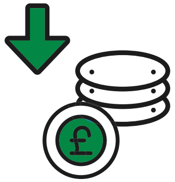
	Trends	Potential impact
Goods	Longer and more complex supply chains	• More on/nearshoring • More storage requirement • Higher costs and longer lead time
	Increasing protectionism	• Higher tariffs for import/export • Reduced global trade and technology transfer • More demand for domestic manufacturing
Resources	Higher and more volatile energy prices	• Accelerates the transition to cheaper renewable energy • But higher costs could also extend the use of cheaper fossil fuels for some time
	Increasing competition for critical minerals and components	• Higher prices, more unstable availability • More European/US investment to compete against China's monopoly
Capital	Greater segmentation of global capital markets Potential declines in cross-border capital flows	• Investment demand and capital flows become more domestically focused • Domiciles with strongest record of capital 'openness' take share of foreign direct investment (FDI) • Greater constraints on FDI from domiciles perceived to be aggressors
People	Restricted movement of people	• Labour shortages and wage pressure • Reduced international travel and tourism spending • Fewer international students • A need to skill domestic populations
Security	Increasing defence spending	• Greater demand for defence manufacturing and cybersecurity capacity
	Geopolitical instability	• Greater risk of conflicts, border closures and shipping disruptions • Friend-shoring • Mitigated in part by safe-haven effects where capital is attracted to physical assets beyond its shores

US tariff on Chinese imports (current and new)



Source: The White House, as at August 2024

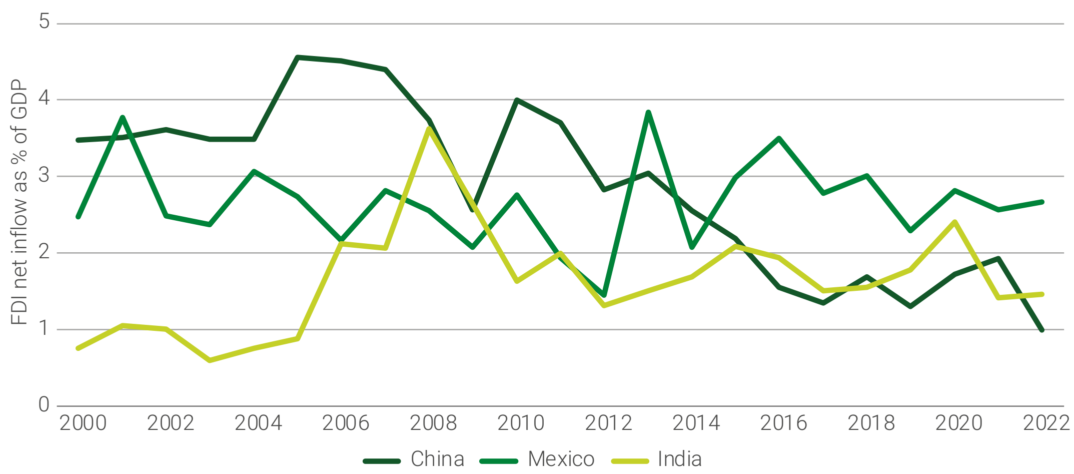
Macro implications:
Higher inflation, slower growth



In general, we believe deglobalisation to be inflationary, which other things being equal would also put upward pressure on interest rates relative to a more integrated global economic system. Economic growth is likely to be more sluggish as a result of weaker consumer demand and more volatile business cycles.

A more restrictive global trading environment will drag on productivity growth because of less global competition and knowledge sharing. Cross-border capital flows could face more barriers, redirecting foreign direct investment (FDI) either back home or towards other countries. An example is the ongoing retreat from China by Western countries, resulting in a notable reduction in FDI net inflow into China over the last 10 years. 'Friend-shoring' may have benefits for certain countries with more constructive foreign policy relationships with the US and Europe, such as Mexico and India, although it could take several years for the impact to feed through to macro data.

Foreign direct investment net inflow as % of GDP in China, Mexico and India



Source: World Bank, as at August 2024

Another aspect of deglobalisation is the push to reduce immigration in the US and Europe. However, recent academic research has shown that new immigrants account for a large proportion of post-pandemic job growth in the US. They also bolstered consumer spending and drove a small increase in GDP.[1] Similar research in Europe showed that there is little evidence of a negative impact on employment over the long term.[2] Developed economies with ageing populations are reliant on immigration. A reduction therefore risks putting more pressure on labour availability and wage inflation.

It goes without saying that any military conflicts or wars will be economically destructive for the countries involved, with knock-on implications for global growth.

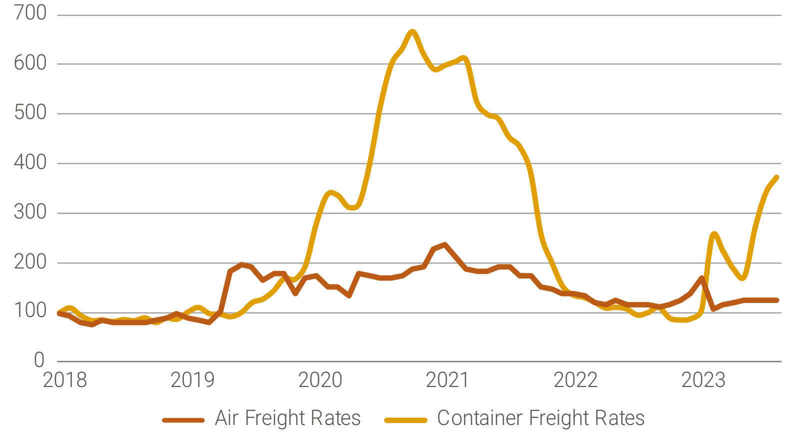
1. Source: The Brookings Institute, "Net immigration estimates help make sense of the pace of the employment", March 2024
2. Source: Deutsche Bundesbank, March 2022

Sector implications:
Real estate

Industrial real estate would be a likely beneficiary from trade frictions. Recent history has shown that where there are frictions in supply chains (such as those caused by Brexit or the pandemic) companies require greater storage as they switch from 'just in time' supply chains to 'just in case'. It would not be clear cut, however, with risk around firms' ability to hire labour and, in a stagflation scenario, cyclically reduced consumer demand for physical goods.

Beyond supply chain frictions, other sources of demand emanating from deglobalisation may come from government initiatives to develop local competitive advantage in specific industries such as electric vehicles, batteries and life sciences and pharmaceuticals, or specific geographic initiatives like freeports. Within industrial, we think logistics would be a main beneficiary – but this is the segment most likely to have the supply elasticity to meet new demand and neutralise rental growth. More niche areas like urban logistics and urban multi-let estates would also benefit, in our view, especially from targeted growth industries. Reducing wage arbitrage, which up until recently has supported the manufacture of goods overseas, may also support domestic demand for manufacturing processes.

Freight price index (December 2018 = 100)



Source: Bloomberg, Drewry Shipping Consultants, as at August 2024

We see further risk for the office sector should flows of talented employees reduce, affecting corporate and city economies as well as wider vibrancy. There could be similar risks for some residential segments in theory, but we feel the scale of undersupply in that sector is so acute that impacts would be limited. The one exception within residential would be student accommodation, where restrictions of overseas students would clearly hit demand. We already recommend that capital deployment into universities and student accommodation is very targeted on the right institutions and locations and deglobalisation risks amplify this message.

Elsewhere, lower tourist flows would affect hotel demand and spending patterns in high streets in tier-one cities, but the effects may be mitigated by greater domestic demand as consumers spend more onshore.

Real estate income styles of long-income inflation-linked leases would become more popular, especially where caps could match higher rates of inflation. Operational styles, despite inherent risks around removing the protection of a lease, could boost investors' income when properly targeted to location, strategy and operator.

In summary, sectors that were best positioned to outperform in a stagflation scenario tended to be those where income can be maintained or grown and this related to supportive supply and demand fundamentals. There would be a similar strategy in a scenario of significant deglobalisation, with some nuances around student accommodation.

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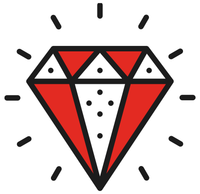
Corporate



In the face of higher inflation and slower growth, strong pricing power and inelastic demand are critical. Such an environment favours non-cyclical and cash generative sectors such as utilities and consumer staples over GDP-sensitive sectors such as consumer discretionary.

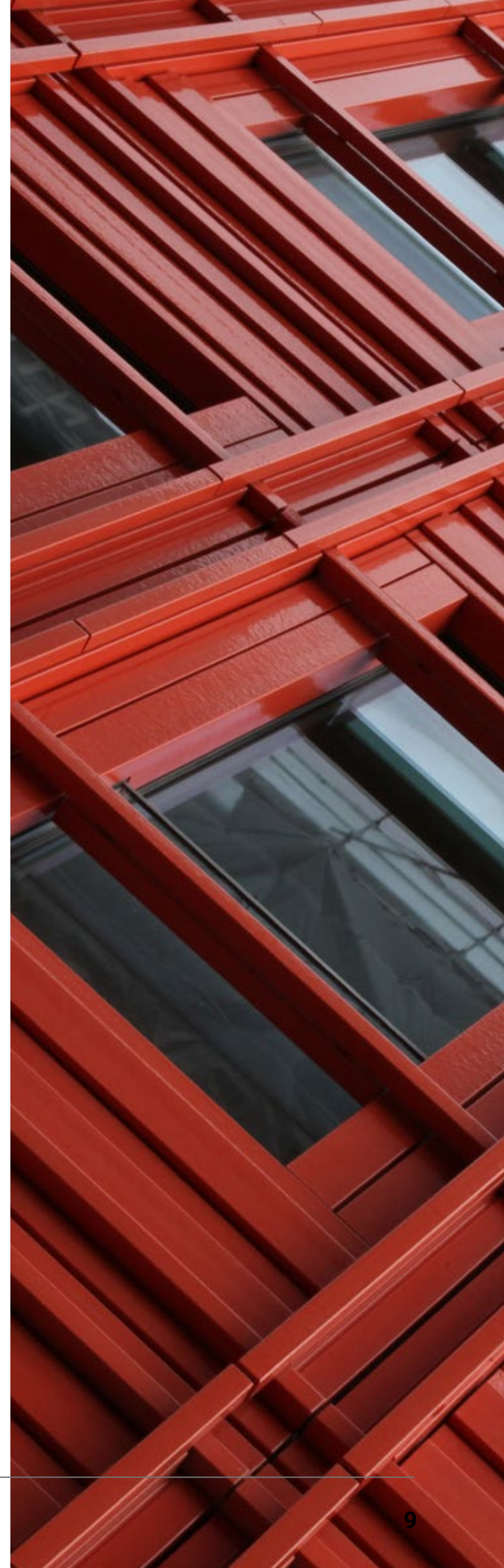
Trade friction and supply chain issues will impact all corporates, the extent of which will depend on business models and the ability to adapt and maintain margins/revenue growth. A less globalised environment is likely to act as a brake on corporate expansion into international markets as it becomes harder to do business and consumers pivot towards local alternatives. This could be a headwind for industries that generate a significant proportion of revenue from overseas markets, such as financials and autos.

Several sectors have supply chain pinch points related to China. Semiconductor manufacturing is a well-publicised example. Taiwan accounts for over 60% of global production[3], so any disruptions related to geopolitical tension could have widespread implications for the technology sector and beyond. China is also the primary producer or processor of critical raw materials used in clean tech, pharmaceuticals and construction materials, among others.

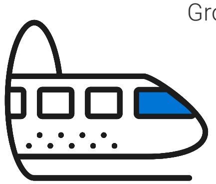
3. Source: Council on Foreign Relations, July 2023

We are likely to see more investment in North America and Europe to reduce such dependence by supporting domestic capacity, new supply chains and new technologies, which can generate investment opportunities. However, this may not be feasible for all industries, so some concentration risk is likely to remain.

Rising geopolitical tension is also expected to benefit defence and technology firms as a result of increased spending. In contrast, higher education, a frequent user of the private credit market, could face a reduction in overseas student numbers. Retail and travel companies reliant on international tourism face a similar risk. We echo comments in the real estate section about being selective in these sectors, focusing on entities that are leading players in their field with resilient demand.



Infrastructure

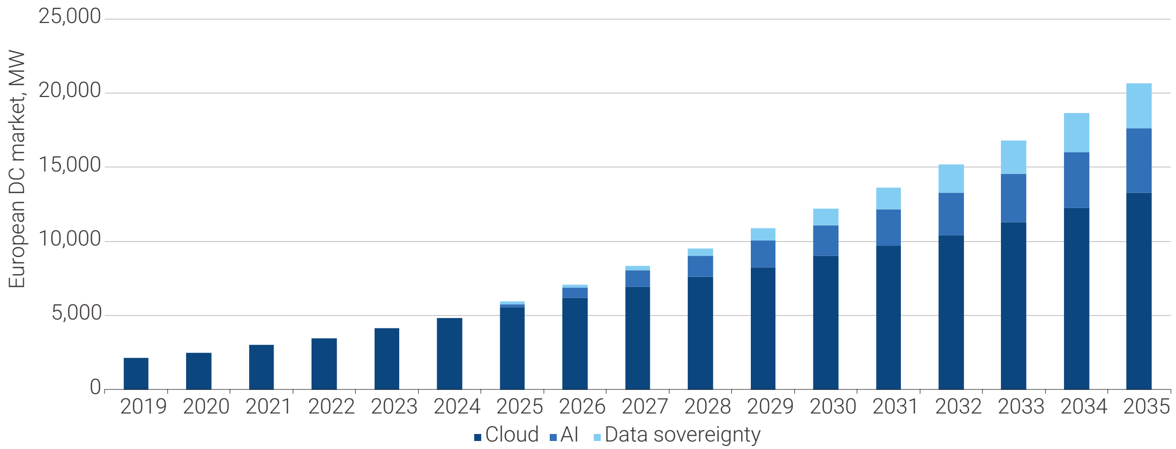


Growth prospects of transport infrastructure assets are inextricably linked to economic growth and the seamless flow of global trade. Such assets would face headwinds in a deglobalising world, where trade, growth and purchasing power decline.

Sensitivity of sub-sectors within transport infrastructure to deglobalisation forces can vary considerably. Adverse impacts may be somewhat dampened by government subsidies and support in segments such as passenger rail transport. Road traffic is likely to be resilient absent a sharp GFC-like contraction in economic growth. Ports and airports would likely be most exposed. Airports in particular are exposed to both global GDP and purchasing power growth, as an increasing proportion of revenues is derived from the retail segment.

Renewable energy is expected to benefit from a favourable regulatory backdrop as governments aim to reduce reliance on imported fossil fuels. Subsidies and expedited planning are the key measures which will support project returns over the coming years. New project development, however, could be hampered by global supply chain disruptions and possible increases in costs.

Data sovereignty to boost data centre demand in the long term



Source: Morgan Stanley Research, as at February 2024

Deglobalisation and security concerns have made data sovereignty a key policy priority for governments across the world, including in the US, EU, Australia and Japan. Data sovereignty usually involves re-localising of data processing to the jurisdictions where the data is collected. For digital infrastructure, this means the demand for data centre assets, and interconnecting infrastructure such as fibre networks, will increase over the coming years. This, together with the increased digitalisation of social and economic life, will provide a tailwind to digital infrastructure assets, in our view.

Spotlight on clean energy

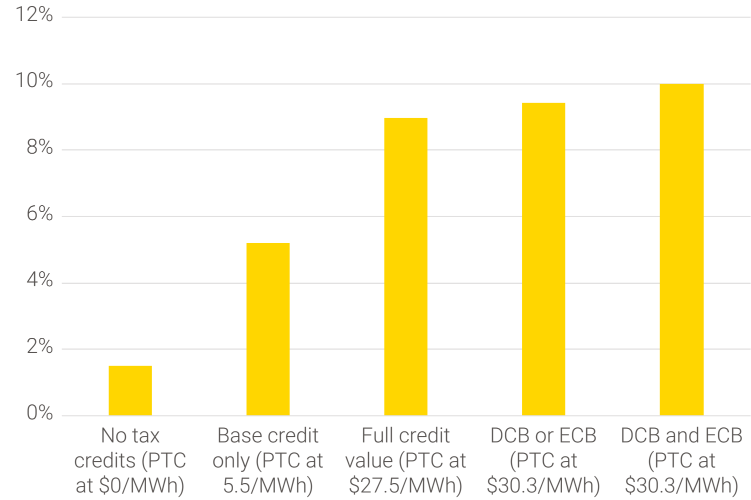
Clean energy infrastructure is at the frontline of global trade tensions and the energy security debate. Large portions of clean energy supply chains are dominated by China, putting clean energy equipment at the centre of ongoing global trade tensions. Meanwhile, the Ukraine war has made governments across the EU cautious about their dependence on fossil fuel imports. Energy security is therefore a top policy priority on both sides of the Atlantic, with subsidy packages available across the value chain, from manufacturing to clean energy generation, hydrogen and EVs.

Project developers and investors stand to benefit, as subsidies boost project economics and returns. In the long term, the cost of locally produced equipment is expected to decline, leading to improved supply chain resilience. However, in the short term, trade tensions and potential supply chain disruptions could affect project development, leading to increased costs and project delays, as many projects depend on China-made equipment and components.

Investors will have to carefully consider the appropriate level of development risk in clean energy portfolios, in our view. While projects in earlier stages of development tend to offer higher returns, the timeline for delivery can span several years, leaving investors exposed to equipment and labour cost fluctuations. Procuring the equipment early on can fix the costs, while sourcing fixed-price offtake agreements provides revenue visibility and can help de-risk project returns.

In conclusion, supportive policy is expected to improve project economics of operational clean energy assets. In light of elevated trade tensions, we believe investors should carefully calibrate exposure to development risk and hedge it appropriately.

Subsidies are crucial to US onshore wind returns



Source: BloombergNEF, as at June 2024
Note: DCB is domestic content bonus, ECB is energy community bonus. PTC is production tax credit. Assumes a partnership flip model for tax equity structure. Does not consider renewable energy certificates and capacity payment revenues. Calculated using BNEF's Energy Project Valuation Model. Assumes project receives a first-year all-in tariff of $37.7 per megawatt-hour, increasing by 2.4% annually for 25 years.

Portfolio implications:
Rotate towards resilience

How should private market investors de-risk their portfolios against deglobalisation? In our view, the initial step should be a review of the portfolio's exposure to the various risks posed by deglobalisation. To be effective this needs to be a granular exercise, potentially down to the asset level, to fully capture the multi-faceted nature of deglobalisation.

The shift to a multipolar world order also leads to changing correlations across markets and divergent policy responses. Investors need to test whether their existing risk and return assumptions still hold. This is likely to have implications for their overall strategic asset allocation as well as sector tilts.

We expect more investors to consider portfolios improving liquidity by pivoting towards either open-ended funds, listed proxies or 'safe haven' private assets that are expected to attract strong demand on the secondary market.

In terms of mitigation, the key is to increase resilience. One defence against stagflation is to rotate towards assets with counter-cyclical and inflation-linked revenue growth. We called out a number of examples earlier in this paper, by no means an exhaustive list. Additionally, floating-rate debt, where interest coupons increase with higher rates, can protect against interest rate sensitivity.

Another consideration is the impact on the underlying cost and availability of capital. Recent experience is a useful precedent in this context where higher rates have made it much harder for GPs and LPs to exit private equity assets and deploy capital when valuations are highly uncertain. We expect more investors to consider improving liquidity by pivoting towards either open-ended funds, listed proxies or 'safe haven' private assets that are expected to attract strong demand on the secondary market, even in adverse macro conditions. Examples include core infrastructure and investment grade private credit.

Ultimately, deglobalisation increases the likelihood of tail-risk events. Stress testing, liquidity planning and diversification will help investors prepare for unforeseen shocks.

It should be noted that diversification is no guarantee against a loss in a declining market. Stress testing does not fully eliminate the risk of investment loss.

Conclusion

We expect deglobalisation to create inflationary pressure and a headwind to economic growth. It is another factor for investors to consider when determining their asset allocation and risk management. At the same time, deglobalisation will also have materially different impacts across geographies, sectors and individual holdings – we believe recognising and incorporating those impacts in portfolio strategy could drive resilience and enhanced risk-adjusted returns in this changing landscape.

Contact us

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Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.

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