The evolving financial landscape – Part 1

Key catalysts for the economy and markets

Image courtesy of Destination NSW.

Overview

The objective of this report

Today, we are releasing Part 1 of a series of papers that delve into the themes that we think will have a pervasive influence on financial markets over the next several years. Our aim is to explore what *could* happen rather than assert what *will* happen, which is more in line with TCorp's mantra to 'prepare not predict'. By understanding the possible paths that lie ahead, we at TCorp can take a more informed approach in our decision-making.

This report replaces our previous '9 things to watch report' that presented forecasts for 9 developments that we thought would exert a decisive influence on the performance of financial markets in the year ahead.

This report will be released in 4 parts, with each instalment highlighting a different economic theme. The four themes we have chosen are:

1. Geopolitics and a multipolar world
2. The energy transition
3. Technology and artificial intelligence
4. Aging populations and immigration

The themes were chosen for their ubiquity and the potential magnitude of their impact. While these themes are presented as distinct ideas, there are likely to be common implications across them. These include:

- Increased global investment
- Higher levels of government debt in advanced economies
- More volatile inflation, and potentially a higher average inflation rate
- Higher government bond yields in advanced economies

We will discuss these implications in more detail in Part 4.

Part 1 – Geopolitics and a multipolar world – Summary

There has been a growing divide between the US and China over the last decade as both countries more forcefully try to exert control over their sphere of influence. While that competition is likely to intensify, the election of President Trump has created more instability in the global order with trade wars injecting additional uncertainty. Meanwhile, creating secure supply chains and increasing defence spending is becoming an even more important driver of economies.

Geopolitics and a multipolar world

In 2014, the economist Mohammed El-Erian wrote a book titled ‘The only game in town’ which argued that central banks and monetary policy had become the key driver of economies and financial markets. But while that may have been accurate then, times have changed. Not only is monetary policy *not* ‘the only game in town’, it is arguably no longer the most important game, with the emergence of geopolitics a key factor with which investors must now contend.

While this issue has received more attention since the inauguration of President Trump, it has played an increasingly important role in financial markets over past decade. The trigger was the rise of the Chinese economy and the Chinese Government’s determination to leverage their development model and create their own ‘sphere of influence’. As US policymakers perceived that China’s goals conflicted with their own, and that the US economy had become overly dependent on Chinese supply chains, the seeds were sown for geopolitical tension.

Friend-shoring and global supply chains

In response to the China risk, the US progressively introduced policies designed to reduce their exposure to the Chinese economy, limit China’s access to sensitive technologies and develop more reliable and robust supply chains. After an extended period where companies in the Western Hemisphere ‘offshored’ production to cheaper regions in Asia or Eastern Europe, now the talk is about ‘on-shoring’ production by returning manufacturing to the US or ‘friendshoring’ which involves shifting production to countries that accept US geopolitical leadership.

This motivation drove two key policies from President Biden: the CHIPS Act and the Inflation Reduction Act. The first policy provided support for firms to invest in high-tech manufacturing, such as semi-conductors, while the latter policy provided subsidies for industries that would assist in the transition to Net Zero, such as solar panels. While these policies were justified as fiscal stimulus to support the US economy during the pandemic, they were clearly designed to drive a structural change in the economy itself.

While the US led the way on rebooting its economy, other countries and regions are increasingly following this path. The Australian Government announced its ‘A Future Made in Australia’ policy which echoes what the US has done, although on a much smaller scale. In Europe, Mario Draghi released a report into European competitiveness which argued that European governments must take a much more activist role in stimulating investment (through government intervention and deregulation) or accept much lower living standards and irrelevancy.

Tariffs and protectionism

Obviously, these developments pre-date the re-election of President Trump. That said, geopolitics has become even more relevant since his inauguration. Alongside the trend towards onshoring, President Trump’s protectionist policies are particularly notable. While some analysts debate whether Trump views tariffs as a useful bargaining chip to extract concessions from trading partners, an easy way to raise revenue and reduce the budget deficit or if he really does believe that tariffs will underpin a renaissance in US manufacturing, the one thing he has been consistent on is his argument that companies can avoid tariffs by producing their goods in the US.

Of course, there is no evidence that tariffs are an effective way to develop an efficient, productive manufacturing capability. They will, however, tend to reduce trade and cross border investment, particularly if US trading partners raise their own tariffs in response to the US actions, as Canada and the EU have done.

This is a demonstrably different world than the one existing in the 1990s and early 2000s with mixed implications for companies. In this new world, having an absolute or competitive advantage will be less influential in economic policymaking. Some firms might benefit from government policies and subsidies while others will be adversely affected by higher costs and weaker demand for their goods. Either way, geopolitics will play a key role when they are considering where to invest and *if* they should invest.

Conflict and military spending

The influence of geopolitics, however, goes well beyond the impact on trade and investment and extends to issues such as the risk of armed conflict and defence spending. Countries enjoyed a 'peace dividend' after the fall of the Berlin Wall as defence spending in Western economies halved as a share of GDP and has remained low by historical standards. Now, countries are experiencing a 'security surcharge' as nations including Japan, Australia and Germany boost defence spending substantially. This will be a boon to firms that make weapons and armaments. But the increased spending is likely to be sufficiently large that it will affect broader economic activity in the regions where it takes place. This includes the retooling of some industrial production to defence.

Military conflicts can also affect labour markets, inflation and investment. For example, after Russia invaded Ukraine, it is estimated that 6.6 million Ukranians became refugees in neighbouring countries which had notable impacts on housing and labour supply of host countries.

The Russian invasion also highlighted how economic sanctions can affect investors and companies. Investors will be cautious about investing in countries that could potentially be sanctioned in future. And those countries at risk of being sanctioned will avoid investing in markets and territories that could impose sanctions.

The Ukraine war also highlighted how military conflicts can disrupt supply chains and lead to bouts of inflation. With Europe reliant on Russian gas, the sudden cessation of that supply resulted in sharp rises in the price of LNG and alternative energy sources such as coal. This delivered windfall profits to the countries and companies producing these commodities at the expense of the firms and households that consume them. Surging energy prices was, of course, unpopular with households and many governments felt compelled to provide cost of living relief which worsened their budget position.

On the other hand, many sovereign wealth funds benefit from higher energy prices which provided an additional inflow of funds into financial markets during that period.

Financial repression

Another implication for investors is understanding how government will finance increased defence spending. The impact on the economy and financial markets will be very different if taxes rise, other areas of spending are cut or if governments simply run larger budget deficits. Historically, periods of military conflict have been associated with large rises in government indebtedness. And the recent decision of the new German government to effectively abandon its 'debt brake' (which limited the rise in German debt) suggests that larger budget deficits might accompany increased defence spending.

The problem for many governments around the world is that debt levels are already very high. So far, investors have been willing to fund those large deficits at moderate bond yields. But will they continue to do so. And, if they do, at what price?

These questions are critical because with government debt levels so high even a relatively moderate further increase in bond yields could quickly make a government's fiscal position unsustainable. This is the so-called 'government debt doom loop' in which investors demand higher bond yields to compensate them for the risk that they won't be repaid. But those higher bond yields make the country's fiscal position even less sustainable.

If private investors aren't willing to fund a government's budget deficit, then a government may compel them to do so. In the past, governments have put caps on interest rates, imposed capital controls and directed bank lending. This is usually referred to as 'financial repression' and, while it is not a sustainable solution to lax fiscal policy, it can provide a temporary reprieve while the government gets its fiscal house in order.

Patriotic investing

While we generally think of financial repression as affecting bond market investors (since they receive a lower return than they would in a free market) other investors could also be affected. Rather than simply compel investors to buy bonds to fund the government's spending priorities, the government could instruct private institutions to undertake the spending that the government identifies as necessary.

US Treasury Secretary Scott Bessent has said that he plans to 're-privatize' the US economy and while it's not clear what that means precisely, one interpretation could be that something that is currently been paid for by the government – such as childcare – becomes the responsibility of the private sector.

While Western governments haven't taken that extreme step yet, there are several examples where governments are taking a more interventionist stance in directing where investment goes. In the US, the aforementioned CHIPS and Inflation Reduction Acts were clear examples. More recently, the Trump administration has indicated that they want to reinvigorate US shipbuilding. To do that, they have proposed taxing Chinese shipping and subsidizing US investment.

The 'Future Made in Australia' is another example of a government indicating and facilitating where investment should occur. Treasurer Jim Chalmers also directed the Future Fund to invest in housing and renewables and said that superannuation savings can and should play a role in supplying capital to 'megatrends' that will reshape the Australian economy.

This is also part of a trend towards more nationalistic investing. In the UK, for example, the government wants pension funds to commit 10% of their assets to listed and unlisted British equities. The President of the European Commission Ursula von der Leyen wants to borrow €150 billion to boost defence spending but argued that "these loans should finance purchases from European producers to help boost our own defence industry". There has also been increasing acceptance of the idea that investing in defence companies is – or can be – compatible with ESG considerations.

Less trade, less cross-border investment, less need for an international reserve currency?

One reason that the US is less likely to experience a debt crisis despite its very high level of debt is the US dollar's role as the international reserve currency. Because so much of global trade is priced in US dollars, importing firms need to hold US dollars even if they are not trading with the US. And exporters will receive US dollars even if they aren't located there. With so much trade conducted in US dollars it also makes sense for countries to hold their foreign exchange reserves in US dollars. According to the IMF around 57% of global foreign exchange reserves are in US dollars, and this helps fund the US budget deficit.

It is also worth noting that when trade grows faster than overall global economic activity – as it did during the 1990s and early 2000s – the demand for US dollars also grows rapidly.

In a multipolar world, however, with geopolitical rivalry and the threat of military conflict some analysts question whether the US dollar will remain the reserve currency. And certainly countries such as China and Russia have encouraged that speculation. While we don't think there is a viable alternative to the US dollar it is interesting to ponder how the US dollar's role may evolve if the world continues to follow down the path of more protectionism, less trade and increasing self-sufficiency. With less trade and less cross-border investment there would be less demand for the US dollar. So even though the US dollar might remain the world's reserve currency, the 'exorbitant privilege' that it bestows may recede to become a 'moderate benefit'.

A more isolationist US economy could also have significant implications for its stock market. Around 40% of US company revenue comes from offshore and for the big tech companies it is more than 50%. If other countries begin to favour 'local heroes' this could be a headwind for US earnings growth. So far this year, we have already seen US defence stocks lagging, while European counterparts have surged. US stocks also account for more than 60% of global stock market capitalisation. If the marginal global investor simply reduces the proportion of their incremental fund inflows that they allocate to the US it would also be a headwind for US stocks. And if they actually reduced their exposure to US assets the impact would be far greater.

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