



Globalization Backlash Is Nowhere to Be Seen in Financial Markets

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Following the news these days, it is easy to conclude that the world — or at least the liberal, internationalist consensus that has steered the global economy for a generation — is falling apart. One U.S. presidential candidate, Republican Donald Trump, threatens all-out trade war with China and other economic partners. His opponent, Democrat Hillary Clinton, disowns the Trans-Pacific Partnership, a pact she once supported that was supposed to settle the rules of open trade between Asia and the Americas for the 21st century.

Germans demonstrate en masse against the Transatlantic Trade and Investment Partnership, which aims to join the U.S. and the European Union in a vast, free economic zone. Their Economics minister, Sigmar Gabriel, pronounces the “de facto failure” of years of talks on the TTIP. International trade volumes, meanwhile, are lagging global economic growth after decades of exceeding it.

U.K. voters’ shock decision in June to leave the EU threatens, at a minimum, the future of London’s global financial center. With 80 percent of Europeans heading to national polls over the next two years, Brexit copycats seem a distinct possibility. Marine Le Pen, a leading candidate for the French presidency in next year’s election, has promised a so-called Frexit referendum if she wins.

Economic diplomats like Susan Schwab, who served as U.S. trade representative under president George W. Bush, perceive a war on progress that progress may well lose. “I

have never seen it this bad,” says Schwab, who now teaches at the University of Maryland. “The mood is not just antitrade, it’s antibusiness. The solutions being articulated will hurt small business as much or more than multinational corporations.”

But the world looks very different to investors like John Reinsberg, deputy chairman of New York–based Lazard Asset Management, which manages \$174 billion. He sees money speeding around the globe like never before as market barriers relax, and digital innovations from 3-D printing to online education spreading heedless of national borders.

Reinsberg marshals considerable beyond-the-headlines evidence for his point of view: The percentage of home country equities held by the average portfolio manager in Group of Seven (G-7) countries slid from 65 percent in 1998 to 43 percent last year. (For managers in EU countries, the entire 28-nation bloc counts as the home market.) Global investors have doubled their holdings of emerging-markets corporate debt since 2008, to \$1.7 trillion, according to the Bank for International Settlements (BIS). The developing world increasingly is returning the favor: Asia was the fastest-growing region for asset management in 2015, with a 10 percent rise, and a good part of that sum will likely head West. China was a net exporter of portfolio investment for the first time in the first half of 2015, to the tune of \$57.2 billion, according to the People’s Bank of China.

Corporations also seem to have missed the memo that globalization is stalling. Foreign direct investment worldwide leaped by 38 percent last year, to \$1.8 trillion, nearly matching the record set in the feverish year of 2007, according to the United Nations Conference on Trade and Development. The U.N. agency predicts a 10 to 15 percent decline this year, followed by a rebound in 2017, driven in part by a string of huge announced cross-border acquisitions, such as German Bayer’s purchase of U.S. chemicals giant Monsanto Co. for \$66 billion, China National Chemical Corp.’s \$43 billion tie-up with Monsanto’s Swiss rival Syngenta, and Japan-based SoftBank Group Corp.’s \$32 billion acquisition of ARM Holdings, a U.K. semiconductor design company. “Financial globalization is alive and well,” Reinsberg concludes. “The U.S. and Europe drawing inward is more a political than an economic, phenomenon.”

Other large institutional asset managers seem to agree, diversifying their investments

globally and paying little heed to the political front page. The California State Teachers' Retirement System (CalSTRS), the second-largest U.S. pension fund, continues to push a "globalization megatheme" that aims to lift the non-U.S. weight of its \$193 billion in assets to 19 percent from 9 percent, chief investment officer Christopher Ailman reports. "Globalization is a trend that can't be stopped," he says. "The U.K. suddenly woke up after Brexit and realized they need international trade or they wouldn't have strawberries for Wimbledon."

The \$171 billion Ontario Teachers' Pension Plan is likewise trending global, says Wayne Kozun, who heads public equity investment there. Toronto-based OTPP has opened two offices in Asia since 2008 and is expanding its London operation to reduce its dependence on the North American market. "The U.S. has done well, but long-term we're looking for diversification," Kozun says. "Globally, we sort of expect things to muddle along for the time being."

Very rich individuals are also looking to diversify globally, says Alexandre Monnier, president of the Family Office Exchange in Chicago. Annual surveys of his 360 members, mostly U.S.-based families with a median net worth of \$500 million, show international portfolio holdings rising steadily since 2008 to an average of 13 percent. He sees no evidence of this year's political events altering that trend.

A pessimist might note that financial internationalism also seemed robust on the verge of past catastrophes — in 1914 and 1929, not to mention 2008. But the sangfroid of long-term institutional investors stems from a different calculus from that of political scientists. The political news is dominated by a swath of the electorate in advanced economies that blames global business competition for lost jobs and stagnating wages, and global immigration for reduced social cohesion. That backlash is particularly noteworthy because it stretches across established left-right ideological lines and is advancing most dramatically in the traditional bastions of free-market capitalism, the U.S. and the U.K.

Investors' default assumption is that the neo-nationalist revolt will fall short politically or quickly moderate its program if it wins — even if such a softening hasn't yet been seen in post-Brexit Britain. But they also focus on what has escaped the ire of the

antiglobalization crowd: investment and transnational capital flows.

A telling example comes from Jacques Gordon, Chicago-based chief of research at global real estate firm LaSalle Investment Management. In 1989, Japan's Mitsubishi Corp. caused an uproar by purchasing a majority stake in New York's iconic Rockefeller Center, sparking fears that Japan Inc. would buy up much of the U.S.'s prime real estate. Today the ownership of the Waldorf Astoria hotel by a Chinese business, Anbang Insurance Group Co., seems to bother no one (except, perhaps, the White House travel office, which no longer books the president at the hotel). "The mayor of New York is thrilled with this investment, and other cities react in the same way," Gordon says. "They're not putting people out of work, and they are creating tax revenue."

Fast-growing emerging-markets economies, led by China and India, also seem to be on a long-term trajectory toward greater investment openness, equating foreign capital with job creation. In February the People's Bank of China announced it was scrapping quotas and would allow most non-Chinese institutions to invest in a domestic bond market worth some 35 trillion yuan (\$5.25 trillion). "Probably the most significant progress in the past few years has been China opening its equity, bond, and capital markets to foreign investment," says Mark Mobius, executive chairman of Templeton Emerging Markets Group. "The trend will certainly continue."

Dig deeper, though, and financial globalization is fueled by anxiety as well as optimism. One reason to spread capital around the globe is as a hedge against wrenching turns like Brexit in once-trusted national markets, Gordon says. "The best approach now is to be in eight, ten, or a dozen countries," he says. "When the demand picture for London offices changes, you can't move your building to Paris or Frankfurt, where it might be needed."

Danish state pension fund ATP, with some 800 billion kroner (\$118 billion) under management, has piled into U.S. government bonds because it no longer trusts the sovereign credit of Denmark's Southern European neighbors — or even France. "Before the euro crisis France was a key part of our holdings," says chief executive Carsten Stendevad. "Now only Germany and Denmark have that status in Europe."

The cross-border merger wave may also reflect acquirers' fears of constrained exports to the target company's market. "Multinationals can afford to go anywhere, and the absence of new trade agreements means they will," says former trade representative Schwab. "Actual exporters are increasingly small and medium-size companies."

Above all, financial globalization is driven by enormous pools of capital scouring the globe for returns that might match their obligations to stakeholders and investors. With core holdings of U.S. Treasuries or Bunds delivering derisory or even negative rates of interest thanks to low-rate policies and quantitative easing (QE), institutional investors are far more focused on the scramble for yield than on Trump or Le Pen. "The minute an Australian toll road goes on the market, every pension fund in the world is bidding on the thing," says Michael Drexler, head of investor industries at the New York office of the World Economic Forum (WEF). "You have \$30 trillion to \$50 trillion in pension and insurance capital available for infrastructure alone."

The feverish search for yield entails risks no less serious than stalled trade integration. With spreads falling sharply on high-yield bonds, for instance, investors may not be getting compensated for the credit risks they are assuming, creating the potential for big losses if the economy takes a downturn. And any tightening in today's ultraloose central bank policies could send investors running for the exits, driving interest rates up and bond prices down. The eventual fallout could make Brexit look like a small local problem. "What we really worry about is interest rates," ATP's Stendevad says. "You can wipe out a pension fund with the wrong scenarios on rates."

Politics on both sides of the Atlantic could further complicate central bankers' already thorny dilemma of how to wean the world off the monetary drip feed, financiers fret. Trump has included Federal Reserve chair Janet Yellen on his long list of forces keeping America from being great, accusing her of keeping interest rates near record lows for political reasons. Pressure on the European Central Bank comes from a different quarter: elements of the German establishment that grumble persistently about the ECB's cheap money. "A big part of our risk scenario is political developments in Europe that could undermine ECB credibility," says Salman Ahmed, chief investment strategist overseeing \$48 billion (\$49 billion) at Lombard Odier Investment Managers in London. "We know

the Bundesbank is not on board with QE policy.”

International financiers’ second-biggest worry, after monetary policy, is China. Trump and other Western populists paint China as an all-powerful bête noire that destroys other countries’ industries with an artificially depressed currency. Schwab and the Washington establishment see China as a rival scheming to warp international trade rules as the U.S. retreats. “If the U.S. loses its position as world leader, China will step forward with a very different agenda,” says Caroline Freund, a senior fellow at the Peterson Institute for International Economics in Washington. “Theirs will be based on big Chinese-financed infrastructure projects around the world, which U.S. suppliers may be largely left out of.”

Investors have little choice but to hope for China’s continued success, though. Since 2008 the country has become a much bigger if less reliable cog in the fitfully running global economic machine. Beijing did the world an enormous favor by putting its economy into overdrive while the Great Recession shrank demand elsewhere. Since 2007, China has accounted for a remarkable 60 percent of the growth in the world’s nominal gross domestic product, says Eswar Prasad, a professor of economics at Cornell University and a former director of the International Monetary Fund’s China department. But the price was a quadrupling of public and private sector debt, to \$28 trillion, or nearly three times Chinese GDP, according to the McKinsey Global Institute.

Financial globalization is drawing strength from another consequence of the financial crisis: the retreat of global banking and its replacement by bond markets that spread capital more abundantly but perhaps less expertly and that are prone to big swings in sentiment. The quantity of international bank loans has remained flat since 2007 at some \$30 trillion even as the world economy has expanded by 28 percent, to \$73.5 trillion in 2015, according to data from the BIS and the World Bank. U.S. and European regulations requiring more capital and separate capitalization of each national bank subsidiary are largely responsible, WEF’s Drexler says. “It’s a very sound principle, but it’s caused some retrenchment in banking strategy,” he explains. “Barclays decided Asia is not worth it to them, for instance.”

Portfolio investors have jumped into the breach, increasing their international holdings by

more than \$5 trillion, [according to the World Bank](#). Years ago faraway bond investors moved beyond the marquee, state-supported names of China Inc. to back a slew of developers with thin credit histories and high leverage to the country's volatile property markets, like Future Land Development Holdings and Xinyuan Real Estate Co. High-yield hard currency issues by such companies reached \$67.7 billion last year, according to Thomson Reuters.

China proved last year that you don't have to own its securities to feel ripple effects from its growing pains. The Shanghai A-shares stock market was virtually closed to foreigners when it crashed by 40 percent between June and September 2015. Nonetheless, the S&P 500 index of U.S. stocks slid by 8 percent during the same period. Investors fear that could be just a prelude to a huge debt workout in which global bondholders will be directly exposed. "I'm an optimist relative to those who say China is about to collapse," Cornell's Prasad says. "But it will be very painful and costly to resolve the financial sector's problems."

Back in Europe the possibility of further exits from the EU fold sits surprisingly low on global investors' wall of worry. Brussels' polyglot bureaucracy is far from popular among the bloc's 508 million constituents. A Pew Research Center survey taken on the eve of the Brexit referendum showed a slender 51 percent of Europeans with a positive opinion of their union, against 47 percent with a negative view. But the U.K. vote seems to have enhanced the attraction of the status quo, even among firebrand nationalists like Norbert Hofer, a slight favorite to be elected president of Austria in a rerun election in December. "It would undoubtedly damage Austria if it were to leave the EU," he told newspaper *Die Presse* in July. "I have been annoyed for days about these insinuations."

A post-Brexit survey in Italy found voters there would choose to remain in the EU by 66 percent to 26 percent. Denmark, Finland, and Sweden all saw double-digit increases in EU support in polls taken in July. "Other member states saw what the U.K. lost in a few hours after Brexit, and now the polls are quite positive for the EU," says Robin Huguenot-Noël, a policy analyst at the European Policy Center in Brussels. Although British stocks rebounded quickly from their postreferendum plunge, with the FTSE 100 index closing 10.1 percent above its prereferendum close on October 13, the pound has dropped by

18 percent against the dollar and by 15.2 percent against the euro, and the City of London's future hangs on what promise to be tough negotiations with Brussels about access to the EU single market.

France's Le Pen is the most dangerous immediate threat to the continental European order. Her popular support appears stuck at about 30 percent, enough to push her into the runoff phase in the election next May but far from enough to win. In the Netherlands, Freedom Party leader Geert Wilders promises a "Nexit" poll if his party wins power. (He also wants to close all the country's mosques and ban the Koran.) But polls show the Freedom Party limited to 30 to 40 seats in the 150-member Dutch Parliament. The upstart anti-immigrant party Alternative for Germany has gathered about 15 percent in public support in the country and shocked the establishment by finishing ahead of the ruling Christian Democratic Union in a September election in Chancellor Angela Merkel's home state of Mecklenburg–West Pomerania. That result cast doubt on Merkel's reelection prospects in national elections slated for next fall. But financiers aren't panicking — for the moment. "The far right is gaining ground but is not in a position to come into power yet," Lombard Odier's Ahmed says.

What concerns investors more is an expected end to the harmony among the world's Big Three central banks: the Fed, the ECB and the Bank of Japan. "Antiglobalization rhetoric doesn't help business confidence, but the really important event is divergence of monetary policy among the G-3 economies," Prasad says.

The banks cut their policy rates to historic lows in the wake of the 2008–'09 crisis and would go on to develop massive bond-buying programs under quantitative easing strategies, with results that are debatable. Lately, their policies have begun to diverge. While the ECB and the BoJ have forged even deeper into unconventional territory by cutting some rates below zero, the relative strength of the U.S. economy prompted the Fed to hike its policy rate by 25 basis points in December 2015, and most analysts are anticipating a second increase next month.

The logical consequence of such a divergence would be continued strength for a dollar that has already climbed by 20 percent, according to the Fed's broad trade-weighted

index, since the central bank began tapering its QE program in January 2014. Rising U.S. rates and dollar strength, in turn, risk spurring fresh turbulence in global markets and a rush by investors back to U.S. assets. Far from undermining financial globalization, however, such a reaction would underscore how deeply intertwined markets are around the world and how financial turmoil can be damaging to underlying economic activity. “If the Fed goes hawkish, the dollar will rocket, which will be very bad for the U.S. and world economy,” says Lombard Odier’s Ahmed.

An even stronger dollar would particularly discourage long-term investment in emerging markets and depress currencies, from the South African rand to the Indian rupee, that have already lost close to half their value against the greenback since 2011, says WEF’s Drexler. “If the currency risk in South Africa is 20 percent a year, it’s hard to market an infrastructure investment that yields 5 percent,” he says.

If the Fed stands pat, it runs the risk of fueling worldwide asset inflation, if not classic U.S. price inflation, and leaving itself with virtually no monetary weapons for the inevitable next recession. “The U.S. has a year to exit lower-for-longer and guide the rest of the world,” Drexler says. “We have had seven years of recovery, weak or not, and history shows us we will have a downturn every seven to ten years.”

The global tilt of giant North American investors like CalSTRS and OTPP reflects, in part, faith that the dollar will revert to its historical mean at some point. But right now the world lacks the tools to get there from here. Some emerging-markets specialists, like Jan Dehn, head of research at Ashmore Group in London, advocate a modern-day version of the 1985 Plaza Accord, in which the U.S., Germany, Japan, France, and the U.K. agreed to take action to reduce the dollar’s value and succeeded in lowering it by 40 percent over the following two years.

But most observers see little prospect of such coordination given Japan’s relative decline over the past three decades and the creation of the euro, which as Greece’s travails painfully underline has fostered economic imbalances inside the single-currency area.

The world’s new economic power, China, is already spending heavily to prop up its

currency (notwithstanding Trump's charges of "currency manipulation" by Beijing). The renminbi has retreated by 11 percent against the dollar since the greenback went on a global tear in 2014, but it stands 30 percent above its level of a decade ago and remains on a long-term strengthening trend on a trade-weighted basis. "The only country you could easily charge with having an undervalued currency is Germany, and that's because they are in a currency union," says the Peterson Institute's Freund.

Cross-border trade and investment tend to be mentioned in the same breath as interlinked elements of globalization, but they have diverged over the past five years or so. Trade volumes have been curtailed by slackening demand for commodities and heavy industrial equipment, largely thanks to China's economic slowdown. Cross-border investment has been given an adrenaline shot by unconventional monetary policies, which have simultaneously flooded markets with liquidity and depressed returns from traditional core bond holdings.

Trade faces a threat from the politics of rage emanating from the working and middle classes in the U.S. and Europe — and from a talented crop of office seekers who have emerged to exploit it. For cross-border investment the key driver is policy: the potential for growing monetary policy divergence among the Fed and other leading central banks, and the largely secret drama of China trying to tame its debt addiction without going cold turkey on growth. Compared with these issues, other factors can seem like small stuff not worth sweating. "We think about black-swan events on a daily basis," says CalSTRS' Ailman. "Internet hacking, terrorism, North Korea, Middle East. On the other hand, they happen every day but don't necessarily move the market."

The financiers' and trade wonks' outlooks overlap at one critical point: We live in a world that is becoming irresistibly more interconnected while policy decisions remain intransigently national. "Trade is fine for economists but difficult for politicians because there is no such thing as a global voter," says Pascal Lamy, former head of the World Trade Organization and now president emeritus of the Jacques Delors Institute, a Paris-based think tank. Forces ranging from ISIS to Trump are inflaming nationalist passions even as each Chinese bankruptcy or utterance from the Fed exerts increasing influence over global financial markets.

The world will have to muddle along with this contradiction. It will be with us for a long time yet. •