Continental Drift

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1. Summary

Economists can no longer ignore geopolitics, yet the implications of a fragmenting macroeconomy are complex and uncertain. Globalisation is not ending, but it is evolving. Economic power is diffusing to Asia and the global south. Conflict, climate risks, and geostrategy are putting the global order under strain. And policy makers are busily pursuing economic statecraft, catalysed by events, politics, and a need to build a more resilient and sustainable economy. A 'continental drift' is underway.

At the heart of the economic machine, aggregate supply conditions have become more hostile. It is a stark contrast to what economists have been used to over the last thirty years. Without a positive offset from technology or good policy, potential growth will fall and inflation will be more volatile. The so-called 'nice' business cycle (i.e. no inflation, consistent expansion) of the 1990s and early 2000s, is at risk of becoming 'vile' (i.e. volatile inflation, limited expansion), reminiscent of the cycles of the 1960s or 1970s. A retro look for the economy might be justified but it won't be costless, and it will have profound implications for investment markets.

2. (De)globalisation facts and fiction

These days, the news seems to be filled with alarming headlines about rising geopolitical risk, economic fragmentation, and deglobalisation. It's not just hype – elevated uncertainty is visible in the data. Google Trends, for example, shows a rising number of attention and internet searches devoted to these topics. Another metric, devised by economists Dario Caldara and Matteo Iacoviello, which tracks newspaper coverage of geopolitical events over time, is on the rise (see figure 1). Meanwhile, in financial markets, the gold price – a typical safe harbour for nervous investors – is among the best performing asset classes in the world in 2024 (see figure 2). That's particularly noteworthy in a market context of rising bond yields and a stronger US dollar; two typical headwinds for the yellow metal.

Figure 1 – Geopolitical risk index elevated

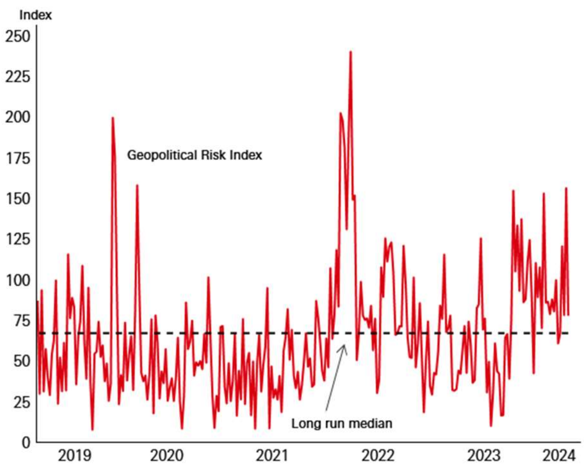
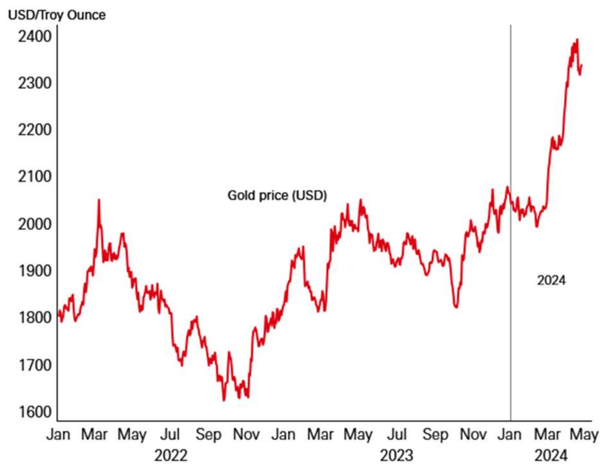


Figure 2 – Gold price strength in 2024



Thought leaders are concerned too. Many analysts see the economy heading for a soft landing at the cyclical horizon. But some are now asking what happens after that. Harvard economist Ken Rogoff suggests the soft landing, *"means little if the runway is in an earthquake zone"* – noting numerous political, geopolitical, and economic challenges ahead. The IMF's Managing Director Kristalina Georgieva speculates that the world is at risk of falling into a *"tepid Twenties"*, driven by a toxic mixture of low productivity and globalisation reversing. While IMF Deputy Director Gita Gopinath – a highly respected economist, and hardly someone for hyperbole – fears the economy is on the brink of Cold War 2.0.

One could be forgiven for worrying that history is repeating. Over a hundred years ago, the great economist John Maynard Keynes penned his famous book, *The Economic Consequences of the Peace*. In it, Keynes noted that, *"internationalisation was nearly complete in practice"*, but worried that there was a complacency about the stability and permanence of the global order. Of course, his fears proved prophetic. Figure 3 shows long run data on the trade share of GDP, sourced from the Macro History Database. Beginning with the First World War, continuing with the stock market crash of 1929, the years of depression and protectionist trade policies through the '30s, and culminating with the Second World War – it was a period of 'reverse globalisation' and economic destruction. And it left scars. It took until the early 1980s for the trade share to fully recover.

Figure 3 – The long run story of the trade share as % of GDP (1870-2021)

The parallels between Keynes' time and today are disturbing. The good news is that there is little evidence that globalisation is in retreat today, despite the current geopolitical turmoil. Figure 4 shows the latest trade trends from April's IMF World Economic Outlook. The time series is consistent with a peaking-out of globalisation - or a 'slowbalisation' as the wags at the 'The Economist' magazine have put it. A flat line in figure 4 means that trade is growing at a similar pace to GDP; hardly a disaster. And this tallies with the analysis from the World Trade Organisation (WTO) in their latest outlook.

Digging deeper, the details of the trade data show a complex pattern. The boffins at the Swiss KOF Institute track a measure of globalisation which combines economic, political and societal data. That also shows that globalisation has recently run out of steam. (see figure 5). Meanwhile, the economist Richard Baldwin notes a discrepancy between data on the trade share of GDP in nominal terms versus in real terms. This seems odd but, Baldwin argues, provides an important clue that while globalisation in goods is declining, globalisation in services remains strong (this effect is due to trade being predominantly in goods, but GDP predominantly in services). What's more, country-specific data points to different trends across nations. Interestingly, the strongest deglobalisation trend, since around 2016, appears to be in China. Overall, the data shows globalisation is evolving, rather than ending.

Figure 4 – IMF data on trade share

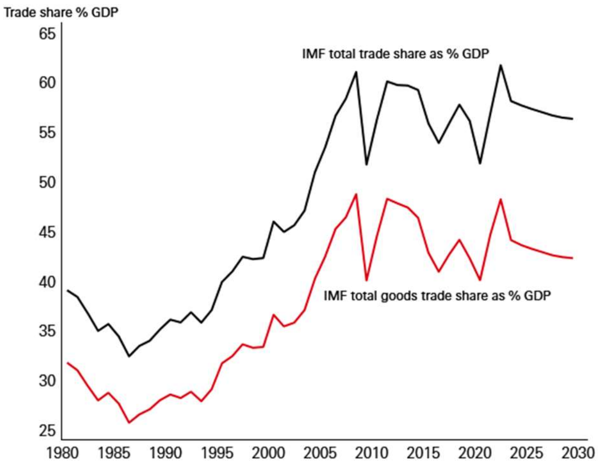
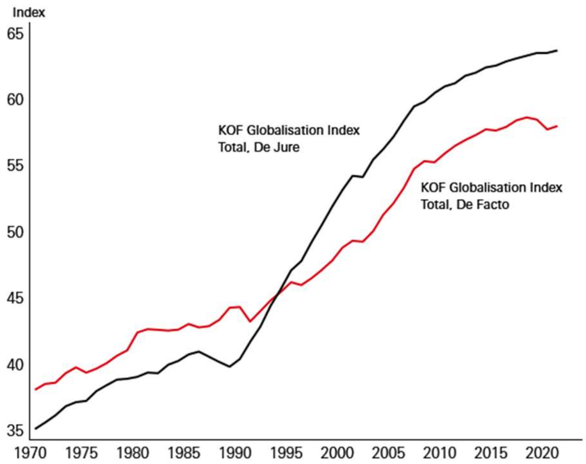


Figure 5 – KOF globalisation indices



Meanwhile, the history of globalisation emphasises the importance of regimes. Indicators like the world trade share (figure 3) or the KOF indicator (figure 5) move in waves, driven by significant world events. Historic upticks in globalisation followed key moments like the fall of the Berlin Wall (early 1990s), or China and India's accession to the WTO (mid 1990s onwards). While the period following the Global Financial crisis (2010s) began a slowing of globalisation, as policies became more inward-looking.

Today, it seems like we are on the verge of another regime change. The pandemic and recent geopolitical events are causing trade patterns to shift again. Recent research from the IMF, for example, has shown that while global trade growth has fallen since the start of war in the Ukraine, trade between economic blocs that are not politically aligned has slowed materially more. If persistent, this politicisation of trade flows will have a structural influence on the workings of the macroeconomy.

3. From convergence to divergence

The world economy is changing. Economic power is diffusing to Asia and the emerging economies. And these changes in the distribution of power are an important, ongoing source of geopolitical tensions. Figure 6 shows how the share of global GDP in the advanced economies is about to be overtaken by emerging nations. And, according to analysis by the IMF, the 10 EM economies in the G20 (Argentina, Brazil, China, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa and Turkiye) now account for 30% of global GDP and 25% of global trade. For as long as growth differentials continue to favour EM and Asia, this trend of changing power dynamics has momentum.

Figure 6 – EMs to overtake G7 GDP by 2027

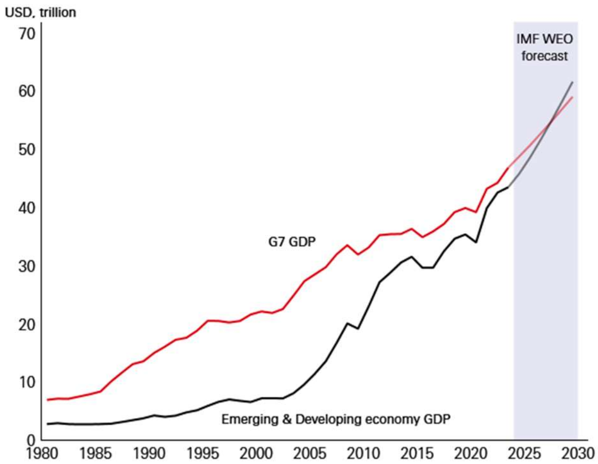
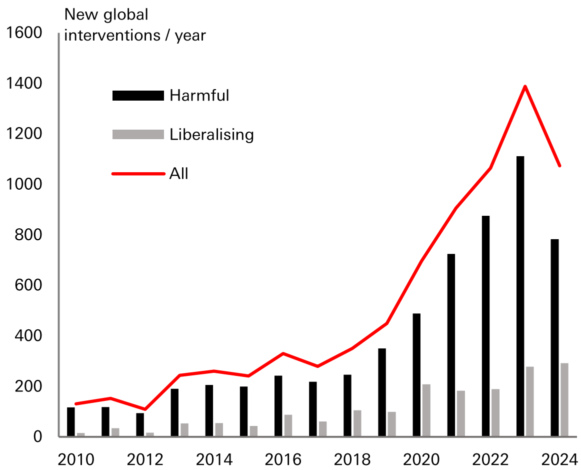


Figure 7 – Global trade interventions have risen



Longer run studies show an even more striking picture of how the global GDP league table could change. A recent article by Kevin Daly and Tadas Gedminas predicts that China, the US, India, Indonesia, and Germany, will be the five biggest economies by 2050. By 2075, the authors reckon that seven of the world's top ten economies would be classified by today's economists or stock market index committees as 'emerging' or 'frontier'. Evidently, this kind of 'growth accounting' exercise can only be indicative; a possible future world. But such a scenario intensifies the tension between western countries (wanting to maintain the post-1945 world order) and the new economies of the global south (seeking to have their say).

The political environment has also become less friendly to international co-operation. In the 1990s and early 2000s, the era of hyper-globalisation expanded the world production frontier and grew the consumer base. It increased global growth, but also fostered a sense of injustice. Many felt that, *"globalisation isn't working for us"*, due to its uneven benefits across economies and within societies. Politics became angrier, and policies more populist and inward-looking.

Recent events have extended these trends. The pandemic, for example, has vividly revealed the vulnerability of global supply chains. In its place, governments are pursuing 'economic statecraft'. The zeitgeist is a common one, but the rhetoric and policy implementation is national and regional. In America, politicians talk about 'friend-shoring', in Europe they say 'de-risking', while the Chinese speak of 'self-reliance'. But everywhere, trade interventions are on the rise (figure 7). Meanwhile, conflicts and geopolitical tensions have forced our societies to re-learn where key inputs come from, particularly in the case of food, energy, and other strategically important areas (such as semiconductors).

Divergence has replaced convergence. Whereas economic, political and social incentives previously acted 'centripetally' to stabilise and sustain the global order. Today, divergent interests, economic fundamentals, and policy agendas now strain it, creating a 'centrifugal' and disruptive force.

4. From tailwinds to headwinds

This story of 'continental drift' contributes to the most complex and uncertain economic environment of my career.

For thirty years prior to the pandemic, four ‘tailwinds’ – as identified by economist Augustin Carstens in a recent speech – shaped the global economic cycle: (i) stable geopolitics, (ii) rising globalisation, (iii) technological advances, and (iv) favourable demographics. These tailwinds consistently delivered a benign mix of growth and low inflation. Economists nicknamed this outcome ‘the divine coincidence’.

Low inflation was the consequence of contestable markets, a globalised labour force, and a supply chain that could be flexible to changing demand conditions. Economic downturns were either due to negative growth shocks, or credit cycles going wrong. And while central bankers hit or undershot inflation targets, policy was free to focus on stabilising economic activity, and averting any inappropriate tightening of financial conditions (the so-called ‘Fed put’). As former Bank of England Governor Mervyn King once cleverly quipped, it was ‘nice’ (i.e. a non-inflationary, consistent expansion). And as Mr Carstens points out in his speech, you can see the distinct profile of this economic regime during the 1990s and 2000s just by eyeballing the growth and inflation data. This business cycle looks quite different to that of the 1960s and 1970s (figure 8).

Figure 8 – OECD GDP and inflation trends

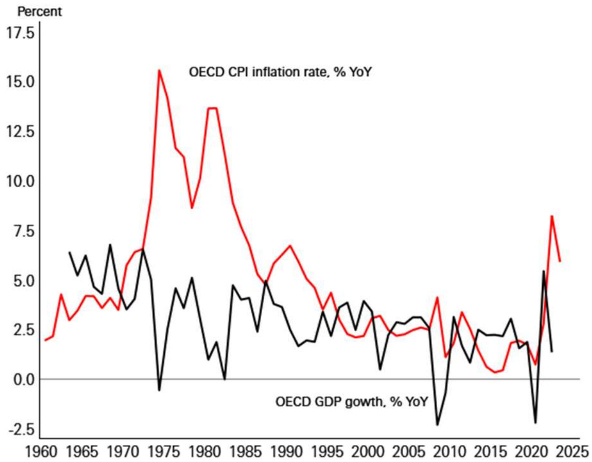
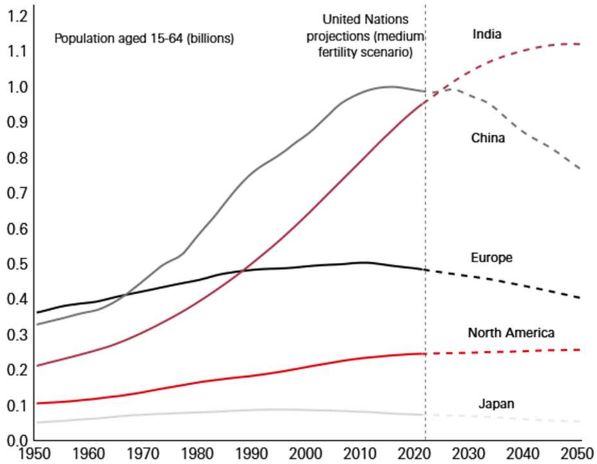


Figure 9 – Working age populations (UN projections)



Fast forward to today and a number of these tailwinds are either exhausted or have become outright ‘headwinds’. As discussed above, globalisation is losing steam and geopolitical alliances are re-aligning, with economic consequences. As such, the era of a globalised and flexible production network is at an end. Another previous economic tailwind, demographics, also looks like it is fading. The global working age population grew rapidly from the 1970s, as emerging market workers were added to the global labour pool. But fast-growing global south economies can’t retain their status as low-cost producers forever. China and India have already moved up the value chain. And there is no equivalently sized pool of cheap labour to take on that role. Rather suddenly, labour looks less abundant. Figure 9 shows the trends for major economies; while working age population is still rising strongly in India, it is already declining in China (and in Europe.)

Ultimately, what all this means is that the economic machine becomes more reliant on technology - the last remaining tailwind. Without a technology-driven positive supply shock to boost-up productivity, the prospects for the global economy are no longer ‘nice’, but ‘vile’ (i.e. volatile inflation, limited expansion).

5. A new paradigm

In this new paradigm, much of the economic and policy rulebook of the last thirty years is ripped up or reversed. Three changes are particularly important for economists to understand.[1]

The first change is that **supply shocks are set to have a much greater influence on the economic cycle**. That's a result of some of the tailwinds becoming headwinds. But it's also exacerbated by a new supply shock: climate change. The process of greening the economy is not a straight-forward one. As old capital stock is rendered obsolete and new investment in fossil fuels discouraged, there is another drag on aggregate supply - at least until clean energy capacity is online. Meanwhile, the more hostile supply side means that not only does our planet face the risk of greater and more frequent climate events, but the economic system is more fragile to these shocks too.

Intuitively, the result is a higher and spikier profile for inflation (figure 10), and a trickier environment for central bankers. Local economic conditions will become a more important determinant of economic slack and inflation (again). And the policy trade-off – the balancing act between unemployment and inflation – will be a more prominent part of interest rate deliberations. Interestingly, recent experience gives us some clues as to how the policy reaction function might adapt to this new environment. After the 2021-22 inflation surge and the fastest interest rate tightening cycle since the 1980s, global central bankers have been keen to cut rates since late 2023, even as inflation has remained sticky. Policy makers' aversion to recession means that a bit more inflation, even temporary overshoots of inflation targets, will be tolerated in a supply-shocked world.

Figure 10 – Supply shock on the economy

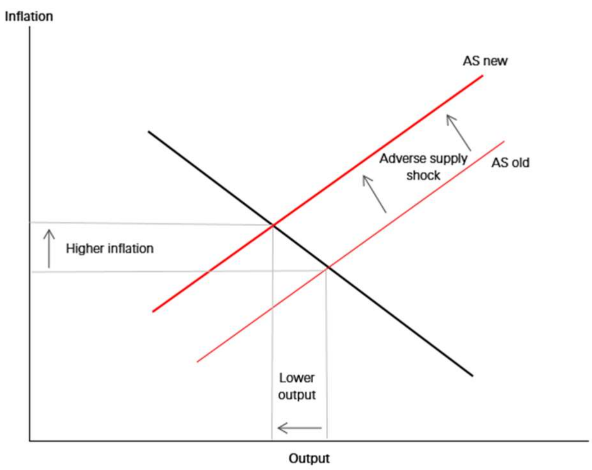
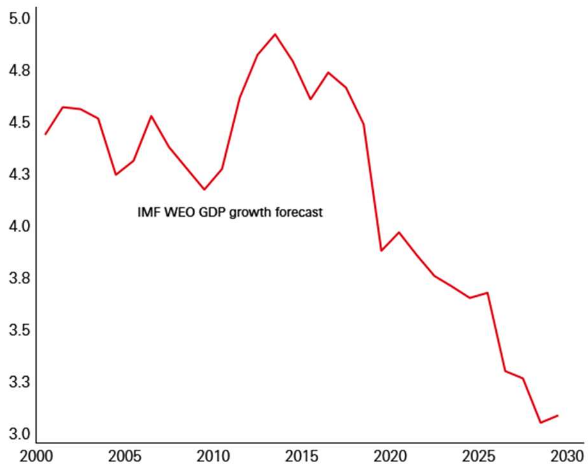


Figure 11 – Global growth prospects are sliding



The second change seems inevitable: there will be **a much greater role for fiscal policy**. In a world of supply shocks, fiscal policy is well suited for a bigger role in economic stabilisation. A good example is the welfare-enhancing subsidies for firms and households during Europe's recent energy crisis. And with macro volatility now coming from both the demand and the supply side, fiscal policy is set to move beyond just 'demand management' and into so-called 'supply side liberalism'. Done right, such public spending to support the economy's supply side, holds the promise of boosting potential growth and ameliorating inflation. In practice, for example, it might manifest as more investment

[1] This section draws on a superb recent speech from former ECB President Mario Draghi.

into healthcare and childcare to support human capital and labour supply. Different versions of this strategy have already been developed around the world; the Inflation Reduction Act in the US, NextGenerationEU in Europe, and Dual/Internal Circulation in China.

Political motivations will drive ‘fiscal activism’ too. Policies to address inequality and promote social cohesion would help meet the criticisms of globalisation’s discontents. While in some countries, greater defence spending will take a bigger and more senior claim in budget planning. And there will be a significant role for government in addressing serially disappointing productivity growth. Harnessing the positives of AI, clean technologies, and other technological advancements will be crucial for our economies and societies.

Figure 12 – Bond market vigilantes?

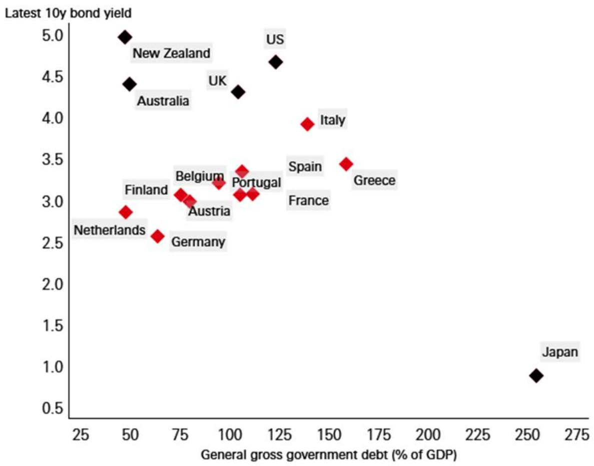
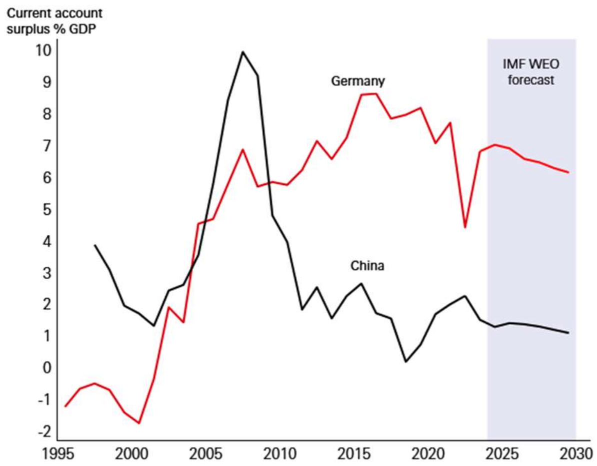


Figure 13 – China and Germany surpluses



This all means larger public deficits, but fiscal policy will also have to operate within limits. Debt ratios have risen since the pandemic. And there are fresh worries that the ‘bond market vigilantes’ will return. The supply shock environment – a combination of lower potential growth and higher market interest rates – could be a toxic one for the fiscal arithmetic. Bond investors will remain on high alert for signs that debt sustainability is slipping. Meanwhile, new sources of tax revenue seem hard to come by (perhaps wealth? carbon?). The rising burden of interest payments on public finances could become an important political issue too.

The line between monetary and fiscal policy will blur as policy becomes more co-ordinated. Academics might worry about a rising political influence on central banks, but this concern seems unfounded. There is no reason why independence can’t co-exist with collaboration. For central bank watchers, however, it will require some adaptation. New ideas like the ‘dual interest rate’ - a subsided cost of capital to supercharge the green transition – could gain traction as interest rates stay ‘higher for longer’. While, industrial, regulatory and competition policy are no longer just microeconomic curiosities. The western policy toolbox could evolve to look more like what we see in Asian economies today; with multiple policy levers influencing a broad gamut of activity.

Finally, a third change reflects how **the multi-polar world will be less tolerant of large trade surpluses.** Over the last thirty years, Europe and Asia have both pursued strategies of ‘surplus accumulation’. In Asia, it was a deliberate insurance policy against a repeat of the Asia Financial Crisis. And in Europe, trade surpluses followed fiscal austerity, by boosting export competitiveness and dampening domestic demand. These formed the basis of what former Fed Chair Ben Bernanke referred to as the ‘global savings glut’, with savings sloshing around the financial system and depressing interest rates.

Looking forward, it could be that access to export markets becomes conditional on accepting imports, with the threat of protectionist measures to deter cheaters. And those Asian and European savings will be re-allocated toward domestic investment (likely), or will reduce themselves alongside GDP declines (less likely). Such an evolution points to a future shape of trade in a more ‘concentric’ pattern. Politically aligned nations will become more closely integrated, or in regional and plurilateral trade agreements. While bilateral deals - more transactional relationships with other nations – would exist on the periphery. Some countries may make headway by remaining non-aligned and exploiting a status as ‘connector economies’. That strategy might enable them to take a larger slice of global trade, but it’s likely to be a smaller pie.

In these three ways, the ‘vile’ economy changes the playbook. But there is significant uncertainty. It is still possible – although wishful thinking in my view - that the system can avoid an economic fragmentation. A more optimistic, alternative scenario would be that productivity gains from AI, green tech, and other sources, counter this ‘continental drift’. And that the worst versions of fragmentation can be avoided. But even more modest versions of the story will change the game, and a return to the economy of the 2010s seems increasingly unlikely.

6. Investment implications

The new paradigm of supply shocks has some challenging implications for financial markets, but will also create opportunities.

This could be a surprise for many investors. Practical experience and empirical studies both conclude that geopolitical factors have - on average - only a fleeting influence on financial markets. Many investors, especially those with a value style, maintain that geopolitics just creates a long-term buying opportunity. But the context matters, and while this notion might be historically-sound, the law of averages may be a misleading guide to the future. Today’s combination of the multi-polar world and a more hostile supply side has more in common with the oil shocks of the 1970s, than many of the other geopolitical episodes in the last few decades. Importantly, these shocks had a more permanent impact on investors’ risk aversion and on economic trends. Investors assuming only transient market implications may be in for a shock.

A shorter and more volatile business cycle will also be a disturbing dynamic for investment markets to digest. Being nimble will help investors. But even against this difficult backdrop, nominal growth – and other nominal variables, like corporate profits - could still surprise us. That may be more about inflation than faster real GDP. But it would still mean that investors who can be granular in their approach, who can identify stocks and sectors with pricing power, and who can access them at reasonable valuations, can still profit.

Amid economic divergence, market dispersion is likely to be high. ‘Country effects’, as well as ‘sector effects’ will become more important as a source of (relative) return. Historically, for example, investors have tended to view emerging markets as one homogenous allocation, and as a high-octane play on the global liquidity cycle. But as the balance of economic power shifts, domestic economic strategies diverge, emerging markets’ dependence on the dollar falls, globalisation regionalises, and interest rate cycles disconnect, country market correlations will also change.

We have become so used to seeing the world through a US-centric lens, that this adjustment may feel confusing. But correlations between emerging and frontier markets are already lower than you might expect (see figure 14). The recent decoupling between China and India is perhaps the starkest demonstration of this new pattern (figure 15). Shifting economic power and the multipolar world will mean the global south will be emboldened to act more in their own interest, and market price action will become more idiosyncratic. In the end, one might ask, *"why should Colombia correlate with Korea?"*.

Figure 14 – Emerging market correlations

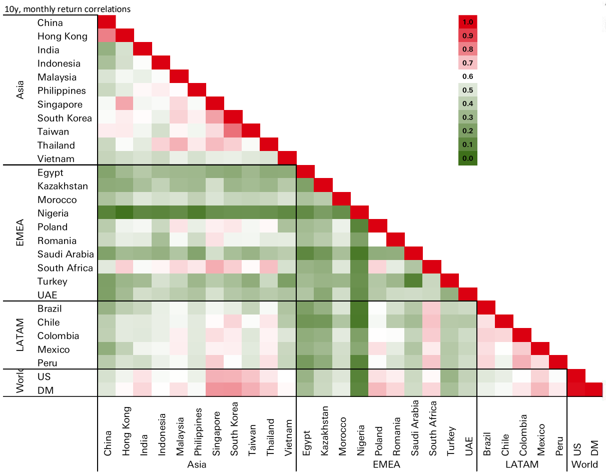


Figure 15 – India stock market versus China

And core to multi-asset portfolios, the spikier profile of inflation will change the risk characteristics of bonds. The reliable, negative correlation between stocks and bonds was a function of the economic and policy environment of the 2010s. A more hostile supply side and a different policy mix (with greater fiscal activism) will make bonds a less reliable portfolio hedge. Even if they will still offer diversification.

Long run studies suggest that the average stock/bond correlation is around zero. That seems like a reasonable working assumption for strategic investors to carry-forward. Critically, geopolitical or climate shocks will now bump-up against a less flexible supply side, meaning occasional inflation spikes and a surging stock/bond correlation. Investors will need to keep this new feature in mind. Portfolio strategists will see a strong case for real assets and other alternative investments as 'new diversifiers' in modern asset allocations.

As the well-known investment strategist Peter Oppenheimer observes in his recent book, this market environment could have a retro, 'post-modern' feel. History won't repeat itself exactly. But the next market cycle could be reminiscent of the 1960s and 1970s. Just as supply shocks and geopolitical stress might remind economists of that period too.

7. **Conclusion**

The world is changing, and so is the economic regime. Many economists and investors have spent their entire working lives in a paradigm of structural tailwinds and abundant supply. This fostered an era of low inflation and growth cycles, where the source of economic volatility came from demand fluctuations. But that era is now over, and analysts clinging to the past will be wrong-footed about future trends.

Supply conditions are becoming more hostile, catalysed by an increasingly multi-polar world, adverse geopolitics, globalisation running out of steam, climate change, and less favourable demographics. Harnessing the productive benefits of technology, as well good policy-making to limit global fragmentation, can help prop-up aggregate supply and mitigate the worst effects. But we are still left with a different macro playbook, and a retro feel to the economic outlook, with lower potential growth, higher inflation volatility, more active fiscal policy, and a new, concentric pattern to global trade.

Forewarned is forearmed. But this new regime will require some mental agility for investors too. Shorter and more frequent business cycles, greater market dispersion, changing correlations, and a need for more complex asset allocation solutions will be unsettling. But there will be opportunities too.

Altogether, it means the economic and investment market outlook is more complex and more uncertain than I have experienced at any time in my career. The world faces many challenges in the new paradigm. It will also need good economists.

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The author is Managing Director and Global Chief Strategist at HSBC Asset Management, but is writing in a personal capacity.