THE INVESTMENT RAMIFICATIONS OF A MULTIPOLAR WORLD

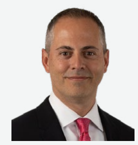
Investment Insights Series

While the push toward globalization lifted nearly all emerging market boats 20 years ago, increased localization will likely result in a dispersion of outcomes based on unique country factors.

The global economy is experiencing the most broad-based rise in commodities prices in over a decade. Given the historical role energy, metals and other natural resources have played in furthering emerging market (EM) economic growth, one must ask whether the current pricing environment – should it be sustained – represents a secular tailwind for commodities exporters and EMs as a whole. We do not think this is the case. Too much has changed since the apogee of the earlier commodities super-cycle. That period was fueled by rapid globalization, exemplified by China's integration into the world economy. What is presently occurring likely harkens the opposite trend, one where deglobalization is on the ascendency. Just as with what occurred during globalization, the reversal of that trend has considerable investment implications. Foremost, the unwinding of supply chains that were constructed to maximize efficiencies is inherently inflationary. Yet, the reconfiguration of trade flows will likely present investors with opportunities that did not exist only a few years ago. We believe this shift will be most acutely felt in EMs, and that equities investors should therefore seek to understand how this new multipolar economic paradigm will impact these regions' prospects in the years to come.

The Unrepeatable Super-Cycle

The better part of the 2000-2010 decade was dominated by a once-in-a-lifetime global commodities cycle that supercharged EM economies. Impressive growth rates were predominantly driven by the need to supply the necessary raw materials for the emergence of China on the global stage. During this decade, EM equities, as measured by the MSCI Emerging Markets Index, generated 10% annualized returns. This stands in stark contrast to the S&P 500® Index, which lost 9% over the period, and decidedly poorer performance for growth stocks, as measured by the Russell 1000® Growth Index. Emerging market outperformance was most acute between 2002 and 2007. During this six-year period, the MSCI Emerging Markets Index returned a staggering 29%, annualized, far outpacing the S&P 500's 6% return and the Russell 1000® Growth Index's 4%.



Daniel J. Graña, CFA
Portfolio Manager

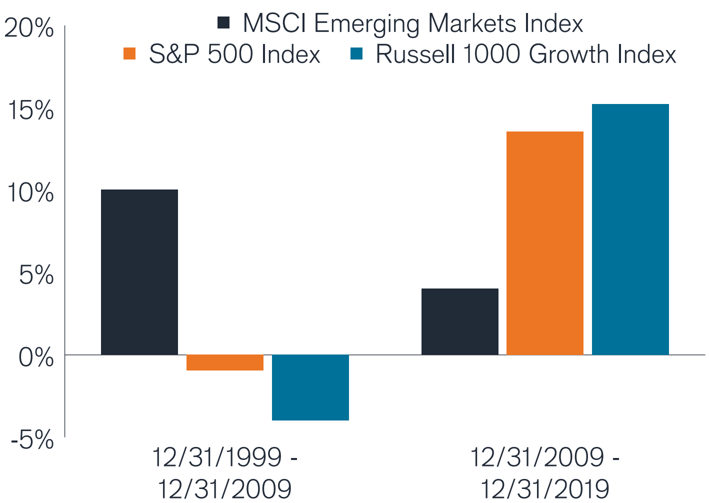
Matt Culley
Portfolio Manager
Research Analyst

Key Takeaways

- Unlike during the rise of globalization and the commodities super-cycle 20 years ago, emerging markets (EM) now face a host of unique conditions that will help determine their attractiveness for investors.
- The multipolar world that is developing is one in which each region strives to control a greater portion of its key economic inputs and processes.
- Both China and the U.S. are likely to reverse the past two decades' economic tactics, with the former seeking to increase innovation and the latter reshoring manufacturing capabilities.

Annualized Returns of Select Equity Indices

The complementary forces of emerging market growth and a commodities super-cycle that defined the first decade of the 21st century were unable to sustain momentum during the ensuing 10 years.



Source: Bloomberg, as of 29 April 2022.

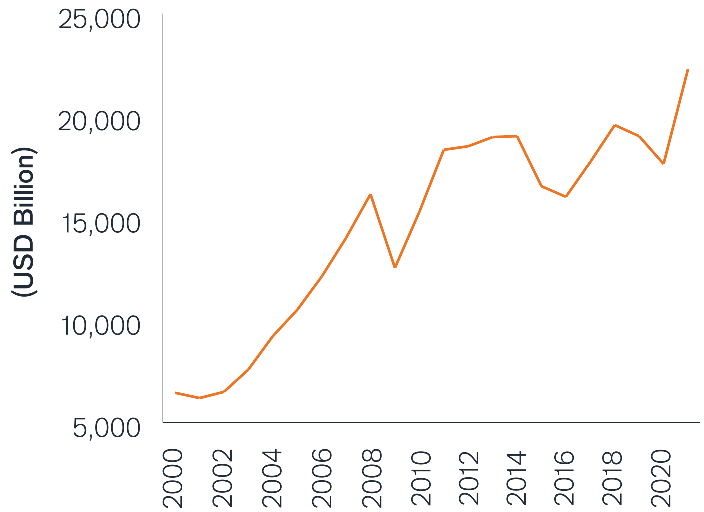
The question facing us today is whether we are on the cusp of another one of these turning points, where spiking commodities prices, exacerbated by Russia's invasion of Ukraine, will lead to another commodities super-cycle. Will a rising tide lift all boats as it has in the past? To answer this critical question, we must delve deeper into the forces behind this shifting tide.

Goodbye, Globalization

Many pundits began calling for "peak globalization" as far back as 2010 (source: Peak Globalization (hbr.org)). In the years following the Global Financial Crisis (GFC), the world's total export value grew just 2.4%, annually, from 2010 to 2019. This pace has undoubtedly slid further when including the impact of COVID-19 over the past two years. As one would expect, returns of EM equities over the last decade reflect this development, with the MSCI EM Index clocking in a similarly pedestrian 4% annual rate. In contrast, the S&P 500 averaged a 14% annualized return from 2010 to 2019.

Value of Global Goods Exports, 2000-2021

Even before the pandemic, global trade began losing momentum as the world's economy likely reached "peak globalization."



Source: World Trade Organization, as of 29 April 2022.

In 2020, we published, "Investment Considerations of a Bipolar World," which explained our thesis that globalization was likely to wane in the coming years as the world became more localized and end markets more fragmented. The decades of laissez-faire free-market capitalism, which had culminated in globalization, began to break down with the China-U.S. trade war under the Trump administration. The early events of 2022 have only reinforced our conviction that the global economy is positioned to become less – not more – integrated in the years ahead. The most likely evolution we see is the emergence of a multipolar world, with Europe becoming the third region – joining the U.S. and China – to command its own economic orbit. Investors must take note of this development as rising geopolitical tensions, national security concerns and multipolarity should all lead to an acceleration in deglobalization, which is inherently less efficient than a global economy where capital, labor and manufacturing capacity flow to regions with the highest level of utilization. We believe that these developments are inherently inflationary.

Country Matters

In contrast to the 2000-2010 commodities super-cycle, a possible new incoming tide in commodities would likely not lift all boats. The near-term energy price shock is likely to have a dichotomous impact across EMs. For countries dependent upon U.S. dollar denominated energy imports, a sustained period of higher prices has the potential to aggravate fiscal imbalances. The timing could not be worse as it's occurring while the Federal Reserve (Fed) is aggressively raising interest rates, thus placing additional downward pressure on EM currencies.

The current account balances of several EM countries – among them the Philippines and India – are poised to take a hit due to the energy price shock. Notably, this is occurring in India despite an otherwise conservative approach to external financing. Meanwhile, EMs positioned to benefit from higher energy prices are likely to see their current account balances improve. For the countries on the wrong side of this equation, inflation will likely remain a persistent headwind until commodities prices moderate.

Demographics and Destiny

There are other factors at play besides whether EM economies are commodities producers or consumers. Demographics also get a vote on how EM regions navigate the next two decades. North Asia (China, Korea, Taiwan) and Thailand generally have unfavorable demographics as their aging populations are resulting in savings rates beginning to fall. Conversely, a majority of other EM countries generally possess more favorable demographics, with younger populations and a low base of savings that has room to rise. Countries with high investment needs and relatively low savings rates (e.g., Latin America and Turkey) tend to run structural deficits that must be financed either through foreign direct investment or portfolio inflows. This dependence, again, makes these countries vulnerable to higher interest rates and appreciating currencies in developed markets, namely the U.S. This vulnerability bears acute relevance as the Fed has indicated its commitment to increase policy rates.

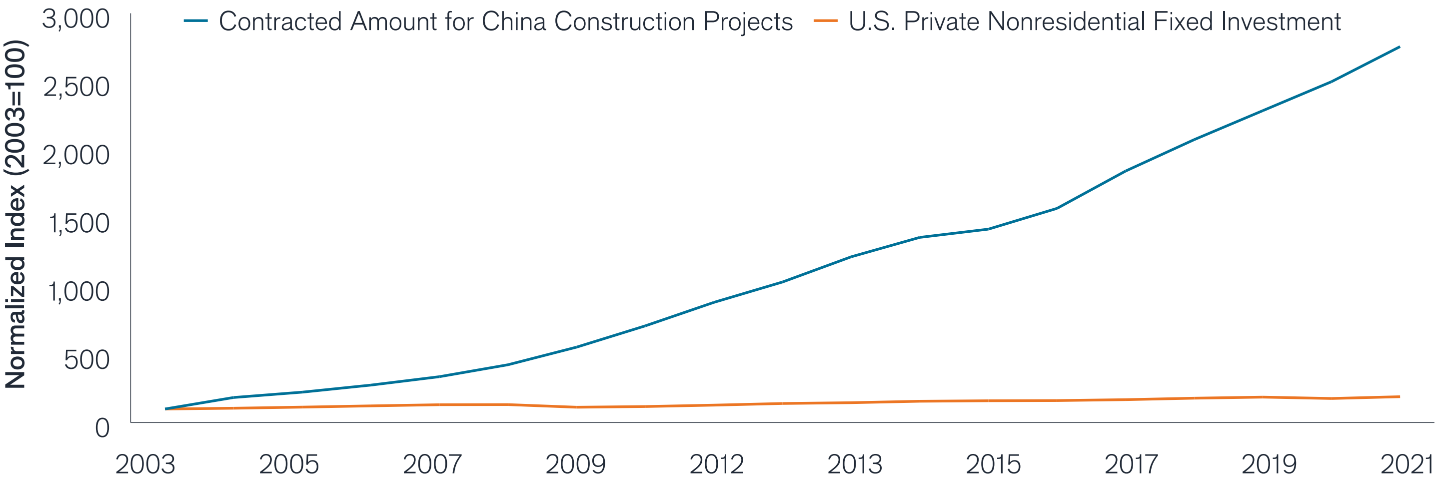
Growing populations tend to equate with rising GDP, and this trend should be magnified by the pace at which today's EMs with younger workforces are pursuing productivity-enhancing innovation to further boost economic growth. Countries that effectively manage their fiscal positions and successfully ascend the production value chain – fueled by a younger and more educated workforce – are, in our view, more likely to control their own path in a multipolar global economy compared to those left to the whims of external forces such as commodities price swings and developed market interest rates.

The China Context: Physical vs. Digital

At the risk of oversimplifying, the last 20 years of development in the U.S. have been largely defined by investment, development and innovation in digital assets and technology-based intellectual property (IP). In contrast, the last two decades of Chinese development has been characterized by the vast buildup of physical infrastructure at a pace not seen before. With the emergence of a multipolar world, these two regions may reverse roles with respect to future areas of focus as the U.S. pushes to build semiconductor capacity and the rise of techno-nationalism causes China to focus on digital innovation and IP. In our view, this has vast implications for the thematic drivers of EM returns going forward.

Disparity in Fixed Asset Investment Among World's Two Largest Economies

As the world's economy deglobalizes, China aims to decrease its reliance on capital investment in favor of value-added innovation while the U.S. faces rebuilding some of the domestic manufacturing capacity it has outsourced in recent decades.



Source: Bloomberg, as of 31 December 2021.

We believe this marks a paradigm shift for investors as the demographic dividend premised on cheap labor and an export-led development model have come to an end in China. While the country maintains a high propensity to save, as the population ages, the savings rate should decline. At the same time, the marginal productivity of labor has clearly peaked. The infrastructure-led growth of the 2000s and even the 2010s – after the enormous stimulus post the GFC – can no longer support continued growth. From here, China faces two potential outcomes: either investment levels must decline, or the current account balance will turn negative. The latter scenario would require increasing levels of external funding. Given the amount of leverage deployed at both the sovereign and consumer levels, increasing productivity via innovation is key to preventing the country from falling into the middle-income trap. We believe this is essential if China is to avoid a slowing economy as growth stalls in the wake of an aging population and built-out infrastructure. Given the emergence of a multipolar world, along with the reaction of Western governments to the Russian invasion of Ukraine, importing Western innovation or becoming beholden to Western capital are two untenable prospects for China.

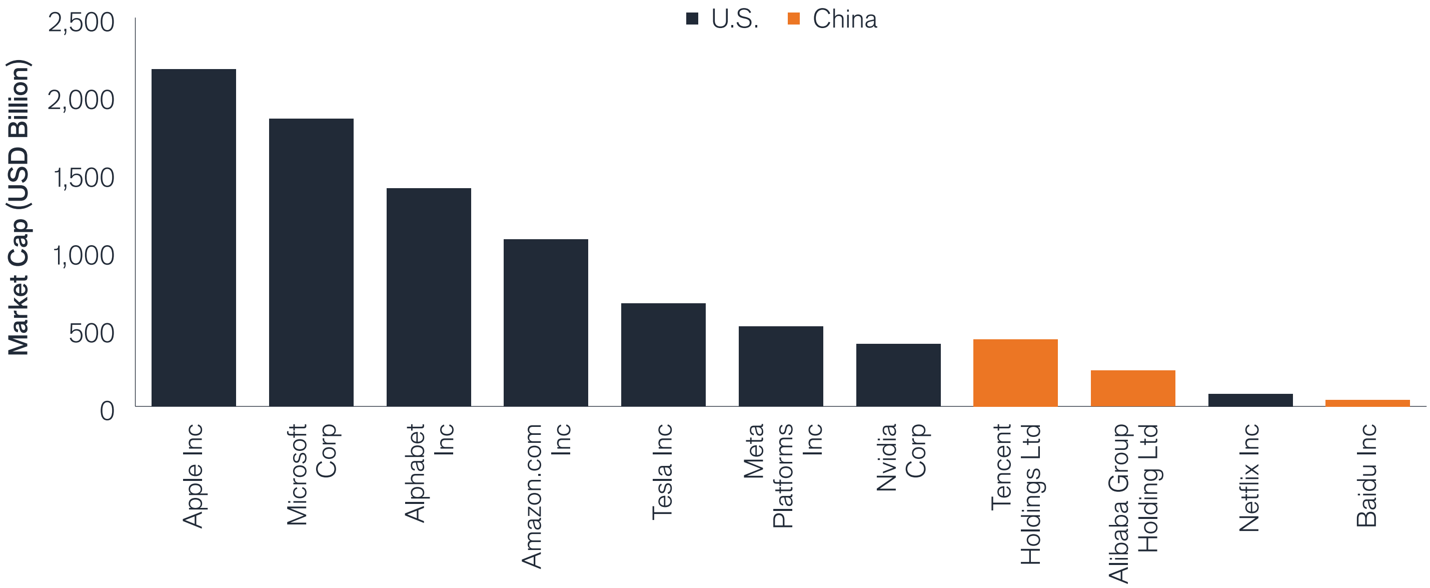
China Not Quite Going It Alone

Multipolarity is being fueled by many forces. One that stands out in particular is China's goal of establishing a Dual-Circulation economy. This initiative is premised on fostering domestic innovation and "buying China where possible, buying foreign only when necessary." In the minds of policymakers, Dual Circulation is a way of creating innovation by restricting – or at least reducing – the space for foreigners to operate, thus expanding the end market for domestic champions.

By contrast, Latin America and India have historically struggled from a policy perspective to implement similar measures as local firms didn't sufficiently innovate. Instead, they simply sought to reap windfall profits from having less competition from foreign companies. While we are beginning to see that trend changing as the key ingredients for innovation have been redistributed across other EMs, China remains the undisputed leader in EM innovation. Outside of Silicon Valley, the only region to produce dominant innovators in the web 2.0 era has been China.

Leading Global Tech-Related and Internet Companies by Country and Market Capitalization

China seeks to enlist the country's already formidable technology companies in achieving national priorities such as increased innovation and common prosperity.



Source: Bloomberg, as of 10 May 2022.

Dual Circulation is also a critical driver in China's goal of reaching carbon neutrality. The volatility in energy markets and the breakdown of supply lines highlight the fragile nature of a globalized world seeking to draw hardened lines across spheres of influence. With the vast majority of the renewable supply chain residing in China, the cost of renewables at or below grid parity, and a relative lack of domestic natural resources, it is both economically and geopolitically sound for China to build its renewable energy capacity as fast as possible.

Europe: Reassessing Supplies

What the events of 2021 showed us is that the myopic push toward renewables in China has an economic cost. Going forward, we do not expect a change in renewable policy but rather a more measured buildup of energy infrastructure. This is perhaps not dissimilar to Europe, where a renewables buildup has already been underway – at a significant cost to its economy. The continent is now having to rethink the pace of hydrocarbon shutdowns post the Russian invasion of Ukraine. We believe the inevitable result of this duplicative infrastructure – when combined with the inefficiencies inherent in a multipolar global economic regime – is likely to lead to continued higher inflation. The commodities necessary to drive decarbonization such as copper, nickel, cobalt and lithium materials are gaining importance for reasons beyond climate change. Securing these resources now, in our view, is increasingly becoming a national security issue.

Multipolarity Meets Multiple Pillars

We believe we have moved beyond "peak globalization" and are now entering a new phase of deglobalization. While a multipolar economic construct is likely inflationary, ample opportunities for attractive investment returns both at the corporate and country level remain. The two pillars that drove EM returns over past decades – outsourcing and convergence – will, in our view, increasingly be complemented by the emergence of innovation as a driving force of future returns. The re-architecting of supply chains and redundancy build-out should drive new opportunities for countries such as Vietnam. The nature of convergence is increasingly being driven by innovation that furthers inclusion and creates entirely new markets. Investment returns are unlikely to be ubiquitous moving forward, but rather will require active management that incorporates top-down country and bottom-up company analysis within a framework of both political and corporate governance.

FOR MORE INFORMATION, PLEASE VISIT **JANUSHENDERSON.COM**

Janus Henderson INVESTORS

IMPORTANT INFORMATION

MSCI Emerging Markets Index℠ reflects the equity market performance of emerging markets.

S&P 500® Index reflects U.S. large-cap equity performance and represents broad U.S. equity market performance.

Russell 1000® Growth Index reflects the performance of U.S. large-cap equities with higher price-to-book ratios and higher forecasted growth values.

Diversification neither assures a profit nor eliminates the risk of experiencing investment losses.

Foreign securities are subject to additional risks including currency fluctuations, political and economic uncertainty, increased volatility, lower liquidity and differing financial and information reporting standards, all of which are magnified in emerging markets.

Alternative investments include, but are not limited to, commodities, real estate, currencies, hedging strategies, futures, structured products, and other securities intended to be less correlated to the market. They may be subject to increased risk and are not suitable for all investors.