Investor’s Outlook

Quarterly edition of investment ideas from the research experts at Francis Investment Counsel

April 2022

Welcome to this quarter’s edition of Investor’s Outlook

The research team at Francis Investment Counsel is a busy group of investment professionals. The depth of our investment research, however, goes far beyond what is seen in quarterly reports and heard in meetings alone.

For this reason, we created the Investor’s Outlook. The vision of this quarterly newsletter is to climb up, zoom out, and provide a higher level view of investing trends, philosophies, and practices that formulate our investment discipline. It’s our goal to give you a deeper understanding of the capital markets, share research resources we find particularly useful, and to deliver to you a source of new ideas.

In this issue, you’ll read:

- **The Zero Hour for Deglobalization**

  Russia’s invasion of Ukraine this past February has led many experts to see this event in the same light as the ongoing trade war with China. It’s further evidence the world economic order continues moving past peak globalization and is headed for “deglobalization.” We explore the implications for investors seeking to build globally diversified portfolios.

- **Research Review**

  Disunited Nations: The Scramble for Power in an Ungoverned World by Peter Zeihan

  Zeihan’s thesis is the world is entering a period of chaos as the U.S. grows more isolationist; regional conflicts abound with winners favored by geography, demographics, and economic ties to the United States.

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The Zero Hour

For Deglobalization

Russia's Invasion of Ukraine Accelerates the Momentum for Deglobalization

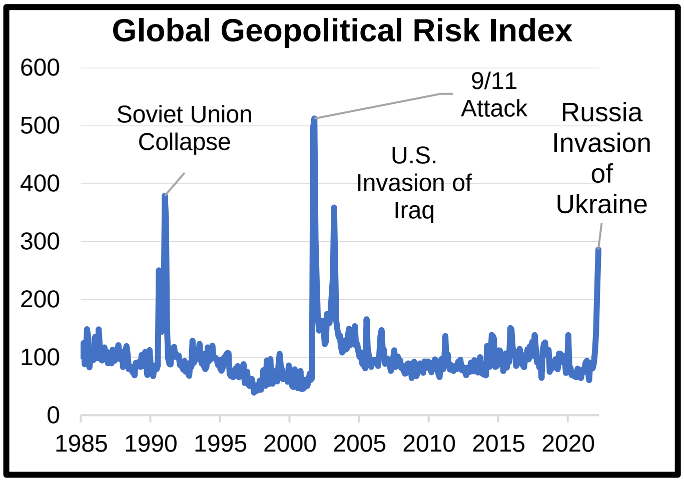
Russia's stunning invasion of Ukraine this past February is just as much a tectonic shift for geopolitics as it is for the changing economics of globalization. Many experts see this event in the same light as the ongoing trade war with China, as further evidence the world continues moving past peak globalization and is headed for "deglobalization."

Since the invasion, Russia and hundreds of Putin's friends have been (in the lingua franca of the social media age) "de-platformed" from the global economic system. So far, these measures haven't stopped the war as it's increasingly clear that no matter how egregious Putin's actions are, the World still needs Russian natural resources. Exemptions to sanctions as well as less visible avenues have maintained trade in energy and metals which are vital to the Kremlin's treasury. The reality is stark as globalization created dependencies which cannot readily be turned off. In the parlance of Michael Porter's five forces describing competitive strategy, Russia retains significant power as a supplier. Even if Western economies can't detach themselves fully from Russian trade today, major changes are in the works to see to it in the future.

By way of review, globalization is an economic paradigm that went mainstream at the end of World War II. Countries operate in cross-border trade via what economists refer to as *comparative advantage*. The concept is this, not every country does everything equally well, so why not form a trade agreement to tap into each other's strengths versus going to war? If a country's citizens can collectively consume more in cooperation versus going it alone, the World can optimize maximum consumption via peaceful means. In the context of World history, the arrangement has worked out very well as the system produced historic prosperity. However, globalization is no less susceptible to the forces of fear and greed which have frequently changed the course of history. The war in Ukraine serves as a sobering reminder of this reality.

> **"…the zero hour for deglobalization has arrived…to move resources to where they are safest as the transition away from globalization intensifies."**

The Russo-Ukrainian War is one of the most disruptive events in the post-World War II era as seen by the "Global Geopolitical Risk Index" below. The readings today are like other historic events including the collapse of the Soviet Union, 9/11 and the Iraq invasion. In those instances, the World's geopolitical calculus shifted dramatically. Going forward, expect greater emphasis on alliances for safeguarding assets and bigtime government spending on infrastructure to avert disruptions to critical supply chains in the future.



[Source: https://www.policyuncertainty.com/gpr.html](https://www.policyuncertainty.com/gpr.html)

Predicting Geopolitical Outcomes is Problematic

Forecasting short-term geopolitical outcomes has been shown to be as illusory as ever. Several investment managers with dozens of years of experience investing in Russia, some of which even visited Moscow in January, came home persuaded there would be no invasion. As for academics who love quantitative models to address dynamic problems, they too are impractical in these prediction exercises. No one can apply a hypothesis test to 3 or 4 different policy ideas from a data set and rank order the best possible outcomes. The point is this, when it comes to geopolitics and the short-term, our traditional methods for analysis and resulting conclusions can produce nothing more than fine sounding conjecture.

The Zero Hour for Deglobalization (cont'd)

Fundamentally, attempting short-term predictions in geopolitics as well as in the stock market sets-up the perfect trap for mistakes. Particularly under duress, our minds are prone to rapidly seek a solution via several heuristics or more simply, by *rules of thumb.* We routinely categorize data, concepts, abstract ideas, and judgments on such matters into narrow buckets. Renowned author Nassim Taleb puts forward the notion that our minds are susceptible to "linear causality" given our failure to recall and use everything ever studied and experienced in life in an instant. So, what does this brief foray into how we think about solving complex problems have to do with allocating capital in the future? It's about risk management and harkening back to the concept of diversification, but we must dig a little deeper and look to longer-term factors when attempting to build an investment strategy.

Diversification in a Deglobalizing World

The familiar mantra championed by the U.S. institutional asset management world is to diversify. There are many choices to diversify, and international investing has gradually gained traction within target retirement date strategies, model portfolios, and risk tolerance approaches. There are good reasons for doing so such as tapping into growth opportunities in emerging markets which produced enormous gains at the same time U.S. stocks faltered. For instance, the MSCI BRIC Index containing stocks in Brazil, Russia, India, and China, returned an annualized 11% in the 2000's while the S&P 500 Index declined by nearly 1.00% annualized in what is infamously known as the "lost decade" for U.S. equities. In the back half of the 1980's, Japanese stocks soared by over 27% and outperformed the S&P 500 Index which advanced a still impressive 20%.

Circling back to how we are hard-wired to solve problems and using *rules of thumb*, the most common solution for investing a portfolio of late has been to "go passive." Such an approach has directed trillions of dollars in investments. The difficulty in using passive benchmarks, however, is that it can lull investors into complacent risk management practices. For instance, investment committees and institutions look to the country allocations such as within the MSCI All-Country World Index for their baseline while active managers use them for determining how much "benchmark risk" they want to take. But if the world is deglobalizing, a portfolio guided by these indexes could in fact be steering it into unintended peril. Just ask anyone who held Russian stocks and bonds who was forced to mark those securities to zero. Even worse, some active managers in emerging market equities held a double overweight to Russia vs. the MSCI Emerging Markets Index on the eve of the invasion. Rather than just take the passive benchmark "as is," we recommend investors apply another level of analysis related to alliances and geography.

"Going forward, expect greater emphasis on alliances for safeguarding assets and bigtime government spending on infrastructure to avert disruptions to critical supply chains in the future."

Military Alliances - The NATO Factor

You've probably spent little time thinking about military alliances when it comes to global capital allocation, but ponder this as you recall the ancient saying, "All Roads Lead to Rome." The Roman Empire thrived on a sophisticated highway system to deploy its military and protect its real estate. The Romans also had a stout navy, but it was second chair to the renowned legions. Similarly, the NATO alliance functions as modern-day network linking highways, airways, and sea routes between allies. These alliances and relationships between countries are also important from an investment point of view.

An investable NATO Index isn't something you can buy, but our analysts created a market cap-based framework suggesting the presence of a "NATO Factor" in explaining returns over the last decade.[1] For example, in the 10-years ending March 2022, the MSCI All Country World Index returned 10.57% but a market cap weighted NATO Index gained nearly 13%. The biggest driver of returns was the adjustment of increasing the U.S. weight from around 50% to north of 75%. The other major constituents of our NATO Index include Canada, U.K., France, Germany, the Netherlands, and Denmark. If the U.S. is removed from the NATO Index and reconstituted, we found the 10-year return for the NATO countries averaged 6.60% versus the MSCI All-Country World Ex-USA Index return of 6.04%. More recently, the NATO Index outperformed the MSCI ACWI in the first quarter of 2022 albeit with a loss of -4.31% vs. -5.26%.

Being a member of NATO in no way guarantees superior returns. Greece, Turkey, Poland, and Bulgaria illustrate this plainly as returns in their stock markets were negative or barely positive over the last decade. We nevertheless put forward the concept that considering military alliances between countries, though unconventional in today's thinking, as relevant from an investment point of view. Given how large corporations are relocating their factories and supply chains in the wake of geopolitical disputes, investors are wise to examine this transformation and review previous capital allocation methods to test their effectiveness within a deglobalizing framework.

The Zero Hour for Deglobalization (cont'd)

The Western Hemisphere – the Geography Factor

From the perspective of big corporations, the zero hour for deglobalization has arrived to enact strategies to move resources to where they are safest as the transition away from globalization intensifies. Taiwan Semiconductor is constructing manufacturing facilities in Arizona and automotive companies like Honda, BMW, Kia, Toyota, Ford, and Volkswagen have taken up production facilities in Mexico where 90% of all cars produced there are exported. Geographically, Mexico is protected by oceans on its coasts and the most powerful military on the planet just across the Rio Grande. That's a good thing as geopolitically, Mexico remains an ongoing beneficiary of the Monroe Doctrine, the implicit guarantee the United States will confront any power that intrudes into the Western Hemisphere. This core doctrine has been part of U.S. foreign policy for close to 200-years and that, along with the USMCA (or New NAFTA) places Mexico in a solid position for years to come along with other South American economies.

The gains achieved through international trade via globalization in the modern era were exceptional and at times offered excellent rates of return for investors. What's briefly been highlighted here is that even during the Pax Americana, the most competitive rates of return over a long-time horizon were in U.S. securities with some coat tail effects for the NATO alliance countries. In an age where the U.S. continues to shrink its global influence, the implications for capital allocation are unmistakable. After all, if the cycle ahead has less U.S. influence than the one just behind it, a time when international equities still underperformed, capital allocators must consider the strategic impacts on a globalized portfolio in a deglobalizing world. Commerce between nations will remain as necessary as ever with time-tested factors like alliances and geography once again determining the shape of the future.

Investment Implications in a Deglobalizing World

- U.S. equities and companies in NATO countries like Germany, France, and the Netherlands are worth extra consideration in a diversified portfolio.

- Breaking away from bad actors like Russia will necessitate bigtime government spending which is inflationary and favors strategic allocations in TIPS and Commodities.

- EM countries in the Western Hemisphere like Mexico, Colombia, Peru, and Argentina have materially underperformed U.S. equities and Asia in the last decade but look attractive in the next.

"In an age where the U.S. continues to shrink its global influence, the implications for capital allocation are unmistakable…"

Summary

- *Comparable to the impact from the trade war with China, Russia's ground war in Ukraine accelerates developments towards deglobalization.*

- *The familiar mantra from the U.S. institutional asset management world is to diversify, but a world in process of deglobalizing means investors must dig deeper into the ramifications for building a globally diversified portfolio.*

- *Thinking about military alliances between countries is perhaps unconventional but we see them as relevant from an investment point of view. Our research suggests the existence of a "NATO Factor" in explaining relative outperformance versus a standard global index over the last decade.*

- *The gains achieved through international trade in the modern era via globalization were exceptional and at times offered excellent rates of returns. Deglobalization is changing how capital is allocated; the most likely winners in the decade ahead are countries with the strongest ties to NATO, allied to the United States, or located in the Western Hemisphere.*

[1] The NATO Index comprises all members of NATO with an investable stock market as aggregated by MSCI weighted by market cap in U.S. dollars. Some NATO members do not have an MSCI Index representative of their equity markets. This is not an investable index; transaction and investment management expenses are not considered in this analysis.

DISUNITED NATIONS

Disunited Nations

The Scramble for Power in an Ungoverned World

Authored by Peter Zeihan (2020)
Summary by Edward McIlveen, CFA

Peter Zeihan is a geopolitical strategist and founder of the consulting firm Zeihan on Geopolitics; he's readily one our favorites for his insights, wittiness, and capacity as a prolific content creator. His volume, *Disunited Nations*, weaves a narrative of the global future utilizing the core educational disciplines of geography, history, and economics.

The introductory chapters review how the British Model ruled the World and contrasts it to the American Model which has since ruled following the end of World War II. While the British believed in using the "stick," the Americans preferred to hold out the "carrots" by providing physical and maritime security for all, unfettered market access, and a global currency with massive liquidity to facilitate trade. No one could counter the American's takeover of superpower status in the 1940's given its superior navy.

Today, Zeihan maintains the United States is reducing its global influence and turning to a more isolationist foreign policy. As a result, regional powers will dictate the shape of the future. Geography and demographics emerge as the leading influential factors while political systems are secondary. Zeihan argues many pundits are consequently betting on the wrong horses. For instance, France, not Germany, will lead Europe. Saudi Arabia, not Iran, will rise as the bigger global threat. As for China, Zeihan contends it's grown into a behemoth which is overleveraged and too dependent on international trade which it cannot exert control. In a word, Zeihan asserts China is "overhyped."

The other countries which Zeihan delves into include Japan, Russia, Turkey, Brazil, and Argentina. He succinctly presents his opinions in a "report card" format for each country before rendering a verdict. The report card appraises each country's borders, resources, demography, military might, economy, and outlook.

"For instance, France, not Germany, will lead Europe. Saudi Arabia, not Iran, will rise as the bigger global threat."

Excerpts from the Report Card for China (p.104)

Borders: Hard to secure, nuclear threats surrounding the country, "superior maritime power to the east."

Resources: China could run out of everything needed to continue industrialization.

Demography: "Breakneck urbanization combined with Maoist population controls gutted the Chinese birthrate for decades."

Military Might: Big but not necessarily relevant in terms of technology and adaptability.

Economy: "Every system that has followed China's path has crashed. So to will China."

Outlook: "…everything that has made China successful will end with it and no one will reach out with a helping hand."

In the concluding chapters, Zeihan asserts a rather optimistic view of the United States for the next three decades. Its military and stalwart economic apparatus look to be dominant until at least 2050. The country is resource rich and isolated from the worst potential trade disputes which could impair energy and food supplies. Nations such as Ireland, Germany, and China are aren't so fortunate. Emerging regional powers are most likely to be Turkey, Iran, Japan, and Argentina based on favorable geographic and demographic tailwinds. Zeihan further predicts "a generation of wildly educated people desiring escape from dark influences" will most likely land in America. He draws comparison to Einstein's defection from Germany to the U.S. in the 1930's as the World grows more chaotic.

Lastly, while the road ahead has many similarities to the one just traveled, forces are at work which could take many by surprise at first but will eventually be found integral to what's molded World history beforehand.

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Ed leads the Firm's research efforts at Francis Investment Counsel and has been on staff since 2005. Ed graduated from Marquette University with a Masters of Business Administration specializing in finance and attended Gustavus Adolphus College where he earned a Bachelor of Arts Degree in History (graduated cum laude). Ed holds the Chartered Financial Analyst (CFA) designation.