Global investing is at a crossroads

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The world is at a crossroads. After the disruptions caused by Covid, geopolitical tensions, the simmering trade war between the US and China and unprecedented indebtedness, there is much uncertainty around what direction the global economy and financial markets will take from here.

But the dramatic economic and financial market events being seen today and over the past 10 years can arguably trace their roots back to changes that were put in train several decades ago. The global economy moved from overregulation, state intervention and the Cold War political ideologies of the 1970s to a more liberal, globalised free trade economy from the 1980s onwards. The monetary, deregulation and privatisation reforms expedited by the likes of Thatcher and Reagan set models for the liberalised, free market and low friction globalised economy that followed the end of the Cold War.

Interest rates and unemployment fell, data processing become ever cheaper and globalisation (and China) flourished, helping to drive down inflation as globalisation circulated deflation and geopolitics became fairly benign under pax-Americana and fiscal and monetary policies loosened.

Then the Global Financial Crisis in 2008 disrupted a stable world that was functioning but which had a gross excess of leverage in the system. The central banks' response was 'more of the same': greater liquidity, lower interest rates, more permissiveness and more fluidity. This hit another plane altogether when Covid struck.

Past divergences

A handful of prevalent divergences in performances characterise financial markets over the last decade, including the comparative performances between growth and value; emerging versus developed markets; and small versus large caps.

Value and growth have gone through periods of comparative out- and under-performance over several decades, but since 2012, growth has been the clear winner. The general decline in interest rates was beneficial for 'growth' companies, which saw their share prices boosted disproportionately because their future profits were discounted less. Growth became harder to come by, but the extraordinarily high liquidity pulled bond yields into unattractive territory and encouraged investment into higher risk assets such as equities. Growth stocks benefited from this to a much greater extent than their value counterparts.

The growth phenomenon was seen most profoundly in the US. Dominated by technology companies, the US stock market outstripped the rest of the world, typified by the eye-watering performance delivered by Facebook, Apple, Amazon, Netflix and Google (FAANGs). Covid accelerated this outperformance as the stay-at-home aberration of the lockdown pushed growth companies, such as Peloton and Netflix, to incredible multiples.

Over the long term, emerging markets (EMs) and small caps have significantly outperformed developed markets (DMs) and large caps, which is to be expected, given the comparative risk premiums and growth trajectories pertaining to these assets. However, over the last-decade, DMs and large caps have been the relative winners by some margin.

A step back from globalisation

Several factors will make the next decade's 'big picture' very different to the last one. We are already seeing a less liberated global environment with weaker capital flows and reduced movement of goods and labour.

Governments will be more inward-looking, devoting fiscal policies to benefiting domestic populations more by raising expenditure on public services and infrastructure. China, for example, which has seen such phenomenal growth thanks to globalisation, has already demonstrated its willingness to exchange a higher quantum of growth for higher quality, focusing more on its domestic consumer market and developing a technology sector with greater value-add.

We see a multi-speed world in which national economies behave differently and monetary and fiscal policies will no longer be in lockstep as governments deal with their domestic conditions and outlook rather than just following the Federal Reserve.

Reverting to longer term trends

Looking through the short-term noise, going forward, we expect to see many assets reverting to performances that are more akin to longer-term trends and directions of travel as economies adjust to new – yet also old - realities. A key lesson from history is that markets ebb and flow.

Over time, for example, we would expect the strong economic growth trajectory, favourable demographics, governance improvements and risk premiums of EMs will bear fruit for the patient investor. We are also optimistic over the longer term that investors in small cap companies will be rewarded, given their nimbleness and growth profile.

Regarding the growth versus value style trade-off, US tech stocks' astounding outperformance over the last decade was an anomaly that it would be unwise to assume will persist indefinitely. We have had an overweight in value for a couple of years that has started to come to fruition. But we believe some of the extreme valuation spread is behind us. We are drifting towards a more neutral view now and will continue to adjust exposure according to market conditions. Stylistic exposure should be a matter of emphasis rather than a binary approach, meaning that we retain a broad stylistic allocation to global markets even when expressing a preference for a particular style.

Two other market aberrations are worthy of investors' consideration. The high correlation between bonds and equities that has frustrated investors looking to diversify their portfolios year to date will likely abate as market conditions normalise in the longer term. The sudden rising strength of the US dollar recently should also make investors who are long the greenback wary because it won't remain so strong forever.

Trying to predict when asset classes will out-perform is a hazardous pursuit. But being laser-focused on a handful of assets just because they might have done well in the past would be a mistake, too.

Playing future opportunities

The factors causing financial markets to be so volatile in 2022 – rising inflation and interest rates, looming recession, supply disruptions and war in Ukraine – will either drift into history or cease to provide as acute a source of investor concern. Likewise, the assets that outperformed strongly over the last decade because of pervading conditions are unlikely to be the consistent outperformers over the next as other market drivers come into play. Markets will shift quickly and their cycles shorten as ever greater volumes of information will be delivered more rapidly, and the geopolitical landscape evolves.

In such an environment, it will be important to have an investment process that can cut through the market noise and respond to market nuances, investing in a diversified range of asset classes, styles and funds that will provide steady returns with neither reliance on any one scenario playing out nor wholesale shifts in allocations.

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