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Insight

Special report

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Wealth Management

Worlds apart: Risks and opportunities as deglobalization looms

With trade relations more fragmented and the potential for a great power rivalry between the U.S. and China, investors need to be ready for a new paradigm.

Kelly Bogdanova

For important disclosures, see page 14.

All values in U.S. dollars and priced as of market close, May 17, 2023 unless otherwise stated.
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Special report

Worlds apart: Risks and opportunities as deglobalization looms

Kelly Bogdanova
San Francisco, United States
kelly.bogdanova@rbc.com

The world is at an inflection point. After decades of close trade ties and economic progress, globalization is being unwound. With trade relations becoming more fragmented and the potential for a great power rivalry between the U.S. and China, it's paramount to understand the economic realities of the new paradigm. This is the first article in a series exploring the trend away from globalization and its ramifications for investors, economies, and financial markets.

U.S.-China relationship: From fruitful to frosty

Years ago, Chinese officials were repeatedly welcomed with open arms in Iowa, America's heartland and one of the country's biggest agriculture-producing states.

Iowa inked 20 trade agreements with China valued over $1 billion following high-level meetings in 2013 alone. The deals were touted by the state's leading newspaper as the Iowa business community's opportunity "to compete more effectively in the new gold rush for the huge business and consumer markets now evolving" in China.

CNN wrote a warm article in 2016 titled "China's Xi Jinping keeps Iowa close to his heart" to recap Xi's second trip to the state as president. At a formal reception, then-Iowa Governor Terry Branstad, who later became the U.S. ambassador to China, remarked to Xi, "We consider you a great friend of Iowa." The two first met in 1985 when Xi led a small delegation to the state as a young regional official.

Those cordial exchanges and cooperation were a microcosm of what had manifested throughout America. Back then, government officials and business leaders of both countries had established mutually fruitful and friendly partnerships in a variety of industries that deepened national trade ties.

Fast forward to 2023, the warm feelings and trade deals have been replaced by hostile statements and disagreements.

Now, Iowa officials strongly advocate restricting Chinese firms from investing in Iowa farmland. Senator Joni Ernst regularly speaks about this on the Senate floor and explains how she is "working to decrease our country's dependency on China and secure our supply chain."

There is a host of initiatives in Congress, the White House, and in states that would erect trade barriers and reduce cooperation with China. Sanctions against the country, its companies, and officials have begun to mount, and the U.S. actively lobbies its allies to follow suit.

The U.S.-China relationship is mired in mistrust, security concerns, and tensions related to Taiwan. We think there is little doubt relations have deteriorated to their worst level since the groundbreaking détente in the 1970s.

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Globalization helped to deliver widespread progress

Major shifts in relations between great powers have economic and financial market implications, and change the investment environment, in our view.

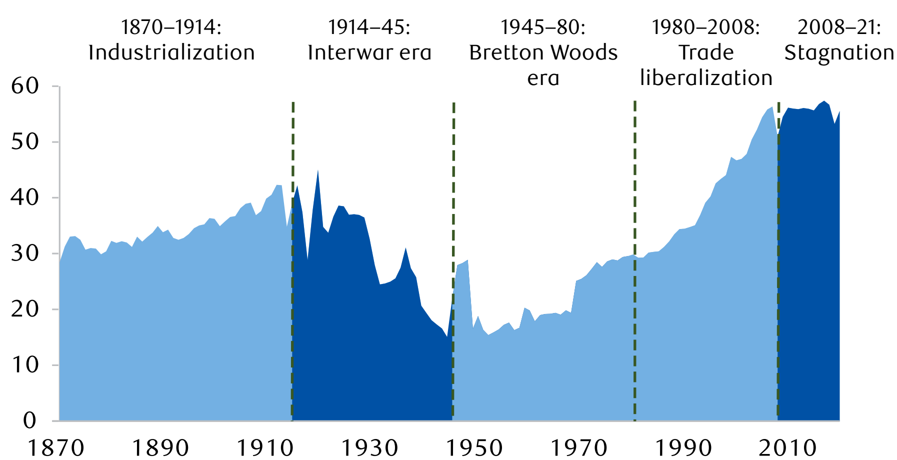
Globalization flourished after China started integrating into the global economic system, especially from the 1980s onward, and after the end of the Cold War when post-Soviet commodity-producing countries became more integrated with Western economies. Significant technological achievements, which criss-crossed national borders, also spurred trade and global economic growth.

Despite its many shortcomings and imbalances, globalization over the past several decades lifted hundreds of millions of people out of poverty, particularly in China. In the U.S. and other developed countries, there is plenty of evidence that globalization boosted aggregate wealth and helped push inflation to low levels.

We think it fueled corporate earnings, particularly for large multinational companies. This, in turn, contributed to handsome stock market gains, especially in North America.

Globalization flourished from 1980–2008, but later began to stall out

Trade openness 1870–2021; sum of exports and imports as a percentage of GDP



Source - RBC Wealth Management, IMF; based on data from the Jordà-Schularick-Taylor Macrohistory Database, Penn World Data (10.0), Peterson Institute for International Economics, World Bank, and IMF staff calculations; sample composition changes over time

Is the sun setting on globalization?

Now a different era is taking shape. Decades of prosperity associated with globalization are clashing with geopolitical realities.

With the U.S.-China rivalry heating up and NATO-Russia risks boiling, trade relations are fragmenting and countries are becoming more protectionist and focused on national security. More recently, manifestations of deglobalization have arisen; in other words, there are risks that globalization could break down, rather than merely stagnate as it has been for some years.

This didn't happen overnight.

We think globalization began to stagnate in earnest with the global financial crisis in 2008. The stagnation persisted during the U.S.-China trade standoff in 2018 and 2019. Global trade momentum languished again during the COVID-19 crisis in 2020, which exposed supply-chain vulnerabilities. The world then

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moved further away from globalization following Russia's military intervention in Ukraine in early 2022.

As a result of these events, major powers and other large and strategically important economies have been reformatting relationships.

Disruption of the global order

It's not just U.S.-China relations that have shifted.

Saudi Arabia no longer views the U.S. as its principal ally, according to RBC Capital Markets, LLC's Global Head of Commodity Strategy Helima Croft, a Middle East expert. Rather, the U.S. is just one of a handful of partners that Saudi Arabia will work with.

The Saudis have forged a close, formal strategic partnership with China in recent years that the Middle East power seems unwilling to break or diminish, despite the efforts of two successive U.S. administrations.

Saudi Arabia's rapprochement with its longstanding regional rival Iran—brokered in dramatic fashion by China in March 2023, to the surprise and dismay of Washington—was partly driven by its desire to cement its constructive relationship with China, in our view.

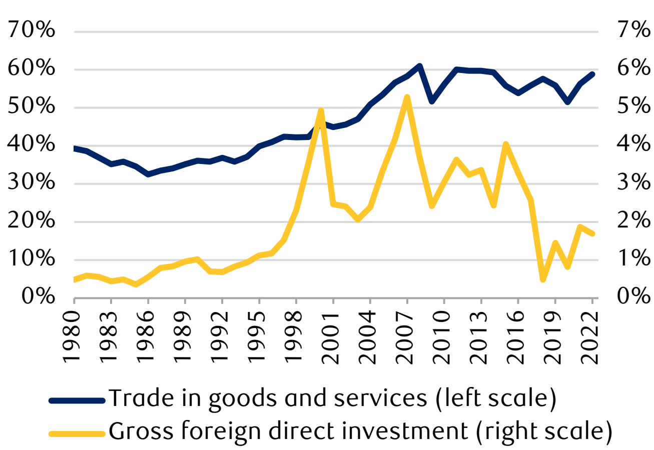
Changes have occurred throughout the Middle East. Many other Arab countries have also forged important partnerships with China. And after years of war and disputes, Syria has just been readmitted to the Arab League despite U.S. and UK objections. Syria is a military and strategic ally of Russia and Iran, and views China as a key partner.

Two entities in which China, Russia, and India play key roles—the BRICS association and the Shanghai Cooperation Organisation (SCO)—are expanding their memberships, and countries within them are deepening their ties.

India's relations with Russia are at their strongest point in 70 years, according to retired Indian career diplomat and former ambassador to Russia Venkatesh Varma. The two countries describe their relations as "special and privileged." Chinese and Russian diplomats characterize their countries' relations as being at the highest level in history. Meanwhile, Brazil is intensifying its strategic partnerships with China and Russia.

Globalization is waning: Trade has stagnated, foreign investment has dropped

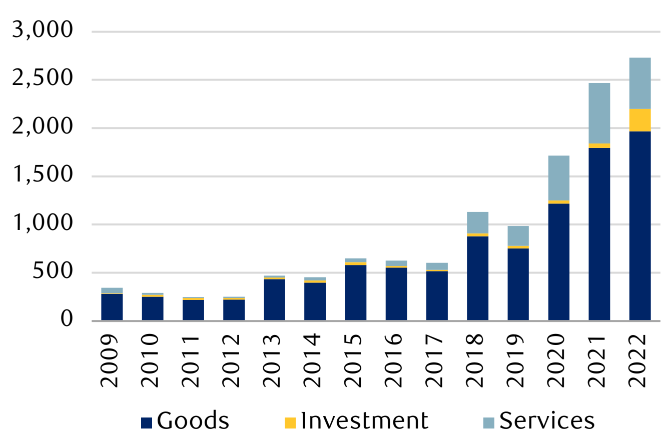
Figures in percentage of global GDP



Source - IMF World Economic Outlook April 2023, IMF staff calculations

Trade restrictions have surged in recent years

Number of harmful trade restrictions imposed globally per year



Source - IMF World Economic Outlook April 2023, Caldara and Iacoviello (2022), Global Trade Alert; data as of 2/1/23

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The growing influence of non-Western institutions

By design, BRICS and the SCO are not formal alliances—and we don't think they will be anytime soon.

They are not tightly knit or well-oiled like the U.S.-led G7 or relations between the U.S. and EU. They don't have the informal arrangements and obligations of Western alliances, nor do they have related military blocs like NATO and AUKUS.

This lack of formal bloc status of BRICS and the SCO is part of the appeal for the existing members and countries that seek to join, in our opinion. Their structures are intentionally flexible and accommodating.

In contrast with the G7 and U.S.-EU alliances, BRICS and the SCO neither promote nor informally require adherence to certain forms of government, political ideologies, economic frameworks, or social values. They don't coordinate direct or indirect military interventions and assistance, nor do they impose joint economic sanctions. BRICS and SCO countries refrain from intervening in each other's internal affairs and promote sovereignty.

Recently, a number of these countries have begun trading goods and commodities in their national currencies or in Chinese yuan, bypassing the U.S. dollar. BRICS has a Shanghai-based development bank, headed by economist and former Brazilian President Dilma Rousseff, which funds infrastructure and development projects. We think it will be more active in the future.

A complex web of ties

There are contradictions and longstanding rivalries between some BRICS and SCO countries. For example, a border dispute between India and China remains ongoing.

BRICS and the SCO seem set to expand

BRICS	Shanghai Cooperation Organisation (SCO)	
Members[1]	**Members**	**Dialogue partners**
Brazil	China	Armenia
Russia	India	Azerbaijan
India	Iran	Cambodia
China	Kazakhstan	Egypt
South Africa	Kyrgyzstan	Nepal
Requested to join	Pakistan	Qatar
Iran	Russia	Saudi Arabia
Saudi Arabia	Tajikistan	Sri Lanka
Interested in joining	Uzbekistan	Turkey
Algeria	**Observer states**	
Argentina	Belarus[3]	
Bahrain	Mongolia	
Indonesia	Afghanistan	
United Arab Emirates[2]		
12 other unnamed countries		

1. BRICS members will discuss expansion and accession procedures at meetings on June 2–3, 2023.

2. UAE is a BRICS New Development Bank member.

3. Belarus will likely become a member of the SCO in 2023.

Source - Shanghai Cooperation Organisation, United Nations, Indian Council of World Affairs, Bloomberg

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Yet the two countries' involvement in these organizations has helped foster dialogue and cooperation. Total trade between China and India increased 444 percent from $25 billion to almost $136 billion from 2006 to 2022. China is India's largest trading partner in terms of goods.

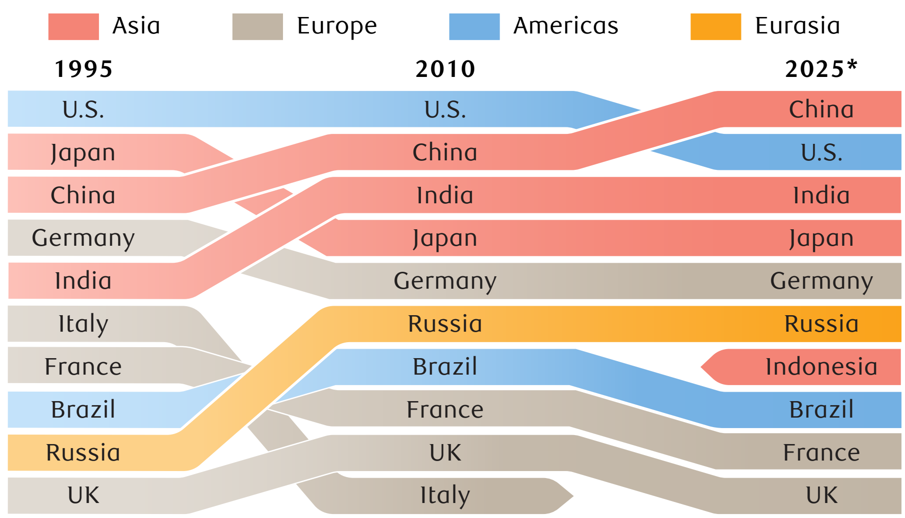
India's and China's top diplomats, finance ministers, security leadership, defense ministers, and heads of government and heads of state meet regularly and more often because of the SCO and BRICS.

In addition, many BRICS- and SCO-affiliated countries, including India and Brazil, seek to maintain constructive relations with the U.S. and its allies.

Such countries are involved in Western-oriented organizations, and we see little evidence this will change in the near term. Those that coordinate with the West find it economically and strategically important to do so.

Economic influence is shifting to Asia

Countries ranked by the highest annual GDP based on purchasing power parity in U.S. dollars



* 2025 ranking based on IMF data projections as of 5/15/23.

Source - Statista (exhibit concept), IMF (data)

The return of great power rivalry

The sticking point in the eyes of the West is that BRICS and the SCO seek to form a "multipolar world" wherein a number of countries would play a role in global leadership and decision-making, and in resolving disputes between nations.

Many countries within these organizations view the U.S.-led Western hegemony as a thing of the past or something that will be outdated soon. They have stated the world has moved—or is moving—beyond the post-Cold War era when U.S. leadership reigned supreme, and Washington and its allies set the terms.

BRICS and SCO participants generally believe the world order has already transformed because of:

- China's significant economic expansion and global influence
- India's long-term economic growth prospects and bigger voice in international affairs
- Russia's role as the world's leading commodity producer

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The unprecedented asset freezes and sanctions levied against Russia, combined with U.S. sanctions and trade barriers against China, have caused BRICS- and SCO-affiliated countries to reassess their economic and financial vulnerabilities.

We think many leaders and elites in countries outside of the West perceive their dollar assets may not be as safe as they once thought. The CEO of one of India's largest publicly traded banks, billionaire Uday Kotak, recently said as much and expressed the view that the dollar has disproportionate power.

Who are the powers that be?

Whether the U.S.-led world order is still intact or the multipolar world is already upon us is up for debate.

One of the most prominent international relations academics, Professor John Mearsheimer of the University of Chicago, says the multipolar world is already here, like it or not.

There are other academics and think tank analysts who believe the multipolar view is nonsense, and that the U.S. continues to maintain its primacy and dominant role in what is frequently described as the "unipolar world" that has existed since the Soviet Union collapsed.

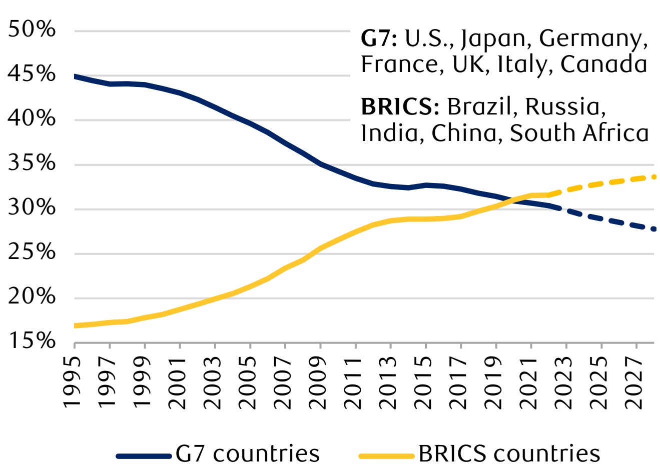
Other specialists in various camps argue that the world is turning into a bipolar struggle between the U.S. and China. This is most often the narrative of the Western media and the view of many American politicians on both sides of the aisle.

However, the highest-ranking U.S. military official, General Mark Milley, chairman of the Joint Chiefs of Staff, recently stated in an interview with *Foreign Affairs* that we're in a tripolar world with the U.S., China, and Russia as the "three great powers," which he acknowledged is "very difficult to manage."

Others see the world largely through an economic lens and point to the three largest economies being in the leadership role: the U.S., China, and the EU.

BRICS GDP surpassed G7 GDP in 2021, and the trend is expected to continue

Share of global GDP based on purchasing power parity in U.S. dollars*

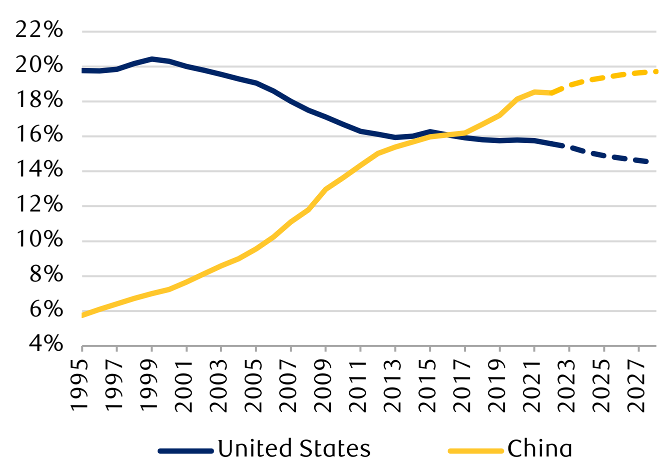


* Data from 2023 through 2028 are IMF projections.

Source - RBC Wealth Management, IMF database; data as of 5/17/23

China GDP surpassed U.S. GDP in 2017, and the trend is expected to continue

Share of global GDP based on purchasing power parity in U.S. dollars*



* Data from 2023 through 2028 are IMF projections.

Source - RBC Wealth Management, IMF database; data as of 5/17/23

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While such a tripolar structure makes a lot of sense from an economic perspective, this configuration does not correspond to geopolitical realities, in our view. Since the Ukraine crisis has evolved, relations between the U.S. and greater Europe have become tighter and more unified.

Even though some European countries have expressed desires to take a neutral stance on the escalating rivalry and tensions between the U.S. and China—Europe has significant economic relationships with both powers—we think the EU will increasingly be incentivized and pressured to align more toward the U.S. The same goes for Canada and other key U.S. allies such as Japan and South Korea, in our view.

Looks like the genie is out of the bottle

How specialists and the media define this period is not our primary concern. Call it whatever you like—a unipolar, bipolar, tripolar, or multipolar world, or come up with a more eloquent or catchy term to describe the state of geopolitical relations today.

For investors, we think the important point is that relations between the great powers, and countries with large economies and/or strategic and commodity resources, have already changed and will likely transform further.

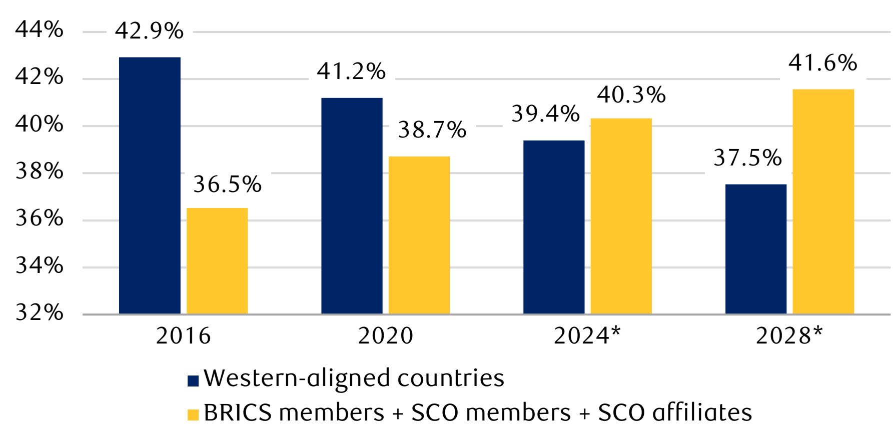
BRICS and SCO countries want a bigger say in global affairs and decision-making. They have a lot of economic, commodity, and rare earth mineral leverage to assert a more collective, multipolar approach.

But we highly doubt the U.S. and its allies will quietly acquiesce to a multipolar framework.

No power that has sat in the driver's seat for over 30 years, like the U.S. has, would willingly relinquish its dominant role. And many countries in the West are suspicious that some BRICS and SCO countries have aims beyond just a multipolar arrangement.

The size of BRICS & SCO economies is projected to slightly overtake that of Western-aligned economies in 2024, and the gap should widen by 2028

Share of global GDP based on purchasing power parity in U.S. dollars*



* Data for 2024 and 2028 are IMF projections.

Western-aligned countries are the U.S., EU (27 nations), UK, Canada, Japan, South Korea, Australia, and New Zealand. Data are adjusted for Brexit.

BRICS members are Brazil, Russia, India, China, and South Africa. SCO members and SCO affiliates are listed in the table on page 5. Countries that are involved in both BRICS and SCO are counted once.

Source - RBC Wealth Management, IMF database; data as of 5/17/23

Therefore, we think the great power struggle will drag on and intensify, pushing the global economic system further away from integrated globalization into something more fragmented. And the threat of deglobalization will at least hover in the background, if not manifest itself on the surface.

This creates risks for economic growth, markets, and sectors—and therefore for portfolios.

But it also should provide investment opportunities, in our view, as countries and industries are forced to cooperate differently and innovate under pressure.

Realpolitik is back

Many countries—regardless of their worldview or form of government—are now understandably more focused on security and sovereignty issues.

They are either contemplating or are already attempting to develop technological security, energy security, food security, and health security initiatives—all of which dovetail with national security. One catch-all term for this is "sovereign development." It involves boosting and coordinating internal investment and research and development (R&D) in key areas.

China has been pursuing this strategy for many years with elaborate and coordinated economic planning that emphasizes internal investment and R&D spending to achieve its goals.

The country's annual R&D spending surged from only $34.9 billion in 1995 to roughly $370 billion in 2020, and it jumped to $449 billion in 2022. While the government's formal plan incorporates a seven percent increase in R&D expenditures each year through 2025, in practice China has boosted R&D at a 12 percent average annual rate for many years. If China keeps investing at that higher rate, R&D spending would reach over $1.1 trillion by 2030, the year it seeks to achieve the status of a global technology leader. By comparison, the U.S. will likely spend around $850 billion in R&D in 2023.

But these figures don't take into account purchasing power parity—the reality that spending in China goes further than it does in the U.S. partly because labor is cheaper, and R&D spending is labor-intensive.

In addition to internal investments, China's Belt and Road Initiative and its other multilateral and bilateral projects with BRICS, the SCO, and other countries contribute to its sovereign development plans.

At the same time, the U.S. and its allies have recently begun to encourage and incentivize the onshoring of manufacturing and "friend-shoring." The latter term, popularized by U.S. Treasury Secretary Janet Yellen, represents the deepening of trade relations and manufacturing supply chains between allied and like-minded countries.

The U.S., some EU countries, Japan, and South Korea are boosting R&D budgets for technological innovations, including the building-out of semiconductor supply chains and green energy advances.

The West's strategy also involves restricting trade with China in sensitive technological and security areas, which has included the termination of some scientific cooperation projects, and sanctions against select Chinese companies and government officials.

In a speech at Johns Hopkins University in April, Yellen said, "As in all of our foreign relations, national security is of paramount importance in our relationship with China … We will not compromise on these concerns, even when they force trade-offs with our economic interests."

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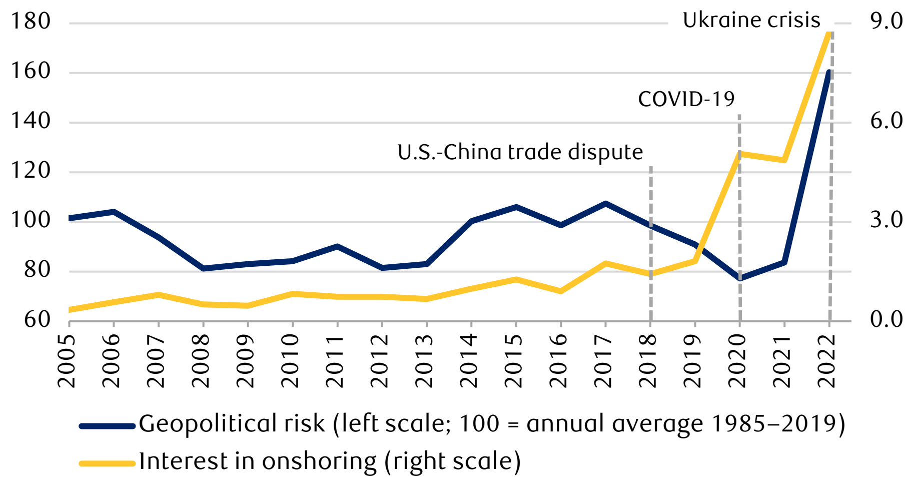
As geopolitical risks have increased, interest in onshoring has risen



Note: The interest in onshoring is measured by the average frequency of mentions of reshoring, friend-shoring, or near-shoring in firms' earnings calls based on a large sample of multinational corporations.

Source - IMF World Economic Outlook April 2023, Bailey, Strezhnev, and Voeten (2017), Hassan and others (2019), NL Analytics, IMF staff calculations

All told, these actions by the West and non-West push the economic order further away from globalization, and toward what the International Monetary Fund (IMF) describes as "trade fragmentation," at the very least.

Some silver linings: Industries that could benefit

We view onshoring and friend-shoring, and the concept of trade fragmentation, as old-fashioned protectionism with new, more palatable names.

Protectionism can have short- and medium-term economic benefits between trading blocs and industries.

It's not a stretch to envision increased economic activities among Western allies and some companies domiciled within them. Onshoring and friend-shoring could boost economic activity for a time, particularly within certain priority sectors.

And we think there will be greater integration among countries that have strategic partnerships and constructive relations outside of the West, such as those affiliated with BRICS and the SCO. These flexible entities seem poised to gain more members, particularly from the Global South. Some in these organizations have also expressed interest in creating new economic and financial structures. We think total trade among these countries has the potential to increase over the near and medium term.

Such changes in the West and outside of the West could boost industries that are geared toward sovereign development:

- Advanced technologies, including semiconductors and artificial intelligence
- Cybersecurity
- Critical minerals and rare earths
- Energy transition technologies
- Water resource technologies
- Select industrial and infrastructure technologies
- Military and space equipment
- Advanced health care, including biotechnology and life sciences

Pitfalls in the new paradigm

If protectionism persists over the long term—with more trade barriers, tariffs, and sanctions piling up—we believe the economic drawbacks would eventually come home to roost.

Protectionism has the potential to ultimately give way to economic inefficiencies and higher inflation compared to the era of globalization.

Many companies could eventually be faced with higher expenses, including wages; more friction within supply chains; more difficulty sourcing select commodities; and lower corporate efficiencies. This would inevitably create headwinds for global economic output, investment, and growth.

Innovation, including the implementation of artificial intelligence and other advanced technologies, could make up for some of the costs and inefficiencies associated with protectionism. But we think economic growth would still lag the period of the early 1980s through 2008 when globalization surged.

The top IMF official, Kristalina Georgieva, pointed out in January 2023 that recent estimates vary widely for the impact of trade shifting further away from globalization to more fragmented conditions.

She wrote, “The longer-term cost of trade fragmentation alone could range from 0.2 percent of global output in a limited fragmentation scenario to almost seven percent in a severe scenario—roughly equivalent to the combined annual output of Germany and Japan.” A separate IMF staff analysis estimates the full impact of trade fragmentation could be even larger.

Most sources agree that if technology cooperation between the U.S. and China is cut off to a great extent, there could be more damaging global economic consequences.

While there is a wide range of potential outcomes, we think it’s logical to conclude that protectionism could weigh on corporate earnings overall, which could result in less robust equity price growth than occurred during the era of booming globalization.

Investing in a post-globalization world

The further shift away from globalization will likely take place over years. It’s a long-term secular trend that won’t necessarily be visible in economic data or market performance at all times.

There will still be prominent shorter-term, cyclical events—such as changes in monetary policies and the business cycle, including recessions and recoveries—that will capture investor attention and impact corporate earnings and markets.

But we think this overarching protectionist trend, punctuated by deglobalization risks and manifestations, will hover in the background. This will be particularly visible when major geopolitical, diplomatic, military, and geo-economic events surface.

We believe the long-term trend toward a more fractured world order argues for rethinking how one views country and industry exposures in investment portfolios.

Sub-asset allocations within equities and fixed income should no longer be viewed through the lens of cooperative globalization. Instead, they should be viewed through the lens of trade fragmentation and protectionist risks, and the

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realignment of relations between nations into formal and informal blocs and associations.

We think the trend away from globalization—and the risks of deglobalization—begs for more active asset management for country, industry, and company exposures.

A number of strategically important industries seem poised to benefit. But if the protectionist trends persist over the long term, we think global economic growth and equity market gains could be more muted than they were during the globalization heyday.

Research resources

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David Storm, CFA, CAIA – Chief Investment Officer, BI & Asia, RBC Europe Limited

Yuh Harn Tan – Head of Discretionary Portfolio Management & UHNW Solutions, Royal Bank of Canada, Singapore Branch

Joseph Wu, CFA – Portfolio Manager, Multi-Asset Strategy, RBC Dominion Securities Inc.

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As of March 31, 2023

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Hold [Sector Perform]	591	40.20	132	22.34
Sell [Underperform]	55	3.74	4	7.27

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