GERSTEIN FISHER
INVEST WITH REASON

A WORLD AT ODDS EVENT RECAP

From left: Rawi Abdelal, Gregg Fisher

The current economic and political landscape presents us with a host of questions: Has the recent trend toward globalization moved into reverse? Can our citizens today even agree on what is true and what is false? Does the rise of China signal an end to US hegemony? How should one invest in this messy world? To address these key issues, among others, Gerstein Fisher hosted a special event on May 14, 2019, "A World at Odds: Investing in an Era of Brexit, the Mueller Report, and the Rise of China." Harvard Business School Professor Rawi Abdelal, our guest speaker, discussed the political and social implications of fraying relationships around the globe.

Gregg Fisher, Gerstein Fisher Founder, Portfolio Manager, and Head of Research, analyzed the multiple challenges of investing globally in today's market environment. Following are a recap and key takeaways from the evening's discussion.

RAWI ABDELAL, PhD

Herbert F. Johnson Professor of International Management, Harvard Business School
Director of Harvard's Davis Center for Russian and Eurasian Studies, Harvard University

"In an ever-changing, incomprehensible world, the masses had reached the point where they would, at the same time, believe everything and nothing, think that everything was possible and that nothing was true." – Hannah Arendt

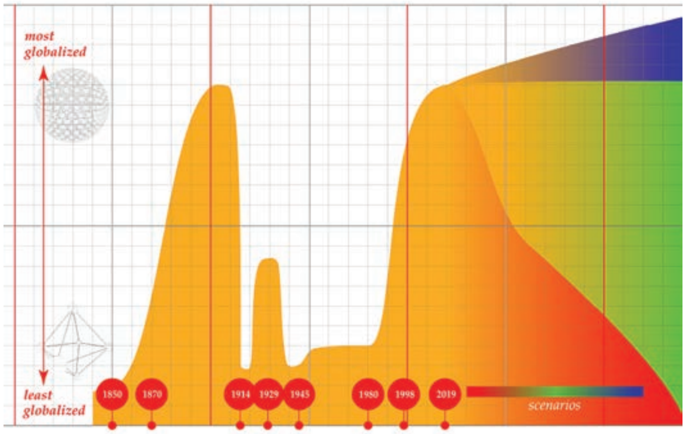
Philosopher Hannah Arendt's discomforting words, from her 1951 study of the rise of totalitarianism in the first half of the twentieth century, still resonate today. Have we entered an era in which confusion reigns as the global economy is fragmenting? First, let's agree that "globalization" is a measure of how integrated markets for goods, services, and capital are across the borders of sovereign states. Quantifying this economic data, Exhibit 1 traces the ebb and flow of globalization through modern history (with some possible future scenarios). The period from 1870 to 1914 marked its first great era, as the economy flowed across the borders of nations. And in line with human behavioral biases, the business and investment community expected what was happening *then*, i.e., global-market integration, to continue indefinitely into the *future*. It didn't happen.

Globalization Under Siege (Again)

The world economic system, and with it, globalization, was shattered after World War I erupted in August 1914. After the war ended, globalization began to make a tentative recovery in the 1920s, only to be devastated by, in quick succession, the great stock market crash of 1929 (which triggered a global equity-market collapse); the onset of financial chaos and the Great Depression in the 1930s;

and the rise of trade protectionism in the US, which triggered trade wars around the world. The devastation of the Second World War put the finishing touches on the destruction of the world trading system. It took until about 1980 for globalization to rebound.

Exhibit 1: Globalization Has Ebbed and Flowed Over Time



Source: Rawi Abdelal

Now, after another round of cross-border economic integration, this time nearly four decades long, globalization is again under siege, for a host of reasons: the simultaneous rise of both left- and right-wing populism; levels of income inequality that are incompatible with social solidarity; a great-power transition underway in the global economy (as was the case in the 1910s and 1920s); and huge flows of migrants around the world (a disruption a century ago as well). To examine the challenges fragmenting the global system and to assess where we may be headed, let's focus on three key events today, which I like to call "metaphors": Brexit, a crisis of democracy in some key nations, and the rise of China.

Brexit Reveals Deep Underlying Divisions

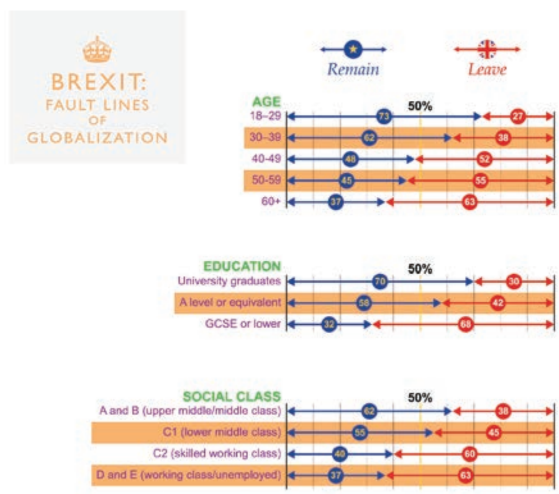
We still don't know the endgame for the departure of the United Kingdom from the European Union (i.e., a deal or no-deal Brexit, or even no exit after all). But big picture, the Brexit movement was born out of a fear of globalization, of pan-Europeanism, and of immigration – and out of nostalgia for bygone times.

Further, the rise of income inequality in the UK was a powerful driver of Brexit, along with the country's unusually low degree of intergenerational economic mobility (e.g., between father and son). Mobility in the UK isn't as pitifully frozen as in some Latin American countries, but it is among the lowest in the developed world. In other words, if you are not born into a household with a high income, you are highly unlikely to become wealthy (the US also scores low on this measure, but slightly better). The social-class stasis is an underlying source of fear, anxiety, and frustration in the country, and it fed in to the calls for Brexit.

Exhibit 2 provides a demographic analysis of 2016's historic Brexit vote. The young voted overwhelmingly to stay in the EU, while the old voted to leave. More-educated citizens (and those from higher social classes), with skills to compete in a global labor market, had a far higher propensity to vote for staying in the EU. Politically, Brexit appealed to Britain's right-wing populist agenda: A staggering 97% of the nation's Independence Party voters (and 56% of Conservatives) supported exiting the EU at the polls, compared to just 25% of Labor and Liberal Democrat voters.

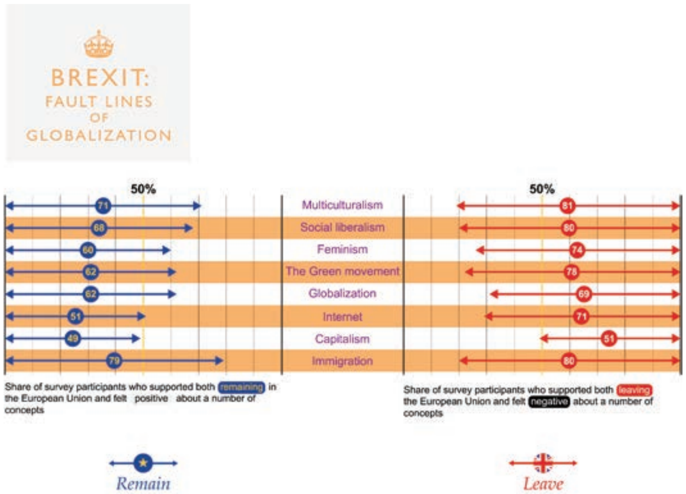
Exhibit 3 builds on those trends by illustrating the sharp polarization among the British populace on issues linked to the Brexit referendum, such as multiculturalism, immigration, and social liberalism. In short, half of British society saw the previous 30 years as an era of progress, while the other half reckoned that the country had taken a decidedly wrong turn.

Exhibit 2: Brexit: The Sharp Split Among Voters by Demographics...



Sources: Lord Ashcroft Polls and Rawi Abdelal

Exhibit 3: …And by Social and Economic Viewpoints



Sources: Lord Ashcroft Polls and Rawi Abdelal

"Truth" in the US: Up for Grabs

Beyond Brexit, I think that today we need to resurrect the philosophical concept of epistemology: how we know what is *true*, and what is *not true*. In an age of rising populism coupled with left- and right-wing political polarization, people not only disagree on how to proceed on societal issues, but even on what is fact and what is fiction (or half-truth). Which brings me to the US and the Mueller Report.

Some Russians hacked into Democratic National Committee servers and collected tens of thousands of emails that were then leaked to the public. Some of the emails described how Hillary Clinton was conspiring with the DNC to prevent Bernie Sanders from becoming the Democratic Party nominee in the presidential race. This was demonstrably true, not disinformation.

The question of whether there was collusion between the Trump campaign and the Russians is more of a gray area. The Mueller Report concluded that collusion (or conspiracy) did not occur, but it wasn't for lack of trying by the President's sons. The Report is much more nuanced on whether Trump tried to obstruct the Mueller investigation, in the end hinting he was guilty while refusing to either accuse him or exonerate him. Meanwhile, paradoxically, the Report determined that there was no underlying crime for Trump to obstruct. Blurry lines indeed.

As to the social-media strategy employed by the Russians during the election campaign, it was shockingly cheap ($150,000 to $200,000) and effective. Even the Russians were no doubt surprised by how easy it was to disrupt the American democratic system via a low-budget disinformation campaign on sites such as Twitter, Facebook, and YouTube. The Russians delivered both right-wing (nativist, populist) and left-wing (socially liberal) nonsense to US social media in the form of fabricated stories attributed to actual news organizations. The strategy may have been to further polarize Americans, pushing them away from the center of the political spectrum toward both the unstable right and the unstable left.

This is where epistemology comes in: We are now living in an age of epistemological fragmentation. Fifteen or 20 years ago, we basically all had access to the same facts and could agree on what was true and what was not. Today it's the opposite: We each live in our own epistemological space, with a customized flow of information (68% of Americans report that they get their news from social media) that confirms what we already believe – some of which may be true and some which may not be. In essence, Americans have made a collective decision to dwell in alternate, hermetic realities. So we no longer share the same facts with our neighbors. But the Russians didn't create this problem: We did it to ourselves.

Who's on Top in the Global Economy?

Adjusting for purchasing-power parity, China has already overtaken the US as the world's largest economy. The zenith for the US came in 1960, when by the same measure it accounted for a quarter of world output (five times that of China). That figure is now down to 15%, compared with 18% for China.* In absolute terms, the US and the EU are still growing, but their economies are in relative decline as a share of the global pie.

In sum, the global economy is transitioning away from US dominance toward a binary system with two great powers, the US and China, of roughly equal weight. But they have starkly different world views and political systems. It remains to be seen how the two will coexist. One concluding note: Chinese growth has depended to a large extent on US household consumption. But the Chinese leaders know that this path will prove unsustainable, since the US appetite for their goods will eventually taper off. And so China is looking around the world for markets that might pick up the slack – hence its ambitious "Belt and Road" Initiative designed to bolster Chinese trade and influence worldwide.

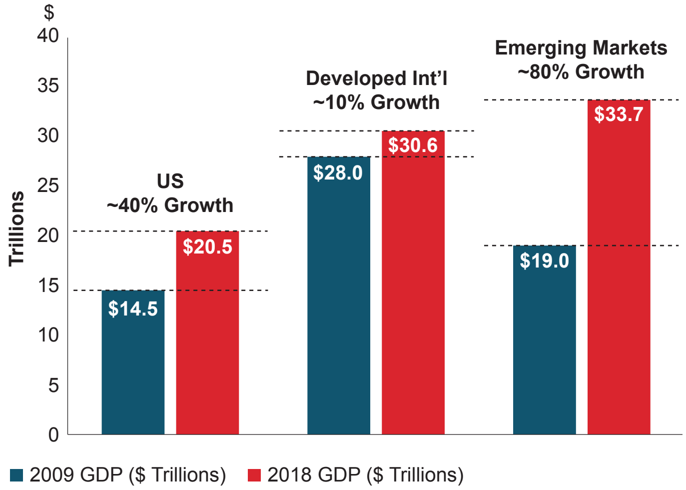
* The US still leads China, 25% of global output vs. 15%, when adjusted for local pricing.

GREGG S. FISHER, CFA

Gerstein Fisher Founder, Portfolio Manager, and Head of Research

The global economy is slowing, and the dispersion of growth rates around the world is wide (see Exhibit 4 for a comparison of how much growth each region has generated over roughly the past decade). Patterns of consumption have been similarly different: From 2009 through 2017, consumption expanded by a third in the US, but actually contracted in Germany and Japan while growing explosively in China and India (183% and 130%, respectively).

Exhibit 4: Where is Growth Happening?
Jan. 1, 2009-Dec. 31, 2018



Sources: OECD and Gerstein Fisher Research

Challenges and Resilience

Unfortunately, global economic growth over the past decade has come with a rapid accumulation of debt: sovereign, corporate, and household. The ratio of global debt to GDP is currently at nearly 3:1, a record. Student loans have been a contributor: The amount of student-loan debt in the US has tripled over the past decade to $1.6 trillion, and the system is threatening to employ some draconian collection solutions for delinquent loans, such as garnishing debtors' working wages or withholding drivers' licenses. A friend of mine recently commented: "Debt doesn't matter until it does – and then it matters terribly." History informs us that periods of elevated debt don't usually end well.

Political headlines are also spooking investors, but we need to separate between temporary distractions and long-term investing discipline. For example, Britain is still struggling to come up with a Brexit plan, but this wouldn't stop us from investing in UK-listed securities such as Unilever, HSBC, and BP – global companies serving customers not only in Britain but around the world. Likewise, uncertainty in trade between the US and China has fed market volatility, but that doesn't necessarily change the fundamentals for corporations that look interesting to us as investments. The headlines can be unnerving, but companies have ways of adjusting to new challenges. To take one example, when the US began imposing tariffs on imports from China, Foxconn, a leading Taiwan assembler of Apple iPhones, started to move some production from China to India. Of course, some companies are able to adjust much more quickly than others, which affects what investors are willing to pay for their stocks.

Surging China

We've entered an era of Big-Power rivalry between China and the US, as Rawi suggested. China's economic rise has been astonishing: From 2000 to 2019, China's share of world GDP quintupled to almost 20% (the US proportion declined during the same time frame). For two decades (from 1990 to 2009), China's annual GDP growth compounded at 10%, though it's trended down to about 6% now. Since China has been such a large component of global economic growth, when their engine slows the world economy slows.

But the economy and markets are not the same thing, and the linkage can be murky. Take the US and China as examples: From January 2000 to April 2019, despite much higher economic growth in China, the cumulative return for stocks in both countries was almost identical, about 200% (although you could argue that on a risk-adjusted basis the US outperformed). But what's really interesting – and speaks to the benefit of global diversification in stocks – is the divergent pattern of returns. The decade from 2000 to 2009 was a lost one for American investors (marked by two epic market crashes): If you put $1 into stocks, you ended up with just $0.91 after 10 years. But during our lost decade, Chinese stocks soared 175% cumulatively. And lately?

If you fast-forward to the period from 2010 to April 2019, US stocks surged 220%, versus an anemic 15% cumulative gain for their Chinese counterparts.

Meanwhile, there's no denying China's enormous ambition. Signals from Beijing indicate they're prepared to spend $1 trillion on its Belt and Road Initiative, a sort of global infrastructure plan that will tie other developing countries more closely to the Chinese economy. And China aspires to be the world leader in artificial intelligence by 2030, which means, if it comes to pass, that they will capture gigantic amounts of data. Already, AI technology is allowing China to leapfrog industries. For example, Ant Financial, an affiliate of China's retail/tech giant Alibaba, deploys an AI-enabled platform for banking, lending, and private-wealth management. Ant effectively skipped the old brokerage-system era and is currently valued at $150 billion – twice the market cap of Goldman Sachs.

A Riskier Investment Regime

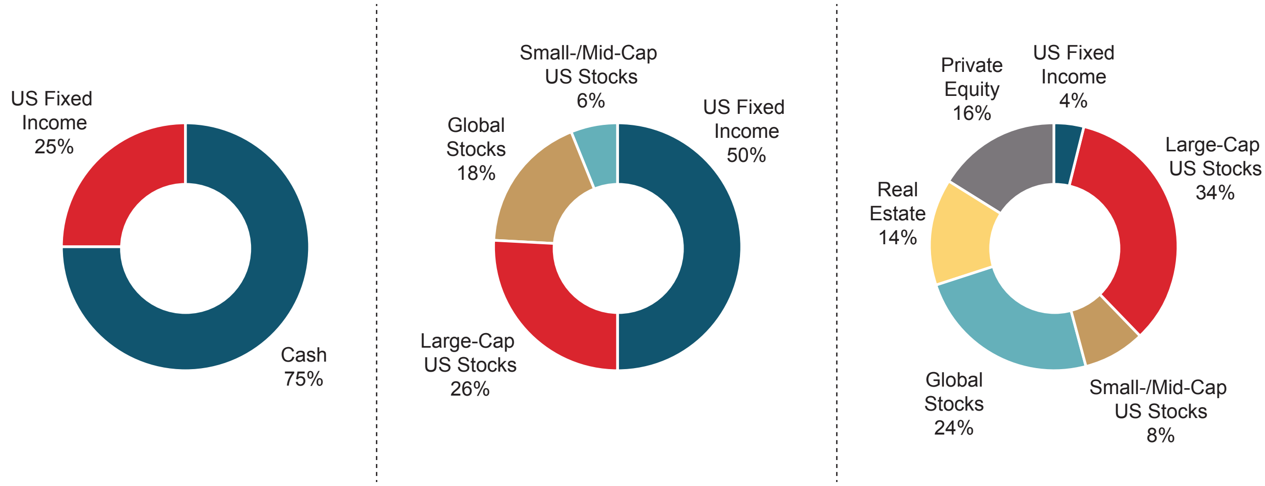
Back at home, investors face several challenges. If you're a pensioner, or an individual planning for retirement, achieving an expected compound return of, say 7.5%, is much more difficult and risky than it was 30 years ago. As Exhibit 5 shows, in 1989, when interest rates were high, you could have attained that level of expected return simply by allocating a quarter of your money to bonds and keeping three-quarters in cash. Risk, as measured by the standard deviation of return, was just 3.1%.

Fifteen years later, in the regime of 2004, achieving the same 7.5% expected return would require investing half your assets in diversified global stocks and the other half in US bonds, which would nearly triple the risk of the 1989 portfolio. To get to an expected 7.5% in today's markets implies allocating 96% of the portfolio to "risky" assets including public and private equities, and just 4% to fixed income. This risk-dominated construction has an expected volatility of 18%: six times the risk of the 1989 portfolio for targeting an identical expected return of 7.5%.

A Glance Toward the Future

Stock-market dynamics are also changing, with the rapid rise of passive indexing. Today, index funds (including exchange-traded funds) account for perhaps 35% of the market. Jack Bogle, the index pioneer, wrote shortly before he passed away recently that indexing could well extend to 50% of the market in time. Even this index titan looked

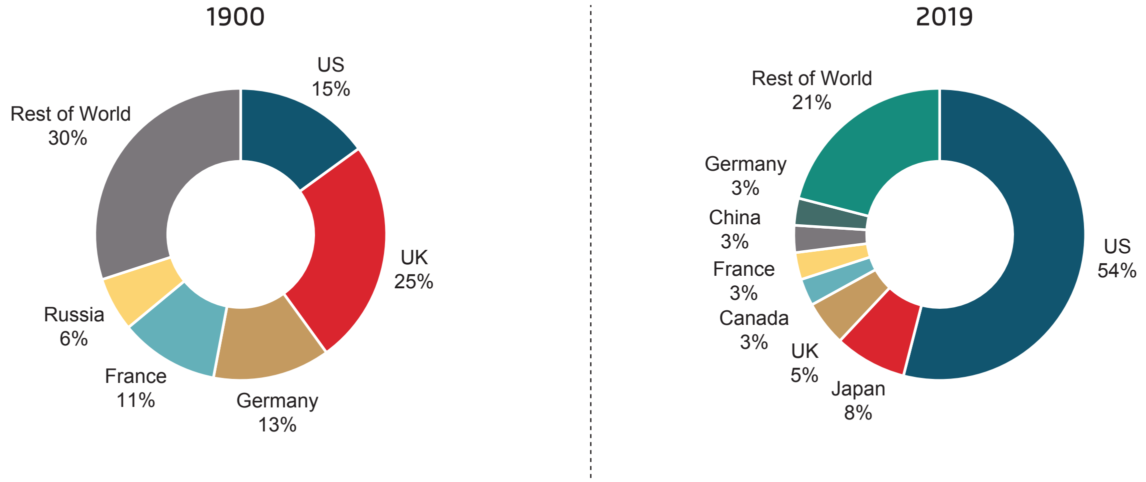
Exhibit 5: You Need to Take More Risk Today to See the Same Level of Return
Risk Required to Earn an Expected 7.5% Annualized



Regime	1989	2004	2019
Return	7.5%	7.5%	7.5%
Risk	3.1%	8.9%	18.0%

Sources: Callan and Gerstein Fisher Research

Exhibit 6: The Stock Markets 120 Years Ago vs. Now



Sources: Elroy Dimson, Paul Marsh, Mike Staunton, London Business School; Credit Suisse Global Investment Returns Sourcebook; MSCI; Gerstein Fisher Research

with caution at this trend. Dominance by passive indexing, he thought, could create risks – weaker corporate governance among them, since there would be fewer active managers and analysts asking tough questions of company managements.

The intersection of private and public equity is also a bit worrisome. Investors have committed about $1 trillion to PE funds, which, with leverage, could mean $3 trillion of cash waiting to be invested anywhere (including overseas). The PE industry is already affecting public markets; for instance, the number of publicly traded securities has shrunk by half over the past 20 years. A small, private company could now probably raise funding more cheaply from a PE firm than by going public – which will likely lead many businesses to stay private. There are already fewer small-cap stocks available for investment. Plus, we're also seeing rising correlations between the private and public markets, which dilutes the diversifying benefit of adding PE to a portfolio. In contrast, the opportunity set overseas for investing in public companies is expanding, particularly in China.

Finally, it's an interesting thought experiment to consider global investing in the context of history. Exhibit 6 illustrates what a good century (120 years, to be exact) it has been for investing in America. From 1900 to 2019, the US share of global stock-market capitalization shot up from 15% to more than 50%. What will this bar chart look like 100 years from now? Nobody knows, of course, but an investor could assign probabilities to a range of possible outcomes, informed by the issues we've been discussing here – particularly to what degree the world is becoming less globalized and more fragmented.

Thank you for your continued trust and confidence.

Sincerely,

Gregg S. Fisher, CFA
Founder, Portfolio Manager & Head of Research

A World At Odds: Key Takeaways

Globalization: Out of Favor (Once Again) (Rawi Abdelal)

- "Globalization" and its opposite, global fragmentation, aren't new phenomena. The latest era of global economic integration, which began around 1980, is now threatened by disruption.
- Among the events pulling apart global cooperation are Brexit, a crisis of democracy in some key nations, and the rise of China (a new world power challenging the established order).
- In Britain, while we don't know the Brexit endgame yet, we do know what its driving forces were – a fear of globalization, pan-Europeanism, and an immigration crisis. And we know how the British electorate split on the issue along demographic, political, and ideological lines.
- In the US, exacerbated by the ambiguities in the Mueller report, "truth" has seemingly become what any American wants it to be – a discomforting development probably abetted by social media.
- Meanwhile, the global economy is transitioning away from US leadership toward a binary system shared by the US and China, each with vastly different political systems and world views.

Investing in a New Global Landscape (Gregg S. Fisher)

- The global economy is slowing, and the dispersion of growth rates worldwide, along with patterns of consumption, has been dramatic over the past decade or so.
- Global debt is at a record level relative to GDP, and that may come to matter (a lot).
- But there's also a great deal of noise surrounding us that investors need to filter out – political uncertainties often among them: They don't necessarily change the company fundamentals that are important to us in making investment decisions.
- The US-China rivalry bears watching, but don't confuse economics with the investment markets. Over the past decade, for example, even as China's economy eclipsed ours at home, their stocks barely budged.
- We'd highlight three challenging market trends:
  - The relatively high level of risk that investors will probably need to take to achieve their return goals
  - The rapid rise of passive indexing (and hence fewer active market participants asking company managements the tough questions), and
  - The growing importance of private equity (depleting the public markets)
- Not surprisingly, the global stock markets have gone through remarkable changes since the dawn of the twentieth century. No one knows what the markets will look like 100 years from now – but we believe that part of the answer lies in the degree to which the world embraces globalization or fragmentation in the intervening swath of time.

GERSTEIN FISHER
INVEST WITH REASON

800-846-6202 | info@GersteinFisher.com | www.GersteinFisher.com