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Bi-Weekly
Geopolitical Report
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Eight Megatrends Every Investor Should Know

One of the defining characteristics of our investment strategy work here at Confluence is that we pay close attention to big, global trends in geopolitics, economics and trade, demographics, technology, and even social and political developments. We then try to determine how to incorporate those trends into our strategies, either by managing the risks they impose or identifying and investing in the associated opportunities. We think this discipline can be fruitful because big, global trends are often long lasting and relatively predictable. Shorter-term, idiosyncratic forces can still make asset prices volatile from time to time, but the impact of "megatrends" often comes back to the fore relatively quickly.

Our regular readers know that we pay especially close attention to geopolitical trends. However, in this report, we want to provide a broader survey of several megatrends that are likely to remain in place for at least the next decade and be especially salient to investors. This list isn't necessarily comprehensive; another writer could easily come up with an alternative set. All the same, we think it will be interesting for investors to consider the wide range of global trends that could affect their investments.

1. Income and Wealth Inequality

When we focus on income and wealth inequality around the world, it's not for ideological reasons. Rather, it's because we're looking for the root cause of today's political, economic, and social tensions. In our view, one key reason for these tensions is the inequality that has arisen in recent decades because of several interrelated geopolitical, economic, and technological developments in the United States and its allies. These developments include:

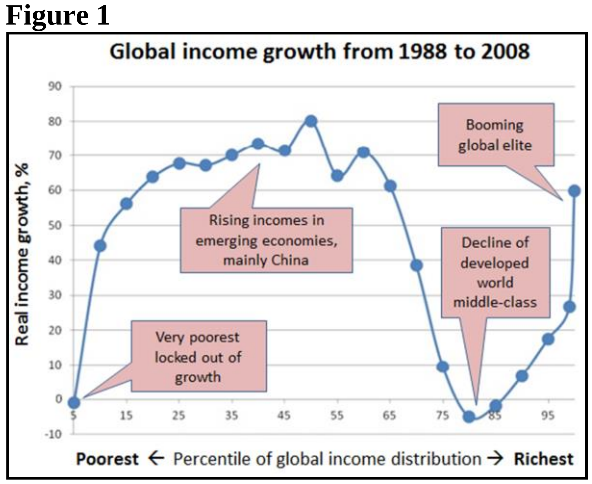
- ***The Efficiency Cycle.*** After the explosion in consumer price inflation in the 1970s, the US and some other developed countries actively deregulated their economies to lower costs for businesses and make them more efficient. The aim was to reduce price pressures. Besides eliminating onerous rules, the efficiency policies worked to reduce union membership, cut taxes on firms and business owners, and prune back income support programs for workers with lower skills. Over time, these policies gave greater scope for business owners and other economic elites to build wealth.
- ***The End of the Cold War.*** When the Soviet Union disintegrated in 1991, its communist ideology and centralized, state-planned economic model were discredited in the eyes of many around the world. In contrast, the efficiency policies discussed above had helped bring down inflation and spur resurgent economic growth, adding to the ideological appeal of private property protections, low regulation, low taxes on capital, and flexible labor markets. The result was to reinforce those policies that had provided economic advantages to better-educated elites and continued

challenges for many in the working classes.

- ***US Hegemony and Globalization.*** As we've often written, the policies used by the US to maintain its role of global hegemon and keep the peace also imposed costs on non-elites in the working class. Most onerous were the policies aimed at making the dollar the world's reserve currency, i.e., free trade and capital flows. Especially after China entered the World Trade Organization in 2001, those policies resulted in massive import flows and the transfer of factories abroad, throwing many people out of work, or at least out of the middle class. As shown in Figure 1, middle-class workers in China and other developing economies saw their incomes surge as this globalization took hold, and so did US and Western elites. In contrast, middle-class workers in the US and the rest of the West say their incomes were stagnant or fell.
- ***Information Technology.*** With the development of new information processing technologies from the 1960s until today, labor demand shifted decisively in favor of the highly educated, well-traveled new class of "knowledge workers." These workers could not only command high salaries, but their jobs were often relatively insulated from foreign competition. Younger people from the lesser-skilled working class found it hard to break into the knowledge class with its high incomes due, in part, to the high cost of a college education.

On a global scale, high levels of income and wealth inequality have spawned or worsened many other important trends. In countries such as Germany and China, for example, the concentration of income and wealth at the top of society has held down total domestic consumption (after all, wealthier people typically spend a smaller share of their income than those of more modest means). Meanwhile, the wealth-friendly policies and deregulated capital flows of the efficiency cycle mean that much of the enormous savings of the foreign wealthy is invested in the US, which has relatively better economic growth and investment opportunities. In turn, those capital flows have helped drive up the price of US stocks and bonds. They have also helped buoy the value of the dollar, expanded the US trade deficit, and contributed to the US government's burgeoning debt.

Figure 1



The globalization "elephant chart." (Source: Pew Research Center)

2. Nationalist Populism

Our regular readers know that we think populism [is a key trend in the US and around the world](). In our view, the income and wealth disparities described above have helped spark a nationalist, populist backlash, not only in the US, but also in other major developed countries, especially in Europe. Driven by a sense that they've been left behind by rich elites, populists on the political left and right have begun to clamor for policies blocking imports and protecting domestic jobs, cutting immigration, and hiking taxes or otherwise cutting the elites down to size. To overcome resistance by the elites, populist leaders also often look to strengthen state power, earning them a reputation for being friendly toward authoritarianism.

Nationalist, populist policies can now be found in the agendas of both right-wing and left-wing political parties in the US and Europe. Moreover, populist politicians have been able to take power in various countries, such as former US President Trump and Hungarian Prime Minister Viktor Orbán. But even in countries where left-wing populists might come to power, we would expect to see more policies aimed at helping the non-elite working class or middle class, while taking aim at the elites. For example, we would expect to see more government support for unions and fiscal programs favoring the working class.

3. Global Fracturing

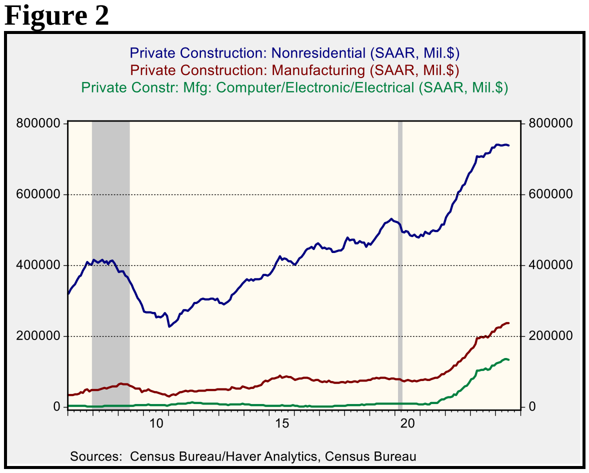
Ironically, the US's hegemonic policies since World War II eventually helped boost economic growth in key authoritarian countries, such as China and Russia, especially after 2001. As these authoritarian economies began to gain heft, we believe their leaders also took note of growing populist isolationism in the West. China, Russia, and their allies have therefore become more forceful in asserting themselves on the world stage. For China in particular, its predatory economic policies have now been matched by a vigorous military buildup and territorial hostility. Russia and Iran have also become more aggressive.

In response to the growing geopolitical tensions associated with these developments, countries around the world have begun to coalesce into relatively separate geopolitical and economic blocs. They have begun to draw closer to their allies, while pulling back from potential enemies by restricting trade, investment, technology, information, and people flows between them. As a result, global supply chains have begun to shorten and become less efficient. Going forward, the result is likely to be relatively lower corporate profits, higher and more volatile price inflation, and higher and more volatile interest rates. As we've noted before, another result will likely be greater defense spending across the developed countries, which should benefit defense stocks and the stocks of technology or other firms that provide goods or services to the military.

4. Re-Industrialization

As the world fractures into different blocs, governments around the world have begun to focus on building greater economic resilience and reducing their dependence on foreign resources. Facing a more chaotic world, corporate managers have also begun to "near shore" or "friend shore" by relocating production back to the US or at least to US-friendly countries.

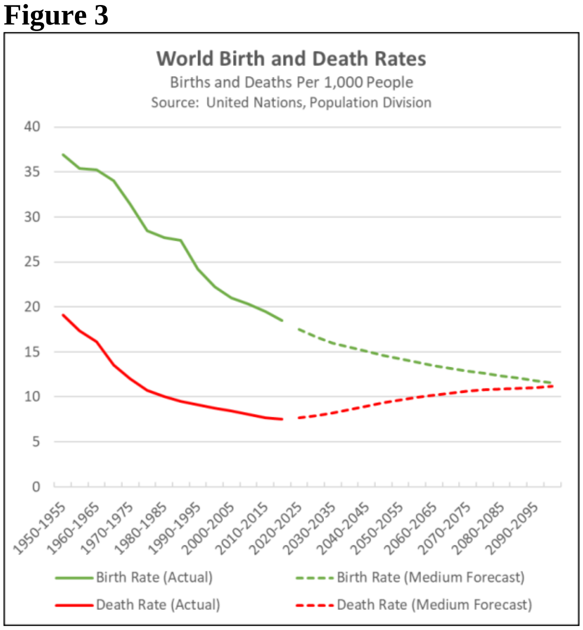
Figure 2



One result of this is that the US and other countries are in the middle of a boom in factory construction (see Figure 2). As the US rebuilds its factory sector, a range of ancillary industries are likely to also expand, such as railroads, trucking firms, basic material suppliers, and corporate services. Naturally, the stocks of companies in those industries should provide good returns. As manufacturing regains its share of the US economy, labor demand will also likely become more diversified, creating new opportunities for those who don't go to college.

5. Population Aging
Re-industrialization and the expected recovery in factory jobs are interesting in themselves, but more so in the context of falling birth rates, slowing population growth, and population aging across the globe. Reflecting both cultural and economic factors, birth rates have declined in developed and emerging countries alike (see Figure 3), often to the point where new births are insufficient to offset deaths. In many countries, the total population has already started to fall. In even more countries, the working-age population has started to decline. Just as important, average ages have increased around the world, meaning each younger person is supporting more and more retirees or older people.

Figure 3

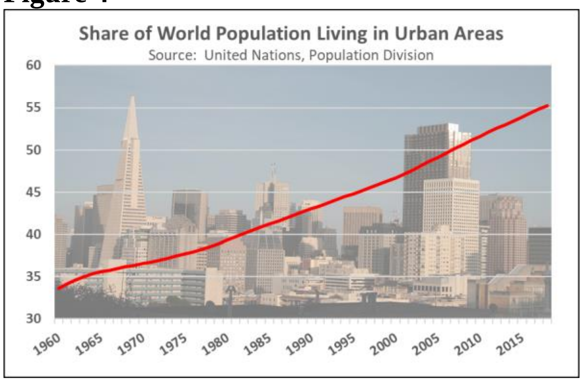


These trends have multiple potential implications for the economy. For example, a declining labor force or falling population is likely to be a headwind for total economic output. Population aging and a higher "dependency ratio" are also forcing many governments to spend more on retirement, health, and other benefits, which helps boost their debt levels. Countries that are relatively more open to immigration will, therefore, likely have an advantage in the coming decades. Countries that still have relatively high birth rates could also become more attractive as a market or production base. For example, continued high birth rates could well make Africa a favored investment target in the years ahead.

6. Migration
Although international migration gets the most attention in the US and several other developed countries, it may be useful to think of migration in a broader sense. In simplistic terms, personal mobility has been boosted by factors such as falling transport costs, increased information flows, and the development of social structures (ranging from legal refugee protections to human smuggling operations). As people look to escape bad conditions and better their lives, it should be no surprise that many are taking advantage of the new circumstances to move somewhere else. Indeed, many of them seek to migrate to a different country, such as the US or Germany. Others, however, simply seek to move from the countryside to a city (see Figure 4, next page).

Migration from rural areas to cities has been especially important to the world's recent economic history. The "China shock" that occurred when China entered the World Trade Organization and began its enormous growth spurt and export surge, depended heavily on the migration of millions of Chinese people leaving their impoverished farms and hamlets in the countryside to work in the new factories of Shanghai and other new metropolises. Similar, albeit smaller, urbanization trends have taken place in other developing countries. The economic impacts, which are continuing, include deeper pools of available labor, the potential for developing and disseminating new innovations, and greater demand for steel, cement, and other products that go into urban infrastructure. That has already buoyed commodities used in construction, such as iron, and the commodity producers that provide them. To the extent that urbanization continues, commodities and commodity producers are likely to provide good investment returns.

Figure 4



7. Electrification of the Economy

Obviously, electricity is a very old technology, and the initial electrification of society and the economy was more than a century ago. Nevertheless, there is now a new wave of electrification happening across the globe. Much of the impetus to electrification today stems from concern about global warming and a belief that electrified transport, heating, or other aspects of the economy will slash greenhouse emissions. The issue has become highly politicized, and many investors are repelled at the idea of the government pushing companies to favor one type of energy over another. Despite that, a trend is a trend, and we think investors should think about the investment opportunities that green energy and electrification could bring.

Without doubt, the strong impetus toward green technology and electrification is prompting a lot of wasteful investment. But then, so did the development of the railroads when that technology was being adopted a century and a half ago. The initial stage of electrification also produced some bad investment. All the same, those overall investment programs were useful. Going forward, the build-out of green energy facilities and greater electrification could help diversify the energy mix in the US and other countries. That, in turn, could make the US and other countries more resilient to geopolitical shocks and the risk that global fossil fuel supplies could be disrupted. Electrified vehicles, including tiny drones, are also finding uses in the military. And not surprisingly, the prospect of greater electricity demand has boosted stock prices for utilities and uranium miners.

8. Smart Machines

Of course, every investor is now probably aware of the excitement over artificial intelligence and any companies that facilitate its development. We think it may be helpful to place AI in a broader category of related technologies in which better data processing is leveraged to make industrial and information machines smarter and more autonomous. Besides AI, this would include military and civilian drones, for example. AI and autonomous vehicles or machines are closely related to each other, and both are likely to have a similar impact on the economy. By reducing the need for people to do work, they may help the economy grow despite the slowdown in population growth and the developing labor shortages discussed above. In turn, that could well boost average productivity and help raise living standards, even if there is a risk that many workers will lose their jobs and find it hard to adjust.

Investment Implications

To reiterate, this review of investable megatrends isn't meant to be comprehensive. There are probably several other big, long-lasting trends that could be added to the list. Nevertheless, we wanted to give a sense of how many such trends there are, even if we at Confluence tend to talk most about populism and global fracturing, along with their economic and financial market implications. With each trend discussed here, we've tried to provide a brief overview of how they may affect investment outcomes for various asset classes and overall investment strategy. Overall, we think most of these various trends will tend to promote greater and more volatile inflation, higher and more volatile interest rates, a need for new investment, and the potential for higher commodity prices. In an investment environment like this, we think the Confluence style of investing — which focuses on managing risk and addressing it through diversification — is especially well suited.

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September 23, 2024

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