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3D Reset: Three Trends Reshaping the Economy

Trends in deglobalization, decarbonization, and demographics are likely to have implications for investors in the years to come.

Insight from sub-adviser Schroders Investment Management

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There are three key trends currently reshaping our economies and societies: deglobalization, decarbonization, and demographics—the “3Ds.” And as they begin to usher in a new world order, the 3Ds will likely have lasting implications for investors that will continue to shake out in the coming years.

After years of low inflation and zero interest rates, this regime shift may feel like something totally new in the markets, but in many ways it’s a reset to how things were just a few decades ago. This “reset” brings new challenges, but for active investors it also brings opportunity.

Investors should expect higher inflation and tighter economic policy for longer. In the near term, central banks may have done enough to lower inflation from the peaks we saw last year—when US inflation hit a 40-year high—but there’s been a drastic change in the trade-off between growth and inflation.

Following the Global Financial Crisis, central banks stepped in to support the real economy and markets at the first sign of each downturn. Interest rates were cut to record lows, and trillions of dollars’ worth of quantitative easing were all seen as necessary to fight the risk of deflation. Now, amid rising political pressures, central banks are actively trying to slow growth to lower inflation—even if that triggers recession.

Inflationary pressures brought about by the 3Ds could result in tighter and more restrictive monetary policy than before the COVID-19 pandemic if central banks are to meet their obligations to maintain price stability.

Key Points

- Deglobalization, decarbonization, and demographics are reshaping our economies and could weigh on inflationary pressures, leading to higher for longer monetary policy.
- These new trends may feel like a totally new regime shift to some, but in many ways, it’s a reset to the market of a few decades ago.
- Understanding these trends, how they affect the global economy, and what that means for market volatility, could help investors decipher what may be coming next and where new opportunities could arise.

The 3Ds of the Reset

Taken together, the 3Ds are reshaping the investment landscape. Understanding these trends, how they affect the global economy, and what that means for market volatility, could help investors decipher what may be coming next and where new opportunities could arise.

Demographics: Ongoing worker shortages could push labor costs higher. Since the pandemic began, the labor-force participation rate has fallen in both the US and in other economies, such as the UK. In December 2022, there were 11 million job vacancies in the US, and only 5.7 million unemployed people. Basic economics dictates that where demand exceeds supply, prices, or in this case wages, must rise.

Deglobalization: Deglobalization is also adding to long-term inflationary pressures. The already strained relationship between the West and China intensified during the pandemic, as widespread blockages in the Chinese supply chain exacerbated inflation and highlighted the over-reliance on imports. The Russia-Ukraine war exposed similar dependencies, particularly regarding energy and agriculture in Europe.

In response to these disruptions, we’re seeing a new world order develop. Companies are diversifying their production and relocating nearer to home in a process known as reshoring. This means one of the great deflationary forces of

recent decades—the growth of low-cost production in China—may have run its course. Globalization can still play a role in lowering costs as production moves to new countries, but the easy gains, otherwise known as the globalization dividend, could be over as firms place an increasing importance on security of supply.

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Decarbonization: Commendable as it may be, decarbonization is likely to have a significant inflationary impact as well. Although the cost of producing renewable energy is falling sharply, the cost of replacing carbon-based energy is likely to raise energy inflation for many years to come.

The 3D Reset
Schroders
What today's investors need to know
A new regime shift for markets
After years of low inflation and zero interest rates, higher inflation brings the end of easy money
Central banks take center stage as tighter policies will raise interest rates, bringing greater volatility
The 3D Reset
Decarbonization, Deglobalization and Demographics are reshaping the investment landscape
Businesses will spend more:
Decarbonization
To accelerate the energy transition to cut CO_2 emissions
Deglobalization
For resilient supply chains
Demographics
For scarce talent and productivity-boosting tech
What it means for active investors
Diversify to hedge inflation and interest rate changes
Explore innovative technologies such as robotics and AI
Evaluate the beneficiaries of changing supply chains
Find yield opportunities throughout the cycle

Source: Schroders.

What Does This Mean for Investors?

Higher interest rates for longer will have significant consequences for investors and financial markets. From the implications for asset valuations to the additional volatility that will be introduced, investors may have to adapt to a world in which the Fed put[1] cannot be relied on to bail out risk assets.

Suddenly, every asset has had to reprice to compete with a yield on cash. Valuation matters.

[1] A Fed put is the market belief that the Federal Reserve would step in and implement policies to limit the stock market's decline beyond a certain threshold.

Gone are the one-way streets of "FOMO" (fear of missing out) equity markets dominated by the US and vanishingly small bond yields. Now, it's time to return to the careful analysis of winners and losers among companies—not just in the US—and seeking out interest-rate opportunities as monetary policy diverges.

In many ways, investors need to consider what worked in the last decade, and then do the opposite.

In recent years, the appeal of bonds was found in their negative correlation with equities. When bond prices rose, equities fell and vice versa. However, recent market activity indicates that investors may no longer be able to rely on the historical correlation between the two asset classes. Indeed, in 2022 bonds moved in lockstep with equities both upward and downward—their appeal now lies in their yield.

When it comes to equities, a renewed focus on valuations rather than speculative growth may be required, as well as a broader geographic focus. In an environment in which US market leadership is unlikely to be maintained, investors may want to consider looking further afield for more attractive opportunities.

The way investors look at commodities has also changed notably. Amid deflation, commodities weren't a first choice to diversify a portfolio, but now look more interesting as a potential hedge against inflation and geopolitical tension. The decarbonization trend may also lead to additional demand for metals as part of the energy transition, as well as underinvestment and under-supply of traditional fossil fuels.

On the face of it, a great deal has changed as a result of the 3D reset. Investors should value assets differently, consider new risks, and broaden their horizons. However, in many ways, this is a return to normal for active investors. It's once again time to be discerning, analytical, and valuation focused.

In many ways, investors need to consider what worked in the last decade, and then do the opposite.

Talk to your financial professional to learn more about positioning your portfolio for a changing investment landscape.

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