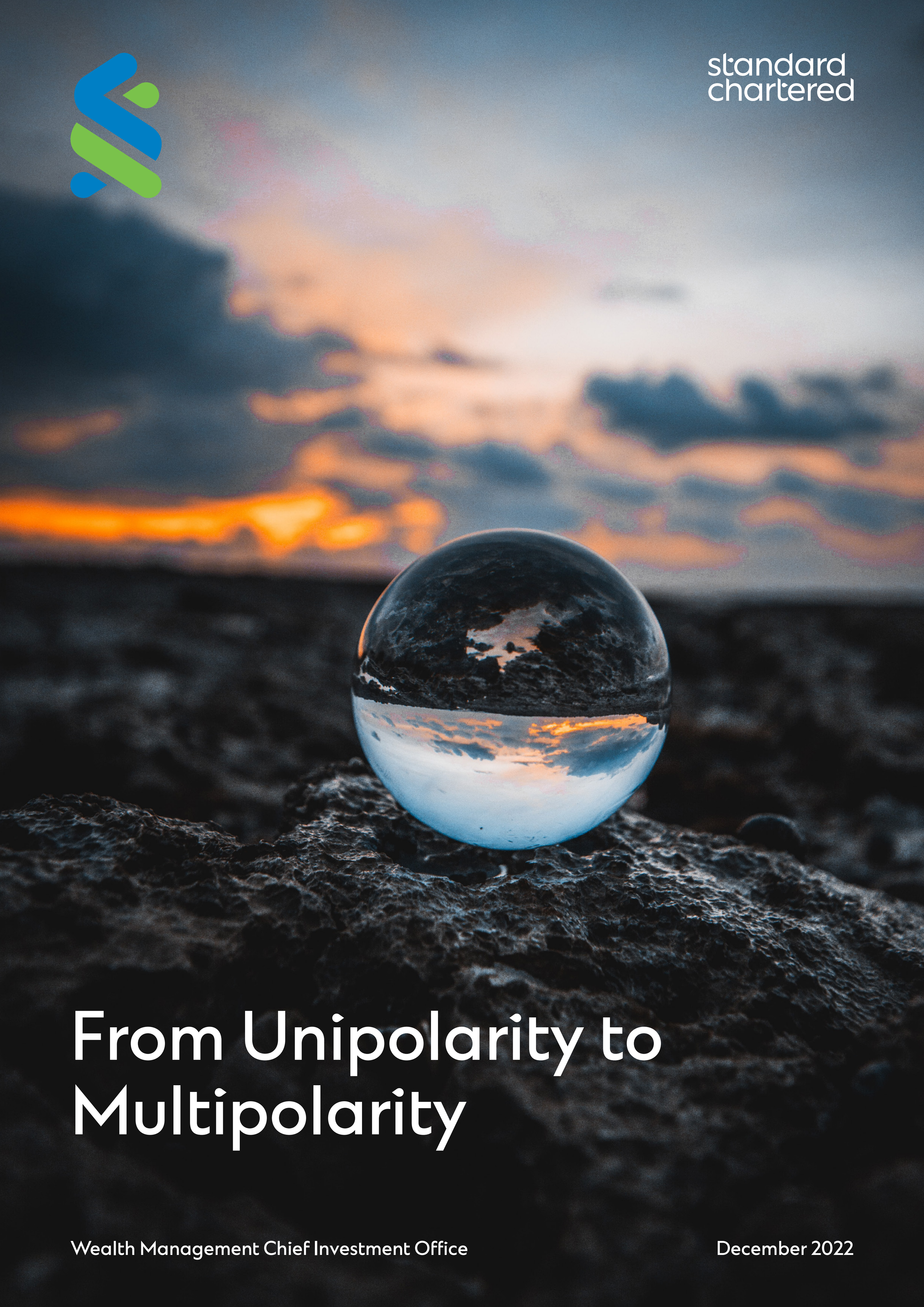

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From Unipolarity to Multipolarity

Wealth Management Chief Investment Office

December 2022

Navigating the rise of multipolarity

Throughout history, the World has witnessed cycles of shifting world order. Periods of political and economic predominance of a single power ('unipolarity') have been followed by periods when rising powers challenge the pre-existing order (rising 'multipolarity').

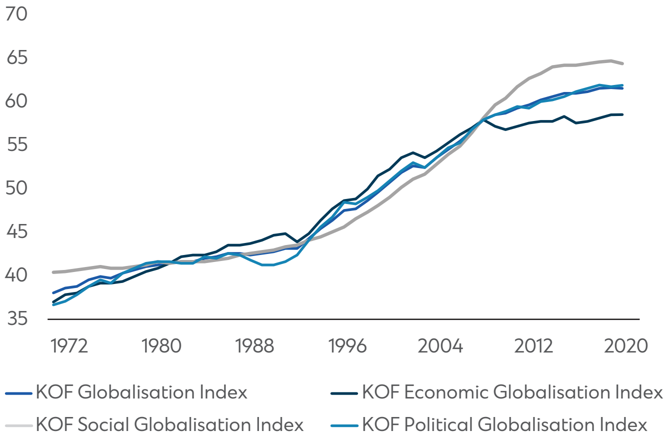
The shift often occurs when unipolar powers witness a decline in their relative position, either because they lose their pre-eminence in absolute terms (due to rising indebtedness or over-extending their reach, for example) or in relative terms (due to the rise in economic or military power elsewhere, for instance). In the 1600s, the Dutch Guilder was viewed as the world's de facto reserve currency, but rising indebtedness and a weakening army prompted a challenge from an ascendent United Kingdom and the Pound Sterling which itself reached a pinnacle in the 1800s before giving way after World War 2.

Rising multipolarity tends to breed instability

The transition from a unipolar to a multipolar world has historically been marked by intensifying conflict and competition. Unlike a unipolar world, where there is only one dominant global power or influence, a multipolar world involves multiple competing powers that are more equal in strength. Historians have argued that, during periods of multipolarity, sovereign states have pursued their foreign interests independent of one another and international cooperation and commerce have flowed according to alliances and trade agreements. Geopolitical risks have tended to rise during such periods as disputes grow in frequency. In his book "Why Nations Succeed and Fail," Ray Dalio analyses the rise and fall of empires and notes that this period of growing multipolarity and strategic rivalries can last between 10 and 20 years before the emergence of a new world order ushers in a period of relative peace and prosperity lasting 40 and 80 years.

The trend towards multipolarity has played out in the economic realm. Notably, the dispersion in GDP based on purchasing-power-parity (PPP) among the world's leading economies has narrowed considerably. As a proportion of the global total, the United States' GDP (PPP) now trails that of Mainland China, a dramatic shift from the early 1980s when it accounted for more than a fifth of the global total. There are also signs that the post-World War 2 trend of globalisation may have already peaked. Economic globalisation, as measured by the KOF Swiss Economic Institute, has plateaued, while trade and foreign direct investments as a proportion of global GDP have been on the decline.

Globalisation indices have plateaued in recent years



Economic globalisation: international trade, taxes and tariffs, capital account openness, foreign investments; **Social globalisation:** voice and data traffic, tourism, student exchanges, migration; **Political globalisation:** new trade treaties, treaty partner diversity, NGO activities, etc

Source: KOF Swiss Economic Institute, Standard Chartered

Recent events have further reinforced our conviction that the gears of multipolarity are in motion. Discontentment with the ills of globalisation has brought populist leaders into power and precipitated the breakaway of the UK from the European Union. The COVID-19 pandemic has exposed the fragility of global supply chains and prompted a shift toward nationalist policies. The war in Ukraine has engendered more distinct blocs in the geopolitical system. Meanwhile, the US' undermining of France's submarine contract with Australia has cast doubts within Europe in the existing transatlantic alliance.

Audrey Goh, CFA

Head, Asset Allocation and Thematic Strategy

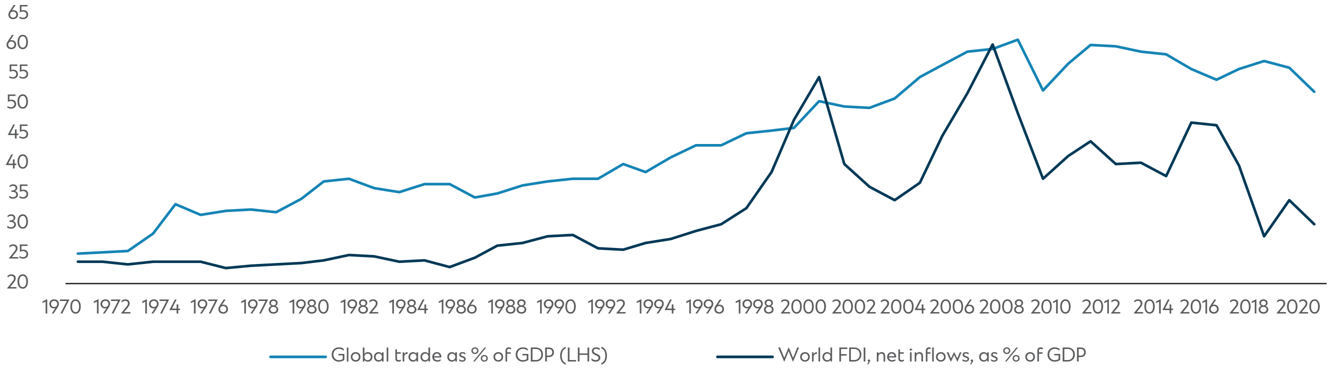
Tay Qi Xiu

Investment Strategist

The shifting global landscape is likely to present both opportunities and challenges for small and medium-sized economies as they seek to enhance their security and tread the fine line of avoiding being firmly part of one competing power's 'block'. For investors, in our view, navigating through this period of heightened geopolitical uncertainty is likely to require an understanding of the economic and market implications of geopolitical changes, identifying potential winners and losers from a revenue or cost perspective and when hedging decisions can add value.

Global trade and FDI have not been able to reclaim previous peaks

Global trade and FDI as a percentage of GDP



Global trade is defined as the sum of exports and imports

Source: World Bank, Standard Chartered

Geopolitical implications

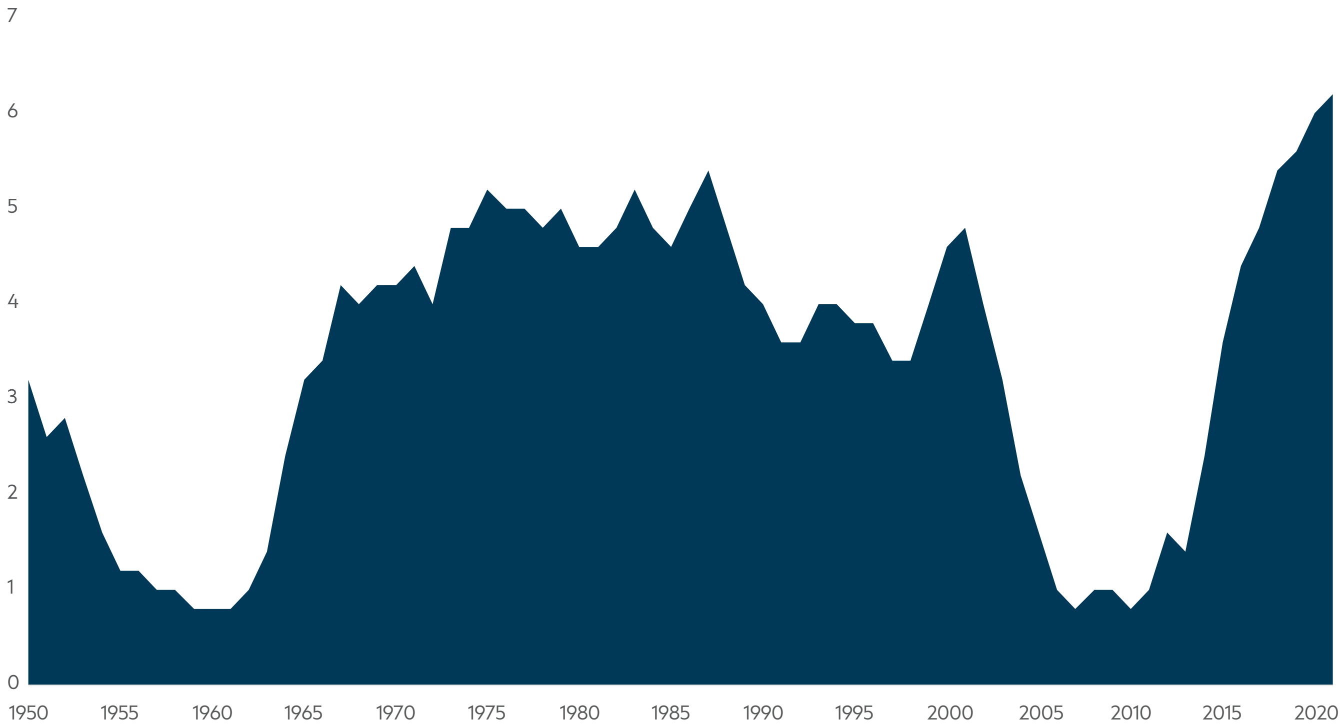
Multipolarity breeds conflicts

The rise of multipolarity has broad geopolitical and economic implications. On a geopolitical level, history argues multipolarity breeds conflict. In seeking to enhance their security, competing powers have ended up making their rivals feel compelled to respond to maintain the balance of power, creating a self-reinforcing 'spiral of distrust'.

The chart below illustrates how interstate and internationalised internal conflicts rose during periods of rising multipolarity. During the Cold War in the 1970s and 80s, interstate conflicts remained elevated for years and fell only following the dissolution of the Soviet Union, which then ushered in a period of relative peace. In recent years, as indicators of multipolarity once again start to rise, the number of interstate conflicts have risen to levels not seen in at least 70 years.

Number of conflicts have risen sharply in recent years

Number* of interstate and internationalised internal conflicts#



*5-year moving average

#**Conflicts** are defined as state-based armed conflicts between two parties, where one party is the government of a state and the other a government of a state or an organisation that is supported by a government of a state. Conflicts involve at least 25 battle-related deaths in a calendar year.

Source: Uppsala Conflict Data Program, Department of Peace and Conflict Research, Clocktower Strategy, Standard Chartered

Higher risk of conflicts at global trade hubs could spark negative externalities

One specific risk of rising multipolarity is the way it can engender unexpected consequences at strategic locations along the world's trade routes. A study conducted by the Proceedings of the National Academy of Sciences (PNAS) found that strategic territories at maritime choke points were more prone to conflicts as local powers competed for control. During periods of globalisation and booming world trade, influential major powers have stronger incentives to mediate in these conflicts and ensure the smooth operation of these crucial waterways.

The reversal of globalisation, thus, risks having a detrimental impact on the stability of key trading centres which, in turn, can ignite a chain of negative externalities globally. The recent grounding of the container ship Evergreen, which temporarily obstructed the Suez Canal, is an illustration of how bottlenecks along vital commercial routes can have knock-on economic implications.

Power struggles to intensify in multiple domains

Competition and rivalry in a multipolar world are not necessarily waged on the grounds of a physical battlefield alone. While data shows internationalised skirmishes are already rising in number, recent events illustrate that conflicts are also likely to spill over to other domains including trade, technology and finance. As competing powers seek to lessen interdependence and improve their national security, they are increasingly likely to decouple with their rivals from an economic, financial and social points of view.

Evidence of such spill-overs have been abundant in recent years. The relationship between the US and Mainland China provides several examples of these three forms of decoupling. On the trade front, we have witnessed the increased use of both tariff and non-tariff trade barriers. The delisting threat of Chinese ADRs is an example of financial decoupling, Meanwhile, the share of non-immigrant visas issued by the US to Chinese citizens dropped from 16% in 2018 to 4% in 2021 is a form of social decoupling.

Macroeconomic implications

A deglobalised world is less efficient and inherently inflationary

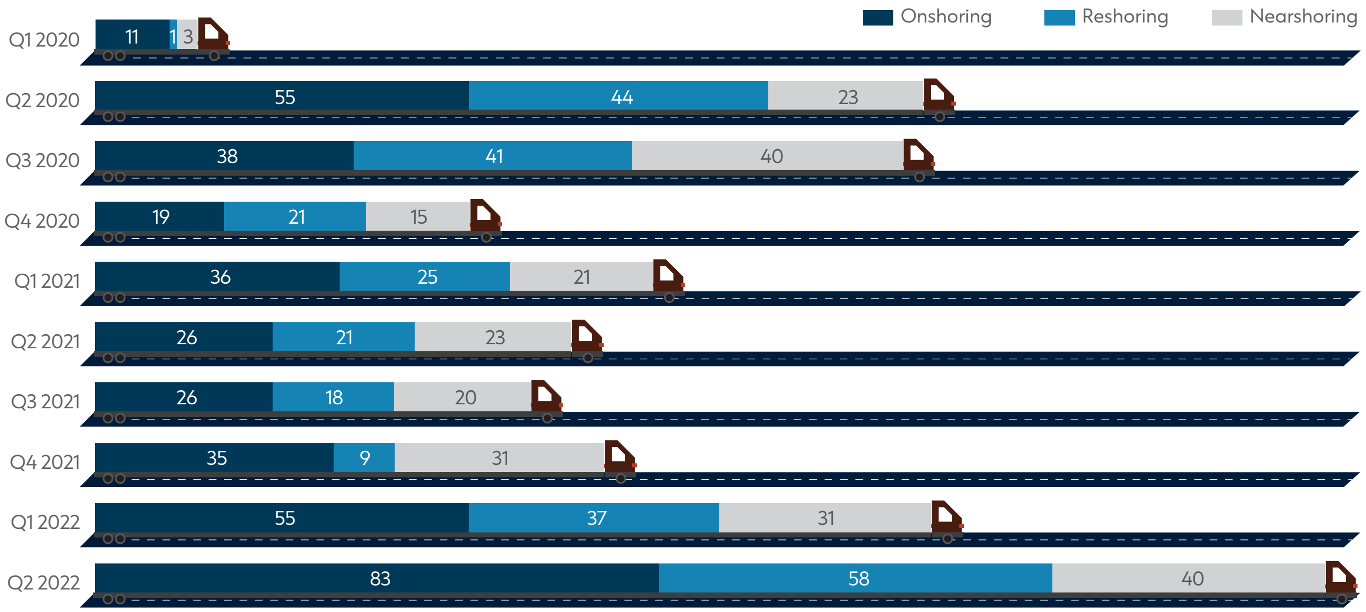
As these examples illustrate, a key consequence of an increasingly multipolar world that is accompanied by rising geopolitical tensions and national security concerns is a potential acceleration in deglobalisation. Compared to a globalised economy where the factors of production, labour and capital are free to flow to regions with the highest comparative advantages, a deglobalised economy is less efficient and, thus, inherently inflationary.

Delicate balance between stability and efficiency in supply chains

The conflict in Ukraine has also exposed the vulnerability of supply chains to disruptions arguably related to rising multipolarity. This is increasingly forcing businesses to re-evaluate their supply chain strategies. Onshoring, nearshoring and reshoring were mentioned a record number of times by CEOs in their Q2 2022 earnings reports, according to a Bloomberg analysis of earnings call and conference presentations. However, this drive for supply chain resilience has both costs and benefits. Reorienting supply chains may improve manufacturing and logistical stability, especially during challenging or uncertain geopolitical times, but there is often a trade-off in the form of greater costs and inefficiencies that have to either be passed on to consumers or be absorbed by profit margins. Companies will have to increasingly find a balance between stability and efficiency.

Corporate leaders have been re-evaluating their supply chain strategies

No. of mentions in “Onshoring, reshoring, onshoring” in Q2 2022 earnings season



Source: Bloomberg, Standard Chartered

Rising resource nationalism bears inflationary consequences

The rise of 'resource nationalism' is also a developing trend as more governments turn their back against global trade for the sake of national interests. In May 2022, India announced a ban on wheat exports after hot weather affected crop yields and sent local prices soaring. This aggravated global food supply chains that were already under pressure in wake of the Ukraine war. Indonesia also banned the export of palm oil in April 2022 to secure domestic supply and bring down local prices. Similarly, Malaysia banned the export of live chickens to Singapore.

According to the World Bank, in the first half of 2022, 34 countries imposed restrictive export measures on food and fertilisers, a figure that comes close to that during the 2008-2012 food crisis, when 36 countries imposed export restrictions. Rising resource nationalism, predictably, raises commodity prices and squeezes discretionary spending as households spend a greater share of their income on food and energy.

The call for self-sufficiency could be beneficial in the near-term, but harmful in the long run

In a more multipolar environment, history suggests policymakers are more likely to focus on improving domestic self-sufficiency and economic security despite the high costs involved. For instance, the US plans to spend USD 1tn on energy, infrastructure and semiconductor production over the next decade. Europe is also seeking longer term solutions to reduce its dependence on Russian energy supplies. Mainland China has also launched state-led industrial policies that seek to make it more competitive in global high-tech manufacturing and towards renewables to reduce their energy dependency.

Greater government spending to bolster competitiveness in technological and energy independence is expected to lead to higher deficits and inflation, but boost employment in the short run. Long-term, a fall in cross-border collaboration and the cross-pollination of ideas risks discouraging innovation and leading to a decline in productivity. In addition, while antitrust efforts may be curtailed to foster national champions in strategic sectors, the growing monopolistic strength of a few national champions risks having a negative impact on consumers in the long run.

Barriers to capital flows to result in higher interest rates

Additionally, inflationary pressure and limits on international financial flows could lead to an increase in nominal interest rates. In an increasingly multipolar world, governments are more likely to rely on allies and domestic investors for financing, which risks inadvertently crowding out domestic investment opportunities, thus raising the cost of capital.

Investment implications

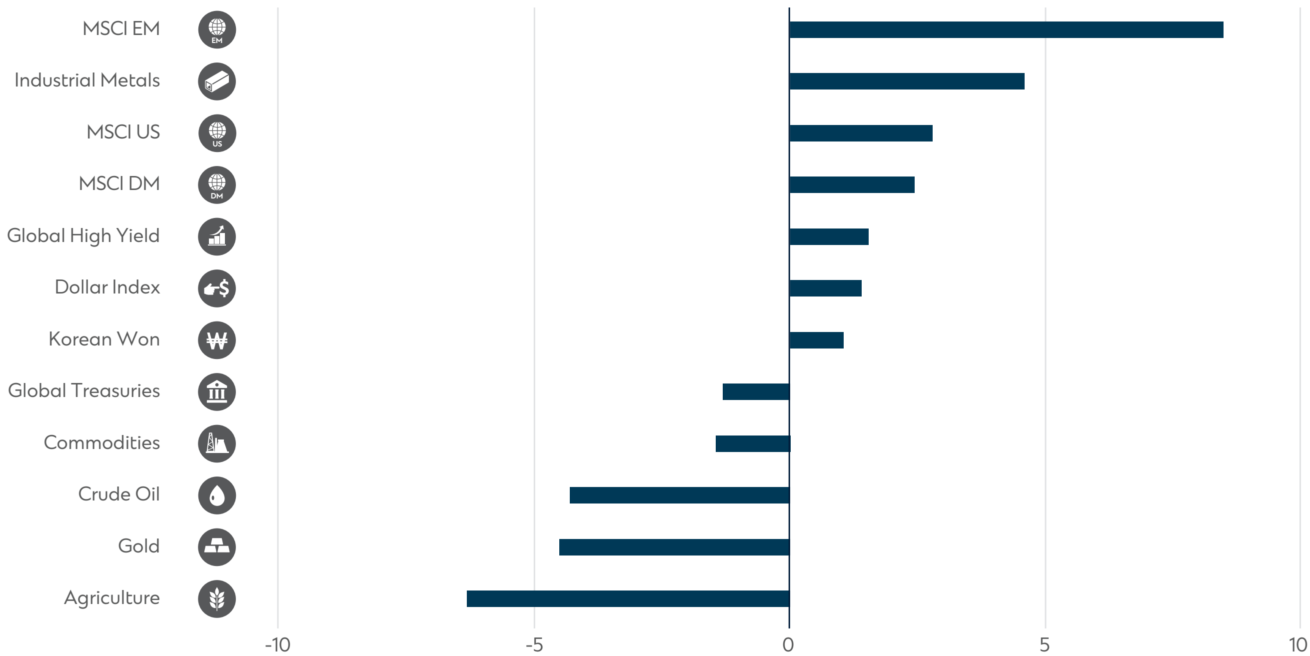
Increasing exposure to assets with low beta to global trade

As resource nationalism rises, commodities like crude oil and agriculture are likely to benefit, as was the case during the Russian invasion of Ukraine. Broadly, commodities share a negative beta to global world trade after adjusting for the impact of US' monetary policy.

But not all commodities stand to benefit from slowing globalisation. Industrial metals share a large positive beta to global trade, as their demand has increased alongside the growth of Mainland China in recent decades. A more fragmented global economy could thus restrain the growth of emerging economies like China, which would in turn dampen the demand of key industrial metals. This explains the large positive beta that EM equities share with global trade, as emerging economies tend to see improving real productivity growth and better local currency returns during periods of globalisation. In addition, it should also come as no surprise that the currencies of trade-reliant economies would also suffer as deglobalisation accelerates.

Emerging markets and industrial metals have high positive beta to global trade

Beta of financial assets to global trade*



*Regression coefficients of financial assets relative to global trade, which is defined as the sum of total exports and imports as a proportion of global GDP. Regressions have been adjusted for the US Federal Fund policy rate and are based on 20-year horizons

Source: Bloomberg, Standard Chartered

The rise of non-traditional reserve currencies

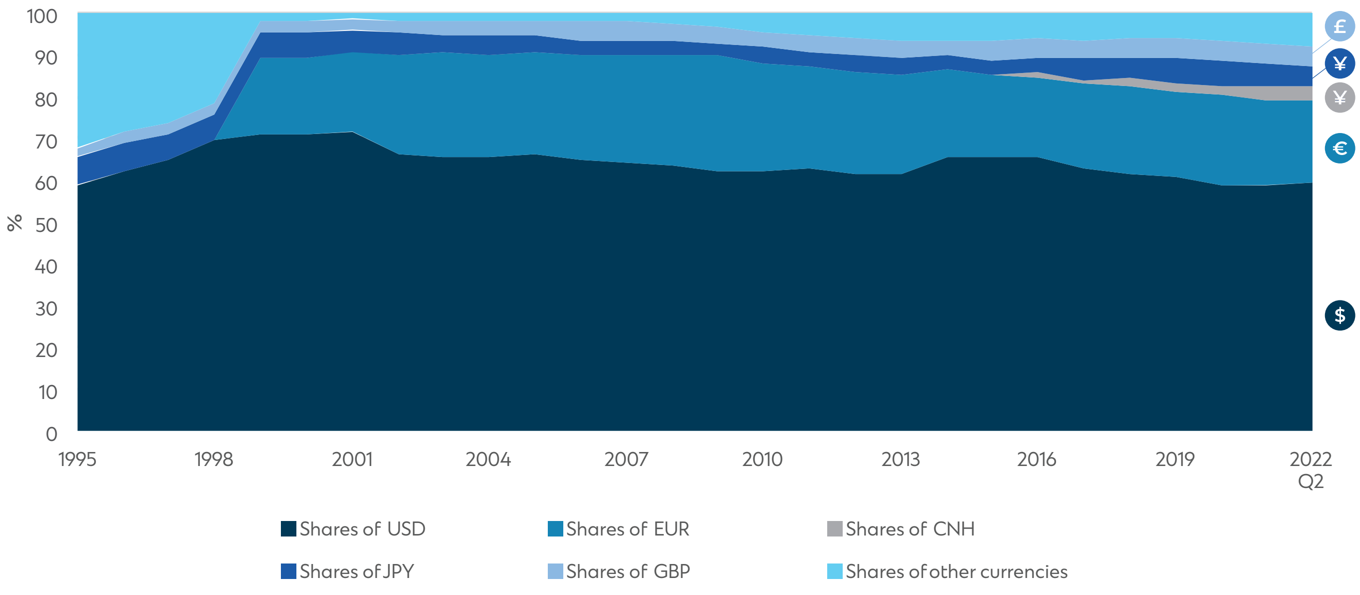
The recent sanctions on Russia to prevent her access to foreign reserves and the SWIFT payments system has also caused a seismic shift in the policy of neutrality. Crucially, it signals to the rest of the world that any nation's access to its reserves may become contingent on its foreign policy. An obvious repercussion is that global central banks may start considering geopolitics in reserve management decisions. This is by no means unprecedented, however. Historians will point out that in the period preceding World War I, when there was a proliferation of strategic alliances, the reserve compositions of central banks were similarly shaped by geopolitical concerns.

That being said, the demise of the US dollar as the world's reserve currency is, however, not imminent. China is not ready to open its capital account and the Chinese renminbi continues to lag the US dollar as a payment currency and form of reserves. Usage of the Chinese renminbi as a cross-border currency thus remains low, accounting for only 2% of transactions booked by SWIFT. Meanwhile, until Europe breaks away from US foreign policy and accelerates efforts to advance its strategic autonomy, the euro is unlikely to serve as an effective diversifier in central bank reserves.

The likely beneficiaries of the shift in global foreign reserves are non-traditional reserve currencies issued by smaller economies: the Swiss franc and Singapore dollar come to mind. Economies that are home to large consumer bases such as the Indian rupee, Indonesian rupiah and Brazilian real are also possible contenders, though these currencies will come with their own domestic risks.

The share of the USD in global foreign exchange reserves has fallen below 60%, but its role as the world's reserve currency is likely to remain dominant for the foreseeable future

Composition of global central banks' foreign exchange reserves



Source: IMF COFER, Standard Chartered

Gold to benefit as an alternative, if inefficient, means of exchange

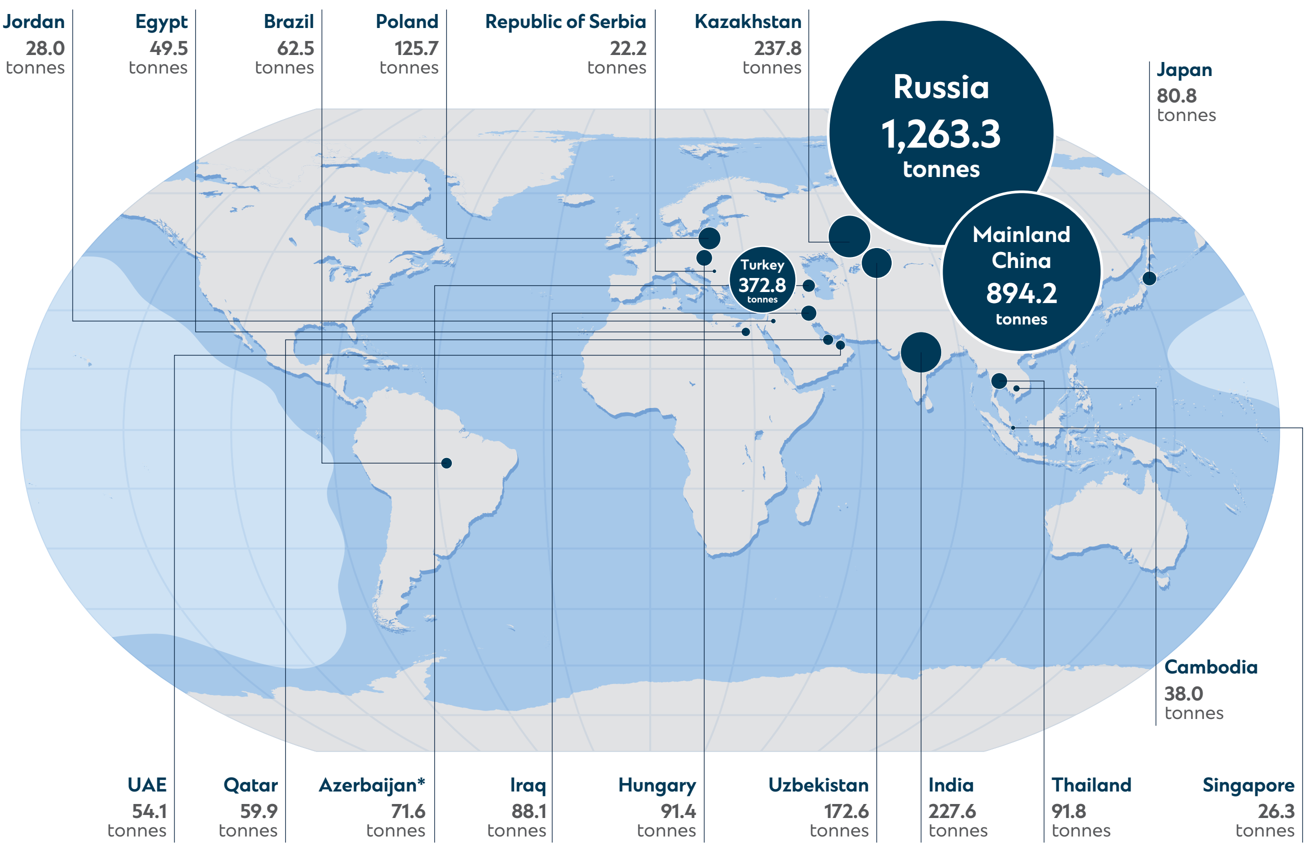
Gold is also a likely beneficiary in a developing multipolar reserve system. In Q3 2022, central banks purchased almost 400 tonnes of gold, the highest quarterly demand seen in available data. This lifted YTD purchases to 673 tonnes, the largest since 1967, when European central banks abandoned the US dollars for gold as the Bretton Woods system came to an end.

A lesson from the Ukraine war is that the reserves of foreign central banks are not immune to sanctions from the US. Gold is not a perfect substitute for the foreign securities and deposits held by central banks. When held in domestic vaults, gold can escape sanctions, but when used as a form of payment, it might expose counterparties to secondary sanctions. Gold is also difficult and expensive to transport. For instance, studies have shown that shipping USD1bn of gold by road would require six 20-foot trucks.

Having said that, gold could be the only viable alternative form of exchange in transactions with countries that have been sanctioned. This might explain why some of Russia's major trading partners have been the largest buyers of gold since the invasion of Crimea in 2014. As the trend toward multipolarity gains further traction, gold could be increasingly favoured as a form of diversification in the reserves of global central banks.

Largest purchase of gold by central banks since 2014

Purchase of gold by central banks



*Purchases made by the State Oil Fund of the Republic of Azerbaijan

Source: World Gold Council, Standard Chartered

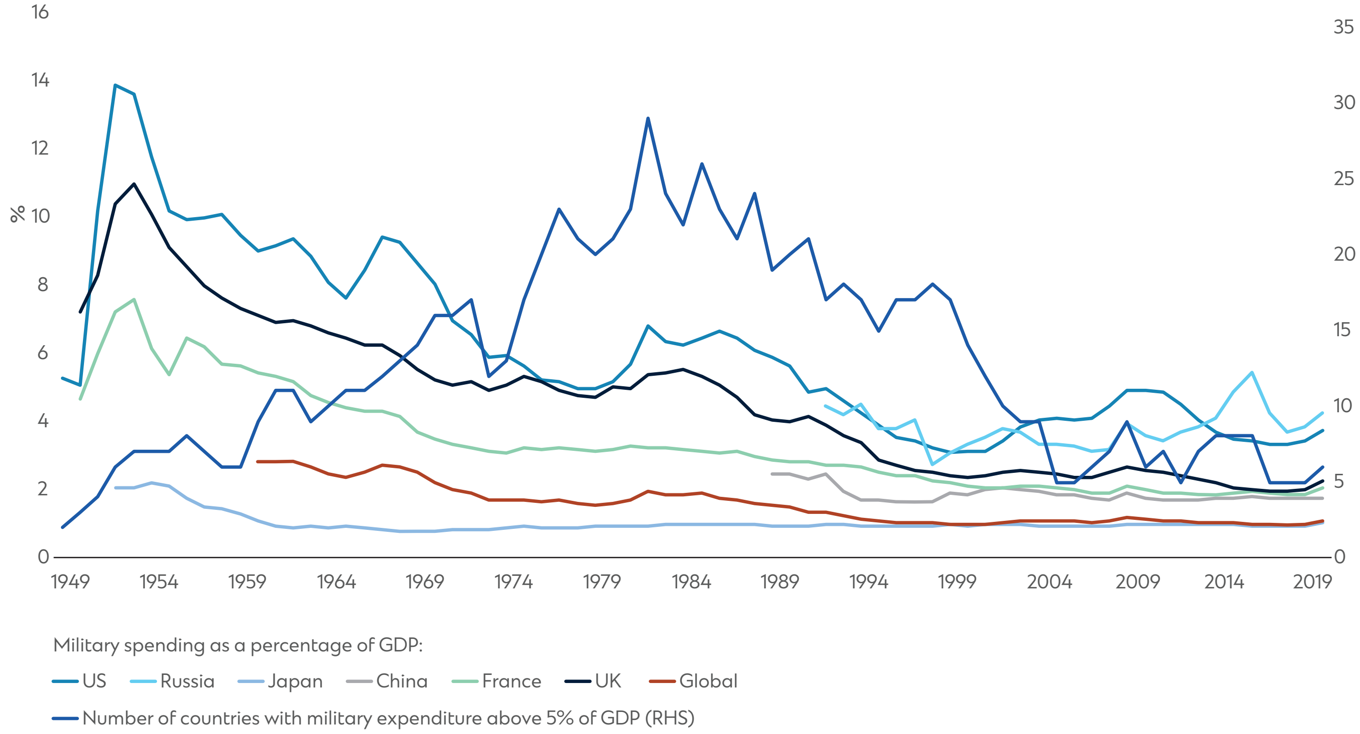
A rethink of military budgets a potential tailwind to global defence stocks

With rising multipolarity, governments are rethinking about their defence strategy. Finland and Sweden are now on the verge of joining the North Atlantic Treaty Organisation (NATO), while Germany, France, Italy, Norway, Poland, Romania and Belgium have announced military budget increases, post the Russian invasion of Ukraine on February 24, 2022. But European nations are not the only ones to have been galvanised into boosting their military capabilities. In Asia, Singapore, Japan, South Korea and Australia all aim to raise their military spending. A more militarised environment comes with predictable risks and will inflame existing tensions at geopolitical flashpoints concerning Ukraine, Taiwan and North Korea.

However, the increases in spending will occur from a low base, as global expenditure has been on the decline for decades since World War 2. The number of countries with military budgets in excess of 5% of GDP also remains low relative to the heights seen during the Cold War. This means that while a global drive to build-up military capabilities has been catalysed by the war in Ukraine, the global arms race is still in its nascent stages and several years away from the highly militarised global environment seen in the 1970s and 80s. Global defence stocks thus have long runway for further growth in the years ahead.

Still a long way for military expenditure to pick up in a rising multipolarity world

Military expenditure as a percentage of GDP and the number of countries with military expenditure above 5% of GDP



Source: The World Bank, Our World in Data, Standard Chartered

Emerging trends in the era of self-sufficiency

The shifting tide in the world order toward multipolarity calls for greater emphasis on self-sufficiency and independence. This would provide additional momentum to emerging trends that have been gaining traction in recent years. The reorientation of supply chains, for instance, would necessitate greater domestic manufacturing capabilities. This would entail the improvement of local infrastructure, which, in turn, would stimulate demand for commodities such as industrial metals that would otherwise be hampered by slower growth in emerging economies during a period of deglobalisation. Increasing supply chain resilience will necessitate the development of more efficient and cost-effective production techniques, especially as the existing model of labour arbitrage loses favour.

Meanwhile, the push for energy independence would also favour renewables and the ensuing green transformation, which is a rare area of global unanimity amid a messy multipolarity world order. The war in Ukraine and the impacts of climate change have also taught world leaders the significance of ensuring food security. This will stimulate additional investments and R&D in enhancing domestic food production capacities, helping industries such as vertical farming and alternative meats, particularly in land-constrained nations.

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