more than money

National Australia Bank

# A world of INSIGHT

## A focus on global trade and capital flows in relation to Australia/NZ and the UK/Europe

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# ARE WE WITNESSING A DECLINE IN GLOBALISATION?

**Three decades of stable economic growth, generated by widespread political and economic harmony, is in danger of being eroded by increasing political polarisation.**

### The efficiency machine

During the past 30 years, "economic growth, market liberalisation, the spread of democracy, and the strengthening of the system advanced hand in hand," said Lord Mandelson, Co-founder and Chairman of regulatory, political risk and public policy advisory business Global Counsel, in his keynote address at National Australia Bank's (NAB's) second annual Insight Series seminar in London on Wednesday, 4 September 2019.

Lord Mandelson emphasised that "good economics and good politics go together," but we are now seeing a geopolitical shift around the world, as a result of a growing imbalance between politics and economics.

"Governments across the world, from the West to Asia, and to a large extent Africa as well, have been in line with each other, and so the global economy has become an efficiency machine with respect to supply chains, the production of goods and services, and the improved mobility of labour," he said.

By contrast, the rapid emergence of "illiberalism, nationalism and authoritarianism," is currently putting this "efficiency machine" under tremendous strain, he observed.

"With the rise of China, we are seeing the emergence of two competing economic systems – state control and market liberalisation – as well as two competing sets of interests. We are seeing a trial of strength between two powers, China and the US, and the rest of the world is being forced to take sides."

**Lord Mandelson,** Co-founder and Chairman, Global Counsel.

Doing business across borders "is increasingly complex and, importantly, costly."

**David Watson,** Senior Trade and Investment Commissioner – UK, Ireland and the Nordics, Australian Trade and Investment Commission.

## Competing economic systems

Political polarisation has yet to cause a dramatic slowdown in global trade and capital flows, according to Tylor Hartwell, General Manager – Client Coverage/Corporate Finance Europe, NAB.

"Currently the market is fantastic," he said. "There's a lot of issuance happening. There's an unlimited amount of capital. But the underlying questions are these: Will the underlying geopolitical turmoil cause us grief? Will the prevalent anti-globalisation be a long-term or a short-term issue? And where will we sit in a year's time, and past that?"

Lord Mandelson's predictions were clear: "With the rise of China, we are seeing the emergence of two competing economic systems – state control and market liberalisation – as well as two competing sets of interests. We are seeing a trial of strength between two powers, China and the US, and the rest of the world is being forced to take sides."

"What will inevitably emerge from this confrontation is a loss of trade, a fracturing of supply chains and efficiency, the balkanisation of technology – which we're already seeing – and the accumulative reduction in business efficiency."

Doing business across borders "is increasingly complex and, importantly, costly," observed David Watson, Senior Trade and Investment Commissioner – UK, Ireland and the Nordics, Australian Trade and Investment Commission, but not merely due to political polarisation.

"It's a much more difficult equation," he said, pointing to how costs have also been pushed up by, for instance, the need to apply Environmental, Social and Governance (ESG) investment principles to investment propositions.

"Consumers demand to know where ingredients are coming from, so the cost equation relates to the entire supply chain."

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## Cautious optimism

Martin Woodhams, Global Commodities Advisor, MW Advisory, accepts that geopolitical risks are increasing, but he is nevertheless reasonably optimistic about underlying fundamentals.

Crude oil and natural gas markets are important underpinnings of world trade, and as both markets are structurally oversupplied, "the risk is benign at worst," he reasoned.

The shipping industry, which Trevor Crowe, Director, Clarksons Research describes as "the glue of the world economy," is also coping well.

A slowdown in global trade and the US-China trade stand-off "is just about manageable," as the market for ships is bolstered by more stringent environmental standards, Crowe said. "Shipowners are not worried about a trade war."

But "the impact on investor sentiment has been negative," he added, pointing to a growing reluctance to undertake trading investment or to invest in steel and other assets.

## Cautious investors

This negative sentiment is proving challenging to companies and institutions eager to raise finance in the global money markets, where they can sometimes get better deals than in their domestic money markets.

"You're never quite sure where the best pricing's going to be, in which markets," said Matt Cooper, Tax and Treasury Director, Places for People, a UK housing association. "We've taken advantage of opportunities that we wouldn't have seen if we'd just been in Sterling, but with that comes a lot of investor work."

Mollifying cautious investors can be a complex task, so issuers are having to work harder than ever to make sure they understand exactly what they are buying into.

"It's about not just focusing on yourself as an issuer, but focusing on the whole of the sector and what foreign investors might be interested in," said Cooper.

"We've got to go out and meet investors to make sure they understand what a UK housing association is, make sure they understand the UK property market, and how they fit together."

"It's about doing the groundwork and meeting the different markets, and not necessarily going out there with an expectation of wanting to issue X amount for so many years, it's going out and getting feedback from investors, seeing if this is something they're interested in, and if it is, putting something together that works."

Ian Duncan, formerly Treasurer of APA Group and Ausgrid, agrees. "The relationship is the name of the game," he said.

"Even if you do a seven-year issuance, you've got to come back for a replacement at some point, so relationships over a long period of time, ideally with recurring people, are very important. That way, you don't have to explain the rhyme or reason of complicated structures to someone new every time you need an issuance."

In Europe, for instance, the 'Simple, Transparent and Standardised Securitisation Regulations', which were introduced on 1 January this year, "put an onus on the issuers to supply requisite amounts of information for investors to make their own decisions as to the credit worthiness of the bond."

**Neil Calder,** Head of Portfolio Management – Credit, EBRD.

## Building relationships

Issuers that are prepared to educate and build strong, lasting relationships are welcomed by investors, according to Dia Villafuerte Savant, Director of Private Placements – Private Credit, M&G Investments.

"I tend to want to meet the issuer in person. That's in my investors' best interest," she said.

David Scilly, Head of Dealing, Colonial First State agrees. "We're spending more and more time trying to have direct contact with the issuers. It's the kind of asset managers that we are. We're in for the long term, we're not flippers. And I'd be very surprised if the issuers wouldn't want to take investment from established long-term investors as well."

Such relationships are particularly important for issuers in markets such as Australia and New Zealand, who often have less reason to maintain offshore investor contact.

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## International requirements

In addition to strong relationships, issuers must also meet international regulatory requirements. Again, Australian and New Zealand issuers are at a disadvantage in terms of access to an offshore investor base. This is because some requirements there, notably due diligence and risk retention regulations, are less stringent than those in the UK, Europe, Japan and the US.

In Europe, for instance, the 'Simple, Transparent and Standardised Securitisation Regulations', which were introduced on 1 January this year, "put an onus on the issuers to supply requisite amounts of information for investors to make their own decisions as to the credit worthiness of the bond," said Neil Calder, Head of Portfolio Management – Credit, European Bank for Reconstruction and Development (EBRD).

"In addition, there are some pretty stringent and specific requirements that also apply to offshore issuers when they are selling into the investor base of the EU."

"This has created a bit of a problem because some of the smaller non-bank financials, that for instance didn't always get a listing, aren't geared up to provide the information that is required and haven't necessarily addressed the whole risk retention issue, have suddenly found they've met a bit of a brick wall in Europe."

## ESG credentials

Proving that they are meeting ESG requirements is also important for issuers, wherever they are in the world.

"We always look for it when we're issuing our credit papers," said Savant. But "while investors want all our credit papers to address ESG across the board – it's a must-have – it's a little slower than you'd expect."

This is largely because the infrastructure to determine how ESG performance is assessed, and how ESG credentials are granted, remains underdeveloped.

"If you try to monitor it you go onto Bloomberg, and for any kind of major public company there will be a whole raft of ESG ratings," explained Calder.

"But it's very difficult to distinguish which one is the right one for that particular business, and some of them seem to be quite contradictory, so I think we are in the early stages."

## Disciplined investors

The current climate, characterised as it is by expanded regulatory requirements and a strained geopolitical situation, requires investors to stay focused.

"How you structure your portfolio is really important now. In this kind of environment, you really want to be long duration, and you potentially want to be long US dollars as well," said Scilly. "But you also want to hold onto physical assets where you can, then use derivatives and overlays to give you the flexibility to get the hedge that you need."

Savant believes a transaction's structure, pricing and credit should be considered separately. "As long as you're disciplined in your approach, you may have to give away on pricing, but you don't give away on structure, and your insurance is to sit at the table with the banks when there's a bump in the road."

Calder cautions against seductive issues that are popular thanks to their labels, rather than because they are fundamentally solid.

"ESG requirements for instance, particularly green labelling, aren't always consistent, so you're left with a situation where a bad structure with a marginal credit and a far too long maturity suddenly gets a green sticker on it, and that is what moves it. I don't see that you are actually supporting the market by crowding in the people who have less ability to be discriminating just because it's labelled in a particularly favourable way."

"Just stick to the rules that you've had all the way through and don't get diverted."

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### Is globalism actually in decline?

In conclusion, the nature of the UK and Australia as mercantile islands means that their trading and investing communities remain committed to maintain and deepen mutual cross-border access to markets. Indeed, at our Insight Series seminar in London, roughly 50% of the audience was of the opinion that globalisation will remain a major force in the world economy. This was despite it being evident that trade and capital flows, as they have existed for some time now, are having to adapt to the current political climate as well as to the economic and regulatory environment, with the effects being more severe in certain industries.

It is more important than ever to protect the rules-based trading system that has emerged during the last half a century to ensure it continues to generate economic growth, Lord Mandelson pointed out. After all, he said, "trade wars are a very negative sum game for all."

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