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Update on the Road to 2030: a medium-term thematic perspective

Thematic investing is about grasping, and getting on the right side of, multi-year top-down trends. Our Road to 2030 project, which we launched in 2020, highlighted five thematic areas – debt, demographics, the rise of China, technology and climate change – and various secondary, tertiary and quaternary themes, and the connections between them, that were relevant for investing over this decade. Developments since – a pandemic, war and persistent inflation – have highlighted the importance of thinking thematically and contextually about the phenomena that are affecting portfolios.

There are any number of general observations that can be made about medium-term thematic trends. We restrict ourselves here to three narrow, analytical points. First, monetary policy tightening is going to constrain fiscal policy for the foreseeable future. Second, US-China tensions are not likely to end globalisation but to push in favour of regionalisation in the years ahead. Third, we are seeing an historic acceleration in fossil-fuel demand destruction as a result of the Russia-Ukraine conflict.

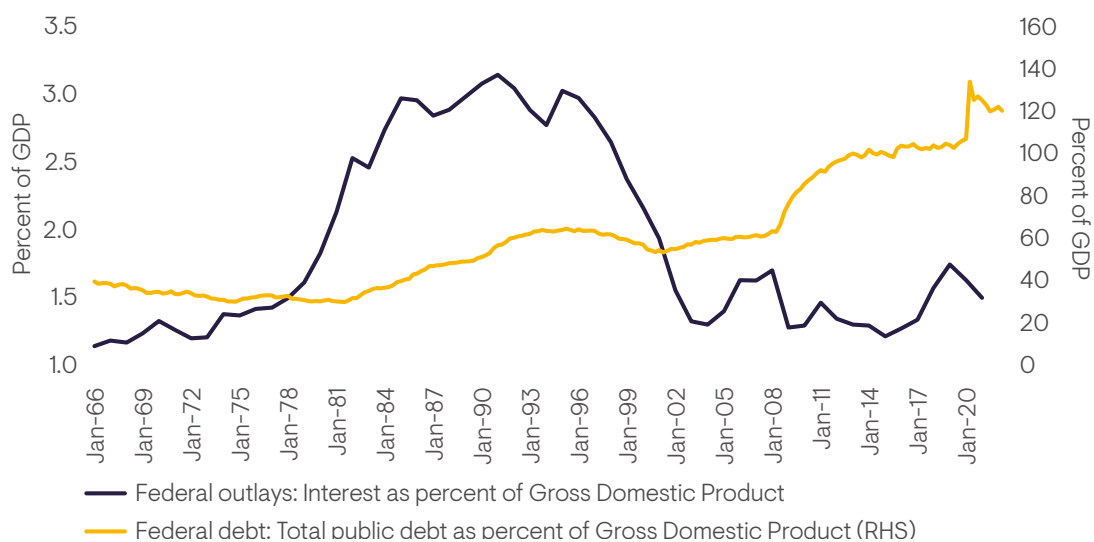
“Toto, I have a feeling we’re not in Kansas anymore” – this line from The Wizard of Oz will feel more familiar to investors as the decade unfurls. Looking at the energy transition (which, as we’ve noted, has been accelerated by Russia-Ukraine conflict), deglobalisation (underpinned by both geopolitical tensions and lockdowns), the end of household deleveraging in the US (as millennials form households, move to the suburbs and take on more leverage), and the fact governments crossed the Rubicon during COVID when it comes to joint fiscal-monetary policy, over the next 10 years we are likely to find ourselves in a very different cycle from the secular stagnation period of the 2010s.

This implies somewhat higher and more volatile inflation, more volatile interest-rate cycles, higher asset correlations, multiple de-ratings, and a capital and resource intensive cycle – all of which could drive new market leadership.

Tightening monetary policy is going to constrain fiscal policy

Because of above-target inflation, the world is undergoing the most comprehensive tightening of monetary policy in history. While the Volcker moment after 1979 involved steeper interest-rate rises, today’s moment involves far more central banks. This matters because, since the GFC, both conventional and unconventional central-bank policy has tended to constrain debt-service costs from rising too fast. Interest costs as a percentage of GDP for the US are nearly half where they began in the early 1990s, despite debt doubling during that period.

Figure 1: US federal outlays vs. federal debt



Source: US Federal Reserve

Monetary tightening reverses this dynamic: now, higher debt levels cannot go hand-in-hand with lower interest costs. On balance, this puts pressure on treasuries to constrain spending and increase revenues. In other words, higher rates will squeeze budgets. To the extent that governments choose not to add these costs onto existing debt loads, they invite more attention on medium-term policy frameworks – which is exactly what happened in the UK in September 2022.

Just how big of an impact is this likely to have? In the US, the Congressional Budget Office (CBO) estimates that net interest outlays are projected to increase from 1.7% of GDP in 2023 to 3.3% in 2032, well above the 50-year average of 2.0%¹. In US dollar terms, that means net interest outlays will triple from US\$399 billion in 2022 to US\$1.2 trillion by 2032. Total net interest outlays from 2023-2032 are expected to be US\$11 trillion, but just 18 months ago that figure was estimated to be US\$2.5 trillion lower². This figure is equivalent to two years of current Medicare and Medicaid spending, an extremely large amount. The assumptions behind these CBO forecasts are not particularly onerous – it is easy to imagine worse scenarios. They include that inflation settles at 2.4% by 2027-2032 and that the 10-year treasury settles at 3.8%.

Why does this matter for investors? Over the past decade, investors benefitted from a consensus within central banks and the economics profession that, most of the time, it was far better to have too much macroeconomic stimulus (high deficits, very low interest rates) rather than too little. We are now going into a world where the assumption behind that thinking has been destabilised.

Going forward, tighter budgets increase the probability of higher taxes on companies and investors; they raise the cost to governments of spending to boost growth, even during downturns; austerity policies increase the likelihood of distributional conflict and political polarisation; and tighter budgets increase financial stability risks at the margin. At the very least, this implies more uncertainty, greater cyclical and greater volatility in cash flows – and lower multiples for risk assets.

1. Net interest outlays consist of interest paid on Treasury securities and other interest that the government pays (for example, interest paid on late refunds issued by the Internal Revenue Service) minus the interest that it collects from various sources (for example, from states that pay the interest on advances they received from the federal Unemployment Trust Fund when the balances of their state unemployment accounts were insufficient to pay benefits promptly). Net interest outlays are determined mostly by the size and composition of the government's debt and by market interest rates.

2. Congressional Budget Office, August 2022.

The multi-polar order will lead to regionalised supply chains and disproportionately benefit non-aligned third countries

Our second high-level observation is that supply chains will continue to evolve in a regional direction, given the rising salience of values in geopolitics and the tensions brought about by multipolarity. This order will disproportionately benefit non-aligned countries. This is a much more complex picture than the simplistic deglobalisation narrative that has often been referenced as a tail risk. For one thing, supply chains were never very globalised, as charts of complex value chains compiled by the World Trade Organisation reveal. Except for US-China direct trade, goods-related globalisation was already becoming more intra-regional than inter-regional. For example, in the early 1990s, North America absorbed 35% of East Asia’s exports, while today that figure is under 20%. East Asia’s share of exports to itself grows every year. For another, if headline measures of globalisation have stalled in recent years, it is because Asian countries are consuming more of what they produce, an entirely natural outcome as they move up the value chain.

Most supply chains were anyway regional, as the charts below show. Trade is likely to evolve in that direction.

Export destination partner shares for three regions

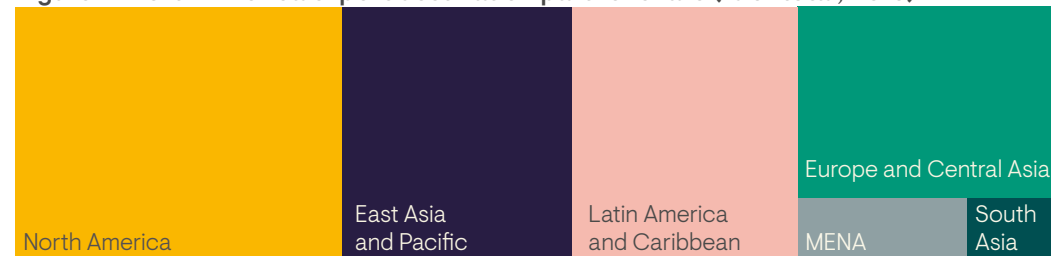
Figure 2: East Asia and Pacific destination partner share (% of total, 2018)



Figure 3: Europe and Central Asia destination partner share (% of total, 2018)



Figure 4: North America export destination partner share (% of total, 2018)



■ East Asia and Pacific
 ■ North America
 ■ Europe and Central Asia
 ■ South Asia
■ Latin America and Caribbean
 ■ Middle East and North Africa
 ■ *Sub-Saharan Africa

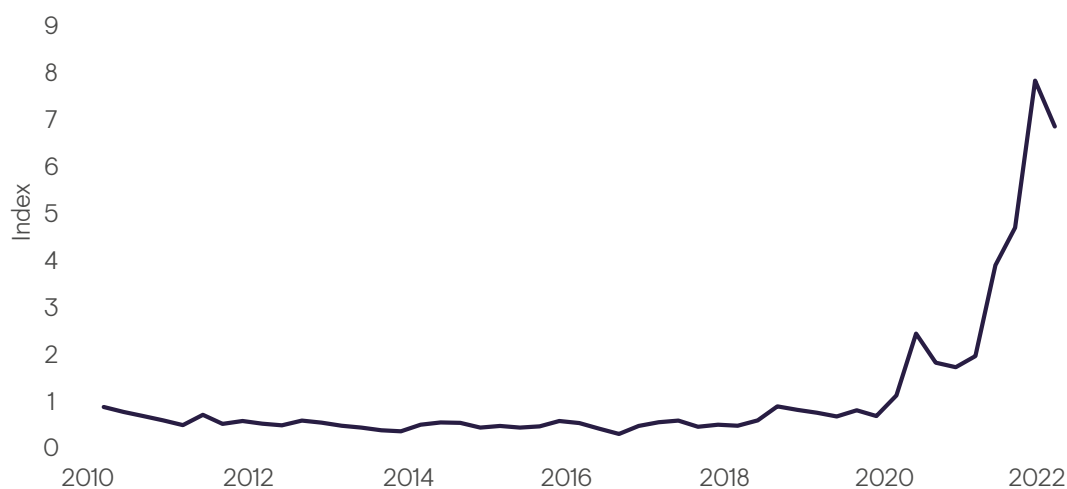
Source for Figures 2,3,4: World Integrated Trade Solution, “Exports, imports and trade balance by country and region,” 2018.

Yes, global businesses that did depend on the vast political and trading relationship that was Chimerica are now beginning to search for alternatives. What they are doing is creating ‘China for China’ supply chains, and rest-of-the-world supply chains. Apple is a prime example. China-based factories now churn out the majority of Apple’s products, yet the company has made a concerted effort to diversify production bases out of China to India and Vietnam. This is in part because consumption from India and Vietnam has continued to grow, but it is also because those countries are relatively non-aligned in the new world. Whereas today less than 5% of Apple’s products are made outside China, by 2025 the figure is estimated to be around 25%³. ASEAN⁴ and South Asia are set to benefit disproportionately from the manufacturing boom.

The next cycle looks likely to see an acceleration of the regionalisation trend. Many companies are actively discussing de-globalisation, reshoring and improving supply-chain resilience⁵. We think that will continue.

Investors may benefit from being exposed to the regional (primarily Asian) economies that are non-aligned, as well as small caps over large caps on the grounds that large caps are more likely to have global businesses. There may also be headwinds for large global businesses in sensitive areas like technology and healthcare, where national-security considerations are demanding resilience and consequently domestic production capabilities.

Figure 5: Share of sentences mentioning supply chain reshuffling in Russell 3000 earnings calls



Source: GS DataWorks, Golman Sachs Global Investment Research.

3. *The Economist*, October 2022.

4. ASEAN = Brunei, Cambodia, Indonesia, Myanmar, Lao, Malaysia, Philippines, Singapore, Thailand, Vietnam.

5. Oppenheimer postmodern cycle piece GS.

Fossil-fuel demand destruction is accelerating

Finally, we are seeing a historic acceleration in fossil-fuel demand destruction as a result of the Ukraine crisis, particularly in Europe. As the International Energy Agency (IEA) has pointed out, the global energy crisis has “turbo-charged” the shift away from fossil fuels⁶. Global solar capacity will climb 18% higher by 2030 than expected last year, and wind 14%. CO₂ emissions are now set to peak by 2025 at the latest, potentially putting the world on target for 2.5-degree warming from pre-industrial levels. The IEA report was prepared throughout the first half of 2022, so these estimates are likely conservative.

The policy mechanisms behind these shifts differ by region. The EU's Green Deal had already aimed at making the EU carbon neutral by 2050, but the REPowerEU package after the invasion of Ukraine accelerated that. In the US, the Inflation Reduction Act prioritised green investment in a number of different areas. The expected shift in gas consumption has been most dramatic. Last year, gas demand was expected to grow 20% by 2050. Now the figure is just 2%, though consumption may well rise in certain regions before it goes into structural decline. The role of natural gas as a ‘transition fuel’ continues to divide opinion.

Resource efficiency in particular has been a big driver of demand destruction. We know from the past that resources were being consumed inefficiently. In Cape Town, water use in agriculture declined between 2017 and 2018 by 60% after persistent drought changed behaviour⁷.

Today, too, efficiency is increasing. We are seeing strong adoption of consumer and industrial technologies to structurally reduce use of resources. For instance, since April, gas consumption by households and businesses in Germany is running at 75% of 2021 levels⁸. Heat-pump sales in Finland jumped 80% in the first half of the year⁹.

For investors, there are clearly opportunities. For one thing, demand destruction for fossil fuels is unlikely to precipitate a supply response in commodities. So, paradoxically, the prices of those commodities are likely to stay high, a condition the European Central Bank's Isabel Schnabel calls ‘fossilflation’. Investing in transition assets – those with heavy emissions today but with credible plans to transition – may deliver good outcomes for society and investors.

6. [CarbonBrief, October 2022](#).

7. [Water security in Cape Town, South Africa. OECD iLibrary](#).

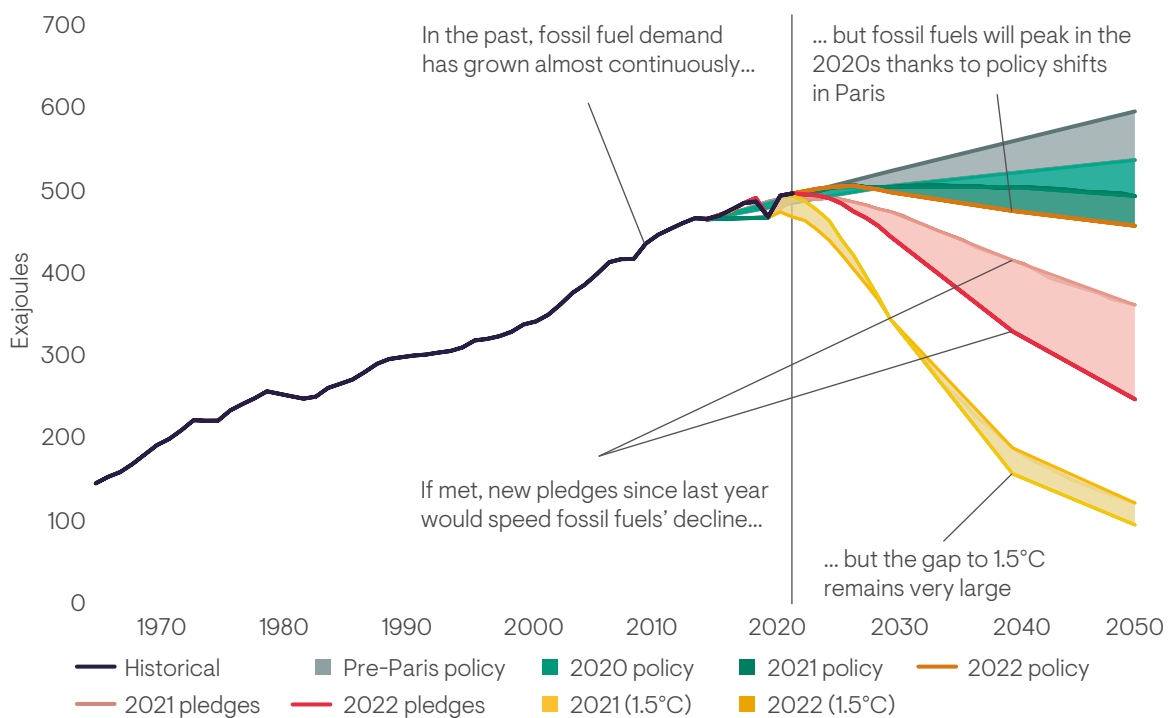
8. [Bundesnetzagentur](#).

9. [Politico, October 2022](#).

Beyond the traditional commodity sector, the IEA report looks at the manufacturing capacity needed for key clean-energy technology supply chains. It finds that for solar, batteries and electrolyzers, enough capacity is planned by 2030 to meet current climate pledges. However, for heat pumps, lithium and copper, there is a shortfall relative to what will be needed.

Meanwhile, there is a large gap between the cost of clean-energy finance in developed versus developing economies. The cost of capital differential was 9.0-13.5% in emerging markets vs 2.5-5.5% in advanced economies and China. That high cost of capital is not good for the transition in the long run, but in the short run there is an opportunity for investors.

Figure 6: The global energy crisis is dramatically accelerating the shift away from fossil fuels



Source: CarbonBrief Clear On Climate, October 2022.

Evolution of the Road to 2030

There are always top-down trends that structure the experience of market participants. But since 2020, we have lived in a world in which these have arguably grown more powerful. The three trends outlined here – the impact of monetary policy on fiscal policy, the shift towards regionalisation and fossil-fuel demand destruction – are but three that are putting us in a very different context from the low-growth, low-inflation world of the 2010s. This implies potentially quite different market leadership over the next cycle, in the context of somewhat higher and more volatile inflation, more volatile rate cycles, higher asset correlations, multiple deratings, and a capital and resource intensive cycle.

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