Regime Change Will Reflect Regional Economic Blocs, Demographic Differences

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Transcript of a video recorded 10/14/19.

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Trade conflict has been front and center. After some hopes for "the deal of the century," investors have come to recognize that a truce might be the outcome for what has been a drawn out and complicated affair. The challenge for any deal is that this is no longer a purely Trump-Xi issue.

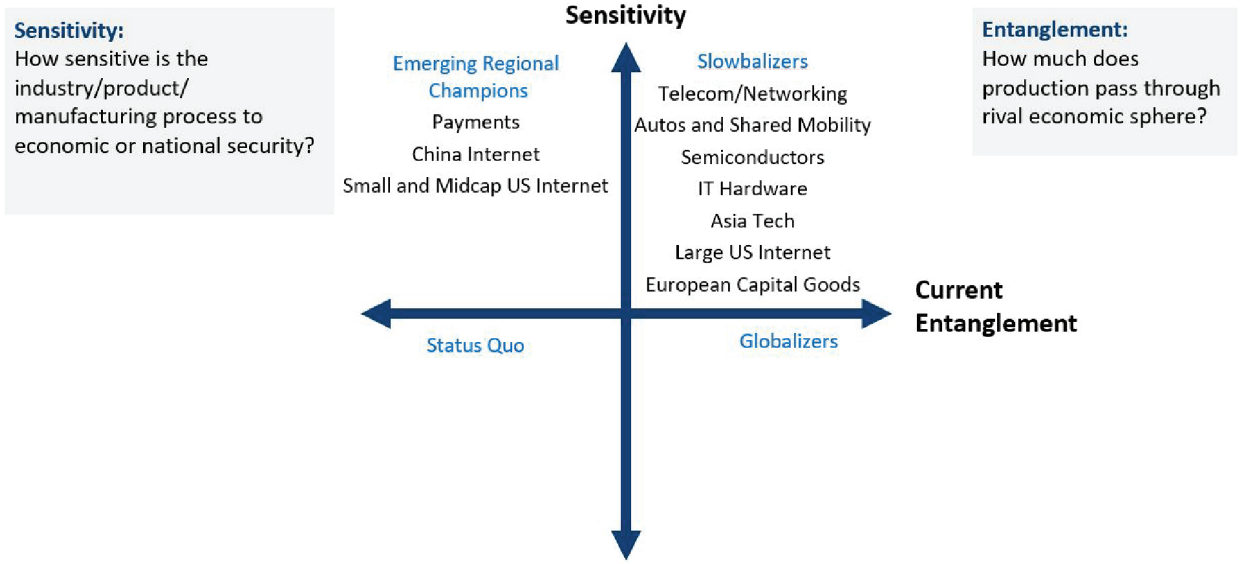
The essential difference between China and the West concerns the people. In the West those who are governed can remove those who govern them from power, at least in principle. Many of the trade and technology issues come back to this divide across governance values.

The U.S. and China have conflicting visions of globalization and thus, differ on how technology can be harnessed. Global supply chains are giving way to more regionalized trading blocs built around different technology and regulatory standards and, eventually, separate monetary cycles. Europe is debating whether it will follow its own path or ultimately join the American way.

This new digital "Cold War" has no precedent. The prior Cold War occurred when the global economy was far less integrated. Investors face a radically different landscape that demands a rethink of the global investment approach. We expect a messy decoupling that ebbs and flows depending upon the dominant issues of the day and which stakeholders have the upper hand.

"De-globalization" implies a new approach

Factors that determine the impact of reversing of globalization



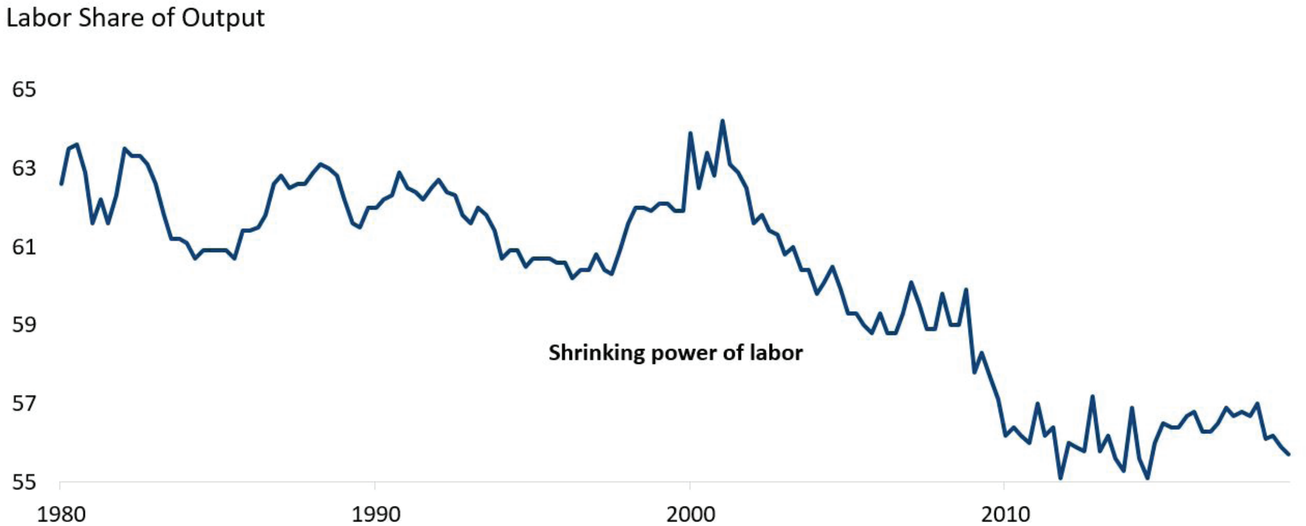
Source: Morgan Stanley Research, How Slowbalization Will Fit Business Strategy.

Beyond the tweets, there are deeper implications here for the investment regime of the 2020s. This reversal of globalization combined with shifting demographics suggests U.S. policymakers could be much more successful in generating reflationary growth.

Demographics and new technologies played a decisive role in the disinflationary forces of recent decades. When China and Eastern Europe began their integration with the developed economies in the 1990s, they opened an estimated 800 million workers for manufacturing supply chains. This "opening"—combined with the new technologies of communication—was eventually transformed into the iconic investment theme of "global growth led by China." A flood of Western capital followed, driving a correlation of performance across emerging markets assets.

This new supply of global labor contributed to the multi-decade decline in U.S. labor's share of national income, which is the root of today's populism. Firms were able to substitute local, unskilled workers with the much cheaper labor in the emerging world and in Asia in particular. National output gaps, which had historically determined inflation, were superseded by a new global output gap that negated inflation pressures across the developed countries.

The root of today's populism: A multi-decade decline in U.S. labor's share of national income



Source: Calamos Investments using Macrobond, IMF.

That flood of labor is reversing fast, partly because trade and tariff uncertainty has raised the cost of extending supply chains abroad. As highlighted by U.S. managements, trade tension is incentivizing companies to look for national and regional suppliers. Capacity constraints will become more homegrown, with positive possibilities for domestic incomes.

But there is a more brute reality related to demographics.

Parts of the emerging world, and China in particular, are aging rapidly. They no longer enjoy either the excess supply of labor or a sufficient cost advantage as new automation technologies are making it easier for U.S. manufacturers to compete. In fact, China's working population is entering or has entered an absolute decline that will extend through the middle of this century.

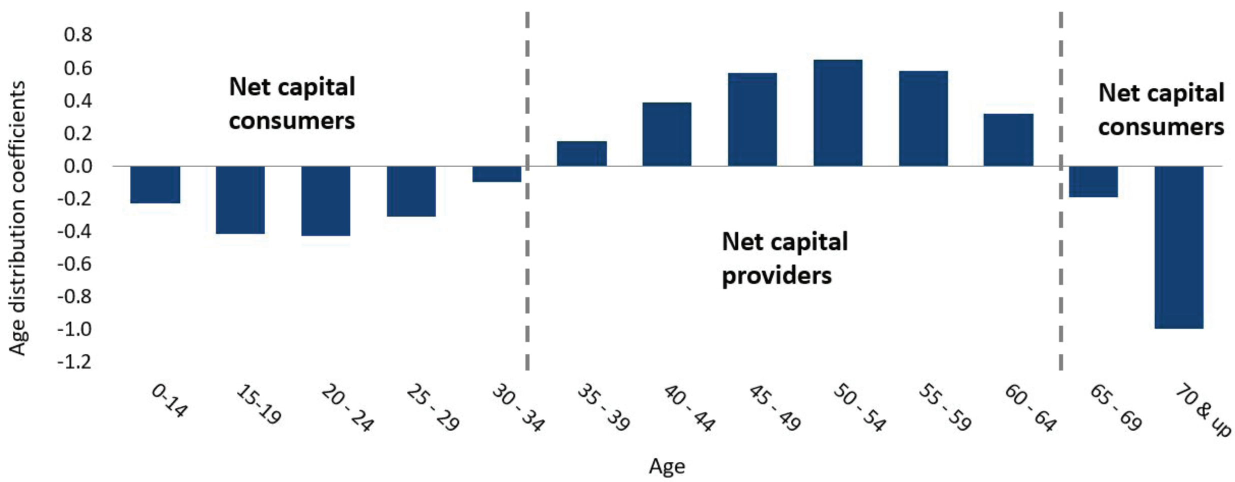
This combination of a shrinking global workforce and rising barriers to trade argue for more traditional cyclicality for the inflation outlook. Into the 2020s, the cry of "populism" for rising wages, and by implication, higher nominal prices just might be heard. At minimum, it argues that the deflationary forces from the emerging world that have frustrated America's attempts to reflate its economy are waning.

The role of demographics does not end here.

Middle-age workers tend to produce more than they consume and thus, supply more capital than they demand. As this global demographic bulge emerged in the 1980s, the global population was inclined to save rather than consume, contributing to the secular pressure on interest rates.

Propensity to be a net capital provider rises in middle age

Regression analysis of 85 countries over 1960-2005*



Source: Gavekal Research using Brookings, Gavekal Data/Macrobond. *Bosworth & Chodorow-Reich, 2006

These demographic winds are reversing as the "bulge" enters the retirement years and tends to consume more than it produces. From a structural perspective, demographics may be reversing what has come to be long known as the "savings glut" and thus, reversing the long downward pressure on both inflation and rates.

While this aging trend could weigh on consumer demand, it is striking how much better the U.S. demographic profile compares with both Europe and China. The Millennial generation will likely lead a consumer revival through the next decade for the U.S., underpinning key industries such as housing.

In short, the U.S. economy could be a virtual island of reflation, while policymakers seek to limit the impact of weak demand abroad.

One final conclusion: The high correlation of performance across the EM world was related to Western capital flows. These have decisively reversed, with political risk becoming structurally negative for many emerging countries. After decades of trading like a single asset class, the non-U.S. equity world demands a highly discretionary approach that recognizes the waning influence of common risk factors.

Videos recorded 10/14/19.

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