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WHITE PAPER

THE RISE OF BIG GOVERNMENT

– INVESTMENT IMPLICATIONS

The Rise of Big Government – Investment Implications

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"The nine most terrifying words in the English language are: I'm from the Government, and I'm here to help."

– President Ronald Reagan, August 1986

"Regarding the activities that are the most a question of national sovereignty, it must be considered that the state should retake the capital of EDF (Electricite de France)."

– President Emmanuel Macron, March 2022

Abstract

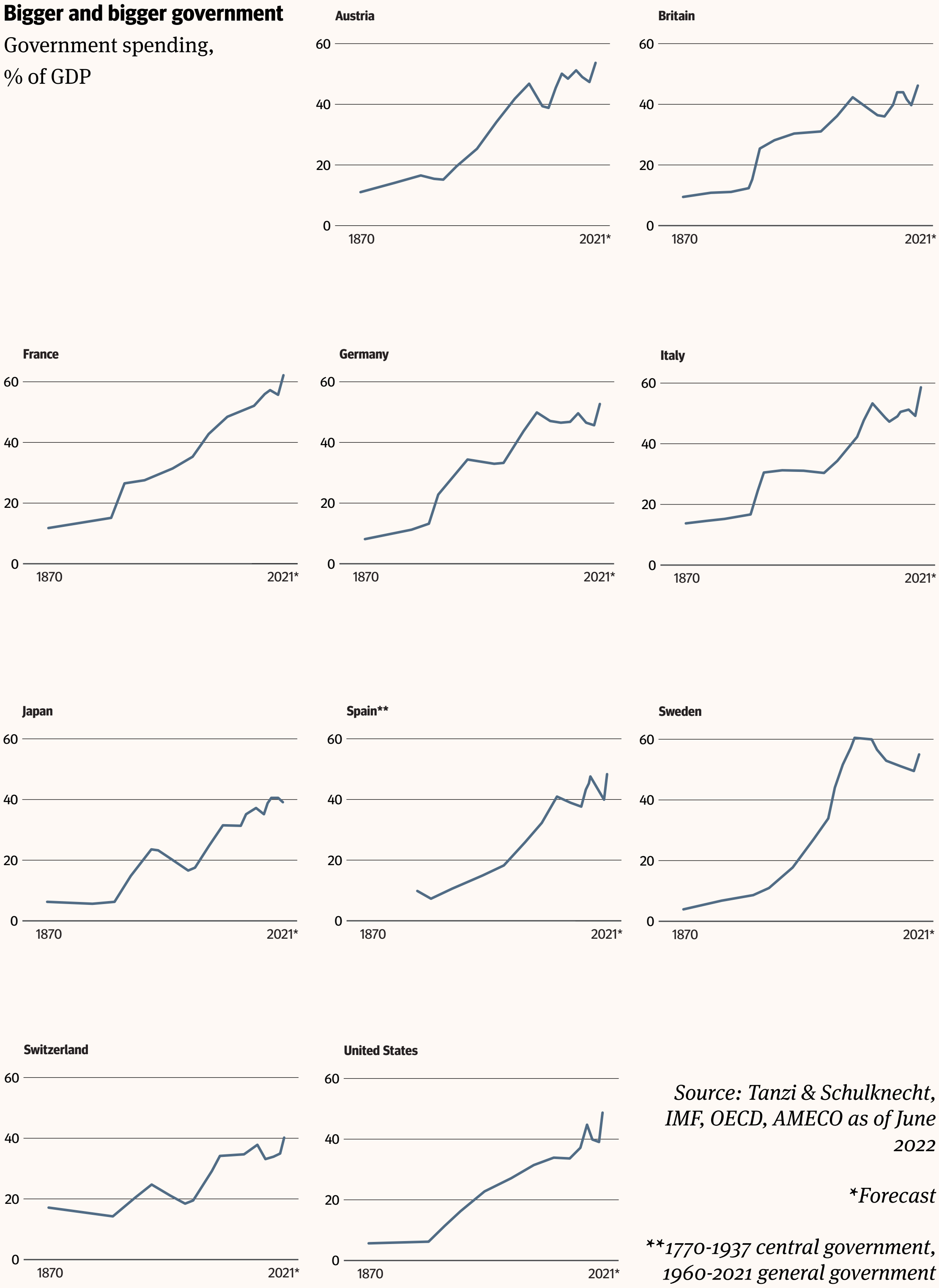
The two quotes above can be seen as great bookends of a brief period in modern history spanning 40 years – the period of free market capitalism that grew out of the inflationary 1970s, only to finally be terminated by the double punch of COVID-19 and the Russian invasion of Ukraine.

President Ronald Reagan's famous quote frames a unique and short-lasting period in modern economic history. After many decades of an ever-increasing role of government in society which lasted most of the 20th century – a trend that up until then culminated in the chaotic and inflationary 1970s – opinion shifted in the 1980s. The view, as expressed by Reagan (and the zeitgeist of the time), was that government is inefficient to such a degree that instead of helping, it often causes harm. Government spending, with the intent to spur growth, instead often acts to crowd out private investment and innovation. Furthermore, governments create unpredictability due to constantly changing policies, an unpredictability that has probably intensified over recent years due to the rise of social media and the need to constantly react to whatever the mood is on social media.

Since our first identification of the theme of "Big Government" back in 2009, the theme has grown in relevance, but its zenith still lies ahead. Investors need to understand that Big Government makes it impossible to normalize monetary policy and in fact will likely lead to further manipulation of interest rates in the years ahead. As a consequence, the country factor will again – in contrast to the previous period of globalization – be an important capital allocator. India and the US are two countries which stand out favorably in an overall more hostile investment environment with this thematic headwind. The Big Government theme cuts across and influences many of our other themes. In thinking about the future and searching for thematic tailwinds it is becoming much more important to understand the long-term priorities of governments. In this White Paper, we explore how ever more omnipotent governments are affecting the global investment environment of the 2020s.

Bigger and bigger government

Government spending,
% of GDP

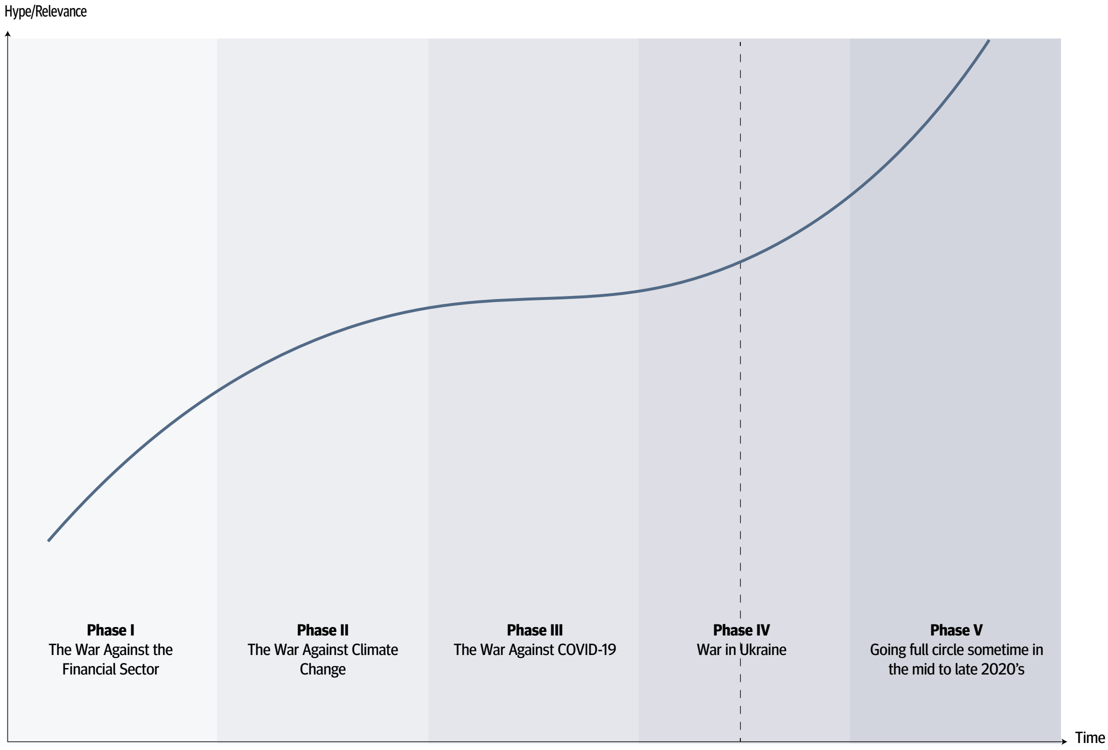


Source: Tanzi & Schulknecht, IMF, OECD, AMECO as of June 2022

**Forecast*

***1770-1937 central government, 1960-2021 general government*

The Rise of Big Government



The Rise of Big Government

If one does not stop and reflect on how certain aspects of society have changed over recent decades one can easily overlook the fact that the governing model of western societies is not a constant but has changed in a dramatic way since the time of Reagan. Both the role and the view of government in society has moved like a pendulum from one extreme position in the 1980s to gradually but forcefully moving to the opposite position over the following decades. These swings in sentiment are determined by complex interactions between population cohorts. Each cohort is influenced by experiences in one's own formative years and early adulthood. As the external environment constantly shifts between economic prosperity and recession, peace and war, etc., so does the social mood of different population cohorts and what they require from the government. While the overall mood of society in the 1980s was for less government involvement in society, in more recent years there has been a remarkable shift toward wanting a much more active involvement of government in all aspects of society.

We identified "Big Government" as a theme with a broader impact on markets back in 2009 in the aftermath of the Great Financial Crisis (GFC). Recent events have taken the theme to unprecedented levels of importance as we will discuss in this paper. As illustrated in the above figure, we have mapped the Big Government theme into five phases.

Big Government – Phase I – The War Against the Financial Sector

Although blame for the GFC can be attributed to many actors including government institutions like the FED and other central banks, a narrative was created that the reason for the GFC was because of excessive liberalization of financial markets in prior years and that banks and other

financial institutions had abused the trust given to them. There had been a "market failure" and as a result, a loss of confidence in "free markets". The people turned to government for leadership which in turn swiftly introduced massive levels of regulation in the financial sector in order to ensure that the GFC would never be repeated.

Big Government – Phase II – The War Against Climate Change

This is not intended to be a historical account of how the political consensus has gradually, over recent decades, come around to accepting that climate change is a reality and that human activity – especially the burning of fossil fuels is to be blamed. Suffice to say, a few years after the GFC, the war on climate change has moved to the front page of the public agenda. Again, the consensus narrative has been that governments are needed to play an active role as regulators and enablers, as markets are not fit for this purpose.

Big Government – Phase III – The War Against COVID-19

As COVID-19 spread across the globe in the early part of 2020 governments around the world decided to lock down economies and suspend normal civil rights. This was driven largely by policymakers' fears that if large numbers of people died, they would be held accountable in the court of public opinion. "We apply a precautionary principle, and we should rather act today than regret tomorrow" was the message from one of the first movers in shutting down societies, the Danish Prime Minister Mette Frederiksen.

It seems that the "precautionary principle" or "do-what-ever it takes" principle trumps "cost-

"It seems that the precautionary principle or do-what-ever it takes principle trumps cost-benefit analysis in public governance today."

benefit" analysis in public governance today. Of course, no policymakers want a surge in deaths on their watch. But economies did not get shut down during the 2009 swine flu pandemic, nor during SARS in 2003, nor the Hong Kong flu pandemic of 1969, or even the Spanish flu pandemic of 1918. So, what changed between the time of SARS and the time of COVID? One obvious answer is the rise of social media and its immediate effect in swaying public opinion. When something bad happens, such as the COVID-19 out-break, an outcry rapidly arises on social media that "something must be done." Wishing to show swift and effective governance, politicians latch on to the first policy that might conceivably be "something" to silence social-media opinions.

Big Government – Phase IV – The War in Ukraine

Much like the COVID-19 outbreak, the Russian invasion of Ukraine evoked deep-seated fears in western governments and populations, created previously unheard-of unity amongst western nations, and led to rightful conclusions that "something must be done" about this atrocious act of war. As with the COVID-19 response, politicians quickly seized on the first available "somethings" and implemented them as policy before studying the likely longer-term effects in any depth. Examples of these responses were the freezing of Russian state and individual's assets without legal due process and consideration of the longer-term consequences for the attractiveness of western reserve assets, massive rearmament in Europe over the coming decade financed through increased indebtedness as well as an instigation of policies to reduce the continent's dependency on Russian oil and gas over the coming decade. Due to the historical underinvestment in primary energy since at least 2015 because of the war on climate change, Europe now faces a decade of very tight energy supplies and structurally high energy prices with potentially devastating consequences for the European economy. We concur that the west had to react in the strongest possible way against this blatant crime against humanity, but we also need to discuss the longer-term consequences of our acts. The west is in a new cold war with Russia, which can also be seen as the first proxy war between China and the US, and will likely lead to further fracturing of globalization, a geopolitical polarization splitting the world up into a US and a Chinese sphere of interest.

"Because of the war on climate change, Europe now faces a decade of very tight energy supplies and structurally high energy prices with potentially devastating consequences for the European economy"

This happens in 'the transparent society,' where governments are expected to act much faster than in the past. In our new age of social media, the policymaking process has accelerated tremendously.

The rise of Big Government will continue throughout the 2020's and perhaps beyond. Following historical patterns, we will have to go through phase V to move full circle.

Big Government - Phase V - Starting Soon

Here, the "Big Government" theme goes full circle – with a possible full reversal of what happened in the 1990s – with privatizations and western governments resorting increasingly to nationalizations – most likely in the energy space and other industries vital for the independence of the nation-state, including nearshoring and "friend-shoring" production as suggested by Treasury Secretary Janet Yellen in a recent speech. Some key European politicians have already reached the conclusion that energy markets are too important not to be state-controlled, as exemplified by President Macron's quote about EDF at the beginning of this paper.

"In an era of Big Government, where the state controls the cost of capital, normalization of real interest rates will not be allowed."

Investing in times of Big Government is challenging, and one needs to purposefully build a robust portfolio that takes this into consideration. In particular, the "war economy" mindset has significant implications.

Big Government – Consequences

Macro: If central banks really combat inflation and raise real interest rates sharply, there will be a triple contraction in demand for goods and services. Directly, due to higher real interest rates; on top of that via negative wealth effects due to a fall in asset prices; and finally, through the inability to keep fiscal policies expansionary if real interest rates normalize. The cost of combating inflation in terms of lost wealth, activity, and jobs would therefore be very high. Is that acceptable? We think not, and in an era of Big Government, where the state controls the cost of capital, normalization of real interest rates will not be allowed. The 2020s require suppression of interest rates and potentially capital controls, as was the case up until the beginning of the 1980s.

Country: The country factor has over recent decades, lost importance when allocating capital. This is changing with a fracturing world economy and the rise of Big Government – because simply put, governments run countries.

China has the highest-octane version of Big Government, where the system has always been

more important than individual rights. Lately, President Xi has taken this to new extremes with the crackdown on the education, tech, and property sectors by deemphasizing shareholders vs other stakeholders.

The overall objective of the Chinese Communist Party is the preservation of power by realizing the "China Dream / Vision 2049" through the programs of "Common Prosperity" and "Dual Circulation". This creates tailwinds for companies engaged with renewable energy, Chinese developed tech, automation and military spending, while companies in housing and education will see headwinds because less and less activity here will be allowed to be driven by private enterprise on commercial terms.

"Claiming to be the dominant superpower conflicts with being dependent on supply chains controlled by one's adversary."

The United States has a historically strong tradition of isolationism, a practice that has been in hibernation since WW2, but that has resurfaced recently. Increasingly, there is an unusual consensus in US politics that the US economy has paid a high price for globalization in the form of lost manufacturing jobs and rising inequality domestically. The US is withdrawing from the Middle East since its dependency on energy imports has been significantly reduced due to the shale revolution. Instead, the focus is turning to the growing struggle with China, and the key focus here is probably the need to develop resilience by rebuilding manufacturing capabilities (including high-paying manufacturing jobs) and reshore activities that have been outsourced to greater China in prior decades. This is especially the case within tech, as semiconductors have become fundamental to all economic as well as military activity and claiming to be the dominant superpower conflicts with being dependent on supply chains controlled by one's adversary. Therefore, the US government in the coming decade will subsidize the construction of leading-edge semiconductor capacity domestically in order to reestablish self-sufficiency in this all-important area. But the manufacturing renaissance in the US will not be limited to advanced tech, as the US (and Canada) is gifted with structurally lower energy costs than most other regions of the world. Therefore, many heavy energy-consuming

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industries will move to the US and export to energy-starved regions of the world, most of all Europe. Broadly, politics will support domestic ahead of foreign production and in a Big Government world, corporate America will reshore capital investments because of the rise of US nationalism in an era of growing conflict with China.

India looks like a long-term winner. In a geo-politically fracturing world that increasingly will be split between a China-centric and a western group of nations, a strongly growing and independent India stands as a neutral observer and will likely benefit from growing antagonism between east and west. India has something only a few large countries have, namely positive demographics. The country has a positive Big Government reform agenda that has set in motion deep structural change across the subcontinent. Financial inclusion and a rapidly growing housing sector are strong investment themes for the 2020s and are supported by government reform initiatives.

The Achilles heel of the Indian economy has historically been the economy's sensitivity to energy prices and falling dollar liquidity, last evidenced by the so-called taper tantrum in 2013. India stands as one of the major winners from the Ukraine war, in that the freezing of Russian reserve assets will lead to a fragmentation of reserve assets as well as acceptance of paying for energy imports in currencies other than the US dollar. India (as well as China) will be paying for (Russian) oil in its own currency which is a huge privilege, and something only the US has had historically. This will lower the cyclicality of the Indian economy, making it much more resilient to swings in commodity prices and dollar liquidity.

Western Europe is probably the continent that will see the biggest headwinds from the fracturing of the international rules-based system because the EU has been so dependent on producing and selling to the wider world in a deeper and deeper globalized system. The reversal of globalization is a big blow to Europe. In fact, it could be argued the "business model" of Europe is being totally upended. Up until today, Europe has outsourced its energy needs to Russia and its defense to the US while offering an expensive welfare state to its populations. Moreover, producing advanced products for the world, it has benefitted significantly from the rise of China over the last few decades. That is coming to an end. Europe must get off its dependency on Russian energy while rearming in order to defend itself since the US is turning away from Europe and focusing on the conflict with China. The silver lining of the debacle is that Europe is coming together in this time of crisis, both in deeper defense cooperation as well as a likely deeper fiscal integration; when barbarians are at the gates we tend to move together. As formulated by Jean Monnet, one of the founders of the EU, "Europe will be forged in crises and will be the sum of the solutions adopted for those crises".

"The silver lining of the debacle is that Europe is coming together in this time of crisis, both in deeper defense cooperation as well as a likely deeper fiscal integration."

Europe needs to accelerate the energy transition, but renewable power will not be able to compensate in any meaningful way for the reduced imports from Russia. Imports of gas from friendly countries will be paramount – and expensive. Logic – but not yet EU politics – dictates that nuclear power will eventually become a major part of the solution in Europe but will not be able to bridge the gap before mid-2030 at the earliest. The conclusion must be that Europe will face structurally higher energy prices in the decade to come. Politicians will feel an urge to "do something", and this "something" will likely involve even more government involvement in European energy markets, including the nationalization of energy companies because the zeitgeist is that the market has failed, and the government must engage.

Europe today sees its major threat on the eastern border with a hostile and aggressive Russia. However, Russia is not the only "bad neighbour"; the real long-term challenge for Europe continues to be the population explosion in poor Middle Eastern countries and Africa, a problem that has deepened due to the food crisis and as a result of the war in Ukraine. The political focus in Europe has so far not been on how Europe will ensure economic prosperity in poor Middle Eastern countries and Africa so that immigration flows do not overwhelm Europe's migration capacity. This must be the biggest challenge for Europe longer term and something which seems almost impossible for politicians to solve given social media's focus on immediacy and the short election cycles.

How Big Government affects our thinking around Trends and Themes

Big Government is one of 42 themes we have identified as changing the world as we know it over the coming decade. But Big Government is more than a stand-alone theme in that it cuts across and influences many of our themes. It is our view that our themes and thematic approach are well aligned to the current world environment, but as Big Government accelerates in the years ahead, we also need to stay on top of how this "super theme" interacts with and affects other identified thematic changes.

In thinking about the future and searching for thematic tailwinds, and avoiding thematic headwinds, it is becoming more important to understand the long-term priorities of governments. What are the probabilities of intervention and the probability of making sustainably high returns on capital in a world where the government is taking up more space than in previous times?

We think the risk of a simple value-based or sector-based strategy is too high, and that you need to base stock picking decisions on a thematic and country-specific framework. Finding high sustainable returns at low risk is simply more difficult now.

The risk of intervention if you earn abnormal returns in times like these is high (private education in China, offshore wind parks in the UK and windfall profit tax on energy companies are recent examples). Thematic thinking is designed to take bigger government agendas into consideration.

The Productive and Digital Society

We see the move to a more productive and digital society coexisting with the agenda of Big Government. Big brother wants to know what you are doing. The digitization of society offers the potential of 20/20 vision for governments when it comes to economic activity, especially in a future world where central bank digital currencies have been rolled out.

Work From Home has seen massive acceleration due to COVID-19. More time spent working and enjoying being at home with experiences in safe "metaverses" is supported by Big Government. This will be facilitated by the continuous growth of cloud computing and other advanced technologies and the major companies here will increasingly be seen as western foot soldiers in the conflict with the East, rolling out tech solutions to the benefit of western economic advancement. Advanced manufacturing is another area that will be accelerated by Big Government agendas, in energy efficiency, process optimization, and self-reliance in semiconductors.

Sociodemographic change

Financial inclusion and housing inclusion are major government sponsored efforts in many emerging economies, not least in Indonesia and India, where whole societies and individual companies will see massive opportunities as governments roll out the infrastructure required to grow inclusion. Localization of production and resilient supply chains have taken on new importance after COVID-19, the war in Ukraine, and rising tensions between East and West, and will lead to less efficient but more robust production systems.

Big Government goes together with the rise of the nation-state and stakeholder capitalism before shareholder capitalism. Labors' share of total income is likely to rise in the 2020s in order to reverse previous decades' growth in inequality. We are mindful that companies with a high ratio of wages to total revenues will face headwinds in the 2020s.

The necessities of life

The major branded consumer products tend to be owned by multinationals. In the years to come, it will be vital for these brand owners to be perceived as being local and not global. This means local development and production so that value-added is given back to the nation-state where the product is consumed.

Digitization of payments has reached high levels of penetration in many markets but will continue to offer good defensive growth for the rest of the decade as the transition from cash to card is completed in most markets. The transition is supported by governments as it reduces the black economy, lowers transaction costs, and raises financial inclusion for the poor.

Pursuit of a better and longer life

The themes of healthcare of the future and life-style diseases are areas where there are many cross-currents; technological advancement promises to accelerate product pipelines and expand total addressable markets for pharmaceuticals but goes up against the question of affordability. Most societies will see rapid cost inflation in healthcare because of the aging of societies, and only clearly

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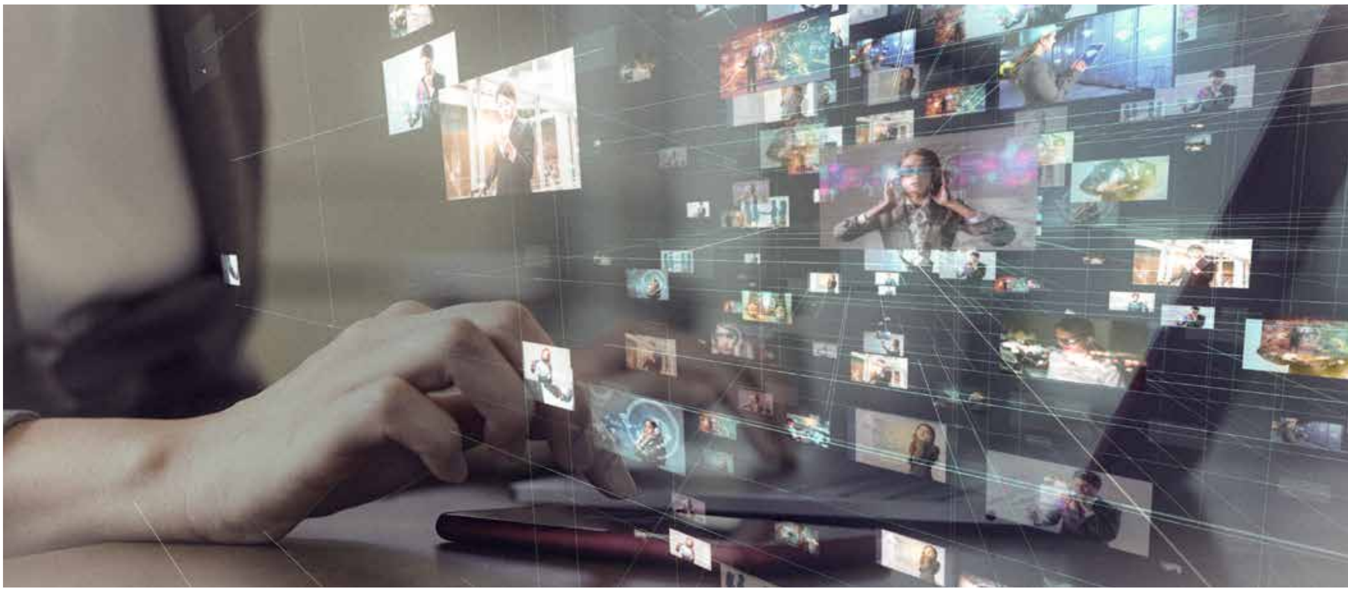

"In the years to come, it will be more important than ever to ask how companies' activities fit with the priorities of the government."

differentiated products that offer better treatment at lower costs will have pricing power. One needs to be very selective and stay on the right side of government.

The circular society and efficient use of scarce resources like energy and water will be critical in the years to come and will be at the center of attention of governments. Investments in renewable energy will be massive and on first analysis are an attractive, rapidly expanding market but due to their importance to the government, most companies will not be allowed to earn super-profits. In order to invest in this area, one needs to make sure the specific market is off the radar of Big Government.

Conclusion

In the years to come, it will be more important than ever to ask how companies' activities fit with the priorities of the government. This has been the case for investors focused on the Chinese equity market for many years, but as western governments extend their reach into our economies the same application of an assessment of the political economy also becomes essential when investing in western markets.

We believe our thematic framework for analyzing change is well placed to assess the changing investment landscape in the 2020s as we live through the full and final reversal of the swing of the pendulum of government involvement in economies and markets.

Our focus has been and will continue to be the analysis of secularly growing end markets and the identification of compounder companies exposed to these markets. The government will expand its role in society as described above but there will still be ample opportunities to identify attractive companies in the 2020s. We are strong believers in concentrated, thematically based stock picking and believe the opportunity set in front of us is bigger than ever before in our 30-year careers.

Please find more information on cworldwide.com.

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Active Investments

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