

Mid-Year Geopolitical Outlook and Business Leader Agenda

July 10, 2023

1. Key Geographies

US: Politics will swamp the business agenda.

- Inflation, health costs, and bipartisanship were Americans' top concerns in June, but these priorities and those of the business community will get **pushed off the agenda** in the fall as the election season ramps up.
- The **Republican race will dominate** the narrative until a presidential candidate seizes the nomination: Anti-government, anti-woke, and anti-elite themes will prevail.
- **The Democrats** will offer a much less gripping, more-of-the-same platform that touts policy continuity ("getting the job done") and progress under the banner of Bidenomics. This will include a focus on infrastructure, manufacturing, and R&D.
- **China bashing**—a bipartisan pastime—will escalate and the US-China relationship will be punctuated by periodic political shocks (including new rules governing exports and outbound FDI) even as the Biden administration seeks to put guardrails on a competitive relationship.
- Given a highly politicized atmosphere, **business leaders will speak up less** on societal issues as they focus on the operational challenges of slow growth and business transformation. In June, BlackRock CEO Larry Fink said he no longer used the term ESG because it had become so toxic.

China: The focus will shift from near-term pandemic recovery to the country's long-term attractiveness.

- Key economic data point **to a weak recovery**. The producer price index, for example, fell 4.6% YoY in May—the steepest decline in seven years, including during the Zero Covid period. Plus, in 2022, China lost its standing as the top FDI destination for US businesses.
- **Many other issues will shape the agenda as well:** Access to market intelligence; labor practices in supply chains; data and cybersecurity regulation; trade and investment restrictions; demographic trends; consumers' shift away from Western brands; businesses' alignment with the Communist Party; and Hong Kong's standing as a top financial center.
- Investor and business leader concerns and tense relations with the West are **unlikely to motivate Beijing to shift course**, given the leadership's distrust of the US, national security orientation, and focus on ideological discipline.
- To this point, Beijing will remain **steadfast in its "no limits" partnership with Moscow**. As a result, China's brand in Europe will continue to suffer. ▶

Key economic trends in China (2019 = 100)



Gavekal Dragonomics via *The Economist*, June 18, 2023.

Ukraine: Escalation will set the stage for de-escalation.

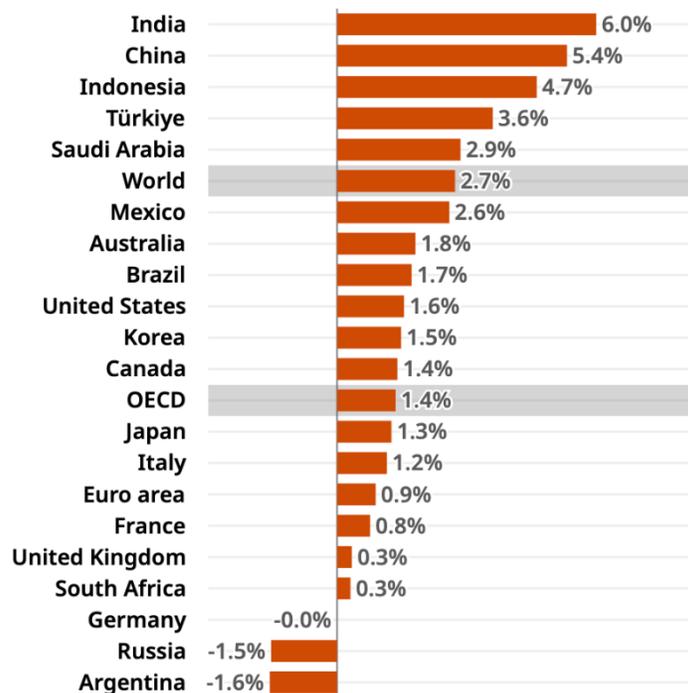
- The fighting, death, and destruction **will peak over the summer and fall** as Kyiv presses its counteroffensive and deploys the arms and training it received from the West over the winter and spring. The violence will subside again in winter, leading to questions about what comes next.
- The Kremlin is making tactical changes in the wake of the Wagner mutiny, but it will continue **struggling to defend its areas of occupation**. In this context, it will rely more on asymmetric warfare (attacking cities, infrastructure, and, perhaps, nuclear facilities).
- Western support will remain robust, but **concerns on both sides about a forever war** will spark talk this winter of finding ways to end the violence and move Ukraine and Europe forward. One scenario: A frozen conflict akin to the Korean standoff.
- Western financial, infrastructure, defense, and professional services firms **will be prepositioning** to deliver rebuilding, resupply, and governance projects once the situation stabilizes.

Europe: The continent sticks together as it focuses on the future.

- The **eurozone economy will slowly but steadily recover** after a contraction in 1Q23. Prospects will continue to improve in 2024. But Germany—historically the economic engine of Europe—will underperform. Brussels will continue pursuing its ambitious economic competitiveness agenda focused on manufacturing, digital innovation, and the green transition. ►

- **Energy security and inflation** will continue as top economic concerns. The EU was quick to cut its dependence on Russian hydrocarbons last year and the narrative has now shifted to a focus on energy independence, to be secured by massive investment in renewables. Meanwhile, governments will continue to be concerned about how businesses and households can afford this and other rising costs.
- **The war in Ukraine will continue to dominate European politics.** The pace and depth of EU and NATO enlargement and cohesion in the implementation of sanctions against Russia will face pushback from some countries. The extent to which security guarantees can be provided to Ukraine—to ward off Russian aggression and spur reconstruction—will require tough negotiation.
- **China skepticism will grow** and technology export and import restrictions and outbound and inbound FDI screens will be a result. Some countries—especially Germany and France—will strive to maintain strong economic relations, but businesses will have a hard time finding ways to derisk against geopolitical vulnerabilities. ▶

G20 growth expectations in 2023



OECD, June 7, 2023.

India: The subcontinent will be the world's most interesting growth story.

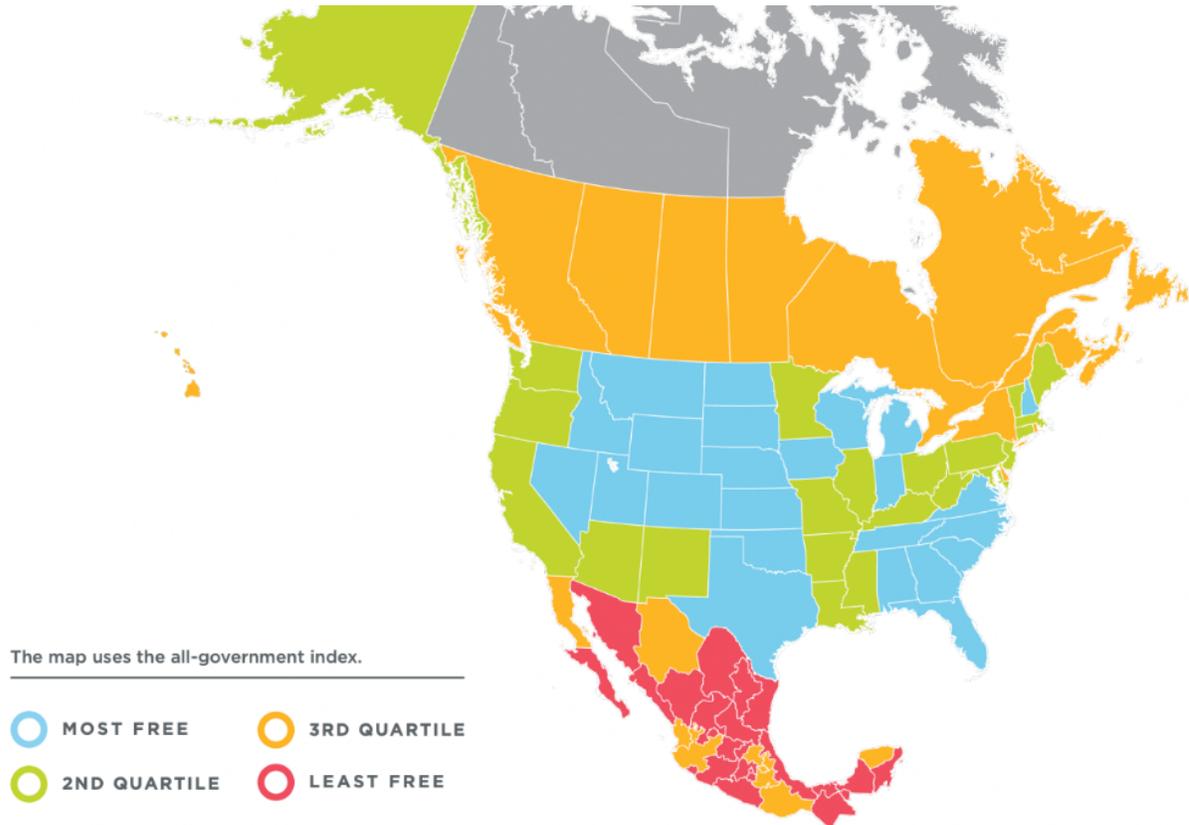
- Continuing a trend of the past few years, **India will be the fastest-growing major market.** The OECD expects GDP to grow by 6.0% in 2023 and accelerate to 7.0% in 2024. Presently, India has the world's 5th largest economy, but it is expected to leapfrog Germany and Japan into third place soon.
- India's leadership sees their nation as a **superpower in a multipolar global order.** “India deserves a much higher, deeper and wider profile and a role,” Prime Minister Modi asserted in June. ▶

- In September, **Modi will host the G20 leaders' summit**, which (along with the UN General Assembly) will highlight the position of non-aligned, developing nations (a.k.a. the Global South). But, the meetings will reinforce the sense that global governance is fractured and dysfunctional.
- Nevertheless, **India's economic integration with the West will accelerate**—as a manufacturing alternative to China; as a fast-growing market to sell into (e.g., record-breaking purchases of airliners); and as a skilled labor pool to backfill shortages in the West (engineers); and via R&D collaboration (AI, quantum computing).

Mexico: Does the country capitalize on the nearshoring opportunity?

- **Voters will elect a new president in July 2024.** The outgoing AMLO government has been ambivalent about foreign businesses and investment, and the vote will elevate questions about the country's economic, political, and security trajectory.
- Outside of the automotive sector (which is favored by USMCA), the country's status as a friendshoring/nearshoring **alternative to China will remain limited**, given political and security risks.
- Canada's Fraser Institute, a right-leaning think tank, examined economic freedom across North America. **Mexico's 32 states ranked lowest**, with many in the least-free quartile. ▶

Economic freedom across North America, 2022



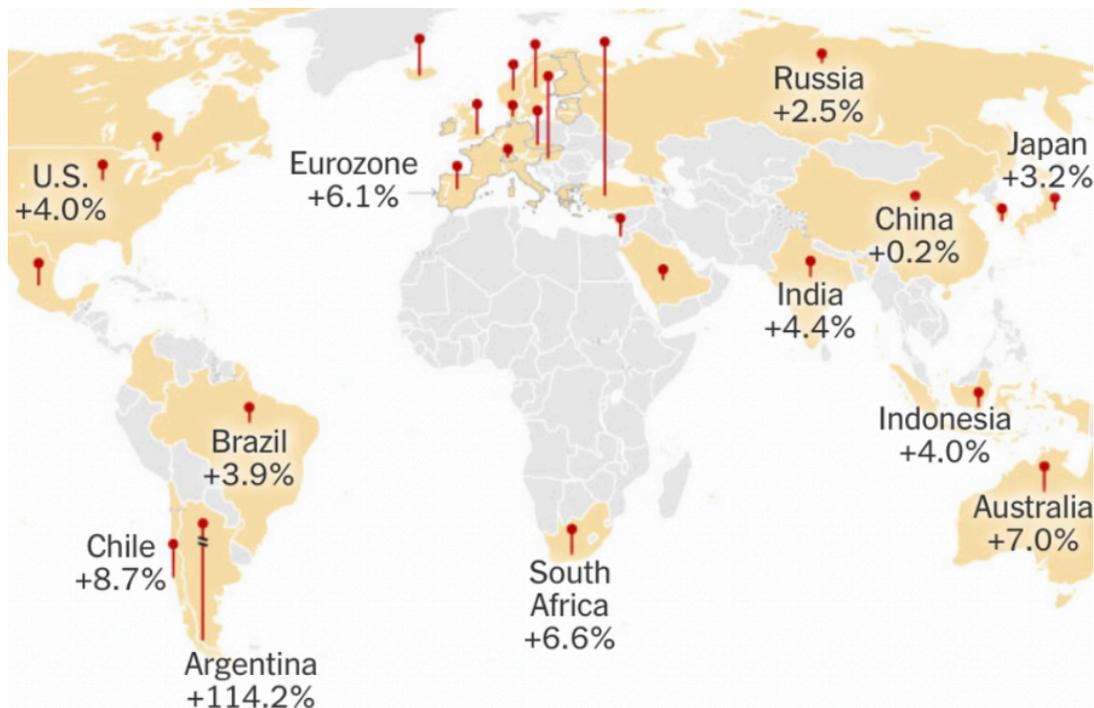
Fraser Institute, January 26, 2023.

2. Key themes

Economic sentiment: As expectations of a downturn recede, will businesses regain more forward-looking, growth-oriented agendas?

- **Headlines have been volatile and confused** as economists have struggled to sort out assumptions and drivers from the pandemic, the Ukraine war, inflation, and demographic trends. This situation has made business planning and strategy difficult, and risk aversion dominated over the past 12 months.
- **The world appears to be turning a corner.** Inflation is receding as a topline concern and consumer sentiment is improving. In June, the OECD upgraded its 2023–2024 economic outlooks, but growth would still be the weakest since the global financial crisis (excluding 2020).
- **The world has also entered a new economic supercycle:** China's status as a global growth engine is no longer a given; unbounded free trade is politically untenable; slower population growth and migration no longer counter talent shortages and wage pressures; and geopolitical tensions are adding costs and complexity.
- **Developing market growth rates will be uneven,** with Brazil, South Africa, and Russia underperforming. And, investors and businesses are more sensitive to political risks. This will make segmenting the market and seizing opportunities harder. ►

YoY change in consumer prices as of May



New York Times, July 5, 2023.

Geopolitics: Countries and companies will derisk and decouple.

- **The world is sorting into three business spheres**—the West, China-Russia, and the non-aligned Global South. An intensifying war in Ukraine will highlight this divide even more in the coming months.
- **The idea of “the West”**—markets with shared norms, rules, practices, and technologies—will shape business and investing (i.e. friendshoring). Japan, South Korea, and India are becoming more prominent members of this club.
- Meanwhile, **China will continue pulling Global South nations** closer through trade deals, lending, affordable technology, and infrastructure projects.
- **Global institutions are reverting to international organizations.** The WTO, the UN, the G20, and the WEF are losing their mojo as platforms for global cooperation, instead becoming forums to air disagreements. And Beijing's constant but vague calls for diplomacy and multilateralism won't move the needle.

ESG: Does it develop or wither?

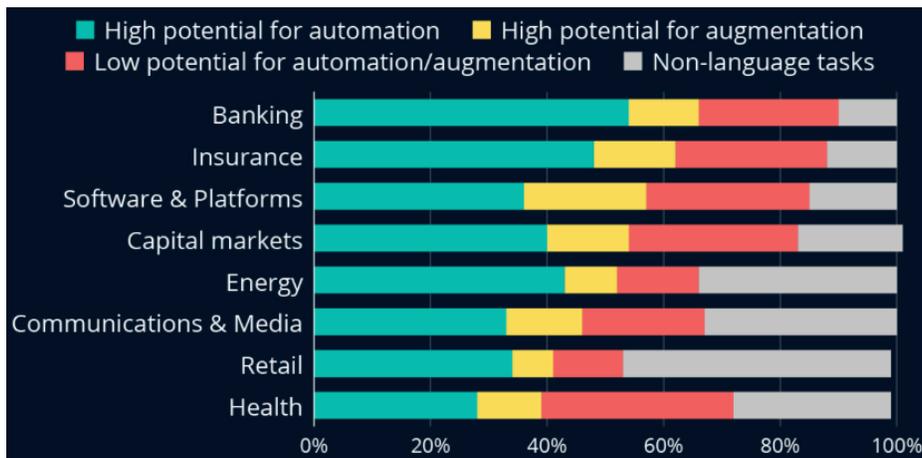
- The next months will be focused on putting **material meaning** behind what has been a fuzzy and disparate concept through, for example, more rigorous climate and human capital disclosures. The ISSB's and the SEC's actions on these fronts are being closely watched.
- The merit, impact, and approach of **climate and DEI initiatives** will also be in focus. Employees will be especially critical: An Edelman survey on business and racial justice found 57% of respondents said their organization was not making much meaningful progress in addressing racism at work.
- Getting strategy, tactics, and messaging right will be hard, and **accountability will be a business leadership flashpoint.** Companies and asset managers are being more measured in their words as they seek to find the right way forward and the data to support it. Regulators are expecting it.
- **The COP28 climate summit** will be held in Dubai in late November. The Middle East location is spurring a focus on the oil and gas sector, SOEs, and the role of freedom of speech in combatting climate change.

AI: The challenge will be making sense of the opportunity, hype, and risks.

- The take-off of ChatGPT has sparked an **investment, acquisition, and commercialization** gold rush. The result: AI development and deployment wave will move faster in the coming months.
- **But, but, but:** News about transformative applications and deals will be punctuated by headlines about misinformation and mishaps.
- **Every company will seek to become an AI enterprise.** Back-office functions, customer engagement, IT, and R&D are ripe for transformation. Accordingly, the financial services sector is likely to undergo major changes in the near future. ▶

- **The EU's proposed AI Act** will be debated and, like the General Data Protection Regulation, it could become a global standard. In a gridlocked US, the Biden administration will emphasize cooperative efforts to develop guardrails with industry. Beijing will constrain and focus AI to serve Communist Party objectives.
- **Other issues to watch:** Competition between open-source (versus proprietary systems); the positioning of incumbent tech giants versus AI upstarts; and AI's ability to boost productivity and the implications for headcount. ■

Share of working hours in selected industries in the US with tasks that could be automated/augmented by AI



Accenture data via Statista, June 8, 2023.