INVESTMENT
STRATEGY UPDATE

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DEGLOBALIZATION

As the world struggles with the COVID-19 pandemic, the economic shocks created by widespread shutdowns have laid bare the risks of the globalized economy. In the post-Cold War era, borders opened, transportation became cheaper, and the Internet transformed communications. These changes encouraged companies across the developed world to move factories to countries with cheaper labor, investing their capital where it could get the highest return. This rapid expansion of globalization peaked in 2007 and never fully recovered from the Great Financial Crisis of 2008-2009. Then came the pandemic. The resultant two-month shutdown of China's economy revealed just how much global supply chains in critical industries had come to depend on one country. Previous disasters had revealed the risks to global supply chains by interrupting the production of consumer goods, but now crucial items such as protective medical supplies were caught up in the disruption. As a result, governments and businesses are starting to make decisions that will lead us into an era of deglobalization, where strategic stockpiles and national security issues will move to the forefront and government influence over the economy will increase.

Efficient Supply Chains…

There has long been an emphasis on creating supply chains that minimize cost and expand corporate margins. It is expensive for companies to carry excess inventory and pay for idle plant capacity. The development in Japan of just-in-time manufacturing meant that every raw material and intermediate component went swiftly through factories running full out twenty-four hours a day, leaving little room for error. Without additional inventory or plant capacity to smooth over problems, a snag in any step of the supply chain could cause major disruptions to the creation of finished products. Many industries learned this lesson after the Japanese earthquake and tsunami of 2011. The floods in Thailand later the same year drove the point home for the hard disk drive and semiconductor industries.

So how will businesses make their supply chains more robust? Depending upon the product in question, the strategy will combine elements of geographical diversification, onshoring, and automation, as well as purposeful inefficiency. The result will likely be lower operating margins across many industries.

A study by the New York Fed has shown that while imports from China plummeted during its lockdown, total imports into the U.S. dropped much less. Companies with existing import relationships in other countries, primarily Vietnam, India, and Bangladesh, were able to shift production to those countries and continue importing goods. Given the heavy reliance on China in the past two decades and worsening relations between the governments of China and the U.S. in the past few years, we expect to see businesses increasingly diversify their supply chains specifically away from China to other low-cost countries.

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In fact, North America further solidified its own trading block in March by ratifying the United States Mexico Canada Agreement. While this agreement is similar to its predecessor, NAFTA, it creates even more incentives for trade in goods within North America. Due to Mexico's favored trade status, we can expect there will be some shifting of lower-wage production to our neighbor to the south.

The European Union is taking a similar approach by encouraging businesses to shift manufacturing to developing countries that are geographically closer to its member states. The EU High Representative for Foreign Affairs has called on European companies to shorten their supply chains and shift their trade closer to home, particularly Central Europe, the Balkans, and Africa. These countries have closer political ties to Europe through trade and immigration that the EU believes mitigate some of their inherent risks.

…versus National Security

Most people in the U.S. were surprised to learn that almost all antibiotics and more than 70% of raw ingredients for drug manufacturing were sourced from overseas, the majority coming from China and India. Surprise turned to horror as the pandemic unfolded and nations began to hoard precious medical supplies and stake claims to the first doses of any new vaccine made with their intellectual property, capital, or factories. This dependence on other countries for critical medicines and supplies has raised the question of whether a government should try to bring this production back to its own shores to ensure the security and well-being of its citizens.

National security is not a new issue. For years, the U.S. and other countries have been concerned about Huawei, the Chinese communications network equipment company with close ties to its government. The fear that Huawei's equipment can be used to spy on its users has resulted in the U.S. lobbying against its deployment domestically and in allied countries, as well as threatening to restrict semiconductor manufacturers from supplying Huawei. As a result, Taiwan Semiconductor, a leading supplier of microchips to Huawei, has announced it will build a new plant in Arizona that will use U.S. equipment and employ U.S. citizens, thereby making it a U.S.-based supplier.

The United States, China, and Japan are taking other specific steps to encourage onshoring. The U.S. Biomedical Advanced Research Development Authority is making investments to bring the drug supply chain back to the U.S. In 2015, China rolled out its China 2025 initiative to make 70% of what it defines as "core" materials domestically by 2025. Japan, meanwhile, recently set aside a $2 billion fund to help manufacturers bring their plants back from China.

Factories in developed countries have the major disadvantage of needing to employ expensive labor. For this reason, production has become increasingly automated over time. As of 2018, by far the highest industrial robot deployment densities were found in Singapore, South Korea, Germany, and Japan. In the United States (only #8 on the list), almost 40% of factory workers have college degrees and spend their time setting up the machines that do the actual manufacturing. If developed countries want to bring more of their manufacturing back within their own borders, they will have to make significant investments in expanding and improving automation. Increased automation would have a two-fold benefit in a post-pandemic world: it allows firms to manufacture at lower costs and makes it easier for them to create a workable factory environment even if the employees must wear protective gear and maintain "social distance." There are estimates that businesses in the U.S. spent about $12 billion on robotics and automated processes in 2019 and that this could grow to $34 billion by 2023. Much of this expenditure is driven by the explosion of applications for artificial intelligence ("AI"), and investment in AI is expected to quadruple over the next four years.

It isn't just goods that flow across borders, but also capital, and in a globalized world, businesses have a broader array of countries where they can allocate their capital. Like global trade, foreign direct investment peaked in 2007 and has fallen 60% since then. Companies have had less reason to build new plants overseas during the slow economic recovery and decline in trade. Some countries, particularly in Europe and the U.K., are considering strengthening laws that make it harder for their domestic businesses to be acquired by foreign companies. Such actions are part of a more widespread resurgence of the idea that some businesses are "national champions" that need to be protected due to their importance as technological leaders or major employers. We therefore expect foreign direct investment to continue to be depressed.

Governments are also considering rolling back some of the deregulation that allowed international investing. The U.S. Senate passed new legislation that would require companies listed on a domestic stock exchange to prove they are not controlled by a foreign government and are audited by a U.S.-approved accounting firm. These rules are targeted at Chinese companies that list on U.S. exchanges and will shut down the overseas Initial Public Offerings of Chinese stocks, through which $140 billion was raised over the past five years.

Investment Implications

Shifting away from a purely economics driven globalization will raise costs to businesses and consumers. On the margin, companies will carry more inventory, have more capacity, and operate in higher cost countries. Their choice is either to absorb these costs, which will hurt investors, or raise prices, which will impact customers and the demand for their products. While it is not possible to quantify such costs so early in the deglobalization process, we can assume they will be high for those industries that shifted the greatest amount of their production offshore over the past twenty years, such as aircraft and aerospace, machinery, auto and auto parts, electrical equipment, and apparel.

In response to higher costs, we will likely see a surge of investment not only in automation but also in AI. While the obvious beneficiaries are companies that produce industrial robots and process automation systems, there are large software companies that offer machine learning tools to end users. There are other software firms that automate the design process. And there are also semiconductor companies that specialize in chips for AI applications.

The more a company automates, the more it needs to beef up its cybersecurity. Considering the geopolitical aspect that underlies the deglobalization process and the fact that hackers recognize no borders, we are more convinced than ever of the need for companies that specialize in identity and access management, network protection, and other elements of cybersecurity.

To the extent that the increase in automation results in new or expanded factories, the expertise of large engineering and construction firms will be needed to design and build the new infrastructure.

Pharmaceutical companies are the immediate focus of the U.S. government's efforts to bring essential medical production onshore. While these efforts started with a relatively modest investment fund, more typical incentives include tax-breaks and legislation granting some level of exclusivity. Investors should keep a close eye on these developments. We favor those U.S. drug companies that already make crucial vaccines and antibiotics.

Even though the need for excess inventories or more redundant supply chains makes any company less profitable, we believe the larger companies will be able to benefit overall. Scale, after all, has its advantages. We are therefore comfortable sticking with our large-cap investment focus.

The United States is a beneficiary of massive inflows from overseas investors, particularly into U.S. Treasury debt. Foreign investors own more than 25% of Treasuries, with Japanese and Chinese investors holding the largest amounts. The demand from these investors helps reduce interest rates and is particularly important while the government is financing the multi-trillion-dollar stimulus to get us through the pandemic. Political or economic disputes that cause foreign investors to withdraw from our markets could put upward pressure on interest rates, so we would be careful about owning longer-maturity bonds.

A deglobalizing economy is expected to have higher costs and lower profits, but more reliability. However, it will also mean that governments will become more involved in private-sector decisions. To the extent that this participation achieves greater security for citizens, it can be viewed as an overall benefit. However, anytime politics are inserted into free enterprise, there will be additional risk across the investment spectrum. Lower profits and increased political risk may lead to somewhat lower overall equity market returns, making security selection even more important.

Market Outlook

After the sharpest bear market in history, stocks in aggregate have recovered much of their losses. Economic data appear to have bottomed as most states are beginning to re-open their economies after a near-total shutdown of all unessential activity. The Federal Reserve has unleashed massively supportive monetary policy, keeping interest rates on the floor.

We agree that the worst of the pandemic is over for the economy and the financial markets. In addition to the Fed's increase in the money supply and unprecedented buying of fixed income securities, fiscal support and stimulus has put a lot of money in people's pockets, and more could be on the way. At the same time, however, progress against the novel coronavirus will not be made in a straight line. The economies of the world cannot truly come back to normal until there is a vaccine or other treatment that renders the virus impotent. Our concern at this point is that the stock market may have gotten ahead of itself in the rush to discount a newly resurgent economic environment, so we remain cautious about adding to equities.

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