The Private Bank

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Reborn in the USA

Changing times may bring new opportunities back home

SEPTEMBER 2020

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Key takeaways

- China's inclusion in the World Trade Organization (WTO) in 2001, coupled with the slow reversal of decades of protectionism globally, allowed for significant Chinese domestic investment in low-cost manufacturing—placing them at the center of the global supply chain.
- Economic and political shifts that have been taking place over the past decade have reduced China's relative advantage, creating potential opportunities to reshore manufacturing back to the United States.
- This transition quietly began during the post-global financial crisis era, and is expected to accelerate going forward as a result of COVID-19. If this trend persists, investment opportunities could arise.
- We expect opportunities to exist over multiple time horizons, starting with public equities, moving into private capital, and concluding with structural tailwinds that would benefit specific industries and geographic areas.

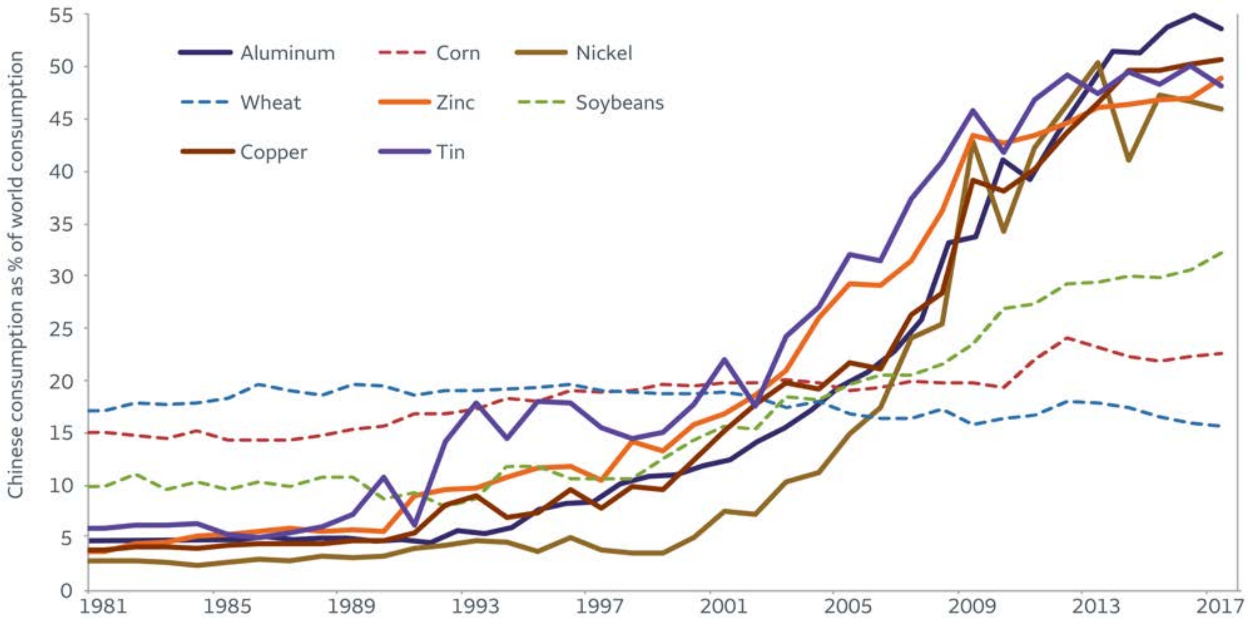
A historical perspective: Reflecting on China's offshoring influence

China's ascent and the global pricing decline

To better understand the drivers of the recent U.S. reshoring movement, it helps to first recognize the decades-long influence that China wielded over global offshoring. For decades, developed nations including the U.S. were deliberate in their attempts to preserve their own domestic manufacturing by limiting the surging exports of lower cost goods from developing economies. The Multifiber Arrangement (MFA) of 1974[1] was one example of such efforts. The MFA was an international agreement designed to limit textile exports from Japan and Hong Kong into the U.S. and the European nations. It was later expanded to other developing producer nations, including China. However, instead of limiting China, it encouraged them to pivot resources to pursue other product categories that were in demand globally. Such diversification presented prospects of sustainable economic growth, and history proves that China was one such country uniquely positioned to capitalize on the rising tide of global trade.

In 2005, the World Trade Organization (WTO) concluded its 10-year phase-out of the MFA, creating an environment for a huge surge in Chinese exports. U.S. imports during the first nine months of 2005 grew by 15%. Imports from many textile exporters fell, including Mexico, Guatemala, sub-Saharan Africa, Hong Kong, and Taiwan. On the other hand, imports from China rose 1,094%.[2] China quickly became recognized as a key player on the global stage, convincingly validating its 2001 ascent into the WTO.

Chart A: China's consumption of commodities may slow



Sources: Bloomberg, U.S. Department of Agriculture, World Bureau of Metal Statistics, and Wells Fargo Investment Institute, as of December 31, 2019. Consumption data for Aluminum and Nickel as of December 31, 2018. The commodities markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in commodities is not suitable for all investors.

As its global share of trade increased, China saw opportunities to invest more aggressively into its domestic infrastructure—along with creating more manufacturing capacity, housing, and even entire cities—ushering in a dawn of urbanization. It quickly established itself as a key trade partner, perhaps one of necessity rather than choice. Neighboring trade partners were quick to align with China, resulting in an increasingly complex global supply chain that very much centered on China. This aggressive growth strengthened China's influence over commodity demand and prices.

Through its rising dominance and unapologetic investments, China expanded its skill set from low-end manufacturing to high-end manufacturing and services, and from capital investment toward consumption. There is a shared view that it was during this time that China's modern-day Renaissance began in earnest. In the two decades since it became a member of the WTO, China transformed from being a dependent manufacturing and export-led economy to a far more independent services and consumption-driven economy.

With its expanding export categories and an emerging source of investment capital, China's global footprint continued to expand. Its dominant competitive position was secured by its low-cost and scalable production, driving down global sourcing costs. Along with the rise of its neighboring low-cost producer nations, this helped contribute to the pervasive and decade-long trend of disinflation across the developed world.

Current economic and political environment

Over time the benefits to developed nations of leveraging China's low labor costs and manufacturing process began maturing. At the same time there was an increase in conflict due to disparate aspirations for China and the United States. Hopes that China's inclusion in the WTO would "Westernize" the country slowly faded as China used their economic might to strengthen their place in the international pecking order while failing to conform to western economic and democratic norms, creating further distance between China and the U.S. A shift away from China is not a new phenomenon but rather has been slowly building over the past decade as a result of growing discomfort. Issues of concern include China's political influence, human rights violations, military aspirations, intellectual property theft, and market access.

Economic environment

In the early years after its inclusion in the WTO, China was able to leverage its relatively low cost of labor, massive investment in manufacturing, and lax regulations to drive its extraordinary economic growth. With this economic success has come an ever-expanding middle class with increased demand for higher wages and services. China's labor costs have approximately doubled since 2010, putting them well ahead of most other Southeast Asian countries such as Vietnam, Indonesia, and the Philippines. Current labor costs in China are even slightly higher than Mexico— the low-cost producer on the North American continent.[3] Additional changes that have narrowed the cost advantage for China include:

- The U.S. now ranks second in terms of the cost-effectiveness of its electricity production and is only behind Norway.
- The fracking revolution of the previous decade has resulted in natural gas prices in China being anywhere from 4-5x prices in the U.S.
- Changes to the U.S. tax code through the Tax Cuts and Jobs Act of 2017 narrowed the difference in corporate tax rates between the two countries to less than 1%.

Additionally, the recent economic shock as a result of the coronavirus pandemic could create secular tailwinds to reshoring, driven by its potential to alter consumer behavior. The historical pattern after such a shock is a shift away from consumption and toward savings, as consumers become more sensitive to the uncertainty of future income. The best known example of this is the Great Depression; that experience created a generation whose thrift lasted a lifetime.

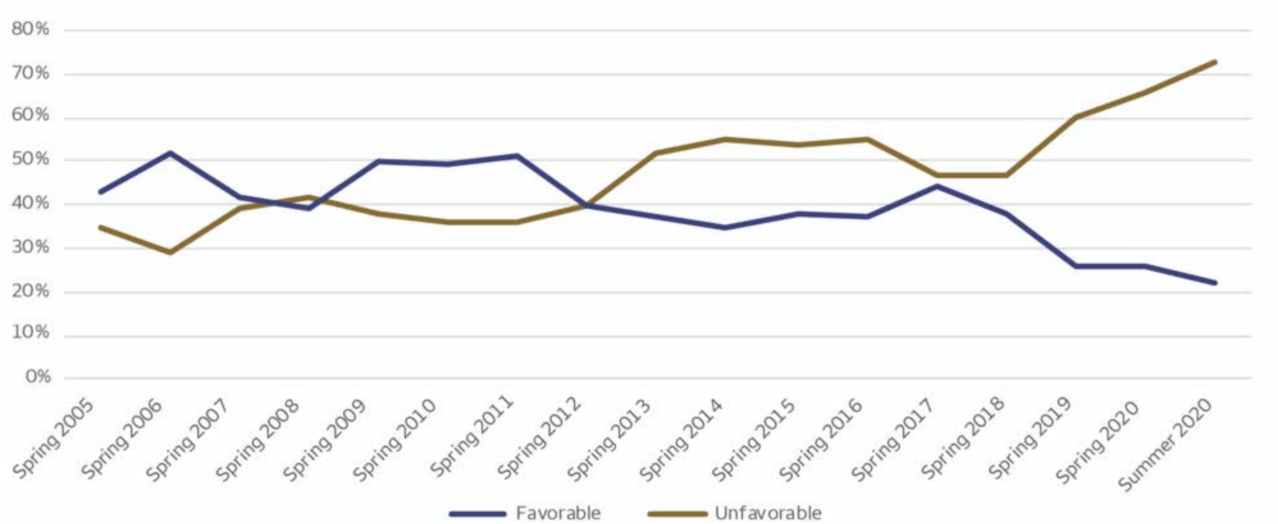
Even if partially driven by the stay-at-home orders and social distancing measures implemented across the country, we already experienced this shift to saving. Personal savings rates in April soared to 34%.[4] This is expected to come down as people return to work and the uncertainty surrounding future wages dissipates; but savings could remain above prior trend levels on a secular basis. Additional lift in the savings rate would shift the components of GDP away from consumption, creating further reshoring opportunities through increased investment.

Political environment

Recent geopolitical events have created incentives for the U.S. government to focus on reshoring within the healthcare and technology sectors. As confirmed coronavirus cases accelerated during March, one key topic of conversation was the vast amount of personal protective equipment (PPE) and pharmaceuticals required to medically combat the virus and the stark realization that the U.S. was almost entirely dependent upon other countries for these items. FEMA Administrator Pete Gaynor called the U.S. reliance on overseas suppliers of PPE "a national security issue" in a presentation to the House Committee on Homeland Security. The scare produced strong incentives for politicians to ensure we don't face a similar dilemma in the future. Current consensus seems to be that public health risks far outweigh cost savings—this should push parts of the healthcare supply chain back within our borders.

The issue of where technological components are produced and consumed has also become increasingly important for politicians. The technology-related tensions between the U.S. and China escalated in 2019 following an executive order that banned U.S. companies from using technology from any company deemed a national security threat, which many took as directed at Chinese communications giant Huawei. The latest escalation came in May when the U.S. Commerce Department granted the government the authority to require licenses for sales of semiconductors made elsewhere with U.S. technology. Relatedly, Taiwan Semiconductor recently announced plans to build a $12 billion advanced chip factory in Arizona, placing them further outside of Huawei's (and the Chinese government's) grasp.

Chart B: Unfavorable views of China reach new highs in U.S.



Source: Pew Research Group.

In addition to pressure for both public health and national security reasons, further political considerations could increase reshoring going forward:

- The ongoing trade war between the U.S. and China will increase uncertainty and costs.
- U.S. politicians on both the left and right are increasingly hostile to globalization.[5]

- According to Pew Research Group, the American public's view of China peaked in 2005 during a global economic boom and coincided with the peak in marginal benefits of having China at the center of global trade. Since that time, the unfavorable rating has moved from 29% to 73%, creating an incentive for additional action regardless of which party occupies the White House.

Future opportunities

If current trends persist and we see a continuation or even an acceleration of reshoring manufacturing to the U.S., our expectation would be for this to take place over a multi-year and likely multi-decade time horizon. In fact, the Mid-Year Outlook published by the Wells Fargo Investment Institute touches on many of the themes outlined here, such as an increased savings rate, a re-examination of supply chains, and shifts in the Chinese economy. How and where this reshoring would occur is fluid, with more information to come as opportunities become clearer. For now, a few broad points can be made:

- **Reshoring will cut both ways.** We mentioned earlier several of the benefits of bringing production of critical goods back within U.S. borders, but that will come at a cost. First, we have come to rely on the integration of the global supply chain giving us just-in-time access to goods and services. Disentangling that network will mean companies and households alike will have to wait longer for things. Relocating production from low cost areas to high(er) cost areas makes items more expensive. Some of that will be offset by lower transportation costs, but the rest will get added to the cost of producing a good. The end result will likely be very mixed.
- **Public markets will be quicker to integrate reshoring developments.** According to the non-profit Reshoring Institute approximately 750,000 manufacturing jobs have been brought back to the U.S. from overseas from 2010 through 2018. These announcements are typically met with a great deal of fanfare, but Wall Street analysts are quick to crunch the numbers to gauge whether these moves are in fact smart, additive, and even material to the bottom line. Broadly speaking, robotics, automation, software, and industrial companies could all see a spike in interest as beneficiaries of an increase of "Made in America." But railroads, trucking, and utilities could also benefit. As with everything in investing, the devil will be in the details. It is easy to envision three similar firms in the same industry taking three distinct approaches to reshoring and seeing three distinct paths forward for stock prices.
- **Private capital market impact will take longer to develop.** Mid-term opportunities could arise in the private markets. Private equity and venture capital funds with 2019-2021 vintage years could be looked back upon as "lucky" to have dry powder to deploy into a shifting economic regime as opposed to those from a few years earlier that may have purchased assets more focused on leveraging the benefits of cheap labor and production overseas. Private natural resources strategies will likely be an important part of how the U.S. responds to the likely stress that increased local manufacturing would put on the nation's energy, waste treatment, and transportation grid.
- **Long-term structural changes will occur.** If reshoring gains momentum, it WILL result in some tectonic economic shifts. Currency regimes could change—a decrease in dollar-based trade could create a dollar headwind. A new inflation environment may percolate due to production shifting from low-wage areas to higher-wage areas. The spreading of the production chain to facilitate just-in-time inventory has theoretically smoothed earnings streams for certain industries. Reversing these factors could lead to structurally higher stock market volatility in the future. A new cold war between the U.S. and China could realign the geopolitical landscape. Lastly, reshoring of manufacturing could shift the center of economic growth within the country. Coastal cities have been the dominant source for growth over the last few decades. Will former rust belt staples return to glory or will the next generation of manufacturing be built on even newer ground?

[1] https://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm5_e.html

[2] The World Bids Farewell to the Multifiber Arrangement, Stephen MacDonald, US Dept. of Agriculture, 2/1/2006 Large Manufacturers, BCG Survey Finds

[3] https://www.cnbc.com/2017/02/27/chinese-wages-rise-made-in-china-isnt-so-cheap-anymore.html

[4] US Bureau of Economic Analysis, Personal Income and Outlays

[5] https://www.forbes.com/sites/kenrapoza/2014/08/19/manufacturers-love-u-s mexico/#:~:text=Mexico%20has%20been%20a%20low,a%2 cheaper%20place%20to%20produce.