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Stu's View

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Globalization versus localization – implications for investors

Those closest to me know that I am a huge fan of the popular 90s sit-com, Seinfeld. Similar to most Seinfeld fans, I often use "Seinfeld-isms" – whenever and wherever possible. As I thought about the topic of this article, I was reminded of the fifth season episode, "The Stall," made famous by the catch-phrase, "can't spare a square." To make a long and funny story short, one of the main characters, Elaine, realizes her bathroom stall is out of toilet paper and asks the lady in the next stall if she can borrow some from here. The woman refuses, claiming she "can't spare a square." Later on in the episode when Jerry finds out his girlfriend refused to spare a square for Elaine, he tries to defend his girlfriend's actions and tells Elaine that "you can't judge a person on a situation like that. I mean it's like asking for someone's canteen in the desert ... it's battle conditions."

The integration of national economies into a global economic system has been one of the most important developments of the last century. This process of integration, often called Globalization, has materialized in a remarkable growth in trade between countries (Chart 1). Shown in the chart is the "trade openness index." This index is defined as the sum of world exports and imports, divided by world GDP. It is certainly difficult to gauge anything material from the change of direction in Chart 1, yet when corroborated with geopolitical factions, a possible near-term direction (i.e. downward) towards localization may be interpreted. It would be irresponsible for us to insist upon a widespread change of direction in global trade based on the direction of chart 1, yet we consider the consequences of this trend for the longer-term in this article.

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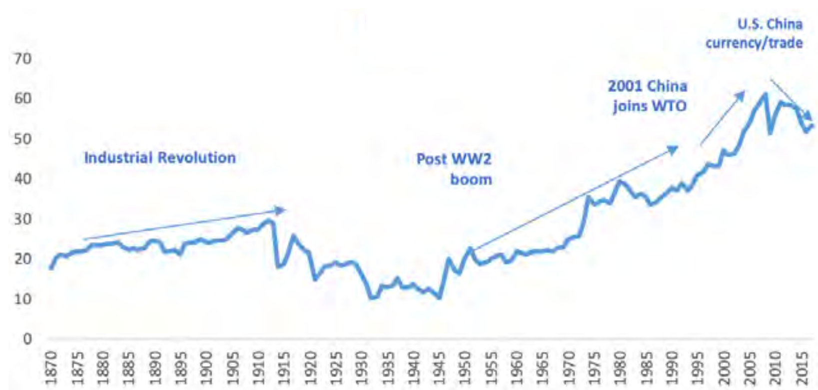
COVID-19 may accelerate a further shift away from globalization

As the coronavirus has spread around the world, countries have been instituting restrictions on the export of medical equipment and other essential items. In essence, refusing to "spare a square" out of national interests, defending said position on the world stage as theoretical battle conditions. Further discussion about restrictions related to national security interests (technology, health care and aerospace/defense), are ongoing and seem to have been accelerated changes as a result of the virus.

National lines continue to be drawn in the sand, so to speak. Trade disputes/trade wars, currency wars are not new risks to financial markets, yet COVID-19 seems to have accelerated nationalism in certain regions, even as physical borders begin to reopen. Putting politics aside, there is a growing view in both U.S. political parties that the U.S.-China economic relationship needs to be fundamentally reexamined. This has the potential to impact the outsourcing and globalization trend that has been in place for decades, and which we argue has been a boon for most investors and most consumers.

Modern era U.S./China relations began in earnest with the first visit to China by a sitting U.S. President when President Nixon visited in 1972. Nixon called it "the week that changed the world" and, almost 50 years later, his outlook seems to have been validated. U.S./China relations continued to develop over the next few decades with Chinese leaders and officials making similar visits to the U.S., principally with China's entry in to the World Trade Organization (WTO) in 2001, and further supported by China's cooperation with the U.S. post 9/11 to combat terrorism. In 2017, Chinese President Xi Jinping visited U.S. President Donald Trump's

Chart 1: Is globalization in retreat for the first time since 1945?



Source: Our World In Data (https://ourworldindata.org/). MARIKO KLASING, AND PETROS MILIONIS, Journal of International Economics, 2014, vol. 92, issue 1, 185-197. World trade as a share of GDP based on Klasing and Milionis' own estimates using non-PPP adjusted GDP estimates. Note that PPP stands for Purchasing Power Parity, which is a measurement of prices in different countries that uses the prices of specific goods to compare the absolute purchasing power of the countries' currencies. The typical narrative regarding the evolution of world trade prior to World War II refers to a secular rise starting around 1870 and a subsequent collapse beginning in 1914. This narrative, however, is based on measures of trade openness that do not fully take into account purchasing power differences across countries. Due to lack of alternative data, the measures employed in the existing literature are typically based on non-PPP-adjusted trade data denominated by PPP-adjusted GDP data. The present paper seeks to resolve this inconsistency by constructing new trade share estimates for 62 countries, representing 90% of world GDP, for the period from 1870 to 1949. Variable time span 1870 – 1949. Data published by Klasing, Mariko J. and Milionis, P. (2014). "Quantifying the Evolution of World Trade, 1870-1949," Journal of International Economics 92(1), pp. 185-197. Data publisher's source Historical import and export figures. Accessed May 25, 2020: https://www.sciencedirect.com/science/article/pii/S0022199613001074?via%3Dihub. For consistency, the 62 countries used in Klasing and Milionis are used to calculate the world trade to GDP ratio for the period 1950-2011. The list can be found in Appendix A2 of their paper.

resort in Mar-A-Lago, where Trump called the meetings "positive and fruitful."

Trade and currency wars

Prior to his Presidential win in November 2016, Trump was already voicing his concern of unfair trade practices from China, including subsidization of industrial production and requirements to transfer proprietary U.S. technologies, and he previewed moves to apply tariffs under sections 201 and 301 of the 1974 Trade Act. In March 2017, Trump, now President, called for tighter tariff enforcement in anti-subsidy and anti-dumping cases and a review of U.S. trade deficits. Despite the "fruitful" comments from their first meeting, in July 2017 the two sides failed to agree on new steps to reduce the U.S. trade deficit with China within 100 days. In August 2017, Trump ordered a "Section 301" probe into alleged Chinese intellectual property theft. This was the first action in a series of executive power actions, U.S. trade laws, tweets, WTO proceedings and threats over the next three years in what could only mildly be put as an unconventional approach to trade relations.

As 2018 rolled around, the U.S. and China trade war really started to pick up steam. Beginning with Trump imposing tariffs on all imported washing machines and solar panels – not just those from China. There were tariffs levied on steel and aluminum imports, and China imposed tariffs for over 100 U.S. products, including airplanes and soybeans, hitting at the Trump heartland supporters. Tariffs and taxes on imported products from the U.S. or from China continued to be raised, and trade talks were on-again, off-again for most of the year. In 2019, The U.S. banned Chinese telecoms giant Huawei Technologies from buying parts and components from U.S. companies. In the spring of 2019, there were signs of life in a new U.S./China trade deal with intense talks over a few days, yet with no real development, and arguably via "the art of the deal" posturing, Trump announced another 10% of tariffs on

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$300 billion worth of Chinese imports. Two weeks later in August 2019, the U.S. Treasury accused China of "currency manipulation," and equity markets plummeted.

Phase "one" trade deal signed in early 2020

Fast forward to January 2020. The U.S. and China signed an "momentous" trade deal, which leaves a record level of tariffs in place and forces China to buy $200 billion worth of specific products within two years. On February 14, 2020, the Economic and Trade Agreement between the United States of America and the People's Republic of China: Phase One went into effect.

Phase One lacked any progress to resolve other key issues in the long-standing trade dispute. Some unresolved issues are cybersecurity and China's tight controls over how companies handle data and cloud computing. China rejected demands that the text include promises to refrain from hacking American companies, insisting it was not a trade issue. The agreement also includes a pledge by both countries not to devalue their currencies to gain an advantage in export markets. There was no resolve, however, on the issue of China subsidizing and supporting crucial industries that compete with American companies, like solar energy and steel. American businesses blame those economic practices for allowing cheap Chinese goods to flood the United States. Potentially these issues will be addressed in some fashion in Phase "Two", after the November U.S. election.

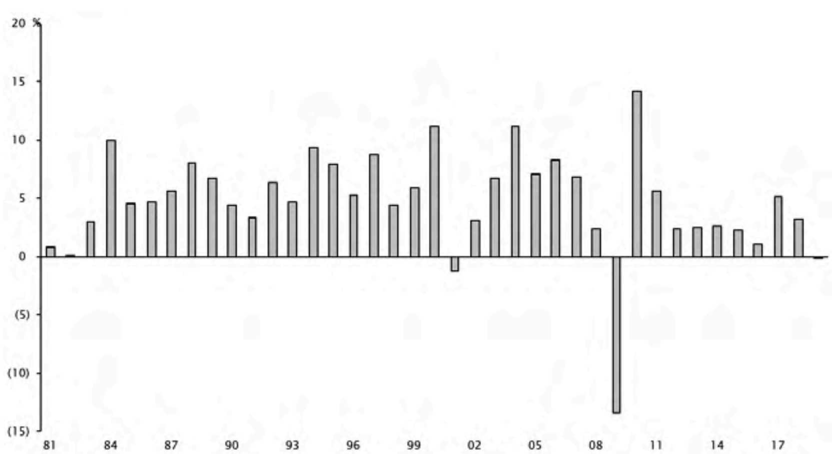
The most recent uptrend in globalization began when China joined WTO in 2001. We can see this as after 2001, U.S. imports as a percentage of U.S. GDP rose sharply, as more and more U.S. consumer goods were imported, particularly from China, which enjoyed an investment boom itself. U.S. and other consumers around the world benefited from relatively less expensive products coming from China (Chart 2).

The trend toward localization/ protectionism, and away from globalization really began prior to COVID-19's arrival, given trade wars (e.g. U.S./China, U.S./Europe, Japan/ Korea), and in some instances an anti-immigration stance by politicians. Trade in manufactured goods were slow to grow after the Great Financial Crisis of 2008, and in the last year did not grow at all (Chart 3).

Chart 2: Price indices for consumer goods and U.S. imports from China

Source: Empirical Research Partners, LLC, reprinted with permission (publishing date May 13/20). Source data: Bureau of Labor Statistics, Empirical Research Partners Analysis. All goods excluding food and energy commodities, Commodities less food and energy commodities in U.S. city average, all urban consumers, seasonally adjusted. Base period 1982-84 = 100.

Chart 3: World imports of manufactured goods, Y/Y changes in volume (1981-2019)



Source: Empirical Research Partners, LLC, reprinted with permission (publishing date May 13/20). Source data, World Trade Organization (WTO), Merchandise import volume indices - annual (Index - (prev. year =100), data 1981 through 2019.

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Investors have benefited from globalization

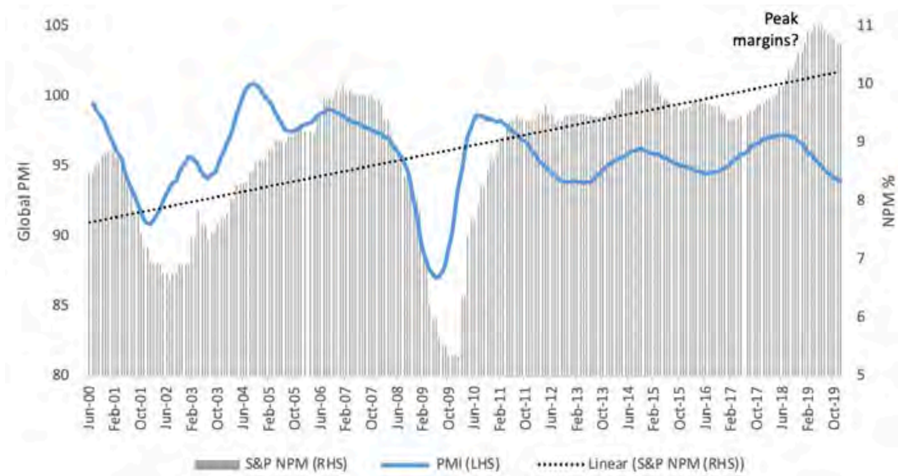
We have tried to maintain a politically neutral perspective in this note, leaving aside the humanitarian impact that globalization has had on people in less developed countries. There is little doubt that despite the benefits of globalization realized by domestic consumers and investors, there has been an environmental and social impact that is not being captured herein. We'll leave that discussion for a future edition of Stu's View, and how this may impact investor returns.

For investors of U.S. companies, we see in Chart 4 the benefits of globalization over the last few decades. Here we show net profit margins for the S&P 500 index overlaid against the JP Morgan Global Purchasing Managers Index (PMI) over the last 20 years, beginning in 2001 as China entered the WTO. We question the impact of potentially peak profit margins for U.S. companies should the prior benefits of globalization stagnate through political unrest between U.S. and China, or through natural selection as U.S. companies seem to diversify their supply chains away from China.

Measuring the potential impact of an end to globalization trends

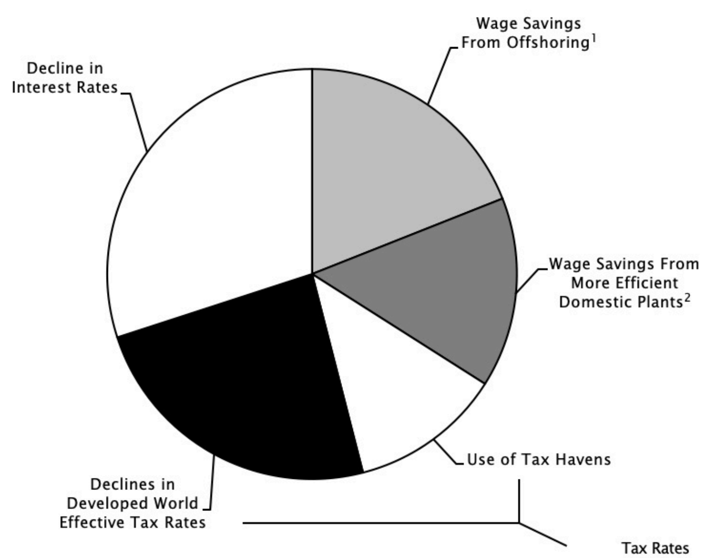
In Chart 5, we illustrate the impact of various drivers of U.S. manufactures' net profit margin over the last 20 years. The composition of these manufacturers consists almost equally weighted between ten different industry groups, including semiconductors, industrial capital goods manufacturers, technology software and health care equipment manufacturers. Surprisingly while offshoring of global supply chains has accounted for approximately one-fifth of the margin expansion over the last 20 years, there were other, equally

Chart 4: Global manufacturing benefiting domestic profit margins



Source: RBC Global Asset Management Inc. M-LAB for JPM Global Purchasing Manufacturing Index, 1 Month Difference (D1): The JPM global PMI is the global version of US PMI (Purchasing Manufacturing Index) which is a composite index reflecting business conditions and the health of the manufacturing sector in the specified month. The Global Report on Manufacturing is compiled by Markit based on the results of surveys covering over 10,000 purchasing executives in 32 countries. Together these countries account for an estimated 89% of global manufacturing output. To extend the history for this indicator, the values prior to January 1998 is back-filled with US ISM PMI. Data are presented in the form of diffusion indices, where an index reading above 50.0 indicates an increase in the variable since the previous month and below 50.0 a decrease. S&P 500 Net Profit Margin (%), sourced from FactSet, represents trailing 12-month net profit margin (NPM% formula = net income/total revenue) from June 2000 to December 2019.

Chart 5: S&P 500 manufacturers net profit margin contribution factors (2019 versus 2000)



Source: Empirical Research Partners, LLC, reprinted with permission (publishing date May 13/20). Sources include U.S. Bureau of Labor Statistics, U.S. Census Bureau, corporate reports and Empirical Research Partners analysis. Wage savings from Offshoring assumes that the lost U.S. jobs were replaced by one-for-one by jobs in China at lower rates of compensation. Wage savings from "More Efficient Domestic Plants" assumes the decline in the labour intensity of these plants matches that for the entire U.S. manufacturing system. Manufacturers include listed companies in the S&P 500 index under the following sector groupings: Technology Software, Semiconductors, Technology Hardware, Pharma & Biotechnology, Health Care Equipment, Household and Personal Products, Food/Beverage/Tobacco, Consumer Durables, Auto and Auto Parts, and Industrial Capital Goods.

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important drivers of margin expansion which have taken on less political grand-standing.
An equal share of net profit margin growth occurred through the benefits of automation and networking, which led to a long-running decline in the labor cost burden at the plant level. That trend was reversed however in the early 2010s as the bulk of the offshoring had occurred by then. So, while lower labour costs have played a role in the margin expansion story in the S&P 500, declines in interest rates and taxes had a larger role to play. To hypothesize about a potential risk to S&P 500 margins as a result of a shift away from globalization, investors should also be considering the extent to which these other factors or drivers of margins may be potential offsets. Interest rates remaining low, or potentially moving lower, taxes staying low or potentially moving lower are both scenarios that likely come with smaller probabilities today than they would have 10 or 20 years ago.

Recent trends in supply chain management as a result of COVID-19

In April 2020, RBC Global Asset Management published a report titled "Supply chain risk management in the time of COVID-19" where it outlined that in recent years, mounting competitive pressure and tighter margins have impelled companies to pursue a range of strategies to reduce costs and improve the efficiency of their supply chains. Companies are continually reviewing and revising their supply chain management practices to optimize performance. While the attention and focus is (rightfully) on managing the immediate needs of the current crisis, the COVID-19 pandemic has exposed vulnerabilities in global supply chains.

RBC Global Asset Management went on to mention that once the crisis has passed, this experience may lead companies to increase their focus on:

- Digital solutions – working/ transacting from a distance using technology
- Supplier mapping and diversification – likely continues for some time
- Workforce management – health/ safety, labour relations

Speeding up the shift away from globalization of supply chains to more localization are four trends: relocation, diversification, modularization and automation. Additionally, some companies are shifting their supply chain from "just in time" to "just in case", creating contingency plans for situations such as quarantine disruption like we are living through now. Furthermore, companies are moving from cost focus to resilience. Recognizing the need for diversification of supply chain, not necessarily the lowest cost basin. As a result of COVID-19, CEOs and boards are needing to secure the supply chain from disruption risks never really considered before. Efficiency is being measured against just in time resiliency, for critical ingredients in light of tariffs and pandemic disruption.

In fact, some large global pharma companies have already announced plans to move manufacturing back to their home country and away from China. Sanofi S.A., a French multinational pharmaceutical company, announced plans in February 2020 to move more production back to France. Sanofi management indicated that "Our calculation is strategic before being economic" and that "admittedly, our manufacturing costs here will be higher than in Asia, between 10 and 15 per cent higher, but that's the price we have to pay to maintain a pharmaceutical industry in Europe."

Also, Taiwan Semiconductor Manufacturing Co., which is the world's largest contract manufacturer of silicon chips, said in May 2020 that it would spend US$12 billion to build a chip factory in Arizona, as U.S. concerns grow about dependence on Asia for the critical technology. Bringing supply chains closer to local markets requires companies to simplify designs and modularize components for easier assembly while automation further lessens the cost pressures caused by shifts to higher-wage countries.

The potential impact on portfolio construction

The end of globalization would have an impact on a number of industries and companies. Investors need to understand how management teams can pivot business models, supply chains and strategic direction if the trend to globalization is in fact coming to an end.

From a sector perspective, there are certain industries that may be more vulnerable to these shifts away from globalization. Manufacturing – autos, electronics, durables and machinery are probably susceptible to long-term disruption, while domestically focused sectors such as real estate, telecommunication and utilities may be less susceptible to these changes. Those companies that have exposure to industrial automation, robotics engineering, software engineering, aerospace and defence contracting should fare well as onshoring of manufacturing continues. For some companies, their Intellectual Property (IP) may even be considered strategic from a political level, creating additional barriers to entry for other competitors. All of these considerations will have implications for valuations in certain indices and regions given the underlying constituents of those

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composites. It will be more important than ever to better understand the underlying exposures within certain indices over others, suggesting that not all passive investment allocations should be treated equally.

Potential disruption from a shift away from globalization should be considered in sectors like the autos and in health care where most popular pharmaceutical formulas are manufactured in China. For example, 95% of ibuprofen, 90% of vitamin C, 91% of hydrocortisone, 70% of acetaminophen, 80% of antibiotics and 45% of penicillin come from China. As manufacturing shifts out of China, Vietnam is one of the biggest beneficiaries of relocation given cheaper labour and relatively stronger supply chain/infrastructure. Taiwan offers more tech sector talent, and India's population suits larger-volume, labour-intensive components.

You could possibly aggregate these potential sector winners and losers and overlay a regional perspective as well. This would assume that countries would not offer some financial incentive for companies to maintain supply chains as they are today. Nevertheless, regionally, some countries in Southeast Asia may be more susceptible to a trend away from globalization given a higher percentage of exports in manufacturing sectors such as autos, machinery, apparel and electronics. As technology and automation trends continue, it could further disadvantage certain regions where labour cost advantages were once sought after ahead of supply chain flexibility. Moreover, today labour is a smaller portion of manufacturing costs, and transportation cost savings from moving the product closer to end-demand may prove to disadvantage some regions over others.

What about a potential rise in inflation as a result of a trend away from globalization? Theoretically there should be some upward pressure on prices, and perhaps wages as manufacturing is brought onshore from cheaper offshore options. However, referring back to Chart 1, even as world trade has declined, and especially in the U.S. where imports (excluding oil & gas) peaked in 2014 close to 15% of nominal U.S. GDP compared to 13.3% in December 2019, U.S. annual inflation has been relatively muted (Chart 2). Yet it is unclear how this may trend in the coming few years, or perhaps longer. When also considering the support for the labour share of national incomes as a growing priority for governments, the growth of the money supply in the major economies getting stronger, and at some point the deflationary shock of COVID-19 has to end, consideration should be made for a future inflationary environment within portfolios. We discussed some of potential inflationary hedges in the May 11, 2020, Stu's View article "Gold'n'Stocks and the Six Bears."

What we're watching

Since our last note, it certainly feels like things are getting "less bad" both on the health front and economically. I would call this last two weeks a net positive, as the trend is moving in the right direction. It is remarkable that the markets have almost retraced all the way back to pre-February sell-off levels on the S&P 500 and MSCI World Index. Yet it still feels like we are in the neutral zone at the moment, with an even fight between the bulls and the bears. As most economies continue to reopen in some fashion or another, the debate is what will the real impact be over the next two to three months as both monetary and fiscal policy have done a good job of cutting out the "left tail risk" (downside) scenario. Certainly these are lessons learned from the Great Depression and the Great Financial Crisis of 2008. The response so far is the fastest and largest in peacetime, compared with the 1930s, when the absence of a social safety net plus a glacial fiscal response meant a decade of depression.

The backdrop does not at this time dictate making substantial bets either way on the short-term outcome of COVID-19 on financial markets. We would continue to recommend proper diversification of portfolios across multiple layers (i.e. by asset class, region and investment strategy). Time in the market, versus timing the market. Simplicity over complexity. And systematic rebalancing back to appropriate strategic asset allocation weights are all sound investment principles to go by in any market environment.

Be well,
Stu

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S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.

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