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US-CHINA RELATIONS – SUPPLY CHAIN IMPLICATIONS

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In this article, Tom Miedema, Investment Manager, discusses how the fractious relationship between the two superpowers is not the only factor impacting supply chains. Economic changes in China, ESG concerns, new technologies and the Covid-19 pandemic have prompted a rethink amongst some companies. Reconfiguration of trade flows and supply chains is occurring, but China is still a vital cog in the global trade machine – from a supply and demand perspective.

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"To get rich is glorious". This alleged quote from Deng Xiaoping, former premier and architect of China's economic reform, is symbolic of the cathartic shift in policymaking that saw the country transition from failing Maoist state to global economic superpower. In unleashing the forces of capitalism in the form of 'socialism with Chinese characteristics', Deng sought to foster growth and ameliorate poverty through attracting foreign investment and becoming an export engine while maintaining the power of the Communist Party. Viewed in the context of Ricardian economics, China had many comparative advantages – natural resources aplenty, but also a huge and cheap workforce.

The success of the export-driven model is evidenced by the fact that over the forty years of reform, China has, on average, doubled its GDP every eight years[1]. Its trade surplus with the US ballooned from US$83 billion in 2001 to a US$418 billion peak in 2018[2], propelled by China's accession to the WTO in 2001 and the forces of globalisation. China became a huge source of affordable goods across the world. But a key component of the reform process over the last two decades has been the fostering of domestic economic development, with the country becoming a major driver of world growth, sucking in imports ranging from natural resources to cars to financial services.

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Pre-Trump US administrations had shown relative tolerance of the accumulating deficit with China, with so many US MNC's sourcing from and selling to the country. Granted, the US had forced the hand of Japan in tackling its trade surplus through the Plaza Accord of 1985, but the election of President Trump in 2016 heralded a sea-change in the manner in which America conducts itself with longstanding trading partners.

The US relationship with China has a distinct narrative however, as the US is seeking to address a variety of issues. The first one is the still-gargantuan trade deficit with China. The tit-for-tat trade war saw the US introduce tariffs across a range of goods to the value US$360 billion by the end of the last salvo in September 2019, while China introduced tariffs on more than US$110 billion on US goods. The efficacy of this has been questionable. While the US trade deficit with China shrank to US$345 billion in 2019[3], it did so at the cost to a number of US companies which were affected by tariffs, and also saw a shifting of trade flows to other countries such as Vietnam as US corporations re-adjusted their supply chains. There was consequently a minimal decline in the overall trade balance in 2019, and indeed 2020 saw the US monthly trade deficit reach a record high in August, albeit distorted by the Covid-19 pandemic. The irony of the source of the pandemic being the world's largest exporter of personal protective equipment is not lost. The 'Phase 1' agreement of January 2020 attempted to draw a line in the sand in the trade dispute, with the US reducing tariff rates, and China committing to buy an extra US$200 billion of US goods over the next two years. Despite the seeming rancour in current relations, and the fact that there have been complaints that China is not living up to its obligations, there's been little sign of either side reneging on the deal.

Secondly, it needs no reminding that two superpowers are engaged in a geopolitical and commercial rivalry. The political angle has seen the US become more entwined in Taiwan and its Cross-Straits relations with China, as well as getting embroiled in the dispute over China's re-interpretation of Hong Kong's Basic Law rights. From a commercial and security aspect, President Trump's administration is fearful of intellectual property (IP) theft with regard to the exporting or acquisition of technological and industrial know-how. However, the weaponry being deployed to tackle this has been one of diktat rather than tariff based. The US likely wants to slow the 'Made in China 2025' initiative. The aim of this national project is to hoist China up the value-added ladder, to be more self-reliant, and become a competitor in areas of industry currently occupied by Western companies. China wants to be in the vanguard of the Fourth Industrial Revolution, setting standards in fields such as artificial intelligence and facial recognition.

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Reflecting this growing tension, over the past three years we've seen an escalation in the US strategy of effectively barring companies that pose a threat to US interests through the establishment of an 'entity list'. This growing list of businesses includes telecommunication companies ZTE and Huawei but moves by the White House look set to put Chinese semiconductor company SMIC, and oil and gas company CNOOC on the quasi-blacklist, (under the guise of unacceptable links with the military) with the administration proposing to commence a US investor ban on blacklisted companies in November 2021.

The implications of all this are changing trade patterns, but the US-China relationship cannot be examined in isolation. There are factors at play that have been altering the dynamics of the global supply chain beyond the

influence of increasing Sino-US rivalry. As China's economy has developed, it has moved up the value-added chain. Nominal wages have doubled between 2011 and 2018[4]. The diminution of former comparative advantages it had in areas such as textile manufacture has aided the development of the industry in countries such as Vietnam and Bangladesh. It is also the case that as developed-market producers and consumers alike have become more attuned to ESG, China has been under increasing scrutiny. Political motives have arguably been merged with such concerns, with the US banning some goods allegedly produced by forced labour in the Xinjiang region, where China stands accused of suppression of the Muslim Uighurs. Increasingly, China's customers and indeed its investors will be expecting China to clean up its act on all ESG fronts, though China is not unique amongst developing countries in facing ESG challenges.

Furthermore, the adoption of digitisation has enabled companies to become more efficient and get closer to their markets. Labour cost arbitrage is becoming less significant in production location decisions. Speed-to-market in areas such as clothing and sportswear is becoming a differentiator in business performance.

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However, the virus-ridden elephant in the room with regards to supply chains, is the Covid-19 pandemic. The crisis has highlighted the fragility of global supply chains for many companies. At Walter Scott, given our 'bottom-up' process, analysing changes in operational dynamics is done on a case-by-case basis. Our regular discussions with a variety of management teams have illustrated how companies are re-evaluating their supply chains.

The result seems likely to be a degree of reversal of the *über*-efficient, 'just-in-time' supply chains that are current common business practice. Companies may sacrifice some 'economics' for the assurance of supply. Some manufacturing will likely relocate as a result, either because products are too important in a process to have the supply interrupted, or because these products are highly strategic and the world has woken up to the risk inherent in those supply chains.

As a foundation for economic progress, the semiconductor industry falls strongly into the strategically important bracket. Its supply chain is highly concentrated in Asia, but there is clear pressure on the industry to diversify its manufacturing footprint, and this is felt acutely in the US. Although America leads in chip design and sales, only 12% of advanced chips are manufactured there. Furthermore, Intel's revelation in July 2020 that it was 12 months behind schedule on its next generation of chips highlighted the supply vulnerability. Indeed, the Trump administration's greater interest in Taiwan goes beyond support for a fellow democracy.

Although Taiwan has always been cast by China as an errant child of the Motherland, Taiwanese companies have nonetheless had significant presence on the Mainland. Recent political developments have encouraged a rethink by many Taiwanese corporations with regard to future investment plans. Taiwan Semiconductor (TSMC) is straddling the Sino-US political divide. The company has a foundry in China servicing local customers, of whom Huawei was the biggest. While there are rumours of TSMC applying for a licence to provide low-end chips to Huawei, the situation remains unclear, though in any case, the company has customers ready to take up any Huawei slack given the strong global demand for semiconductors. But TSMC is also positioning itself to address US sensitivities with regards to Taiwan aiding Chinese technology efforts, as well as enhancing its US growth prospects. The company is spending US$12 billion on its first US foundry in Arizona.

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In recent years, many leading global companies have seized on the opportunities afforded by the huge expansion of the Chinese market, yet positioned their manufacturing assets to acknowledge the changing commercial dynamics and the shifts in the political environment. NIKE, for one, has diversified its production base. China accounted for 41% of global production of footwear and apparel 10 years ago, compared to 25% today. For the US market, less than 25% of footwear and apparel sold comes from China and that number will shrink, as the company aims to keep Chinese production for the Chinese market[5].

Some companies such as Taiwanese contract manufacturing giant Foxconn, a key supplier to many of the world's leading technology brands has spoken[6] of the likelihood of there being a greater fragmentation of supply lines – one for China, one for the rest of the world. Cognisant of political sensitivities and the fact it employs hundreds of thousands people in China, the company has been wary of overstating such shifts. For many businesses,

untangling long-established supply chains is a difficult and complex task however, and indeed while we have seen a diminution of Chinese comparative advantages in some areas, its journey up the value-added ladder has sustained its competitive advantage in many areas of manufacturing. The country doesn't have a massive trade surplus for nothing. Given the allure of burgeoning Chinese demand, many multinational companies that sell into that market may well expand their operations in the country.

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Walter Scott has a long-term, often multi-decade investment horizon. Political ructions, crises, cycles, and innovation bring opportunities and threats to a company's operating environment over the course of a typical holding period. Our focus is on globally diversified market-leading businesses with the ability and financial strength to adapt to changing circumstances, leveraging on opportunities afforded by their technological capability or the strength of their brand. The ability to maintain diverse or secure supply chains is a key element in our consideration of a stock, and as the world undertakes a degree of supply chain reconfiguration, that attribute will be of particular importance.

But for all the discussion of a parting of the ways between China and the US, there are many aspects of their tetchy relationship that continue to link the two superpowers. Both are huge markets. The fortunes of many US companies have been driven by China over the years. The US currently enjoys a US$36 billion services surplus with China, with US financial companies continuing to knock on China's door. The Chinese economy has been staging a robust post-pandemic recovery amidst an ocean of global gloom, helping to enliven the prospects of its regional neighbours. Many US corporations will not buy the idea of economic decoupling in what remains a buoyant market. Just how far relations deteriorate will be tempered by the economic advantage that trade between the two still brings. With President Trump ramping up measures against Chinese companies in his last few months in office, there is hope that President-elect Biden will adopt a more gentle approach, although that remains to be seen.

Globalisation may be changing, but it is not dead. The benefits of trade based on comparative advantage remain intact for both producers and customers. In many industries, the developing world has cultivated highly efficient and specialised clusters in manufacturing and service ecosystems, whether it is smartphone manufacturing in China, or footwear production in Vietnam. It is exceptionally difficult and inefficient to replicate this in the developed world. China remains a vital cog in world manufacturing and is a key driver of demand for products of many leading global brands, and this will continue to shape world trade for years to come.

[1] China's Economic Rise: History, Trends, Challenges, and Implications for the United States. Congressional Research Service, June 2019.
[2+3] US Census Bureau.
[4] International Labour Organisation data.
[5] NIKE data as at August 2019.
[6] Bloomberg article, August 12th 2020.

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STOCK EXAMPLES

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