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COVER

How Investors Should Navigate Globalization's Decline

By Avi Salzman and Nicholas Jasinski March 15, 2019 7:27 p.m. ET

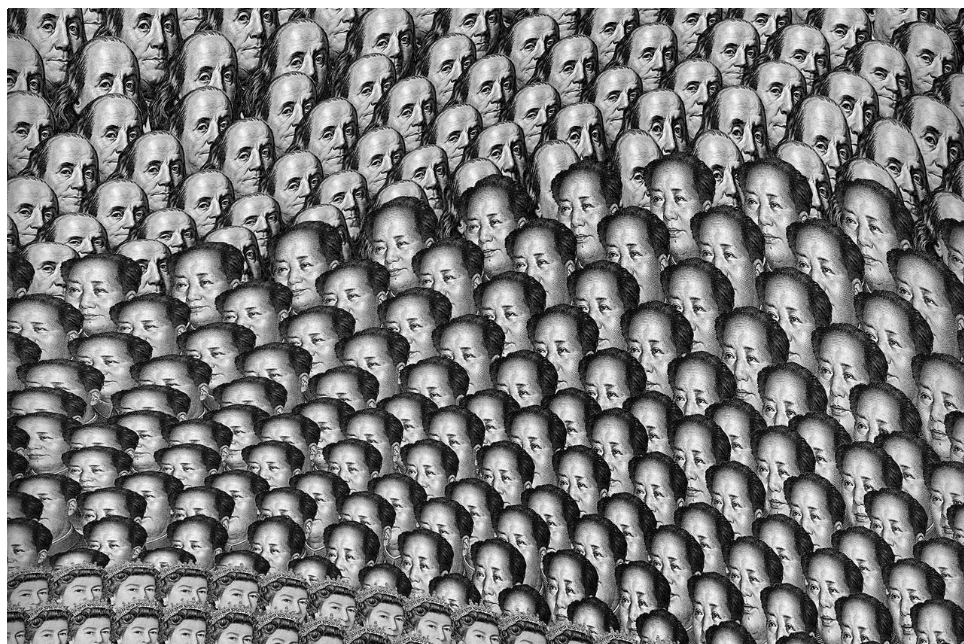


Illustration by Nicolas Ortega

Investors have been on edge as the world's two largest economies, the U.S. and China, tiptoe toward a trade agreement. Yet even if President Donald Trump and President Xi Jinping reach a deal, a tariff peace won't mean a return to the old ways of doing business.

The global system of trade is being realigned. A decadeslong drive toward freer trade across borders has begun to reverse. Globalization is being overwhelmed by populism, nationalism, and protectionism.

Brexit threatens to erect new trade barriers between the United Kingdom and the rest of Europe. India just moved to limit foreign operators selling goods online.

An eroding global consensus on free trade has led U.S. companies to modify their supply chains, often bringing suppliers closer to their end markets.

In the 1990s, global trade regularly grew at twice the rate of worldwide gross domestic product; since 2012, it has been rising only slightly faster than GDP, on average, according to the World Trade Organization. For this year, amid

slowing global economic growth and rising barriers, the WTO has lowered trade expansion expectations to 3.7% from 4%, and said that first-quarter trade is slumping to 2010 levels.

Seaborne shipments to the U.S. fell 4.5% in February, including a 4.6% drop from the European Union. It was the first such decline in almost two years, according to Panjiva, a supply-chain data provider.

A recent Bain & Co. survey of more than 200 executives at multinational companies who do business in China found that 60% felt that the recent trade war had given them a chance to recalibrate their business strategies. Over the next year, 48% said, they expect to seek out new suppliers, and 42% expect to find raw materials elsewhere.

Corporate executives are adapting to a world where globalization is no longer the dominant force.

“I probably never would have said it was going to end, but I’m starting to wonder,” says Don Allan, chief financial officer at Stanley Black & Decker (ticker: SWK). “The trend seems to be heading that way. Countries are becoming more focused on protecting their world and less on how to work together as a global economy.”

Allan has been struck not just by the Trump administration’s antiglobalism agenda, but also by changes elsewhere, like the fragility of the European Union since the financial crisis.

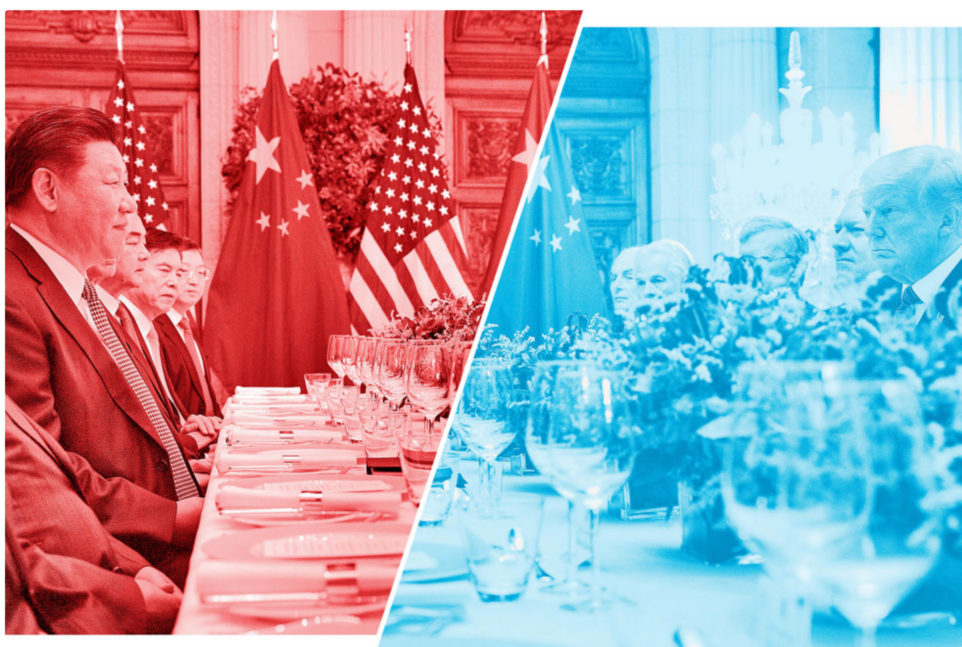
“There’s definitely a major shift that has been going on for the past 10 years, and it has accelerated in the past five years,” Allan says.

The shift comes at a time of profound technological and political changes—including the advent of new robotic-manufacturing techniques, a North American energy boom, and China’s state-led push to sell higher-value goods—that have already led companies to reconsider and realign their global footprints. Those changes could eventually prove to be even more powerful than antiglobalization at rerouting global trade.

Investing in these trends will be tricky because they are likely to play out over decades. People can make money off supply-chain shifts by purchasing stocks that will benefit from new Chinese investment, including in renewable energy and batteries; focusing on countries, such as Vietnam, that will play a bigger role in global trade; and buying shares of companies that build robots used in manufacturing, some investors say.

While economists and politicians have promoted the idea of global trade for years, a slowdown and even a reversal in its pace wouldn't be a historical anomaly. Globalization has actually risen and fallen in cycles, according to Bank of America Merrill Lynch analyst Ajay Singh Kapur. "There is really no permanent trend, just lazy intellectuals confusing a long cycle for a perpetual-motion machine," he wrote in a report last year that included a chart that extended back to the birth of Jesus.

Yet the rapid increase in trade in the second half of the 20th century made globalization seem to be an inexorable force. "The world is governed by market forces," Alan Greenspan said in 2007. It seemed hardly debatable at that point. From 1950 to 2007, the value of global trade grew by 6.2% a year, on average, almost four times as fast as the global population rose. Transportation costs fell, regions specialized, manufacturers chased the lowest-cost inputs, and supply chains became longer and more complex.



President Donald Trump meets President Xi Jinping of China at the Group of 20 summit in Buenos Aires on Dec. 1. While investors have been hopeful for a trade deal, companies are already modifying their supply chains. **Photograph by Tom Brenner/The New York Times/Redux**

Initially, the trend coincided with steady employment and wage gains for workers in developed economies. Those gains, however, deteriorated as manufacturers fled developed economies in the 1980s, seeking cheaper labor. In 1975, manufacturing represented over 20% of U.S. GDP and 22% of labor employment—today, it's just 11% and 9%, respectively. After adjusting for inflation, incomes for nonsupervisory U.S. workers remain where they were in the late 1970s. Other developed nations have seen similar declines in manufacturing, coinciding with rising income inequality.

The political backlash against the perceived winners of globalization has

manifested itself in events like Trump's election and Brexit. Hoping to protect jobs, countries have sought to become increasingly self-reliant, putting up ever-higher barriers to trade.

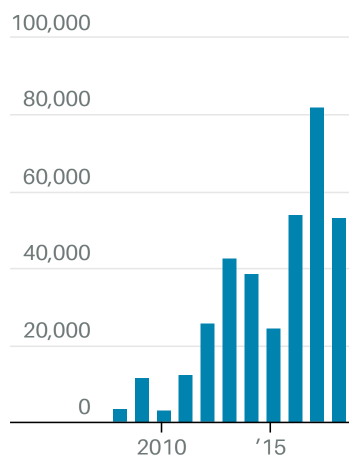
Supply-chain decisions have rarely been so politically fraught. The Made in China label doesn't disappear so easily into the seam of a U.S. company's dress in an age of tariffs and angry presidential tweets. American-designed, Chinese-assembled iPhones have lost their status in Beijing, where consumers increasingly favor domestic brands.

Given the political implications, companies are mostly keeping quiet as they realign their supply chains, lest they invite pushback. *Barron's* contacted more than 50 small and large ones that had applied for tariff exemptions or discussed changing their supply chains. Only two were willing to talk.

Bringing Jobs Back

Domestic manufacturing can produce political benefits, save on transportation costs, and reduce supply chain time and complexity. So-called re-shoring to the U.S. is on the rise.

Manufacturing Jobs Slated to Return to U.S.



Source: Reshoring Initiative

Bank of America Merrill Lynch analyst Andrew Obin says that "job creation (or lack thereof) is likely at the core of their ambivalence." Even when corporations return production to the U.S., they might add more robots than humans.

And Trump isn't the only one they risk alienating. "For companies shifting production out of China, they likely don't want to advertise their moves, either," Obin notes.

Such "reshoring" by U.S. companies is on the rise. More jobs were gained through reshoring than lost to offshoring in 2016, for the first time since 1970, says the nonprofit Reshoring Initiative. In 2017, employers announced decisions to bring a record 82,250 jobs back, up from just 3,221 in 2010. Preliminary numbers for 2018 show that reshoring announcements slowed last year, to 53,420—possibly a result of "uncertainty from the trade wars, dysfunction in Washington, and the dollar being up a little bit," says the nonprofit's founder, Harry Moser. But he calls the trend powerful and persistent. "It's not just a trickle here or there."

Many companies have found it attractive to regionalize all or some of their product procurement or assembly closer to their end markets. The rewards: cheaper and faster transportation, less complexity and risk of disruption, reduced inventory requirements, and the political benefits of making

products where they're sold.

GoPro (GPRO) is maintaining its Chinese factory to supply Asian customers. But it plans to move its manufacturing to Mexico from China for cameras bound for the U.S. "While the threat of tariffs served as a catalyst to improve supply-chain efficiency, this approach makes strategic sense, regardless of tariffs, and we expect to generate modest savings, to boot," Its chief financial officer, Brian McGee, said on an earnings conference call last month.

Hasbro (HAS) started making Play-Doh at a factory in Massachusetts late last year, the first time it had produced the toy in the U.S. since 2004. Hasbro says lower transportation costs influenced the decision.

Solar-module maker SunPower (SPWR) is likewise working to move more production closer to its end markets. In industries with razor-thin margins, reducing shipping and other logistics costs can mean the difference between making or losing money.

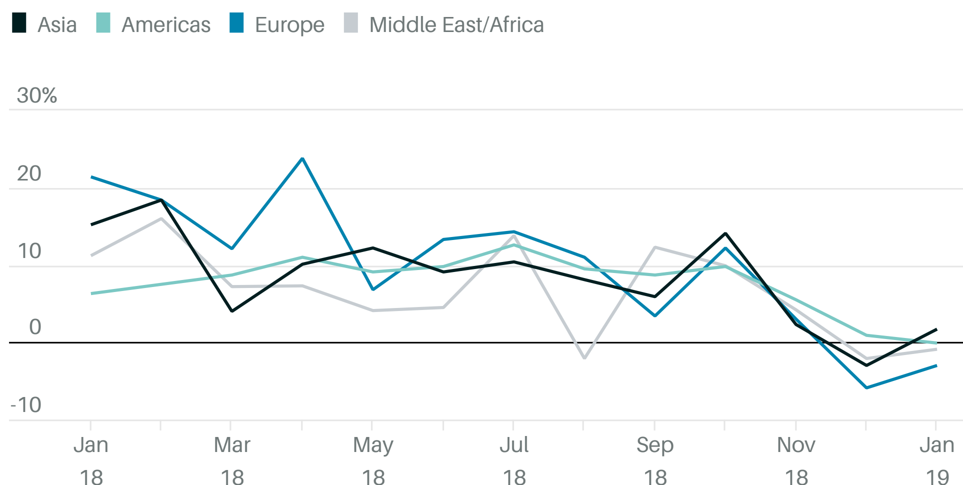
SunPower's core product is a solar module enclosed in glass. It sells for about $1 per watt to power plants and up to $2.25 to residential customers. As much as a dime of the cost is attributable to logistics.

"The bigger it is, the more the logistics cost it has, and the more likely you want to regionalize production," SunPower CEO Tom Werner tells *Barron's.* "The panel tends to be the first thing solar companies look to regionalize, to bring it closer to end demand." SunPower has been expanding operations in Mexico for products it sells in the States. It even bought a small U.S. solar manufacturer last year.

Trade in Decline

Global trade growth has decelerated in recent quarters, as countries have erected new barriers to the free flow of goods across borders.

Change In Total Exports



Source: Panjiva

Other companies are making similar moves. Early in the 20th century, the companies that now make up Stanley Black & Decker largely made their tools in the U.S. But in the 1980s, production began to shift to China and other Asian countries, Allan, the CFO, says.

By the late 1980s, only about 25% of U.S.-bound production was made domestically, but that has since risen to 50% as the company brings jobs back. One reason for the decision is that it appeals to customers who value U.S. craftsmanship, even if the goods are made in the same way as they would have been in China.

"I wouldn't say that everybody in the U.S. wants everything made in the U.S., but I think there are certain industries where that desire for Made in the U.S.A. products has elevated over the past 10 years," Allan says. He hopes that eventually 80% of the company's goods sold in America will be made here.

Regionalization also has been spurred by the U.S. shale boom and the spread of more-sophisticated refineries on the Gulf Coast. Together, they've made the nation less dependent on overseas oil and made it cost effective to move energy-intensive manufacturing to the U.S. or Mexico, says Peter Guarraia, the Bain & Co. partner who heads the management consulting firm's global supply-chain practice. "When you think about fundamental input industries like chemicals or fertilizer—anything that is energy- or petroleum-based—I think you'll start to see that volume of production is going to shift out of China and back to the U.S.," he observes.

Companies will continue to search for the right balance, saving some labor

cost here and transportation expenses there to reduce their overall input costs. "Industries with high labor content will be more likely to stay in Asia for the near term, because there's still a substantial labor advantage in the East Asian markets," Guarraia adds.

Rising labor costs may cut China out of the supply chain for some businesses. Wages there have more than doubled since 2010. And the threat of tariffs has made other countries in Southeast Asia more attractive.

GoerTek , a Chinese company that makes Apple's AirPods, reportedly told suppliers last year that it was moving production to Vietnam. It will join companies like LG Electronics (066570.South Korea) and Samsung Electronics (SSNLF). And it's not just tech: Chemical company Huntsman (HUN) announced last summer that it had opened a plant in Vietnam, its first in Asia outside China. In fact, manufacturing grew more in Vietnam than in any other major Asian country last year, IHS Markit has calculated.

"I do think the area with the most potential is going to be Southeast Asia," says Robert Horrocks, chief investment officer for Matthews Asia, a mutual fund outfit. "From there, you have relatively easy access to the big consumer markets in China, growing consumer markets in India, and those in Japan. You have fairly easy container-shipping access also across to Europe."

China, for its part, has larger ambitions. Its goal is to develop more-sophisticated products itself, instead of simply assembling things designed elsewhere. To achieve that, it will probably have to "outsource that assembly and manual labor to other parts of the world, and it has the capital to do that," Horrocks adds. He expects Vietnam, with its young labor force, relatively low wages, and deepwater ports, to be the biggest beneficiary.

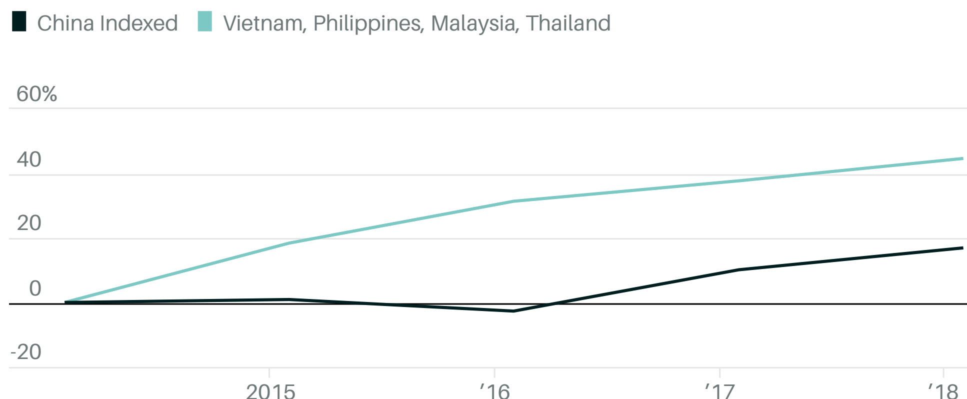
To capitalize from this trend, Horrocks advises that investors stay away from investing in manufacturers that put together goods for foreign operators. "You could invest directly in manufacturers in, say, Vietnam," he says. "But we're talking about parts of the supply chain that are generally low value-added and where you're in a situation where you're beholden to some greater economic power, be it Apple in the U.S. or Samsung in Korea."

A manufacturing boom benefits local economies, which opens other investment opportunities. "Therefore," Horrocks asserts, "the best way of investing is to invest in local businesses with a strong competitive moat that can feed off the increased purchasing power from the new industrial workforce."

Outpacing China

As labor costs in China rise, production and assembly in many nearby countries has become more attractive. These four countries have outpaced China in exports to the U.S. for several years.

Change In U.S.-Bound Exports of Electronics and Machinery



Source: Panjiva

The top holdings in the Matthews Emerging Asia fund (MEASX) are seafood processor Vinh Hoan (VHC.Vietnam) and Saigon Beer Alcohol Beverage (SAB.Vietnam). Exchange-traded fund (VNM) bets on local companies and multinationals that operate in Vietnam. The VinaCapital Vietnam Opportunity closed-end fund (VCVOF) also invests in local companies.

China, meanwhile, is focusing on developing higher-value goods domestically, as opposed to just assembling them. Horrocks expects the nation to become a bigger player, not only in technology and autos—areas where its efforts already have drawn global attention—but also in sectors such as biotech. "You'll see much more of a health-care industry developing in China," he predicts.

Bank of America has advised investors to put money into Chinese companies that are investing in other areas likely to be major growth drivers in their homeland. Examples: waste-treatment specialists, such as China Everbright International (257.Hong Kong), and wind-power outfits, such as China Datang (1798.Hong Kong). Renewable power and battery producers like BYD (1211.Hong Kong) are also in industries growing in China.

These kinds of shifts were under way before President Trump came to office, but his protectionist policies have accelerated them, at times complicating U.S. companies' decision-making.

For Stanley Black & Decker , the Trump tariffs have made it costlier to manufacture some items in the U.S. A 25% tariff on Chinese chucks—a kind of clamp used to tighten a bit on a drill—has increased the U.S. manufacturer's cost of that part, even as competitors can import fully made drills from

overseas without facing a tariff. "Our cost to make this product is actually going up, versus our competitors," company CFO Allan laments.

Companies can't expect to cover such costs just by raising prices. The Bain survey of executives found that only 33% plan to pass on the tariffs' toll to consumers, a sign that companies are rejiggering their supply chains to avoid or minimize the levies, instead of jacking up prices to consumers and endangering sales.

"This is changing how companies look at their total supply chain," says Steve Bowen, CEO of Maine Pointe, a global supply-chain and operations consulting firm. "We're discovering new suppliers for these folks. Where they thought there were four, now they see there are 20 or 25." Tech companies seeking to introduce new products "will go and have that product built by several different entities, rather than just one," Bowen says. "That's a huge change, and you'll see that play out over the next four or five years."

One manufacturer that Bowen advises uses steel products from China, but is now looking for suppliers in Europe. "It would allow them to revisit buying steel from China if there are tariffs," Bowen says. "It's opening up their eyes to the potential of the supply chain of the future."

In some industries, however, the supply chain of the future still can't replicate the benefits of the supply chain of today. That's particularly true in China, which has reinvented tech manufacturing in the past two decades.

Companies that depend on sophisticated factories there find it hard to move production to other countries. Indeed, China is home to several "industrial commons" that can't be quickly recreated elsewhere, according to Patrick Spence, CEO of Sonos (SONO), which builds its speakers at two Chinese sites.

"There are hundreds of parts and hundreds of suppliers that are involved in the products that we build, and they're all located in China," Spence notes. "That's something that has built up probably over the past 30 years, in terms of that complex. That's there for a reason; it's very strong; it works well today."

While SunPower has moved final assembly of some U.S.-bound solar panels to Mexico, it still sources the constituent parts from the Philippines and Malaysia. In those countries, an ecosystem of parts producers exists. These companies are in close proximity to one another, allowing SunPower to combine materials efficiently and inexpensively. "To ship the glass to make a module can be several pennies, which can be the difference between profit and loss," SunPower CEO Werner says.

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Shay Scott, executive director of the University of Tennessee's Global Supply Chain Institute, says: "It's not just the manufacturing capability, it's the tacit knowledge that comes in the community of people that design, innovate, and manufacture. You can't just snap your fingers and recreate those in a different environment."

Companies leaving China for locales with higher labor costs will probably rely on automation to lower the cost differential, while benefiting from lower transportation or energy tabs.

The International Federation of Robotics forecasts that the global tally of industrial robots will increase by more than 10 times from 2009 to 2021. Factory robot makers, including Rockwell Automation (ROK) and Fanuc (FANUY), are working to make adopting automation cheaper than offshoring.

Stanley Black & Decker has ramped up its use of robotics. Instead of replacing workers, Allan says that the company is retraining them to manage the robots (though the use of robots may reduce future hiring). The machines are allowing the company to bring manufacturing back to the U.S. at a more reasonable cost, he says. "It doesn't completely close the gap between a country like China and the U.S., but it does close it a fair amount."

Tariffs now cost Stanley Black & Decker $150 million a year, and the company doesn't pass the full impact along to consumers. Even if Washington and Beijing make a deal, Allan doesn't think that tariffs will go away completely. "With this acceleration of trade wars and tariffs, it has really forced us to think more aggressively. How do we achieve these goals in a much faster time frame?" he asks.

The tectonic plates of global trade are in motion. Even a handshake between Trump and Xi won't stop that shift.

This is the first in a series of special reports that will examine the realignment taking place in the world economy as a long push for globalization starts to unravel.

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