Trade war and the rethinking of supply chains

The trade war between the U.S. and China has become a key defining element in the markets and one of the short-term decelerating factors of global economic activity. Tariffs have made it more costly for companies to source production inputs from traditional low-cost manufacturers such as China, thus pushing companies to “rethink” their supply chains. In addition, the increased political uncertainty surrounding trade policy has caused companies to pause and reconceive their strategic and production planning processes. When structural changes such as the reshaping of supply chains occur, it is normal to expect deceleration in economic output.

However, we stress that a slowdown in economic activity does not necessarily mean that a recession is on its way. The factors that signal a recession are still not flashing in their totality, and U.S fundamentals are still looking strong. When it comes to recession signals in the U.S., it will be important for investors to monitor what happens in specific sectors of the economy, specifically the manufacturing sector. When it comes to understanding how much longer this long economic cycle can last, the most important variable to monitor for GDP will be the I (for Net Investments or Net CAPEX).

Global threats and economic slowdown

Investors have had to grapple with the uncertainty of whether Trump and Xi Jinping will strike a trade deal in the coming months or if retaliatory tariffs will escalate. The geopolitical environment is becoming more complex by the second, and financial markets are responding accordingly. We are living in a world where polarized U.S. political institutions, Brexit, trade wars, and a global rise of populism and nationalism are breaking up the world into separate segments that used to be interconnected.

Investors have also had to cope with worrying signals about the durability of the global economic expansion. The global economic slowdown adds further complication to the reality faced by decision-makers at companies around the world. The International Monetary Fund (IMF) now projects a 3.5% growth rate worldwide for 2019 and 3.6% for 2020. These are, respectively, 0.2 and 0.1 percentage points below the IMF’s last forecasts in October — the second downturn revision in three months. China is the protagonist of this story as well. Last year, China’s economic growth dropped to its slowest annual rate in almost three decades. The trade war with the U.S. and Beijing’s end on a debt-heavy

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Companies have started to reshuffle their global supply chains due to the U.S.-China trade war and its consequences. This is causing global economic activity to slow down in the short term.

Despite the economic deceleration, fears of an imminent recession are unfound. U.S economic fundamentals are still looking strong, and there has never been a global recession without a U.S. one.

There are still challenges ahead, reason why we think an increase in capex will be key for the sustainability of a prolonged business cycle. For recession monitoring, investors should pay close attention to economic indicators, especially those of the manufacturing sector.

We recommend investors to stay invested and diversified, maintaining at least a 10% allocation to cash and short-term fixed income. Alertness will be important as investors are likely to witness more volatile “late cycle” markets, which we believe will still have a decent performance during this calendar year.

For more on how we are positioning our portfolios, please contact your investment advisor or ideas@bigsurpartners.com

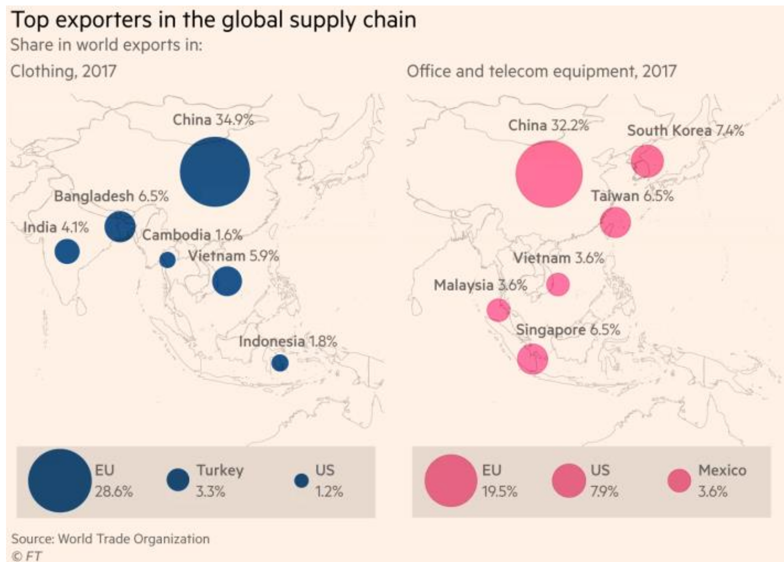
corporate spending program impacted Chinese companies and consumers. In addition, China is going through its own internal transformation. The second largest economy is moving from a manufacturing-driven economy to a consumer-driven economy — from being the global production powerhouse to the biggest consumer in the world. Just as China is suffering an economic deceleration because of structural changes in its economic model, the global economy is slowing down because of the structural modifications that global supply chains are undergoing as a result of the current geopolitical dynamic. The question now is how will the world economy deal with all of these changes?

"Localizing" of supply chains reduces short term output

As a result of increased trade tensions, companies and investors have been paying more attention to supply chains. According to Barron's, companies are talking more and more about their supply chains in their earnings calls. During Q3, companies mentioned supply chain 1,271 times – a 55% jump from the quarter's previous five-year average.

Because of tariffs, a large amount of U.S companies have seen their costs increase due to the geographic layout of their supply chains. The consequent reassessment of global supply chains has resulted in a phenomenon known as "localizing", which is the concentration of supply chains in local regions rather than the global arena. This process inevitably leads, at least in the short term, to a slowdown in global economic activity due to higher production costs as well as production bottlenecks that affect both supply and demand.

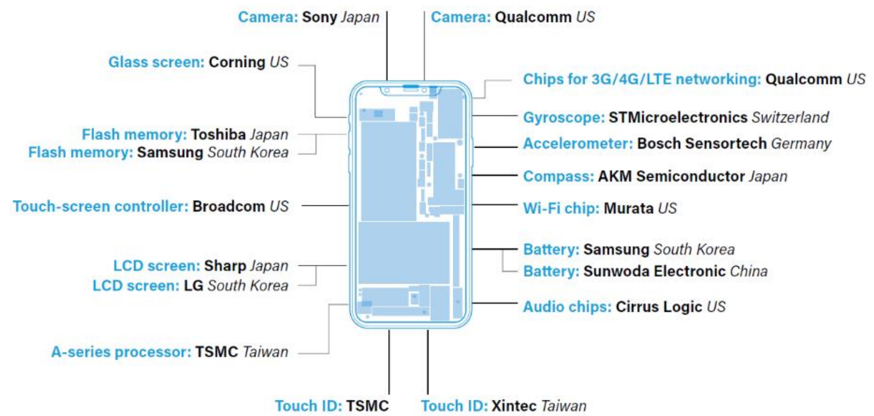
For many manufacturing, technology and industrial companies, a few countries are still key links in their global supply chains. China is one of the main examples because of its position as the biggest provider of low-cost labor. This China-centric phenomenon started at the beginning of the millennium when companies started to acquire their production inputs from the cheapest possible source. The concentration of global supply chains on a handful of countries was becoming an issue for companies given that they were becoming more reliant on different sourcing locations and their idiosyncratic geopolitical dynamics. With the arrival of Trump's MAGA and "Buy American" policy programs, it became more imperative for corporations to "localize" their supply chains in order to counter rising tariffs.



Companies that are heavily exposed from an operational standpoint to tariff-prone countries (such as China) are now reconsidering new countries for sourcing. Some companies, such as power tool giant Techtronic, are keeping China as an important part of their supply chain while they ramp up production

in other low-cost countries. Other companies are planning and executing supply chain moves. For example, Google's hardware maker Flex is looking to relocate its production centers to Mexico or Malaysia.[1] Stanley Black and Decker has been speeding up plans to produce hand tools in the U.S. If companies start to slow down their production in order to accommodate changes to their supply chains, global economic growth and corporate earnings growth could be affected negatively, especially during the short term.

Manufacturing and technology: key examples of how trade war affects supply chains



Source: Eurasia Group

To understand the complexities of global supply chains, let's take as an example Apple's iPhone. Apple's most popular product is sourced from more than 300 companies in China, more than 100 companies in Japan and the U.S., and other smaller suppliers in Europe and South America[2]. To reorganize the production of an iPhone, Apple would have to not only reconsider changes in cost efficiencies and pricing, but also to analyze the changing geopolitical dynamics that would affect any new supply chain.

Geopolitical rivalry is gripping trade-sensitive industries such as manufacturing and technology. The consequences of a trade war will make the production of manufactured and high-tech products more expensive and complex, thus straining the capital flowing into those sectors. Moving supply chains is a challenging task and could be a costly one. For example, from a labor perspective companies would have to relocate or hire new human capital with specialized knowledge. This disruption, although a short-term one, could lead to a decrease in collaboration and knowledge flow, thus resulting in reduced innovation. This will hurt not only tech and manufacturing companies, but also companies that depend greatly on those two sectors for their operations. The disruption of complex, integrated supply chains hinders the operations of companies around the world, hence creating a slowdown in economic activity. New investment opportunities might be created in new locations, as companies move operations to other countries. However, in the meantime, deceleration of growth and uncertainty will arise as companies recalculate their steps.

Deceleration does not equal recession

The rising concern over global companies' vulnerability to extended supply chains might lead to a restructuring of the whole global trade system. Consequentially, researchers have come up with the

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[1] "As Tariffs Hit, Supply Chains Become a Hot Topic for Investors." Barron's. November 10th, 2018.
[2] "US-China trade war prompts rethink on supply chains." Financial Times. September 3rd, 2018.

concept of "Slowbalization" – the idea that globalization has slowed down and transformed into a more trans-regional phenomenon. Although there are positive consequences to more integrated regions, such change will slow down global economic activity while companies localize their supply chains and stabilize again their operations.

Nonetheless, this deceleration does not mean that a recession is imminent. According to Strategas, there has never been a global recession without the U.S. economy suffering one. The factors that signal a recession in the U.S. are still not flashing and the U.S economic landscape is still looking favorable. Strategas argues that six economic leading indicators are showing that this business cycle still has some time left: nonfarm payrolls are still growing, labor share of GDP has not bottomed, wage growth is below the 4% YoY threshold, the 2-10 yield curve has not inverted yet, consumer confidence is recovering from its late 2018 drop, and PMIs are not looking weak despite recent deterioration. When it comes to recession signals, it will be important for investors to monitor these leading indicators, especially those related to sentiment in the manufacturing sector.

Although a recession is not imminent and we are not as "late-cycle" as some headlines might suggest, there are still challenges ahead. For example, data from the auto, housing and manufacturing sectors are still source of worry for investors. We agree with Strategas that it will be key for the U.S. economy to see a significant increase in capex during 2019. If the U.S. economy becomes capex-driven this year, we would see the much needed rise in productivity that will help prolong the business cycle in a sustainable manner. In the meantime, given the uncertain global market backdrop, we suggest being patient and diversified in a time where volatility might become the norm.

BigSur View

The world is facing an economic slowdown in the short term due to the reassessment of global supply chains caused by trade war concerns. Companies who are rethinking their production schemes are looking to counter rising costs associated with tariffs and a more uncertain geopolitical environment. Nonetheless, this deceleration does not mean that a recession, specifically a U.S. one, is in near sight. Leading economic indicators suggest that the U.S. economic cycle still has some time left – a comforting message given that a global recession has never occurred without a U.S. economic downturn. Before getting carried away by recessionary fears, investors should pay close attention to the performance of specific sectors of the economy, most specifically the manufacturing sector. Considering the length of this economic cycle and the challenges to be faced in such late stage, it will be key for the U.S. to transition from a consumer-led economy to a capex-led one in order for this cycle to continue in a sustainable manner. As the Eurasia Group puts it, the overwhelming majority of geopolitical dynamics that matter are now headed in the wrong direction and the geopolitical environment is the most dangerous it's been in decades. However, they do not expect a crisis yet during 2019. We have a world without leadership, with world's decision-makers allowing a broad array of future risks to germinate, with serious consequences for our collective midterm future. In the meantime, investors should stay invested and diversified, maintain at least a 10% allocation to cash and short-term fixed income, and stay alert as they witness more volatile "late cycle" markets, which we believe will still have a decent performance during this calendar year.

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