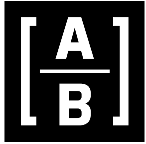

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INSTITUTIONAL INSIGHTS

What COVID-19 Means for the Economic Policy Puzzle

Authors
Darren Williams
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The COVID-19 pandemic, together with its associated policy response, has already shattered historical records. The plunge in global GDP and the blowout in government deficits witnessed through the first half of 2020 are unprecedented outside of wartime.

But the story isn't over. The pandemic is likely to have longer-running repercussions of historical scale, too—not only for societies, but for economic performance and government policies. It's difficult to predict the precise shape of those repercussions, but homing in on areas where the pandemic's impact is reinforcing existing long-term trends—pushing on an open door, if you like—should be a major focus.

In our view, deglobalization, a continuing trend toward populist politics and the consequences of mounting government debt are three key themes to pursue.

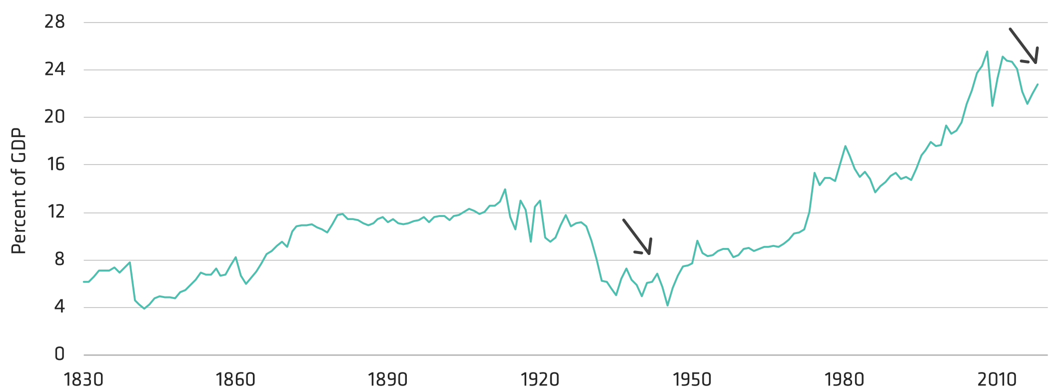
Have We Passed Peak Globalization?

Take the first of those themes—deglobalization. Over the last 30 years, the world has seen an era of unparalleled international economic cooperation and integration—with China at the heart of the process.

As trade boomed, exports rose steadily as a percentage of gross domestic product (GDP) *(Display)*. Following the global financial crisis (GFC), this trend started to reverse. This was partly a result of vulnerabilities revealed by the GFC, but an increase in onshoring of production—driven by automation—also had an impact.

The Ebbing Tide of Globalization
World Exports as a Percentage of Gross Domestic Product

As globalization increased international trade over the years, exported goods and services steadily increased in proportion to GDP. But that trend seems to have reversed in the years following the Global Financial Crisis.



Historical analysis does not guarantee future results.
Through December 31, 2018
Source: Haver Analytics

More recently, high-profile trade wars have shaken the institutional framework for free trade, with the global rise of populism stoking the frequency and intensity of trade disputes. Public policies are becoming more national and less global—a channel for populism that we call "raising the drawbridge." In addition to one-on-one country disputes, we've also seen withdrawals from multinational arrangements, such as the Trans-Pacific Partnership and the Paris Climate Accord. The anti-Brussels sentiment that led to Brexit is another notable example of populist-inspired deglobalization momentum.

COVID-19 amplifies some of the causes of the upswing in populist politics. It has revealed yet another downside of global connectedness—efficient transmission of viruses.

Many of the cohorts in society who were already the losers from 30 years of globalization and market-based policies—minorities, lower-skilled workers and young people—have been hit hardest in this crisis. In some countries, far from drawing people together, the pandemic has highlighted societal fractures, institutional failures and other weaknesses. In short, populist pressures are intensifying—and, with them, more downward pressure on globalization.

A material decline in international trade integration would be a major structural shift for the world economy. Globalization has been a powerful positive supply shock, boosting economic growth and productivity while damping down inflation. We should expect the opposite effect as this process reverses. To stretch the metaphor, if COVID-19 opens the deglobalization door even further, the escalating geopolitical conflict between China and the West in the wake of the pandemic threatens to blow it off its hinges.

The ongoing trade war between China and the US is one of the most obvious signs that the mutually beneficial period of global cooperation is over. But the rising tension is about far more than trade. It's about a tectonic shift in the global balance of power, with China and India emerging from a long slumber and the West, while remaining important, slowly losing power and influence.

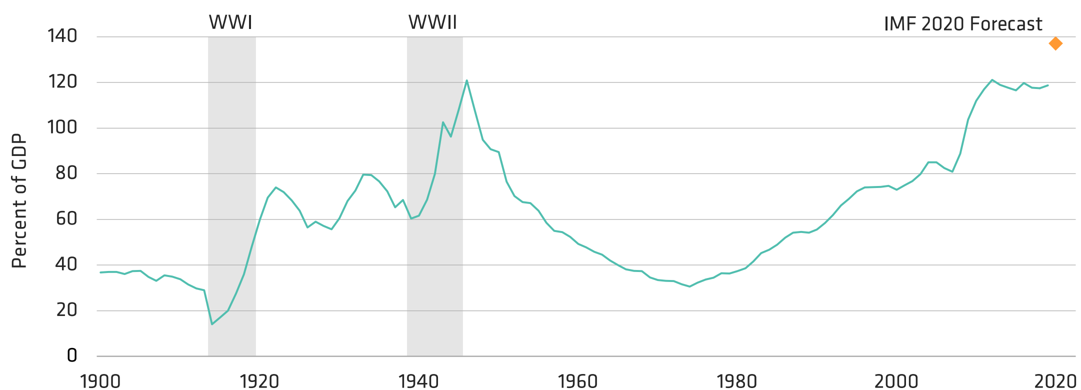
Government Debt Overhang and Financial Repression

These developments clearly intensify the global challenges of policymaking. But there are domestic challenges, too. Here, perhaps the most important area in which COVID-19 is pushing on an open door is rising government debt *(Display)*. Public-sector debt in developed economies had already reached record highs before the pandemic emerged, with gross government debt well over 100% of GDP for the G-7 nations. The massive fiscal support unleashed this year could lift the debt ratio by 20% or more for many countries.

Developed-Market Debt Burdens Have Soared

G7 Gross Government Debt as Percent of GDP

Government debt, which has risen steadily over the past 40 years or so, had already hit a peak of about 120% of GDP before the COVID-19 pandemic erupted. Based on the IMF's 2020 forecast, it could reach nearly 140% this year.



Historical analysis does not guarantee future results.

Through June 30, 2020

Source: Haver Analytics, International Monetary Fund (IMF), Jordà-Schularick-Taylor Macrohistory Database and AB estimates

How governments choose to deal with the debt overhang will go a long way toward determining the secular outlook. Historically, there have been a number of choices: default, growth, austerity and financial repression, but not all are on the menu this time around.

It would be problematic—delusional, perhaps—to rely on strong economic growth, given the unfavorable demographic trends and subdued prospects for productivity growth. Populism's resurgence will likely further reduce the appetite for a long fiscal austerity effort, with higher taxes and spending cuts. Outright default is another option, but reneging on domestic-currency debt would be a politically fraught decision—and a historical anomaly.

What has been more historically common—for example, in the aftermath of World War II—is financial repression. Many countries during this era used a mixture of ultralow interest rates and modest inflation to reduce debt-to-GDP ratios. Japan has used similar policies over the past decade to stabilize its public debt at just under 240% of GDP (and much lower if we exclude government debt on central bank balance sheets). Low interest rates and modest levels of inflation have been powerful tools in the past—and could be again.

Indeed, evidence of a shift to that approach continues to accumulate. One side of the equation is already in place. The level of interest rates is extraordinarily low, with policy rates now set at or below the zero lower bound. In addition, the structure of nominal government bond yields is now heavily controlled, courtesy of successive rounds of quantitative easing and yield-curve-control frameworks.

Is Higher Inflation Achievable? Regime Change Is the Key

The missing piece is, of course, inflation, which seems a long way away today. For the time being, COVID-19 and the economic dislocations it has created pose a challenge to our longer-term view of higher inflation. Developed economies are operating well below their economic potential today, and that could continue for some time—leaving huge output gaps.

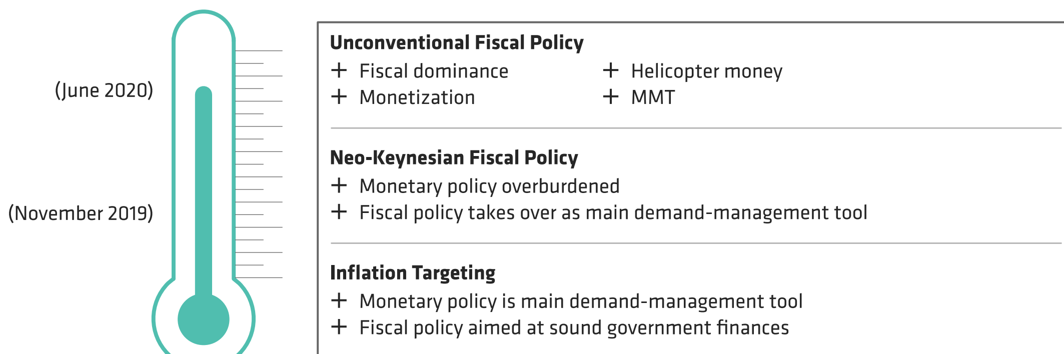
But our longer-term inflation view isn't dependent on cyclical factors or the immediate disruptive effects of the pandemic on pricing behavior. Rather, it's all about changes in the global monetary and fiscal policy regime, driven in turn by the debt overhang, populism and deglobalization. And as we've discussed, these trends are being reinforced by the changes the pandemic has ushered in. In fact, COVID-19 has already seen widespread acceptance of two factors needed for a higher-inflation regime.

The first is recognizing the necessity for central banks to finance fiscal stimulus—monetary and fiscal policy working in concert or joined at the hip. The second factor is the idea that money should be channeled into the real economy—not into banks. Pushing funds into the real economy is much more likely to raise consumer prices, in contrast to the post-GFC experience when funneling money into banks drove up asset prices instead.

But there's one more ingredient needed to give inflation a chance to ignite, and it's in the hands of central banks. It involves taking further steps into unconventional policy territory (Display). In order to generate sustained higher inflation rates, central banks need to reset inflation expectations higher.

Where Are We on the Path Toward Higher Inflation?

Since late 2019, the world has moved farther on the path toward higher inflation, but we're not there yet. The last step requires additional moves into unconventional fiscal policy supported by a credible commitment from central banks.



Current analysis does not guarantee future results.
As of June 30, 2020
Source: AllianceBernstein (AB)

This will require a credible commitment—just as it did (in reverse) in the early 1980s, when central banks worked to break the back of rampant high inflation. Today, a commitment to breaking convention is likely to involve central banks downgrading or even abandoning their inflation targets. These targets, aided by demographics and globalization, have underpinned the low-inflation era of the last three or four decades. To reverse the tide, policymakers will need to undermine the credibility of the current monetary-policy regime.

We've seen baby steps. In August, the US Federal Reserve announced a major change in its policy framework to "average inflation targeting." Moving forward, the Fed will be more willing to let inflation run above the established 2% target before it considers hiking interest rates. But while this is a welcome move, it's unlikely to be enough by itself to generate a material shift higher in inflation performance.

As it stands, the Fed's new framework is still rooted in the old policy regime, for fear that a bolder move would lead to a market overreaction. But it's just that type of overreaction that central banks need to risk if they want to jolt markets and shift inflation expectations higher.

Have Expectations Already Started to Budge?

As we mentioned, several of the key pieces for a higher-inflation environment are falling into place. With central banks now openly toying with their policy frameworks and with money-financed fiscal stimulus now commonplace, we're certainly closer now than we were a few months ago.

It may seem odd to talk about the chances of higher inflation during a massive slump in global activity, but a couple of recent developments suggest that the topic is at least worth a discussion. Consumer prices jumped sharply in June and July across the globe, and that looks to have continued into August in some countries. We've also seen an upward shift in some market-based measures of expected inflation.

The CPI jump is likely more noise than signal, but it's broad-based. At a time when the cyclical inflation story is a tug-of-war between deficient demand and impaired supply, that noise shouldn't be ignored. When we add policy regime shift into the mix—a willingness and an ability to accommodate higher inflation—the stakes become even higher.

Are inflation expectations breaking loose? Right now, changes in breakeven inflation rates in the market for Treasury Inflation Protection Securities (TIPS) seem driven more by liquidity considerations. We are starting to see some signs of inflation uncertainty—in the form of a wider distribution of expected inflation outcomes—in survey data. It's a tentative development, but is worth watching.

So, getting back to our question of inflation and when the narrative will shift, our answer for now seems to be not quite. But we've started on that path, and, with markets still priced for Japanese-style deflation, that's an important development.

Darren Williams oversees the Global Economic Research Group for Fixed Income. Guy Bruten is a member of the firm's Global Economic Research team.

Author
Inigo Fraser Jenkins

Post-Pandemic Equity Investing
The Strategic View

There's no doubt the COVID-19 pandemic has thrown a great deal of uncertainty into markets when viewed through a near-term, tactical lens. But looking beyond that time frame over the next several years, what are the strategic takeaways for equity investors?

Not Just About Sector Cash Flows

This isn't simply a question of looking at the impact to industry business models in the post-pandemic world. Investors need to assess equity markets from multiple dimensions that collectively will shape relative sector performance.

For one thing, we think real interest rates will stay low and that the COVID-19 policy response will be inflationary. In our view, the entire policy reaction function has shifted to a fiscal-monetary combination that departs from the macro framework of the last 30 years. A reaction against the shareholder-first capitalism of the last 30 years also seems likely, given the added pressure from higher unemployment and sharply higher inequality.

The US election outcome will clearly influence this aspect in the near term, but beyond the current election cycle and considered globally, tax rates seem destined to rise. It also seems likely that policies will shift bargaining power back to labor, which could influence labor-heavy industries where pay is lower. And the model of levering up corporate balance sheets for share buybacks may come into question.

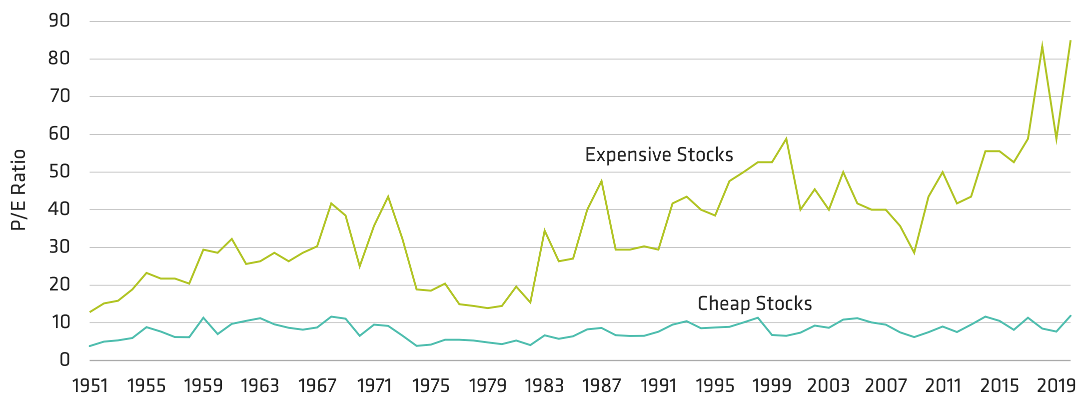
New Patterns of Asset-Owner Demand

Real returns will likely be lower, finding income will be a challenge and stock-bond diversification may not be as effective as it has been. As a result, equity investors may need to adopt a cross-asset perspective for many sectors. As assets shift out of high-grade fixed income, sectors that benefit as inflation rises, those that can deliver sustainable dividends and those that offer long-term access to real growth are likely to see more interest.

One sizable issue for asset owners? Nearly all assets—stocks, government bonds and credit—are historically expensive right now, and valuation spreads are extreme by some measures (Display). From a strategic perspective, how much of this valuation spread can mean revert? The outlook for a prolonged period of low or negative real interest rates implies that at least some of the spread may not revert in the near term, though there are elements of value cyclicals that may benefit from this.

Valuation Spreads Haven't Been This Extreme in Decades

Nearly all assets are historically expensive right now, and equity valuation spreads are extreme by some measures. For example, the spread between the most expensive and cheapest stocks hasn't been this wide in over half a century. How much of this spread can mean revert?



Through August 31, 2020
The historic series, derived from the Ken French Data Library, is the market-cap weighted 12 months trailing P/E ratio for the most expensive and cheapest quintile of stocks from among the largest 1,200 US stocks. The latest data points are estimates derived by Bernstein Research based on current valuation data. Stocks with negative trailing earnings are excluded.
Source: Bloomberg, FactSet, Ken French Data Library, MSCI and Bernstein Research

Another sizable change in investor demand is likely to come from environmental, social and governance (ESG). We think that much of the active management approach to ESG will focus on engagement, which lends itself more to stock-level investing rather than broad sector conclusions. Part of this will be a shift away from buying companies that are already "good" toward those that can improve, in order to make real change. Cheap passive implementation (smart beta) will be more relevant for asset owners looking for broad access to individual themes such as decarbonization.

So how do these trends translate into sector implications over the strategic horizon?

Tech, Healthcare and Growth Consumer Cyclicals

With real rates anchored at low levels for a long time and with more persistent growth and profitability for high-growth and high-profitability companies, long-duration equity sectors can maintain high valuations. Yes, US growth stock valuations have risen above average relative levels of the last decade, but the valuation spread between high- and low-growth stocks is still far from its historical extremes, and discount rates are far lower than they were in the previous 2000 peak.

There's more to the issue than justifying the valuation of growth stocks—there's also a question of demand. Corporations themselves have been the main source of equity demand for the past 10 years via buybacks. While buybacks are currently suppressed, when they bounce back tech seems likely to lead. Moreover, if antitrust concerns make it hard for tech companies to conduct M&A, this would also support buybacks.

The macro risk for growth stocks is the potential for a change in policy regime—in other word, a move to tighten perceived antitrust and privacy issues, a continued trend of deglobalization and tax changes. Tech and healthcare are the two sectors in the US that have benefited most from being able to lower their effective tax rates over the last decade.

Consumer Staples: Income and Real Growth Potential

We think the staples sector is one where the cross-asset lens makes the most sense, because of its ability to deliver an income stream and its claim of positive real growth potential in the long term.

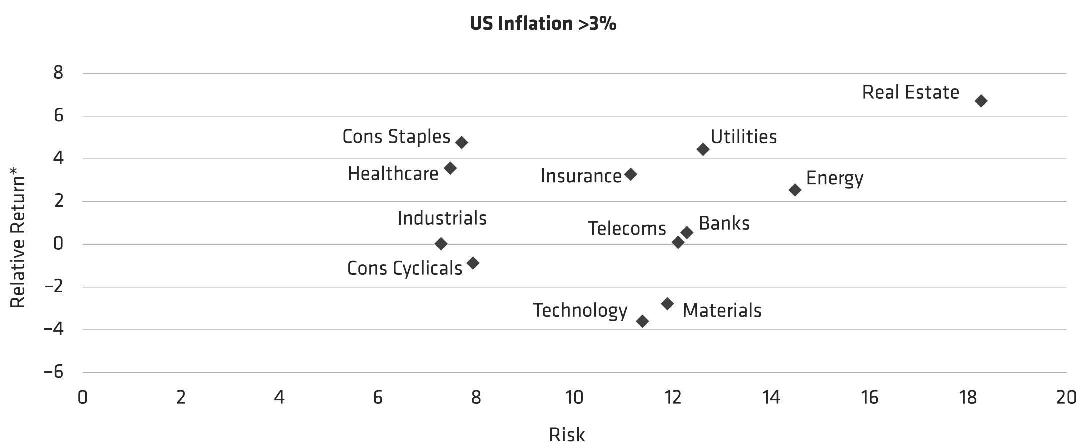
The spread between staples' dividend yields and bond yields has never been wider. Unlike more cyclical or financial sectors, there is evidence that these companies can maintain this level of dividend and also see it grow in real terms. The pushback against why individual equity securities can be seen as part of a replacement for fixed income is that they're more "risky."

Yes, in a sense that remains the case, but some elements of this stance are less clear than they perhaps were historically. The duration, and hence interest rate risk, of high-grade fixed income is higher than it's ever been before. As a result, bonds are likely to be a less effective diversifier of equity risk. Also, in an age when elements of Modern Monetary Theory–like policies are on the table and the age of Pax Americana is over, it's not even clear that there's such a thing as a risk-free asset.

If we're right in our call that inflation is set to rise in the coming years, consumer staples, along with healthcare, tends to be the sector with the best return/risk trade off *(Display)*. Note: this comparison unfairly punishes tech; for most of this period, tech was very different from how it looks now.

US Sector Relative Return and Risk With Inflation Over 3%

If inflation is set to rise in the coming years, some sectors will likely be better equipped to outperform than others, based on history. For example, consumer staples and healthcare have delivered the best risk/return tradeoff when inflation has been over 3%.



As of July 31, 2020
*Relative year-over-year return of sector vs. the market when average inflation (CPI) during the year was above 3% from 1973 to 2019.
Source: Datastream and Bernstein Research

Consumer and Industrial Cyclicals: The Easiest Case for "Undervalued"

As we mentioned earlier, there's controversy around the question of whether the wide valuation spread across equity markets will close. Will mean reversion drive sector returns? There are structural reasons why the valuation factor—broadly defined across a blended collection of valuation metrics—hasn't worked in recent years, such as declining bond yields that have impeded mean reversion and the switch of corporate investment from tangible to intangible assets.

But one key missing piece has been inflation. Over the past 90 years, the value factor has done best when inflation has risen, and inflation has persistently disappointed on the downside over the last five years. If inflation is now set to rise, is this the key support pillar for value that has been lacking? And if so, should investors be buying cheaper value sectors? We think there has to be a differentiation between kinds of value trades.

Perhaps the easiest case to make is for "undervalued," as opposed to simply being low-multiple, industrial and consumer cyclicals. These names may derive support from a longer-term recovery in inflation expectations. Thus, an eventual recovery means that investors can take a value position in select subsectors, including airlines and hotels. Also, within industrials there's a group of automation names that we think have a structural case for growth. With deglobalization likely to be a persistent feature, activity bought back onshore is likely to be heavily automated.

Energy and Mining: Commodity Cyclicals Offer Inflation Protection

A second area of value cyclicals that we think could benefit from inflation and long-run mean reversion are commodity cyclicals. For investors who think that the inflationary effects of the policy response to COVID-19 will be inflationary sooner rather than later, there's a case to be made for an overweight to these sectors.

In some cases, there's been a painful downward adjustment of dividend levels within energy and mining. But if we assume that the greater capital discipline of recent years can be maintained, then the level of dividend yield that now prevails in the sectors also leaves them looking attractive from a cross-asset income perspective.

Banks: No Yield-Curve Steepening Blunts Inflation Benefit

We expect a disconnect between the financial and nonfinancial components of the value factor.

Banks have tended to respond very well to inflation increases historically, but increases in inflation are usually accompanied by or followed by a steepening yield curve. This time, we don't think that will happen. The announced shift in policy makes it clear that rates will stay low even if inflation rises. Moreover, that policy could be further adapted to more tightly control the yield curve if need be.

In our research, we can unstitch the impact of inflation and the yield curve using simple bivariate regressions. Depending on the definition of inflation used, inflation either loses its explanatory power for banks' performance when considered alongside the yield curve, or at best is equal with the yield curve. The bottom line: without a steepening curve, inflation is a less powerful support for banks' relative performance.

There's also the question of bankruptcies. We think that there's an extended bankruptcy cycle still to come. It has been blunted by policy support, but at some point it still needs to happen. We also worry that ultimately banks may not be masters of their own destiny, given their key role in directing credit.

Real Estate and the Equity Diversification Question

In theory, an investor being told that a period of higher inflation is coming and that real returns are low would typically respond by allocating a much higher exposure to real estate, because that sector performs better when inflation rises. However, we think asset owners will be forced to hold a higher strategic equity exposure if the prospect of real returns elsewhere is low and inflation rises.

If bonds are no longer as effective a diversifier, other parts of the portfolio will be needed to help diversify the overweight equity position. REITS have a correlation with equities that rises with inflation, so are unlikely to be good diversifiers. In addition, the fundamental outlook for large parts of the real estate sector that have exposure to central-city office spaces and retail malls may be impaired by changes in work patterns post COVID-19.

Inigo Fraser Jenkins is Co-Head of the Portfolio Strategy team at Bernstein Research

AB Equity Roundtable: Perspectives on Global Supply Chains

Perspectives on Global Supply Chains

What You Need to Know

Supply chain disruptions hit many industries as a result of the pandemic. Many companies were gradually moving out of China before the crisis amid rising labor costs and trade war concerns, mostly to Southeast Asia and Mexico, rather than back to developed countries. In this roundtable, AB equity portfolio managers provide their insights on how companies are adapting their supply chains and what it could mean for profitability and investment returns.

Key Takeaways

+ COVID-19 created supply chain disruptions across most sectors and led many countries to realize the importance of controlling manufacturing in vital industries. Many companies accelerated plans to relocate some portion of their manufacturing footprint.
+ As a result of the pandemic, many companies built additional safety stock; this trend may persist. Companies with stronger pricing power should fare relatively well amid increasing supply chain costs by passing on incremental costs to customers.
+ We see opportunity for companies that facilitate the diversification and automation of supply chains, as well as software providers that enable the digitization of manufacturing. Solutions that drive efficiency and lower costs are needed to help support profit margins.

For decades, companies have stretched their supply chains around the world in a quest to lower costs. Now, trade wars, technology battles, populist politics and the COVID-19 crisis are forcing companies to rethink how they source supplies and where they assemble products. Changes to global supply chains could have a far-reaching impact on corporate profitability and shareholder value. We asked five AB equity investment professionals to talk about how they're thinking about supply chains when researching companies and investment candidates.

1. How will the experience of COVID-19 affect the repatriation of supply chains?

Samantha Lau, Co-Chief Investment Officer of Small and SMID Cap Growth Equities: If all we were dealing with was COVID-19, companies might have simply needed more buffer inventory for future disruptions. But the confluence of COVID-19 and the US-China trade war together has led to a perfect storm that will necessitate a broader redesign of company supply chains. In technology, for example, a geographically distributed supply chain that has undergone globalization for over 20 years has certainly made it more complicated.

> **"The confluence of COVID-19 and the US-China trade war together has led to a perfect storm that will necessitate a broader redesign of company supply chains."**
>
> Samantha Lau
> Co-Chief Investment Officer of Small and SMID Cap Growth Equities

Dan Roarty, Chief Investment Officer—Thematic and Sustainable Equities: According to research from Bank of America, 80% of global industries faced supply chain disruptions as a result of the pandemic, causing many to consider or accelerate existing plans to localize some portion of their manufacturing footprint. Supply chain resilience has quickly become a popular topic on corporate earnings calls. Many US-based companies are employing technology, including artificial intelligence and the internet of things, as well as increased automation to improve efficiency, lower costs, and reduce the harmful environmental impacts of their operations. Given the complexity of relocating supply lines, rapid shifts are unlikely.

Tawhid Ali, Chief Investment Officer—European Value Equities: I think trade war concerns are still the much bigger issue. Many companies were already gradually moving out of China before the crisis, due to increasing labor costs and more stringent environmental regulations in China. This trend has accelerated since the beginning of the trade war, especially in technology. Pharmaceutical companies are "talking" about some repatriation.

In terms of COVID-19, after the initial stress to the system, it's been remarkable just how well the global supply chain held up. For example, Hubei province in China, which was the epicenter of the pandemic, was a major supply source, yet the province hasn't lost share to other regions that were not locked down. We did see many companies build additional safety stock, and that's a change that might be longer lasting.

"Many companies were already gradually moving out of China before the crisis, due to increasing labor costs and more stringent environmental regulations in China. This trend has accelerated since the beginning of the trade war."

Tawhid Ali
Chief Investment Officer–European Value Equities

2. With increasing pressure on US companies to reduce their supply chains in China—amid rising labor costs, political tension and concerns around environmental, social and governance (ESG) issues—how are companies responding and reconfiguring their global networks?

Frank Caruso, Chief Investment Officer of US Growth Equities: Where there has been activity by US companies, it's been out of China and into places like Vietnam, the Philippines, Malaysia or Thailand, rather than back to US. This is particularly true in cases where their customer base remains in Asia. For example, Lam Research recently announced construction of a new technology center in South Korea and a new manufacturing facility in Malaysia. Why these two locations? Korea reflects the increasing importance of being close to Samsung, which has been a beneficiary of US-China political tensions in communications and foundry. The move to Malaysia addresses supply chain redundancy and helps to lower manufacturing costs.

"Where there has been activity by US companies, it's been out of China and into places like Vietnam, the Philippines, Malaysia or Thailand rather than back to the US."

Frank Caruso
Chief Investment Officer of US Growth Equities

John Lin, Portfolio Manager of China Equities: Chinese companies were already starting to move their own products offshore well before the current trade war with the US, to reduce labor costs. When we visited an Adidas supplier in the coastal city of Ningbo five years ago, the company told us that the shift of production to Vietnam was already well under way. Last year, when our analysts visited the Vietnamese factories for Chinese garment and electronic manufacturers, they found that Vietnam labor costs were about 40% lower than their equivalents in China. During these visits, we also discovered that companies have learned important lessons about modern slavery. We've engaged with managers in Vietnam who seem very attuned to global scrutiny of working conditions and understand that employers must be sensitive to cultural sensitivities for outsourced operations to succeed. Investors should pay close attention to these ESG issues as supply chains are reconfigured.

The trade war accelerated the offshoring trend for many Chinese companies. Many textile companies sped up timetables for setting up factories in Vietnam, Cambodia and Indonesia. Interestingly, many US retail brands continue to partner with long-established suppliers, even though the factory locations have now changed, partially to sidestep US tariffs. So for investors to access these cash-flow streams, they're largely buying the same set of Chinese and Taiwanese companies.

Samantha Lau: In the smaller-cap universe where we invest, the semiconductor industry has had an agile supply chain for some time. Even before COVID-19, many suppliers for the post-fabrication process—cutting, bonding and packaging—were already based in Vietnam, Thailand and Mexico. This trend has continued because all component manufacturers are trying to make sure that manufacturing isn't dominated by one country, so that the origin of the product can be more ambiguous to avoid scrutiny. For example, Monolithic Power Systems uses some fabs in the US, but enough steps are done in these other countries so the components can be labeled "Made in Vietnam." Southeast Asia and Mexico will continue to be beneficiaries of this trend.

3. What financial stresses has the economic crisis revealed regarding supply chain risks for companies, and how can investors assess the risks?

Frank Caruso: In some cases, supply chains were revealed to be vulnerable. For example, Arista Networks, a network equipment manufacturer, saw both extended lead times (by two to four weeks) as well as constrained product shipments as a result of COVID-19. In response, the company said it would increase its inventory levels through the end of the year in order to improve lead times and help buffer against future pandemic-related supply chain disruptions.

Companies better positioned were able to mitigate supply chains risks with greater ease. ASML, the semiconductor equipment maker, has been able to pass through higher costs of doing business in this environment to its customers, reflecting pricing power and an oligopolistic industry structure. Texas Instruments has benefited from its large scale, the long shelf life of its products, internal manufacturing and a pristine balance sheet. In mid-2020, the company was able to maintain high utilization in its factories, building "buffer" inventory while its peers cut capacity. As a result, Texas Instruments was able to service better-than-expected orders and picked up market share.

Product flow is definitely a risk. Companies that have relied on steady goods flow (ships, trucks, warehouses) have stumbled. Ironically, fast-turning companies were hit harder in the very short term versus slow-turning companies. There are acute working capital effects resulting from payables and inventories. So during the first couple months of the crisis, they hemorrhaged cash, and as soon as they cut orders, the cash flow partially reversed.

Tawhid Ali: During the early days of the pandemic, investors became particularly sensitive to leverage, worrying about the vulnerability of companies to a revenue slowdown. In order to really assess this risk, we used data science to look at not just our holdings' leverage, but also leverage along the supply chain that could disrupt operations. It provided a quick way to highlight potential risks that might not be obvious.

4. What types of companies and countries are likely to benefit from the changing global supply chain landscape?

Dan Roarty: We see tremendous opportunity for companies that facilitate the localization, diversification and automation of supply chains. For example, providers of factory automation systems and equipment help manufacturers improve productivity, asset utilization, product quality, resource efficiency, waste production and even employee safety. These are many of the most important issues companies will need to consider as they reconfigure supply chains and face potentially increased costs.

"We see tremendous opportunity for companies that facilitate the localization, the diversification and the automation of supply chains."

Dan Roarty
Chief Investment Officer–Thematic and Sustainable Equities

Software providers that facilitate the digitization of manufacturing should also benefit. Core products such as digital engineering design, simulation and product life cycle management software help customers track and reduce the use of unnecessary materials and improve overall resource efficiency. In the intermediate term, China is likely to lose some share of global outsourced manufacturing as many developed market–based companies re-shore or relocate to other Asian or Latin American countries with fewer perceived political and trade issues.

John Lin: COVID-19 made clear to many countries the importance of controlling manufacturing capability of vital industries. From China to Taiwan to the US, governments helped companies set up production lines for surgical masks and PPE. Once the pandemic emergency is over, the push for onshoring or near-shoring of these vital supplies—from masks to vaccines to data centers—is likely to continue. China has long been the "world's factory" and the location for much of the manufacturing capacity for some of these vital goods. Chinese manufacturers, therefore, are likely to lose market share in many categories of these manufactured goods, as countries around the world ignore the higher costs and set up their own production lines.

For China, COVID-19 both heightened geopolitical tensions with the US and highlighted vulnerability of parts of its supply chain—particularly in energy and food companies. China is pressing ahead with initiatives to reduce its dependence on imports in both areas, which could create opportunities for investors in these sectors.

"For China, COVID-19 both heightened geopolitical tension with the US and highlighted vulnerability of parts of its supply chain—particularly in energy and food companies. China is pressing ahead with initiatives to reduce its dependence on imports in both areas."

John Lin
Portfolio Manager, China Equities

5. As companies reconfigure supply chains and manufacturing costs rise accordingly, how should investors evaluate the potential impact on earnings and profitability?

Frank Caruso: I think this depends on the pricing power of the company. For companies that can pass on incremental costs to customers, gross profits would be less affected. In the case of Arista Networks—and looking back at tariffs put in place in 2018—the company was able to at least partially push those increased costs to their customers. As a result, their revenues increased, but gross profits stayed mostly neutral.

One way to evaluate the potential impact on profitability would be to investigate how much of a company's sourcing was already coming from best cost regions. A shift away from these areas would present a potential relative disadvantage versus peers.

Tawhid Ali: Increased inventories are likely to be a feature going forward. During the last few decades, we've seen demand for more efficient supply chains and more efficient working capital for companies. We are seeing companies with higher gross margin products talk about pivoting a bit more from "just in time" to "just in case." All else being equal, costs are likely to go up. However, it's not clear whether margins will come down. Certainly, companies with pricing power will be able to push this through to consumers.

John Lin: For Chinese technology companies, the tech war, with the expressed purpose of disrupting the Chinese technology supply chain, must be watched closely. In the short term, US sanctions against Chinese tech firms such as Huawei are seriously disrupting industries from semiconductors to telecommunication equipment manufacturing. In response, the Chinese government drastically increased state support for Chinese tech firms to increase self-sufficiency of its technology supply chain. Over the long term, the global tech supply chain will probably splinter into two camps—one centered in the US, the other in China. This may reduce capital efficiency; for example, hypothetically, if there are two standards for 6G mobile communications a decade from now, tech firms will likely see a lower ROIC for their R&D investments.

Dan Roarty: While localizing supply chains is likely to result in increased costs for many companies, the ultimate impacts are more than just financial. Globalization allowed companies to reduce their labor costs, but that benefit was often accompanied by environmental degradation and poor working conditions. Investors should broaden the lens through which they evaluate changes to supply chains and consider the longer-term implications for all their stakeholders—not just the shorter-term implications for their shareholders. For many companies, higher short-term costs of relocating manufacturing facilities can reduce brand risk, lower regulatory risk, and improve employee productivity and morale. As these trends unfold, investors have a very important role to play by monitoring how and why companies are relocating their supply chains and engaging with them on ESG issues where necessary.

Samantha Lau: Regardless of COVID-19, the automation and utilization of robotics was already rising due to increased labor costs. This is happening not just in technology but in fast-food industry, transportation, etc. If US companies begin to onshore more manufacturing steps back to the US, this will be the most important trend to monitor. Innovation and automation will be a key characteristic for investment ideas in the next cycle. Companies that invest in solutions, both software and hardware, that can drive efficiency and lower their cost structure will differentiate themselves and deliver better margins than the competition. We want to focus on forward-thinking companies that are committed to making investments to automate and reconfigure their supply chains in order to cope with whatever unique challenges they may face. Staying still is unlikely a winning strategy.

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