

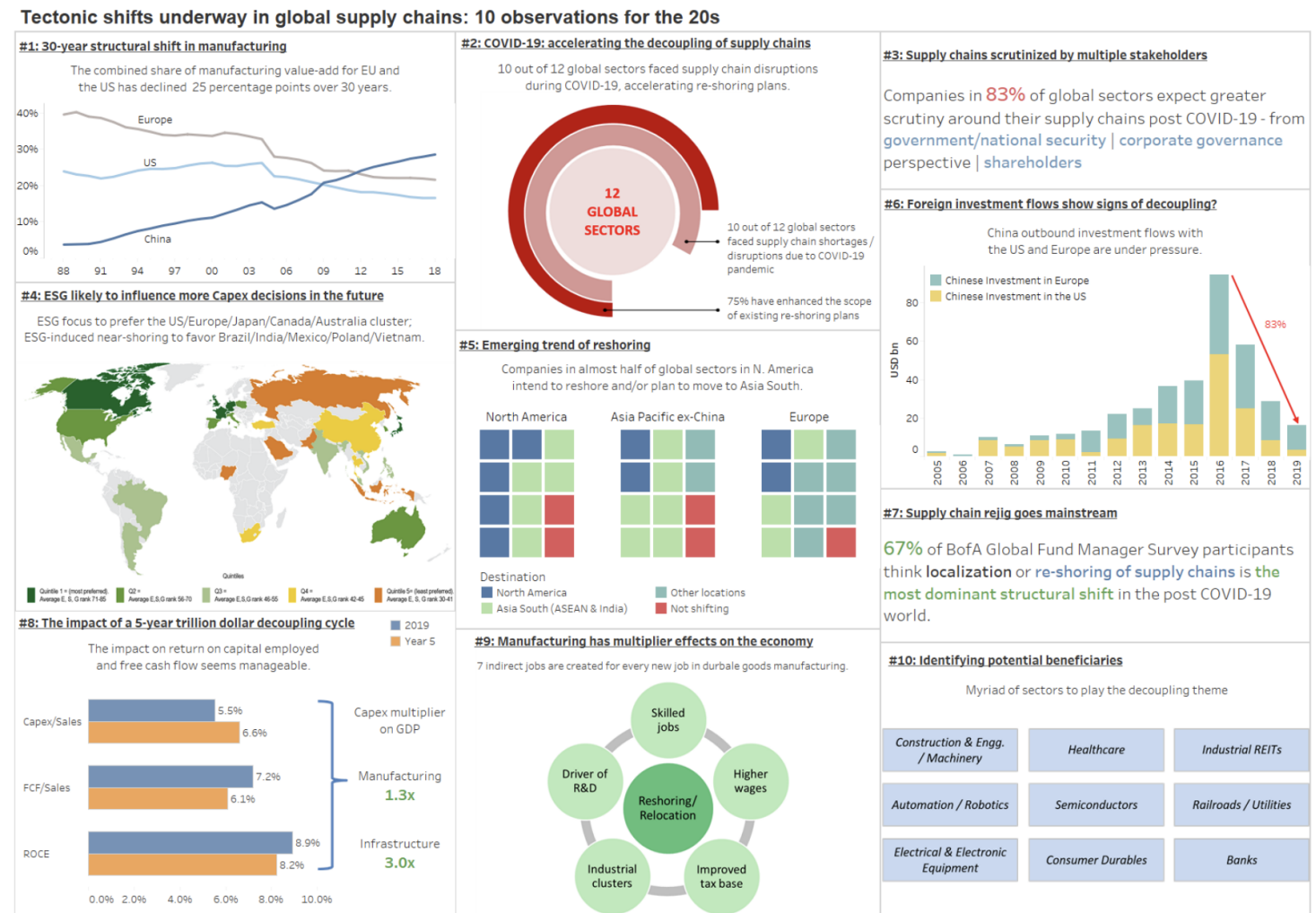


04/04/2021: Slowbalization and Near-Sourcing

For 60 years after World War II we witnessed a steady rise in international trade and revolutionary changes in how products are made and sold. Today, through complex networks of suppliers, a single smart phone or appliance contains parts sourced from many countries.

In the last decade, though, international trade has leveled off, and our new findings suggest that what had seemed a **relentless march toward globalization may now be reversing**. Of course, that doesn't mean that international trade will end. But when you consider that the companies in the 12 global industries we cover **represent \$22 trillion in combined market value, even incremental shifts toward "de-globalization" could have major implications for economies, jobs and consumers...** In some cases, reshoring will mean moving supply chains to nearby developing countries. So **Mexico is likely to benefit from reshoring of U.S. companies, for example.**

Figure 1: Breaking Chains & its Impact



Source: BofA Global Research, UN, Rhodium Group, The China Global Investment Tracker (CGIT) from the American Enterprise Institute, Heritage Foundation, FactSet.

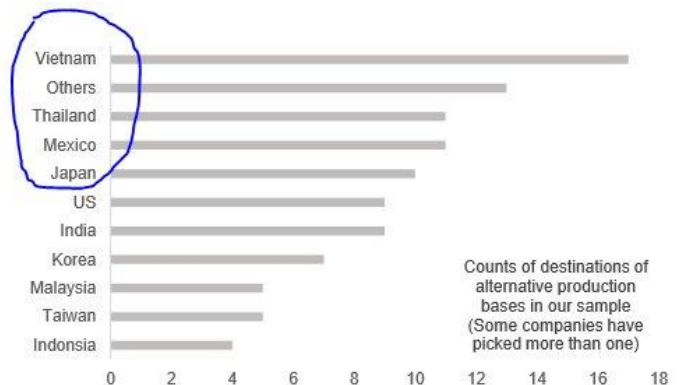
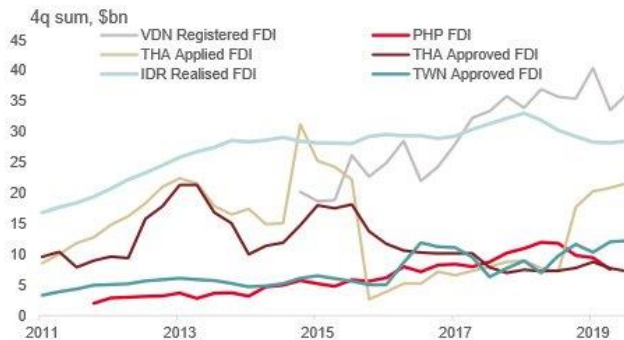


The above is from a BofAML report titled *Tectonic Shifts in Global Supply Chains* (with emphasis by me) that was published in the summer of last year.

The BofAML research team found that more than 80% of companies across 12 industries, from semiconductors to capital goods, were rethinking parts of their supply chains. According to the American Chamber of Commerce as shared in a recent report from Societe Generale, 40% of companies surveyed “said they were considering relocating or had relocated manufacturing facilities outside China.”

RE-SHORING IS ACCELERATING

- European Chamber of Commerce
 - 2/3 of European companies in China unaffected by US tariffs, and will not change their business strategy in China.
 - Only 10% said they have moved or are moving relevant production out of China
- American Chamber of Commerce
 - 40% of respondents said that they were considering relocating or had relocated manufacturing facilities outside China.
 - They favoured SE Asia (25%), followed by Mexico (11%).
 - But only 6% of companies favoured the US.



Source: CEIC, SG Cross Asset Research/Economics

The process of deglobalization, or rather “slowbalization” — a term coined by *The Economist* — is hardly a new phenomenon. In fact, the trend towards increasingly sprawling supply chains peaked roughly 13-years ago. *The Economist* notes that this trend is being driven numerous factors, such as:

The cost of moving goods has stopped falling. Multinational firms have found that global sprawl burns money and that local rivals often eat them alive. Activity is shifting towards services, which are harder to sell across borders: scissors can be exported in 20ft-containers, hair stylists cannot. And Chinese manufacturing has become more self-reliant, so needs to import fewer parts.

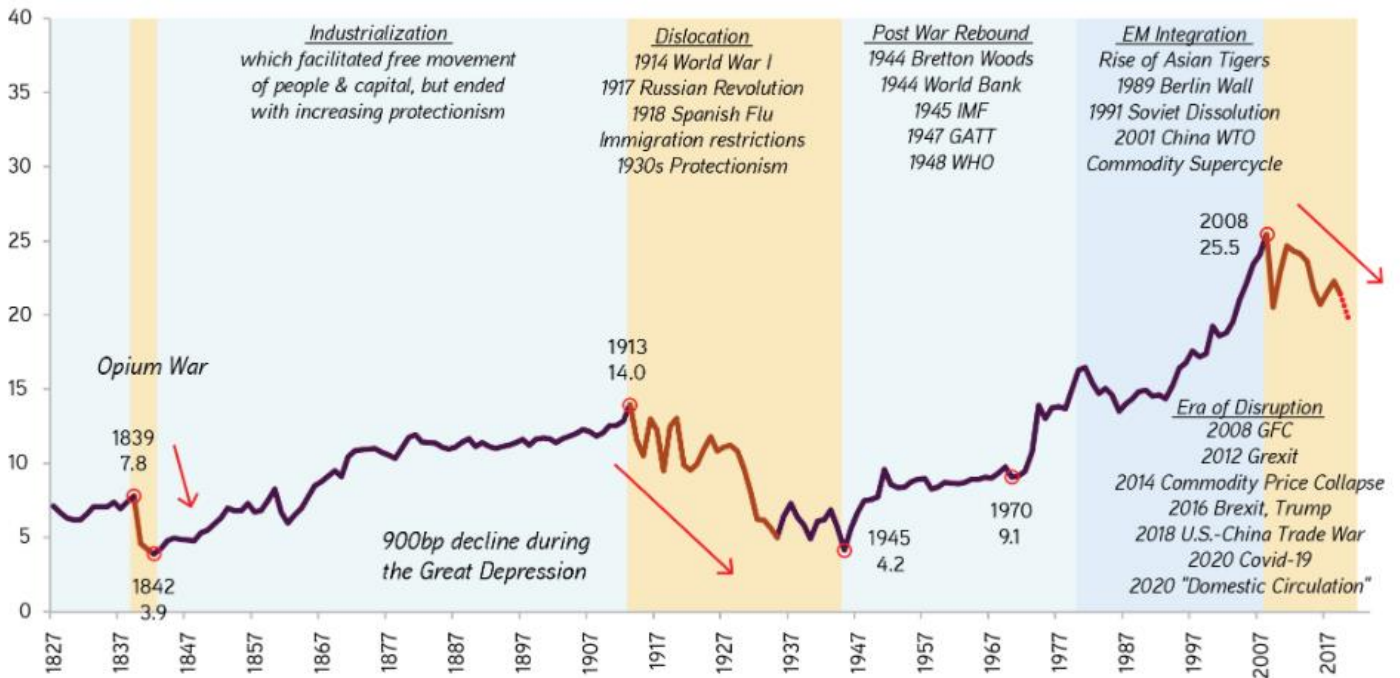


Global trade relative to GDP has been in decline since the Great Recession. We are now firmly on the backside of a 60-year up cycle in global trade growth (chart via [KKR](#)).

EXHIBIT 1

For Decades, Companies Have Built Supply Chains by Taking Advantage of Globalization to Increase Efficiencies

Global Merchandise Exports as a % of Global GDP

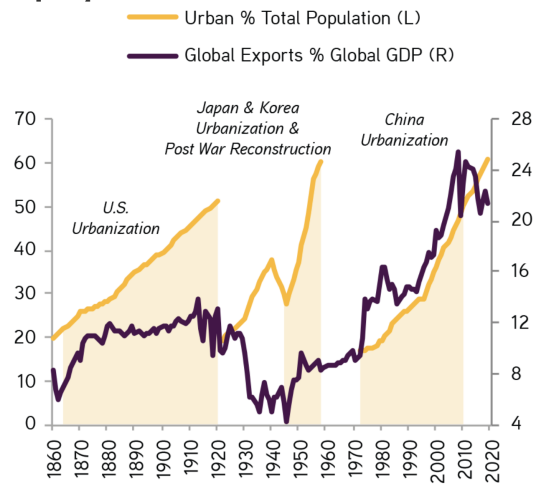


Data as at December 31, 2019. Source: World Bank, United Nations, IMF, OurWorldInData.org, Fouquin and Hugot (CEPII 2016), Haver, KKR Global Macro & Asset Allocation analysis. @MacroOps

Like demographics, these types of cycles have a slow burn to them... I'm reminded of an old quip by C.S. Lewis who said "Isn't it funny how day by day nothing changes, but when you look back, everything is different." Over the next decade, the world will change subtly... then *incredibly fast*.

Trade cycles typically correlate to developing country investment cycles. More earthmovers, steel, and cement, etc... are needed when rapidly developing. Over the last century and a half, we've experienced three major urbanization investment cycles with the US at the turn of the 19th century, Japan reconstruction post-WWII, and China over the last few decades.

Trade Super Cycles Are Tied to Urbanization and Investment Super Cycles



Data as at December 31, 2019. Source: World Bank, United Nations, IMF, OurWorldInData.org, Fouquin and Hugot (CEPII 2016), Haver, KKR Global Macro & Asset Allocation analysis.



We are unlikely to see another one of these anytime soon. KKR notes that “we do not believe any of the large emerging countries have the ability to urbanize as rapidly as the aforementioned countries.” I’d agree.

There’s a number of other reasons to be skeptical of further global integration. One of them being what geopolitical strategist Peter Zeihan calls the end of “the Order”. He wrote a book on the topic titled “[Disunited Nations](#)”. It’s a good, quick read.

The point he makes is that the post-1945 era of peace and prosperity was a historical aberration. It was only made possible by an American-led system of trade and alliances — this being “the Order”. This hegemonic system, supported by the full might of the US Navy, is what provided the security needed for decades of progress in health, education, democracy, and peaceful international relations.

However, Americans are now turning inwards... We’re tired of supplying the blood and money needed to maintain peace and order in far-off lands. We have more than enough problems to occupy us at home. As a result, this uniquely halcyon period has come to an end... Zeihan predicts we are reverting back to our global historical norm. One that will be marked by collapsing markets, escalating conflicts over food and energy, and great-power struggles over maritime supremacy and territorial borders.

As a rational optimist, I hope Zeihan is being a bit too fatalistic. Though admittedly, the historian in me is accepting of this real possibility. It aligns all-too-well with the many other grand cycles at work and which we discussed in “[A Hungry World](#)”. The trend in the data over the last decade also bears this out.

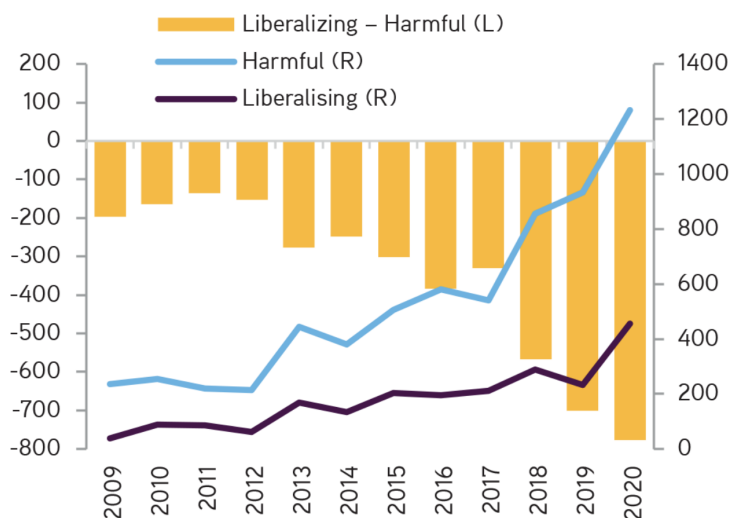
There are other factors at work... such as financial deepening in emerging markets allowing for large scale self-financing for the first time ever. As well as technological advancements in manufacturing — think 3D printing and robotics — that make the diffusion of supply chains and political and economic cooperation across borders, less necessary and even economically disadvantaged in many instances.

So... the world is changing, and it’s changing fast.

EXHIBIT 3

Trade Barriers Are Going Up

New Interventions Affecting Foreign Commerce Per Year



Global Trade Alert provides timely information on state interventions taken since November 2008 that are likely to affect foreign commerce. It includes state interventions affecting trade in goods and services, foreign investment and labor force migration. Data as at October 8, 2020. Source: GlobalTradeAlert.org.



How exactly this new order will look, is anybody's guess. A number of smart people believe we're moving towards a [Tri-polar world](#). One dominated by the regionalization of the global economy, split between the US, China, and Europe. Others argue we're moving towards bipolarity. Where the world will be divvied up into two major spheres of influence between the US and China.

I don't know what the correct take *is* but some sort of reshoring and creation of regional manufacturing / trade spheres seems all-too likely.

That BofAML report that I cited at the beginning lays out some of what this means in the short term.

*...global supply chains are on course to be uprooted and brought home, or **transplanted to strategic allies. Manufacturing is moving back to North America after a hiatus of three decades**, as evident from the number of job vacancies in the US. About 400,000 US factory jobs are unfilled – close to the highest level in nearly two decades – as companies compete for skilled labor in the midst of record-low unemployment.*

The investing implications that will be born from this developing trend are endless. **One favorite of ours is Mexico.**

The American cities of LA, Phoenix, Tucson, El Paso, San Antonio, Austin, Houston, and San Diego, all sit less than 300 miles from the US-Mexican border. This border is connected by excellent infrastructure.

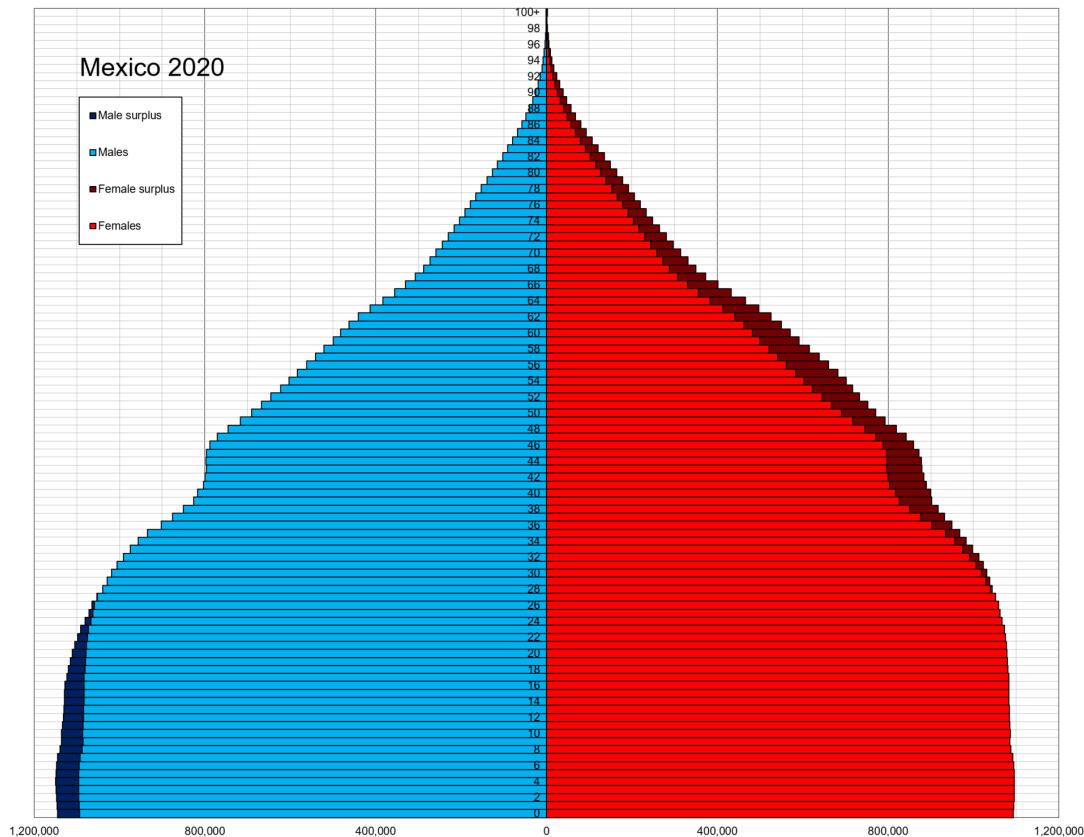
Turning back to the geopol strategist Zeihan who points out that this “existing integration between Mexico and the United States already makes for the world's busiest manufacturing, energy, financial, and passenger transfer border”. This is how Mexico became America's largest trade partner, in 2019 — a title that's unlikely to be supplanted within our lifetimes.

Over the last few decades, Mexico has built itself into the manufacturing powerhouse of Latin America. To quote Zeihan again, “Mexico is the most trade intensive Latin American country by a factor of three, and over 80% of its exports are manufactured goods, with nearly all its products flowing north.

For these reasons, Mexico stands to be a huge beneficiary from the reshoring and regionalization of the American manufacturing base.

They are one of the favored locations for US-based companies looking to move their operations out of China, in a trend that's being called “[near-sourcing](#)”.

Mexico has one of the best demographic profiles of any country in the world, with 28% of its populace under the age of 14.



In constant dollar terms, manufacturing wages are now lower than those in China. As of 2019, the fully burdened direct laborer wage was roughly [\\$3.95 in Mexico versus \\$4.50 per hour in China](#).

Not to mention, the peso is cheap and trade terms between it and the US as ratified under the new USMCA are *extremely* favorable.

This is why we started looking for investments into the country last year and why we really like our current two holdings, Qualitas Controladora (Q) up 5% since purchase and Betterware de Mexico (BWMX) up 21% since purchase.

Another avenue to play the long-term Mexico bull trade is through its currency, which as I noted, is cheap.

It's currently the highest yielding major currency.



And one of the cheapest on a purchasing power parity basis, as measured by the Big Mac and OECD indexes.



From a technical perspective, the peso (MXNUSD) is in a nice recovering bull trend off its COVID bear market lows.



The pair is close to completing an inverted H&S bottom. I'm of the firm belief that this is the start of a major bull trend. Both because the [USD is in a cyclical bear](#) and because of the peso's numerous positive secular drivers.



Mexico has been hamstrung, along with the rest of Latin America, by a third wave of the COVID virus over the last few months. However, the Biden administration is about to [send millions of vaccine doses](#) to both Canada and Mexico — no doubt a sign of the US's commitment to what will become an *ever more important* political and economic partnership between the three neighbors.

We want to be long the peso and Mexican assets. The US is flooding the world with dollars. These dollars are beginning to trickle out of a saturated and richly valued US market into EM assets. This trickle will soon turn to a flood once [US relative market performance begins to wane](#)... Mexico has tailwinds within tailwinds, from its world-leading demographic profile to its strategic location in what will be the new economic order.

The team and I will keep looking for deals in the country. And we'll be taking swings at the currency and building on the position once the bull trend gets going again.

Your Macro Operator,

Alex