Re-examining Supply Chains

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Interviewer 1: Francine Lacqua, Bloomberg Television
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Francine: Now the latest survey says that COVID-19 has turned these tectonic shifts to visible fault lines. And we're delighted to be joined, as you mentioned, by Candace Browning, Head of Global Research at Bank of America Securities. And frankly, when the big guns write research papers, you should sit up and listen. So Candace, thank you so much for joining us on Bloomberg Surveillance. The premise is basically saying that these supply chain shifts are real, that they're tangible, that they will make a big difference. And you also mentioned that there's a $1 trillion cost of re-shoring. Will companies, first of all, be able to afford that?

Candace: Well, yes, companies, we think will be able to afford it. Based on our analysis, we think that the return on capital employed, if you assume a $1 trillion CapEx cycle over a five-year period, we think that the return on capital employed will actually decline by just 0.7%, so not a big number. And if you look at free cash flow to sales, you'd see a decline of about 1.1%. So again, not a huge number. Now, you could argue that perhaps financial markets will look at that decline in profitability, and then they assign lower multiples of stocks going forward. But, on the other hand, if the supply chains are moved back, either to the United States or to other locations, you're going to see less disruptions and less volatility in earnings, and therefore, maybe financial markets will not mark stocks down if this $1 trillion in CapEx is spent.

Francine: Again, why are these supply chains actually shifting? Is it U.S.-China tensions, or is it really just so much pressure from the pandemic? And once you move a supply chain, can it go back to the way it was?

Candace: Yeah, Francine, I think that's really the key question. So when we first wrote this report six months ago, nobody had heard of COVID, and unemployment was near all-time lows. And of course the world has dramatically changed since then. But, even six months ago, companies were talking about moving their supply chains, and there's a lot of reasons for it.

First of all, one of the main reasons that supply chains were moved in the first place is because China was so much of a less expensive alternative. Well, that arbitrage has significantly narrowed. That's a result of wages going up in China, but it's also a function of more automation coming into manufacturing, which has reduced manufacturing costs here in the United States and in other locations. So number one, the cost arbitrage has narrowed.

And then you throw in national security concerns. And then, in addition, you throw in this idea of ESG concerns. So you think about carbon footprints. Well, the average t-shirt actually makes two trips across the Pacific before you purchase it. And the fashion industry has the second-highest CO_2 footprint, just behind oil and gas. So there are environmental concerns, there are social concerns, there are governance concerns. So you've got ESG, you've got this labor cost arbitrage, you've got national security. And then you throw in COVID. And what COVID did is it disrupted 80% of the companies who have global supply chains.

Tom: Yeah, Candace, I think Savita Subramanian has really been industry leading on this. I did some work with her at Davos that I thought was just brilliant on ESG. Candace, I want to get out in front of your next thematic piece, which I'm going to call the digital dominance. I mean, it's absolutely unreal what we're seeing from Target, what we're seeing from Walmart, what we're seeing from Home Depot, and then you've got Amazon is an overlay. How will Bank of America study the persistence of the digital dominance we see in this pandemic?

Candace: Well, I think it's a great question, Tom. And I think it really underlies the point that, yes, we're in a period of profound distress, but out of that is coming some profound opportunities. And this digital disruption is certainly one of them. And I think it's got real legs, and we're going to continue to see it operate in so many different industries. So how are we going to study it? We're going to do it the same way we did it with the supply chain. We cover 3,000 companies. We have more than 500 analysts covering those companies, and we're going to go out to those analysts and survey them.

Tom: As you know, Candace, one of the seminal pieces here, this has got to be 15 years ago, at the time at Credit Suisse was Michael Mauboussin, that there would be few winners within the internet, within the networking space of digital. There would be very few winners. You follow 3,000 companies. Do you assume that in 10 years, you're going to be following 1,500 companies because of digital dominance?

Candace: Actually, that's a very interesting point. And one of the pieces that we put out yesterday actually argued that if there is this re-shoring of supply chains back to the United States and a CapEx cycle begins here, actually the companies that are going to benefit, interestingly, are the smaller companies.

Tom: Interesting.

Candace: Because, and by the way, if you correlate small cap revenues to CapEx, it's a very high correlation. So, look, nobody knows, and there are a lot of risks out there, but I actually think that this digital disruption and CapEx cycle improving in the U.S. could be very good for small companies.

Francine: Candace, does re-shoring automatically lead to higher prices? Is it something that we should be exploring more?

Candace: Francine, I think the answer, you know, it could, I think, is the answer. However, remember the re-shoring's going to be offset by more automation, which is going to be not inflationary. You're also going to have things like tax incentives and probably some subsidies like you saw in Arizona with the TSMC factory being built there. So yes, we are concerned about the fact that prices could be a bit higher, but there are also some offsets.

And the other thing to think about is the fact that if you do move manufacturing back to the United States, each manufacturing job creates somewhere in the area of six to seven other jobs. So this re-shoring could be very good for employment in America.

Francine: Candace, thank you so much for joining us today. Candace Browning there, Head of Global Research at Bank of America Securities.