

Rebuilding Global Supply Chains Post-Pandemic

Interview on CNBC

Recorded August 24, 2020

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Interviewer 1: Mandy Drury, CNBC

Interviewer 2: Sri Jegarajah, CNBC

Mandy: Vikram Sahu is the Head of APAC Research at BofA Securities, and he joins us now from Singapore. Vikram, thank you very much for your time. Look, this is something that was already happening, right? You know, a backlash against globalization was occurring not just because of the U.S.-China trade war, but also costs. Labor costs were getting more expensive in China and it just didn't make a whole lot of sense for multinationals to be using China as the factory of the world. To what degree has COVID-19 sped up that process that was already in the works?

Vikram: So first and foremost, thank you very much for having me on the show. Mandy, you're spot on. We as a firm have been exploring this notion of shifting supply chains for a while and decoupling and that's an effort that's been led by Candace Browning, who is our Global Head of Research. And we've done a lot of work on it at a macro level. And about six months ago, we decided that we were going to drill down to the micro level to get a better sense, a more granular sense of what was actually going on. And I'll cast your mind back, six months ago most people had never heard of COVID. We had unemployment at historic lows and we also had a Trade 1 deal signed with China. And against that backdrop, we surveyed our analysts around the world and we cover something like 3,300 companies. And we got a sense from them for what was happening with supply chains and the findings were actually very simple, but very profound.

In over 90% of instances where you had global supply chains, what our analysts were saying to us was that there was evidence that these supply chains were moving. Now, that in itself is not unusual because supply chains have been moving for three decades now. Well, what was unusual was the direction. So at the time, what our analysts were saying to us is that chains were moving to the usual suspects in places like Southeast Asia. And that would be, because of your point, around the cost arbitrage in China becoming a little narrower than it used to be. But what was very interesting was that the North American companies, the direction of the chains moving was westward. So companies were talking about reallocating supply chains to North America.

Now, I want to emphasize over here, while this was a trend that seemed to be quite broad, it was only a millimeter thick because at the time, what companies appeared to be doing was keeping the bulk of their supply chain still intact in China, not messing with that, but putting down pilots in other jurisdictions. And at the time, what we thought was that the velocity of future change would be determined by the success or failure of these pilots.

Mandy: Okay, so where does this leave China, though? How is China going to be able to offset global supply chains shifting out of their country?

Vikram: Great question. Two points, though, six months later, what we found is that companies are telling us that the scale of these pilots are being expanded. So, COVID, as you said, has seemed to accelerate the shift. Now, coming to your point about China, the scope and scale of what we think is happening over years is roughly about a trillion dollars' worth of revenues that are manufactured by global companies in China for global markets. So that is the amount that we think is going to be moving out of China over time. That equates to roughly about 7% of China's GDP. So what China's going to be faced with is the challenge of trying to offset that. And we believe that is going to happen in a couple of ways. One is, again, the effort to stimulate domestic consumption as well as overseas investment through vehicles like One Belt One Road.

The other point I would like to make is that this isn't all doom and gloom. We've done some work that shows that when you have great power rivalries, what you actually have is improvements to productivity. You have improvements to nominal GDP. And to put it in another way, if you're playing tennis, you improve your game by playing against somebody who is better than you. So we actually think that this dynamic of decoupling could have productivity increases both for the U.S. as well as for China.

Sri: Vikram, if supply chains are being redistributed and if it is starting to look structural, then this is inevitably going to mean higher costs for us, the consumers. The companies who are doing this, I mean, do they have the pricing power to pass on those higher costs to us as the consumers, or are they going to be forced to absorb it?

Vikram: So that's a fabulous question, and then that comes back to the point that Mandy made earlier about the costs being not as high as you might think. Now, a trillion dollars sounds like a lot of money, and it is. But at the end of that five-year period, what you would have as a consequence of that incremental spend is ROCEs for companies dropping by 70 basis points. It would drop from, we calculate, about 8.9 percentage points down to 8.2 percentage points. So that means that you'd have to absorb that, but it's not as much as you might think. Now, coming to your point about being able to transfer it on to customers, we aren't even talking about the offsets that you would have to those higher costs by things like automation, by tax breaks, by government subsidies, all of which are being announced by jurisdictions around the world. So, again, it may not be as much as you think. And then finally, in terms of passing it on, I think it's going to be possible in some sectors and not in others, which is why I think what you're likely to see is a bifurcation of where these supply chains head. If you are in a low return industry, the probability is you're going to try to move your supply chains to places in South Asia, whether it's Vietnam or India. And if you're a high market industry, it's back to North America.

Sri: The perfect segue into my next question, Vikram. The whole re-shoring discussion has become very politicized in the current environment. And I'm just curious, if President Trump has managed to get these commitments from TSMC, et cetera, to invest in manufacturing capacity in the U.S., to what degree is that purely symbolic or is it really going to be transformative from a diversification point of view?

Virkam: We think it's transformative and we think these are tectonic shifts that are taking place. Now, it may well be that orbit has accelerated it, it may well be that a change in administration means that the pace might slow down, but we think it is structural and we think it is long term and will play out. The reason for this is because we're shifting, we think, from shareholder capitalism, where you were maximizing the returns for shareholders to stakeholder capitalism, where you're trying to solve for the interests of multiple stakeholders, and that includes consumers, your employees, the state, as well as shareholders. And we think that will prevail.

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