PICTET WEALTH MANAGEMENT

Regionalisation of supply-chain network

Prioritising resilience over costs may benefit new industrial hubs

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FLASH NOTE

SUMMARY

- The covid pandemic likely accelerated the restructuring of global supply-chains, with companies shifting to a more regionalised sourcing model to prioritise agility and resilience.
- Supply-chain migration from China to the ASEAN economies continues to gather momentum on the back of strong flows of foreign direct investment. While the region as a whole has improved its manufacturing capabilities, certain countries and industries have likely benefitted more than others.
- Looking forward, the demand for new production sites may imply higher capital expenditure in the host countries/regions. Emerging industrial hubs, including ASEAN, India and Mexico, may also see a rise in their market share of global exports, particularly for some labour-intensive products.
- That said, China will likely remain a global manufacturing powerhouse while moving up the industrial value chain. Economic bonds between Asian countries will likely be strengthened by the signing of the Regional Comprehensive Economic Partnership (RCEP) in 2022, which could also lead to stronger complimentary trade relationships between China and the ASEAN economies in the years ahead.

FROM GLOBALISATION TO REGIONALISATION

A global supply-chain network has grown evolved in recent decades to deliver goods and services at the least cost. But this has come at a price that has been not fully appreciated by most people until very recently. In other words, the network as it has developed has proved to be fragile in nature and to lack the flexibility and visibility to deal with disruptions and manipulation.

In particular, the covid pandemic revealed the risks of a globalised supply-chain system focused on low costs that depends heavily on Asian (especially Chinese)

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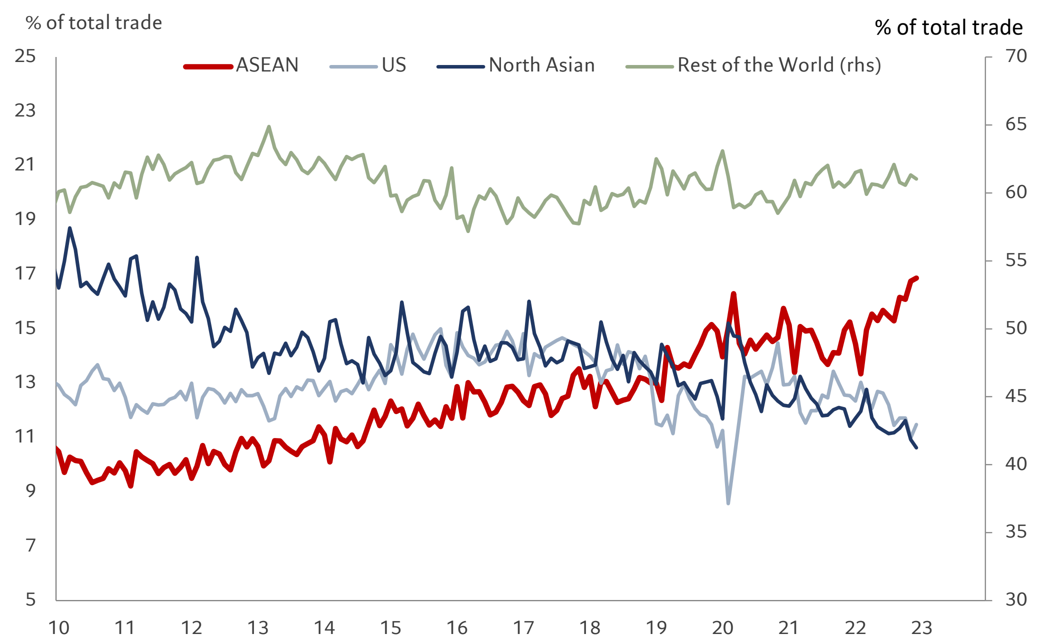
manufacturers. The stringent covid controls adopted by China (especially in 2022) added to the tremendous supply-chain pressure and uncertainties caused by the pandemic. According to a flash survey carried out by the German Chamber of Commerce in China during the full lockdown of Shanghai in April 2022, 46% of German companies' supply chains were "completely disrupted or severely impacted by the COVID-19 situation in China." On the geopolitical front, heightened tensions between the US and China have also increased the incentives for firms to reduce their dependence on China and to distribute production across multiple suppliers and regions.

Consequently, the trend toward supply-chain regionalisation—a process that involves reorganising manufacturing into smaller, more localised blocks, has likely accelerated. The shift to a more regionalised sourcing model has been underway for some time, particularly in the ASEAN economies, whose trade exposure to China climbed steadily from 10% in 2012 to 16% in 2022 *(Chart 1)*. In our view, this process will likely pick up speed and broaden to other regions going forward, including the Americas and Europe. By diversifying their supply-chain networks so that they are less China focused, multi-national corporations (MNCs) hope to build resilience and to hedge against future shocks, including those caused by geopolitical tensions.

Chart 1: Shares of total trade done with China



Source: Pictet Wealth Management, Wind, Bloomberg Finance L.P. as of 13.06.2023

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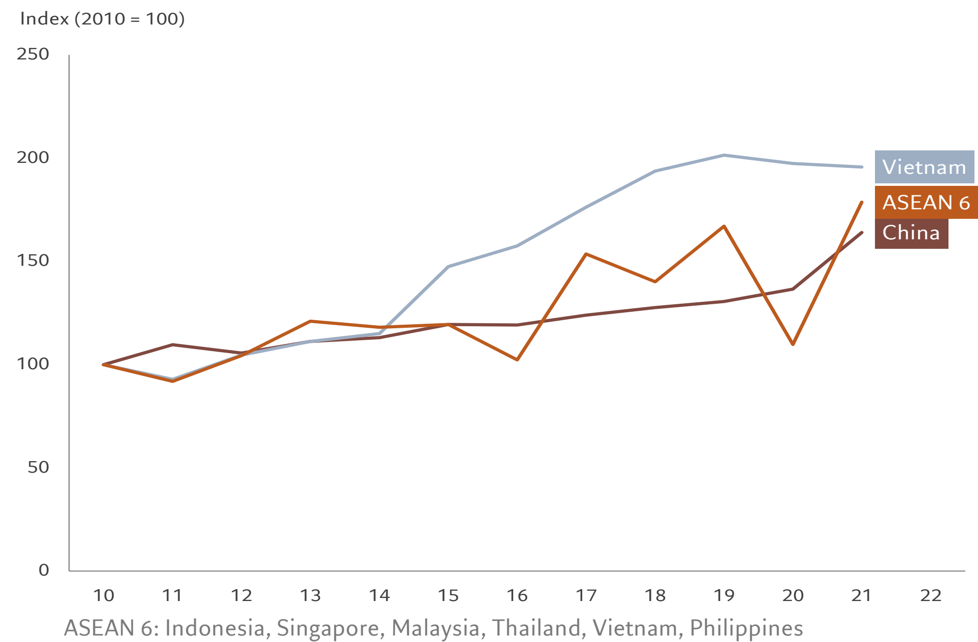
SUPPLY-CHAIN MIGRATION CONTINUES TO UNFOLD IN ASIA

Supply-chain migration to the ASEAN economies continues to gather momentum on the back of strong flows of foreign direct investment (FDI) into the region *(chart 2)*. Some significant examples include Apple's moving production of its MacBooks from China to Vietnam, and Intel's setting up chip factories in Malaysia. In the decade 2011-2021, the six major ASEAN countries' exports grew by 41%, much higher than global export growth of 22%. While the region has as a whole improved its manufacturing capabilities, certain countries and industries have grown disproportionately.

Chart 2: Foreign direct investment into ASEAN, Vietnam and China (index-based)



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Vietnam

We believe Vietnam could be one of the top beneficiaries of the relocation trend. The country is located conveniently between China and other southeast Asian countries and has a large and relatively low-cost and skilled workforce. Vietnamese exports have grown a remarkable 219% in the past 10 years, led by labour-intensive industries (including textile, garments and footwear) as well as the machinery and electronics sectors. Heavy government investment in infrastructure to stay competitive has contributed to the strong growth in fixed-asset investment in the past decade *(chart 3)*. In 2020, the country launched the USD300 mn 'Vietnam SuperPort' project in an effort to drive down its relatively high logistical costs and to strengthen supply-chain connectivity to the rest of the ASEAN region. Upon expected completion in 2025, this world-class logistics hub will provide multimodal connectivity to manufacturers by air, sea, rail, and road. There will also be an on-site supply chain and logistics academy in the Vietnam SuperPort to train and develop talents to ensure sustained improvement.

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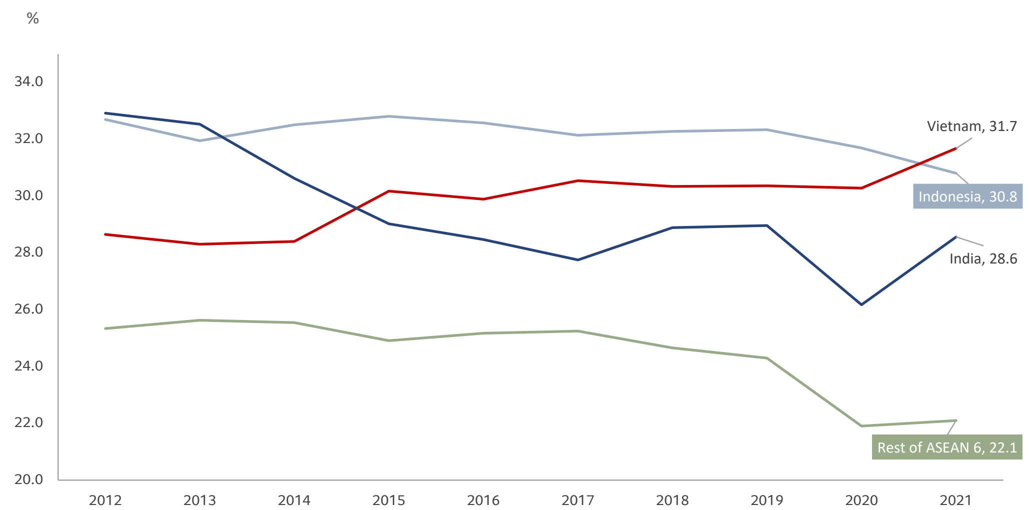
Chart 3: Fixed-asset investment as a percentage of GDP of major Asian economies



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Indonesia

Indonesia, the largest economy in the ASEAN region, and the fourth-largest country in the world by population (282 million), has been stepping up its strategy to extract economic benefits from its rich natural resources as the global energy transition gathers pace. In 2014, the Indonesian government banned exports of nickel ore in order to encourage domestic production of processed metals. It seems this strategy has worked. According to the World Bank, Indonesian exports of ferronickel (an i alloy of nickel and iron) increased from 68.2 million kg in 2013 to 3.5 billion kg in 2021 *(Chart 4),* accounting for 80% of total global exports. The Indonesian government plans to follow the same strategy for copper and a number of other raw materials such as bauxite, cobalt and tin. Looking forward, with these industrial policies in place, Indonesia may be able to unleash its potential and greatly increase its industrial footprint, particularly in the commodity and refining industries.

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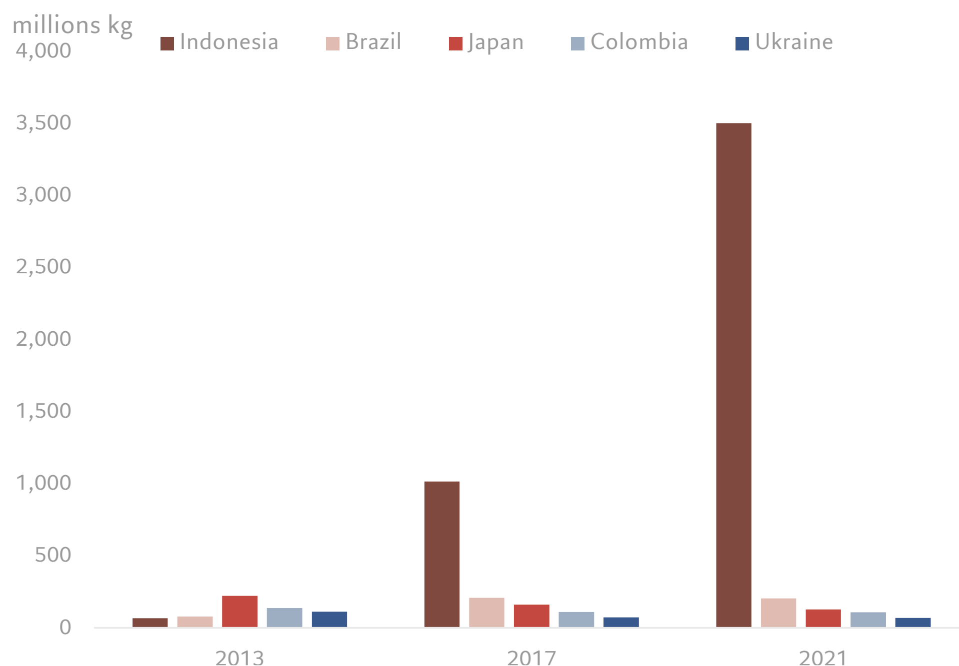
Chart 4: Major exporters of ferro-nickel



Source: Pictet Wealth Management, World Bank, as of 13.06.2023

Thailand

Thailand has successfully developed into the leading producer of motor vehicles in South-East Asia, with production expanding by 18% in 2021 alone. The country could also become a major producer of electric vehicles (EVs). In 2022, the top three Japanese automakers (Toyota, Honda and Nissan) and AutoAlliance (a joint venture between Ford and Mazda) announced that they would start manufacturing EVs in Thailand. Under the country's 30:30 electrification policy, Thailand wants at least 30% of all new vehicles produced in the country to be zero-emission vehicles by 2030. In addition, the government aims to have 12,000 charging points available by 2030, up from approximately 1,000 in early 2022. Government incentives will likely encourage global auto manufacturers (particularly US and Japanese ones) to further expand their production base in the country.

Malaysia

Malaysia has established a strong footprint in the electrical and electronics (E&E) industry, which has been contributing significantly to Malaysia's industrial growth, investments and employment. In 2021, foreign investment in E&E was worth RM146.3 bn, representing around 70% of the country's total annual FDI. In 2022, E&E products represented 38.3% of Malaysia's total exports, up from 32.9% in 2012 *(Chart 5a)*. In fact, the government has set a target under the 12thMalaysia Plan (12MP) for the E&E industry to contribute RM120 bn to Malaysia's GDP in 2025, up from RM86.1 bn in 2020 (+39.4%). Looking forward, the industry is therefore set to continue to play a vital role in the country's economic development.

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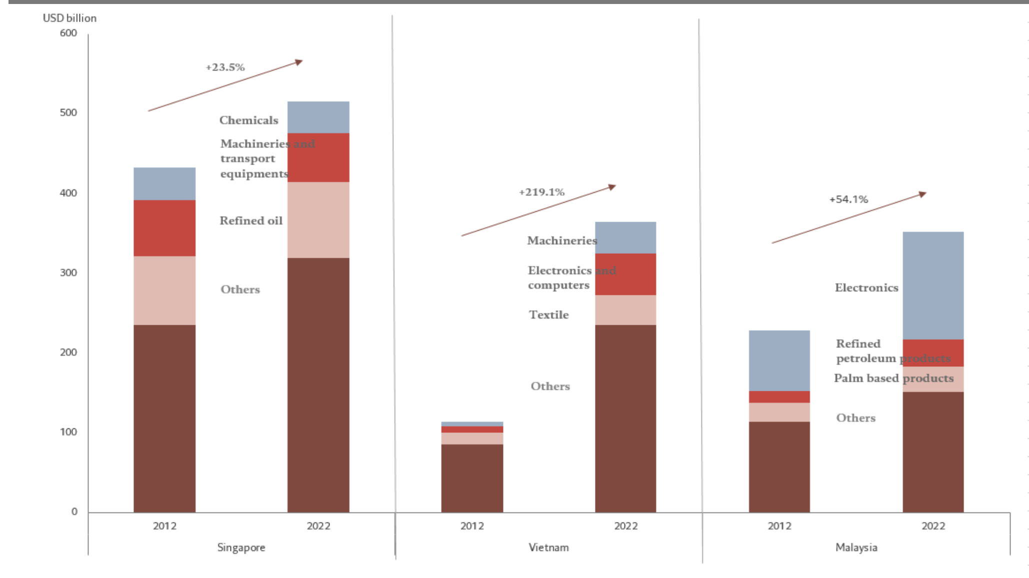
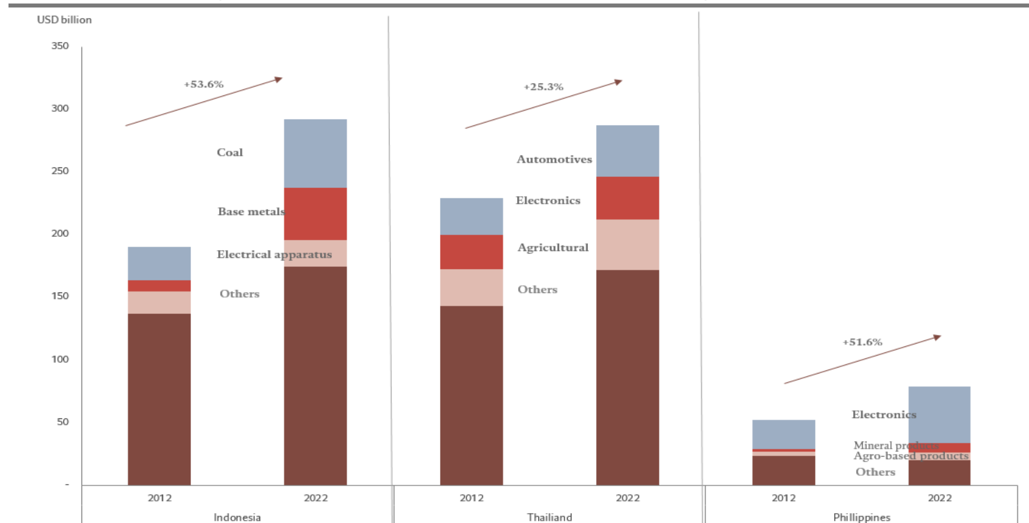
Chart 5a: Export growth of the ASEAN 6 economies (total and major categories)



Source: Pictet Wealth Management, Wind, Bloomberg Finance L.P. as of 13.06.2023

Chart 5b: Expors growth of ASEAN 6 (total and major categories)



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India

Looking beyond the ASEAN economies, the need for many MNCs to diversify supply chains away from China could also benefit India, especially in the current context of US-China de-coupling. For example, Apple has accelerated its iPhone production shift to India and has required its Chinese suppliers to set up local factories in that country. That said, efforts to transform India into a major manufacturing hub are at an early stage given numerous hurdles, including underdeveloped infrastructure and regulations that are unfriendly to foreign investors.

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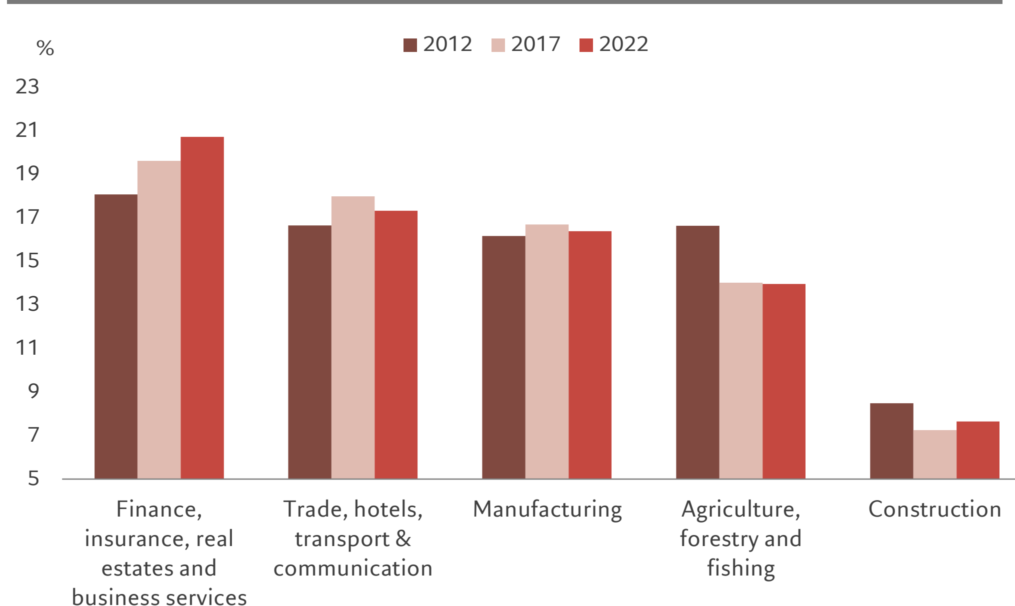
Manufacturing's contribution to Indian real GDP (at constant 2011-2012 prices) has remained stagnant at around 16% for the past decade, whereas services' increased to 38% in 2022 from 34% in 2012 *(Chart 6)*. In an effort to boost the manufacturing sector and reduce imports, in 2020 the government introduced the Production-Linked Incentive (PLI) Scheme to give companies incentives to sell products manufactured in India. The scheme, now rolled out to around 14 sectors, is set to last until FY 2025-26. It has achieved notable progress already in some industries, including electronics and pharmaceuticals. For example, the annual trade deficit in telecom instruments plunged to USD3.5 bn in fiscal year (FY) 23 from USD21 bn in FY18, while the two-year compound annual growth rate (CAGR) of Indian mobile phone exports stands at around 90%. Simultaneously, the India government has been trying to catch up in infrastructure by significantly increasing its related capital spending in recent years. In India's federal budget for the current fiscal year (2023-24), capital spending will increase by 37% from last year and will be three times higher than in 2019.

Chart 6: Sector contribution to Indian real GDP (constant 2011-2012 prices)



Source: Pictet Wealth Management, Bloomberg Finance L.P. as of 13.06.2023

In addition, India has demographic advantages over China and its peer competitors. As the world's most populous country, it has a vast domestic market and an abundant labour force whose median age is about 10 years lower than China's. India has huge room for future growth as its per-capita income is only about one fifth of China's. All these factors will likely provide structural tailwinds for India's industrial and exports growth and could help it benefit from supply-chain relocation in the coming years.

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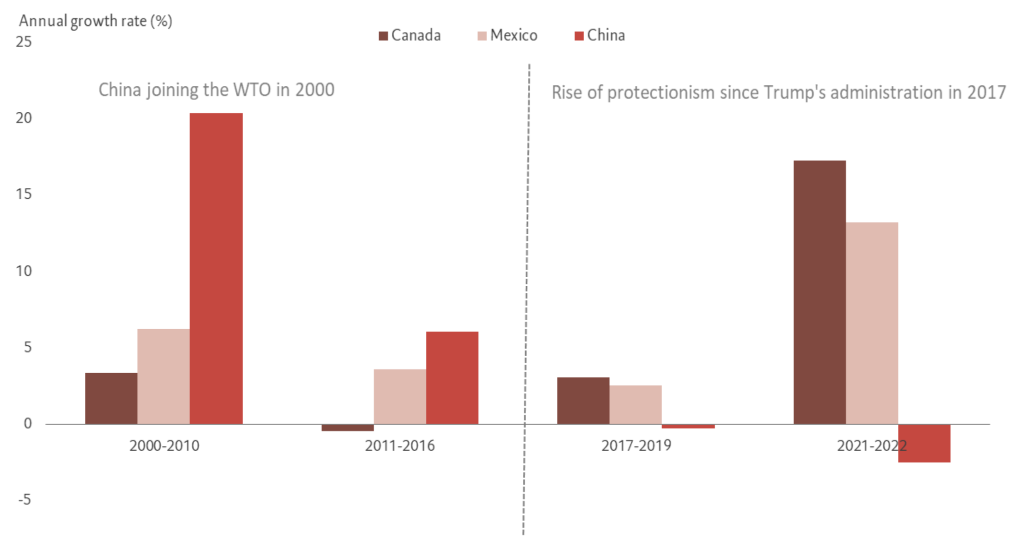
"NEAR-SHORING" PICKS UP STEAM

Another supply-chain trend called 'near-shoring' involves moving production closer to one's home market if outright 'reshoring' proves to be too expensive or unfeasible. Near-shoring continues to gather steam amid heightened geopolitical tensions. Indeed, despite the surge in demand for tech products during the pandemic, most of them made in China, US's average monthly imports from China in 2019-2022 were 7.9% below the average in 2017-18. In contrast, during the same period, US's average imports from Canada rose by 12.0% and from Mexico by 15.7%.

Data suggest that near-shoring for some US-based companies started under the Trump administration, even before the pandemic *(Chart 7)*. In recent years, the Biden administration has introduced a number of funding and tax-incentive schemes—including the Chips and Science Act, the Inflation Reduction Act and the Build Back Better Infrastructure Bill—that encourage US manufacturers to move production back to the US. These incentives could also benefit alternative production sites in the Americas. Specifically, four sectors—high-capacity batteries, semiconductors, critical minerals and materials, and pharmaceutical APIs—are on the US government's priority list for improving supply-chain resiliency, as outlined in a 2021 report.

Chart 7: Annual growth of US total trade with its major trading partners



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From a business perspective, by moving production closer to their0 home market, US corporates may lower shipping costs significantly and better supervise production quality. In particular, Mexico, which has a total population of 127 million with a median age of 29 and lower labour costs than China, could support large-scale manufacturing *(Chart 8)*.

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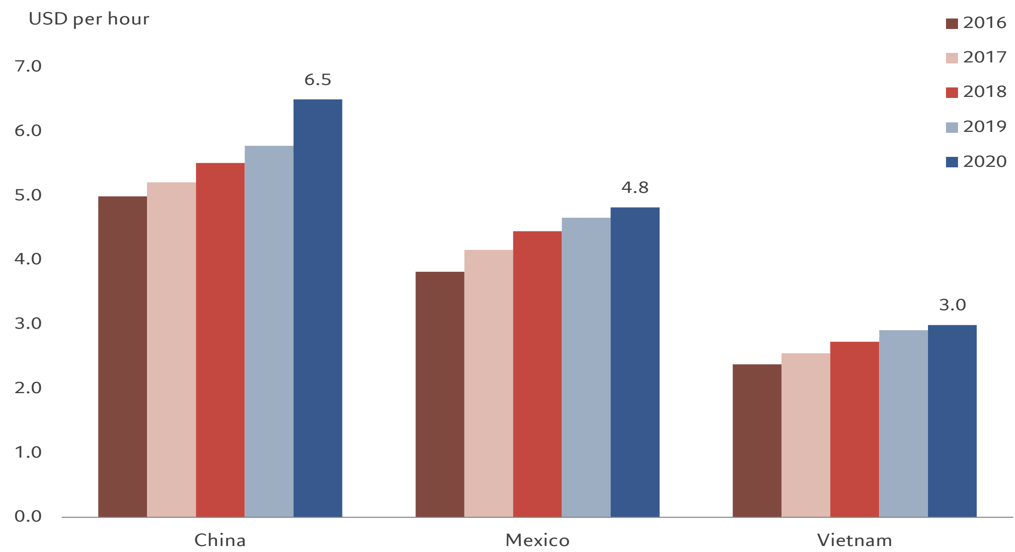
Chart 8: Manufacturing labour costs in China, Mexico and Vietnam (2016-2020)



Source: Pictet Wealth Management, Statista as of 13.06.2023

OUTLOOK FOR SUPPLY-CHAIN RELOCATION

Looking forward, supply-chain regionalisation will likely continue to gather momentum. To the extent their focus shifts from cost optimisation to building supply-chain resilience, companies may see an increasing need to relocate their production facilities. This may imply sustained inflows of FDI and increased corporate capital spending in the destination countries. For example, Korea's Samsung, the largest global memory chip maker, has lately pledged to invest USD228 bn in a new semiconductor complex in its home country in the years up to 2042. In our view, FDI inflows into Asia will continue to be stronger than for the other two major economic regions (Europe and the Americas), as they have been in the past decade *(Chart 9)*.

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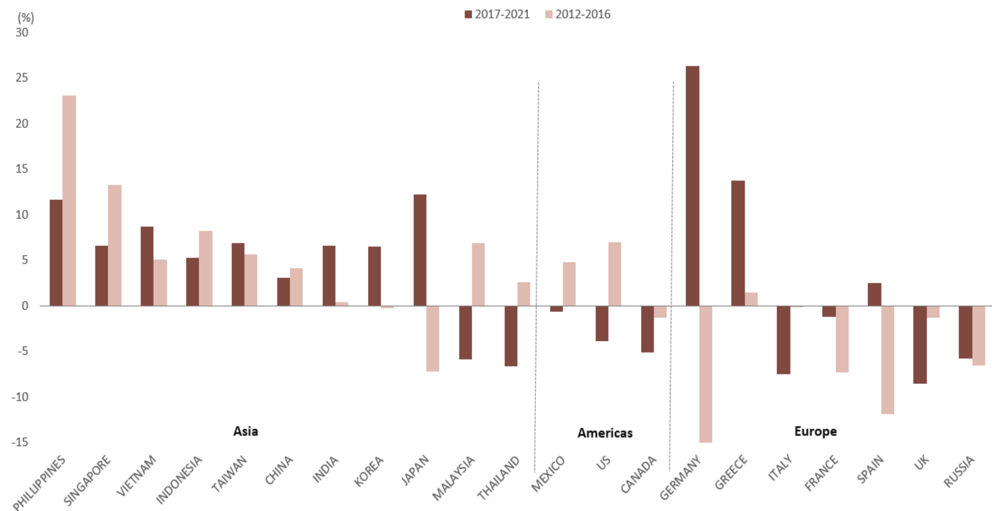
Chart 9: Annualised growth of FDI over the past five-year cycles



Source: Pictet Wealth Management, Wind as of 13.06.2023

Emerging industrial hubs, including ASEAN, India and Mexico, may see a gain in their market shares of global exports—particularly in labour-intensive sectors as corporates seek to diversify production capacities under "China Plus One" strategies.

That said, reducing dependence on China is easier said than done, especially for industries that rely heavily on technologically advanced inputs (including high-density interconnect circuit boards, precision castings, quality synthetic fabrics and so on), where China has an edge as it moves up the value chain.

Building new industrial ecosystems and supplier infrastructures comparable to what China has to offer will take enormous amounts of time and capital. Furthermore, China's vast and growing consumer market will likely encourage businesses to maintain or even to grow their presence there. As a result, China will likely remain a top global manufacturing powerhouse, with some of the more labour-intensive industries being replaced by higher value-added sectors.

It is also worth noting that, despite ongoing supply-chain relocation, the complimentary trade relationship between China and the ASEAN economies may tighten further *(Chart 10).* The establishment of the Regional Comprehensive Economic Partnership (RCEP) in January 2022 could be an additional catalyst in this process. Accounting for one-third of global GDP and trade, the RCEP has been hailed as the world's largest free-trade agreement and is expected to enhance Asia's regional economic integration by improving the overall business environment, harmonising tariffs and coordinating efforts to attract more foreign direct investment in the years to come.

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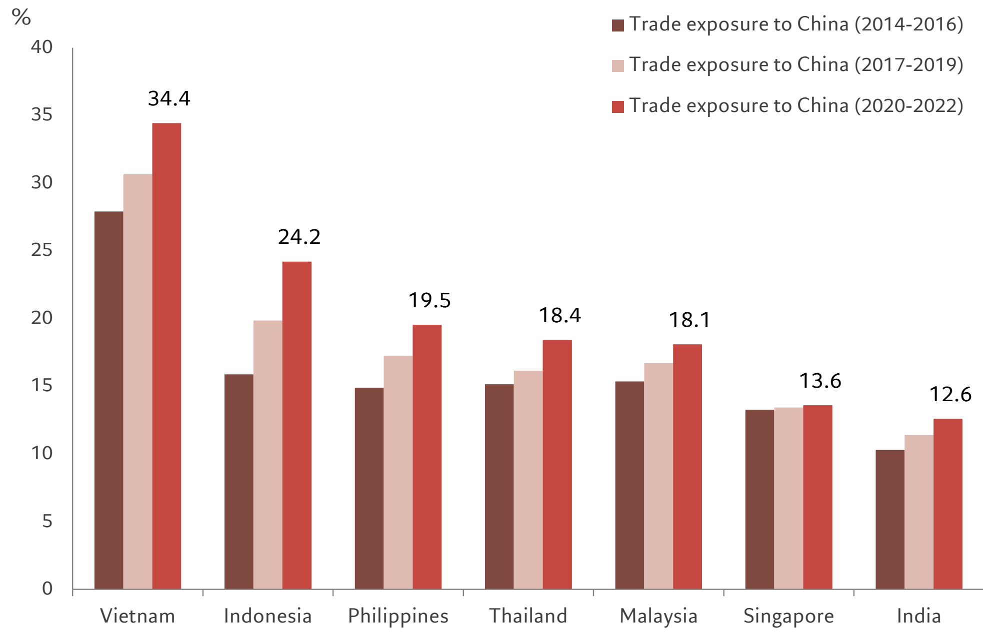
Chart 10: Selected Asian economies' trade exposure to China



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