
Shifting global trade patterns bring new opportunities

Rob Lovelace & David Polak | Capital Group | 18 August 2017

What will global trade and commerce look like in the coming years, and how will it influence the investment landscape? It is a question that has been at the forefront of investors' minds as a new administration in the US seeks to renegotiate relationships with key economic partners and establish what it views as more equitable terms of trade. In Britain, too, the government will work towards new or modified tariff and trade regimes that can preserve its commercial ties with Europe even as it seeks a new national identity independent of the European Union.

The rhetoric of trade negotiations can often seem abrasive as participants on all sides try to extract maximum benefits. Yet what unfolds in the political arena over the next few months or years may not be that different.

This paper examines the shift in the world order and its impact on global trade. It also argues that the advancement in technologies and how they continue to reshape industries will determine the future of global business as much as political negotiations.

CONTOURS OF GLOBAL TRADE ARE UNDERGOING PROFOUND CHANGE

In many ways, the contours of international commerce have already undergone a profound transformation over the past two decades (Figure 1). If the 20th century was defined by a phenomenal rise in the transfer of goods and industrial commodities, the 21st century is being characterised by the rapid digitisation of services and the increasing automation of manufacturing. Automation is rapidly changing the economics of labour and will affect trade patterns in significant ways. Already, many companies are moving production lines closer to end markets.

China's rise as an economic power and its major influence on global growth is another important aspect of the shift in the world order. The US and China have economic and financial interdependencies that are deep and complex, and will likely lead to terms of trade that are ultimately accommodating and beneficial for all parties. While negotiations of this type are by their nature unpredictable, the outcomes need not be extremely positive or negative for one side or the other. The next few sections discuss each of these issues in greater detail.

Figure 1: The changing shape of global trade

From	To
Predominantly flow of physical goods	Increasing flow of data and information
Industrial and consumer-oriented companies	Global companies of the knowledge economy
Build-out of transportation infrastructure	Focus on digital infrastructure
Labour economics drive decisions	Automation reduces importance of labour costs
Western economies dominate trade	China a major force in global trade
Production lines closer to cheap labour	Production lines closer to end markets

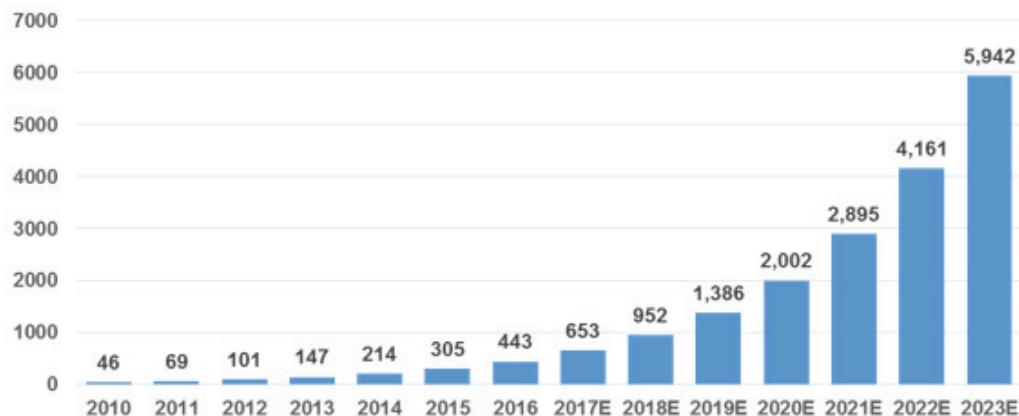
Source: Capital Group.

THE DIGITAL TRANSFORMATION KNOWS FEW BOUNDARIES

The very notion of a global company has evolved over the past two decades. There are the old-line multinational behemoths dominant in commodities, heavy industrials and consumer products. But there is also an entire generation of new global companies that have emerged over the past two decades that are giants in the digital economy. Alphabet (Google), Amazon and Priceline are among the most prominent examples.

Many parts of the digital economy are not captured in traditional metrics of international trade and gross domestic product growth. Similarly, many aspects of the digital economy cannot be easily dictated by trade agreements or tariff regimes. As an indicator of the expansion in this area, cross-border digital traffic has grown 40 times larger since 2007.¹ Figure 2 shows that data traffic is projected to grow by another 13 times in the next seven years as digital trade progresses. The impact of trade renegotiations is likely to be more severe for manufacturers than these companies.

Figure 2: Global cross-border bandwidth (terabits per second)



Sources: TeleGeography, Global Bandwidth Forecast Service.

Digital platforms are also changing the economics of doing business across borders, bringing down the cost of transactions. Enterprise software solutions and cloud computing are enabling firms to innovate new products and solutions in multiple locations, with faster speed to market. Small- and medium-sized businesses have been able to gain global access by using digital platforms such as Amazon, eBay, Facebook and Alibaba to connect with customers and suppliers in other countries.

As their size grows, issues related to digital commerce and intellectual property are gaining prominence in trade agreements. Similarly, regulators are seeking greater purview over issues of privacy, location of servers and access to online information and services. These issues will continue to get attention as digitisation of ideas, information and commerce increases.

SUPPLY CHAINS ARE ENTRENCHED AND NOT EASILY UPROOTED

Supply chains today are deeply entrenched across the globe and will not be easily uprooted. Take Apple as an example (Figure 3). Its supply chain spans 30 countries, and it uses that to its advantage, sourcing suppliers that can turn out parts in the most cost-effective way while still adhering to the company's quality requirements. Apple's strategy is motivated by the need to scale and manage supply chain risk rather than just cost. The company could further diversify its sourcing across countries to be closer to end markets, including bringing some production to the US.

Figure 3: Apple's supply chain spans the globe

Fabrication units per country					
China	351	Malaysia	21	Germany	10
Japan	127	Philippines	20	Mexico	8
US	74	Vietnam	20	UK	6
Taiwan	44	Thailand	16	Indonesia	5
South Korea	29	Singapore	11	Brazil	5

Source: Apple.

Moreover, as supply chains have become global, companies have gained specialisation and scalability that is difficult if not impossible to replicate. For instance, Taiwan Semiconductor Manufacturing (TSMC) dominates certain areas of the computer chip market that are nearly impossible to recreate in design or scale. Similarly, Broadcom dominates the market for smartphone chips. Visa and MasterCard control the credit card payment system nearly worldwide. Three companies — Novartis, Amgen and Roche — account for half of the global sales of cancer drugs. Given their dominance in their respective industries, these companies can be considered global champions.

In some industries, companies are willing to absorb higher costs because the long-term benefits of operating in certain locations outweigh the near-term burden. Caterpillar, General Motors and Ford are just a few of the large US companies that have said they remain committed to restructuring plans that involve moving production to Mexico, which has established itself as a premier auto and auto parts manufacturing centre over the years. About 90 of the world's top 100 auto parts makers have production operations in the country. The facilities are concentrated in five Mexican states, reducing transportation costs. Mexico also has free trade agreements with countries across the world that give it access to most major markets.

CHINA HAS EXTRAORDINARY INFLUENCE ON TRADE AND COMPANIES' GROWTH PROSPECTS

China's rise as an economic power over the past two decades continues to have a profound impact on global trade. Its role as the world's largest manufacturer of all kinds of goods is well-known. Its rapid urbanisation has created a boom in the property market. As a result, it has an outsized influence on the commodities cycle.

Over the past decade, China has also become the largest growth market in the world for a vast array of industries, ranging from robotics and autos to aeroplanes and smartphones. In 2015, it accounted for 27% of global sales of robotics, 30% of elevators, 32% of autos and

16% of Boeing's aircraft. It is the fastest-growing market for Starbucks, which operates 2,500 stores in the country. Despite a deceleration in economic growth, China remains the most important driver of revenue and earnings growth for many companies around the world (Figure 4).

Figure 4: Firms with exposure to China have outpaced broader markets and China-domiciled firms

At 21 March 2017



Sources: MSCI, RIMES. Note: MSCI has not approved, reviewed or produced this report, makes no express or implied warranties or representations and is not liable whatsoever for any data in the report. You may not redistribute the MSCI data or use it as a basis for other indices or investment products. Past results are not a guarantee of future results.

To calibrate the success of the global efforts of many companies, it is critical to understand their China strategy. Substantial resources should be dedicated to that effort, both on the ground in China and around the world.

Trade negotiations between China and the US will be important to monitor. China's relationships with the US are multidimensional and deep, with many mutual interdependencies. The US trade deficit with China was US\$347 billion in 2016, with exports at US\$116 billion and imports at US\$463 billion. A large chunk of the imports are from US manufacturers that have set up assembly lines and factories in China. Meanwhile, China relies on some key high-tech products produced only in the US. It is seeking to reduce this dependence by developing its own semiconductor chip industry and electronic payments systems. But these will take time.

There are substantial linkages on the financial front as well. China holds about US\$1.25 trillion in outstanding US government debt, or a little shy of 10% of the total. Meanwhile, Chinese companies raise capital in the US financial markets through initial public offerings and offshore dollar bonds.

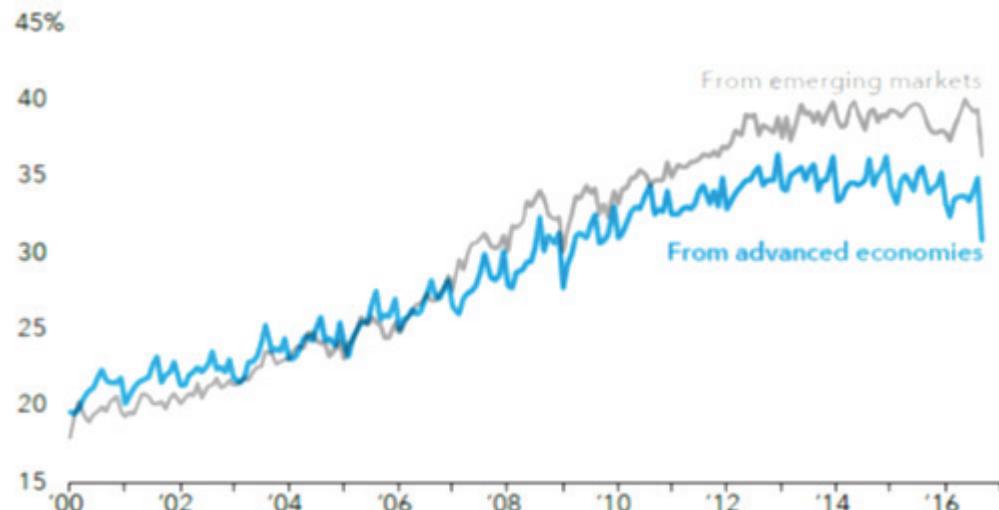
CHINA'S INFLUENCE LEADS TO MORE TRADE FOR EMERGING MARKETS

China's engagement in trade negotiations may also help the central government in its own ambitions to open up its economy. It could provide China's leadership with the platform it needs to implement much-needed reforms. Any negotiations will have multiple layers of relationships to consider, and businesses with interests on both sides are likely to influence new deals.

While the negotiations may be characterised by bouts of potentially unfriendly rhetoric, ultimately, any new trade agreements are likely to have accommodations for both sides, given the mutual economic and financial dependencies. The impacts are likely to be company-specific and any investment strategy must be able to address the volatility with a view on the long term.

China's influence has also led to greater trade by emerging markets among themselves and with developed economies (Figure 5). In 2015, 30% of developed market exports went to emerging markets, and 46% of the trade by emerging markets was among themselves.² Emerging markets' share of global GDP has risen significantly.

**Figure 5: Percentage of exports to emerging markets
At 30 September 2016**



Source: Thomson Reuters Datastream.

With domestic demand rising to become a greater share of total output, regional industry leaders are emerging in Asia. Thai Beverage, Lenovo, Larsen & Toubro, Sun Pharmaceuticals and Tencent are just a few examples. Many of these companies are less vulnerable to demand from the US and Europe.

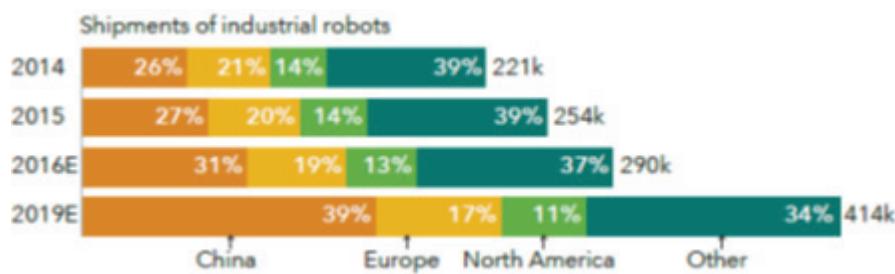
Moreover, as the global economy gains momentum — especially the industrial economy, and, with it, commodities — emerging markets should benefit. Already, there has been a recovery in profit growth. Earnings for emerging market companies are estimated to increase 17% in 2017, led by information technology and industrials.³

LABOUR COSTS MATTER LESS AS AUTOMATION RISES

There is no doubt that the tax benefits of operating in multiple jurisdictions have historically driven some of the decisions of multinationals in locating plants and production facilities. The low cost of labour has been another important factor. Both of these benefits could diminish in the coming years.

Rising wages in China are reducing the labour cost advantage that the country has enjoyed for the past three decades. More importantly, rising automation in production lines across a host of industries is likely to further diminish the benefits of any cross-border labour arbitrage. As Figure 6 shows, there were more than 250,000 industrial robots sold in 2015, with one in four being sold to China.⁴ Mexico is another significant destination, in addition to the US and Europe.

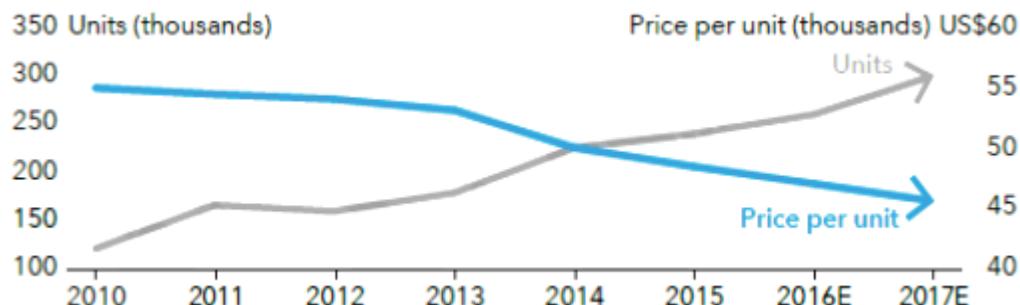
Figure 6: Industrial robots are finding their way into factories worldwide



Source: IFR/World Robotics.

The economics of automation have hit a sweet spot, where costs of robotics systems are declining (Figure 7) and capabilities are improving rapidly.

Figure 7: Robot sales have risen as prices have declined



Sources: Barclays Research, IFR, Kuka.

China is also seeing a generational shift, with younger workers less willing to do repetitive tasks. With automation reducing the importance of labour costs, production could move closer to end-markets. It is this transformation in the economics of labour that could bring manufacturing and jobs to the US.

Many established multinationals like Unilever, Nestlé and Coca-Cola have been moving closer to end-markets over the years. They have devolved their operations to be much more local to gain a deeper understanding of local markets and compete with domestic companies. Coca-Cola's CEO, referring to the company as a "multi-local business", said at a recent earnings call that the company "distributes locally, sells locally and pays taxes locally", and is not too concerned about any shifts in trade regimes.

CONCLUSION

Global commerce has been transformed over the past two decades. Global companies account for 80% of trade, 75% of private sector research and development, and 40% of productivity growth.⁵ Global trade patterns are likely to evolve with the increasing digitisation of commerce and potentially new trade, tariff and tax structures in many parts of the world. Shifts in economic and trade regimes and turning points in markets provide asset managers the opportunity to capitalise on short-term distortions in asset prices and to invest in companies that could be winners in the long term.

Not all global companies will thrive in this new environment. Fundamental research will be key. Nevertheless, successful multinational companies typically have innovative management teams, diverse sources of revenue and the resilience of solid balance sheets. These attributes offer the potential for future success.

ENDNOTES

1. TeleGeography, Global Bandwidth Forecast Service.
2. International Monetary Fund.
3. Consensus estimates compiled by FactSet.
4. International Federation of Robotics.
5. Playing To Win: The New Global Competition for Corporate Profits. McKinsey & Company, September 2015.

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