Is China's Manufacturing Dominance Coming to an End?

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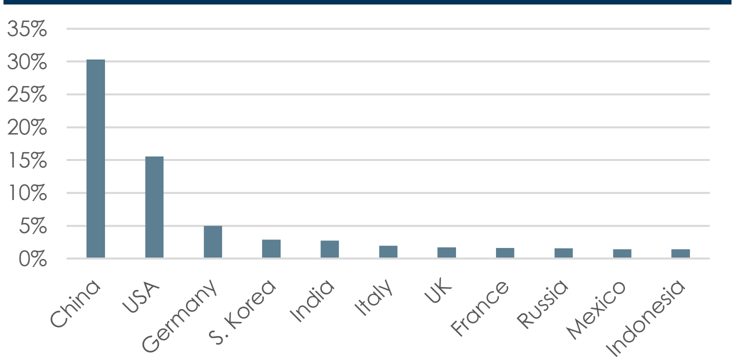
- **In just a few decades time, China has achieved its longstanding goal of becoming the "world's factory"**
- **China's low labor costs and rapid development of supply chain infrastructure were key drivers in this transformation**
- **Government policy and rising geopolitical tensions pose potential headwinds to China's manufacturing dominance**

How Did China Become So Dominant?

Just-in-time manufacturing was originally developed in Japan to minimize manufacturing costs by ordering components to arrive just before assembly, thereby reducing the need for inventory and warehouse space. China incorporated just-in-time practices into its rapid industrial transformation, quickly becoming the manufacturing hub for the world. As many corporations across the globe looked for ways to reduce costs and increase profits, China positioned itself as the "world's factory," offering a large, skilled workforce with significantly lower labor costs. A broadly less stringent regulatory environment provided further cost benefits and efficiencies to multinational companies. Recent World Bank data shows the magnitude of China's manufacturing dominance.

Share of Global Manufacturing



Source: The World Bank, ACG Research, 2021 data.

What Changed?

For many companies around the world, the practice of manufacturing in China and exporting the goods to their final destinations worked very well until recently. The COVID pandemic exposed the risks of concentrating manufacturing in one country. China's Zero COVID policy essentially locked down entire cities/regions within China, which shut down production of many goods and disrupted supply chains as transportation logistics were negatively impacted. The pandemic disruptions, combined with elevated geopolitical tensions, including issues of national security and protection of intellectual property rights, has resulted in many companies reassessing their global manufacturing and supply chain management. Most recently, the war in Ukraine has highlighted a similar concentration risk with respect to commodities, as much of Europe's energy supply has traditionally been sourced from Russia. In the latter half of 2022, countries dependent on Russian energy had the unenviable task of trying to diversify their energy supply before the onset of winter.

Potential Beneficiaries

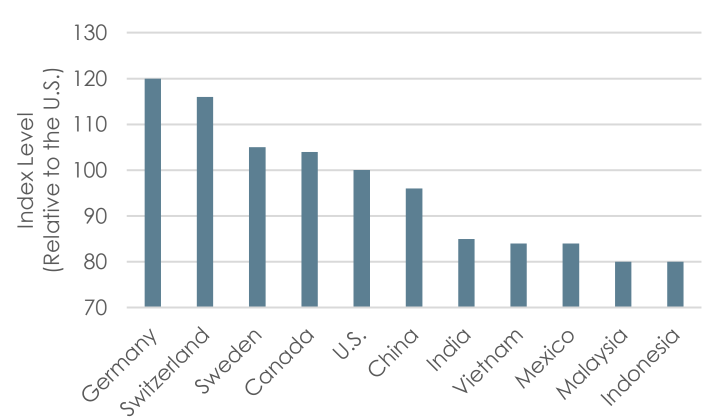
For any given country, the ability to onshore their Chinese manufacturing operations will depend on multiple factors, including domestic manufacturing infrastructure, labor force skill level and cost structure, and the regulatory environment. Other factors include tariff structures, tax incentives, and trade pacts/treaties between countries. Many of these same factors also apply to offshoring outside of China, increasing the appeal of countries such as India, Mexico, and Vietnam.

A recent example of onshoring includes Intel, which is considering relocating portions of its production to the US, citing potential US government regulations. Several large multinational companies have announced potential changes to their offshore manufacturing capabilities. Nike is looking to increase manufacturing in Southeast Asia, citing potential quality improvements and cost savings. Microsoft is considering Europe as a manufacturing option to reduce supply chain risks, and HP is looking to Mexico to improve efficiencies and reduce costs.

Unintended Consequences?

Diversifying production away from a single country brings additional concerns that must be factored into the production decision. Labor costs are not static and can change over time, language and cultural barriers can be more significant, currency risk increases, and sourcing qualified workers can prove challenging. Politically, China is a significant trade partner with other Southeast Asia countries, and that fact could be used to dissuade these countries from taking on the production previously based in China. Tariffs and trade policies could be altered to impact companies who move portions of their manufacturing from China. This could result in fragmented production (where the same product is made in multiple countries), which could increase manufacturing costs and reduce efficiency.

Global Manufacturing Cost Competitive Index (Landed Cost)



Source: Boston Consulting Group, ACG Research, 2022 Study

Investment Implications

Changing global manufacturing networks will take time, and companies will need to balance expected benefits with potential trade-offs. As manufacturing networks evolve, there could be positive and negative implications, favoring the use of active managers who can analyze the various outcomes and adjust exposures as appropriate. With respect to overall portfolio construction, we believe the best approach is to maintain long-term, globally diversified investment portfolios designed to weather any short-term negative volatility, while positioned to participate in longer-term positive trends.

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