

Tales From the Emerging World

## Untangling Supply Chain Linkages

EMERGING MARKETS EQUITY TEAM | MACRO INSIGHT | MARCH 2023

After the pandemic and Russia's invasion of Ukraine, supply chain security became the new manufacturing mantra. Companies implemented, or at least discussed, strategies to reduce exposure to supply hiccups that brought about shortages ranging from semiconductors and car parts to food and medicine. The "China Plus One" theme has gained traction for several global brands looking for alternative production hubs. Increasing labor costs in China, geopolitical tensions and human rights issues have encouraged other companies to rely less on Beijing as the world's factory. Others are shifting from a "just in time" to a "just in case" cycle. These developments will create winners and losers as companies shift factories to different countries impacting economies, trade routes and payments globally.

Since 2018, the decoupling of the two economic superpowers has gathered pace. The U.S. has employed tactics, such as tariffs on certain goods and sanctions on China, to gain digital sovereignty and punish companies for human rights violations. The disentangling of the two economies has led to critical manufacturing coming home (onshoring) and a shift in imports from China to the Association of Southeast Asian Nations (ASEAN), India and Mexico, countries that provide more competitive labor costs and friendlier relations (*Display 1*).

Onshoring is supported by recent legislation. The U.S. is allocating vast resources to secure technological advantages and facilitate the green transition. The landmark Inflation Reduction Act (IRA) directs nearly \$400 billion to boost clean energy and reduce dependence on China in critical areas such as batteries for electric vehicles (EVs). The bulk of the funding is in the form of tax credits, with an estimated \$216 billion directed toward corporations to catalyze private investment in clean energy, transport and manufacturing. Another \$43 billion in IRA tax credits aims to lower emissions by making EVs, rooftop solar panels, geothermal heating and home batteries more affordable.

### AUTHORS



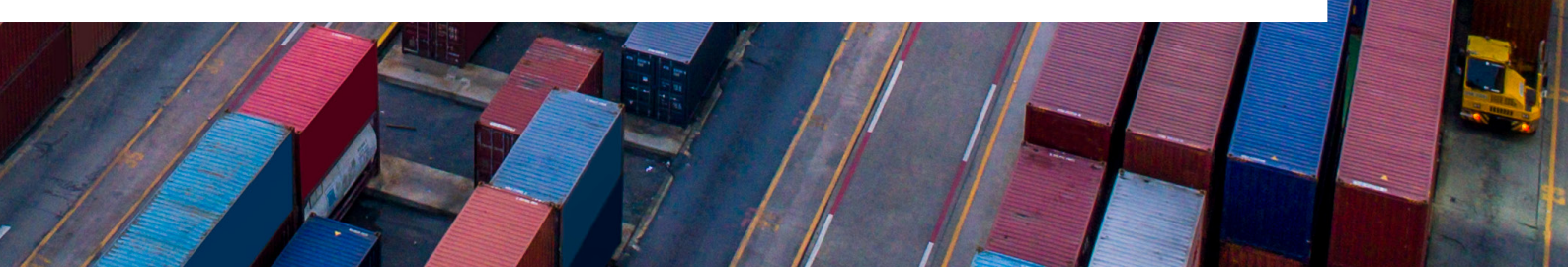
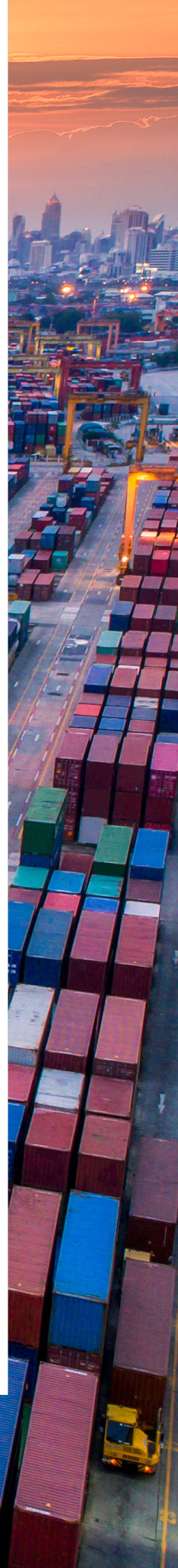
#### JITANIA KANDHARI

Head of Macro & Thematic Research, Emerging Markets Equity  
Deputy CIO, Solutions & Multi Asset Group  
Portfolio Manager, Active International Allocation



#### SAUMYA JAIN

Senior Associate  
Emerging Markets Equity Team



Similarly, the U.S. CHIPS and Science Act allocates \$52 billion to revitalize semiconductor manufacturing.<sup>1</sup> The European Chips Act also promises €43 billion of investment in chip development on the continent. In the U.S., growth in manufacturing jobs has been the highest since 2010. About half of these job gains can be attributed to onshoring, according to the Reshoring Initiative, which lobbies for bringing industrial jobs back to the U.S.

However, the factors that made offshoring attractive, such as lower labor costs, are still relevant today. Production costs are much higher in the U.S. and Europe. For example, a machine operator in the U.S. makes around \$26 an hour, while those in Europe earn \$32. By comparison, a similar position in Mexico pays \$4 an hour. A machine operator earns \$7.50 in China, four times that in Vietnam.

This is why we believe onshoring will be limited to critical industries, such as fabrication of advanced microchips. Since 2020, semiconductor companies have proposed more than 40 projects in the U.S., valued at \$200 billion, that would create 40,000 jobs. However, a shortage of qualified workers and a

maze of regulatory roadblocks may still hamper efforts to onshore electronics manufacturing. The world’s biggest chipmaker is building a \$40 billion semiconductor facility north of Phoenix, but the plant will be twice as costly as a similar plant in Taiwan.<sup>2</sup>

Although complete decoupling from China is unlikely because dependencies and interlinkages between China and the world are too strong, supply chain diversification is happening. Some corporations are spreading their bets by adopting the “China Plus One” strategy, where they keep part of their production capacity in China while adding a supplier in other parts of Asia. Beijing now accounts for 18% of total U.S. imports, declining from 23% in 2018. Over the same period, U.S. imports from ASEAN increased to 10% from 7%. Countries like India, Indonesia, Malaysia, Thailand and Vietnam are taking initiatives to promote investment in industries like textiles, electronics, chemicals, pharmaceuticals and machinery. Malaysia established fast track channels for investors and businesses to diversify supply chains; Vietnam offers preferential treatment to science and tech enterprises; India has launched

Production Linked Incentive (PLI) schemes and is building infrastructure to attract foreign manufacturers.

In the West, Mexico, with its low cost of production, also stands to benefit from its proximity to the biggest consumer market in the world. Mexico, Latin America’s leading exporter of manufactured goods, already accounts for 14% of U.S. imports, second only to China. The country needs to improve electric grid capacity and infrastructure to capitalize further on this nearshoring trend.

Global trade patterns are shifting. Regional trade agreements have increased substantially, with 42 goods notifications submitted in 2021 to the World Trade Organization, compared with only 7 a year earlier.<sup>3</sup> Despite its declining share of U.S. imports since 2018, China’s slice of global exports has in fact risen by two percentage points to 20% since 2019.<sup>4</sup> In the late 1990s, 70% of Asian exports went to the West, whereas today, 60% stay in Asia.<sup>5</sup> Last year, China and 14 regional economies created the Regional Comprehensive Economic Partnership (RCEP), the world’s largest free trade agreement. Trade between the bloc’s 15 economies, estimated at \$2.3 trillion in 2019, could rise by nearly \$42 billion, because of the agreement on tariff concessions. Beijing has also increased shipments to Europe and other developing countries, notably the ASEAN region.

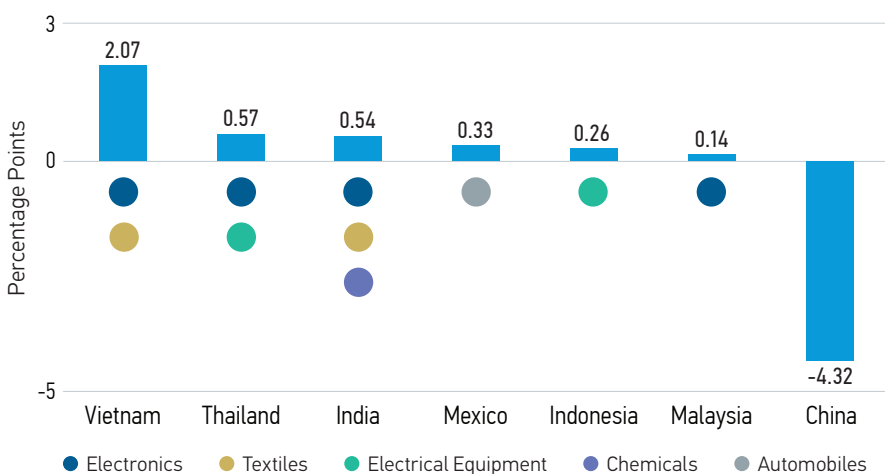
Extra shipments require additional infrastructure and port facilities. Singapore’s PSA and Chinese state-owned rail operators entered a joint venture to build dry ports in China. Currently, a \$300 million inland container depot in northern Vietnam is being funded by the World Bank. The IMF says by 2027 Indonesia, Malaysia, Singapore, the Philippines and Thailand will be the fastest growing bloc in the world by trade volumes.

European countries have seen the largest increase in regional trade agreements. Shifting manufacturing to Eastern

**DISPLAY 1**

**Beneficiaries of Reshoring and Nearshoring**

Change in share of U.S. imports since 2018



Each dot represents a major exporting industry. Source: Haver Analytics, MSIM EM Research as of Oct 2022.

<sup>1</sup> The White House Fact Sheet, CHIPS and Science Act 8/9/22.

<sup>2</sup> New York Times Feb 2023.

<sup>3</sup> World Trade Organization.

<sup>4</sup> Haver Analytics, MSIM EM Research. As of Sept 2022.

<sup>5</sup> The Economist, “Investment in Ports Foretell the Future of Global Commerce” January 14, 2023.

European nations such as the Czech Republic, Poland and Hungary is an attractive option, given their existing industrial base along with a skilled and relatively low-cost labor force.

Improving supply chain resilience will not be without cost. The extra layers of security, storage and resiliency will

be inflationary. The non-optimal allocation of resources, barriers to knowledge and data transfer will result in higher capital expenditure and hinder movement of a skilled workforce across borders. However, some countries and sectors will emerge as winners of this repositioning.

Emerging markets like India, Vietnam, Thailand, Indonesia and Mexico are likely to benefit from reshoring, friendshoring and nearshoring. Supply chain untangling has created an opportunity, and these countries are best poised to grab it.

**Risk Considerations:** There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. The risks of investing in **emerging market countries** are greater than the risks generally associated with investments in foreign developed countries.

#### DEFINITIONS

**Gross Domestic Product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

#### IMPORTANT INFORMATION

There is no guarantee that any investment strategy will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

**A separately managed account may not be appropriate for all investors. Separate accounts managed according to the particular Strategy may include securities that may not necessarily track the performance of a particular index. Please consider the investment objectives, risks and fees of the Strategy carefully before investing. A minimum asset level is required.**

**For important information about the investment managers, please refer to Form ADV Part 2.**

The views and opinions and/or analysis expressed are those of the author or the investment team as of the date of preparation of this material and are subject to change at any time without notice due to market or economic conditions and may not necessarily come to pass. Furthermore, the views will not be updated or otherwise revised to reflect information that subsequently becomes available or circumstances existing, or changes occurring, after the date of publication. The views expressed do not reflect the opinions of all investment personnel at Morgan Stanley Investment Management (MSIM) and its subsidiaries and affiliates (collectively "the Firm"), and may not be reflected in all the strategies and products that the Firm offers.

Forecasts and/or estimates provided herein are subject to change and may not actually come to pass. Information regarding expected market returns and market outlooks is based on the research, analysis and opinions of the authors or the investment team. These conclusions are speculative in nature, may not come to pass and are not intended to predict the future performance of any specific strategy or product the Firm offers. Future results may differ significantly depending on factors such as changes in securities or financial markets or general economic conditions.

This material has been prepared on the basis of publicly available information, internally developed data and other third-party sources believed to be reliable. However, no assurances are provided regarding the reliability of such information and the Firm has not sought to independently verify information taken from public and third-party sources.

This material is a general communication, which is not impartial and all information provided has been prepared solely for informational and educational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The information herein has not been based on a consideration of any individual investor circumstances and is not investment advice, nor should it be construed in any way as tax, accounting, legal or regulatory advice. To that end, investors should seek independent legal and financial advice, including advice as to tax consequences, before making any investment decision.

Charts and graphs provided herein are for illustrative purposes only. **Past performance is no guarantee of future results.**

This material is not a product of Morgan Stanley's Research Department and should not be regarded as a research material or a recommendation. The Firm has not authorised financial intermediaries to use and to distribute this material, unless such use and distribution is made in accordance with applicable law and regulation. Additionally, financial intermediaries are required to satisfy themselves that the information in this material is appropriate for any person to whom they provide this material in view of that person's circumstances and purpose. The Firm shall not be liable for, and accepts no liability for, the use or misuse of this material by any such financial intermediary.

This material may be translated into other languages. Where such a translation is made this English version remains definitive. If there are any discrepancies between the English version and any version of this material in another language, the English version shall prevail.

The whole or any part of this material may not be directly or indirectly reproduced, copied, modified, used to create a derivative work, performed, displayed, published, posted, licensed, framed, distributed or transmitted or any of its contents disclosed to third parties without the Firm's express written consent. This material may not be linked to unless such hyperlink is for personal and non-commercial use. All information contained herein is proprietary and is protected under copyright and other applicable law.

Eaton Vance is part of Morgan Stanley Investment Management. Morgan Stanley Investment Management is the asset management division of Morgan Stanley.

#### DISTRIBUTION

**This material is only intended for and will only be distributed to persons resident in jurisdictions where such distribution or availability would not be contrary to local laws or regulations.**

**MSIM, the asset management division of Morgan Stanley (NYSE: MS), and its affiliates have arrangements in place to market each other's products and services. Each MSIM affiliate is regulated as appropriate in the jurisdiction it operates. MSIM's affiliates are: Eaton Vance Management (International) Limited, Eaton Vance Advisers International Ltd, Calvert Research and Management, Eaton Vance Management, Parametric Portfolio Associates LLC and Atlanta Capital Management LLC.**

This material has been issued by any one or more of the following entities:

#### EMEA:

This material is for Professional Clients/Accredited Investors only.

In the EU, MSIM and Eaton Vance materials are issued by MSIM Fund Management (Ireland) Limited ("FMIL"). FMIL is regulated by the Central Bank of Ireland and is incorporated in Ireland as a private company limited by shares with company registration number 616661 and has its registered address at The Observatory, 7-11 Sir John Rogerson's Quay, Dublin 2, D02 VC42, Ireland.

Outside the EU, MSIM materials are issued by Morgan Stanley Investment Management Limited (MSIM Ltd) is authorised and regulated by the Financial Conduct Authority. Registered in England. Registered No. 1981121.



Registered Office: 25 Cabot Square, Canary Wharf, London E14 4QA. In Switzerland, MSIM materials are issued by Morgan Stanley & Co. International plc, London (Zurich Branch) Authorised and regulated by the Eidgenössische Finanzmarktaufsicht ("FINMA"). Registered Office: Beethovenstrasse 33, 8002 Zurich, Switzerland.

Outside the US and EU, Eaton Vance materials are issued by Eaton Vance Management (International) Limited ("EVMI") 125 Old Broad Street, London, EC2N 1AR, UK, which is authorised and regulated in the United Kingdom by the Financial Conduct Authority.

**Italy:** MSIM FMIL (Milan Branch), (Sede Secondaria di Milano) Palazzo Serbelloni Corso Venezia, 16 20121 Milano, Italy. **The Netherlands:** MSIM FMIL (Amsterdam Branch), Rembrandt Tower, 11th Floor Amstelplein 1 1096HA, Netherlands. **France:** MSIM FMIL (Paris Branch), 61 rue de Monceau 75008 Paris, France. **Spain:** MSIM FMIL (Madrid Branch), Calle Serrano 55, 28006, Madrid, Spain. **Germany:** MSIM FMIL Frankfurt Branch, Große Gallusstraße 18, 60312 Frankfurt am Main, Germany (Gattung: Zweigniederlassung (FDI) gem. § 53b KWG). **Denmark:** MSIM FMIL (Copenhagen Branch), Gorrissen Federspiel, Axel Towers, Axelortv2, 1609 Copenhagen V, Denmark.

#### MIDDLE EAST

**Dubai:** MSIM Ltd (Representative Office, Unit Precinct 3-7th Floor-Unit 701 and 702, Level 7, Gate Precinct Building 3, Dubai International Financial Centre, Dubai, 506501, United Arab Emirates. Telephone: +97 (0)14 709 7158).

This document is distributed in the Dubai International Financial Centre by Morgan Stanley Investment Management Limited (Representative Office), an entity regulated by the Dubai Financial Services Authority ("DFSA"). It is intended for use by professional clients and market counterparties only. This document is not intended for distribution to retail clients, and retail clients should not act upon the information contained in this document. This document relates to a financial product which is not subject to any form of regulation or approval by the DFSA. The DFSA has no responsibility for reviewing or verifying any documents in connection with this financial product. Accordingly, the DFSA has not approved this document or any other associated documents nor taken any steps to verify the information set out in this document, and has no responsibility for it. The financial product to which this document relates may be illiquid and/or subject to restrictions on its resale or transfer. Prospective purchasers should conduct their own due diligence on the financial product. If you do not understand the contents of this document, you should consult an authorised financial adviser.

#### U.S.

**NOT FDIC INSURED | OFFER NO BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A BANK DEPOSIT**

#### LATIN AMERICA (Brazil, Chile Colombia, Mexico, Peru, and Uruguay)

This material is for use with an institutional investor or a qualified investor only. All information contained herein is confidential and is for the exclusive use and review of the intended addressee, and may not be passed on to any third party. This material is provided for informational purposes only and does not constitute a public offering, solicitation or recommendation to buy or sell for any product, service, security and/or strategy. A decision to invest should only be made after reading the strategy documentation and conducting in-depth and independent due diligence.

#### ASIA PACIFIC

**Hong Kong:** This material is disseminated by Morgan Stanley Asia Limited for use in Hong Kong and shall only be made available to "professional investors" as defined under the Securities and Futures Ordinance of Hong

Kong (Cap 571). The contents of this material have not been reviewed nor approved by any regulatory authority including the Securities and Futures Commission in Hong Kong. Accordingly, save where an exemption is available under the relevant law, this material shall not be issued, circulated, distributed, directed at, or made available to, the public in Hong Kong. **Singapore:** This material is disseminated by Morgan Stanley Investment Management Company and should not be considered to be the subject of an invitation for subscription or purchase, whether directly or indirectly, to the public or any member of the public in Singapore other than (i) to an institutional investor under section 304 of the Securities and Futures Act, Chapter 289 of Singapore ("SFA"); (ii) to a "relevant person" (which includes an accredited investor) pursuant to section 305 of the SFA, and such distribution is in accordance with the conditions specified in section 305 of the SFA; or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. This publication has not been reviewed by the Monetary Authority of Singapore. **Australia:** This material is provided by Morgan Stanley Investment Management (Australia) Pty Ltd ABN 22122040037, AFSL No. 314182 and its affiliates and does not constitute an offer of interests. Morgan Stanley Investment Management (Australia) Pty Limited arranges for MSIM affiliates to provide financial services to Australian wholesale clients. Interests will only be offered in circumstances under which no disclosure is required under the Corporations Act 2001 (Cth) (the "Corporations Act"). Any offer of interests will not purport to be an offer of interests in circumstances under which disclosure is required under the Corporations Act and will only be made to persons who qualify as a "wholesale client" (as defined in the Corporations Act). This material will not be lodged with the Australian Securities and Investments Commission. **Japan:** For professional investors, this material is circulated or distributed for informational purposes only. For those who are not professional investors, this material is provided in relation to Morgan Stanley Investment Management (Japan) Co., Ltd. ("MSIMJ")'s business with respect to discretionary investment management agreements ("IMA") and investment advisory agreements ("IAA"). This is not for the purpose of a recommendation or solicitation of transactions or offers any particular financial instruments. Under an IMA, with respect to management of assets of a client, the client prescribes basic management policies in advance and commissions MSIMJ to make all investment decisions based on an analysis of the value, etc. of the securities, and MSIMJ accepts such commission. The client shall delegate to MSIMJ the authorities necessary for making investment. MSIMJ exercises the delegated authorities based on investment decisions of MSIMJ, and the client shall not make individual instructions. All investment profits and losses belong to the clients; principal is not guaranteed. Please consider the investment objectives and nature of risks before investing. As an investment advisory fee for an IAA or an IMA, the amount of assets subject to the contract multiplied by a certain rate (the upper limit is 2.20% per annum (including tax)) shall be incurred in proportion to the contract period. For some strategies, a contingency fee may be incurred in addition to the fee mentioned above. Indirect charges also may be incurred, such as brokerage commissions for incorporated securities. Since these charges and expenses are different depending on a contract and other factors, MSIMJ cannot present the rates, upper limits, etc. in advance. All clients should read the Documents Provided Prior to the Conclusion of a Contract carefully before executing an agreement. This material is disseminated in Japan by MSIMJ, Registered No. 410 (Director of Kanto Local Finance Bureau (Financial Instruments Firms)), Membership: the Japan Securities Dealers Association, The Investment Trusts Association, Japan, the Japan Investment Advisers Association and the Type II Financial Instruments Firms Association.

Explore our site at [www.morganstanley.com/im](http://www.morganstanley.com/im)