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RECOVERY AMID A STRAINED GLOBAL TRADE SYSTEM

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U.S.-China trade at yet another crossroads

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Distant drums

Anyone expecting a fresh start to U.S.-China trade relations under the new administration has been disappointed. Trade talks are on hold, leaving in place U.S. tariffs on $370 billion of China's exports. The focus of the Biden administration, instead, has been on proposed tax incentives and penalties as part of a broader reshoring strategy in its Build Back Better platform. If implemented, China would be among the most exposed to changes likely applied more broadly to U.S. trading partners.

Beyond tariffs, President Biden has signed an executive order to analyze global supply chains in a 100-day review of electric vehicle batteries, pharmaceuticals, critical minerals, and computer chips — all are products suffering both from the pandemic and from the U.S.-China trade war.[1] Also planned is a yearlong review of supply-chain risks in six broader industries, including energy, medical supplies, agricultural commodities, transportation, defense, and information technology.

A report last year by the United Nations Conference on Trade and Development (UNCTAD), a UN body, estimated that about 20% of global trade in the intermediate goods supply chain originated in China.

Source: Pamela Ugaz and Sijia Sun, "Case Study: China's Trade Facilitation Responses to the COVID-19 Pandemic," May 22, 2020

Ties that bind

Competition is likely to lead China and the U.S. toward further measures that limit each other's access to markets (by China) and to technology and capital (by the U.S.). However, we believe that talk of a thoroughgoing supply-chain reform and a slow decoupling of the world's two largest economies beyond industries directly and indirectly affecting national security is too simplistic. The symbiotic "Chimerica" relationship between the two largest economies in the world is evolving but we believe it runs deep enough to encourage accommodation by both sides.

Large U.S. technology firms have the greatest stake in improved relations with China, sourcing 14% of global revenues from the country, which is double that of second-ranked materials producers among the 11 S&P 500 sectors.

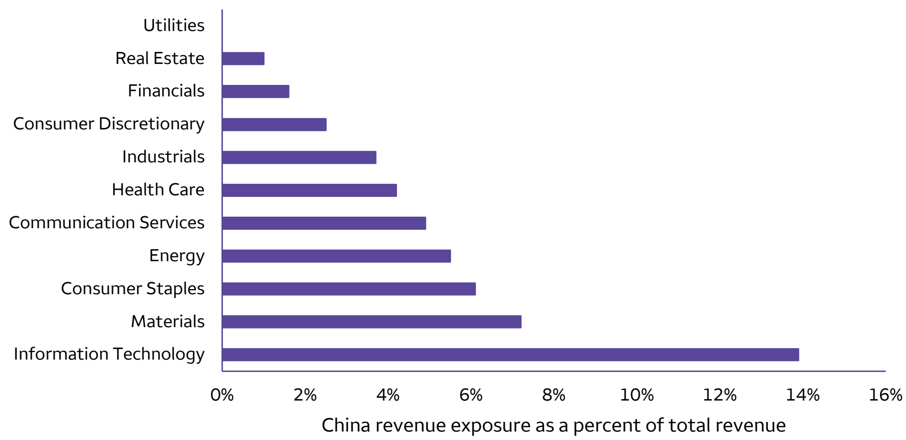
Perhaps the strongest argument in favor of a more enduring trade relationship between the two countries is China's importance in the global supply chain. United Nations Conference on Trade and Development (UNCTAD) estimated last year that about 20% of global trade in the intermediate-goods supply chain originated in China.[2] U.S. dependence on manufacturing inputs from China may be even higher. China's advantage in the global supply network extends beyond a narrowing wage advantage to a skilled workforce along with a logistics network and infrastructure far more developed than those among other potential competitors in the supply-chain network.

Maintaining a smooth flow of exports to the U.S. and, for that matter, to other advanced economies is equally important for China during a critical transition to greater debt control and to a longer-term shift to more moderate, consumer-led growth. For U.S. and other multinationals, China's move toward more consumer-oriented growth enhances the country's importance beyond its role in the global supply chain to its sizable and dynamic local market.

1. "The US-China Trade War Is Still Happening," The Diplomat, March 3, 2021
2. "Global Trade Impact of the Coronavirus (COVID-19) Epidemic," UNCTAD, March 4, 2020

The stakes in U.S.-China trade are particularly high for U.S. multinationals in the technology industry, among the most exposed to China as a supplier of hardware and as a market for finished goods. As indicated in the chart below, the 14% share of China-sourced revenue for multinationals in technology is double that of second-ranked materials producers among the 11 sectors making up the S&P 500 Index. Our view that trade relations with China, though strained, ultimately will endure is an important reason for the favorable view of technology in our portfolio strategy recommendations, along with economically sensitive small caps, industrials, and materials producers and other emerging markets.

Chart 1. S&P 500 Index China revenue exposures by sector



Sources: FactSet and Wells Fargo Investment Institute, data as of February 28, 2021, based on companies' most recently released financial reporting

More than just old wine in a new bottle?

Our view has been that any departure by Democrats from Trump's China stance would be more in negotiation strategy than in the goals themselves. However, with a change in style has come substance. Bipartisan support for a "get tough" approach toward China has strengthened the president's determination for change.

But we also see Biden's promise of greater transparency and predictability as providing a more stable backdrop for negotiations. Common goals with China, on climate change and nuclear nonproliferation, for example, add to an atmosphere more conducive for the two sides to compromise on these and trade issues. A multilateral approach, avoiding the risk of intransigence by a boxed-in China, would add to the leverage in addressing core grievances in trade with the country, such as improved access to its local market, subsidies to Chinese firms, and intellectual property protection for U.S. and other Western multinationals. We view issues like these as being at the heart of strained relations between China and its trading partners. Resolving them would be a critical step toward turning the corner in what continues to be a relationship critical to the U.S. and global economies.

Key takeaways

- Competition between the U.S. and China is likely to intensify, but we believe that China's importance in the global supply chain and as a market for global multinationals provides the basis for continued connection with the U.S. and our allies.
- Prospects for improved trade relations between China, the U.S., and other trading partners have improved, with a change in U.S. negotiating strategy and a focus on core grievances at the heart of the deterioration in commercial ties.

Supply-chain reaction

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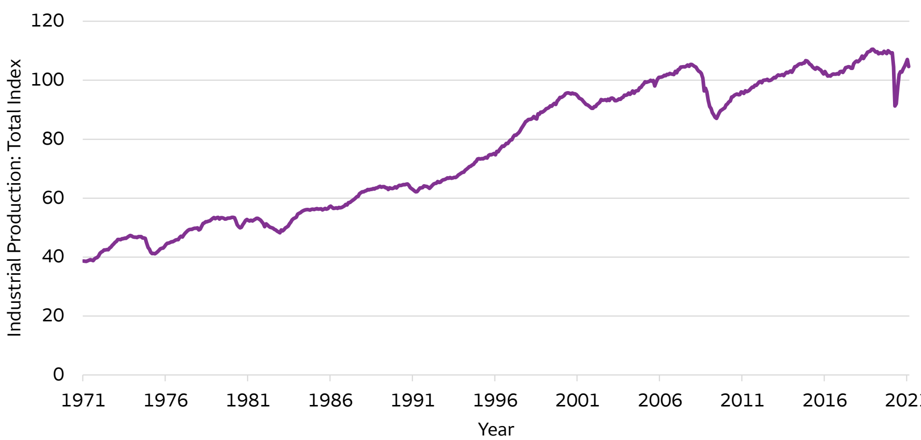
The current state of supply chains

The current issues surrounding supply chains have essentially boiled down to supply and demand. As Chart 2 illustrates, the decrease in U.S. industrial production in 2020 was both incredibly steep as well as incredibly sudden in comparison with previous recessions, giving producers very little time to adapt to the changing ecosystem. Meanwhile, massive economic stimulus has increased disposable income, which, as a result of quarantine harming consumer services, primarily has concentrated in consumer goods. This effect is best demonstrated through the current semiconductor shortage, where huge demand with limited supply has resulted in massive order backlogs extending out through the end of 2021.[3]

In April of 2020, U.S. production fell to its lowest levels since the global financial crisis of 2008.

Source: Board of Governors of the Federal Reserve system, "Industrial Production: Total Index," retrieved from FRED, Federal Reserve Bank of St. Louis, on April 1, 2021

Chart 2. U.S. Industrial Production Index from 1971 to 2021



Source: Board of Governors of the Federal Reserve system, "Industrial Production: Total Index," retrieved from FRED, Federal Reserve Bank of St. Louis, on April 1, 2021. The Industrial Production Index measures real output for all facilities located in the U.S. manufacturing, mining, and electric and gas utilities. Index 2012=100, data is seasonally adjusted.

Roughly 127 million $1,400 stimulus payments have been issued since the latest stimulus was passed in March 2021.

Source: "About 127 million $1,400 stimulus checks have been sent. What we know about those payments," CNBC, March 25, 2021

Producers are working on the supply issue, but it won't be an overnight fix. U.S. container shipping imports remain markedly higher from January 2020, while freight capacity is similarly stressed.[4] COVID-19 restrictions continue to exacerbate this backlog. Notably, air freight, used for medicine and other items where quick transit is required, has produced significant supply shortages from limited domestic and international flights.[5]

As bottlenecks increase production costs and limit supply, the immediate concerns for investors are lost revenue and earnings and, more broadly, a return of consumer price inflation. In February, the Producer Price Index

3. See, for example, Mark Sweney, "Global Shortage in Computer Chips 'Reaches Crisis Point,'" The Guardian, March 21, 2021, and Nicolas Rivero, "Broadcom Won't Catch up on Semiconductor Orders Until at Least November," Quartz, March 5, 2021
4. Kara Dapena and Dylan Moriarty, "America's Imports Are Stuck on Ships Floating Just Off Los Angeles," The Wall Street Journal, March 31, 2021
5. Zac Rogers, Ph.D.; Steven Carnovale, Ph.D.; Shen Yeniyurt, Ph.D.; Ron Lembke, Ph.D.; and Dale Rogers, Ph.D., "January 2021 Logistics Managers' Index," Logistics Managers' Index, February 2, 2021

increased by 2.8% year over year, indicating higher costs for producers, which may point to higher costs to consumers and price inflation. However, the Federal Reserve has been optimistic that this should be short-lived, primarily due to the eventual end to the spending surge, probably around mid-2022.[6] Even though some producers have seen increased transport costs, we believe that this will be far outweighed by the stronger sales volume and demand they have seen from consumers. In keeping with this expectation, we raised our earnings-per-share forecast for the S&P 500 Index from $175 to $190 in March.[7]

Looking forward

COVID-19 has demonstrated the need for resilient supply chains, and as we saw with President Biden's recent executive order, we believe that production of certain medicines and personal protective equipment may shift to domestic sources. Other supply chains may come under some upward cost pressures but are unlikely to shift away from China. For supply chains to significantly shift to a country like Malaysia or Vietnam, for example, would require unfeasibly large capital expenditure by producers and local governments.

While the past year has been a stressful time for supply chains, we believe that the continuing economic recovery will end up being a positive for producers. The supply and transportation bottlenecks should normalize and allow producers to better tackle increased demand as well as existing order backlogs from 2020. The U.S. has rolled out a significant amount of vaccinations in a short period of time,[8] which should help shore up some of the productivity issues that have plagued the last year. We reiterate our favorable views on several sectors tied directly to strength in consumer demand and an economic recovery — namely, Consumer Discretionary, Industrials, and Materials. We believe these sectors will see added earnings strength as they continue to fill sales backlogs through the rest of the year.

Key takeaways

- Industrial production crashed during the 2020 COVID-19 lockdowns and is now scrambling to again match household and business demand, which has skyrocketed due to economic stimulus.
- Looking ahead, we expect supply chains to continue to play catch-up, but increasing vaccination efforts should help.
- We continue to be favorable on sectors tied closely to consumer demand and an economic recovery — namely, Industrials, Materials, and Consumer Discretionary.

6. Lucia Mutikani, "U.S. Producer Prices Rise; Consumers' Inflation Expectations Ease," Reuters, March 12, 2021
7. Wells Fargo Investment Institute, "Adjusting Guidance for a Stronger 2021 Growth Outlook," March 5, 2021
8. Justine Coleman, "U.S. Vaccination Rate Reaches Almost Five Times Faster Than the World Average," The Hill, April 5, 2021

Vaccine diplomacy and COVID-19

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Race for containment

Vaccines have occasionally played a role in diplomacy. Advanced nations or rising powers that share medicines with less-developed economies can see a return on their benevolence in the form of soft power, commanding respect and admiration. China took an early lead in COVID-19 vaccine distribution overseas, and now the U.S. is catching up. Yet, some market observers worry about Beijing's lack of transparency surrounding the source of the outbreak and flaunted campaign of inferior products with unreliable efficacy rates. As global containment efforts continue, we believe that market repercussions could disproportionately affect the developing world.

89% of U.S. adults consider China a competitor or an enemy rather than a partner.

Source: Pew Research, March 4, 2021

Health diplomacy reappears

Vaccine diplomacy involves using vaccines to bolster a country's diplomatic relations and global influence. Typically, this type of health diplomacy is led by nations with deep pockets and solid scientific and medical expertise despite geopolitical leanings. During the Cold War, the U.S. and Soviet Union set aside differences to eradicate polio and smallpox. Since then, health diplomacy has attracted little attention but regained prominence with COVID-19.

The world's two largest economies are leading vaccine distribution with distinct approaches. China has taken a unilateral approach with ambitions to showcase its scientific capabilities and governance model. U.S. distribution efforts employ a multilateral approach.

China's Belt and Road Initiative is a global infrastructure strategy that includes over 70 countries, largely in the developing world.

China's antidote

Last spring, President Xi Jinping offered the COVID-19 vaccine as a "global public good" and part of a "Health Silk Road." China has provided vaccine aid to 69 countries and exported doses to 43 more.[9] Yet, its exports have exceeded donations by 100-fold.[10] And all but one of the countries to which China has pledged vaccines are part of its Belt and Road Initiative (see sidebar 2), leading some to speculate about potential strings attached.[11]

Today, India manufactures more than 60% of the world's vaccines.

Source: Reuters, December 10, 2020

China's fast-tracked vaccine program is also raising concerns. China raced through development stages, skipping Phase 3 clinical trials. This coupled with a low "reported" incidence of cases allowed China to accelerate offshore distribution. Yet, efficacy rates of China's vaccines are questionable.[12] Some contend that this determined effort may backfire, similar to when China sold defective medical supplies last year.

9. China Daily, March 30, 2021
10. Shiming Yang, "Rising-Power Competition: The Covid-19 Vaccine Diplomacy of China and India," The National Bureau of Asian Research, March 19, 2021
11. Thomas Bollyky, "Democracies Keep Vaccines for Themselves," The Atlantic, March 27, 2021
12. Hal Brands, "America Is Overtaking China in Vaccine Diplomacy," Bloomberg, March 23, 2021

Building coalitions

After a sluggish start, the U.S. rollout is building momentum. Operation Warp Speed is injecting 2.5 million shots daily, with over 66 million citizens fully immunized.[13] At that pace, the U.S. should achieve herd immunity faster than other countries, including China. With containment in sight, the Biden administration is now stepping up distribution through coalition-building. In December, Congress approved $4 billion for COVAX, a global coalition to deliver vaccines to lower-income countries. China did not join COVAX until October 2020, pledging to buy 15 million doses and has yet to do so. The U.S. and the Quad (Australia, India, Japan, and the U.S.) aim to produce 1 billion doses for distribution across the Indo-Pacific region. Biden has also promised 4 million doses to Mexico and Canada.

Key takeaways

- Vaccine diplomacy involves using vaccines to bolster a country's respect and influence.
- China took an early lead in vaccine distribution, and now U.S. efforts abroad are catching up.
- We believe vaccine distribution, improving sentiment, a weaker dollar, and the global recovery should help bolster emerging market equity performance, reinforcing our favorable outlook.

Implications for investors

Table 1. COVID-19 vaccine doses ordered

Country/group of countries	Doses
European Union	1,835,000,000
United States	1,210,000,000
COVAX	1,120,000,000
African Union	670,000,000
United Kingdom	457,000,000
Latin America	382,000,000
Japan	314,000,000
India	116,500,000
China	100,000,000
Chile	88,400,000

Sources: Wells Fargo Investment Institute and Atlas Magazine, April 12, 2021

The developing world is lagging developed countries in vaccine access. Supply constraints appear to be the main culprit. Most developed countries have ample doses; certain emerging markets, such as Chile, do as well. Last quarter, Chile was the top-performing emerging market equity market due, in part, to vaccine distribution from China and the U.S. Looking ahead, we believe increases in vaccine aid distribution, improving consumer sentiment, continued strong commodity prices, a weaker U.S. dollar, and a continuing recovery should help bolster emerging market performance. We remain favorable on emerging market equities.

Looking ahead, the U.S.-China rivalry could accelerate distribution and synchronize global inoculation efforts. Yet, it may also lead to reconfigurations of supply chains and realignments of geopolitical allegiances. What's more, China's assertiveness since the onset of the pandemic has aggravated geopolitical tensions, fostering increasingly negative views worldwide. Many countries now place China at the center of foreign policy agendas. In the U.S., taking a tougher stance on China has become a bipartisan issue, which we address in this report's section on U.S. supply chains originating from China.

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13. https://ourworldindata.org/covid-vaccinations, April 8, 2021

Risk considerations

Forecasts and targets are based on certain assumptions and on views of market and economic conditions which are subject to change.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

Definitions

An index is unmanaged and not available for direct investment.

Producer Price Index (PPI) is a family of indexes that measures the average change in selling prices received by domestic producers of goods and services over time.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

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