



## Letter n°74

### Protectionist pressures and the risk for stock market valuations (2).

*"Nothing can come of nothing" Shakespeare, King Lear, act1, sc2.*

The question is whether companies will be able to abstract themselves from politics and the pressures of civil society? The Russian example is interesting. Leaving Russia is easy but, contrary to reports, few companies have done so. Leaving China is difficult and many continue to establish themselves there.

In order to understand why we should ultimately avoid protectionism and its damaging effects on margins and stock market valuations, we will take two approaches, economic and corporate.

Two ideas, then: on the one hand, the resistance of firms, and on the other, the feeling that the West has everything to gain by persisting in controlled free trade, with safeguards in place.

#### **From a corporate perspective:**

There are various pressures on multinational companies, both in terms of location and environmental sustainability. But the links forged over the last thirty years will be difficult to unravel. Relocation is an important issue for governments, but a difficult strategy for companies to implement.

#### **- Four examples of linkages:**

The American example: deglobalisation will be slow because China is both the leading customer, 18% of American exports, and the leading supplier to the United States and because the interlocking links at the firm level are dense.

The Japanese example: Japanese companies cannot do without trading with China. In 2021, a quarter of Japanese imports came from China and 22% of Japanese exports went to China.

In Europe, the German example is similar: China remains the largest trading partner. Despite the tensions, trade growth was 20% in 2022 over one year and the German trade deficit reached a record €85 billion.

The Russian example: we have talked about the withdrawal of Renault, Shell and McDonald's, but according to an IMD study, almost a year after the onset of the conflict, less than 10% of Western companies have left the country, sometimes for lack of buyers or because of a blockade by the Russian authorities. And, the companies that left first would in fact be the least profitable.

#### **- Three possible avenues for relocation:**

Diversification: there is no deglobalisation of companies, but rather the use of palliatives, such as diversifying the number of suppliers on the one hand, and increasing precautionary stocks on the other.

Vertical integration of firms: it could come back in vogue, meaning that subcontracting of essential components could decrease. This is somewhat like the Tesla model.

Government involvement: state ownership will also become relevant again in sectors considered strategic, such as energy, for example with the nationalisation of EDF in France.

- ***Limits to relocations:***

No major power will ever be self-sufficient or at a very high cost. Diversification of supply sources must therefore take precedence over relocation.

The idea of relocations, for example in the French pharmaceutical industry, is not met with much enthusiasm because the selling prices of medicines, under the influence of the social security system, are considered unattractive and production taxes are too high. Many groups prefer to produce generic drugs in India, the world leader in this field, ahead of China, which has a 20% market share.

Halfway between relocating to China and relocating production units to the consumer's country, we see regional relocations. This is the case in the United States, where China now accounts for only 16.5% of US imports, down from 21% in 2016. At the same time, imports from Mexico have increased from 13% to 14%, as have those from Canada.

There are numerous counter-examples, but we will limit ourselves to four below:

Samsung closed its factories in China in 2019 but this is not the case for Apple. The firm works with Chinese companies Luxshare, Goertek and Wingtech and of course with the Taiwanese company, Foxconn. Apple employs 1.5 million people in China, and relocation is not so easy. In Vietnam, Apple is expected to produce half of its AirPods and 20% of its iPads by 2025, but while wages are at least 50% lower, the quality is not the same. India produces 15% of the world's iPhones, but these are the low-end models because the country lacks adequate infrastructure, and the quality of the workforce is not the same as that of China.

The second example is Exxon, as the company is considering a \$10 billion investment in the Chinese province of Guangdong.

The third example is Chinese company Haier, as it is strengthening its production capacity in Europe in the household appliances sector.

Finally, CATL, the world's number one electric battery manufacturer, will invest \$3.5 billion in Virginia, USA, with Ford to build a factory with technology transfers.

In other words, whether rightly or wrongly, the pursuit of profit and opportunism take priority over political considerations for these multinational companies.

**From an economic perspective:**

Many Western governments advocate for a certain level of protectionism, but wrongly so, as can be seen in the first point below and through three sectoral examples.

- ***Advantage of market economies over planned economies:***

The unfounded belief in the efficiency of authoritarian regimes and the preconception of their supposed ability to see far ahead have been undermined by recent crises, such as Covid and Ukraine.

In contrast, the rule of law offers a favourable framework for innovation, and the market economy has been able to address shortages quickly, such as the development of effective vaccines in the United States, not in China. All of this, the democracies, even if imperfect, know how to achieve.

Likewise, thanks to the flexibility of capitalism, shortages have been able to be quickly resolved. For example, in transportation, there has been an increase in the supply of ships, and freight rates between Shanghai and Los Angeles or between China and Europe have fallen to 2019 levels.

Western economies would be on the wrong track to succumb to the timidity of retreat.

- ***Developments in the semiconductor industry:***

In the semiconductor industry, perceived as strategic by all countries, the major countries have planned \$380 billion in incentives over the next seven years and in the United States alone, the "Chips Act" provides for \$55 billion.

Formerly the world's leading producer of semiconductors in the 1980s, Japan, now accounting for 17% of the global market, intends to regain pre-eminence in 2-nanometer chips and also wants to encourage its companies to leave China and relocate domestically.

Overall, there are many subsidies that could alter the optimal allocation of capital in the world, increase production costs, and cause overcapacity in this sector. TSMC estimates that the cost of production in its future U.S. plant will be 50% higher than the cost in Taiwan.

- ***Developments in batteries:***

Another sector chosen for subsidies aimed at attracting investors is electric batteries, a sector dominated by the Chinese with 6 out of the top 10 global companies, almost 80% of global production, and their two major players, CATL (37% of the global market) and BYD (13% of the global market).

In recent years, Asia has attracted 80% of investments, Europe 13%, and the United States 5%, but this will change with the implementation of the IRA in the United States.

In the United States, under the IRA, if half of the battery components are produced in North America, the buyer of an electric vehicle will receive \$7500 in subsidies. An example of collaboration between the United States and China, despite political tensions, is the announcement of a partnership between Ford and CATL, the world's number one battery maker, to build a \$3.5 billion battery plant in Virginia.

In Europe, the dependence on China is evident. CATL has set up a plant in Germany and invests nearly €2 billion, with an additional €7 billion investment planned in Hungary.

- ***Developments in renewable energies:***

All major countries - the United States, Japan, China, India - are launching substantial plans to support the development of renewable energy.

Over the past decade, China, through subsidies, has enabled the creation of some of the world's leading companies in wind power and solar panels.

In the United States, under the new plan, investments in solar and wind power will benefit from subsidies if they include at least 50% American components, such as steel and iron.

Caught between the United States and China, Europeans are considering an appropriate response. Filing a complaint against subsidies at the WTO would take years and would probably not be the ideal route. Establishing a plan similar to the American plan would be an option, but the question of financing remains, whether through community funds or a debt issuance that frightens the Dutch and Germans. Another possibility would be for the Americans to offer their allies access to the American market in exchange for aligned positions against China.

Energy independence will gain substance with the development of renewable energies. Trade imbalances in countries such as the United States will be reduced, and flows between producer and consumer countries will eventually decrease.

At the same time, while China remains the undisputed leader in renewable energy, it is gradually losing its role as the world's workshop to countries such as Vietnam, Bangladesh, and India.

*In conclusion, "We have lived in fear, now we shall live in hope." Tristan Bernard.*

Three reasons for optimism, three reasons to believe that avoiding protectionism that is harmful to company valuations is possible:

- ***The possible misstep of protectionism:***

The West cannot and will not abandon high-potential economic zones to China. For example, the West cannot convince Southeast Asian countries to stop trading with China, but it must not refrain from trading with them.

The West cannot do without rare earths or lithium, of which China refines over 50% of the global production.

- ***The false solution of relocations:***

Certainly, the search for countries offering the lowest wages or the most flexible working conditions is no longer the way forward for multinationals. Certainly, in the event of relocation, the assistance of AI and robotics will make it possible to temper the erosion of margins, but if various relocation plans have their appeal, care must be taken not to increase product costs, not to forgo economies of scale, and not to fracture the Western alliance with protectionist measures.

- ***Resistance of multinationals:***

Multinationals account for two-thirds of international trade and they do not want to give up promising markets, notably the Chinese market, where the country buys 50% of most metals, a third of luxury goods, 30% of semiconductors, and 20% of oil. But this is also true for Western and all other countries.

In summary, it is more appropriate to speak of diversification of supplies for companies than of relocation, and stock markets should not be at risk. This is good news because, according to the IMF, protectionism could cost seven points of global growth, a bad sign at a time when countries must invest more in energy transition and military equipment.

Geneva, 17<sup>th</sup> February 2023

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