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Dear Client:

In selling his administrations infrastructure investment plan, President Biden framed the policy in the context of reshoring manufacturing saying, "There is simply no reason why the blades for wind turbines can't be built in Pittsburgh instead of Beijing." The reshoring of jobs was a key justification for the last president's mercantilist rhetoric and, while ultimately ineffective, reshoring became an inevitable policy once the pandemic revealed the supply chain fragility of critical parts and products. While the size and scope of investment makes its way through Congress, investors must consider what a U.S. reshoring plan means for corporate profits.

To begin, if the U.S. is to again be a manufacturing nation, structural trends spanning decades must be reversed. According to the Bureau of Economic Analysis, the manufacturing sector's value-added was more than 25% of GDP in the 1950s, fell to ~20% in the 1980s, and settled in at ~11% more than a decade ago. This is due in part to the U.S getting richer (as incomes rise people consume more services than goods), and of course, globalization and the ascendancy of wage arbitrage. There is little dispute about the need for a policy that spurs innovation, productivity, and skills upgrades. And there are additional incentives: manufacturing jobs are mostly unionized and come with better pay/benefits than service sector jobs, which are generally not unionized (the share of union jobs has fallen from 25% of the workforce in the 1970s to ~10% today).

The aim of any infrastructure policy is to persuade/coerce/incentivize manufacturers to invest and hire in the U.S. The administration has an array of tools at its disposal and, based on its vision, fall into three main categories: 1) Spur manufacturing by subsidizing investment (R&D tax credits, direct investment in transport infrastructure, the power grid, broadband networks, and workforce training); 2) "Inflate" demand for domestically produced products (rebates and tax credits to buy American-made, mandating an electrification of federal cars and school buses, tightening rules for federal procurement); and 3) Weaken incentives for offshoring (tax overseas profits). The effect on some targeted industries may be compelling: the auto industry stands to get government largesse in R&D, production investment, infrastructure building, consumer subsidies *and* federal procurement. Hence, it will be hard for automakers not to make their electric vehicles in the U.S.

What is the likely impact on the U.S. corporate sector? Manufacturing is an inherently more volatile activity as companies must manage inventory cycles that service providers do not, so we should expect a rise in volatility for both revenue and profits, and a decline in margins. The last 20 years saw U.S. firms outsource production to China and focus domestic operations on high-value activity, which led to a sharp fall in labor costs as a share of value added (a key driver of the structural rise in profits in the trailing decades). Looking ahead, if production is lured back on the promise of juicy government contracts, manufacturers will have to live with lower margins. In order to meet local-sourcing requirements and get subsidies, a manufacturer could run parallel supply chains in the U.S. and China, but this would end up being less efficient and less profitable.

One thing is for certain, the policy mix must be potent: China has proven a tough competitor and the pandemic further shifted the advantage towards them, as they contained the virus and reopened its economy well ahead of other developed countries. China was therefore able to meet surging demand for medical equipment and electronic gadgets, while other industrialized rivals were shut down. So, the result cannot be simply to incentivize, but to improve U.S. manufacturing's competitiveness. And that begins with fortified infrastructure.

Regards,

Adam S. Abelson, CIO
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