INSIGHTS & STRATEGIES

FEBRUARY 29, 2024

RJL Investment Strategy (Canada) | RJLInvestment.StrategyCanada@raymondjames.ca
Neil Linsdell, CFA, Head of Investment Strategy | 438.843.0150 | Neil.Linsdell@raymondjames.ca
Eve Zhou, CFA, Multi-Asset Analyst | 647.577.8766 | eve.zhou@raymondjames.ca
Sean Darcel, Investment Associate | 647.251.4042 | sean.darcel@raymondjames.ca
Peter Tewolde, Senior Equity Specialist | 416.777.7045 | Peter.Tewolde@raymondjames.ca
Luke Kahnert, Mutual Fund & ETF Specialist | 416.777.7168 | Luke.Kahnert@raymondjames.ca
Ajay Virk, Head Currencies Trader | 416.777.6413 | Ajay.Virk@raymondjames.ca
Charlotte Jakubowicz, Fixed Income and Currencies | 416.777.6411 | charlotte.jakubowicz@raymondjames.ca

March 2024 Insights & Strategies: Will Reshoring Create New Opportunities?

Neil Linsdell, CFA - Head of Investment Strategy; Eve Zhou, CFA - Multi-Asset Analyst; Sean Darcel - Investment Associate

In 2020, as the COVID-19 pandemic came to global attention, international trade and production volumes declined drastically, similar to the Great Financial Crisis (GFC) of 2008/09 and World War II. In the case of the pandemic however, the speed of the decline and subsequent recovery was much quicker. Nevertheless, the damage was done, and both corporations and countries gained a new-found appreciation for secure and dependable supply chains.

We might think of globalization as a relatively recent phenomenon, as U.S. companies expanded their supply chains globally through the 1990s, pushing the value of imports from 10 per cent of GDP in 1991 to 14 per cent by 2000, and growing to over 17 per cent over the subsequent decade. Historically however, more significant changes in the way manufacturers managed supply chains can be traced back to the 19th century, as the U.K. drove globalization of textiles and industrial goods. Then of course globalization could depend on your perspective of the size and scope of the world, so with a little imagination, we can actually think of the origins of globalization in the first century B.C., as luxury (silk) goods from China started appearing at the other edge of the world, in Rome. The goods had traveled thousands of miles along what was dubbed the 'Silk Road'. This trade route thrived under protection of the empires of Rome and China, but after several centuries, the Silk Road closed, only to be revived under the protection of the Mongol Empire (in the 13th-14th centuries). Similarly, by the 9th century, Muslim traders dominated shipping through the Mediterranean and Indian Ocean, focusing on spices and transporting goods between Indonesia and Spain.

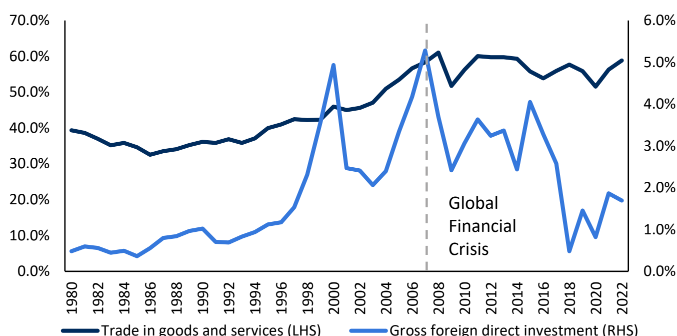
In 2013, China launched the ambitious Belt and Road Initiative (BRI), also sometimes dubbed the New Silk Road. Originally intended as infrastructure development and investment initiatives to link East Asia and Europe, the project has since expanded to Africa, Oceania, and Latin America. The investments so far in railways, highways, pipelines, ports, and other infrastructure has been estimated at over US$1 trillion, and is forecasted to reach as much at US$8 trillion.

Globalization can bring benefits by reducing manufacturing costs, expanding consumer choices, and more. Those of us residing in North America have undoubtedly enjoyed these advantages for years. However, following the GFC, there has been a prolonged slowdown in trade reform and a decline in political support for open trade amidst rising geopolitical tensions. In the U.S., over the last decade, imports have slowly declined to under 15 per cent of GDP. The International Monetary Fund (IMF) refers to this phenomenon as "slowbalization"[1]. This trend is somewhat subtle in terms of trade in goods and services, but more significant in terms of foreign direct investment (FDI) which reflects longer-term interests. The aftermath of the GFC, Brexit, and trade tensions between the U.S. and China collectively, led to a notable decrease in global FDI levels. As a percentage of global GDP, FDI dropped from 5.3 per cent in 2007 to a trough of 0.5 per cent in 2018. In recent years, the COVID-19 pandemic and escalating geopolitical tensions have further affected FDI, causing it to fluctuate around 1-2 per cent of global GDP, a level similar to that observed 25 years ago (Chart 1).

Key Takeaways

In the following pages, we look at the movement towards 'reshoring', 'nearshoring', or 'friend-shoring'. This was underway well before the pandemic hit, but has gained more attention as consumers still recall the pain of goods shortages on store shelves and inflation that is still front and centre of the current narrative. We look at how FDI is shifting between countries, and specifically away from China as the U.S. continues to de-risk its dependency on that country. In the short-term, rather than an immediate resurgence of U.S.-based manufacturing, we see more of a shifting of countries that the U.S. relies on. This will likely include benefits for countries like Canada, but also India and Poland. Mexico is already an important trading partner with the U.S., and so will likely continue to prosper, but in the same industries that it currently thrives in. Over the long-term, the U.S. aims to bring high-tech work back home, but the process will take time, offering future benefits.

Chart 1 - Trades and FDI As Percentage of GDP (Global)



Source: IMF staff calculations

Chart 2 - FDI Reallocation by Regions (% Chg in Number of FDIs)

Source Regions \ Destination Regions	United States	Americas excl. US	Advanced Europe	Emerging Europe	Asia excl. China	China	Rest of the world
Rest of the world	6.9	-12.4	-14.2	-8.1	-23.2	-44.2	-0.9
China	-41.6	-26.4	-37.3	-50.8	-63.8		-51.4
Asia excl. China	-22.7	-28.2	-31.2	-21.9	-43.2	-68.7	-23.9
Emerging Europe	8.1	-16.6	-9.6	-1.4	-41.8	-5.6	-31.0
Advanced Europe	-12.0	-31.2	-10.2	-20.4	-29.3	-39.2	-10.9
Americas excl. US	-0.9	7.8	-4.6	14.5	-13.6	-32.8	8.1
United States		-10.3	-18.9	-0.1	-17.2	-60.1	2.1

Source: fDi Markets; IMF staff calculations. Changes are computed using the number of greenfield FDI in 2Q20 - 4Q22 and average number in 1Q15 - 1Q20.

What Does Fdi Tell Us About Shifting Supply Chain Dependencies?

A closer look at the reallocation of FDI across regions reveals a growing fragmentation worldwide. FDI declined in the post-pandemic period from 2Q20 to 4Q22 by almost 20 per cent compared to the pre-pandemic average following the GFC[1]. However, this decline has been highly uneven. FDI flows to and from China experienced the most significant decrease, far worse than the aggregate change of a 19.5 per cent decline, particularly involving the U.S. and other Asian countries. Conversely, there has been an increase in FDI flows between the U.S. and emerging Europe, as well as between the U.S. and the rest of the world. This shift indicates that the U.S. is actively diversifying its supply chains away from countries like China towards countries deemed more geopolitically friendly. Additionally, there is a noticeable uptick in optimism regarding FDI from the Americas excluding the U.S., into other countries around the world, except China.

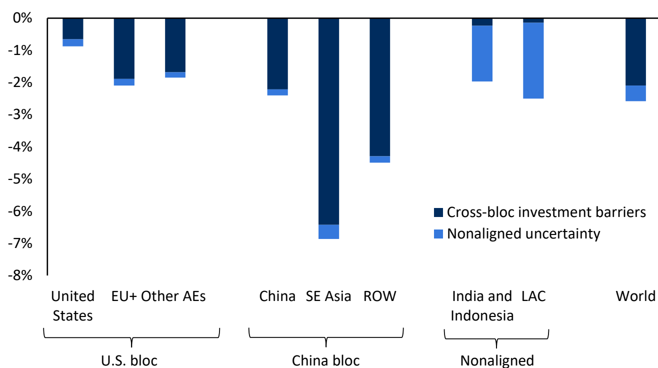
There is certainly a cost associated with the growing fragmentation as resources are allocated less optimally due to cross-bloc investment barriers (Chart 3). However, the impact on countries varies. According to the IMF's model-based quantification[1], in their baseline scenario, the U.S. is expected to suffer the least, while the EU, other advanced economies, and China may experience a ~2 per cent decline in long-term GDP losses, similar to the world average. Southeast Asia and the rest of the world (e.g., Central Asia, the Middle East, Russia, sub-Saharan Africa) are projected to face the largest negative impacts. For unaligned regions like India and Latin America, the impact on GDP heavily depends on their bargaining power, which is full of uncertainty.

Despite the potential long-term GDP losses, governments of major economies have underscored the strategic importance of supply chain resilience. In April 2022, U.S. Treasury Secretary Janet Yellen argued that firms should transition towards "friend-shoring" of supply chains. This call was influential as a growing number of larger, more profitable, and more knowledge-intensive firms expressed interest in reshoring during their earnings calls[1]. The U.S. government has enacted policies employing both 'sticks' and 'carrots' to achieve this goal. The 'carrots' include recent policy bills strongly tied to the industrial base, such as the Inflation Reduction Act (IRA), CHIPS and Science Act, and the Bipartisan Infrastructure Deal, while the 'sticks' consist of export controls and tariffs imposed on rival countries. The European Commission has also proposed the Net Zero Industry Act to counter U.S. IRA subsidies. Additionally, the French government has urged the EU to prioritize "Made in Europe" initiatives. In China, the government has provided substantial support, both financial and policy-based, to foster the growth of local advanced technology companies, aiming to reduce dependence on geopolitical rivals. It's noteworthy that many of these strategic policies are closely linked to the electrification theme we discussed back in January, emphasizing the importance of achieving electrification autonomously.

Investment Opportunities: Canada's Friend-Shoring Potential

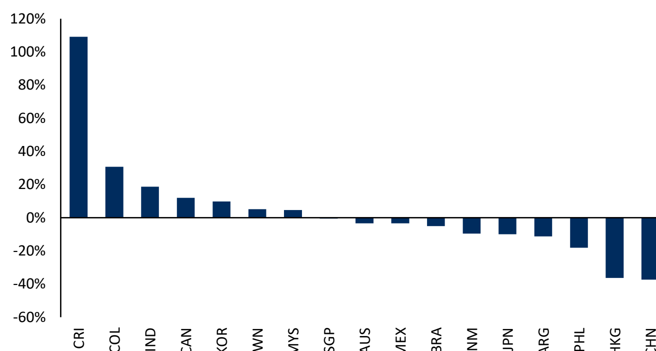
Given that Canada is the top trading partner of the U.S. and considering the longstanding binational supply chains between the two countries, any shift in the U.S. stance on geo-politics and industrial policy could significantly impact Canada as well. The U.S. is still a globalizing economy, but the "de-risking" of supply chains is ongoing. If we are going to see a push for U.S. companies to favour geographically convenient or politically secure partners and/or resurgence in manufacturing in the U.S., does Canada stand in an enviable position? Encouragingly, we have observed that Canada has been receiving more FDI from the U.S. in recent years, with geopolitical factors increasingly influencing decision-making processes. This suggests a long-term optimistic outlook for U.S.-Canada trade (Chart 4).

Chart 3 - Long-Term GDP Losses



Source: IMF staff calculations. AEs = advanced economies; EU+ = European Union and Switzerland; LAC = Latin America and the Caribbean; ROW = rest of the world; SE = Southeast.

Chart 4 - Change in Outward U.S. Foreign Direct Investment



Source: fDi Markets; IMF staff calculations. Changes are computed using the number of greenfield FDI in 2Q20 - 4Q22 and average number in 1Q15 - 1Q20. Labels on the x-axis use International Organization for Standardization country codes.

While we are still in the early phases of the reshoring trend, one thing that appears more certain is that the U.S. will prioritize friend-shoring strategic industries, particularly related to advanced technology such as electric vehicle (EV) batteries, stationary storage batteries, and semiconductor packaging[2]. These industries form a crucial component of the Canada-U.S. partnership, supported by robust binational government funding and policy initiatives. As previously mentioned, there is significant overlap between these industries and those discussed in our January piece on electrification. This is because one of the primary reasons for securing the supply chain is to facilitate a robust transition to clean energy.

On the manufacturing front, Canada and IBM have already joined forces to expand semiconductor packaging and testing capabilities at IBM's Bromont (QC) facility, creating jobs and economic activity in both countries. We also expect the U.S. and Canada to further partner with automakers, battery manufacturers, and organized labour to share training initiatives and cross-border credentials, addressing the rising demand for EVs in North America[2]. Canada's robust immigration system and highly skilled workforce will further bolster this friend-shoring trend.

Canada Has an Abundance of Critical Minerals

More importantly, Canada is one of the few Western nations that have an abundance of cobalt, graphite, lithium, and nickel — essential to creating stationary storage batteries and EVs. On top of that, Canada ranks as the world's second-largest producer of niobium, a vital metal for the aerospace sector, and is the fourth-largest producer of indium, a critical component in semiconductors and various materials essential for advanced vehicle manufacturing[3]. Therefore, we see the supply of critical minerals as a significant long-term opportunity (Chart 5). As tensions between the U.S. and China mount, there's a growing push in the U.S. to reduce reliance on Chinese imports of critical minerals. Currently, China is the leading supplier, providing the U.S. with the largest number (24) of non-fuel mineral commodities[4]. In response to this, the Canada-U.S. Joint Action Plan on Critical Minerals was announced on January 9, 2020, to advance bilateral interest in securing supply chains for the critical minerals needed in strategic manufacturing sectors. In 2020, bilateral mineral trade was valued at $95.6 billion, with 298 Canadian mining companies and a combined $40 billion in Canadian mining assets south of the border. Just two years later, in 2022, the bilateral mineral trade surged to $135.5 billion, reflecting a substantial increase of 41.7 per cent[5]. While certain minerals, like rare earths, require complex refining processes and mining projects can take 5 to 25 years to become operational, Canada's International Trade Minister Mary Ng affirms that “Canada wants to be a part of the solution”.

In addition to the U.S., Canada has also established partnerships with other allies concerning critical minerals. For instance, there's the Canada-EU Strategic Partnership on raw materials and the Canada-Japan sectoral working group on critical minerals. Over the past two years, we've seen several success stories in this area, including collaborations with global corporations. Two notable examples include LG Energy Solutions signing agreements to source battery minerals from three Canadian mining companies and Volkswagen's memorandum of understanding with Canada to secure a supply of battery minerals.

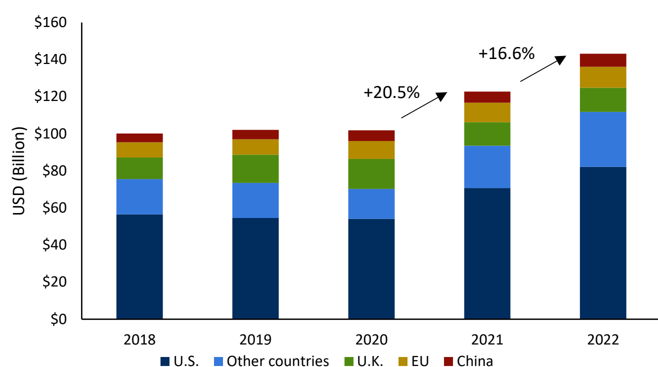
Investment Opportunities: Other Countries Around the World

Other countries set to benefit from the reshoring trend include India and Poland. India has a robust and cost-effective labour force, along with political stability for an extended period, making it highly attractive to multinational corporations and offering significant upside potential. For example, Apple is accelerating its shift to India to diversify its global production away from China. It's also evident that strengthening ties with India is now a top priority in U.S. foreign policy. Meanwhile, Poland, as part of emerging Europe, has experienced a rise in FDI from the Americas

in recent years. According to BCI Global, over 60 per cent of European and U.S. companies anticipate reshoring some production activities from Asia back to Europe or the U.S. within the next three years. Poland emerges as one of the most favoured new production locations, thanks to its shorter delivery times, modern road infrastructure, and large warehouse stock[6]. As shown in Chart 6 below, Poland and other emerging European countries have seen significant growth in trade with the U.S. since the GFC. Although India's growth rate is slightly lower, it remains one of the fastest-growing countries, with a relatively large combined volume of exports and imports. Vietnam has also experienced impressive growth and has a significant combined trade volume. However, Vietnam faces higher non-aligned uncertainty due to its more balanced approach between the two great powers and its geographical location, which partly explains the decline in FDI from the U.S. in recent years, making its situation more complex.

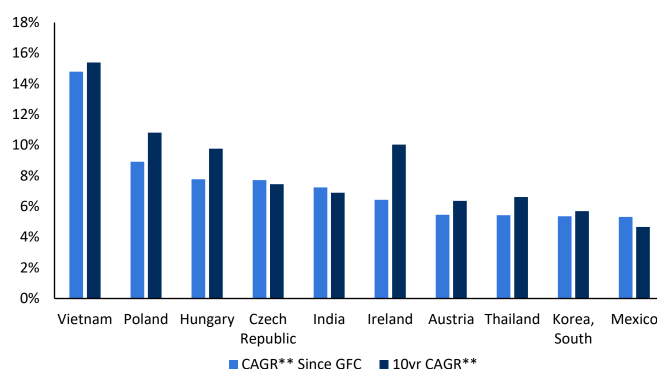
In summary, after years of increasing globalization, we are now observing a trend toward greater fragmentation globally. This shift is driven by major economies realizing the need for resilient supply chains and their strategic importance in achieving nationwide goals such as the clean energy transition. These developments mark the very beginning stages of reshoring. With changes in the U.S. stance on geopolitics and industrial policy, opportunities should arise for Canada in critical minerals and advanced technology manufacturing. Similarly, emerging Europe and India stand to benefit. Reshoring, akin to past offshore trends, is expected to remain a long-term theme for years to come.

Chart 5 - Canada: Exports for Mineral and Metal Products, Excluding Fuels



Source: Natural Resource Canada; Data as of November 15, 2023.

Chart 6 - Growth in Trade Activity* with the U.S. - Top Ten Countries



Source: United States Census Bureau; Raymond James Ltd.; Data as of December 31, 2023. *Trade Activity: exports and imports combined. **Compound annual growth rate.

[1]IMF (2023), Chapter 4 Geoeconomic Fragmentation and Foreign Direct Investment, IMF, https://www.elibrary.imf.org/display/book/9798400224119/CH004.xml

[2]The White House (2023), FACT SHEET: Strengthening the United States-Canada Partnership, The White House, https://www.whitehouse.gov/briefing-room/statements-releases/2023/03/24/fact-sheet-strengthening-the-united-states-canada-partnership/

[3]Government of Canada (2023), The Canadian Critical Minerals Strategy, Government of Canada, https://www.canada.ca/en/campaign/critical-minerals-in-canada/canadian-critical-minerals-strategy.html

[4]U.S. Geological Survey (2024), Mineral Commodity Summaries 2024, USGS, https://tableau.usgs.gov/views/MCSDashboardWorkbook_2024-01-30/MCSDashboard?%3Aembed=y&%3AisGuestRedirectFromVizportal=y#7

[5]Natural Resources Canada (2023), Mineral Trade, Government of Canada, https://natural-resources.canada.ca/maps-tools-and-publications/publications/minerals-mining-publications/mineral-trade/19310

[6]BCI Global, Reshoring Production Back to Europe and the US Is on the Rise, Particularly for Critical Parts and Final Production Processes, BCI Global, https://bciglobal.com/en/reshoring-production-back-to-europe-and-the-us-is-on-the-rise-particularly-for-critical-parts-and-final-production-processes

Manufacturing in the U.S.

Tavis C. McCourt, CFA - U.S. Institutional Equity Strategist

In January, the ISM Manufacturing Purchaser's Manager Index stood below the key 50 threshold for the 15th consecutive month, which is consistent with modest contraction across the manufacturing sector in the U.S. for over a year now, even as overall economic growth has been reasonably strong (thanks to strong services spending). That data makes it difficult to argue that we're in the midst of a broad based manufacturing resurgence in the U.S. However, from a longer term perspective, there is clear reason to believe that there is a stronger longer term outlook for manufacturing in the U.S. than there has been in a number of decades.

From the U.S. point of view, America started "de-risking" its supply chains starting in 2018 as the trade war with China, although having a very limited monetary impact, forced CEOs to realize the risk inherent in relying on a single country for raw materials and product supply. This concern was heightened during the COVID pandemic as even the U.S. government was suddenly faced with supply disruptions of products that were potentially crucial in managing through a pandemic (masks, raw materials for drugs, etc…). This accelerated the trend of the U.S. diversifying its supplier base across numerous industries, and particularly away from China towards other more 'friendly' countries.

Inflation adjusted imports of goods and services by the U.S. have grown 14.5 per cent since 2017 (~2.4 per cent/year), which is a slight deceleration of the real growth in imports over the previous 5-year period (~3.8 per cent/year), but hardly an indication that the U.S. is 'de-globalizing'. However, since 2017, imports from China have declined ~14 per cent, while overall imports into the U.S. have increased by ~31 per cent, so we can definitely see that geographic diversification of imports has increased. Another important data point is that the number of employees in Manufacturing businesses in the U.S. is 12.9 million vs. 12.8 million pre-pandemic, so essentially back to pre-pandemic levels.

What these statistics show is that the U.S. is still a globalizing economy, and its importation of goods continues to grow, albeit more modestly. However, it is relatively rapidly moving from imports from China to imports from other countries in order to lessen the risk of a "single point of failure" in global supply chains broadly, including health care, technology, apparel, etc... Additionally, there is no evidence that re-shoring to the U.S. is all that substantial, as of yet, as overall growth in manufacturing employment is about the same today as it was in 2019 before the pandemic, partially due to the mild "goods recession" the U.S. has been in for well over a year. We do expect this "de-risking" of supply chains, from a central location (China), to more decentralized supply chains across the U.S. and numerous friendly countries, to continue for many years and even decades.

This likely opens up an opportunity for a number of countries that are friendly to the U.S. politically, and geographically close to the U.S., including Canada, to potentially see increases in exports to the U.S. of goods such as raw materials/commodities as well as manufactured products over the coming years and decades. Already, Canada is the third largest goods exporter to the U.S., and as China likely continues to decline due to U.S. companies' desire to de-risk their supply chains, Canada should benefit on the margin.

The End of Globalization? Risks and Opportunities of a New Economic Era

Ed Mills - Washington Policy Analyst

Are the U.S. and Chinese economies decoupling, or are we seeing a more strategic approach to national security priorities and supply chain resiliency? How important is the 2024 Presidential Election? The answer to these questions depends upon the policy decisions over the next several years and could have massive implications for the global economy and equity markets. We are of the view that a broad-scale decoupling and the formation of regional economic blocs is less likely, but a trend of reindustrialization and de-risking will be a market theme that investors will navigate in the years ahead. We also argue that recent U.S. policy decisions are the foundation for an industrial renaissance aimed at building up the economic base of the U.S. and protecting it against some of the geopolitical and supply chain risks that have had significant impacts in recent years—most acutely felt during the COVID supply chain shortages of critical materials. Key aspects of this industrial renaissance are the series of 'carrots' in the form of tax subsidies and direct support vs. the initial phase of 'sticks' in the form of tariffs, blacklistings, and technology restrictions. However, the potential reelection of former President Trump and his pledge to add new tariffs will add to the uncertainty of the relationship.

U.S. and China at a Crossroads: A Shift in the Global Economic Order

Concern over China's longer-term geopolitical ambitions and the threat posed by China's military to the U.S. and key allies has been a major focus of U.S. policy in recent years. During the Trump administration, concerns about China's unequal market access and intellectual property theft led to the 2018 'trade war' with tariffs levied against a broad set of China's imports into the United States. A key concern was that U.S. technology designed for civilian use could be repurposed for military application. This led to U.S. policy viewing technology as a national security asset, thereby implementing new export restrictions, and blacklisting various Chinese companies from receiving access to U.S. technology, especially in the semiconductor space. The flow of U.S. capital into critical sectors in China that finance China's economic competition with the U.S. also came under enhanced scrutiny. While this economic confrontation was initially driven by national security considerations, the COVID-19 pandemic exposed additional vulnerabilities around global supply chains, particularly with technology components and medical goods that drove shortages and spiked prices. These conditions set the stage for a rethinking of U.S.-China economic relations that quickly became a bipartisan consensus in Washington.

Government Response: Securing Supply Chains & Investing in the Domestic Industrial Base

In response to these dynamics, the U.S. government has enacted policies with both 'sticks' and 'carrots' that create challenges and opportunities for investors navigating the shifting global environment. Export controls, tariffs, and economic restrictions through the blacklisting of certain companies have created revenue and cost challenges for U.S. companies with significant exposure to China's market. However, policymakers have also unleashed more than US$1 trillion in domestic investment across pandemic relief measures and new funding for domestic infrastructure, semiconductor manufacturing, and the energy transition. These new policies direct federal funds and catalyze private sector investment toward what we refer to as the 'reindustrialization' of North America. The goal of these policies is to fortify the U.S. domestic industrial base and limit future economic dependencies that can drive economic disruptions or be used against the U.S. as economic leverage. Even with this level of new investment, we still see significant appetite in Washington to build on, and supercharge, certain aspects of the domestic economic agenda, including permitting reforms, investments in critical minerals, and preserving a role for legacy energy to limit transition risks. Vulnerabilities experienced by countries with oil and gas dependencies following Russia's invasion of Ukraine have prioritized projects that build out legacy energy infrastructure and limit potential vulnerabilities around critical minerals as the energy transition gains pace. In this sense, policymakers are wary of replacing dependence in the oil and gas space with critical mineral dependencies with supply chains heavily concentrated in China.

Overall, the events of the last several years have placed national security and economic disruption concerns as leading drivers of policymaking in Washington – with clear winners and losers from an investment perspective. As federal funding is deployed and the reindustrialization theme plays out, we expect Industrials to be a beneficiary. New investment and market opportunities for the energy transition will be a material boost for clean energy equities. We see the transition as balanced across the energy space with permitting reform boosting the buildout of energy infrastructure and increasing demand for liquified natural gas. In terms of potential headwinds, the technology sector will be a space that is exposed to risks as the policy impact unfolds. Emerging technologies such as artificial intelligence, quantum computing, and robotics will be in the crosshairs of new controls and regulations which can limit the ability of certain companies to scale and penetrate China's market. Biotechnology and pharmaceuticals are other areas to watch which could see similar controls in the future.

What's Next?

Investors should be aware of critical trends that will impact the evolution of this emerging theme. First, China's response (such as targeting U.S. companies as a retaliatory step) can increase market risks if U.S. policy actions are seen less as 'derisking' and more as 'decoupling' by

another name. While the Biden administration is taking steps to deescalate tensions around Taiwan, China perceiving Taiwan as moving closer to independence could accelerate the timeline for a regional conflict that could drive global economic disruption on a significant scale. Political instability within the U.S. Government could also play a role, but not always in a straightforward manner. Perceived U.S. weakness has been generally viewed as a reason for Beijing to wait, but internal Chinese domestic concerns could cause a recalculation. Lastly, the inflationary impact of a shifting global economic order will have important consequences for the direction of monetary policy. Higher costs and elevated spending could weaken the Federal Reserve's tools to fight inflation and prolong high interest rates—a 'higher for longer' scenario. We expect attention to increase on these issues over the next year, especially as the U.S. prepares for the 2024 presidential election campaign that will help determine the trajectory of a changing macro investment environment.

Industry Leaders Thoughts on Reshoring Trends

Peter Tewolde - Senior Equity Specialist

US companies, having faced recent supply disruptions mainly influenced by the pandemic and global events, and their government, have re-evaluated supply-chains and made a concerted push towards reshoring and/or nearshoring. In this article, we will explore the recent commentary from executives at **Bank of America (BAC-US)**, **BlackRock (BLK-US)**, **Caterpillar (CAT-US)**, **Qualcomm (QCOM-US)**, and **Union Pacific (UNP-US)**, from various conferences in 2023, to help us understand how they view these developments.

- In June 2023, at BlackRock's Investor Day, Richard Mark Rieder discussed the broader economic shifts shaping this new manufacturing trend: *"Demographics, de-globalization, and the significant spend on clean energy, infrastructure, and tech are shaping a new economic landscape... It's inflationary but necessary for a sustainable future."* From Rieder's comments, it is clear he views macroeconomic forces propelling the shift towards localized manufacturing will have both a negative and positive impact, but a necessary one if we are to achieve a more resilient global supply chain.
- Lisa G. Clyde of Bank of America, speaking at the BancAnalysts Association of Boston Conference in November 2023, discussed how it is impacting their clients: *"Our clients are also thinking about the decoupling of supply chains and the China Plus One that's occurring... we fully expect that some of our biggest areas of growth are in Mexico with nearshoring."* This highlights the nearshoring trend and desire of companies to diversify their supply chains, creating opportunities in the near term for banking.
- D. James Umpleby III, CEO of Caterpillar, shared his perspective during a BofA analyst meeting, emphasizing the impact of legislative initiatives and infrastructure investments on the industry: *"Well, certainly a positive for us. I talked earlier about non-residential construction representing 75 per cent of Construction Industries. You know whether it's the CHIPS Act, the IRA..., those all create opportunities for us… if you think about some of these projects like a big battery plant, as an example. If you go to one of those big battery plants or a big chip plant, you'll see 100 — literally hundreds of pieces of construction equipment at that — those big mega sites putting that together. So, that's a positive thing for us."* Umpleby's remarks reflect the sector-specific benefits arising from the reshoring trend, notably in construction and infrastructure sectors spurred by acts like the CHIPS Act and the Inflation Reduction Act.
- At the Deutsche Bank AutoTech Conference on November 9, 2023, Nakul Duggal from Qualcomm highlighted the evolving dynamics in the automotive supply chain: *"Post-pandemic, we have direct relationships with most of the major automakers... there is a heightened sense of supply chain sensitivity."* This shift towards closer collaboration and transparency with automakers underscores the industry's adaptation to the new supply chain realities.
- Finally, Kenny G. Rocker of Union Pacific, during the Q4 2023 Earnings Call, was asked a question by Stifel, Nicolaus & Co's analyst, which confirmed the shifts in logistics and supply chain strategies: *"…the nearshoring is real. We've seen the billions that have gone in, in all of 2023. These are — a number of them are highly industrial and rail-centric, which we find encouraging… We have seen some wins with us having the fastest product coming out of Mexico, especially in time-sensitive products like auto parts, again, it's daily service. We're reaching into the Midwest. We're reaching into different parts of Canada."* Rocker's comments validate the substantial investments and operational shifts taking place to leverage the nearshoring, which is impacting rail and logistics demand in a notable way.

Conclusion

Considering the views from industry leaders and the current reshoring/nearshoring trends taking place, focusing on industries that help companies make these changes could be advantageous for investors in the near term. Some notable industries and sectors to consider include construction, heavy machinery, transportation, and technology. Additionally, companies aiming to diversify their supply chain are also likely to be more resilient to global disruptions in the future once they have completed their efforts in reshoring and/or nearshoring.

Industrial & Infrastructure ETFs

Luke Kahnert, MBA, CIM - Mutual Fund & ETF Specialist

The reshoring of supply chains may open up a range of investment opportunities within the industrial and infrastructure sectors of certain countries. While the Canadian ETF market has yet to introduce a strategy that addresses this specific "reshoring" theme, Canadian investors may find exposure through a sector ETF with distinct country exposures that align with their views of the global reshoring idea.

First Trust AlphaDEX US Industrials Sector Index ETF (FHG)

For investors looking for exposure to the U.S. industrial sector, First Trust offers the only U.S.-specific industrial sector ETF available in the Canadian marketplace. This ETF seeks to replicate the performance of the StrataQuant Industrials Index which begins with the constituents of the Russell 1000 index. Companies are then screened, ranked and weighted. The final portfolio consists of a list of 133 holdings across various sub sectors — an attractive option for investors looking for exposure that focuses on the U.S. industrials sector (Table 1).

BMO Equal Weight Industrials ETF (ZIN)

For investors looking for exposure to the Canadian industrials sector, BMO offers a Canadian industrials ETF where each security in the index is assigned an equal weight, regardless of its market capitalization. While the ETF only consists of Canadian companies, the performance of the ETF is naturally closely tied to the U.S. economy. According to data from FactSet, 34 per cent of revenue generated from companies in ZIN is derived from the U.S. as of January 31st, 2024. Given the Canadian industrials sector is dominated by a few names from a market cap perspective, using an equal-weight approach may be more attractive from a diversification standpoint and may help reduce concentration in larger cap names such as Canadian National Railway Company and Canadian Pacific Kansas City Limited. However, while the equal-weight approach will reduce company-specific concentration risk, the methodology will also overweight smaller-cap names compared to a market-cap weighted alternative (Table 2).

iShares Global Infrastructure Index ETF (CIF)

For investors looking for a global strategy, the iShares Global Infrastructure ETF provides exposure to global infrastructure opportunities by replicating the performance of the Manulife Investment Management Global Infrastructure Index. Currently, over 95 per cent of the ETF's infrastructure exposure is in North America and South America. This may be a desirable solution for those looking to leverage an infrastructure ETF that provides exposure outside of the U.S./Canada to include South American opportunities (Table 3).

Additional Thoughts

- This year, not only is the U.S. preparing for a presidential election, but 64 countries (plus the European Union) are expected to hold national elections making 2024 a busy year as it pertains to global politics[7]. Changes in political administrations often introduce changes in policies affecting the infrastructure and industrial sectors. Factors such as government spending, regulation, trade policies, development projects, etc., can influence the performance of these sector ETFs.
- In 2023, two U.S.-listed reshoring ETFs (RSHO-US and SUPP-US) were launched offering exposure to companies that stand to benefit from manufacturers moving to the US. Upon further analysis, according to FactSet, these ETFs have only generated a combined US$24.7 million in flows as of February 16th, 2024, indicating a surprisingly low level of investor interest. Until these U.S.-listed ETFs start to generate stronger demand, it is unlikely that a Canadian ETF provider will launch a similar ETF in the Canadian marketplace.
- Using a passive sector ETF can provide general exposure to sectors that may benefit as a result of reshoring trends, but it may also be too broad of an approach for certain investors. The opportunity may come down to uncovering specific companies that stand to benefit from this global theme. For those looking for a more direct approach, it may be more beneficial to leverage a U.S. Equity fund manager who is actively identifying reshoring opportunities or selecting individual equities.

Table 1 - FHG Geographic Breakdown

FHG Geographic Breakdown:	
United States	88.44%
United Kingdom	6.35%
Ireland	3.15%
Bermuda	1.89%

Source: ETF Provider website, as of February 16, 2024.

Table 2 - ZIN Market Capitalization (%)

Market Cap	FactSet Ranges (USD)	Allocation
Large Cap	>$12.9 billion	13.52%
Mid Cap	$2.7 billion - $12.9 billion	32.09%
Small Cap	$600 million - $2.7 billion	54.53%

Source: FactSet, as of January 31, 2024.

Table 3 - CIF Geographic Breakdown

CIF Geographic Breakdown:			
U.S.	46.80%	Mexico	2.57%
Canada	32.54%	Norway	1.15%
Brazil	8.04%	U.K.	1.04%
Bermuda	3.53%	Cash	0.64%
Chile	3.10%	Other	0.59%

Source: ETF Provider website, data as of February 19, 2024.

[7]Koh Ewe (2023), The Ultimate Election Year: All the Elections Around the World in 2024, Time, https://time.com/6550920/world-elections-2024/

CAD Overshadowed by U.S. Economic Data and Fed Speculation

Ajay Virk, CFA, CMT - Head Trader, Currencies

After falling over 5 per cent in the final two months of last year, USD/CAD has seen a modest recovery so far in 2024 after beginning the year in the 1.32's (gaining +2.5 per cent at the time of writing). The slate of relatively robust U.S. economic data, particularly on the employment front, has given the broad U.S. dollar quite a decent lift and put a dent in the soft dollar undertone that was developing as of late. The primary catalyst for this recent stint of dollar strength can also be attributed to the market's continuing adjustment of the Fed's easing expectations, both on the timing and breadth of potential rate cuts this year.

The surprising resilience of the U.S. labour market cannot be understated; this may imply a robust income backdrop for consumption and GDP growth, at least through the first half of the year, which would underpin sustained U.S. dollar strength over the short term. As a result, the market has been gradually pushing Fed rate cut odds further out, with the first rate cut now being penciled in for June/July. The BoC also shares a similar profile for the timing of its first potential rate cut (Chart 7).

Bank of Canada Policy Easing Understated?

As far as an outlook goes, we have posited that the primary driver for U.S. dollar price action as of late has been the market's expectations for the timing and scope of the Fed's eventual easing of policy. The market is pricing in roughly ~110bps of easing for the Fed this year, versus ~105bps for the BoC, at the time of writing. The consensus view continues to be that the market is underpricing the extent of BoC policy easing, which may lead to strength in USD/CAD through at least Q2 should the market decide to beef up their BoC rate cut expectations for this year and beyond. The idea behind this view is that the U.S. economy has been seen as relatively sturdy to adapt to an environment of "higher rates for longer," while Canada and other countries that deal with relatively higher levels of household debt (e.g., consumer mortgages and the perceived reset risk to higher rate levels) are naturally more susceptible to negative impacts from a higher-rate environment. For comparison, most mortgages in the U.S. are longer-term, fixed rate mortgages. All this to say, the market may fine-tune their BoC easing expectations (i.e., raise them), which should weigh on CAD over the short term and thus result in some modest strength in USD/CAD.

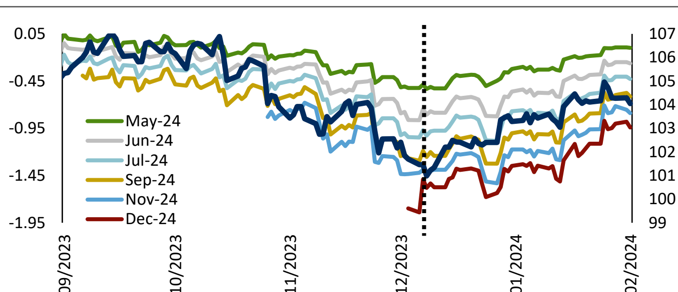
Taking a quick look at FX volatility indexes going out one year, there is an apparent sense of uncertainty in the short term (i.e., 1 month), while volatility measures remain largely elevated out to one year (which covers the U.S. presidential election). As a result, we may see a brief period of consolidation in FX markets before things begin to shake up (Chart 8).

A Tale of 2 Halves

The recent trajectory higher for the broad U.S. dollar has shed some light on the importance of economic data, and the associated implications for Fed rate cut expectations, and how it continues to underpin U.S. dollar performance in this environment. Given what was initially excessively dovish Fed expectations in the back-end of last year, the recent slate of stronger-than-anticipated U.S. economic data has led many to scratch their heads at how soon the so-called "Fed pivot" will actually materialize and how far its easing cycle will go.

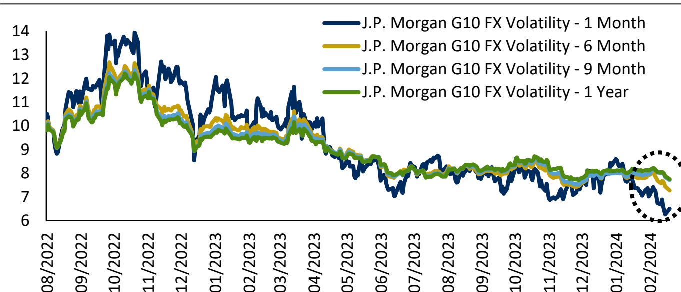
To recap, while the general call is for the Fed to kick off their easing cycle in June/July, and as the market continues to re-price itself around this time frame, the USD can still see some modest strength over the near term. In the back-end of the year however, we expect the theme to shift to U.S. dollar weakness as the Fed looks to wind down the pace of quantitative tightening with an anticipated ~3-4 rate cuts under its belt by then. In addition, additional drags on the USD may also stem from relatively more hawkish monetary policy abroad, continued deficit spending, and a broader sense of dollar overvaluation on a longer-term basis.

Chart 7 - Dollar Higher as 2024 Fed Easing Odds are Dialed Back



Source: FactSet; Raymond James, Ltd.; Data as of February 20, 2024.

Chart 8 - Possible Period of Uncertainty as 1-Month FX Volatility Reading Dips to 1-Year Lows



Source: FactSet; Raymond James, Ltd.; Data as of February 20, 2024.

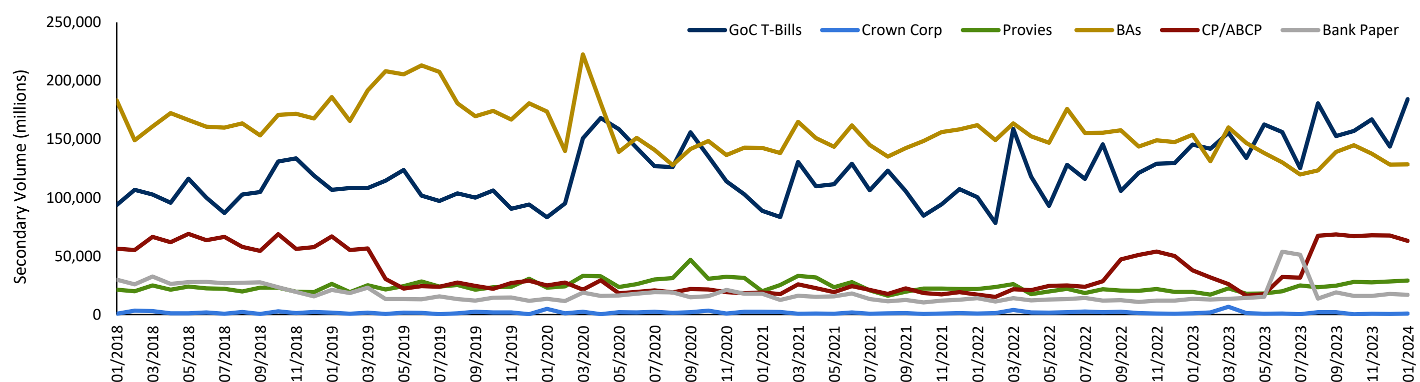
Bye Bye BAs

Charlotte Jakubowicz, CMT, CIM - Vice President, Fixed Income and Currencies

Investors purchase securities for a range of reasons. Sometimes, they look to invest for a long time horizon (think years or decades), whereas other situations are better aligned with short-term investments. For the latter, many individuals look to money market instruments, with their relative safety, high liquidity, and ease of purchase. Within the category of money market, bankers' acceptances (BAs) play a major role, as they represented around 20 per cent of outstanding assets, behind only Government of Canada treasury bills. However in June 2024, BAs will cease to be issued, leaving investors looking for a suitable alternative. Here, we discuss why this is occurring, and offer some replacements for retail investors.

Broadly speaking, money market is a category of fixed income products with a time to maturity under a year. They are issued on a discounted basis, meaning the security does not pay a coupon. Instead, the investor's return is the difference between the purchase price and the final maturity value – often par, or 100. And within the classification of money market, BAs have been a popular investment. For numerous reasons outside the scope of this publication, the Canadian Alternative Reference Rate working group had determined that the BA lending model was no longer effective and it was their expert recommendation that the underlying pricing basis, the Canadian Dollar Offered Rate (CDOR), cease to be published. Due to this cessation, BAs will cease to be created as well. Since this decision, reduced issuance volume and lower liquidity for larger sizes has resulted and can be expected to be magnified as we move closer to the June 28 date (Chart 9).

Chart 9 - Secondary Money Market Trading



Source: CIRO; Data as of January 1, 2024. Category "other" not shown.

As the second-biggest money market security type, there will surely be a gap in the market as we move forward without BAs as an investment vehicle. Although there are a number of alternative instruments that may mirror the term, yield, credit quality, liquidity, etc. of bankers' acceptances, none are a perfect swap.

BA alternatives

- Bearer Deposit Notes (BDNs): These instruments are issued by the major banks, carrying their credit quality. BDNs are readily available for purchase. However, they tend to have longer maturities than what bankers' acceptances are offered in, making that its largest detractor.
- Treasury Bills (T-bills): The Government of Canada (GoC) and some provinces issue T-bills. Today, new GoC T-bills are auctioned at three month, six month, and one year terms. Treasury yields are lower than BAs, reflecting a lower level of perceived risk.
- Commercial Paper (CP): These are short-term debt obligations of corporations. They are not as liquid as other money market instruments, with less availability on a secondary basis.

The biggest gap will be felt in the one-month tenor, as it carries the largest disconnect between issuer funding needs and where investors wish to place their funds. To address this, a temporary issuance of one-month GoC T-bills is being considered, giving the industry time to introduce new policies, roll out technology, and create new products.

It's worth noting that existing securities that reference CDOR must switch to their agreed upon fallbacks, such as CORRA (Canadian Overnight Repo Rate Average) calculated in-arrears, Term CORRA, or another suitable alternative during the transition. The cessation of bankers' acceptances is a huge change to the money market landscape which is sure to evolve and shift as investors identify the securities that best resonate with them and match their requirements. Beyond both retail and institutional investors, however, issuers, policy creators, and those managing regulations must stay tuned in to ensure the transition beyond BAs is a success.

IMPORTANT INVESTOR DISCLOSURES

Complete disclosures for companies covered by Raymond James can be viewed at: Disclosures https://raymondjames.bluematrix.com/sellside/Disclosures.action

This newsletter is prepared by the Private Client Services team (PCS) of Raymond James Ltd. (RJL) for distribution to RJL's retail clients. It is not a product of the Research Department of RJL.

All opinions and recommendations reflect the judgement of the author at this date and are subject to change. The author's recommendations may be based on technical analysis and may or may not take into account information in fundamental research reports published by RJL or its affiliates. Information is from sources believed to be reliable, but accuracy cannot be guaranteed. It is for informational purposes only. It is not meant to provide legal or tax advice; as each situation is different, individuals should seek advice based on their circumstances. Nor is it an offer to sell or the solicitation of an offer to buy any securities. It is intended for distribution only in those jurisdictions where RJL is registered. RJL, its officers, directors, agents, employees and families may, from time to time, hold long or short positions in the securities mentioned herein and may engage in transactions contrary to the conclusions in this newsletter. RJL may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this newsletter. Securities offered through Raymond James Ltd., Member-Canadian Investor Protection Fund. Financial planning and insurance offered through Raymond James Financial Planning Ltd., not a Member-Canadian Investor Protection Fund.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. The results presented should not and cannot be viewed as an indicator of future performance. Individual results will vary and transaction costs relating to investing in these stocks will affect overall performance.

A member of the PCS team responsible for preparation of this newsletter or a member of his/her household has a long position in Bank of America Corporation and BlackRock, Inc..

Securities mentioned in this publication may entail higher risk. Clients should contact their Financial Advisor to determine if the securities are compatible with their risk tolerance and investment objectives.

Information regarding High, Medium, and Low-risk securities is available from your Financial Advisor.

RJL is a member of the Canadian Investor Protection Fund. © 2024 Raymond James Ltd.