FISCHER STRALEM
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Dear Client:

In our recently published quarterly letter, we began to unpack the industrialization of the Mexican near-shore and the perceived threat for China to circumvent U.S. trade sanctions. We made note that the latest round of protectionism is motivated by two factors: excess capacity and innovation. We tackled the innovation angle in the letter and are taking the opportunity here to circle back to look at the domino effect of China's excess capacity -- an issue which has further catalyzed long-simmering worries about trade dependency in the face of Chinese government stimulus of critical, labor-intensive, blue-collar industries.

More than a decade ago, China launched its ambitious *Made in China 2025* program which was its economic policy roadmap to replace key imports in advanced manufacturing industries with indigenous products. China has since moved methodically to dominate ever more industries, from toys and clothing to solar panels and electric vehicles (EVs). According to research from the Centre for Economic Policy Research (CEPR), China produces ~35% of global manufactured goods -- more than the U.S., Germany, Japan, South Korea and Britain *combined* -- and yet represents just ~13% of global consumption.

This mismatch is the very definition of overcapacity, and, despite a slowing domestic economy, the stimulus keeps flowing into these sectors, forcing finished goods to find buyers outside their home market. Whether this is structural or temporary is beside the point: both versions manifest as a tsunami of cheap Chinese goods flooding world markets and threatening other countries' manufacturing industries. As such, most of the new trade barriers and industrial policies that we see in developed markets are China-linked.

The focus on this topic has been the auto sector so we will remain in that lane. China's auto industry has become an economic powerhouse, churning out highly competitive, low-cost electric vehicles (EVs), as well as ever-cheaper internal-combustion-engine (ICE) cars. But after years of booming sales, demand has slowed substantially. As the froth comes off the recent boom, overcapacity and falling prices have become more evident. According to our friends at GaveKal Research, China has more than 100 factories with the capacity to build ~40 million ICE cars a year. That is roughly twice as many as its domestic market can support and sales of these cars are falling fast as electric vehicles (EVs) become more popular. Sales of domestic ICE cars fell to 18 million units in 2023 from 29 million in 2017 -- a decline equivalent to the entire U.S. annual car and light truck production. Making matters worse is that, at the end of May, U.S. automakers had ~3 million cars and light trucks in stock on dealer lots, one million more than at the same time last year (Bloomberg). This translates into more than 100 days' worth of inventory. Setting aside the specter of price discounting to come, the shadow of inexpensive Chinese autos – either from China or Mexico -- is not a favorable prospect.

According to the generally accepted data, the U.S. lost more than one million manufacturing jobs to Chinese competition over the decades as U.S. rust-belt manufacturing followed labor and production costs off-shore. Since then, Chinese overproduction has become a permanent feature as a way to avoid domestic unemployment. That the U.S. has yet to formulate a working strategy beyond trade barriers to combat this is one thing, but so too is the failure of American manufacturers' sability to build something consumers want at a cost they can afford. Fiscal stimulus can help, but politicians have increasingly lost faith in the benefits of free trade and see a more vigorous response to the loss of manufacturing jobs as a political necessity. Politicians are vying to win votes by promising to protect workers from foreign competition. It will be interesting to see this play out in the next administration and the one after that (and after that).

Regards,

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