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INVESTMENT MANAGEMENT

The Industrial Reset In Emerging Markets

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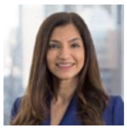
Assembly lines worldwide are humming with activity, signaling a promising revival of the manufacturing sector after decades of sluggishness. Governments are at the heart of new industrial policies, pumping billions of dollars to revive their critical domestic industries and build friendlier supply chains.

The share of manufacturing in global gross domestic product (GDP) peaked in the 1980s when manufacturing increasingly moved to lower-cost countries. This resulted in an influx of investment capital to countries like China, where abundant labor facilitated the production of cheap goods. Globalization and a move toward market-oriented policies in many developed economies led to services becoming an important driver for economic growth, while economies like Japan and Korea shifted to more sophisticated manufacturing. By 2021, the services sector's contribution to global GDP rose to 67% from 58% in 1980. This seismic shift in how the world produced its goods reshaped geopolitics and created significant global dependencies.

The turmoil caused by the COVID-19 pandemic highlighted the risks associated with overreliance on a single country for manufacturing needs. The outbreak of the Russia-Ukraine conflict, which disrupted Europe's access to cheap Russian gas, then accelerated the demand for renewable energy, and brought the focus on defense expenditures. Further, generative artificial intelligence (Gen AI) adoption is also leading to investments in the physical world, making factory automation more efficient, semiconductor production more critical and electrification and grids indispensable.

In emerging markets (EM), this capital expenditure (capex) revival is being supported by governments and better macro conditions. Emerging economies, like India, Indonesia, Malaysia and Brazil, are entering a new credit cycle, boosting capital spending driven by public and private investments.

AUTHORS



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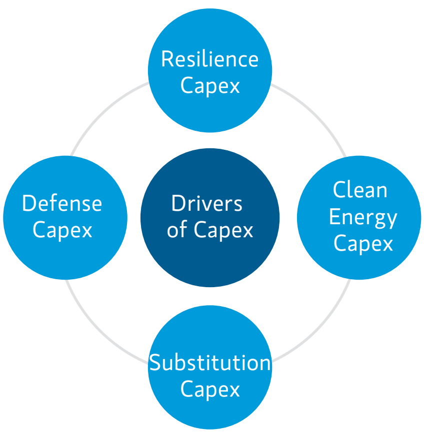
Resilience Capex: Disruption to Durability

The decoupling of the two economic superpowers, China and the U.S., has brought critical manufacturing and infrastructure investment home (onshoring). Additionally, it led to a shift in the share of goods the U.S. imports from China to other EM countries (nearshoring / friendshoring). The U.S. now imports more from Mexico than China. Countries like Vietnam, Malaysia, India and Indonesia are also gaining share in U.S. imports because these "China plus One" countries provide competitive labor costs and friendlier relations.

DISPLAY 1

The 4 Capex Drivers in Emerging Markets



Source: Morgan Stanley Investment Management

In developed markets (DM), countries are investing in energy, industrial commodities, food, semiconductors and medicine to mitigate supply chain risks. In EM, excluding China, capex is being deployed for the manufacturing of chemical components, textiles and electrical equipment because of this reshoring trend. China, on the other hand, invested $28.2 billion in 2023 and $30 billion in 2022 in its electric vehicle (EV) related industries and is actively diversifying away from American consumers. Key markets for Chinese EVs now include European countries like Belgium and the UK, and EMs like Brazil, Thailand and the Philippines.

Offshoring capex is also driving the need for better infrastructure, logistics and power, which should boost the engineering and construction industrials. Vietnam stands out as the leading beneficiary of manufacturing moving beyond China, allocating 6% of its GDP to infrastructure, a figure almost three times the ASEAN average of 2.3%. India increased its capex on roads and railways from 0.6% of GDP in 2020 to 1.5% in 2023, and this year it has allocated $134 billion to infrastructure development, with an emphasis on improving its transportation networks. In Latin America, Brazil is witnessing an infrastructure super-cycle and is planning to auction off 35 highway projects by 2026.

With emerging economies accounting for as much as 85% of global incremental electricity demand over the next two years, substantial investment in resilient electrification infrastructure and renewables is also needed, further boosting capital expenditure. Over the past five years, China, India, Turkey, Indonesia and Poland have experienced the highest growth in power consumption. China's electricity usage is expected to increase by 1,400 TWh by 2026, growing at 5% annually, which amounts to approximately half of the EU's current usage. Similarly, India's electricity consumption is expected to grow by around 6%.

Clean Energy Capex: Powering the Future

The global push in electrification will drive investments in renewables to meet the growing demand for power. Moreover, AI's voracious appetite for data is fueling a dramatic increase in demand for data centers which consume vast amounts of electricity. To reach a net zero emissions target by 2050, clean energy investments worldwide will need to more than triple by 2030 to around $4 trillion annually, according to some estimates.

China, the global leader in EV production and battery technology, is also dominant in green energy supply chains. China is expected to make the largest power grid investments in the world in 2024 and 2025. While other EM countries are trying to take a bigger share in the clean energy ecosystem, this will require significant effort. India plans to add 500 gigawatts of renewable energy capacity by 2030, which will require high-voltage, direct current lines and equipment as well as grid stability technology ("Weaving India's Future: A Tapestry of Green and Grey Energy").

The Chilean government plans to decarbonize the country's energy by 2030, investing $30 billion to generate 15 gigawatts of clean energy and to build transmission and storage infrastructure. Excluding China and India, EM economies are set to spend $300 billion on clean energy investments in 2024, or 15% of the global total.

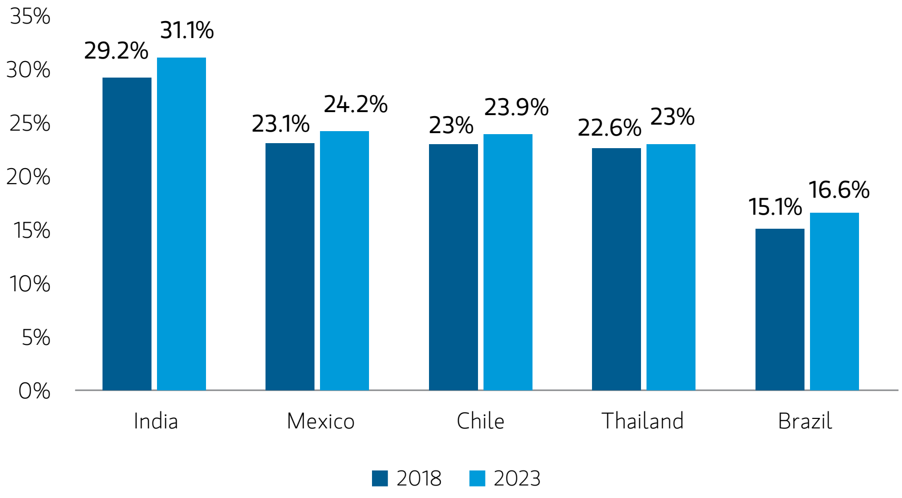
Substitution Capex: Tech Solves Demographic Bottleneck

Currently, the industrial sector faces dual challenges: inefficient supply chains and falling labor supply. The once robust baby boom has gone bust, as women are having fewer babies. Between 2012 and 2021, the global labor force participation declined by 1.3 percentage points. In the wake of rising labor costs, businesses are increasingly turning to technology to bridge the gap. Automation, especially through

DISPLAY 2

Steady Fixed Capital Investment Climb in Emerging Markets

Gross Fixed Capital Investment's Share of GDP in Several EM Countries



Source: Haver Analytics. As of 12/31/2023.

advanced robotics and software solutions, presents a major opportunity for industrial companies in both developed and emerging economies.

EMs are both adopters and producers of new automation technologies. The less headline-grabbing opportunities of AI lie in industrial automation, making manufacturing processes more streamlined and efficient. Countries like South Korea, China and Taiwan are major manufacturers of industrial robots and automation equipment. Even the structural growth in green energy boosts the need for automation and energy efficient motors, evidenced by China's ongoing upgrading and digitalization of its grid system. Along with the conventional winners of industrial automation like robots, equipment and machinery, industrial software companies also have pricing power due to differentiated product offerings.

Defense Capex: Defense Is the Best Defense

At the end of the Cold War, many western governments cut their defense expenditure, putting procurement and production decisions on hold. Fast forward and the consequences are stark: half of Europe's land-based systems and as much as 80% of land-based air systems are more than 30 years old. Russia's invasion of Ukraine brought the focus back on security, leading to a surge in spending on defense and aerospace equipment, with factories cranking up production of military vehicles and munitions. Last year, global spending on military and weapons jumped 7% to $2.4 trillion, the highest in the past 35 years.

Outside of Europe, geopolitical tensions in the Middle East and China's assertive claims on Taiwan and the South China Sea have pushed countries to devote more resources to their military capabilities. China's $230 billion defense budget is currently more than three times as large as India's $75 billion, but far below the Pentagon's $880 billion. India, already the fourth largest military spender globally, plans to increase its defense expenditure by 9% in 2024. Taiwan, facing the threat of a Chinese invasion, has boosted defense spending by 3.5% to a record $19.1 billion for 2024.

Industrial Re-evolution

The world is experiencing a resurgence in industrialization fueled by a powerful blend of geopolitics, the spread of AI and pressing environmental needs. Emerging markets are playing a pivotal role in this process and benefiting from this shift. Supply chain realignment, infrastructure development, increased automation, and electrification provide opportunities in several countries that are capitalizing on their unique strengths. Investing in these themes have long-term potential driven by structural changes that are reshaping global industrial policy.

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