

# Manufacturing a Revival

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Years from now, when the fog clears, it will become apparent that the big recession gave birth to a profound change in the structure of the US manufacturing sector—a process that is currently in full swing. The combination of strong demand from emerging markets<sup>1</sup> and US manufacturing firms that are reformatting themselves to meet that demand is realigning the sources of US economic growth, and opening up new investment opportunities in that space.

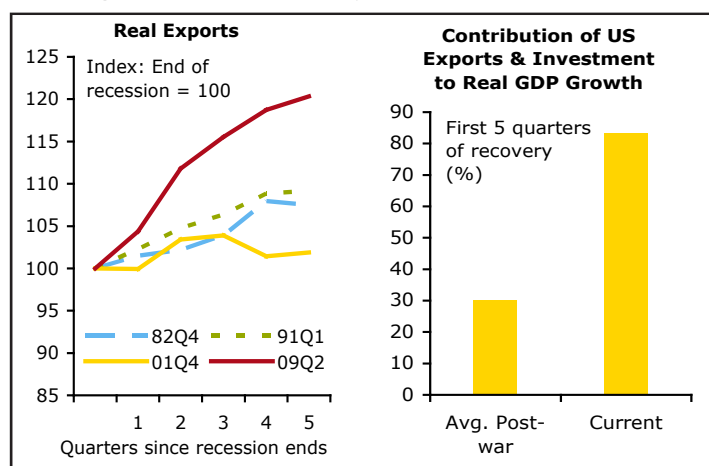
## US Manufacturing Still Going Strong

Amidst a disappointing expansion, the US manufacturing sector continues to surprise on the upside. Factory shipments in October continued to expand at a year-over-year rate of more than 7% while new orders are rising even faster. The closely watched ISM index is now at a five-month high and at just shy of the 57 mark, having been above the 50 level marking expansions for 15 consecutive months (Chart 1). While manufacturing shipments are still 14% below their pre-recession peak, the gap is closing quickly, with activity in the technology sector already surpassing that threshold.

With the US consumer still in the bunker, American manufacturers are pursuing more enthusiastic overseas consumers. Merchandise exports have risen by an annual rate of more than 10% during the first three quarters of 2010. All of the ground lost during the recession has

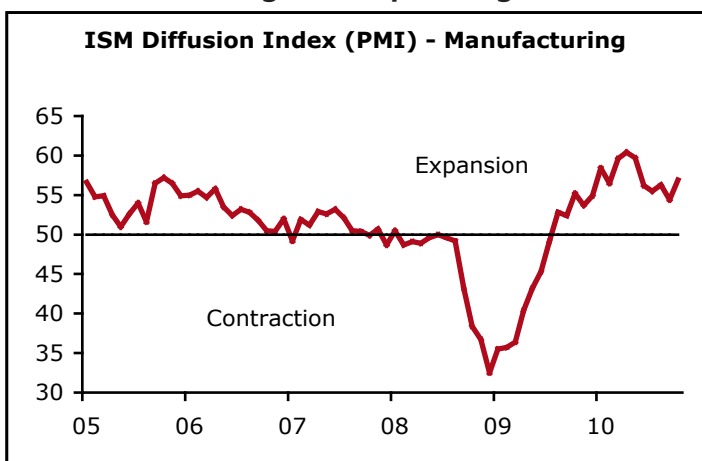
been recouped—making it, by far, the fastest export recovery in the post-war era (Chart 2, left). And there is more to come. The ISM index of new exports — a reliable predictor of future export activity—broke the 60 mark in October and is currently hovering at a level not seen since the 1980s. The ongoing export boom and the related investment activity are already changing the nature of the US economic recovery, with a contribution to overall GDP growth three times larger than the average contribution seen in the post-war era (Chart 2, right).

Chart 2  
**Strong Export Recovery**



Source: Bureau of Economic Analysis, CIBC

Chart 1  
**US Manufacturing Still Expanding**

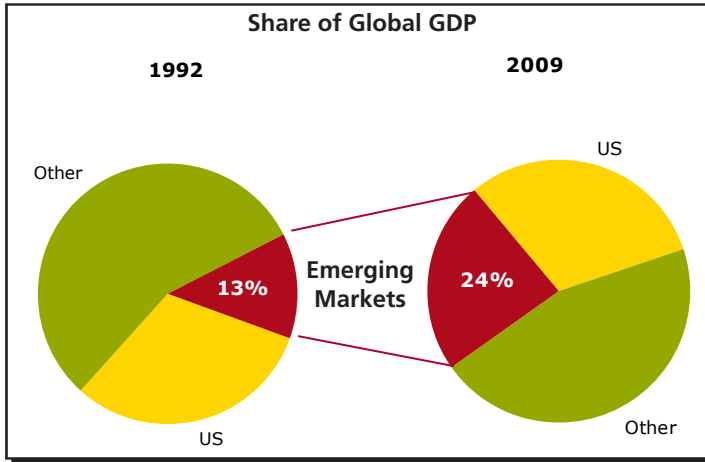


## Targeting Emerging Markets

The traditional pattern, in which American consumers are the driver of global growth, has been turned on its head. This time around, emerging markets were the first to rebound. And the impact of that growth spurt was magnified because emerging markets had become much bigger players in the world economy than ever before. In the early 1990s, the combined value of emerging markets' GDP was a mere 40% of the US economy. Today, they are almost 80% of the US economy, and nearly a quarter of global GDP (Chart 3). Emerging markets are now large enough to fuel a global economic recovery, as demand from their end-markets has replaced the function traditionally performed by American consumers in recoveries.

Chart 3

### Emerging Markets Sizeable Enough to Carry Global Recovery



Source: IMF, CIBC

Evidently, American exports have been able to elbow their way into these growing markets. Total US exports to emerging markets have risen by an impressive 45% since the beginning of 2009—more than twice the increase seen in exports to the developed world (Chart 4, left). And it’s not just a currency story. While the 15% depreciation in the US dollar vs. the currencies of emerging markets since early 2009 clearly helped, that currency adjustment was in line with the one seen against the currencies of the developed world (Chart 4, right).

Exports to emerging markets are helping to offset the risks from weaker pockets of the global economy, particularly those in Europe. US merchandise shipments to Europe

fell more than 3% (annualized rate) during the third quarter of the year vs. more than a 15% (ar) increase to emerging markets. Since Europe has not played a key role in the US export cycle, the ongoing weakness in the euro area, would make only a minor impact on US export growth in 2011.

While exports continue to play a significant role, domestic demand in these regions is becoming increasingly important in driving their economic growth, creating a target market for US exporters. The numbers are stunning. Since 2007, total retail sales in emerging markets have risen by close to 60% vs. a mere 5% increase in advanced economies (Chart 5).

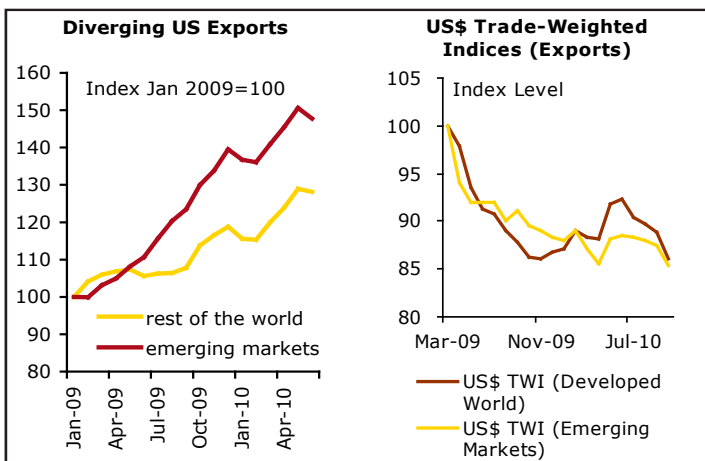
### Restructuring to Hit the Target

But the ability of US manufacturers to penetrate emerging markets reflects much more than increased demand. Being fully aware of the limited opportunities at home, manufacturers are restructuring their operations with relentless focus on cost, quality, design, engineering and new products. The shift from labour intensive to capital intensive production is nothing new, but the trauma of the recession is working to accelerate this process. During the past 18 months, the ratio of production in high capital intensive sectors to that of low capital intensive sectors rose by more than 15 points. Historically, it took no less than six full years to achieve an equivalent rise in that ratio.

What’s more, not only is the ratio of spending on R&D to shipments at a record high, but for the first time since the 1980s, that measure continued to rise during

Chart 4

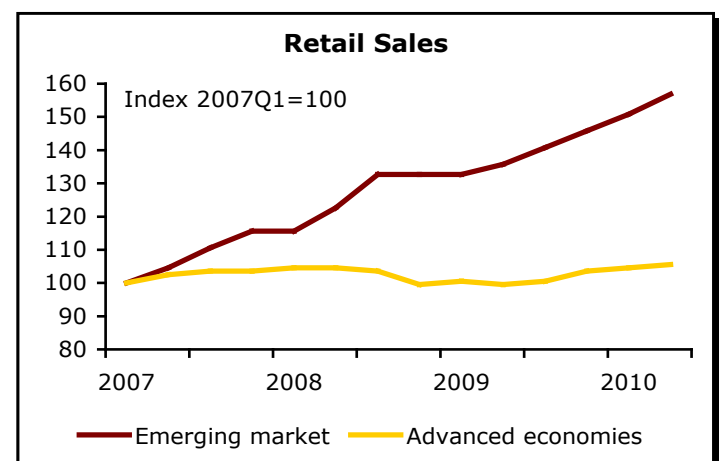
### Surging Exports to Emerging Markets—Not a Currency Story



Source: US Census Bureau, CIBC

Chart 5

### The New Consumer



Source: IMF, CIBC

a recessionary period (Chart 6, left). Labour productivity in the manufacturing sector is still advancing at a healthy year-over-year rate (Chart 6, right). Even more important, multifactor productivity—a good gauge of innovation at work within an economy—clearly suggests that through a combination of cost cuts, product innovation and advanced manufacturing processes, US companies are more efficient than ever before. In fact, with multifactor productivity gains rising faster than in all advanced countries in the past decade (and lagging only Korea and Taiwan), the manufacturing sector in the US is now recapturing lost market share in emerging markets, even at the expense of Germany—still the leading exporter to these countries.

### What Do Emerging Markets Buy?

Orders from emerging market are rising across a wide range of industries. A detailed analysis of manufacturing sector shipments to the Chinese market, for example, reveals strong growth in autos, chemicals, electrical equipment, appliances and components (Table 1). The high-tech manufacturing sector in China is currently expanding at an annual rate of more than 15%. That's opening the door for US companies that export precision machinery used in high-tech manufacturing.

Food and agricultural processing in China is another opportunity. This industry is currently expanding by 30% on an annual basis and generating ample opportunities for US exporters of high-tech processing equipment.

But perhaps the most surprising finding is the strong growth in export orders in consumer-related industries

such as apparel, furniture as well as sporting goods, pharmaceutical and personal care items—some of which were long considered lost to US manufacturers. This demand is driven by the fact that a growing upper and middle class segment of Chinese consumers is becoming more sophisticated, with quality and value-for-money increasingly replacing cost as the key decision factors in retail purchases. That bodes well for many American manufactures that are unable to compete on a cost basis.

Granted, the US manufacturing sector is not large enough to snap its fingers and turn a subdued economy into a thriving one overnight. Indeed, exports could be a bit slower in the near term in the wake of policy tightening abroad. But behind the scenes, we are witnessing a substantial and lasting realignment in the composition of growth in the American economy. The resurrection of US exports is not just a temporary deviation from past trends, but the result of rapidly shifting global economic dynamics and a more competitive American manufacturing sector. A strong export cycle, along with the attendant rise in capital spending, will provide ample growth opportunities to US firms operating in this space as well as those Canadian firms that successfully integrated into the supply chain momentum that this trend will generate.

*Note:*  
 (1) In this study, we use the OECD definition of emerging markets which comprises the largest 21 emerging economies.  
 Data source: US Census Bureau.

Chart 6  
**US Manufacturing Is Restructuring**

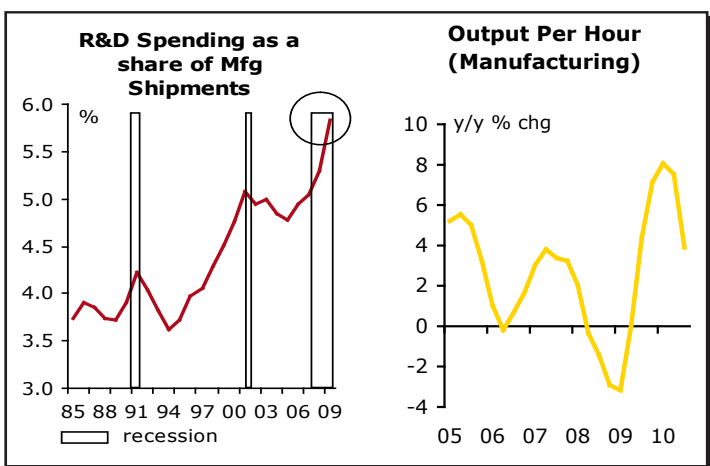


Table 1  
**Fastest Growing US Export Sectors to China**

	Cumulative Year-to-September (2010 vs. 2009)	
	\$Mn	%
Motor cars and other motor vehicles	1399.7	204.5
Cotton textile fibers	630.2	130.3
Nonferrous base metal waste and scrap	581.2	62.3
Machinery and equipment specialized for particular industries	554.2	108.0
Food processing equipment	322.5	32.0
Wood in the rough or roughly squared	206.4	146.2
Pigments, paints, varnishes & related materials	188.7	117.8
Toys, games and sporting goods	151.5	177.0
Inorganic chemical elements, oxides and halogen salts	151.1	63.3
Nitrogen-function compounds	113.8	71.7

Source: US Census Bureau, CIBC