CIO | VIEW

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Marketing Material

MANUFACTURING REBOUND? SIGNALS ARE MIXED EVEN BEFORE THE VIRUS

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IN A NUTSHELL

_ The recovery in manufacturing has been slow, a longer wait is now likely
_ Global manufacturing PMIs remain in contraction territory
_ Equipment: indicators show better spend on computer equipment
_ Construction: weak especially at manufacturing and energy businesses
_ Currency: strong U.S. dollar and weak EM currencies are no help
_ Bottom-up fourth quarter EPS now up 1.2% year-over-year, led by growth and defensive

THE RECOVERY IN MANUFACTURING HAS BEEN SLOW, A LONGER WAIT IS NOW LIKELY

Weakness in the United States and especially global manufacturing was a challenge for global growth in 2019 and a big challenge for corporate earnings growth. Global growth will likely finalize at 3.1% in 2019 or about a half point lower from the already slowing 3.7% rate of 2018. Corporate earnings were flattish to down worldwide, with declines in manufacturing-sensitive economies such as Japan and Europe, but slightly positive earnings growth in the United States. Many have argued that the weakness in manufacturing would recover after the peak of the trade tensions between the United States and China passed. We have argued that the recovery in manufacturing, would be slow, even with a "truce" trade deal because there is excess capacity in most of the world's heavy industry.

This note examines the latest indicators of U.S. and global manufacturing, investment spending, trade activity, commodity prices, currency exchange rates, earnings trends and more, which show that the recovery in manufacturing is slow and has yet to return to growth. Now with the outbreak of the coronavirus in China and the U.S. election is looming ever closer, we think the return to growth in global manufacturing activity will take more time and when growth returns that it remains slow for the rest of the cycle.

GLOBAL MANUFACTURING PMIS REMAIN IN CONTRACTION TERRITORY

Manufacturing Purchasing Managers' Indices (PMIs) will be reported next week for January. We expect only slight improvements from still weak December figures. In December, the U.S. manufacturing ISM was 47.2, Japan 48.4 and Germany 43.7. China was the only encouraging read at 50.2. Such persistent weakness in manufacturing reports often causes sharp dips, yet stocks rallied. Early indicators for the U.S. January manufacturing ISM are soft. January's preliminary manufacturing PMI from Markit ticked down instead of up to 51.7. December non-defense capital goods orders were weak. New York, Kansas, and Dallas manufacturing surveys stayed weak; Philadelphia was decent. Only regional surveys, that include service activity, were healthy. Yet, most recently a very weak Chicago all business activity report, noteworthy given its manufacturing sensitivity.

EQUIPMENT: INDICATORS SHOW BETTER SPEND ON COMPUTER EQUIPMENT

U.S. manufacturing and industrial production data shows generally better conditions and a more significant recent upturn for computers and semiconductors. But activity in the manufacturing of industrial capital goods and energy equipment and also cars remains weak with greater excess capacity. IT equipment and research and development (R&D) spending is healthy. We remain convinced that U.S. investment spending on equipment will stay soft overall, but healthy on productivity enhancers and weak on capacity additions.

CONSTRUCTION: WEAK ESPECIALLY AT MANUFACTURING AND ENERGY BUSINESSES

Non-residential construction is barely growing at a weak 2% year-over-year pace. Construction at exploration, power & manufacturing is declining 5% year-over-year. These industries make up about one-third of non-residential construction: oil & gas exploration 14%, power 10% and manufacturing 8%. Until we see many of the headwinds to these industries ease, non-residential construction growth will remain anemic at best. Excluding these industries, construction expands 5.5% year-over-year.

CURRENCY: STRONG U.S. DOLLAR AND WEAK EM CURRENCIES ARE NO HELP

Strong U.S. dollar is not helping. Weak Euro makes European industrial and manufactured goods more competitively priced. Weak emerging-market (EM) currencies such as Chinese Yuan (CNY) and Brazilian Real (BRL) make U.S. capital goods less affordable to these countries. And the very weak BRL also makes it harder for China to turn away from Brazil and toward the United States for agricultural and energy products imports.

BOTTOM-UP FOURTH QUARTER EPS NOW UP 1.2% YEAR-OVER-YEAR, LED BY GROWTH AND DEFENSIVE

225 S&P 500 companies comprising 65% of S&P 500 earnings have reported fourth quarter results. Bottom-up fourth-quarter earnings per share (EPS) is up 1.2% year-over-year, sales up 2.9% year-over-year, and non-GAAP net margin 11.5% vs. 11.9% a year ago. Based on our macro grouping of S&P 500 industries, bottom-up EPS growth is superior at growth (5.4%) over value (-0.4%); and superior at defensives (6%) over cyclicals (-0.5%). Manufacturing oriented industries had sharp fourth-quarter EPS year-over-year decline: durables (-41%), commodity (-35%), energy (-42%), metals/chemicals (-14%), and capacity addition (-12%). Also fourth-quarter EPS growth is weak at trade-sensitive industries (-7%) and geopolitical-risk industries (-43%). Macro groups with strong fourth-quarter EPS growth include: services/experience (11%), productivity (13%), innovation (13%), financials (12%), high research and development (R&D) (7%), and consumer TMT (9%).

GLOSSARY

The Brazilian real (BRL) is the official currency of Brazil.

The Chinese yuan (CNY) is legal tender on the Chinese mainland and the unit of account of the currency, Renminbi (RMB).

Earnings per share (EPS) is calculated as a company's net income minus dividends of preferred stock, all divided by the total number of shares outstanding.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The euro (EUR) is the common currency of states participating in the Economic and Monetary Union and is the second most held reserve currency in the world after the dollar.

Generally accepted accounting principles, or GAAP, are a set of rules that encompass the details, complexities, and legalities of business and corporate accounting.

The ISM Purchasing Manager Index, published by the Institute for Supply Management, measures economic activity by assessing the sentiment among purchasing managers. It is an important indicator of the economic health.

Margin describes borrowed money that is used to purchase securities.

The Purchasing Managers Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The U.S. dollar (USD) is the official currency of the United States and its overseas territories.

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