Yardeni Research

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Morning Briefing

The Shifting Sands Of Global Manufacturing

Check out the accompanying chart collection.

Executive Summary: Manufacturing sectors have been contracting in many countries of the world, although not in the US or Vietnam. Today, Melissa examines the troubling trends behind the downturns, globally and for specific countries. Notably, China remains the world's number-one producer of manufactured products, though its position is rapidly eroding. Conversely, Vietnam's pro-business policies are attracting global manufacturers seeking to diversify their supply chains; foreign direct investment in Vietnam rose 7% last year. … The era of green automation is also changing the global manufacturing landscape, with innovations that improve operational efficiency and address environmental challenges.

Global Manufacturing I: Shifting Power Dynamics. Global manufacturing is undergoing seismic upheaval. Among the forces shifting the trade winds are geopolitical tensions, fractured supply chains, scarce skilled labor, and rising labor costs.

Local sourcing and reshoring are now highly touted as corporations and governments seek to safeguard domestic industries and jobs. US-China trade disputes, the Covid-19 pandemic, and the Russia-Ukraine conflict have bolstered the global impetus to enact change, increasingly on national security grounds.

Established manufacturing hubs like China and Germany are losing their competitive edge, while emerging markets such as Mexico and Vietnam are stepping in to fill the void. The US government is incentivizing the revitalization of its domestic manufacturing base with tax breaks and other subsidies.

Global industrial production continues to rise—its geographic composition is what is shifting (*Fig. 1* and *Fig. 2*). In our Roaring 2020s scenario, companies are likely to invest in technology to offset some of these challenges. Burgeoning productivity growth suggests this is already happening (*Fig. 3*). Indeed, these investments and supply-chain reordering are likely to prove inflationary, and therefore may result in higher global interest rates.

Here's more on how historical hubs of global manufacturing and relative newcomers are faring:

(1) *The fading dragon*. China continues to lead global manufacturing, particularly in electronics and machinery. Over *6 million Chinese firms* contribute *more than $4 trillion* in net value-added to the Chinese economy.

However, China's dominance is being eroded by *escalating labor costs*, decoupling from trading partners, and an aging population. We believe China's demographic issue is among its foremost challenges in the coming years and decades (*Fig. 4*). The Chinese Communist Party (CCP) can no longer rely on mass urbanization and a booming working-age population to power its growth (*Fig. 5*). To begin transitioning from a developing to a developed economy, the CCP's "Made in China 2025" initiative aims to pivot manufacturing from a concentration on mass production of consumer goods to high-tech innovation in artificial intelligence (AI), semiconductors, and electric vehicles (EVs).

Additionally, US-China trade tensions are pushing manufacturers with operations mostly in China to diversify their production geographically. But the demographic challenges are still likely to inflate labor costs and stifle innovation in the long run.

(2) *The weakening strong man*. Germany's manufacturing sector, primarily renowned for precision engineering in automobiles and machinery, contributes nearly *$900 billion* to its $4.5 trillion economy.

However, Europe's industrial powerhouse is increasingly vulnerable to rising energy costs. It is very slowly transitioning toward green manufacturing and renewable energy sources. Recall, Germany shut down its last three nuclear power plants in April 2023. The sick man of Europe shot himself in the foot.

The 2022 energy crisis prompted German firms to rely more heavily on liquefied natural gas. Boston Consulting Group *anticipates* that German firms are underestimating the impact of a potential increase of 50%-100% in natural gas prices by 2030.

German automakers are racing to innovate and ramp up their EV offerings to stay competitive. China's EV market dominance is intensifying competition and squeezing market share for brands like Volkswagen and BMW. Nevertheless, Germany recently *voted* against the European Union's recently approved tariff on China-made EVs, fearing *retaliation* in Chinese markets for German autos.

Additionally, global *reliance* on China's battery supply chain is a strategic challenge for German EV makers.

(3) *The nationalist revivalist*. The US is experiencing a manufacturing renaissance driven by reshoring initiatives, technological advancements, and supportive legislation. The nation's manufacturing firms collectively produce about *$2.5 trillion*, with a focus on aerospace, autos, electronics, and high-tech products.

Legislative measures signed into law in 2021 and 2022—specifically, the Infrastructure Investment and Jobs Act, the CHIPS Act, and the Inflation Reduction Act—incentivize companies to bring production back home to enhance national security and address supply-chain vulnerabilities. These measures have helped stimulate a doubling of private investment in manufacturing structures construction within real GDP (*Fig. 6*).

In recent years, US industrial production has plateaued amid an ongoing shortage of skilled labor, supply-chain disruptions, climate-related challenges, and competition from lower-cost and emerging markets with larger, younger workforces (*Fig. 7*).

(4) *The backdoor to China*. Mexico is positioning itself as a critical player in nearshoring, particularly for US companies seeking alternatives to producing goods in China. Mexico's manufacturers contribute about *$360 billion* to its economy, predominantly driven by automotive goods. Competitive labor rates and favorable trade agreements further enhance Mexico's competitive advantage as an exporter.

As Western firms withdraw from China, many Chinese manufacturers are relocating operations to Mexico to capitalize on these advantages. The United States-Mexico-Canada Agreement encourages global firms to invest in Mexican manufacturing, supported by significant investments in logistics and infrastructure. However, challenges such as political instability, domestic corruption, and cartel violence continue to undermine the investment landscape.

(5) *The emerging frontier*. Vietnam's manufacturing sector is rapidly rising as a favored low-cost producer. Global companies seeking to diversify their supply chains are attracted to Vietnam's competitive workforce, strategic location to trade routes, robust export infrastructure, and pro-business policies. It's a beneficiary of the "China+1" strategy and boasts production output of about *$100 billion*, particularly in electronics and textiles.

Foreign direct investment in Vietnam increased 7.1% last year to $4.6 billion.

Vietnam's pro-business policies include tax incentives for manufacturers, favorable trade agreements like the *Comprehensive and Progressive Agreement for Trans-Pacific Partnership*, and a focus on the expansion of industrial parks.

Vietnam's manufacturing sector still lacks the competitiveness and robustness of China's, however. Weaker productivity, skilled labor shortages, import dependence, and lack of energy security weigh on its output.

Global Manufacturing II: US Holds Amid Global Contraction. Global manufacturing remains weak, with Manufacturing Purchasing Managers' Indexes (M-PMIs) pointing to contraction across major economies. China's decision to dump cheap exports onto global markets has crushed Germany's manufacturing sector, for instance, and weighed on many others.

Here's a brief summary of the latest M-PMIs globally and by major country:

(1) *Worldwide.* The S&P Global Manufacturing PMI (M-PMI) fell to 48.8 in September 2024, marking a sustained contraction (*Fig. 8*).

(2) *China.* China's national M-PMI dropped to 49.3 in September from 50.4 in August, led by a renewed downturn in new orders and the lowest reading since July 2023. This decline stems mostly from a sluggish domestic market (*Fig. 9*).

(3) *Germany.* Germany's M-PMI plummeted to 40.6 in September, down from 42.4 in August (*Fig. 10*). Additionally, the volume of German manufacturing orders decreased in August (*Fig. 11*).

(4) *United States.* The US M-PMI held relatively steady at 47.3 in September versus last month's 47.9 (*Fig. 12*). New orders rose slightly to 46.1 (*Fig. 13*).

However, US M-PMIs have decoupled from their historical correlation with real GDP goods. The former has been in contraction for much of the past two years, while the latter rose 2.7% y/y in Q2 (*Fig. 14*).

(5) *Mexico.* Despite numerous tailwinds at its back, even Mexico's manufacturing sector is suffering from weaker global demand and increased supply. Mexico's M-PMI suddenly deteriorated in September, to 47.3 from 48.5 in August (*Fig. 15*). Companies have reported sharper declines in new orders, production, and employment.

(6) *Vietnam.* Vietnam's M-PMI plummeted to 47.3 in September from 52.4 in August, entering contraction territory for the first time since March (*Fig. 16*). Typhoon Yagi caused temporary, though significant, disruptions last month, including business closures and production delays; but the future outlook is brighter.

Global Manufacturing III: In Its Green Automation Era. The global manufacturing sector is undergoing a profound transformation driven by automation and green technology. Innovations in these areas can enhance operational efficiency and address environmental challenges. As manufacturers embrace AI, robotics, and renewable energy solutions, they are poised to redefine productivity and sustainability for the future.

Here's more:

(1) *Automation*. Staffing firm *Hamlyn Williams* explores how automation technologies are reshaping manufacturing and the industry's hiring needs through breakthroughs in AI, robotics, and the Industrial Internet of Things (IIoT). AI optimizes production and enhances uptime via predictive maintenance, while collaborative robots (a.k.a. cobots) boost productivity alongside human workers. IIoT integration facilitates real-time monitoring, enabling data-driven decisions that streamline operations.

As these technologies become increasingly affordable, their adoption will accelerate, promising significant gains in efficiency and output.

(2) *Sustainability*. In response to environmental regulations and consumer preference trends, manufacturers are racing to adopt green practices to drive sustainability forward, enhancing both brand reputation and resilience. From cutting waste to improving energy efficiency, the focus is on eco-friendly methods across all stages of production, Hamlyn Williams observes. Many are turning to renewable energy sources like solar and wind to reduce dependence on fossil fuels and curb carbon emissions.

Calendars

US: Thurs: Headline & Core CPI 0.1%/0.2%; Headline CPI 2.3%y/y; Initial Claims 229k; Williams; Cook. **Fri:** Headline & Core PPI 0.1%/0.2%; University of Michigan Consumer Sentiment Index, 70.5; Goolsbee. (FXStreet estimates)

Global: Thurs: Italy Industrial Production 0.2%; ECB Publishes Account of Monetary Policy

Meeting; Nagel. **Fri:** Japan PPI -0.3%m/m/2.3%y/y; Elderson. (FXStreet estimates)

Strategy Indicators

Stock Market Sentiment Indicators (*link*): The *Bull-Bear Ratio* slipped to 2.35 this week, after climbing the prior three weeks from 1.92 (the lowest since November 2023) to 2.61. *Bullish sentiment* slipped to 53.2% this week after a 12.2ppts climb the prior three weeks, from 43.5% to 55.7%—which was the most bulls since early summer, when there were seven straight weeks of bulls above 60%. Bullish sentiment was at 43.5% four weeks ago—which was the lowest percentage since last August. Meanwhile, *bearish sentiment* edged up 1.3ppts to 22.6%, after falling 1.6ppts point from 22.9% to 21.3% the prior week. This week's percentage is still far above the mid-July percentage of just 14.9%. The *correction count* rose to 24.2% this week, after a three-week decline of 10.9ppts (to 23.0% from 33.9%). In the *AAII Sentiment Survey* (as of October 3), bullish sentiment among individual investors about the short-term outlook for stocks fell during the latest week, while both bearish and neutral sentiment increased. *Bullish sentiment* fell 4.2ppts to 45.5%, above its historical average of 37.5% for the 47th time in 48 weeks. *Bearish sentiment* climbed 3.6ppts to 27.3%—below its historical average of 31.0% for the seventh time in eight weeks. Meanwhile, while *neutral sentiment* edged up 0.6ppts to 27.3%, below its historical average of 31.5% for the 13th straight week.

S&P 500 Earnings, Revenues, Valuation & Margins (*link*): The S&P 500's forward profit margin ticked up 0.1ppt during the October 3 week, back up to its record high of 13.4%. It is now 3.1ppts above its seven-year low of 10.3% during April 2020. Forward revenues rose 0.5% w/w, and forward earnings rose 0.9%. Revenues and earnings have been steadily making new record highs for just over 12 months now. That compares to its prior 16-month string of record highs from March 2021 to June 2022; prior to that, they peaked just before Covid-19 in February 2020. The consensus expectations for forward revenues growth dropped 0.1ppt w/w to 5.6% and is down from a 23-month high of 5.8% during the August 1 week. It has gained 3.3ppts from its 33-month low of 2.3% during the February 23, 2023 week. That's down from a record high of 9.6% growth at the end of May 2021 and compares to 0.2% forward revenues growth during April 2020, which was the lowest reading since June 2009. The forward earnings growth forecast rose 0.2ppt w/w to a 36-month high of 14.1%. It's now 10.8ppts above its 31-month low of 3.3% during the February 16, 2023 week. That's down from its 23.9% reading at the end of April 2021, which was at its highest since June 2010 and up substantially from its record low of -5.6% at the end of April 2020. Analysts expect revenues to rise 4.6% in 2024 (down 0.1ppt w/w) and 5.7% in

2025 (unchanged w/w) compared to a revenues gain of 2.1% in 2023. They expect an earnings gain of 9.8% in 2024 (down 0.1ppt w/w) and a 14.9% rise in 2025 (down 0.1pt w/w) compared to an earnings gain of 2.4% in 2023. Analysts expect the profit margin to rise 0.5ppt y/y to 12.4% in 2024 (unchanged w/w), compared to 11.9% in 2023, and to rise 1.1ppts y/y to 13.5% in 2025 (unchanged w/w). The S&P 500's weekly reading of its forward P/E fell 0.2pt w/w to 21.4 from a 33-month high of 21.6 and is up 1.7pts from a 14-week low of 19.7 during the August 8 week and 6.1pts from a 30-month low of 15.3 in October of 2022. It also compares to 23.1 in early September 2020, which was the highest level since July 2000, and to a 77-month low of 14.0 in March 2020. The S&P 500 weekly price-to-sales ratio is down 0.02pt to 2.86 from its twin record highs of 2.88 a week earlier and during the December 30, 2021 week. That's up from a six-month low of 2.22 during the October 26, 2023 week and compares to a 31-month low of 1.98 in October 2022. The latest reading matches its record high of 2.88 at the end of 2021 and is up from a 49-month low of 1.65 in March 2020.

S&P 500 Sectors Earnings, Revenues, Valuation & Margins (*link*): During the October 3 week, forward revenues rose for ten of the 11 S&P 500 sectors and forward earnings rose for ten sectors. This led to rising forward profit margins w/w for ten sectors. Seven sectors posted record-high forward revenues this week: Communication Services, Consumer Staples, Financials, Health Care, Information Technology, Real Estate, and Utilities. Consumer Discretionary and Industrials had record-high forward revenues recently during the past few weeks. Energy and Materials are the biggest laggards at 5.0% and 12.7% below, respectively. These five sectors had record-high forward earnings this week: Communication Services, Consumer Staples, Industrials, Information Technology, and Utilities. These five sectors are less than 2.2% below their recent records: Consumer Discretionary, Financials, Health Care, and Real Estate. Forward earnings remains depressed for Energy and Materials; both are more than 20.6% below their post-pandemic highs. Looking at the forward profit margin, all of the sectors are showing signs of recovering from their early 2023 forward profit margin lows. Industrials is the only sector with a forward profit margin at a post-pandemic or record high this week. In recent weeks, the Consumer Discretionary, Financials, and Information Technology sectors were in that club. Among the laggards, Energy's forward margin has tumbled 0.9ppt from its six-month high of 10.9% in mid-June to a 30-month low of 10.0%; Consumer Staples' is 0.2ppt above its seven-year low of 6.7% in March 2023; and Health Care's is 0.3ppt above its 8.5% record low in April. The annual profit margin is expected to fall y/y in 2024 for Energy, Materials, and Real Estate and to improve for the other eight sectors. Here's how the S&P 500 and its 11 sectors rank based on their current forward profit margin forecasts along with their record highs: Information Technology (26.4, up 0.1ppt w/w and down from its 27.6% a record high in September), Financials (19.3, down from its 19.8 record high in August 2021), Communication Services (18.0, up 0.2ppt w/w and down from its 18.1 record high during the August 8 week), Real Estate (17.3, down from its 19.2 record high in 2016), Utilities (14.2, up 0.1ppt w/w and down from its 14.8 record high in April 2021), S&P 500 (13.4, up 0.1ppt w/w to match its 13.4 record high during the September 20 week), Materials (11.3, up 0.1ppt w/w and down from a 20-month high of 11.6 in July and from its 13.6 record high in June 2022), Energy (10.0, a 30-month low and down from its 12.8 record high in November 2022), Industrials (11.2, up 0.1ppt w/w to a new record high), Consumer Discretionary (9.2, up 0.1ppt w/w to a record high this week), Health Care (8.8, up 0.3ppt from its record low at the end of April and down from its 11.5 record high in February 2022), and Consumer Staples (6.9, down from its 7.7 record high in June 2020).

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