The U.S. is undergoing an industrial revival

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Don't look now, but having led the global economy into recession in 2007, the U.S. is showing signs of leading the rebound. U.S. manufacturing is now a competitive player after a decade of adjusting to the shock that came with China's 2001 entry into the World Trade Organization. New jobs are emerging as corporations add production. And it is attracting investment at the expense of developed countries, such as Canada, and from emerging countries, such as China. This is not an anomaly, but instead reflects the increase in U.S. competitiveness that has been driven by lower labour and energy costs.

The next decade will see a robust recovery in U.S. manufacturing, which will drive economic growth, create jobs and reduce the deficit. Strong manufacturing growth will help end the country's sub-par growth, while stronger private sector growth can help the country to address its deficit. Research on worldwide manufacturing by Boston Consulting identified "tipping point" industries that could boost U.S. output by US$100 billion, create two to three million jobs and lower the non-oil trade deficit by 35% in the next five years.

Meanwhile, Citigroup's report, *Energy 2020, North America, the New Middle East?*, stated that "For the first time since 1949, the U.S. has become a net petroleum exporting country and has edged out Russia as the world's largest refined petroleum exporter. On the supply side, the U.S. has become the fastest-growing oil and natural gas producing area of the world and the most important incremental source for oil and gas. With the shale gas production boom, the U.S. could begin to transform other sectors, including power generation and transportation. But the most momentous change is likely to be the re-industrialization of America based on dramatically lower cost feedstock than is available anywhere in the world." While there are hurdles to overcome, the potential consequences are extraordinary.

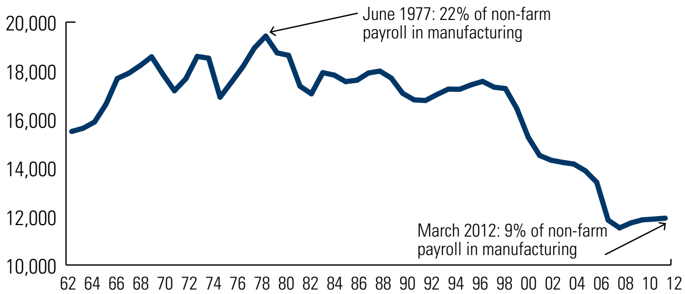
Two distinct trends are emerging. This appears to be coincidental, but both developments can trace their roots back to 2001 – the year China entered the WTO and unleashed a massive supply of low-cost labour into the global economy. That fuelled the wave of outsourcing and caused an adjustment in global manufacturing. It was also the year that oil prices started the climb from US$20 a barrel to US$100. Sharply higher oil prices drove exploration and technological change. After a decade of adjustment and innovation, the U.S. will now see the benefits and investors must take notice.

Individually, either of these developments would require a rethink of the U.S. outlook over the next five years, but the emergence of both concurrently requires a new perspective on how the global economy operates. It is imperative to understand the investment implications of these trends.

U.S. manufacturing renaissance

Since China entered the WTO, it became the default destination for outsourcing and the globalization of manufacturing supply chains. Cheaper wages and expanding infrastructure attracted industries to relocate production. Led by industries with the highest unskilled labour costs, such as garments, and followed by products such as technology. Within a decade, China became the largest exporter in the world. Today, that evolution is well understood. What is less understood is that it is over!

Chart 1 – U.S. employment in manufacturing, thousands



Source: U.S. Bureau of Labor Statistics

Factor price equalization tells us that following a shock, such as the increase in cheap Chinese labour, the price of labour in the U.S. must fall, while the price in China must rise to the point where the labour cost advantage is eliminated. It doesn't mean that wages have to be equal, but that the labour cost advantage is offset by differences in productivity and other expenses, such as transportation. For many industries, facing rapidly rising Chinese labour costs, and flat to down costs in the U.S., the global labour market is reaching a new equilibrium. China's low-cost advantage is fading, while a highly productive and flexible workforce is once again making the U.S. competitive for many goods sold in North America.

U.S. getting cheaper

Despite decades of talk about the hollowing out of U.S. manufacturing, data from the Bureau of Labor Statistics show that the number of employees in manufacturing was roughly flat from the 1980s until 2001 around 17 to 18 million. By 2004, it had fallen to 14 million and by 2010 was down to 11.5 million (See Chart 1). The hollowing out of jobs only commenced in 2001 and coincided with China's entry into the WTO. The loss of six million manufacturing jobs was a painful adjustment, but it is critical to understand that the U.S. has adjusted. Adjusted for productivity, unit labour costs in the U.S. have been flat for 30 years.

According to Boston Consulting, by 2015 many goods that are manufactured in the U.S. will be as cheap as those from China. With wages increasing at 15% to 20% annually, China's cost advantage over some U.S. states, such as Alabama, will fall from 55% today to 39% by 2015. Because labour only accounts for a portion of overall costs, for many products the savings from outsourcing will drop to single digits. Once a company factors in transportation, duties, real estate etc, cost savings can disappear. It is not inconceivable that for some industries, certain U.S. states could emerge as the lowest-cost production sites in the world.

China getting expensive

China's days as the world's lowest cost exporter are over as wages rise and labour shortages occur. A decade ago, the labour force exploded as it experienced a boom in its working age population, a migration to urban areas and the downsizing of state-owned companies. Today, because of its one child policy, China is becoming an aging society that will soon see its working age population peak. China has been deliberately moving its economy up the value-added chain and shifting to domestic consumption as a key economic growth driver. Rising wages are supportive of growing consumer demand, but less so for a low-cost export-oriented manufacturer. This is not to say that China will cease to be the world's leading manufacturer – it won't, but increasingly, manufacturing will be focused on supplying the local Chinese market.

Not just China

The U.S. advantage doesn't apply to just China. In fact, a bigger advantage will accrue over countries such as Germany and Canada, which have similar industrial structures. U.S. unit labour costs relative to other developed countries peaked in the mid-80s and have since declined by 50% against a basket of 14 developed countries. Over the past decade, the U.S. has become a lower-cost manufacturer as wages declined and the dollar weakened. And the workforce is becoming more flexible as productivity grows. The auto industry is a good example. Even the UAW appears to be working with companies to lower costs, increase competitiveness and fight to attract jobs to the U.S. The recent closure of a Caterpillar locomotive plant in London, Ontario, and its relocation to Indiana is an example of Canada's vulnerability to U.S. competitiveness.

Currencies matter

Another factor has been the devaluation of the U.S. dollar, which has fallen by one-third since 2002. A cheaper currency is the simplest way for an economy to restore its global competitiveness. The decline of the U.S. dollar is a major contributor.

Industry differentiation

Every industry has its own parameters. The notion behind comparative advantage is that countries will produce products in which they have a comparative advantage. Manufactured products that are labour intensive, such as manufacturing shoes and apparel, are not coming back to the U.S. These jobs are moving from China to Vietnam or Thailand. But The Boston Consulting Group identified seven industries that it expects to see expanding production in the U.S.: transportation goods, computers and electronics, fabricated metal products, machinery, plastics and rubber, appliances and electrical equipment, and furniture.

For many industries, the new mantra is localization, localization, localization. Today companies want to produce closer to their customers with shorter, more responsive supply chains, reduced uncertainty from currency and faster turnaround time. As the world's largest economy, the U.S. will be a beneficiary of this trend. As the world's second-largest economy, so will China, as companies move to meet domestic demand.

The U.S. – energy superpower?

A second very significant driver for U.S. competitiveness is the explosion in natural gas production, driven by technological innovation. It is almost impossible to overstate the importance of these developments in North American energy markets. This has pushed natural gas prices from US$8 per million BTU in 2008 to around US$2 today. For industries using natural gas as a feedstock, the U.S. has become a global low-cost producer. The difficulty in exporting natural gas due to infrastructure constraints suggests that the U.S. will retain this cost advantage through the end of the decade. The implication is that to arbitrage lower U.S. costs companies will consume gas locally and export upstream products. Investment in gas extraction and petrochemical industries and converting power plants from coal to gas will continue to grow.

Natural gas is used as a feedstock to produce ethylene, plastics, fertilizers, electricity, and in some cases can be used in transportation. Already, the U.S. is benefiting from the oil and gas boom. We expect this trend to continue and expand as several companies have already announced plans to expand their U.S. petrochemical facilities.

Conclusions

After a decade of rebalancing, a vibrant U.S. manufacturing base is emerging. It offers companies competitive labour costs, a favourable exchange rate and lower property prices. Coupled with a lower cost secure and stable power supply, the manufacturing boom is getting underway. Development will not be a straight line and it will not solve the structural challenges, but it will drive future economic growth. For all of its challenges, the U.S. remains the most flexible economy in the world. For investors, and for us at Signature, recognition that the U.S. and its many companies are regaining global competitiveness will be important return drivers in coming years. Not only will it influence the relative attractiveness of specific companies and industries, it will also influence the behaviour of all asset classes including interest rates, foreign exchange rates, property trends and commodity prices. ❖

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