James Swanson, CFA
MFS Chief Investment Strategist

MICHIGAN SEEMS LIKE A DREAM TO ME NOW

QUICK POINTS

Profits have slumped; manufacturing is sputtering — is it time to run from US equities?

There are signs that the global growth slowdown may be flattening or even ending.

I believe Michigan and the rest of the US industrial base can come back to life.

Only a couple of years ago, many economists were touting the rebirth of US manufacturing. Some even suggested that a rust belt state like Michigan would revitalize, becoming the "new China" of growth stories. Manufacturing in the United States had been doing a bit better during the economic recovery, but now appears to be faltering. Will this slowdown put an end to the business cycle and push down earnings and the equity markets?

Capital goods and profits slump

The slump in capital goods manufacturing has been heavily influenced by energy companies that have sharply curtailed spending. Along with the energy sector, equipment manufacturers have suffered a severe hit to corporate earnings, largely the result of the US dollar rising over the past 18 months. Third-quarter earnings have now come in — the worst quarterly earnings for the S&P 500 Index since the business cycle began in 2009.

A number of strategists are saying that this could be a harbinger of the cycle's bitter end. If so, the revival of manufacturing in states like Michigan seems more like a dream than a reality.

Not the bitter end

Unlike others, I don't see this as the beginning of the next recession. Here's why. While US exports have fallen, much of that decline comes from not only the stronger dollar but also weaker world growth — China's slowing economy in particular. Just recently, however, manufacturing purchasing managers' indices or PMIs — the best forward gauges of global economic momentum — have bottomed and are even showing signs of rising.

Though China's slowdown may not be over, house prices have started to rise again, while the service sector is no longer decelerating but picking up speed. And sales of consumer goods and electronics have been increasing.

Among the world's other major economies, Brazil is not improving, nor is Russia. But Germany — a big exporter to China — has posted domestic sales growth. The United Kingdom is making progress. Credit is expanding in Europe, and money supply growth — often a forward sign of economic recovery — is climbing in Japan. Canada has been hit hard by lower oil prices and faltering natural resource exports, yet some of its indicators have begun to tilt upwards.

As I see it, the slowdown in global growth may be flattening out or even coming to an end.

Wishful thinking?

Historically, oil price declines have averaged about 15 months, and this oil slump has just crossed the 15-month mark. In other periods when oil prices have fallen without a decline in the demand for oil, the result has been pain in some sectors and countries initially, along with an eventual pickup in world growth overall.

Is it just wishful thinking that the global economy could benefit from cheap oil? I don't think so. The biggest users of oil products are US consumers, and their spending on oil as a percent of disposable income is now at the lowest level since the 1960s. Japan imports 100% of its energy, so lower prices have the potential to help this otherwise stagnant economy. The heavily industrial parts of Europe are also big users of imported oil and are now getting a lift through lower costs to run plants.

For US consumers — whose spending in dollar terms exceeds the entire economy of China — wages are rising, workweeks are getting longer and the number of jobs keeps expanding. Yet the boost from lower energy costs has not translated into higher spending on other goods and services. If history is any guide, however, US consumers are unlikely to save this entire windfall when they could enjoy the benefits — buying bigger cars and trucks, driving more miles, eating out frequently and so on.

Cycle of organic growth

The US economy is internally facing, primarily based on the domestic consumption. The propensity of the US consumer to spend could eventually drive inventory accumulation. And that must come from manufacturing, which in turn would tend to spur job creation.

Adding to this notion of organic growth, US governments at the federal, state and local level that had curtailed expenditures during this cycle have now started to increase their budgets. Much of the new fiscal spending is directed toward building and repairing roads and bridges, along with other infrastructure projects.

So what about Michigan? The idea of a revival in Michigan — and the entire US industrial base — isn't dead yet but derailed, as reflected by the retrenchment in manufacturing. Low energy prices can be the fuel and decent infrastructure may provide the path for final demand to expand. Once US producers see that US consumers have the means to spend again — while other global economies stop moving downward and resume an upward arc — I believe the US manufacturing sector will come back to life.

The story hasn't played out. A long-lived business cycle is still in the works, despite the bad earnings season we've just gone through on the heels of disappointing results from energy, materials and capital goods. The rest of the S&P 500 sectors and industries have shown strength. Health care has advanced, technology and telecommunications have zoomed along, utilities have prospered and consumer discretionary companies have flourished, with the auto industry back to full production.

This is not the end, but a turning point that signals to me the need for selectivity and systematic analysis of investment opportunities — especially among troubled emerging markets. My optimism about the US economy and markets remains on a firm footing, based on strategic advantages including positive demographic trends and favorable unit labor costs, as well as cheap and abundant oil.

Past performance is no guarantee of future results.

MFSE-SWANSON-NL-11/15
32235.12