The American Industrial Renaissance

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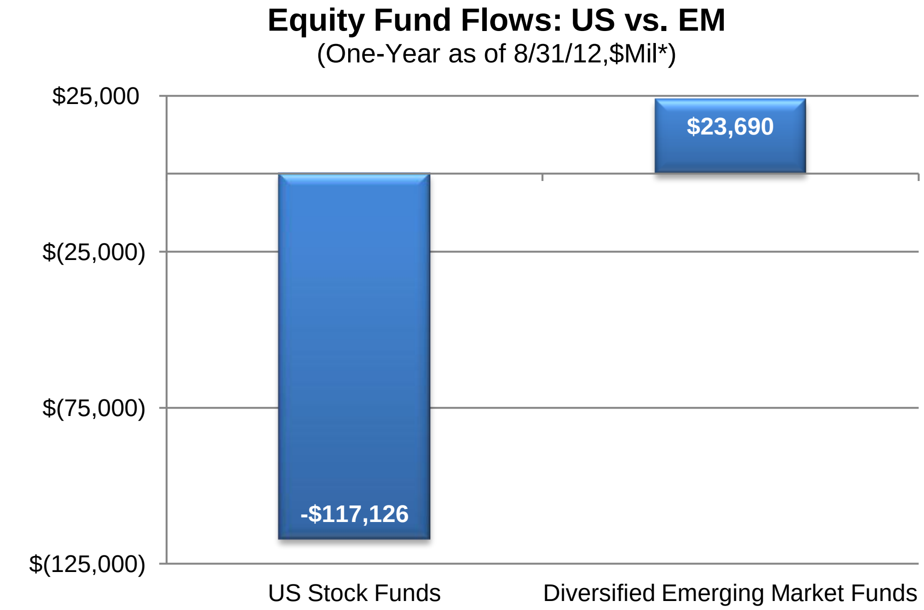
The American Industrial Renaissance **September 27, 2012**

The "American Industrial Renaissance" remains one of our favorite investment themes. We prefer to implement this theme through small US-centric industrial companies and small financial institutions that lend to public and private industrial firms.

It is unlikely that the United States will again be the manufacturing powerhouse that it was during the 1950s and 1960s, but many factors are suggesting that the US industrial sector will gain market share over the coming decade.

Investors seem to still be enthralled with the emerging markets despite the increasing economic and political headwinds facing companies that operate within these countries. Global growth has slowed more than investors had previously anticipated and political risk is rising, yet flows into emerging markets funds continue unabated (see chart 1).

Chart 1:



Source: Morningstar Direct Asset Flows
* Includes liquidated and merged funds.

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Because of the lack of interest in US stocks, the American Industrial Renaissance investment theme appears to still be in its infancy. The theme is beginning to garner some important early attention. Reports published in early-September by the Boston Consulting Group and the ISI Group have strongly supported our theory. However, these reports are the exceptions, and pale in number relative to the number of reports touting the emerging markets.

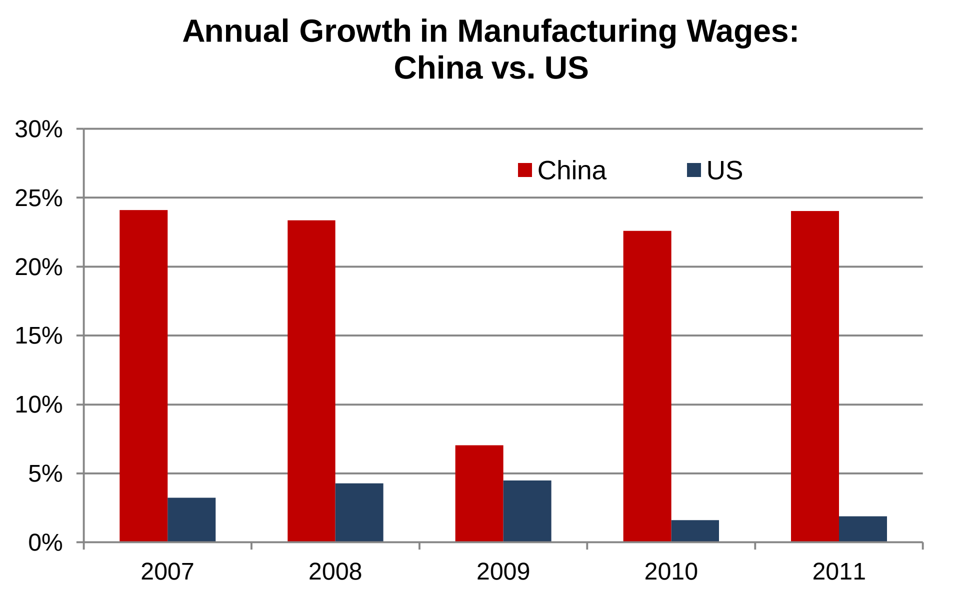
There are many reasons why the US manufacturing sector seems likely to gain market share. Our three main reasons are wages and productivity, energy costs, and political stability.

Wages and Productivity

Markets do not value assets on the absolutes of good or bad. Rather, markets price on whether fundamentals are getting better or worse. Investors, therefore, should generally ignore analyses that don't highlight measures of marginal improvement or deterioration.

With that in mind, wages within the US industrial sector seem to be increasingly competitive. For example, manufacturing wages in China have increased 20-25% per year in four of the last five years, whereas US manufacturing wages have risen less than 5% each year (see Chart 2).

Chart 2:



Source: Richard Bernstein Advisors LLC., U.S. Dept. of Labor, U.S. Bureau of Labor Statistics, Bloomberg, CEIC

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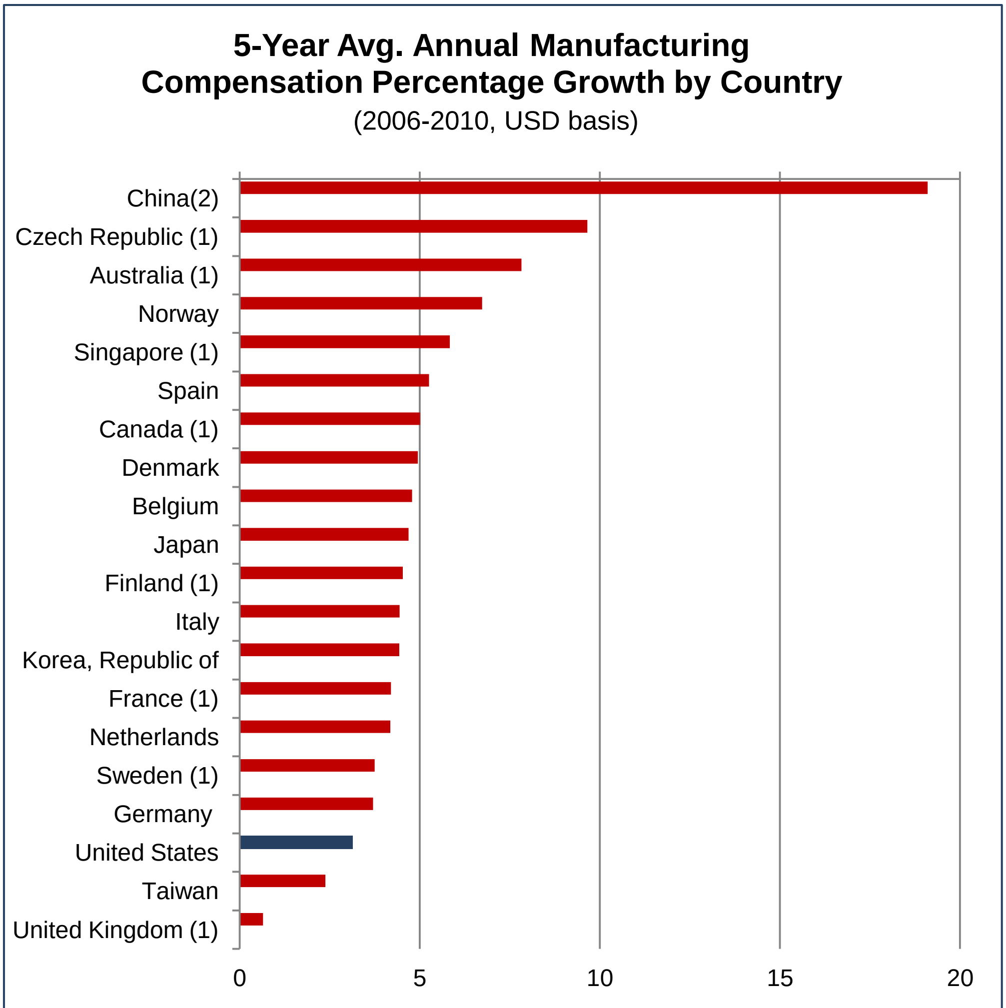
US manufacturing wage growth has not only lagged Chinese wage growth, it has lagged wage growth in most of the world. Chart 3 compares the compound rate of wage growth from 2006 to 2010 for a broad range of countries. US wage growth ranks close to last, which implies that many countries' absolute wage advantage over the United States is shrinking.

Chart 3:



Source: Richard Bernstein Advisors, LLC, U.S. Dept. of Labor, U.S. Bureau of Labor Statistics (October 2011), CEIC, Bloomberg
The data relate to all employed persons (employees and self-employed workers), except for Belgium and Taiwan, where data relate to employees (wage and salary earners). 1. Compensation adjusted for employment taxes and government subsidies to estimate the actual cost to employers. 2. China data source is CEIC via Bloomberg as it is not included in the 19 country U.S. BLS data series.

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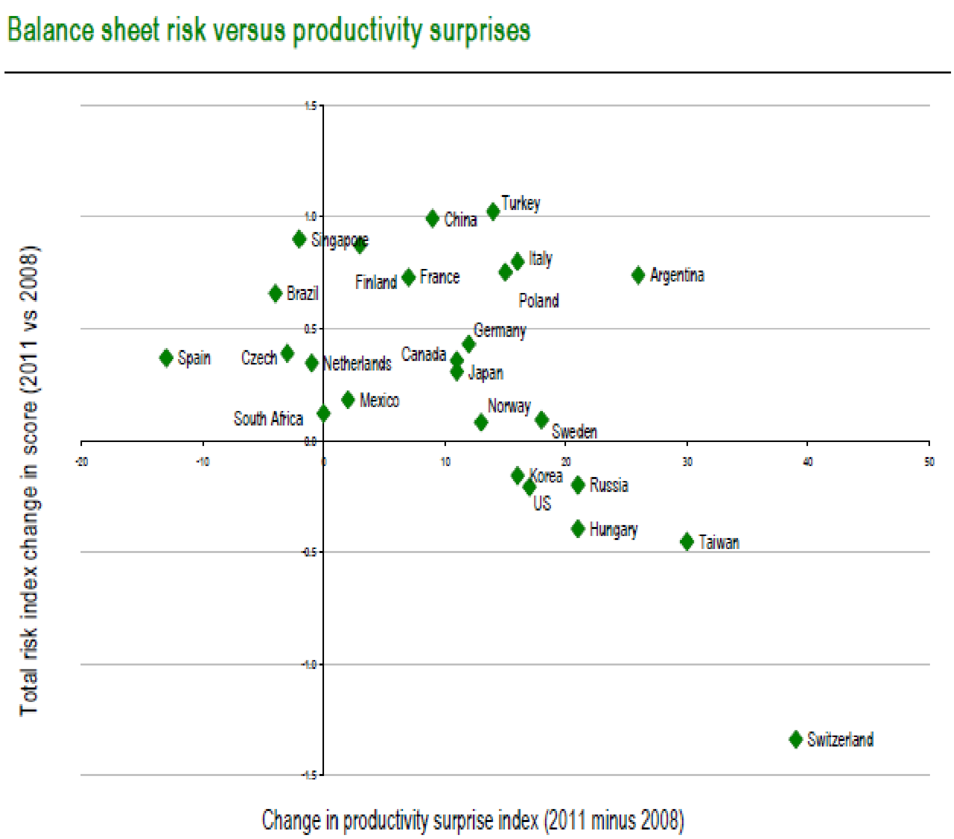
Productivity is generally thought to be a better gauge of overall labor costs than are wages alone. Chart 4, courtesy of UBS, shows the relationship between unanticipated productivity improvements and country balance sheet strength. Countries in the lower right quadrant are those that have generated surprising strength in productivity while strengthening balance sheets (i.e., by decreasing leverage, etc.).

The US appears quite attractive within this analysis because US productivity has remained healthy and total US debt as a percent of GDP is shrinking at an historic rate. Countries like Brazil, China, and even Singapore seem to have been able to generate better-than-expected productivity only at the expense of deteriorating balance sheets.

Chart 4:



Source: UBS calculations/Bloomberg/National sources/Haver/IMF/CEIC. The south east quadrant of this chart shows economies that have seen reduced balance sheet stress yet positive productivity surprises. The north west quadrant shows economies that have seen heightened balance sheet stress and negative productivity surprises. The productivity surprise index is an aggregation of our growth surprise index and our inflation surprise index. Positive growth surprises and negative inflation surprises are assumed to represent a positive productivity surprise. Our balance sheet risk indices are measured with respect to a host of domestic financial and external fragility indicators. The details can be found in 'Global Balance Sheets – Where are we now?' Global Economic Perspectives, 3rd July 2012.

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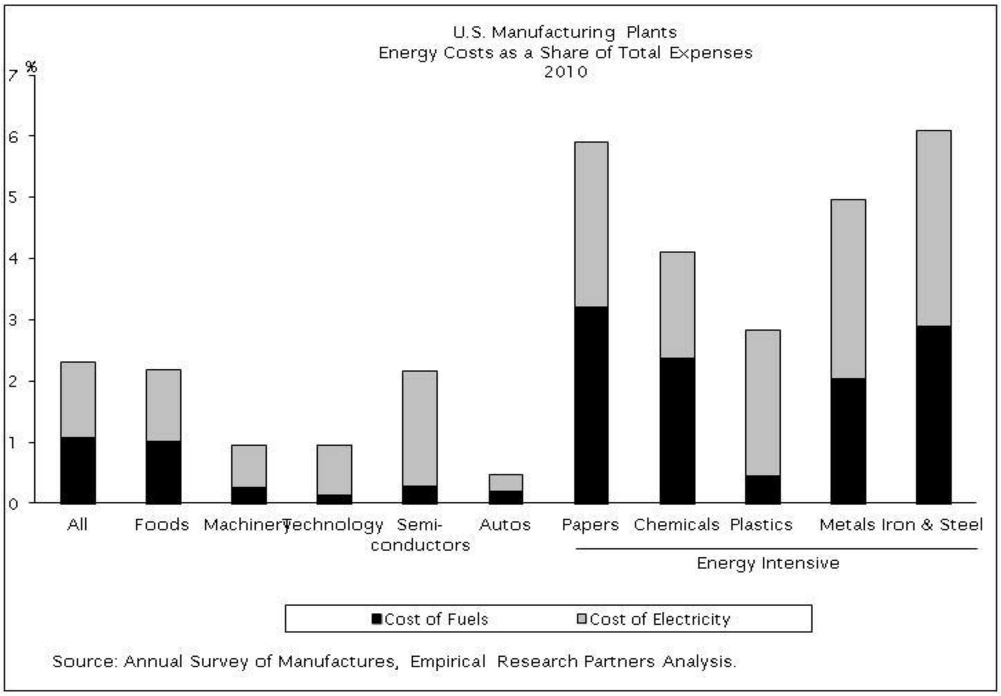
Energy Costs

Energy is not as large of a factor input to manufacturing as many might expect. Chart 5, courtesy of Empirical Research Partners, highlights that energy costs are generally less than 7% of total expenses for US manufacturers.

Chart 5:



Energy is a more significant component of supply chain and distribution costs, and in this respect the United States is also becoming increasingly competitive. The following chart, from Cornerstone Analytics, shows comparable gasoline costs around the world. Middle East countries have relatively cheaper gasoline prices, but gasoline in the US is inexpensive relative to its cost in most countries outside of the Middle East. US gasoline is cheaper than is gasoline in most of the major emerging market manufacturing countries like China, Brazil, India, and South Korea.

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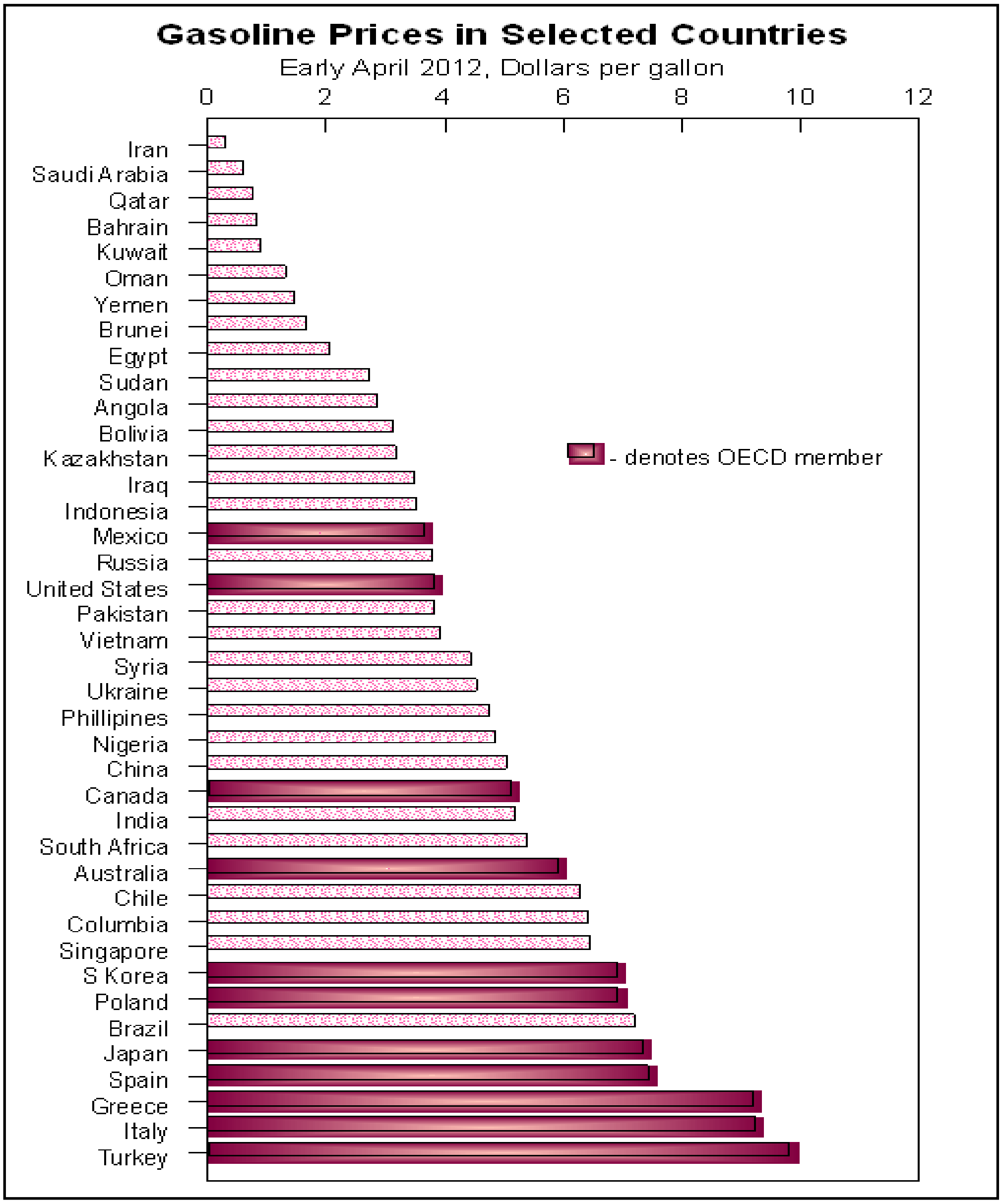
Chart 6:



Source: Michael Rothman, Cornerstone Analytics

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Political Stability

Academic studies have cited various relationships between economic growth and political stability. Governments tend to be more stable when an economy is healthy, but significant deterioration in economic growth can increase political risk. Countries sometimes resent when foreigners' local operations are profitable while the domestic economy suffers. When this occurs, politicians sometimes take drastic actions, such as nationalizing foreign companies' facilities, to appear as though they are rectifying their domestic economy's problems.

Argentina's nationalization of the energy company YPF earlier this year seems to fit that historical precedent. The New York Times described YPF's nationalization as follows:

"In seizing control of YPF, [Argentina's President] has adroitly shifted attention away from her country's soaring inflation, capital flight and her own falling approval ratings, focusing instead on a longstanding subject of resentment here: the market-oriented policies of the 1990s, which preceded a severe economic crisis at the start of the last decade." (NYT, April 26, 2012)

Nationalizations are extreme and infrequent, but one might have thought that Argentina's move would have alerted emerging market investors that political risk might increase as emerging economies' growth slows. More recently, worker riots at a large Chinese manufacturing plant highlighted additional risks to locating production in emerging market countries. Judging by the continued inflows to emerging market mutual funds, it appears as though most emerging market enthusiasts have chosen to ignore these signs that political risk has begun to increase.

Geopolitical and geo-economic risks may become a larger consideration for companies searching for locations for new plant and equipment. Although the current political rhetoric of a Presidential election might suggest otherwise, the US is an extremely safe place for corporations to do business. The US respects the rule of law and enforces contracts.

The American Industrial Renaissance – a secular theme

The US is unlikely to be the industrial leader that it was in the 1950s and 1960s. However, it seems very likely that the US industrial sector will gain global market share over the next decade. Narrowing wage differentials, lower energy and logistical costs, and political stability are just some of the factors that investors should consider.

We continue to believe that investors are over-estimating the risks within the United States and under-estimating the risks in the emerging markets. If we are correct in that assessment, then the American Industrial Renaissance could be an investment theme for many years.

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