IN THE SPOTLIGHT

"Black Swan Events" Making Winners & Losers in Manufacturing

What you need to know: *Food, pharmaceutical, and medical producers who support new consumer buying patterns, as well as supply chain partners like the packaging industry, will benefit from the current economy. With consumers stuck at home, automotive; aerospace; oil and gas; marine; agriculture; and rail industries will suffer.*

Taken together, leading indicator movements and black swan events suggest annual US total manufacturing production will likely decline through at least the remainder of this year. Staving off the worst effects of industrial sector business cycle decline this year and into early next year will require tough decisions. Manufacturers will need to be creative to maintain their ability to meet demand later in 2021 and into 2022 as the US industrial sector recovers and rises.

US total manufacturing production posted the largest proportional February-to-March decline on record. While annual manufacturing had been declining mildly since a June 2019 peak, the recent back-to-back "black swan" events (COVID-19 pandemic and extreme oil price drop) exacerbated the pace of decline in the last month. As March data trickles in, the impact of shutdowns is becoming clearer across a wide swath of manufacturing markets.

These black swans will produce relative winners and losers. The winners look to be those who align most closely with shifts in consumer behavior. US food production and US pharmaceutical and medicine production posted proportionally larger than normal February-to-March changes. These sectors have a clear role in meeting essential needs. As consumers demand goods for in-home consumption, the packaging industry, too, will offer opportunities. Sectors that are relatively insulated from the current economic gyrations, such as the defense industry, are also likely to be relative winners. Relative losers include automotive (consumers stuck at home), civilian aerospace (limited travel), as well as oil and gas (excess supply and weak demand). Markets tied to commodity prices and/or transportation -- such as the marine, agriculture, and rail industries -- will also suffer.

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READERS' FORUM

Why do some economists consider low oil prices to be a second "black swan event?"

Oil prices became a black swan event when supply decisions were made on political grounds, rather than on a rational, economic basis. Saudi Arabia and Russia failed to agree on production cuts -- a response to the COVID-19-induced cut in demand -- at the OPEC+ meeting in early March. Saudi Arabia subsequently decided to increase production and heavily discount their oil, flooding the market and pushing prices lower. Russia also put forth plans to increase production, according to some market pundits, as an attack on the US oil industry. Such actions are political in nature and the resulting severe drop in oil prices is a second black swan event. (The first being the COVID-19 pandemic and response.) OPEC+ agreed on April 12 to cut production by 9.7 million barrels per day, but the muted market response suggests the move may be "too little, too late."

A Closer Look: The Consumer

What you need to know: *Before the detrimental economic impacts of COVID-19, the US consumer was in a strong position relative to history. While there will be more pain ahead, this resiliency should help mitigate the worst effects of the downturn.*

As the effects of COVID-19 and related shutdowns resonate across the US economy, we are in for some sharp negativity coming from news stories and economic data releases. It will be more important than ever in the coming months to avoid overreacting to fear-inducing statistics. Instead, try to keep the current downturn in context. As bad as things feel now, they could certainly have been worse.

Before the pandemic swept through the economy, the health of the US consumer was, fortunately, strong. If COVID-19 had struck when our consumer sector was less stable -- as it was heading into the Great Recession, for example -- the impact would have been significantly more severe. Outlook for US real gross domestic product (GDP) calls for 2.1% peak-to-trough contraction, about half the 4.0% drop we saw in the Great Recession.

In fact, consumer behavior changed in the wake of the Great Recession in ways that braced us for a black swan event of this type. Overall, the US consumer has become much more conservative. We stress-test our portfolios not against a regular business cycle downturn, but against the once-in-a-generation collapse of 2008. Consumer debt ratios have improved markedly relative to the sizeable imbalances carried pre-Great Recession. Personal savings have jumped in the past decade, to 8.2% of disposable personal income in February 2020 compared to an average of 3.6% in December 2007, just prior to the financial markets' 2008 turmoil. Taken together, these factors point to a much more stable base and greater coping ability for any economic disruption.

More recently, a tight labor market further bolstered consumer health. The unemployment rate of 3.5% in February was far below the long-term average. Wage growth (3.7%) was outstripping inflation (2.3%), partly due to the tough competition in attracting and retaining qualified workers. (At 4.1%, wage growth and inflation were equal in December 2007.) As a result, consumer spending was increasing, albeit at a slowing pace of growth following a 2018 business cycle high. Since consumer spending accounts for roughly two thirds of GDP, this rise was strongly supportive for the US macroeconomy.

These trends do not deny that there is pain ahead for the US consumer. Job losses are mounting, workers are furloughed, and others are simply spending less as they shelter in place. However, the consumer's resilient position represents a silver lining. An economic downturn will not suppress activity to the same degree that it might have, given a different starting point.

As with any downturn, this contraction does not mean that all activity will cease. Look to the opportunities. As brick-and-mortar stores close their doors, shopping will move online. Construction sites may fall silent, but homebound consumers will identify needed renovations. Although opportunities may shift, they will not disappear entirely. Block out the noise and find them.

INDUSTRY SNAPSHOTS

Arrows indicate 12-month moving total/average direction through FEBRUARY

Retail Sales

- Up 0.2% from February, mildest February-to-March change since WWII
- Decline in annual Retail Sales imminent, likely to persist to early 2021
- Consider increasing online presence, as consumers will likely turn to online shopping

Rotary Rig

- US rotary rig down 25% compared to Q1 of 2019
- Oil prices plunged below $10 a barrel as production cuts by OPEC+ failed to mitigate reduced global demand
- Many firms in the industry have announced capex cuts

Wholesale Trade

- US total wholesale trade through February even with 1-year ago
- Year-over-year decline in oil prices will contribute to decline in US wholesale trade of nondurable goods in the coming quarters
- Durable goods segment likely to decline in coming quarters

Capital Goods

- Annual US nondefense capital goods new orders in February virtually the same as year-ago
- Annual US defense capital goods new orders through February up 7.9% year over year

Auto Production

- Annual N. America light vehicle production down 3.7% through February
- Expect annual production to decline into early 2021
- US light vehicle sales fell 26.4%, record worst February-to-March percent

Nonresidential Construction

- US total nonresidential construction rose in Feb, up 3.3% from 2019
- Construction expected to decline as projects are deemed nonessential or face supply chain disruptions
- Expect decline to extend into at least early 2021

Manufacturing

- Annual US total manufacturing production declined further in Feb
- Industries deemed essential during COVID-19 outbreak may fare better in near term; oil- and gas-related manufacturing will likely take hit
- Production likely to decline through the rest of 2020

Residential construction

- US residential construction during 3-months through Feb up 12.3%
- US single-unit housing starts in Mar below Feb for first time since '58
- Nat'l Assoc of Home Builders April Housing Market Index down 52.4% from 2019

Copper Prices

Copper averaged $2.55 per pound January to March 2020, down 11.6% from the same period one year ago. Prices have generally fallen during the last year with increasing volatility based on current economic conditions. Future pricing outlook is mixed based on both demand uncertainty and possible supply chain disruptions.