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May 10, 2006 Economic Commentary

The Manufacturing Renaissance

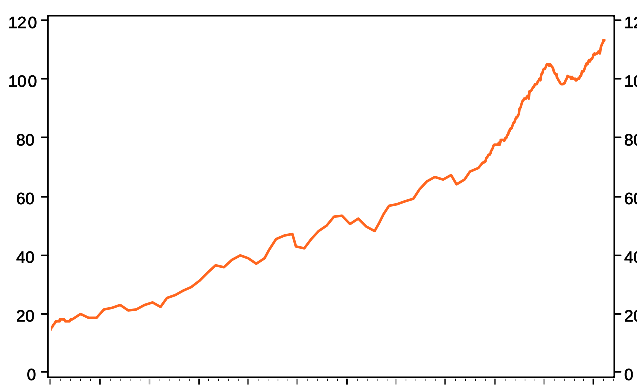
Hardly a day goes by without a gloomy report on the state of manufacturing in the United States. The woes of Ford, GM, Delphi or Visteon have been covered endlessly on the front page of the business section. And when those stories lose some steam, we are barraged with the loss of manufacturing jobs to low wage countries, like China. The negative press is apparently endless. It seems like everybody knows – US manufacturing is dead, right?

Wrong. The reports of its death are greatly, and magnificently, exaggerated. In fact, it appears that the American manufacturing sector is in the midst of an amazing renaissance.

According to the Federal Reserve Board, US manufacturing output has never been higher. The Fed's industrial production index for manufacturing (a series that measures unit output) is currently at an all-time high (see chart below).

Industrial Production: Manufacturing [SIC]

SA, 2002=100



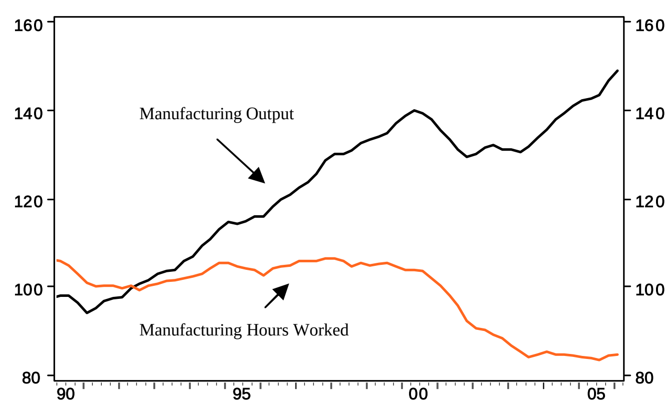
Source: Federal Reserve Board /Haver Analytics

In March, manufacturing output was up 4.8% from a year earlier and 42.5% over the past ten years. During those same time periods, real GDP grew 3.7% and 39.3%, respectively. The difference is a reflection of productivity. Non-farm productivity (an economy wide measure of efficiency) has grown at an a 2.9% average annual rate in the past ten years, while manufacturing productivity has expanded at an annual average of 4.5%.

The end result is that US manufacturers are producing more with less – hours worked by manufacturing employees have declined by 17.4% in the past ten years (see chart below). US producers have become so successful at driving down costs they can compete with virtually anyone in the world, especially in producing high value-added products.

Producing More With Less

SA, 1992=100



Source: Bureau of Labor Statistics /Haver Analytics

While many fear China, its competitiveness is beginning to wane. As wage and input costs rise, its temporary advantage from importing capital and technology and utilizing cheap labor is fading.

Moreover, as productivity expands, and labor costs fall, external factors become more important for global competitiveness. And here, the US wins hands down. The US transportation, financial, labor, and legal infrastructure is abundantly more efficient than that of developing countries. So, as US companies boost productivity, they become more competitive by the day.

This is especially true for small and mid-size US companies, that are not saddled with union contracts and legacy costs which limit flexibility, diminish productivity and eat into profits. Old-line, established companies are often slaves to markets that already exist and have little incentive to encourage customers to try new things. Small companies tend to be technology leaders and often build markets for products that large companies cannot possibly comprehend. As a result, small companies have led the renaissance.

Investing in the Renaissance	Price Appreciation (12/31/2003 - 5/8/2006)
S&P 600 Industrials	74.7%
S&P 600	49.7%
S&P 500	19.1%
S&P 500 Industrials	30.2%

Source: Standard and Poors

Believers in this renaissance have been richly rewarded. The S&P 600 (a small-cap index) includes 99 industrial companies. In just a little over two years (between December 31, 2003 and May 8, 2006) these S&P 600 industrial company stocks have advanced 74.7%. During the same time period, the overall S&P 600 has gained 49.7%, while the S&P 500 large-cap index is up just 19.1%. Industrial companies in the S&P 500 have outperformed the overall index (up 30.2%), but have underperformed small-cap stocks in general and small-cap industrials by a significant margin.

Manufacturing in the US is doing much better than the conventional wisdom understands or believes. While some large manufacturers struggle and garner pessimistic headlines, the American manufacturing sector, especially small, more entrepreneurial firms, are thriving.

There are many positive developments that bode well for these firms and their investors in the years ahead. Pricing power has returned. All three branches of the US federal government are reviewing Sarbanes-Oxley, and there is a high probability that small business will get relief from this onerous regulation. Technology continues to transform the economic landscape, the 2003 tax cut will likely be extended through 2010, and tax provisions are still tilted toward small business investment. For these reasons, the renaissance in American manufacturing is nowhere near a peak.

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