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Research Global

Manufacturing cycle sputtering – where to go from here?

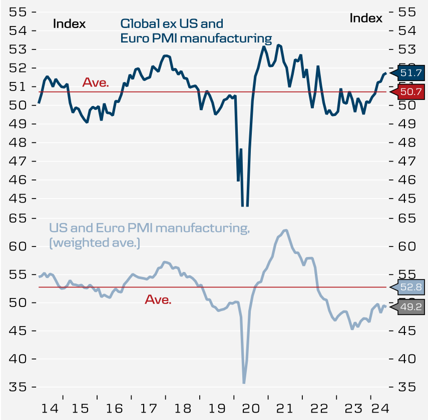
- **After recovering in early 2024, US and euro PMIs have sputtered lately. Is the manufacturing recovery failing - or just taking a pause?**
- **Based on our checklist we believe PMIs should start rising again soon. Asian PMI's have continued to rise, financial conditions have eased, the inventory cycle is still supportive and metal prices have trended higher. These factors normally point to a global manufacturing recovery covering all regions.**
- **However, we continue to see an only mild recovery with a peak during the second half of 2024. It is expected to result in moderate goods inflation but not a new surge.**
- **As the manufacturing sector is only a small part of the economies, a gradual recovery should not get in the way of central bank easing.**

Back in February we argued that the global manufacturing cycle was turning (see *Research Global: manufacturing cycle has turned – more to come*, 7 February 2024) and we did indeed see signs of that going into the spring months. In April we argued for continued, albeit mild, manufacturing recovery in *Research Global – Manufacturing recovery to continue into the summer*, 15 April 2024. We have indeed continued to see global PMI manufacturing move higher but this has been driven by markets outside the US and Euro area In recent months manufacturing PMIs in these regions as well as the US ISM manufacturing index have fallen back and cast doubt over the manufacturing recovery. However, looking through our check list for manufacturing activity, we believe the recent weakness is more a pause than a new prolonged set-back. Below we go through the list one by one:

1. **Asia PMI** : Asia is generally the manufacturing hub of the world with economies like South Korea and Taiwan being key manufacturers of key components that go into manufacturing, not least microchips. The activity signals in these economies tend to give a short lead on manufacturing in Europe (chart 3) as well as the US. PMIs have continued higher in both South Korea and Taiwan in Q2 (chart 4) and the same has been the case in China, another key manufacturing hub. The AI boom and demand for advanced microchips may explain some of the increase in Taiwan and South Korea but that argument does not hold for China suggesting there is more to it than AI chips demand.

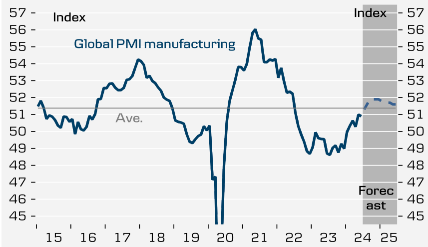
2. **Inventory signals** : Order-inventory ratios in the PMI statistics tend to provide a short lead on the overall cycle as well. While the ratios across countries have tended to flatline lately, they still indicate there is more 'catching up' to do in the actual PMIs (chart 5). The flatlining of the ratio does suggests, though, that the recovery will be mild and peak during the second half of the year.

Chart 1: US and Euro area has clearly underperformed rest of world



Source: Macrobond Financial, S&P, Danske Bank

Chart 2: Global manufacturing outlook – a continued mild recovery



Source: Macrobond Financial, S&P, Danske Bank

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3. **Financial conditions** : The changes in financial conditions tend to be a good indicator for US manufacturing as well. Over the past six months, we have seen a decent easing as equities have rallied, credit spreads have narrowed and bond yields moved lower. In the Euro zone a similar development has taken place providing support to activity (however the empirical correlation of changes to financial conditions with the manufacturing cycle is not as strong here).

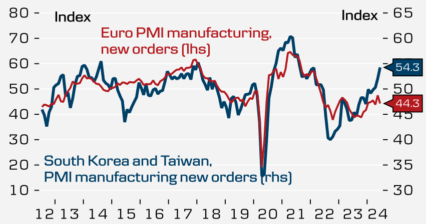
4. **Metal prices** : As producing goods typically requires some sort of metals, their prices tend to give a good cross-check on manufacturing activity (chart 7). This year metal prices have seen a decent lift and although there was a set-back in the past couple of months, they are still much higher than at the start of 2024. Actual manufacturing activity has not been as strong as metal prices have signalled, which indicates that speculative flows may be exaggerating both the upturn as well as the recent decline.

To sum up, we still see a wide range of signals that suggests to us that there should be more left in the PMI recovery in the US and the Euro area. PMI recoveries rarely move in a straight line but tend to move along a bumpy road also being affected by changes in seasonal factors. It is also worth noting that in the case of the US hard production data have actually performed better than indicated by the soft data from PMI and ISM surveys so maybe the survey respondents are just too gloomy compared to reality (chart 8).

However, we continue to believe the recovery will be mild in a historical context (chart 2 on front page) as there is not a lot of pent-up demand or very strong inventory dynamics to drive a big surge in activity. We also see factors dampening demand from US goods consumption in the coming quarters due to low savings and lagged impact of the monetary tightening and in the Euro zone still weak goods consumption and structural drags are also in play, see also *Research Germany – Worst is over in German manufacturing sector*, 16 April 2024.

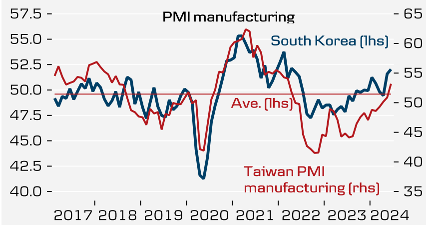
With an only mild manufacturing recovery, we still see room for the Fed and ECB to ease monetary policy as a) it is unlikely to be very inflationary given the slow speed and b) policy rates come from quite restrictive levels and lowering rates moderately will still keep them in restrictive territory for some time. We also expect China to continue to be a disinflationary force for global goods inflation as it suffers from excess capacity and tough competition in many sectors.

Chart 3: Recovery in Asia normally rubs off on the Euro area



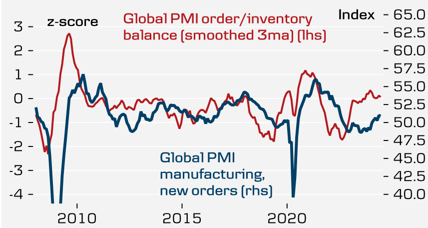
Source: Macrobond Financial, S&P

Chart 4: Both Taiwan and South Korea have seen continued recovery



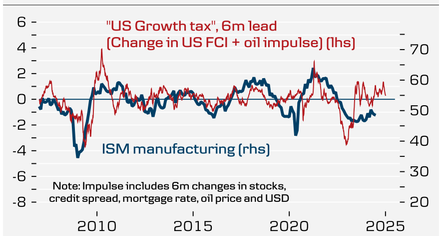
Source: Macrobond Financial, S&P

Chart 5: Clear signs the inventory cycle is turning



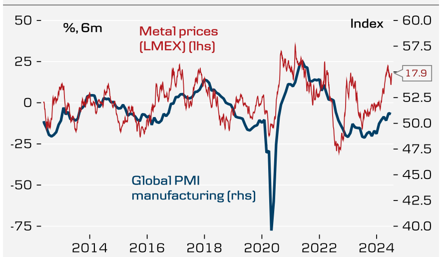
Source: Macrobond Financial, S&P, Danske Bank. Note: Z-score measures the order/inventory balance in standard deviations.

Chart 6: Easing US financial conditions leads the manufacturing cycle



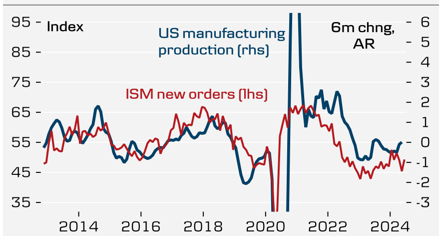
Source: Macrobond Financial, Bloomberg, Danske Bank

Chart 7: Metal prices have seen a lift this year



Source: Macrobond Financial, S&P, Danske Bank.

Chart8: Actual US production has been better than ISM suggests



Source: Macrobond Financial, BEA, Danske Bank

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