07 February 2024

Research global

Manufacturing cycle has turned – more to come

- **We point to five signs that the global manufacturing cycle has turned and expect to see further upside in global PMIs across regions over the next 3-6 months.**
- **The covid pandemic created big swings in the manufacturing cycle with the pendulum swinging from a huge boost in goods demand to a subsequent bust. We now believe the pendulum is starting to swing back supported by a turn in the inventory cycle and a moderate improvement in goods demand.**
- **The expected turn in manufacturing supports a soft landing scenario for the global economy and is one of the reasons we believe central banks will move with caution when they start cutting rates.**

For a while we have seen some tentative signs that a turn in the global manufacturing cycle was in sight but broad based evidence was scarce. However, in January we got the most clear sign so far that the deep recession in the industrial sector in 2023 is coming to an end. Global PMI manufacturing for January jumped from 49.0 to 50.0, the biggest monthly increase in 3½ years, and it represented a synchronized increase across regions. We see five reasons that this will mark the inflection point for global manufacturing:

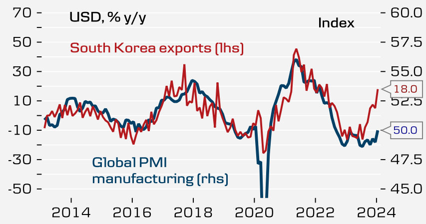
First, Asian manufacturing data has been improving for a while and they tend to lead the global cycle about 2-3 months as economies like China, South Korea, Taiwan and Singapore are manufacturing hubs of key components into final goods, not least semiconductors (one exception to this picture was a big drop in Taiwan export orders in December but we are inclined to believe it was one-off as Taiwan PMI has increased and no other Asian countries have seen a similar drop in orders).

Second, PMIs for the euro area and the US have finally turned. For some time they showed signs of stabilisation but moved sideways at low levels for more than a year reflecting continued recession. In January, however, we saw a quite strong increase in the US ISM manufacturing new orders index and the euro PMI order index increased for the third month in a row. At 44.7 the latter index is still clearly below 50, which signals production is still declining but just at a slower pace than before. However, historically once the index turns it continues higher over the coming year.

Third, financial conditions have eased, which normally is a leading indicator of a turn up in the manufacturing cycle (see chart page 2). For some time, equities have rallied, credit spreads are tighter and bond yields have moved lower. Oil prices are also lower from the peak levels in 2022 adding to the tailwind. This is the evident in both US and Europe.

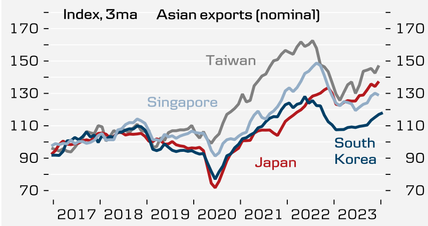
Fourth, the order-inventory balances in PMI releases indicate that the global inventory cycle is turning. Changes in inventories work as accelerators on the business cycle. During the pandemic, very high goods demand and supply chain challenges drove down inventories and triggered a desire to build higher inventories to be more resilient. Hence, for a while businesses had to lift production above actual demand.

Clear turn in South Korean exports send positive signal for global cycle



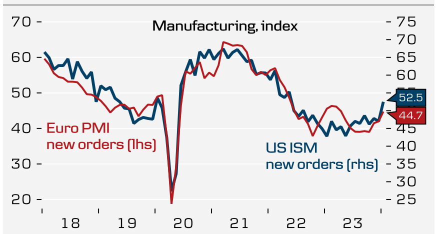
Source: Macrobond Financial, Bank of Korea, S&P

The lift to Asian exports is broad across countries



Source: Macrobond Financial

US and euro now show signs of turning



Source: Macrobond Financial, S&P

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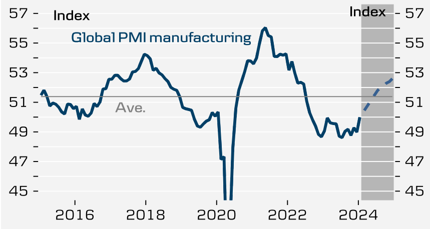
When the demand declined, inventories started to build fast and focus suddenly shifted to reducing inventories. That implied that production had to move *below* demand. The data coming in now suggests that inventories have fallen to desired levels, which all else equal, should drive a turnaround in production in order to at least lift it back up to the level of demand.

These dynamics are well known and part of why we tend to see cycles in production. This time, the forces have been even stronger than usual because the pandemic led to extremely high goods demand for some time as we were not able to spend money on services. The manufacturing 'pendulum' thus swung to a more extreme level than usual. When it started to swing the other way it also led to a longer manufacturing recession than usual. The signals now, suggest the pendulum is finally starting to swing back again which would signify a turn in the cycle.

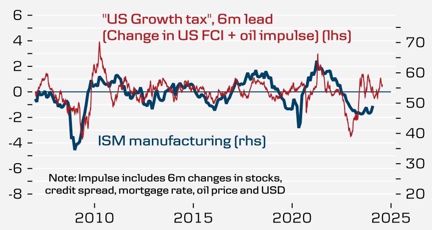
Fifth, actual goods demand shows signs of recovering – at least in the US. That the pendulum has started to swing back is also showing up in consumer goods demand in the US, where the latest data have revealed a recovery in goods spending (see right chart below). The same is not the case in the euro area, where goods demand from households continues to move gradually lower but with the US consumption being a fairly big chunk of global consumption, the turn in the US is important. Hence, the turn in the manufacturing cycle does not seem to be driven by an inventory cycle only but also underlying demand from US consumers. Importantly, though, since the consumer goods recovery is starting from an already high level, we don't look for a new boom but merely moderate upturn.

We look for a moderate global manufacturing recovery this year



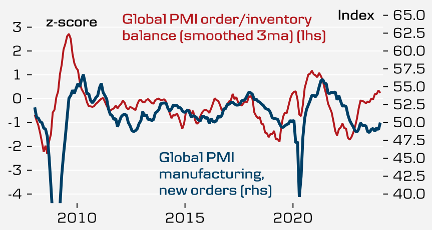
Source: Macrobond Financial, S&P, Danske Bank

Easing financial conditions normally leads the manufacturing cycle



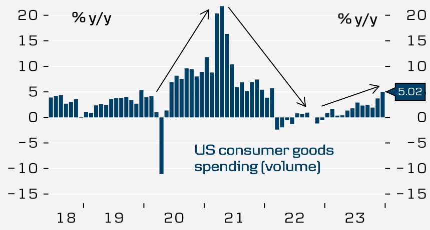
Source: Macrobond Financial, Bloomberg, Danske Bank

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.

Pendulum in US goods demand has started to swing back up



Source: Macrobond Financial, BEA, Danske Bank

Outlook and implications

The bottom line is we forecast a further gradual rise in global PMI towards 52.5 by the end of this year as manufacturing moves from contraction to moderate growth. Importantly, PMIs measure *changes* in activity so at current levels of 50 in the global PMI, we have just moved to a break-even level where manufacturing activity is no longer falling. A move to 52.5 is not a boom in any way but in line with a gradual recovery and global manufacturing businesses will start to see positive sales growth again.

If we are right in our view, it should support the case for a soft landing in the global economy and reduce the risks of economic recession. Overall growth should be tempered by soft activity in the service sector, though.

A rise in manufacturing PMIs also supports the case for central banks cutting rates with caution as the starting point is an economy with no slack to begin with because unemployment is still at very low levels. Too fast easing would create the risk that the overall economy bounces back, and that inflation pressures come back with a vengeance.

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Report completed: 07 February 2024, 15:30 CET

Report first disseminated: 07 February 2024, 15:55 CET