# ECONOMIC INSIGHTS
# FOR MANUFACTURERS

Q2/Q3 2024

# THE BIG **PICTURE**

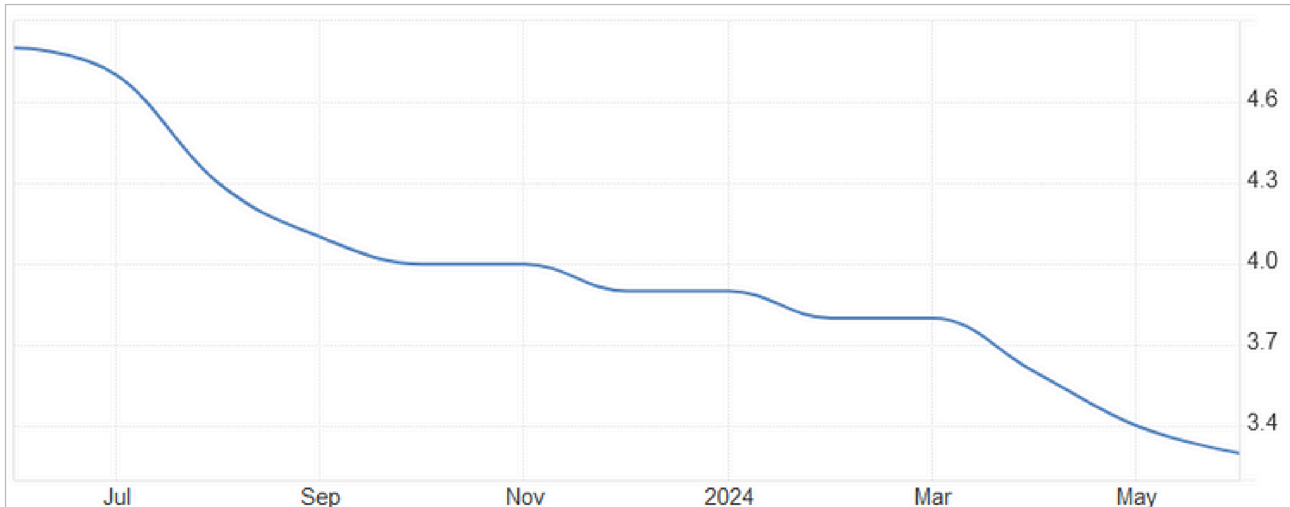
With the first half of the year behind us, it's time to review the main factors that have impacted the manufacturing sector so far and look ahead to how Q3 might unfold. The most relevant drivers affecting the manufacturing market remain the same, but their relative importance has shifted. Let's take a closer look at these issues.

In our prior edition of Economic Insights for Manufacturers, we noted the growing contrast between the financial markets and the manufacturing sector. On one hand, financial markets are at all-time highs, while on the other, the manufacturing sector has experienced several consecutive contractions.

This phenomenon intensified during Q2, with the Institute for Supply Management's Manufacturing PMI indicating contractions in the manufacturing market for 19 of the last 20 months. This is particularly notable given the steady growth of the GDP. In other words, the manufacturing sector's share of the economy continues to decline.

One of the multiple reasons for this reduction is the Federal Reserve's interest rate policy. High base rates, around 5.35%, impact the entire economy but particularly the manufacturing industry. As an asset-intensive sector, it relies heavily on credit to expand its operations.

The good news is that this situation of high interest rates may start to change soon. According to the latest inflation data from Q2, price growth in the economy is slowing. Core inflation, which excludes volatile items like energy and food, decreased for three consecutive months between April and June, settling at 3.4% over the past 12 months.




*Source: BLS, Core inflation YoY change.*

This could lead the Federal Reserve to cut rates at least once this year. According to bond market data, interest rates are expected to be around 4.65% by December, which is 25 basis points lower than mid-Q2 levels.

Another encouraging factor to consider is the correction in relative prices across the economy. Most commodity prices continue to decelerate while manufacturing prices are rising, which helps alleviate margins for companies in the sector.

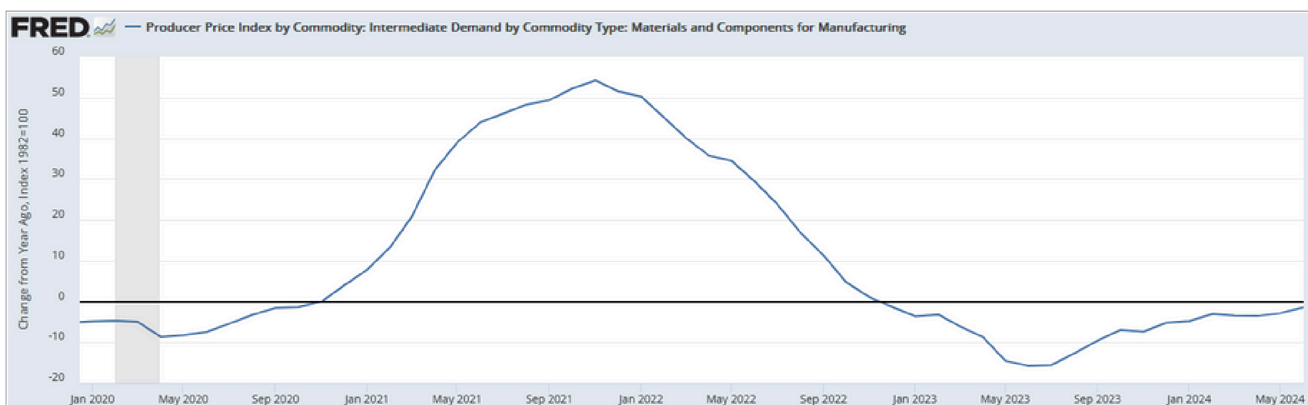
In our last edition, we mentioned that the key question for manufacturers is how long this situation of inflation and stagnation in the manufacturing sector can persist. In May, the resolution of this stage seemed distant. Currently, we can say that the situation has improved, though not clearly or with prospects for sustainable growth.

# MARKET **FORCES**

Both the financial asset and commodities markets have remained robust in recent months. In the former case, the market upticks can be attributed to the dissipation of recession expectations across the entire economy for 2024. Meanwhile, in the commodities market, demand from China, the world's leading importer of raw materials, has stagnated due to slower economic growth.

Simultaneously, the rise in domestic prices of manufactured goods and the overall economy, continued, albeit at a slower rate than previous months. This indicates that despite the volume contraction, there has been an improvement in the gross margins of the manufacturing sector.

Specifically, the Producer Price Index for materials and components used in manufacturing, which reflects the prices of inputs and commodities faced by sector companies, decreased by 1% over the past 12 months. Looking ahead to the second half of the year, we can expect this adjustment in relative prices to continue, albeit also at a slower pace. In other words, while demand may remain constrained, margins could continue to improve gradually, and by the end of the year, we might anticipate an uptick in sales volumes.




Energy prices remained relatively stable during Q2, with oil prices unchanged and gas, despite a rise during the quarter, remaining 20% lower YTD. Meanwhile, inputs showing a significant price jump include electrical and electronic components. According to data from the Bureau of Labor Statistics, the cost of electricity has been rising above inflation. Therefore, careful management of indirect costs could still make a difference in Q3.

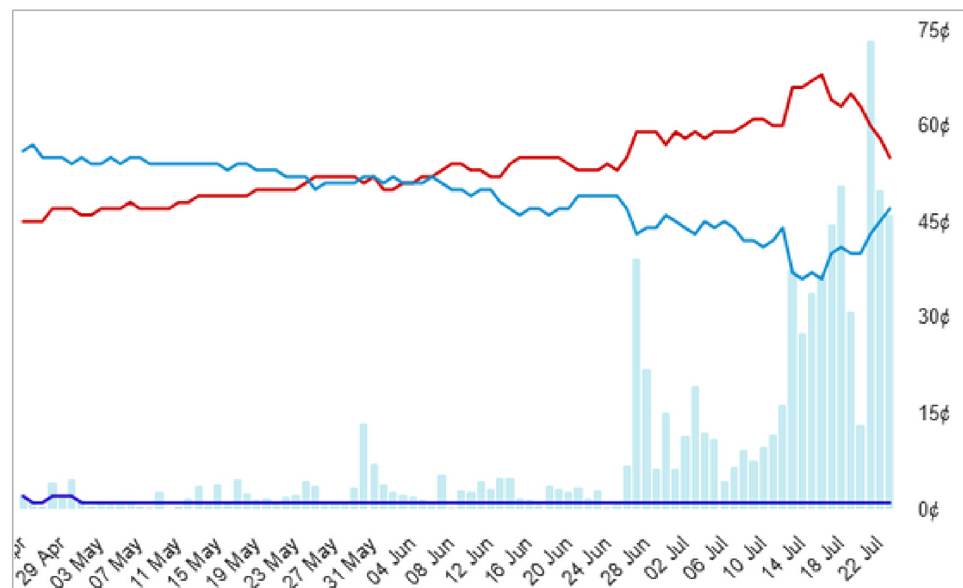
Despite most of these factors implying moderation in international commodity prices, prices in the United States continue to grow in line with inflation. Leaders in the manufacturing sector should continue to expect price increases throughout the supply chain, stemming from the inertia of previous years.

# CURRENT EVENTS **& OPINIONS**

In November, the United States will elect its president for the next four years, potentially initiating various changes in external regulations and trade policies. Ongoing processes such as the so-called "trade war" and the "decoupling" from China, which began in 2017, may see further developments or intensifications.

In the last two years, there have been no major changes in trade policies because the government is virtually divided, with Democrats controlling the Senate and the executive branch, and Republicans controlling the House of Representatives. This could change soon, especially if there is a Republican trifecta.

Recent polls indicate that the presidential race has shifted in Donald Trump's favor. The assassination attempt on Trump, combined with Biden's withdrawal and the resulting indecision within the Democratic Party about its leadership, suggest a growing likelihood of a Republican Party victory.




*Source: PredictIt betting odds.*
*Red line: Republican Party. Blue line: Democratic Party.*

In a highly significant interview with Time magazine in late April 2024, Donald Trump stated his intention to substantially increase import costs. He made it clear that he would push for an additional tariff of at least 10% on all imports, and possibly over 60% on imports from China.

Leaders in the manufacturing sector must remain vigilant regarding potential increased tariffs on imports of foreign goods. While the electoral victory of the Republican Party remains a possibility, it may be prudent to build up inventory before these new tariffs are imposed.

Tariffs could have dual effects: They could escalate input and output costs and they could create opportunities if viable manufacturing substitutes emerge. In other words, leaders in the manufacturing sector should consider the possibility of replacing goods or services currently produced in China or Europe with domestic alternatives.

The optimal strategy for Q3 appears to be similar to that of Q2: increasing inventories and inputs while taking advantage of the current price stability. This strategy is prompted by the decrease in commodity prices and the potential for imports to become more expensive in the event of a change in government.

To wrap up, manufacturing faces a complex landscape marked by economic uncertainties and shifting policy dynamics. As we approach Q3, it's crucial for industry leaders to capitalize on stable or decreasing inventory pricing by strategically increasing stockpiles.

Moreover, given the possibility of Republican control post-election, proactive measures should be taken to mitigate potential tariff hikes or direct restrictions on imports. This includes exploring domestic alternatives for goods currently sourced from China or Mexico, ensuring resilience in the face of changing trade policies. By embracing new strategies, manufacturers can effectively address challenges while positioning themselves to capitalize on emerging opportunities.

If you have any questions or would like to continue the conversation, I encourage you to reach out to your dedicated Rehmann advisor. You can also visit our website at rehmann.com for additional resources and insights. Alternatively, feel free to give us a call at 866.799.9580. We’re here to assist you!