INVESTMENT STRATEGY UPDATE

September 28, 2012

RE-"MADE IN THE U.S.A." –
THE COMING MANUFACTURING RENAISSANCE

Get ready to start learning some new buzzwords. In the next few years, "onshoring," "reshoring," and "insourcing" are going to become part of our economic lexicon, due to the fact that the U.S. is rapidly becoming the location of choice for new manufacturing facilities. This puts the lie to what has long been an article of faith among pundits: that American manufacturing is in a state of inexorable decline, attacked on all sides by imported goods, primarily as a result of uncompetitive wages, but also due to questions about quality. While there was once a real basis for this belief, it was always a little misguided. After all, it is true that manufacturing as a percentage of our economy peaked in 1953 and that the total number of manufacturing jobs has dropped by 40% since the 1979 high. However, the U.S. is still the world's largest manufacturing economy, and an American worker is 3.5 times as productive as he or she was in 1979. Now, a combination of factors is leading to what we believe will be a new era, where manufacturing employment could very well grow significantly in the coming years, with potentially enormous positive implications for the U.S. economy, overall employment, and domestic investments.

<u>The Decline of American Manufacturing</u>

In the years following World War II, the U.S. was the undisputed heavyweight champ of global manufacturing. This country produced the highest quality goods, and "Made in the U.S.A." basically meant "the best." The reasons were simple: We were blessed with abundant natural resources, a productive labor force with a strong work ethic, and an industrial infrastructure that was almost entirely intact in the wake of one of history's most destructive conflagrations. As a result, we could produce high quality goods at reasonable prices. We had competitive advantages, and we used them.

However, this manufacturing power gradually eroded. Rejuvenated economies in other countries, especially Japan, began to increase their share of the world market thanks to cheaper labor costs and weaker currencies. Meanwhile, prosperity in our country was accompanied by rising costs of labor, fuel, and other manufacturing inputs. Additionally, the perceived quality of our manufactured goods began to decline, perhaps due to complacency after years of global dominance. This was epitomized by the troubles that American automobile makers had in keeping up with their relentless Japanese competitors. "Made in the U.S.A." became a less desirable product trait, as imported goods took on a perceived air of better quality and increased desirability.

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In response, many American companies closed basic manufacturing facilities in the States and outsourced production to lower-cost countries, retrained the remaining American workers they employed, and searched for new higher-value-added products. By the late 1990s, U.S. industry began to dominate once again, this time in areas such as electronics, aerospace, and pharmaceuticals.

Then, as the 21st century dawned, China began to rise as a serious competitor, as government policies there aimed at encouraging a more industrial economy took hold and major cost advantages such as cheap, abundant labor were exploited. In 2001, China entered the World Trade Organization at the same time that global trade was becoming increasingly open. American manufacturers responded to this new competitive wave by outsourcing still greater amounts of production. As a result, U.S. domestic manufacturing employment took a major hit, with some 6 million jobs lost between 2000 and 2009. At that point, China was exporting nearly 10% of all internationally traded goods.

Reversing the Trend

During the last few years, however, our competitors' advantages have begun to diminish and the attraction of manufacturing domestically has increased. A number of factors have contributed to this change, but by far the most important is the cost of labor per unit of production. Specifically, U.S. manufacturing unit labor costs have risen much more slowly than those of our major global competitors.

In China, for instance, wages and benefits have quadrupled since the turn of the century. Shortages of Chinese workers in manufacturing regions, stronger labor movements, and government policies aimed at raising national income levels have all put upward pressure on their labor costs. The recent riot at a Foxconn facility in Northern China is presumably at least indirectly related to a restless workforce's desire for better pay, among other things. By contrast, average labor costs for American manufacturers have risen by only one-third over the same time period.

Furthermore, U.S. productivity has continued to improve thanks to increasing use of technology and automation. Despite our clear fiscal difficulties, private capital remains abundant in America. While Chinese worker productivity has also increased, it has not kept pace with its growth in wages. Chinese employment costs remain well below the U.S. average, but the gap is shrinking. According to one estimate, the total labor-cost savings of manufacturing in China vs. the U.S. will only be about 10-15% by 2015. For a labor-intensive manufacturing process, such a difference will still be important. But for more capital-intensive industries, any labor-cost advantage could be neutralized by other factors.

Energy, for instance, is one of the largest cost inputs to many manufacturing processes, and it is an area where the U.S. is actually gaining an absolute advantage. As discussed in our most recent *Investment Strategy Update*, a new abundance of domestically produced natural gas and oil has the potential to dramatically reduce our dependence on foreign energy sources and lower the relative cost of this important manufacturing input.

Lower domestic energy costs change the transportation equation, as well. Rising international oil prices increase the cost of shipping goods over the long distances from Asia to our shores. That, along with the currently low production of new container ships and potential capacity constraints at container ports, means that shipping rates are likely to increase over time, raising the prices of imported products.

There are other reasons to manufacture in the U.S., as well. As demand within Asia grows, there will be less Chinese capacity available for export, and the other low-cost countries, such as Vietnam and Indonesia, don't have the capacity or the skilled workforce to make up the difference. Regardless of capacity, as the largest consumer market in the world, the U.S. could be viewed as the logical default manufacturing location. After all, companies prefer to be close to their customers. Supply chains are less extended, which means less threat of disruption due to port closures or natural disasters and lower inventory expenses. For a U.S. company, manufacturing domestically can also mean greater ease of management and fewer quality control problems, which in turn means more reliability and greater customer satisfaction. Manufacturing in the U.S. also entails benefits from excellent corporate governance relative to many other countries and far less chance of intellectual property theft.

Improving the U.S. Economy

It has been estimated by the Boston Consulting Group that production of up to 30% of the goods that America now imports from China could shift back to our country by the end of this decade. Domestic manufacturing growth in industries affected by all overseas competitors, combined with increased U.S. exports, could add between $80 billion and $120 billion to our annual gross domestic product. This could directly and indirectly create up to 3 million new jobs and reduce unemployment by 1.5 to 2 percentage points.

Evidence is building that this shift has already started to occur. Automobile companies such as BMW, Ford, and Toyota are choosing to relocate manufacturing capacity from other countries or expand existing U.S. production. Additionally, aerospace companies based in Canada, Europe, and South America are all currently building new facilities here. Samsung invested over $3 billion last year to expand a semiconductor plant in Texas that makes chips for iPhones and iPads, and is investing another $4 billion this year. The popular perception that Silicon Valley is moving all of its production offshore is belied by the fact that 8,000 new manufacturing jobs have been created there in the last two years.

It's not just about high tech, however. For example, the Coleman Company is in the process of moving production of plastic coolers back from China. If one looks, the newspapers are starting to fill up with anecdotal evidence of such moves across America. A survey by Boston Consulting Group found that 37% of American companies with annual sales of $1 billion or more planned to reshore production or were actively considering doing so.

Investment Implications

Many of the industries hit hardest by the movement of manufacturing to other countries will be among the biggest beneficiaries as it returns. Producers of industrial goods, such as electrical equipment, machinery, heating and air conditioning systems, and farm and construction equipment will see input costs moderating, thus boosting profit margins, improving their competitiveness and expanding export opportunities.

As the reshoring trend picks up and U.S. manufacturing capacity ramps up, there will be an enormous need for new and upgraded production facilities. The aging domestic transportation infrastructure will also need repair and rebuilding to handle the efficient movement of parts and raw materials throughout the country. Engineering and construction firms should benefit, as will logistics and transportation companies.

As noted, increased domestic manufacturing will also depend on plentiful supplies of fuel. Oil and gas exploration and production companies focused on domestic resources like the Bakken Shale, oil services companies, and pipelines will all see increased demand from the manufacturing sector as less fuel is imported.

Even if manufacturing in the U.S. is not the absolute cheapest option and does not improve the bottom line in the short term, we believe that increasing numbers of companies will decide that the combination of reasonable costs and fewer headaches makes domestic production attractive. With a growing manufacturing employment base here, overall employment and economic growth will improve, ultimately to the benefit of just about every domestic company in which we could invest. This manufacturing renaissance is part of the reason we are bullish long-term on the American economy and American stocks.

Stock Market Comment

Year-to-date the stock market is up nearly 18%, including dividends. The magnitude of this rise was almost wholly unexpected. The flow of global economic and financial news has been quite discouraging overall, and seems likely to remain so going forward. And yet with today's rapid communications, past, current, and expected events are almost immediately reflected in the securities markets. So, future changes in stock prices have little to do with news that is already known or expectations that have already been priced into the markets.

At the beginning of this year we postulated that the major low for this stock market cycle was in early 2009. We thought that the environment of high volatility would likely continue, but we planned to remain invested, bolstering equity weightings during periods of weakness and shaving them on future strength. That strategy remains intact. We are neither bullish nor bearish at the current time. Rather, we remain opportunistic.