Investment Insight

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Manufacturing sector shows weaknesses

The ailing Chinese economy is a contributory factor to the worsening of the Eurozone's foreign trade environment despite the currently robust US economy. Primarily manufacturing companies are becoming more sceptical. By contrast, service providers still appear relatively unimpressed, but are also likely to become more cautious in future.

The US job engine is running smoothly. Although at 134,000, fewer new jobs were created in September than expected, the unemployment rate surprisingly decreased from 3.9% to 3.7% and thus reached an almost 50-year record low. The bottlenecks in filling job vacancies are thus increasing and are likely to drive wage growth in the next few months. Recently wages rose at an annualised six-month rate of 3.3%. Although wage growth is thus higher than in the previous year, the momentum of wage increases is still moderate in historical terms. For example, the Federal Reserve can currently maintain its course of gradual interest rate hikes and does not need to contemplate acceleration.

The US economy as a whole looks just as positive as the labour market – based on the most recent corporate surveys. The US service sectors in particular are in a dazzling state of health. The corresponding ISM Purchasing Managers' Index increased from 58.5 points to 61.6 and was only four tenths of a point off the previous all-time high from 1997. Accelerated revenue growth (65.2 points following 60.7), more extensive new orders (61.6 points following 60.4) and greater job growth (62.4 points following 56.7) were responsible for the increased optimism.

We expect markedly decreasing growth momentum in the US for 2019

Manufacturing companies also remain confident on the whole. However, the ISM Index fell from 61.3 points to 59.8, with the order component the determining factor. It decreased from 65.1 points to 61.8 points and is now far removed from its cyclical peak in December 2017 (67.4 points). The same applies to the sub-index on order development in the service sector, which tends to be a leading indicator. We see this as a confirmation of our long-term economic outlook and expect significantly decreasing growth momentum for 2019 – because then the tailwind will decrease as a result of the fiscal stimuli and the headwind increase as a result of higher interest rates at the same time.

Unlike in the USA, the economic trend is already downwards in China. The purchasing managers' indices for manufacturing decreased significantly in September: The Manufacturing PMI of the National Bureau of Statistics (NBS) unexpectedly decreased significantly from 51.3 to 50.8 points. The Markit equivalent in fact reached the expansion threshold for the first time in 16 months at 50.0 points. Although the Bureau of

Statistics' Service PMI increased from 54.2 to 54.9 points, this does not change the fact that the 3rd quarter saw considerably declining momentum on average compared to the average for the 2nd quarter.

Due to the high correlation to GDP growth, the important PMIs thus continue to point to a slowdown of economic growth. The hoped-for positive real-economy knock-on effects of the recently launched government stimuli therefore remain a long time in coming. The Bureau of Statistics announces the GDP figures for the 3rd quarter next week. We expect an increase of 6.6% following 6.7% in the 2nd quarter. But a somewhat more significant weakening to 6.5% is also possible.

In Germany, incoming orders in manufacturing were a positive surprise in August. At +2.0%, they increased more than twice as much as expected compared to the previous month. Primarily, orders from abroad (+5.8%) were responsible for the good August result. Domestic demand, by contrast, decreased by 2.9%. Although the most recent upturn in foreign orders is encouraging, it cannot hide the fact that the overriding outlook for exports is still to be viewed sceptically. Not only the uncertainty as a result of the USA's protectionist behaviour is having a negative impact. The slowdown in growth in China is also acting as a brake.

The highly export-oriented German manufacturing sector feels this in particular. Among other things, this is indicated by the sub-index on the development of foreign demand in the September purchasing managers' survey. It decreased from 51.8 points to 48.1 points. The remaining PMI data by and large also indicate a gloomy outlook. Accordingly, the rate of expansion in European manufacturing has decreased significantly. At 53.2 points following 54.6, the corresponding index plummeted to its lowest level in two years.

The negative effects resulting from the worsening of the foreign trade environment spare no country in the export-dependent Eurozone. The latest data for Spain and Italy shows that neither country has been able to escape the overriding downwards pull in the manufacturing sector. In Spain, the manufacturing index slipped to a two-year low at 51.4 points following 53.1. In Italy, the expansion threshold was in fact reached at 50.0 points following 50.1.

The service sectors can only resist the slowing manufacturing momentum in the short term

Whereas the manufacturing sector is suffering from the decreasing tailwind from foreign trade, the service sectors have recently been able to hold their ground. Like in Germany and the whole Eurozone, stabilisation could also be seen in Spain and Italy. Looking ahead, however, that is only cold comfort. The service sectors can only resist the slowing manufacturing momentum in the short term. The longer the slowdown in the manufacturing sector continues, the more braking effects on the service sector are also likely to emanate from this. Our leading indicators point to such an enduring slowdown for the manufacturing sector in the wake of the slowing growth momentum in China and the dampened outlook in the long-term for the US economy – the service sectors should find themselves in rougher waters in this environment.

Bonds were recently in the spotlight for investors on financial markets. First, it was the budget dispute in Italy that caused interest rates and risk premiums for Italian bonds to rise, then US yields rose significantly. Based on the almost constant flow of positive economic data in the past few weeks, financial market participants believed more strongly that the Federal Reserve could raise interest rates even further than previously priced in by the interbank lending markets. Treasury yields followed hot on their heels. Two-year treasury notes climbed to a new 10-year high at 2.89% and 10-year treasury notes rose to a new seven-year high of 3.23%. Yields could definitely increase again in the short term, but the turning point is likely to come in 2019. When fiscal stimuli come to an end and tighter financing conditions curb corporate investment with a delay of several months, economic growth should decrease noticeably and the labour market recovery also lose momentum in parallel. The Federal Reserve will then take a break in the rate hike cycle. As always, government bonds will anticipate this – yields will fall again.

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