Rust Belt Rising—Maryland's Manufacturers Are Rising

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U.S. and Maryland manufacturing have receded for the past 40 years as cheaper emerging market manufacturing resulted in the wholesale relocation to the emerging markets. Outsourcing has been a persistent buzzword. There is growing evidence that manufacturing in the U.S. and Maryland is on the rise. During the challenges of the past 40 years, the industry was not thrown a lifeline and has been forced to reinvent itself.

What Changed?

The manufacturing industry has quietly but persistently reinvented itself. The single biggest contributor is productivity gains. Monotonous mind numbing tasks are now supported by automation. This in turn has lowered production costs. Between 1987 and 2008 productivity of U.S. manufacturing grew by 103%, almost double the productivity increase of the rest of the business sector. While manufacturing accounted for on average 15% of GDP, it accounted for 22% of overall productivity.

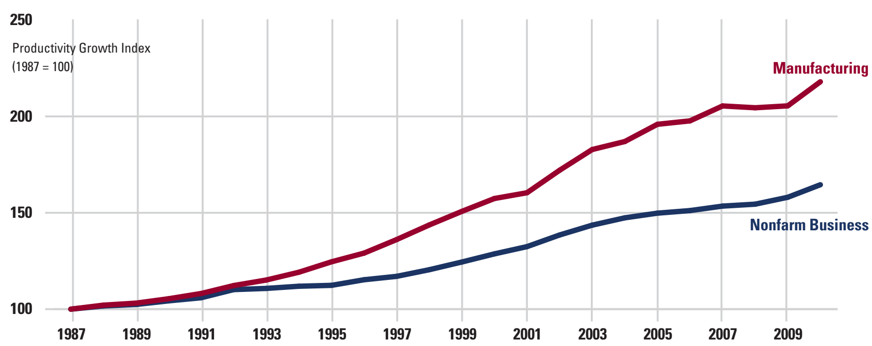
How to Judge Success?

If you measure manufacturing in terms of historic employment levels, the numbers have clearly fallen. The same is true with farming. In 1930 21.5% of the U.S. work force was employed in agriculture. Today 1.9% of the U.S. work force is employed in agriculture. There is little lamenting about the farmer's use of mechanization to complete otherwise backbreaking or monotonous work. While the employment levels in manufacturing and farming have fallen, productivity has significantly improved. Federal Reserve Chairman, Ben Bernanke has observed that productivity growth is «perhaps the single most important determinant of living standards».[1] Higher productivity means more can be produced with less available resources which is the basis for higher wages and living standards.

Historical Perspective

Following World War II the world's manufacturing base - outside North America - had been destroyed or heavily damaged. U.S. manufacturers were the only game in town and the world desperately needed manufactured goods to rebuild. For manufacturers, it was a sellers' market, if there was enough credit. The U.S. government's Marshall Plan (officially the European Recovery Act) and separate aid to Asia helped fuel a period of enormous prosperity for U.S. and Maryland manufacturers. Manufacturing companies had some of the highest profit margins in recorded history and

Figure 1: Growth of Maryland Manufacturing vs. Non-Farm Businesses



Source: U.S. Bureau of Labor Statistics

along with that prosperity came higher incomes and appreciating currency. Wages grew and labor sought greater participation in the prosperity. In 1948 the National Labor Relations Board compelled employers to include pensions in collective bargaining. As pension participation accelerated, collective bargaining sought the expansion of pension benefits. During the 1950's and 1960's, Europe and Asia rebuilt and our customers became our competitors. In many cases the goods produced were of inferior quality, but over time foreign companies moved up the quality curve and gained higher and higher levels of market share.

The extraordinary sellers' market for U.S. manufacturing following World War II was not sustainable. Management and labor agreed to wages and pension benefits that were not sustainable as competitive advantages were lost. At the same time the value of the dollar was appreciating and magnifying growing cost disadvantages. The incremental return on building new production abroad was superior to building new production domestically, since labor, benefits and taxes were cheaper. Through this entire process evolving levels of technology have removed distance and facilitated even greater levels of outsourcing.

In 2011, most defined benefit plans have been closed to new entrants and have been replaced with defined contribution plans e.g. 401Ks. The strength of 401Ks is the participants know what they will actually receive and companies match costs their to the operating period the benefits are given. The importance of pension obligations cannot be over looked. One needs to look no farther than the big three automakers. There are two more silent trends that are of significant importance. The long-term depreciation of the U.S. dollar and rising labor costs in the emerging markets that are favorable to manufacturers in the U.S. and Maryland.

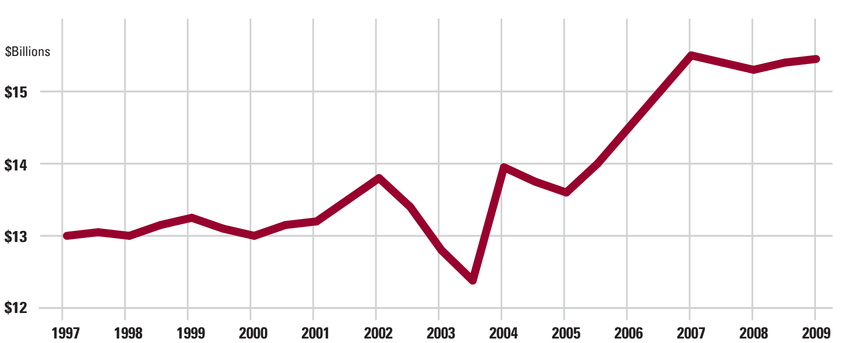
Dollar Depreciation Favors Manufacturing

In 2010, manufacturing's share of exports from Maryland was 90%. Since 1986 the declining value of the dollar on a trade-weighted basis has substantially improved the competitive position of U.S and Maryland manufactured goods. There is no guarantee on the direction of the dollar. A collapse of the Euro would undoubtedly strengthen the dollar.

To date two quantitative easing programs have occurred that expanded the Federal Reserve balance sheet to $2.8 trillion. Federal Reserve Chairman Ben Bernanke has in recent comments and Federal Open Market Committee meeting minutes indicated a willingness to engage in QE3 if market conditions warrant. In January 2012 the terms of the three dissenting members of the Federal Open Market Committee are set to expire. This will likely facilitate even more quantitative easing by the Federal Reserve as it seeks to attain fuller employment with aggressive monetary policy. While positive for manufacturing these changes present inflationary pressures as the money supply grows. Year-over-year import prices in the U.S. increased by 13.4% in September 2011 per the U.S. Department of Labor. Oil imports accounted for 7.9% of that increase.

A metal-cutting laser at Marlin Steel in Baltimore

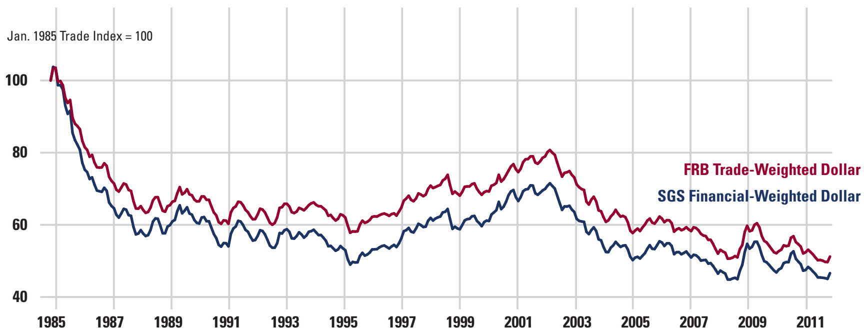
Figure 2: Maryland Manufacturing Output



Falling Unit Labor Cost

Relative to emerging markets where double-digit wage inflation is the norm rather than the exception, U.S. unit labor costs are falling. The primary driver is increasing productivity. The closing of most defined benefit pension plans has reduced pension costs. The 401K defined contribution plans give employee's a level of certainty since the retirement assets are titled in the employees name. Healthcare expenses continue to increase at a double-digit rate which are an ongoing challenge for manufacturers.

Figure 3: Financial- vs. Trade-Weighted Dollar Indicies



Where Do Things Stand?

Historically, Maryland's economy was dominated by manufacturing as proximity to the port and the railroads was a dominate consideration since it granted access to both end markets and natural resources. Today, manufacturing in Maryland accounts for 5.4% of the total output of the state, employing 4.6% of the work force. Total output from manufacturing has been rising the past several years (see Figure 2), and the output of Maryland's manufacturers totaled $15.4 billion in 2009. Manufacturing compensation is almost 54% higher than other nonfarm payrolls in Maryland. The average annual compensation for manufacturing employees in Maryland is $78,781. Maryland has 3,860 manufacturing establishments. Eighty-seven percent of Maryland's exporters are small businesses. Between 2003-2010 the growth in manufactured exports doubled, and now stands at $9 billion annually. The top five export markets for Maryland's manufactured goods in 2010 were Canada (16%), Netherlands (7%), Saudi Arabia (5%), Mexico (5%) and Egypt (4%).

Some Interesting Examples of Maryland's Manufacturing Success

W.R. Grace & Co.(Columbia - NYSE ticker GRA) ships cracking agents that are used in refiners around the world to make gasoline and other fuels. **Millennium Chemicals** (Hunt Valley - private) manufactures titanium dioxide, which puts the white in the color white. **Goetze's Candy Company** (Baltimore- private) manufactures its signature Cow Tales candy. **Marlin Steel** (Baltimore - private) manufactures wire and sheet metal structures for a diverse number of manufactures. **Sensata Technologies** (Cambridge - NYSE ticker ST) manufacturers electrical switches and sensors. **Colfax** (Fulton - NYSE ticker CFX) is a leading manufacturer of a wide range of heavy duty industrial pumps. **Beretta USA** (Accokeek - private) manufacturers pistols on the Eastern Shore that are widely used by police departments around the world. **Allison Transmission** (White Marsh - private) leading manufacturer of medium and heavy-duty transmissions. **CRTL Systems** (Westminster - private) a leading manufacturer of ultrasonic detection devices and sensors used to detect, maintain and inspect complex mechanical systems. **Northrop Grumman** (Linthicum - NYSE ticker NOC) manufactures F-16 radars. **Cambridge International** (Cambridge - private) is a leading manufacturer of metal belts. **Ellicott Dredges** (Baltimore - private) a leading manufacturer of dredges used around the world. Exports represent a significant part of the sales for each of the manufacturers noted above and the prospects for future growth look strong.

Conclusion

The relative strength of manufacturing in the U.S. and Maryland is improving. Given current trends in productivity, relative cost, and dollar depreciation, an often overlooked part of the economy, manufacturing, is quietly rising.

References:

1 Federal Reserve Board Chairman Ben Bernanke's commencement address at MIT, 2006

Bloomberg
Maryland Department of Business and Economic Development
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Regional Manufacturing Institute
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Disclosures:

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