

The Real Economy: **Trends in U.S. Manufacturing**

A discussion between The Carlyle Group's
Brian Bernasek and RSM US LLP's Joe Brusuelas

Sponsored by



The Real Economy: Trends in U.S. Manufacturing

Experts from The Carlyle Group and RSM US LLP discuss the outlook for the U.S. manufacturing sector, including how it would be impacted by a strong dollar, by a new White House administration, by rising wages, and by a scarcity of skilled workers

The Panelists



Brian Bernasek
Managing Director,
The Carlyle Group

Privcap: Manufacturing is a huge sector in the U.S., and a huge potential investment opportunity for private equity. What do you expect in the manufacturing sector in 2017?

Brian Bernasek, The Carlyle Group: I think we're expecting more modest growth in '17 than we've had, certainly, in the past couple of years, driven by a couple of key factors. One is the general uplift in the commodity cycle we're seeing. There's an improvement in oil prices and an improvement in general commodities that should help. In the last couple of years, we saw the consumer-facing industrial businesses that perform well, but we expect to see a bit more lift in the commodity-driven side as well. We're seeing this in some of the order books in our own portfolio and certainly in the big macro-picture statistics, as well.



Joe Brusuelas
Chief Economist,
RSM US LLP

Joe Brusuelas, RSM US LLP: When it comes to manufacturing, you're likely to see a tale of two halves. The first half you're likely to see is relative, modest acceleration in overall activity spurred by strong consumer demand. Now, unfortunately, we've seen an appreciation of the dollar in the second half of 2016. So, around the second half of 2017, you're going to see that pass-through begin to impact demand from abroad, especially as competitiveness problems begin to crop up.

Given the fact that the United States Federal Reserve will likely increase rates three times this

↓ CONTINUES ON NEXT PAGE

year—with a possibility that they might go four or more—we should expect to see changing terms of trade due to rate differentials and, of course, the appreciation of the dollar. This could be brought forward if the euro-dollar test parity in the first quarter of the year ... I would not be surprised if we see that because we're on the cusp of watching the dollar begin to move strongly against the euro and the yen, and against a broad-weighted ... basket of goods.

Brian, is the strong dollar something you're keeping your eye on? And how does that affect your potential investment opportunities?

Bernasek: It's absolutely a place that we're watching closely. It's [had] a big impact on our investment portfolio over the last couple of years. Almost every business that we're invested in is a global business in this environment, in this day and age, and that strong dollar has impacted the performance of businesses. We've been able to hedge primarily through capital structures, but it's been a big headwind. And, as Joe mentioned, certainly that's a big headwind in the general economy, and [it's] one we're watching very closely. It's a key metric.

What technologies do you think will impact the productivity of manufacturing?

Brusuelas: General automation is one. Two, the integration of industrial robots is clearly, over the medium or longer term, the much bigger factor in pushing productivity rates up further in overall manufacturing. We're going to see lots of policy changes here over the next couple years. Indeed, we saw a big lift in steel prices with the expectation that there's going to be some protectionist measures put in place. Over time, those will dissipate and not matter much as we move toward a more automated manufacturing sector.

One of the unfortunate conversations we're having right now, and indeed it's a very false conversation, is this idea that one's going to be able to bring jobs back to the U.S. simply by erecting protection or neo-protectionist barriers. That's simply not the case. I think it'd be very nice if Apple set up a production facility in Wisconsin. I'm absolutely 100 percent certain that it will create hundreds of jobs for multi-degreed individuals overseeing a complete 100 percent automated workforce.

To what extent is labor a restraint on the ability of manufacturing to thrive?

Brusuelas: We have a very tight labor market. The unemployment rate's sitting at roughly 4.6 percent. We expect to see problems in attracting and retaining labor—especially skilled, semi-skilled, and public-facing labor—going forward, especially in the manufacturing sector, where it's very difficult to actually attract those skilled workers and keep them employed. Right now, we have a fairly significant problem with job skills mismatch in the economy. We're not training workers to work in the manufacturing sector. It's a lost art, something that fell out of favor 25 to 30 years ago. Now, we're paying a severe price for it.

Bernasek: We're absolutely seeing this sort of graying, if you will, of the skilled workforce, where in a lot of our investments we're finding that there's a key part of that workforce that is retiring.

Brusuelas: If you take a look at wage growth, what's happening is we have a lot of people who are retiring. Say they're making \$175,000 a year and they're taking a \$12.00 an hour job at Cabela's to keep themselves busy, right? That tends to depress the overall wage structure when you have more than 10,000 baby boomers retiring each day. If you correct for that, however, the wage picture looks dramatically different. We're seeing overall wages rise by somewhere between 3.8 percent and 4 percent. If you are employed and you take a new job, wages are up almost 5 percent and that's smoothed out over the economy.

If you focus or deep-dive down into some micro areas, you're getting 10 percent increases in wages for people who changed jobs, and that's really asymmetrically impacting the manufacturing sector. That points to further tightness, I think, in the second half of the year, where those pressures really begin.

Brian, what sectors do you expect to be very active as far as dealmaking in 2017?

Bernasek: I expect it's going to be a fairly robust M&A environment in 2017 versus some of the last couple of years on the industrial side, driven by the fact that there is this general[ly] positive view about overall industrial activity. Even

↓ CONTINUES ON NEXT PAGE

building products and chemicals are up—the order boards all look pretty good for businesses. It's not over the top, but it feels like there's a little bit of pent-up opportunity.

So, I expect that in board rooms, people are going to be more positively inclined toward M&A and toward growth and investing in their businesses and resultant acquisitions. What that often means is that there are divestitures that come out of those combinations. When you dive into particular sectors, I expect we'll see some strength in energy. We'll see strength in building products and probably continue to see packaging opportunities. I think some of the places—automobiles, for example—are going to be a little trickier because the source is just so high, in the U.S. anyway. It just feels so strong, driven by the low rates and that people have gone after and bought new cars.

Brusuelas: You're going to see continued strength in energy and building products. I think the auto aftermarket later this year and into early 2018 might provide opportunity, at least for some consolidation.

What are your predictions for the impact that a new Trump administration will have on the U.S. manufacturing sector?

Brusuelas: The two words we want to think about are “value chain.” I'm expecting not so much outright protection, but the enforcement of laws on the book in a much more stringent way that may impact the value chain for very large discounters. That's one.

You mean like Wal-Mart?

Brusuelas: Wal-Mart, Target, and even Amazon. Two, I think we'll have to look at the so-called border arrangement tax system being proposed, which, from an economic point of view, is an American value-added tax. That's new. That's new terrain. Indeed, if the administration and Congress intend to push through on the scope of tax cuts they're talking about, there will have to be revenue to support that. An American value-added tax that targets imports is likely to accompany those changes.

What will be some huge changes in the manufacturing sector that your average nonindustrial expert might be surprised to see?

Bernasek: I mentioned the oil and gas extraction. I think that is ... [more deeply] immersed into the general industrial economy than most folks probably appreciate.

By oil and gas, you mean the technology to extract the energy from rocks is just advancing at a pace that is ...

Bernasek: It's faster than people appreciate. And this downturn has resulted in a lot of the services businesses [that] are doing that extraction becoming better and better and doing it in a more efficient way—both from a cost perspective and an efficiency perspective. I think it's going to continue to play in that sector and, again, that just ripples through the industrial economy and the economy at large.

Joe, what do you think some surprising changes are going to be that will take place in the manufacturing sector?

Brusuelas: A more rapid pace of integration of artificial intelligence into overall manufacturing. And when I say manufacturing, it's defined much more broadly. For example, I expect that the arrival of driverless trucks and transportation vehicles will occur much faster than what's been priced into the market. Of course, when you talk about truck drivers, that's the single largest employment sector of males between 25 and 54. And it's expected that close to 80 percent of all those people who are employed in that industry will no longer be needed a decade or so out.

Bernasek: We see that side of the industrial economy that is becoming more automated and becoming more and more skilled. I think that transition might take a bit longer than Joe does, to see that in full. But that might be also because the businesses that we're invested—it's not happening as rapidly. There are places where we do see growth that can come from an uplift in the economy. That can mean more hiring, not just more robots. ■