Has the peak of demand in the industry already passed?

hpo economic commentary, 3rd quarter 2022

hpo forecasting
we predict your business

The signals from the economy are very contradictory.

Order intake in the engineering sector is still high. Wages are rising, unemployment rates, particularly in the USA and Europe, are very low. Private consumption remains very buoyant, and in the USA industrial production is currently celebrating a revival.

At the same time, a whole series of leading indicators are sending strong signals of an imminent, significant cooling of the economy. Many economists and renowned institutions have significantly reduced their GDP forecasts for the global economy in recent months.

Meanwhile, financial markets fluctuate between depression and euphoric upward swings when inflation figures in a month's time are not quite as high as previously feared.

Added to this delicate mix are major geopolitical risks, especially in Eastern Europe and Taiwan, which are difficult to assess. A real energy crisis in Europe in the winter half-year or a prolonged interruption of semiconductor production in Taiwan would have serious consequences for the industry and society as a whole.
In this hpo economic commentary, we highlight the most important developments in the global economy as usual, with a specific focus on the real economy and the consequences for the industry.

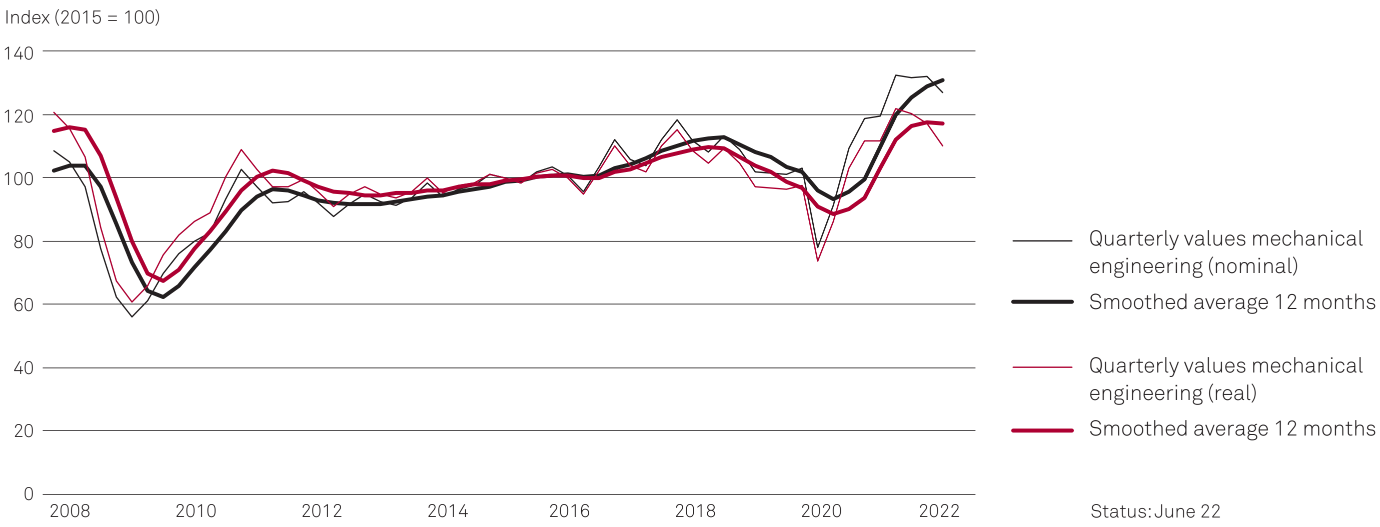

Fig. 1: Order intake mechanical engineering Germany nominal and real
Source: Destatis raw data, presentation by hpo forecasting

1. Order intake figures in the mechanical engineering sector stagnate at a high level

Driven by massive stimulus measures in the wake of the pandemic, the **machinery sector** benefited from a very strong increase in **2021** and reached new record levels in Germany, for example. For three quarters order intake has now been moving sideways, with a downward trend. **In the second quarter of 2022 order intake was 4 % lower than in the first quarter of the year,** according to data from the German statistics office Destatis. Compared with the prior-year quarter, there was still a nominal increase of 6 %. The peak in demand now appears to have passed, but the order backlogs of many companies are still very high.

If the **real (inflation-adjusted) values** are compared instead of the nominal ones, the order intake of German machinery manufacturers fell by 1% year-on-year in the second quarter and reached its lowest level since the beginning of 2021.

Most sub-segments of the mechanical engineering sector recorded negative growth in order intake compared with the first quarter of the year, both in nominal and real terms. This applies in particular to textile machinery and construction equipment manufacturers, which benefited from exceptionally strong demand last year but have recently had to accept major slumps.

According to VDMA data in Germany, the exceptions with still positive growth figures in the last quarter include robotics and automation as well as materials handling technology, which are benefiting from increasing automation in production processes as well as the expansion of warehouse capacities.

2. The real economy continues to deliver solid actual figures

Looking at the general economic indicators, the following points are worth highlighting:

Unemployment rates have fallen to very low levels in the USA (3.5 %) and Europe (6.6 %). In China, in the wake of the particularly restrictive Covid-19 measures in April and the real estate crisis, it rose temporarily from 5.3 % in January to 6.1 % in April, but fell back to 5.5 % in July. The sharp rise in youth unemployment in China to almost 20 % is a cause for concern.

Retail sales have recently declined somewhat in Europe and the USA, but remain at a high level. In China, the growth rate of retail sales appears to be leveling off in a long-term comparison. After all, the year-on-year growth figures in July were positive again (+3.1%), having previously been well into negative territory for three months.

Industrial production is also still extremely lively in all regions and has also recovered in China after the slump in April (lockdown in Shanghai and other cities). However, the year-on-year growth rate is low by Chinese standards and the country is benefiting above all from still buoyant demand from overseas. In China itself, the smoldering crisis in the real estate sector is unsettling. With a direct and indirect share of over 25 % of GDP, the weakness in the real estate sector is a stakes burden for the overall economy.

Sector	Change vs. Q1 2022 (nominal)	Change vs. prior-year quarter (nominal)	Change vs. prior-year quarter (real)
Machinery industry	−4 %	+6 %	−1 %
Machine tools	−3 %	+19 %	+13 %
Tools	−11 %	−5 %	−10 %
Textile machinery	−20 %	−16 %	−22 %
Manufacturing of machinery for mining, quarrying, construction	−15 %	−6 %	−13 %

Fig. 2: Change in order intake of selected segments of the German mechanical engineering industry
Source: Destatis raw data, hpo forecasting calculation

hpo forecasting
we predict your business

3. Leading economic indicators point to a storm

There is a major discrepancy between the above positive figures in the West and the leading indicators. The **Business Confidence Index (BCI),** which reflects business sentiment, is generally a good leading indicator of demand in the engineering sector. Since the beginning of the year this value has been falling rapidly in Europe and the USA, but in Europe it is still in expansionary territory, while in the USA it has recently fallen slightly into contractionary territory. In Asia the value has recovered somewhat since the temporary low in April, but is still below the neutral value of 100, sending a negative signal.

A look at **consumer sentiment** is worrying. Since the beginning of the survey, consumer sentiment in Europe, the USA and China has never been so low, and there is still no sign of it bottoming out.

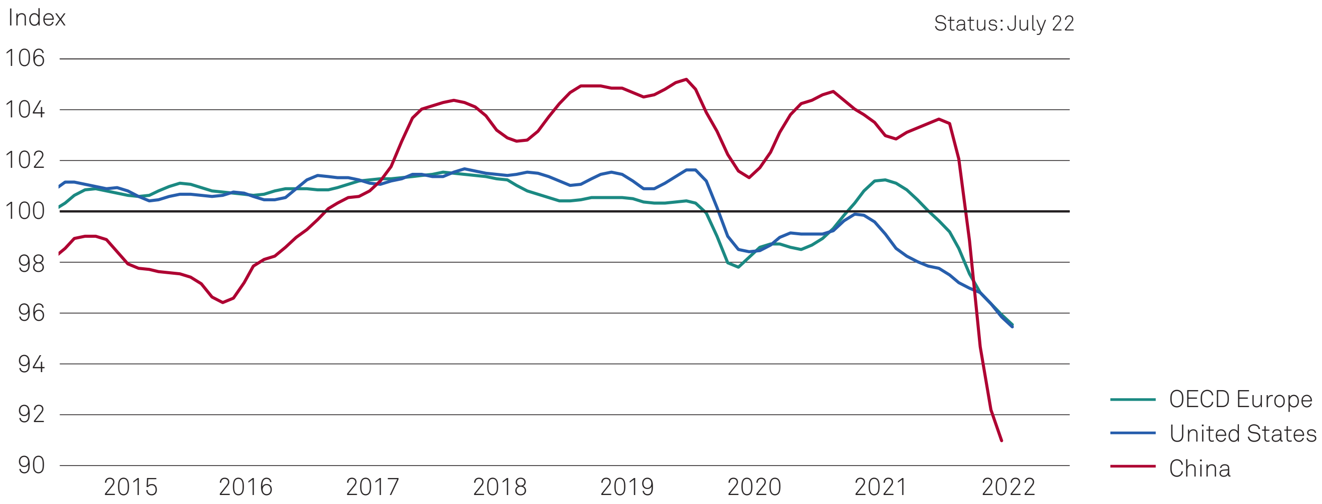

Fig. 3: Consumer Confidence Index (CCI) in Europe, the USA and China (values below 100 = pessimistic consumer sentiment)
Source: OECD raw data, illustration hpo forecasting

The situation is exceptional. The above-mentioned actual values of the real economy suggest the picture of a stable economic situation, but no longer with strong growth figures. However, the sentiment indicators and especially consumer sentiment are pointing in the opposite direction.

According to hpo forecasting, the economy will cool down in the coming months. For this purpose, we analyzed the **recessions of the last 60 years in Europe and the USA** and the following pattern emerged:

- The **unemployment rate** is a very late-cycle indicator, and a low rate is not an indication that the economy is stable. The unemployment rate reacts slowly to cyclical changes and a high unemployment rate is not the cause but the consequence of an economic downturn.
- In the past, **consumer sentiment** always fell sharply before or at the beginning of a recession. However, consumer sentiment can also send out false signals, or in other words: not every sharp drop in consumer sentiment leads to a recession, but in very many cases this is the case.

- In economically stable times, **business sentiment (BCI) and consumer sentiment (CCI) correlate little. Before or at the beginning of a recession, however, both values almost always fall to a low level, and the CCI usually collapses before the BCI.** In times of crisis, the CCI is therefore almost always more early-cyclical than the BCI, just as we have observed again this year.
- The **BCI correlates strongly with order intake in the machinery sector** and usually runs a few months ahead of it. If the BCI continues to fall in the coming months, a further decline in demand for machinery is also very likely.

Fig. 4: Copper price per pound in USD
Source: Trading Economics, retrieved on August 15, 2022

Another signal pointing to an imminent economic slowdown is the marked **drop in the price of copper** and other industrial metals in recent months.

Due to the widespread use of copper in numerous sectors, **a falling copper price is associated with a weakening economic situation.** After peaking at the end of February, the copper price has meanwhile slumped by more than a third and was still down by around a quarter in mid-August.

4. Geopolitics and monetary policy – the great unknowns

At present, the geopolitics of the major powers and the monetary policy of the central banks are particularly important for the economy. At the same time, these developments are the most difficult to forecast, as they are ultimately based on decisions made by a very manageable group of people. The following brief assessments are provided in this regard:

- **Monetary policy:** Even though the U.S. inflation rate fell from 9.1% to 8.5% in July, inflation is still far too high. The euphoric reaction of the financial markets to this news and the near-record low unemployment rate tend to give the Federal Reserve more leeway again to continue raising key interest rates sharply. Falling labor productivity, rising unit labor costs and higher inflation expectations are a delicate mix, and the danger of a wage-price spiral has not yet been averted.

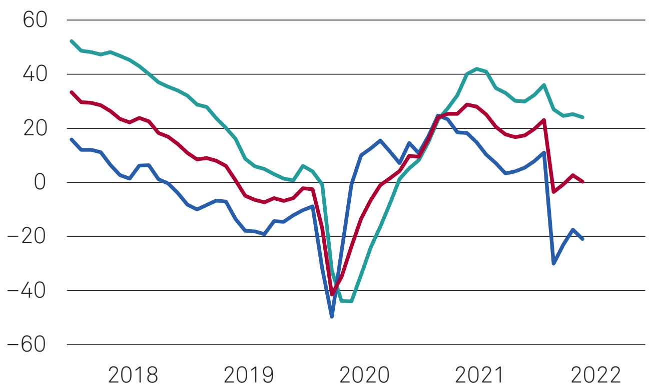

Fig. 5: ifo Business Climate (red line), Business Situation (green line) and Business Expectations (blue line) for the Manufacturing Sector
Source: ifo Institute of the University of Munich

- **Ukraine war and energy crisis:** An easing of the Ukraine war is currently not foreseeable. As a consequence, an energy crisis in Europe is becoming a serious scenario. We cannot judge whether it will come to that. Although Russia is currently supplying only a fraction of the normal amount of gas to Europe, storage levels in Germany are roughly in line with the average of recent years. At the same time, however, European diesel stocks are very low and, according to research firm Wood Mackenzie, will shrink in November to their lowest level since 2011. In addition, at the beginning of 2023, the EU's ban on importing petroleum products by sea from Russia will come into force. However, it is more feasible to switch to alternative suppliers for crude oil than for natural gas.

- **Taiwan:** An escalation of war in Taiwan would lead to major upheavals in the global economy, since the island plays an absolutely leading role in semiconductor production. Among others, the largest (TSMC, at the same time also the technological leader) as well as the third largest (UMC) chip contract manufacturer in the world are located in Taiwan. Despite hot rhetoric from the parties, a military escalation in the near future seems unlikely to us, as the economic collateral damage for all parties would be enormous and many times greater than in the Ukraine war. More likely, we see continuing tensions and military and diplomatic pinpricks below the threshold of war.

5. Looming clouds and a ray of hope

The great uncertainty in the economy is well illustrated by the **ifo Business Climate Index for the manufacturing sector** in Germany. The majority of companies surveyed assess the current business situation (green line) as positive, but business expectations (blue line) for the coming six months are clearly negative and fell again sharply in July. This results in a negative general business climate in the manufacturing industry (red line).

Finally, a **ray of hope for the capital goods industry:** the "just in time" production philosophy with minimal inventory has reached its limits since the outbreak of the pandemic, and great efforts are being made to make supply chains more resilient. This is not about deglobalization, but about greater diversification of suppliers in order to reduce dependencies on individual companies and countries. To do this, alternative production capacities must be built up. In addition, larger component inventories will also be held for the foreseeable future. For example, inventories in the euro zone have been rising for a few weeks at the fastest rate since the statistics began in 1995.

For the time being, this development is still having a supportive effect on the capital goods industry and may provide some rays of hope in the midst of the looming storm clouds in the coming months.

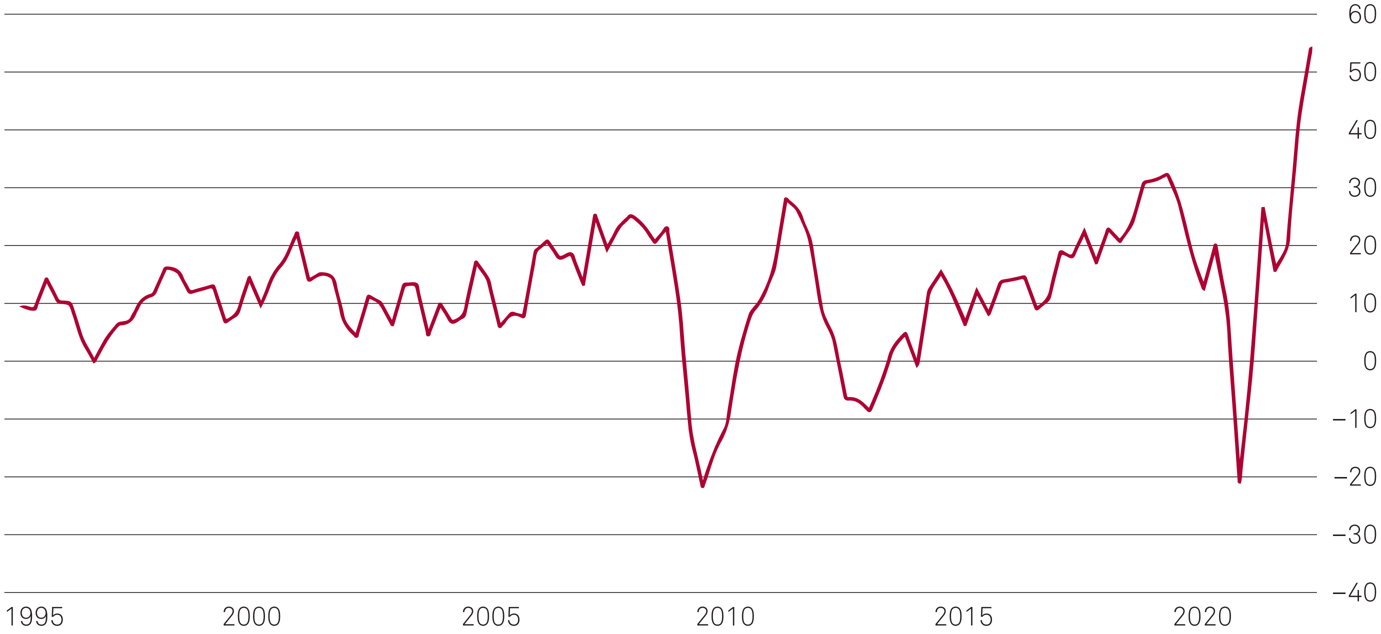

Fig. 6: Changes in inventories of companies in the euro area in billions of euros
Source: EUROSTAT, downloaded from tradingeconomics.com on August 15, 2022

Interested?
Put us to the test!

hpo forecasting
we predict your business

Contact us for a free **preliminary analysis** of your incoming order data.

Who is hpo forecasting?

Our specialists at hpo have an in-depth understanding of the macroeconomic context and sound knowledge of the industries in which their clients operate. Prediction is their passion.

They enjoy working in a team and are committed to the concerns of their clients.

hpo forecasting – we predict your business

If you would like to know more about hpo forecasting and would like to receive a free preliminary analysis, schedule a free, no-obligation appointment using this **QR-Code:**

Your contact at hpo forecasting

Josua Burkart
M. A. HSG
Managing Director
josua.burkart@hpo.ch
+41 44 787 60 15

Benjamin Boksberger
M. A. HSG
Forecasting Manager
benjamin.boksberger@hpo.ch
+41 41 461 00 22