November 1, 2019

US ISM-Manufacturing Improves, But Is It Sustainable?

- Manufacturing activity contracted at a slightly slower pace
- ISM built upon nonfarm reactions in financial markets
- Prices paid are falling due to weaker raw materials prices…
- ...as a caution on reading too much into core PCE implications
- New export orders might have risen because of front-running trade concerns…
- ...while the domestic order book looks to have remained weak…
- ...which might have explained soft imports
- Comments suggest autos weakness went beyond temporary strikes

US, ISM Manufacturing Index, October:
Actual: 48.3
Scotia: 48.8
Consensus: 48.9
Prior: 47.8

The overall takeaway is that ISM indicates less price pressure (dovish) albeit only through raw materials prices, weak current activity (dovish) but stronger forward looking prospects (hawkish). The debate should be focused upon whether the forward looking variables improved for genuine reasons or because orders got front-loaded ahead of what still remains high trade policy risk such as the auto tariff decision in a couple of weeks and the US-China phase 1 'deal' and beyond that Trump keeps guiding but that China has cautioned against.

Chart 1 shows how ISM indicates that manufacturing output is probably still declining. We'll find out on November 15th.

Was there a transitory auto strike effect or something more disturbing going on in the sector? Comments suggest that underlying momentum is poor:

> "Automotive sales continue to decrease"
>
> "Automotive related manufacturing is definitely slowing in the U.S. I think we are seeing the negative impacts of the tariff war with China and the unsigned [U.S.-Mexico-Canada Agreement] deal starting to hurt consumer confidence, especially on large purchases. Corporations are slowing orders/production accordingly."

With these important caveats in mind, the details were better than the headline.

New export orders posted a massive improvement to 50.4 from 41.0 but industry breadth remains soft. Did the global economy suddenly post a massive improvement? Not really. Maybe orders for US exports picked up to front-run trade concerns. Five industries reported higher export orders including energy, wood, electrical equipment and appliances, food and beverages and miscellaneous manufacturing. Ten industries still report falling new export orders.

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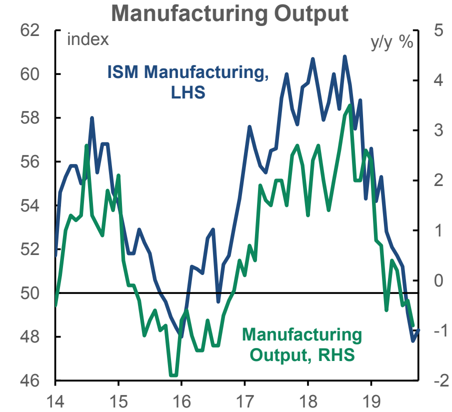
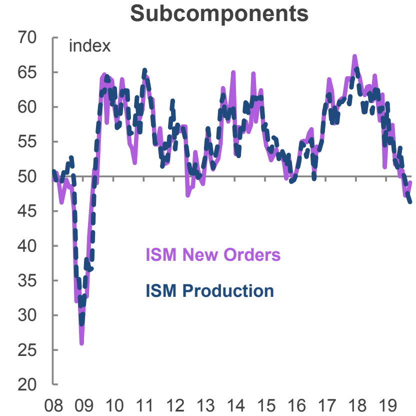
ISM Points to Continued Decline in Manufacturing Output



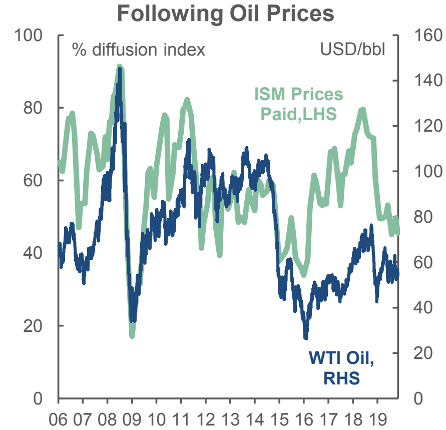
Sources: Scotiabank Economics, Institute for Supply Management, Federal Reserve.

US ISM Manufacturing Subcomponents



Sources: Scotiabank Economics, ISM.

US Manufacturers are Just Following Oil Prices



Sources: Scotiabank Economics, Bloomberg.

Total orders improved to 49.1 from 47.3. **Given the large improvement in export orders, it's not clear there was improvement in the domestic order book to back the improvement in total orders.**

The order backlog deteriorated a bit (44.1 from 45.1).

Production also slipped to 46.1 from 47.3. Production and new orders are shown in chart 2.

The pace of inventory unwinding ebbed to 48.9 from 46.9.

Prices paid fell to 45.5 (prior 49.7) which reflects weaker raw materials prices. "Respondents reported decreases in prices for aluminum, copper, basic chemicals, steel, steel scrap and freight expenses." Some chemicals prices increased. Only four industries reported paying higher raw materials prices whereas twelve industries reported paying less. As chart 3 shows, prices paid has a heavy energy component alongside the broader raw materials drivers and thus be careful toward drawing overly strong implications for the Fed's preferred inflation gauge (core PCE).

Jobs are still falling but at a slower pace (47.7 from 46.3).

Imports shrank at a faster pace of 45.3 (48.1 prior). Five of the six largest sectors imported less, but this could be temporary as the ISM folks flagged how "Respondents noted a need to place orders in advance of the Lunar New Year season in Asia." Nevertheless, softer imports could reflect softer prices paid for raw materials and a softer domestic order book than the export order book.

Improvements across industries backed up the better details. 28% of industries now report growth (17% prior). 28% report growth in new orders (17% prior). 33% report growth in production (17% prior). 28% report more hiring (22% prior). Fewer (22%, 28% prior) report higher prices.