May 3, 2021

US & Canadian Manufacturing Hit By Inflationary Bottlenecks

- **US order backlog hits all-time high**
- **US prices paid rising at fastest pace since 2008**
- **US respondents indicate strong demand, difficulty responding…**
- **...due to clogged ports and shortages of material and labour**
- **Canada's manufacturing PMI softened for similar reasons…**
- **...and may have contributed to US supply chain issues**

US ISM-mfrg PMI, April, SA:
Actual: 60.7
Scotia: 67.0
Consensus: 65.0
Prior: 64.7

Canada Markit manufacturing PMI, April, SA:
Actual: 57.2
Consensus: n/a
Prior: 58.5

Supply chain issues held back US and Canadian manufacturers last month by enough to lead to a pair of somewhat disappointing manufacturing PMIs.

The readings still signal strong growth well north of the 50 dividing line above which expansions occur, but we're entering the part of this cycle when supply side issues are hindering the pace of the near-term expansion. The degree by which bottlenecks are being indicated is reflective of difficulty sourcing raw materials and intermediate inputs and labour and the consequence is to drive serious backlogs while fanning price pressures on both sides of the border. Note that we haven't even gotten into the environment in which vaccines and fiscal stimulus will combine and feed upon one another in the most powerful manner yet which continues to lean toward the notion that while supply chain issues drive inflation now, it's very unclear this will all go away when other drivers kick in. In particular, wait until services join the party.

Given that the Canadian manufacturing PMI disappointed just 30 minutes ahead of the ISM reading it may have been an advance clue that ISM would disappoint given the correlated connection between the readings (chart 1). In fact, it's feasible that Canada's third wave might have contributed to US supply chain issues and logistical challenges given cross-border integration.

As far as the market response is concerned, the kneejerk headline reaction in US 10s made no sense. Yields fell sharply despite the inflationary signals amid strong

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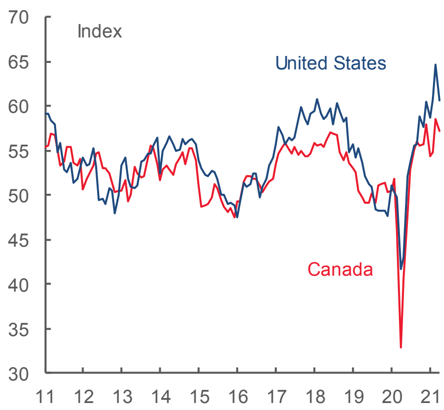
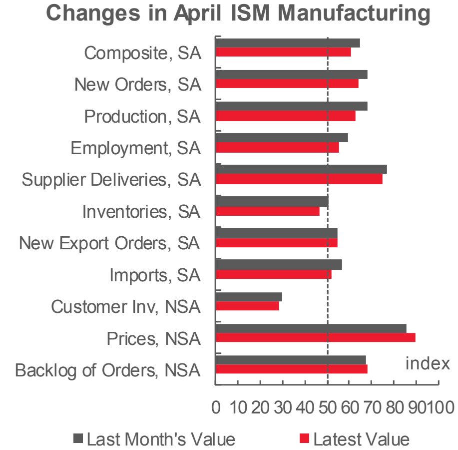
Chart 1
US & Canada Manufacturing PMI



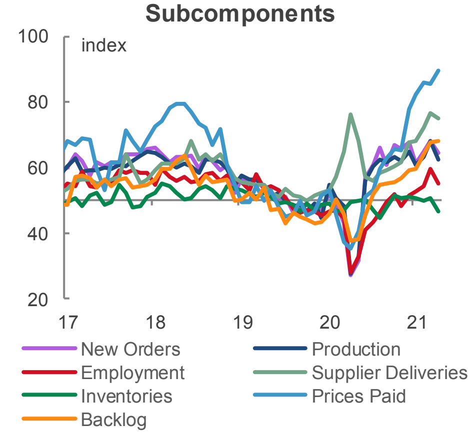
Sources: Scotiabank Economics, ISM, IHS Markit..

Chart 2
Changes in April ISM Manufacturing



Sources: Scotiabank Economics, ISM.

Chart 3
US ISM Manufacturing Subcomponents



Sources: Scotiabank Economics, ISM.

demand held back by supply chain issues. When market participants dug a bit deeper they reversed this initial effect and the US 10 year yield is now roughly unchanged from just before the ISM release and should arguably go higher yet.

WHY US ISM DISAPPOINTED

Most of consensus had fairly high conviction that demand and coincidental indicators would lead to a rise in the ISM headline. In fact, about three-quarters of consensus expected a higher ISM reading and no one expected this much of a decline. Most of us were going with a couple of drivers behind the call such as the balance of the regional surveys from Fed District banks supplemented by transportation sector data like expectations for today's pending release for auto sales, given that the regional Fed manufacturing reports tend to underrepresent transportation. There can still be a fair amount of noise around ISM prints.

So what happened? The detailed components are shown in charts 2 and 3. The new orders and employment subindices both slipped by around 4 points each while still growing, but the order backlog hit a record high and prices paid increased and is running at its hottest since 2008 (details here).

The ISM folks note that input-driven constraints combined to drag the ISM headline 5.9 points lower than would have otherwise been the case in isolation of other influences. That dominated the headline drop. Widespread shortages of components, raw materials and labour all made worse by clogged ports were a setback to the pace of the manufacturing sector's expansion that nevertheless remains robust.

The comments provided by members to the ISM folks (here) back-up the supply chain problems that sparked weaker orders and hiring as business was thwarted and turned away while the backlog and prices paid nevertheless increased. In fact, consider the summary remark from the ISM folks that about says it all:

> "Survey Committee Members reported that their companies and suppliers continue to struggle to meet increasing rates of demand due to coronavirus (COVID-19) impacts limiting availability of parts and materials. Recent record-long lead times, wide-scale shortages of critical basic materials, rising commodities prices and difficulties in transporting products are continuing to affect all segments of the manufacturing economy. Worker absenteeism, short-term shutdowns due to part shortages, and difficulties in filling open positions continue to be issues that limit manufacturing-growth potential."

A sampling of other remarks by industry that were offered by the survey organizers and respondents is available at the original source link above and you should review them for evidence of how widespread anecdotes of supply chain issues have become. Comments referenced chip and component shortages to "crazy high" steel prices and "In 35 years of purchasing, I've never seen everything like these extended lead time and rising prices" while "supply chain delays hamper our availability and ability to sell more."

CANADA'S SOFTER MANUFACTURING READING HAD SIMILAR DRIVERS

Canada's manufacturing sector also stumbled somewhat last month (here). Strong growth continues to be recorded, but at a cooler pace than previously. Like the US report, the details behind the less widely followed Canadian reading reinforced the role played by bottlenecks.

A distinction, however, is that pandemic-related restrictions were more acute in Canada due to public policy reactions to the third wave of COVID-19 cases. Canada's third wave and its effects on supply chains could have indirectly contributed to some of the softness on the US side given how tightly integrated several industries tend to be such as autos.