LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

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MANUFACTURING HEALTH AT 14-YEAR HIGH

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KEY TAKEAWAYS

Peaks in ISM's PMI, a gauge of manufacturing health, have consistently preceded significant phases of U.S. economic growth.

August's ISM PMI peak was driven by strong domestic demand as the benefits of fiscal stimulus outweighed trade concerns.

While Markit's PMI headline reading last month dropped to a 10-month low, the data are still consistent with strong manufacturing growth.

Strong manufacturing growth is a bellwether for overall economic health. Even though manufacturing is a dwindling part of domestic output, accounting for about 12% of gross domestic product (GDP), strong manufacturing growth has consistently preceded significant phases of GDP growth. Because of this, the Institute for Supply Management's (ISM) U.S. Purchasing Managers' Index (PMI) survey is one of the gauges we monitor in our Recession Watch Dashboard. Over its past five cycles, the U.S. economy has fallen into a recession an average of 46 months after the ISM index peaked [Figure 1].

ISM's U.S. PMI just posted its strongest reading in 14 years, a sign to us that the current cycle still has fuel left in the tank. The ISM gauge jumped to 61.3 in August, its highest point since May 2004.

DOMESTIC DEMAND

Growth in manufacturing output last month was primarily driven by domestic demand. ISM's gauge of new orders jumped 8.1%, the strongest monthly growth since August 2014. The jump in new orders is a strong sign that the impact of $350 billion in fiscal stimulus continues to outweigh trade concerns, a theme

1 MANUFACTURING STRENGTH IS A BELLWETHER FOR ECONOMIC GROWTH AND STOCK GAINS

ISM Peak Date	Beginning of Recession	Months from ISM Peak to Beginning of Recession	Cumulative S&P 500 Performance from ISM Peak to Beginning of Recession
Jul 1978	Feb 1980	18	12.9%
Nov 1980	Aug 1981	9	-12.6%
Dec 1983	Aug 1990	80	95.6%
Oct 1994	Apr 2001	77	164.5%
May 2004	Jan 2008	44	23.0%
	Average	45.6	56.7%
	Median	44	23.0%
	Max	80	164.5%
	Min	9	-12.6%

Source: LPL Research, Bloomberg 09/06/18

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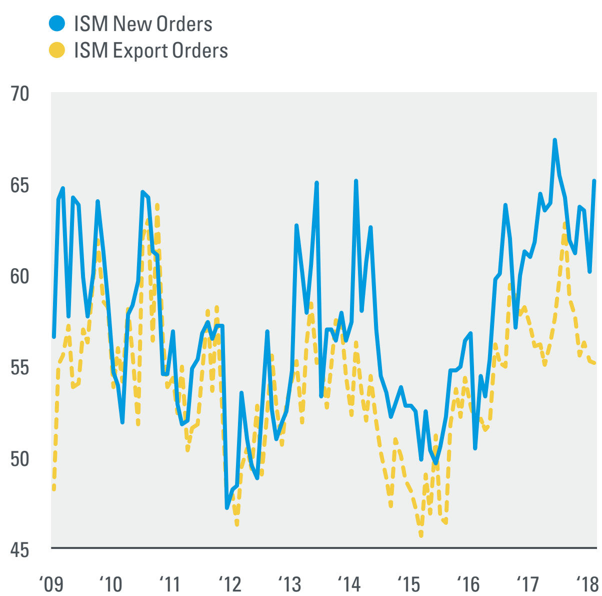
we've emphasized this year. New orders are also viewed as a leading component (rising orders will typically lead to increased production), so the robust increase in new orders could forecast future manufacturing growth.

Looser tax policy has boosted business and consumer spending this year, driving second quarter GDP to its strongest growth since 2014. Spending also buoys manufacturing—if demand picks up, the manufacturing industry must respond by producing more inventory. We expect these forces to continue to lift business and consumer spending, likely to the benefit of the manufacturing sector.

However, manufacturing may be especially susceptible to future weakness from trade tensions. Respondents to ISM's survey were still "overwhelmingly concerned" about the impact of tariffs on revenue and manufacturing locations. Cooling in trade activity has also emerged in the divergence in ISM data on domestic and international orders. Even as new orders soared last month, ISM's new export orders fell to a 10-month low and new import orders dropped to an 11-month low [Figure 2], providing further evidence that recent manufacturing growth has been driven by domestic demand.

2 DOMESTIC-INTERNATIONAL DEMAND DIVERGENCE GROWS IN ISM ORDERS DATA



Source: LPL Research, Bloomberg 09/06/18

As shown in Figure 2, new orders have historically moved in tandem with export and import orders, highlighting the importance of international demand on U.S. manufacturing activity. If domestic demand wanes and global demand remains weak, U.S. manufacturing activity may decline at a much quicker pace than expected.

SUPPLY CHAIN CONSTRAINTS

While the most recent ISM PMI signals more economic gains, other data hint to potential weakness and pricing pressures. Details in the report point to continuing supply chain disruptions, or difficulties for manufacturers in getting the supplies necessary to produce goods, a trend we've noticed in other recent economic reports.

ISM's measures for supplier delivery times and order backlogs were near cycle highs last month as supply chain constraints strapped production. New orders, boosted by strong demand, are growing at an unusually fast pace relative to inventories. New orders outpaced inventories by 9.7 percentage points in August, higher than the average of 7.8 percentage points since June 2009. Supply chain disruptions have not yet weighed meaningfully on manufacturing, but if these trends persist, demand may temper as firms combat inventory shortages with higher prices.

DATA DIVERGENCE

Another notable dynamic was the stark divergence between ISM and Markit's PMI measures last month. Markit's PMI fell to 54.7 in August, its lowest level since November 2017. Even though Markit's PMI readings typically come in lower than ISM's, August's 6.6-point difference was the largest between the two gauges on record.

It's difficult to say which gauge is more telling in this scenario. Because Markit's PMI has a short history (its data track back to September 2015), there is no way to determine whether one of the surveys tends to have the greater pull after the two have diverged. However, some small—yet key—differences exist that can explain this divergence. The five components that make up the final PMI for ISM and Markit are basically the same, and both weight their indexes by industry classifications. However, Markit doesn't weight its five survey components equally, and its weightings are higher for larger companies that represent a greater portion of manufacturing activity. The two gauges also have different methods for seasonality adjustments.

To us, Markit's PMI is more reliable when trying to evaluate manufacturing's current state, but ISM is more useful for conclusions on trends over time. Given these nuances and the noisiness of economic data, we monitor both gauges, and view the likely "true" value somewhere in the middle. Fortunately, both reports mirror the same trends in manufacturing. Markit's PMI reading of 54.7 is above its all-time average reading of 53.5, and Markit characterized its report as "a strong overall manufacturing performance." Because of this, we are not concerned with last month's drop in Markit PMI.

CONCLUSION

The fresh high in ISM's PMI bodes well for future U.S. economic growth, and the forces buoying strong manufacturing reflect the positive impacts of fiscal stimulus. Even though we are encouraged by this and other signs of manufacturing health, we recognize that supply chain constraints and global trade anxieties could weigh on output if they persist. Overall, we believe strong manufacturing growth may continue to support U.S. corporate profits and forecast growth in output as the business cycle matures. ■