ECONOMIC UPDATE

REGIONS

January 3, 2017

December ISM Manufacturing Index: High Expectations Heading Into 2017

- The ISM Manufacturing Index rose to 54.7 percent in December from 53.2 percent in November.
- The new orders component rose to 60.2 percent, the employment component rose to 53.1 percent, and new export orders rose.

The ISM Manufacturing Index left expectations in the dust in December, rising to 54.7 percent for the highest reading since December 2014. The underlying details of the December survey are generally positive, as the indexes for new orders, current production, and employment registered highs for the year. Of the 18 industry groups included in the ISM's survey, eleven reported growth in December, matching November and up from only seven as recently as September. Sentiment across the factory sector ended 2016 on a clear upswing but, as is the case in the broader economy, it will remain to be seen whether actual performance lives up to expectations for 2017 that are much higher than was the case a few short months ago.

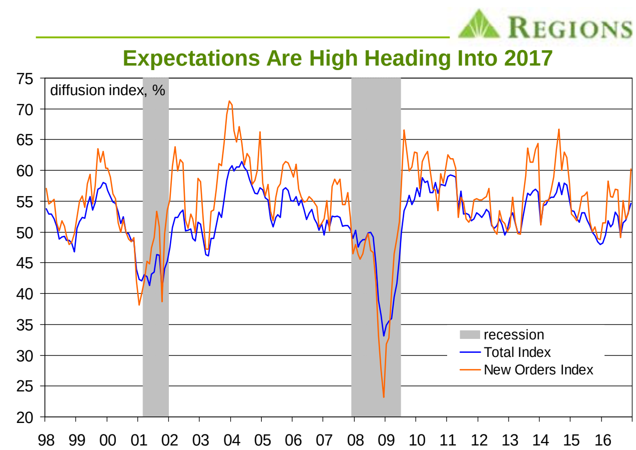
The index for new orders jumped to 60.2 percent in December from 53.0 percent in November. This is the largest monthly increase in the gauge of new orders since August 2009, when the manufacturing sector first began to emerge from the 2007-09 recession. Of the 18 industry groups in the ISM survey, 12 reported rising orders in December, up from nine in the November survey. The index for current production rose to 60.3 percent in December from 56.0 percent in November. December's reading is the highest since November 2014. Ten of the 18 industry groups in the ISM's survey reported higher production levels in December compared to nine in November.

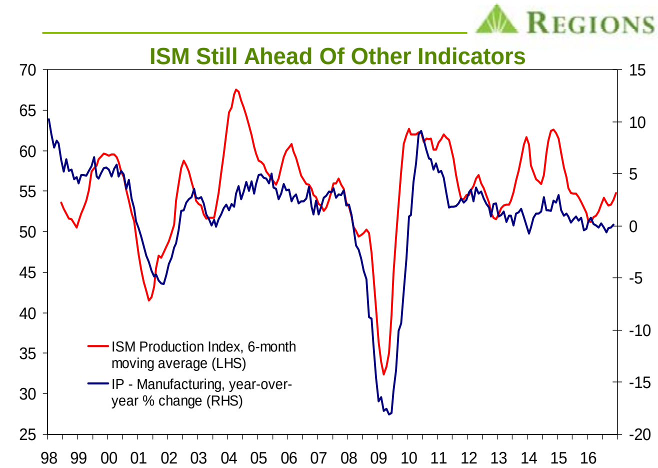
Still, as we have noted previously, the gauge of current production in the ISM data has been running ahead of other indicators, most notably the manufacturing component of the Industrial Production Index published by the Federal Reserve, and the gap between the two has been widening. Going forward we'll be watching to see whether the ISM gauge of production will slip or the industrial production gauge will improve. It is perhaps worth keeping in mind that the ISM reports diffusion indexes, which tell us the direction but not the intensity of activity. It could be that the gains in production seen in the ISM data are but modest gains that, even in the aggregate, are not driving improvement in broader measures of manufacturing activity. That said, however, the data on new orders seen in the ISM data and the Commerce Department data have been more closely aligned over the past few months, so it could be we start to see more meaningful increases in manufacturing output in the industrial production data.

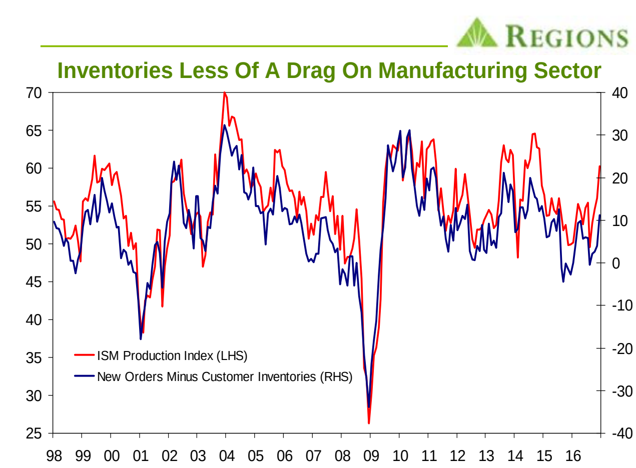
For a third consecutive month, survey respondents deemed customer inventories as being too low, which does offer hope that manufacturers will see further gains in orders and production over coming months. For some time inventories have been a drag on manufacturing activity, the question now is how much of a lift diminished customer inventories will provide. After what was a prolonged inventory correction, we're inclined to think firms will remain fairly disciplined on inventories barring evidence of meaningful and sustained acceleration in demand growth. To be sure, expectations do seem to be improving, but that will have to be followed up by sustained growth in orders. Additionally, November marked the 18th consecutive month in which manufacturers' inventories of raw materials declined, a sign that manufacturers themselves remain cautious in their expectations of demand growth.

Elsewhere in the December data, the index for new export orders rose to 56.0 percent, the highest reading since May 2014 and the tenth consecutive month of rising export orders, while the employment index rose to 53.1 percent, the highest since June 2015. Our earlier caveat about the nature of diffusion indexes is useful here as well, as other data series have yet to corroborate what is being reported in the ISM data.

It will be interesting to see how 2017 plays out for the factory sector. Improving sentiment and prospects for firmer capital spending could run head on into a firmer U.S. dollar and a less friendly export environment. Expectations are high; time will tell if these expectations are warranted or not.







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