ECONOMIC UPDATE

REGIONS

June 15, 2017

May Industrial Production: Manufacturing Weighs On Total Industrial Production

- Industrial production was unchanged in May, with manufacturing output down by 0.4 percent.
- The overall capacity utilization rate fell to 76.6 percent, while the utilization rate in manufacturing fell to 75.8 percent.
- On a year-over-year basis, total industrial production was up by 2.2 percent in May, with manufacturing output up by 1.4 percent.

Total output amongst the nation's factories, mines, and utilities was unchanged in May, matching our below-consensus forecast. The flat headline print, however, masks stark differences amongst the individual components, as manufacturing output fell by 0.4 percent while output in the mining sector rose 1.6 percent and utilities output was up by 0.5 percent. Weakness in manufacturing output was fairly broad based in May, but it should be noted that this comes on the heels of what was a very strong performance in April, when total manufacturing output was up 1.1 percent. Splitting the difference shows the manufacturing sector on a path of steady, though not stellar, growth, with motor vehicle production the main source of concern. Year-on-year, total industrial production was up 2.21 percent, the largest such gain since January 2015.

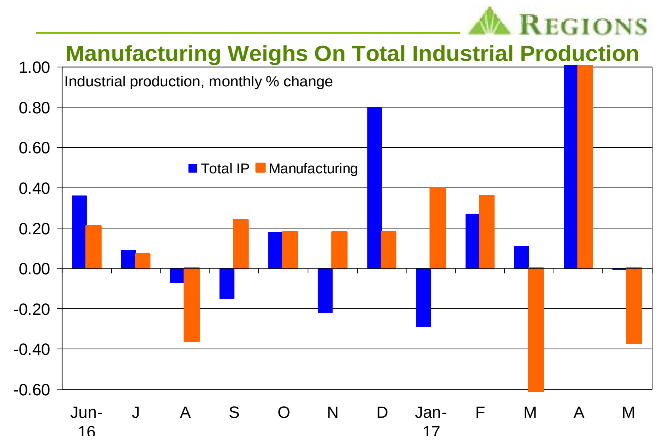
Assemblies of autos and light trucks dipped to an annualized rate of 11.287 million units in May, leaving the three-month moving average at 11.238 million units, the lowest since October 2014. We look for further declines in production in the months ahead, as motor vehicle sales are receding from their cyclical peak and manufacturers are seeing rising inventory backlogs, particularly of smaller more fuel efficient automobiles. Indeed, at least some manufacturers are getting an early start on their annual shutdowns for retooling for the new model year, and further job cuts are likely as well. It is common to see consumer spending shift as economic expansions mature, with spending on consumer durables, including motor vehicles, diverted to spending on nondurables and on services as the expansion progresses. So, in that sense, what we are seeing is not surprising, but it is notable in that motor vehicle production had for so long been a key driver of growth in the factory sector and it has now shifted to acting as a drag.

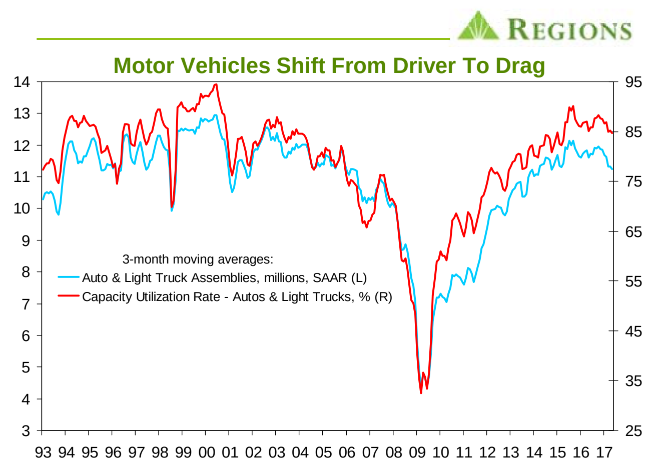
Still, conditions across much of the rest of the manufacturing sector continue to improve at a moderate rate. As we have noted elsewhere, one pattern in the data from the ISM Manufacturing Index over the past several months is that the expansion in the factory sector has become notably more broad based. And, again, the May data should be taken in the context of the strength seen in April. One key factor going forward, however, will be the path of business investment spending. While no one expects the robust growth rate seen in the Q1 GDP data to be sustained, there is reason to expect more moderate growth in business investment spending, and there is upside potential depending on the course of tax and regulatory policy. At the same time, firmer global economic growth will lend support for exports of U.S. manufactured capital goods.

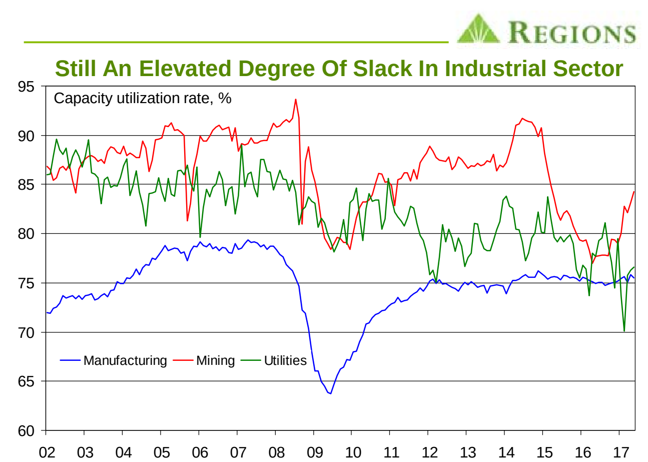
It will be worth watching over coming months whether the recent increases in mining output, which mainly reflect rising oil and gas production, will be sustained over coming months given the recent leg down in market prices. Output in the mining sector as a whole is up 7.7 percent thus far in 2017 and increased capital investment in the energy sector has been one of the supports for growth in broader capital spending. With a persistent supply overhang acting as a weight on oil and gas prices, however, it is not unreasonable to expect mining output to turn lower, at least in the near term.

Capacity utilization rates, particularly in the manufacturing sector, remain notably low, particularly for eight years into an expansion. While discussions of slack in the U.S. economy almost exclusively revolve around the labor market, we think it important to also consider what remains an elevated degree of slack in the industrial sector. If nothing else, this idle capacity will continue to constrain price pressures even as global demand for goods and services continues to expand at a somewhat faster pace.

Just as the April data overstated the vigor of the industrial sector of the U.S. economy, the May data understate the case. Sagging vehicle production aside, rising domestic and foreign demand should be sufficient to support moderate growth over coming quarters.







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