ECONOMIC UPDATE

REGIONS

June 15, 2018

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May Industrial Production: Motor Vehicles Sink Industrial Production In May

- Industrial production fell by 0.1 percent in May, with manufacturing output down by 0.7 percent
- The overall capacity utilization rate fell to 77.9 percent, while the utilization rate in manufacturing fell to 75.3 percent
- On a year-over-year basis, total industrial production was up by 3.5 percent in May, with manufacturing output up by 1.7 percent

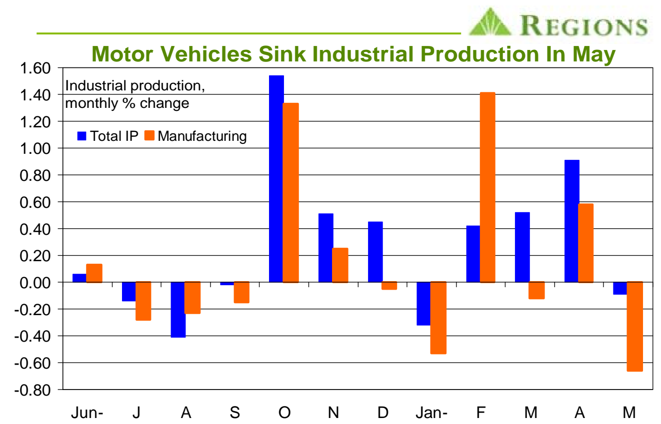
Total output amongst the nation's factories, mines, and utilities fell by 0.1 percent in May, matching our forecast but below the consensus forecast of a 0.2 percent increase. Manufacturing output fell by 0.7 percent in May, with mining output up by 1.8 percent and utilities output up by 1.1 percent. The sizeable decline in manufacturing output may seem at odds with the run of upbeat data on the factory sector over the past several months, but the weakness seen in the May industrial production data mainly reflects the sharp decline in motor vehicle assemblies as a fire at a major parts producer held down production of SUVs/light trucks. Excluding motor vehicle production, total industrial production would have been up by 0.3 percent in May.

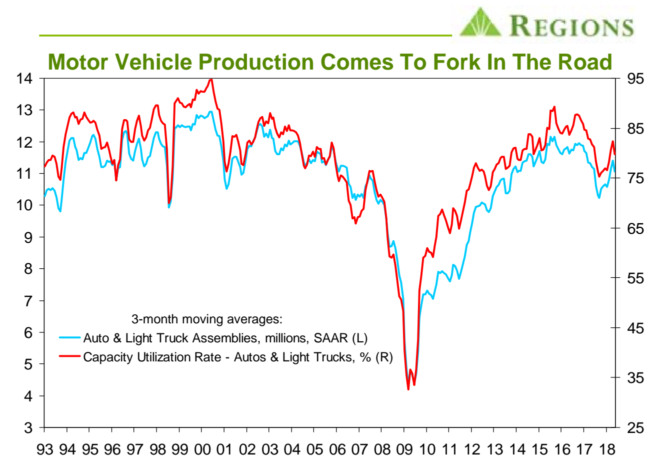
With production of SUVs/light trucks back online, there should be a sizeable increase in motor vehicle assemblies in the June data, which in turn will boost overall industrial production. Where motor vehicle production goes from here, however, is an open question. Overall motor vehicle sales continue to drift lower as the post-hurricane spike in demand recedes, and inventories of smaller, more fuel efficient automobiles have risen sharply over the past several months, leading to production cutbacks. While demand for SUVs/light trucks remains fairly healthy, unit sales have fallen in each of the past two months and higher gasoline prices and higher interest rates won't help stem this decline over coming months. Clearly, motor vehicle production has come to a fork in the road, and somehow we think the advice offered by Yogi Berra – when you come to a fork in the road, take it – won't be of much help to producers over coming months as they decide whether, or to what extent, to pull back production of SUVs/light trucks.

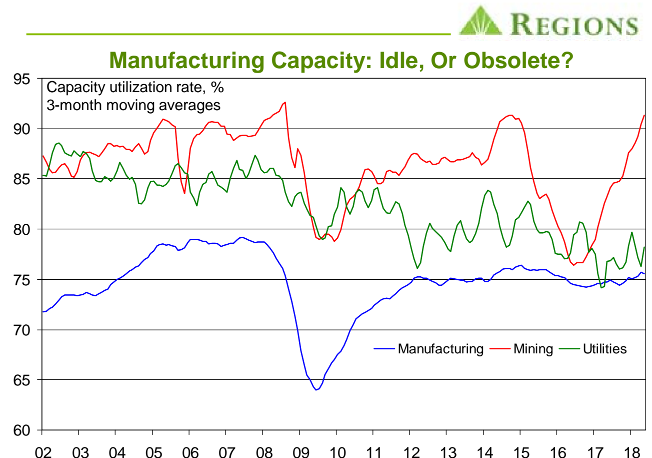
Still, not all of the weakness in manufacturing output in May can be attributed to the slower pace of motor vehicle assemblies. Excluding motor vehicles, manufacturing output was down 0.2 percent in May, as output of industrial machinery fell by 0.9 percent. This decline, however, follows a sizeable – 2.3 percent – increase in April, and the path of orders for core capital goods implies production of industrial machinery will bounce back from May's decline. One major wild card looming over the manufacturing sector is the impact of tariffs. The data already indicate price effects, as evidenced by the increases in input prices reported in the data on producer prices and import prices. But, to the extent the tariffs were aimed at stimulating domestic production of steel and aluminum, that has yet to materialize, with output having turned lower over recent months. To the extent tariffs spread to the motor vehicles industry and/or retaliation from trading partners impacts sales of U.S. produced commercial aircraft, the overall impact on domestic manufacturing will be contrary to the intended effects.

Output in the mining sector rose by 1.8 percent in May, good for a year-on-year increase of 12.6 percent. Mining output is up solidly over the past four months, reflecting higher oil prices. But, as seen in our bottom chart, capacity constraints could soon impinge upon domestic energy production, further complicating matters for producers already running into storage and transportation constraints. Assuming at least stability, if not further increases, in oil prices, one would expect to see further growth in capital spending in the domestic energy industry. Looking at the capacity utilization rate in the manufacturing sector, which for some time has hovered at just over 75 percent, one might conclude there is little need for firms to invest in new capacity when they are sitting on so much idle capacity. Our counter, however, is that the age of the capital stock calls into question the extent to which this idle capacity simply reflects obsolete stock with limited scope for more intense utilization, which would argue for stronger, and broader, growth in capital spending over coming quarters.

May's sharp decline in factory output is a one-off event, at odds with the underlying health of the U.S. economy. Trade policy, though, looms as a major uncertainty.







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