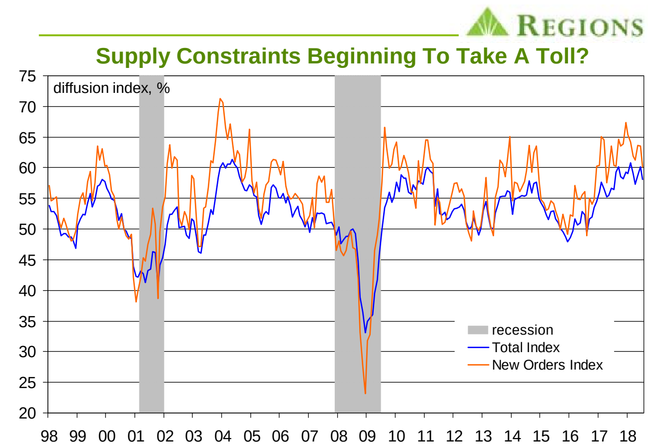
ECONOMIC UPDATE
REGIONS
August 1, 2018

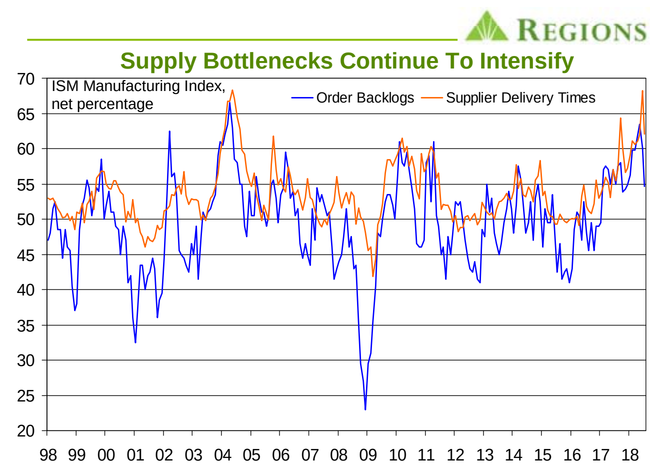
July ISM Manufacturing Index: Supply Constraints Beginning To Take A Toll?

- The ISM Manufacturing Index fell to 58.1 percent in July from 60.2 percent in June
- The new orders component fell to 60.2 percent, the employment component rose to 56.5 percent, and new export orders rose.

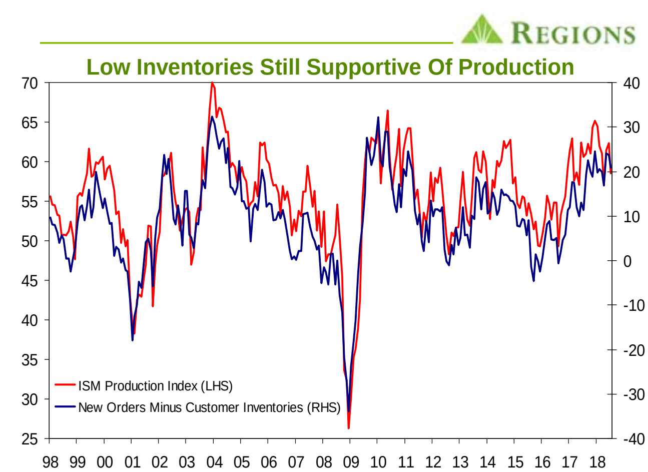
The ISM Manufacturing Index slipped to 58.1 percent in July, a larger decline than we and the consensus anticipated, but one which nonetheless leaves the headline index above the 50.0 percent break between contraction and expansion for a 23rd consecutive month. Last month we noted the headline index was stronger than was implied by the underlying details, as a sharp slowdown in supplier delivery times was the primary catalyst for the spike in the headline index. In that sense, the level of the headline index in July can be seen as a more apt portrayal of conditions in the manufacturing sector, as new orders, current production, employment, and export orders all logged further growth. That said, the slower pace of growth of current production bears watching, as this could reflect a number of factors including higher inventories, labor shortages, or shortages of raw materials. At the same time, trade continues to loom as a dark cloud on the horizon, but here we'll make the same point we made last month, which is that at present it seems the main risks from trade are more to the breadth and intensity of the robust expansion in the factory sector than to the expansion itself.



Of the 18 industry groups included in the ISM survey, 17 reported expansion in July with only the primary metals industry reporting contraction, which could reflect the adverse effects of ongoing trade battles. Still, as has been the case for some time now, the expansion in the factory sector remains notably broad based. Comments from survey respondents center on a few key themes – still-solid growth in demand, disruptions from trade policy, and increasing difficulty in finding skilled labor. One respondent, in the wood products industry, noted that orders from China have virtually dried up, which is leading to higher inventories which are causing the firm to rethink sales and revenue projections. It is interesting to note that respondents suggest mixed results in firms' attempts to pass along higher input costs along to domestic customers.



The index for new orders fell to 60.2 percent in July, still strong but below the 63.6 percent average of the prior two months, and this decline trimmed seven-tenths of a point off of the headline index. Sixteen of the 18 industry groups reported higher levels of new orders in July, with no industry group reporting lower orders. While the decline in the index of current production was more pronounced – from 62.3 percent in June to 58.5 percent in July – 15 of the 18 industry groups reported higher levels of production in July, with only primary metals reporting lower output. ISM notes labor shortages and transportation difficulties (in the form of delays in obtaining deliveries from suppliers) are acting as constraints on production. As such, while the decline in the index of current production knocked eight-tenths of a point off of the top-line index, it seems far more likely that supply constraints, not dwindling demand, are the main culprit, and this view is reinforced by continued solid growth in new orders. Along those lines, supplier delivery times slowed further in July – the 22nd straight month of slowing delivery times, with 15 of the 18 industry groups reporting slower delivery times in July. While backlogs of unfilled orders grew further in July, the rate of growth of backlogs did slow a bit, but it seems unlikely backlogs will be cleared to any meaningful degree over the near term. Though seemingly at odds with numerous references to shortages of labor, particularly skilled labor, the employment index rose to 56.5 percent in July from 56.0 percent in June, with 13 of the 18 industry groups reporting increased head counts. Keep in mind, however, that a diffusion index of the sort employed by ISM can tell us the direction, but not the intensity, of a move in a given metric and it could be that while firms added workers in July, they may have added even more had they been able to find greater numbers of skilled workers.



The U.S. manufacturing sector remains on an impressive roll. While growth in demand remains solid, supply constraints, whether due to inadequate labor supply or slowing deliveries of materials, seem to be a growing source of stress. On top of these growing supply constraints, trade policy remains a source of considerable uncertainty.

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