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September ISM Manufacturing Index: Expansion Persists Amid Downside Risks

- The ISM Manufacturing Index fell to 54.5 percent in September from 54.6 percent in August
- The new orders index rose to 55.3 percent, the production index fell to 56.7 percent, and the employment index rose to 52.7 percent

The ISM Manufacturing Index slipped to 54.5 percent in September from 54.6 percent in August, below what we and the consensus anticipated but nonetheless marking a ninth straight month with the headline index above the 50.0 percent break between contraction and expansion. Order books continued to expand, and backlogs of unfilled orders grew further which, in conjunction with firms deeming customer inventories too low, sets up continued expansion in the manufacturing sector in the months ahead. That manufacturing payrolls are expanding – with the BLS's monthly count in harmony with the ISM's gauge – suggests firms are becoming increasingly confident in the staying power of the ongoing expansion. That said, there is seemingly no shortage of threats to the expansion, with firms citing higher costs for fuels and other inputs, difficulty in sourcing materials, delays in receiving shipments, ongoing trade tensions, and shortages of skilled labor as disruptive factors. While we have been pointing to these risks for some time, we continue to believe that the expansion in the factory sector will continue, but the pace at which it does so will be slower than would be the case if even some, let alone all, of these drags were to dissipate.

While only twelve of the eighteen broad industry groups included in the ISM survey reported growth in September down from fifteen in each of the prior two months, only two (textile mills, printing and related activities) reported contraction, with the remaining four broad industry groups noting little net change in activity. As indicated above, comments from survey respondents were mostly constructive on the demand side while at the same time relaying wariness of the array of hurdles facing the factory sector. An increasing cost structure, uncertainty over trade policy, and difficulty sourcing materials were the most commonly cited hurdles. More than one industry group cited the recent trade spat between Canada and the U.S. as impacting availability and cost of inputs. Against this backdrop, ISM reports that forty percent of comments were positive and sixty percent were negative, suggesting that firms have no shortage of worries despite ongoing solid growth in order books.

The new orders index rose to 55.3 percent in September from 53.7 percent in August. While ten of the eighteen broad industry groups reported growth in orders, the fewest in any month since January, the firm

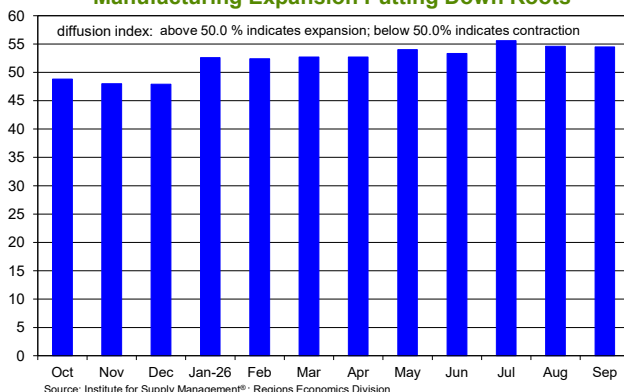
level data are more constructive. There was little change in the percentage of firms reporting lower orders, but the percentage of firms reporting orders growth increased, with a sizable majority of firms reporting no change in order volumes. Still, ISM notes that sentiment around orders growth slipped in September, perhaps reflecting firms worrying that the array of challenges facing the factory sector will begin to drag down orders. The index of current production slipped from 58.3 percent in August to 56.7 percent in September, with ten industry groups reporting higher output, but the firm level data reveal little change in output volumes. Even with the production index indicating expanding output in each of the past eleven months, backlogs of unfilled orders continue to expand, with September marking the ninth straight month in which order backlogs have gotten larger. At the same time, firms' assessments of customer inventory levels continue to point to inventory levels being too low. This suggests further growth in orders, though obviously customers have to agree with this assessment for that to translate into them placing orders. That said, we continue to characterize continued growth in new orders, growing order backlogs, and customer inventories being too low as representing the growth trifecta for the factory sector, which is one reason to think that despite the obvious challenges confronting firms and their customers, the expansion in the factory sector has further to run.

We'll again note that expanding manufacturing payrolls, particularly amongst producers of durable goods, are evidence that firms share our views on the staying power of the ongoing expansion. The employment index rose to 52.7 percent in September, and ISM notes that the ratio of firms hiring to managing/reducing headcounts has flipped in recent months and now shows a greater share hiring. To that point, we look for the September employment report to show a fourth straight month of growth in manufacturing payrolls.

The unavoidable red flag in the September survey is the jump in the prices paid index, hitting 77.9 percent from 71.1 percent in August. We've noted that input prices significantly predated the headline index flipping from contraction to expansion. That front-end inflation pressures show no signs of abating suggests back-end inflation pressures will be sustained, particularly when higher fuel and shipping costs are added to the mix.



Manufacturing Expansion Putting Down Roots



Order Books Point To Continued Expansion

