Economics

Economic Indicator — October 3, 2022

ISM: If You Have the Hot Potato, You Are Out

Summary

Manufacturing activity expanded at the slowest pace of growth in the pandemic era in September, according to the ISM. Key measures point to slowing activity, but it is inventories that hold the key to understanding what is happening in the sector today. Firms are tired of having input prices weigh on profits, but are also leery of procuring hard-to-get supplies. In an effort to mitigate both of these risks, they are making sure someone else is holding the inventories.

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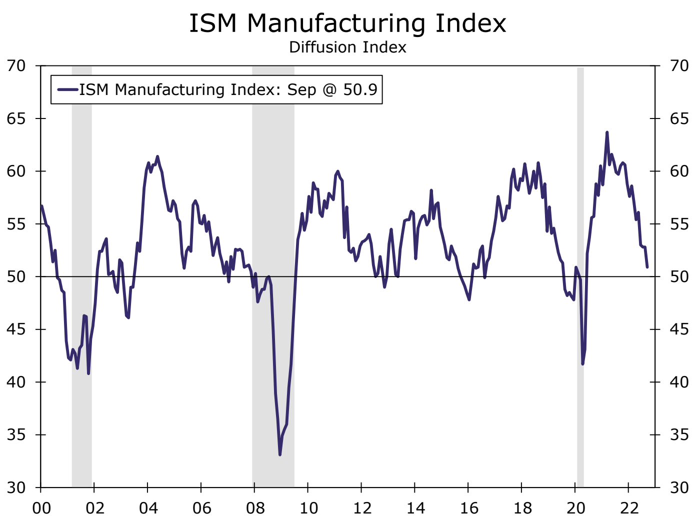


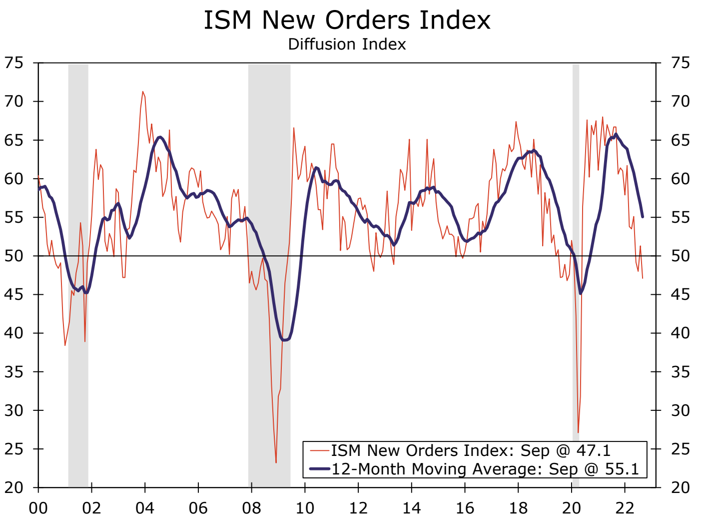
Source: Institute for Supply Management and Wells Fargo Economics

Forget Just-in-Time, You Hold the Inventory

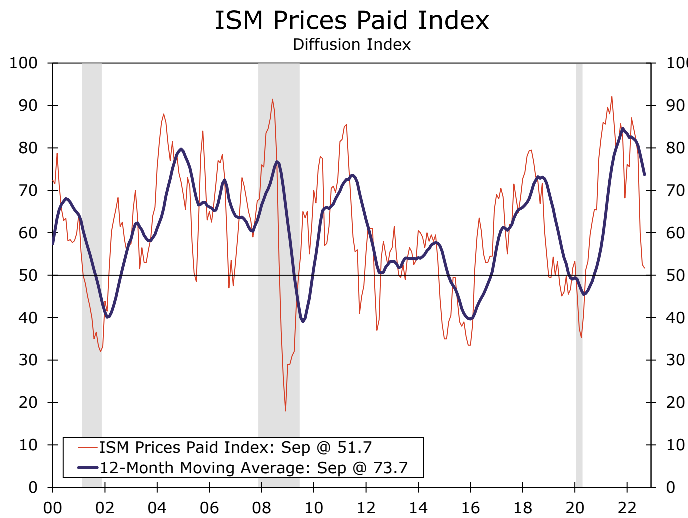
To understand what is happening in the manufacturing sector today it is helpful to consider everything in the context of inventories. Let's start with the main numbers in the September manufacturing ISM. The headline fell to 50.9, a figure that is still in expansion territory, but marks the slowest pace of growth in the pandemic era (chart). Employment dropped 5.5 points to fall back into contraction territory, though with respondent comments still focused on tight labor market conditions, we suspect this remains a supply problem rather than a demand one. Still this was the largest monthly component swing and could signal slower payroll growth or at least less of a boost from manufacturing jobs.

The next biggest drop was new orders which fell 4.2 points to 47.1 (chart). There is no sugar coating it: key measures point to a slowing in activity. New orders has been teetering between expansion and contraction the past four months, and point to slower growth ahead. Watching how factories manage their inventories is a time-honored strategy for interpreting where things are REALLY headed in the manufacturing sector. That has never been more true than it is in the current cycle.

Purchasing managers have had a tough time the past couple of years. The short COVID-shutdown bust was quickly followed by a boom in goods spending and a surge in activity. Warehouses and stores emptied as firms could not keep up with demand particularly amid widespread supply chain hold-ups. Many of the medium-sized manufacturers we spoke with last year lamented the fact that they were turning away business for lack of supply. That specter still haunts firms today; a miscellaneous manufacturing representative stated, "We are not able to accept any new orders for shipment (for the rest of) 2022 due to motor and electronic component shortages".



Source: Institute for Supply Management and Wells Fargo Economics



Source: Institute for Supply Management and Wells Fargo Economics

For a while it looked like the playbook was going to be: pivot from *just-in-time* to *just-in-case*. In other words, forget about optimizing efficiency through inventory management, focus instead on a mission to rebuild depleted stockpiles at all costs. But COSTS are exactly the problem.

Soaring demand and messed up supply chains initially resulted in the fastest wholesale inflation in a generation, but those sky-high prices gave way to sudden price declines as some commodity prices plunged. If prices were moving consistently in one direction, manufacturers could manage inventory more intentionally and with less of an impact on profit margins. But passing on price increases is difficult to do and an even worse problem is holding inventory of something that is falling sharply in price. The ISM prices paid component has plunged in recent months to 51.7 in September from a reading of over 80 just four months ago; overall prices may still be growing, but many categories are sharply lower (chart).

So *just-in-time* to *just-in-case* as a playbook is out. Hot potato is in. Tired of having input prices weigh on profits but also leery of procuring hard-to-get supplies, firms are now trying to mitigate both risks by making sure someone else in their supply chain is holding the inventories. This is clearly stated by a representative from the food & beverage industry said, "It seems no one wants to keep inventory on hand anymore."

This inventory dynamic explains why orders are dropping off; no one wants to be stuck holding the hot potato or as someone in the machinery space put it "we have more stock than needed on some key items—specifically imports—and have begun reducing open purchase orders and decreasing extended forecasts on those items in order to bleed down inventory."

We expect these supply and inventory dynamics to direct manufacturing activity for some time. To the extent supply issues continue to ease, production held up in September but only modestly so. At 50.6, the production index remained dangerously close to the 50-line distinguishing expansion from contraction. Continued production amid some supply easing has allowed producers to chip away at order backlog and is driving supplier devliery times lower.

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