Economic Indicator — March 1, 2024

ISM Manufacturing: Always Darkest Before the Dawn

Summary

The ISM has been in contraction for 16-straight months, and employment fell to its second-lowest reading since 2020. Yet, if we zoom in on the industry-level breakdown and zoom out to include regional Fed surveys, we see some encouraging signs of life in manufacturing.

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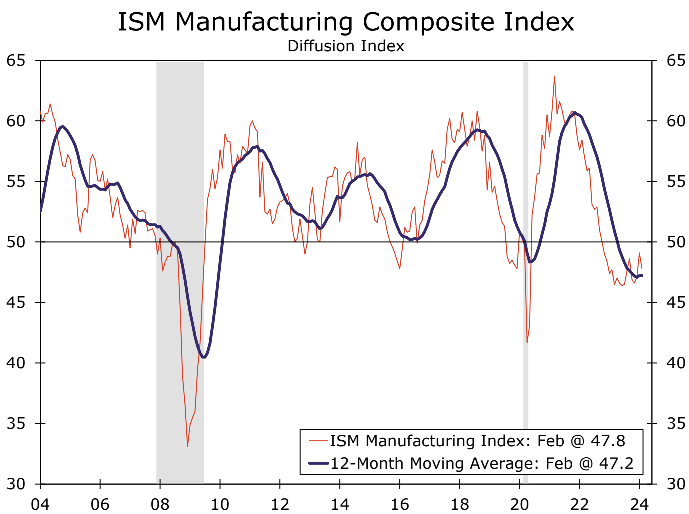


Source: Institute for Supply Management and Wells Fargo Economics

Heavy Industry Is Getting Back on Its Feet

The ISM manufacturing index slipped 1.3 points to 47.8 in February (chart). The drop comes after the index hit a 15-month high at the start of the year, and the details are not what you want to see when it comes to the ISM. New orders, production and employment were all down, and while the measure of prices paid declined, it is still consistent with an expansion in prices last month (chart).

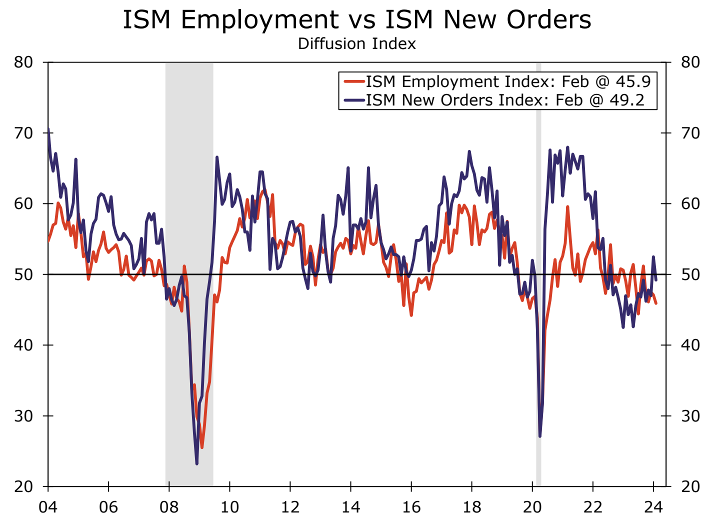
The largest decline was in new orders where the 3.3 point drop pushed the component back below 50 for the 17th time in the past 18 months. The February decline in new orders also marks the largest one-month pullback in new orders since September 2022. This outturn makes January's pop look like a potentially seasonal-related fluke, despite the series being adjusted for seasonal factors.

The select industry comments strike a notably more optimistic tone than the ISM components suggest. Purchasing managers cited increasing sales, strong expectations for 2024, demand picking up, steady orders and a stable business outlook. In fact, the only glimmer of pessimism in the selected comments came from the computer & electronic products respondent who said, "customer softness continues in China, Japan and Europe." In addition, some respondents stated weather challenges idled operations and shipments in the nonmetallic mineral products' industry.

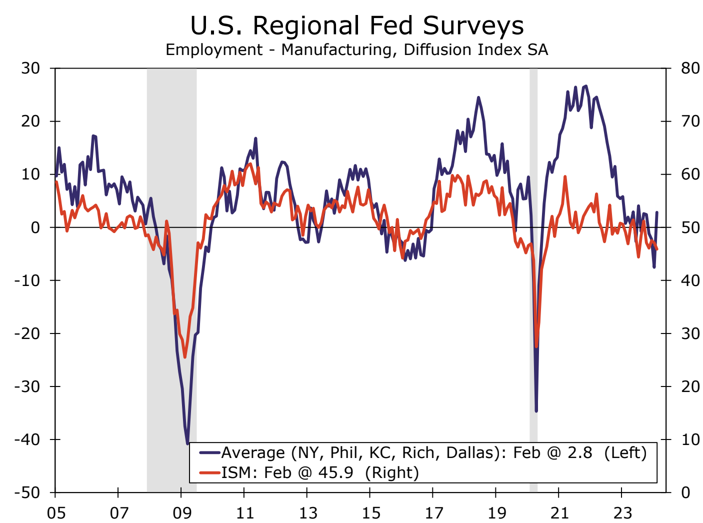
Throughout the current interest rate tightening cycle, it has been evident that manufacturing has been more negatively impacted than the services sector. Yet, upon closer inspection, there is a story in the breakdown of which industries are doing well and those that are continuing to struggle. Broadly speaking, the sorts of industries that provide products and components for other manufacturing industries are evidently seeing growth. The sorts of businesses that tend to be tied to consumer discretionary spending are the ones that are still struggling. That is no surprise given yesterday's report on how consumer spending is pivoting back toward outlays on just the essentials.

Look for example at the eight manufacturing industries reporting growth in February; they tend to be the sorts of industries that support other industrial activities, such as: Nonmetallic Mineral Products; Primary Metals; Plastics & Rubber Products; Fabricated Metal Products; Chemical Products; Miscellaneous Manufacturing; and Transportation Equipment. The sole exception would be the more consumer-oriented category: Apparel, Leather & Allied Products.

When we examine the seven industries reporting contraction in February, here we see evidence of that consumer pivot away from discretionary in industries, such as: Furniture & Related Products; Wood Products; Computer & Electronic Products; Food, Beverage & Tobacco Products; Paper Products; and Electrical Equipment, Appliances & Components. The sole exception here is Machinery, which also contracted.



Source: Institute for Supply Management and Wells Fargo Economics



Source: Federal Reserve System, Institute for Supply Management and Wells Fargo Economics

The point overall is that we are seeing some evidence that pure manufacturing and industry is showing some signs of life even as the consumer-centric parts of industry continue to struggle.

Since the start of the current Fed tightening cycle, which began two years ago this month, policymakers have had the luxury of focusing more on the price stability side of their mandate without having to be too concerned about the maximum employment side. As we mentioned, the prices paid component improved but remains consistent with an expansion of prices paid in the sector. Eleven industries reported paying increased prices for raw materials last month.

The employment component is perhaps more concerning and may garner closer attention from the Fed. The employment component slipped 1.2 points to 45.9, marking the second-lowest level since coming out of the depths of the pandemic in 2020. This outturn suggests some downside risk to the February employment report, but we caution against getting too carried away on this reading alone. It can be particularly volatile month to month and isn't always a great indication of the broader labor market. The services ISM is a bigger driver of overall hiring, which we'll receive Tuesday. As seen in the nearby chart, the regional manufacturing data were also notably stronger in February. The Fed's focus is still on inflation, but increased attention may be given to the other side of its mandate in coming months as inflation gets closer to the mark.

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