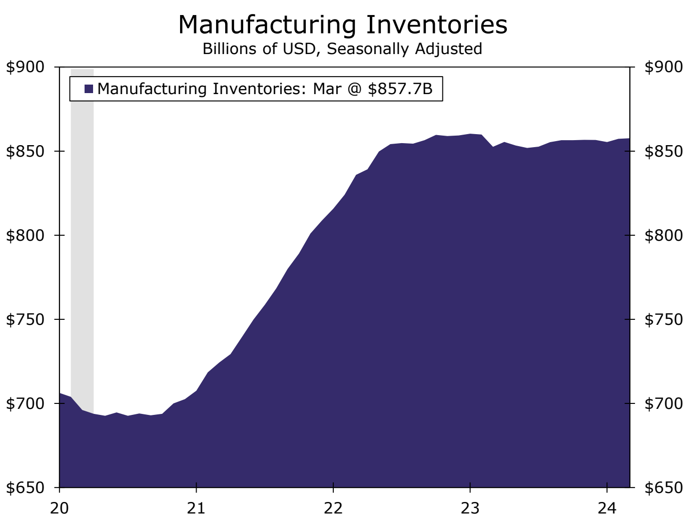
Special Commentary — May 8, 2024

Inventories Are Quiet...A Little Too Quiet

Summary

The economy is in the midst of an unusually calm stretch with respect to inventory investment. It is like the point in the scary movie when someone points out that all the forest creatures have gotten quiet. It is a classic set-up for a jump scare and thus warrants an extra measure of vigilance.



Source: U.S. Department of Commerce and Wells Fargo Economics

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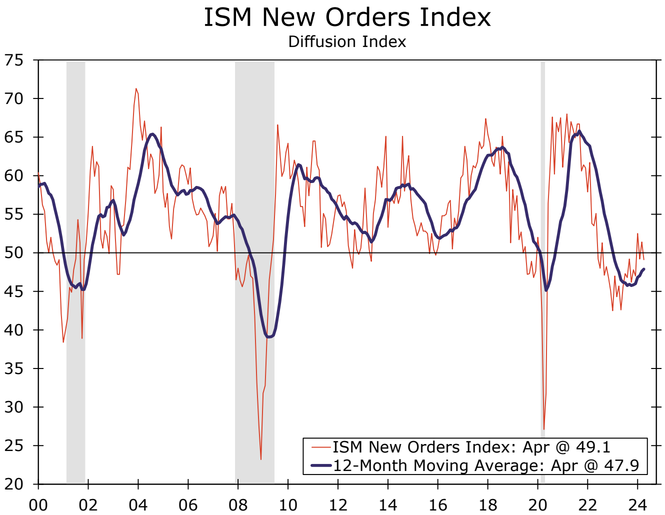
Inventories, A Potential Storm Front Is Quiet for Now

A theme that we have focused on in the past couple years is how manufacturers have been disciplined about not overproducing into a weakening demand environment. Cognizant of the lessons of supply shortages during the pandemic, firms were initially eager to rebuild depleted inventories, only to be caught overstocked as demand cooled. The new playbook is to only take on inventory and ramp up production as needed.

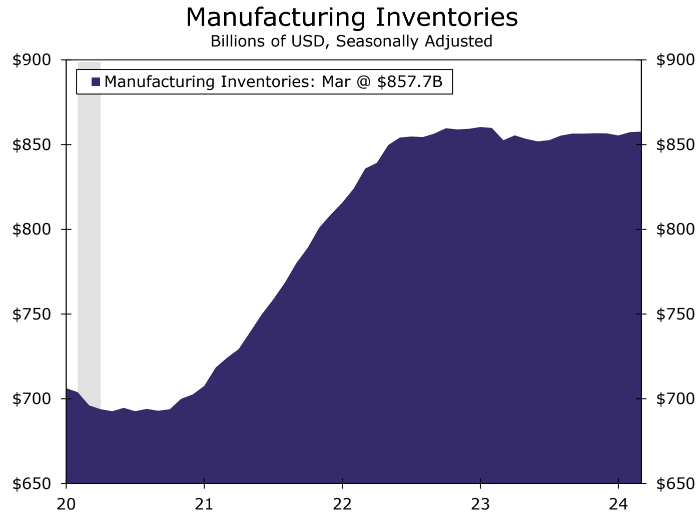
The trouble is: there has been little need for either of late. Demand in the manufacturing sector has stagnated for much of the past two years. For 16 consecutive months between September 2022 and December 2023, the ISM new orders index was below 50, indicating that new orders in the manufacturing sector were contracting (Figure 1). In addition to the ISM manufacturing index, data for industrial production and durable goods orders also both indicated that the manufacturing sector was in contraction last year.

Figure 1



Source: Institute for Supply Management and Wells Fargo Economics

Figure 2



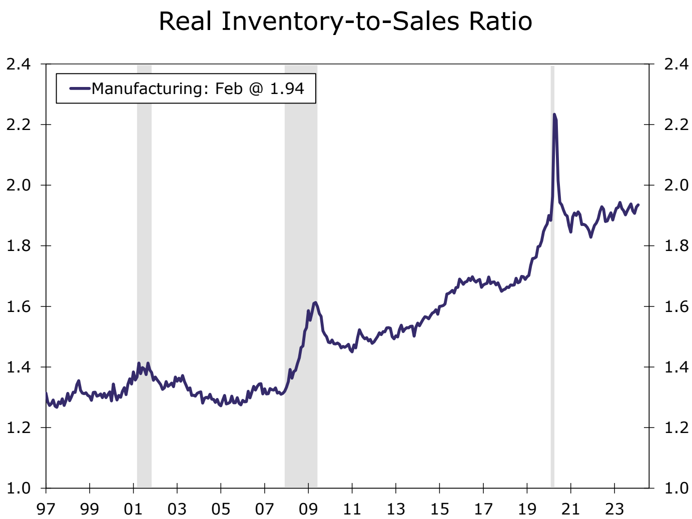
Source: U.S. Department of Commerce and Wells Fargo Economics

From Just-in-Time to Just-in-Case

Manufacturing inventories have largely stagnated beginning in early 2022 as producers notched down production amid weak demand (Figure 2). This is unusual in that manufacturing inventories comprise over a third of total business inventories and are the second largest category behind wholesale. Yet, even as total business inventories have grown $66 billion over the last 21 months, manufacturing inventories have *only* grown $3.2 billion, meaning they accounted for less than 5% of the total growth in inventories.

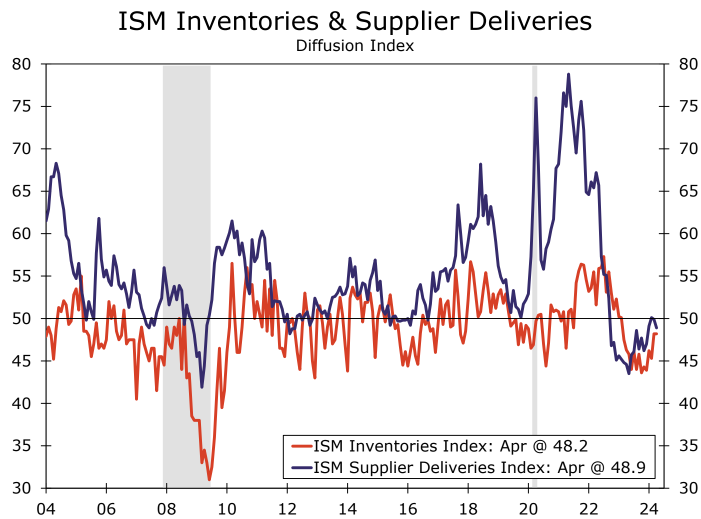
The discipline around manufacturers' inventories is evident in inventory levels relative to sales. The real manufacturing inventory-to-sales ratio has risen on trend since early 2022 and remains elevated at 1.94 through February 2024, yet it is not far off where it stood just prior to the onset of the pandemic in January 2020 (1.90) (Figure 3). This has come even as manufacturing sales have declined, falling $6 billion between June 2022 and March 2024. Getting into the details of inventories by stage of manufacturing process also shows that most of the post-pandemic build has occurred in inventories of materials and supplies specifically. No surprise that manufacturers who experienced the worst supply chain crisis in recent memory may want a bit more inputs on hand today.

Figure 3



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 4



Source: Institute for Supply Management and Wells Fargo Economics

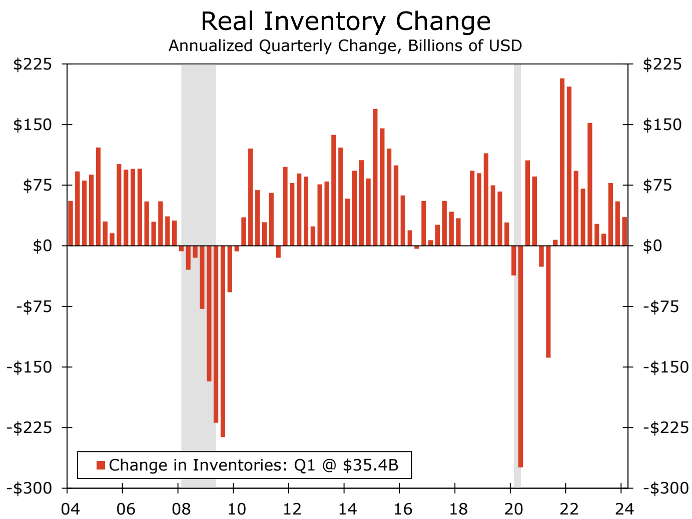
At the same time, the ISM inventories index has begun to tick higher, though it remains consistent with contraction, and the supplier deliveries index has been below 50 for 18 of the last 19 months, demonstrating that delivery times for orders have been getting shorter and manufacturers have been able to source needed inputs at a quicker pace (Figure 4). These developments echo a comment included in the April ISM release, which noted producers "continue to indicate a willingness to invest in manufacturing inventory to improve on-time deliveries, gain precision in revenue projections and improve customer service. However, they are proceeding judiciously on this objective, preferring to wait for additional demand." The discipline of manufacturers coupled with a supply chain that has ample capacity to ramp up means that producers have placed themselves in a nimble position, with the ability to increase production as demand warrants and move it to customers at speed.

Implications for Growth: Be on the Lookout for a Jump-Scare

An under-appreciated facet of this discipline is how it has dulled the typical inventory swings in GDP. Consider, for example, the fact that the quarterly change in private inventories has been less than $100 billion in each of the past five quarters after having posted quarterly swings of more than $100 billion in four out of the prior ten quarters (Figure 5). In Q1, the first estimate for inventory changes was a mere $35 billion, the smallest in more than two years.

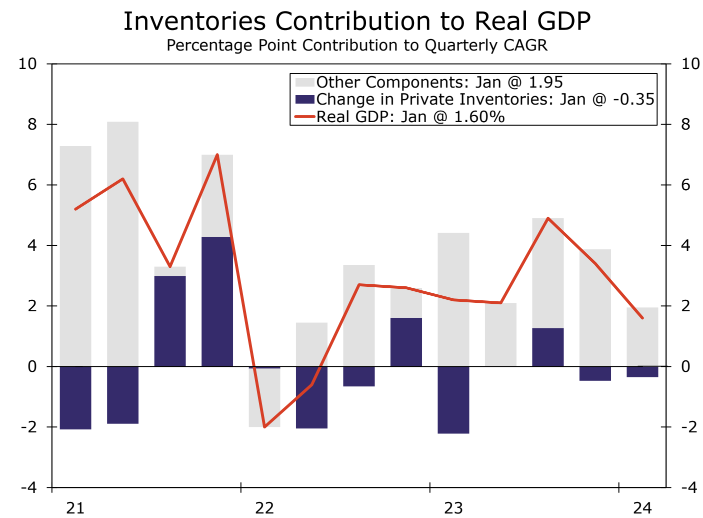
The upshot is that to the extent a rebuilding ever gains serious momentum, there is scope for a disruptive impact to GDP. To illustrate this dynamic, consider our latest forecast update: we anticipate a quarterly inventory change of just $49 billion in Q2. If realized, and with no revisions to prior inventory estimates, that would result in a boost of two tenths of a percent to headline GDP in the second quarter. Rather than the $49 billion dollar build that we expect, if the quarterly change in inventories matched, for example, its average during 2022—which was $128 billion—the boost to GDP would be a whopping 1.6 percentage points. Such swings are not uncommon in the hard-to-predict world of inventories. In fact, 1.6 percentage points was exactly the boost that inventories added to GDP in Q4 2022. In Q4 2021, inventories added more than four percentage points to headline GDP (Figure 6).

Figure 5



Source: U.S. Department of Commerce and Wells Fargo Economics

Figure 6



Source: U.S. Department of Commerce and Wells Fargo Economics

To be clear, we are not anticipating a major swing or dramatic inventory shift as manufacturing demand remains constrained. We are simply pointing out the uncommon stretch we have enjoyed with respect to inventory investment. It is not unlike the point in the scary movie when someone points out that all the forest creatures have gotten quiet. It is a classic set-up for a jump scare and the remarkably orderly pattern in inventories over the past year or so warrants an extra measure of vigilance.

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