THE ECONOMIC OUTLOOK GROUP

475 WALL STREET
PRINCETON, NEW JERSEY 08540 TEL: 609 - 529 - 1300
WWW.ECONOMICOUTLOOKGROUP.COM

ECONOMIC TALKING POINTS

Bernard Baumohl
Chief Global Economist & Managing Director

January 2, 2009

ISM Manufacturing – What Does It Tell Us About 2009?

The first economic report of the year pretty much sums up what 2008 was all about. The Institute for Supply Management's purchasing managers index slumped to 32.4 in December, its lowest reading in 28 years, and the sixth consecutive monthly decline. Last month's figure was also considerable below the average for 2008, which came to 45.6.

Just about every component in the PMI took a dive last month. The new orders index plummeted to 22.7, its lowest reading since this index was compiled in 1948. Of the 18 industries surveyed (from mining to textiles to computers) --- **NONE** reported a growth in new orders.

There was more bleak news for the job market too. The ISM's employment index hit a bottom at 29.9 last month, the weakest reading since the 1982 recession. Again, **NONE** of the industries polled reported an increase in hiring.

Given the profound weakness in the economy, it should come as no surprise that pricing power was non-existent. The price index continued to fall, touching 18 last month. (It was as high as 53.5 as recently as September.) The latest price measure was the lowest the ISM has recorded since 1949. Again, **NONE** of the manufacturers reported paying higher prices.

The one last vestige of growth in the US economy in 2008 --- exports ---also took an unsettling tumble last month. The new export orders index dropped to 35.5, its third straight monthly decline, after experiencing 70 consecutive months of increases. Soft export orders underscore that we are now in a serious global downturn, with the US, Europe, Asia and many of the major emerging countries battling recessionary conditions.

So, yes the ISM numbers are dismal. But 2008 is gone. Let's look ahead. Does the December PMI release tell us anything us anything about 2009?

Actually, it does. Of the ten main components in this report, we have found two that are fairly good leading indicators for the overall economy --- **new orders** and **supplier deliveries.**

In past business cycles, both measures would begin to slip months *before* the onset of a downturn, and had a habit of rebounding while the economy was *still* in the darkness of recession. There's no mystery why this occurs. During an economic downturn, retailers, wholesalers and manufacturers try to sell off their inventories by way of aggressive discounts and sales, all in an effort to improve cash flow. Remember, inventories are often financed through short term loans and vendors have to raise the cash to service that debt. At some point, however, inventories are drawn down to a point where there's little left to sell. At that point, vendors will cautiously begin to replenish their stock by increasing orders for new goods --- even with the economy still in recession. Such orders help plant the seeds of an economy recovery.

The second leading indicator, supplier deliveries, measures the amount it takes to receive an order after it is placed. During an economic slump, delivery times tend to be faster since producers have few other customers to satisfy. But once economic activity picks up and more orders come in, the lag time between order and physical delivery gets longer.

OK, given this background, what can we infer from the latest ISM data on new orders and supplier deliveries? Essentially this: the US economy will continue to contract in the first three months of 2009, and very possibly through the spring quarter too. It's only after new orders and supplier deliveries turn up that we can say with more confidence that the economy is approaching the recovery stage.

Based on all current macroeconomic data and the magnitude of the stimulus to come out Washington later this month, our forecast calls for the US economy to contract an average of 1.4% in the first half of the year, followed 1.7% growth in the second half.

Next week we'll get some fresh data on construction spending (expect another dismal report), factor orders (forget it; nothing uplifting seen here either), consumer credit (a difficult indicator to read during the holiday season) --- and the all-important job numbers. **Once the employment report is released, look for changes in temporary employment and hours worked in the nondurable goods industries for early signs the economic clouds are parting**. We're not expecting much from either of the two. But those are the key indicators to watch at this point in the business cycle.

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THE ECONOMIC OUTLOOK GROUP, L.L.C.
475 Wall Street
Princeton, New Jersey 08540

www.EconomicOutlookGroup.com
Tel: (609) 529-1300

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