THE ECONOMIC OUTLOOK GROUP

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ECONOMIC TALKING POINTS

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No Surprise that Manufacturing and Construction Turn More Cautious

What did you really expect? Given the multiple downside risks business leaders face this fall, the dismal performance in manufacturing and construction activity should not surprise anyone. This is an economy that looks to be swimming in peanut butter. It just cannot achieve any decent forward momentum because of the policy paralysis in Washington and Europe, a more troubling slowdown in China, and heightened fears of a military clash with Iran.

With such an ominous backdrop, companies are content to sit on the sidelines, unwilling to ramp up spending or hiring until there is greater clarity on the economic outlook. For now, that outlook is about as opaque as it gets and explains why August's overall PMI for manufacturing has contracted in August to 49.6, making it the third consecutive month the index has been stuck below the break even 50.

Particularly disconcerting is the persistent drop in new orders to manufacturers. Demand for goods have weakened to the point where retailers, wholesalers and factories increasingly worry about getting stuck with inventory they can't sell. The PMI inventory index, for example, just shot up to 53 (a rare leap of 4 pts in a single month!). With stockrooms now getting full, one should expect new orders fall off. Thus, August new orders plummeted to a multi-year low of 47.1. Since new orders influence future production, it is very likely last month's decline in production to 47.2 --- a level not seen since the last recession --- will continue its descent in the months ahead.

MANUFACTURING AT A GLANCE AUGUST 2012						
Index	Series Index Aug	Series Index Jul	Percentage Point Change	Direction	Rate of Change	Trend* (Months)
PMI™	49.6	49.8	-0.2	Contracting	Faster	3
New Orders	47.1	48.0	-0.9	Contracting	Faster	3
Production	47.2	51.3	-4.1	Contracting	From Growing	1
Employment	51.6	52.0	-0.4	Growing	Slower	35
Supplier Deliveries	49.3	48.7	+0.6	Faster	Slower	7
Inventories	53.0	49.0	+4.0	Growing	From Contracting	1
Customers' Inventories	49.0	49.5	-0.5	Too Low	Faster	9
Prices	54.0	39.5	+14.5	Increasing	From Decreasing	1
Backlog of Orders	42.5	43.0	-0.5	Contracting	Faster	5
Exports	47.0	46.5	+0.5	Contracting	Slower	3
Imports	49.0	50.5	-1.5	Contracting	From Growing	1

Source: Institute for Supply Management

Also troubling in the PMI report was the softness in export orders. Exports have been the single strongest sector of the US economy the past three years. Yet it too seems to be softening as the slump overseas becomes more serious. Two out of every three U.S. industries surveyed by the ISM noted orders from other countries have dropped.

The one puzzling outlier in the August PMI release has been the employment index, which, at 51.6, indicates hiring expanded somewhat in August. Yet even this index may soon slip below 50. According to ISM, August manufacturing employment increased at the slowest pace since November 2009!

Construction Spending

One area in the economy that has demonstrated signs of life lately has been construction. But after three straight months of rising outlays, construction spending tripped in July, falling 0.9% to an annual rate of

$834.4 billion, the smallest level since last April. Spending on both public and private construction tumbled. One main reason for the decline has been a significant cutback in home improvement expenditures, which is troubling since it provides more evidence of how reluctant consumers are to part with their money.

Table 1. **Value of Construction Put in Place in the United States, Seasonally Adjusted Annual Rate**
(Millions of dollars. Details may not add to totals due to rounding.)

Type of Construction	Jul 2012[p]	Jun 2012[r]	May 2012[r]	Apr 2012	Mar 2012	Jul 2011	Percent change Jul 2012 from - Jun 2012	Jul 2011
Total Construction	834,384	842,224	838,778	825,133	817,842	763,468	-0.9	9.3

Source: Commerce Department

Nevertheless, we do expect construction spending to turn up again in the coming months as record low mortgages, the huge pent-up demand for both new single-family houses and apartments, and the availability of more bank credit should all support more residential building. On the commercial side, low investment returns in the financial markets have encouraged large investors to shift more private equity capital to fund non-residential construction,especially in the areas of lodging (spending up 26.3% year-over-year) and education facilities (up 18.8% YOY).

Bottom line:

Let’s get serious. There is no question the underlying fundamentals of the US economy today are better than they were four years ago. Nonetheless, business leaders and consumers are held hostage to a multitude of dangerous domestic and geopolitical risks. ***With Congress still unwilling to deal with the fiscal cliff, a Federal Reserve essentially out of ammo, and a tight presidential race with Obama and Romney each pushing radically different domestic agendas, who can blame the private sector for turning hyper cautious***. Our forecast calls for US economic growth to continue its sluggish pace of 1.5% to 2% the rest of the year, before finally breaking out into the 3% to 4% range in 2013.

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