Capital
INVESTMENT SERVICES
of America, Inc.

Observations

June 2015

MAY 2015 ISM

Signal or noise? That's always a question to ask when reviewing economic data points. It is becoming more widely recognized that the government's first quarter GDP estimates are providing lots of *noise* and less meaningful *signals* about the pace of the economic expansion. This year is no exception as 1st quarter's GDP (like 2014's) was recently revised into contractionary zone. (More on this below.)

In contrast, we believe the Institute of Supply Management's monthly Purchasing Managers' Index (PMI) provides some pretty decent *signals* about the economy. Hence, these brief PMI summaries from us.

Even though manufacturing is no longer regarded as a Big Kahuna in terms of its influence on domestic economic activity; it remains highly correlated to the economy at large. And, in the business cycle theory we believe best describes reality; recessions occur primarily because of accumulated excesses. One of the excesses (besides debt and inflation) relates to the state of inventories. The PMI gives a status report on inventory levels each month.

The table below provides the details on May's report, but here are the relevant investment signals for May as we see them:

- All-important new order activity remains healthy.
- Employment continues to grind higher. Higher wages are ahead which should augment consumer spending.
- Inventories are, if anything, too lean and not a worrisome "excess" at this point.
- The economic expansion is not, of course, operating at a boom-time pace, but it continues to grind forward at a decent pace. In the ISM's words:

  A PMI® in excess of 43.1 percent, over a period of time, generally indicates an expansion of the overall economy. Therefore, the May PMI® indicates growth for the 72nd consecutive month in the overall economy, and indicates expansion in the manufacturing sector for the 29th consecutive month. Holcomb stated, "The past relationship between the PMI® and the overall economy indicates that the average PMI® for January through May (52.4 percent) corresponds to a 2.9 percent increase in real gross domestic product (GDP) on an annualized basis. In addition, if the PMI® for May (52.8 percent) is annualized, it corresponds to a 3 percent increase in real GDP annually."

- Raw material prices rose during the month but from sharply depressed levels (think oil). While we do expect inflation to pick up over the course of this business cycle, it also is not an "excess" threat at present. The economy remains sufficiently resilient to withstand interest rate hikes as the Federal Reserve appears intent on moving away from the "crisis" (zero-interest rates) policy stance that has prevailed since the Financial Panic of '08. Just as the stock market proved resilient to the end of the Fed's "QE" (bond buying) actions, it should be able to withstand a shift in Fed policy from "ultra" to "extremely" accommodation.

In sum, the economic backdrop should continue to support the general rise in corporate earnings and the bull market in stocks. The time will indeed arrive when investors will need to worry that excesses are accumulating and represent a threat to both the expansion and the bull market. But those days are still likely well out into the future.

Here's the PMI table:

MANUFACTURING AT A GLANCE MAY 2015						
Index	**Series Index May**	**Series Index Apr**	**Percentage Point Change**	**Direction**	**Rate of Change**	**Trend* (Months)**
PMI®	52.8	51.5	+1.3	Growing	Faster	29
New Orders	55.8	53.5	+2.3	Growing	Faster	30
Production	54.5	56.0	-1.5	Growing	Slower	33
Employment	51.7	48.3	+3.4	Growing	From Contracting	1
Supplier Deliveries	50.7	50.1	+0.6	Slowing	Faster	24
Inventories	51.5	49.5	+2.0	Growing	From Contracting	1
Customers' Inventories	45.5	44.0	+1.5	Too Low	Slower	6
Prices	49.5	40.5	+9.0	Decreasing	Slower	7
Backlog of Orders	53.5	49.5	+4.0	Growing	From Contracting	1
Exports	50.0	51.5	-1.5	Unchanged	From Growing	1
Imports	55.0	54.0	+1.0	Growing	Faster	28
OVERALL ECONOMY				Growing	Faster	72
Manufacturing Sector				Growing	Faster	29

Manufacturing ISM® *Report On Business®* data is seasonally adjusted for New Orders, Production, Employment and Supplier Deliveries indexes.
*Number of months moving in current direction

Regarding GDP statistics; we came across a study some time back that makes the case for a measure that improves the signal content of GDP. There are two ways the government calculates GDP—the measure the markets focus upon (the so-called expenditure approach), and the less-timely-available income approach. The study noted that an average of the two measurement approaches does a much better job reflecting underlying economic trends.

The Philly Fed is publishing a combined GDP (they call GDPplus). We believe this measure would be helpful to investors and we will have more to say about it in a new post to our website (capinv.com) soon.

NOTE: All figures except backlog of orders, customer inventories, imports, exports, inventories & prices paid are seasonally adjusted. The diffusion index is calculated by adding the percent of positive responses plus one half of those responding the same.

*A PMI™ reading above 50 percent indicates that the manufacturing economy is generally expanding; below 50 percent indicates that it is generally declining. A PMI™ in excess of 42.2 percent, over a period of time, indicates that the overall economy, or gross domestic product (GDP), is generally expanding; below 42.2 percent, it is generally declining.