

December 2015 ISM

While the doom and gloom crowd are out in full force with the turn of the calendar, don't fear the reaper for the domestic economic expansion quite yet.

December's Purchasing Managers' Index (PMI) was again below the level (50) which is consistent with manufacturing activity detracting from overall economic growth. But a domestic recession is not likely in the cards anytime soon.

The Institute of Supply Management (ISM) provides much needed context around the overall Index:

- "A PMI[®] above 43.1 percent, over a period of time, generally indicates an expansion of the overall economy." (December reading was 48.2)
- "The past relationship between the PMI[®] and the overall economy indicates that the average PMI[®] for January through December (51.4 percent) corresponds to a 2.6 percent increase in real gross domestic product (GDP) on an annualized basis. In addition, if the PMI[®] for December (48.2 percent) is annualized, it corresponds to a 1.6 percent increase in real GDP annually." (2%-ish growth has generally characterized this economic expansion since it began in 2009)

In addition, as this chart of the *all-important New Order* sub-index reflects, dips below the 50 line within the context of an on-going business expansion are the rule rather than exception.



The weakness in manufacturing reflects the commodity bust and the significant decline in capital spending in agriculture and oil and gas exploration, in particular. Amid slumping demand, the "commodity super-cycle" mentality has taken awhile to diminish and has left some manufacturers with excessive inventories. These are being worked down to some degree as the inventory sub-indices (see accompanying table) suggest. New orders did stabilize during the month and if that persists as we expect, the mini-inventory overhang should be alleviated in the next few months. Meanwhile, fundamentals underlying the rest of the economy look reasonably sound. Wages are rising to support consumer spending (auto sales at near records) and employment is improving overall. Recessions arise less from a lack of drive and more so from excesses (typically debt and rising inflation) that demand a correction.

As we've pointed out in the past, the good news in the current expansion that's been characterized by slow growth and generally very cautious economic behavior is that few serious excesses have accumulated to this point. The ISI Group recently provided a quote from economist Rudi Dornbusch that's worth repeating: "No post-war recession has died in bed of old age. The Federal Reserve murdered every one of them."

Consider the past U.S. business cycle: debt was widespread in the midst of the massive housing bubble, financial companies were highly levered (20:1/30:1), the Fed raised rates 17 times and by 425 basis points. This cycle, the saving rate is rising, financial firms are better capitalized compared to the past few decades and housing starts remain *below* their 1960's levels (despite a significantly larger population base currently) while household formations are rising, and lower energy costs are a budget-booster for most.

Some worry that the only prop underneath the economy (and stock prices) has been Federal Reserve bond buying and zero interest rates. We are not in this debt-deflation camp, at least regarding the domestic economy. The treat of 1930's style debt-deflation was disarmed by the Fed's lender-of-last-resort actions of 2008 and 2009. We believe the economy can withstand the Fed's modest moves towards allowing market forces to determine the level of interest rates. We also suspect part of the reason Fed policy moved recently was out of concern that their ultra-stimulating policies were setting the stage for a new round of excesses.

Stock bear markets are usually coincident with recessions. With recession not at hand, the uptrend in corporate earnings cycle is also likely to resume in 2016. Earnings were biased lower in 2015 by the collapse in earnings for commodity-related companies and the big spike up in the value of the dollar. Both of these counter-trends are likely to be less of a drag on general corporate earnings as the year progresses.

MANUFACTURING AT A GLANCE						
DECEMBER 2015						
Index	Series Index Dec	Series Index Nov	Percentage Point Change	Direction	Rate of Change	Trend* (Months)
PMI®	48.2	48.6	-0.4	Contracting	Faster	2
New Orders	49.2	48.9	+0.3	Contracting	Slower	2
Production	49.8	49.2	+0.6	Contracting	Slower	2
Employment	48.1	51.3	-3.2	Contracting	From Growing	1
Supplier Deliveries	50.3	50.6	-0.3	Slowing	Slower	5
Inventories	43.5	43.0	+0.5	Contracting	Slower	6
Customers' Inventories	51.5	50.5	+1.0	Too High	Faster	5
Prices	33.5	35.5	-2.0	Decreasing	Faster	14
Backlog of Orders	41.0	43.0	-2.0	Contracting	Faster	7
Exports	51.0	47.5	+3.5	Growing	From Contracting	1
Imports	45.5	49.0	-3.5	Contracting	Faster	3
OVERALL ECONOMY				Growing	Slower	79
Manufacturing Sector				Contracting	Faster	2

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

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. The information contained in this report is based on sources believed to be reliable, but we do not guarantee its accuracy or completeness. The information is published for informational purposes and does not constitute an offer, solicitation, or recommendation of an investment or advisory services