Capital
INVESTMENT SERVICES
of America, Inc.

Observations

June 2014

May 2014 ISM

Today's release by the Institute of Supply Management's Purchasing Manager's Index (PMI), was consistent with ***steady*** growth in the manufacturing sector last month. The table below reflects details of the latest report.

By way of review, we typically comment on the PMI report each month due to its relatively tight correlation with conditions in the overall economy. And while last week's revision of the widest gauge of the economic conditions (GDP) was revised into negative territory for the 1st quarter—and heightened worries about the health of the economy by some pundits—we suggest much better insights into overall economic conditions are provided by the commentary accompanying today's release:

"The past relationship between the PMI® and the overall economy indicates that the average PMI® for January through May (53.3 percent) corresponds to a 3.3 percent increase in real gross domestic product (GDP) on an annualized basis. In addition, if the PMI® for May (53.2 percent) is annualized, it corresponds to a 3.3 percent increase in real GDP annually."

Sustained growth around 3%, in our estimation, would be darn close to a goldilocks environment for the stock market. Such a growth rate is not conducive to a rapid accumulation of the types of excesses (debt and inflation) that ultimately sets the stage for the next downturn in both the general economy and in corporate earnings. Such conditions would also be consistent with our expectation that the expansion in both the economy and corporate earnings likely have years to run yet.

However, 3% real growth with 2%-ish inflation on top (for nominal growth around 5%) *is not* consistent with the current interest rate backdrop (10-year Treasury yields around 2.5%). But the likely rise in yields ahead as the Federal Reserve allows market forces to "market clearing" interest rate levels, is not so large as to threaten the expansion itself (although the yield rise would not likely be a picnic for bond investors.)

Within the details of the report:

- The all-important new order index slipped some from April's level, but remains on solid footings. The domestic manufacturing renaissance that we believe is unfolding continues to reveal itself in export orders.

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- Employment also registered a decline for the month, but remains consistent with the net hiring trend of the past year or so.

- Inventory levels do not appear troublesome.

- Some survey respondents did report "*areas of concern regarding raw materials pricing and supply tightness and shortages."*

MANUFACTURING AT A GLANCE MAY 2014						
Index	Series Index May	Series Index Apr	Percentage Point Change	Direction	Rate of Change	Trend* (Months)
PMI®	53.2	54.9	-1.7	Growing	Slower	12
New Orders	53.3	55.1	-1.8	Growing	Slower	12
Production	55.2	55.7	-0.5	Growing	Slower	3
Employment	51.9	54.7	-2.8	Growing	Slower	11
Supplier Deliveries	52.5	55.9	-3.4	Slowing	Slower	12
Inventories	53.0	53.0	0.0	Growing	Same	4
Customers' Inventories	46.5	42.0	+4.5	Too Low	Slower	30
Prices	60.0	56.5	+3.5	Increasing	Faster	10
Backlog of Orders	52.5	55.5	-3.0	Growing	Slower	4
Exports	56.5	57.0	-0.5	Growing	Slower	18
Imports	54.5	58.0	-3.5	Growing	Slower	16

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.

NOTE: Shortly after publishing the comments above, ISM discovered an error in their PMI calculation. The index was revised ***higher*** (to 55.4) as was the New Order component (***revised up*** to 56.9). The upward revisions do not alter our comments, however.