Capital
INVESTMENT SERVICES
of America, Inc.

Observations

November 2015

OCTOBER 2015 ISM

Manufacturing conditions stabilized last month as the sharp fall in commodity prices continues to work its way through the economy. Inventory levels remain mixed (see table below) with some reported as a bit “too high” and others as “too low”. Most importantly, however, the leading indicator within the Purchasing Managers’ Report (PMI)—New Orders—is providing readings that strongly suggest any remaining inventory overhangs should be worked off in short order.

One comment offered by Purchasing Managers was the following:
“Customer backlogs are increasing now that the perception[s] of raw material[s] pricing have bottomed out."

While we believe lower commodity prices are a boon to the economy over time, the abruptness of their price decline and a lingering “commodity super-cycle” mentality likely caught many with more commodity inventory (acquired at higher prices) than proved desirable. Adjustments are made over time and it appears the economy is close to having the initial (negative for growth) effects of lower commodity prices behind it.

Recession risk remains very low in our estimation. The Institute of Supply Management (which compiles the PMI) offers a similar big picture interpretation of their report:

A PMI® above 43.1 percent, over a period of time, generally indicates an expansion of the overall economy. Therefore, the October PMI® indicates growth for the 77th consecutive month in the overall economy, and indicates expansion in the manufacturing sector for the 34th consecutive month. Holcomb stated, "The past relationship between the PMI® and the overall economy indicates that the average PMI® for January through October (52 percent) corresponds to a 2.8 percent increase in real gross domestic product (GDP) on an annualized basis. In addition, if the PMI® for October (50.1 percent) is annualized, it corresponds to a 2.2 percent increase in real GDP annually."

Sub-3% is slow growth to be sure, but what else is new? Such growth has been the hallmark of the present business expansion and remains an investment backdrop favorable for companies that can figure out how to grow at rates that separate their business performance from the corporate pack. Slow growth and economic crisis are different conditions. The Fed’s zero interest rate policy is consistent with an economic crisis. It no longer is appropriate in our estimation.

Slow growth has also contributed to the general lack of accumulating excesses (debt, inflation and inventories) that make an expansion vulnerable to recession. In this context, Fed efforts to “normalize” interest rates should not prove problematic for the economy anytime soon.

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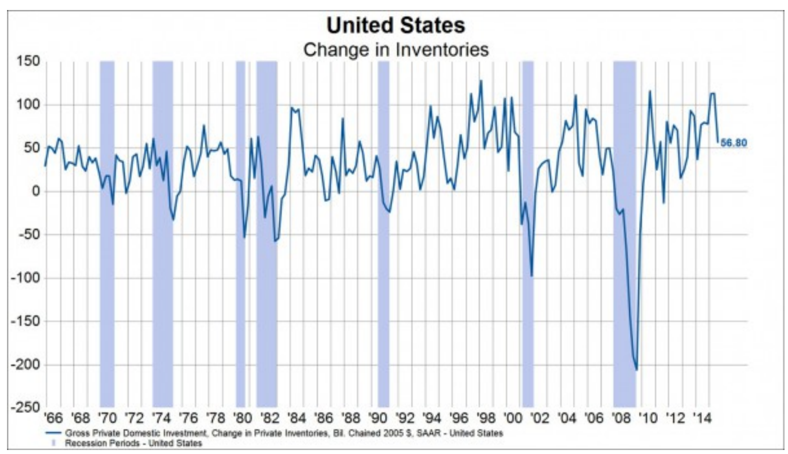
Here’s the PMI table:

MANUFACTURIUNG AT A GLANCE OCTOBER 2015						
Index	**Series Index October**	**Series Index September**	**Percentage Point Change**	**Direction**	**Rate of Change**	**Trend* (Months)**
PMI®	50.1	50.2	-0.1	Growing	Slower	34
New Orders	52.9	50.1	+2.8	Growing	Faster	35
Production	52.9	51.8	+1.1	Growing	Faster	38
Employment	47.6	50.5	-2.9	Contracting	From Growing	1
Supplier Deliveries	50.4	50.2	+0.2	Slowing	Faster	3
Inventories	46.5	48.5	-2.0	Contracting	Faster	4
Customers’ Inventories	51.0	54.5	-3.5	Too High	Slower	3
Prices	39.0	38.0	+1.0	Decreasing	Slower	12
Backlog of Orders	42.5	41.5	+1.0	Contracting	Slower	5
Exports	47.5	46.5	+1.0	Contracting	Slower	5
Imports	47.0	50.5	-3.5	Contracting	From Growing	1
OVERALL ECONOMY				Growing	Slower	77
Manufacturing Sector				Growing	Slower	34

One final point regarding inventories. The current mini-inventory cycle represents common business cycle dynamics. The research firm Gavekal recently provided the following chart and commentary that puts some context around inventory “mini-cycles” within an on-going business expansion and inventory excesses that prove part of the constellation of excesses that make recessions.



Gavekal comment: “While recessions always have an inventory correction component, a reduction in inventories alone doesn’t mean a recession is imminent. As the chart shows, it is when the change in private inventories breaks below zero that it becomes likely a recession is upon the US economy.”

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.