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Economics Group

WELLS FARGO SECURITIES

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Jump in Durable Goods Belies Weakening Business Spending

A 1.6 percent jump in June durables goods orders was substantially better than the 0.3 percent gain the consensus expected. However, our key yardstick of business spending is signaling increasing weakness.

Headline Number Seems Out of Step With Other Recent Reports

Durable goods orders started the year on shaky footing. A 4.9 percent decline in January kicked off a run that resulted in shrinking orders for three out of the first four months of the year. Ironically, as other parts of the economy have faltered in recent months, durable goods orders have been picking up steam. Not only did today's print beat consensus forecasts, the increase in the prior month was upwardly revised. So what explains this apparent strength in an otherwise softening economy?

Aircraft and Defense Orders

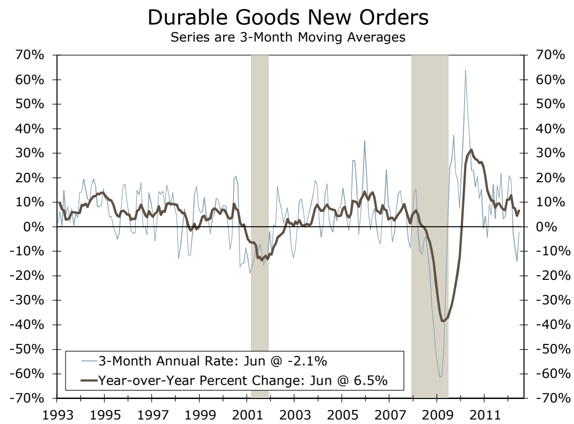
The answer lies in a surge in transportation orders. These types of orders by their nature have an exceptionally long lead time, which explains why these components seem out of step with more recent trends. Defense capital goods orders, which comprise about 5 percent of total durables orders, surged a staggering 62.0 percent in the month. We do not have an immediate explanation for the jump here, but the last time we had an increase of this magnitude was in 2007 when we were actively fighting two wars. With a gradual drawdown of military presence overseas and looming potential defense spending budget cuts, it hardly seems reasonable to expect this to be a sign of things to come.

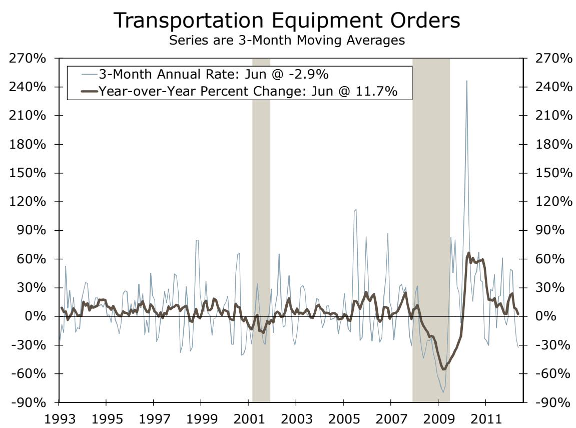
The other major jump in today's report was in nondefense aircraft, where orders increased 14.3 percent in June. A major domestic aircraft manufacturer has reported steady (though not overwhelming) increases in orders in recent months, so this increase does not come as a complete surprise.

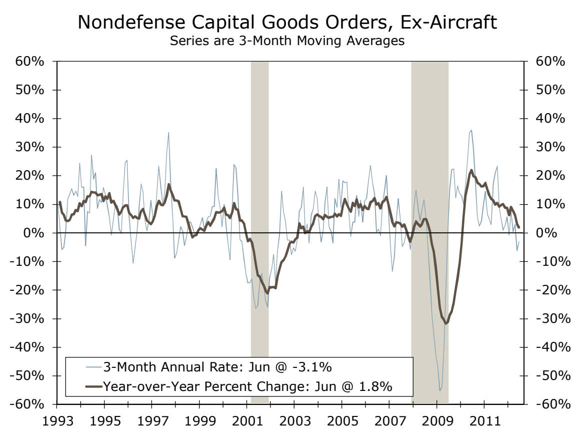
What Does This Tell Us About Business Spending?

When you exclude the volatile transportation sector, orders actually fell 1.1 percent, making June the weakest month for ex-transport orders since the 4.1 percent nosedive reported in January.

Our favored gauge of future business spending also fell into negative territory. Nondefense capital goods orders ex-aircraft fell 1.4 percent. On a 3-month annualized basis, this series has contracted at a 3.1 percent rate. Unfilled ex-defense orders also fell and have been weak for several months. What is particularly troubling now is that there appears to be few orders in the pipeline to sustain future growth. The reason we care so much about *orders* for non-defense capital goods orders, ex-aircraft is that, over time, it leads *shipments* of the same category which goes into the calculations for GDP. Keep in mind that it is not a perfect leading indicator. After all, orders can be cancelled, and that is more likely to happen in times when things are cooling off in the broader economy. Given the weakness in the orders components of recent purchasing managers' indices, we are getting worried about business spending.







Source: U.S. Department of Commerce and Wells Fargo Securities, LLC

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