



Economics Group

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ISM: Slower Pace of Expansion, Yet Prices Remain an Issue

Moderation of the elevated level of the ISM index suggests growth in the factory sector is slowing, which is consistent with our GDP forecast of 1.8% in Q2. However, the cyclical upswing in prices remains a concern.

ISM Index Suggests Sustained Growth at a Slower Pace

Headline ISM moderated again for the third straight month as the manufacturing sector continues to exhibit growth although at a pace that remains disappointing to many. In May, the ISM index came in at 53.5 from 60.4 in April (top chart). The basic message is that the factory sector continued to expand although the pace of expansion has moderated, as evidenced by the drop below 60 readings for production, new orders, export orders and employment. The headline index at 53.5 is consistent with our 1.8 percent estimate for GDP growth in the second quarter.

Underlying components still confirm the expansion in the manufacturing sector. The production component came in at 54.0 with 12 industries reporting growth including electrical equipment, computers, paper, plastics and machinery. Meanwhile, the employment component came in at 58.2 and would indicate another gain in manufacturing jobs to be reported later this week.

New Orders Component Suggests Slowdown Ahead

Declines in new orders (middle graph) and supplier deliveries intimate that while there is a sustained support for gains in the manufacturing sector, the outlook for the manufacturing sector has dimmed. Eleven industries reported growth in new orders including electrical equipment, chemicals and machinery.

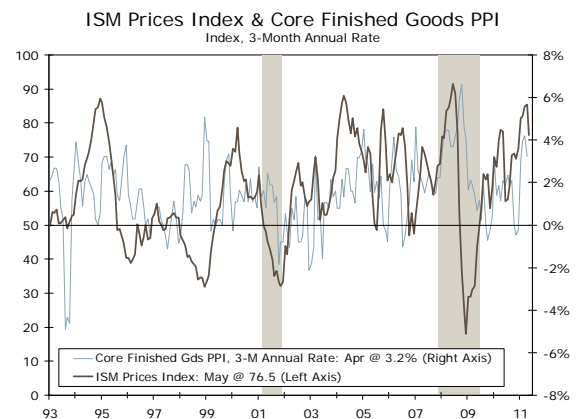
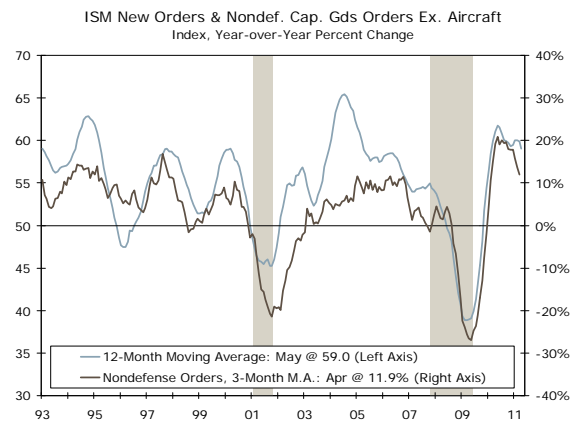
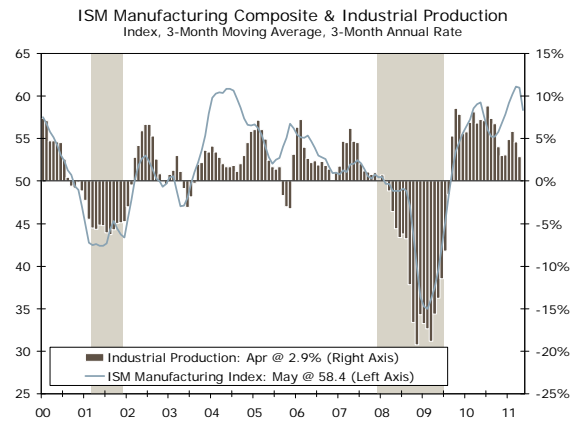
On the trade side, the new export orders component fell to 55 in May and may reflect the impact of the Japanese tsunami. The above 50 breakeven does indicate that American producers see greater strength in orders from foreign countries. Eight industries reported a gain in export orders. This result suggests that many manufacturing industries, for example machinery, paper, transportation equipment and chemicals, in the United States can compete globally.

Prices Paid: A Problem for Cost Control and Profits

The most troubling problem for private business and public-policy makers has been the steady rise over the last year of the prices paid component. The price index at 76.5 in May remains elevated (bottom chart). Fifteen of the 18 sectors reported higher prices paid including chemicals, paper and machinery.

For inflation, the complete pass-through of rising commodity prices to consumer prices does not seem very likely, but there certainly will be some elevation in prices. For decision makers in both the private and public sectors, the bias on future prices is to the upside even though the current pace of inflation appears moderate.

Commodities up in price include metals, plastics, caustic soda and even the sacred cocoa/cocoa powder used in chocolate. What next?



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