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Economics Group

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Factory Sector Gains Continue, Pace Moderating

Industrial production managed a 0.1 percent gain in June following its increase of 1.3 percent in May. And slower growth over the next few months after a very strong first half is the theme in the factory sector.

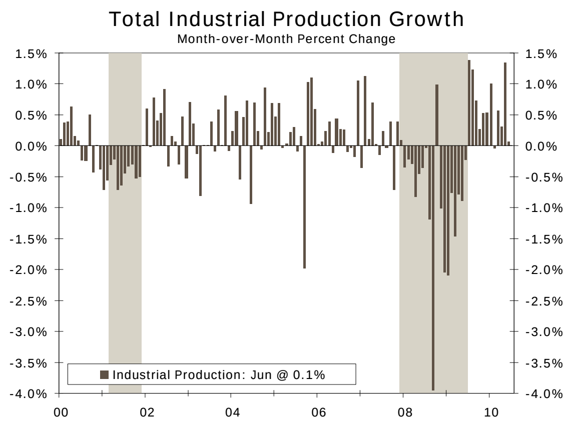
Industrial Production

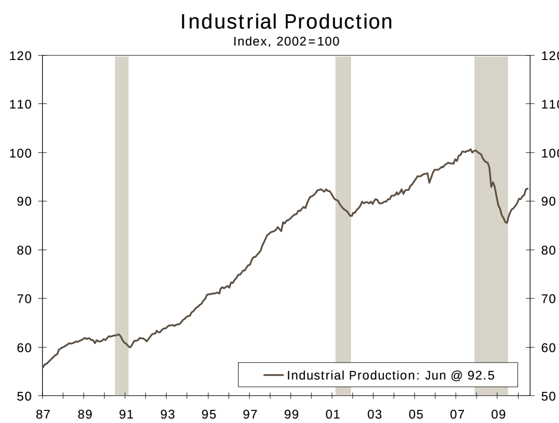
The hot summer month of June helped to boost utilities output by 2.7 percent. But the more telling manufacturing component fell 0.4 percent, with gains in high technology industries more than offset by a decline in the motor vehicle sector. With anecdotal evidence that auto manufacturers will not shut down this summer, we could see that drop reverse over the next few months. Neither gains nor losses predominated as business equipment, energy and materials saw gains while consumer durable and nondurable goods production fell off. Metals and machinery performed well but food, beverages and tobacco as well as chemicals declined.

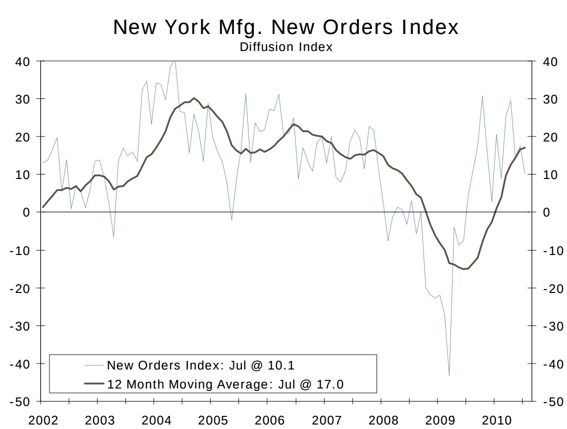
Though we cannot always count on a slew of economic indicators to tell the same story, when it does occur we are prone to believe them. The ISM manufacturing survey, Empire State survey, and now hard data on industrial production and capacity utilization, all signal a deceleration of growth. This is not an outright contraction—indeed, the factory sector remains very strong relative to a year ago—it is simply the inventory rebound drawing to an end. During the second quarter production rose at a 6.6 percent annual rate, but we expect the third and fourth quarters to perform around a 3 percent annual pace. This story is confirmed by the inventory data we have seen recently, where manufacturers have been the first businesses to step on the breaks on inventory restocking. Now that inventory levels have been recalibrated and have recovered much of the recession's declines, restocking will no longer be a major driver of production, making final demand a more important factor. With the relatively strong dollar and a softening economic recovery globally, especially in Europe, demand is not likely to come from abroad. Instead manufacturers will rely on the domestic economy to determine production needs. These factors will result in slower production and weaker economic growth in the second half of 2010.

Regional PMIs – Philadelphia and New York

Both regional surveys underperformed relative to expectations, but held onto expansionary readings nonetheless. Empire State manufacturing at 5.08 in July from 19.57 in June was a disappointment. Large drops in new orders and shipments, and significantly weaker unfilled orders show that demand is softening, and the support provided by the inventory cycle is falling away. The Philadelphia Business Outlook Survey at 5.1 in July relative to 8.0 a month ago revealed an outright decline in new and unfilled orders readings. While we do not expect the factory sector to contract, slow growth through the end of the year is likely. Expectations for six months from now in both surveys reflected that businesses are anticipating a deceleration in the factory sector.







Source: Federal Reserve, Federal Reserve Bank of New York and Wells Fargo Securities, LLC.

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