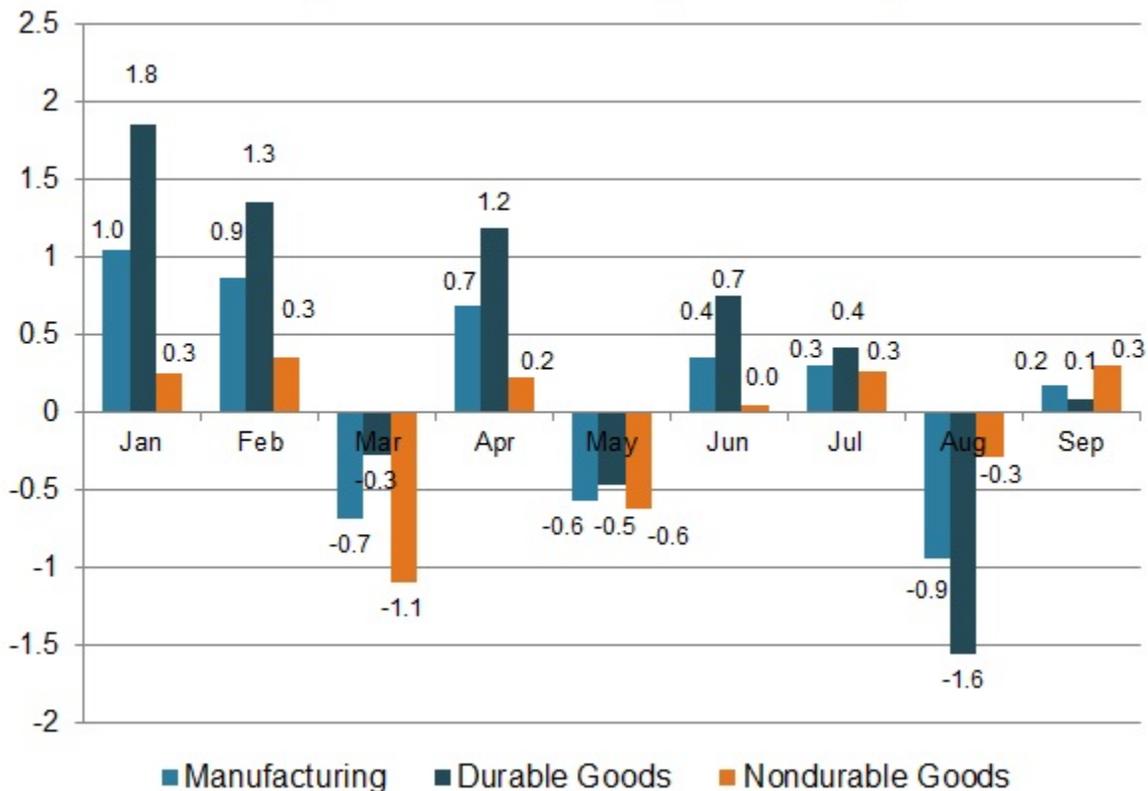




October 22, 2012

Percent % Changes in Manufacturing Production, 2012



The Conference Board's Leading Economic Index, which forecasts where the economy is headed in the months ahead, rose 0.6 percent last month. As with many indicators released during the past few weeks, this one suggests some improvement in the current environment, albeit with persistent weaknesses still present in the marketplace. The largest driver of growth for the Leading Economic Index was the large jump in housing permits, which soared from an annualized 801,000 to 894,000 units from August to September. Housing starts also rose to an unexpected high of 872,000 new residential units, a sign that this all-important sector continues to move in the right direction.

Manufacturing production also improved in September; however, the 0.2 percent gain was not enough to fully offset August's 0.9 percent loss. Capacity utilization remained unchanged and well below the levels seen earlier this year. Data from the regional Federal Reserve Banks in New York and Philadelphia tend to support this softness. While respondents to the Philly Fed survey were more optimistic on overall business conditions, the underlying components reflected a contraction for new orders, shipments and employment. The same was true in the Empire State survey. Both surveys found manufacturers in their respective regions cautiously optimistic for increasing activity levels six months from now, but with less certainty than in prior months.

On the consumer front, Americans remain more upbeat than the economic headwinds facing the economy might suggest, as seen in recent data on [consumer confidence](#) and [personal spending](#). Last week, retail sales reports showed strong growth of 1.1 percent in September, building on impressive gains in retail sales in both July and August. A 4.5 percent increase in electronics spending boosted the September figure, with the new iPhone 5 almost single-handedly moving the market. Other major sectors showed strength as well. Modest inflationary pressures have helped lift consumer spirits. Even with higher energy prices, core consumer prices have risen just 2 percent over the past 12 months, indicating modest pricing pressures.

With inflation in-check for now, the Federal Reserve Board is expected to continue the [expansionary policies](#) announced at its September 13 meeting. No major changes are anticipated this week from the Federal Open Market Committee (FOMC), which meets October 23–24. The other big news this week will come on Friday with the announcement of GDP figures for the third quarter. I estimate this should be around 1.8 percent growth in real GDP, an improvement from the 1.25 percent growth in the second quarter but still disappointing overall. Other releases this week include regional manufacturing surveys from Kansas City and Richmond, Flash Purchasing Managers' Index (PMI) data from Markit regarding the United States and Europe, and durable goods sales.

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Economic Indicators

Last Week's Indicators:

(Summaries Appear Below)

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*Empire State Manufacturing Survey
NABE Outlook Survey
Retail Sales*

Tuesday, October 16

*Consumer Price Index
Industrial Production
NAHB Housing Market Index*

Wednesday, October 17

Housing Starts and Permits

Thursday, October 18

*Conference Board Leading Indicators
Philadelphia Fed Manufacturing Survey*

Friday, October 19

*Existing Home Sales
Regional and State Employment*

This Week's Indicators:

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None

Tuesday, October 23

Richmond Fed Manufacturing Survey

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*FOMC Policy Statement
Markit Flash Manufacturing PMI (United States, Eurozone)
New Home Sales*

Thursday, October 25

*Chicago Fed National Activity Index
Durable Goods
Kansas City Fed Manufacturing Survey*

Friday, October 26

Gross Domestic Product

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Summaries of Last Week's Economic Indicators

Conference Board Leading Indicators

The Conference Board's Leading Economic Index (LEI) reported an increase of 0.6 percent in September, more than offsetting its 0.4 percent decline in August. The primary driver of this gain was housing permits, which soared last month to 894,000 units. Increased permitting alone accounted for 0.3 percentage points—or half—of the increase. Other positive contributing factors included rising stock prices and improved interest rate and credit conditions.

Manufacturing provided a mixed contribution to the index calculation, which should not be surprising given recent weaknesses. The measures for new orders from Census Bureau and the Institute for Supply Management moved in opposite directions, somewhat negating one another as a contributor to the index. Consumer confidence was also a drag on the LEI calculation.

The Coincident Economic Index, which looks at the current economic environment, rose 0.2 percent in September, reversing August's 0.2 percent decline. In contrast to the Leading Economic Index, manufacturing helped to fuel this month's gain. Increases in industrial production and higher manufacturing and trade sales both contributed to recent improvements. Other positive factors were slight gains in non-farm payrolls and personal income.

Consumer Price Index

The Consumer Price Index rose 0.6 percent in September, according to the Bureau of Labor Statistics. This matched August's increase. Higher energy costs were the main contributor to the gains, with consumer energy prices up 5.6 percent and 4.5 percent for the past two months. Gasoline prices in September rose 7 percent.

Food prices rose 0.1 percent for the month. Higher nonalcoholic beverages prices (up 0.9 percent) were offset by declines in meat, poultry, fish and eggs (down 0.6 percent) and fruits and vegetables (down 0.4 percent). Year-over-year food prices were up a modest 1.6 percent.

Excluding food and energy prices, core inflation from September 2011 to September 2012 was 2 percent. This is in line with Federal Reserve Board targets, suggesting that pricing pressures are under control.

The Producer Price Index for September noted some higher food and energy costs at the intermediate and crude levels that will be forthcoming in future months. Even with these projected increases, inflation is expected to remain modest. If not, the Federal Reserve Board might need to readjust its current expansionary stance. For the time being, however, the Federal Reserve Board is more concerned about slowing global and U.S. economic growth than inflationary pressures.

Empire State Manufacturing Survey

The Federal Reserve Bank of New York reported that overall business conditions in its district remain weak, despite a slight gain this month. The index of general business conditions rose from -10.4 in September to -6.2 in October, with negative values indicating contracting activity. While nearly one-quarter of respondents said that conditions were improving, almost 31 percent said the opposite. This was the third consecutive month that the index declined.

Reduced new orders helped to slow overall activity, with decreased sales for four consecutive months. The new orders index went from -14.0 to -9.0 for the month. Shipments, inventories and employment also contracted.

The forward-looking measures suggest that manufacturers in New York expect positive growth in sales, shipments and capital spending over the next six months. However, each indicator has pulled back a bit in October, reflecting some diminished optimism. Employment is now not expected to grow in the months ahead, with the index for number of workers down from 8.5 to 0.

Overall, this is one more sign that the manufacturing economy remains soft at best. The Empire State

Manufacturing Survey's findings are consistent with other indicators, with weaker sales and economic uncertainties hampering growth.

Existing Home Sales

The National Association of Realtors announced that existing home sales declined 1.7 percent in September. The decline from 4.83 million existing homes sold in August to 4.75 million homes in September represented a slight pullback from the 8.1 percent increase seen the month before. Still, the levels seen in August and September suggest strength in the existing home market, with year-over-year growth from September 2011 to September 2012 of 11.0 percent.

The number of months of supply on the market declined from 6.5 months in June to 6.0 months in August and 5.9 months in September. This inventory reduction is a positive sign of market growth, with it falling below 6 months for the first time since 2006. The median price for an existing home sold was \$183,900 in September, up 11.3 percent from one year ago.

Housing Starts and Permits

The Census Bureau and the U.S. Department of Housing and Urban Development reported that new residential construction jumped from a revised 758,000 in August to 872,000 in September. This represents a 15 percent gain and the highest level since July 2008. New residential construction finally moved past the 800,000 housing starts threshold, which was expected by year's end and foreshadowed by the previous month's permit figures. Even so, September's reading was well above the consensus estimate by about 100,000 units.

Both single-family and multifamily units saw gains. Single-family residential construction increased from 543,000 to 603,000, and multifamily starts rose from 215,000 to 269,000.

Most important, housing permits also increased significantly, up from 801,000 to 894,000, suggesting that the improvements in residential construction are expected to continue in the months ahead, with permitting a proxy for future activity. Permits were higher for both single-family and multifamily units.

The residential housing market continues to stabilize, with the sector being a bright spot in the economy this year. To keep it in perspective, housing starts were 594,000 in September 2010 and 647,000 in September 2011. This is good news for manufacturers—especially those who depend so heavily on construction and home furnishings—and for the larger macroeconomy.

Industrial Production

The Federal Reserve Board reported that industrial production increased 0.4 percent in September, partially recovering from its sharp 1.4 percent decline in August. The largest drivers of the gain (as well as the prior month's fall) were in the mining and utilities sectors, with production in the two up 0.9 percent and 1.5 percent, respectively, in September.

Manufacturing production grew by 0.2 percent for the month, an improvement from the 0.9 percent loss the month before. Year-over-year growth has been 3.2 percent, a slowdown from earlier in the year. July 2011 to July 2012 gains in manufacturing production were 5.0 percent.

Manufacturing growth has been modest at best, with significant weaknesses apparent in the data. Capacity utilization remained at 76.8 percent in September, but it had stood at 78.0 percent as recently as February.

Looking at specific sectors, the largest monthly gains were in the aerospace (up 2.4 percent), electrical equipment and appliances (up 1.8 percent), apparel and leather (up 1.6 percent) and food and beverages (up 1.1 percent) sectors. The steepest declines were in motor vehicles (down 2.5 percent), printing (down 1.1 percent), primary metals (down 1.0 percent) and plastics and rubber (down 0.7 percent) sectors.

This report reflects continued weaknesses in manufacturing, despite September's increase. Growth among manufacturers has been disappointing in recent months, with softness in global sales and uncertainties in the U.S. market taking a definite toll. I would expect for this choppiness to continue in the months ahead, especially

with the looming fiscal abyss and uncertain business climate on the minds of manufacturers.

NABE Outlook Survey

Business economists lowered their growth estimates for 2012 and 2013, and yet they remain cautiously optimistic about growth prospects for next year. According to the latest Outlook Survey from the National Association for Business Economics (NABE), real GDP is now expected to increase 1.9 percent in 2012 and 2.4 percent in 2013, down from 2.4 percent and 2.8 percent, respectively, from May's survey.

The largest driver of growth is expected to be residential and nonresidential investment, with modest gains in consumer spending and a slight narrowing of the trade deficit. Government spending will continue to be a drag on growth. Hiring should be modest (averaging 155,300 each month next year), with the unemployment rate not much different than what it is today.

It is worth noting that this forecast assumes that the United States will not fall in the fiscal abyss. Specifically, respondents said the following about the fiscal abyss and possible solutions:

- ⌘ 59 percent expect for the 2001–03 tax cuts to be extended for one year for all income levels, and 36 percent felt that they would be extended only for those making less than \$250,000 per year.
- ⌘ 59 percent also believe that the temporary payroll tax cut will be allowed to expire at year's end.
- ⌘ 77 percent expect for legislators to "diminish" the effects of sequestration resulting from the Budget Control Act in some way.

If the fiscal abyss cannot be averted, these forecast figures would change dramatically. While the NABE survey does not mention it directly, failure to address the fiscal abyss will cripple job creation and economic growth moving forward.

NAHB Housing Market Index

The National Association of Home Builders (NAHB) and Wells Fargo announced that their Housing Market Index (HMI) rose from 40 in September to 41 in October. The HMI was 17 one year ago, and it was 29 in June. Indeed, builder confidence has risen sharply during the past few months. This is its highest point since June 2006, and improving sentiment is also reflected in housing starts and permits data.

NAHB Chief Economist David Crowe noted the growth in homebuilder confidence, but he also kept it all in perspective. "The speed at which the housing recovery is proceeding is being moderated by various constraints, such as tight credit, difficult appraisals and, more recently, the limited inventory of buildable lots in certain markets," he said. He added that these could "make it difficult for builder confidence to reach and surpass the 50-point mark, at which an equal number of builders view sales conditions as good as poor."

Philadelphia Fed Manufacturing Survey

The Federal Reserve Bank of Philadelphia's Business Outlook Survey's top-line number improved, but larger weaknesses are still persistent in the underlying details. The composite index of general business conditions improved from -1.9 in August to 5.7 in September, representing a significant gain from June's -16.6 reading. However, nearly 23 percent of respondents reported that business activity was lower.

Looking more specifically at the various components, manufacturing activity remains weak across-the-board. The index for new orders fell from 1.0 to -0.6 for the month, indicating a slight contraction. Shipments were also modestly lower, even with an improvement in its index from -21.2 to -0.2. In addition, there were fewer employees and a shorter workweek. Almost 22 percent of respondents reported that they reduced their workforce during the past month, with more than two-thirds saying there was no change.

Forward-looking measures remain positive, albeit with significant easing from last month. The expected general business activity index for six months from now fell from 41.2 to 21.6. While this still suggests strong growth, its pace has diminished. Indicators for new orders, shipments, hiring and capital spending show this weaker pace. Manufacturers now expect their capital expenditures to decline in the coming months, with the index dropping from 4.8 to -1.9.

Regional and State Employment

The Bureau of Labor Statistics reported that unemployment rates fell in September in most states, consistent with the larger decline nationally from 8.1 to 7.8 percent. States with the largest monthly declines included California (10.6 to 10.4 percent), Hawaii (6.1 to 5.7 percent), Louisiana (7.4 to 7.0 percent), South Carolina (9.6 to 9.1 percent) and Utah (5.8 to 5.4 percent). The highest unemployment rate can still be found in Nevada (11.8 percent), with the lowest in North Dakota (3.0 percent).

Looking specifically at manufacturing employment, September's largest gains were in Texas, up 3,800 workers. This increase was entirely from higher durable goods industry employment on net, up 4,400 for the month. The number of non-farm workers in Texas declined by 600 in September. Outside of Texas, states with the biggest manufacturing increases included New Jersey (up 900) and Florida, Oklahoma, South Dakota and South Carolina (all up by 700 each).

On the flip side, 31 states experienced declining manufacturing employment, reflecting recent weaknesses in the sector. Some of these states were ones that have the largest post-recessionary gains, suggesting some industry-specific losses might be at play.

Retail Sales

The Census Bureau reported that retail sales rose a strong 1.1 percent in September. This builds on the healthy 0.7 percent and 1.2 percent gains in July and August, respectively, which should bode well for second quarter consumption and GDP figures. In general, consumers continued to spend, despite a number of economic headwinds, with year-over-year retail sales up 4.8 percent.

The primary driver of September's increased sales was the new iPhone 5. Retail spending in the electronics and appliances sector was up 4.5 percent. Other leading sectors were gasoline stations (up 2.5 percent), non-store retailers (up 1.8 percent), motor vehicles (up 1.3 percent), food and beverages (up 1.2 percent) and building materials (up 1.1 percent). Department store sales were the only weak area, down 0.2 percent.

In general, higher retail sales figures match up with other recent economic indicators, including personal spending and consumer confidence data. Even with slowing global growth and uncertainties in regarding the fiscal abyss, Americans remain cautiously positive about the future, evident by modest spending gains. This might seem counterintuitive. However, it appears that consumers have yet to react to the fiscal abyss or other economic pressures, perhaps even discounting them for now.

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