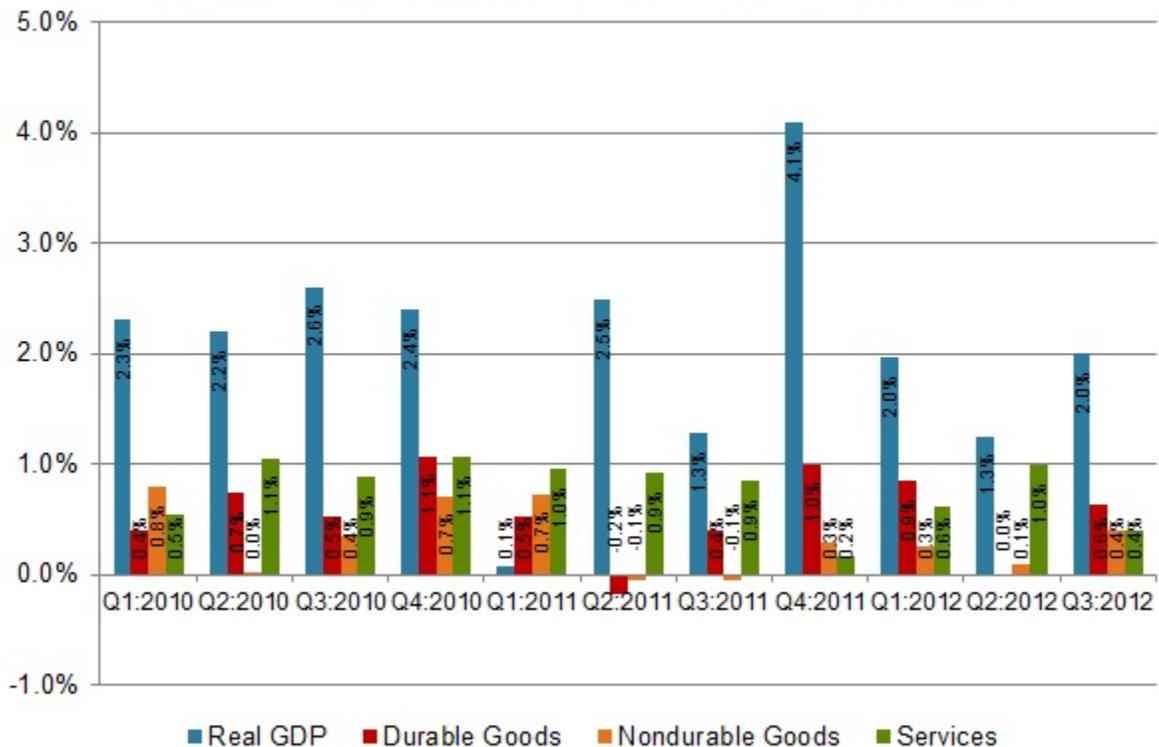




October 29, 2012

Percentage Growth in Real GDP and Contributions to Real GDP of Goods and Services



The U.S. economy grew modestly in the third quarter of 2012, up 2 percent according to the latest data from the Bureau of Economic Analysis. The federal government, housing, and stronger spending on consumer goods helped to boost growth, with durable and nondurable goods contributing half of the increase in real GDP. However, business spending stalled somewhat in the third quarter—in contrast to the second quarter—with building levels off and investment in equipment and software unchanged. In addition, weaker global economic growth has dampened goods exports, providing a drag on the nation's output. In essence, the GDP data provide mixed news for manufacturers as a whole.

Regarding international trade, export volumes are challenged. Flash Purchasing Managers' Index (PMI) data from Markit indicate that Europe's problems continue to deepen. The Eurozone PMI fell from 46.1 in September to 45.3 in October largely on falling sales. Manufacturing employment is also declining, with the largest declines coming outside of France and Germany. Meanwhile, the Chinese economy continues to be weak. Its PMI data, however, are moving in the right direction, up from 47.9 to 49.1. Improvements in new orders, exports and output helped to lift the index, which remains nonetheless in contraction territory. Look for additional details on the international front in the next edition of the NAM's *Global Manufacturing Economic Update*, which will be

released on Friday.

In contrast to Europe and China, U.S. manufacturing has seen some signs of improvement despite continued headwinds. The Markit Flash PMI for the United States increased slightly from 51.1 to 51.3 on some gains in output, employment and inventories. However, new orders eased slightly, and exports continued to fall.

Durable goods orders rose a whopping 9.9 percent in September largely on improved sales in the aerospace sector, but this was mainly a recovery from August's 13.1 percent decline. Volumes are still lower than they were in July. Similarly, the Chicago Federal Reserve Bank's National Activity Index (NAI) improved from -1.17 in August to 0 in September, with manufacturing production providing the largest lift. However, looking at the three-month average, this same index still shows a macroeconomy that is operating below its historical trend.

In short, the U.S. manufacturing sector continues to be weak. On Friday, October 26, the NAM released a study, titled *Fiscal Shock: America's Economic Crisis*. The report found that the fiscal abyss is already impacting the economy, cutting 0.6 percentage points from GDP in 2012. The impacts in 2013 and 2014 will be even more severe, and it could take most of the decade for economic activity and employment levels to recover.

This week, the key highlight will be the employment numbers out on Friday—the last that will be released before the election. I would expect the trend of disappointing non-farm and manufacturing job growth to continue. Aside from hiring reports, we will be looking closely at the Institute for Supply Management's (ISM) PMI on Thursday. Last month, the ISM data surprisingly showed slight growth. Look for the October data to not move too far from its September readings. In addition, this will be a data-rich week, with new data on construction, personal spending, productivity and factory orders.

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Economic Indicators

Last Week's Indicators:

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Monday, October 22

None

Tuesday, October 23

Richmond Fed Manufacturing Survey

Wednesday, October 24

FOMC Policy Statement

Markit Flash Manufacturing PMI (United States, China and Eurozone)

Thursday, October 25

Chicago Fed National Activity Index

Durable Goods

Kansas City Fed Manufacturing Survey

Friday, October 26

Gross Domestic Product

This Week's Indicators:

Monday, October 29

NABE Industry Survey

Personal Income

Texas Fed Manufacturing Survey

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Wednesday, October 31

ADP Employment Report

Employment Cost Index

ISM-Chicago

Thursday, November 1

Construction Spending

ISM Manufacturing Index

Productivity and Costs

Vehicle Sales

Friday, November 2
BLS Employment Report
Factory Orders

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Summaries of Last Week's Economic Indicators

Chicago Fed National Activity Index

The Chicago Federal Reserve's NAI improved from -1.17 in August to 0 in September. A zero value suggests that the U.S. economy is growing along its historical growth trend. This release provides us with only modestly goods news. On the one hand, it suggests that August was a very bad month, as the [original estimate](#) for the NAI was -0.87.

This month's progress was due in large part to gains in production, employment and sales from significantly weaker data the month before. [Industrial production](#) rose 0.4 percent in September after falling 1.4 percent in August. Manufacturing accounted for the largest source of improvement in the NAI. On the employment front, the [unemployment rate](#) dropped from 8.1 percent to 7.8 percent, even with disappointing non-farm payroll growth, especially for manufacturers. Gains in housing and consumer data also helped improve the NAI last month.

However, the three-month moving average remains in negative territory. During the past three months, the moving average was -0.21 (July), -0.53 (August) and -0.37 (September). Clearly, this month's data helped the three-month average, and yet, the U.S. economy continues to operate below its historical trend. Moreover, the headwinds that are pushing the NAI lower are unlikely to be resolved in the next few months, suggesting that it will remain choppy moving forward, at least in the short term.

Durable Goods

The Census Bureau reported that [durable goods orders rose 9.9 percent in September, recovering most of August's 13.1 percent decline](#). There were no new orders for nondefense aircraft and parts in August, which drove the figure sharply lower. In September, nondefense aircraft and parts orders increased from virtually zero to \$14.7 million. Transportation orders overall were up 31.7 percent in September (after falling 33.7 percent in August), with higher defense aircraft orders up (27.2 percent), as well. Motor vehicle orders dropped 0.4 percent.

Excluding transportation, new orders were up 2.0 percent. August's data were mostly down across-the-board. Sales for September improved in some sectors, but were mixed overall. Sectors with the largest gains included machinery (up 9.2 percent), primary metals (up 4.1 percent) and other durables (up 0.6 percent). Sectors that saw declining sales included electrical equipment and appliances (down 2.7 percent), computers and electronic products (down 2.5 percent) and fabricated metal products (down 0.7 percent).

Meanwhile, shipments of durable goods increased 0.8 percent in September, only partially offsetting August's 2.9 percent decrease. Excluding transportation, durable goods shipments were up 0.6 percent. The sector-by-sector shipments data were mixed, mostly falling in-line with the data for new orders. Some exceptions included defense aircraft (down 2.9 percent), fabricated metal products (down 0.4 percent) and machinery (down 0.1 percent).

Even with a large headline increase in durable goods orders in September, the data mostly confirm the weaknesses in manufacturing right now. Both shipments and new orders are below July's levels, and, perhaps more troubling, core capital goods orders (or nondefense capital goods orders excluding aircraft) were unchanged for the month, suggesting an economy that is stalled, at least as far as manufacturers are concerned.

FOMC Policy Statement

The Federal Reserve Board's [Federal Open Market Committee \(FOMC\) made no significant policy changes at its October 23–24 meeting, as expected](#). At its [September meeting](#), the FOMC decided to pursue additional monetary stimulus by purchasing \$40 billion in mortgage-backed securities each month for an undisclosed time

period. This is often referred to as “QE3,” since it is the third round of quantitative easing approved by the Fed. During the meeting, the FOMC also provided guidance suggesting that interest rates would stay “exceptionally low” through mid-2015.

This most recent statement does not stray too far from the earlier one. Where it does deviate is in its description of the current economic environment, noting improvements in housing and consumption but a pickup in pricing pressures. Specifically, it states the following:

Information received since the Federal Open Market Committee met in September suggests that economic activity has continued to expand at a moderate pace in recent months. Growth in employment has been slow, and the unemployment rate remains elevated. Household spending has advanced a bit more quickly, but growth in business fixed investment has slowed. The housing sector has shown some further signs of improvement, albeit from a depressed level. Inflation recently picked up somewhat, reflecting higher energy prices. Longer-term inflation expectations have remained stable.

As with past statements, Jeffrey Lacker, the president of the Richmond Federal Reserve Bank, was the only dissenting vote. Lacker is a well-known “inflation hawk,” and he opposes the expansionary moves made by the FOMC, particularly the statements regarding the length of time to keep interest rates low.

Gross Domestic Product

[The Bureau of Economic Analysis announced that real GDP rose 2.0 percent in the third quarter.](#) This was just slightly above the consensus estimate of 1.8 percent growth and higher than the second quarter’s 1.3 percent increase.

There are three big differences between the second and third quarters. First, consumers—which were more skittish in the second quarter—increased their spending in the third quarter. Other indicators show this as well, including recent data on [retail sales](#) and personal spending.

For manufacturers, this was better news. The contributions from durable and nondurable goods consumption in the second quarter were negligible and disappointing (just 0.08 percent of the 1.25 percentage points of growth). In the third quarter, contributions were 0.63 percent for durable goods and 0.40 percent for nondurables, or 1.03 percent in total. This means that half of the growth in last quarter’s GDP number stemmed from goods consumption, putting manufacturers back on a path of outsized contributions to output (where the sector has been for much of the past three years).

The second difference between the second and third quarters can be seen in service sector consumption and private investment. Both of these were the largest drivers of growth during the second quarter. Service sector consumption added another 0.39 percentage points to growth, a falloff from the 0.99 percent added in the second quarter.

Fixed investments fell from 0.56 to 0.20 percentage points between the quarters. Investment in equipment and software was unchanged, providing no contribution, and construction of new structures fell. Inventories were also lower. One bright spot in this category is residential investment, as we have seen in the latest [housing numbers](#).

Third, the government sector added to the GDP in the third quarter for the first time since the second quarter of 2010. This gain stemmed from the federal government, with defense spending up 13.0 percent and nondefense spending 3.0 percent higher. State and local government spending was down just 0.1 percent, an improvement from previous quarters. Overall, government spending contributed 0.71 percentage points to the GDP.

Outside of the weaker business spending numbers, the other big disappointment involved international trade. Given recent slowness in the global economy and the latest [trade balance](#) data, this was expected. Goods exports were down 3.5 percent in the third quarter, falling faster than the 1.3 percent decline in goods imports. The net result was a negative contribution of 0.18 percentage points to the GDP for the net exports of goods and services.

In summary, today's GDP numbers confirm that the U.S. economy is growing modestly, with 2 percent growth becoming the new normal. Stronger spending on consumer goods, housing and defense lifted the economy from the second quarter's weak 1.3 percent growth rate. Yet, the impact of domestic and global economic headwinds cannot be minimized. Business investment was flat or falling, and goods exports were down. Economic uncertainty continues to hamper growth.

Kansas City Fed Manufacturing Survey

[The Kansas City Federal Reserve Bank reported that manufacturing activity in its district was slower in October, with its monthly composite index down from 2 in September to -4 in October.](#) This was its first negative reading since December. Unlike many other regional sentiment surveys, the Kansas City region saw modest growth up until now. According to Chad Wilkerson, the Federal Reserve Bank's vice president and economist, "We saw factories pull back this month for the first time in a while, which many firms attributed to the impact of the uncertain political and fiscal situation on customers' willingness to order."

Various components of the index were all lower. The index for new orders has dropped from 11 in August to -2 in September to -11 in October. This suggests a high degree of deterioration in sales volumes, with five of the past seven months seeing reductions in new orders. Production, shipments, exports and employment also contracted. The prices paid for raw materials remained elevated, reflecting the pickup in costs seen during the past few months.

Manufacturers in the Kansas City region are also less optimistic about the future than they were last month. The composite index for business activity for six months from now decreased from 16 to 3. Production, shipments, new orders and hiring all remained positive, but with each easing from last month's levels. The average workweek and export sales are expected to decline on average in the coming months. One bright spot is capital spending, with its forward-looking index rising from 11 to 16, suggesting some modest gains in the number of firms planning investments.

Nonetheless, this is another report showing weaknesses in the manufacturing sector, with anxieties about the U.S. and global economies first and foremost in business leaders' minds.

Markit Flash Manufacturing PMI (United States, China and Eurozone)

Markit's latest data show a global economy that remains stalled, even with improvements in some areas. [In the United States, the Flash Manufacturing PMI increased slightly from 51.1 in September to 51.3 in October.](#) This suggests very slow growth in U.S. manufacturing activity, with improvements masking the fact that these indicators reflect considerable weaknesses.

The various index components reflect mixed news. The index for output rose from 50.6 to 51.5, with similar upticks in employment and inventories. On the other hand, the pace of new orders eased slightly, down from 52.3 to 51.6.

New export orders were virtually unchanged in contraction territory, up from 48.0 to 48.1. Slowing sales have been the main driver of either improvements or decline in many of these types of sentiment surveys in recent months, and with weak global economies, export sales have generally been lower. Meanwhile, pricing pressures picked up, which is consistent with other surveys, with the index of input prices rising from 52.8 to 57.6.

Across the Atlantic, Europe's economic woes deepen. [The Flash Eurozone Manufacturing PMI dropped from 46.1 in September to 45.3 in October,](#) bringing it back essentially to where the PMI was in August when it was at 45.1. Steep falls in new orders continue to be the problem, although the rate of decline appears to have eased somewhat from last month. While the challenges are continent-wide, Markit reports that the worst "performance was again seen outside of France and Germany." European employers reduced employment overall, especially in manufacturing.

On a more positive note, the Chinese economy has made some progress in the past month, even as it remains in contraction. [The Flash China Manufacturing PMI rose from 47.9 in September to 49.1 in October,](#) near July's level of 49.3. This is seen as progress, particularly improvements in new orders, exports and output. Yet, each of

these indicators remains below 50—the threshold for expansion in the sector—and the pace of declines in hiring appears to have picked up. This suggests that the Chinese economy continues to be weak, with larger headwinds having an impact even as the October readings show some stabilization.

Richmond Fed Manufacturing Survey

The Richmond Federal Reserve Bank found that manufacturing activity in the region softened again in October. The composite index of general business conditions fell from 4 in September to -7 in October. Last month, the improved figures suggested some progress on the manufacturing front, with the composite index positive after three consecutive months of negative values. That appears to have been short-lived.

New orders, which were positive in September with an index reading of 7, returned to negative territory in October (-6). Poor sales numbers have often been the main driver of these types of sentiment surveys in recent months, and the Richmond Fed is no exception.

In addition to new orders, other components contracting include shipments, capacity utilization and employment. On the latter element, the index for net job hiring has been at -5 for three straight months. Weak sales and production are reducing the desire to bring on new workers, at least for now.

The forward-looking measures remain more upbeat, but with mixed and often reduced expectations for the next six months. Respondents anticipate strong growth in new orders, shipments and capacity utilization, with sales growth below September's forecast (but still high). This reflects a degree of cautious optimism regarding future activity, and, as a result, the index for expected hiring increased slightly. However, some anxiety is still present in these numbers, as capital expenditures are now expected to be flat over the next six months.

Pricing pressures have resurfaced, with raw material prices increasing by 3.21 percent at the annual rate in October, more than double the 1.42 percent growth in input prices reported in September. Future costs are also higher, with the prices paid for raw materials expected to be up 2.55 percent over the next six months. That is an increase from the 1.33 percent forecast noted last month.

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