11 January 2016
Asset management

# SchISM

## Economist Insights

Just one week into 2016 and consensus forecasts for US growth are being challenged by a drop in the ISM manufacturing survey. But while manufacturing is weak, ISM non-manufacturing still looks robust, and this divergence suggests the problem is external weakness. Despite popular perception, manufacturing does not always lead non-manufacturing. But in any case, neither survey is weak enough to suggest recession.

**Joshua McCallum**
Head of Fixed Income Economics
UBS Asset Management
joshua.mccallum@ubs.com

**Gianluca Moretti**
Fixed Income Economist
UBS Asset Management
gianluca.moretti@ubs.com

There is something about the beginning of the calendar year that makes people want to prognosticate about the future. This persists, despite the consistent failure of such prognostications in recent years. Once again, 2015 showed consensus forecasts for growth in the US (and China) to have been too optimistic at the start of the year. Just as in previous years, these were substantially revised down as the year progressed (see *Functional Forecasts*, 12 January 2015). Forecasts for US growth this year have started out more modestly, but are already being challenged by a drop in one of the most important leading indicators.

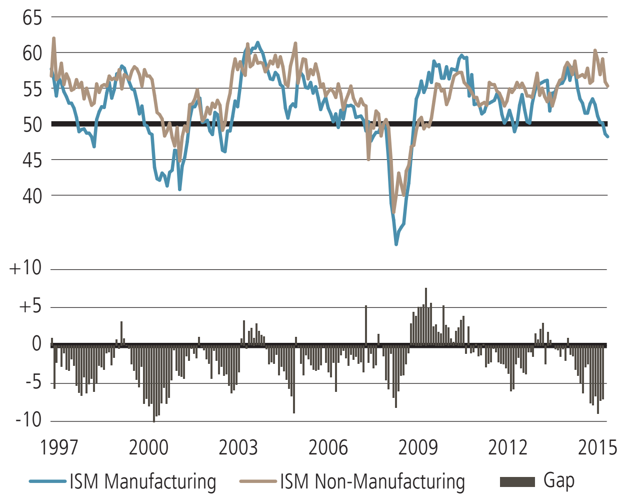
The ISM manufacturing PMI has a long and hallowed role as an early indicator of the health of the US economy. For a long time it has been one of the news releases that triggers the biggest market reaction, beaten only by the likes of the labor market report (which, ironically, is a lousy leading indicator). Investors still watch it very closely.

Back in the 1960s and 1970s not only was manufacturing a larger part of the economy, it was before the advent of just-in-time processing. Inventories often ran too high during booms and then too low during recessions, so manufacturing swung around wildly with the economic cycle. This made manufacturing even more cyclical, and hence a far better leading indicator of the cycle.

Since then, the service sector has become much more important and it now represents almost 80% of the private sector economy. In 1997 the ISM non-manufacturing survey was created to capture the changing composition of the economy. At times the surveys have moved together, (chart 1) often with manufacturing leading by a month or more. For example, the ISM manufacturing led on the way down in 2000. But then sometimes the ISM non-manufacturing has led, as in 2009, signalling the start of recovery. So at times they diverge, yet very rarely has that divergence been as large as it has been of late.

**Chart 1: Performing and non-performing**

ISM surveys, diffusion indices where 50 is neutral




Source: Institute of Supply Management

International trade is relatively more important for manufacturers, especially the larger manufacturers that are likely to respond to surveys like the ISM. But the service sector is geared far more towards the domestic economy. So it could be that the convergence or divergence of the surveys is telling us a lot about whether the shocks hitting the economy are external or domestic. The distinction is important: there is no historical pattern of how the two surveys re-converge after such a divergence. Sometimes the ISM non-manufacturing follows the manufacturing down, at other times the reverse occurs, and sometimes they meet in the middle.

In 2001 the bursting of the tech bubble was a domestic shock that hit both manufacturing and services. As did the financial crisis in 2008. But the recent divergence points far more to an external shock. There are some obvious culprits. Firstly there is the strength of the USD, which makes US exports more expensive, and manufacturers will find it harder to compete against cheaper imports from overseas. On top of that, the slowing in many external markets, especially emerging markets, means that demand for exports is lower even if the USD had not appreciated. But none of this has much effect on the service sector. If anything, cheaper imports reduce costs for the service sector (especially retail).

Low oil prices may also explain some of the divergence. For non-manufacturing, lower oil prices are pretty unambiguously positive. Cheaper energy costs reduce production costs, and lower gasoline prices mean consumers have more money in their pocket. While these factors should also help manufacturing there are some offsetting factors. Low oil prices have been bad, not just for the shale gas and wider energy industry, but also for producers of machinery for that industry (rigs, pipelines, tankers, etc.). Even if we cannot be sure whether the drop in oil prices is net positive or negative for US manufacturing at the moment, it does help explain why the divergence between the surveys should be so large.

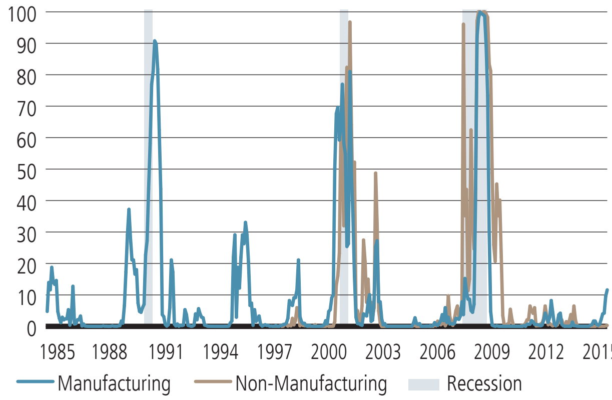
Nonetheless, the ISM manufacturing survey is signalling outright contraction (it is below 50). Does that mean a recession is imminent? Not necessarily. And statistically not even likely. While the ISM manufacturing survey is correlated with GDP, it takes a much lower reading to signal a recession. Manufacturing is a small part of the economy, and at any one time some sector of the economy can be contracting without the whole economy shrinking.

The statistically implied probability of a recession, based on ISM manufacturing, is just 11% (chart 2). The ISM non-manufacturing disagrees and places the probability at 0%.

Should this make us overly confident? Not necessarily; in the past the probabilities have often been low right before a recession. But that requires a new shock. In fact, it is more often that an implied probability of 11% is a false alarm. The ISM manufacturing has given at least six readings of this level that did not lead to recession.

**Chart 2: Bad but not that bad**

Probability of recession implied by ISM surveys (manufacturing since 1985, non-manufacturing since 1997) %




Source: ISM, NBER, UBS Asset Management.
Note: Probit regression against NBER defined recessions, concurrent readings.

Neither survey is a clearly better predictor. In the 2001 tech bubble the ISM manufacturing actually flagged recession before it started, and it took non-manufacturing a bit of time to catch up. But then in 2008 it was non-manufacturing that raised the alarm while manufacturing took many months to catch up. This reflects the fact that the first shock was more manufacturing based while the second was services based (finance and housing).

What can investors take from this? For a start, it is important to understand what the surveys are telling us about the nature of the stresses hitting the US economy. There is an external shock to manufacturing that is persisting, while the domestic economy is doing well. For one thing, that suggests that final domestic demand (which excludes imports and exports) will be stronger than overall GDP. The inventory cycle that started late summer (see *Inventive Story*, 23 November 2015) is taking a lot longer than anyone would have thought, so that will be another drag on overall GDP. But unless the US domestic sector faces some other shocks (like too rapid tightening of financial conditions), it looks more likely that the schism in the ISMs will be healed by an improvement in manufacturing.