U.S. Economic Comment

- The manufacturing sector: ISM overstating the degree of softening
- Average hourly earnings: softness concentrated in supervisory positions

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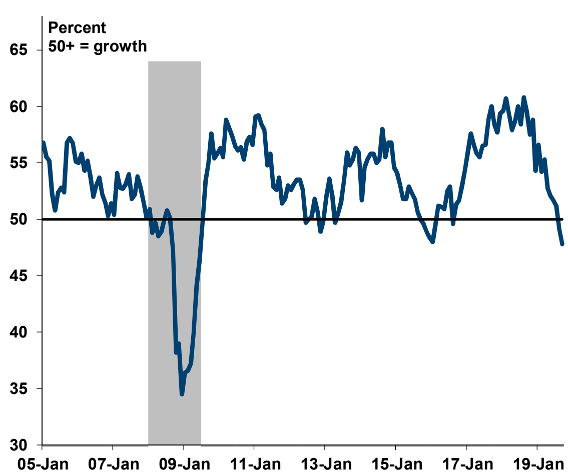
Manufacturing: In Retreat or Steady?

The manufacturing index published by the Institute for Supply Management (ISM) captured the attention of market participants this week, as the measure fell further in September from an already soft reading in the prior month. The observations for both August and September were below the critical value of 50 percent, and the latest reading of 47.8 percent was the lowest since June 2009, which was the trough of the Great Recession (although the reading of 48.0 percent in January 2016 was close to the latest tally; chart, left). Against a background of heightened economic and political uncertainty, many investors and traders see the swoon as a sign of a faltering economy.

Other indicators related to the manufacturing sector paint a different picture. For example, order flows are holding their own. Bookings for durable goods have a downward tilt, but soft results in the aircraft category because of issues at Boeing are playing a role. Durable orders ex-transportation, while no longer advancing after gains in 2017 and much of 2018, are holding steady. Results in the nondurable area are more encouraging, as orders excluding petroleum and coal have increased for five consecutive months and have broken out of a sideways trend (chart, right). We doubt that such a spurt would occur if this sector were sliding into recession.

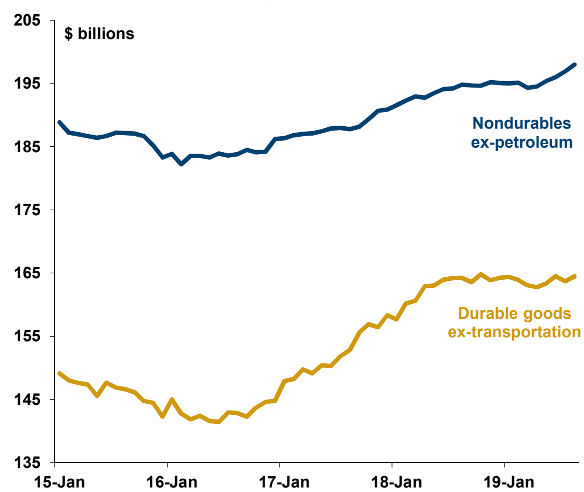
The latest employment report also points to a less-than-dire situation. Manufacturing employment fell in September, but the change was modest and followed gains in the prior five months (chart, next page). The average monthly payroll gain of 5,000 so far this year is shy of the 22,000 from last year, but manufacturers have been adding workers on balance rather than trimming.

ISM Manufacturing Index*



* *The shaded areas indicate periods of recession in the U.S. economy.*
Source: Institute for Supply Management and National Bureau of Economic Research via Haver Analytics

Manufacturers' New Orders



Source: U.S. Census Bureau via Haver Analytics

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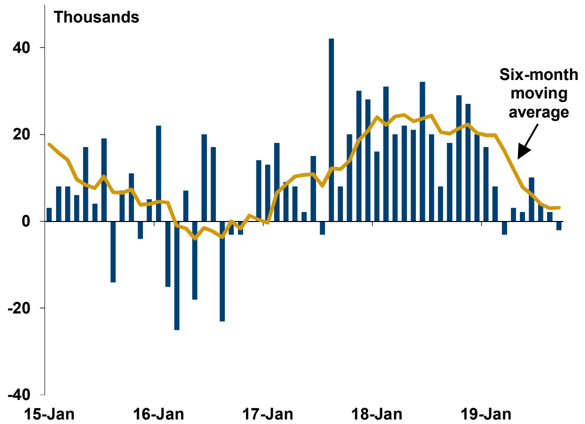
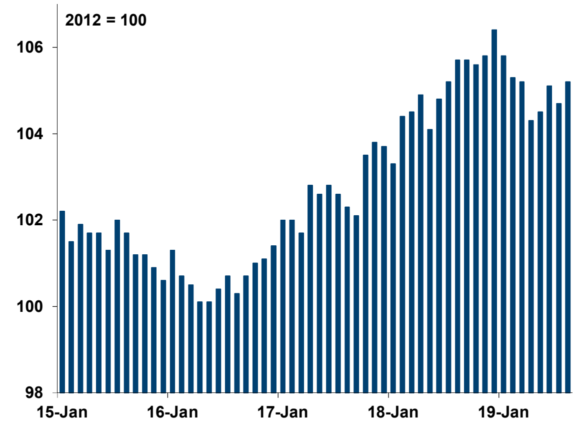
Change in Manufacturing Payrolls



Source: Bureau of Labor Statistics via Haver Analytics

Industrial Production: Manufacturing



Source: Federal Reserve Board via Haver Analytics

Another indicator -- the manufacturing component of the Federal Reserve's industrial production index -- is perhaps the best gauge of conditions in the factory sector, as it shows what firms have produced. This measure fell in the early months of the year, but it has retraced some of that lost ground with increases in three of the past four months (chart, right). The ups and downs registered this year are not sharply out of line with the ebb and flow that is common for this indicator.

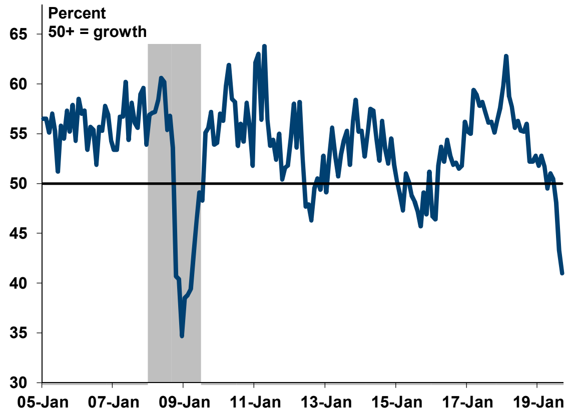
Against this background, we are inclined to downplay the significance of the retreat in the ISM index. In fact, we generally give this index less weight than we do to other measures because it is not necessarily based on hard economic data; rather, it largely reflects the impressions and attitudes of purchasing managers. Respondents to the survey undoubtedly monitor economic and political developments, and the tone of the news flow could influence their responses. In the current environment, several factors could be leading to a negative bias in responses: the trade war, talk of slower economic growth around the world, and various geopolitical uncertainties.

Even if purchasing managers used hard data to form their answers, the limited choices in their responses lessen the insight from the survey. That is, respondents have only three possible replies to the survey questions: conditions are better, the same, or worse. The recent surveys have shown a distinct pickup in the number of responses indicating that conditions have worsened, but it is not clear if activity has slowed fractionally or substantially. Thus, the index provides useful information on the direction of change, but it is not well suited for assessing the magnitude of change. The results from recent reports on orders, employment, and production lead us to suspect that the shifts sensed by purchasing managers, while in the downward direction, have not been pronounced.

The detail of the ISM report suggested that the trade war was an important factor behind the recent soft readings. Specifically, the index for export orders has declined in the past four months (and in six of the past seven), moving to 41.0 percent, a level last seen during the depths of the Great Recession (chart, next page).

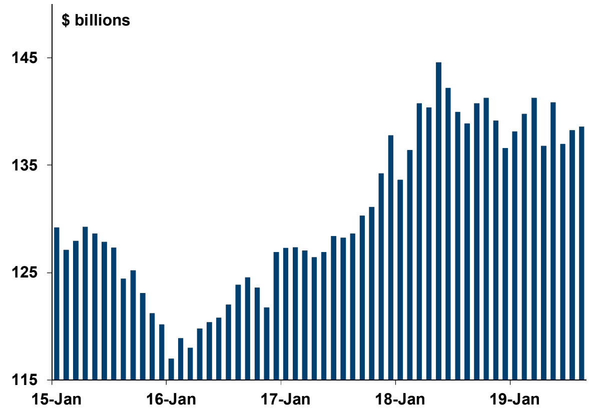
This pronounced move supports the view that the ISM report is useful for indicating direction of change, but it does not provide good insight into the magnitude of change. The combination of the trade war and slow growth abroad has led to a softening in U.S. exports of goods, but the recent trend is best described as a downward drift (chart, next page). Certainly, the drop in exports in no way resembles the movement in the ISM export index. Of course, the ISM index relates to orders for export, and thus actual shipments could soften in the months ahead. However, the ISM export index has been moving sharply lower since the spring of 2018, and actual exports have not matched this pattern.

ISM Manufacturing: New Export Orders Index*



** The shaded areas indicate periods of recession in the U.S. economy.*
Source: Institute for Supply Management and National Bureau of Economic Research via Haver Analytics

Exports of Goods



Source: Bureau of Economic Analysis via Haver Analytics

Our view is that the ISM manufacturing index is not sending reliable signals on the economy's performance at this time; it is overstating the degree of softening.

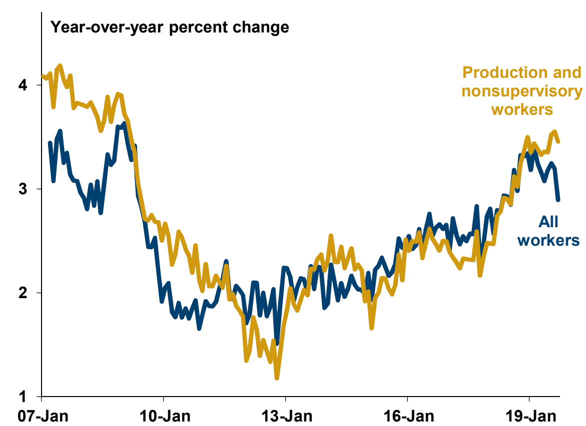
Average Hourly Earnings

The latest employment report was generally favorable: employment growth was respectable (up 136,000 in September with upward revisions totaling 45,000 in July and August), the unemployment rate fell two ticks to 3.5 percent, and the length of the average workweek remained comfortably within its recent range. The change in average hourly earnings, in contrast, was disappointing. The measure was flat in September (down slightly if rounded to more than one decimal point: -0.036 percent), which left year-over-year growth at 2.9 percent, down from 3.2 percent in August and a cyclical high of 3.4 percent in February (chart, blue line).

We are tempted to view the soft result as statistical noise -- payback for increases of 0.3 percent in the four preceding months. However, mere payback would not lead to the notable deceleration in the year-over-year change. Alternatively, a compositional shift in employment growth might be a factor. This measure is not fixed-weight, and thus rapid growth in low-wage areas or slow growth in high-wage sectors could result in a restrained change in the "average" wage. However, the industry breakdown of job growth did not show meaningful deviations from recent averages. Thus, we are left to conclude that the results might be signaling a soft patch in wage growth. In this regard, wage growth in the past several months has lagged results in late 2018.

The situation is less troubling if one focuses on average hourly earnings of production workers -- that is, excluding managerial and supervisory positions. Wage growth in this group rose 0.2 percent in September and year-over-year growth eased only slightly from the reading in August (and remained above results in late 2018; chart, gold line). Politicians and Fed officials have focused intently in recent years on the distribution of income and have been seeking to share the gains from economic growth more evenly across the population. From this perspective, average hourly earnings are showing continued progress, although here too gains are slower than they were from 2016 through 2018.

Average Hourly Earnings



Source: Bureau of Labor Statistics via Haver Analytics

Review

Week of Sept. 30, 2019	Actual	Consensus	Comments
ISM Manufacturing Index (September)	**47.8% (-1.3 Pct. Pts.)**	**50.0% (+0.9 Pct. Pt.)**	The ISM index for September again signaled weakness in the manufacturing sector, as the measure moved to its lowest level since the 46.3% reading in June 2009. The new orders component remained soft, as the increase of 0.1 percentage point was inconsequential and the level of the measure was low at 47.3%. Within the orders realm, the index of new export orders fell 2.3 percentage points to 41.0% and was the weakest reading among all the measures included in the report. The soft results on the export front suggest that the trade war is influencing the manufacturing sector. With order flows soft, production retreated, with this component dropping 2.2 percentage points to 47.3%. The employment index also was weak, falling 1.1 percentage points to 46.3%.
Construction Spending (August)	**0.1%**	**0.5%**	A drop of 1.0% in the business sector restrained overall construction activity in August, with the decline adding to the irregular downward trend that began last fall. Offsetting the weakness in the business sector, government-sponsored construction advanced 0.4%, continuing a firm performance that has been in place throughout the year. Private residential activity also provided an offset, as it rose 0.9% after a gain of 0.6% in July. The recent changes in residential activity interrupted a downward trend that had been in place since early 2018, although the offset has been modest.
Factory Orders (August)	**-0.1%**	**-0.2%**	New orders for durable goods rose 0.2% (published last week), restrained by bookings in the volatile transportation category (bookings for both aircraft and motor vehicles fell). Orders for durable goods excluding transportation rose 0.5%, offsetting nearly all of the drop in the prior month and preserving the flat trend that has been in place since late last year. New orders for nondurable goods slipped 0.3%, with most of the decline reflecting a drop of 3.6% in the petroleum and coal category, which was heavily influenced by lower prices. Nondurable orders ex-petroleum and coal rose 0.6%, which marked the fifth consecutive advance. This series had been moving sideways, but it has improved considerably in recent months.

Review Continued

Week of Sept. 30, 2019	Actual	Consensus	Comments
ISM Nonmanufacturing Index (September)	**52.6% (-3.8 Pct. Pts.)**	**55.0% (-1.4 Pct. Pts.)**	The drop in the ISM nonmanufacturing index in September continued the downward trend that began late last year and moved the measure to the low portion of the recent range. Both the new orders and business activity components contributed importantly to the drop in September, as both fell more than six percentage points. The levels of these measures were elevated in August (both above 60%), and thus the new readings could still be viewed as respectable (53.7% for orders and 55.2% for business activity), but the month-to-month declines were notable. The employment index also was soft, falling 2.7 percentage points to 50.4%.
Payroll Employment (September)	**136,000**	**145,000**	The increase in nonfarm payrolls for September trailed the average of 157,000 in the prior six months, but results for July and August were revised upward by 45,000. The combination of the September advance and the revisions represented a respectable performance. The unemployment rate provided a pleasant surprise with a drop of 0.2 percentage point to 3.5%. Moreover, the decline was a “strong” one; that is, employment as measured by the household survey was stronger than the increase in the size of the labor force (391,000 versus 117,000). Average hourly earnings were flat in September, a surprise and a disappointment. The change left the year-over-year increase at 2.9%, down from 3.2% in the prior month and a cyclical high of 3.4% in February. The softness seemed concentrated in supervisory or managerial positions, as the results among production workers were better (up 0.2% in September and 3.5% in the past 12 months).
Trade Balance (August)	**-$54.9 Billion ($0.9 Billion Wider Deficit)**	**-$54.5 Billion ($0.5 Billion Wider Deficit)**	Both exports and imports rose in August, but the change in imports was larger (0.5% versus 0.2%), and the trade deficit widened slightly as a result. The increases on both sides of the ledger were mildly encouraging, as they suggested that the trade war was not leading to marked retrenchment in international dealing. The real trade deficit in goods widened slightly in August, which left the average shortfall so far in Q3 a bit wider than that in Q2. The data suggest that net exports will be a mild drag on economic growth in the third quarter, probably less than one-quarter percentage point.

Source: Institute for Supply Management (ISM Manufacturing Index, ISM Nonmanufacturing Index); U.S. Census Bureau (Construction Spending, Factory Orders); Bureau of Labor Statistics (Payroll Employment); Bureau of Economic Analysis (Trade Balance); Consensus forecasts are from Bloomberg

Preview

Week of October 7, 2019	Projected	Comments
PPI (September) (Tuesday)	**0.0% Total, 0.1% Core***	Lower gasoline prices are likely to constrain the energy component, which should more than counter an increase in food prices after a drop in August. Prices of core goods are likely to remain on the soft trend that has been evident in the past seven months (no net change in the past four months and increases of only 0.1% in each of the three months before that). The volatile services component should be calm after firm increases in two of the prior three months, but surprises in this area are common.
CPI (September) (Thursday)	**0.1% Total, 0.2% Core**	Gasoline prices fell in September, although other energy items (fuel oil, natural gas, electricity) could provide partial offsets. Food prices are likely to remain subdued for the fourth consecutive month after surprising upward pressure from December through May. Core prices should settle after jumps of 0.3% in each of the prior three months, which reflected in part idiosyncratic changes (such as rare increases in computer prices).
Federal Budget (September) (Thursday) (Possibly Postponed)	**$65.0 Billion Surplus**	September typically involves strong revenue flows because of estimated tax payments by corporations and individuals, which usually leaves a monthly budget surplus. Available data suggest that receipts this year were exceptionally strong (up approximately 11% from the same month last year). Outlays are likely to be substantially larger than the total from September 2018, but the jump reflects unusually light expenditures last year associated with a calendar configuration that moved some Social Security and Medicare spending from September to August. The expected surplus, if realized, would leave the budget for fiscal year 2019 at $1,002 billion.
Consumer Sentiment (October) (Friday)	**92.0 (-1.3%)**	Suggestions of slower economic activity and the retreat in the equity market are likely to dampen consumer sentiment. Extensive media coverage of impeachment proceedings may have had a negative influence as well.

** The core PPI excludes food, energy, and trade services.*

Source: Forecasts provided by Daiwa Capital Markets America

Economic Indicators

September/October 2019

Monday	Tuesday	Wednesday	Thursday	Friday
30	1	2	3	4
CHICAGO PURCHASING MANAGERS' INDEX Index / Prices July 44.4 / 56.1 Aug 50.4 / 59.8 Sept 47.1 / 57.3	**ISM INDEX** Index / Prices July 51.2 / 45.1 Aug 49.1 / 46.0 Sept 47.8 / 49.7 **CONSTRUCTION SPEND.** June -0.9% July 0.0% Aug 0.1% **VEHICLE SALES** July 16.9 million Aug 17.0 million Sept 17.2 million	**ADP EMPLOYMENT REPORT** Private Payrolls July 143,000 Aug 157,000 Aug 135,000	**INITIAL CLAIMS** Sept 14 210,000 Sept 21 215,000 Sept 28 219,000 **FACTORY ORDERS** June 0.5% July 1.4% Aug -0.1% **ISM NON-MFG INDEX** Index / Prices July 53.7 / 56.5 Aug 56.4 / 58.2 Sept 52.6 / 60.0	**EMPLOYMENT REPORT** Payrolls / Un. Rate July 166,000 / 3.7% Aug 168,000 / 3.7% Sept 136,000 / 3.5% **TRADE BALANCE** June -$55.5 billion July -$54.0 billion Aug -$54.9 billion
7	8	9	10	11
CONSUMER CREDIT (3:00) June $13.8 billion July $23.3 billion Aug --	**NFIB SMALL BUSINESS OPTIMISM INDEX (6:00)** July 104.7 Aug 103.1 Sept -- **PPI (8:30)** Final Demand / Core* July 0.2% / -0.1% Aug 0.1% / 0.4% **Sept 0.0% / 0.1%**	**JOLTS DATA (10:00)** Openings (000) / Quit Rate June 7,248 / 2.3% July 7,217 / 2.4% Aug -- / -- **WHOLESALE TRADE (10:00)** Inventories / Sales June -0.1% / -0.3% July 0.1% / 0.3% **Aug 0.4% / 0.2%** **FOMC MINUTES (2:00)**	**INITIAL CLAIMS (8:30)** **CPI (8:30)** Total / Core July 0.3% / 0.3% Aug 0.1% / 0.3% **Sept 0.1% / 0.2%** **FEDERAL BUDGET (2:00) (POSSIBLY POSTPONED)** 2019 / 2018 July -$119.7B / -$76.9B Aug -$200.3B / -$214.1B **Sept $65.0B** / $119.1B	**IMPORT/EXPORT PRICES (8:30)** Non-fuel Imports / Nonagri. Exports July 0.0% / 0.2% Aug 0.0% / -0.4% Sept -- / -- **CONSUMER SENTIMENT (10:00)** Aug 89.8 Sept 93.2 **Oct 92.0**
14	15	16	17	18
COLUMBUS DAY	**EMPIRE MFG INDEX**	**RETAIL SALES** **NAHB HOUSING INDEX** **BUSINESS INVENTORIES** **BEIGE BOOK** **TIC DATA**	**INITIAL CLAIMS** **HOUSING STARTS** **PHILLY FED INDEX** **IP & CAP-U**	**LEADING INDICATORS**
21	22	23	24	25
	EXISTING HOME SALES	**FHFA HOME PRICE INDEX**	**INITIAL CLAIMS** **DURABLE GOODS ORDERS** **NEW HOME SALES**	**REVISED CONSUMER SENTIMENT**

*Forecasts in Bold. * The core PPI excludes food, energy, and trade services.*

Daiwa Capital Markets

Treasury Financing

September/October 2019

Monday	Tuesday	Wednesday	Thursday	Friday
30	1	2	3	4
AUCTION RESULTS: Rate / Cover 13-week bills 1.840% 2.49 26-week bills 1.795% 2.83 **SETTLE:** $12 billion 10-year TIPS $40 billion 2-year notes $41 billion 5-year notes $32 billion 7-year notes	**ANNOUNCE:** $45 billion 4-week bills for auction on October 3 $40 billion 8-week bills for auction on October 3 **SETTLE:** $45 billion 4-week bills $40 billion 8-week bills		**AUCTION RESULTS:** Rate / Cover 4-week bills 1.750% 2.90 8-week bills 1.710% 2.86 **ANNOUNCE:** $87 billion 13-,26-week bills for auction on October 7 $28 billion 52-week bills for auction on October 8 $38 billion 3-year notes for auction on October 8 $24 billion 10-year notes for auction on October 9 $16 billion 30-year bonds for auction on October 10 **SETTLE:** $87 billion 13-,26-week bills	
7	8	9	10	11
AUCTION: $87 billion 13-,26-week bills	**AUCTION:** $28 billion 52-week bills $38 billion 3-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on October 10 $40 billion* 8-week bills for auction on October 10 **SETTLE:** $45 billion 4-week bills $40 billion 8-week bills	**AUCTION:** $24 billion 10-year notes	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $16 billion 30-year bonds **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on October 15 $17 billion* 5-year TIPS for auction on October 17 **SETTLE:** $87 billion 13-,26-week bills $28 billion 52-week bills	
14	15	16	17	18
COLUMBUS DAY	**AUCTION:** $87 billion* 13-,26-week bills **ANNOUNCE:** $45 billion* 4-week bills for auction on October 17 $40 billion* 8-week bills for auction on October 17 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills $38 billion 3-year notes $24 billion 10-year notes $16 billion 30-year bonds		**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $17 billion* 5-year TIPS **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on October 21 $20 billion* 2-year FRNs for auction on October 23 $40 billion* 2-year notes for auction on October 22 $41 billion* 5-year notes for auction on October 23 $32 billion* 7-year notes for auction on October 24 **SETTLE:** $87 billion* 13-,26-week bills	
21	22	23	24	25
AUCTION: $87 billion* 13-,26-week bills	**AUCTION:** $40 billion* 2-year notes **ANNOUNCE:** $45 billion* 4-week bills for auction on October 24 $40 billion* 8-week bills for auction on October 24 **SETTLE:** $45 billion* 4-week bills $40 billion* 8-week bills	**AUCTION:** $20 billion* 2-year FRNs $41 billion* 5-year notes	**AUCTION:** $45 billion* 4-week bills $40 billion* 8-week bills $32 billion* 7-year notes **ANNOUNCE:** $87 billion* 13-,26-week bills for auction on October 28 **SETTLE:** $87 billion* 13-,26-week bills	

**Estimate*