

AEGON INSIGHTS

Macro Musings: Interpreting the Softening in Manufacturing

The River Is Running Low Upstream: Two recent manufacturing surveys—one from the Institute for Supply Management and the other from the Dallas Federal Reserve—give us a good indication as to the level of upstream activity. While the Federal Reserve Bank of Dallas' Texas Manufacturing Outlook report¹ on Monday showed quite a dismal outlook for manufacturing activity in that region, we wanted some corroboration before making a big deal about it. To use a Texas saying, we wanted to make sure the Dallas survey wasn't "All hat and no cattle."

Well, Wednesday's national manufacturing ISM² report definitely had some cattle to it. While the headline declined and remained under 50 (signaling contraction) it was both the broad level of weakness and the negative tone in the commentary that stuck out. This dovetails with the comments in the Dallas Fed Survey, which were decidedly negative by about a 4 to 1 margin. To us, this marks a noticeable shift upstream.

Snippets from Respondents: Yes, there were some positive comments, but they were way, way less in number. The comments below mark a noticeable negative shift upstream:

- **Chemical Manufacturing:**
 - **Dallas Survey:** "Limited Optimism."
 - **ISM Survey:** "Economy is absolutely slowing down. Less optimism regarding the first quarter of 2024."
- **Computer & Electronic Manufacturing:**
 - **Dallas Survey:** "Overall customer projections are said to be up for 2024, but our forecasts don't match and are down."
 - **ISM Survey:** "Markets remain tough."
- **Fabricated Metal Product Manufacturing:**
 - **Dallas Survey:** "We are seeing a pronounced slowdown in orders going forward."
- **Food Manufacturing:**
 - **Dallas Survey:** "Food service demand is soft. Retail (grocery) demand has remained steady. Our premium pet food business has fallen off significantly."
 - **Dallas Survey:** "We have experienced a small reduction in our workforce over the last several weeks."
 - **ISM Survey:** "Markets appear to have slightly slowed."



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Frank Rybinski, CFA, is head of macro strategy responsible for guiding the firm's global macroeconomic view as it pertains to tactical and strategic asset allocation. This includes analysis of the economy, interest rates, and the relative value between asset classes. In this capacity, Frank frequently appears in leading financial media outlets like Bloomberg, CNBC, Fox Business and the Wall Street Journal. Prior to his current role, Frank was a credit strategist for UBS Investment Bank. Prior to that, he worked as an analyst for ZT Zurich Trust in Zurich, Switzerland. Frank began his career as a trader for Spear, Leeds & Kellogg and held a similar position at The Royal Bank of Scotland. He has been in the industry since 1996 and started with the firm in 2008. Frank received his BA in economics from Boston College. He is a CFA® charterholder.

¹Texas Manufacturing Outlook Survey, Federal Reserve Bank of Dallas, October 30, 2023.

²October 2023 Manufacturing ISM Report on Business, Institute for Supply Management, November 1, 2023.

- **Machinery Manufacturing:**
 - **Dallas Survey:** "Business has slowed down significantly; we see no signs of improvement in business activity."
 - **Dallas Survey:** "Six months from now is actually quite scary."
 - **Dallas Survey:** "We just lost another long-time customer to China *where the pricing for the finished product was what we pay for the raw material*. With the inflation we have being imposed on us here in the U.S., we won't ever see those customers come back."
 - **Dallas Survey:** "We are off by 20 percent this year so far. I don't expect it to get better."
 - **ISM Survey:** "Seeing a slowdown on bookings, and our backlog is down to 5 days from 15 weeks earlier this year."
- **Miscellaneous Manufacturing:**
 - **Dallas Survey:** "In a consumer business, we are hearing a lot more "I can't afford this" than we ever have before."
- **Paper Manufacturing:**
 - **Dallas Survey:** "Activity is definitely slowing down."
- **Primary Metal Manufacturing:**
 - **Dallas Survey:** "The economy is slowing."
 - **ISM Survey:** "A slow 4Q, and we're clearly in a mild industry recession."
- **Printing & Related Support Activities:**
 - **Dallas Survey:** "Quote levels are way down, which is a bad indicator of what's to come.... We are trending into a softer economy that is going to have repercussions for our industry for a while."
- **Textile Product Mills:**
 - **Dallas Survey:** "The general consensus among other manufacturers/sellers is that demand/sales are weak, and no one is sure what the short-term future holds."
- **Transportation Equipment Manufacturing:**
 - **Dallas Survey:** "We are currently forecasting a 20% drop in 2024, so the market forecast has worsened over the month."
 - **ISM Survey:** "Backlog is starting to dip a bit. We're hearing of cutbacks in 2024 orders."

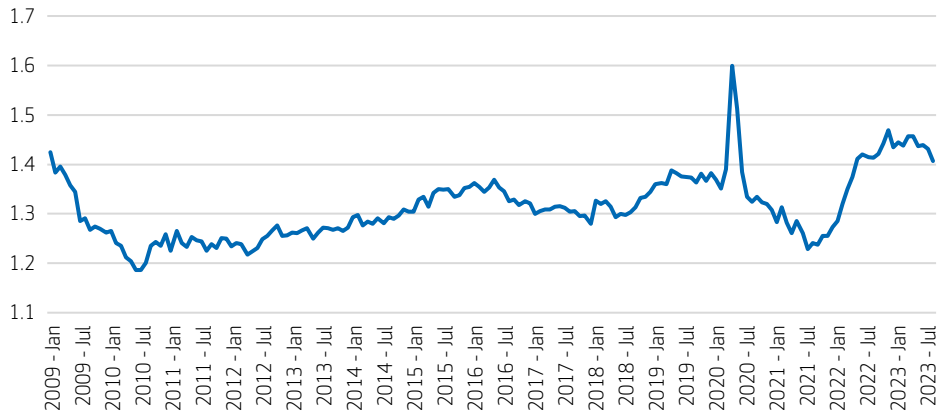
The merchant wholesale inventory to sales ratio is at multi-decade peak levels (outside of recessions).

This was part of the catalyst behind the Atlanta Fed downgrading its 4Q23 GDP Nowcast on Wednesday from 2.3% to 1.2%. While we are very wary of Nowcasts, especially this early in the quarter, it's the direction and magnitude of the change that we find interesting.

Christmas bargains on the Horizon?

Today's ISM report showed upstream inventories remain low. However, that is because product has been pushed into the mid-stream portion of the chain, which is now quite full. Specifically, the merchant wholesale inventory to sales ratio is at multi-decade peak levels (outside of recessions).

Exhibit 1: Inventories/sales ratio: Merchant wholesale trade industries, seasonally adjusted



Sources: Census Bureau, Haver Analytics

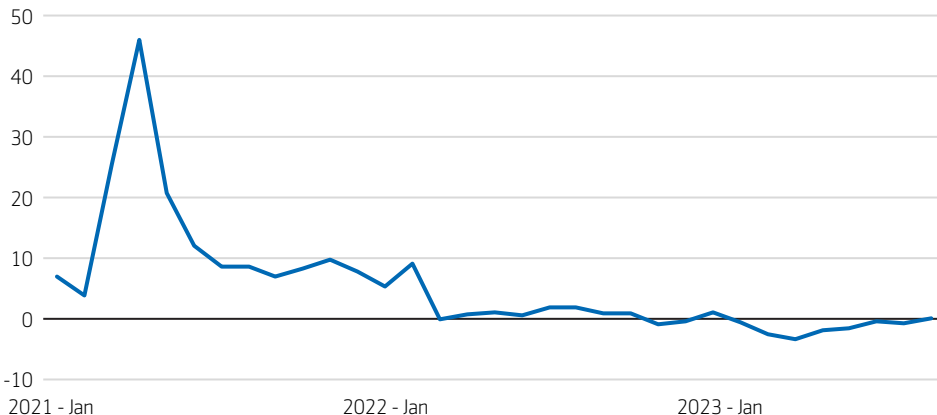
Further downstream at the retail level, inventories have recovered and have been oscillating in a range, as retailers actively manage the lack of real retail customer demand.

Exhibit 2: Inventories/sales ratios: Total retail, excluding motor vehicles & parts dealers, seasonally adjusted



Sources: Census Bureau, Haver Analytics

Exhibit 3: Real retail sales and food services: % change year to year, seasonally adjusted, 1982-1984 dollars

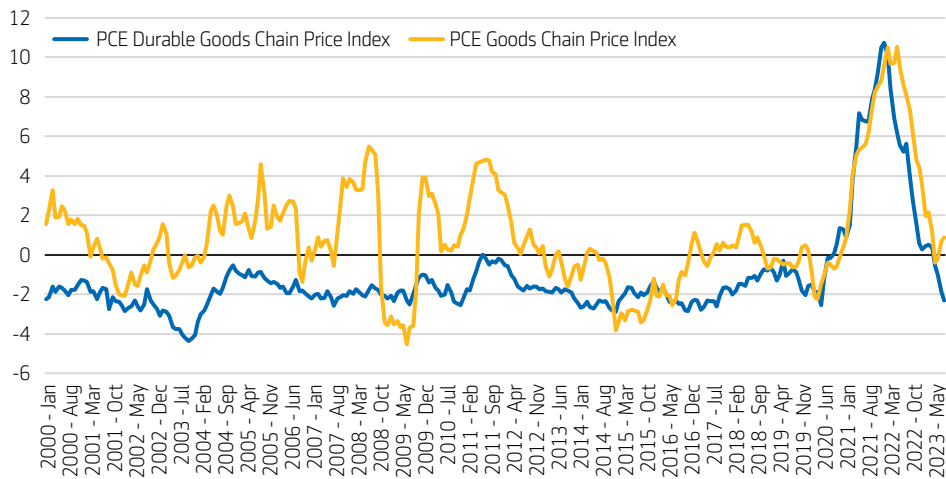


Sources: Census Bureau, Bureau of Labor Statistics, Haver Analytics

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What does it all mean? Typically, merchant wholesalers react to bloated inventories by cutting prices to move product. Retailers make room for new product by discounting older products. A generalization for sure, but the broader point is that a disinflationary impulse may be coming to store near you (if it hasn't already).

Exhibit 4: Personal Consumption Expenditures Price Index: % change year to year, seasonally adjusted 2017=100



Sources: Census Bureau, Haver Analytics

Macro Takeaway

When all piled together, Manufacturing and Retail Sales of goods account for about 30% of the US economy. Manufacturing is clearly slowing and the goods inventory bloat is going to keep goods in disinflation for a while.

Services are a much larger side of the economy and, if it eventually follows suit, it may finally help the Federal Reserve achieve a better balance in the labor market, a precursor to the Fed softening their policy stance in the direction towards the ever-elusive dovish pivot. Until then ...

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