ISM: The Devil's in the Details

6th May 2021

Summary

- **The drop in the headline Manufacturing ISM Index suggests activity has peaked**
- **But in reality, the weakness is a function of input shortages, not weak demand**
- **Customer inventory and order backlogs suggest demand will remain robust into 2022**
- **Wages and input costs are a real problem. To offset margin pressures, prices must rise**

As you know, we at MI2 are huge fans of PMI reports. Very simply, the level of forward insight and granularity they provide on economies is hard to beat. In that regard, our favourite survey is the ISM Manufacturing Survey. This may seem a little odd given that the US economy is dominated by the service sector. However, as we have discussed elsewhere, unlike policymakers who often focus on the level of activity, markets tend to trade on the first derivative of activity, the rate of change. So, despite its relatively diminutive share of GDP, manufacturing is disproportionately important because it is subject to the two most volatile underlying cycles; the capex and inventory cycles. Bottom line, 90% of the time, if you get the direction of manufacturing right, you have a jump start on the whole of the economic cycle. Given this, it is fair to say that after years of parsing thousands of PMIs, it takes a lot to surprise us. Yet that's exactly how we feel about a recent interview from Tim Fiore, the Chairman of ISM Manufacturing, which contains some amazing insights into issues such as labour demand, wage costs, whether firms will pass on prices etc. To facilitate the flow, we have placed Tim's original comments in a Q&A format using our questions.

After Monday's four-point drop in the headline index to 60.7, some observers suggested this was a sign that the economic recovery is peaking. Before we move on to Mr Fiore's comments, we would like to add our own quick reminder. PMIs are diffusion indexes that measure rates of change, not the level of activity. Anything above 50 is growth, and a drop from 64.7 to 60.7 simply means that the rate of economic expansion has decelerated slightly. But our musings aside, here's what Tim said:

> *Yeah, a really, really good month again. Another great month. You know, we started climbing out of this post-pandemic situation back in August, and the numbers just continue to get better, better, better…. You know I measure the sentiment of the panellists. We were 11 to 1 positive in the month of April, up from 8 to 1 in March, and it's been a steady sequence. Back in August, it started at 1.4 to 1. So, you know that the supply community, supply management community is very bullish about the future. <u>It's a great story great month again, so don't get hung up on a 4-point loss on the PMI.</u>*

Having dismissed the pessimists, let's jump into the details:

> *So, you know I like to talk about demand, consumption, and inputs. Demand was again a very, very strong month. We had New Order levels of 64.3, down slightly from the prior*

month, but 64.3 is a fantastic report. Production level at 62.5, I think that was hampered. It could have been higher, and I'll explain that in a minute. On the demand side, we had new orders at 64.3, new export orders relatively flat at 54.9. I mean, that's a little bit concerning it was down last month, but I think, you know, our international partners are still struggling a bit, and you see the China PMI is still at 51, which is surprising when people are such as China's doing so well. But not as surprising when you look at Europe or, for that matter, Latin America. Our global partners still need to come back. So new export orders were okay, not great.

We all know that most of the world is lagging the US in terms of vaccinations. Therefore, until that changes, it's hardly shocking that US exports and even the Chinese PMI, which is dependent on global demand, is lagging. However, is there anything else that strikes you in the report?

But the big thing was customer inventories set another record again, meaning that our panellist company's customers do not have enough material to sell. We've had, I think, nine straight months of under 40, which, remember, 50 is about right, 51 is too high, 49 is too low. We came in at 28.4, an unbelievably low number. So, lots of opportunity for the future and then, you know, my favorite number here is backlog, which grew again to another record at 68.2, up from 67.5, which was itself a record. And these are records that go back to the early to mid-90s. So, you know, all in all, demand was very good, and we ended the month with record backlog and record empty shelves. So, that's really good.

So why was the headline down, and what's the reason US production was held back?

The headline number was down a little bit compared to March, but there's a good reason for that. It's not because of lack of demand. It's because we continue to have problems on the input side as well as labor issues.

Pray elaborate, Tim:

So, and I think I've been mentioning that, you know, the inventory number hanging around 50 +/- 1 says that we've kind of achieved an equilibrium. But we really want to grow the inventories to be able to have enough assurance that we can really deploy people and convert material. Well, the inventory was, I think it's the story this month. It dropped 4.3 points. 46.5 on the raw material inventory side. So, we consumed more inventory than we actually received, that's the summary on that. And we could have consumed more inventory if we had it, and I think that's the issue around the PMI dropping off a little bit.

But on the input side, so imports we're down a little bit which are still reflecting problems at the ports, still haven't cleared that. The initial thought was that would clear in May and June, now the feeling is it is going to clear in August-September, and it probably will carry right through into the holiday season. So, we're probably dealing with drag issues and container

<u>*issues all the way through until January February of next year*</u>*, which is not a bad thing, it's just something that we're going to have to deal with it.*

In our supplier delivery section, <u>*we had 39% of the respondents comment around transportation issues, same as last month. In the month of December, it was 24%. So, it's not abating. It's continuing to get worse*</u> *until that peaks out, when those comments start to drop down to the 20-25% level again. In the general comment section, which you can put in whatever you want, 23% of the comments were transportation-related, which is really high. I think the prior month was 18%. So, you know, transportation, as I mentioned, leads manufacturing, which leads to services industry, and transportation is continuing to expand from the standpoint of economic activity. As I mentioned last month, the issue is shortages at the supplier facilities and shortages at the panellist companies. Panellist companies are telling them, "Ship a half a truckload." So, what used to take one truck to move inventory to the client is taking two trucks. That puts a big strain on not only the equipment but on the driver issue. So, and it's not going away, it's still, it's still very strong.*

Tim, you mentioned labour issues. Could you expand on that topic?

We continue to struggle with labour issues across not only our panellists' companies, but also our supply base, and it's getting to the point <u>*where we're now in a situation where wage increases are seriously being looked at*</u>*.* <u>*We had 10% of our employment comments were turnover related, which I think was a bit alarming.*</u> *That is absolutely not an efficient way to run a factory to have constant turnover and the reason there's turnover is because people are leaving for other jobs that pay more. That's generally what happens on the factory floor. So, you know last month, I think we reported that there's a lot of people who, there's a real retention issue at not only our panellist companies but their suppliers and people show up for work, and then, you have 100 people show up, and then 90 wouldn't come in 3 days later and* <u>*I think that's simply because the support that's out there for staying out of work*</u>*.* (PS This is what happens when you pay high unemployment benefits…Cheers, President Biden).

And I think that any talk about extending those unemployment benefits would be crazy (Dems are proposing making the changes permanent). *We all said months ago, when they extended them all the way the end of September, that there was no need for that, at least in the manufacturing economy, we've been struggling for hire, for people for a while now.*

Tim, how are your panellists responding to these input constraints?

<u>*I'll tell you when it comes to supply/demand, this is the first month where it's been very clear that buyers will pay whatever it takes to get the material they need.*</u> *Our raw material lead times are the highest level in the last three years, if not longer than that. I was only able to really go back a couple of years. So, the lead times are being shoved out, a lot of comments*

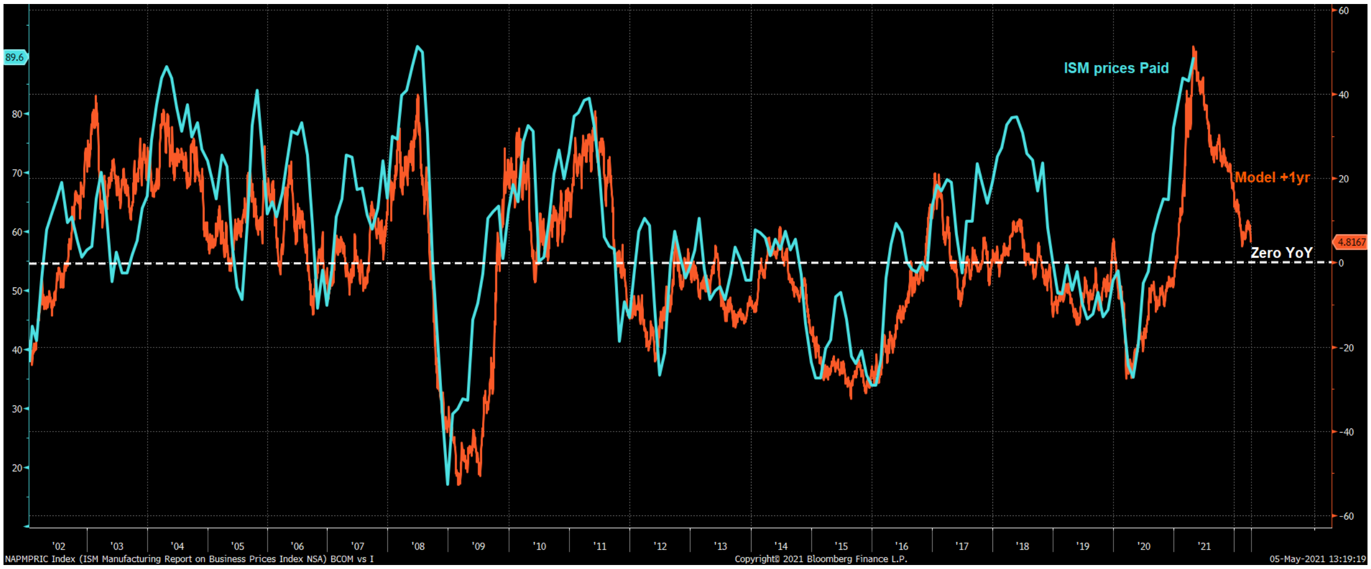
around that again. Haven't had that many comments on lead times since January/February. Shortage issues are still very high. Usually, you have lead time comments first, and then shortage issues show up later. Then if you get into another cycle and then you've really got something going. But we're into that other cycle now. <u>So, there's no doubt that buyers are going to pay whatever it takes. The priority here is get the material. Do whatever it takes, and that conversion happened really in the, uh, probably late March-early April time frame.</u> (That suggests it has yet to show up in PPI, let alone CPI)

The big question facing markets is will companies pass these prices on and stoke inflation? Jay Powell thinks not and specifically said, "You'll see people reluctant to raise prices." Tim, what do you think?

So, the government's calling it transitory, and it's usually transitory. It goes up, it comes down. That's why you have P & Ls, that's why you have margin, that's why you have productivity. But you've got to keep factories running. You need to get the revenue. You need to absorb that fixed cost, and that's what's happening. So, it's a, it's a difficult time for buyers for sure because they're having to pay the variance. <u>There are companies that are piling up that material price variance like big, big buckets, and we're going to see whether they pass it through.</u> You saw the earnings reports that have started to come out; they're all very strong. But you know they reflect inventory accounts that probably had material costs in there from late last year. So, will I get the same for a couple months? <u>I mean, we're really not going to know about that pass through until Q2 earnings, and then we'll see the real story of it.</u> But in the meantime, people are paying, and it's going into price variance, and they're then trying to absorb it. But you know prices have to go up, or margins get compressed if the productivity number isn't there.

When we get into an equilibrium situation, definitely they'll relax. You know, steels at 14 something, up, the short ton, should be at 650. Copper is no better, foods,… Everything's up. Plastics are up. The only sign of anything relaxing is really plastics and chemicals now that the force majeures are abating on the Gulf Coast. Material is starting to flow better. <u>We're probably six weeks away from a better balance.</u> We have more access to plastics, more access to chemicals. You won't see it really in this report this month, but probably <u>in May, you'll start to see some of the stuff show up down in prices.</u>

Tim, our models agree that we are close to the peak in price acceleration. However, thus far, they are still above zero, which suggest that the rate of increase will slow and not that prices will fall.



So, input material costs are clearly an issue. But you also mentioned wage pressures:

> *The big concern now is that people are now raising wages, and that's part of the issue around employment. I believe that, and the numbers support that, that we're having difficulty in hiring. But there's also an issue that, you know, you can hire whoever you want if you're willing to pay whatever it takes. But the problem with paying whatever it takes, you can't just take it back, and the only way you get it back is through a recessionary downturn* (aka wages are sticky downwards). *And nobody is counting on anything that looks like that until the end of 2022 at this point. I think everybody thinks that first half of 2022 is going to be a strong half.*
>
> *If you raise new employment wages, you have to raise wages for your workforce because you get out of balance. So, we're in that situation now, I think the demand has been clear, it's not going away, this isn't just a pent-up demand that then peters out in a short period of time. Companies are challenged with losing share if they don't maintain the proper employment levels. In order to do that, they have to raise wages, and that's really, that's inflationary. Wage raising is inflationary.*

Tim, would you mind going through some of the details of the labour/wage picture?

> *So let me give you some numbers on that, they're real interesting numbers. You know, I count employment comments. We had 76% of our respondents say that they were hiring or trying to hire. We had 0% saying that they were firing. Okay, good numbers. We had 10 to 1 saying they were hiring versus "force manage", which means hiring freezes firing or achieving goals through attrition. That number is up from, I think, 8 to 1 in the March timeframe. As I mentioned, 10% of the comments were about turn over, and I've never counted turnover before because it's never been an issue. It's now an issue, and, which*

means it, like I said, people are leaving for higher-paying jobs down the street. So, they're going to another company that's offering higher wages, which force is everybody else to do the same. We had 28% of the total comments comment that they're having problems hiring. So, remember, 76% said that they were hiring, 28%, almost a third of them, more than a third of them, said that they were having trouble hiring. So, that says to me, okay, time to make a decision, and the decision is raise your wages or lose share, and nobody's going to lose share. It's too hard to get it back. You lose share, it takes you two years to build it back. So, I think that's the, that's the word for part of April-May and probably June.

Tim, our own models suggest that input and now labour costs are a real threat to inflation. What do you see for H2?

We're getting ready to release our updated forecast. It is coming out on the 18th of May. I'm very anxious to see it because, if you recall, in December, we forecast a 2.9% increase (in prices) *in the calendar year 2021, of which 2.5% would be experienced in the first six months. Well, I would wager to guess that our panellists are going to come back and say that they've seen at least 4% so far year to date, and they expect another 3 to 4% through the end of the year. We haven't seen a year like that probably since I've been around, and I've been around.*

Do you see any other risks to the recovery?

I think we kind of juiced it a bit here with this stimulus when, you know, it should have been more targeted. Like I said, manufacturing is doing fine. We don't need any more. Demand is going to stay constantly strong for at least the next six months and probably longer. I think last month, I mentioned that even when the service sector reopens and the summer moves to the fall, there's going to be a 6-month overlap of people still wanting cars and goods, including durable goods.

Tim finally, what signs would you be looking for that would suggest conditions are normalising and pressures abating?

I think, you know, you need to see the labour come back, you need to see transportation ease, and then you'll see customer inventory start to refill. I think, I'm going to be an optimist here and say it's going to be a natural occurrence. For me, natural will be getting (customer inventories) back to 43-44, not 50, 43-44, and we're way off right now from that. I mean, we're what, we're 15 points off from that. That won't happen overnight. So, when you have the first indication, you'll see the transportation numbers ease a little bit. And right now, you know, I don't see it. I just don't see it yet.

Thanks, Tim.