

A Global Chill Slows U.S. Manufacturing

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Highlights

- U.S. manufacturing activity has weakened, mainly due to global factors such as weaker foreign demand growth and elevated trade uncertainty. Digging into the details, the greatest declines in manufacturing shipments have been in export-intensive sectors.
- Meanwhile, domestic conditions continue to hold in. This should help put a floor under slowing manufacturing activity.
- Going forward, potential Fed rate cuts should improve manufacturing activity by locking in more supportive global financial conditions, limiting dollar strength, and lending greater support to domestic demand.

Manufacturing industries around the world are undergoing a synchronous slowing (Chart 1). In fact, in some major economies, the manufacturing sector is in contraction (i.e. China, Euro Area), while in the U.S., the pace of expansion has decelerated.

Softness in the U.S. manufacturing sector is particularly concerning as it could be a harbinger of a broader economic slowdown. In the current context, manufacturing weakness appears less related to domestic issues, and more to global factors. Specifically, elevated trade uncertainty and slowing global growth. Indeed, the deepest declines in manufacturing shipments are concentrated in sectors that are relatively more export intensive.

While external conditions have worsened, U.S. domestic demand remains healthy. As in previous episodes, most recently in 2015-2016, resilient domestic demand will likely put a floor on U.S. manufacturing activity. However, if external conditions weaken drastically, it could push manufacturing to levels that are consistent with a more widespread economic slowdown. Shielding against this outcome is a key reason for the Fed's pivot to insurance cuts. Given the delicate state of the U.S. economy this is an area well worth paying attention to.

Cooling Manufacturing Activity Linked to External Sector Developments

U.S. manufacturing activity started cooling in the middle of last year, when growth in manufacturing shipments, measured in real terms, began to trend down (Chart 2). Shipments growth weakened from around 3% year-on-year in April 2018 to 0.6% in May 2019.¹ While Boeing production cuts had some impact, they were only implemented in April 2019. The longer-running drop in shipments growth appears to be driven by exports, which saw growth decline significantly over the same period. Meanwhile, domestic absorption growth – that is output intended for the domestic economy – weakened slightly, but not nearly as much as exports.² This indicates that the moderation in manufacturing shipment growth is due primarily to external factors.

Chart 1: Manufacturing Activity Is Cooling Across the Globe

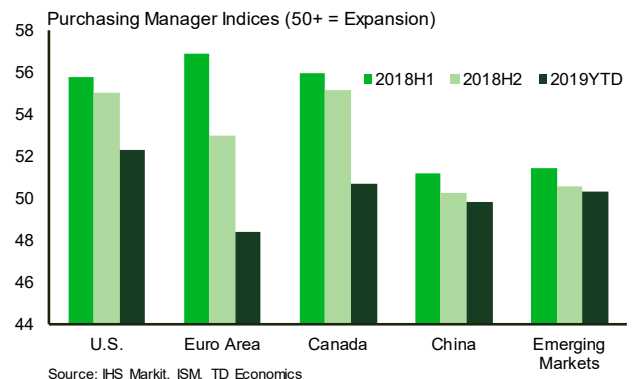
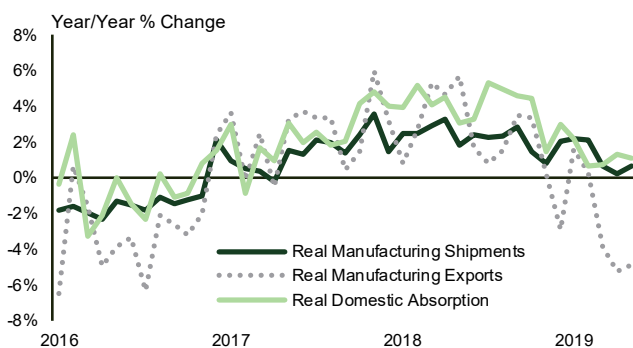
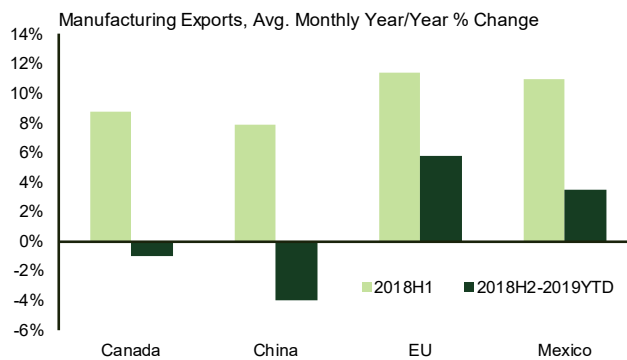


Chart 2: Weaker Manufacturing Shipment Growth Driven by Weaker Exports, While Domestic Absorption Held Steady



Source: Census Bureau, TD Economics

Chart 4: Manufacturing Export Growth Weaker Across Major Trading Partners



Source: Census Bureau, TD Economics

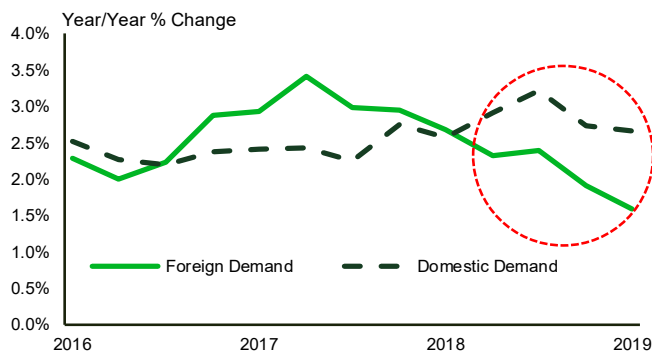
Indeed, foreign demand growth moved below that of domestic demand in the second half of 2018, tracing the trend in manufacturing shipments (Chart 3).³ Rising uncertainty and cyclical slowing likely brought foreign demand growth lower but disentangling the two impacts is difficult. What is discernible is that U.S. manufacturing shipments are responding to global conditions.

A plausible reason for the turn down in shipments is the direct intensification of the U.S.-China trade war. It's no coincidence that manufacturing activity and associated exports began falling around the same time as the ratcheting up of the U.S.-China trade war. After all, it was in September 2018 when the two countries went punch-for-punch with tariff measures.⁴ Interestingly, while these developments likely dampened manufacturing exports to China, we observe slower growth across all major trading partners (Chart 4). Average monthly year-over-year export growth

went from being above 7% in the first half of 2018 to contractions for China and Canada, while falling by around six percentage points for the European Union and Mexico. Given that the decline in export growth has been broad-based, it appears to be less due to the direct trade disruption between China and the U.S. and more due the measurable slowdown in global growth alongside the fog of uncertainty created by the growing trade disputes.

We find further evidence of this by decomposing manufacturing shipments by sectors. Those that are more export-intensive experienced the largest declines in shipments since 2018 (Chart 5).^{5,6} Less export-intensive sectors had a mix of fortunes, but many still saw a contraction in shipments. Notably, most non-durable sectors experienced contractions in shipments despite being relatively less export-intensive. These declines, however, were not nearly as severe as those faced by durable sectors.

Chart 3: Foreign Demand Growth, Reflecting Manufacturing Shipments, Moved Lower Than Domestic Demand in 2018H2



Source: BEA, National Sources, TD Economics

Finally, we cannot ignore the role of exchange rate. The real effective exchange rate appreciated by almost 7% over the course of 2018, weighing on manufacturing shipments. Our modelling suggests that the exchange rate effect was about a third of the impact of weakening foreign demand on manufacturing shipments over 2018.⁷

Healthy Domestic Demand Helps Limit Manufacturing Weakness

Rising trade uncertainty and slowing global growth have weakened U.S. manufacturing activity. In the first quarter of 2019, growth in manufacturing sales sharply declined, which likely prompted less hiring (Chart 6). This will likely

Chart 5: Sectors With Higher Export Intensity Had Weaker Shipments Growth

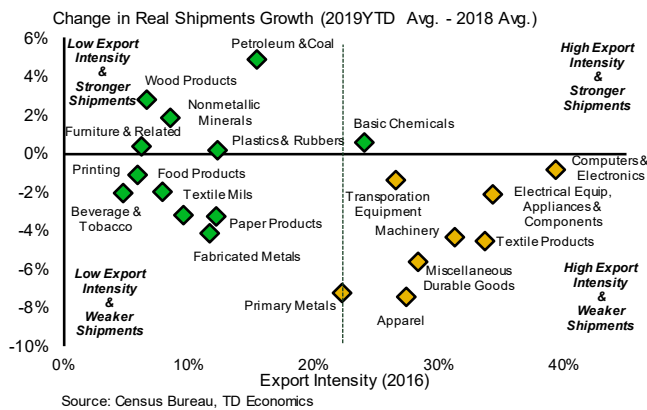
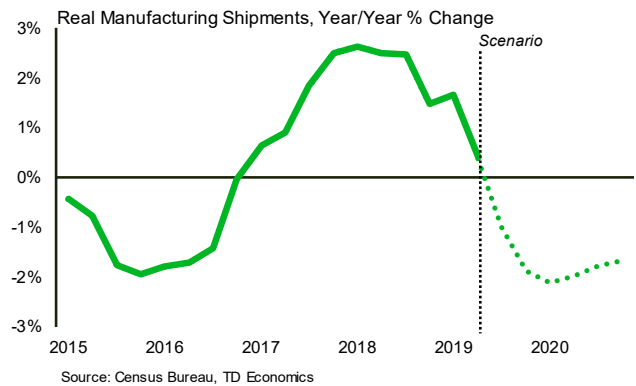


Chart 7: Healthy Domestic Demand Growth Will Likely Put Floor on Manufacturing Activity



get worse before it gets better, as there seems to be a six-month lag between sales and hiring.

To the extent trade uncertainty continues to rise and/or global growth weakens further, the manufacturing sector will bear the brunt of the impact, with sales and hiring continuing to decline. However, healthy domestic demand growth will likely provide some counterbalance to international weakness.

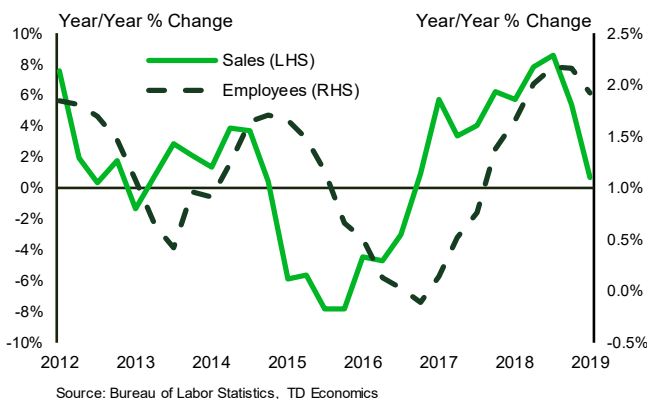
To illustrate this point, we examine a scenario where domestic demand increases at a steady rate of around 2% out to the fourth quarter of 2020, while foreign demand has continued to fall, declining to 1% – the lowest growth rate since the Great Recession. In this scenario, manufacturing shipments contract through the rest of 2019, before stabilizing then rising modestly in 2020 (Chart 7).

This scenario assumes a weaker path for foreign demand than we currently expect, but still produces a manufacturing

projection that is not recessionary. In 2015–2016, manufacturing shipments saw a similar decline for almost identical reasons: global growth weakened, and the exchange rate appreciated sharply. However, domestic demand remained resilient, effectively introducing a floor on manufacturing activity. We expect domestic demand to again soften the blow brought on by external factors.

Still, the domestic demand shield is not impenetrable. Existing trade disputes may escalate, new trade wars may open up, geopolitical risks may rise, or the European economic slowdown may turn out to be much weaker than anticipated. On the whole, the direct hit of slowing manufacturing activity to the U.S. economy will likely be small (given manufacturing only makes up 11% of U.S. GDP), but the indirect effects may be larger. Whenever the Institute for Supply Management’s (ISM) manufacturing index has dipped below 50 for an extended period, a recession has followed (Chart 8).

Chart 6: Drop in Sales May Mean Less Hiring in Manufacturing Industry

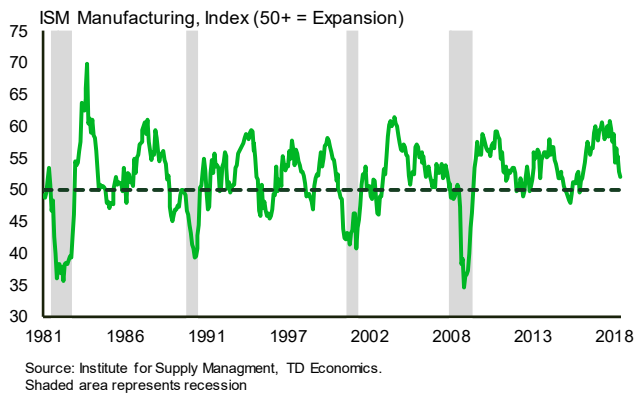


Bottom Line

U.S. manufacturing activity has slowed in recent months as global developments such as rising trade uncertainty and softening global growth constrain foreign demand. Domestic conditions, on the other hand, appear more stable and do not seem to be weighing heavily on manufacturing activity. Indeed, within manufacturing, sectors with lower degrees of export-intensity have either avoided contraction or experienced a much more muted slowdown so far this year.

Identifying the source of recent manufacturing weakness gives some insight into what developments to keep on the

Chart 8: Extended ISM Dips Below 50 Usually Precede Recessions



radar. First, it means continued attention to global growth. From an already-weakened state, any sharp deterioration could bring manufacturing activity to a level that becomes a risk to the broader U.S. economy. On the other hand, signs that global growth is bottoming implies that this risk may begin to fade.

Second, with weakened foreign demand, domestic demand becomes an even more important driver of both manufacturing and broader U.S. economic growth. In the past, its resiliency has softened the impact of negative external shocks on manufacturing activity. There are positive signs in recent data on this front, particularly in retail sales that have rebounded with gusto from their soft patch earlier in the year.

The Fed's communicated pivot to insurance cuts should work through both of these channels. Lower U.S. interest rates support global financial conditions and limit upward pressure on the dollar. But, more directly, lower interest rates are meant to shore up domestic demand. If successful, they should show up in improved manufacturing activity in the months ahead.

Endnotes

1. The decline does not appear to be related to an inventory buildup. The inventory to sales ratio was at low levels when shipments growth began to wane.
2. Domestic absorption is calculated as shipments plus imports minus exports.
3. U.S. foreign demand is calculated as a weighted average of real GDP growth across major trading partners. Domestic demand is real final sales to domestic purchases.
4. The U.S. imposed tariffs on \$200 billion worth of Chinese imports, while China retaliated with tariffs on \$60 billion of U.S. goods.
5. Leather and allied sector was removed from the chart as it had an idiosyncratic surge in growth at the start of 2019.
6. Export intensity is measured as manufacturing exports over shipments.
7. The baseline scenario of the counterfactual exercises assumed domestic and foreign demand grew at post-crisis averages, while the real effective exchange rate remained flat through 2018.

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