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KEY INSIGHTS

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A Tale of Two Sectors: Manufacturing Weakness & Consumer Strength in 2019

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Key Insights

- Strong consumer spending has kept the U.S. economy on track for 2.2 – 2.3% annual growth in 2019 despite contraction of the manufacturing sector.
- The current industrial slowdown is broader and deeper than the manufacturing recession of 2015 – 16 and has the potential to spill over into the rest of the economy should declining sector employment and corporate profits translate into lower consumer spending and lost confidence.
- Despite a spate of recent positive headlines, key economic indicators (including the yield curve) suggest lingering downside risks and continued manufacturing weakness heading into 2020.

Introduction. Strong consumer spending has been the main driver of U.S. economic growth throughout 2019, which has helped extend the longest economic expansion in U.S. history. This year has also seen the U.S. manufacturing sector slip into contraction – and yet, the rest of the economy has hummed along. Paradoxical performance across sectors raises the question of whether (and how) manufacturing weakness might spread to the rest of the economy, or even pull the U.S. into economic recession.

The manufacturing sector has been in contraction since late summer – but U.S. consumers continue to spend.

Manufacturing Contraction. The U.S. manufacturing sector has been in contraction since late summer. The Purchasing Managers' Index ("PMI") for manufacturing has held below 50 (the threshold for contraction) since August,[1] while September's manufacturing PMI of 47.8 was the weakest reading since 2009. Although the pace of contraction eased somewhat in October, two consecutive quarters of negative investment growth and three months of annual declines in new orders excluding transportation suggest that the ultimate depth of the downturn has yet to fully materialize.

- **Sectoral Decline.** Historically, the performance of the manufacturing sector has been a bellwether for the health of the overall economy. Major declines in manufacturing output have consistently led or accompanied

[1] Institute for Supply Management Report on Business

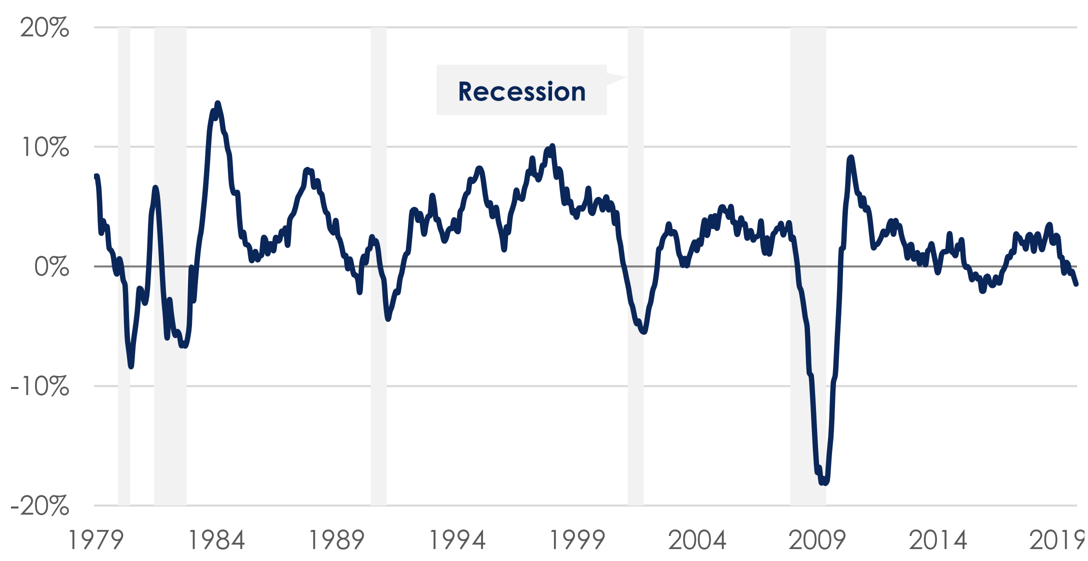
economic recessions (see Fig. 1) — a bad omen given the current state of the industry. The U.S. economy today, however, is far less dependent on manufacturing than in the past. Just 8% of the American workforce is employed in manufacturing today[2] — half the share in 1989 — while manufacturing value added accounts for just 11% of GDP compared to 70% from the private service-producing sector (compared to 16% and 64% in 1998, respectively).[3]

- **Pathways of Contagion**. For the current manufacturing contraction to drive a downturn in the broader economy, it would need to depress consumer spending, which accounts for roughly 70% of total economic output. A likely pathway for manufacturing weakness to spread to consumers is the labor market: if declining profits push manufacturing firms to lay off workers, consumer spending will fall (all else being equal) as the newly jobless have less money to spend on goods and services. Recession can also ripple beyond manufacturing due to lost confidence as nervous workers in other sectors start to pull back on spending out of fear that job losses in the goods producing sector portend similar losses in others.

  The single biggest threat manufacturing poses to consumer confidence, however, is its potential to weigh on the stock market. If falling profits lead to sharp declines in stock prices, consumer confidence will almost certainly follow.

Major declines in manufacturing output have consistently led or accompanied U.S. recessions.

Figure 1. U.S. Manufacturing Industrial Production
Year-over-year percent change



- **Are Consumers Next?** The question today is whether the manufacturing sector is large enough, or the current slump deep enough, to cause a broad decline in consumer spending. In answering that question, the recent 2015-16 manufacturing downturn in the United States is informative. Although consumer spending growth eased toward the end of 2015, it

[2] US Bureau of Labor Statistics Current Employment Statistics
[3] US Bureau of Economic Analysis

The key question is whether manufacturing weakness might spread to the rest of the economy.

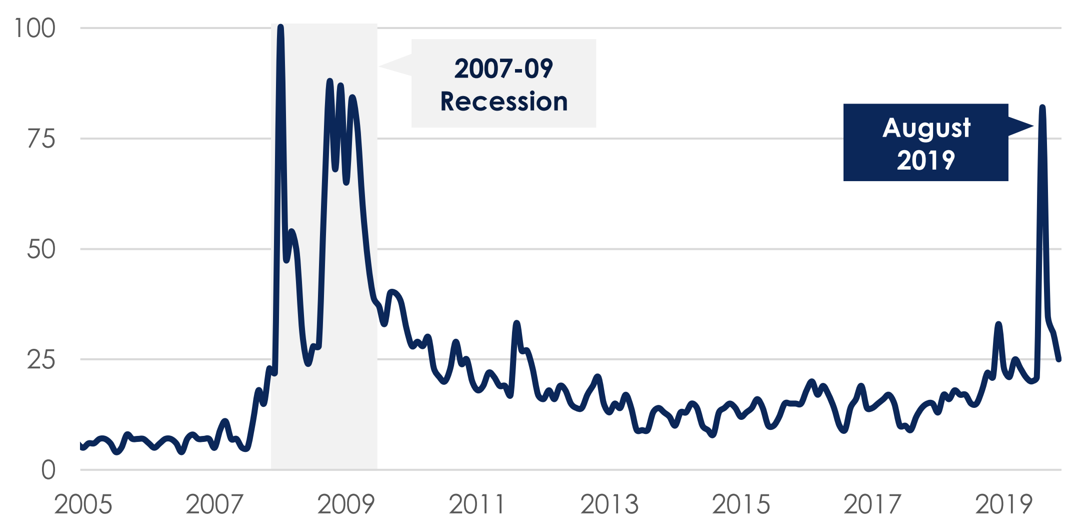
recovered quickly and never approached contractionary territory. The 2015-16 manufacturing downturn came and went without a corresponding decline in consumer spending or heightened fears of another U.S. recession.

Will consumer spending be impervious to the manufacturing slump this time around? Perhaps — but perhaps not. The 2015-16 contraction was largely confined to the part of the manufacturing sector servicing the oil and agricultural sectors, which were hit by a simultaneous decline in commodity prices and appreciation of the U.S. dollar. The current slowdown is more widespread, with a confluence of factors — from waning global demand to trade uncertainty — weighing on a broad swath of goods-producing firms.

Recession Risks. The manufacturing contraction was not the only piece of economic news making headlines this summer. The current expansion passed the 10-year mark in July, eclipsing the '90s boom to become the longest U.S. expansion on record. The unprecedented growth streak coupled with mixed data had many economists wondering how much longer the good times could last, and it didn't take long for headlines to seize on the notion that a recession might be just around the corner. (Strikingly, the Google Trends chart for the term "recession" shows a massive spike in searches in August 2019, reaching an intensity not seen since the Great Recession.) [4]

Recession fears spiked in August after the current expansion became the longest U.S. expansion on record.

Figure 2. Google Trends: U.S. Web Search Interest for "Recession"
Indexed to Peak (Peak = 100)



- **Shifting Narrative.** Since August, however, the mainstream doom-and-gloom narrative has receded. Stronger-than-expected headline GDP growth estimates for both Q2 and Q3 (driven by robust consumer spending) have bolstered the view that, despite several obvious headwinds, the

[4] www.google.com/trends

outlook for the U.S. economy is less gloomy now than it was just a few months ago.

The popular narrative has become more positive, but key indicators show little real improvement.

Unfortunately, there is little in the way of data to support the shift in narrative. The movement from (somewhat exaggerated) pessimism to a moderately optimistic view has created the false impression that the real economy has undergone a substantive positive transformation.

Looking beyond headline growth reveals two consecutive quarters of contracting investment spending and a notable deceleration in consumer spending last quarter.[5] Meanwhile, the Conference Board's Index of Leading Economic Indicators, a broad assessment of national economic growth, declined in both August and September and has seen annual growth slow to nearly zero. Neither is there much sign that the manufacturing sector has turned a corner. The latest PMI still indicates contraction, and continued declines in new orders of manufactured durable goods[6] are likely to translate into future reductions in sector activity.

- **Yield Curve Inversion.** One of the most well-known recession indicators, the yield curve, has also been seized on to support — and then refute — the doom-and-gloom story. The spread between short-term and long-term government bond yields "inverted" in late August when (by one measure) 2-year Treasury yields rose above 10-year Treasury yields. The yield curve has reliably inverted prior to past recessions and rarely produced false signals, so observers were understandably spooked when the 10-2 spread dipped into negative territory.

Reversion of the yield curve does not mean recession risks have disappeared.

It is probably a mistake, however, to interpret the reversion of the yield curve as a sign that recession risks have receded. Each time the yield curve inverted prior to a past recession, it reverted several weeks or months before the recession began. What appears to matter for the sake of anticipating recession is the first instance of inversion, not the length of time inversion persists. If the yield curve is currently saying anything about the likelihood of recession, it's that the economy is closer to recession now than it was back in August.

The Bottom Line. While U.S. economic growth is poised to continue easing in Q4, it is still on track for solid 2.2-2.3% growth for the full year 2019. The labor market remains tight and consumers are still spending despite contracting manufacturing activity and weakening leading indicators. Going into 2020, most U.S. risks remain to the downside. By all appearances, the manufacturing slump has yet to bottom out, and ongoing deceleration of the global economy and unresolved trade disputes will not help. Most economic indicators are not currently sounding the alarm for a general recession in the next six to nine months, but the first half of 2020 should provide key signals about whether consumers will continue to propel the economy forward.

[5] US Bureau of Economic Analysis Advanced Estimate of 2019 Q3 GDP
[6] US Census Bureau Survey of Manufacturers' Shipments, Inventories, and Orders

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