US manufacturing feels the strain as trade tensions mount

The latest manufacturing survey from the US will do little to dampen concerns about an economic slowdown. But while the risks are mounting, we think markets may be getting a little bit ahead of themselves when pricing in four rate cuts by the end of 2020

Source: Shutterstock

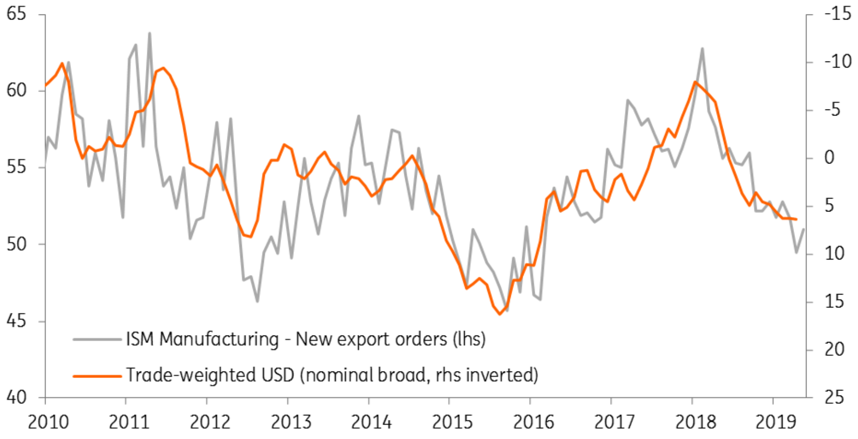
At 52.1, the US ISM manufacturing survey is now at its lowest level since October 2016, which will do little to help improve market sentiment on the US economic outlook. For a second month running, growth in new orders was pretty subdued, and this has translated into a sharp decline in backlogs of work.

Firms look to unwind elevated inventory levels

Some of this can probably be explained by the strength in the dollar over the past year. More importantly, production appears to be stalling as firms look to run down elevated levels of stock. The overall level of inventories has risen consistently over the past three quarters, which can be partly explained by businesses looking to stockpile components/finished goods ahead of planned tariff hikes (most notably before the start of 2019, when President Trump was initially expected to increase charges on $200 billion of Chinese imports).

All of this implies that manufacturing output is likely to stall over the next few months, which could potentially hit employment in the sector too.

Stronger dollar has been a headwind for manufacturing



Source: Macrobond

Markets may be getting ahead of themselves on the Fed, although risks are building

For President Trump, who appears to have been emboldened by recent economic strength to increase the pressure in trade talks, a weaker manufacturing base would present a challenging backdrop as he prepares to enter a key election year.

But when it comes to the outlook for the Fed, it's worth remembering that the manufacturing sector only represents just over 10% of economic output. For the time being, the broader economy has remained supported by solid consumer spending, which has been buoyed by the ongoing strength in the jobs market.

We therefore think markets are getting slightly ahead of themselves by pricing in a series of Fed rate cuts (roughly four 25 basis point moves are expected by the end of 2020). That said, the possibility of tariffs on the remainder of Chinese imports (which includes a large chunk of consumer electrical products) coupled with subsequent retaliation, nevertheless suggests the economy is entering a challenging phase.

Author

James Smith
Developed Markets Economist, UK
james.smith@ing.com

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