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May ISM Manufacturing Index: Settling Into A Steady Expansion

- > The ISM Manufacturing Index <u>rose</u> to 54.9 percent in May from 54.8 percent in April.
- The new orders component <u>rose</u> to 59.5 percent, the employment component <u>rose</u> to 53.5 percent, and new export orders <u>rose</u>.

The ISM Manufacturing Index edged higher in May, rising to 54.9 percent from April's reading of 54.8 percent. May's reading came in slightly above the consensus forecast of 54.8 percent and below our forecast of 55.2 percent. May marks the ninth consecutive month in which the headline index was above the 50.0 percent break between expansion and contraction in the factory sector, and the underlying details as well as comments from survey respondents are generally positive. More significantly, the expansion in the factory sector remains notably broad based, which has not always been the case over the current expansion.

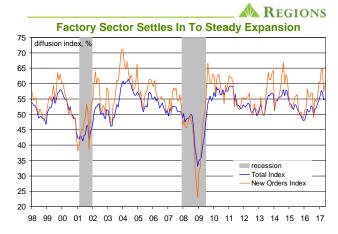
Of the 18 industry groups included in the ISM's survey, 15 reported expansion in May, two reported contraction, and one reported no change in activity. Over the past nine months in which the headline index has been above 50.0 percent, the number of industry groups reporting growth has steadily climbed higher, which is an encouraging sign as to the durability of the expansion in the factory sector. Comments from survey respondents point to steadily rising demand, difficulty finding qualified labor, and increasing pricing pressures for commodities. Tellingly, politics continue to loom in the background, with one respondent noting that while the economy is strong, "the political environment can change things very quickly," and another, from the paper products industry group, noting the resolution of tariffs on Canadian lumber could have an impact on pricing.

The index for new orders bounced back in May after having dipped in April, with 14 of the 18 industry groups reporting higher order volumes, and only the apparel, leather, and allied products industry group reporting a decline in orders. The index of current production dipped slightly in May (this accounted for our miss in our forecast for the headline index), but 14 of the 18 industry groups reported higher output levels while only the apparel, leather, and allied products group reported lower output.

Steady growth in new orders bodes well for production over coming months, particularly in the context of what remain lean customer inventories and a still-growing backlog of unfilled orders. For an eighth consecutive month, survey participants deemed their customer inventories to be too low, which has been one support for new orders and has helped push output levels higher. At the same time, order backlogs grew for a fourth consecutive month in May, which again supports the notion that output levels will continue to expand over coming months. Additionally, the employment index rose to 53.5 percent in May, with 11 of the 18 industry groups adding to payrolls. It is, however, worth noting that the degree to which the ISM's production index has risen continues to outrun the "hard data" on production, such as the Federal Reserve's industrial production index. Still, the ongoing strength in new orders, growing order backlogs, and lean customer inventories suggest further improvement in measures such as industrial production over coming months.

The ongoing growth in new export orders in the ISM data is consistent with other indicators that show global economic growth has firmed over recent months. May marks the 15th consecutive month of growth in new export orders, and one factor contributing to this growth is what has been a softer U.S. dollar over recent months. Given that U.S. exports become more expensive in overseas markets as the U.S. dollar strengthens, the dollar's performance over the past few months means it is less of a drag on U.S. exports. Again, though, prospects for further growth in exports is one area in which the politics, at home and abroad, could get in the way of the economics.

The U.S. manufacturing sector is on a nice roll. Rising demand, domestic and foreign, and lean inventories have set the stage for a broad based expansion which we expect to persist over the months ahead. At this point, the downside risks seem more political than economic in nature.





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