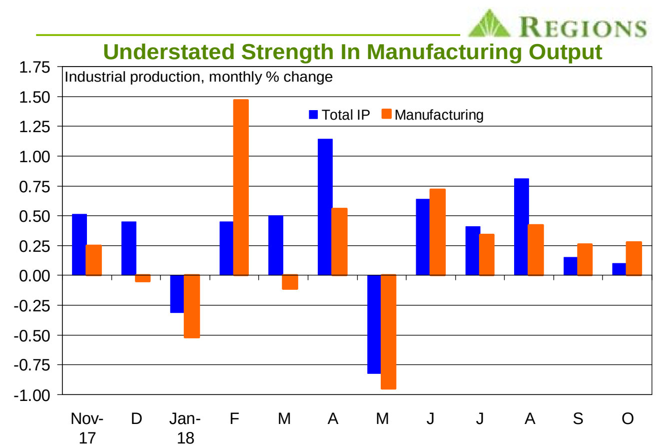
ECONOMIC UPDATE
REGIONS
November 16, 2018

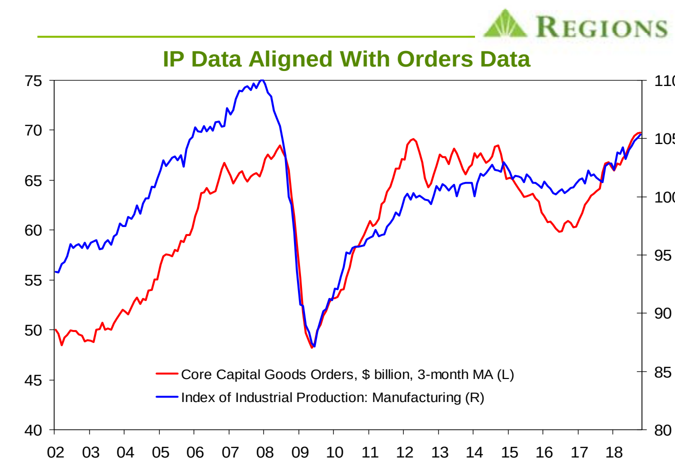
October Industrial Production: Understated Strength In Manufacturing Output

- Industrial production rose by 0.1 percent in October, with manufacturing output up by 0.3 percent
- The overall capacity utilization rate fell to 78.4 percent, while the utilization rate in manufacturing rose to 76.2 percent
- On a year-over-year basis, total industrial production was up by 4.1 percent in October, with manufacturing output up by 2.7 percent

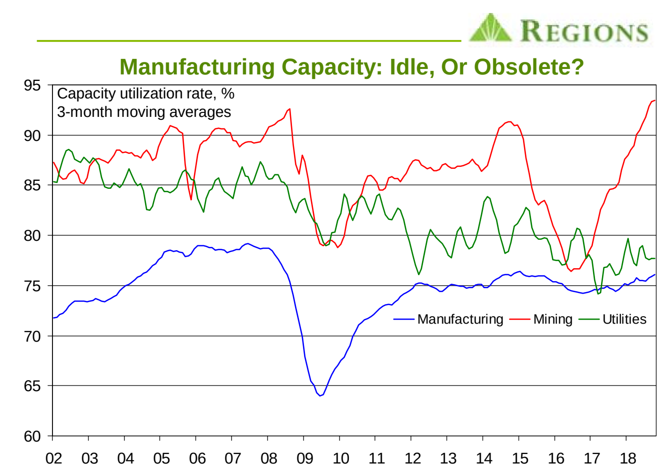
Total output amongst the nation's factories, mines, and utilities rose by 0.1 percent in October, lagging the 0.2 percent increase we and the consensus expected. Output in the manufacturing sector rose by 0.3 percent, which in and of itself may not seem like much of an increase but this comes despite a significant decline in motor vehicle assemblies that acted as a drag on output in the broader manufacturing, while output in the utilities sector fell by 0.5 percent and output in the mining sector fell by 0.3 percent. As was the case with the September data in the wake of Hurricane Florence, the October data were impacted by Hurricane Michael, but the Federal Reserve estimates that Michael had less than a one-tenth of a point impact on total industrial production. Total output was up 4.1 percent year-on-year in October, with manufacturing output up 2.7 percent. The overall capacity utilization rate fell to 78.4 percent in October, with the utilization rate in the factory sector edging up to 76.2 percent.



Excluding motor vehicle production, manufacturing output would have been up by 0.5 percent in October and total industrial production would have been up by 0.3 percent. Motor vehicle assemblies declined by 4.6 percent in October while production of auto parts fell by 1.0 percent. While output in this industry group tends to be volatile from one month to the next, motor vehicle assemblies are down slightly on a year-to-date basis and we expect further declines in the months ahead as lower output of autos and light trucks will more than offset higher output of heavy trucks. Vehicle sales had already been settling back towards a more sustainable pace before interest rates began to head higher, and we expect this retreat in sales to continue. To be clear, however, there is a difference between motor vehicle sales settling back into a more sustainable pace and completely collapsing, and we expect the former, not the latter. Aside from motor vehicle production, there were broad based increases in output across the manufacturing sector in October. Primary metals, furniture, textiles, business machinery, and aerospace & other transportation equipment posted some of the largest increases in output. The 0.8 percent increase in output of business equipment is particularly notable as this is the component that has the biggest impact on labor productivity growth. For various reasons, many were quick to seize on a weak print on business fixed investment in the preliminary Q3 GDP data as "proof" that capital spending was fizzling out and that the 2017 tax bill was "a flop." We characterized such statements as "nonsensical" and stand by that characterization. We go by what the economic data are telling us, which is that capital spending is still growing and began growing at a much more rapid pace in Q1 2017, i.e., before there even was a 2017 tax bill. To be sure, growth is decelerating, and uncertainty over trade policy is likely contributing to that deceleration. That said, the ISM Manufacturing Index points to continued growth in capital spending, and the data on core capital goods orders tell the same story, as seen in our middle chart.



One place where we could see slower growth in capital outlays is in the mining sector, given the recent dip in energy prices, which clearly contributed to lower mining output in October. But, as seen in our bottom chart, there is very little spare capacity in the mining sector, and if prices rebound over coming months so too will output, which will lead to further capital outlays. While still low on an absolute basis, capacity utilization in the manufacturing sector is steadily rising. We have argued that the measured utilization rate in manufacturing overstates the degree of idle capacity, as years of underinvestment and an aged capital stock mean that least some of this "idle" capacity is actually obsolete capital with limited scope for more intense utilization. This would argue for solid growth in capital spending in manufacturing over coming quarters.



The industrial production data are consistent with other indicators showing steady and broad based growth in the manufacturing sector, which in turn is supporting overall growth in the U.S. economy. Trade policy, though, looms as a major uncertainty.

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