Munk Advisory Services

# ECOMENTARY™

MAS080204

## Soft Spot, Hard Spot: which is it?

Press 98<GO> to make a copy, 99<GO> to clear news alerts. Govt **BIL**
Screen Printed
21:21 **INSTITUTE FOR SUPPLY MNGMT** Page 1 / 2
94<GO> View News.

| SECURITY | Ticker | CURRENT | DATE | PREVIOUS | DATE | PCT CHNG | FREQ |
|---|---|---|---|---|---|---|---|
| Manufacturing | | | | | | | |
| 2) ISM PMI | NAPMPMI | 62.00 | 07/31/04 | 61.10 | 06/30 | 1.47 | Monthly |
| 3) Prices paid | NAPMPRIC | 77.00 | 07/31/04 | 81.00 | 06/30 | -4.94 | Monthly |
| 4) Production | NAPMPROD | 66.10 | 07/31/04 | 63.20 | 06/30 | 4.59 | Monthly |
| 5) New orders | NAPMNEWO | 64.70 | 07/31/04 | 60.00 | 06/30 | 7.83 | Monthly |
| 6) Backlog orders | NAPMBACK | 58.00 | 07/31/04 | 58.50 | 06/30 | -.85 | Monthly |
| 7) Supplier | NAPMSUPL | 64.20 | 07/31/04 | 68.10 | 06/30 | -5.73 | Monthly |
| 8) Inventories | NAPMINV | 49.90 | 07/31/04 | 51.10 | 06/30 | -2.35 | Monthly |
| 9) Employment | NAPMEMPL | 57.30 | 07/31/04 | 59.70 | 06/30 | -4.02 | Monthly |
| 10) Export orders | NAPMEXPT | 56.20 | 07/31/04 | 56.70 | 06/30 | -.88 | Monthly |
| 11) Imports | NAPMIMPT | 59.90 | 07/31/04 | 57.60 | 06/30 | 3.99 | Monthly |
| Non-Manufacturing | | | | | | | |
| 13) Business activit | NAPMNMAN | 59.90 | 06/30/04 | 65.20 | 05/31 | -8.13 | Monthly |
| 14) Prices paid | NAPMNPRC | 74.60 | 06/30/04 | 74.40 | 05/31 | .27 | Monthly |
| 15) New orders | NAPMNNO | 62.40 | 06/30/04 | 61.30 | 05/31 | 1.79 | Monthly |
| 16) Back orders | NAPMNBO | 55.50 | 06/30/04 | 56.50 | 05/31 | -1.77 | Monthly |
| 17) Deliveries | NAPMNSD | 57.50 | 06/30/04 | 56.00 | 05/31 | 2.68 | Monthly |
| 18) Inventory change | NAPMNIC | 57.50 | 06/30/04 | 54.00 | 05/31 | 6.48 | Monthly |
| 19) Inventory sentim | NAPMNIS | 60.50 | 06/30/04 | 60.00 | 05/31 | .83 | Monthly |
| 20) Employment | NAPMNEMP | 57.40 | 06/30/04 | 56.30 | 05/31 | 1.95 | Monthly |

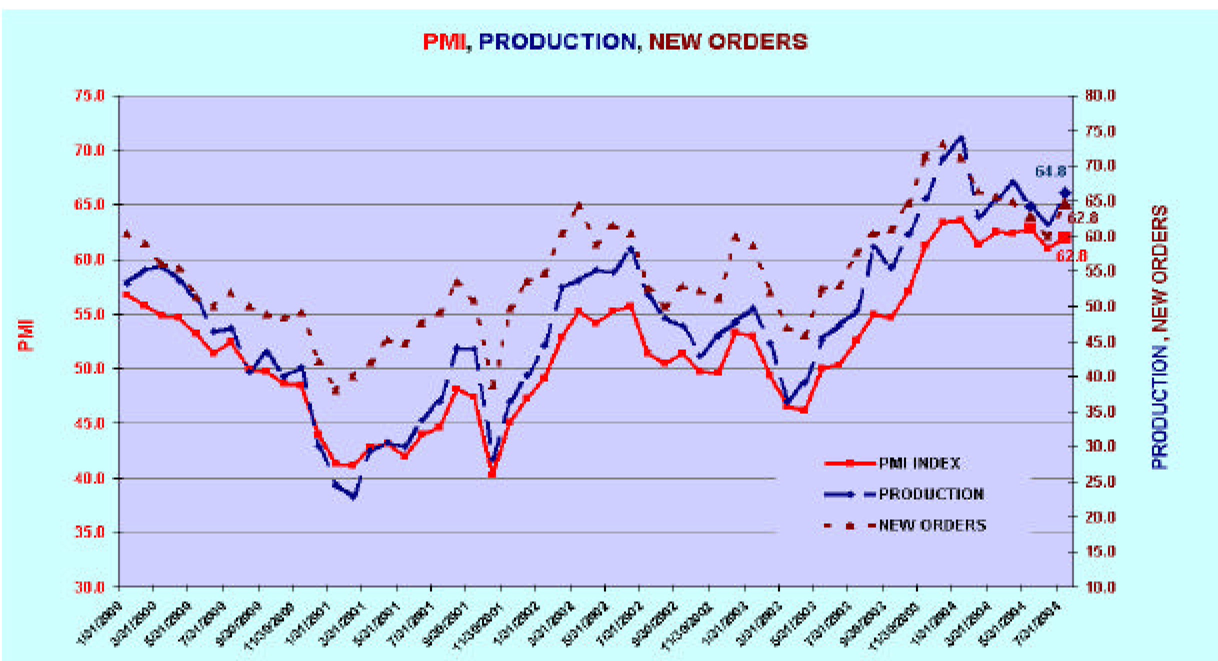
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2004 Bloomberg L.P.
G819-202-0 02-Aug-04 21:21:49

The component indices of the ISM tell an interesting story. Production and new orders accelerated while export orders were at nearly the same pace of expansion as in the prior month. Backlog orders fell and supplier delivery times improved. But, if this Presidential election is all about jobs, there is a continued suggestion that jobs at least in the key, manufacturing sector are not going to grow as rapidly as the Republican Party might like.

Politicians may make a lot of noise about the lack of job growth, but something unusual, when judged by historical recovery patterns may be taking place: the normal relationships that we have come to expect between orders and inventories and production and employment seem to have changed. One school of thought suggests that while this recovery is in many ways 'different,' it is not a horse of a different color. Inventories, according to that interpretation, are below even their falling trend lines, and inventory growth should be a driver for GDP in the second half. Secondly, as orders grow, there will be a significant improvement in job growth. Some economists suggest that the second half should grow at 200-225 thousand jobs per month, or in excess of 1.5 million jobs. The fact is that we really don't know how to calibrate some of the key trends that have emerged in the post cold war period. Fragmentation of production processes (globalization to some) has given many firms the capability to move pieces of the productive process away from its past mountings. Maybe we should call this 'dis-integration' of production, but we prefer the term 'fragmentation' partly because it does not carry any sort of ethical implications. What connects these fragments, however, is inventories of many kinds, such as goods in process. No one consumes a microprocessor chip as a final good, and the components of the chip itself are someone's production and inventory. But in a just-in-time world, each of these connective pieces requires some manager, somewhere, to make a 'buy' or 'make' decision. In a world of very rapid technology change or equally a world of high uncertainty, there are strong incentives to be a minimalist in the inventory sphere.

Secondly, the growth of non-wage benefits has become such a large part of the compensation package that hiring permanent employees has become something of a capital investment decision all on its own…and we believe this may account for the slow uptake of employment in the face of fairly good current demand for output. This is a qualitative judgment. We don't really have the metrics to calibrate either of these trends, but it seems reasonable to us to think that conventionally driven forecasts will typically overestimate the amount of inventory growth or employment growth that corresponds with any given growth in GDP.

The ISM is interesting in that regard. Here, again, output growth is accelerating, but employment growth is not accelerating---the drumbeat of this recovery heard once again. The production and new order data suggest



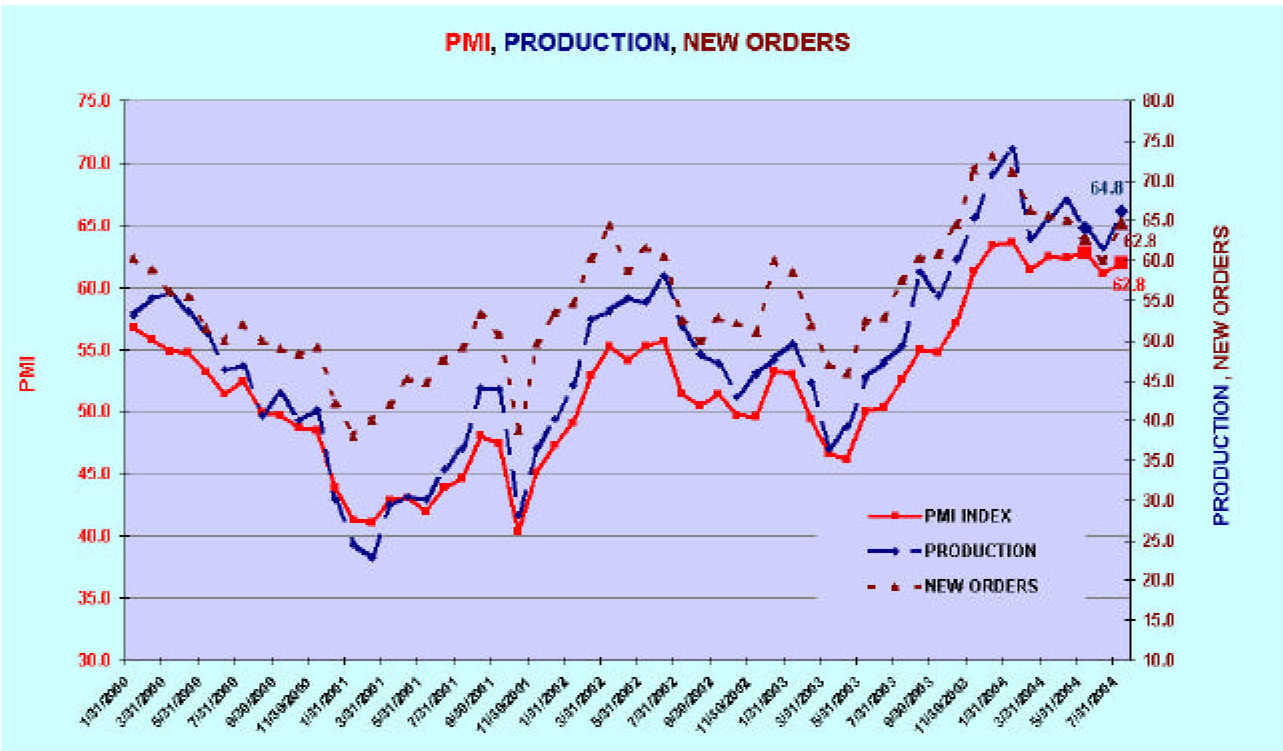

that the June soft spot may be transformed into a hard spot. It is not a big 'recovery,' but the direction of all three barometers is the same. The amount of acceleration is less than it was at the end of last year or earlier this year, but the direction will warm some red hearts! The problem is employment.

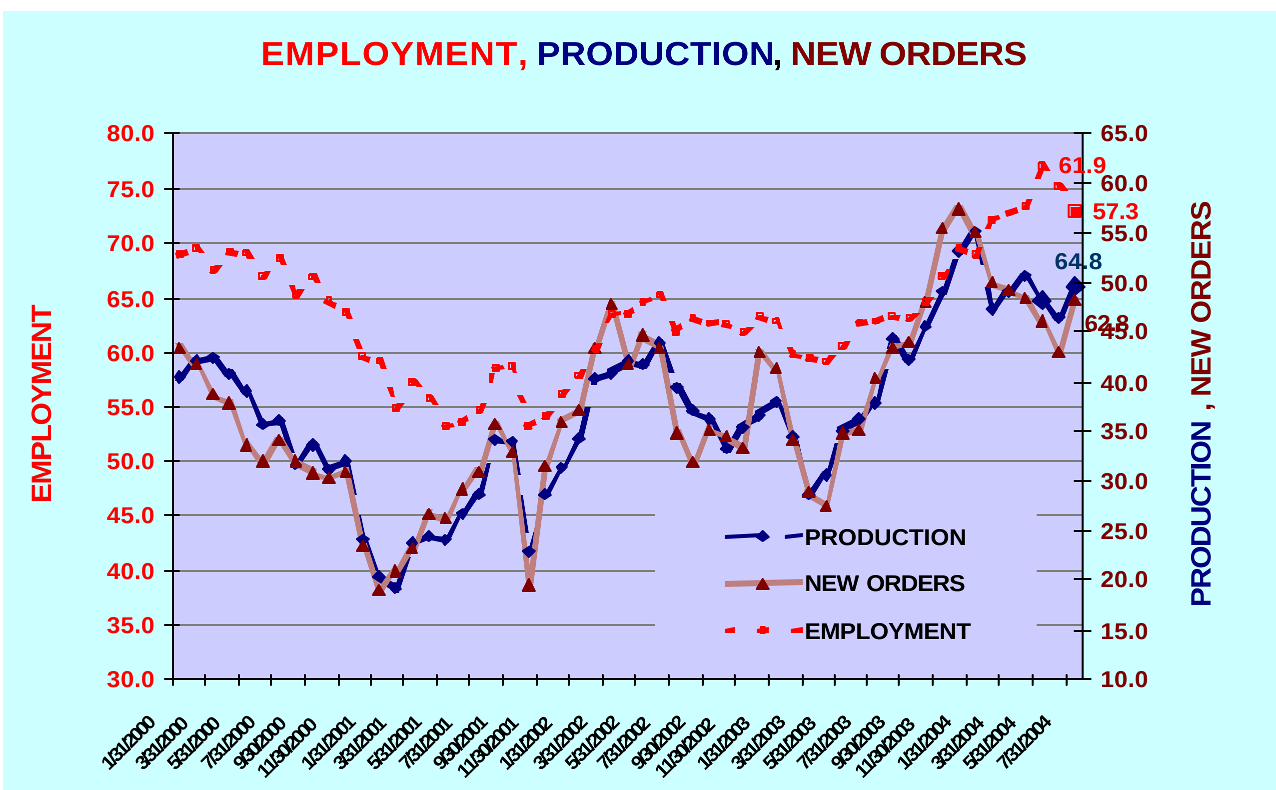
We don't have the non-manufacturing survey data yet and it has shown a pleasantly rising curve, but for manufacturing, acceleration in employment intentions slowed in July.

Munk Advisory Services

# ECOMENTARY™

MAS080204



Casual inspection suggests of the two graphs above suggests that while the ISM top line index moves essentially coincidentally with production and new orders, employment (lower graph), seems to depend on some sort of lagged relationship to the rate of expansion of production or new orders. As new orders and production begin to expand rapidly, employment picks up with a bit of a lag. That seems sensible to us. Firms would want to wait to be sure if the order pattern was changing before taking on the commitment to hire a more permanent workforce.

One consequence of this is that Soft Spot-Hard Spot is a kind of trend breaker and if our conjecture is true, then the mere reversal in one month of production and new order expansion may not lead to commensurate employment gains. It will take a re-establishment of a growth trend to push up employment. Here's a casual test: the Bloomberg consensus for non farm payrolls is now 243,000 as compared to last month's 112,000 and for manufacturing the swing is from –11,000 to plus 10,000 which is a fairly substantial gain. But the ISM data tell us that production and new order surveys are operating in a trough…not really going anywhere and the employment survey question suggests a move to the downside. If we are correct, the consensus should have overestimated the amount of employment gain in non-farm jobs and particularly in manufacturing. Friday brings the employment report. We will all get a bit of education. If jobs do grow anywhere near the consensus numbers, we should expect consumer demand will be bouncing back. If jobs do not grow as much as the consensus, we speculate that Wall Street will worry even more about the outcome on November 2nd.

It seems to us that one principal difference between the parties is tax policy. It would be hard to argue that Wall Street will feel good about an increase in corporate and/or personal taxes, particularly as some of the recent tax reductions run out at the end of the year. A bad jobs report would make it a lot harder for the equity averages to sustain their recent rally. We should know a bit more on Wednesday when the non-manufacturing ISM comes in.