Strong Manufacturing Report

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis exclaims that all is good in the USA on the manufacturing front as well as with Fed actions to date.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Strong manufacturing report**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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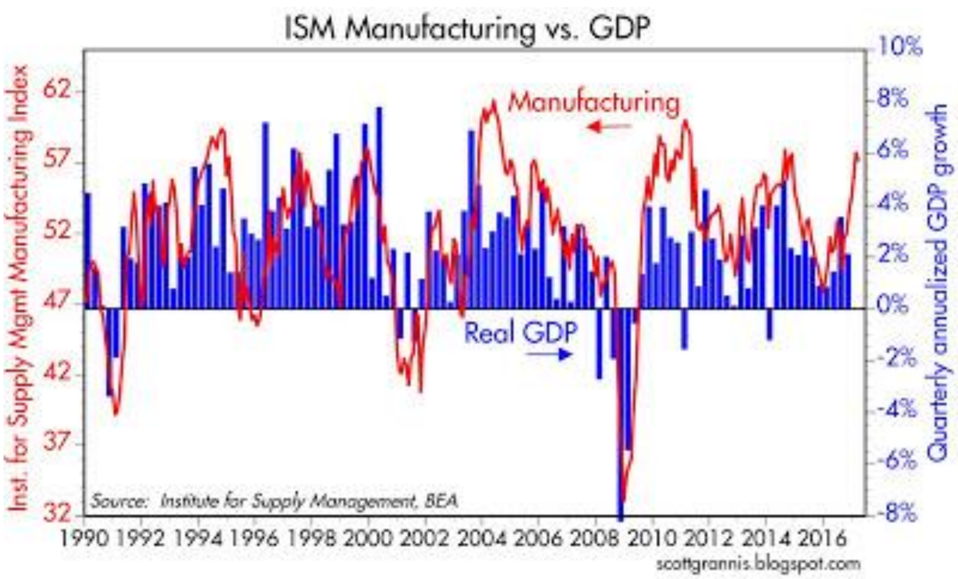
Bob Weir, CFA: Director of Research

Monday, April 3, 2017

Strong Manufacturing Report

The March ISM manufacturing indices, released today, were uniformly strong, pointing to an improving economic outlook in the months to come. In this context, the Fed's recent moves to raise short-term rates do not yet constitute a tightening of monetary policy, nor are they a threat to growth.

The ISM manufacturing index does a pretty good job of tracking quarterly GDP growth, as the chart below suggests. Recent strength in the ISM index is consistent with Q1/17 growth of at least 3%-4%, substantially higher than Q4/16 growth of 2.1%.



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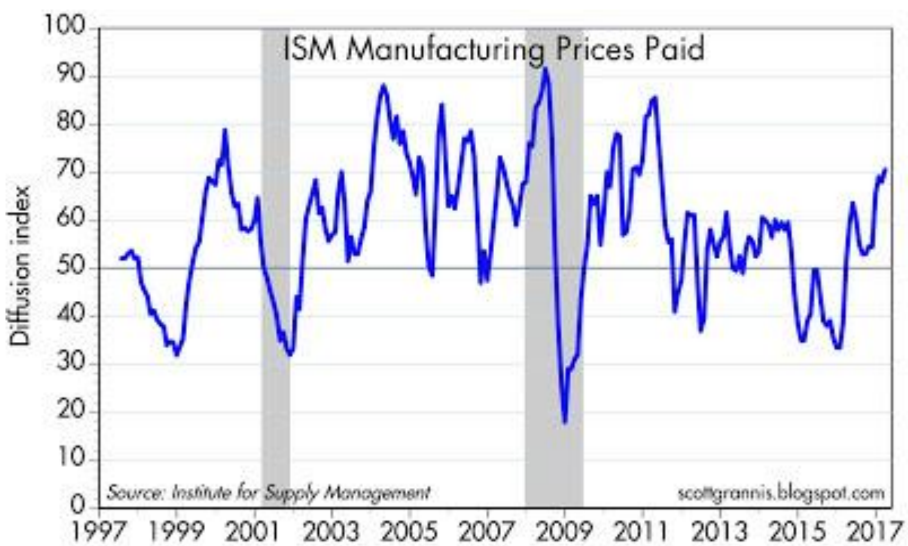
The strong reading for export orders, shown in the next chart, is particularly encouraging, since it likely reflects improving conditions overseas.

The prices paid index registered its strongest level in many years (see chart below).



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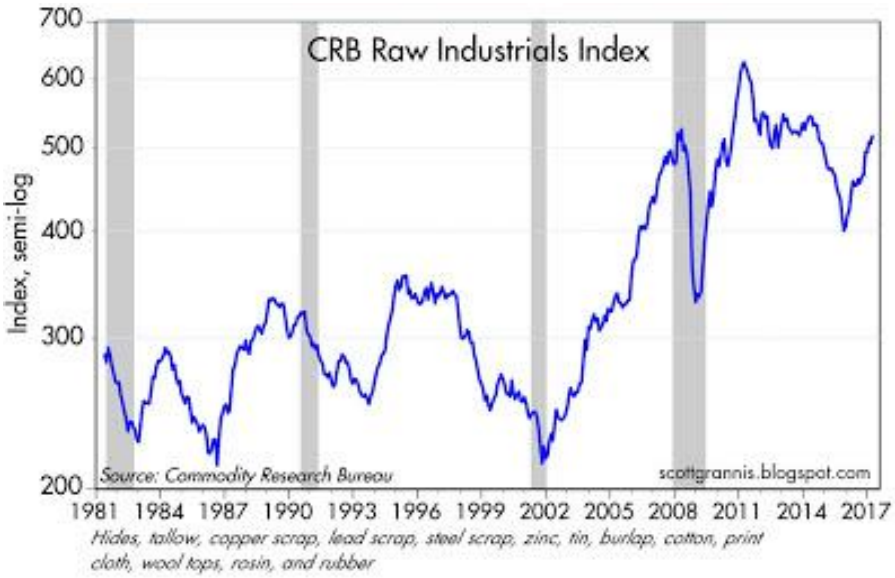
The strength in the last chart is corroborated by the strength in the industrial commodity prices in the next chart. Prices are rising because global demand has proved stronger than commodity producers had anticipated.



Manufacturing firms are becoming more confident about the future, as seen in the chart above which reflects optimistic hiring plans.

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It is encouraging to see that both Europe and the U.S.A. are experiencing improving manufacturing conditions. Coordinated recoveries can reinforce themselves.

The next chart suggests we are likely to seeing rising revenues per share in the months to come, since the ISM manufacturing index has a strong tendency to lead year-over-year gains in S&P 500 company's revenues per share.

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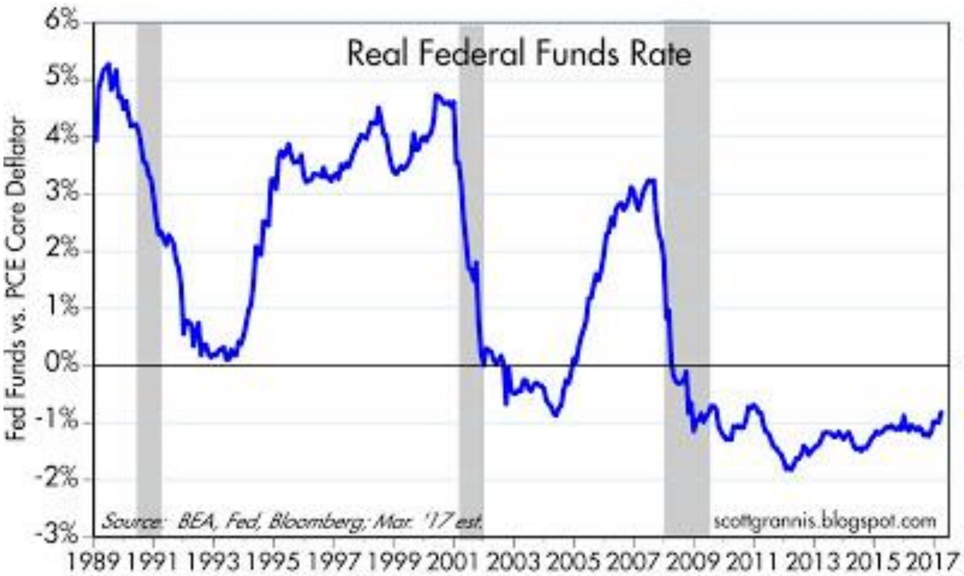
The chart above shows the inflation-adjusted level of the Fed's short-term interest rate target, using the Fed's preferred measure of inflation, the Core PCE Deflator. This is the true measure of the impact of Fed policy, as the Greenspan Fed made clear in the late 1990s. Short-term rates have been negative in real terms for almost 10 years, and are still quite negative despite three rate hikes since late 2015. Negative real short-term borrowing costs incentivize borrowing (because borrowers can repay their loans with cheaper dollars), thus increasing the supply of money (because banks create money by increasing their lending activity) and reducing the demand for money (because negative real interest rates make holding cash equivalents unattractive). The net result is accommodative monetary policy. If the Fed persists in keeping short-term interest rates negative while economic activity and confidence rise, it risks allowing inflation pressures to rise.



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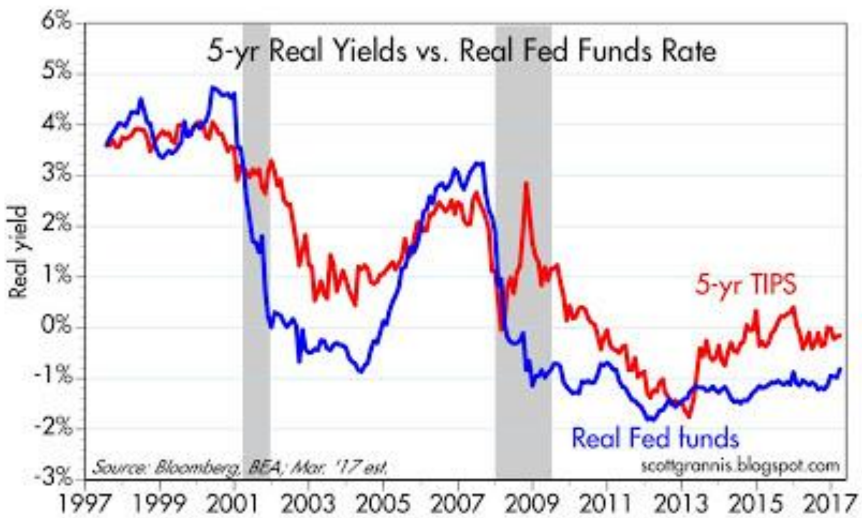
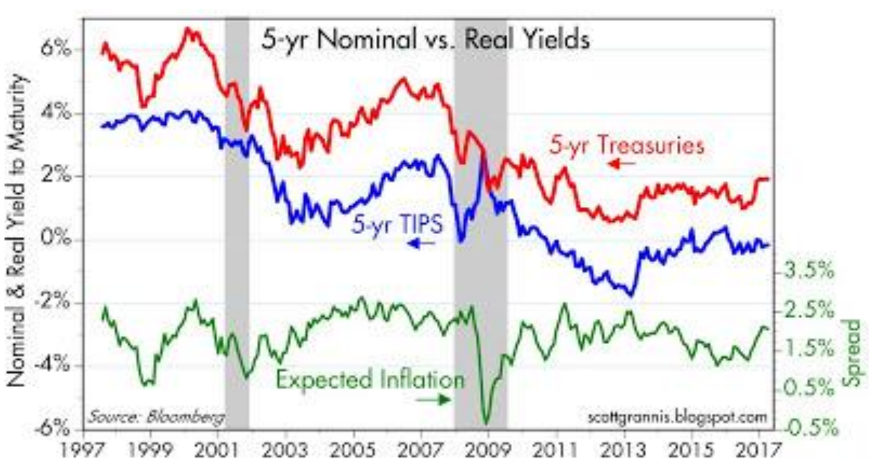
The next chart below compares the real Fed funds rate to the level of real yields on 5-yr TIPS. The latter is a proxy for what the market believes the real Fed funds rate will be in 5 years' time. A positive spread between the two indicates an upward-sloping real yield curve, and that, in turn, reflects the market's expectation that the Fed will likely continue to raise rates in the years to come. The time to worry is when the spread becomes negative (as it did prior to the last two recessions), since that means the market expects the Fed to lower rates in the future because the market senses a significant weakening of economic activity. In short, the chart below tells us that the market is comfortable with the Fed's actions to date.



The chart below shows the level of real and nominal 5-yr Treasury yields and their difference, which is the market's expectation for inflation over the next 5 years. So far, we see nothing unusual afoot; the Fed has been managing policy in a manner consistent with relatively low inflation.



BW: See ABOUT THE AUTHOR on the following page.

ABOUT THE AUTHOR

Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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