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Economics Group

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ISM in Contraction Territory, Trade Most Significant Issue

Today's report is the latest and so far most undeniable evidence of the rising cost of the trade war and growing stress in manufacturing. There is a clear trajectory of escalation in the trade war in coming months.

So Much for "Growth at a Slower Rate," This Is Outright Decline

It is no longer simply a matter of "expanding at a slower rate." We are now talking about outright declines, as the ISM manufacturing index slipped into contraction territory in August for the first time since 2016 (top chart). More worryingly, the ISM new orders component fell to 47.2, which ties the cycle low set in 2012. In order to find a steeper pace of decline in new orders you need to go back to April 2009, which was during the throes of the recession.

"[T]rade remains the most significant issue," according to the text that accompanied this month's report. References to the trade war and tariffs are widespread across industries, and the export orders component plumbed a new cycle low of 43.3. In fact, the only time export orders has been lower in the past 30 years—even during recessions—was a seven-month stretch during 2008-2009.

The middle chart plots the export orders component alongside the year-over-year growth rate in real goods exports. If the historical pattern holds, today's decline suggests that exports are poised to decline more than they already have.

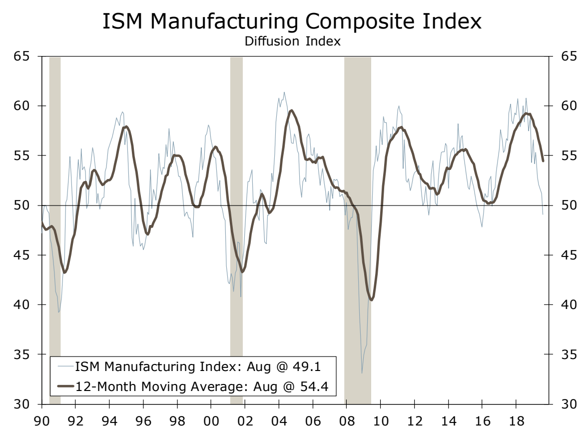
Manufacturing employment continues to expand, although the pace of hiring is slower than last year. In a potential warning for this coming Friday's employment report for August, the employment component of today's ISM report slipped into contraction territory for the first time in three years.

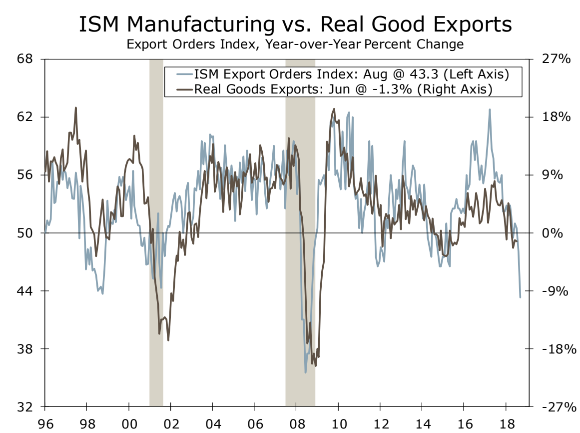
No Denying the Link to Trade War, and Only Escalation in Sight

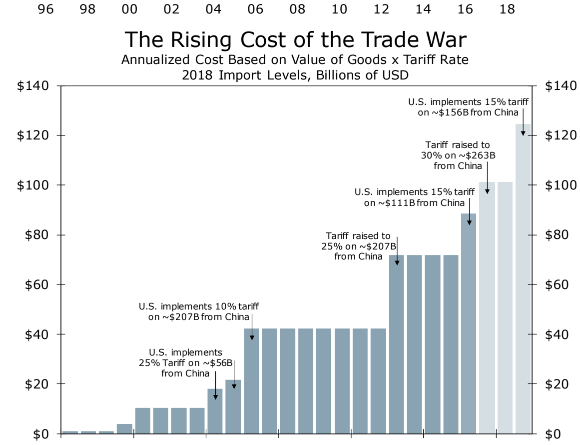
In a $21 trillion economy, the direct impact of tariffs remains manageable, but businesses can no longer pretend that tariffs are not impacting activity. Trade uncertainty is rising, and with it the indirect costs of the trade war. Today's report is the latest and so far most undeniable evidence of growing signs of stress in the manufacturing sector.

The report of slowing factory activity has something in common with Friday's latest survey from the University of Michigan which confirmed consumer sentiment fell to 89.8. One in three respondents spontaneously mentioned tariffs and the trade war.

Not only is there no sign of slowing, there is a clear trajectory of escalation in this trade war. The next increase in tariffs is set for October 1, when the 25% tariff on approximately $263B of Chinese goods will increase to 30%. After that, the next milestone is December 15, when another $156 billion tranche of mostly consumer goods will be hit with a 15% tariff. The bottom chart is our latest tool for visualizing the increasing costs of the trade war. It applies the stated tariff rate at various dates to the dollar amount of the impacted goods at their 2018 import level. At a time when consumers and businesses are citing trade tensions as the reason confidence is wilting, the trade war is slated to escalate further.







Source: Institute for Supply Management, U.S. Department of Commerce, USTR and Wells Fargo Securities

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