THE VISION COUNCIL · ITR ECONOMICS

JUNE 2016 VOLUME 16

SNAP SHOT INDICATORS

Published by ITR Economics

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↑ Steep Rise
↗ Mild Rise
↓ Steep Decline
→ Flat
↘ Mild Decline

MACROECONOMIC OUTLOOK

US Real GDP is growing at a seasonally adjusted annual rate (SAAR) of 2.0%, but US Industrial Production is down 1.0% on a year-over-year basis. US Real GDP is being supported by a strong consumer enjoying rising wages (up 3.5%, the highest growth rate in over seven years), low inflation (1.1%), and low interest rates (30-year mortgage rate at 3.6%).

A weak May jobs report (38,000 new jobs created) made headlines and sent interest rates diving. We are watching the labor market indicators closely for further signs of weakness, but a single bad month for jobs within a larger Employment rising trend is not without precedent. Expect US Real GDP to rise through at least 2018 supported by US consumer spending. Retail Sales Excluding Gas Stations (deflated) is up 3.9% on a year-over-year basis. This is 0.6 percentage points higher than the five-year average which occurred in a period of uninterrupted growth in US Real GDP.

The US Purchasing Managers Index, which leads US Industrial Production by nine months, is generally rising following a tentative December 2015 low. In recent months, the Index has remained above the 50 threshold indicating US manufacturing is expanding. Plan for US Manufacturing Production (up 0.5%, year-over-year) to avoid recession this business cycle, although annual Manufacturing Production is currently stagnating. Year-over-year contraction in US Mining Production (down 8.3%) and US Electric & Gas Utilities Production (down 2.0%) are putting US Industrial Production into a declining trend.

We expect that the annual growth rate for US Industrial Production will reach a low in the third quarter of 2016. The subsequent rising trend will extend through the end of 2017, supported by rising commodity prices (see page 3) and stronger global demand for US goods. US Exports of Goods are down 7.9% on a year-over-year basis, but the quarterly growth rate has risen for three consecutive months and has upward passed the annual growth rate. This is an ITR Checking Point that suggests US Exports of Goods is due to transition into a recovery trend in the coming months.

World Industrial Production is showing signs of future improvement. The rate-of-change for the OECD Plus Six Non-Member Economies Leading Indicator, which includes major emerging economies such as China, India, South Africa, etc., is rising. If the rising trend persists it suggests a third quarter low in World Industrial Production. A stronger global economy at the end of 2016 and moving into 2017 will be welcome news for US exporters and the general US economy.

As you head deeper into 2016 and plan for 2017, ask yourself whether your company has a business plan that takes into account rising wages over the next three years. Skilled workers in particular are becoming increasingly difficult to hire and retain. To offset higher wages you will need to think of alternate means to preserve your margins. If you have a sufficiently strong balance sheet, consider undertaking capital expenditures to automate labor intensive processes. US Material Handling Equipment New Orders are growing at an annual rate of 15.1%; firms are taking advantage of today's low interest rates to invest in capital as they look ahead to more expensive labor on the horizon.

In addition, examine your price escalator plan. As the macroeconomy strengthens, do you have a plan in place to grab market share, increase your margins, or both? If you need to differentiate your brand in order to do so, now is the time to consider what your consumer base values and how you can most effectively deliver top notch quality product as you become busier in 2017.

MAKE YOUR MOVE™

Factor in wage increases for the next three years. Invest in efficiencies to improve productivity in order to maintain your margins. Also, look to use the upcoming higher price environment to your advantage; develop a business plan to capitalize on rising commodity prices.

INDUSTRY ANALYSIS

Retail Sales

US Retail Sales (deflated) totaled $2.267 trillion in the 12 months through May, up 2.1% year-over-year. Strong employment and rising wages are driving consumer spending. Additionally, pricing pressures are diminishing as oil prices mildly rise; Retail Sales Excluding Gas Stations are up 3.9%.

Wholesale Trade

Annual US Total Wholesale Trade fell to $5.273 trillion in April, down 4.1% from the prior year. Wholesale Trade of Durable Goods is down 1.4%, and Wholesale Trade of Nondurable Goods is down 6.4%. Weakness is being influenced by Wholesale Trade of Farm Product Raw Materials (down 13.6%) and Petroleum and Petroleum Products (down 31.7%).

Manufacturing

Total Manufacturing Production in the 12 months through May was up 0.5% compared to the previous year. The US dollar is generally weakening against a basket of our largest trade partners, which may boost the exports of manufactured goods later this year. Despite weakness in the industrial economy, Manufacturing will avoid recession this year.

Interest Rates

The Federal Open Market Committee decided against further rate hikes in June, citing slower-than expected growth and uncertainty abroad. Short-Term Interest Rates rose slightly to 0.565% in May, while 30-Year Conventional Mortgage Rates ticked down to 3.60%.

Medical

US Medical Equipment and Supplies Production in May was up 2.5% on a year-over-year basis. Monthly and Quarterly trends are both accelerating, signaling further year-over-year growth this year. Retail Sales at Health and Personal Care Stores was up 5.6% in May, and Total Hospital Construction was up 9.9% in April.

Capital Goods New Orders

Nondefense Capital Goods New Orders totaled $775.5 billion in the 12 months through April, 3.7% below the previous year. Despite decline in the annual growth rate this month, the Phase A, Recovery, trend is expected to persist through 2016.

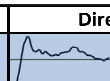
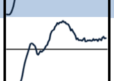
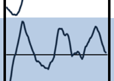
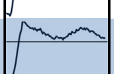
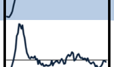
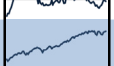
Japan

Japan Industrial Production was down 1.5% in May on a year-over-year basis. The Bank of Japan kept interest rates negative this month, although aggressive monetary policy has failed to kick start the Japanese economy. Despite recovery in Passenger Cars Production, negative quarterly trends suggest Industrial Production will decline further.

US Private Sector Employment

US Private Sector Employment averaged 120.9 million jobs in the 12 months through May, up 2.2% from the previous year. Part-Time Employment for Economic Reasons is down 11.4%, and labor mobility is up. Decline in the number of people unemployed over 27 weeks shows that Americans are transitioning back into the work force with greater ease.

SNAPSHOT INDICATORS

Indicator	Direction		What it means for the US economy
ITR Leading Indicator™ (Actual)		Rise	The indicator ticked up in May suggesting the economy will be stronger in late 2016.
Housing Starts (Most recent 12 months compared to same 12 months one year ago)		Mild decline	Housing Starts are rising and will support to the economy throughout 2016.
Consumer Expectations Index (Most recent 12 months compared to same 12 months one year ago)		Decline	Cyclical decline indicates weaker economic conditions through the end of 2016.
Chicago Fed National Activity Index (Six-month average)		Flat	A tick up in April shows tentative growth which points to a stronger second half of 2016.
US Leading Indicator (Most recent month compared to same month one year ago)		Decline	May ticked up from a March low, suggesting a reversal in the US Industrial Production trend in the coming months.
Purchasing Managers Index (Most recent month compared to same month one year ago)		Rise	Despite ticking down for the second consecutive month, the overall rising trend points to a stronger US economy in the second half of 2016.
S&P 500 Stock Prices (Raw Data)		Mild decline	May's tick down waves caution to the potential trend reversal for the economy in the coming months.

LONG-TERM VIEW

2016:
Recovery in the Second Half

2017:
Ongoing Strength

2018:
Slower Growth

EMERGING SIGNS OF COMMODITY PRICE RISE

By: Eric Post

The decline in commodity prices was one of the main headwinds facing the global industrial sector over approximately the last year and a half. However, commodity prices of many types are showing nascent signs of rise. Consider the following table of commodity prices:

Commodity	3-Month moving Average: Peak	3-Month Moving Average: Trough	3-Month moving Average: May '16	% Decline, Peak to trough	% Rise, Trough to May
Steel (gross ton)	$385.00	$143.33	$210.00	-62.8%	46.5%
Copper (lb)	$3.32	$2.08	$2.19	-37.4%	5.2%
Oil (barrel)	$105.00	$34.80	$44.45	-66.9%	27.7%
Natural Gas (MMbtu)	$4.64	$1.95	$2.14	-58.0%	9.9%
Wheat (metric ton)	$278.96	$162.03	$162.22	-41.9%	0.1%
Soybeans (bushel)	$14.87	$8.69	$10.03	-41.6%	15.5%

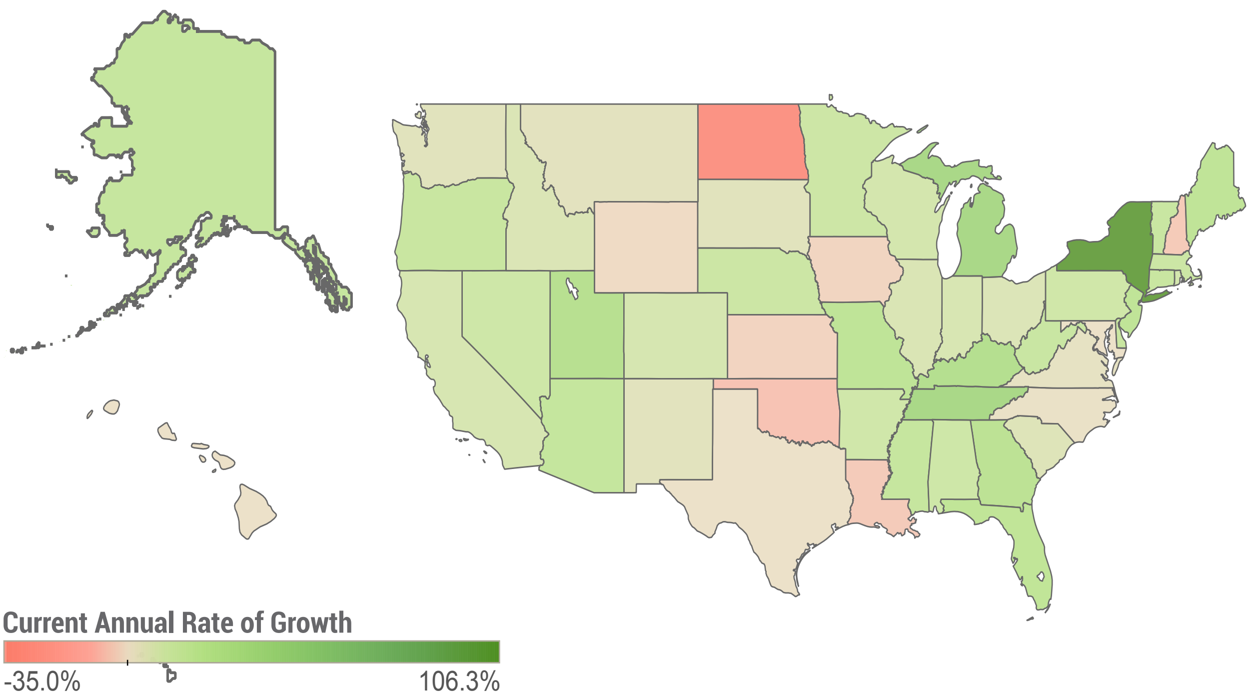
The table highlights two main trends. First, each of these commodities lost between one-to-two thirds of its value over the course of roughly two years. Second, the current rising trend is disparate. The hardest-hit commodities such as steel and oil have generally rebounded (in percentage terms) more rapidly, while copper and wheat have not yet appreciated as significantly.

When analyzing if commodity price rise is here to stay, we first consider why the commodity price decline occurred. Declining commodity prices resulted from weak demand and excess supply. Weak demand was due in large part to China's slowdown, as China is the world's largest consumer of many commodities. The annual growth rate in China Industrial Production fell from an August 2010 peak of 16.7% to 5.9% as of April 2016 (latest data available). Meanwhile, China Railroad Freight Carried went from a total of 2.9 trillion ton kilometers in 2013 to 2.4 trillion ton kilometers in 2015, an 18.6% decline. Production of many commodities did not experience the same cutbacks. OPEC member nations, for example, have continued to pump large quantities of oil. The strength of the US dollar also played a part in keeping commodity-dependent countries producing by taking some of the sting out of depreciated local currencies.

Fast forward to the present time. Signs are pointing to cutbacks in production in some regions and improved demand, suggesting that commodity price rise will extend throughout at least the remainder of 2016 and likely 2017 as well. China Railway Freight Carried is in a recovery trend; its quarterly growth rate rose 11.8 percentage points from a November 2015 low of -17.9% to the current April quarterly growth rate of -6.1%. The China Leading Indicator rate-of-change (nine-month lead time to China Industrial Production) is rising. On the supply side, the decline in new drilling activity in the North American oil & gas sector is helping to curtail the oil supply glut. China Crude Steel Production is also declining, down 2.4% year-over-year. US Primary Smelting and Refining of Copper Production is still rising at a double-digit rate, suggesting that the upward price pressure on copper will take time to build momentum. However, commodity prices are generally moving higher rather than lower. Rising commodity prices bode well for the US and other global industrial economies in the second half of 2016 and especially in 2017.

Prices suggest you will need to factor rising input costs into your plans for next year. Consider your relationship to rising commodity prices. If rise in prices gives you a competitive advantage, develop a plan to increase your market share and/or improve your margins as your market position strengthens. If your business is hurt by rising commodity prices, investigate alternate means to protect your market share and margins. For example, are you able to increase your efficiency by investing in capital equipment utilizing today's low interest rates? Develop a plan today to get ahead of your competition.

STATE-BY-STATE: Permits



State Housing Permits for the majority of the United States have risen above the year-ago level. There is positive momentum building in states within the West Coast, Great Lakes, and Southeast Regions. Larger, more economically diverse states are able to offset weakness stemming from low oil and commodity prices (which are weighing on states with strong ties to the mining and agriculture industries). The most noticeable cluster of Home Permit decline is located among states more dependent on the oil & gas, agricultural, and energy sectors within the Central and Southwest Regions. However, the recovery in commodity prices are supporting nascent signs of recovery in North Dakota (-35.0%), Oklahoma (-7.0%), Louisiana (-5.0%), and Kansas (-3.0%).

READER'S FORUM

My company began experiencing weakness in the Oil & Gas sector early in the second quarter of 2016. This prompted us to downward-adjust our corporate staff last week as we expect third and fourth quarter shipments to fall. Since the price of oil started its free-fall in June of 2014 and we are just feeling it now, it would suggest that we lag the event by about six quarters. Everything I read says that the oil majors would consider re-investing in capital projects when oil reaches $60/barrel. Is that what ITR is hearing?

Brian Beaulieu, CEO of ITR Economics™, answers:

Sustaining oil pricing at or above $60 a barrel would likely get the investment capital flowing again in the industry. Please note the use of the word "sustained". We think that the industry is going to need to see that prices are "real" and that they can count on them to hold before money starts flowing back into this sector. From our perspective that means we are one or two quarters into 2017 before capital starts moving in appreciable amounts. However, we are not so sure the price has to be $60/bbl. Technological developments to enhance rig production have improved since the collapse in 2014-2015 and we are hearing that prices holding in the $50's would suffice to return profitability to the sector. If so, we are there now and we think prices in the $50 range will hold though the rest of this year before moving higher in 2017 (increasing confidence levels in putting capital back into the market). If low $50's is indeed the new "break-even number", we may see some revival in the oil patch late this year or early next year.

Please send questions to questions@itreconomics.com