US Q2 INVENTORY LIQUIDATION POINTS TO HEALTHY PRODUCTION GROWTH IN H2

- Inventories were liquidated in Q2, as strong domestic demand growth outpaced production, and the level of inventories relative to sales have fallen to three and a half year lows

- We expect ongoing strength in production in H2, as domestic demand remains healthy and manufacturing firms work to replenish inventories. Inventory investment should add one percentage point to Q3 real GDP growth, reversing its negative impact on Q2 real GDP growth

- The low levels of business inventories, efficient production processes and a favorable outlook for domestic demand based on monetary and fiscal stimulus, suggest that the probability of recession in the medium term is low.

- We expect real GDP growth to increase by 3.1% annualized in 2018 H2, following its 3.1% growth in H1, as consumption, business investment and government purchases rise solidly, while a wider trade deficit largely offsets inventory building.

The outright liquidation of inventories in Q2 lowered real GDP growth by 1 percentage point relative to domestic demand (Chart 1). The liquidation reflected very strong demand rather than a deliberate decision by firms to unload excess inventories. Real final sales to domestic purchasers, a proxy for domestic demand, grew by a robust 3.9% qoq annualized in Q2, a marked acceleration from the average 2.4% gain between 2012 and 2017 (Chart 2). Moreover, nominal GDP, the broadest measure of current dollar domestic production, jumped by 7.4% qoq annualized in Q2 (see “US nominal GDP acceleration: pay more attention to it”, August 6, 2018). Industrial production accelerated by a robust 6% qoq annualized, despite a reduction in motor vehicle production.

Chart 1: Real Change in Private Inventories

Chart 2: Real Final Sales to Domestic Purchasers

08 August 2018

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The inventories-sales (I/S) ratio is near three and a half year lows, reflecting the stronger sales growth relative to inventories growth in the manufacturing durable goods, wholesale durable goods, and retail industries (Chart 3). These sectors account for roughly 73% of all inventories. In the nondurable goods sectors, inventories and sales growth have grown at similar rates, so the inventory-sales ratios remain close to trend.

Durable goods industries are responding favorably to the Tax Cuts and Jobs Act that provides lower corporate tax rates and the immediate expensing of new equipment investment, plus the deregulatory environment. Better global growth following the 2015-16 industrial slump has increased foreign demand for capital goods, and the rebound in oil prices has boosted oil and gas field machinery equipment investment. Employment growth in the manufacturing and wholesale durable goods sectors through July 2018 (+186k) has already matched the 2017 total (185k).

The inventory-sales ratio for the manufactured durable goods sector is near 2015 lows. It is much lower for the wholesale durable goods and retail sectors, reflecting to a larger extent bottlenecks in supply chains and distribution (Charts 4-9). The manufacturing durable goods sectors with the largest declines in inventory-sales ratios are fabricated metal, machinery, computer and electronic products. In the wholesale durable goods sectors, they are motor vehicles and parts, computers and software, and machinery equipment and supplies. With momentum in key advanced nations expected to pick-up and momentum in domestic sectors carrying into H2, sales of these durable goods should remain strong.

The retail sector is benefiting from solid gains in employment and personal income, the boost to disposable incomes provided by tax cuts, and high confidence stemming from the favorable labor markets and the record level of household net worth. The rebound in job gains in the retail industry (2018 ytd total monthly increase: +83k, 2017: -29k), despite the well-documented struggles of brick and mortar stores reflects renewed momentum in the sector.
The inventory-sales ratio for the retail industry has been inching lower for years due to structural changes in how consumers are purchasing retail goods and dramatic innovations in distribution. The downward trend was exacerbated in late 2017 by the surge in consumption during the holiday season and strong replacement demand for hurricane-damaged goods (Charts 8-9). The I/S ratio in retail rebounded temporarily in Q1, but fell after the strong 8% qoq annualized acceleration in Q2 retail sales. With the inventory-sales ratio so low entering Q3 when retailers prepare for the upcoming holiday shopping season, we expect a near-term push to significantly replenish inventories. This will involve higher domestic production and rising imports. Retail sectors with the largest declines in inventory-sales ratios include clothing and accessories, and department stores.
The currently low inventories, along with other signs of efficient business production processes and the favorable outlook for sustained growth in aggregate product demand suggest that the probability of recession is low. It is noteworthy that the U.S. avoided a broad-based decline in economic activity in 2015-2016, even as the industrial sector and exports struggled.

The favorable outlook for sustained healthy product demand is supported by the healthy gains in employment and personal income, and monetary and fiscal stimulus. With a zero real Federal funds rate and significant liquidity in the financial system, monetary policy is accommodative. Fiscal policy is stimulative, reflecting the tax cuts and reforms of the Tax Cuts and Jobs Act and the Bipartisan Budget Act of 2018 that increases government purchases. The changing regulatory environment has also boosted business confidence. Consistent with this view, of the 88% of S&P 500 companies that have reported Q2 financial results so far, 83% have posted positive earnings surprises, with earnings up around 24%. Our research of prior economic expansions shows that on average the S&P 500 continued to appreciate for roughly seven quarters following the peak in corporate profits, and based on a favorable outlook for sustained growth in real GDP, the outlook for further increases in corporate profits is positive (see “U.S. stock market and economy: room to rise”, June 22, 2018).

In terms of GDP accounting, inventory investment should contribute sizably to real GDP growth in Q3. Following five prior quarters of significantly slower or outright depletion in inventories in this expansion, on average inventory investment contributed 1.2pp to real GDP growth in the following quarter (Chart 10). At the same time, a widening of the trade deficit, primarily due to stronger imports related to growth in U.S. domestic demand and preparation for the holiday season, will have an offsetting impact on real GDP growth. A repeat of a healthy holiday shopping season should support product demand and GDP.
Survey data are consistent with recent trends in inventories and support our outlook. The ISM manufacturing survey asks firms to characterize the state of their customers’ inventories: are they too low, too high or just right? As shown in Charts 11 and 12, in July, only 4.8% of survey respondents viewed customers’ inventories as being too high, tied with August 2017 for the lowest since July 2010, while 26% viewed inventories as being too low, one of the highest in 6.5 years. This suggests that firms plan to keep production levels robust. Other components of the ISM manufacturing survey such as new orders, production and backlog of orders indexes declined, but remained at elevated levels. This points to some moderation in momentum in H2 and is consistent with our view that real GDP growth will moderate to 3.1% annualized in H2, from 4.1% in Q2.

What are the risks to this outlook?

1) Business and consumer responses to fiscal policy fade. We expect that the biggest response of consumer spending to the tax cuts is occurring and expect a
lessening impact in 2019. We anticipate that some of the provisions that reformed corporate taxes, plus the more favorable regulatory environment, will support more sustained gains in business fixed investment.

2) **Trade war tensions escalate and lead to a sharp decline in confidence that constrains consumption and business activity.** The expanded imposition of tariffs that are disrupting select industries has not been large enough to date to have a material impact on the U.S. economy, but this deserves close scrutiny. As we have emphasized repeatedly, the elevated levels of consumer and business confidence have added significantly to spending and investment, and a sharp fall off for any reason could dampen activity.

3) **Economic momentum in other advanced nations softens further in H2, which would reduce the demand for U.S. exports.** Berenberg Economics is anticipating a rebound in European economic growth in H2 following the recent soft patch (“Eurozone GDP: Autumn Rebound Ahead After a Soft Patch Now, July 31, 2018). Japan has also bounced back following a temporary decline in GDP in Q1, and its underlying fundamentals continue to improve. Japan will report its Q2 GDP this Friday, and we expect they will show a healthy rebound. China continues to register strong growth, albeit a bit below target. These trends require close monitoring.

4) **A sharp rise in wages and inflation would harm the economy and lead the Fed to quicken its rate increases and likely adversely affect the stock market.** However, inflationary expectations remain well anchored, and a pickup in productivity gains is mitigating the impact of higher wages on unit labor costs and business margins. We anticipate that next week's report on productivity and costs will reveal a strong gain in Q2 labor productivity.
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