Cougar Global Viewpoints

The link between ISM manufacturing and GDP is not set in stone

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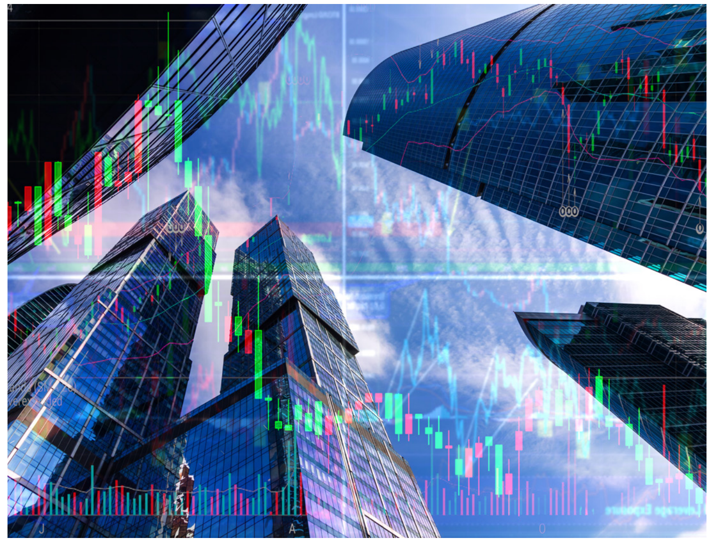
In the 1950s, a widely repeated saying was that "What's good for General Motors is good for America."[1]

And until a few years ago, there seemed to be a similarly strong link between the outlook for manufacturing in the United States and the growth of U.S. gross domestic product (GDP). In the last few years, however, that link has gotten weaker. This paper explores several reasons why and the lesson they offer.

Growth remains a key focus for markets, with various data releases sending somewhat mixed messages about economic momentum. Any systematic economic forecasting program incorporates both hard and soft data. Soft data, such as business and consumer confidence, purchasing managers' surveys, and industry surveys, are usually useful in gaining insight into the state of economic activity. In recent years, however, investors learned that focusing too much on soft data was not very helpful in timing a turn in economic activity. Certain widely followed survey-based indicators have been signaling an elevated chance of economic weakness for some time. However, hard data, such as retail sales, GDP, and the unemployment rate, which represent actual results of the choices that people make, have painted a more positive underlying economic reality. The divergence between hard and soft data is not unique to the United States, as many developed markets have acknowledged a deterioration in data collection and the reliability of surveys.

That said, the usefulness of soft data cannot be discarded because survey-based activity data provides more current information and focuses on the future, while hard data is historical and shows results over time. Therefore, investors continue to pay attention to confidence surveys, for example, in the assessment of economic conditions.



Many U.S. economic nowcast and forecast models use the Institute for Supply Management (ISM) manufacturing survey data as an input in the process of identifying turning points in the economy. It's interesting to graph the sensitivity of GDP to the ISM manufacturing Purchasing Managers' Index (PMI) over time. As you can see from the chart, historically there was a strong relationship between the two series. In effect, the ISM manufacturing PMI indicated whether manufacturing and the economy in aggregate was expanding or contracting. But not recently. The ISM Manufacturing Index has been in negative territory for 22 of the past 24 months, while GDP has expanded over that period.

One reason for this divergence is that the COVID-19 pandemic had a dramatic impact on the relationship between the ISM manufacturing survey data and growth. At the early stages of the pandemic, we saw a rotation of demand away from services towards goods. Then, as economies emerged from lockdowns, spending rotated

[1] The original quote was slightly different: "For years I thought that was what good for the country was good for General Motors and vice versa," but the shorter version cited above is what gained traction and popular usage. Source: Charles E. Wilson, Dwight Eisenhower Administration, Historical Office, Office of the Secretary of Defense, https://history.defense.gov/Multimedia/Biographies/Article-View/Article/571268/charles-e-wilson/

U.S. GDP growth (quarter over quarter annualized % change) and ISM manufacturing PMI

Source: Macrobond Research, Cougar Global Investments, as of 9/1/2024

heavily from goods to services. Consequently, service-sector purchasing managers' indices now are at historically healthy levels, consistent with an overall positive global economic backdrop, compared to the soggy ISM manufacturing survey data. And there are no signs that the gap will narrow. Even the sluggish euro area economy is showing such a divergence.

Another explanation for the discrepancy is that soft data come from surveys and reflect feelings and expectations. When asked about their general economic perceptions, the public tends to regurgitate whatever the news media highlights, and bearishness sells. The result is that economic perceptions do not reflect the fact that the manufacturing-sector share of GDP has structurally shrunk in the United States and other advanced economies to the extent where it is now much smaller than that of the service sector.

In conclusion, the ISM manufacturing index remains stubbornly in contraction, which indicates that the manufacturing sector is still under pressure. But that doesn't mean the economy as a whole is struggling. We are dealing with a very different cycle, one that was distorted by idiosyncratic forces. This led to a widening gap between manufacturing and service sectors compared to past cycles. In other words, the ISM manufacturing survey isn't as important a barometer of overall economic conditions as it used to be. Soft data is impacted by feelings and expectations. However, soft data is still relevant because it is timelier, compared to hard data, which is retrospective. Just like General Motors and the United States in the 1950s, the outlook for manufacturing is not everything when it comes to the growth of GDP, but it's not nothing, either.

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DEFINITIONS

Annualized estimates represent short-term calculations or rates that have been converted into annual rates.

Gross domestic product (GDP) is the total value of goods and services provided in an economy during a specified period, often one year.

The Institute for Supply Management produces several surveys assessing business conditions and outlooks across a variety of industries. They include the ISM Purchasing Managers' Index (PMI), which measures the prevailing direction of economic trends in the manufacturing sector, and the Services ISM® Report on Business®, which is based on data compiled from purchasing and supply executives and reflects the change, if any, in the current month compared to the previous month in supplier deliveries along with seasonally adjusted business activity, new orders, and employment.

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