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What is Manufacturing Production Telling Us?

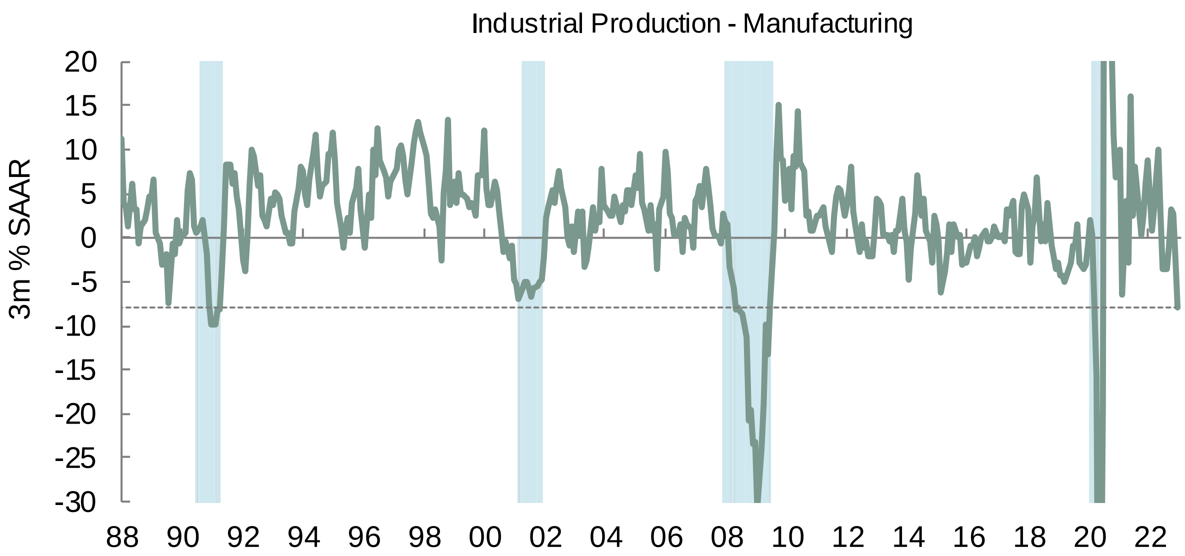
Yesterday's drop in the December industrial production figures were noteworthy because they typically do not occur outside of recession. Headline production was down 0.8% after falling 0.6% in November and remaining flat in October. More importantly, **manufacturing output was even weaker than headline production**. Since this series is highly cyclical, its movements tend to forecast that of the broader economy.

Last month, manufacturing production was down 1.3%. This followed a 1.1% decline in November and a 0.3% increase in October. **Over the last three months, manufacturing production is down 8% at an annualized rate**. As illustrated in the chart below, the current decline generally does not happen outside of recession.

Moreover, the back-to-back declines in manufacturing output corroborate the back-to-back sub-50 readings on the manufacturing ISM survey. **The factory sector appears to have entered the early stages of a downturn**. In addition, the January production data are likely to show further contraction. Both the New York and Philadelphia area purchasing managers reports remained in negative territory.

While monetary policymakers often given the "qualitative" purchasing managers type releases short shift, this will not be the case with the industrial production release since the Fed produces the data. **Another likely decline in industrial production in January will not go unnoticed at the Fed** because it implies another large decline in the capacity utilization rate. Remember capacity usage measures slack in the factory sector, so a falling utilization rate means that inflation pressure is dissipating.

Given rising recessionary risks and the current bond bullish trend in various inflation metrics, **current hawkish Fed rhetoric appears out of place**. But this could be due to policymakers' concerns that a pivot in language will cause financial conditions to ease significantly further. For example, the futures market is already discounting 75 basis points (bps) in rate cuts by next January after peaking at around 4.90% sometime this spring. While this may appear aggressive, history tells us that when recession comes and the Fed begins cutting, it is a lot more than just 75 bps. Bond bears have been forewarned.



Source: FRB, Haver, SMBC Nikko

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