

ECONOMICS: US PERSPECTIVES—JULY 30, 2010

Durable-Goods Manufacturing Gains Despite Weak Aircraft Sector

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A strong second quarter for durable-goods orders, especially capital goods, provides a positive sign for business investment and bodes well for sustained strength in manufacturing.

The US economy has admittedly produced uneven and at times lackluster results as it emerges from the deepest recession in the postwar period. But through the scattered clouds that have shadowed this economic recovery, the durable-goods manufacturing sector has been a ray of light.

As a rule, durable-goods results are lumpy, tending to be volatile on a month-to-month basis. While May and June durable-goods orders posted modest declines and caused many onlookers to express concern over a slowing economy, results for the second quarter as a whole and over the past year indicate strong underlying momentum. Total durable-goods shipments increased at a 9.4% annualized rate in the second quarter and are up 10.4% over the past year, the strongest such gain since 1994 (**Display 1**).

Assuming that the current recovery cycle started one year ago, the gain over the past 12 months represents the biggest jump in the first year of a rebound since 1983—easily outpacing initial gains in the recoveries of 1991 and 2002.

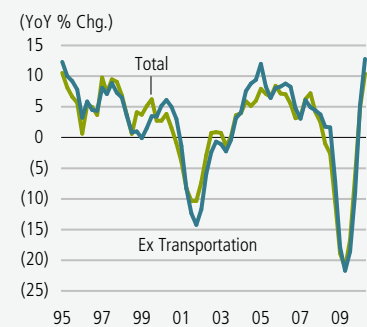
As impressive as this increase is on the surface, it's even more so in light of the 10% decline in shipments of commercial aircraft and parts—for both defense and nondefense uses—that occurred over the past year. This sluggishness reflects the slow recovery in air travel globally, as well as production delays at Boeing. Excluding the transportation sector, durable-goods shipments rose 12.8% over the past 12 months, and the second-quarter gain of 15.1% annualized was the strongest in the past year.

A Broad Durable-Goods Rebound

Shipments have surged in nearly every major durable-goods sector in the past year, led by an impressive 50.8% increase in primary metals, a 22.3% gain in computers and related products, and a 22.2% rise in machinery. Electrical equipment, appliance and components activity rose 15.9% and motor vehicles 15.6%, while fabricated metals posted a 12% increase. Communication equipment, in addition to the commercial-aircraft sector, was the only other major sector to record a decline, with shipments falling by 10%.

Display 1
Durable-Goods Manufacturing—Best Gains Since 1994

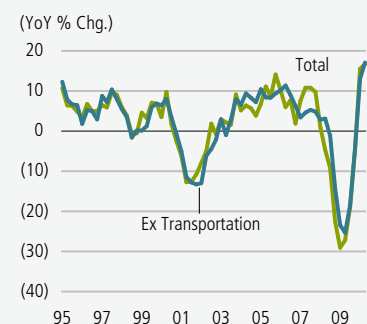
Manufacturing Shipments: Total and Excluding Transportation



Source: Census Bureau and Haver Analytics

Display 2
Strong Rebound in Order Bookings

Order Bookings for Durable-Goods Manufacturing: Total and Excluding Transportation



Source: Census Bureau and Haver Analytics

Historically, a year of strong gains in durable-goods manufacturing shipments has typically been followed by a year of slower growth, as shipments lose steam. But this time, there's reason for optimism because of a bright outlook for the all-important cyclical durable-goods manufacturing sector. Order bookings in this sector have posted very strong gains (**Display 2, previous page**), climbing 16.7% in the past year, 17.1% excluding transportation. Each result represents the best showing since 1983—nearly three decades ago.

More order bookings represent future shipments in the pipeline, and every major industry was able to deliver double-digit increases. Even the commercial-aircraft sector saw an improvement in order bookings—boding well not only for that segment but for other durable-goods segments with strong links to commercial-aircraft manufacturing.

Bigger Order Backlogs—Even in Technology

Not only are orders growing, but so are order backlogs (**Display 3**)—implying that durable-goods production must continue expanding to meet demand.

Order backlogs grew by \$5 billion in the second quarter on the heels of a \$4.6 billion gain in the first quarter—the first gains since early 2008. Most of the increase has been centered on the machinery sector, reflecting very strong overseas demand. Commercial-aircraft order backlogs have also started to grow again, and should jump even more in the third quarter, based on a flurry of new customer orders received by Boeing at the July Farnborough International Air Show in the UK.

Backlogs have swelled even for computers and related products (**Display 4**), an area that normally sees smaller backlogs due to its short product cycles and the relatively limited shelf life of technology products. In the second quarter, order backlogs in this sector climbed by \$500 million to \$5.7 billion, the highest since 2003.

Rising backlogs are likely a sign that the cycle of corporate technology spending is not just robust but lasting, which should quell talk of an economic double dip. The second-quarter report on real gross domestic product provides more evidence of very strong technology and capital-expenditure cycles: the data showed a 21.9% annualized gain in business spending on equipment and software, following an upwardly revised 20.4% gain in Q1—resulting in the strongest back-to-back quarterly gains since late 1994/early 1995.

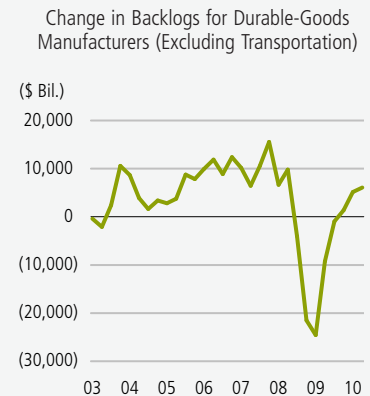
Firms Rebuilding Inventories Again

Another sign of rising confidence among durable-goods manufacturers is their rebuilding of inventory positions, which increased \$8.8 billion (non-annualized) in the second quarter, after a \$4.2 billion increase in the first quarter. These are the largest back-to-back increases in inventory positions since late 2006.

While higher inventories could be perceived as worrisome, we don't see it that way: indeed, as firms raise production in order to meet the increase in orders and backlogs, inventory requirements increase as well. But as that process starts, the ratio of inventories to order backlogs remains near all-time lows (**Display 5**), indicating that there's no overhang of unnecessary materials and supplies or finished goods to saddle firms or slow the process.

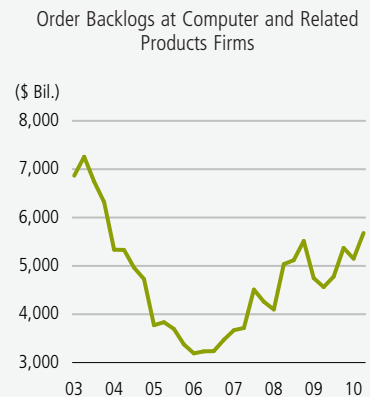
The upturn in durable-goods shipments over the past year has a strong link to customers outside the US. According to our analysis, foreign demand accounts for approximately one-third of the gain—a share that could rise in the coming year, since much of the incremental business in commercial aircraft is linked to overseas sales. Since we expect particularly fast growth through 2011 in emerging-market economies, which receive 55% of US exports, we believe that the growth prospects for durable-goods manufacturing also remain bright. ■

Display 3
Good News: Order Backlogs Rising Again



Source: Census Bureau and Haver Analytics

Display 4
Wow! Computer Firms' Backlogs the Highest Since 2003



Source: Census Bureau and Haver Analytics

Display 5
Inventory/Backlog Ratio at Historic Lows



Source: Census Bureau and Haver Analytics

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