United States

Positive signs

- **Industrial production rebounded strongly in January, and the upturn could continue in the next few months judging by certain leading indicators.**
- **After their January meeting, FOMC members were worried about greater downside risks to the activity and inflation outlook.**
- **This week's developments are fairly reassuring, but there could be too little objective evidence between now and March 15th to change the Fed's cautious stance.**
- **Prices are its main concern and, before it raises rates again, the Fed could wait until the ongoing doubts regarding the medium-term inflation outlook have dissipated.**

The ISM manufacturing index suggested it, the jobs report stated it more clearly, and the figures published this week by the Fed confirmed it: industrial production rebounded strongly in January. The overall index rose 0.9% last month, with most components showing an improvement. In December, spring-like temperatures pushed down energy production, but in January the snow fell again, sometimes very heavily, and electricity and natural gas production rose 5.4% month-on-month.

The manufacturing sector, which is less sensitive to changes in the weather, showed an improvement that could prove longer-lasting. Manufacturing activity rose 0.5% month-on-month, the fastest increase since July (chart 1). Although that came after two months of contraction, several factors suggest that January marked a turning point rather than a temporary correction.

That is borne out by survey results. Although the ISM manufacturing index remained below the 50 level that separates expansion from contraction in January, its two components that show the greatest correlation with activity turned positive (chart 2). The production component rose 0.3 points to 50.2 in January and, most importantly, the new orders component jumped 2.7 points to 51.5. Whereas orders remained a drag on the manufacturing business climate at the start of 2016, this effect could fade away in the next few months if order books continue to fill up. The components that are usually proving slowest to recover are delivery times (50.0 in January) and inventories (43.5). However, the jobs component could soon move back into positive territory, and that could be enough to push the overall ISM index above 50. The upturn could be especially fast given that the decline in the ISM jobs index did not result in a fall in payrolls, since the manufacturing sector created 47,000 jobs between October 2015 and January 2016.

Regional surveys, particularly those carried out by the New York and Philadelphia Fed Reserve Banks, are still far from optimistic, but they suggest that manufacturing activity in the Northeast USA is gaining traction. In the New York Fed's district, the business climate remains gloomy, but less so than in January, and the indexes we use to

Upturn

Manufacturing production (m/m, %)

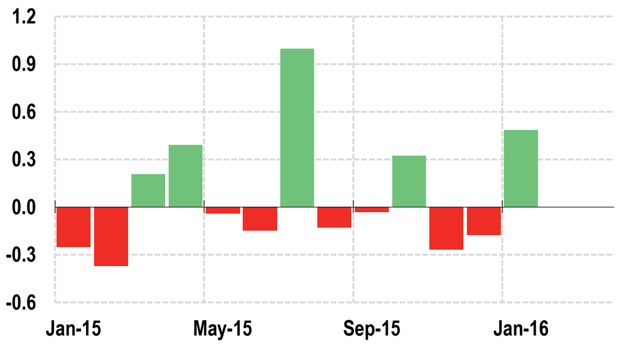

Chart 1 Source: Federal Reserve

Manufacturing ISM and components

ISM; Production; --- New orders

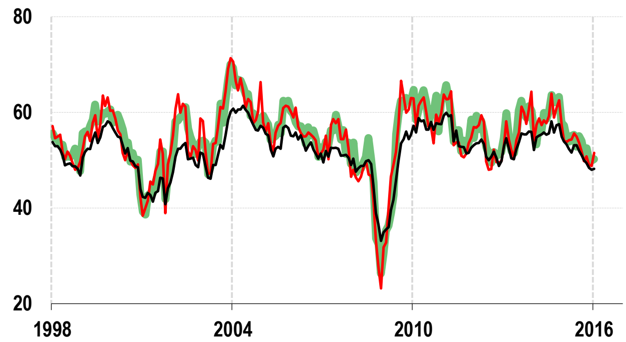

Chart 2 Source: ISM:

create a PMI directly comparable with the national ISM index show a broad improvement. This "NY-PMI" rose 2.2 points between January and February, although it remained very low at 47.3. In the Philadelphia Fed's district, where the manufacturing sector is both larger and more diverse than it is further north, sentiment was slightly better but also more stable in February, with a "Philly-PMI" of 48.6, up 0.1 points compared with January. Overall, our NEM Index (the aggregate of the two regional PMIs) rebounded slightly to 48.7 in February, suggesting an ISM manufacturing index reading of close to 50 (chart 3).

Finally, certain leading indicators of industrial production were very strong in January, i.e. production of intermediate goods (business supplies +1.2% m/m) and non-energy materials for further processing (+0.5%). Production of the latter was particularly buoyant in the upstream part of the production chain (+0.7% m/m for materials used in the production of intermediate goods as opposed to

0.2% for those used in the production of finished goods), suggesting a self-sustaining recovery in US manufacturing. Supporting this hypothesis, production of equipment for the manufacturing industry also rebounded (+0.5% m/m).

The upturn in industrial production, along with the confirmed momentum in the jobs market, is likely to reassure Fed members. However, the minutes of the late January meeting held by the Fed's monetary policy committee (FOMC), published this week, show increased concern. Aside from movements in financial markets, whose decline they regarded as difficult to reconcile with the US economic fundamentals [1] and limited enough not to require any revision of the economic outlook[2], FOMC members were concerned about the low level of activity in late 2015 and took the view that, overall, the downside risks to their scenario had increased since the December rate hike[3].

Taking into account the minutes and recent comments by certain FOMC members[4], it appears that concern is focusing on the inflation outlook, as we discussed last week[5]. The minutes emphasise several times that certain FOMC members preferred to wait until they were sure that inflation was rising again before continuing to normalise monetary policy[6]. January data clearly point in the right direction, with a sharp upturn in the producer price index (+0.6% m/m excluding food and energy) while core inflation remained above 2% for the third straight month (2.2% in January versus 2.1% in December, 2% in November and 1.8% on average in the first 10 months of 2015).

Will the slight upturn in oil prices and inflation expectations (chart 4) be enough to reassure the Fed? A week of renewed calm in the financial markets is certainly not enough. Between now and March 15th, FOMC members will gain more perspective, although they will not receive many more data to help them gauge the strength of the US economy.

The Fed remains inclined to normalise policy as quickly as possible – particularly in order to rebuild its ammunition – but it may leave rates unchanged in the next FOMC meeting for the sake of caution. In any event, that seemed to be the approach in January: "Several participants noted that monetary policy was less well positioned to respond effectively to shocks that reduce inflation or real activity than to upside shocks, and that waiting for additional information regarding the underlying strength of economic activity and prospects for inflation before taking the next step to reduce policy accommodation would be prudent".

Confidence gradually returning?

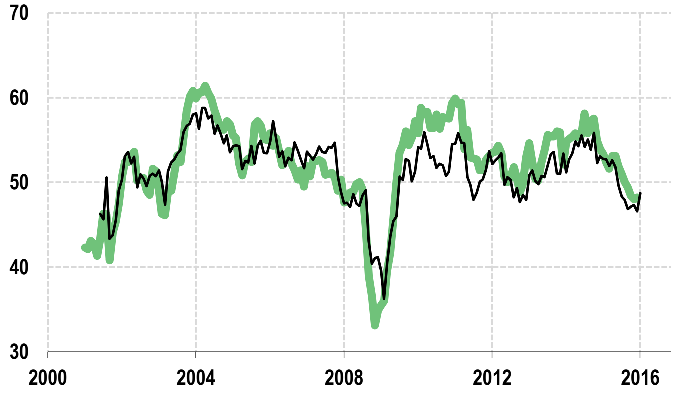

Chart 3 Sources: ISM, BNP Paribas Economic Research

Moving higher again

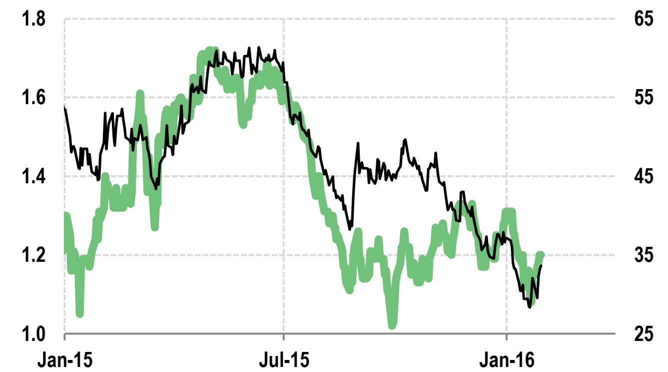

Chart 4 Source: Bloomberg, Federal Reserve

[1] "A number of participants noted that the large magnitude of changes in domestic financial market conditions was difficult to reconcile with incoming information on U.S. economic developments."

[2] "While acknowledging the possible adverse effects of the tightening of financial conditions that had occurred, most policymakers thought that the extent to which tighter conditions would persist and what that might imply for the outlook were unclear, and they therefore judged that it was premature to alter appreciably their assessment of the medium-term economic outlook."

[3] "[…] data releases since the December meeting on spending and production had been disappointing. […] Participants agreed that uncertainty had increased, and many saw these developments as increasing the downside risks to the outlook."

[4] Particularly Patrick T. Harker (President of the Philadelphia Fed, non-voting member this year), Eric S. Rosengren (Boston, voting) and James Bullard (St Louis, voting).

[5] "If labour was the only criterion…", Alexandra Estiot, Eco Week BNP Paribas, February 12th, 2016.

[6] "[…] a few participants noted that direct evidence that inflation was rising toward 2 percent would be an important element of their assessment of the outlook and of the appropriate path for policy."