

For the past three months we have observed some disconnect between the national and the Buffalo-Niagara Falls regional indices. This disconnect widened in February when the National PMI indicated continued and accelerating expansion, while our regional index suggested a further deceleration in the economy from its October – November peak levels. Our regional PMI dropped to its lowest level since June of 2009. The index declined by 7.6 points to 45.8, a level indicative of contracting manufacturing activity in the region. In the next month we are likely to see the two indices converge. The national PMI is likely to retreat in March while our regional index will likely post a small gain. Furthermore, our regional index does not yet indicate a contraction in the manufacturing activity, but rather a leveling off with near zero growth in the region's manufacturing activity during February.

The regional PMI posted a sharp monthly decline as most individual indicators retreated in February. The seasonally adjusted production index dropped by 11.1 points from 54.8 to 43.7. However, this drop was not due to a sizable increase in the number of responders indicating reduced production levels, but was rather caused by a drop in the number of responders indicating higher levels of production. Half of our survey responders indicated that they kept the level of production constant in February relative to the previous month. The number of responders indicating lower production levels increased only slightly: from 28.6% to 31.2%.

Another indicator decline was seen in the New Orders index. The region's New Orders index collapsed from 53 to 32.2, but even that large collapse to levels not seen for this indicator since June of 2009 is also not all that pessimistic in its immediate term interpretation. Again, we did not see a sharp increase in the number of responders indicating lower levels of new orders, but rather a strong decline in the number of responders indicating higher levels of new orders. Only 6.2% of responders indicated increased new orders activity, down sharply from the 42.9% we saw in January. But half of our responders indicated constant levels of new orders. This observation is consistent with a near zero growth in activity, but not a pull back, at least not yet.

Another negative indication is seen in the Employment index. The Employment index fell from 56.5 to 41.6 in February. Here we did see some real, although minor deterioration as the number of responders indicating lower employment levels increased from 21.4 to 31.3% of the survey responders. More than half of responders continued to indicate constant employment levels.

Commodity prices, inventories, and deliveries indicators continued to advance in February. The Inventories index advanced by 7 points to 57.4. Commodity prices continue to advance. Our Commodity Price index advanced to 78.1 with 62.5% of survey responders indicating higher commodity pricing.

The performance of the region's PMI in February is consistent with near zero growth in the manufacturing activity. Commodity prices continue to remain of major concern and with the recent rise in the price of oil and the ongoing fiscal and monetary issues, this concern is not expected to go away any time soon. In fact, inflation is only in the starting stage at this point. During December – January, overall inflation as measured by the CPI increased at an annual rate of almost 5% (www.bls.gov). While the core inflation increased only at the rate of 1.9%. This disparity in the two inflation rates is a negative factor as inflation clearly appears to be driven by commodity prices, in this case food and energy costs.

But even more interesting is the fact that the prices of finished goods do not inflate as fast as those of crude goods (PPI statistics from www.bls.gov), meaning that businesses find it difficult to pass these cost increases onto consumers. This means that businesses will continue to seek labor productivity enhancements as a way to maintain profitability. In turn, this will hold back job growth.

The GDP statistics paint a mixed picture. The 4th quarter GDP numbers were revised slightly downward last week when the real growth was lowered from 3.2 to 2.8% (www.bea.gov). The growth appears to have been driven by the consumer spending. The growth in consumer spending on domestically produced durable goods was 21%, driving up the demand for manufactured goods. This explains the October – November peak levels of manufacturing activity we observed in our region. But it remains questionable if the consumer will remain such a strong engine of growth in 2011 with the unemployment rate being where it is. There was another positive factor in the GDP statistics; the nonresidential structures investment posted a 4.5% increase. This was the first positive rise in this component of the GDP since the second quarter of 2008. This does imply the potential for a return to meaningful job growth. However, it remains to be seen if this is indeed a sign of a turnaround in the labor market, or just a short term mild rebound in a very depressed spending category. The government sector continues to weigh on the GDP growth, and that effect is expected to continue to persist throughout the year, especially in state and local government spending.

The same negative factors continue to remain in the economy. These are the fiscal spending on the Federal level that creates uncertainty about the future of the US taxation and monetary policy; state and local government budgetary problems; commodity inflation; high unemployment. The only thing that appears to have changed during the course of February is that in addition to these seemingly usual problems we also got increased risk associated with the price of oil. The sharp rise in the price of oil helped boost the value of the Canadian Dollar, helping our region's retail activities. The rise in the Canadian Dollar will also help reduce some of the competitive pressure imposed on the US manufacturers, but the relationship is not going to be so pronounced during 2011 in part because many of our manufacturers purchase crude and intermediate products from their Canadian suppliers. Generally speaking, the USD should advance against most other currencies over the course of the next two months, but the rising price of oil may prevent this advancement against the CAD. The long term outlook for the US dollar seems to remain negative.

Our region's manufacturing activity appears to have leveled off in February. Although the regional PMI is expected to increase in March, the outlook for the first half of the year remains that of nearly 1% lower growth than that of the second half of 2010. Commodity inflation is a serious concern and the recent oil price increase only adds to an already problematic situation. If the job market does not turn around in a meaningful way (monthly job gains in excess of 150K), which is not expected at this point, we will see commodity inflation negatively impact profitability and substantially weaken consumer spending which served as the engine of growth in the fourth quarter GDP.

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