Global Industrial Outlook Weakens

Following upturns in our international future inflation gauges, advanced-economy inflation is on the rise.

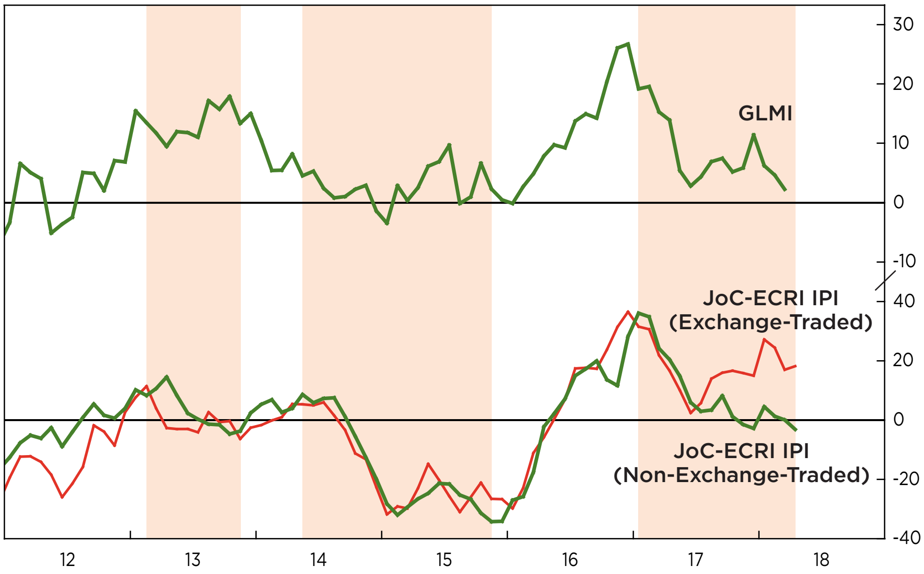
Forked Tongue Spiking commodity prices have misled the markets into optimism about the global industrial growth outlook. In fact, those prospects have already dimmed, according to ECRI's leading indexes, which are designed to discern cyclical signals from noise.

Indeed, ECRI's Global Industrial Growth Long Leading Index turned down last summer, and remains in a cyclical downturn, falling to an 11-month low in March. Following suit, our Global Industrial Growth Short Leading Index turned down by year-end, as did our Industrial Production Diffusion Index – a coincident indicator of global industrial growth – which has now dropped to a seven-month low (not shown). With these long leading, short leading and coincident indicators all in cyclical downturns, the ongoing global industrial growth downturn is set to persist.

That is also the message from ECRI's Global Leading Manufacturing Index (GLMI), whose growth rate – a short leading indicator of industrial growth – is in a clear cyclical downturn, falling to a 26-month low in March (Chart 1, upper panel). Following that downturn, growth in the non-exchange-traded portion of the JoC-ECRI Industrial Price Index (IPI) turned down in early 2017, and has stayed in a cyclical downswing, re-entering negative territory and sliding to a 25-month low (lower panel, green line). All of these leading indexes are telling the same story: global industrial growth is slowing, and will keep easing for the foreseeable future, with no end in sight.

Globally, the main risk — especially at the Fed — is confusion of cyclical with structural and the presumption of economic "normalization," while rising inflation spurs policymakers to keep hiking rates amidst cyclical crosscurrents they disregard.

Chart 1: Global Industrial Indicators, Growth Rates (%)



Shaded areas represent cyclical downturns in the JoC-ECRI IPI Growth.

In stark contrast, growth in the exchange-traded part of the JoC-ECRI IPI – after turning down in line with the GLMI growth downturn and falling to a 13-month low last June – has since turned up, though it has come off January's 11-month high (lower panel, red line). Its message seems to be quite different from that of its non-exchange-traded counterpart. The question is why.

One unique feature of the JoC-ECRI IPI is that about half of its components are exchange-traded, but the rest are not, making the overall IPI less susceptible to speculative forces. While the exchange-traded IPI is subject to speculative forces, its non-exchange-traded counterpart is relatively immune to them. In this case, there are a number of reasons for their divergence, including supply-related factors affecting exchange-traded commodity prices.

In recent weeks, the prices of aluminum and nickel shot up on fears of U.S. sanctions on Russia, before easing a bit lately as those concerns abated. Separately, due to labor problems at major mines in Chile and Indonesia and the threat of further labor strife, copper prices had surged between last spring and last fall and – while essentially treading water since then – remain elevated. Meanwhile, rule changes regarding permits for tin exports from Indonesia – the world's largest tin producer – have caused supply shortages and boosted tin prices. Years of underinvestment, followed by the shutdown of major mines in Australia, Ireland and Canada, and the environmental clampdown in China – responsible for a third of global output – have spurred zinc prices higher since last spring. And China's environmental measures also lifted lead prices. In other words, a perfect storm of supply constraints has driven the run-up in primary metals prices.

In India – the world's biggest cotton producer – pink bollworms have eaten into cotton supply and crimped exports. Meanwhile, the Chinese crackdown on pollution emitters has hurt its production of synthetic fabrics, potentially boosting cotton's market share and putting further upward pressure on cotton prices.

Finally, Saudi Arabia and Russia have deliberately kept crude oil production in check to support oil prices, while Venezuelan oil production has been plunging. In the meantime, supply bottlenecks in the Permian basin are limiting U.S. oil production. This combination of supply problems – along with geopolitical concerns – has driven oil prices higher.

While disparate supply issues have plagued these exchange-traded commodities, pushing their prices up over the past several months, this does not add up to a sustainable cyclical upswing in commodity price inflation. Of course, its advance has also been aided by the downturn in the U.S. dollar since the beginning of 2017. The point is that there is no cyclical upswing in global demand growth acting as a tailwind – quite the contrary. In essence, the rise in exchange-traded IPI growth is not indicative of an upswing in global industrial growth, but could result in higher inflation in the near term.

It is worth noting that the exchange-traded and non-exchange-traded IPI growth rates really do tend to move together, as Chart 1 shows. Indeed, the sort of divergence currently evident between them is highly unusual, because it is a matter of not only magnitudes, but also cyclical direction. The only other time in history that such a clear directional divergence has persisted for a bit was between the fall of 2005 and the spring of 2006, before they both changed direction to approach convergence by early 2007 (not shown). This period was marked by a boom in commodity demand from emerging markets – especially China – coming after a period of low investment, particularly in extractive commodities, along with geopolitical concerns affecting oil prices. Also aiding the commodity price boom was a decline in the U.S. dollar from late 2005 to the spring of 2008.

There is one other relevant similarity with the mid-2000s. It was also a period of rising inflationary pressures, with the Fed raising rates gradually from mid-2004 to mid-2006. By the time the Fed had completed its rate hike cycle in 2006, the yield curve had inverted.

Inflation Rising One consequence of the recovery in oil prices is that, after years of anticipation, headline inflation rates in the major economies are approaching their respective central bank targets. Thus, year-over-year (yoy) growth in the U.S. personal consumption expenditures (PCE) deflator has now risen back up to 1.75% (Chart 2, upper panel, black line), just a shade below the Fed's 2% target (red line). With inflation close to its target, the fed funds rate has been nudged up to just a touch below that, at 1.625% (blue line).

In the Eurozone, however, even with yoy CPI growth at 1.37% (second panel, black line), within striking distance of its inflation target – defined as "below, but close to, 2% over the medium term" – but with core CPI growth at just 0.21% (not shown), the European Central Bank (ECB) has kept its main refinancing rate at zero (blue line), and its overnight deposit rate at -0.4% (light blue line). Meanwhile, ECB policymakers recently indicated that they would now wait until July to announce how they plan to end quantitative easing (QE).

