Canadian Manufacturers Suffering From Inventory Bloat

- Inventories are getting completely out of hand…
- …which suggests further production weakness is ahead
- The new order and backlog pipeline is weak
- The figures were weak even after excluding ‘temporary’ shutdowns
- Will the BoC remain upbeat if 3 of the past 4 quarters disappoint…
- ...or is it waiting to clear the air on the election?

Manufacturing shipments, m/m% change, SA, July:
Actual: -1.3
Scotia: 0.0
Consensus: -0.1
Prior: -1.4 (revised from -1.2)

No matter how one slices it, this is a pretty bleak report and the underlying signals suggest that further damage likely lies ahead.

What caught my eye in particular was further evidence regarding the inventory bloat that is going on. The inventory-to-sales ratio now sits at 1.54. **The last time inventories were so high relative to sales was way back in December 2008** and hence in the dirty days of the evolving GFC (chart 1). Inventories that are costly to finance and store are getting out of hand. In order to burn off these inventories, manufacturers are likely to scale back production and related investment and hiring. It frankly still amazes me that this can happen given modern inventory management techniques.

While the 1.3% m/m drop in the **value** of shipments was the third drop in the past four months, all of the 1.3% m/m decline came through a 1.6% drop in **volumes** as prices inched higher. The volume of shipments has also fallen in three of the past four months.This means that all of this will flow through to GDP.

How much so? For July GDP, we have hours worked down 0.7% m/m, housing starts down 9.1% and manufacturing shipment volumes down 1.6%. That translates into a mild decline in GDP so far with retail sales and wholesale trade still ahead. **At a very preliminary stage of tracking the data, Q3 GDP is running at about ½% q/q at a seasonally adjusted and annualized pace with a lot of data still ahead.** In fact, at this early stage, GDP tracking has little to go by. Recall that the BoC had forecast 1.5% annualized GDP growth in Q3 after sharply underestimating Q2 growth by forecasting 2.3% (3.7% actual).

Shipment volumes are tracking about a 5% annualized decline in Q3 over Q2 following a nearly 7% rise in Q2. The Q2 gain was fed in part by transitory one-offs, most of which is being reversed so far but with most Q3 data still ahead.

New orders fell by 1.6% after a prior decline of 4.3% m/m which implies further softening in shipments ahead. **The unfilled order backlog fell by 1.4%** after a prior 1.2% drop. Combined, there is nothing in the tank to drive nearer term production growth by way of new orders and the backlog.

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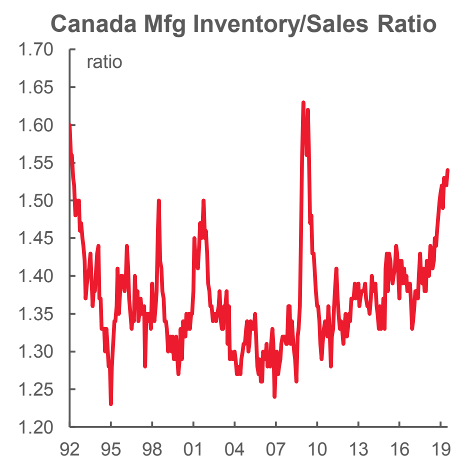

Sources: Scotiabank Economics, Statistics Canada.

Breadth was poor as 11 of 21 sectors saw lower shipments. Within the sector mix, transportation sector shipments fell 3.4% m/m led by a 4.7% drop in vehicle shipments, but a 26.7% decline in rail and 10.8% decline in ships marginally contributed in weighted terms.

Five of ten provinces fell including the four biggest. Ontario saw a 1.5% m/m decline in shipments, Quebec fell by 1.2%, BC declined by -2.2% and Alberta was off by -2.8%.

It's tricky to judge the shutdown effect that StatsCan cited in these numbers, only some of which was previously understood. Nevertheless, **don't dismiss the weakness because of shutdown effects** that were particularly concentrated in the transportation sector. Excluding transportation, shipments would still have declined by 0.8% m/m, new orders ex-transportation fell by 0.7%m/m and the backlog fell by 1.2% m/m ex-transportation. **If we exclude not only transportation but also primary metals that also had some shutdown effects then total shipments were still down by about 0.1% m/m.** Not all of the weakness in transportation and primary metals was due to shutdowns, and even assuming it was still leaves behind a weak trail of overall manufacturing activity in July.

So overall, this is not to be dismissed as anything other than a weak report. The degree of integration between US and Canadian industry is making Canada no exception to the trade war that has induced a slowdown in the global industrial sector.

What does it mean to the Bank of Canada? At this point, not a great deal. We're still plodding ahead at a fairly early stage of tracking the breadth and depth of the deceleration across the economy in 2019H2 following a strong second quarter. That second quarter was a big head fake at 3.7% and the only decent quarter over the prior three. If we wind up with only one decent quarter for growth in the past four by the time we have enough information on Q3 GDP, then the BoC will face market pressure to ease dependent also upon external factors.