Durable Effects Of Durable Goods

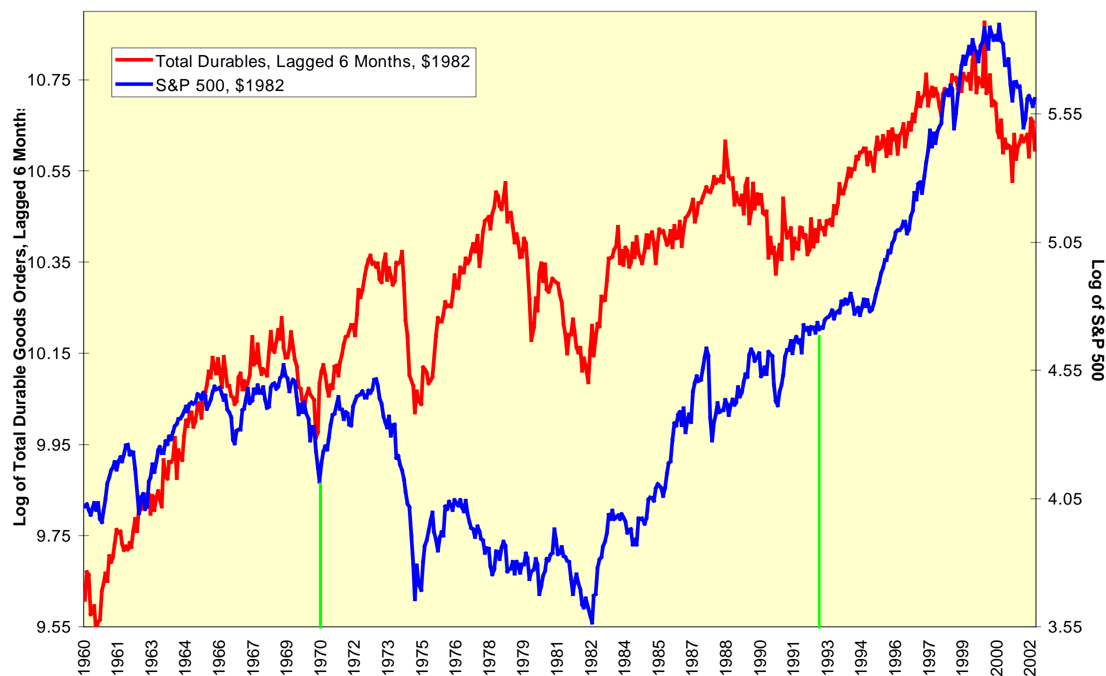
Halloween derives from various pagan rituals surrounding the dearly departed rising from the dead, such as relatives, pets, and both Lucent and Nortel. Reverse split, anyone? Myths come and go surrounding economic data as well. Most of those in the honored profession I'm so proud to call home have a forecasting record worthy of blue-painted Druid priests, so let's take a look at one cherished belief, that durable goods is an unimportant economic number.

Newcomers into the trading business are socialized into what they should and should not consider important. Bond traders, for example, are taught to over-react to every employment or producer price report. Fashions in equities come and go; the consumer sentiment numbers have been given outsized importance during the bear market, but they were always just a shrug before. We seem to take turns whether to pay attention to the complete consumer price number or exclude the "volatile" food and energy numbers as if they either count or don't count depending on our mood. But one thing all traders agree on is that the durable goods datum is noisy, that a few large defense or aircraft orders can distort things so much as to be meaningless - and this in the most manic depressive business in the world.

For long-term investors, a classification whose numbers surely shall dwindle if the bear market continues, durable goods count. The linking variables include both long-term interest rates and the stability of the dollar.

Just The Facts, Ma'am

First, stock traders calling durable goods volatile is a classic case of the pot calling the kettle black. If we compare the growth of the two series since 1960, we can see that the S&P 500 is at least as volatile as are total durable goods orders. The durable goods numbers are lagged six months to account for the leading nature of equity prices; the January prices for the S&P are matched against the July report for durable goods. Both numbers are deflated by the producer price index.



A second, and perhaps more important, phenomenon is visible as well, and that is the long-term disconnection between the two numbers. Prior to the collapse of the Bretton Woods systems of fixed exchange rates in the early 1970s, stock prices led durable goods orders on a reasonably mechanical basis. After the massive currency upheaval

in Europe in 1992, the most famous component of which was George Soros' winning bet against the Bank of England, the relationship began to restore. Incredibly, the stock market and durable goods orders have been linked more closely during this post-industrial, information-rich, everyone's-got-a-Web-site economy than they were during the late 1970s and early 1980s, an epoch made famous by the death of the Rust Belt and the "deindustrialization" of America.

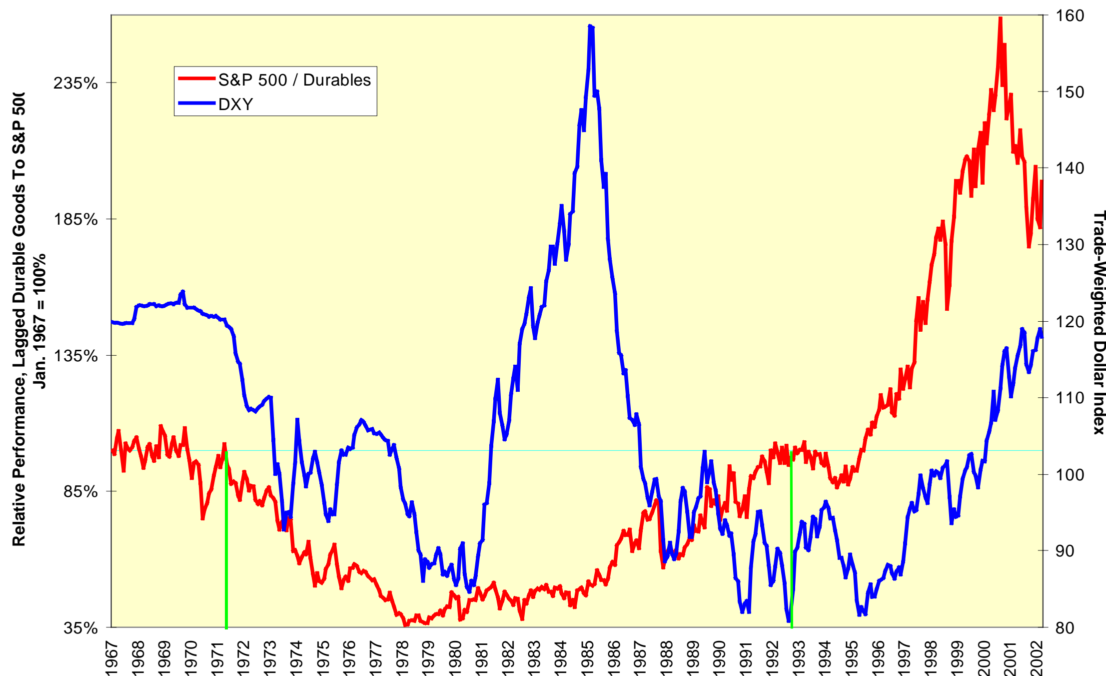
Finally, much verbiage has been expended on whether this market resembles the 1930s, the 1970s, or some other era. Someone told me the other day that this market resembles 1805-1815; naturally, I smiled and agreed politely. We should note that the 1982-dollar value of the S&P 500 did not bottom until 1982, well after the nominal bottom of 1974. Yuck.

Claims And Goods

It is important to remember that stocks, which clearly can trade in bubbles, panics, manias, crashes and other regimes, (that's what we need, a regime change) ultimately must represent a claim on the discounted stream of future earnings. Anything that raises the risk of holding this claim on future earnings - and that includes both chicanery in its various forms and political incompetence - will depress stocks relative to the current state of the economy.

The collapse of the Bretton Woods system ushered in both massive currency volatility and an era of high inflation; central banks were absolutely clueless as to how to manage the new floating exchange rate regime, but of course had to maintain their usual pretense of omniscience. Thanks, guys.

Currency volatility increases risks to investors in several ways, including the relative cost advantage of locating manufacturing facilities in one country as opposed to another and the real rate of return to investors located outside of that currency. Inflation erodes the attractiveness of all financial assets. Since currency volatility raises the premium investors must receive for long-term commitments, we can compress these two factors into one relationship and compare the relative performance of the S&P 500 to durable goods orders with respect to the trade-weighted dollar index.



Viewed in this light, the importance of currency stability is easy to discern. The S&P started to underperform increases in durable goods orders once floating exchange rates were introduced, and stocks started to outperform the real economy once some semblance of order returned to currencies after 1992.

I've several times opined that equity markets do not care where the dollar or any other currency is trading so long as the level is perceived as set in the market and free from political manipulation. Should the greenback start to decline in an orderly fashion, U.S. exports may become more competitive in world markets and the level of durable goods orders may rise, but only after stock prices rise.

The combination of a rising equity market and falling durable goods orders, the same combination seen last week, is perfectly logical. But let's not dismiss durable goods orders as unimportant just because they lag stock prices.