The Permanent Importance Of Durable Goods

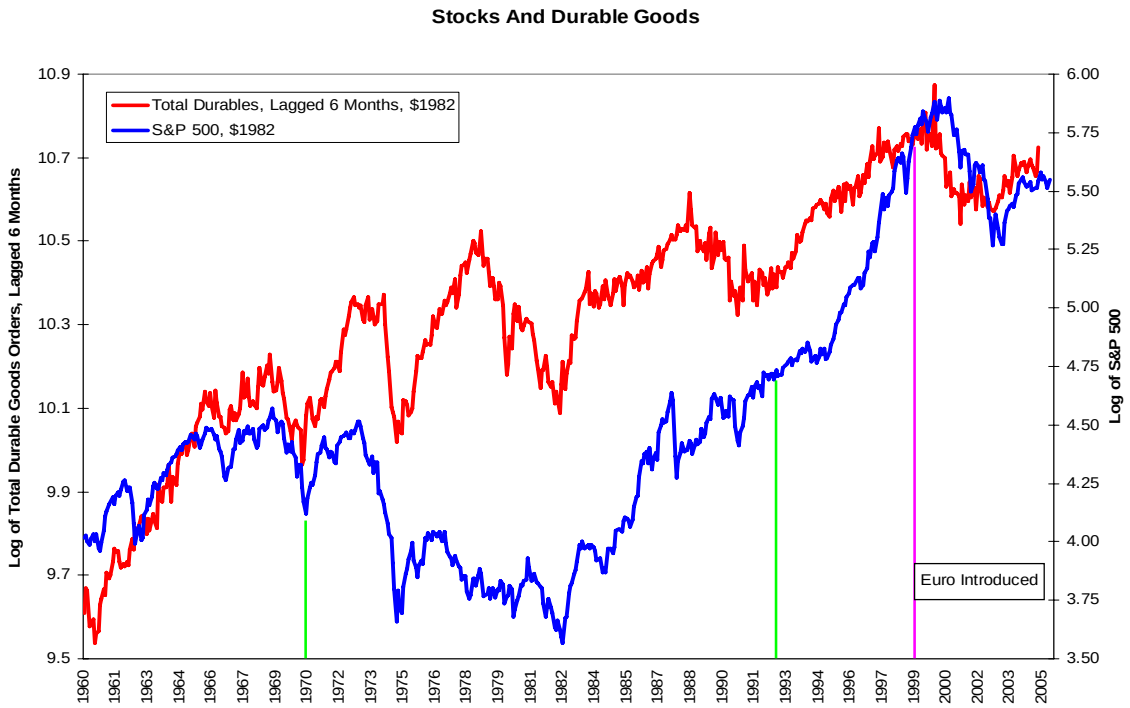
Traders are socialized into what is and is not important. This task is sure to become more difficult as fewer and fewer entry-level positions are available at exchanges, banks and trading firms. Regardless, the urban legends of the community will persist as if transmitted through the ether. For example, is there a monthly report pooh-poohed with greater regularity than the one on durable goods? No, but caution is in order as well as a reminder he who poohs last poohs best.

The durable goods number is dismissed on account of its volatility. The arrogance of this assumption is breathtaking; both considering the track record of economists in forecasting various monthly indicators (see "Working At Employment," June 2005) and the usual hurlers of these invectives. For traders in stocks, bonds and futures to call any economic series volatile is truly the pot calling the kettle black. Even worse, even many economists have fallen into the trap of dismissing the portions of monthly reports that do not conform to the prior wishes; this is parallel to the readiness to transform the monthly inflation reports into "core" inflation reports when expedient (see "The Price Is Right. Sometimes," May 2005).

Durable Relationships

For long-term investors, a population whose self-described membership rises and falls in accordance with unrealized equity, durable goods count. The linking variables between durable goods orders, the economy and the stock market include both long-term interest rates and the stability of the dollar. This would all be fine and dandy in an academic sense alone, but there is something better for traders: Durable goods orders lead stock prices on the order of six months in advance. And, as is so often the case, we can distill useful information from those periods when the relationship between the stock market, as measured by the logarithm of the constant-dollar S&P 500, and durable goods, as measured by the logarithm of the constant-dollar total durable goods number, diverges.

Two points are noted in the long-term comparison between stocks and durable goods. The first is the start of the breakdown of the Bretton Woods system of fixed exchange rates at the end of the 1960s. The second is the September 1992 collapse of exchange rate intervention in Europe. This latter episode is remembered best as George Soros breaking the Bank of England. This episode, which is estimated to have cost European taxpayers $60 billion so that their central banks could defend some arbitrary exchange rate band, did more to hasten the advent of the euro than any other event (see "The Euro And The Logic Of Money," March 2005). Note the tight correlation between the S&P 500 and durable goods since the euro's arrival on the scene at the start of 1999.

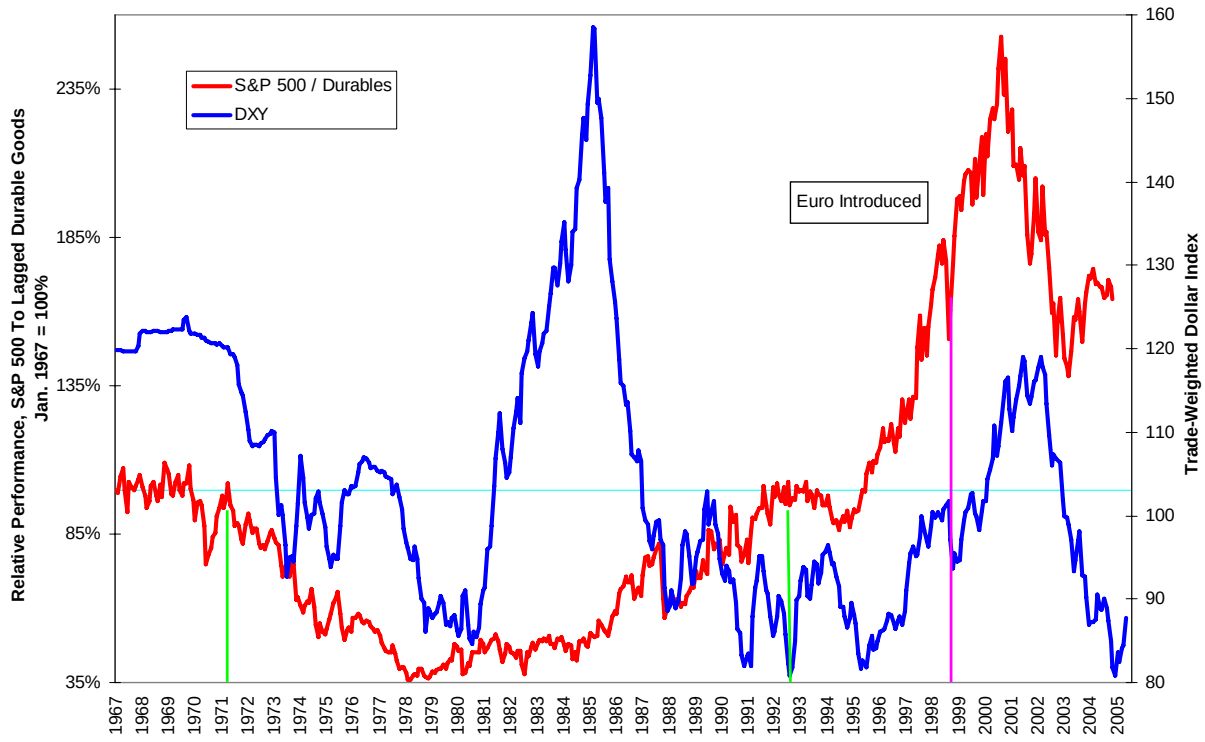


Why, you might ask, would the stability of the dollar affect the course of the stock market? The answer is deceptively simple. Currency movements are determined by a single equation with three variables, the spot exchange rate and the two short-term interest rates of the countries whose currencies are involved. This equation cannot be solved without either fixing two of the variables or one of the variables and the relationship between the other two. If the spot rate of exchange is fixed or held firm by official intervention – which replaced fox-hunting as the purview of a malevolent ruling class – and one of the interest rates is more or less stable, then the other interest rate must swing about wildly to solve the equation.

This interest rate volatility effectively raises the discount rate for corporate earnings and steepens the yield curve. Both damage stocks. All we need to do is see how the growth rates of stocks and durable goods were parallel both before and after this great and ultimately failed experiment in floating exchange rates.

The extent to which currency volatility dominated markets during the period in question is becoming lost in the collective memory. Let's restate the information from the previous graph to an index of the relative performance of the S&P 500 to total durable goods orders and overlay the dollar index thereon. Two relationships emerge. The first is how much greater the level of stock prices a given level of durable goods orders could support once a modicum of currency stability was achieved in the mid-1990s. The second is the S&P 500 / durable goods index appears to lead the dollar and with a multiple-year leading time interval. This is not spurious correlation: The index reflects changes in American economic activity, risk acceptance and industrial competitiveness. These forward-looking assessments later affect the returns on dollar-denominated assets relative to global alternatives.

Dollar Stability Helps

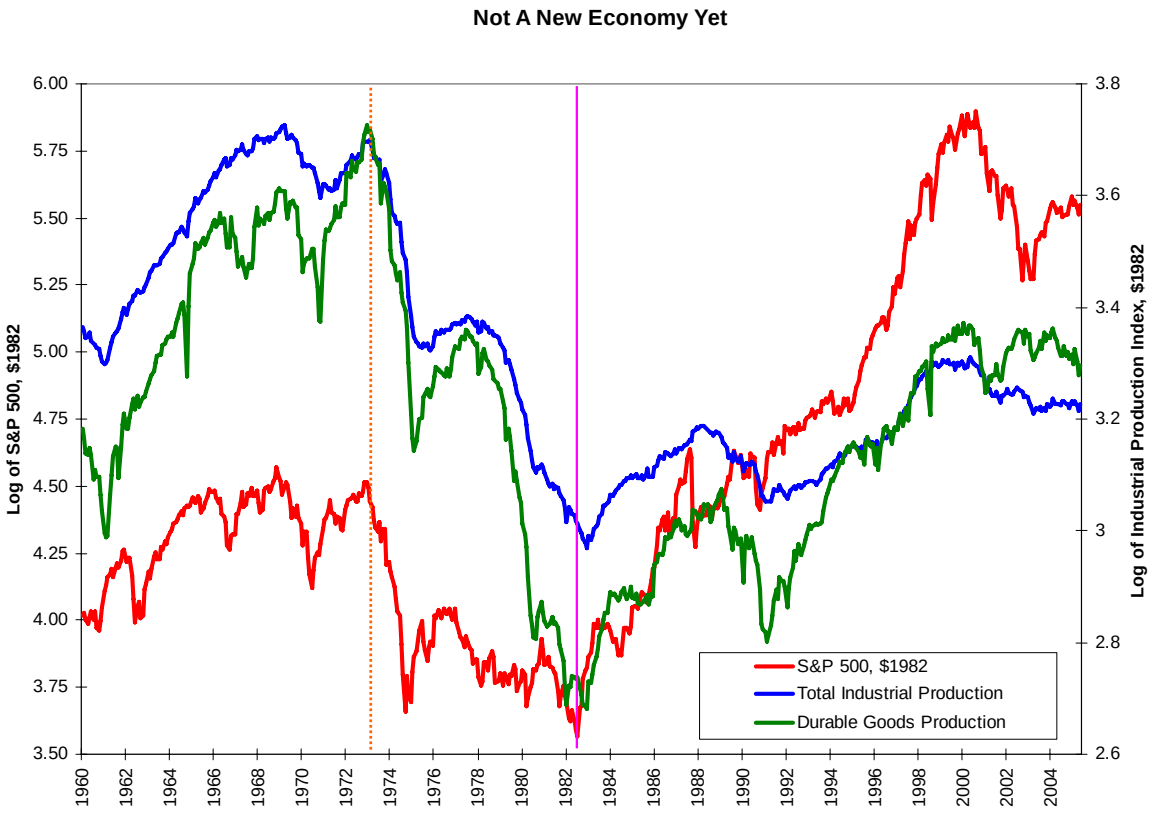


New Economy? Not Yet.

You remember the New Economy, don't you? It had something to do with ordering dog food over the Internet and other harebrained adventures. A common protest to the argument offered above linking durable goods orders to financial markets might be that the United States is no longer an industrial economy as much as it is a service economy. All this is well and good, but it sacrifices facts for a theory. The constant-dollar S&P 500 bottomed in July 1982, as did constant-dollar durable goods production. Constant-dollar industrial production bottomed in December 1982.

The era between 1960 and 1973 was characterized by rapidly increasing durable goods and total industrial production; the constant-dollar value of the S&P 500 exclusive of dividends rose during this period. When the constant dollar value of the production measures fell between 1973 and 1982, the S&P fell. The dual increases resume after 1982, the only exception of note came during the shallow recession of the early 1990s. Yes, the S&P

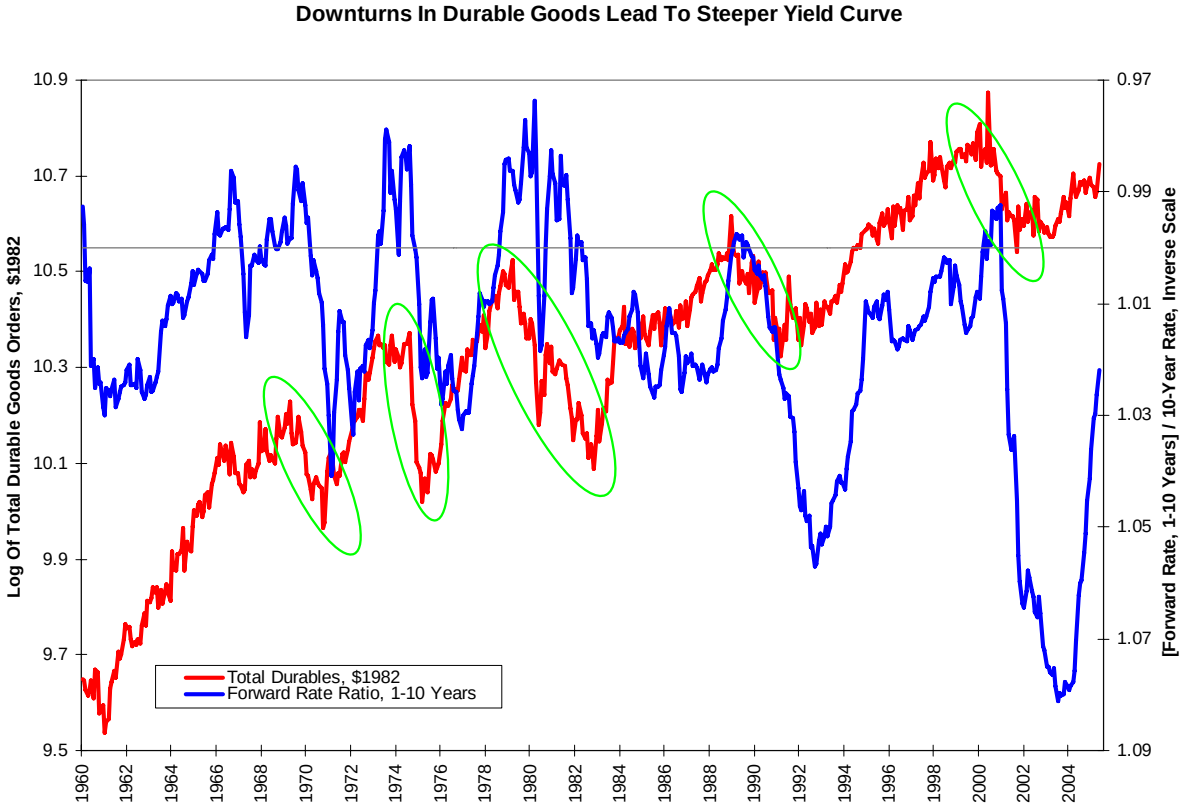
500 outperformed the industrial measures during that period, a testament to increased productivity and the shift in economic output, but the simple fact remains: The performance of stocks is linked still to the industrial economy. How the ever more rapid shift of industrial production to the lowest-cost producer within the dollar bloc, China, will affect the performance of stocks remains to be seen. We do have reason to be concerned, however.



Durable Goods And The Yield Curve

The yield curve is linked to durable goods as well. Let's use the ratio of the forward rate between one and ten years, the rate at which you can lock in borrowing for a nine-year period starting one year from now, to the ten-year rate itself as the measure of the yield curve's steepness or flatness. A number greater than 1.00 indicates a positively sloped yield curve and loose monetary policy; a number less than 1.00 indicates a flat yield curve and tight monetary policy.

We have seen five downturns in constant-dollar durable goods orders since 1960. Each of these downturns led immediately to a quick and decisive loosening of monetary policy as evidenced by an increase in the forward rate ratio. Traders, who by necessity must have a short time horizon, may regard the durable goods number as trivial, but it is clear the Federal Reserve watches these numbers and their trends closely.



We began this discussion by noting how traders are socialized by their peers into what is and is not important. Traders, just like normal people, fall into the trap of projection; they believe what is important to them must be important to others as well. Not so: Just because the monthly reports on durable goods, industrial production and capacity utilization are not well-suited for the dramatic renting of clothes and gnashing of teeth so favored by traders and the poorly educated commentariat urging them on does not mean these reports lack for importance. They are important to long-term investors and decision-makers. Restated, these are the people who make the trends for others to follow.