Do Not Dismiss Durable Goods

Instant analysis has its place. There is no need to hear an opposing viewpoint, say, when the building is on fire. But should we be so quick to make decisions based on a headline number? This is something of a trick question. If the number in question is producing a runaway freight train response in the market, get off the tracks before pondering the long-term implications of the next move. Speeding trains create a refreshing breeze on a summer's day.

If, however, your mental state cannot be described as permanently agitated and you fancy yourself as a longer-term investor, one for whom signal is as least as important as noise, do not be so quick to pull the trigger. The durable goods report released last Friday is a case in point. This is one of those monthly numbers amusingly dismissed by the very same people to pander to instant analysis as "too volatile." Each and every month we hear about how a few aircraft orders here and there can throw the durable goods reading off track.

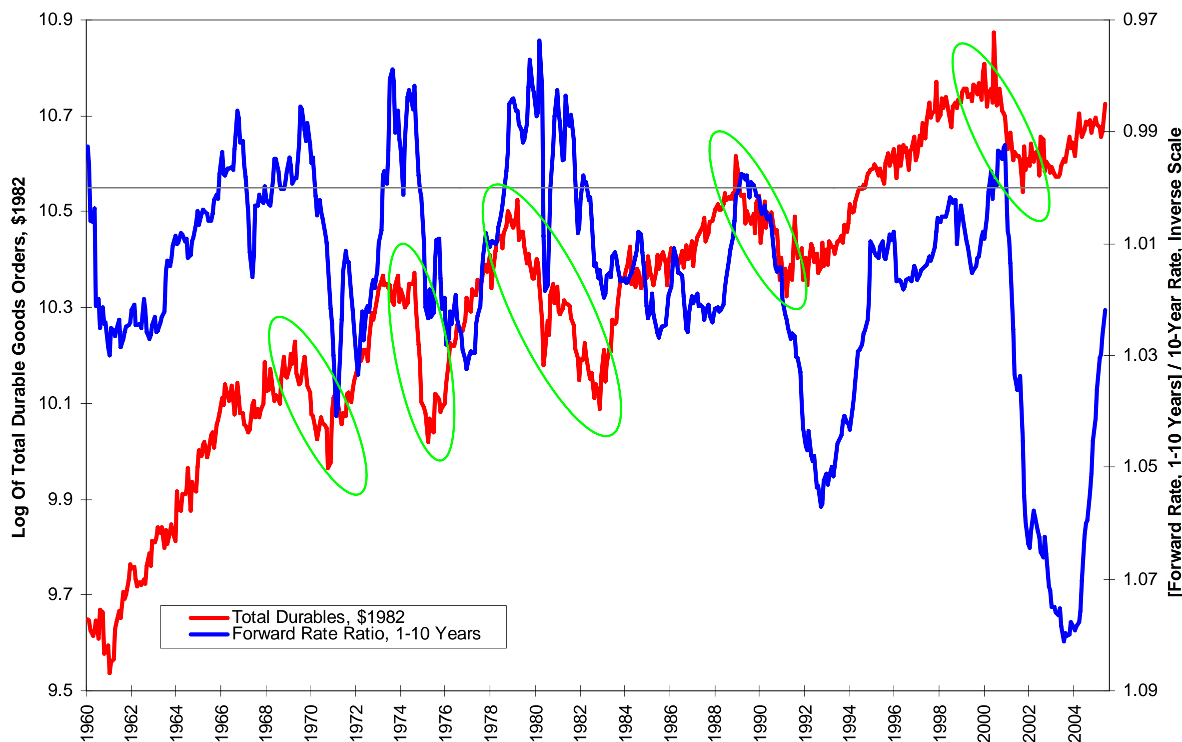
To quote Ban Johnson, president of the American League during the 1919 World Series thrown by my beloved White Sox, upon being informed by Charles Comiskey something was not right, "That is the yelp of a beaten cur!"

Those who start picking and choosing which parts of economic data are worthy of their acceptance are guilty of intellectual dishonesty, pure and simple. Don't like the inflation numbers? Focus on the core data. Don't like the retail sales numbers? Find a snowstorm somewhere to blame. Don't like the earnings report? Whip out something pro forma. As the U.S. Department of Agriculture warns about its Pig Crop Report, "ya gotta take the whole hog."

The Federal Reserve Cares

One of the best reasons to care about anything is that someone who can make your life miserable cares. In this case, that special someone is the Federal Reserve. Let's compare the inflation-adjusted level of durable goods, depicted on a logarithmic scale, to the shape of the yield curve depicted inversely. The shape of the yield curve will be measured by the ratio of the forward rate between one and ten years, the rate at which you can lock in borrowing for nine years starting one year from now, to the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve and by evidence the looser the monetary policy.

Downturns In Durable Goods Lead To Steeper Yield Curve



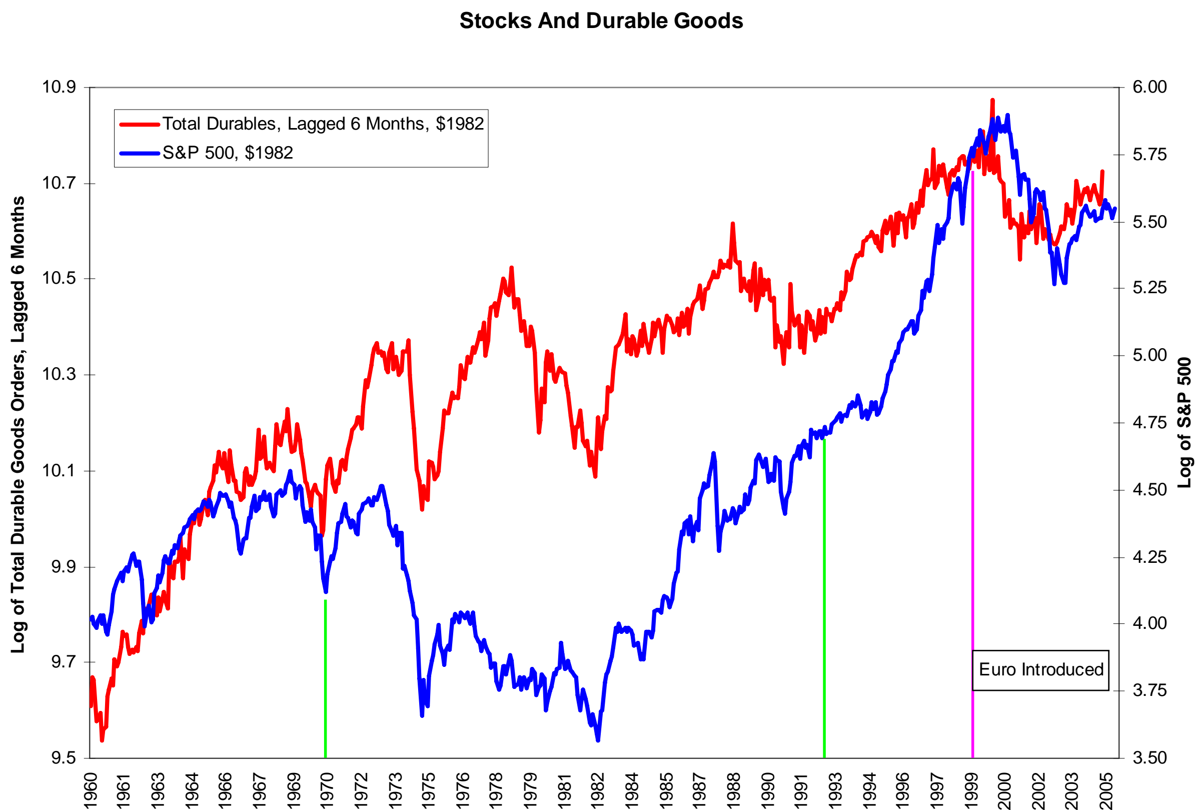
Five periods of downturn in the durable goods measure, marked with ovals, are visible since 1960. Each and every one of them led to an immediate and further steepening of the yield curve. The message is clear: We can yammer on

about service economies and New Economies, but the one thing that will get the Federal Reserve's attention fast is a downturn in durable goods orders. And, as is obvious in the next chart, stocks can outperform durable goods when both indicators are rising, but stocks cannot rally unless real growth is seen in the durable goods numbers.

Dollar's Impact

Let's take the same inflation-adjusted measure of durable goods and compare it to the inflation-adjusted S&P 500, dividends not included. The durable goods number is lagged by six months to account for stocks' forward-looking relationship relative to the industrial economy.

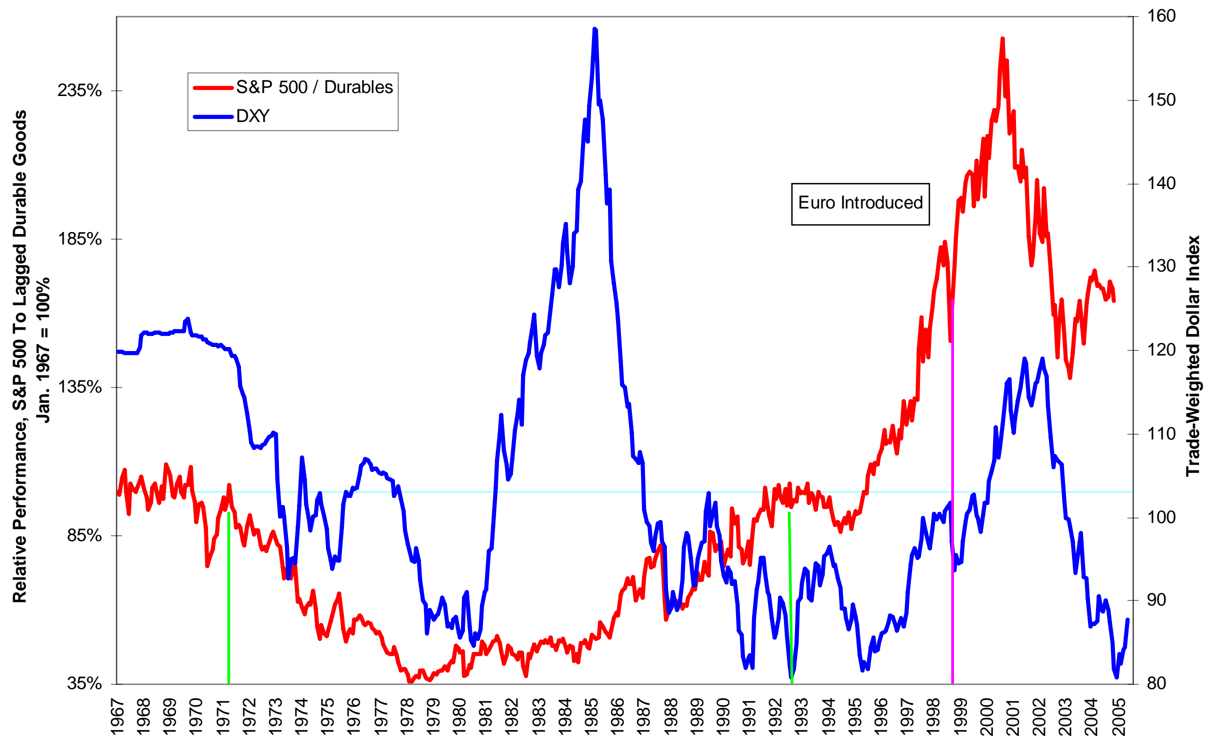
Prior to the collapse of the Bretton Woods system of fixed exchange rates in the early 1970s, an event whose importance cannot be over-estimated and which was discussed here last week, the two series moved in parallel. Once various European central banks got their noses bloodied by George Soros in 1992, the two series started to converge once again. Both of these events are noted on the chart. Finally, once the euro was introduced at the start of 1999, the two series moved back into close correlation.



Why would this be so? Currency trading involves 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 happened often between 1970 and 1992 as central banks tried to find their mojo, then at least one of the interest rates involved has to swing about wildly to solve the equation. Higher interest volatility increases the risk of long-term investments such as stocks; this is why we went through two decades where the growth rate of the S&P 500 failed to match the growth rate of durable goods. Once the European central banks in particular stopped trying to play Masters of The Universe and moved toward a single and somewhat-unified currency, stocks converged rapidly to their long-term growth rate relative to durable goods.

By this logic, the impending move toward a two currency bloc world ought to be good for stocks all by itself. Obviously, there are other factors involved in both durable goods order and stock prices. 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 compare it to the dollar.



Two relationships emerge. The first is how much greater the level of stock prices a given level of durable goods orders could support once greater currency stability was achieved post-1992. The second is the S&P 500 / durable goods index leads the dollar and by a long time margin. This is not data mining: The index reflects changes in American industrial competitiveness. The trend of the last six years, the past year notwithstanding, has been for the S&P 500 / durable goods index to decline; this suggests further long-term weakness for the dollar.

The operative word for durable goods' impact on financial markets is long-term. Asking for perspective in our hyperkinetic age may be asking for a lot, but glacial trends can make you money if you are patient.