Purchasing Managers And The Warning From Main Street

Experienced parents know the hard way that a small child holding a double-dip ice cream cone will lead to some serious hysterics if the top scoop hits the ground. Investors confronting a different kind of double-dip, that of the economy, can be seen reacting in the same manner.

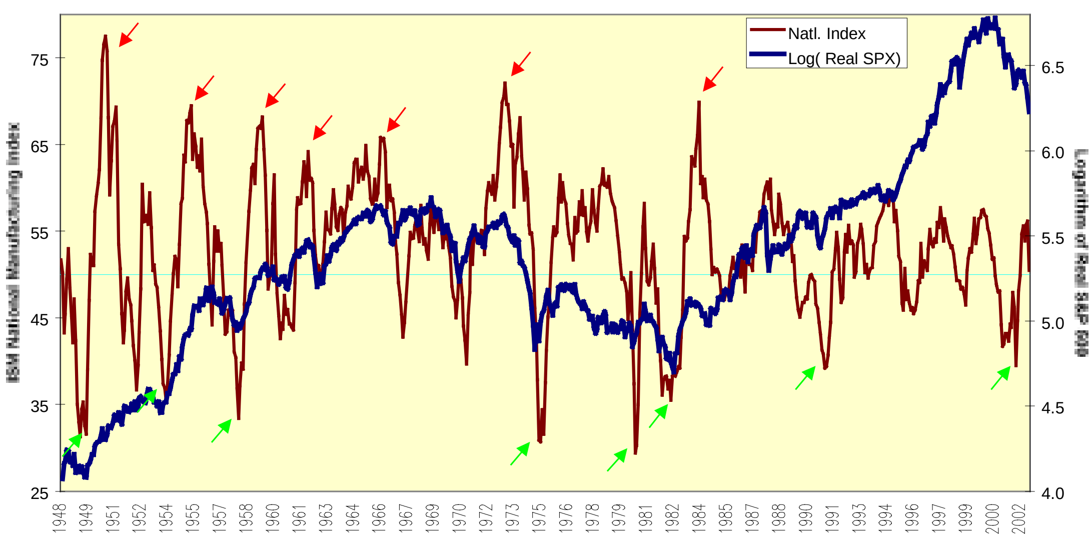
Recalling Harry Truman's famous call for a one-armed economist, one who wouldn't constantly say "on the other hand," economic statistics often are quite ambiguous and subject to different interpretations by reasonable adults. This was not the case this past week, and the Thursday release of weak Institute of Supply Management data (I much preferred the old name of National Association of Purchasing Managers, or NAPM. Then I could say, "napalm" in the trading room and sound cool) made a mockery of any claims for a strengthening economy.

Why Lead When You Can Lag?

I have great respect for ISM and other data generated by troops on the ground; purchasing managers are not infected with salesmen's innate optimism, nor do they receive their information second- or third-hand, as do most of our official number crunchers. Given the restatement of the depth and duration of the 2001 recession, it's clear those folks can use some help. I also think, in all seriousness, that some of our policy decisions would be better if government officials had to spend a minimum number of days each year on the shop floor or a similar venue. My own youthful experiences in manual and menial labor are still useful as a reality check.

Does the venerable and closely watched ISM National Manufacturing Index lead or lag the stock market? Let's trace this relationship all the way back to the administration of the aforementioned Mr. Truman and see whether drops in the index foretell a downturn in stocks.

Supply This: No Leading Relationship



If we first try to answer this question in the negative, we see that the real spikes in the index, numbers in some cases more than 70, (anything over 50 is supposed to indicate expansion) generally precede an abrupt downturn in stocks, often in very short order. The January 1973 reading of 72.1 coincided with an all-time high in the S&P 500, displayed here as the logarithm of its real dollar value to depict an inflation-adjusted growth rate. This high was not breached in nominal terms until July 1980. Conversely, the December 1974 - January 1975 readings of 30.9 and 30.7 signaled the low of the 1973-74 bear market. In other words, the manufacturing index is one of the better negative indicators at its extremes.

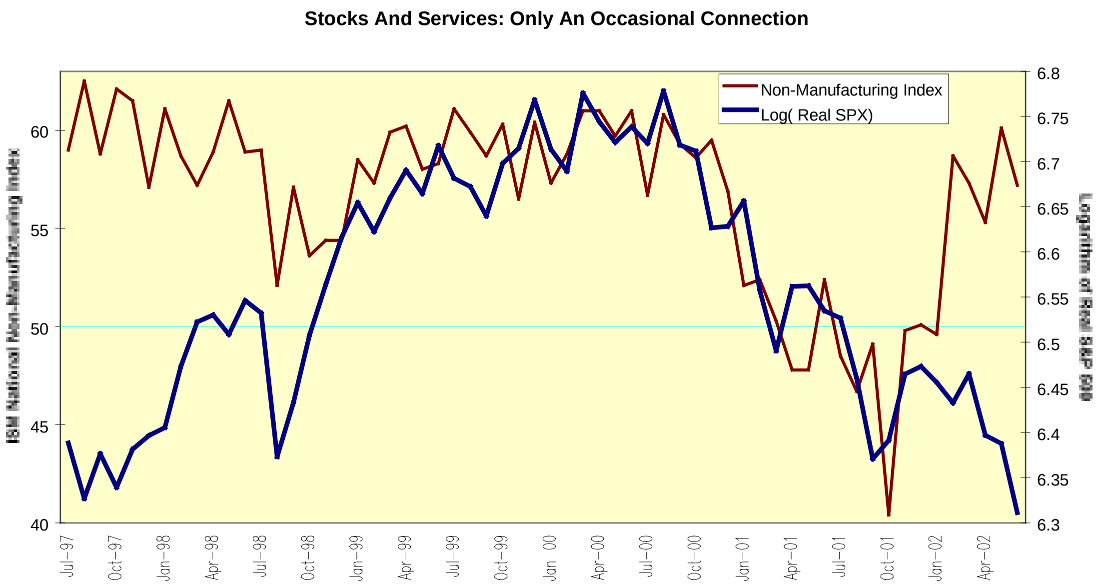
In both cases we can argue the extreme readings prompted a monetary response by our good friends at the Federal Reserve who, as stated by longtime Chairman William McChesney Martin, see it as their sacred duty to either take away the punch bowl as the party gets good, to leave it out when people start yawning, and quite possibly to engage in egregious fraternity pranks therewith when no one is looking.

Neither the present reading of 50.5, a drop from the previous 56.2, nor its one-month downtrend is inconsistent with a strong stock market. Indeed, both the level and trend of the index were lower many times during the 1990s. If anything about the recent history of the index is odd is how it jumped so quickly from last fall's terrorism-related shock while the stock market, a known leading indicator, continued to struggle.

Viewed in this light, the disconnection between the market and the economy, commented on so often in recent months, can be explained as the market starting to get the economic weakness right before the economic data did. The temperature was falling, but Washington's thermometers didn't notice.

Service With A Smile

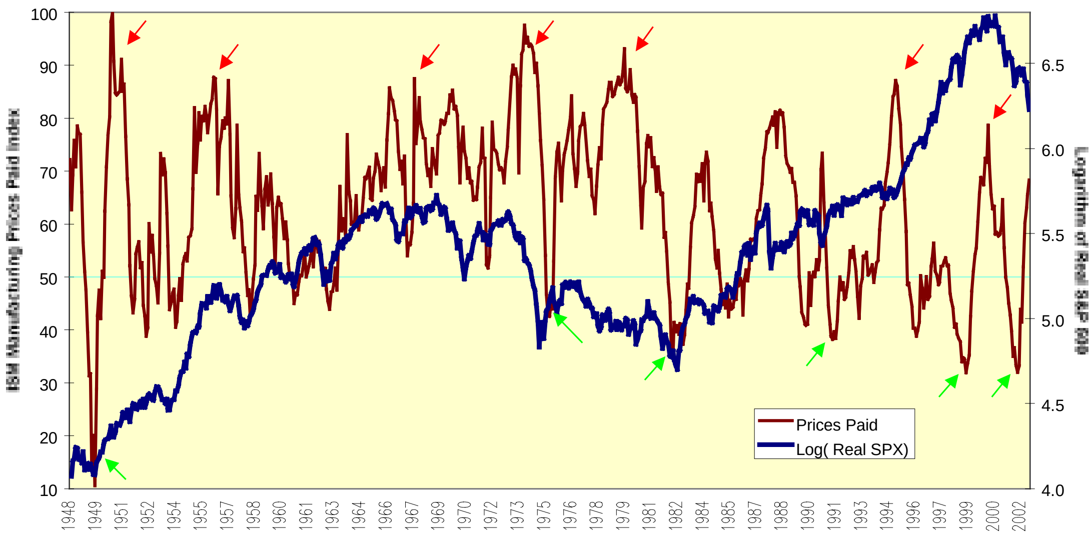
The service sector is now more important in many ways than is manufacturing, and the ISM responded to this development by creating non-manufacturing indices in 1997. If there's a consistent relationship between this index and the S&P 500, it escapes me. The index weakened while stocks were rallied between July 1997 and July 1998, and it started to shoot higher this year even as stocks stalled.



Paying The Price

The real sleeper in this week's data, if the data are reliable, could be the ISM prices paid number for manufacturing. For all of the worry expressed here last week about deflationary pressures, we do have to recognize that a price index can register high values even in a disinflationary or even deflationary environment. How is this possible? Let's take the simple example of steel and lumber, two items hit with tariffs in what could be the Bush administration's worst and possibly fatal decisions. Their higher prices show up in the price index even as demand for them may fall due to substitution or lower demand. If we add the effects of a weaker dollar on the prices for imported goods, we easily can achieve a higher price index in a non-inflationary environment.

Ringing The Register



Regardless, we cannot find a single episode of higher prices paid that corresponded to a jump in the real S&P 500. The closest we came was at the end of 1994, which also was at the end of a series of seven rate hikes by the Fed in that year. The market was looking forward to what is the only episode in recorded history of a "soft landing" engineered by the Fed. Those were the days.

The danger in this deceptive data is that the Fed will confuse the prices paid spike with actual inflation and conclude that their 1.75% fed funds rate is pushing the envelope. I'll disagree right now: The odd combination of circumstances we have right now is masking the deflationary pressures noted last week. Our problem is far closer to insufficient liquidity. Even though the Fed's first 11 rate cuts didn't do the trick, and even though they may be frustrated that they couldn't command the tides this time, they should err on the side of ease on the 13th and cut rates. Twenty-five points good, fifty better.

And then they should get out to the hinterlands and see what's happening. This economy and this market aren't playing pat-a-cake.