Not Buying Purchasing Manufacturers

What is real anymore? Let me count the ways of delusion, illusion and confusion: Credit ratings, auditing statements, earnings statements, politicians' recollections and whatever that is filling various blouses and workout outfits to capacity.

Reality, as physicists will tell you, can be tough to define; they joke about "the dreams stuff is made of." Or, as certain national leaders might say, "I think, therefore I is."

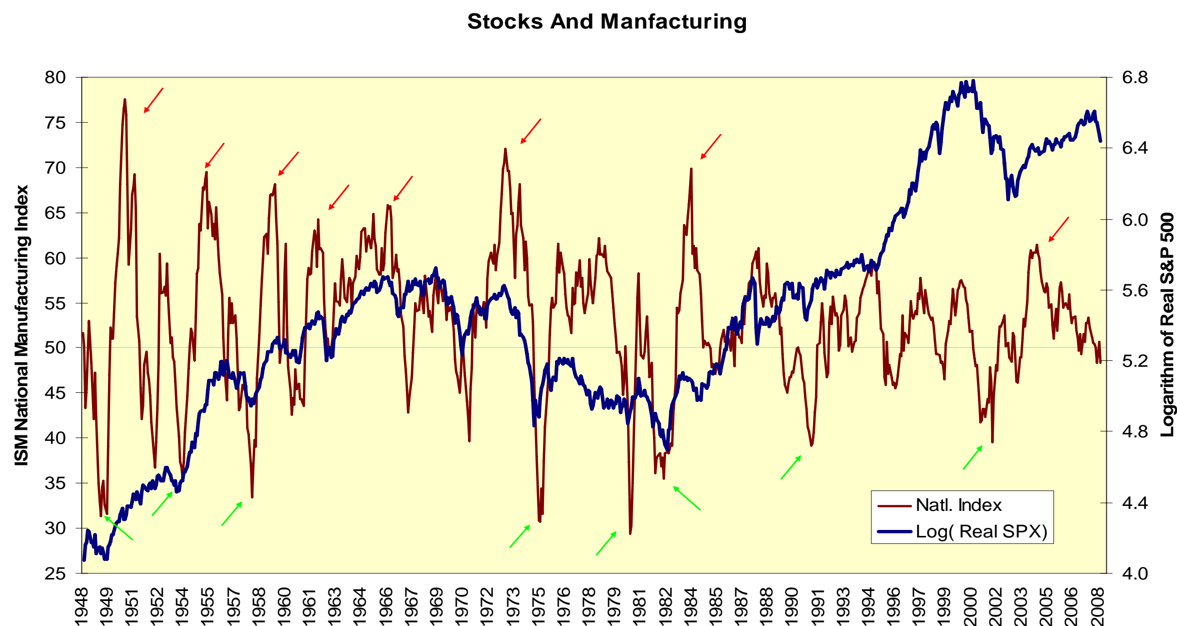
This is why I have gravitated over the years to those economic indicators I thought represented the actions of troops on the grounds, not the machinations of speculators. These included the Baltic Dry Freight index, the prices of various industrial raw materials not buffeted by long-only commodity index funds and the readings of various purchasing managers.

Is It Worthy?

But in an economy increasingly divorced from inventory cycles and ever-less dependent on the vagaries of manufacturing, do the readings from the Institute for Supply Management, the organization formerly known as the National Association of Purchasing Managers, have any real bearing on financial markets?

All of the ISM indices have a very simple comparison point; readings over 50 indicate expansion, while those below 50 indicate contraction. Like many surveys of this nature, it is very difficult to control statistically, and is never reported with appropriate error bands and confidence intervals, but let's not quibble.

If we map the ISM's national manufacturing index against the logarithm of the constant-dollar S&P 500 and mark the peaks and troughs of the index with red and green arrows, respectively, several things stand out immediately. First, the both the peaks troughs of the manufacturing index did mark good buying opportunities for stocks prior to 1990, but then the relationship dissipated. The massive bull market of the 1990s, the bear market of 2002-2002, the subsequent recovery and the current downturn all occurred in the absence of any meaningful turns by the ISM national manufacturing index.



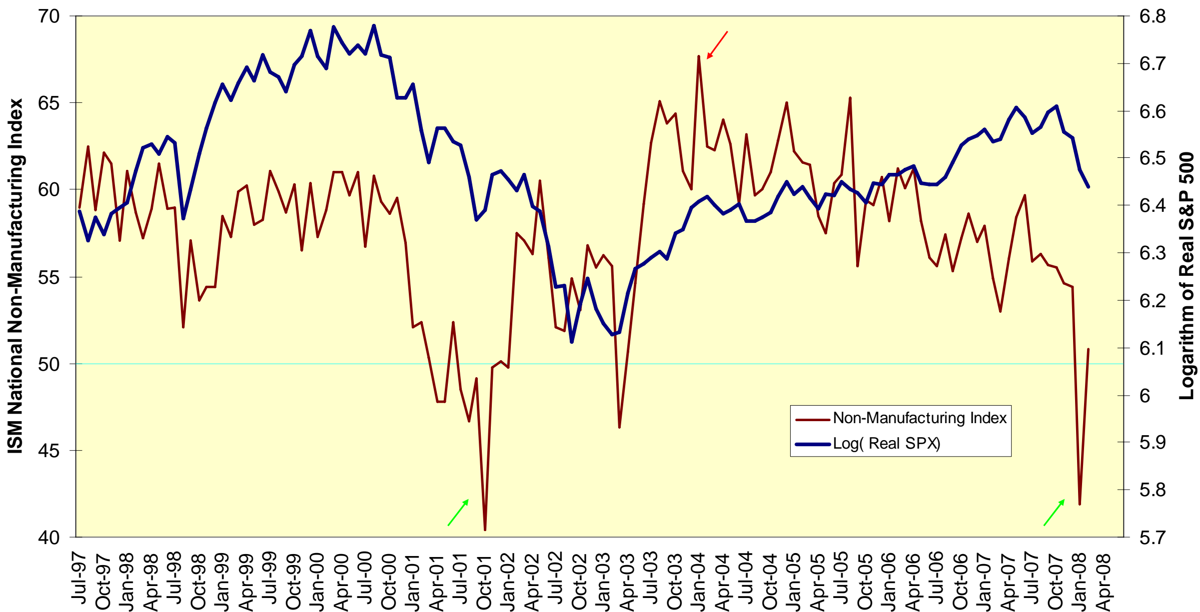
Second, the amplitude of the index' cycles has dropped significantly from pre-1985 levels. Readings above 70 and below 35 used to be common, but no more. Look at the huge swings during the 1970s, the decade along with the 1930s to which this unhappy decade has been compared to most.

Third, the ISM manufacturing index peaked most recently at the end of May 2004, just before the Federal Reserve began its series of 17 consecutive 25 basis point rate hikes. Yet did stock prices collapse, long-term interest rates

plunge or the economy go into a prolonged funk? No, no and no: Any actions taken from this reading would have been premature at best and downright foolish at worst.

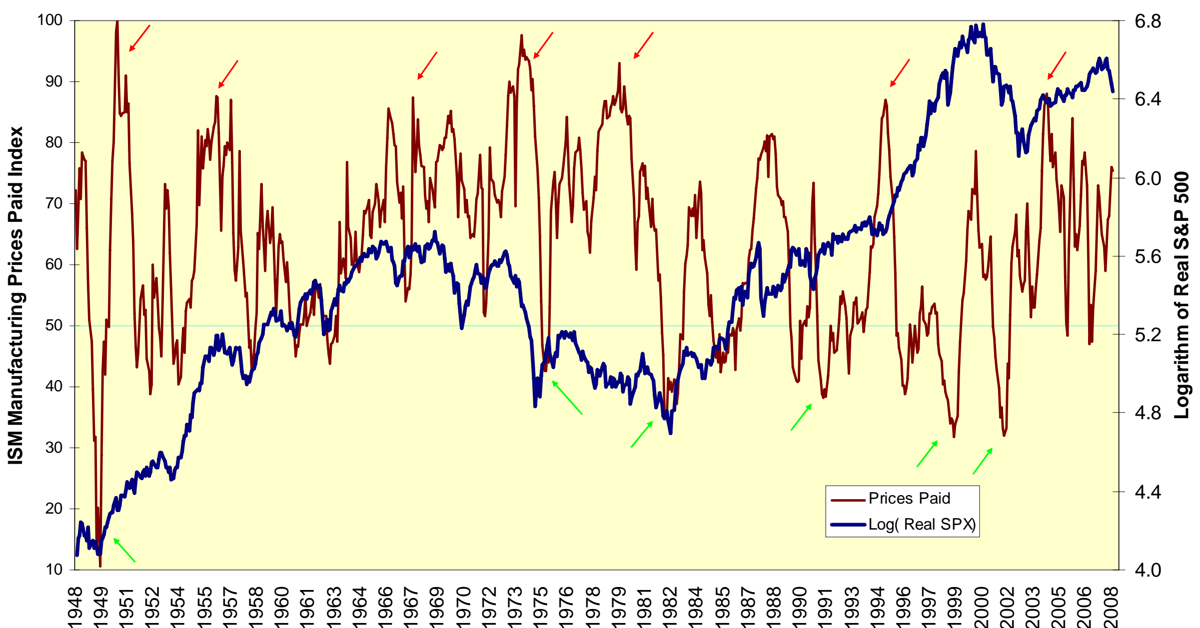
What about the ISM's non-manufacturing index, you ask? This index, over its much shorter history, has yet to produce on successful stock market call, unless you are willing to say its October 2001 trough called the October 2002 market bottom. It peaked in January 2004. Not very useful as a stock market indicator, is it?

Stocks And Services: Only An Occasional Connection



Let's turn to a third ISM index, that for prices-paid. This can be interpreted in two ways. The first is a strong economy pushes prices higher; the second is higher prices are inflationary. As cost bottlenecks and inflation both are negatives in my book, let's mark this index' peaks with red arrows, the last of which occurred in July 2004.

Paying The Price For Prices Paid

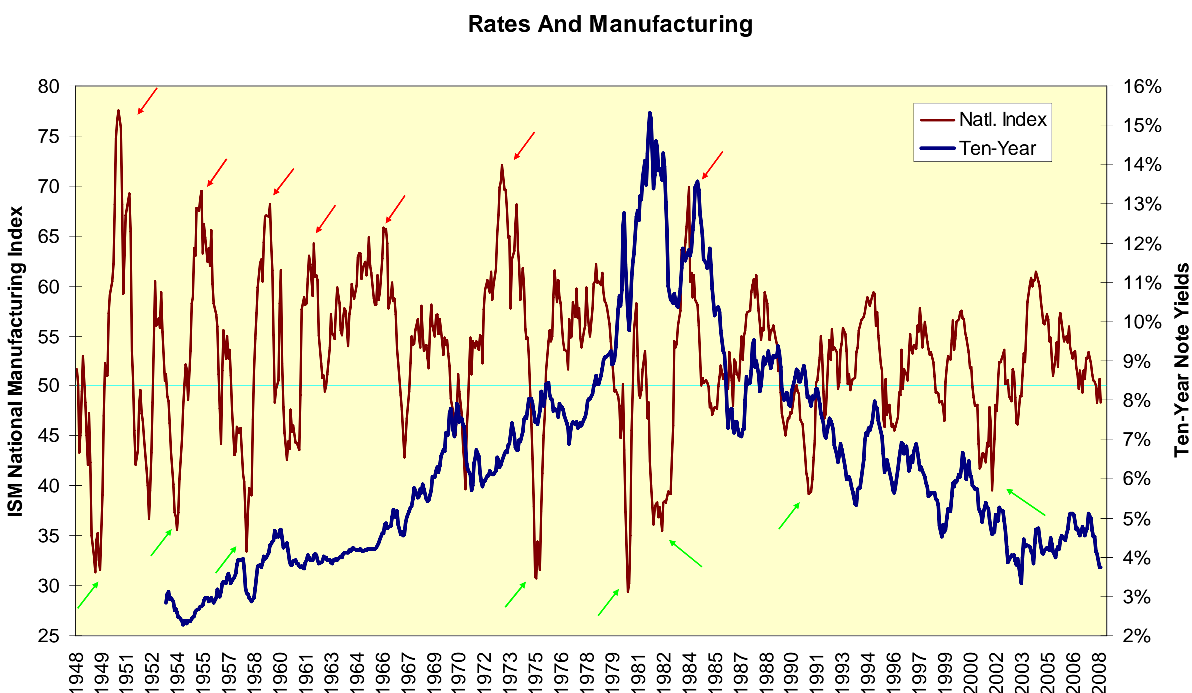


Incredibly, this index has been making a series of lower highs ever since, which hardly seems possible given the constant drumbeat about inflation. Let's attribute this to the impact of lower prices paid for imported goods, chiefly from China, over this period. The implications of a stronger Chinese yuan for this trend, a topic touched upon in January, are not favorable for the U.S.

The Bond Connection

If the national manufacturing index does not push stocks higher or lower with any regularity, did it ever do much for long-term interest rates? The effect is both interesting and complex. Ten-year Treasury yields have had one trend change in my lifetime, their peak in September 1981. They rose broadly until that point, and fell broadly thereafter.

The wide swings of the ISM manufacturing index occurred during the secular bear market for bonds. All those inventory cycles and recessions occurred with rising interest rates. The pattern switched after 1981. It would appear as if rising interest rates and a cyclical industrial economy are linked, and that falling interest rates and a low-cyclical service economy are linked.



This confirms one aspect of interest rate theory, and that is the need for investors to get compensated for risk. Just as inflation and currency devaluation raise the risk of holding bonds, so does macroeconomic risk itself. Those who lament the decline of U.S. manufacturing and want a cheaper dollar to offset it should be careful for what they wish: It would appear as if rising long-term interest rates and a secular bear market in bonds might come along for the ride.

Of course, when it comes down to wondering what is real and what is not and whether we can believe the arguments of protectionists anymore, we should answer the question with a question, "Anymore? When could we ever?" Come to think of it, that should be the answer for the ISM survey data, too. It exists in a vacuum for investors, and those who do anything beyond the shortest-term trading off of it are asking for trouble.