

Worth The Paper It Is Printed On

Iraq is the modern occupant of what the ancient Greeks dubbed Mesopotamia, or the land between the rivers. Let's take a step back from the momentous issues of war and peace, unsolvable in this space anyway, to one of the original competitions in technology and material science: Clay versus paper.

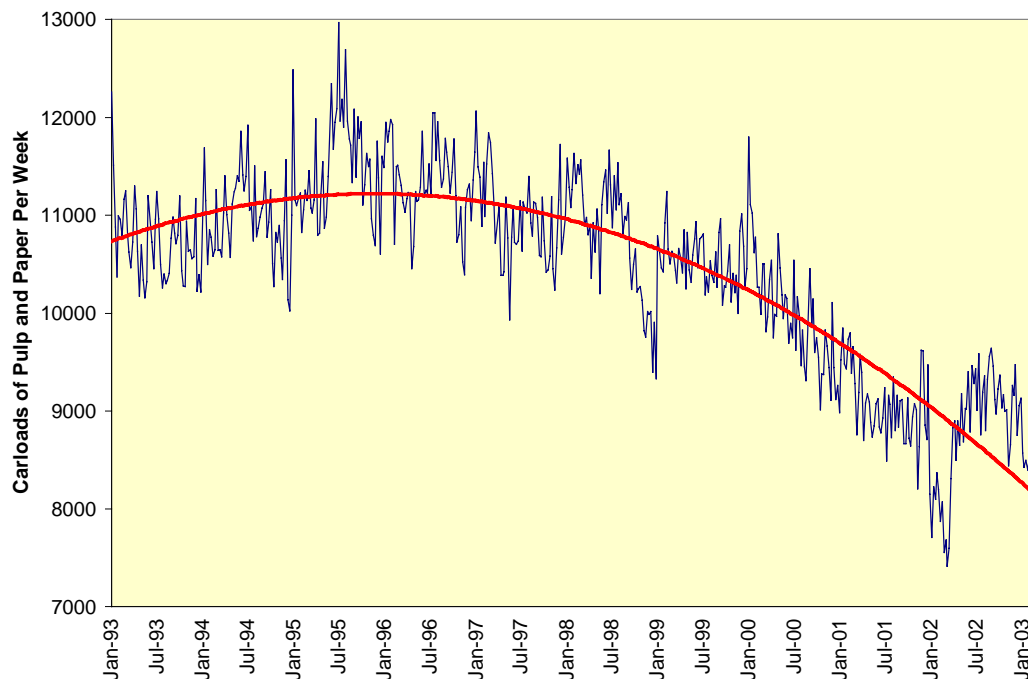
The Sumerians, occupants of southern Mesopotamia, now the Shiite region near Basra, invented a writing system involving the wedged-shaped, or cuneiform, impressions of a reed tip on wet clay tablet. The tablet then was baked, preserving the script for all to see. Not quick or fancy, and certainly not capable of terabyte storage densities, but durable beyond belief: Our videotapes from the 1960s are barely viewable. It is a fair bet that these inscribed pieces of pottery, which already have outlasted the Persian, Hellenistic, Roman, Arabic and Ottoman empires, will see the end of whatever the next regime in Iraq turns out to be.

Our word "paper" derives from the papyrus reed. The other great river-based civilization of the Middle East, Egypt, pounded these reed fibers into pulp and squeezed the pulp into sheets. Not as durable as clay, but a lot more flexible and capable of other uses: Can you imagine using baked clay in place of the various paper products in your daily life? Think the copier jams now?

A Coincident Indicator

Paper's many uses make it an outstanding coincident indicator of economic activity. For this reason, the recent drop in rail shipments of pulp and paper is alarming. Shipments started to break downward out of their range in late 2000, just as the bear market was taking hold in earnest. A sharp drop in shipments in early 2002 preceded last year's May-July market massacre. The recent trend in shipments is consistent with, but given the war-related uncertainties not predictive of, an emerging double-dip recession scenario.

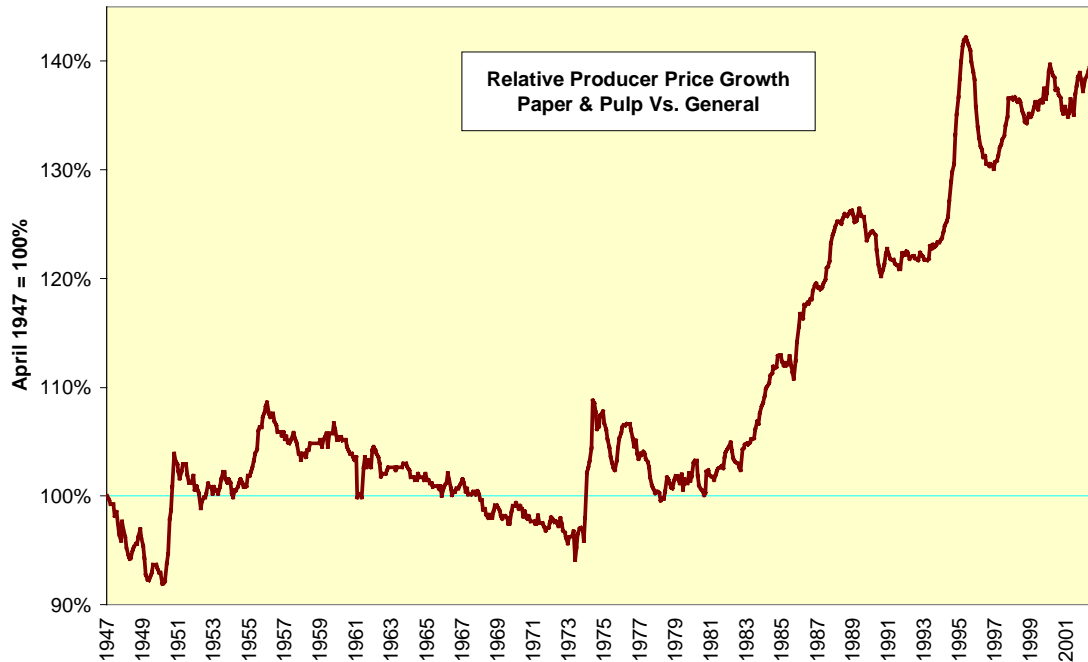
Paper Track Riders



Paper Tiger? Not Really

Of course, one of the reasons why pulp and paper shipments may be declining is that pulp and paper prices have risen more rapidly than have general producer prices for the better part of three decades. Industries are supposed to get more efficient over time, but papermaking may already be as good as it is ever going to be: Both those Egyptian papyrus pounders and a papermaking wasp, if we may anthropomorphisize, would understand what is going on in a modern paper mill.

Paper, Not Money, Grows On Trees



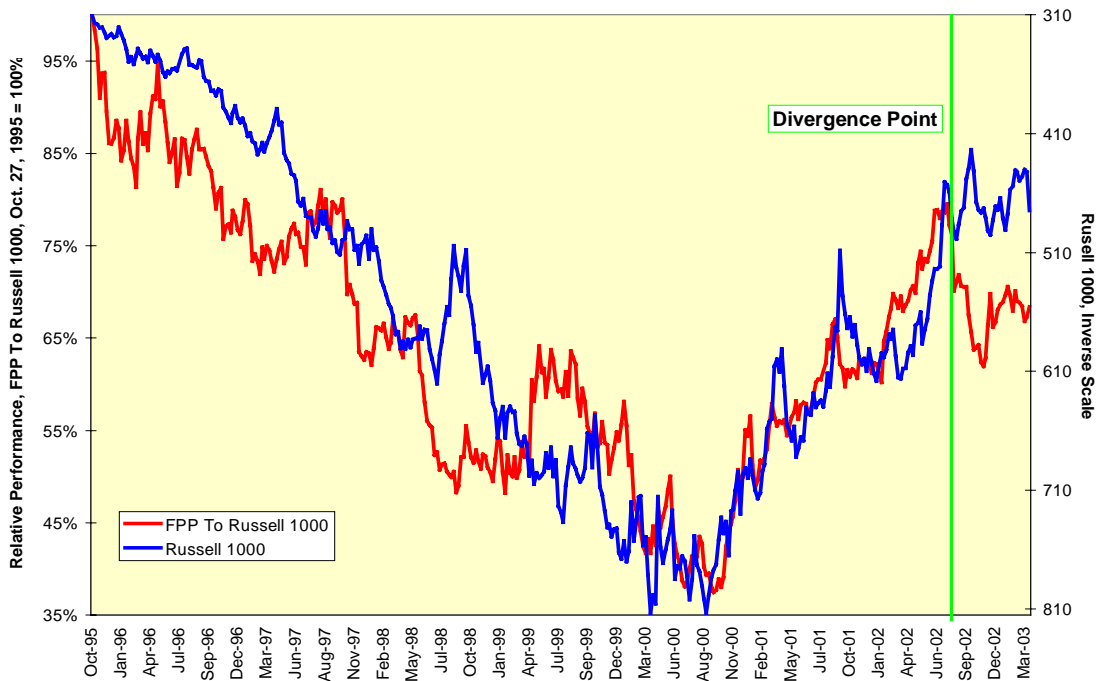
Ironically, many industries would look at this price curve with envy: One of our current profitability problems is the lack of pricing power. However, industries with pricing power encourage both reductions in demand and encroachments by substitutes, including recycled paper.

The pulp and paper industry has met these challenges by consolidation. The names of the 13-member Philadelphia Exchange Forest & Paper Products index (FPP) are not as silly as the concatenated names found in the oil industry, (ExxonMobil, ChevronTexaco, ConocoPhillips, and France's very own and trinomial TotalFinaElf) but MeadWestvaco shows a similar lack of imagination. At least when Weyerhaeuser gobbled up Willamette, they didn't opt for the unpronounceable WeyerhaeuserWillamette despite what it could have done for sales of new letterhead.

Box Stocks

Consolidation, which can continue up to the point where it attracts the attention of various antitrust authorities, has stabilized the forest products stocks, at least for the time being. The pedestrian FPP underperformed the broad market during the late 1990s, and outperformed it during the bear market through July 2002. It has underperformed since despite the broad market's two trips to the bottom in October 2002 and March 2003. If we invert the scale on the broad market, we find the relative performance of the FPP to be a near-perfect negative coincident indicator.

Is This What They Mean By "Market Performer?"

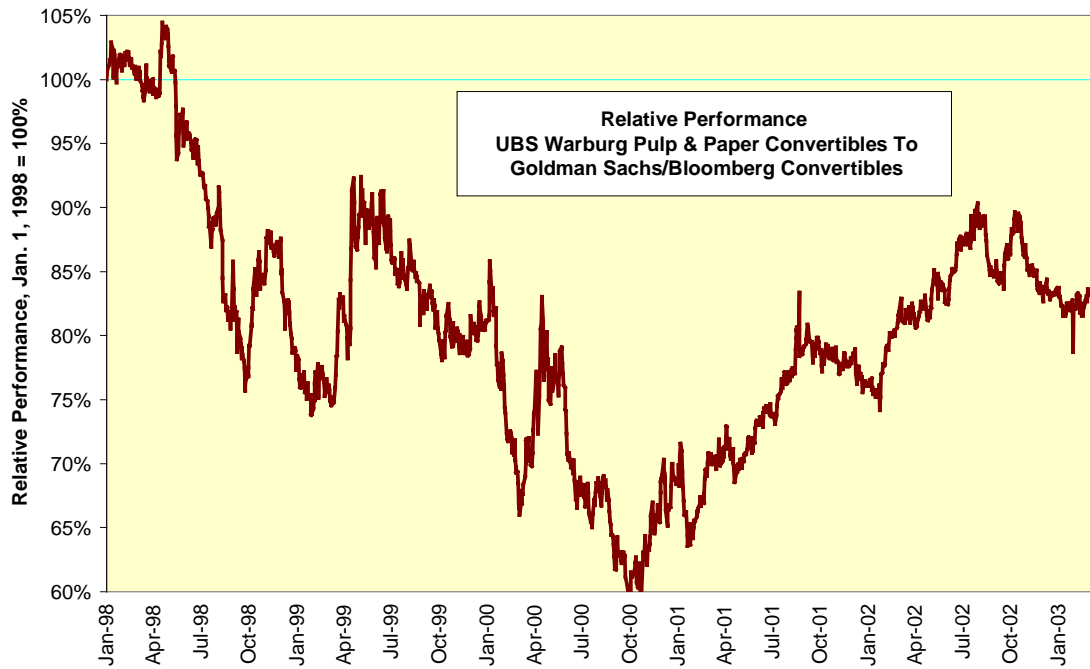


Is this renewed underperformance an odd indication of relative strength in the broad market, or is it a confirmation of the weakness signaled by the drop in pulp and paper shipments? Given the overall torpor of the market since last July, the odds favor a confirmation of economic weakness. Of course, a bull would counter that the market and the economy have both been on hold due to the Iraq-related uncertainties, and everything may turn higher in the near future.

A Top-Down Approach With Convertibles

One final test whether the pulp and paper industry is signaling any sort of economic strength is a comparison of its convertible bonds to general convertible bonds. Why convertibles? These bonds, traded primarily by a small group of sophisticated investors, often are issued by lower credit-quality firms and contain the embedded leverage of a call against the stock. Therefore they are unusually sensitive to changes in financial prospects.

Paper Convertible Bonds Stall As Well



The story here is the same as for the stocks: A hesitancy to make a call on the industry's - and by extension the economy's - general health. This general indecision is going to keep the broad market in a reactive mode instead of an anticipatory mode, and could mean several months more of indecisive and volatile trading before either a renewed push lower or a new push higher emerges.