

Alphabet soup

The shape of things to come

September 18, 2009 – Back at the end of July we reported in these notes that Bank of Canada Governor Mark Carney pretty much declared the recession over. Last Tuesday, US Federal Reserve Board Chairman Ben Bernanke agreed, in a way, stating in no uncertain terms that the recession is “very likely over.” Central banker mumblespeak notwithstanding, the recession in fact bottomed out in the second quarter, and stock markets have been telling the recovery story since mid-March.

Granted, assorted pundits have been arguing about whether the recovery – and they all now seem to agree that it *is* a recovery – will be “V”-shaped, “W”-shaped, or “L”-shaped. This, we also suppose, indicates their opinion about the predicted shape of gross domestic product when plotted on a graph, or perhaps the shape of stock market performance when likewise plotted. It’s hard to say which. The more bearish (and incidentally the loudest) prognosticators, as always, are attempting to cover their tracks in the face of empirical evidence that refutes their predictions of a few months ago. The bullish seers strut and crow and say “I told you so.”

These arguments invariably surface at the end of recessionary periods, and resemble nothing so much as medieval philosophers’ disputations regarding the number of angels dancing on the head of a pin. We suppose they have nothing else to argue about. Investors are wise to take such puffing and blowing with a pinch of salt. Setting investment policy based on someone’s opinion about the future shape of a graph of economic growth is, to put it charitably, short-sighted.

Far better to stay within your defined investment parameters and risk-tolerance level, rebalancing your portfolio regularly or whenever conditions warrant. Underpinned by a real-world approach that acknowledges the cyclical nature of economic growth and, by extension, of capital market performance, you’re more likely to achieve your long-term objectives than if you get distracted by an alphabet soup of ever-shifting economic predictions that ultimately are “full of sound and fury, signifying nothing.”

Conversely, the steady stream of daily economic data does serve a useful purpose beyond mere nerdish statistical number-gathering. It gives us a snapshot picture of the health of the patient, so to speak, and gives us a backdrop against which to make tactical investment decisions. Longer-term, it helps us identify broad trends, which the more

perspicacious among us can use to advantage. (This is far different than attempting to predict the shape of a graph.)

Last week, for example, amid the weird media-driven hoopla over the “one-year anniversary” of the demise of Lehman Brothers, August consumer price data were released in both Canada and the US. Very simply, inflation is, for now and for the near term, a non-issue.

Despite massive increases in the money supply everywhere, and policy interest rates near zero, consumer prices remain constrained as businesses have given up just about any pretence of pricing power.

Statistics Canada reported that Canada’s so-called “headline” consumer price index (CPI, which tracks all prices) rose a seasonally adjusted 0.3% in August from July. Measured against year-ago levels, however, CPI slipped 0.8%. Higher gasoline prices figured prominently in the jump in headline CPI – a significant reversal from the trend over the previous 12 months. “Core” prices, which exclude volatile food and energy prices, rose a scant 0.1% month over month, rising 1.6% from year-ago levels, and posted an annualized 1.1% rise in the June-August period.

Gasoline prices also drove up US inflation in August. Headline consumer prices rose 0.4% from July, but still posted a 1.5% decline over year-ago numbers. Core inflation rose 0.1% from July, and posted a 1.5% increase year over year, but has been trending down since April.

The downtrend in core consumer prices looks to be with us for at least the rest of this year, and possibly into 2010, in both Canada and the US. With unemployment getting set to cross the 10% threshold in the US and industry capacity utilization at 69.6% in August (well below the 80.9% average over the 1972-2008 period), prices are likely to remain under downward pressure for some time yet. And that means Canadian and US central banks will continue to be reluctant to raise interest rates.

Low rates, of course, are a necessary precondition for a revival in consumer demand while providing a well-fertilized seedbed for business growth sometime in 2010. For now, US consumer demand saw a 2.7% month-over-month uptick in August with the much-ballyhooed “cash for clunkers” government-sponsored rebate program providing most of the lift. But the temporary boost to GDP will evaporate in the fourth quarter as various programs and rebates end, and consumers resume their tight-fisted ways.

In Canada, a revival in auto production and demand-growth for primary metals stimulated manufacturing sales to a 5.5% month over month advance in July, the second straight monthly increase for the beleaguered sector. Excluding the auto-sector, manufacturing sales still advanced 2.1% as 15 of the 21 industry groups posted sales increases. It’s an encouraging sign, but still 22.4% down from year-earlier levels.

In markets, Toronto's benchmark S&P/TSX Composite Index advanced 1.7% week-over-week, even though gold and energy stocks came under pressure in Friday's session.

New York's Dow Jones Industrial Average gained 2.2% over the previous Friday's close, as investors showed increasing interest in consumer-related stocks. Likewise, the broader S&P 500 Composite Index advanced 2.5% week-over-week. The growing appetite for risk and increasing flows of sidelined cash into equity mutual funds in the face of just so-so economic data continues to suggest a market with an overbought feel.

December gold traded on the New York Mercantile Exchange, meanwhile, remained above US\$1,000 per ounce, while October NYMEX crude oil closed at US\$72.04 per barrel on Friday.

We confess that we can't find a "V", "W", or "L" in any of this. There is, however, a high "C": Caution is advised. ■

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