Canaries in the coal mine

Still chirping as markets start September with a bang

September 3, 2010 – While US stock markets suffered from a bad case of August torpor, Toronto's benchmark index reveled in others' misfortunes and advanced on the month. But almost as if declaring the end of the summer doldrums, all the major indexes rose in unison on Sept. 1, propelled by unexpected jumps in key some key manufacturing, consumer confidence, and spending indexes. Still, it may be a tad premature to break out the champagne. Let's wait until after Labour Day to see if it's worth revisiting equity weightings.

What got investors all excited last week was the release of a number of global manufacturing indexes. Manufacturing is treated very much as a "canary in the coal mine" as far as reading the macro-economic tea leaves goes. It's simple, really. Even though manufacturing in the big industrialized countries accounts for a relatively small portion of gross domestic product, it's the pace of activity that counts. Broad growth in manufacturing indicates a revival in demand for products – everything from cars to Apple Computer's newest gizmo. It means factories are starting to roll again over and above the inventory replenishing that's been going on for the past year. And that implies growing business and consumer confidence.

The Institute for Supply Management's manufacturing Purchasing Managers Index rose to 56.3 in August from 55.5 in July. That was well above the consensus expectation of around 53. Improvements in employment, inventories, and production all contributed to growth. Any reading over 50 indicates growth in the sector. According to the ISM, the manufacturing index has been on a growth trend for the past 13 months (although the past three months saw a deceleration in the rate of growth), with August's number indicating faster growth once again. What's not so often mentioned is that according to ISM data, a PMI reading over 42 for an extended period generally indicates expansion in the overall economy. The PMI has now posted readings over 42 for 16 straight months.

Other closely watch US indicators also lifted investors' spirits. Consumer spending, for example, rose 0.4% in July over June, or 0.2% when adjusted for inflation. Okay, it's a slim peg to hang your hat on, but it's not negative, which is the main plus at this point in the cycle. In addition the New York-based Conference Board announced that its main consumer confidence index jumped to 53.5 in August from 51 in July, also exceeding forecasts of around 50. High unemployment and weak consumer spending have been the big bogeymen clouding the picture for recovery, and right at the top of the list of reasons that many analysts expect the US to slip back into recession in the next two quarters. Rising consumer confidence indicators tend to militate against that conclusion.

The unexpected August jump in US manufacturing was a pleasant enough surprise after a summer of discontent in just about every other metric. But the general mood was enhanced even further by the equally hopeful news that China's official (i.e., government measured, controlled, massaged, and released) Purchasing Managers Index also rose slightly, to 51.7 from 51.2, following three straight months of decline. Any indication that manufacturing in the world's second-largest economy is not headed into the dumpster was reason enough to celebrate.

Indeed, part of what's been weighing on markets through the summer is the fear that a slump in China's manufacturing would have ramifications for global growth, as demand for both commodities and equipment would erode. With the hairline increase in the Chinese PMI, those fears were allayed, at least for a month.

Markets also perked up at the release of Australia's second quarter GDP growth numbers. With its proximity to the vast markets of developing Asia, Australia is often also considered a "canary in the coal mine" when it comes to global growth. The "land down under" posted robust second-quarter GDP growth of 4.9%, outpacing consensus estimates and leading investors to conclude that the canary is alive and well and still chirping.

The good news from the US, China, and Australia eclipsed some slightly disappointing indicators from Europe. Manufacturing indexes in both the UK and the eurozone lost some momentum in August. While still indicating manufacturing expansion, the UK's CIPS/Markit PMI slipped to 54.3 in August from 56.9 in July, while the eurozone's Markit PMI fell to a six-month low of 55.1 from 56.7 in July. The European Central Bank, meanwhile, held its key interest rate at a historic low of 1%, and extended its liquidity backstop for peripheral countries like Greece, Spain, and Ireland. Still, led by strong German growth, eurozone GDP expanded 3.9% year over year in the second quarter, outpacing the 1.6% rate posted in the US.

That was all grist for investors' various mills last week, as the major market indexes staged a sudden rally on Wednesday.

Toronto's S&P/TSX Composite Index, already ahead 1.7% month over month in August, added to gains with a rally last week that lifted the benchmark above the 12,000 mark for the first time since May. Year to date to the end of August, the S&P/TSX Composite was up 1.4%.

In New York, the Dow Jones Industrial Average opened September with a triple-digit single-day advance on Wednesday last week. Following the worst August performance since 2001, with a 4.3% decline (down 4.0% for the year to date to Aug. 31), the DJIA perked up on all that encouraging manufacturing data.

Similarly, after a 4.7% decline in August (down 5.9% year to date to Aug. 31), the broader S&P 500 Composite Index of big blue-chip stocks also got that boost on Wednesday, taking it close to the 1,100 mark by the end of Thursday's session.

Whether the pre-Labour Day rally is sustainable or not once all the big institutional traders get back into harness next week following a summer of indolence remains to be seen. September markets generally decline ahead of third-quarter earnings warnings as trading volume once again ramps up. On the other hand, August tends to be a positive month more often than not – but not this time, at least not for the US markets.

We suspect that over the next month or two, we'll be at the receiving end of the old Chinese curse: "May you live in interesting times."n

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