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Watch The Economic Data: Improve Investment Decisions by Timing Turns
by: Lakshman Achuthan

Some of you may remember that in the early 1980s, Chrysler had a near-death bankruptcy experience. The story goes that soon after the billion-dollar government bailout of the company, Chrysler's chairman, Lee Iacocca, said to his chief economist, "the only thing I want from you is to let me know six months before the next downturn."

The challenges facing Chrysler were not limited to recessions, but the problem is a fundamental one: When sales fall below projections, inventories pile up, production and jobs may have to be cut, and profits fall. And investors, of course, are always trying to guess where profits are headed. But can you really get what Iacocca demanded? Many people will say "no," and they're in good company. In a special report on business cycles, ***The Economist*** noted, "In March 2001, 95 percent of economists thought there would not be a recession, yet one had already started." Well, I'm here to tell you that you can reliably anticipate cyclical turning points in the economy.

Just a Couple Reports Can Offer Clues

Investors basically fall into two general groups when it comes to the prickly issue of forecasting the economic cycle. The first group believes that while the economy's direction is relevant to their investment decisions, they simply don't have the resources to tackle the problem. This is due largely to the misconception that it takes a full-fledged economics department to monitor the economic cycle. In fact, that's neither necessary nor sufficient.

You really don't have to devote those kinds of resources to effectively anticipate turning points, nor if you do, is there any guarantee they will be able to predict those turning points. The real issue is whether you can spend an hour of your time each month reviewing a couple of pieces of key data.

The second group actively tries to forecast the cycle, but ultimately doesn't have much faith in their ability to do so. This is because – even when resources are no problem – the real-time record of getting the direction right remains dismal.

A couple of years ago, Inc. magazine ran an article promising to reveal the "secret" indicators followed by the U.S. president's top economic advisors. If you looked at this list carefully (I have),

you'd have found that the handful of indicators offered up thoroughly contradicted one another, and most failed to anticipate the 2001 recession and recovery. If you're essentially trying to replicate their efforts, the odds are that you won't do any better.

Who's Vulnerable? The Cyclicality Continuum

Before reviewing the key pieces of data to watch each month, let's identify which types of businesses are more or less susceptible to changes in the economic cycle. Essentially, there are two dimensions to consider: 1) in what sector of the economy a company operates; and 2) how discretionary is their customers' spending.

Manufacturing is more vulnerable because of inventory-driven cycles, and the further you are from the ultimate consumer, the more likely you are to be whipsawed by the cycle. If the business supplies capital equipment like heavy machinery or complex computer systems, swings can be even more violent.

However, if the business is service-oriented, one big advantage is that without significant inventories, there are no inventory cycles.

The more discretionary the spending, the more customers will be able to put off those expenditures in tough economic times. Toilet paper, a consumer non-durable, is clearly something that must be purchased almost regardless of circumstances, but purchasing a new refrigerator, a consumer durable, in most cases can be avoided if the budget is getting squeezed. Similar themes hold for business purchases, too. **Table 1** offers a quick guide to the level of sensitivity various types of business have to the economic cycle.

TABLE 1: The Cyclicality Continuum

Sector	Type of Goods	Type of Customer	Type of Expenditure	
			Low Discretionary	High Discretionary
Manufacturing	Durable & Capital Goods	Business/ Industrial	Moderate Sensitivity	Very High Sensitivity
		Consumer	Low Sensitivity	High Sensitivity
	Non-Durable Goods	Business/ Industrial	Low Sensitivity	High Sensitivity
		Consumer	Very Low Sensitivity	Moderate Sensitivity
Services		Business/ Industrial	Low Sensitivity	High Sensitivity
		Consumer	Very Low Sensitivity	Moderate Sensitivity

Source: Economic Cycles Research institute (ECRI)

What to Watch
But market participants do not have to become experts on business cycle theory and spend time gathering obscure data (as we do at Economic Cycles Research Institute). By keeping an eye on a couple of good leading indexes – one for growth and the other for inflation – they will be better off. These indexes are not some sort of black box or economic crystal balls. Rather, they are firmly anchored in economic theory and backed up by decades of observation.

The Weekly Leading Index (WLI) is updated each Friday at **www.businesscycle.com** and forecasts cyclical turns in growth by eight months on average. My mentor, Geoffrey H. Moore, who also created the original leading economic indicators that were adopted by the U.S. government in the late 1960s, developed it. Essentially, the WLI represents many of the advancements that our research group has made since that original work. Specifically, improvements include higher frequency, greater promptness, longer leads and reported numbers that are not susceptible to revision. These are all important traits to consider when selecting information on which to base a decision.

How does the WLI work? It objectively measures the key drivers of the economy like credit, inventories and profits. Figuring out exactly what are the best measures of these key economic drivers – and how to add them up – is a big part of what we've been researching for generations. (You can find details about this research in ***Beating the Business Cycle: How to Predict and Profit for Turns in the Economy***, a book I recently co-authored with Anirvan Banerji, ECRI's director of research.)

You don't have to take my word for how well the WLI works. It has been around for a long time and was published in ***Business Week*** magazine until the mid-1990s, when they decided that "old economy" cycle indicators were no longer relevant in the "new economy." So if you want to see how well it did in, say, predicting the 1990-1991 recession and recovery, just go look it up. Or simply take ***The Economist's*** word for it when in January of this year the following comment appeared: "ECRI is perhaps the only organization to give advance warning of each of the past three recessions; just as impressive, it has never issued a false alarm."

The second index on which you should focus is the Future Inflation Gauge (FIG), which is designed to forecast turns in the inflation cycle. While inflation is related to the economic cycle predicted by the WLI, the timing of inflation cycle turns can still be quite different than those of economic growth. [Editor's note: For more information on the FIG, readers can see Achuthan's January 2005 story entitled, "Seismic Shift Ahead: What Will a New Fed Head Portend?"]

For instance, in the 1970s, inflation was on an upswing while growth was flagging. The late 1990s

saw the opposite, with stronger growth occurring without much inflation. Impressively, the FIG and WLI were able to forecast this strong growth and low inflation without having to invoke a "new era" as an explanation. It also is notable that the Fed, having paid consistent lip service to the new-era productivity miracle for years, abandoned the thesis when the FIG began rising in 1999 and unexpectedly began raising rates.

Stocks, Bonds and Cycle Turns

Are we saying that with the WLI and FIG, market participants can anticipate the peaks and troughs in equity price and interest rate cycles? No. But it is possible to significantly limit exposure to bear markets that could devastate an investor's financial investments.

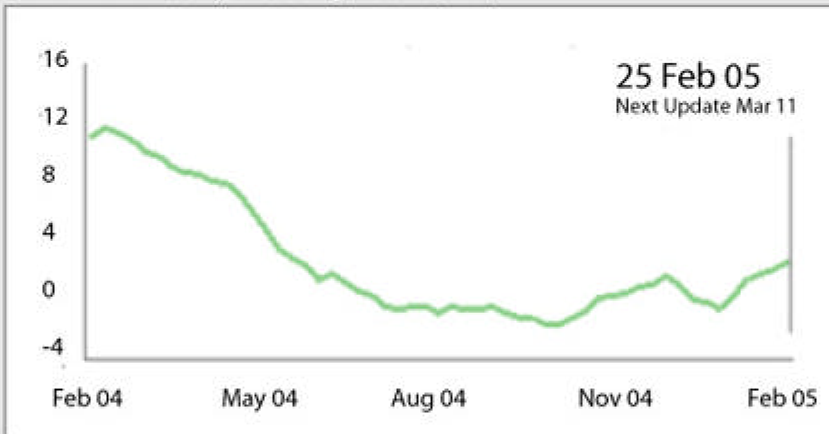
If the WLI were to turn down in a pronounced, persistent and pervasive manner compared to past declines, the risk of a sharp economic downturn or recession probably is quite high. Therefore, the risk of a bear market, which is associated mostly with recessions, is also high, and one should lessen his or her exposure to the stock market. The inverse also is true. If the WLI moves up in a convincing manner, then the risk of owning equities is probably lower than many believe.

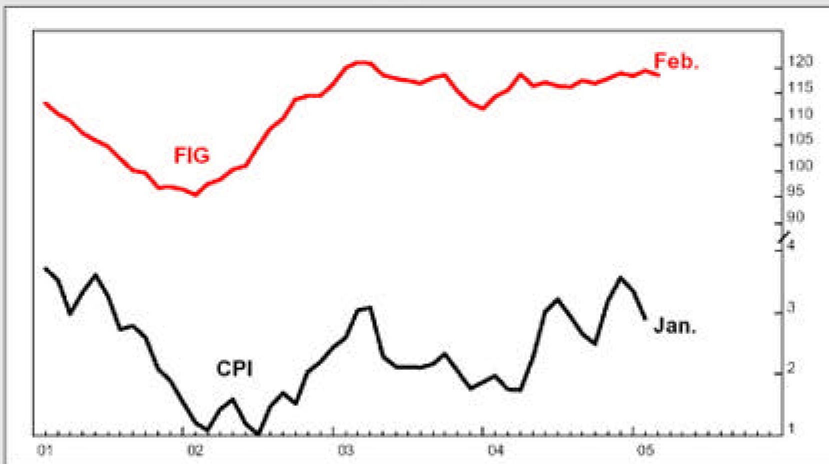
Similarly, when the FIG experiences a cyclical upturn or downturn, the inflation cycle is likely to follow. This can have important implications for interest rates in general and shorter-term rates in particular. For example, the FIG has been in a cyclical upswing since late 2004, and following suit, the Fed has been steadily pushing up short-term rates. Watching the FIG in the months ahead will give a sense of whether they'll tighten more aggressively or ease off the brakes.

What Do They Say Now?

Wondering where the U.S. economy is in the cycle right now? We're in the fourth year of a business cycle expansion, which has included two slowdowns or growth rate cycle downturns. The first began in July 2002 and ended February 2003 when the Iraq war began. The second growth rate cycle downturn was from the very strong six-percent growth of late 2003 to the three- to four-percent range for much of 2004. The latest readings of the WLI suggest that this slowdown is drawing to an end.

Let's take a look at the current WLI and FIG readings. (See **Chart 1** and **Chart 2**.) The WLI is beginning to point to an acceleration of growth as the year progresses. The FIG remains elevated, showing no signs of an inflation cycle downturn in the next few quarters but also no runaway inflation like we experienced in the 1970s. Such cycle outlooks would suggest that the risk of owning equities is not very large and that there is likely to be upward pressure on interest rates.





Monitoring for Bumps in the Road

Overall, we have a positive outlook for the economy between now and year-end. This also may be the year when job growth finally gets some traction. This should be supportive of the stock market, but one concern will be if inflation pressures build to a point where the Fed has to raise rates more aggressively. Currently we don't see this happening, but we'll be keeping a close eye on the FIG for any changes in the inflation outlook. Also, as optimism about economic growth spreads, it will be important to keep an eye on the WLI to see if there are any bumps in the road ahead.

Decide on a Framework

Most people are likely to continue believing that cycle turns cannot be foretold and therefore face being stranded on dangerous shoals by a sharp turn in the economy. Still, a small but growing group of investors is moving to limit the amount of risk they take by paying attention to the cycles that are part and parcel of our great free market.

Without a framework within which to receive all the news and data available to investors today, you are likely to become overwhelmed by the sheer volume of information and become reliant on market experts to tell you what to expect. This can be risky. More and more these days, people have to look out for their own financial well-being. At turning points, your well-being is unlikely to be served by following the crowd. Therefore, the simple cyclical framework outlined in this article is an option worth considering.

The search for ways to improve the timing of decisions has been going on for centuries. In Shakespeare's Julius Caesar, Cassius reflects on the "tide in the affairs of men" where the timing of decisions determines fortune or misery. Now, at least with respect to the economy, I think we have an answer.

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