



>: Market Wrap Up October 27, 2008

Monday, October 27, 2008 / Chris Rowe

Did you see Chris Rowe's most recent market wrap up?

Every Monday afternoon at 6:30pm EST, he's posting a SUPER FAST market wrap-up for those of you who want to take a quick peek at the market, and go back to enjoying your life!

Check out what moved the market, one topic or event affecting the value of your portfolio, and find out where the current bull market can be found - Because "there's always a bull market somewhere!" [CLICK HERE TO SEE THE VIDEO!](#)

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?Profit from the Trend?

A handwritten signature in black ink that reads 'Chris Rowe'.

Chris Rowe

Chief Investment Officer

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Economic Calendar for the week of October 27 to October 31

Tuesday Oct. 28

10:00 Conference Board Consumer Confidence

- * Importance (A-F): This release merits a B-.
- * Source: The Conference Board.
- * Release Time: 10:00 ET on the last Tuesday of the month (data for current month).
- * Raw Data Available At: <http://www.tcb-indicators.org/>.

The Conference Board conducts a monthly survey of 5000 households to ascertain the level of consumer confidence. The report can occasionally be helpful in predicting sudden shifts in consumption patterns, though most small changes in the index are just noise. Only index changes of at least five points should be considered significant. The index consists of two subindexes - consumers' appraisal of current conditions and their expectations for the future. Expectations make up 60% of the total index, with current conditions accounting for the other 40%. The expectations index is typically seen as having better leading indicator qualities than the current conditions index.

Big Picture

Consumer sentiment indices get way too much attention. The simple fact is that sentiment does not correlate with consumer spending and thus has little predictive value. Consumer spending correlates with income. US consumers spend virtually all their income. Higher income will lead to increased spending, regardless of sentiment. Sentiment correlates with the highly publicized trends in gas prices, political events, and other exogenous factors. Sentiment is near record lows, yet real (inflation adjusted) consumer spending was up at a 1% annual rate in the first quarter, and will be up at about a 2.5% annual rate in the second quarter. Consumers are simply grumpy as they head off to the mall to spend their income.

Wednesday Oct. 29

8:30 Durable Goods Orders

- * Importance (A-F): This release merits a B.
- * Source: The Census Bureau of the Department of Commerce.
- * Release Time: 8:30 ET around the 26th of the month (data for month prior).
- * Raw Data Available At: <http://www.census.gov/ftp/pub/indicator/www/m3/index.htm>.

The durable orders release measures the dollar volume of orders, shipments, and unfilled orders of durable goods (defined as goods whose intended lifespan is three years or more). Orders are considered a leading indicator of manufacturing activity, and the market often moves on this report despite the volatility and large revisions that make it a less than perfect indicator. These problems can be minimized by looking at the breakdown of orders. The total number is often skewed by huge increases in aircraft and defense orders. An increase based solely on strength in one sector tends to be discounted, while the market is more impressed with broadbased increases in orders.

Also notable in this report is the narrow category of nondefense capital goods. These goods mirror the GDP category producers' durable equipment (PDE) -- the largest component of business investment. Shipments of nondefense capital goods are a good proxy for PDE in the current quarter, while nondefense capital goods orders provide an indication of PDE growth in the quarters ahead.

Big Picture

Durable goods orders, and total factory orders (which include nondurables orders), continue to show surprising strength given overall economic conditions. Orders are near flat to up a bit on a year-over-year basis and the backlog of orders is at record highs. Manufacturing has been very resilient and has yet to move into recessionary mode even as the housing market and consumer sectors remain depressed. The weakness in manufacturing has been greatly exaggerated.

Thursday Oct. 30

8:30 Gross Domestic Product

- * Importance (A-F): This release merits a B.
- * Source: Bureau of Economic Analysis, U.S. Department of Commerce.
- * Release Time: Third or fourth week of the month at 8:30 ET for the prior quarter, with subsequent revisions

released in the second and third months of the quarter.

* Raw Data Available At: <http://www.bea.doc.gov/bea/dn1.htm>.

Gross Domestic Product (GDP) is the the broadest measure of economic activity. Annualized quarterly percent changes in GDP reflect the growth rate of total economic output. The figures can be quite volatile from quarter to quarter. Inventory and net export swings in particular can produce significant volatility in GDP. The final sales figure, which excludes inventories, can sometimes be helpful in identifying underlying growth trends as inventories represent unsold goods, and a large inventory increase will boost GDP but might be indicative of weakness rather than strength. The broad components of GDP are: consumption, investment, net exports, government purchases, and inventories. Consumption is by far the largest component, totaling roughly 2/3rds of GDP.

In addition to the GDP figures, there are GDP deflators, which measure the change in prices in total GDP and for each component. Though the consumer price index is a more closely watched inflation indicator, the GDP deflator is another key inflation measure. Unlike CPI, it has the advantage of not being a fixed basket of goods and services, so that changes in consumption patterns or the introduction of new goods and services will be reflected in the deflator.

With both GDP and the deflator, the market tends to focus on the quarter/quarter change. Year/year changes are also cited frequently, though they do not provide the most timely indications of economic activity or inflation. The bond market often reacts to GDP, though the price moves are typically small, as much of the GDP data is easily predicted using monthly economic releases such as personal consumption, durable goods shipments, construction spending, international trade, and inventories.

Quarterly GDP reports are broken down into three announcements: advance, preliminary, and final. After the final revision, GDP is not revised again until the annual benchmark revisions each July. These revisions can be quite large and usually affect the past five years of data.

Big Picture

Economic growth is much stronger than generally recognized. Net exports have been a major contributor to growth but this category gets far less attention than deserved. Net exports have added more to GDP growth than housing has subtracted in recent quarters. Consumer spending has also continued to increase. Higher gas prices simply do not subtract enough from consumer spending power given steady (though modest) income gains to produce a decline in spending. Business investment also continues to rise at a steady pace. The manufacturing sector is holding up surprisingly well. Second quarter real GDP growth was near the long-term trend, and third quarter real GDP will be near 3% as well. High gas prices and lower home prices are important negatives for the economy, but GDP, which measures the quarterly change in output, will rise despite the press obsession over these factors.

Key Factors

- The trends in second quarter GDP components reflect a much stronger economy than generally recognized. Consumer spending is sluggish, but the only area of real weakness is residential construction, and the rate of decline there is dropping.
- Net exports contributed a whopping 3.1% to the GDP gain. This included a 1.7% contribution from

the continuing surge in US exports. It also included a 1.4% contribution from a decline in imports. That decline in imports means that personal consumption expenditures were more geared towards purchases of US goods and services, and that US imports of oil dropped. That decline in the volume of oil imports also factored in to the large decline in inventories for the second quarter. The high price of commodities led many firms to carry lower inventory levels.

- The price impact noted above is a major reason that inventories sliced a full 1.4% off the GDP change. Real final sales (GDP excluding the inventory factor), representing underlying demand, rose at a very strong 4.7% annual rate.
- Real government spending rose at a 3.9% annual rate. This included an increase at a 2.2% annual rate of growth for state and local governments. There has been a lot of talk about cutbacks at this level, but those are apparently only limiting growth, and not leading to declines.
- The increase at a 1.7% annual rate in real personal consumption expenditures got a bit of a boost from the fiscal stimulus, but the consumer hasn't spent nearly all of it yet. A dip in spending may occur for July, but strong increases in August and September real PCE are possible, particularly as the deflator may turn negative for those months due to lower gas prices.
- The decline at a 15.7% rate for residential construction is actually very good news. This housing component had reduced real GDP growth by over 1% each of the three previous quarters. In this quarter, it took off only 0.6%. Housing starts have started to bottom, so it may take off even less in Q3 and Q4.
- Nonresidential business investment rose at a 2.2% annual rate due to strong growth at a 13.7% rate for nonresidential construction but a surprisingly soft -3.2% number for software and equipment.
- Our early third quarter estimates call for about a 2 1/2% to 3% GDP growth rate. Net exports will add about 2.0%. Personal consumption expenditures may rise at a slightly slower 1% rate, while nonresidential construction spending should drop only modestly, and software and equipment should rebound. Overall business investment is resilient and isn't trending weak. Inventories will add to third quarter GDP because of the decline in commodity prices. This price drop will lead to an upward inventory valuation adjustment. This could in fact be huge, and reverse the 1.4% decline in the second quarter. If so, real GDP growth could approach 4%. For now, we are keeping our inventory forecast as adding 0.5% in the third quarter.

Friday, Oct. 31

8:30 Employment Cost Index

- * Importance (A-F): This release merits a B .
- * Source: U.S. Department of Labor, Bureau of Labor Statistics
- * Release Time: 8:30 ET, near the end of the first month of the quarter for the prior quarter.
- * Raw Data Available At: <http://stats.bls.gov/news.release/eci.toc.htm>.

Since the employment cost index was mentioned by Fed Chairman Greenspan in July 1996, it has risen into the upper echelon of economic reports in the eyes of the bond market. Its lagging nature still leaves it as a less timely indicator of employment cost trends than the monthly hourly earnings data in the employment report. But the ECI does add something to this picture: an adjustment for shifting employment between industries, and a look at benefit costs. These additions are interesting, but typically do not alter the view of the employment cost picture which was left by hourly earnings. ECI will be much less closely watched during

periods when wage inflation is not a serious market concern.

The market focuses on the quarter/quarter and year/year changes in each of three categories: total employment costs, wages and salaries, and benefit costs. The figures are sometimes skewed by large year-end bonuses in the financial industry; analysts often exclude the sales commission component of wages and salaries to adjust for this factor.

Big Picture

Employment costs are the major component of business costs. The trend in these data therefore have important implications for cost-push inflationary pressures and for profit margins. In recent quarters, the trend has been relatively steady. The year-over-year total increase in the ECI has been at 3.3% for the past few quarters, and has been drifting a bit lower the past couple of years. Weak overall demand in the economy should keep the ECI cost index on the current trend. At 3.3% this does not represent much inflationary pressure, as productivity gains of close to 2% leave unit labor costs rising at a modest pace near 1%. The major inflationary pressures are currently coming from commodity prices, not wages.

9:45 Chicago PMI

- * Importance (A-F): The Chicago PMI merits a B.
- * Source: Chicago Purchasing Managers Association.
- * Release Time: Last business day of the month at 10 ET for the current month.

There are many regional manufacturing surveys, and they tend to be ranked in order of timeliness and the importance of the region. The New York and Philadelphia Fed's surveys are the first each month followed by the Chicago purchasing managers' report on the last day of each month. A few, such as the Atlanta and Richmond Fed surveys, are released after the ISM and are of little value. The purchasing managers' reports are measured like the national ISM -- 50% marks the breakeven line between an expanding and contracting manufacturing sector. For the New York, Philadelphia and Atlanta Fed indexes, 0 is the breakeven mark. These surveys can be of some help in forecasting the national ISM.

Big Picture

The Chicago PMI has little overall economic value, and is only watched by the financial markets because it is usually released one day in advance of the similar national ISM manufacturing survey. A significant move in this regional survey will therefore sometimes be seen as having predictive value for the ISM index.

10:00 University of Michigan Consumer Sentiment Index

- * Importance (A-F): This release merits a B-.
- * Source: The University of Michigan.
- * Release Time: Preliminary: 10:00 ET on the second Friday of the month (data for current month); Final: 10:00 ET on the fourth Friday of the month (data for current month).

The Michigan index is almost identical to the Conference Board Consumer Confidence index, though there are two monthly releases, a preliminary and final reading. Like the Conference Board index, it has two subindexes - expectations and current conditions. The expectations index is a component of the Conference

Board's Leading Indicators index.

Big Picture

Consumer sentiment surveys get way too much attention. Right now, the surveys are greatly influenced by the price of gasoline. Gasoline represents only 4% of consumer spending, and price changes don't have nearly as much impact on consumer spending power as generally thought, but gas prices have a huge impact on sentiment.