

Has the Economy Turned the Corner?

July 1, 2009

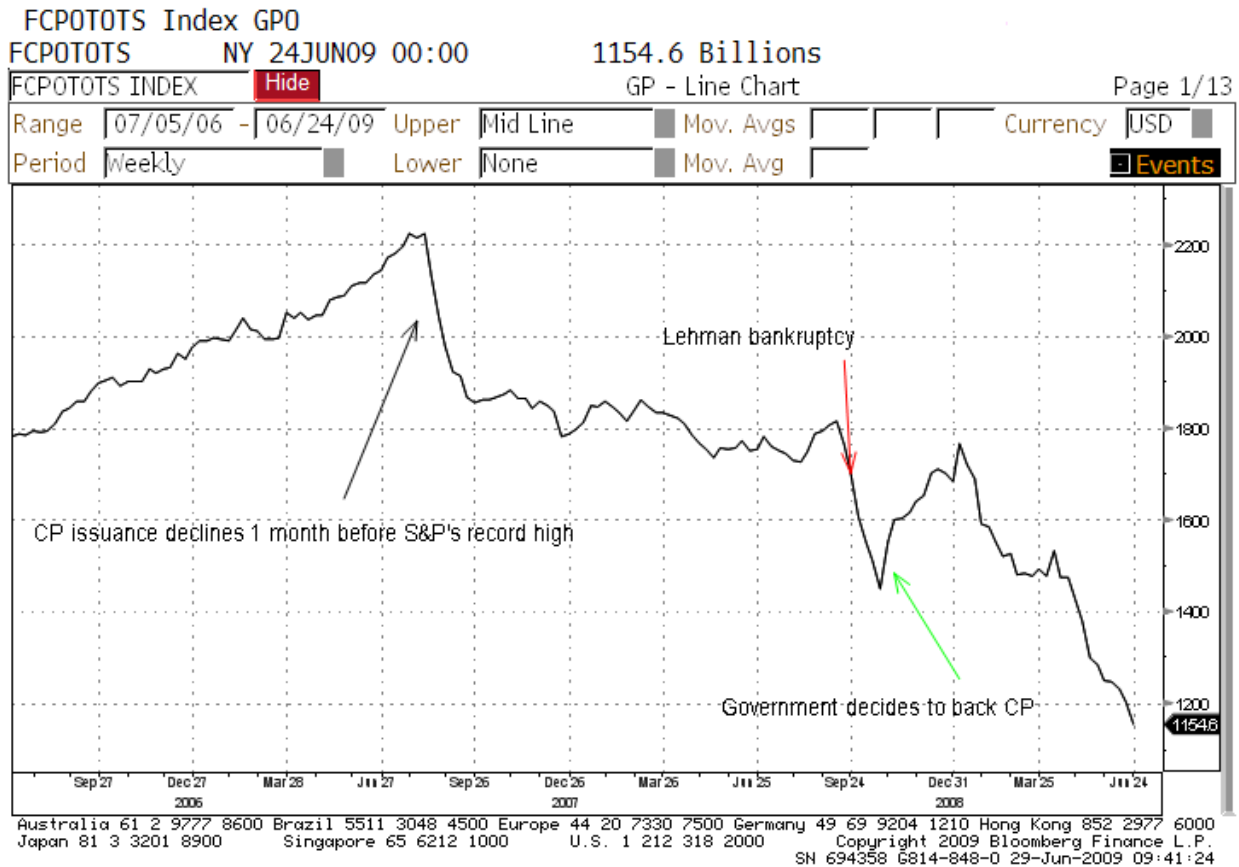
Much has been said over the last number of weeks about the potential economic “recovery” and the fact that the stock market has had a terrific run since the middle of March. What needs clarification, however, is that these two occurrences are not, at this time, related. While we are all enjoying a three month rally in the stock market, the reality is that the economy remains in critical condition.

“Lies, Damn Lies, and Statistics”

Benjamin Disraeli’s famous quote rings very true in today’s quest for economic optimism. Every week we hear about the latest economic indicator; leading indicators, lagging indicators, employment figures, inflation figures, the list goes on. We have reached the point where completely devastating news like the unemployment figures or corporate earnings have become rallying points for the market due to misguided context. That context being that the bad news wasn’t as bad as it could have been. A perfect example is last month’s jobless claims number. The much anticipated number showed the economy lost 345,000 jobs that month. The stock market took this as great news. While it is good to see that it wasn’t as bad as in previous months, we need to keep this in perspective. For comparison, the worst number during the 2000-2002 recession/bear market was.....175,000. Last month we lost nearly double the number of jobs as the worst of the last recession and it was perceived as good news.

Economics 101: Supply and Demand

So, what **do** we look for to see when the economy is turning around? There isn’t any one particular item, but a good start is to watch the new issuance of Commercial Paper. Commercial Paper (CP) is short-term debt issued by companies, to finance their near term needs. Things like inventories, salaries and accounts receivables are the most common uses of this type of funding. When a company issues less commercial paper and does so on a continuous basis it’s usually a sign of a slowing economy. A high level of inventories and fewer employees (lower salary requirements) generally means a company’s short-term funding needs are lower; therefore the need to issue commercial paper is reduced. The following chart shows the commercial paper issuance for the last two years.



As you can see, the CP issuance dropped significantly in August/September of 2007, at least 4-6 weeks before the S&P 500 made a record high. The issuance rate has declined continuously since that time.

While the CP issuance has dropped, the equity markets have followed, except for the last three months. (See chart below) CP issuance, in a recovering economy, should start to move up first and the equity markets will then follow. What has happened instead is that companies reported that they missed on revenues in the second quarter but beat on the bottom line (due to cost cutting). The cost cutting, along with lack of receivables and high inventories (both reflective of lower sales) are highly correlated to the issuance of CP. This is fine for the near term but in the long run revenues will be one of the main factors that drive the stock price.

For a true sustained recovery, look for a surge in CP issuance. When companies truly see their businesses turning around with inventory leaving and more employee hours required, they will start to issue more paper.

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<HELP> for explanation.

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1 Commercial Paper Outstan Px1 USD 2 SPX -- S&P 500 INDEX Px1 USD
 3 [redacted] Px1 4 [redacted] Px1
 Range 7/ 5/06 To 6/24/09 Period W(D-W-M-Q-Y) Normalize N(Y/N/O) Dates 0



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