

Focus on Lagging, Not Leading Economic Indicators

While sentiment towards equities has improved following the September rally, many of our clients that we met last week in Toronto remain nervous on the US economy due to the continued deterioration in leading economic indicators. However, during mid-cycle slowdowns, the lagging indicator is what matters. The data released last week showed a third monthly rise, supporting our view that the back-end of the US economy is recovering, hence, our buy-on-dips equity strategy.

As we mentioned in our July 23 Incubator, while the leading economic indicator is useful in recessions or late in the economic cycle to gauge economic turning points, the lagging indicator, which represents the back-end of the economy (see components next page), is the key economic variable to monitor during mid-cycle slowdowns. This is because as a composite, the lagging indicator measures the ability/potential for the economy to grow on its own, in other words, grow stimulus-free!

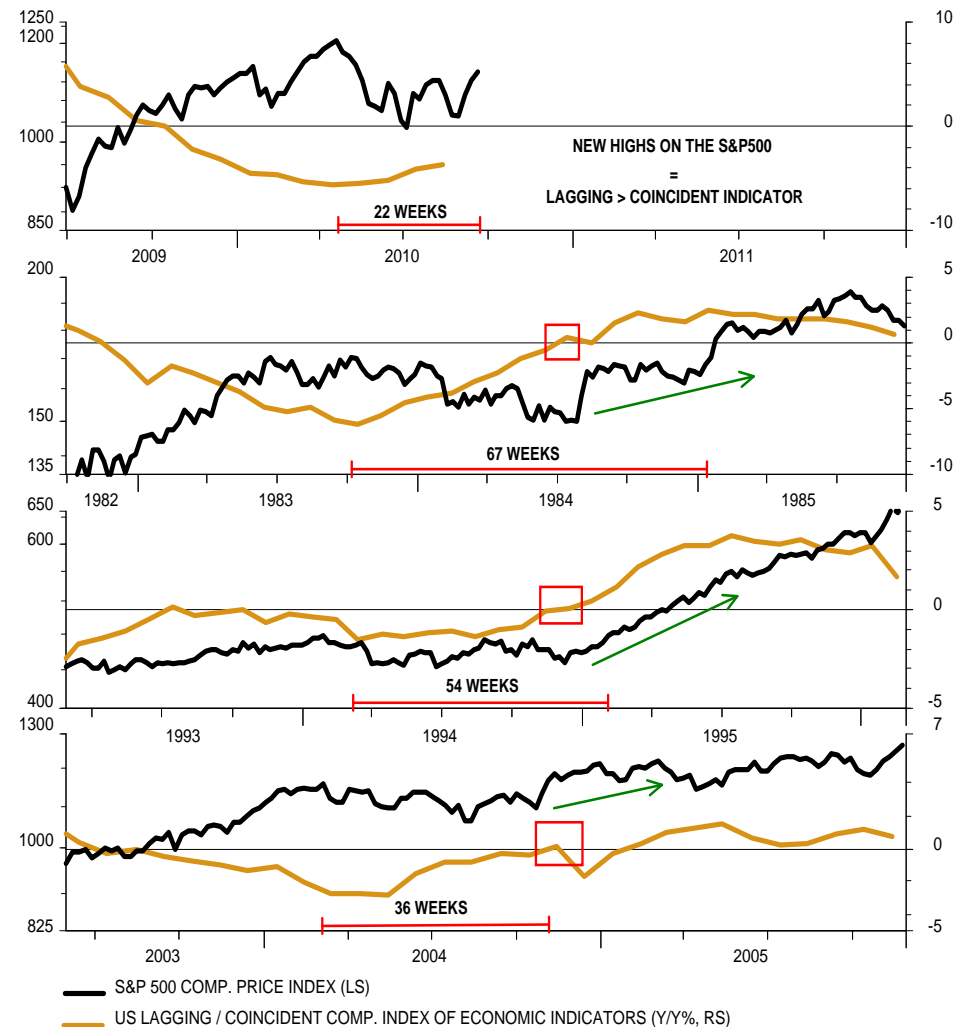
Unsurprisingly, for stock market turning points through mid-cycle slowdowns, our quantitative work shows that the ratio of the US lagging-to-coincident indicator, as opposed to the leading indicator, is the key variable to watch. Indeed, when looking at past mid-cycle slowdowns in 1984, 1994 and 2004 (Exhibit 1, panels 2, 3 and 4) history shows that once the lagging indicator starts growing faster than the coincident indicator (red boxes on the chart), this means that economic growth has become self-sustaining and that equities are ready to move into a higher trading range. In 2004, Exhibit 2 next page shows that had investors waited for growth in the US leading indicator to resume before buying equities, they would have missed most of the 2004-2007 cyclical bull market. The buy signal came from the lagging indicator.

Last week, the Conference Board released the August statistics for the US lagging indicator (+0.2% MoM) and for the third consecutive month, the indicator expanded and outpaced the coincident indicator (flat MoM). While the lagging-to-coincident ratio is still contracting (-3.6% YoY), the pace of improvement suggests that the ratio will expand late this year or early next, making the length of the ongoing "time" correction comparable with those seen in 1984, 1994 and 2004, that is 67, 54, and 36 weeks.

Bottom line: In mid-cycle economic slowdowns, investors should focus on the US lagging, not leading economic indicator! US equities are likely to grind higher and test the upper band of a wide range (S&P 500 1040-1220) as long as the ratio of the lagging-to-coincident indicator recovers. However, only an expansion in this ratio should catapult the S&P 500 into a higher price range. We see this positive resolution late this year or early next. Buy the dips!

Exhibit 1

S&P 500: KEEP AN EYE ON THE LAGGING/COINCIDENT INDICATORS' RATIO



Source: Dundee Securities Corp., Thomson Datastream

Martin Roberge, M.Sc., CFA

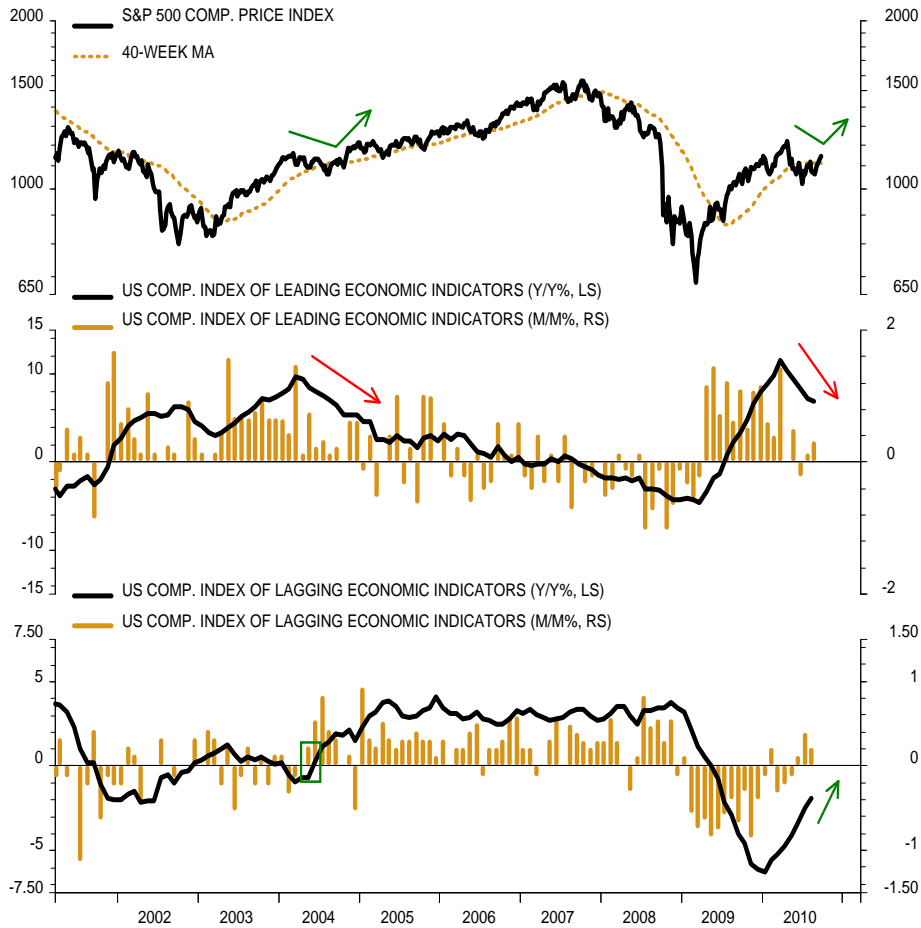
Portfolio Strategist & Quantitative Analyst (514) 396-0368

Guillaume Arseneau

Associate - Portfolio Strategy (514) 396-0369

Exhibit 2

US ECONOMY: FOCUS ON LAGGING NOT LEADING INDICATORS



Source: Dundee Securities Corp., Thomson Reuters Datastream

The Components

Below is a list of the seven components of the Composite Index of Lagging Indicators, according to the board's Business Cycle Indicators.

- **Average duration of unemployment** – This series measures the average duration (in weeks) that individuals counted as unemployed have been out of work. Because this series tends to be higher during recessions and lower during expansions, it is inverted when it is included in the lagging index (i.e., the signs of the month-to-month changes are reversed). Decreases in the average duration of unemployment invariably occur after an expansion gains strength and the sharpest increases tend to occur after a recession has begun.
- **Ratio, manufacturing and trade inventories to sales (in 1996 dollars)** – The ratio of inventories to sales is a popular gauge of business conditions for individual firms, entire industries, and the whole economy. This series is calculated by the Bureau of Economic Analysis using inventory and sales data for manufacturing, wholesale, and retail businesses (in inflation- and seasonally-adjusted form) based on data collected by the Bureau of the Census. Because inventories tend to increase when the economy slows and sales fail to meet projections, the ratio typically reaches its cyclical peaks in the middle of a recession. It also tends to decline at the beginning of an expansion as firms meet their sales demand from excess inventories.
- **Change in labor cost per unit of output, manufacturing** – This series measures the rate of change in an index that rises when labor costs for manufacturing firms rise faster than their production (and vice-versa). The index is constructed by The Conference Board from various components, including seasonally adjusted data on employee compensation in manufacturing (wages and salaries plus supplements) from the BEA, and seasonally adjusted data on industrial production in manufacturing from the Board of Governors of the Federal Reserve System. Because monthly percent changes in this series are extremely erratic, percent changes in labor costs are calculated over a six-month span. Cyclical peaks in the six-month annualized rate of change typically occur during recessions, as output declines faster than labor costs despite layoffs of production workers. Troughs in the series are much more difficult to determine and characterize.
- **Average prime rate charged by banks** – Although the prime rate is considered the benchmark that banks use to establish their interest rates for different types of loans, changes tend to lag behind the movements of general economic activities. The monthly data are compiled by the Board of Governors of the Federal Reserve System.
- **Commercial and industrial loans outstanding (in 1996 dollars)** – This series measures the volume of business loans held by banks and commercial paper issued by nonfinancial companies. The underlying data are compiled by the Board of Governors of the Federal Reserve System. The Conference Board makes price level adjustments using the same deflator (based on Personal Consumption Expenditures data) used to deflate the money supply series in the leading index. The series tends to peak after an expansion peaks because declining profits usually increase the demand for loans. Troughs are typically seen more than a year after the recession ends. (Users should note that there is a major discontinuity in January 1988, due to a change in the source data; the composite index calculations are adjusted for this fact.)
- **Ratio, consumer installment credit outstanding to personal income** – This series measures the relationship between consumer debt and income. Consumer installment credit outstanding is compiled by the Board of Governors of the Federal Reserve System and personal income data is from the Bureau of Economic Analysis. Because consumers tend to hold off personal borrowing until months after a recession ends, this ratio typically shows a trough after personal income has risen for a year or longer. Lags between peaks in the ratio and peaks in the general economy are much more variable.
- **Change in Consumer Price Index for services** – This series is compiled by the Bureau of Labor Statistics, and it measures the rates of change in the services component of the Consumer Price Index. It is probable that because of recognition lags and other market rigidities, service sector inflation tends to increase in the initial months of a recession and to decrease in the initial months of an expansion.

Source: The Conference Board

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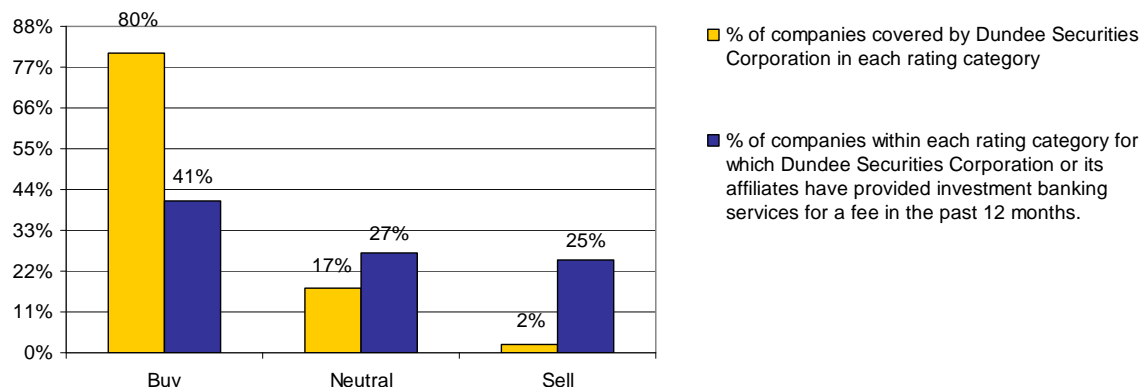
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Dundee Securities Equity Research Ratings



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