

MORE THAN MEETS THE EYE

Key Points

- The NAPM index is a key market mover for both bonds and stocks. Its recent rebound is a recovery signal.
- All financial markets other than the stock market reacted very strongly to the report. The intensity of their movements was highly unusual.
- The last time similar movements took place was in the fall of 1998, just as stock prices bottomed.

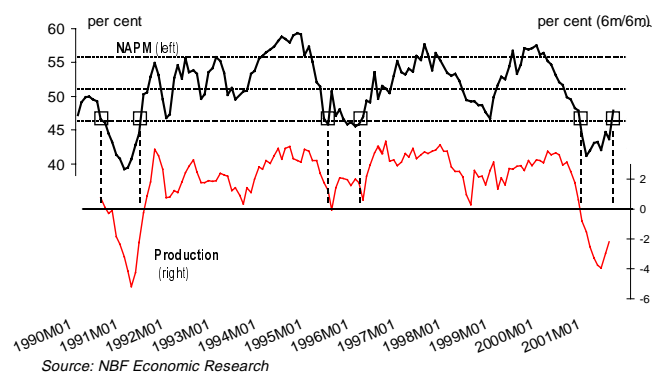
Market movers

Some reports from the economy are market movers. The survey of the National Association of Purchasing Managers, the first economic news released each month, is one of them. The NAPM index of manufacturing activity has leading properties that make it one of the top items of the watch list.

The August index released earlier this week was the highest since November. Its unexpected surge has prompted an outpouring of opinion on how to interpret it – three days later, investors are still debating the market implications. Here is our view.

(1) Hitting a Threshold

NAPM PMI index vs. U.S. manufacturing production

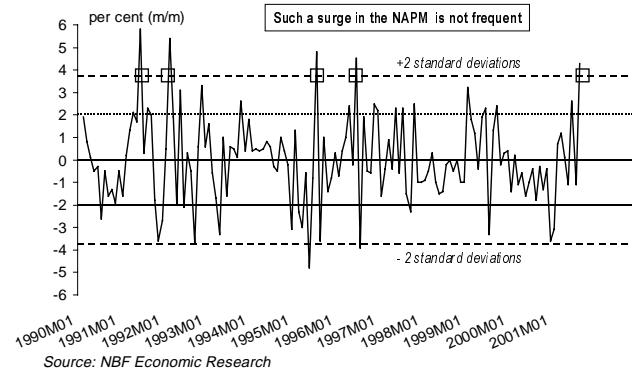


The level

In August the NAPM index jumped to 47.9. What does this level mean? Conventionally, a reading below 50 is said to indicate a contraction in manufacturing, but that's not what the record shows. As chart 1 illustrates, the NAPM is centred on 51.1, with a standard deviation of 4.7. The lower bound of the one-standard-deviation range is thus 46.4. In our view, this is a more important threshold than the widely cited 50. As the chart shows, manufacturing output contracts after the NAPM dips below 46.4 and recovers after it moves above it. In 1995-96, when the NAPM fell below 50 but remained close to 46.4, industrial production slowed but did not contract. The recent rebound in the NAPM is a recovery signal.

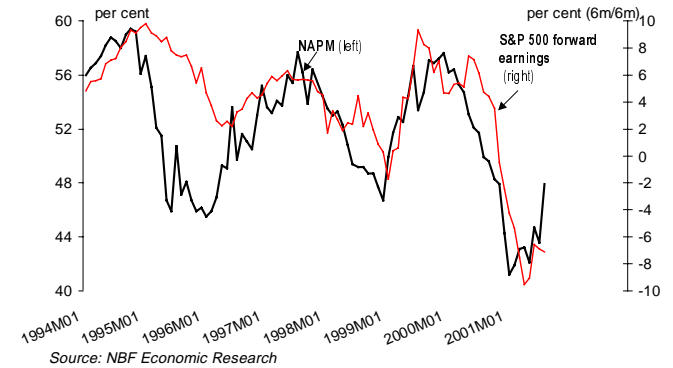
(2) Well-Above Expectations

monthly change in the NAPM PMI index & standard deviations



(4) ...And for Equities

NAPM PMI index vs. S&P 500 12-month forward earnings (6-month % change)



The change

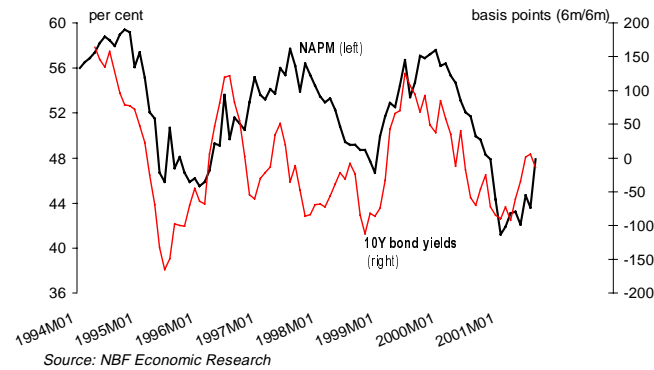
There is more to the story. Amplitude of change also matters, and the NAPM rose 4.3 points from July to August. This is a rare swing. Chart 2 plots the monthly change in the NAPM since 1990, with the standard deviation. The August change exceeded two standard deviations. Since 1990 this has happened only four other times on the way up and twice on the way down.

Moving which market?

As noted earlier, the NAPM is a market mover. But which markets does it move exactly? As chart 3 shows, this indicator clearly matters a lot for the bond market. Its recovery is bad news for U.S. Treasuries.

(3) A Key Indicator for Bonds...

NAPM PMI index vs. U.S. 10-Year benchmark bond yields (6-month change)



The NAPM survey is just as important for stocks. Last week we argued that the missing ingredient for a stock market rally was an improvement in earnings growth expectations.¹ Chart 4 juxtaposes NAPM movements against fluctuations in earnings expectations. As it shows, a rebound in the NAPM usually signals an improvement in earnings expectations.

A brutal market reaction

The really unusual thing about last Tuesday's NAPM report was the market reaction. While stocks were not impressed at all, other markets reacted violently.

- The reaction of the futures market was intense. In a single trading day, the odds of another quarter-point rate cut at the October FOMC meeting temporarily dropped from 90% to about 50%. A one-day shift of this amplitude has occurred only 50 times since the early 1990s, making the odds of such a reaction from the futures markets **63 to 1**.
- The bond market's responded almost as brutally. The NAPM triggered a selling binge in which the price of the 10-year benchmark dropped 1.21%. Daily declines of this amplitude have not been very frequent since 1990. The odds of one occurring are **33 to 1**.

¹ See "A Missing Ingredient?", *Weekly Economic Letter*, August 31, 2001.

- Other markets also reacted strongly. Credit conditions improved sharply – the one-day narrowing in 10-year swap spreads exceeded two standard deviations. Ted spreads (a proxy for U.S. financial tensions) narrowed substantially.
- The currency market also took note of the NAPM report. On Tuesday the U.S. dollar climbed an unusual 1.7% against the euro.

Stars in alignment?

How often do these markets react with such vehemence simultaneously? We checked and found it has never happened before. However, a similar swing did occur over a three-day span from October 7 to 9, 1998, when credit conditions improved, Fed easing expectations shifted down with a thump, bonds retreated brutally and the U.S. dollar rose strongly. As it turns out, October 8, 1998 was a cyclical low in stock prices.

The weaker-than-expected August employment report released this morning will temporarily dash hopes of a recovery. However, a key distinction must be kept in mind. Employment is a coincident indicator, telling us what happened last month. On the other hand, the NAPM is a leading indicator, telling us what to expect over the coming months.

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ECONOMIC CALENDAR : CANADA & UNITED STATES

The Week Ahead (September 10 – September 14)

US Indicators

Date	Time	Release	Month	Previous	Estimate	
					Consensus	NBF
12-Sep	08:30	Current account	Q2 2001	-\$110 B	-\$106 B	-\$108 B
14-Sep	08:30	Retail sales	August	0.0%	0.2%	0.2%
		excl. autos	August	0.2%	0.3%	0.4%
14-Sep	08:30	PPI	August	-0.9%	0.2%	0.4%
		excl. food & energy	August	0.2%	0.1%	0.1%
14-Sep	08:30	Industrial production	August	-0.1%	-0.2%	0.1%
		Capacity utilization	August	77.0%	76.8%	77.0%
14-Sep	10:00	Consumer sentiment	Sep (prel)	91.5	91.0	91.0

Canadian Indicators

Date	Time	Release	Month	Previous	Estimate	
					Consensus	NBF
12-Sep	08:30	Capacity utilization	Q2 2001	84.1%	83.6%	83.2%
14-Sep	08:30	Car sales	July	2.0%	0.6%	-0.1%

Other events:

ECB meeting (September 13)

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