MORNING BRIEFING
September 30, 2020

Inventory Swings

Check out the accompanying chart collection.

(1) Having too much inventory during a recession is a problem. So is not having enough during a recovery. (2) Companies responded rapidly to pandemic by slashing orders and production. (3) Inventory liquidation during H1 set stage for rebound during H2. (4) Pent-up saving and demand during lockdown recession triggered V-shaped recovery as restrictions were lifted. (5) Retail sales lead bungee rebound in business sales. (6) Inventories can be a big swing factor for real GDP. (7) Good for transportation. (8) Something is really not right with jobless claims data.

US Economy: Restocking. My wife and I enjoy watching *Shark Tank*. The television program features wannabe entrepreneurs who pitch five wealthy entrepreneurs on their ideas for new products and services they've conceived. The wannabes hope to convince at least one of the rich and famous capitalists to invest in their businesses. Occasionally, the show follows up to see whether the upstarts that succeeded in attracting some venture capital in previous episodes went on to succeed in their ventures. Unfortunately, the show tends to follow up only with the winners, never the losers. However, it's clear that a main reason new business owners struggle is that they have gotten stuck with too much inventory.

The pandemic certainly caused an inventory problem throughout our economy. However, companies responded very quickly when their sales plunged by slashing their orders and production. As a result, instead of piling up, inventories were depleted. That exacerbated the drop in real GDP during the first half of this year. Contributing to the V-shaped economic recovery during the second half of this year should be a significant rebound in inventories following the dramatic inventory decline during the first half of the year. Consider the following:

(1) *Voluntary and involuntary inventory cuts.* Initially during the pandemic, many companies experienced involuntary inventory buildups when their sales plummeted. They had no choice but to reduce their production and/or new orders to below their rapidly falling sales, in order to slash their unintended stockpiling.

On the other hand, some companies experienced significant unanticipated inventory drawdowns because the pandemic caused their sales to boom unexpectedly. That further depleted inventories for many of them. Now they are all scrambling to rebuild their inventories after they were cut either voluntarily (due to production and orders cuts that exceeded the drop in sales) or involuntarily (due to soaring sales).

(2) *Bungee jump in retail sales.* During the two-month lockdown recession in March and April, there was lots of pent-up demand because stores were closed; this caused personal saving to soar from $1.27 trillion (saar) during January to an all-time record high of $6.40 trillion during April (*Fig. 1*). Saving was boosted by government social benefits that well exceeded the drop in wages and salaries and that weren't all spent right away (*Fig. 2*).

During the lockdown recession, retail sales plunged 21.7% from February through April (*Fig. 3*). Then as the lockdown restrictions were gradually lifted, retail sales soared 30.2% through August to a new record high as consumers satisfied their pent-up demand. They all suffered from cabin fever during the lockdowns, which many of them rushed to cure by going shopping. Of course, some of the fever was reduced through online shopping, which jumped from 35.7% of GAFO retail sales during January to an all-time high of 50.7% during April (*Fig. 4*). It was back down to 41.8% during July. (NB: "GAFO" stands for general merchandise, apparel and accessories, furniture, and other items—i.e., the type of merchandise typically found in department stores.)

(3) *Business sales on upswing.* The rebound in retail sales to a new all-time high has led the recovery in total business sales of goods, which during July was only 1.8% below its record high during January (*Fig. 5* and *Fig. 6*). Manufacturing shipments was only 5.5% below its record high during October 2018, while wholesale sales was only 5.1% below its record high in January.

By the way, the rebound in business sales augurs well for S&P 500 aggregate and per-share revenues, which are highly correlated with business sales even though the series does not include services (*Fig. 7* and *Fig. 8*). Revenues probably bottomed during Q2 and should recover over the rest of this year into next year.

(4) *Inventories set for voluntary rebuilding.* Total business inventories plunged 5.9% from its record high during July 2019 through July 2020, i.e., over the past 12 months (*Fig. 9*). That compares to the 13-month 14.5% drop during the Great Financial Crisis.

Odds are that the inventory decline is already over given that data available for August suggest that inventories bottomed that month for wholesale and retail inventories (*Fig. 10*). (Manufacturing inventory data were still weak in July.)

(5) *Inventories in real GDP.* In the real GDP accounts, inventories is an odd item. In Table 3 of the GDP release, which is compiled by the Bureau of Economic Analysis, it shows up as the change in private inventories, a.k.a. "inventory investment." All the other components show up as levels. So when calculating the percentage changes in GDP, inventories show up as *changes in the change* in inventories, while the other components are included as *changes in their levels*.

During Q2-2020, inventory investment in the real GDP accounts was a record -$286.4 billion (saar) compared to -$80.9 billion during Q1-2020 and -$1.1 billion during Q4-2019 (*Fig. 11*). So the change in the change was a big negative, especially during Q2. Interestingly, manufacturing inventories rose $44.7 billion during Q2, while wholesale inventories fell $30.8 billion. Retail inventories fell $260.2 billion, led by a $213.3 billion drop in auto inventories.

The monthly data show that the three-month change in nominal business inventories has turned less negative through July, when it was -$266.3 billion (saar), which is up from a record low of -$396.1 billion through June (*Fig. 12*). This series is highly correlated with the comparable inflation-adjusted series, which in turn is highly correlated with inventory investment in real GDP.

(6) *Inventories drive trucks, railroads, and ships.* Not surprisingly, inflation-adjusted business inventories is highly correlated with both the ATA Truck Tonnage Index and intermodal railcar loadings (excluding trailers) (*Fig. 13* and *Fig. 14*). The apparent bottoming of inventories during the summer should set the stage for an upturn in the transportation indicators. The same goes for inbound container traffic at the West Coast ports, which is highly correlated with merchandise trade imports (*Fig. 15*).

US Labor Market: Not All They Claim To Be. In our June 29 and July 1 *Morning Briefings*, Melissa and I observed that the weekly unemployment insurance (UI) report compiled by the Department of Labor (DOL) might be flawed as a result of the chaos caused by pandemic support programs.

Our concern focused on the Pandemic Unemployment Assistance (PUA) program, which was introduced on March 27 as a part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. It is intended to support the self-employed, gig workers, and others who would not typically qualify for benefits but who lost their income as a result of the pandemic. More recent evidence suggests that there indeed have been accounting issues in the weekly data. Consider the following:

(1) *Counting claims isn't so simple*. A September 11 *New York Times* article observed: "The Labor Department reports about 15 million claims for [PUA] benefits nationwide. A comparison of state and federal records by *The New York Times* suggests that total may overstate the number of recipients by five million or more."

(2) *California dreamin'*. That jarring conclusion was at least partially confirmed by the September 24 UI report, which compared the week ending September 5 to the week ending August 29. The report separates PUA claims from regular state UI claims for both initial and continuing claims.

An adjustment in California's data drove the national number of PUA claimants down from 14.5 million to 11.5 million. The 6.4 million in the state's PUA continuing claims at the end of August was nearly halved to 3.4 million during the first week in September. A September 15 California Policy Lab analysis raised several questions about the recent reliability of the state's UI data.

(3) *Riddled with discrepancies & fraud*. The DOL simply compiles data reported to it by the separate state UI systems, which may not be consistent. Further complicating matters, the September 11 *New York Times* article pointed out that "California is at the center of increasing concerns about extensive fraud" in the PUA, which may be taking place all over the country.

(4) *Data divergence.* August's employment report, compiled by the Bureau of Labor Statistics, showed that 13.6 million workers were unemployed during the month. Yet the DOL UI report for August 29 showed 13.3 million claimants through regular state UI programs and 14.5 million PUA claimants. Including a few other similar programs, the total was 29.8 million.

The ratio of just the number of people on state UI programs to the number of unemployed workers was relatively stable around 30% from 1987 through 2019 (*Fig. 16*). It shot up to a record 104% during August. The ratio of the number of people on state UI programs to the number of short-term unemployed (for less than 27 weeks) was relatively stable around 45% from 1987 through 2019. It shot up to 118% during August.

The bottom line: There is something very odd about the UI data, which is why we aren't giving it much weight in our assessment of the economic recovery.

CALENDARS

US: Wed: ADP Employment Change 610k, GDP (Q2, final) -31.7%, Pending Home Sales 3.8%, MBA Mortgage Applications, Chicago PMI 52, EIA Crude Oil Inventories, Kashkari, Kaplan. **Thurs:** Personal Income & Spending -2.2%/0.8%, Core PCED 0.3%m/m/1.4%y/y, Initial & Continuous Jobless Claims 850k/12.225m, Auto Sales, Construction Spending 0.8%, ISM M-PMI 56.3, EIA Natural Gas Inventories, Williams.(DailyFX estimates)

Global: Wed: Germany Unemployment Change & Unemployment Rate -8k/6.4%, Germany Retail Sales 4.2%, Italy CPI -0.4% y/y, Japan Tankan Survey, BOE FPC Meeting, Lagarde, Lane, Haldane, Wuermeling. **Thurs:** Eurozone, Germany, France, and Italy M-PMIs 53.7/56.6/50.9/53.5, Eurozone Unemployment Rate 8.1%, Italy Unemployment Rate 10.1%, UK M-PMI 54.3, Japan Unemployment Rate 3.0%, European Council Special Meeting, Lane. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index leads ytd through Monday's close with a gain of 19.1% versus a 13.6% decline for Value. Since their lows for the year on March 23, Growth's 59.9% gain is well ahead of the 36.4% rise for Value. Growth has been making new record highs since July 2 and is now 9.6% above its prior record high on February 19. Value is still in a correction at 14.6% below its January 17 record high. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) and earnings growth (STEG) than Value over the next 12 months. Specifically, 9.0% STRG and 16.4% STEG are projected for Growth, respectively, versus 3.4% and 11.4% for Value. Through Monday's close, Growth's P/E of 27.3 is down from a 19-year high of 30.2 on September 2 and compares to a 15-month low of 16.8 on March 23. That also compares to a record high of 40.9 in July 2000 during the height of the tech bubble. Value's forward P/E of 16.3 is down from 18.6 on June 8, which was then the highest since July 1999 and up from 10.0 on March 23, which was its lowest reading since November 2011. Regarding NERI, Growth's was positive in September for a second month as it improved to a 30-month high of 16.9% from 13.5% in July and from its 11-year low of -35.0% in May. That compares to a record high of 22.3% in March 2018. Value's NERI was also positive for a second month in September, and up to a 30-month high of 11.7% from 7.3% and from an 11-year low of -39.0% in May; that compares to a record high of 21.2% in March 2018. The Tax Cuts and Jobs Act (TCJA) sharply boosted the consensus forward earnings estimates and the forward profit margin for both Growth and Value in 2018. Growth's forward profit margin improved from a low of 14.9% during May to 15.7% on September 17. It remains above the 14.4% prior to the TCJA's passage but is down from its record high of 16.7% during September 2018. Value's forward profit margin of 8.5% is up from a low of 8.0% during May but is well below the 9.1% prior to the TCJA and down from a record high of 10.5% in December 2018.

US ECONOMIC INDICATORS

Consumer Confidence (*link*): Confidence rebounded in September after a two-month decline, climbing to a post-pandemic high, as consumers became more confident about both the current and short-term outlooks. The Consumer Confidence Index (CCI) climbed to 101.8 this month (the highest since March), after dropping from 98.3 in June to 86.3 by August; it was at 132.6 in February. The present situation component of the CCI more than reversed August's 10.1-point decline, jumping 12.7 points in September to a six-month high of 98.5. The expectations component rebounded 17.4 points to 104.0, nearly wiping away the 19.5-point drop from June to August and is within 4.1 points of its pre-pandemic reading. (The present situation and expectations components were at highs of 173.9 and 108.1, respectively, before COVID-19 hit.) Consumers' assessment of present-day conditions improved in September: The percentage of consumers claiming business conditions are good (to 18.3% from 16.0%) climbed to a five-month high, while those claiming business conditions are bad (37.4 from 43.3) fell to six-month low. Consumers' appraisal of the current job market was also favorable. The percentage of consumers saying jobs are plentiful (to 22.9 from 21.4) rose, while the percentage claiming jobs are hard to get (20.0 from 23.6) fell. Consumers' short-term outlook also looked better this month: The percentage of consumers expecting business conditions to improve (to 37.1 from 29.8) jumped 7.3ppts, while those expecting business conditions to worsen (15.8 from 20.7) fell 4.9ppts; 47.1% expect things to remain the same. Consumers' outlook for employment showed those expecting more jobs (to 33.1 from 29.9) climbed to a three-month high, while those expecting fewer jobs (15.6 from 21.2) fell to a three-year low; 51.3% expected employment conditions to remain the same. Worth noting is that the percentage of respondents expecting more jobs is within 8.1ppts of April's record high of

41.2%. Lynn Franco, senior indicators director at the Conference Board, noted that consumers expressed more optimism about their short-term financial prospects, which may help keep spending from slowing further in the months ahead.

GLOBAL ECONOMIC INDICATORS

Eurozone Economic Sentiment Indicators (*link*): The recovery in the Economic Sentiment Indexes (ESIs) continued in September for both the Eurozone and the EU, climbing for the fifth month—recovering nearly 70% of the combined March and April losses of 38.5 and 39.2 for the Eurozone and EU, respectively. The Eurozone's ESI is up 26.2 points to 91.1 over the five-month period, while the EU's is 26.4 points higher over the comparable time span to 90.2. From a country perspective, ESIs are improving in most of the largest Eurozone economies. Those for Germany (to 95.5 from 72.1 in April) and the Netherlands (91.9 from 65.6) rose steadily over the five-month span, while ESIs for France (to 96.6 from 67.7 in May) and Italy (89.0 from 63.0) climbed for the fourth consecutive month. (Strict confinement measures in Italy during April blocked data from being collected that month.) Meanwhile, Spain's ESI took a step ahead in September (to 89.7) after taking a step back in August, though is stalled below July's four-month high of 90.6; it was at 73.3 in April. For the overall Eurozone, at the sector level, both industrial (to -11.1 from -32.5 in April) and retail (-8.7 from -30.1) confidence improved for the fifth successive month, while services (-11.1 from -43.6 in May) climbed for the fourth month. The improvements in both consumer and construction confidence have resumed after stalling over the past couple of months, climbing to -13.9 and -9.6, respectively, this month, with the former up from an April (-22.0) low and the latter from a May (-17.5) low.

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