ACHIEVING PRECISE VELOCITY

The Durable Goods Report

June 2009 Data

Source Data: US Census Bureau

Preliminary Data Release of 8/5/2009

John E. Layden, Prevel Technology

Highlights:

- GDP Q2: DOWN to $14.15 from $14.18 trillion (-0.2%) from prior quarter (reported as -1% seasonally adjusted annual rate).
- Industrial Production: DOWN to $2.624 trillion from $2.629 trillion (-0.2%) from prior month. Eighth consecutive monthly decline.
- Capacity Utilization:
  - Manufacturing: DOWN to 64.7% from 65.0% prior month (lowest on record)
  - Durable goods manufacturing: DOWN to 57.8% from 58.1% prior month (lowest on record)
  - Iron and steel: UP to 38.6% from 35.8% prior month
  - Auto and light truck: DOWN to 28.4% from 30.2% prior month. (second lowest behind January)
  - Machinery: DOWN to 56.4% from 57.2% (lowest on record)
- Durable Goods:
  - New orders: DOWN to $159.1 billion from $162.7 billion (-2.2%). Twelve month moving average DOWN 18.2% vs. prior year.
  - Shipments DOWN to $168.3 billion from $168.5 billion (-0.1%). Twelve month moving average DOWN 11.7% vs. prior year.
  - Unfilled Orders DOWN to $740.2 billion from $746.7 billion (-0.9%). Ninth consecutive monthly decline.
  - Inventory: DOWN to $317.8 from $321.6 billion (-1.2%). Sixth consecutive monthly decline.
  - Inventory to Shipments ratio: DOWN to 1.89. (second highest since 1992 after last month)
- Retail :
  - Total retail (excl. food service): UP to $304.0 billion from $301.5 billion (+0.5%).
    - Autos and Parts: UP to $57.0 billion from $55.7 billion (+0.5%).
    - Gasoline: UP to $29.9 billion from $28.5 billion (+ 5%)
  - Core retail (Excl. food service, gas, autos and parts): DOWN to $217.1 billion from $217.2 billion (-0.1%).
  - Food Service: DOWN to $38.1 billion from $38.4 billion (-0.2%). +3.9% from prior year.
- Housing:

- Inventory- new single family: DOWN to 281,000 from 293,000 units (-3.8%). 25th consecutive monthly decline.
- Median Sales Price: UP to $214,100 from $213,700, 10% below prior year (3MMA).
  - Median price of homes under $400,000: remains 4% below prior year
  - Housing Starts: Total starts UP to 532,000 (+17%); Single family starts UP to 401,000 (+7.5%).

By the Numbers:

Prevel Technology - Durable Goods & Retail Summary				Best Last 12 Mos.	
	Jun-09	May-09	Jun-08	Value	Month
New Orders-Durable	159,059	162,674	213,671	218,163	Jul-08
12 month moving average	177,844	182,643	217,466		
% Change from Prior Year	-18.2%				
Unshipped Orders - Durable	740,239	746,744	810,293		
% Change from Prior Year	-8.6%				
Value of Shipments - Durable	168,339	168,483	211,049	217,549	Jul-08
12 month moving average	188,301	192,018	213,368		
% Change from Prior Year	-11.7%				
Inventory - Durables	317,763	317,763	330,426		
% Change from Prior Year	-3.8%				
Retail Sales	304,027	301,491	338,770	335,947	Jul-08
12 month moving average	314,569	317,614	336,211		
% Change from Prior Year	-6.4%				
Inv to shipments ratio - Durable	1.89	1.91	1.57		
Growth Index - Durable New Ord	0.904	0.879	0.985		
Growth Index - Durable Shipmts	0.903	0.896	0.991		
Growth Index - Retail	0.969	0.957	1.005		
1. Preliminary release data (~5 wks after the end of the period).					
2. Seasonally Adjusted, millions					
3. Prevel Growth Index = 3MMA / 12MMA			John Layden	317-842-6417	

Summary and Analysis

General Overview of the US Economy – June Data

The total economy continued in decline in June. The rate of decline is slower. Durable goods industries are following the same pattern. The bottom for durable goods is still several months away. The effects of stimulus spending are still undetectable.

Durable goods new orders declined by 2.2% and shipments declined by0.1%. The excess of shipments over orders expanded to $9 billion and will require further production cuts (and layoffs).

Durable goods inventory declined for the sixth month. The inventory to shipments ratio has remained in the 1.88 to 1.91 range since January, the highest level since 1994. Further inventory cuts are probable. Jim Owens, Caterpillar CEO, commented that the company had accomplished half of its planned $3 billion inventory reduction by June 30. The other half will be much more difficult. I was reminded by a retired Cummins executive and frequent contributor that the second half of the cuts must come from things that people aren't buying. This process requires something akin to magic.

Of the 18 sub-segments in durable goods, 6 showed modest growth in new orders. Only one showed orders above shipments. More production cuts are coming and will be exacerbated by the additional inventory cuts that are also needed.

One bright spot in durable manufacturing is the Mining, Oil and Gas sector. Orders are up slightly and active rig count is up for the sixth week after 36 weeks of decline. If oil prices remain above $60 the industry may return to something like normal (whatever that means in the boom and bust oil patch).

Export shipments of goods increased by $2 billion to $82 billion in May. In the nine months prior to April. shipments declined from $117 billion to $80 billion. It will be a long way back, particularly if Congress continues to pass protectionist legislation and stir up trade wars with our most important trading partners (Canada, Mexico, and China so far).

The July employment report (247,000 lost jobs, 9.4% unemployment) prompted a stream of claims. Some are accurate. It is correct that the rate of job loss has slowed. That's been true every month since January. It is likely correct that the worst is behind us, but there are still further job losses ahead. It is incorrect that the stimulus money had anything to do with it. To date a total of $75 billion has been disbursed to the states. Less than $10 billion has actually been spent.

The primary drivers in the employment data were:

1) Manufacturers slowed the pace of production cuts in the month (shipments DOWN 0.1%), based on the 1.8% increase in the new orders in May. If orders were going to come back, goes the logic, why have another layoff and operations disruption. The June order numbers overruled May's hope.

2) The restart of auto plants and their supply chains after protracted shutdowns to rebalance inventories (and to deal with the pesky bankruptcies).

3) Almost 800,000 people dropped off the unemployment rolls because they stopped looking for work. An alternate measure of unemployment including discouraged workers increased from 10.1% to 10.2%.

A further problem in the employment data is the situation at the state and local level. Almost 280,000 new jobs have been added to their payrolls this year, while the private sector jobs (and government revenue) evaporate. Growth in a non-productive segment of the economy will hinder future economic growth in the productive sectors.

The modest retail sales increase in June was driven by increased auto sales and gas price increases. Core retail (excluding autos and gas) decreased 0.1%. The advanced release of the July numbers shows a similar pattern. Retail was essentially flat in spite of a 2.9% increase in autos (including the first round of Cash 4 Clunkers). Core retail (excluding autos and gas) declined 0.6%. We'll watch this closely when the revisions are published.

This suggests the trend of consumers to increase savings continues, and it may not be a temporary condition. As the baby boom generation ages the normal pattern is to shift from consumption to savings. People tend to buy their largest home in their 50s. After retirement they begin to downsize. This does not bode well for the upper end of the housing market.

The Cash 4 Clunkers program is being hailed as a huge success. It's hard to understand the logic. In the time between the passage of the law and the initiation of the program, 100,000 pending car deals were put on hold (Edmonds.com). The normal trade in rate of "clunker qualified" cars is 60,000 to 70,000 per month. Had there been no program we would expect 240,000-280,000 clunker trades by November 1st. If the trades don't exceed that number in the period, it will have done nothing except generate another $3 billion of debt. But it's worse than that. It will remove 200,000 inefficient but serviceable vehicles from the market. First time buyers like those on the first rung of the job ladder will pay higher prices due to the shortage of clunkers. The "Buy-here-pay-here" dealers will be at a loss for inventory. Further we will need to consume energy to build replacement cars. The other system-wide effect is to entice many people with no car payment, to sign up for one. Another debt bubble in the making? We should exclude, of course, the Lexus buyers and dealers who were high on the list of early winners.

There is another bubble in the making at the FHA. The FHA is projected to reach $1 trillion in sub-prime mortgage exposure by the end of next year. Isn't this how we got into this mess? The Inspector General for FHA just released a scathing audit that found the organization completely unable to manage the risk of overzealous brokers, bankers and outright fraudsters. Is it possible that the lesson of the sub-prime meltdown has already been lost?

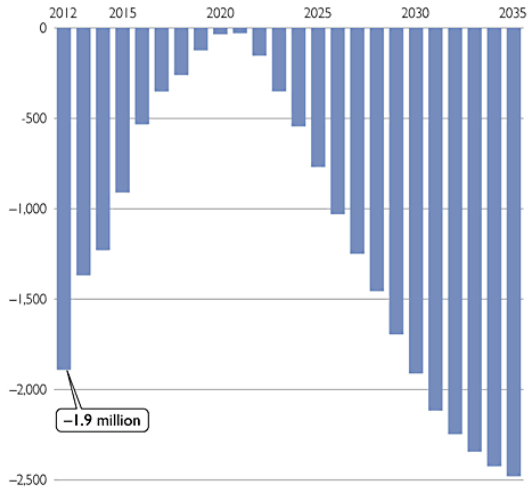
There was a recent interview with a young college graduate published in the Indianapolis Star. I was stunned to read her comment to the effect that she did not mourn the decline of the industrial economy. What is the value of a college degree that doesn't even teach the basic premise of where our wealth originates? Is it just an accident that the top 20 economies in the world are described as the "industrial economies?" Of course this probably reflects the attitude of too many educators. "We're beyond that industrial stuff. We're in the post industrial economy. The knowledge economy. The service economy." They've watched too much Star Trek. It's a complete myth. Without the industrial foundation the rest of the economy will collapse and we will revert to mining or agriculture. There has never been a prosperous economy in the modern age built on this foundation.

Keep a close eye on the direction of cap and trade legislation. This is the largest of several profound threats to the economy. The following charts from the Heritage Foundation (heritage.org) give you the picture. All CEOs are encouraged to review the entire Heritage report. Their analysis is a profound wake up call. If the Congress pass this monstrous bill it will influence all manufacturing in ways that we will never be able to predict. None of it will be positive. It will shrink the economy and make the surviving manufacturers less competitive. Anyone in Congress who votes for this bill or any similar restraint on CO_2 emissions should be sent back to high school. A course in remedial economics wouldn't hurt. Further, the science continues to emerge that the Earth is deficient in CO_2 compared to the last 600 million years. Higher temperature and CO_2 would be a major benefit to mankind, but it is now clear that man has no ability to affect atmospheric CO_2 in either direction even if we wanted to. Both Republicans and Democrats have been hoodwinked by a group of computer modelers unable to find a single piece of scientific evidence to support the theories of their models. After 11 years of global cooling (following the sunspot cycle), the UN still trumpets that we have only four months to save the planet. What rubbish.

Waxman–Markey Climate Change Bill Would Cost Millions of Jobs

The legislation would increase unemployment levels for every year: 1.9 million fewer jobs in 2012, and an average of 1.14 million fewer jobs from 2012 through 2035.

Change in Employment Due to Waxman–Markey Climate Change Bill, in Thousands of Jobs

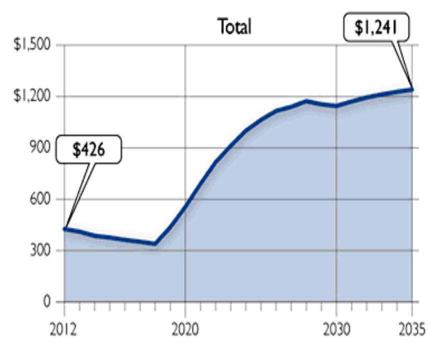


Source: Heritage Foundation calculations based on the IHS/Global Insight U.S. Macroeconomic model.

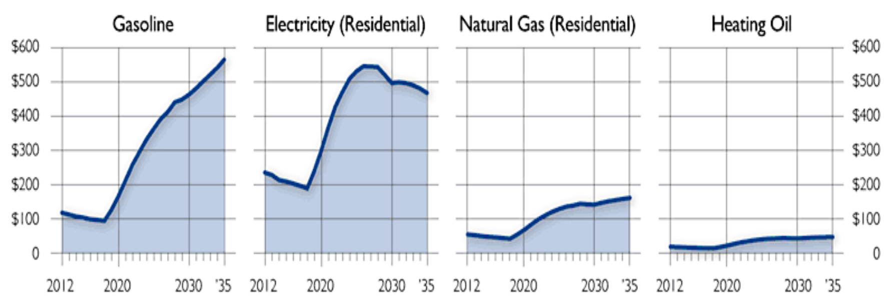
Chart 1 • CDA 09-04 heritage.org

Waxman–Markey Climate Change Bill Would Increase Energy Costs

The Waxman–Markey climate change bill would increase average total energy costs for a family of four by $426 in 2012. Costs would fall slightly until 2019, when they would begin to rise dramatically. Gasoline and electricity costs alone would cost families $1,033 more per year in 2035.



Total Annual Energy Cost Increases For a Family of Four Due to the Waxman-Markey Climate Change Bill, Adjusted for Inflation in 2009 Dollars

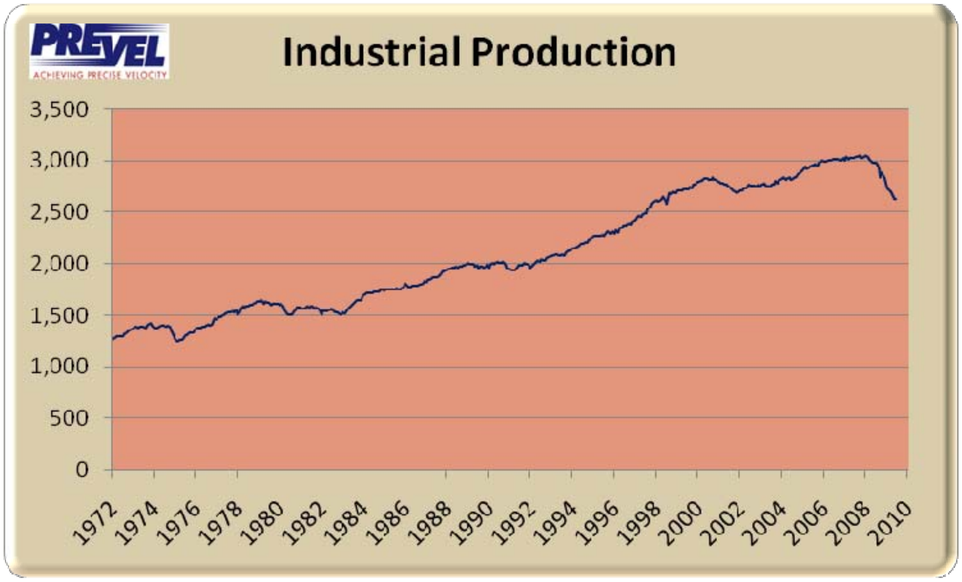


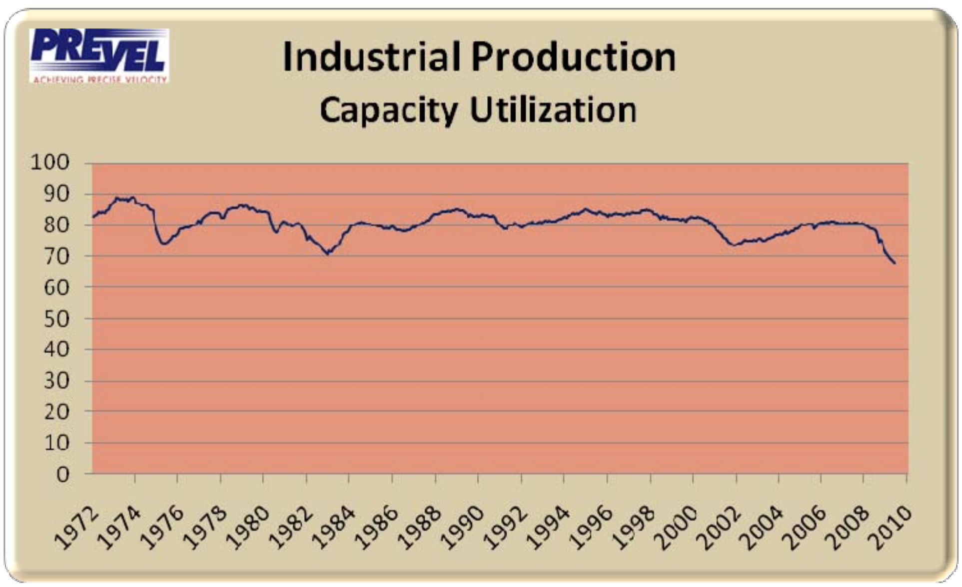
Source: Heritage Foundation calculations based on the IHS/Global Insight U.S. Macroeconomic and Energy models.

Chart 5 • CDA 09-04 heritage.org

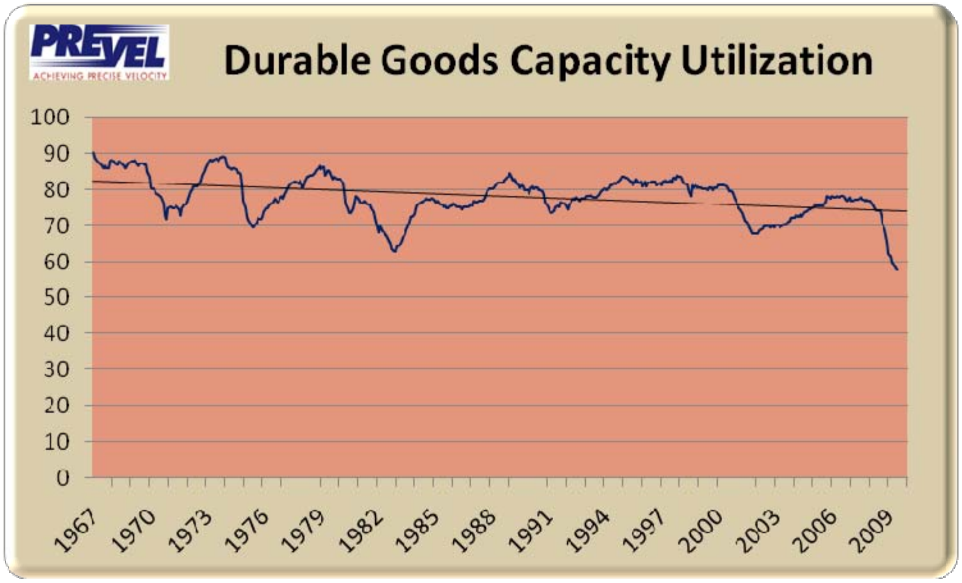
Industrial Production and Capacity Utilization

Industrial production declined 0.2% in June, the 15th decline in the last 17 months. The moderated decline was influenced by increases in the price of energy. With more production cuts coming in durable goods, the prognosis is for further declines before recovery can start.

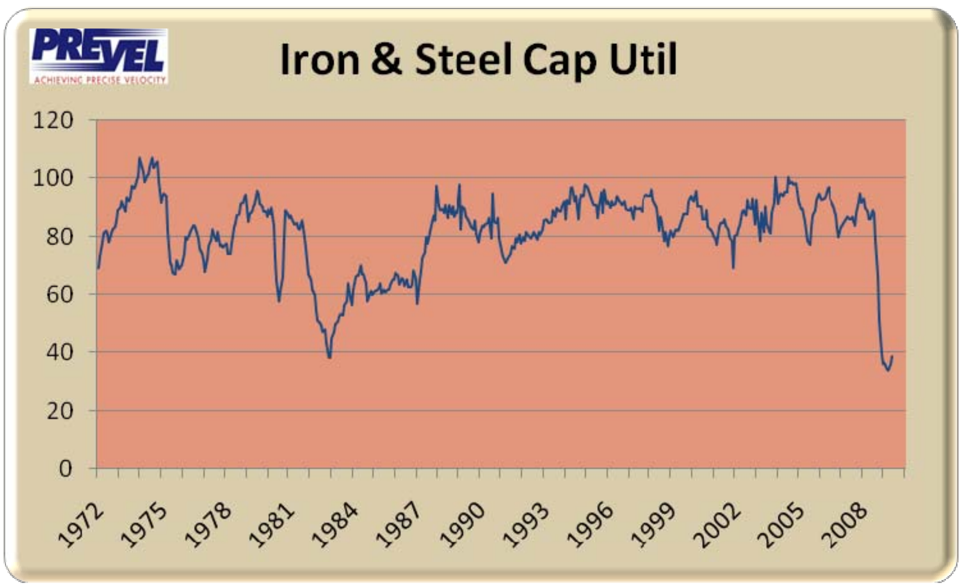




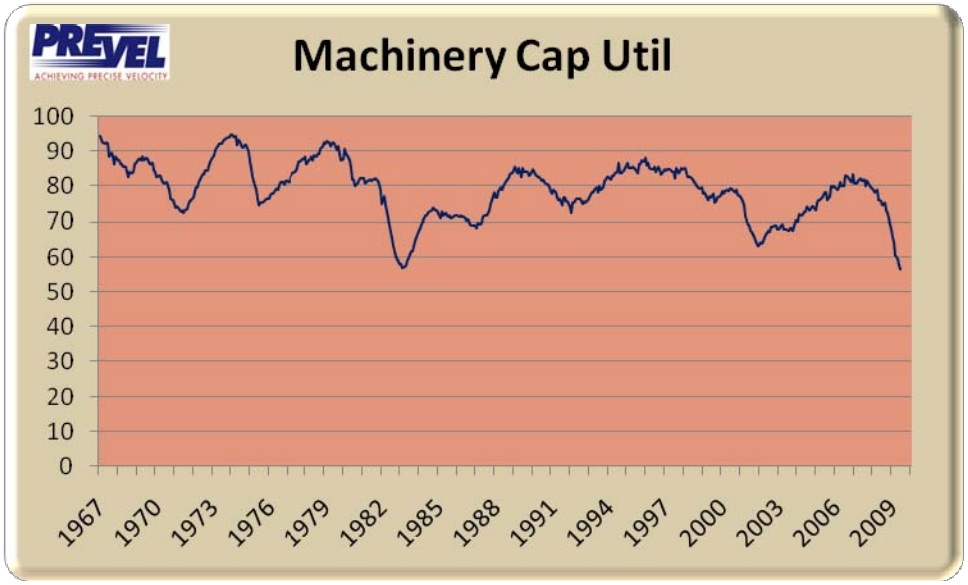
Industrial capacity utilization was 68% for June, the lowest ever recorded.



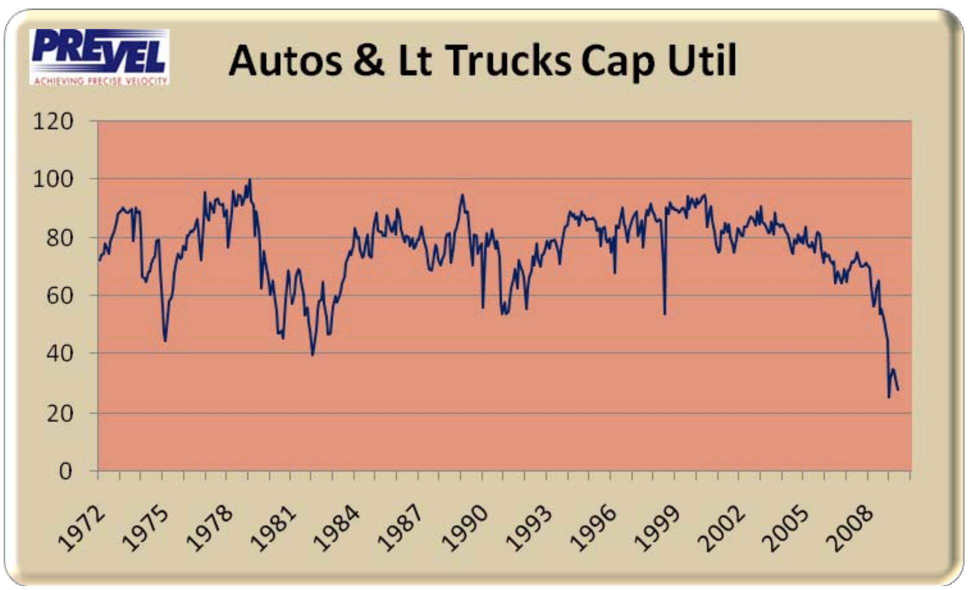
Capacity utilization in durable goods continued to decline, reaching a new low of 57.8%.



The steel industry recovered slightly to 38.6%.



Capacity utilization for machinery manufacturers declined to 56.4%. This the worst performance in the history of the measurement.

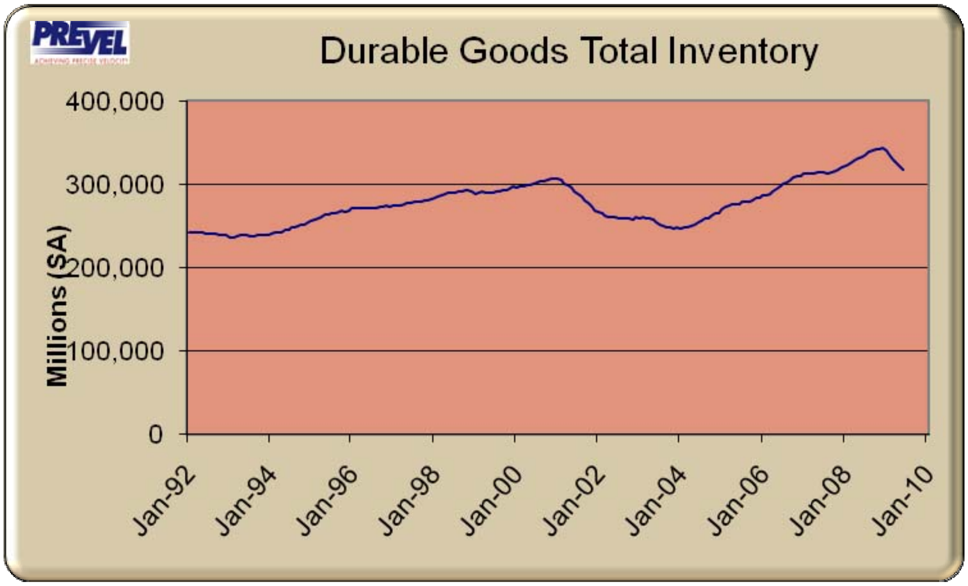


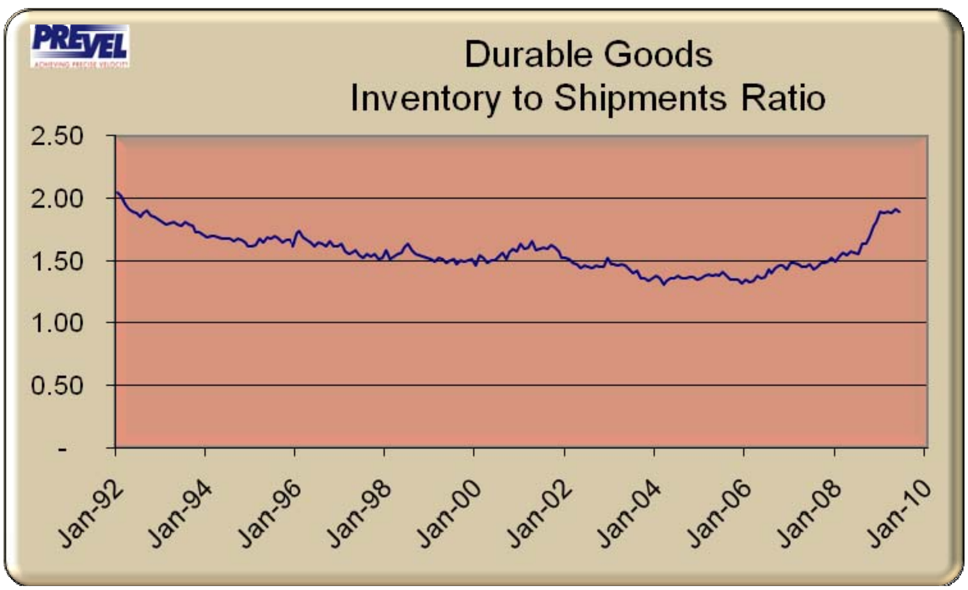
Capacity utilization in autos and light trucks fell to 28.4% after four months above30%.

Durable Goods

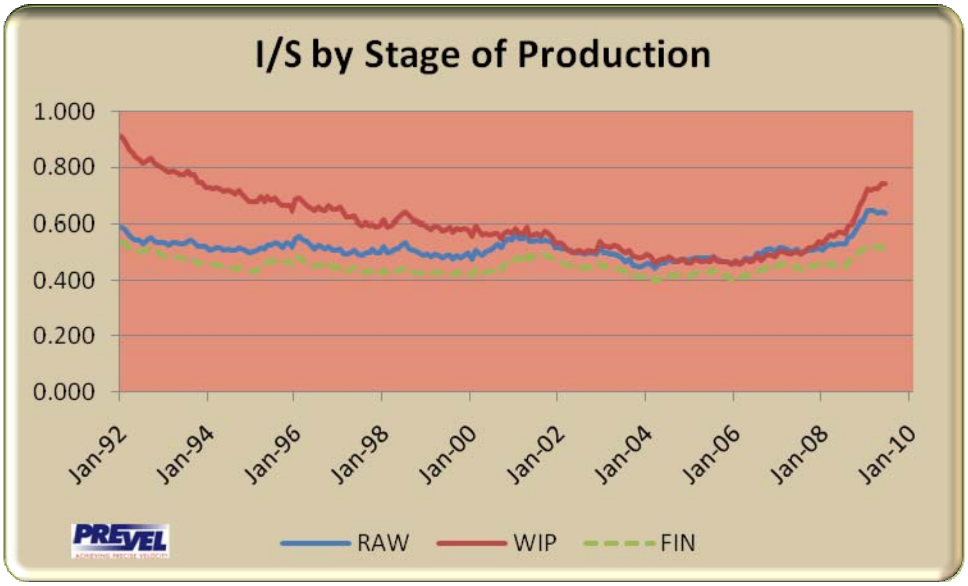
New orders for durable goods decreased to $159.1 billion in June, 2.2% below last month and 18.2% below last year (12 month moving average). Shipments decreased to $168.5 billion, 0.1% below last month and 11.7% below last year (12 MMA). The spread between shipments and orders grew to $9.4 billion in June. The pattern of new orders remains stable, so it is likely that the adjustments to close the gap will come in production rate cuts. While 30% of durable subsectors showed some order growth in the month, all but one had shipments in excess of new orders. The production cuts yet to come will be broad based.

The growth index has not been published in several months. It is a measure of acceleration and intented to detect subtle changes in order patterns. Free fall is not subtle, so it served no purpose. But it will prove useful again in detecting the bottom. The index hit bottom (maximum acceleration) in March with a value of 0.835. Since then it has recovered to 0.904. The first signal of a bottom will be when the index achieves a value of 1.000. We're about a third of the way back to that point at the current pace.

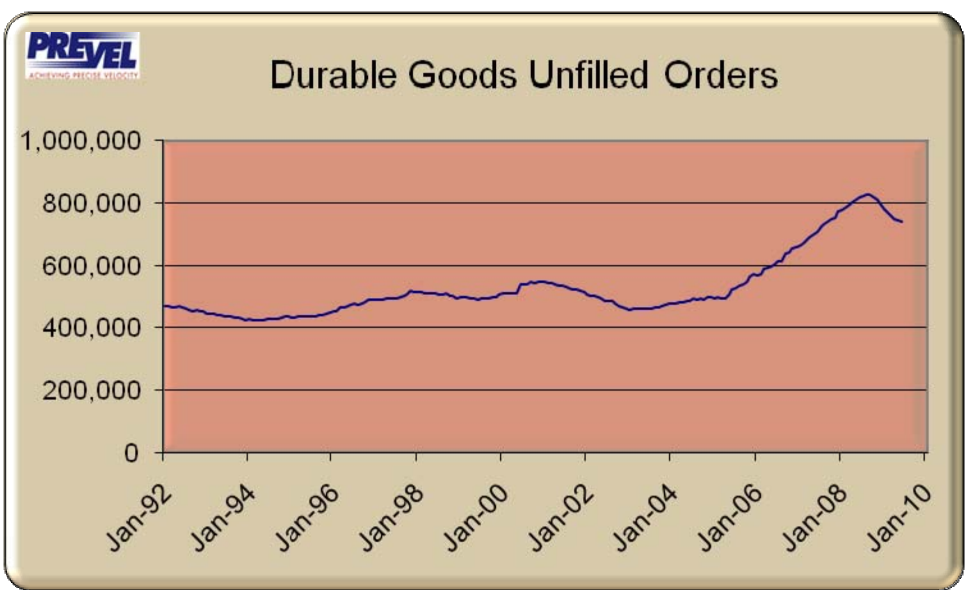




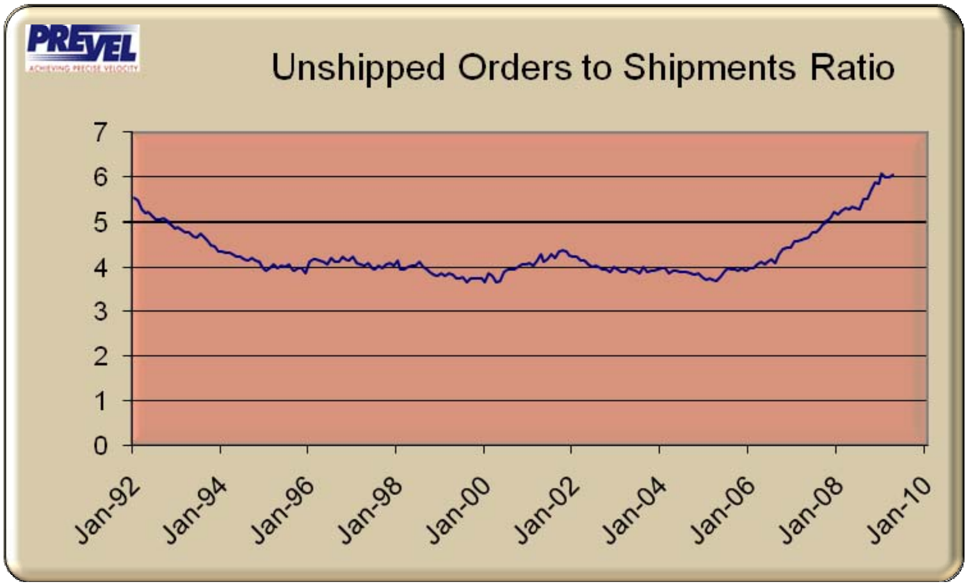
Inventory continued to decline, and the inventory to shipments ratio remained stable. While more inventory cuts are indicated, there will be less urgency for precipitous action.



The inventory to shipments ratio by stage of production shows stable RAW inventories. This would indicate that the inbound supply chain has been corraled. WIP positions continue to deteriorate, which is odd given that so many have bragged about their transition to high velocity manufacturing strategies. It is likely that their version of HVM is based on Lean Manufacturing and Toyota Production System concepts. If so this is probably the cause since the common signaling methods of these systems are inherently unstable during volume transitions.

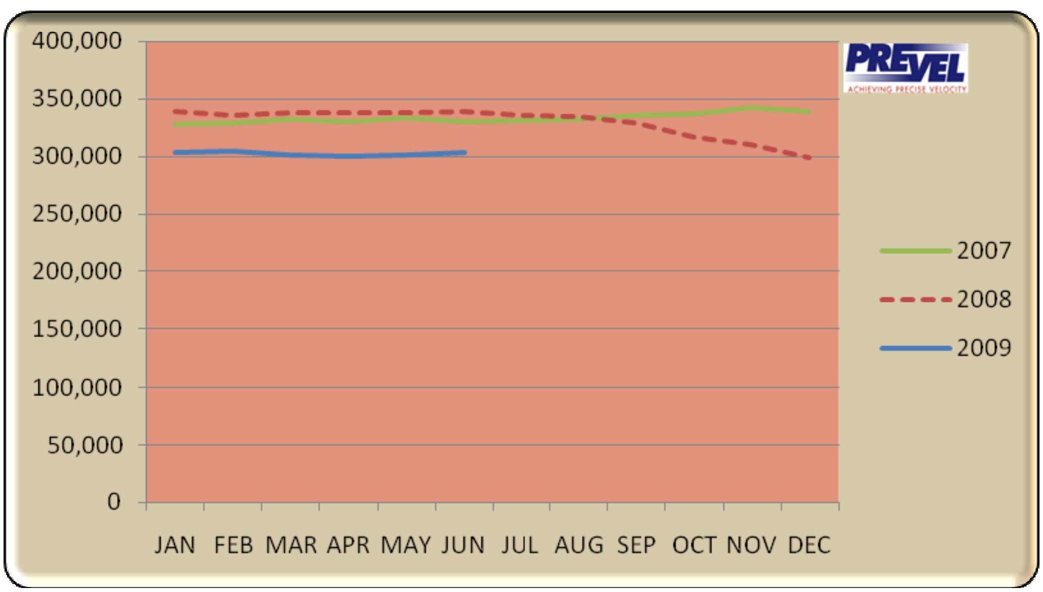


Unfilled orders continued to decline for the ninth consecutive month. The rate of decline has slowed in the past three months.

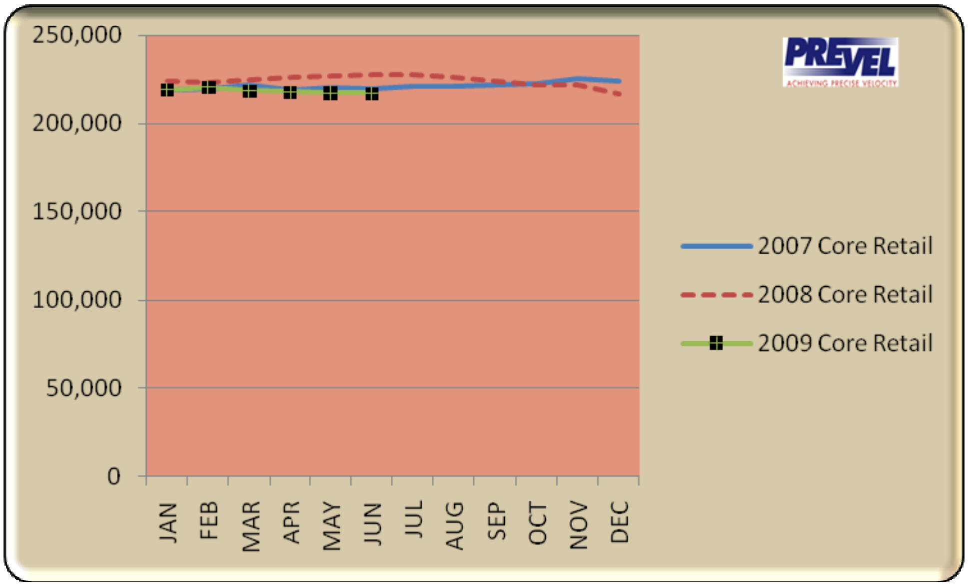


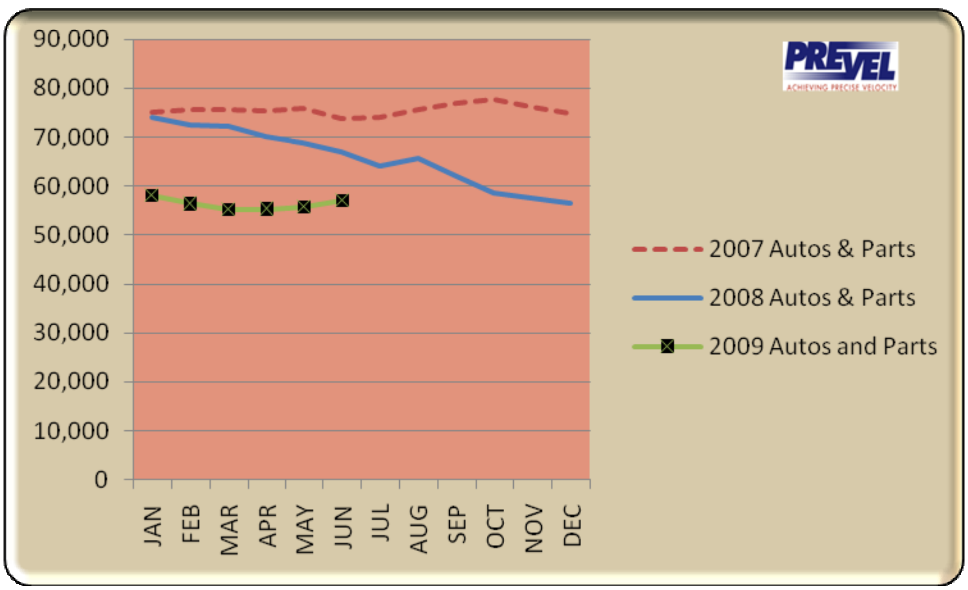
Unfilled orders to shipments ratio is a measure of order velocity. The measure remains stable and implies an average lead time of 6 months at current production rates. Order velocity has not improved during the recession because manufacturers have been quick to adjust production rates as orders declined.

Retail:

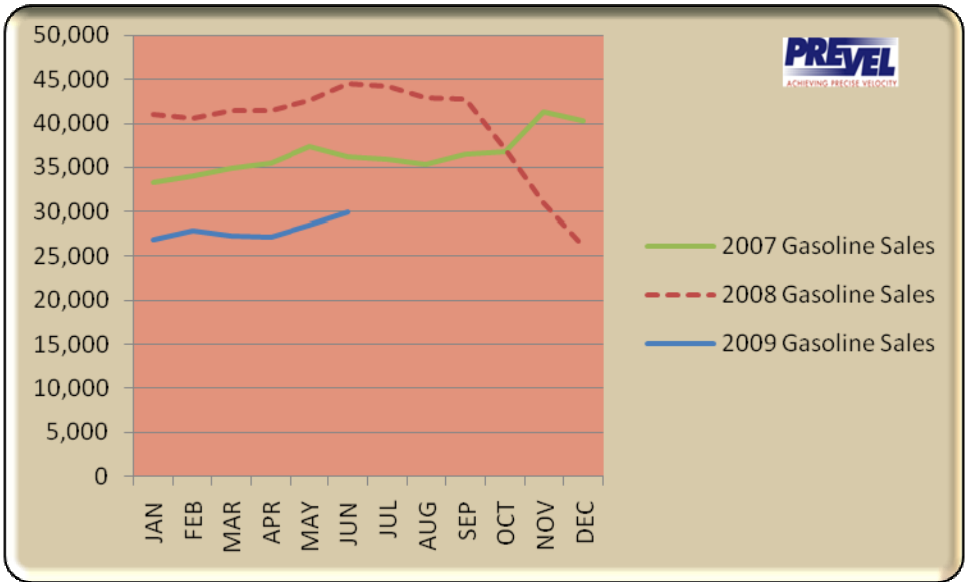


Retail sales increased $2.5 billion, driven by a $1.3 billion increase in auto and parts sales and a $1.4 billion increase in gasoline sales (predominantly price increases). Core retail (excluding autos and gas) declined $0.2 billion.

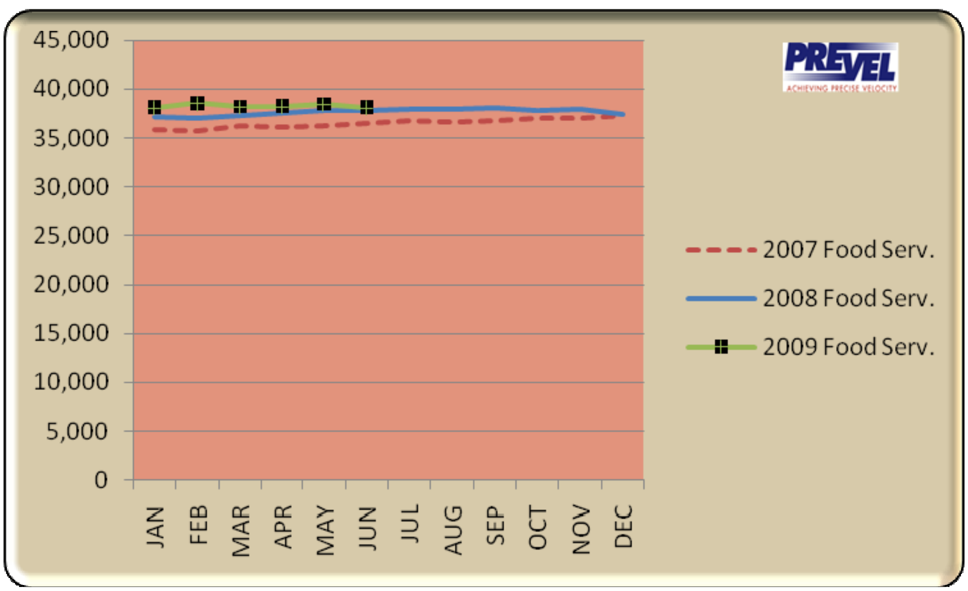




Auto and parts sales increased in June for the third month, suggesting that this sector has begun a modest recovery. Note that this does not include any impact from the Cash for Clunkers program.

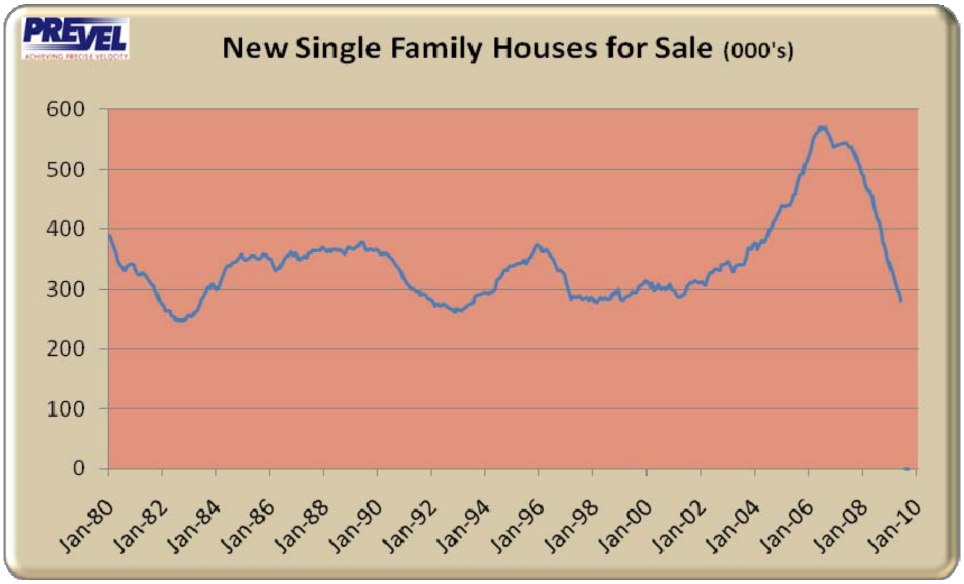


Gasoline sales in June increased 5% for the third month.

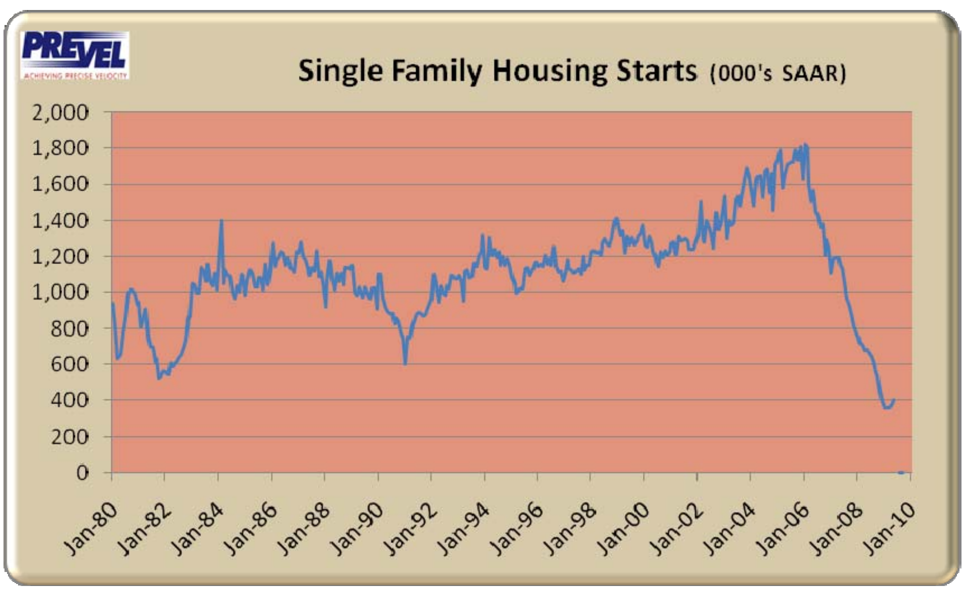


Food service declined slightly, but remained above the prior year pace.

Housing:



The inventory selloff of new single family houses continued for the 25rd consecutive month, ending the month at 281,000 units. Inventory of new homes is no longer a drag on the housing market. While foreclosures continue to increase, the vacancy rate in single family units has declined from 2.9% to 2.7% to 2.5% over the past three months. This suggests the foreclosures are a market clearing process for bargain hunters.



Housing starts revovered for the second month in June from the lowest level since sometime before 1980. This might mark the bottom of the housing recession.

Taxes, Stimulus, Debt, Inflation

A bit of summary may be in order after a year of dramatic turmoil. Last year at this time the surge in commodity prices had just begun to reverse into a downward spiral. Oil would drop from $147 in July to the $30s a few months later. We were within a month of the liquidity crisis of September followed by the TARP bill approval in October. President Obama was elected in November. In December Caterpillar announced to the supply chain partners that they would downsize form $50 billion (2008) to $35 billion (2009). July 2008 new orders for durable goods were $218 billion. March 2009 new orders were $158 billion. The auto industry collapse started at the beginning of 2008. It was thought at the time that it was gas prices, but when gas went down it didn't bring the car sales back. By then the economy faced a liquidity crisis. The CEO of a major RV manufacturer in Elkhart, IN told me that it was clear in May-June time frame that something was amiss with the sales pipeline, and it was credit-focused rather than gas prices. Through this entire period the government tried to stave off the pain rather than letting it take its own course.

It may take a long time to figure out all the dominoes in the line. But something fundamental happened with global liquidity. Much of the rest of the equation (housing, exports, etc) may have been nothing more than bad timing. The economy was due for a normal business cycle. What happened with credit seems more important.

There may be a common thread in the liquidity crisis and the health care debate. In both cases we have separated the risk from the reward. We have created a moral hazard in both cases. We sold off the risk portion of an investment via Credit Default Swaps so that the remainder was now a 100% secure investment. Forty years ago if you didn't like the risk profile of an investment you sold the investment and bought a different one. Today we seem to believe in the tooth fairy that comes and picks up all the risk. If there is no percieved risk the decisions will be riskier.

In health care we have created a culture where we want the best health care and highest technology no matter what the cost. And we demand that someone else pay for it. There are always politicians to accommodate us and an insurance lobbyist to assist. If we see no cost we will demand more. When the government pays for health care, we will complain when they try to contain costs which are viewed by us as a denial of service. Cost is invisible. If expensive remedial treatment is available at little or no cost, we will engage in riskier behavior.

We will never solve the health insurance problem until we put normal supply/demand decision making back into the process. This means that we need to pay for our own health care. This of course leaves many people without even basic health insurance, a condition which most people reject.

The Swiss seem to have found a way to make it work. The government is out of the insurance game. The government provides everyone a subsidy for insurance. Buy whatever insurance suits you. If you want more coverage, go ahead and pay for more. The only decision maker is the consumer. The lobbyists can't gain an advantage from the government. They'd need to lobby the decision maker (the consumer) and we call that advertising. I'd like to see a debate about how they handle pre-existing conditions and "selectivity" in who the carriers accept and reject. There might be an answer in there somewhere.

In a similar vein, we will never fix the derivatives market until the same people who hold the long position also own the risk. There is no such thing as a risk free investment and when we pretend that there is we simply distort the market.

About The Durable Goods Report

The goal of the Prevel DGR is to offer context for the published monthly statistics on durable goods manufacturing in the US. The analysis is historical in nature, and includes no forecasts, but the analysis of historical patterns provides a necessary framework for understanding plausible scenarios. Since a high percentage of durable goods go through retail, this analysis offers a leading indicator of future durable goods activity.

The source data for the Prevel DGR is the US Census Bureau, preliminary publication, which is available about 5 weeks after the end of the period. An earlier publication (advanced release) is available about 3 weeks after the end of the period, but is often subject to substantial revisions, and is not considered adequately reliable for growth trend analysis.

A similar analysis is available for many industry sub-sectors. Contact Prevel for details about this subscription based service.

Technical Note: The "Prevel Growth Index" is measured as the ratio of the 3 month moving average divided by the 12 month moving average. This removes some of the natural noise in the industry data, but also results in a slight response lag. An index value greater than 1.000 is a sign of recent growth.

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