

One of the key questions which any global fund manager would like to get a firm answer for is: Whether the USA economy will go through “An Impending slowdown or , a double dip or an outright recession.” This question currently is one of the sources of uncertainty for the asset markets worldwide, specially the risky ones such as US stocks, commodities etc.

Very often economic lead indicators are relied upon to gauge the future path of the US economy. Some of the lead indicators are based on surveys conducted by agencies such as Institute of Supply Management (ISM) in US, which surveys the supply executives all over US to gauge the upcoming trends in the US manufacturing sector. Readings and surveys are taken in more than 17 industries on their expectations in functions such as production, new orders, employment, prices, inventories etc. The results of the readings and the surveys in form of a diffusion index (Purchase Managers Index-PMI )are declared on a monthly basis. A PMI reading in excess of 50% over a period of time generally indicates a strong expansion of the overall US economy. Similarly a reading below 50% usually indicates a contraction of the overall economy.

Though manufacturing accounts for a relatively smaller portion of the US GDP, fluctuations in the manufacturing sector tend to impact the changes in US GDP. Consequently, developments in manufacturing sector often lead the trends in the overall US economy, making the PMI Manufacturing figure a strong leading indicator of economic turnarounds. And more so due to its timeliness in its release (monthly). A pickup in demand for manufactured products after a period of recession, reflected by a higher PMI figure, strongly suggests a reversal upward. Conversely a slowdown in manufacturing orders and production during a boom suggests a slowing of the economy.

The PMI hit a high of 60.4 in April 2010, but has slowed down since then. The June 2010 reading came at 56.2, which has been the source of worry for the risky assets in US and in the world. In fact the S & P 500 index, peaked co incidentally in late April 2010 and is lower by 10% from the peak now. On 06<sup>th</sup> July 2010 it was lower by 16% from its peak. Inter alia, the rollover of PMI was one of factors behind the fall.

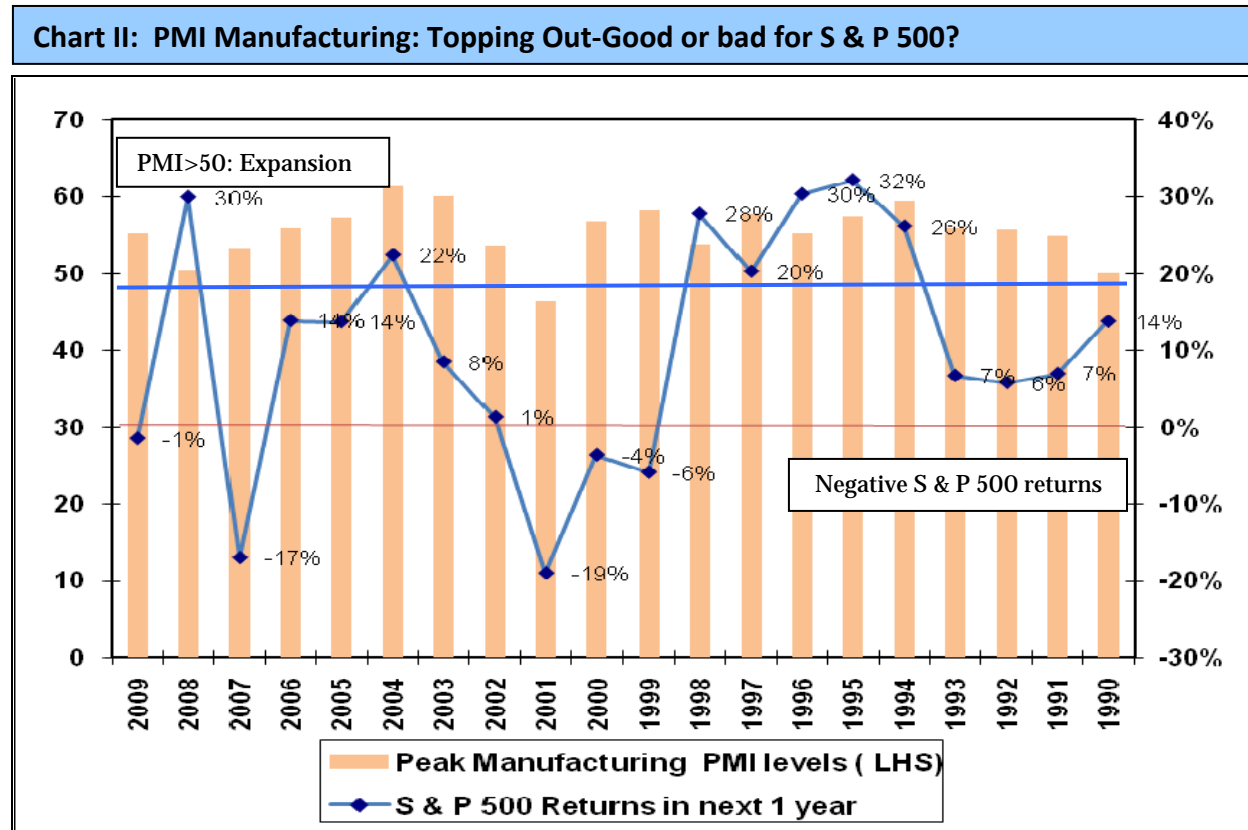
**Chart I: The Manufacturing PMI for US: Rolling Over?**



Source: [www.ism.ws](http://www.ism.ws)

Though the currently PMI stands above the expansion level of 50, the rate of rise has slowed down. Based on historical relationships, the current level of PMI (56.2) corresponds to a 4.8% of annualized growth in real GDP of US.

Since the US markets were worried about the peaking of the PMI in April 2010, we decided to analyze the historical returns from S & P 500 (US Stock Index) for a year after the PMI peaked in every calendar year. We analyzed data from 1990 onwards for 20 years. (Chart II).



Source: Delta Global Partners Research, www.ism.ws, Yahoo Finance.

The results though were surprising. The average returns of S & P 500 in the 12 months from the time the PMI peaked in a calendar year was 11%. This is vis a vis the average of very long term returns of around 6.5% from US markets. In fact since 1990, there have been very few instances of negative returns in the next one year from the time the PMI peaked. Some of these instances are driven more by onetime events such as the terrorist attack on the US twin towers in 2001. One probable explanation for the misalignment between the peak of the PMI and the S & P returns in next 12 months may be: Markets may sniff the peak of PMI a little earlier and some of the negative price action in the stock prices might start before the actual peak in PMI. With the PMI peak more or less in the markets, the markets might have fared better in the year after the peak, unless there is an unexpected event driven shock.

The returns in the next year are also a function of at what levels (above 50) the PMI peaks and starts rolling over. Higher the PMI peaks from which the PMI slows down,

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better are the chances of positive returns in the next year, since the US economy continues to expand albeit at a slower rate.

So the event of the Manufacturing PMI peaking in US on a standalone basis vis a vis the returns from S & P 500 in next one year, is not a negative event if historical data is not to be ignored. The call is: Does history always repeats itself?

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