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Invigorated Inventories: Catalyst for Growth?

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Signs that business has begun to rebuild inventories offer further confirmation of a sustainable economic recovery. No doubt, the swing from inventory liquidation to accumulation will overstate the economy's fundamental growth for a while, but it will also set timing on more fundamental economic considerations, such as rehiring in the jobs market, probably by spring or early summer, and the anticipated move by the Federal Reserve to nudge up short-term interest rates in the second half.

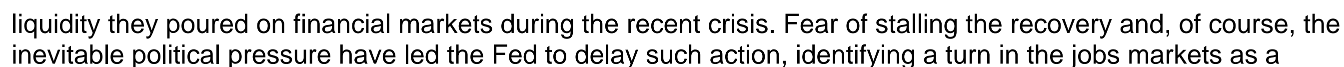
The first indicator of the turn in inventories lies in the acceleration of industrial production. From August to year-end 2009, this index of output at factories, mines, and utilities has far outpaced the growth of final sales in the economy, suggesting that a wide swath of goods producers have begun not just to meet sales but also to restock their shelves and warehouses. Though direct data on inventories are spotty and available only through November 2009, the picture seems to have turned to tentative expansion. Manufacturers' inventories have risen at a seasonally adjusted annual rate of almost 5.0% since September—a noteworthy change, considering that inventories had fallen at over a 12% rate during the prior 12 months. What is perhaps more telling, the increase has been widespread. The biggest jumps have occurred among merchant wholesalers, but increases also are apparent in almost every manufacturing subgroup and even among retailers, despite their striking caution over Christmas sales.

This turn has a long way to go, too, for inventories remain extremely low relative to sales. According to the Census Bureau, overall business inventories in October (the most recent month for which complete data exist) amounted to 1.30 months of sales, down some 6.0% from year-ago levels and nearly 4.0% below the average of the past five years. Business will have to out-produce sales to return to these norms.

That effort during the next few months and quarters will inflate overall growth measures temporarily. During the past year, inventory liquidations have shaved some 1.3 percentage points off measures of real GDP growth. Now with a turn to accumulation, especially if it occurs in a compressed period of time, inventories could add as much as two percentage points to overall growth. Under such an influence, an otherwise sluggish economic recovery, at a real annual growth rate of 2.5%, could look impressively robust for a time, rising to almost a 5.0% annualized growth rate. No doubt during this time, some commentators will begin to describe the recovery as V-shaped. But such perceptions will miss the fundamentals and only last as long as the inventory swing.

However misleading this effect is, the inventory change will, nonetheless, hasten the return to hiring. Because the layoffs of late 2008/early 2009 were particularly severe, the need for workers should come on more quickly in this cycle than previously. Typically, business drags its feet on layoffs, retaining an underemployed workforce during the recession that it then moves more fully to work in the recovery, delaying any rehiring. But the severe layoffs in this cycle have left few, if any, firms with underemployed staff. On the contrary, the layoffs were so severe that business has had to work its remaining workers harder just to maintain reduced levels of output, so much so, in fact, that productivity remarkably rose during the recession. Now though the lack of staff should compel business to rehire more promptly than usual, a short lag will nonetheless prevail. Managements will turn first to overtime and then to temporary workers before businesses make a major turn toward permanent rehiring. That turn will probably wait until late spring, early summer at the earliest, depending, of course, on how fast business ramps up its inventory rebuilding.

This link between inventory rebuilding and employment will, in its turn, trigger the anticipated changes in monetary policy. Fed Chairman Ben Bernanke and his colleagues have long acknowledged the need to reabsorb the excess



liquidity they poured on financial markets during the recent crisis. Fear of stalling the recovery and, of course, the inevitable political pressure have led the Fed to delay such action, identifying a turn in the jobs markets as a

prerequisite for the tightening in monetary policy and the inevitable rise in short-term interest rates. If, then, the rehiring begins as expected in spring, the Fed should begin with modest rate increases in the summer quarter.

Though the whole process will unfold more rapidly than it has in past cycles, these patterns, while spread out over months, will easily seem to dominate the long-term agenda. The economy will seem to grow faster than is reasonable, and the jobs and policy responses will seem delayed indefinitely. Six or eight months feels a lot longer to live through than to look back on. But by this summer, the tone of the economy and Fed policy should have changed dramatically.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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