



DIVINATION

There is a key conversion of information that will occur on October 31, which is the day the Federal Reserve Open Market Committee meets, the day preliminary GDP for Q3 is released, and Trick-or-Treat.

GDP is largely driven by inventory cycles. Inventory cycles are driven in part by anticipated final demand and in part by businesses *buy-in-advance* behavior as result of anticipated price increases of input to production. With heightened price pressure on raw materials we anticipate GDP swings to be exacerbated relative to the halcyon days of the prior dis-inflation cycle.

What we see in the chart is declining inventories at a time when we would expect strong buy in advance inventory building. In fact wholesale inventories are rising at half the pace of last year's growth. The bar chart illustrates the dramatic volatility and impact of inventories on GDP. What we are saying is that businesses are behaving counter-intuitively *or that they see a significant decline in final demand.*

Final demand is often reflected in retail sales. Year-over-year the US is up 5% (s.a.) through September; the UK is 3.8% through August. The US retail sales components of interest to us as investors are gasoline 9%, autos 20%, and



food/beverage at 12%. We won't see US retail sales until November 14.

The bottom line is that businesses are, at all stages of production, extraordinarily cautious about building or holding inventory at a time when some raw materials are pushing 27 year highs. **Given a 6 month lag in economic cycles it leads us to believe that purchasing managers and business owners are in a pre-recessionary mind-set. The other factor maybe the tightness of credit inhibiting inventory accumulation but it's too early to tell.**

-jkm