



**ABOUT
BILL SULLIVAN**

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

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Weekly Commentary by Bill Sullivan, JVB Chief Economist

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No evidence of inventory restocking just yet

A central thesis behind expectations that the economy is poised for a rapid recovery is the widely held belief that business firms will enter into aggressive inventory restocking programs. Any rebuilding of inventories will of course boost production and should eventually lead to some rehiring of factory workers. While this outlook is plausible, available data indicate that the business sector actually continues to prune inventory positions. The reluctance to bolster inventories could reflect a lack of confidence among business planners regarding the overall prospects for the economy. Moreover, the sustained liquidation of inventory holdings could also be a byproduct of the tighter lending standards that are now in place and that many companies simply don't have access to credit to fund restocking efforts. If so, the support for future growth from inventory investment may prove far less than currently envisioned.

According to the Department of Commerce, business inventories fell another \$19.3 billion during August, 2009, the latest month for which statistics are available. The August drop was the twelfth consecutive monthly contraction in business stocks with the total decline over this period registering \$201.3 billion or 13.3%. At \$1.311 trillion, total inventories are at their lowest dollar reading since December, 2005. Within the last year, all three major categories of inventory have recorded outright declines, paced by a \$71.1 billion drop at retailers. Both wholesale and manufacturers inventories are down approximately \$65.0 billion during the last twelve months.

The monthly inventory data are tallied in nominal dollars and hence can be distorted by ongoing price swings in major commodities. As an example, during August, 2008, a barrel of crude oil traded in the \$115 to \$120 range or roughly \$50 above the levels that prevailed this summer. Similarly, copper, grains and meat prices were much higher one year ago as compared to this August. Effectively, some of the decline in inventory positions has reflected lower prices and the drop-off in inflation adjusted terms may be smaller than the nominal data imply. Nonetheless, there is no indication that business firms are poised to rebuild stock positions, given the huge monthly declines that continue to occur. It should also be noted that despite the tremendous contraction in total stocks over the last year, the inventory/sales ratio has risen from 1.30 to one in August, 2008, to 1.33 for the most recent monthly reading. The upturn in the ratio is attributable to a 15.1% decline in total business sales which exceeds the recorded drop in nominal inventories. From that perspective, the business sector has made no progress in the last year in getting inventories into better balance with prevailing sales experience. Conceivably, until the aggregate ratio drops even more, there may be little incentive for business firms to add meaningfully to their stock positions.

The lack of inventory rebuilding, at least through August, could be a further example of the headwinds that a recovery process confronts in the current business cycle. Business firms are apparently reluctant to add to working capital positions as long as

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the nationwide unemployment rate has an upward trajectory, as now appears to be the case. Corporations fully recognize that personal spending will be held in check for the foreseeable future as joblessness climbs in an environment of weak income growth. Against this backdrop, the willingness to commit to restocking programs will remain limited at best. In addition, the health care reform debate in Congress could also be stifling inventory investment as businesses simply don't have useful input on how their cost structures will be affected by any legislation that will be eventually signed into law. This consideration is especially applicable to employee expenses. Until a better fix on these potential costs surfaces, the business sector will not be adding to payrolls. As long as employment conditions remain weak, the odds favor a soft pattern of consumption that basically weighs against firms adding to their inventory positions any time soon.

Although difficult to measure precisely, some probability has to be assigned to the fact that, unlike previous business cycle expansions, the present credit situation may be placing considerable restraints on inventory rebuilding programs. Clearly, major business lenders have revised their credit criteria in the last year or so and, for the most part, borrowing terms are more stringent as compared to the recent past. In response, many firms may no longer qualify for credit and thus don't have access to funds for inventory programs. Similarly, the cost of credit for prospective borrowers may have moved sufficiently higher, given the tightened lending standards, to render unprofitable any attempt at rebuilding inventory positions for many firms. Another disincentive for inventory

investment is the constant references in the financial marketplace to the need for the Federal Reserve to pursue an "exit strategy" before too long. In essence, business planners are on notice that the credit authorities could be shortly pursuing strategies that will raise interest rates and, in turn, ultimately boost the cost of borrowing. The potential for higher interest costs may be another factor that curbs the pace of inventory investment in the quarters ahead. If the business sector does eschew the opportunity to rebuild stock positions, an important prop for the nascent recovery process would be removed. ■

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