

Understanding the Economic Environment and its Effect on the Companies on the Stock Market

Economic growth is always the center of attention of a country. This is because such growth is a necessary ingredient for higher incomes and living standards. This article seeks to explain three indicators of economic growth and their possible impact on some of the companies listed on the exchange. The indicators to be discussed are Gross Domestic Product, Inflation and Unemployment.

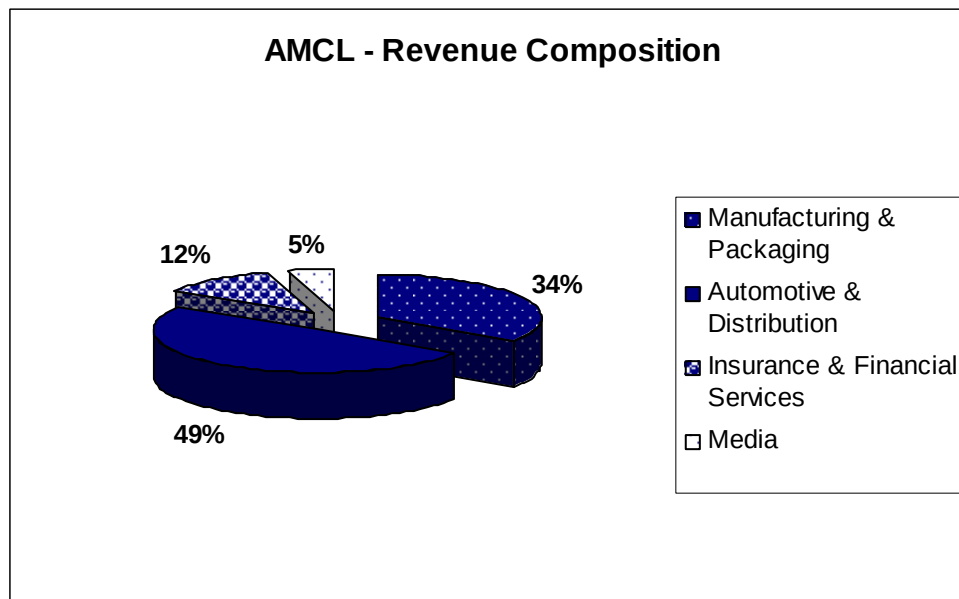
The national output is measured by a country's Gross Domestic Product (GDP). The GDP is basically the value of all the finished goods and services that have been produced within the country. Therefore, comparisons of growth in GDP over similar periods would indicate the health of a country's economy. Real GDP discounts inflation while nominal GDP only reflects changes in prices.

In 2005, Trinidad's Real GDP grew by 7 per cent driven by the energy sector. Partial indicators for this year all point to even faster economic growth as the energy sector remains buoyant while the momentum of the non-energy sector is aided by high government expenditure. One of the main drivers of the non-energy sector is construction.

The phenomenal growth in construction activity supported by government spending on infrastructural development and the erection of office and residential buildings should result in improved performance of the companies operating within this environment. For example, Trinidad Cement Limited (TCL) should ideally prosper from the booming construction activity. In fact, reports are that its plant is currently operating at capacity in order to satisfy demand. Unfortunately, expenses stemming from problems experienced in its first quarter have negatively impacted that period's results.

The Construction boom should also have a positive effect on construction related items such as aluminium, steel, PVC pipes etc. Hence companies which engage in the manufacture of such materials as ABEL and Caribbean Roof Tile Company stand to benefit from better revenues. Therefore as some of these companies fall under the manufacturing arm of Ansa McAl (AMCL), it suggests continued healthy earnings in that division which no doubt bodes well for the Group. In fact AMCL has already reported stellar results for its year ended 2005 in which its bottom line saw a 45 per cent increase. Its Manufacturing segment contributed approximately 34 per cent to total revenue (See Figure 1).

Figure 1



In addition, companies involved in other construction related materials such as home finishings and paints should also reap benefits from the construction boom. Hence, better results should be expected from companies such as Berger Paints and Penta Paints. Penta Paints is part of the Ansa McAl group so any increased revenues would benefit that Conglomerate. Berger Paints however is a company with a small capital of which 75.91 per cent is held by substantial interests. Hence, due to the illiquidity of the share, the price would not be easily influenced by results. In any event, at WISE's forecasted EPS of 7 cents and the current price of \$3.40, this share is trading at an unusually high price/earnings ratio of 49 times.

While the growth in GDP is a favourable statistic for companies operating in this sector, it could also result in limitations being placed on companies if they are not able to supply the market. For example due to the construction boom and the supposed shortage of cement, there have been 'threats' by Government to reduce tariffs on cement making imported cement a viable alternative. In Jamaica, the government had to reduce tariffs previously in place in order to quell the severe shortage that plagued the island. TCL however is vehement that it is able to supply its respective markets and is not bothered by the probability of Government importing cement to support demand.

A booming economic environment however makes it difficult to contain inflationary pressures. Inflation is the rate at which the general level of prices of goods and services are rising. Headline inflation includes the impact of food prices.

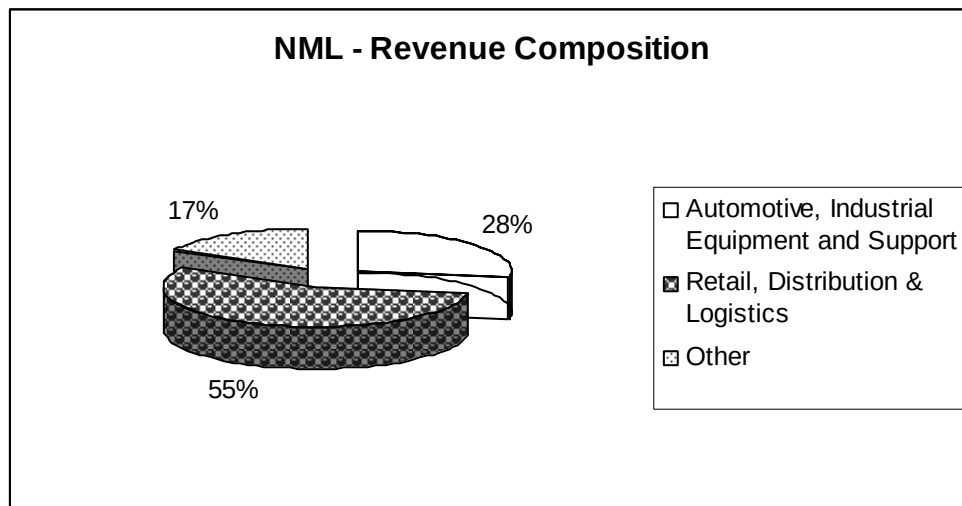
In comparison to the beginning of the century, when the domestic economy saw headline inflation averaging approximately 3.5 per cent from 2001 to 2003, 2004 saw this figure rising to 5.6 per cent and to 7.2 per cent in 2005. The main driver for this was the rise in

food prices which averaged 10.3 per cent from 2001 to 2003 but moved to 20.6 per cent in 2004 and 22.6 per cent in 2005.

The upward spiral of food prices began in 2004 owing to flooding in the last quarter of that year. The floods came at a time when the buoyant economy was boosting domestic demand. The increasing demand in the face of declining capacity therefore resulted in the rise in headline inflation. Large price increases were also witnessed in the pharmaceutical industry.

The increase in prices due to demand should translate to increased revenue for companies with a pharmaceutical arm. For example Agostini's revenues are usually driven by its pharmaceutical sector; hence there should be continued growth in this sector given the demand and the rising prices. The grocery and pharmaceutical arms of the Conglomerates should also do well. For example, Neal & Massy's Retail, Distribution and Logistics sector is usually a major component of revenue contributing over 54 per cent to Third Party Revenue (See Figure 2) and over 30 per cent to Operating Profit. This therefore bodes well for the Conglomerate as it should experience increased Revenue from the segment which should translate into bigger profits. In addition, Neal & Massy's target is to grow at least 15 per cent each year and the current environment makes this target achievable.

Figure 2



The robust economy has lead to low levels of unemployment resulting in shortages of both skilled and unskilled labour. According to a report in Newsday's Business Day, analysts have said that the labour shortage is as a result of the construction boom and greater job benefits on foreign cruise ships. Labour shortages could force companies to increase salaries and so hike their Operating Expenses and ultimately eat away at earnings. Such shortages have already been affecting Companies such as Prestige Holdings Limited which cited the labour shortage as having an effect on its performance. Rising demand in labour could lead to Companies having to spend more on Staff Costs and so result in a hike in expenses.

There is however evidence that technological improvements in the manufacturing sector has lead to a reduction of manual labour. It is important to note though that investments in information technology would initially impact on operating expenses. For example, Unilever Caribbean Limited has had a hefty increase in its Operating Expenses in part to ongoing Information Technology improvements. However, such improvements are supposed to aid efficiency and should eventually add value to the Company as it enables workers to produce more output with the same amount of resources.

Overall, the positive direction of the performance indicators is favourable for the companies. Growth in profit for such companies should translate to the lowering of price/earnings multiples providing further opportunities for attractive buys on the market. One however has to be cognizant of the impact of inflation and the ability of companies to take advantage of the purchasing power of consumers.

Source of Economic Data:

Central Bank of Trinidad & Tobago Monetary Policy Report (April 2006)