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Toronto, Miami and New York

By John Mauldin

This week we will look at a few very interesting items that did not make it into last week's forecast, as that letter was already overly long. Bernanke's arrival, the importance of the housing market to the economy, the length of the recent rally and a note from good friend James Montier on why it both pays, and is painful, to be a contrarian. I include a quick note to some of my fellow brokers at the end of the letter along with a few places to visit on the web for fun. I think we will find a few tidbits to enlighten us.

But first, I must issue a correction and an apology to Elaine Garzarelli. Business Week showed her as the most bullish of forecasters, predicting the Dow to go to 14,000. In an attempt at humor, I asked her what she was smoking? She wrote me a very polite note, saying that she does not normally forecast the Dow and the Nasdaq. "Based on the S&P 500 forecast my staff took the percentage change forecast for the S&P and applied it to the Dow for the Business Week article. I was in Europe." And she noted in a hand-written comment, "I unfortunately do not smoke or drink."

Elaine's work forecasts EPS of 84.40 and their estimate of a fair value of 18.8 for the P/E ratio, based on the equations of how bond yields, productivity, inflation rates, growth deficits, and a host of factors all influence investor willingness to buy at such a P/E ratio. She has not always been bullish, as in 1999 when she thought the market was 46% overvalued. I hope she is right about this year. Bull markets are a lot more fun. And while I still think she will be wrong, her track record for 20 years has been quite good. And she is clearly an astute lady as she noted she enjoys my letter. You can read more about her forecasts at www.garzarelli.com .

The Bernanke Era

Federal Reserve watchers are going to have to adjust to a new era. Greenspan, who has the ability to answer a question without actually having anyone understand the answer is going to be replaced by Ben Bernanke who actually writes and speaks very clearly. I wrote this about Bernanke's first speech as a fed governor back in November of 2002.

"…this speech was actually delivered in very clear, well written English. The average layman could read and follow the thoughts. Bernanke thus disqualifies himself for the role of Fed Chairman when Greenspan finally steps down, as it seems a requirement for the job of Chairman is the ability to talk at length and say very little that can be taken clearly."

So much for my predictive prowess. Now that Bernanke will be installed as Fed chairman February 1 let's look at what we can expect.

First, Bernanke writes and speaks very clearly and it is likely he will continue to do so. I would suggest that serious students go to the Fed site www.federalreserve.gov and read Bernanke's speeches. He has argued that the Fed needs to be more transparent and now he gets to walk his talk. I think he will. That will be good for the markets. Guessing games create uncertainty, and the market hates uncertainty.

It is fashionable in some circles to refer to Bernanke as "Helicopter Ben," a reference to the speech mentioned above where he said in the effort to fight deflation the Fed could as a last resort drop cash from helicopters. When you read the speech, I think this was clearly an attempt at humor, which shows why he is not making a living as a standup comic. But you can also assume Bernanke is not going to let the country slip into deflation in the next recession. Given the choice between mild stagflation and a deflationary depression as in Japan, I would pick the former devil over the latter, and I think most observers would agree. Let us hope we never have to live through either.

You can get my take on Bernanke and that helicopter speech by clicking on http://www.2000wave.com/article.asp?id=mwo102805&keyword=bernanke and reading my e-letter from last October. But in general, the speech was an academic exercise to suggest that the Fed could indeed keep the US economy from going into deflation, which was a very real concern at that time. From reading Bernanke's textbooks and speeches over his life, he is a serious inflation fighter. We will not be running outside waiting for cash to fall every time we hear a helicopter while he is chairman.

We will get our first real peak into Bernanke's mind as Chairman when he appears before Congress in February. He is going to be asked about the Fed and inflation targeting. Bernanke has long been a proponent of inflation targeting. It will be interesting to see if he will actually state what he thinks that target should be now that he can greatly influence the number.

The Sacrifice Ratio

Along with Andrew Abel, Bernanke has written a well-received graduate level economics text, which talks about inflation targeting and such arcane topics as the sacrifice ratio.

David Kotok of Cumberland Advisors believes that the sacrifice ratio is now and is going to be even more a key component of Federal Reserve policy. The Sacrifice Ratio (SR) in very simplistic terms measures the amount of increased unemployment that will be caused by an increase in interest rates vs. the amount of future inflation that will lowered as a result of the increase in rates.

The Sacrifice Ratio

The Fed has two mandates, which the SR demonstrates are in actual conflict with each other. They are supposed to contain inflation and do what they can to increase employment. The SR is the way they measure the tradeoff. It may be their ratio, but it is the unemployed who are sacrificed.

Of course, if they allowed inflation to come back, you would have stagflation and even higher unemployment, so you have to be willing to go through a little potential pain to avoid serious inflation. But how much and how fast?

Kotok wrote this about the SR last October:

“Clearly a low and falling SR is more desirable for Fed policymaking than a high and rising SR. This is where and why the rubber hits the road in 2005. What is the SR now? What was the SR in the Volcker and early Greenspan period?

“Here are the September 29 words of Fed Governor Don Kohn. Remember: Kohn was the Secretary and an economist to the Board of Governors of the Greenspan Fed before he became a Governor himself.

“ ‘......the sacrifice ratio rose from around 2 or 3 in the mid-1980s to around 4 currently. Imbalances between demand and potential supply would thus now be slow to show through convincingly to inflation, but when they do, they may be costly to correct.’

“Here is Chairman designate and then Fed Governor Bernanke’s SR reference in a 2003 speech. Bernanke said: ‘Now make the assumption that the sacrifice ratio is 4.0, a high value by historical standards but one in the range of many current estimates.’

“What does a rising SR mean for interest rates?

“It means the Fed is likely to persist hiking rates higher and longer than the market expects. We have looked at the changes in Fed Funds futures pricing. It is clear that these futures are short term oriented and do not capture this element of Fed policymaking.

“The Fed believes the SR at 4 is higher than in the past (1980s when it was 2 or 3) and that it is rising. They fear that inflation in the future will be much more painful to fight because the SR is this high. That is why the Fed is acting preemptively. It wants to keep inflation low. It does not want to fight a future higher inflation when the SR is this high.

“The Fed is forward looking in its work. The Fed’s staff generates the estimates of the SR from very complex equations. In simple terms, the staff’s forecasts and their econometric work are warning the Fed that the SR is at a level where risk is compellingly great.

"Therefore the Fed would rather take rates higher now and deter inflation rather than fight the actual inflation later. The Fed's research work also suggests that a gradual policy application has the effect of lowering the SR over time. This is why the Fed has been 'measured' in its rate hiking."

You can read the whole very interesting piece on the SR by Kotok at www.cumber.com/comments/103105.htm.

As Kotok recently pointed out, and I agree, the Fed is likely to be through with raising rates after Bernanke's first meeting in late March. But a lot of people think they will be cutting rates later in 2006.

Maybe. Maybe not.

What a high SR implies is that if inflation is allowed to come back it will be more painful in the future to deal with it than to deal with it today. While I think inflation will gradually be coming down over this coming year, there are real risks that this might not be the case. If we see persistent inflation, the Fed may feel constrained to either keep raising rates or to not lower them in the face of a mild slowdown. They will not cut until there is clear evidence of a real slowdown in the economy.

Given Bernanke's position on inflation targeting and his watchful eye on the SR, we should be mindful of it as well when we start to project new policy. If this economy is still growing north of 3.5% in June, it would not surprise me to see the Fed raise rates again.

As Kotok says, "We disagree with those who are already speculating about a Fed rate cut in the second half of 2006. It's not very likely. It will take a catastrophe to get it. The Fed is at the high end of neutral and the sacrifice ratio is high. They will not cut rates unless they see pronounced slowdown characteristics in the pipeline. One example of an indicator that will trigger a rate cut discussion is the ISM numbers under 50. Negative numbers from the NFIB surveys could also trigger cuts. So could a housing meltdown instead of a leveling. These are possible, like all other things, but not likely as long as the economy stays around trend growth rates.

"The Fed will not raise rates just because the dollar may be weakening. It would take an absolute dollar rout to trigger Fed action in the dollar's defense. Don't count on the Bernanke Fed defending the currency at the expense of the US economy. It won't."

Actually, David, I think the Fed would secretly like the dollar to go down in a gradual manner, especially against Asian currencies. This is going to be part of what is necessary if the trade deficit is going to come down.

We are going to have to be patient and keep a very watchful eye on Bernanke's testimony and speeches, as well as see how he crafts his first Fed statement March 28. That will give us our first real clues.

How Important is Housing to the Economy?

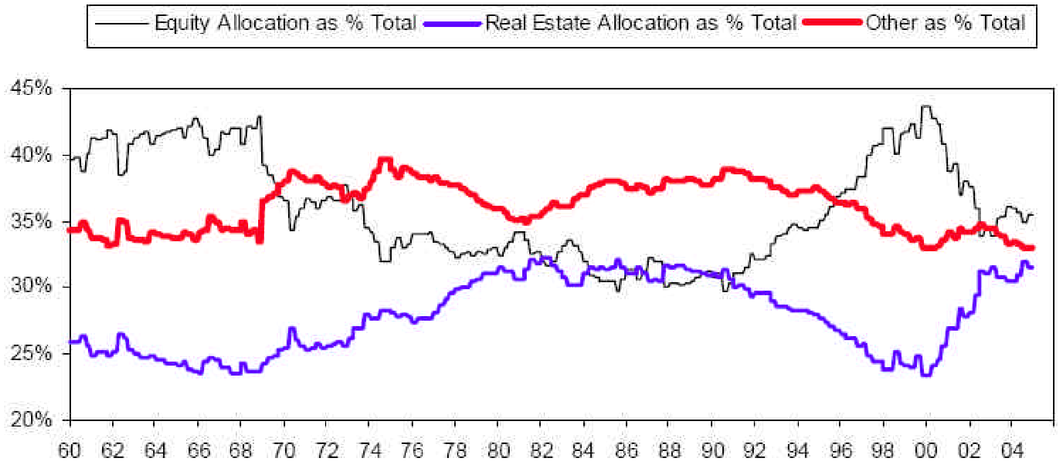
I was recently forwarded a very interesting piece of research from Bridgewater Associates. They suggest that the impact of housing on the economy comes from three sources: the direct impact of housing activity, and "the impact of financing activity related to the housing market, and the impact of the wealth effect of rising or falling home prices. Of the three different impacts, financing activity is at the biggest extreme and is the most vulnerable, while the other two are more at cyclical highs."

"…All in all, the direct impact of housing on the economy is at high but not overly extreme levels, due to high demand for houses and the perception from people and businesses that the demand will continue and prices will continue to rise. A return to more normal activity in the housing market should lead to only about a 1.5% – 1.75% drop in direct GDP contribution over a couple of years.

"Most of the impact of housing has been through the financing of these homes, as rising prices have provided a source of cash for people to spend on all types of goods and services. The chart below shows that people are actually borrowing significantly more money than they are spending on home purchases. As an economy, the difference between these lines represents the money people have borrowed through their home mortgages but can spend on anything. Historically this has been negative as people typically do not finance 100% of their homes, but the figure has recently been growing and is positive for the last three plus years. It is now at an all time high of over $330 billion over the last year, or 2.7% of GDP."

A drop in housing prices and thus activity would lead to a potential drop in GDP of at least 2-3%. (Remember, not all house refinancing would stop, nor would all housing activity, it would just slow.)

They make another very interesting point. They have a chart which shows equity, real estate and other forms of wealth as a percentage of overall wealth allocation. As you can see below, home percentages have risen and real estate has fallen, but equity is still larger than housing.



They go on to note, "From this perspective, household exposure is still greater to equities than it is to real estate, and the volatility of equity asset values is far greater than that of real estate, so the performance of the economy and equities is likely to have more of an impact on people's saving habits than that of real estate."

Thus, if we do see a housing slowdown coupled with a poor stock market, you could see a real slowdown in the economy, which is precisely what I think will happen in the latter part of the year.

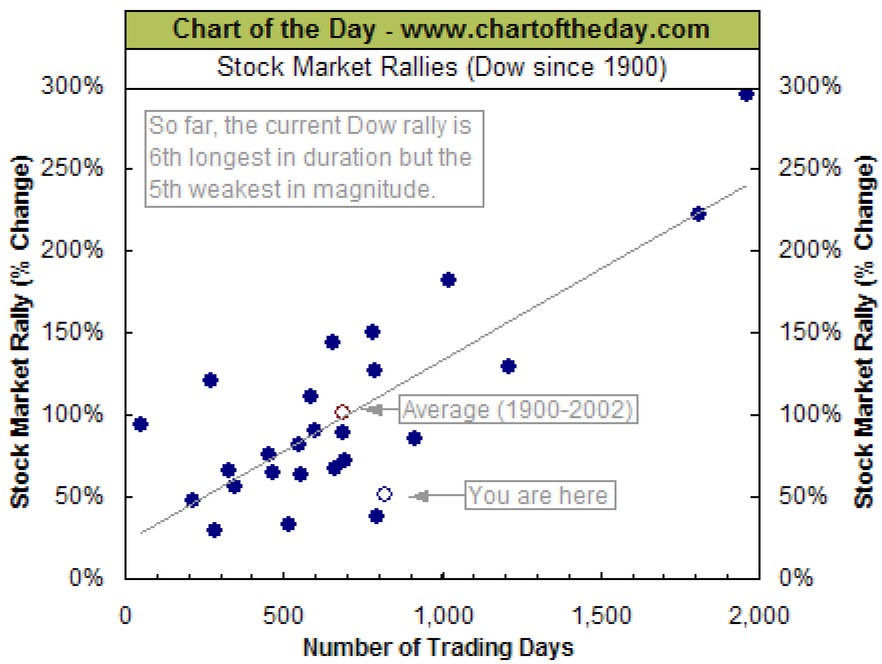
This danger is underscored by Stephen Roach's recent comments:

"Globalization and the powerful cross-border labor arbitrage it has spawned has turned the US labor market inside out. The manufacturing share of US employment hit another record low as 2005 came to an end -- down to 10.6% of total nonfarm payrolls, or about one-third the share prevailing as recently as 1970. At the same time, employment and compensation is being squeezed in services as well, where offshore outsourcing is moving rapidly up the value chain. The speed of this transformation is what's so daunting. Just five years ago, white collar outsourcing was confined to data processing and call centers; today, courtesy of IT-enabled connectivity, it has moved to the upper echelons of the knowledge-worker hierarchy -- software programming, engineering, design, doctors, lawyers, accountants, actuaries, business consultants, and financial analysts. The Internet is living up to its reputation of being the most disruptive technology in the history of the world.

"The implications of these developments are profound. Long lacking in income support, the spending-addicted American consumer has turned to equity extraction from asset holdings in order to support the habit. According to Federal Reserve estimates, the current pace of home equity extraction was around $600 billion in 2005 -- more than enough to compensate for the $335 billion shortfall of real labor income generation noted above. But if the housing market softens and financing costs rise -- both quite likely, in my view -- equity extraction will fade and over-extended American consumers will then have little choice other than to bring spending and saving back into more prudent alignment with income.

"That underscores the potential for a long-deferred and important transition in the US -- away from the newfound joys of the Asset Economy back to the Income Economy of yesteryear. Such a transition undoubtedly spells slower consumption and real GDP growth over the foreseeable future -- a downshift that may already have triggered a slowing in the underlying pace of hiring over the past four months. In that context, further tightening would most likely be out for a deflation-phobic Bernanke Fed, bonds should rally, stocks could be hit by an earnings shortfall, and the dollar will likely fall further. Only a spontaneous and powerful regeneration of labor income would allow the US economy to avoid such an endgame -- an outcome that would imply nothing short of an unwinding of the global labor arbitrage. Barring a dangerous outbreak of protectionism, such a reversal is highly unlikely, in my view."

Finally, the following chart shows us that the current Dow rally is the 6th longest in duration but the 5th weakest in magnitude. Given the concerns of the economy, the very poor growth in personal income, high energy bills, an increase in credit card payments this month due to new legislation coming into effect, the lag time before Fed rate hikes have an effect, I would be somewhat cautious with your long only index funds in your investment accounts. We could certainly see a rally over the next few months, for a variety of reasons, but there are some real headwinds we will be facing in the second and third quarters.



Source - Dow Jones

And finally, I bring you this executive summary of a research paper by one of my favorite writers, James Montier. James is a contrarian of some repute. I think my raders will find this very interesting.

On the Contrary: Why It Pays To Be Different

Whilst the consensus may sometimes be right, it is unlikely you will make money from investing in it. As Keynes put it, investors should "go contrary to the general opinion, on the grounds that if everyone agreed about its merits, the investment is inevitably too dear". So going against the crowd is still likely to be the best recipe for consistently adding value. But where are the big consensus trades now?

? In a world in which everyone is trying to outperform each other, doing what everyone else is doing is unlikely to work as a viable source of long term alpha. As the quotation from Maynard Keynes makes clear, equity prices should reflect the consensus view. So betting with the consensus is unlikely to generate significant outperformance.

? New research by Lehavy and Sloan shows the stocks that institutional fund managers are busy buying are outperformed by the stocks the fund managers are busy selling. In the three years after portfolios were formed, those stocks that had seen the lowest level of interest from institutional investors outperformed those stocks with the highest attraction by over 4.5% p.a. (using data from 1982-2004).

? Of course, going against the crowd is not painless. Neuropsychologists have found that social pain (the pain of going against the crowd, or being excluded) is felt in the same parts of the brain as real physical pain. So contrarian investing is a little bit like having your arm broken on a regular basis.

? The returns to bearing this discomfort can be sizeable. For instance, a model relating the PE people are willing to pay to measures of underlying volatility shows that as volatility declines so people will pay more, but of course, they end up earning less. For instance, buying the market when it is in the comfort zone (i.e. volatility is low) results in very low real returns over the long run (an average of 1.3% p.a.). In contrast, buying equities when it feels absolutely awful to do so can generate high returns. When the market is in the "you must be mad to buy equities" mode, the real return over ten years is 15% p.a.!

? So, where are big consensus trades at the moment? Many investors seem to have itchy trigger fingers when it comes to getting into growth styles. The logic seems to be that after five years of value outperformance, surely growth is due a bounce back. Japanese equities continue to attract a vast amount of support from overseas investors, and surveys consistently show Japan is one the most favoured regions this year. Long US/ Short Europe is becoming another highly consensus trade. After a couple of years of US underperformance, investors seem to think it is time for catch up. However, this ignores valuations. Across a gamut of valuation measures the US is on average 56% overvalued, whilst Europe is around ‘only’ 27% overvalued. Small caps also stand out as an expensive consensus bet.

? Our value-orientated country screen suggests buying Belgium, Norway, Netherlands, the UK and France. Amongst emerging markets Venezuela, Thailand, Indonesia, Peru, Korea and Brazil stand out as cheap. Of course, buying any of these is likely to result in accusations of insanity and calls for your internment in an institution. Such are the joys of being a contrarian.

Toronto, Miami and New York

I will be in Toronto next week working with my partners in Canada, Pro-Hedge Investors. I leave from there to go to Miami, where I will be speaking to a group from EFG. EFG is a Geneva based private bank with a world-wide presence. I am delighted to announce that we have come to an arrangement where they will be my partners in Latin America, the Middle East and Asia, as well as Switzerland. I will tell you more about that in a later letter, but we are getting closer to being able to help readers from all over the world get information and access to alternative investments.

And speaking of traveling, let me recommend the always interesting letter that my friends at International Living write. It gets me thinking and dreaming. If you have an interest in living overseas, it is certainly worth your time.
http://www.isecureonline.com/Reports/IL/WILVG128/

Let me pen a quick note to the regional broker-dealer community. As you may know, I work with my friends at Altegris Investments to bring alternative investments like hedge funds and commodity funds to accredited investors. They have developed a fund which features the work of one of my favorite commodity traders. We will shortly issue a research report on the fund. If you would be interested in having the fund available to you and your clients, and would like to learn more about it, just drop me a reply note and I will have an associate at Altegris contact you or the appropriate person at your firm with more details.

Sorry, because of very clear NASD rules this information cannot go directly to the public. It can only be shown to brokers and then through them to their clients. If you are an accredited investor and would like to know more about alternative investments like hedge funds, commodity funds and other private offerings, I suggest you go to www.accreditedinvestor.ws and sign up for my free service. My friends from Altegris will contact you and help you find investments that may be appropriate for you. And now, if you are in Latin America, Europe, the Middle East, Asia or Canada, we can help you!

(In this regard, I am the president and a registered representative of Millennium Wave Securities, LLC, member NASD.)

I am a little under the weather tonight, so I am going to close and get home and rest. Maybe too much great food, really fine wine and too little sleep when I was with my partners at Altegris in La Jolla for the past few days. They do feed me well when I am there. Try a great new restaurant called Jack's. One of the finest meals I have had anywhere. The cod was simply magnificent, and what a wine list. Tiffani and I want to thank Jon, Bob, Matt and Dick for being great hosts!

Next week will be an extreme. A cold Toronto and a warm Miami. Hard to pack for that trip in a carry-on. Enjoy your week.

Your wondering what Bernanke's thinking tonight analyst,

John Mauldin