Ahead of the Curve
Don't Confuse Me With the Facts
The American Consumer is NOT Profligate
Some Discretion in Discretionary Spending, Please
New York and London and Home

By John Mauldin

The economy grew at a much slower pace last quarter, with GDP only moving forward by 1.1%. This week we look at why and see if we can mine the consumer spending data to give us clues about future growth. We are going to start a two part series inspired by a remarkable new book I am reading called "Ahead of the Curve," sub-titled "A Commonsense Guide to Forecasting Business and Market Cycles."

Joe Ellis was a partner at Goldman Sachs and was ranked as Wall Street's #1 retail analyst for 18 consecutive years by Institutional Investor. I caught up with Joe last time I was in New York as he explained his prediction process. I think there is real value here, and I suggest serious investors get a copy. Even though it was published by Harvard Business School Press, it is a very readable book. You can get your own at www.amazon.com/curve.

What Joe argues is that current forecasting models fail to put information into a useful context. Thus, you get results where the vast majority of business economists do not predict a recession until we are already in one. That leads to two additional and critical mistakes: using recession as the primary indictor of economic harm and tracking data on a quarterly basis. He says doing this causes economists and investors to miss the real economic inflection points and thus lead to costly errors in judgment.

What Joe shows in about 200 pages filled with easy to study charts is that there is a consistent chain of cause and effect that extends from consumer spending through industrial production and then into capital spending and on to employment. The key to economic forecasting is to find indicators which can tell us when things are about to slow down. Typically this slowdown will lead to a very poor stock market or outright bear market and recessions. By the time the recession hits, the damage has been done to your portfolio.

So today, we are going to focus on the consumer, the GDP data and then move to Ahead of the Curve. So where do we begin? With politics, of course. Or actually a study about how we deal with those things which go against our bias. Work with me on this, as there is a connection.

Don't Confuse Me With the Facts

I remember on numerous occasions I would try to convince my Less-Than-Sainted Dad about a particular subject. He would simply answer, "Don't confuse me with the facts. My mind is already made up."

It seems that researchers at Emory University did a study and found that Democrats and Republicans are also adept at ignoring facts. I know that will shock some of you. But the interesting part to me is that we actually enjoy ignoring facts. Our pleasure centers in our brain get positive feedback when we ignore certain facts that might contradict cherished beliefs. (The following story is from www.livescience.com, a rather cool web site on science news. The actual story is at http://www.livescience.com/othernews/060124_political_decisions.html)

"Researchers asked staunch party members from both sides to evaluate information that threatened their preferred candidate prior to the 2004 Presidential election. The subjects' brains were monitored while they pondered.

"'We did not see any increased activation of the parts of the brain normally engaged during reasoning,' said Drew Westen, director of clinical psychology at Emory University. 'What we saw instead was a network of emotion circuits lighting up, including circuits hypothesized to be involved in regulating emotion, and circuits known to be involved in resolving conflicts.'

"Test subjects on both sides reached totally biased conclusions by ignoring information that could not rationally be discounted… 'None of the circuits involved in conscious reasoning were particularly engaged,' Westen said.

And here is the rather amazing part. "Essentially, it appears as if partisans twirl the cognitive kaleidoscope until they get the conclusions they want, and then they get massively reinforced for it, with the elimination of negative emotional states and activation of positive ones."

We get a positive vibe from ignoring negative information damaging to our strong biases. "Notably absent were any increases in activation of the dorsolateral prefrontal cortex, the part of the brain most associated with reasoning."

"The tests involved pairs of statements by the candidates, President George W. Bush and Senator John Kerry, that clearly contradicted each other. The test subjects were asked to consider and rate the discrepancy. Then they were presented with another statement that might explain away the contradiction. The scenario was repeated several times for each candidate.

"The brain imaging revealed a consistent pattern. Both Republicans and Democrats consistently denied obvious contradictions for their own candidate but detected contradictions in the opposing candidate. 'The result is that partisan beliefs are calcified, and the person can learn very little from new data,' Westen said.

In East Texas, back when I was growing up, we had what were called Yellow Dog Democrats. They would only vote for a democrat, even if they put a yellow dog on the ballot. Which shows that things can change over time, as now they are electing republicans even in yellow dog counties. But it was a long time for that change to come. Now, we see some of the opposite patterns. But it is that way all over the world.

That is why you can reliably predict what a "core" vote will be. It is what makes gerrymandering so effective and easy. It is the small group of voters in the middle, whose minds do not get a stimulus from ignoring data where the real political contest is waged. But that study does more than show us about our political problems. It is the human condition. Religion, family, our kids, our favorite weight loss program – we too often come to the table with our biases.

It is only when we are in a crisis of some kind that we seem to look for answers outside our biases.

I keep coming back to psychology time and time again in this weekly letter. It is so important that we understand how our own thought processes can deceive us into acting in ways that are not consistent with good investment practice. Sometimes we believe what we want to believe. If we are confronted with a fact that would not be helpful, we ignore it, explain it away and find some novel new interpretation. Or we look for more facts which favor our position.

Think people in business don't interpret the data which leads to the best conclusions for themselves (and their stock options)? We want to believe things are going to get better. Facing hard facts is so against our psychological systems that it is the rare leader who can do it. (And how many of us explain away our own little personal petty foibles?)

Rather than letting the data "talk to us," we tell the data what to say. We let an improperly interpreted Ibbotson study convince us the market will go up 9.6% over the long run. We stick our money in index funds and expect the market to reward us for perseverance. We invest for the long term, just like the guy selling us the fund suggested. Or we take the path of least resistance in our 401k plans. That path leads more often than not to a dead end alley where you get mugged. Your retirement taken and the prospect of working much longer than you wanted to stares you in the face.

Of course, then we hit a crisis and start to look for answers. Typically we look after we have taken the loss.

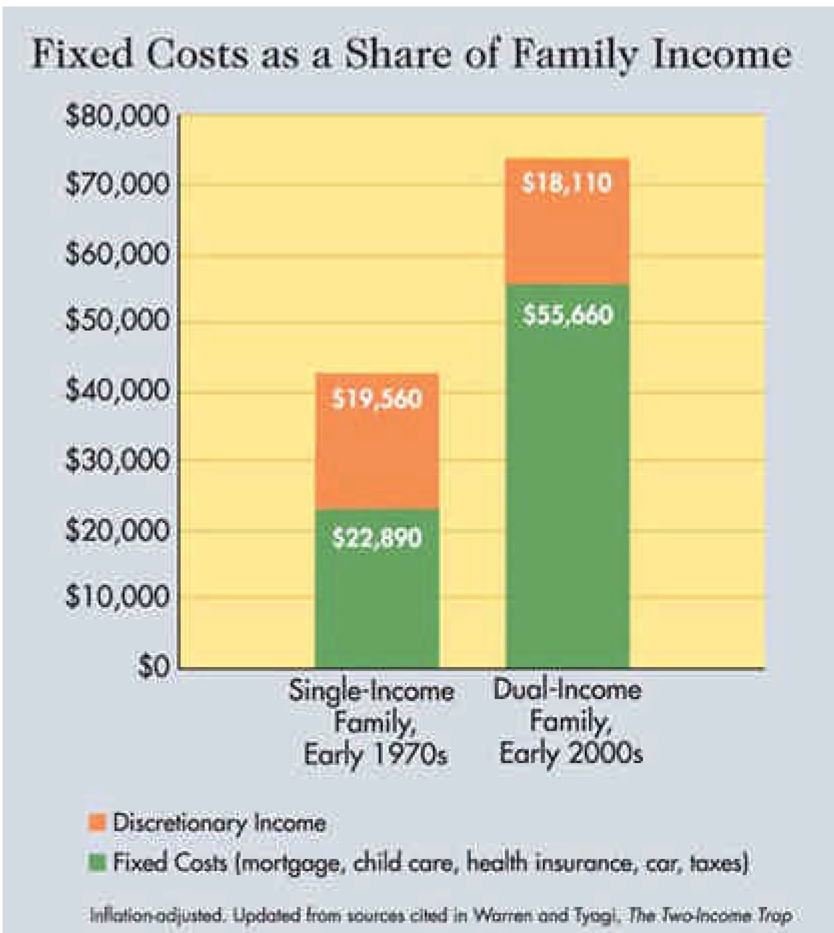
In the next few letters, we are going to let the data talk to us. I suggest you leave your biases at the door. Who knows, we might pick up a useful fact or two.

The American Consumer is NOT Profligate

The image of American consumers is one of drunken revelry, gaily borrowing with abandon to allow all sorts of frivolous spending. There is clearly some of that. 1 in 53 American households filed for bankruptcy last year, a staggeringly high number. But analysis by Harvard law professor Elizabeth Warren in Harvard Magazine suggests that does not tell the entire story.

Today the median income for a fully employed male is $41,670 per year. On an inflation adjusted basis that is nearly $800 less than a generation ago. But today, the typical home consists of two workers, with an average income of $73,770, which is 75% higher than in the early 70's. As Warren points out, in one sense that puts the family at more risk. In 1970, if the husband lost his job, the wife could find work. Today, she is already working, and on average her one income is not enough.

It is convenient to blame the two worker family as simply burdened with lust, craving the latest new toy or must have convenience. But it is not that simple. Look at the following chart.



Today's two income family has higher fixed costs and less discretionary income than families in the 1970s (Inflation adjusted.)

Looking at Bureau of Labor Statistics data, we find that we spend less now on clothes than we did 30 years ago. A lot less. 33% less! Chinese labor, offshore manufacturing and Wal-Mart mean we spend almost $1,200 a year less on clothes.

Today's family of four "actually spends 23 percent *less* on food (at-home and restaurant eating combined) than its counterpart of a generation ago. The slimmed-down profit margins in discount supermarkets have combined with new efficiencies in farming to cut more costs for the American family."

Are we overspending on appliances? Hardly, as compared to the last generation. "But manufacturing costs are down, and durability is up. Today's families are spending 51 percent *less* on major appliances than their predecessors a generation ago."

Yes, we spend more on entertainment and computers, but that is more than offset by the savings mentioned above. "So where did their money go? It went to the *basics*. The real increases in family spending are for the items that make a family middle class and keep them safe (housing, health insurance), that educate their children (pre-school and college), and that let them earn a living (transportation, childcare, and taxes)."

In the 1970s, with half of their income discretionary spending, if a disaster happened, they could cut back on the discretionary items for a while, even if the wife had to work for lower income. There was a margin for error.

"But the position today is very different. Fully 75 percent of family income is earmarked for recurrent monthly expenses. Even if they are able to trim around the edges, families are faced with a sobering truth: every one of those expensive items—mortgage, car payments, insurance, childcare—is a fixed cost. Families must pay them each and every month, through good times and bad; there is no way to cut back from one month to the next, as can be done with spending on clothing or food. Short of moving out of the house, withdrawing their children from preschool, or canceling the insurance policy altogether, they are stuck.

"In other words, today's family has no margin for error. There is no leeway to cut back if one earner's hours are cut or if the other gets sick. There is no room in the budget if someone needs to take off work to care for a sick child or an elderly parent. Their basic situation is far riskier than that of their parents a generation earlier. The modern American family is walking a high wire without a net."

You can read the whole thoughtful article at http://www.harvard-magazine.com/on-line/010682.html. Professor Warren emphasizes the risks and pressures that American families are under.

As I thought about the article, it struck me that the point about how little disposable income average America has is important. When gasoline prices rise, it eats into discretionary consumer spending. This month, new legislation will increase the minimum payments on credit cards. The consumer is getting squeezed.

As noted above, GDP grew at a miserly 1.1%, which shocked most observers, as well as your humble analyst. It was only a few weeks ago I predicted a slowdown in the economy later this year. I would have expected the 4th quarter to come in lower as part of that process. But this is a lot lower. What was the reason? There were several, but one of them is slower consumer spending.

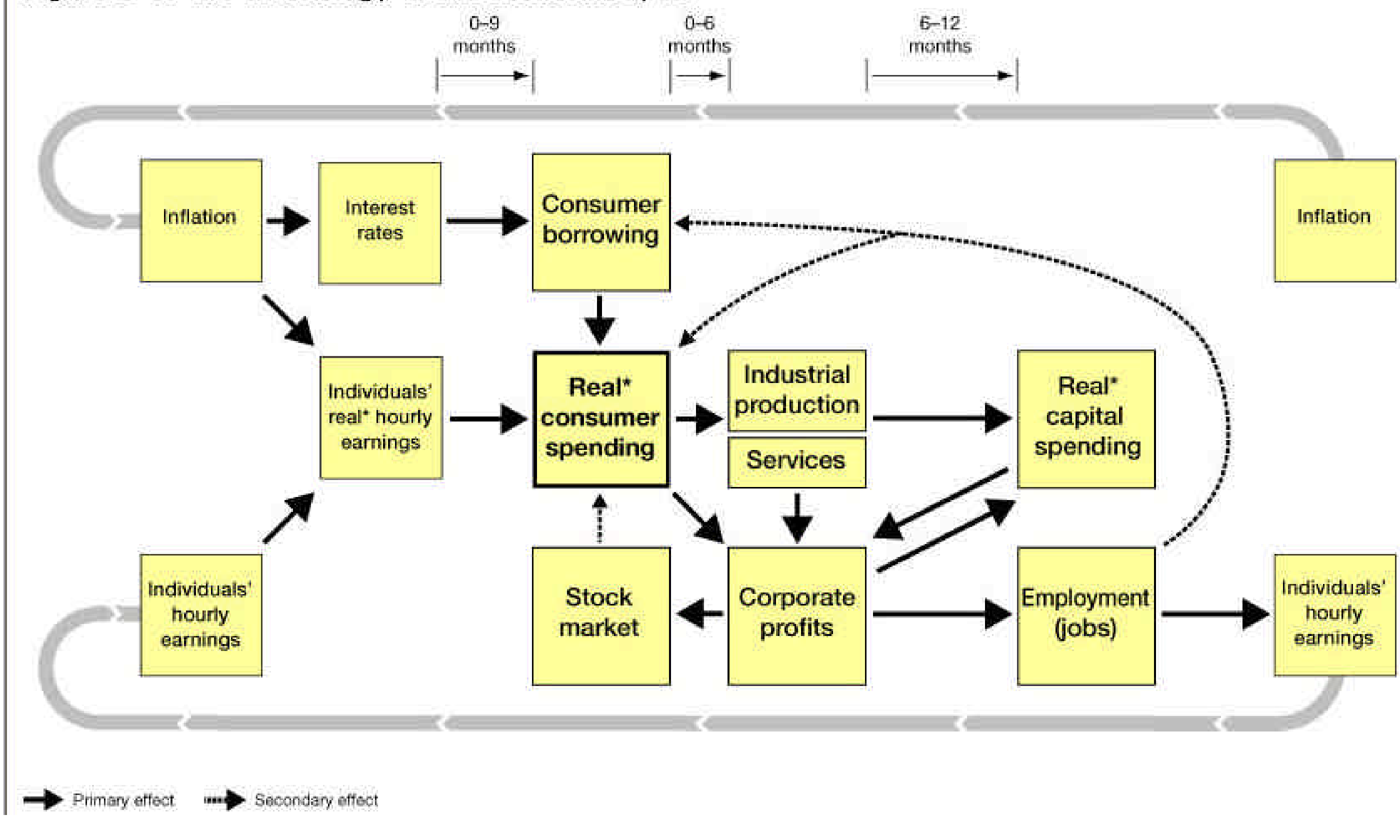
Consumers turned cautious in the final quarter as high energy prices and rising borrowing costs took a toll on their budgets. Their spending grew at a 1.1% pace, the slowest since the second quarter of 2001 when the economy was suffering through a recession.

Most of the weakness came as people cut back sharply on purchases of big-ticket “durable” goods, such as cars. This spending dropped by a hefty 17.5% rate, the sharpest decline since the first quarter of 1987. Businesses also were more restrained, boosting spending on equipment and software at a 3.5% rate in the fourth quarter, the smallest since the first quarter of 2003. (www.yahoo.com)

Some Discretion in Discretionary Spending, Please

And now we turn to Ahead of the Curve. I am going to include two charts. I hope they come through, but if not you can go to www.aheadofthecurve-thebook.com and click on them and a lot more. The first chart is a drawing of how Joe sees the business at work. It is figure 2.1 on the web site.

Figure 2-1: The chronology of the economic cycle



Real consumer spending is at the heart of the process. As the following chart will show, and we will look at in-depth next week, a slowing of real consumer spending will precede a recession. It will trigger a stock market sell-off. If we can see what drives real (by that we mean after inflation) consumer spending, then we can get a real heads up on the cycle.

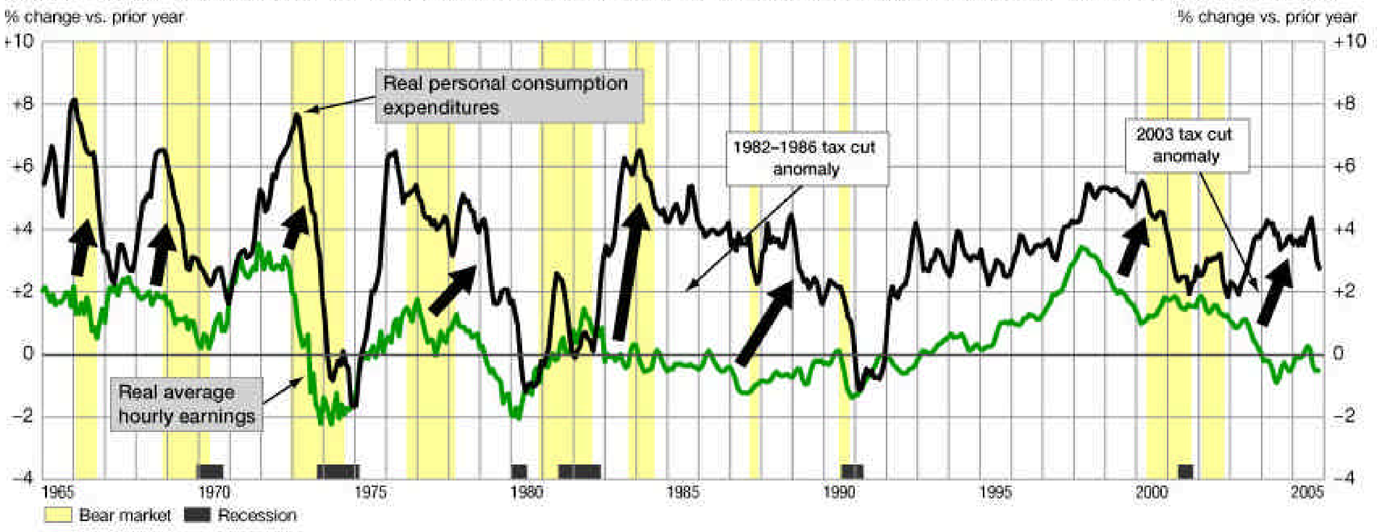
Individual hourly earnings obviously influence the amount that people can spend. Inflation determines how much "real" spending they can do. If your salary goes up 2% and food goes up 2%, then you are spending the same "real" amount on food. Real consumer spending is a combination of real hourly earnings plus what they can borrow. That in turn drive corporate profits, industrial production and services, which drives both employments and the stock market.

By the time employment starts to turn down, the stock market is already in a swoon. By the way, employment confidence is a big factor in consumer borrowing. In 1999, real hourly wages turned down but the recession and bear market was held off for over a year because of the wealth effect (and subsequent borrowing) from the stock market.

And I suspect that we are seeing much of the same phenomena today, except that the wealth effect is from housing. And as we saw cash out mortgage financing dropping precipitously last quarter, we see that consumer spending is dropping as well, something I suggested over two years ago would eventually happen. The link between housing prices, consumer confidence and borrowing is even stronger than the link between the stock market and the consumer.

So, what is the data saying? Let's look at Figure 10-7 (from his chapter 10):

Figure 10-7: Real hourly earnings: Best leading indicator of real consumer spending (PCE) downturns



"Real hourly earnings downtrends of a year or longer have been a generally reliable leading indicator of consumer-spending downtrends. Real hourly earnings gave particularly notable advance warning of the 2000–2002 economic downturn.

"Real hourly earnings are reported on a pretax basis. Therefore, in the mid-1980s and 2003-early 2004, strong gains in consumer spending despite slowing real earnings were an anomaly reflecting federal tax cuts in those periods."

Joe's comment's on this chart: "The renewed downtrend in year-over-year real average hourly earning comparisons—attributable largely to higher energy costs—suggests that growth in consumer spending, which has weakened in recent months, will slow further in 2006. Just as wealth effects from stock-market gains in 1998-2000 postponed but ultimately did not prevent the consumer-spending slowdown of 2000-2001, the recent wealth effects from housing gains are not likely to prevent consumers' recent slowing real earnings gains from occurring during the next 12 months."

Now, as noted above, the 82-86 Reagan tax cuts offset the slowdown in hourly earnings. What would have probably been a recession was avoided. Will the Bush tax cuts do the same? Stay tuned.

Notice that when Clinton increased taxes in the 1990s, real hourly earnings were rising at a very healthy clip, offsetting the increased taxes. I think it is likely a tax increase today would have the opposite effect, as real hourly earnings are low and dropping.

As we will see next week, much of the “shortfall” in consumer spending is made up of borrowing. If housing prices start to stall, we will see an even bigger drop in borrowing.

Without borrowing and with rising energy prices, with increased borrowing costs for those with adjustable rate mortgages which reset this month, with increased credit card costs, higher local taxes, there is very little discretion left in discretionary spending.

The market shrugged off the weak GDP numbers. Evidently, the thought that interest rate hikes may soon be over is a heady drug. Profits seem to be coming in relatively well now, which is part of the reason. But revenues are being guided lower in a significant number of firms. You can work profits for a few quarters, but revenues are harder to play with in a world of Sarbanes-Oxley. Higher interest rates and energy costs will squeeze corporations as well.

I continue to think the market ends up lower this year and potentially much lower in anticipation of a much slower economy later in the year. Stay tuned. Next week we will look at Ahead of the Curve in more detail. You ought to go ahead and get it now. You will want it. www.amazon.com/curve

New York and London and Home

Tomorrow I leave for New York for a quick trip. Then I leave for London in two weeks to guest host on CNBC Squawkbox there February 15. Then I am home for about 10 weeks, and hope to get a lot of writing done on my next book. I am looking forward to being home.

I was reminded once again to day of how important it is to enjoy life as we live it. I was a pall bearer at a funeral, and as you look at the life pictures of this now elderly lady, you see how quickly life slips by. And even more I realized how much of how I enjoy life is a function of how much I enjoy the people who are along for the ride with me. I am lucky in that regard. I have quite a rich abundance of good friends all over the world. I need to spend more time with them this year.

Enjoy your weekend and call a few friends on the phone and go see them.

Your more committed to carpe diem analyst,

John Mauldin