Economic Whiplash
Yield Curve Update, Part VIII
Bold Ben Bernanke
Can a Slowing Economy do the Trick?
A Job Opportunity, EverBank and More

By John Mauldin

The Fed elected to pause in its rate hiking assault on inflation this week. With the backward looking data pointing to higher inflation that must mean they expect the economy to slow down and thus tame what incipient inflation is lurking around the corner. But wait, the data this week suggests the economy may not be slowing down. The market thinks that means the Fed will have to pick up the rate hike cudgel and once again do battle with inflation, which means higher short term interest rates. But the Bond King himself, Bill Gross, declares we are at a turning point and another bull market in bonds is about to appear! Ed Hyman of ISI (no slouch of a prognosticator) says the economy is going to slow down and therefore we are getting ready to have a new bull market in stocks – starting now! (Huh? Did I miss something?) Dennis Gartman thinks the next move the Fed will make is to cut rates, which means the economy will be visibly slowing.

And on and on. It is like watching a tennis match, as each new "data point" suggests seemingly conflicting information. It is enough to give a soul economic whiplash. But if we look at the data, it may not be all that inconsistent. The problem may be that it is not telling us what we want to hear, that both inflation and a slowing economy are a concern. Today we sort through a mound of data and see if we can make some sense of it, all the while pondering what Bernanke must be thinking late at night.

But first a personal note. This month is something of an anniversary. Some six years ago, in August of 2000, I put my first Thoughts from the Frontline on the internet. I had about 2,000 email addresses from a previous print newsletter I had written for another publisher. (Paper, how very quaint! And so 90's!) Over time the letter began to build up readers, and since the content was free, other publishers and web sites began to ask it they could use it. Today, the letter goes out to well over 1,000,000 people each week. I want to thank each and every person who has helped the letter grow, especially those of you who forward the letter to friends and associates, recommending they subscribe.

I am often asked by readers and other writers to speculate on why the letter has been as successful as it has. While there is no one answer, I do have a few thoughts. First, it is free. The price is right, so to speak. But there is another aspect to being a free letter. Early on I started the letter as a way to focus my thinking on my reading of the last week. What did I find that was most important? I write about what interests me most each week, not constrained by subject matter.

Typically when one sells an investment service or letter, the subject matter is more specific. Being able to write on a variety of topics keeps the letter (and me!) fresh.

Not worrying about whether one person subscribes or deletes me is a very a very nice feeling. Not having to worry about renewal rates seems to agree with me.

Finally, the growth of the list is self-selective. On the internet, people subscribe to and read about what interests them. In talking and corresponding with readers, I find that in general they are well read and curious about a variety of topics. I am convinced my readers are among the brightest and most talented anywhere! A letter that is different each week is something they like. In short, the variety is a plus. For many of you, Outside the Box, written by other writers, is your favorite of my letters. I am truly humbled at the response over the last six years. I had no idea how positive the response or the experience would be. It is truly one of the great pleasures of my life to be able to come each week into your world. I take the responsibility quite seriously. Thank you!

Yield Curve Update, Part VIII

Long time readers know that I pay close attention to the yield curve. In fact, that is what I was writing about in August of 2000. The yield curve had seriously inverted, and historical studies by Dr. Campbell Harvey (now at Duke) and later the New York Fed demonstrated that an inverted yield curve was the best tool we had for predicting a recession. The Fed study used a 90 day average and attached a probability of a recession, depending on how inverted the yield curve actually was. Let me re-print the table:

Estimated Recession Probabilities for Probit Model Using the Yield Curve Spread

Four Quarters Ahead Value of Spread

(Recession Probability Percent)	(Spread Percentage Points)
5	1.21
10	0.76
15	0.46
2	0.22
25	0.02
30	-0.17
40	-0.50
50	-0.82
60	-1.13
70	-1.46
80	-1.85
90	-2.40

Note: The yield curve spread is defined as the spread between the interest rates on the ten-year Treasury note and the three-month Treasury bill.

Last January, the yield curve briefly inverted, but the 90 day average never got below 0.10%. That indicates the probability of a recession within four quarters a little less than 20%. As an aside, the 30 day average did not go negative as well.

Today, the 90 day average is once again down to 0.10%, but the 30 day average has turned negative at -0.08%. In 2000, the 90 day average slipped to -0.64%.

In 1989, the yield spread predicted a 25% probability of a recession showing up in 1990 and one did. It was mild, but that was small comfort to those who got caught in its trap.

The Fed paper authors told us in 1996 that things have changed and that now we should be much more concerned about a "mere" 25% probability. Quoting:

"Thus, even a probability of recession of 25 percent--the figure forecast for the fourth quarter of 1990 data on the yield curve spread one year earlier--was a relatively strong signal in the fourth quarter of 1989 that a recession might come one year in the future."

Further down they say,

"There are two reasons why the signal for this [1990] recession may have been weaker than for earlier recessions. First, restrictive monetary policy probably induced the 1973-75, 1980 and 1981-82 recessions, but it played a much smaller role in the 1990-91 recession. Because the tightening of monetary policy also affects the yield curve, we would expect the signal to be more pronounced at such times. Second, the amount of variation in the yield curve spread has changed over time and was much less in the 1990s than in the early 1980s, making a strong signal for the 1990-91 recession difficult to obtain."

Basically they are saying that future studies a few decades from now will probably have much higher probabilities of recession at lower spreads than did their study because things, like volatility, have changed.

Today, we are not all that far away from the same level of probability of a recession that we saw in 1989. We will come back to this point later in the letter.

Bold Ben Bernanke

I was wrong. No question about that. In this letter for weeks and on Larry Kudlow's show last week, I rashly predicted the Fed would raise rates last Tuesday. So, what happened?

I thought the Fed would focus on inflation. That has been the tendency ever since the disastrous policies of the 70's let inflation get out of hand. And the recent data suggested inflation was clearly an issue. Let's do a quick review.

Louis Gave reminded me of the old joke. Economists like to use a decimal point when putting a number on inflation. It proves they have a sense of humor. There is a large does of reality to that line, as inflation numbers are notoriously difficult to gauge.

There are solid arguments that today's inflation number overstate inflation anywhere from 0.6% to 1%. Then others can show that CPI understates inflation by several percent. It all depends on what you want to measure and how you want to measure it.

But however you want to measure it, inflation has been rising this year. Median inflation is above 4%. CPI is well over 3% and approaching 4%. Inflation less food and energy is over 3%. The core CPE that the Fed favors is over 3%.

Many members of the Fed board, including Ben Bernanke, have suggested that 2% is the upper limit on inflation before they become "uncomfortable." We are well past that number. While the economy did slow last quarter, it is not dead.

This week, we had a very strong consumer spending number that is not consistent with a slowing economy. But the reason may have to do more with credit than with economic growth. From Bloomberg: "Consumer borrowing unexpectedly accelerated in June as Americans used credit cards to finance more of their purchases, a Federal Reserve report showed today. Consumer credit, or non-mortgage loans to individuals, rose $10.3 billion to $2.19 trillion following a revised $5.89 billion increase in May. The two-month gain was the biggest since September-October 2004. Americans are relying more on credit-card debt because rising interest rates and a cooling housing market make it harder for them to take out home-equity loans." Consumer Credit has increased $26.5 billion over the past three months.

Productivity is also down and unit labor costs are up 3.2% on a year-to-year basis, the fastest since the last quarter of 2000. All suggest inflation is still alive.

Michael Darda pointed out in an op-ed in the Wall Street Journal on Thursday:

"It is also important to consider the fact that the Fed was running an extremely tight monetary policy in 2000, with the real Fed funds rate rising five percentage points above core inflation, and 4.5% above the GDP price deflator. In today's environment, that would require a Fed funds target between 7% to 8%. During 2000, commodity prices were weak, credit spreads were wide, the dollar was strong and monetary velocity growth was negative. Today commodities are high, the dollar is relatively weak, credits spreads remain narrow and monetary velocity is expanding well above trend. The contrast could not be more glaring."

Manufacturing is up, on stronger exports as the weaker dollar helps. Personal income was up an annualized 6.9% in the second quarter. Forward looking price indicators suggest continued increases in prices. Short term inflation indexed bonds are

pricing in more inflation. (Interestingly, long term bonds do not. The market thinks that deflation is the longer term issue.)

But the Fed has decided that the current inflation data is backward looking. They clearly think that a slowing economy will put a damper on inflation. But is also appears they have moved the upper bound on inflation as to where they are comfortable.

In short, in the quest for a soft landing, they are evidently going to tolerate inflation above 2% so as not to risk a recession. (Richard Berner of Morgan Stanley suggests they are thinking 2.5%) Why put a million people out of work over a silly 0.5% of inflation?

Can a Slowing Economy do the Trick?

In a paragraph entitled "The Meaning of 'Data Dependence'" good friend Paul McCulley wrote this month (and pay special attention to the chart):

"Central banking is the art and science of decision-making under uncertainty. Policymakers at the Fed and elsewhere must base interest rate decisions on their expectation of where the economy is going, not just where it has been. Monetary policy by necessity is explained by reference to the economic forecasts and a reaction to shocks. Yes, as Fed policymakers remind us, monetary policy decisions are data-driven. But the importance of the data lies in its implications for the forecast and the extent to which the data confirm or disconfirm the committee's best guess about the direction in which growth and inflation are headed.

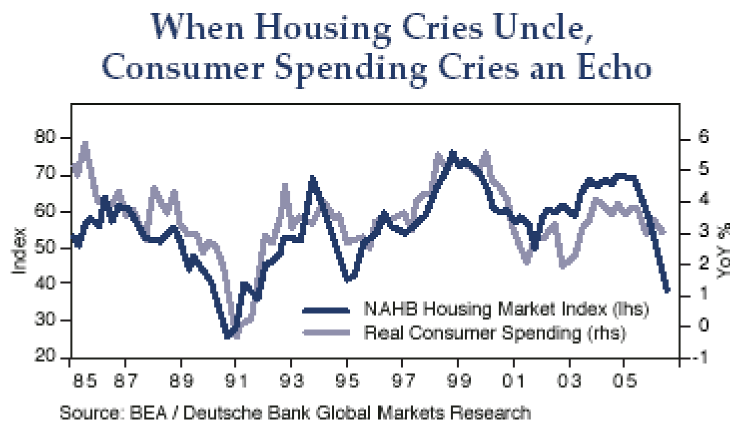

Exhibit 1

"It is no surprise that monetary policy decisions are hardest to make, and to explain, when the economic and interest rate cycles are at a turning point. Alan Greenspan, you might say, got out just at the right time – and you can't help wondering if he planned it that way! It is inevitable that in a period of 'transition,' to use Mr. Bernanke's phrase, that there will be tension between the incoming data and the forecast. Core inflation of late has been higher than the FOMC expected but there is also unambiguous evidence that the housing market is cooling.

Mr. Greenspan might even have had trouble in this current environment, though of course there are great benefits of having established a strong track record over 18½ years, not least the fact that when you say, "just trust me" people may be inclined to do so."

Looking at the graph on the relationship between the housing market and consumer spending, one would expect consumer spending to start to soften. This week it came in quite strong and well above expectations. Of course, one month does not a data series make.

Bernanke has made a very big bet. He has sided with those that think the economy is going to soften (at best). A softening economy should (but not necessarily will) bring down inflation.

If housing prices do not rise, there will be no rising equity it for homeowners to tap in the form of cash out re-financing. 30% of the jobs created in this recovery have been housing construction related. As new home construction and sales slow, so will employment.

High interest rates are starting to hurt those with ARMs mortgages. Mortgage delinquency rates hit 2.33% n the second quarter. "The portion of adjustable rate mortgages which were at least 90 days past due has climbed 141% in the past year. That compares to a modest 27% rise in fixed rate mortgages." (WSJ)

Don't I remember Greenspan extolling the virtues of ARMs a few years ago? Now, some ARMs are adjusting to 8.75%, according to the Wall Street Journal. Many people are seeing their home their mortgages rise by 25-30%. Almost $140 billion of residential mortgages will reset this year and an additional $524 billion plus over the next four years.

It is not just housing. High energy prices are diverting consumer spending. All this portends a slowdown at the least in our future. But Nouriel Roubini, professor of economics at New York University, and a very smart resource, write this week in the Financial Times that a recession will come to the US, and will affect the world. Let's look at his conclusions. Please remove sharp objects from your near vicinity prior to reading:

"Once the housing and consumption slump starts, demand for durable goods becomes interest rate insensitive. Indeed, the recent housing bubble has led to a glut of housing stock, consumer durables and lingering excess capital capacity in the rest of the economy. Thus, as we saw in 2000-01, the housing and consumption slump will dominate any monetary easing effort by the Fed.

"Will the rest of the world decouple from the US recession? The market consensus now sees a divergence in patterns of global growth, between the US on one hand and Europe and Asia on the other. Bu this is only wishful thinking. The world will sharply slow down once the US slumps.

"Trade links are one important reason why the rest of the world will be affected. But the oil shock will have the same stagflationary effect on the eurozone and Asia as on the US. Monetary policy is being tightened in Japan, eurozone and emerging markets. Global chief executives' confidence is sharply down and rising geostrategic shocks are hitting consumer and business confidence.

"The fall of the dollar amid the US slowdown will lead to deflationary forces sin Europe and Asia, and room for monetary and fiscal easing is much more limited now than in 2001, when the Group of Seven industrialized countries slashed policy rates and eased fiscal policy. There are now serious limits to monetary easing as global inflation is up, and fiscal policy cannot be eased either as almost all G7 countries face serious fiscal imbalances.

"Implications for financial markets of this global slowdown will be serious; although we may see a rally in he wake of the Fed's pause and later easing, one can expect a subsequent slump in the US equity market. When the reality of a global recession sinks in, global equity markets will fall with currencies and bonds in emerging markets, especially those with large external deficits. Finally, the dollar risks a disorderly fall as the US current account deficit becomes unsustainable. Central banks and private investors are now concerned about losses and on holdings of dollar assets. Thus, Us consumer "burnout" may be followed by the flight of foreign investment amid rising trade and protectionist pressures."

I think the Fed would not have paused, given the inflation data, unless their models indicate a real potential for a slowing economy. They also have to recognize the potential for inflation to remain high and thus the need to raise rates yet again.

We will have two more sets of inflation numbers between now and the next Fed meeting September 22. If the economy is slowing and inflation is coming down, then they will go on hold. If inflation rises, they may be forced to raise rates or risk a repeat of the 70s.

Either way, I do not see this as an environment that is good for stocks. The yield curve is telling us that the economy is headed for problems. I remember in 2000, when I wrote about a coming recession, that many laughed at me. The economy was slowing, but most economists thought the economy was going to get much stronger. Stock markets were headed back to almost new highs, The NYSE index was only down 3% for the year. The S&P 500, except for the tech portion, was again closing just below its highs. It was a resumption of the bull.

"This time it is different." Five of the most dangerous words in the investment world. To ignore the warning signs is not a prudent thing. This is the time to make sure your portfolio is in an absolute return strategy mode.

A Job Opportunity, EverBank and More

Sadly, my executive assistant is leaving to go back to school. She has been a wonderful asset, making my disorganized life so much easier. For whatever reasons, we are getting far fewer resumes and of less quality than we have in the past. (Maybe the economy is doing better than Bernanke thinks?) If you know of someone in the Dallas area, they can view the job description at www.myspace.com/johnmauldin, where my daughter posted the ad about halfway down the page. Organization and personal skills a must, making up for my lack thereof.

On rare occasions, I pay attention to the ads that sometimes accompany this letter. My publisher tells me that one for my friends at EverBank is going out with this issue. I have recommended them in the past. They offer FDIC insured foreign currency CDs (certificates of deposits) in a wide variety of currencies. You might click on the link to learn more or call my good friend Chuck Butler at EverBank at 800-926-4922.

Speaking of investments with the potential for absolute returns, for those of you whose net worth is $1,500,000 or more, and if you are interested in private funds like hedge funds, commodity funds and other alternative investments, I suggest you go to www.accreditedinvestor.ws. I work with firms in the US, Europe, Canada and Latin America to bring funds and investments to individual investors, family offices and smaller institutions. (In this regard, I am president of and a registered representative of Millennium Wave Securities, LLC, member NASD. Please see the important risk disclosures below and on the web site.)

It is getting late. The Rangers are playing Seattle tonight, and it has been hard to concentrate, as the score is now 13-7 in the fourth. Lots of yelling and noise, but it is good to be on the winning side, at least so far.

This Sunday the larger clan will gather as we celebrate my mother's 88th birthday at my home. She is still quite lively and bionic, with two knee and two hip replacements. She met Dad in Europe after the war, where she was in the WACs. Yes, mother wore combat boots. What an amazing world she has seen, from growing up on a Mississippi farm to today. I am blessed.

Have a great week, and enjoy your family and friends.

Your planning on living to 88 and more analyst,

John Mauldin

Note: John Mauldin is president of Millennium Wave Advisors, LLC, (MWA) a registered investment advisor. All material presented herein is believed to be reliable but we cannot attest to its accuracy. Investment recommendations may change and readers are urged to check with their investment counselors before making any investment decisions. Opinions expressed in these reports may change without prior notice. John

Mauldin and/or the staff at Millennium Wave Advisors, LLC may or may not have investments in any funds cited above. Mauldin can be reached at 800-829-7273. MWA is also a Commodity Pool Operator (CPO) and a Commodity Trading Advisor (CTA) registered with the CFTC, as well as an Introducing Broker (IB). John Mauldin is a registered representative of Millennium Wave Securities, LLC, (MWS) an NASD registered broker-dealer. Millennium Wave Investments is a dba of MWA LLC and MWS LLC. Funds recommended by Mauldin may pay a portion of their fees to Altegris Investments who will share 1/3 of those fees with MWS and thus to Mauldin. For more information please see "How does it work" at www.accreditedinvestor.ws. This website and any views expressed herein are provided for information purposes only and should not be construed in any way as an offer, an endorsement or inducement to invest with any CTA, fund or program mentioned. Before seeking any advisor's services or making an investment in a fund, investors must read and examine thoroughly the respective disclosure document or offering memorandum. Please read the information under the tab "Hedge Funds: Risks" for further risks associated with hedge funds.