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By John Mauldin

With each new slice of economic data the past few weeks, the bond market decided that the economy was getting softer and the potential for the Fed to start cutting rates was growing. Rates have been drifting down for the past few weeks. And then came today's unemployment numbers. The unemployment rate dropped to 4.4%. The bond market simply threw up. Yields on the 10-year bond rose a breathtaking 12 basis points in just a few hours.

But wait a minute. Why should the bond market worry about unemployment? Employment is a **lagging** indicator. In fact, the last time the unemployment rate was this low was during the recession of 2001. The unemployment rate was 4.4% in April of 2001. It dropped to 4.3% in May, before it began its climb to 6.3% two years later. The National Bureau of Economic Research tells us that the official dates for the last recession were from March through November of 2001. Note that the unemployment rate was dropping for two months even as the economy was beginning a recession.

This is not an isolated event. It is quite common for the unemployment rate to fall even as a recession is beginning. That is what we mean when we say lagging indicator.

So if the forward-looking data is suggesting a slower economy, why should the bond market fall out of bed over a lagging indicator?

Today we see if we can find the answer to that question as we look at the recent economic data, briefly look at an interesting concept of wealth, and see if we can find some patterns in history that will give us a clue as to how the housing market will play out. There's a lot of ground to cover, but it should make for an interesting letter. We are going to start out our journey rather far afield, but I hope to get us back to the bond market conundrum with a deeper sense of understanding.

What is Wealth?

"How we define wealth," says good friend Rob Arnott, "or investment success, drives our approach to investing. Benjamin Graham was fond of saying that the essence of investment management is the management of risks, not the management of returns. Well-managed portfolios start with this precept."

Writing in this month's *Financial Analysts Journal,* Rob gives us a different way to look at wealth. (Rob, besides successfully running billions of dollars at various funds, is the editor of the *FAJ* and has given me permission to use this material.) Quoting:

• "Can we measure our wealth as the value of our portfolio? Hardly. Today, $1 million buys much less than it did 25 years ago.

• "Is wealth defined by the real value of our portfolio? Only if we plan to spend it all right away.

• "Is wealth the long-term spending that our portfolio can sustain—the annuity that our assets could procure? This definition is closer to the truth, but like the first, it ignores purchasing power.

• "Is wealth, then, the inflation-indexed real income that our assets could sustain over time? For most investors, this is probably the most useful definition of wealth."

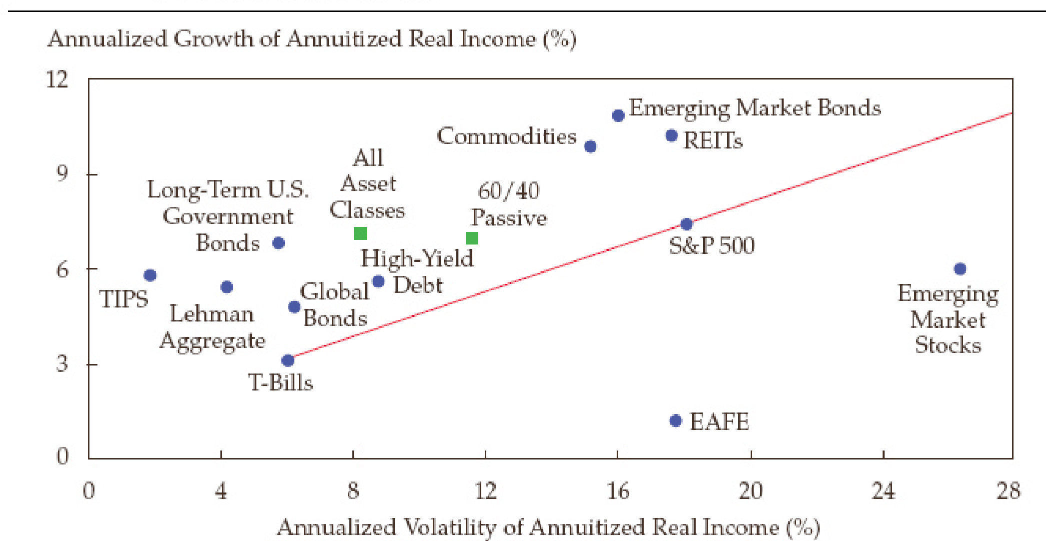
But what assets should we invest in to get the best inflation-indexed returns? Stocks? Bonds? Commodities? And what about the risks of these various asset classes? In a very interesting study, Rob redefines risk not as volatility of the asset class in terms of price but in terms of real sustainable spending. And he defines returns as not just a simple return, but as the growth in the real spending stream that the portfolio can sustain.

It's all about cash flow, or about the cash flow an asset or business can maintain. Real estate can produce a stream of income. Stocks can produce dividends or can be sold and invested in an annuity. Bonds pay an income. Entrepreneurs strive to build a business income model that does not solely depend on their continual involvement. (If you can't walk away and the business still produce an income, or if you can't sell the business to someone for cash to invest, you have a job, not a sustainable business.)

As investors, what we are ultimately concerned with should be future streams of income or cash flow. We work to get our portfolios to grow faster than inflation, and to enough size to support our desired lifestyle. But Rob is suggesting that it is not the size of the portfolio, but the ability to produce a sustainable long-term lifestyle.

Normally we think of T-bills as being the most risk-free investment. When viewed in terms of sustainable spending, however, T-bills become riskier than TIPS (inflation-adjusted bonds) and/or a regular bond portfolio. Look at the chart below. It represents the sustainable spending risk-adjusted returns of various asset classes. The red line is drawn between T-bills and stock market returns (as represented by the S&P 500). This is the classic capital market line between the "risk-free" asset and risky stocks.

Figure 1. Annual Growth and Volatility of Real Spending Power, 10 Years Ended 30 June 2006



Notes: EAFE is the MSCI Europe/Australasia/Far East Index; REITs are represented by the Dow Jones Wilshire Real Estate Investment Trust Index, commodities by the Dow Jones-AIG Commodity Total Return Index, global bonds by the JP Morgan Global Bond Index Global Unhedged, emerging market bonds by the JP Morgan Emerging Markets Bond Index Global, emerging market stocks by the FTSE All-World Emerging Index, and high-yield bonds by the Merrill Lynch US High Yield BB-B Rated Index.

Surprise. What you find out is that almost all asset classes produce a return or alpha higher than does the classic capital market when your define risk in terms of sustainable spending.

And the difference in returns between (1) TIPS, (2) a classic 60/40 stock and bond portfolio, (3) a simple portfolio comprised of all the asset classes, and (4) an all-stock portfolio in terms of sustainable spending is not all that much; but the volatility difference is huge.

I am currently doing a study that I will release later this year, but I'll give you a preview. Let's start with a portfolio diversified among two or more asset classes. At some point one of those asset classes will either underperform or undergo severe volatility. At such times the data suggests that a typical investor will switch to the better performing asset class. And this is precisely what almost guarantees that his total portfolio is going to underperform in the future.

Why? Because now he is over-allocated to an asset class that is likely to regress to lower than normal returns, especially if that asset class is mean reverting, like stock markets.

(This is not an argument that you should stay the course on a poorly performing asset class. Your asset allocation model should strongly depend on the current valuations of the various asset classes.)

But back to the conclusion of Rob's article:

"What can we conclude…? First, [investors] singular focus on portfolio return and volatility and peer-group comparisons, to the exclusion of sustainable real spending and its volatility, is misguided. It leads us away from a balanced assessment of investment success.

"Second, the power of **true** diversification should not be underestimated as a means to sustain long-term real spending power at modest risk. The classic 60/40 balanced portfolio is not **true** diversification. Indeed, one of the best-kept secrets of the investing community is that stock market return so dominates the risk of a 60/40 portfolio that the portfolio exhibits a 98–99 percent correlation with stocks! True diversification involves seeking out uncorrelated or lightly correlated **risky** markets, not low-risk markets. Finally, just as wealth is not solely a function of asset growth, risk is not solely a function of asset volatility."

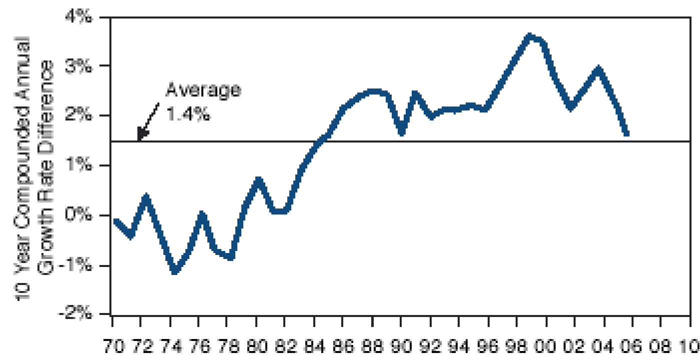
Alpha/Beta Anemia

But seeking out that risk can be difficult, if not, well, risky. And the current investment environment makes that search all the more difficult. Let's turn to this month's column by Bill Gross, the Managing Director at Pimco. I suggest you take the time to read the full piece, but let's review a few of the main points. (www.pimco.com)

How much can we expect our total portfolio of stocks, bonds, and real estate to grow? The answer is, not as much as we have come to expect. Understand, gentle reader, I am talking about everyone else and not you. As in Lake Woebegone, all of my readers have above-average portfolio returns. Your situation is entirely different. But let's look at what everyone else may be facing.

Nominal GDP is real (inflation-adjusted) GDP adding back inflation. If inflation is 2% and the economy grows at 4%, then we say real GDP is 2%. Buying power went up by just 2%. Over the very long term (and by definition), the total dollar value of all assets in the economy cannot grow much faster than nominal GDP. And the chart below shows that on average, total assets in the US have grown by only 1.4% over nominal GDP for the past 37 years.

10 Year Annual Growth Rate of Total Assets
(Stocks, Bonds,Real Estate) in the U.S.
Deflated by Nominal GDP



Total assets in the U.S. are calculated from tables L.5 and B.100 of the Federal Reserve's Flow of Funds report. We add the net worth of U.S. households to the total assets of all sectors to arrive at the total assets in the U.S. The 10-year compounded annual growth rate of total assets in the U.S. does not control for changes in valuations, savings rates, and reinvestment rates across asset classes and asset holders.

Source: PIMCO

Chart 1

"My point," writes Gross, "in bringing this up is to point out that if the "Beta" or return from various asset classes is correlated to the growth rate of nominal GDP, then what we have to look forward to is a rather anemic "Beta" in future years. In turn, if because of that increasing realization, investors have responded by compressing risk spreads and therefore potential Alpha, then what's looming over the immediate horizon is an Alpha/Beta anemia that can't come close to meeting investor expectations or for that matter come close to immunizing this nation's collective liabilities.

"… As nominal GDP growth rates have declined from 11%+ to a recent 5-year average of less than 5%, future asset returns of a similar magnitude are foretold. While [the chart above] suggests that a 5% GDP growth rate can be levered up to perhaps 6% or 7%, that levering is certainly more difficult with a Fed Funds policy rate higher than the current growth rate of GDP and with disinflation near its end. In any case, we appear to be looking at maximum 6-7% average annual returns over the immediate future from stocks, bonds, and real estate in total (stamps too!)."

But investors want more. The desired future sustainable income value of their retirement portfolios demands more than 6-7% returns today. So, they seek out riskier investments. Thus we see risk premiums in all sorts of markets go to historic lows. Emerging market bonds pay shockingly little more than US bonds. The riskiest of high-yield bonds are sought after for their yield.

Canadian income trusts are bought worldwide for their steady, tax-free income. Oops. Seems like the Canadian government decided to change the rules. Those income trusts got

spanked between 10-20% in one day this week, even though the underlying fundamentals of the companies involved changed not one whit.

(This is a horror show preview of what will happen to stocks if the Bush dividend tax cuts are not made permanent. Taxes do figure in the valuation of stocks!)

And note that the 1.4% average is mostly the last 25 years, which was a period of disinflation. We are at an end of that period. We should expect lower than 1.4% in the coming years.

"What to do?" asks Gross. "As noted above, I and we at PIMCO accept many of the realities/fundamentals of this new world low nominal GDP growth. Financial innovation, central bank transparency, and even globalization's great moderation of economic volatility are powerful arguments suggesting the old days of copious Alpha and Beta are over because 5% GDP growth and compressed risk spreads are not likely to permanently return to historic levels. Yet we have a collective sense that risk spreads will not remain so low over the next 12-24 months, and that instability – whether it be sparked by U.S. housing, global overinvestment, or geopolitical events – will one day temporarily resurface. If both major assumptions have merit, then the strategic and structural case for now should be guided by the New Age acceptance of change and the Old Age wisdom that bad things can happen to apparently good assets in the short term."

Again, I suggest you read the full essay.

Driving With the Rearview Mirror

We had another week of (mostly) disappointing economic data. Manufacturing in the US expanded at the slowest pace in more than three years last month, and construction spending "unexpectedly" declined because of a deteriorating housing market. I put unexpectedly in quotes because the consensus forecast was for continued growth. The Institute for Supply Management manufacturing survey came in at an anemic 51.1. Anything over 50 shows growth, but the trend is clearly down. The chairman of the ISM survey committee said in a conference call that he would not be surprised if the index soon fell to below 50, signaling a contraction in manufacturing business.

The "good news" in the survey was that prices paid for raw materials dropped. The monthly decline was the largest since July of 1973. Inflation? What inflation? Yields on the 10-year bond dropped.

The National Association of Realtors said that contracts to buy previously owned homes fell 1.1% in September. Also, the Mortgage Bankers Association said that applications for new home purchases declined to the lowest level since November 2003.

The data had traders betting earlier in the week that there was a 100% chance of a rate cut by March, but by Thursday that there was a 56% chance of a rate cut (Bloomberg). A slowing economy and a slumping housing market, with inflation getting back under control, all suggested interest rate cuts.

But then came the employment data, and it was much stronger than expected. US employers added 92,000 non-farm jobs in October after revised increases of 148,000 in September and 230,000 (!) in August. The median forecast of economists in a Bloomberg News survey was for 123,000 new jobs last month. The changes to September and August added 139,000 jobs to payrolls.

Bloomberg quotes Chris Rupkey, senior financial economist at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York: "Today's report sounds the death-knell for those forecasting recession next year."

Let's review from the top of the letter, Chris. "Employment is a lagging indicator. In fact, the last time the unemployment rate was this low in the recession of 2001. The unemployment rate was 4.4% in April of 2001. It dropped to 4.3% in May, before it began its climb to 6.3% two years later. The National Bureau of Economic Research tells us the official dates for the last recession were from March through November of 2001. Note that the unemployment rate was dropping for two months even as the economy was beginning a recession."

Today's unemployment numbers do not tell us much about whether there will be a recession next year.

The bond market was not simply reacting to new (rearview) evidence of a growing economy. The real concern is that the economy could slow even further and the Fed may not be able to react as quickly.

Greenspan was lucky. He had rising productivity throughout his tenure. He could allow interest rates to be relatively lower than in past eras and not produce inflation, in great part because of increased worker productivity. Thus, we got lower rates and little inflation. Until he retired, and took that old black magic with him.

Yesterday, labor productivity for the third quarter mysteriously stalled. Productivity was unchanged in the third quarter and revised down to 1.2% in the second quarter. Yet the price of labor rose 3.8% and has been up 5.3% for the last 12 months. Understand, I am all for rising incomes, and Lord knows labor has seen little enough the last 10 years.

But labor costs are typically about two-thirds of a company's expense. Labor costs rising above productivity is considered an inflationary problem. Just as rising productivity allowed Greenspan to keep rates low without inflation, falling productivity may create the opposite effect for Bernanke. As I have repeatedly written, the Fed will not allow inflation to continue at today's elevated rates, even at the risk of a slower economy. No Fed governor wants a repeat of the '70s on his watch.

Today's employment report shows the labor market is getting tighter, which means employers are going to have to pay more for labor. Remember that arcane

economic debate I wrote about last week? Part of it was a prediction by senior Fed staffers that the "labor participation rate" was going to come down, for a variety of reasons, but mostly due to aging demographics. That means fewer people (percentage-wise) are available for work. Thus, they concluded, the rate at which the economy could grow without inflation pressures was less than previously thought. Maybe, they mused, as little as 2.7%. Not exactly the heady numbers of recent years.

Even though the recent inflation numbers finally showed some signs of reduced inflation pressures, the last two days showed that inflation has still not had a stake driven through its heart. A cut by the Fed is still on indefinite hold. And the bond market hates that thought.

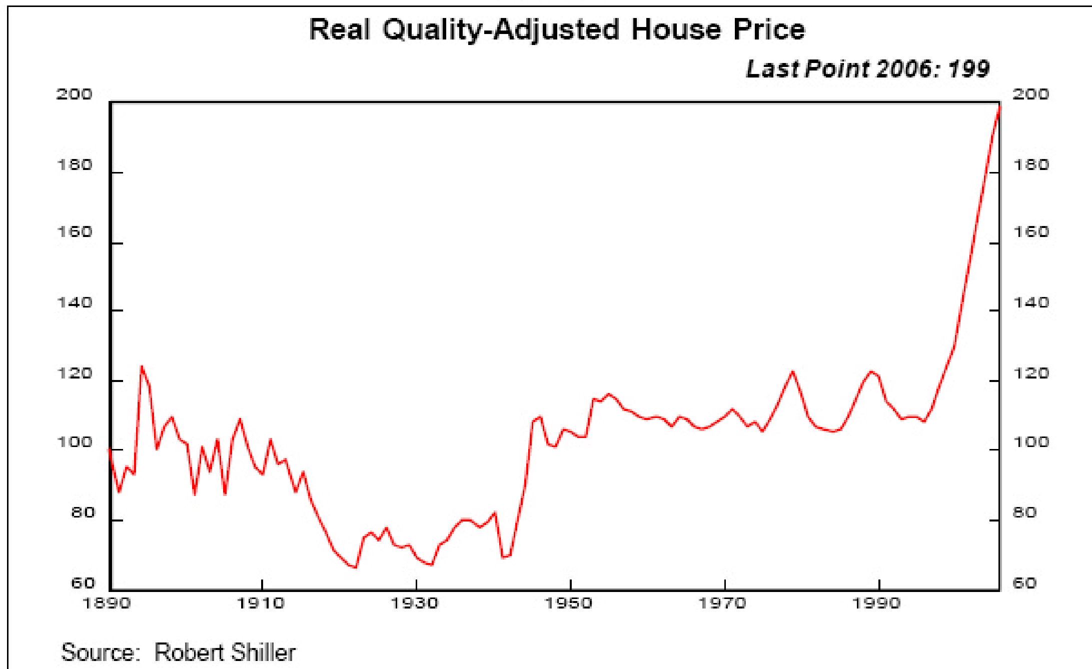
A Few Quick Thoughts on Housing

I look forward each month to getting friend Gary Shilling's newsletter, simply called *Gary Shilling's Insight.* Normally I read most of my letters right from the computer screen, but with Gary's work I have to print it out and move to the recliner to absorb it. This month's letter was one of his better ones, as he makes the case for a collapse in housing prices starting as early as the beginning of next year. I am not as bearish as Gary, but I agree that housing prices have come nowhere close to their final resting place. Gary ultimately sees a 25% drop in housing prices. Bet he doesn't get invited to many real estate conventions.

Let me quote a few selected paragraphs and show some charts from the almost 30 pages of work. (http://www.agaryshilling.com/)

"Even when the increasing size of houses—the McMansion effect—is excluded, inflation-adjusted house prices have jumped as never before in over a century (chart 2):

CHART 2



"What the bulls neglect is the normal lag between the drop off in house sales and the fall in prices that we've discussed many times in past reports. Initially, buyers move to the sidelines but sellers don't accept the reality that the market prices on their houses have fallen. They believe their homes are unique, and there's no daily price quotes to quantify their values. So when their neighbors sell at revoltingly low prices, homeowners can put their heads in the sand, arguing that it's a bad time of year to sell, but spring and a stronger market is coming; they have lousy brokers but will get others; their neighborhoods are temporarily out of favor but will revive. By the time they pull their heads out, prices often times revived. The lack of uniformity in houses prevents panicked sales, but a persistent lack of buyers eventually forces sellers' hands.

"How long will it take this time for house prices to nosedive? There are no historical cases of a national housing bubble collapse since adequate data became available in recent decades. What we can glean from regional cycles, however, suggests a two-year lag between the peak in house sales and the beginning of price collapse.

"But given the huge amount of speculation this time, the gap may be shorter, 1.5 years in our judgment. Since sales peaked in mid-2005, the big slide in prices might well commence roughly at the end of this year. And as builders and homeowners attempt to unload their properties while buyers evaporate, the months' supplies of new and existing homes will jump to the 8-10 month ranges.

"… The National Association of Realtors' surveys reveal that in 2005, 28% of all home purchases were for investment. …Over half of existing homes for sale are vacant, and worried speculators are putting an increasing share of vacant properties on the market."

As I have written in past letters, Mortgage Equity Withdrawal (MEW) has been a significant part of the story in consumer spending. It accounted for 4.1% of spending in 2005. If home prices do not rise, it is going to be harder to do MEWs. And if they fall?

We are just now beginning to see a real slowdown in new home construction, as homebuilders are finishing projects and homes that have already been started earlier in the year. This dropped 1% of off GDP last quarter, and it is likely to do even more in the coming quarters.

By the way, many housing bulls note the strong employment numbers and thus contend home prices cannot drop. But unemployment in Phoenix, as Shilling notes, is a very low 3.1% but housing prices are in free-fall. It is supply and demand, and there is an overhang of supply. With so many homes bought for speculation and unoccupied, either owners have to eat monthly costs or fold their tents and sell.

Add into the pressure the rising foreclosure rates from sub-prime borrowers getting hit with increased mortgage payments due to rising short-term rates, which means more homes on the market, and the housing "problem" is likely going to become a crisis. Prediction: It will be a big piece of the presidential campaign platforms next year.

The housing price futures market, based upon the Case-Shiller Housing Price Index, suggests a decline of 7.6% from June 2006 to August 2007. As the inventory of homes for sale grows, and as prices drop, watch that number go lower.

Fed to the rescue? Don't count on it. As noted above, the Fed may not be able to move until there is real evidence of a recession and inflation pressures recede.

The Return of Muddle Through

In January of 2002, I used the term Muddle Through Economy to describe my economic forecast for that year, which was pretty much on target. I argued in *Bull's Eye Investing* that this decade would be the Muddle Through Decade.

What did (and do) I mean by Muddle Through? Growth that is below the long-term trend of 3% for an extended period of time. My prediction four years ago (how time flies!) was that the average growth for this decade would be below 3%, with at least two periods of contraction. We have yet to experience the second period, but I think we may see that next slowdown/recession in 2007.

The last 3.5 years have seen almost 4% average growth, well above long-term trend. Muddle Through seems kind of silly to even think about in the last few years. That could change.

The Return of the Muddle Through Economy

If we get a drop in home prices and a recession, it will not just reduce consumer spending as a result of lower MEW. It will also have an effect on the psyche of consumers, as they realize they are going to need to save more for retirement.

The wealth that is needed to create a sustainable future income stream? A significant portion of this country has been counting on 10% annual home appreciation to contribute a large portion of that future potential income stream. And in recent years another large group has been counting on 15% annual stock gains.

What happens when they realize it is not going to happen? Denial is the first reaction. Panic. Anger. And then acceptance. As reality kicks in, the savings rate is going to rise. What is good for the individual (increased savings) will be hard for the economy. Consumer-spending growth rates are going to slow after this recession, at least for a while as adjustments are made. It will take some time to play out.

It will be the Return of the Muddle Through Economy. It will not be a period of no growth, just slower than trend. It will eventually give way to more robust growth, but right now it does not look like the next few years are going to see 3% average annual GDP growth. That is going to put increased pressure on corporate earnings, which are at all-time highs in terms of percentage of GDP. That will not be good for the stock market.

Of course, the vast majority of economists disagree with me. But then, most are driving by looking in their rearview mirrors. Let’s hope they are better drivers than I am. I would love to be wrong.

It’s already really late tonight, and I need to hit the send button. As it is, the letter will not be in your box at the usual Saturday morning time. I apologize. Take care and have a good week.

Your thinking I will buy a house next year analyst,

John Mauldin