# Ahead of the Yield Curve
# A Harbinger of Bear Markets
# Earnings Inflection Points
# Is the Yield Curve Inverting?
# London and Then Home

**By John Mauldin**

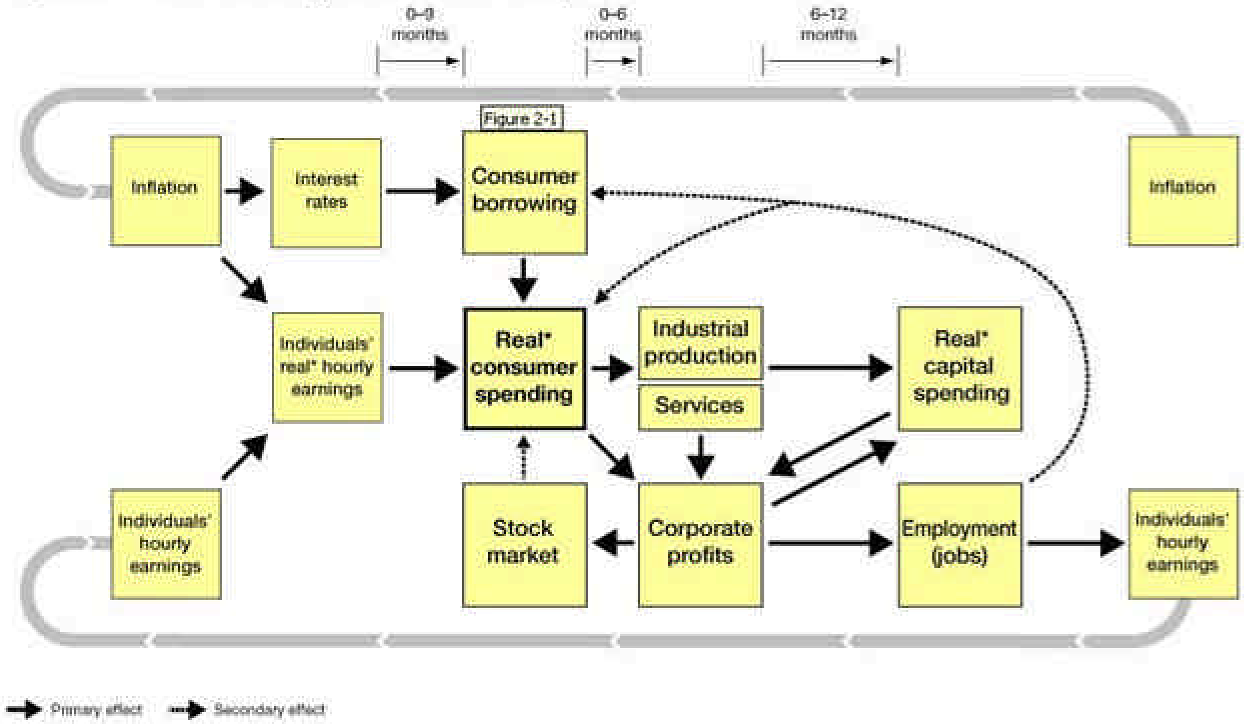
Last week we started a series on a very important book by friend Joe Ellis called **"Ahead of the Curve."** We continue this week looking at specific indicators that Joe thinks give us a heads up when the economy is about to slow down and the stock market will being a bear market. I am then going to marry those thoughts with some work on the yield curve, especially looking at what the yield curve may be telling us today.

Cutting to the chase, I am going to make an argument that it is high time for you to start thinking about taking a defensive posture on your stock market investments. None of the indicators we will be looking at give us anything close to exact timing, but there are enough red flashing lights to give us cause for concern about the direction of the market in the coming quarters.

First, let's review one chart from last week. This is the primary chart from Ahead of the Curve where Joe outlines how the business cycle works. You can see all the updated charts and a lot more by going to www.aheadofthecurve-thebook.com and click on them. If you are serious about investing in the stock market this is a must-read book. 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. Take advantage of the wisdom he is offering. www.amazon.com/curve

In Joe's view of the world, the business and stock market cycles are driven by real (after inflation) consumer spending. As we will see, once real consumer spending peaks, the economy is getting ready to slow down and the market is getting ready begin a bear phase.

Figure 2-1: The chronology of the economic cycle




Let's let Joe give us his explanation of the chart:

? Personal income - largely wages and salaries - is the primary driver of consumer spending, by far the largest sector in the economy. Credit and borrowing play a role, but if we can identify the most important indicators of spending power through wages, we have a shot at forecasting consumer spending.

? Uptrends and downtrends in consumer spending drive advances and declines in manufacturing and services.

? In turn, the capital spending sector of the economy, which includes companies' spending on plants and equipment, follows, like clockwork, the trend set by production and services, and consumer spending before them.

? These three sectors of economic activity – consumer spending, industrial production and services, and capital spending – represent the core of corporate profits produced in the United States, so the dependence of corporate profits on consumer spending is also clear.

? The stock market, which advances and declines as a sensitive predictive mechanism reflecting corporate profits, is therefore also tied closely to consumer spending at the front end of the cycle. This makes it easier to understand the sequencing of the stock market in this chain of cyclical events, with major stock market advances and declines tending to occur at similar points in successive cycles.

? Because business hire or fire workers based on the respective rise or fall of sales and profits, employment – jobs – follows rather than leads the economy. Mastering this fact is one of the core hurdles in overcoming emotional but erroneous reactions to economic news.

"In other words, consumer spending is dominant in the economy as a whole to such an extent that it is, by itself, the sector that cyclically determines the direction of the overall economy. This being the case, carefully monitoring overall consumer spending – or, even more significantly, forecasting the direction of consumer demand – is the key that unlocks effective forecasting for most other developments and sectors in the economy.

Joe's next point is that the obsession with recessions is misplaced. By the time we are actually in a recession, much of the economic damage has already been done. Let's look at this next chart. It is an analysis of various economic data before, during and after the economic downturn of 2000-2002. In his book, Joe looks at several other such downturns, but this recent one will do for our purposes here. As you look at the chart, the yellow area is the bear market and the darker area in the middle is the actual recession.

What do we find? The bear market began when GDP growth was still high, but was peaking. As an aside, the bear market did not really begin in earnest until the third quarter 2000. What we remember as the bear market beginning in March of 2000 was really the bubble of the NASDAQ collapsing. If you look at the average of the NYSE, which had little exposure to tech, it was only off by about 3-4% in September of that year, so the broader bear market began then. I have always maintained there was a difference between the tech bubble and the rest of the market going into a bear phase.

Thus, Joe's point about GDP peaking prior to the bear is even more poignant when viewed from that perspective. And we are watching GDP peaking now. Even though this quarter is likely to be higher than last, the trending average will be down. I still maintain that we will see an economic slowdown this year.

Second, and speaking to his main point, the bear market began as the rate of growth in consumer spending peaked and began to slow. Recently, we have seen real consumer spending begin to peak and slow down.

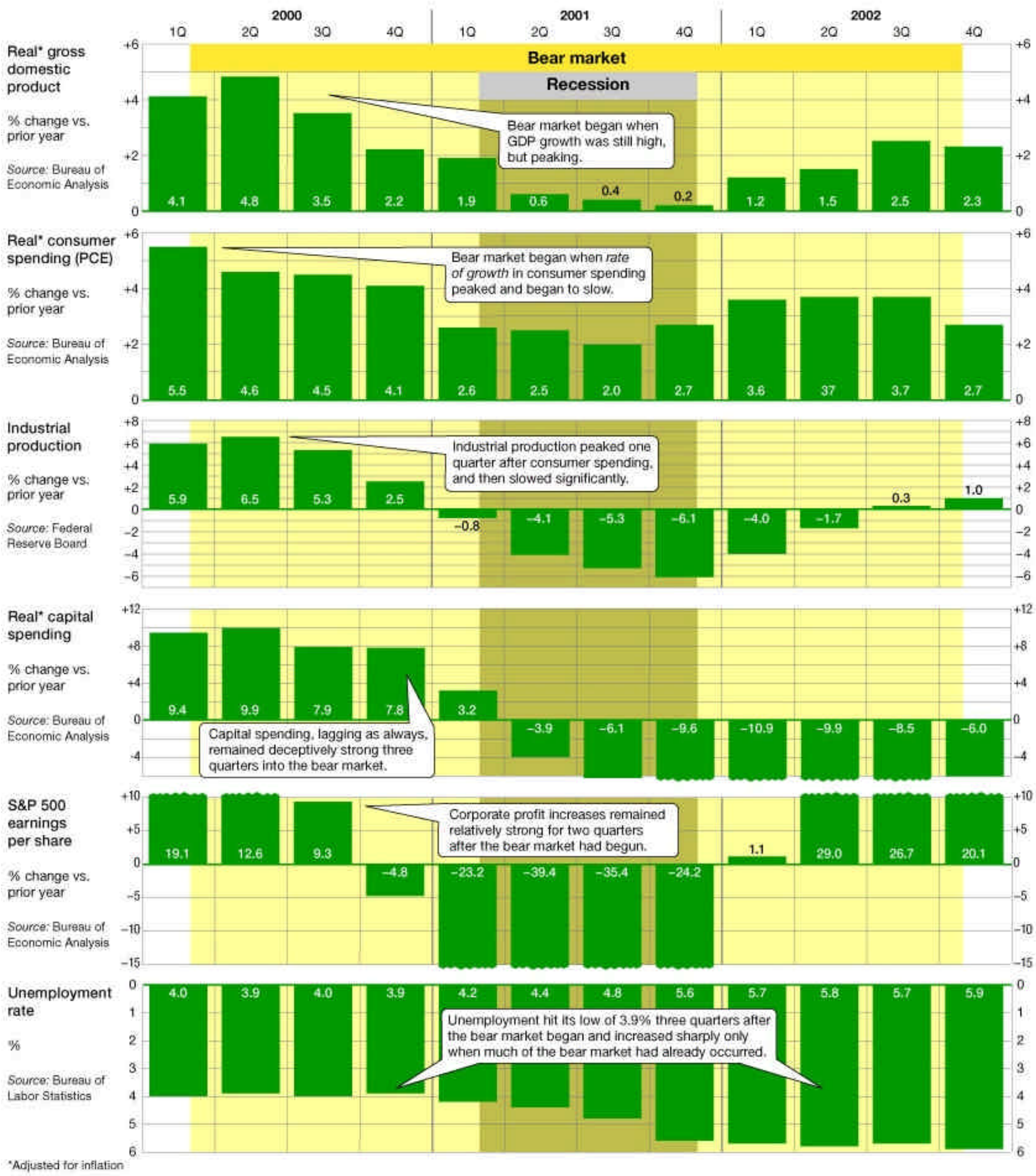
Industrial production peaked one quarter after consumer spending peaked and the bear market began. But capital spending remained strong for three quarters into the bear market and right up until the quarter before the recession started. The same holds true for corporate profits.

This is in concert with a theme that long-time readers will recognize. Bear markets start because of relatively small earnings disappointments. Not so much as to be alarming, but it starts a trend of slower earnings growth. I have written about several very convincing studies which demonstrate this. Investors project recent earnings trends well into the future. When earnings have been growing well over a period of several years, as they have been recently, stocks get priced to perfection. Management is not allowed to disappoint without getting punished, and we are starting to see that happen.

Finally, unemployment hit its low four quarters after the bear market began and peaked well after the recession was over. Basically, you cannot look at unemployment numbers as an indicator of a bear market. As an aside, today the unemployment rate dropped from 4.9% to 4.7%, the lowest since July 2001. OK, now look at the chart.

FIGURE 4-4

Key economic data in the 2000–2002 downturn



Joe also strongly emphasizes that looking at monthly or even quarterly data is not helpful. There is too much “noise” or volatility. The way to look at nearly all of these statistics is on an annual basis of change versus the prior year. Joe often even uses a three month moving average to further dampen out the volatility in the measures. It makes the inflection points just that much easier to see.

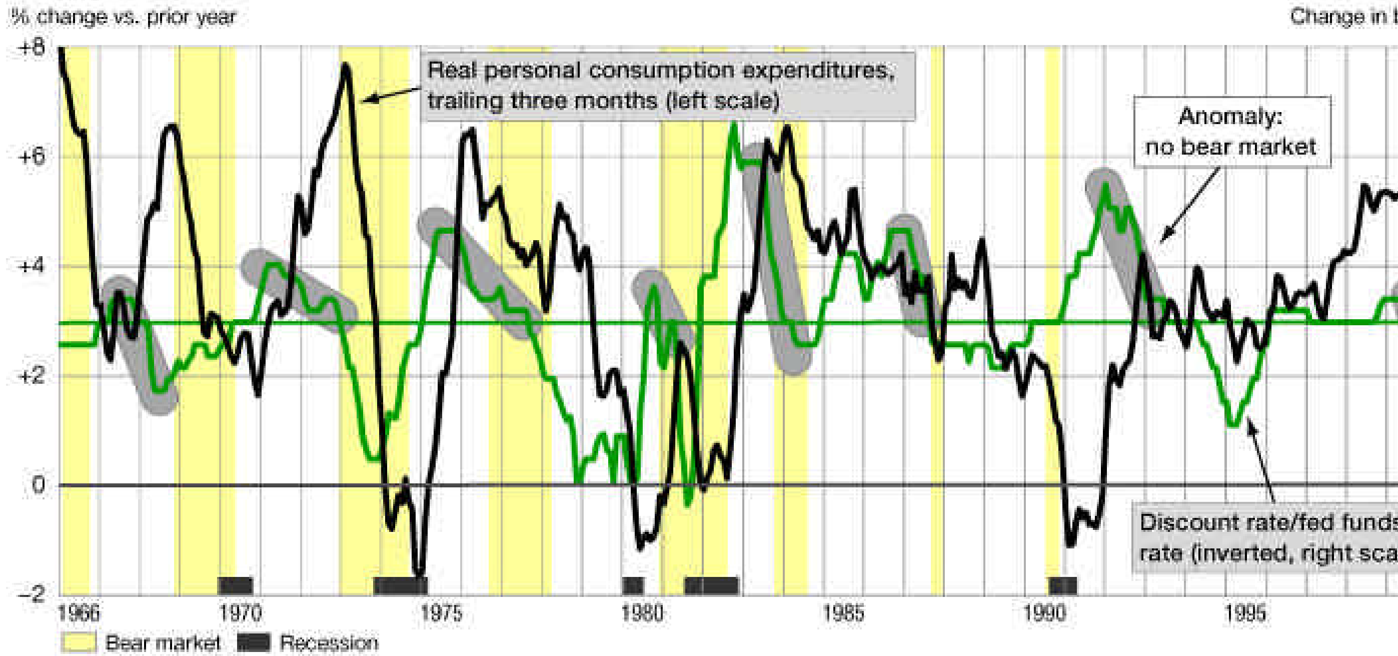
## A Harbinger of Bear Markets

Joe gives us another data point that often precedes bear markets and that is a rising Fed funds rate. For Joe it is not the absolute level of interest rates but the rate of change over a year that is important. In the chart below, he uses an inverted scale for interest rates and compares rising rates with real consumer spending. By inverting the table for interest rates, it makes the relationship easier to see.  The gray shading highlights the rising rates prior to a bear market. We see a bear market follow pretty much every period of rising rates except 1998.

Again, as I often note, the Fed seems to raise rates too far once it begins a tightening cycle. This chart illustrates that. Will the Bernanke Fed do it again? More on that below.

**FIGURE 13-2**

**Rising discount/fed funds rates: A harbinger of bear markets**




*We saw in chapter 8 that bear markets typically begin when the year-over-year rate of growth in consumer spending (black l to fall. As shown in the shaded ovals, rising interest rates (green line, inverted, right scale), because they have been effective consumer-spending slowdowns, also are an effective indicator of approaching bear markets (vertical yellow bars).*

*Sources:* PCE—Bureau of Economic Analysis; Discount/fed funds Rate—Federal Reserve Board
*Discount rate until year end 2000, fed funds rate thereafter

"…When we combine recession, as the wrong definition of economic harm, with quarter-to-quarter rates of change as the wrong method for measuring it, the result is confusion that obscures the real inflection points in the business cycle – when rates of change begin to turn."

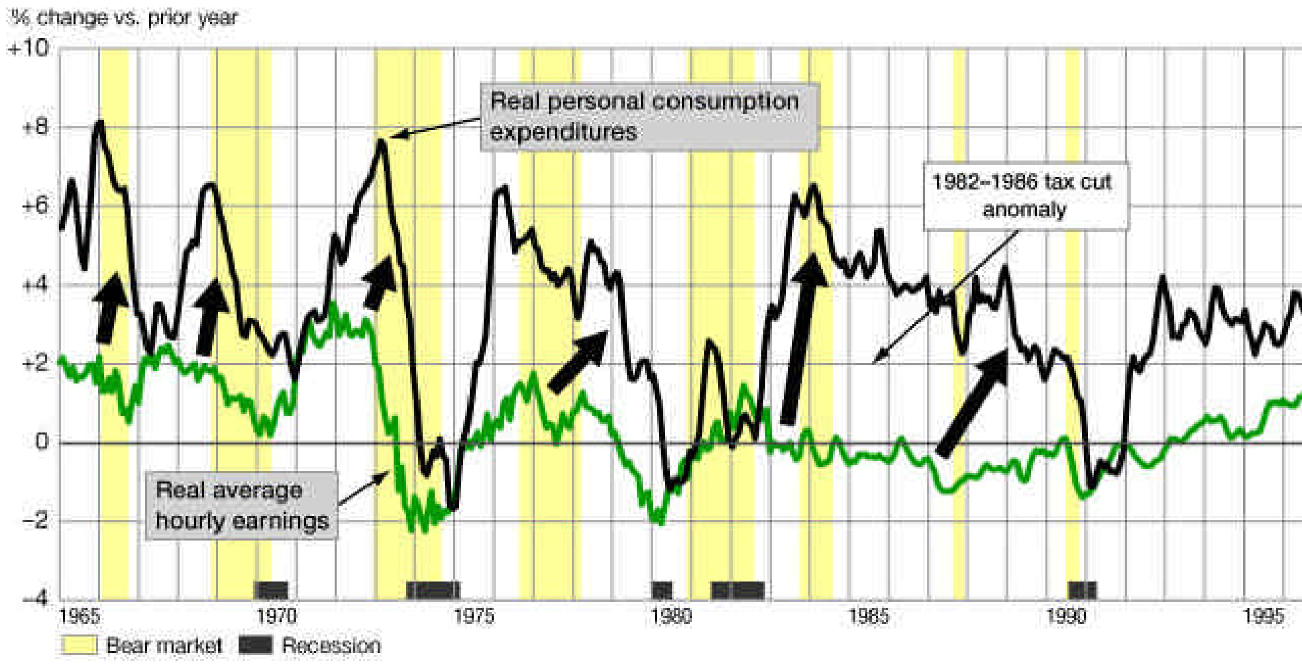
## Earnings Inflection Points

Real hourly average wages for the 4 months beginning in September are down. If you measure them as the percentage change over a prior year three month trailing average, the American worker is not doing all that well. The four number series is -0.37%, -0.58%, -0.46% and 0.02%. January will see a slight rise, and indeed today's number was good. We do not have the inflation number to give us real wages yet. But looking back over the last ten years, there is often a "bump" in January, so it is way too early to say the trend has changed. In fact, that is precisely Joe's point in many places in his book. You simply cannot take one month's data and extrapolate a trend and get anything useful. You simply cannot get focused on one month data. It is noise.

Look at this one last chart from Ahead of the Curve. It compares real personal consumption with real average hourly. Notice that earnings tend to peak before consumer spending does and that consumer spending peaks just as a bear market starts but long before a recession.

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-s 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, strong gains in consum earnings were an anomaly reflecting federal tax cuts in those periods.*

Sources: Earnings—Bureau of Labor Statistics; PCE—Bureau of Economic Analysis

Based on this data, we should be looking for a real economic slowdown later this year, and a bear market to start anytime. Maybe it starts this month and maybe in May. These charts and data do not give us exact timing, but they do urge caution.

## Is the Yield Curve Inverting?

Below is a chart from Bloomberg which you can find at http://www.bloomberg.com/markets/rates/index.html. It is close to the top of my favorite web sites list. The headings might be slightly off in my cut and paste. But the important thing is the graph. It is starting to invert further along the curve.

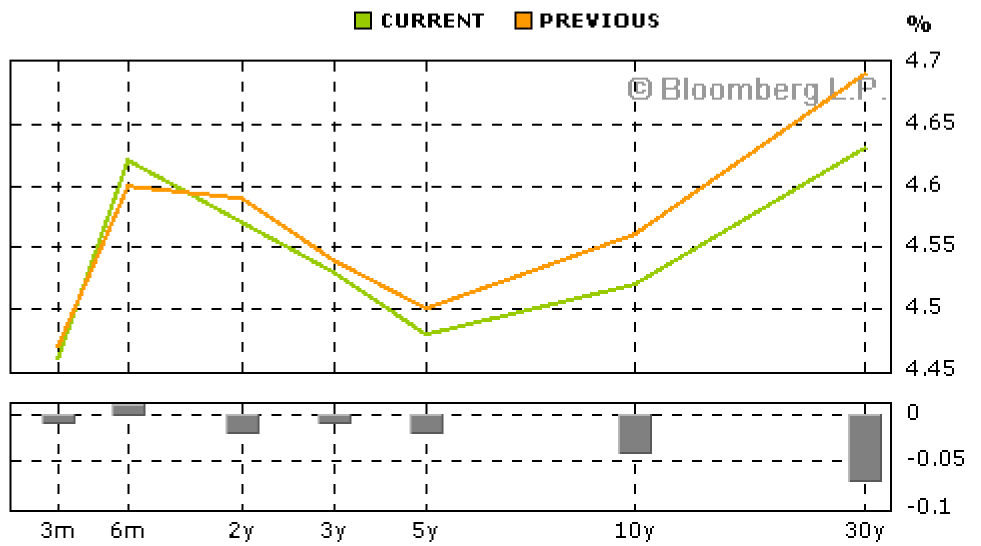
**U.S. TREASURIES**

**Bills**

| | MATURITY DATE | DISCOUNT/YIELD | DISCOUNT/YIELD CHANGE | TIME |
|---|---|---|---|---|
| 3-Month | 05/04/2006 | 4.35/4.46 | 0.04/-.012 | 02/03 |
| 6-Month | 08/03/2006 | 4.46/4.62 | 0.03/.019 | 02/03 |

**Notes/Bonds**

| | COUPON | MATURITY DATE | CURRENT PRICE/YIELD | PRICE/YIELD CHANGE | TIME |
|---|---|---|---|---|---|
| 2-Year | 4.375 | 01/31/2008 | 99-20¼/4.57 | 0-00¾/-.012 | 02/03 |
| 3-Year | 4.375 | 11/15/2008 | 99-18¾/4.53 | 0-00¾/-.009 | 02/03 |
| 5-Year | 4.250 | 01/15/2011 | 98-31+/4.48 | 0-03/-.021 | 02/03 |
| 10-Year | 4.500 | 11/15/2015 | 99-26+/4.52 | 0-10/-.040 | 02/03 |
| 30-Year | 5.375 | 02/15/2031 | 111-01½/4.63 | 1-03+/-.070 | 02/03 |




The green line is today's close. We see the ten year Treasury bond 10 basis points below the six-month yield. If the Bernanke Fed raises rated in March as seems likely, it is quite possible that we could see an inversion across the entire yield curve.

Next week we see the first auction for 30 year bonds in about 4 years. They are going to place $10 billion. I bet there is a great deal of interest in them, as new accounting rules are forcing pension funds to more closely match future liabilities and assets. This demand could actually force down 30 year rates. It will be very interesting to watch.

Of course, if that happens, the bulls will say it is the fault of the Fed for not offering enough 30 year bonds. And they may be right. But as noted many times, an inverted yield curve is the most accurate of all predictors of recession. I think we have to resist all the "this time's its different" crowd if that happens. When inverted yield curves happen, you need to start exercising caution in your stock market investments. The curve has not yet fully inverted. But this is precisely the way the yield curve acts before full inversion.

Now, it would not be unusual for the curve to correct and go back to "normal" before going to a full inversion. So, we cannot make anything but very preliminary assumptions. But as I wrote last December 30 as the curve started to invert we should pay attention. Now we should pay even more attention, especially as consumer spending may be peaking. Stay tuned.

For a fuller treatment of the yield curve, you can go to the archives and read the December 30 letter, or click on [http://www.2000wave.com/article.asp?id=mwo123005](http://www.2000wave.com/article.asp?id=mwo123005).

## London and Then Home

I travel to London at the end of next week for a few days meeting with my London partners (Absolute Return Partners) and to guest host on CNBC. Then I come back for about 10 weeks and start writing my next book in earnest. I am looking forward to being home and having more time to research and write. I am quite excited about this next book. I intend to explore how the world will change over the next 20 years. I am sure some of it will make it into the regular weekly column, as I can only write so much in any given week.

It is time to hit the send button. Tonight is later than the usual Friday because I made the rookie mistake of not saving my letter and hitting the delete key by mistake when I had almost finished. It was just dead and gone. We could not find a temp file with any of the remains. I had to start over at almost 9 pm. Ouch. Live and learn again. Rookie! Rookie! Rookie! Sorry to Doug Harrison who has to put this out before he goes to bed.

I am going to close this week with a letter from a reader, Mike Sullivan. It quite moved me and I asked his permission to share it with you.

"Dear Mr. Mauldin,

"I am a regular reader of your email letter each week. I have also read your book Bull's Eye Investing and enjoyed it very much. Someday soon I will pick up a copy of your latest book and give it a read - I am sure it is great!

"Your email this week really touched home when you mentioned your anecdote about living life in the present. 6 months ago I lost my wife of 12 years suddenly to kidney cancer. I never realized how much I lost until she was gone. My current situation leaves me taking care of 3 young children while maintaining my challenging job. My children are the apples of my eye, so to speak, and I only wish I could spend more time with them each day.

"You often mention how blessed you are with such a large family. Be sure to take your words to heart and enjoy your family as much as you can. One never knows when the unexpected will happen and change your situation forever. There were so many things my wife and I put off (trips, vacations, etc.) because it was never 'the right time'. Unfortunately, now there is no more time for us. I will not make the same mistake with the rest of my family. Be sure to take the time out of your busy schedule to spend time with yours."

Have a great week and let's spend more time with family and friends. That is where the time yield curve is the steepest.

Your going to learn to save everything from the start analyst,

John Mauldin