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By John Mauldin

The GDP data released Friday suggests the economy seems to be slowing. So naturally the stock market surges forward in a very strong move, convinced the bull market is back. After all, how can the Fed raise rates in a slowing economy? And if the Fed is not raising rates, then it follows, does it not, that the stock market will rise? Or so the logic of a 119-point rise, tantalizingly close to a new high for the Dow, seems to suggest. A review of the data says that may not be case, however. This week we take a look at the economy, housing, and inflation, with a view to pondering whether stagflation will return in earnest. It should make for an interesting letter.

But first, Andy Kessler's new book *The End of Medicine* that I wrote about three weeks ago seems to have struck a nerve, with both doctors and entrepreneurs. Feedback from readers is running quite positive, but with some very decisive disagreements from doctors denying that changes in medicine are needed or will happen, countered by enthusiastic entrepreneurs who are working on DNA detection chips, on blood tests to detect the likelihood of a stroke in the next year, and on imaging techniques to find all sorts of disease early. Andy tells me his feedback from the book is running hot, with some name calling from doctors but lots of business plans for early detection and even a few for next-generation eye surgery and stomach stapling. It's great to see that medicine is not a static business. No matter what the business model, there will always be entrepreneurs who seek out change, and we'll all be better off for it. I love to get your responses, by the way.

I highly recommend you read *The End of Medicine*. It is an easy plane-trip or afternoon read, but it will make you think and laugh while you do so. Andy is a great writer. If you did not read my review of the book you can do so here: http://www.2000wave.com/article.asp?id=mwo070706 (July 7 in the archives at www.2000wave.com) You can buy the book at www.amazon.com/medicine.

The Return of Stagflation

The consensus from economists was that GDP growth would be 3.2%. The actual number was 2.5%, down sharply from 5.6% in the first quarter. This drop-off is not as large as it might seem, as the fourth quarter of last year was only 1.7%. Let's look at the chart of annual changes since 2000, below. What you see is a much smoother sideways movement. The light gray bars are the quarterly numbers. (I picked this up from friend Barry Ritholtz.)

Econoday chart courtesy of Barron's

Why the big move in the first quarter? I think we can see the culprit in Katrina. Enough economic activity was moved from the fourth quarter into the first to show the huge differential. The economy was not as bad as the numbers looked in the last quarter of last year, or as good as it looked in the first quarter.

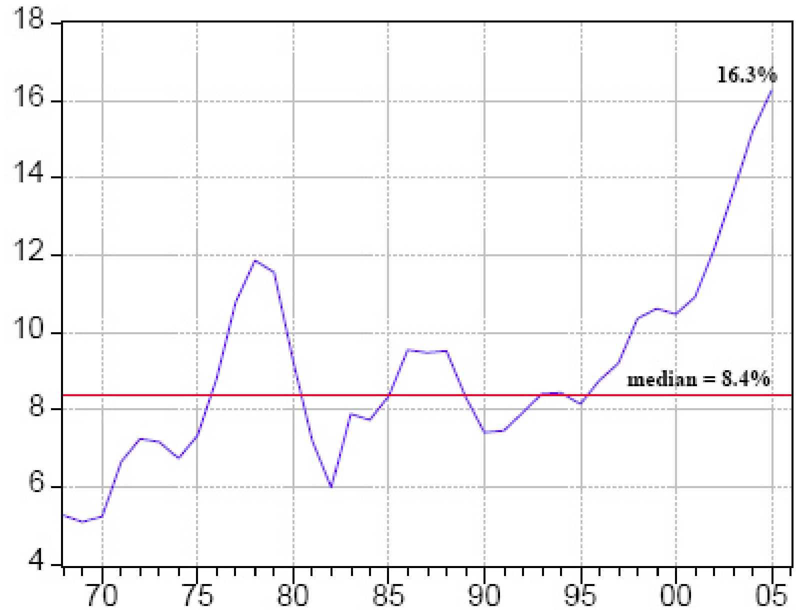
Nevertheless, this quarter is below the annual trend. It was certainly below the consensus forecast. Can we expect further slowing in the coming quarter? If so, will the Fed finally pause? More importantly, should they pause? Let's look at a few facts and then see how you would vote if you were on the FOMC.

The Housing Market Leads the Way

As I noted last week, in their *Quarterly Review and Outlook*, Van Hoisington and Lacy Hunt give us a few facts and graphs that are not all that optimistic. The Leading Economic Index (LEI), as compiled by the Conference Board, has now contracted over the past six months. They note this has happened 13 times since the Korean War, and we had outright recession after 9 of those periods and serious economic slowdowns followed the other 4 episodes. As they are bond managers, they also note that both long-term and short-term rates fell in the aftermath of all 13 slumps.

One of the key components of the LEI is new housing starts. The ever astute Paul Kasriel of Northern Trust notes that it might be even more important this time. Why? Because housing has become a larger component of the economy. Look at the chart below:

Dollar Volume of Single-Family Home Sales* / Nominal GDP
percent



* combined new and existing home sales

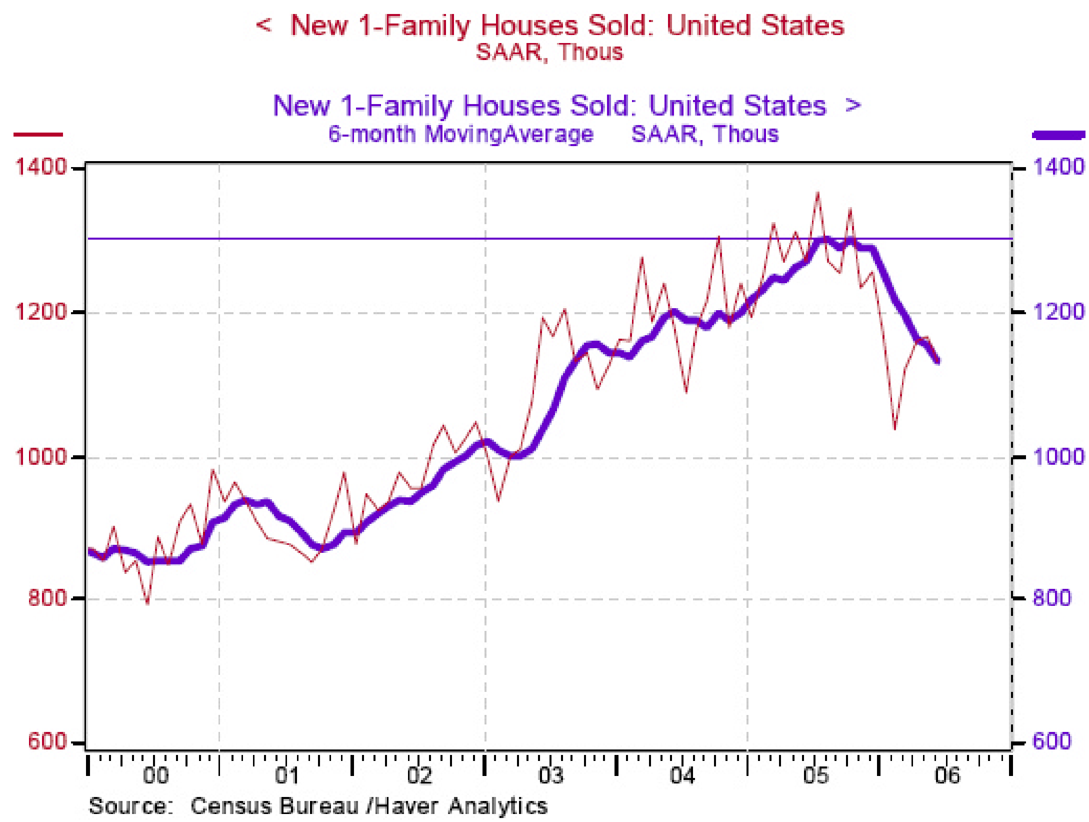
Obviously, we are way above trend. Part of this can be explained by the explosion in home prices, but a lot is from actual new home sales made possible by creative mortgage financing. With real estate construction being one of the three legs of the economy, it is something that we must pay attention to.

One could make a good argument that the above chart is mean reverting. That is, that the percentage of sales to GDP will fall back toward the mean. Now, that most likely will be a rising number, and not 8.4%. The 8.4% median takes into account a lot of very low numbers in the early years. If you take the above chart and draw an imaginary trend line trying to hit the center of the growth, you get a number that should be in the 12-13% range. And since I do not have the data on a Friday afternoon to do the actual trend line, an imaginary line will have to do.

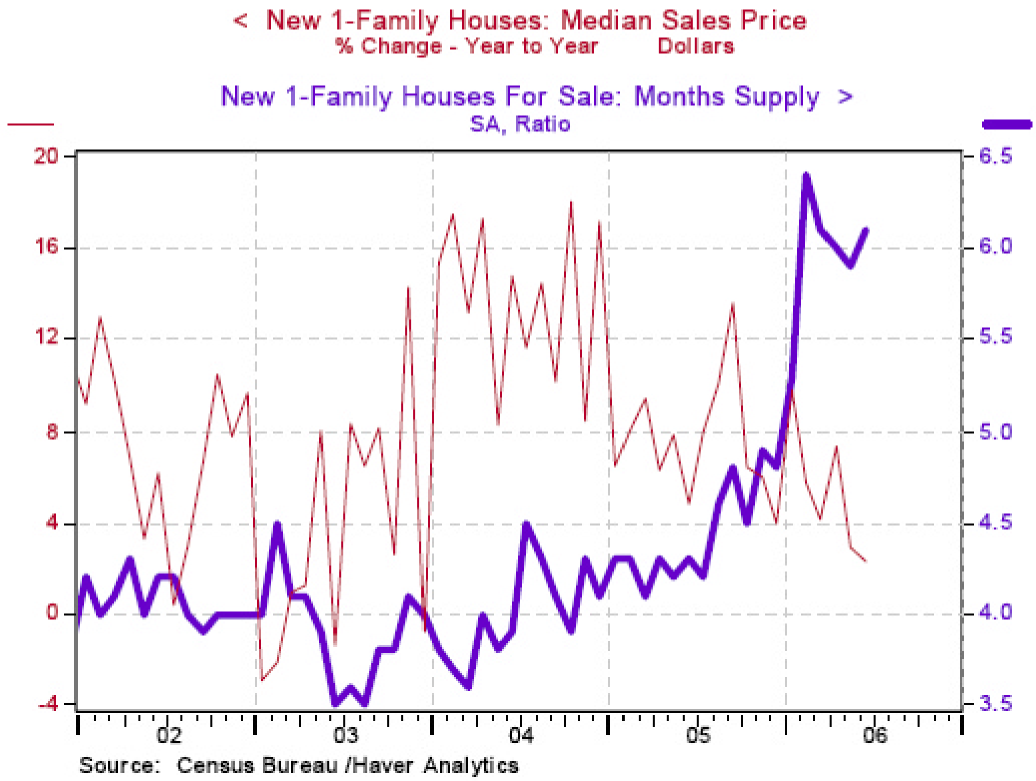
But that is good enough for the point of the argument. If actual sales drops back to something like 12-13% of the economy, that will be a significant hit to new home construction. Jas Jain (of Financial Sense University) estimates a reversion to a lower total sales trend line could result in a loss to GDP of 3% from the highs in 2005. This is by no means trivial. Add to that the 1.5% (estimated at various sources) that cash-out refinancing adds to the GDP, and you could see an economy slow significantly over the coming year as home values stop rising.

And stop rising they have. Kasriel follows up the chart above with these thoughts and charts:

"Sales of new single family homes fell 3.0% in June to an annual rate of 1.13 million units. The 6-month moving average of sales of single-family homes is down 13.1% from its peak in October 2005 (see chart 1). Sales dropped in the Northeast (-11.3%), Midwest (-7.9%), South (-6.0%), but rose in the West (+8.2%). The housing sector is on the top of the Fed's watch list. Today's new home sales numbers would be an entry on the list of indicators supporting a pause at the close of the August 8 FOMC meeting.



"The median price of a new single-family home dropped 1.3% during June to $231,300 from the prior month. On a year-to-year basis, the median price rose only 2.3%, a sharp deceleration after double digit gains in many months of 2004 and 2005. As the inventory of unsold new single-family homes advanced to a 6.1-month supply in June, up from a 4.3-month supply in June 2005, the year-to-year gains in the median price of a new single-family home posted a deceleration in prices (see chart below). "



Sales of New Homes - June 2006

	Sales mom change	MedianPrice yoy change	Inventory months supply
Jan-2006	-6.83%	9.8%	5.3
Feb-2006	-11.51%	5.7%	6.4
Mar-2006	8.00%	4.1%	6.1
Apr-2006	3.48%	7.4%	6.0
May-2006	0.52%	2.9%	5.9
Jun-2006	-3.00%	2.3%	6.1

Unsold inventories of new homes not only have interest costs but property taxes as well. As interest rates rise to home builders, the cost of carrying that home is starting to loom large. We are already seeing increasing incentives from home builders to move inventory. It will not be long before we start to see price decreases.

Higher energy prices, including gasoline, are having an effect on consumer spending. Not since the first three months of 1991 have home construction, consumer spending on durable goods, and corporate purchases of equipment and software all declined in the same quarter.

The futures market went from setting the probability of a raise at the August 8 Fed meeting of over 90% to 28% this morning. (I must admit, I would be in the 28% thinking they will still raise rates.) So, the market thinks the Fed will look at the gloomy sounding data I mentioned above, plus a number of other negative factors, and pause in August.

In essence, they are making the assumption that because the economy is going to slow inflation will slow as well, and that the Fed will not be worried about inflation. If you are not worried about inflation, and the economy is slowing, it would make sense not to raise rates and maybe to start talking about lowering them in the future.

That ’70s Show

But the data I look at tells me something different. The government’s personal consumption expenditures (PCE) index, a measure of prices tied to consumer spending, rose at a 4.1% rate after a 2% rise in the first quarter. The index excluding food and energy, a measure favored by Fed policy makers, rose at a 2.9% annual rate after a 2.1% rise the previous quarter.

Let’s review. The economy is materially slowing and inflation is materially rising. We’ve seen this TV show before. It’s called “That ’70s Show.”

It is quite possible for the economy to slow and for inflation to rise. It happened in the ’70s and it happened last quarter. If you look at inflation that is in the pipeline, it could easily happen this quarter. You can make a case, as the clear majority of the market obviously believes, that a slowing economy will tame inflation. But I am not sure a central banker will buy it.

Let’s return to a theme I am sure may be boring long-time readers, but it is important. When you get appointed to the Federal Reserve, you are taken into a back room and given a DNA transplant. You now have two new genes. One that makes you viscerally fear deflation and another that causes you to hyperventilate when inflation gets too high.

Let’s assume that the core PCE inflation is actually the Fed’s favored measure of inflation. A materially rising PCE is not something you like to see. And the recent monthly data from the Bureau of Labor Statistics confirms the rise. They peg inflation at 5.1% in the second quarter versus 4.3% in the first quarter. They have inflation less food and energy for the last six months at 3.2% and all items at 4.7%.

Where’s my WIN button? Some of us are old enough to remember the Whip Inflation Now buttons of the early ’70s. Remember when Nixon set price controls because inflation got to the nosebleed level of 4%?

Gentle reader, this last quarter we are back to the level that caused Nixon to act (even if foolishly). Oddly, the market looks at 4% inflation and sees nothing but smooth sailing. And just as much of inflation was induced by energy costs in the early ’70s, much of what we have today is from the same source. Excluding energy does not make sense when it is the main driver of inflation. For the last six month, energy costs rose 22.8%.

The absolute worst environment possible, from a central banker’s point of view, would be for inflation to continue to rise. At some point, even if the economy is slowing, you would have to step in and fight inflation. You simply can’t risk a rerun of the ’70s. No one wants to be forced to “pull a Volker” on the economy. Now those were real recessions when he forcibly bled the inflation out of the economy in the early ’80s.

It is all about an obscure statistic used by central banker types called the sacrifice ratio. How much employment and growth do you sacrifice today in order to not have to deal with problem inflation in the future?

The sacrifice ratio is high today. That means the dangers of rising inflation are such that you should risk a slower economy rather than allow inflation to gain a foothold. And at 4%, inflation has not only gotten a foothold, it has started to move into the living room. The sacrifice ratio, which Bernanke has written about and is a leading authority on, says the Fed will raise rates in August. Or at least should.

Last week, I was graciously invited by David Kotok of Cumberland Advisors to go on his annual fishing trip up in Maine. There were a number of financial types there, and the conversation naturally turned to Fed policy, among other things.

Kotok, who is one smart economist, thinks the Fed will raise rates in August and then pause, but inflation will not go away and then the Fed will have to get serious later in the year or early in 2007, even as the economy is weakening. That will be a real recession. He is not optimistic, to say the least.

I think the Fed will look at the inflation numbers that will come out in August and September and then make a decision. If inflation is still rising, they will have no choice but to raise. They are dealing with the problems of too much stimulation in the latter part of Greenspan’s years, which is just now catching up. (As an aside, much of the current board is composed of newer members.)

If the Fed pauses in August, it will only be because they think the economy is going to slow down much faster than it already is. I do not see how that can be good for the stock market. And if they raise rates yet again, they indicate that they are going to maintain the fight on inflation, until inflation and then the economy do in fact slow down. I just don’t see how that is a good environment for the stock market.

One caveat: inflation data is by definition backward looking. If the Fed decides to ignore the rear-view-mirror rise in inflation and trust a slowing economy to handle the future inflation problem, it will be something new. Maybe this current crop of Fed governors only got the deflation-fighting gene. We will know in less than ten days.

The bond market reacted by lowering rates across the board. Bond traders sense a slowing economy. The yield curve remains inverted. If (when?) the Fed raises rates, it will start to significantly invert. That means the statistical probability of a recession next year rises. This is something we are going to pay close attention to. I may be able to dust off my old August, 2000 e-letters where I suggested the yield cure would have us in recession by mid-2001.

Remember that August six years ago? While the NASDAQ was still down huge, the NYSE index was only 3% from its all-time high and the S&P was not far behind. The economy seemed to be doing very well. Calling for a recession and a bear market seemed rather risky, but the data said it was the right call. We are on the cusp as to whether we see a full recession next year. I think a real slowdown is likely. As an aside, Dennis Gartman, who I really respect, thinks we see a material slowdown this year. Stay tuned.

Fishing, Rangers, and Betting on the Economy

As I mentioned a few weeks ago, I am not lucky when it comes to fishing. But David Kotok was kind enough to invite me to Maine and allow me to bring my youngest son. We had a professional guide named Bobby Bacon who has been guiding since 1952. He knew every spot on Grand Lake. We fished a lot of them. There were 22 guys on this trip; two to a canoe plus a guide. Some of them caught well over 50 fish in the two days we were there.

Alas, my luck followed me. I caught four smallish perch and one small trash fish of dubious provenance. However, 12-year-old Trey caught about 25 fish and a few rather nice-sized bass. He had a lot of fun putting his hook where I had not been able to catch anything for an hour and almost immediately pulling in a fish. He had a blast, and the other members of the trip were very gracious to us. It was a lot of fun.

As an aside, on Saturday night everyone gathered to wager on how the economy would fare over the next year. Basically, it was $5-10 on a particular item. This was a group with a wide variety of viewpoints. The average call for the DOW next summer is 11,442, with the high being 13,000 and the low 8900. I was the low, for what that's worth.

The group expected the dollar to fall to 132 against the euro, Fed funds to be at 5.38, the ten-year bond to be a 6.2% (still inverted!!!), and oil to be at $65. Next year, we will see who the winners are. Closest to the actual number gets the pots.

Writing today was a pleasure. As long-time readers know, I have an office physically in the Ballpark at Arlington where the Rangers play. You can walk out on my balcony and watch the game. My "seats" are closer to home plate than some center field seats. It is a great grown little boy's office.

Today, some of the Rangers came out for early batting practice. Practically no one was in the park. It is so quiet at such times, with the silence being punctuated by the solid crack of a wooden bat. You can hear it even through the thick windows. There is something about that sound that brings a smile to the soul. The Rangers traded Milwaukee for a solid outfielder today (Carlos Lee). Giving up our head-case relief pitcher was the major plus, though. Now if we can just figure out how to get some pitching, maybe we can make the play-offs.

It is time to hit the send button. Have a great week and take some time for family and friends. Solid relationships are something that inflation cannot take a bite out of.

Your can't believe the Yankees swept us again analyst,

John Mauldin