A Kinder, Gentler Mr. Market?

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By John Mauldin

The market, my various mentors have all told me, is designed to cause the most pain to the largest number of people. And while I am not in pain, the recent move up in the various market indices is certainly not in keeping with my thoughts that the economy is going to slow down and thus should exert downward pressure on the equity markets. Has the world transitioned to a kinder, gentler Mr. Market? One who views investors with compassion and encouragement? Has he truly turned over a new leaf, and this time promises to be different? Should I simply smile and be patient or throw in the towel and buy the Vanguard 500? And is the stock market really all that good at predicting the direction of the economy?

This week, we look at a few random ideas, throw out a few thoughts on China, comment on oil and analyze today’s inflation data. The good news for long-suffering readers is that this letter should be briefer than usual, or that is my intent as we start out. Let’s see how it ends.

Rounding Out Inflation

Inflation, we are told, was just 0.2%, whether or not you took into account energy and food. That seems like a nice drop down from the well over 3% we have been seeing. But the number is a “strong” 0.2%. What the actual number came in at was 0.2423%. Rounding took it down to the “2” handle. Annualized that is 2.9% inflation. Still higher than a central banker would like, but definitely in the right direction from the last few months.

There are a few cynics who might actually suggest there might have been some effort on the part of the Commerce Department to keep it slightly under the 0.25%, thus not having to round up to 0.3%, which would have been a Rolaids moment for a lot of traders. But if you can’t trust government inflation numbers, then what government statistic can you trust?

Note that energy was up a mere 0.3%, and gasoline was up 0.2% in this survey. That means that next month’s report of September energy is likely to be down for the month, as gasoline is down 15% or so around the country from its highs and more than 20% in a lot of places like my back yard. Funny, it was just a few years ago I thought $2.29 a gallon was outrageous. Now I am happy to find it so low.
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Bottom line: the Federal Reserve got a number they should like and a trend to lower inflation may be in place. One more number like this one and it may be time to call the Fat Lady in to sing her “no more rate hikes” aria.

But that begs the question, where is the next move in interest rates?

**The 6/50 Rule**

Ed Easterling of Crestmont Research (http://www.crestmontresearch.com/) tell us that in the past 35 years (with a two-month exception), there has not been a 6-month period during which interest rates somewhere along the yield curve did not change at least 50 basis points. Interest rates are much more volatile than most investors realize. As history demonstrates, more than half of the time, interest rates change by more than 1.5% (and over 25% in percentage terms) over all 6-month periods.

So, where are rates likely to move 50 basis points in the next six months? The ten year is at 4.79%. Are we likely to see either a move below 4.29% or above 5.29%? For the higher yield to occur, we would have to see a resurgence of inflation or the economy bouncing back strongly. Right now, that does not seem to be in the cards.

What would make longer term rates fall 50 basis points? I think you would need more than a slowdown. You would need a recession for rates to drop back close to 4%.

What about the short end of interest rates? The 6 month is at 5.1%. If the economy starts to slow, the Fed could actually cut rates early next year, which could easily give you a 50 basis point move lower in the short end. I think this is more likely to be where the real interest rates moves are likely to be.

**Soft Around the Edges**

While inflation did indeed come in softer, the numbers which accompanied the inflation numbers also showed that the economy is also softening. Industrial production slowed, capacity utilization and manufacturing output all dropped, as well as utilities generation. The announcements from Ford and Daimler Chrysler this week showed that auto sales, if your name is not Toyota, are soft.

Barry Ritholtz noted that while headline August retail sales were touted as strong, the Census Bureau, which gives us the numbers, includes the sales of used cars, boats, RVs, etc. If retail sales were all that good, would Ford and Chrysler be talking down future guidance? Barry also gives us these thoughts:

“In the past 16 Federal Reserve tightening cycles, there has been one true soft landing in 1994. I continue to look at that not as impossible, but as a low probability event…. My largest present concern is oil and other commodity prices. It’s no coincidence that gas, oil, gold, aluminum and copper all have dropped at the same time. I read that as signs of a global slowing in demand.”
I agree with Barry about natural gas and copper, but a drop in energy prices has been building for months. Supplies have been building up as storage has been getting harder to find. As I have said, it would not surprise me to see oil prices drop below $60 a barrel, and perhaps much lower for a short period, as the price of a barrel of oil that can’t find a quick home will drop pretty fast.

OPEC has made it clear that they would cut supplies in order to hold the price in the $60 range. Can they do it? They all cheat on their quotas, so maybe not if we see a global slowdown. But that would only be a temporary setback. Long term, as world demand for energy of all types will grow, oil prices are going to rise. The easy money in energy stocks has been made. Now it is time for the hard road.

And this statistic from Paul Robinson: What happens when you have 3-plus years without a 10% correction in either the S&P 500 or DJIA? On March 15th, 2006 the market sustained three full years without a substantial sell-off from a six-month high. This long a bull run has occurred only three other times in the past 100-plus years of market history and led to an average decline of 18.5% between the three occurrences.

In summary, I think it is too early to throw in my bearish towel. A slowdown means that earnings are not going to grow as fast as current projected. That means some disappointments may (will?) be coming our way in the next few quarters.

Disappointments are the stuff that makes for bear markets. Can we come to the end of a Fed tightening cycle with no pain? A Kinder, Gentler Mr. Market? Now that would be different.

The Following chart comes from good friend Matt Blackman writing in the EquiTrend Weekly Market Watch. I think most of you will find it useful. It is a very nice visual picture of the how the economic market typically cycles. New cycles are never identical to the previous one, but there is a rhythm. Falling interest rates often signal (trigger?) the expansion phase and rising rates eventually starts the contraction phase. We would now be at 3 o’clock on this illustration.
China Steps on the Brakes

China is stepping on the economic brakes, but it will be interesting to see if they actually work. There are 2,600 major construction sites in Beijing and over 200,000 capital construction projects nationwide. Manufacturing capacity has been doubling every 3 to 4 years, accompanied by constant price destruction in many sectors.

The Chinese economy is growing in the 10-12% range, and perhaps more as much activity probably goes unreported. There is nothing wrong with strong growth, but there is legitimate concern about growth that is not actually market based. The Chinese government is concerned about too much capacity in too many industries, as well as real estate speculation.

Every local government has had access to cheap money. So, they build more factories with little view to markets and profits. As Simon Hunt notes from a recent trip to China:
“In our travels around Shandong province we came across a prime example. A local government company decided in 2000 to construct a power station and a copper tube plant. We cannot comment on the feasibility of the power plant, but it was quite clear from our visit that the ACR tube plant with a capacity of 60kt/a will never make a decent return on capital, let alone will lenders ever get to see their money back.

“Not content with one white elephant the company is building a sheet/strip plant with a capacity of 100kt/a and a capex of US$250 million, using all imported equipment, just to add to the circa 1.5MT/a of new capacity being built in China. Our discussions also showed that they had not undertaken a rigorous market study prior to starting to construct. Power stations, tube and sheet/strip mills have all been fashionable projects; and China is a land of fashion followers.”

How many such projects are there? The central government has laid down rules designed to make it more difficult to build projects which are not economically rational. But the local bureaucrats have ignored the rules. Beijing is starting to crack down. Some 100,000 projects, initiated since the beginning of the year, are under investigation. 40% of these violate at least one rule, and 14% or actually illegal.

Conveniently for the central government, a large number of local bureaucrats are due to be replaced (through retirements or elections). Look for their replacements to be more loyal to the central government.

Beijing is not trying to stop real infrastructure growth. The concern is excess capacity, which leads to deflationary pressure. Directing all this from a central government is a mind boggling task, and one about which I must admit I harbor doubts as to how it will actually work. But so far…?

The government has stated that its objective is to bring down the growth of Foreign Direct Investment (FDI) from the plus 30% in the first half of the year to 20% by year-end. Both monetary and administrative measures will continue to be taken until this goal is in reach. That is a big drop and is already being seen in construction activity, according to a report just issued by Jonathan Anderson of UBS.

How? Among other things, the government has taken back the ability of local bureaucrats to approve land sales. If you can’t buy the land, you can’t build the factory. Adherence to the rules is being aggressively pushed, with strong messages coming from the very top leadership. Plus, in the past few weeks, we have seen some very difficult new positions. Foreign businesses cannot sell land and repatriate their capital. Limits on how much (or even if) foreign firms can invest in businesses in certain sectors, some of which seem to clearly violate WTO rules, at least from this side of the Pacific.

That being said, the Chinese government has affirmed they will meet their WTO obligations to open up their banking sector to foreign firms, although the rules they are adopting will make it expensive to do so.
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All this gives rise to even more protectionist rhetoric from both the left of the Democratic and the right wing of the Republican parties. They demand that China revalue the Renminbi by 30% or so immediately. Such verbalized political garbage may play well to the home crowd, but it makes no economic sense. Exactly why do these politicians want Americans to pay 30% more for their Chinese imports? Such a move would cause a deep and severe recession in the US, not to mention China. Let’s see if we can really destabilize the world. Idiocy.

The Chinese will continue to do what they have done for years, and that is to act in their own best interests, just as every other nation does. And it is in everyone’s interest that they slowly move to a free floating currency, which it evidently seems they are doing. As strong as the Chinese economy is, it is more fragile than it appears. A shock of a quick 30% adjustment in currency valuations would precipitate a deep recession in China. That is something the world does not need.

It will truly be a miracle if the Chinese can avoid a recession over the next few years, as all economies eventually succumb to the normal business cycle. But unless the government makes a large blunder, it will be just like the next recession in the US. It will pass and then the growth will resume. The Chinese government is managing a very difficult transition, that from a centralized socialist economy to a market driven economy. For all the problems, from this seat I think they are doing better than any of us could imagine 10 years ago. Yes, they have a long way to go, but they have come a long way. If they can continue down the path they are on, it will accrue not only to their benefit, but to the world’s advantage.

Meet me in New Orleans and $600 NYC Hotel Rooms

One of the really great investment conferences every year is the annual New Orleans Investment Conference. Originally started by the late Jim Blanchard, the conference has a strong gold contingent, but has expanded to cover a wide range of themes. Last year, the conference had to be rescheduled because of Katrina, but this year it is back and looks to be better than ever.

In addition to yours truly, they have lined up Steve Forbes, Jim Rogers, Marc Faber, Dennis Gartman and Newt Gingrich, plus scores of other well-known speakers, workshops and private sessions. If you register before October 1, you can save $300 on the full price and half off for a friend or spouse. I hope to see you there. Click on the link for more information. (You have to use this link to get the special rate.)


I will be in New York Monday and Tuesday. If there is a slowdown, it is not evident in New York City hotel prices. I am being forced to pay $600 a night for a regular room at a regular hotel. Not a suite. Nothing special. They wanted $800 (plus
taxes) at the Essex. Staggering. It was only a few years ago I could find a very nice room and maybe a suite upgrade for under $300 and sometimes under $250. The BLS must not include New York hotels in the CPI data.

And I am sure they do not include the affect on productivity of the extra lost time at airports as a result of the recent terrorist attempts in Britain. This week was my first time to fly since that event, and it is even more of a hassle, as now you must check luggage even for short hops. I cannot fathom why they cannot get the approved traveler program done and quicker lines.

The Mauldin clan (my seven kids, that is) is gathering tomorrow, though this time the occasion is a somber one. My daughter-in-law’s father, who was younger than I am, passed away suddenly this week. At times like this, it does make one realize how tenuous a lease on life we have, and how precious the moments with friends and family are. It will add a bit of poignancy to our time together.

Have a good week, and I hope you can enjoy the fall (or spring in the southern part of the world) weather. I think I will hit the send button and enjoy a baseball game before heading, as my dad would say, to the wagon yard.

Your wondering where the excitement in travel went analyst,

John Mauldin