

ECONOMIC RESEARCH

July 2001

Synopsis:

Our approach to the economy is unusual in not attempting to interpret Fed policy in order to determine changes in earnings or GDP growth. Instead, we created a set of Boom Indicators based upon the path of key financial series through all 5 previous New Eras. These key fundamentals have anticipated developments the Fed is responding to on an ad hoc basis.

This doesn't include the standard economic series and our approach to stock and bond policy is directly based upon the Indicators and, at expected trend changes, seasoned technical research. In anticipating major changes in investment performance, this has been remarkably reliable.

Although "the economy" is only ancillary to our more direct approach to investment decisions, our work on the business cycle was appropriate in identifying the top near the start of 2000.

TRACK RECORD

January 1, 2000: Turn Of The Decade Study

From the 1870s to the 1980s, there have been 12 decade-ends and a business contraction of varying severity closely followed 11 of them. Essential to this, of course, has been a strong expansion going into the window of the turn of the decade.

February 7, 2000:

As the yield curve turned towards inversion, the Street rationalized it as due to policy and therefore benign. We looked at it as the traditional warning and noted that since the 1850s "**whenever the curve inverted, a recession has inevitably followed**". This was the feature of a February 7th special report entitled **An Important Transition** (Yield Curve and Credit Spreads). This concluded with "**The ratio of risk to reward no longer merits a full commitment to equities. Fixed income managers should minimize exposure in lower grade securities.**"

May 5, 2000:

"In all five [New Eras], the recession started virtually as the bull market ended. The wealth effect turned quickly to the dearth effect."

February 23, 2001:

This edition of **Pivotal Events** included the following review:

The Economy:

We are usually reluctant to discuss the typical series that are so tediously covered by Wall Street economists. This includes housing starts, unemployment, GDP, etc. Our view is that if it doesn't have a board lot, high, low, and last trade, it's unreal. In normal times, the stock market leads the business cycle by some 10-12 months so even during conventional conditions it was difficult to make money in the stock market by studying the "economy". Typically, rising economic numbers kept investors too long into a bear market and then, with some irony, poor numbers kept them out in the early stages of the next bull market. In such conditions, to be brutal, economic studies are misleading.

These are not normal times and, at the end of every financial mania, business activity has declined almost immediately with the failure in the stock market. In most cases, the contraction began rather dramatically. (This was one of our hypotheses made as our research was completed in 1980.) In this case, near the end of a new financial era the conventional set of leading indicators should be changed. The stock market component should be removed from "leading" and placed within the "coincidental" set of indicators.

In moving away from non-trivial academics, the business slump is rapid and seems in line with previous post New Era contractions. As noted on December 15, under these conditions Greenspan will be permitted to lower administered rates frequently until the contraction ends. Also mentioned was that it is dangerous to be confused about cause and effect. As a rule, short rates for senior obligations in the reserve currency rise during the boom and then decline during the contraction.

Boom Indicators:

The behaviour of the key financial series has been similar on the way up each financial mania and then similar in the transition to each contraction. The main ones make up our Boom Indicators, which reached their maximum reading (+12) at the beginning of 2000. These reversed to a warning some 6 weeks before speculation blew out in March. These continued their negative trend such that our May 5, 2000 Pivotal Events introduced our Recession Primer. By June 9, the Indicators had turned negative at -1 and we began the Recession Watch. On June 23, 2000, this observed that if the Indicators remained at that barely negative level for a few months a recession would be inevitable. Since then, the reading declined to -9 in January 2001, from which, with gold's breakdown, it has improved to -8.

Bob Hoye
Editor & Chief Investment Strategist
www.InstitutionalAdvisors.com