MORNING BRIEFING
September 24, 2012

Leading & Misleading Indicators
(1) Fed chatter never ends. (2) Fisher vs. Bernanke, Evans, and Kocherlakota. (3) Despite high-powered models, Fed is clueless. (4) A shortage of money isn't the problem for employers. (5) ECRI: There they go again seeing a recession. (6) False alarms and top secrets. (7) Composite indicators can go rogue. (8) Our own formula is no secret. (9) Bad geopolitical vibes and bad global economic indicators. (10) The case for sector neutrality. (11) "Trouble with the Curve" (+).

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The Fed. Why can't they all get along and leave well enough alone? The members of the Federal Open Mouth Committee (FOMC) are already yapping away about what they should or should not do after implementing "QE3 Forever" less than two weeks ago on September 13. A few are already pushing for "NZIRP Forever." (NZIRP = near-zero interest rate policy.)

On September 20, FRB Minneapolis President Narayana Kocherlakota said the Fed should target the federal funds near zero until unemployment falls below 5.5% as long as inflation doesn't exceed 2.25%. Previously, he tended to side with the FOMC's hawks. Now he is even more liberal than FRB Chicago President Charles Evans, a super-dove who has been advocating NZIRP until the jobless rate falls below 7%. Evans can declare victory since that seems to be the new policy implied in the 9/13 FOMC statement, though Fed Chairman Bernanke denied during his 9/13 press conference that there is a specific unemployment rate that is being targeted.

FRB Dallas President Richard Fisher, an outspoken critic of the Fed's unconventional monetary policy easing programs, is not a voting member of the FOMC this year. However, he undoubtedly lashed out at QE3 Forever during the latest meeting of the Fed's policy-setting committee. He shared his dissident's views with the public on last Wednesday, September 19, in a speech before the Harvard Club of NYC.

His most sarcastic punch line: "We are blessed at the Fed with sophisticated econometric models and superb analysts. … The truth, however, is that nobody on the committee, nor on our staffs at the Board of Governors and the 12 Banks, really knows what is holding back the economy. Nobody really knows what will work to get the economy back on course." It was a not-too-subtle dig at Fed Chairman Ben Bernanke's recent Jackson Hole speech, in which he claimed that the Fed's econometric models confirmed that the Fed's previous unconventional policy measures had worked to boost economic growth and lower the unemployment rate, though the jobless situation remained "grave" by his own admission.

Fisher went on to observe that small and medium-sized businesses, "the wellsprings of job creation," are hesitant to expand their payrolls at a more normal faster pace because of regulatory and fiscal uncertainty, not tight credit (*Fig. 1* and *Fig. 2*). Big business, which accounts for much of capital spending, is also stymied by the same concerns and is using NZIRP as an opportunity to borrow cheaply in the bond market to buy back stock rather than to expand. The positive wealth effect on stocks is more than offset by the weakness in capital spending, in Fisher's opinion. I agree.

US Economy. Meanwhile, on September 13, the folks at the Economic Cycle Research Institute (ECRI) reiterated their prediction that despite everything the Fed has been doing to revive economic growth, the US economy is already falling into a recession: "For the U.S., the economy is recessionary despite all of the extraordinary efforts by the Fed over the past four years. In that sense, one might argue that, as far as the economy is concerned, the Fed's actions have become increasingly ineffective. The plunge in the velocity of money to record lows tells us that the Fed is pushing on a string--so no matter what they do there will only be limited traction. Basically, the recession has to run its course."

While I agree that the Fed's policies have been counterproductive, as argued by Fisher, I'm not at all convinced that the economy is falling into a recession as argued by the economists at ECRI. Indeed, I expect that the recent recovery in the housing industry should help support economic growth through next year, albeit at a slow pace. If so, the Fed's QE3 will undoubtedly get some credit, even if undeserved, since it is focused on pushing mortgage rates to fresh record lows.

The ECRI's most widely followed business cycle indicator is their Weekly Leading Index (WLI). It has actually been turning up in recent weeks. Yet the ECRI's 9/13 statement noted that "a couple of years ago" the WLI had provided a false signal of a recession, but they "flatly and correctly rejected that interpretation." In other words, ignore the WLI and only pay attention to the predictions of ECRI's wizard behind the curtain. Here are a few more observations about the ECRI-WLI along with some comparisons of it to our homegrown YRI-WLI:

(1) *False alarms.* While the ECRI-WLI is highly correlated with the Conference Board's monthly Leading Economic Index (LEI), the former has been much more volatile since late 2008 (*Fig. 3*). It has given three false recession alarms since then, though the Conference Board's Coincident Economic Index remains on an uptrend (*Fig. 4*).

(2) *Top secret.* The components and methodology of the LEI are publicly available. The ECRI keeps its formula for the WLI a deep secret. However, there are only so many weekly indicators available for constructing such an index including a few that are financial ones, specifically the S&P 500 and the high-yield corporate bond spread (*Fig. 5* and *Fig. 6*). Both of these indicators are highly correlated with the ECRI-WLI. Both are currently signaling continued economic growth, not an imminent recession.

(3) *Going rogue.* The ECRI specializes in creating proprietary business cycle indicators. They have had some good calls. However, my experience with leading economic indicators is that they have a tendency to go rogue and are then recalled by their handlers for a fix. That usually entails dropping or adjusting a misbehaving component. The new improved index then replaces the has-been index and is shown to have done a much better job of predicting the past! The Conference Board has been very public about these occasional fixes to its monthly LEI.

(4) *Open book.* I've asked our consultant on such matters, Sailesh Radha, to work with me on constructing weekly leading and coincident economic indicators, a.k.a. YRI-WLI and YRI-WCI. Our version of the WLI includes four weekly indicators: the S&P 500, the high-yield corporate spread, the CRB raw industrials spot price index, and initial unemployment claims (inverted). It is highly correlated with the ECRI-WLI, but tends to amplify that index's swings (*Fig. 7*). It's been swinging higher in recent weeks.

We also compile a weekly coincident index. Our current version of the YRI-WCI has just three components: railcar loadings, electricity output, and petroleum products usage in the US. Our WLI tends to lead our WCI (*Fig. 8*). Our coincident index hasn't been rising as smoothly as the Conference

Board's monthly CEI. Ours surged in 2010, stalled in 2011, dipped during the first half of 2012, and rebounded in recent weeks. It remains below last year's high. (To receive updates of our *Weekly Composite Economic Indicators* click ★.)

Geopolitics and Global Economy. Financial contagions tend to spread. Economic messes tend to spread as well. While European leaders are still struggling to clean up their Euro Mess, it continues to weigh on their economies. That's depressing Europe's imports from the rest of the world. China's economy, which is very dependent on exports, is slowing significantly. China's leaders seem to be fomenting anti-Japanese demonstrations over some disputed islands in the South China Sea to distract their people from the nation's economic and political problems. The tension between China and Japan threatens to disrupt trade between the two, which is bad for both their economies.

The US economy is still growing, but a slowdown in revenues and earnings growth from abroad is bound to weigh on domestic capital spending and hiring by US companies. As noted above, many of them are already hunkering down as a result of the burden of rising government regulations and uncertainty about taxes and the dreaded Fiscal Cliff.

The Global Mess could get much messier if push comes to shove in the Persian Gulf. This morning, my friend Robert Hardy, the informative publisher of *The Geostrat,* notes that Iran is recalling Special Forces units from overseas as their commander warns of war with Israel. Robert writes: "Something has occurred to cause Iran to change its estimation of the likelihood of an attack, because at a news conference held in Teheran … on Saturday, September 22, [Iran's top General Mohammad Ali] Jafari said that Israel will eventually back up its threats and attack Iran. We note this is the first admission by Iran that armed conflict is likely." Meanwhile, last week, the Israeli Defense Force began surprise live-fire war games on the Golan Heights. Officially, the Israeli military is practicing combat readiness to repel a possible sudden attack from Lebanon-based Hezbollah.

None of these developments are good for global economic growth. China's preliminary M-PMI came in at 47.8 for September. That's the eleventh consecutive reading below 50. China's stock market swooned again last week down to the lows of early 2009 (*Fig. 9*). France's M-PMI dropped steeply to a 41-month low of 42.6 in September from 46.0 in August. This morning, we learn that Germany's Ifo business confidence index fell from 102.3 in August to 101.4 in September, the lowest since February 2010 (*Fig. 10*).

Asset Performance & Allocation. This morning's *WSJ* features an article titled, "Managers Take Timeout From Stocks." The story notes: "As 2012 heads to its final quarter, money managers who caught the year's rally are sitting on percentage gains well into the double-digits on stocks. As they look ahead to what could be a choppy few months, some are considering watching the rest of the year from the sidelines."

I still think there is more upside, with the potential to retest the S&P 500's record high of 1565.15 on October 9, 2007. However, I'm not as confident of that as I was in achieving my target of 1450 before the end of this year. So cashing in some of this year's gains so far is appealing given the litany of geopolitical risks discussed above. In addition, while the US economy should continue to grow, it is likely to be weighed down by continued weakness in the global economy.

In any event, our sector-neutral recommendation still makes sense given that Risk-On cyclical sectors alternately outperform Risk-Off stable sectors when central banks pump more liquidity and underperform when global economic indicators disappoint.

Movie. "Trouble with the Curve" (+) (link) stars Clint Eastwood as an aging baseball scout for the Atlanta Braves. He doesn't talk to any empty chairs, though he is losing his eyesight in the movie. But at the same time, he is finding out how to get closer to his daughter, whom he neglected when she was growing up. One of the messages of the film is that computer models can't beat common sense. I hope Ben Bernanke goes to see the film and gets this point.

CALENDARS

US. Mon: Dallas Fed Manufacturing Survey 0.5, Chicago Fed National Activity Index, Williams. **Tues:** Consumer Confidence 64.8, S&P Case-Shiller HPI (20-city) 2.3% m/m/0.5% y/y, FHFA House Price Index 0.8%, Richmond Fed Manufacturing Index -4. (Bloomberg estimates)
Global. Mon: Germany Ifo Headline, Current Assessment, and Expectations 102.5/111.0/95.0. **Tues:** UK Nationwide House Price -0.6% y/y, German Consumer Confidence 5.9. (DailyFX estimates)

PERFORMANCE & ASSET ALLOCATION

Global Stock Markets Performance (*link*): The S&P 500 fell 0.4% last week, ranking in the middle of the 41 stock markets we monitor in a week when 17 markets rose. The S&P 500's performance last week led most of the major MSCI indexes--MSCI Emerging Asia (-0.2%), MSCI EAFE (-0.4), MSCI Word (-0.5), MSCI Europe (-0.6), and MSCI Emerging Latin America (-1.0). The S&P 500's 7.2% gain so far in Q3 trails the 9.0% rise for MSCI Europe, but is ahead of the other MSCI indexes. Year to date, the S&P 500 (16.1) is well ahead of the leaders of the major MSCI indexes, MSCI World (12.3) and MSCI Europe (9.8). With 38/41 markets up ytd, the S&P 500 ranks a better-than-average 11th.

S&P 1500/500/400/600 Performance (*link*): How did the S&P cap groups perform last week? LargeCap fell 0.4%, but beat SmallCap (-1.6%) and MidCap (-2.0) for a fourth straight week. So far in Q3, SmallCap (7.3) is slightly ahead of LargeCap (7.2) and MidCap (6.8). The qtd sector leaders: SmallCap Telecom (16.5), MidCap Energy (14.0), and SmallCap Materials (11.7). Year to date, LargeCap is the new leader (16.1), ahead of SmallCap's 15.2% gain and MidCap's 14.4% rise. The sector winners ytd: MidCap Health Care (28.7), SmallCap Consumer Discretionary (24.3), and LargeCap Tech (23.6). MidCap Energy is the worst performer ytd with a decline of 1.9%, but Utilities predominates among worst performers: LargeCap Utilities (0.1), SmallCap Utilities (1.7), and MidCap Utilities (2.5).

S&P 500 Sectors and Industries Performance (*link*): The S&P 500 fell 0.4% last week for its third decline in the past five weeks as seven of the 10 sectors and 81 of the 129 industries moved lower. Financials fell 2.4% and was the week's worst sector performer. The best were Telecom (2.4%), Health Care (1.8), and Consumer Staples (1.2). The S&P 500 is up 7.2% so far in Q3 with 9/10 sectors up, led by: Energy (11.2), Tech (9.6), and Consumer Discretionary (8.8). The laggards so far in Q3: Utilities (-2.5), Consumer Staples (3.7), and Industrials (4.2). The S&P 500 is up 16.1% ytd, with all 10 sectors up. The ytd sector leaders: Tech (23.6), Telecom (22.4), and Consumer Discretionary (21.9). The ytd sector laggards: Utilities (0.1) and Energy (7.4).

Commodities Performance (*link*): Three of the 16 commodities that we follow rose last week, down sharply from 13 gainers the prior week. The top-performing commodities last week were all metals-based: Lead (up 1.2%), Zinc (1.1), and Gold (0.3). Fourteen of the 16 commodities have risen so far in Q3, led by Silver (25.3), Lead (22.7), Wheat (21.4), Heating Oil (15.8), and Brent Crude Oil (15.7). Stainless Steel (-12.3) has performed the worst qtd. Prices are up ytd for 12 commodities--double the six that rose for 2011 as a whole. Wheat (37.5), Soybean (35.3), and Silver (24.0) are leading in 2012 to date, while Stainless Steel (-24.9), Cotton (-21.6), and WTI Crude Oil (-6.0) are bringing up the rear.

Assets Sorted by Spread w/ 200-dmas (*link*): How are stock indexes and commodities trading relative to their 200-day moving averages (200-dmas)? Spreads between the prices and 200-dmas fell last week for 16/19 commodities, 8/9 global stock indexes, and 36/44 US stock indexes. Fourteen of the 19 commodity indexes are now trading above their 200-dmas; commodities' average spread tumbled to 4.8% last week from 7.4%. Seven of the nine global indexes trade above their 200-dmas, the same as a week earlier. The average global index spread fell to 2.1% from 3.2%. Forty-three of the 44 US stock indexes now trade north of their 200-dmas, up from 33 seven weeks ago; but their average spread fell to 6.8% from 8.2% in the prior week.

Commitments of Traders (*link*): What were Large Speculators doing in the futures pits on September 18? They were slightly bullish on the S&P 500 and bullish on the 10-year Treasury Note. They had a slightly bullish position in the US Dollar (after being very bullish in recent weeks) and a significant bearish position in the Euro (though less so than in recent weeks). They were very bullish on the Canadian Dollar and on the Aussie Dollar. They were bullish on the Pound and the Yen. They were also very bullish on Gold. They had near-record bullish positions in Crude Oil and Soybeans. They are rebuilding their already still sizable net long position in Gasoline.

US ECONOMIC INDICATORS

US Leading Indicators (*link*): The Index of Leading Economic Indicators (LEI) edged down 0.1% in August after a 0.5% gain and a 0.5% loss the prior two months (following an up-and-down pattern since April). Five of the ten components contributed positively, five negatively--deterioration from seven positively in July. The biggest negative contributors matched those of the prior two months: ISM new orders index (-0.17) and consumer expectations (-0.15). The biggest positive contributors were the interest rate spread (0.17) and stock prices (0.12). The Conference Board's Ken Goldstein notes, "The economy continues to be buffeted by strong headwinds domestically and internationally. As a result, the pace of growth is unlikely to change much in the coming months. Weak domestic demand continues to be a major drag on the economy."

US Coincident Indicators (*link*): The US economy is growing at steady pace according to the Coincident Economic Indicators (CEI). The CEI increased in August for the fourth time in five months, rising 0.9% over the period to a new cyclical high. Three of the four components also achieved new cycle highs. Real manufacturing & trade sales was the biggest positive contributor (0.09pps) again, climbing in seven of the last nine months. Real personal income (excluding transfer payments) increased for the ninth straight month, up 0.3% m/m and 3.1% over the nine months. Nonfarm payroll employment was up again in August (0.1%); it hasn't declined since June 2010. Industrial production fell for the first time in five months (by 1.2%) after a four-month gain of 1.5%.

Philadelphia Fed Survey (*link*): Manufacturing activity in the Philly Fed region contracted again in September, though at a slower pace. The Philly Fed's current activity index increased to -1.9 after falling steadily from +12.5 in March to -16.6 in June. It was the fifth straight reading below zero. The new orders index climbed for a third straight month from -18.8 to 1.0 (the first positive reading since April). The shipments index (-21.2) dropped to its lowest since April 2009. The current employment index improved from -8.6 to -7.3, but was the fourth negative reading in five months. The average workweek was -7.3, up from June's three-year low of -19.1. The outlook is brighter: The futures activity index jumped from 12.5 to 41.2, with most indicators up sharply.

GLOBAL ECONOMIC INDICATORS

OECD Leading Indicators (*link*): OECD's composite leading indicators (CLIs)--designed to anticipate turning points in economic activity relative to long-term trend--indicate that the loss of momentum is likely to continue in most major OECD and non-OECD economies. The OECD total CLI edged down to 100.2 in July, a low for the year. CLIs are still pointing to a slowdown in Italy, China, India, and Russia, and continued weak growth for the Euro Area, France, and Germany. Latest reports show a moderation in growth (above trend) for Japan and the US and below trend for Canada. CLIs for the UK and Brazil are tentatively pointing to a pick up in growth, though both remain below trend.

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