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"History does not repeat itself," said Mark Twain, "It rhymes." That observation has a great deal of truth in it. Lately, however, economic history has been more like the cacophonous poetry of the Beatnik generation than the smooth resonating sounds of classic iambic pentameter.

Today we are going to look at interest rates, and see if we can find a rhyme or a reason as to why long term rates are going up and bonds are taking a dive. We'll look at what this means for the economic recovery, and see if we can find some profit potential.

There is a real correlation between interest rates and inflation, or at least inflation expectations. This makes sense, as investors want their bonds to give them a real return over inflation. Typically, 30 year bonds have been about 3% over inflation. Today there is a 4.7% spread. Overall inflation is dropping, yet long term interest rates are rising. What gives?

At the root of the issue is the clear belief by a majority of the investment world that inflation will once again be an issue and that the Fed is going to raise interest rates much higher than your intrepid analyst thinks should be warranted.

Inflation Around the Corner?

This can be illustrated in two ways. Today, the Eurodollar interest rate swaps, used by sophisticated investors and institutions to hedge their interest rate risks, are projecting an increase of 225 basis points (2.25%) in the Fed funds rates in the next 12 months, which would be a 25 basis point increase at every meeting for the next year.

In my opinion, the only way that would be warranted would be if the economy truly did take off. Yet, in the recent Fed statement, there was nothing in their release that indicated a willingness or even a need to reign in an overheating economy. In fact, the statement seemed to be that while the economy is recovering, there is nothing to suggest that the recovery will be robust. This is NOT a Fed which is inclined to kill a slow recovery in the beginning with rate hikes, not to mention what it would do to the stock market.

However, average investors believe inflation is coming back as well. Inflation was 2.6% last year, and just 1.1% for the last 12 months. It is clearly trending down, and most economists think inflation will fall from last year. However, the spread on TIPS (or Treasury Inflation Protection Securities) shows that investors think inflation will rise. Caroline Baum points out "the difference between the yield on the 10-year Treasury inflation protection security and the nominal 10-year note has moved out by 50 basis points in the last two months to 202 basis points." That is a large move, and clearly indicates that investors are fearful of inflation.

Why? The recent economic data seems to suggest that we will be in for a reasonably strong recovery on the order of 4-5% growth per year, if you listen to the cheerleaders on CNBC, and it seems much of America does. If the economy were to actually grow at this level, it probably would cause inflation concerns at the Fed, who would rapidly raise interest rates in response.

Further, growth of that magnitude would suggest that inflation could be in the 3% range, or slightly up from last year. As an investor, if that was your inflation expectation, it is not unreasonable to ask for a current 5.8% interest coupon on your 30 year government bond.

Thus, we have what seems to be a disconnect. Interest rates are rising even as inflation is currently low. It is expectations that drive the market.

The reality is that CPI (inflation) doesn't seem to be an issue. The Future Inflation Gauge of the Economic Cycle Research Institute recently plunged to its lowest level since August 1975. "Thus," concludes Anirvan Banerji, director of research at ECRI, "inflation pressures remain at generational lows, pointing to subdued inflation in 2002." (Grant's)

Inflation for the last 12 months was 1.1%. Inflation for the last nine months has been less than 0.1%. That is one/tenth of 1%. That means that the entire amount of inflation generated in the last 12 months was in the first three month period, and really was in March and April of 2001.

Unless inflation comes roaring back in the next 2 months, we will see a one year CPI number with a "0" in front of it in May of this year. We have not seen that low a number for many decades.

Could inflation come roaring back? The bond vigilantes tell us "yes," and here's how: Single-family housing starts rose to their highest level since 1978 in February. The strength in housing was evident in today's consumer price index for February as well. Shelter costs, which make up 31.5% of the CPI and 40% of the core CPI, rose 0.5%. The three-month annualized increase of 5% is the biggest in 11 years.

We have watched gasoline prices rise 15% so far this month. Energy makes up a big component of CPI.

In spite of this and rising medical costs, the rest of the inflation picture was mostly benign or down, making for a mere 0.2% rise in February. But the bond vigilantes, those intrepid investors always on the lookout for inflation, rightly point out that “core CPI” rose 0.3%. That sounds bad to investors, as 0.3% a month would be about 4%+ inflation per year.

Slicing and Dicing the CPI

But let’s slice and dice this a little further. Is inflation really in our future?

A large part of the rise in core CPI was tobacco, which had a one time rise in federal excise taxes. Take it out and you are back down to 0.2%. So, not really much there.

If mortgage rates continue to go up, will housing remain as strong as it has been? The answer is a simple no. We have already seen a sharp drop-off in mortgage refinancing in the last few months, which has been a real source of consumer spending.

That means two things. Housing prices will soften and the economy will slow as housing construction dips. The main source of inflation will moderate or even go away for awhile.

The Federal Reserve Bank of Philadelphia said manufacturing activity in the U.S. mid-Atlantic region posted a third straight month of growth in March, but factory activity declined from nearly two-year peaks seen in February. This will probably be reflected in other Fed regional reports as they are released as well. Things are good, but not that good.

Companies continue to report poor earnings, and while investors clearly expect earnings to rise, company after company tells us that they remain skeptical about large earnings growth. Without earnings, you will not see a resumption of capital spending that is necessary for solid economic growth.

Almost the entire recent rise in GDP is from inventory rebuilding, as inventories did drop during the last recession. But this is a short term phenomena, unless consumer spending and business capital spending takes off. However, the consumer is maxed out on his credit, and will do good to maintain the current high levels. Capital spending shows no sign of the real level of growth necessary to jump-start an economy to 5% growth levels.

If you are a foreign corporation doing business in the US, it has been a disaster. Profits of US-based foreign affiliates plunged 98% to just $275 million in

the 4th quarter of last year from the high level of $15 billion per quarter in 2000. Since hitting a peak of $18.1 billion in the second quarter of 2000, profits of US-based foreign affiliates have declined along with US economic activity. In 2001, affiliate profits totaled just $28.4 billion, the lowest annual figure seen since 1994.

That means that foreign corporate investment in their businesses here, which is not a small part of our economy, is not going to happen.

I remind readers that a large part of the improvement in the current quarter is from "seasonally adjusted" numbers, which have been artificially inflated by a warm winter. (Example: a 17% drop in housing in January becomes a 16% gain with "seasonally adjusted" salts.) The next quarter is likely to see the growth numbers come down, as seasonal adjustments even out.

Prediction: CNBC and the rest of the market cheerleaders will ignore slower GDP growth numbers next quarter and instead focus on growth from non-seasonally adjusted numbers. Not one talking head will ask an economist to talk about why they choose to ignore the earlier real drops and used seasonally adjusted numbers to proclaim a new bull market. You read it here first.

In short, there are a lot of drags on the economy. Not enough to drag it down, but a lot of reason to be very skeptical about the rosy picture painted by our cheerleader economists. These are the same guys who failed to predict a recession, and I see little reason to trust them now.

I believe the economy will grow this year, but not at a 4-5% rate. It will be closer to 2% than 5%. A lot closer. I continue to maintain we are in the Muddle Through Economy.

The Muddle Through Economy and 2% growth is not an environment in which the Fed is going to aggressively raise rates, or that inflation will be something bumping around in our worry closet.

Shoulda-Woulda-Coulda

That means long term rates SHOULD come down.

However, as Bill Bonner often reminds me, there is a big difference between should and will. Nowhere has this been more evident than in interest rates.

I am personally a holder of long term government bonds. My positions are down 5% from the beginning of the year. I am invested in the Target 2025 fund in the belief that what should happen will eventually happen. This American Century fund is the most aggressive way to play a fall in interest rates, but it can be a very volatile fund if rates go up, not to mention painful.

Should rates come down by this summer? I think they should. But I do not think they should have risen, so what should happen and what will happen are unfortunately not rhyming.

I called two gentleman who have noteworthy track records in calling interest rate directions. Don Peters of Central Plain Advisors is still convinced that rates are going below 4%. He has been in the top 1% of bond managers for the past 25 years (as rated by Callan and Company), and has a solid long–term track record. He does it by predicting long term rate movements and ignoring the peaks and the valleys and the journey to his target. So far he has eventually been proven right, but the ride can be volatile. The fact that rates are back up to him is annoying but he is adamant about maintaining his position, whether it takes 6 months or 2 years or more to get to that 4% level. If he is right, his investors will make 50% or more as rates drop to 4% from today's level. If he is wrong? They will lose about 25% for every 1% rise in rates.

His question is, "Given that inflation is tame, with whiffs of deflation on the wind, and that the economy is not going to recover as fast as most economists believe, which is more likely, a drop to below 4% or a rise to 7%?"

I called Gary Shilling (money manager and columnist for Barron's) and asked his views. Basically, he agreed with Don's view of the trend, but declined to say whether we would see rates come down by this summer. But he does point out that in 6 of the last 9 recessions, we have seen a double dip, as the economy gives us a head fake recovery before dipping down into recession again. He thinks we are headed for a double dip, and that rates will come back down if we do. His view was that interest rates do not reflect reality (or at least his view of it), but quoting Keynes, "The market can be irrational longer than I can remain solvent."

One of my rules for investing is that I look at my positions every day, and if I would not buy that stock or bond or fund at today's prices, I will sell, whether there is a loss or a gain. Holding on to try and get a few more points, or trying to get back to even is a loser's game and a ticket to even further losses.

I look at the price of bonds today, and I want to be a buyer. But I will also confess, if the economy proves to be stronger than I think it will, I will sell. Or, if the economy slows down next quarter, and inflation doesn't creep back up, but long rates continue to rise, I will seriously re-evaluate my position. The latter scenario would indicate to me that something is happening under the radar screen that I cannot see on my terminal. That means "should" is in jeopardy. This summer will be a watershed for me, at least as far as my long-term love affair with bonds.

Why would I possibly sell when things are getting even more out of whack? As my son-of-the-depression Dad drilled into me, “Just because things are bad doesn’t mean they can’t get worse.”

We all invest of terms of what we think “should” happen. But at some point if “should” doesn’t manifest itself, you have to ask yourself what is going on? What relationship am I missing? Is this the best place for my money? If you can’t come up with an answer, you are better off seeking profits in another market, or going to the sidelines waiting for reality to wake up from its nap.

I am not there yet, but I am beginning to scratch my head. I should point out that the markets also said we would not have a recession early last year when Greenspan began to cut rates. They were wrong, and those of us who had already sold our stocks were right. It did make my call look silly for awhile. I remember Jim Cramer saying over and over, “Don’t fight the Fed. Now is the time to buy.” If you did, you are down. I will be patient on my bonds a little longer, as “should” wins more often than not. I continue to think this is a bond market that has very unrealistic expectations. Stay tuned.

High Yield Profits

Speaking of profits, I hasten to change the subject and remind readers of my recent recommendation of CGM advisors high yield bond timing program. It is up over 2.5% for the month. We now have a PDF file I can send you showing their 10 year track record and an analysis of the potential of the high yield bond market. Steve Blumenthal, president of CGM, thinks that we are just at the beginning of a nice long-term run in high yield bonds. I am a big fan of this program, as CGM managed to make good money for their clients in each of the past three years in a very bad high yield bond market. Now, I think the wind could be at their back as the economy recovers, albeit slowly. Slow profits are nice enough, thank you.

Trade War Cannons

A few weeks ago President Bush imposed tariffs on steel. Today we read that we are putting a 34% tariff on Canadian lumber. Mexico just put a huge 200%+ tariff on our corn syrup in retaliation for our tariffs and quotas on their sugar. There is a big fight brewing on Rio Grande water rights between Texas and Mexico. And to top it off, last February we imposed new tariffs on flowers from South America just in time for Valentines.

Europe is threatening new tariffs in retaliation for our steel tariffs, and Asian countries are rattling protectionist swords for a variety of products.

Two thoughts come to my mind. The first begins with the words Smoot-Hawley. One of real reasons the Great Depression went from recession to

Depression was an ever increasing round of protectionist tariffs and trade wars. As the leading proponent of free trade and free markets, we do not seem to be setting a good example.

I admit one can debate the merits of the steel tariffs, although I would be against them. But if we must impose tariffs, then we should have eliminated other barriers to trade to demonstrate we do, indeed, believe in free trade.

For instance, I don't think there is a national security reason to have avocado quotas from Mexico, and yet my wife and I pay 10 times for avocados in Texas as we will next month in Puerto Vallarta. Now I know that is not good news for avocado growers in California, but we could easily find a dozen or so examples like this. Why don't we unilaterally announce a ten year phase-out of a number of these quotas to demonstrate our belief in free trade whenever we feel we need to impose a tariff in the name of national security.

Trade wars like we see developing are very bad for business and the economy. China, Russia and other steel exporters will take their gripes to the World Trade Organization and probably get relief in the form of being allowed to impose tariffs on US products. Will they choose to impose tariffs which are just as economically unsound as the steel tariff? What repercussions will they have on our economy and on world trade. This is a serious issue, and is the one major thing President Bush has done that is a real problem for me. I am a real supporter of President Bush. As a Texan who has sat at the table discussing hard issues with then Governor Bush on a few occasions, I never doubted he would be a great President. I will admit to having been surprised by this move.

But it also brings up concerns about the strength of the dollar. Stephen Jen of Morgan Stanley argues that is another example of the Bush administration subtly arguing that the dollar is too strong, and trying to re-define the strong dollar policy to a more realistic policy of being neutral on the dollar and letting the market decide.

This is another reason, on top of those I wrote about last week, to be concerned about the dollar. You can go to our web site at www.2000wave.com and read last week's article.

Fried Drowned Tomatoes

I got my tomato garden in just in time for the largest rains around Fort Worth in a long time. It looks like I may get to start all over. Weekend suggestion: instead of watching the Oscars, go rent the movie, Tortilla Soup. If you have parents or daughters, it will make you happy and won't annoy you with bad jokes and long sappy speeches. Trust me on this one.

Next week, instead of looking at the current market activity, we are going to explore the main reason why most investors are not successful. It has to do with the random nature of the markets, and how we get fooled into thinking that a track record is an accurate predictor of the future. I spend my working time looking at track records and investment managers on behalf of my clients, and I will give you a few insights as to what to look for, and how to spot the train wrecks before they happen. It will come a little early, as I leave Thursday for a long weekend in Sedona with my wife.

Until then, enjoy your week and remember time invested in your family and friends still pays the best dividends.

Your waiting for the next weekend trip with his bride,

John Mauldin