The Return of Stagflation
An Iranian Miscalculation
As the Fed Turns
The Possibility of a Recession
Leading Indicators Point to Employment Slowdown
Boston, Maine, and Fly Fishing

By John Mauldin

The economy seems to be slowing. Will this be a mid-cycle slowdown as it has been the last two decades or will it evolve into a recession? In either event, does it presage a bear market in equities? Or is this just another oversold buying opportunity, a gift courtesy of panic selling because of the Israeli-Lebanon situation? If you follow the markets with any sense of history, we do in fact live in interesting times.

But before we jump into our main topics, let's turn our eyes to Israel and Lebanon.

This week's events have made it clear why as investors you need to be able to get a handle on world events. My single best source for commentary on geopolitics is George Friedman and Stratfor.com. ABC News recently said they are able to predict world-changing events in ways that no one else can. They are consistently ahead of the curve with their thoughtful analysis of events all over the world. I caught up with George this afternoon and discussed the situation with him.

An Iranian Miscalculation

In his view, for a variety of reasons, Iran has allowed their client terrorists, Hezbollah, to provoke Israel into an attack. They have calculated that this will tie up Israel in much the same way that the US is mired down in Iraq and limit the options of the US and Europe in negotiating with Iran over their desired nuclear abilities. They are willing to give up the headquarters and some infrastructure of Hezboallh in Lebanon for what they consider their more important long-term goals. This all squares with Iran wanting to be the Big Dog in the Middle East, not to mention ending up with some of the Basrah oil field. It is all very complicated.

Israel may not be all that cooperative, however. This is not Shock and Awe. More like Smash and Dash. It is likely they will go into Lebanon and smash anything that has to do with Hezbollah, depriving them of as much infrastructure and weapons as possible and then simply withdraw, calculating that it will take years for Hezbollah to recover. The Israelis are not worried about establishing a democracy in Lebanon. They will not need to stay. Maybe it will even give the Lebanese government the ability to finally assert control over the region.

One thing to think about. In the Western world, and especially in the US, we tend to think of a country as something rather large. The area of Lebanon we are talking about is really quite small. If Lebanon were a state, it would be the 48th in size. And we are only talking about the southern portion where Hezbollah is centered. You can drive from one side to the other (if you are not dodging bullets and bombs) in under an hour.

George also thinks there is likely to be a massive effort to remove Western nationals and especially US and British citizens over the weekend, as a tried and true policy of Hezbollah is to take hostages.

The following is a link to a podcast that George has done on the motives for Hezbollah. It is quite thoughtful. The "catch" is you have to sign up for a free trial.
https://www.stratfor.com/reports/podcasts.php

But the better thing to do is go ahead and subscribe to their service. As I said, I find it essential reading. I talked George's staff into a 50% discount this week, or only $199 a year or $19.95 a month. The link I have below will get redirected to the correct site. You get a lot of value: daily reports, special updates (they are doing one or more a day on the Israeli situation), a very complete website on the situation in all parts of the world, forecasts, etc. It is one of the best information deals I know of.

Click on the link and subscribe:

https://www.stratfor.com/offers/060522-milrate/?ref=060522-milrate-BMG&camp=060522-milrate

And now back to our regular feature.

The Return of Stagflation

"It has been my stated opinion for quite some time that the 'best' and most probable result we will see will be stagflation."

I wrote that on June 13, 2003. The Fed was then in a determined battle with the specter of deflation. It is a battle that determined central bankers can win. But it required they risk the return of a little inflation. I thought that they would err on the side of too much stimulus and that inflation would indeed return. Then they would eventually deal with the inflation at the end of the cycle by going too far in the tightening of monetary conditions.

Stagflation is that condition of rising inflation and a slowing economy. Which if we look at the data is where we are today. Now compared with a period of real stagflation like we experienced in the 1970s, this is pretty tame stuff. Hardly even worthy of the name stagflation. Nonetheless, a period of mild stagflation is upon us, and in this week's letter we will muse upon its advent.

Now was the above quote some sign of great prescience back in 2003? Not really. It was pretty much a slam dunk call. A number of speeches and papers from Federal Reserve economists highlighted their most likely solution to dealing with deflation. It was pretty clear what they were going to do. They were going to stimulate the economy as much as possible, and their preferred method was to hold interest rates far below neutral in order to do so. They were going to deliberately work to beat deflation by inducing a little inflation into the economy. And it worked. Between the easy money policy of the Greenspan Fed and the Bush tax cuts, the stimulus took an economy that was on the brink of deflation and a "rebound" that was very tepid to a powerhouse growth period in 2005 through last quarter. And also an inflation rate that is above 3%, which is by definition above the comfort zone of any respectable central banker.

Of course, much of the growth was financed by cash-out financing on home equities made possible by large growth in home prices, cheap interest rates, etc., but why quibble? The economy rebounded, corporate profits zoomed ahead, and the stock market began a northward climb.

But that's history. Let's look forward.

As The Fed Turns

A few weeks ago we looked at why I think the Fed will raise rates at their August meeting. Essentially, unless we are shocked by a low inflation number next week, the Fed and especially Bernanke will feel they need to prove their inflation-fighting credentials. If the inflation number is above the "comfort zone" of 2%, then I think a raise is almost assured.

After that? I don't think even the Fed knows. They will truly be data dependent. If the two monthly inflation numbers they get between now and the September 22 meeting are lower and trending down, and the economy is visibly slowing, as it may well be by then, they may decide to pause. If inflation has not slowed down, they will raise again. Period. Even if the economy is slowing down, even though the inflation numbers are backward looking, they will raise.

There is considerable debate about what they will do. Paul McCulley thinks they should pause, as does Martin Barnes. Disagreeing with those two worthies is usually not sound advice. Talking with Martin this afternoon, he noted that "Give or take, we are in the zone of fair value [on interest rates]. How much above would we have to go to crush inflation? Not a lot. It doesn't take much of a drop in demand to bring out red pens to slash prices to move products." I agree. Look at autos as an example. And we are seeing the housing market starting to offer special incentives in order to keep sales going.

But there are those who disagree. One is Barry Ritholtz, who very nicely sums up the argument for the reason the Fed will tighten further:

"When making complex decisions with serious ramifications, it is useful to understand what is at risk *if you are wrong*. That one factor impacts various outcomes *dramatically.*

"It's a given that the future is unknowable. The complexity of the economy -- random events, unexpected interactions, dumb luck -- force all forecasters to recognize the inherent possibility, and indeed, high likelihood of error. Typically, that recognition colors policy making. (Consider recent examples where expectancy analysis was *ignored* in the policy making process -- with dire results).

"Once you get through that process of error expectancy, then play out the various decision tree possibilities: The results are why the Fed tendency to overtighten is all but a *fait accompli.*

"And, we like it that way. Why? What is the worst case scenario if the Fed over tightens? The economy slows, maybe we even have a recession. Not to make light of what is always a painful situation, but -- so what? Recessions are a normal part of the business cycle. The U.S. economy is flexible, multi-faceted and resilient enough that a mild recession -- or even a strong one -- is a minor inconvenience in the grand economic scheme of things.

"Consider: A recession reprices overvalued assets. It creates a cathartic cleansing that forces efficiencies where there were none before. It removes excesses that have developed. Has the U.S. ever not bounced back from a recession? Of course not. Over the next century, we will have a dozen or more recessions, and an equal number of recoveries.

"But consider the alternative error: What happens if inflation is no longer contained -- if it *gets away from them?* That is a ***far, far worse outcome*** than a recession. I am old enough to remember the nightmare of the 1970s. I have no desire to live through *THAT again* (and I'm not referring to Disco, Bell bottoms or Nixon). It was UGLY.

David Kotok at Cumberland Partners (www.cumber.com) also thinks the Fed will go too far. He penned this a few weeks ago.

"We are in a transition from money too easy to money too tight. We do not believe the Fed can get it just right. Transitions are a murky time in each and every cycle and this one is no different.

"In this transition period, we see housing weakening and everyone now guessing at how far down it will go. We, at Cumberland, are in the bearish camp. We have written about this for months and even warned for years. Simply put, $1 trillion in mortgages reset higher this year; $1.7 trillion next year. When mortgage interest rates rise and impact over 10 million households in two years, you must get a slowing. It is unavoidable.

"In this transition, we see a persistent $70 dollar oil price working its way through the system. Government has botched up the ethanol introduction and made things worse. In addition, we still have not opened up the US energy prospects for relief on the supply side. No new refineries, no new drilling areas. At Cumberland, we see the oil price going higher on any shock. There is no cushion in the system."

Now, $80 oil is on the table. We may be getting a classic oil price shock.

As long-time readers know, I have been writing about the sacrifice ratio for a long time. I mentioned it again last week:

"First, there is that obscure item called the "sacrifice ratio." How much pain in terms of a slower economy and lower employment do we take today to make sure we do not have excessive inflation in the future? Higher inflation in the future will ultimately mean even higher rates and a possible deep recession, as the Fed would then have to tighten aggressively. It is a trade-off or sacrifice. There is a number which characterizes the risks and rewards, called the sacrifice ratio, and today and for the last few years it has been high, which is why the Fed has continued to raise rates."

Kotok wrote me the following quick comment which I pass along:

"Obscure is an understatement and the markets and most folks to not understand this concept. The SR has an additional dimension and that is time. How much pain and over what period of time is the numerator. It is not just the pain; it is also for how long the pain must be endured. The concept arises out of an output gap model. That alone makes it hard to estimate. In addition, the SR computation changes continually as the effects of Fed action are realized; meanwhile this occurs while the lags are variable. Talk about tough math!!!!

"At 4.6% unemployment, 63% of population over age 16 in the labor force, and with service wages rising at twice the inflation rate, the Fed faces an acute dilemma. Much more than is realized by markets. The real risk is not an overshoot, it is an undershoot. I believe that is what lies ahead. We get another tap up or two. Then they pause for a while. Markets discount the wrong outcome. Then the Fed must take on another round of raising rates because the inflation rates will be higher and will be looking at the 3 handle and not the 2 handle."

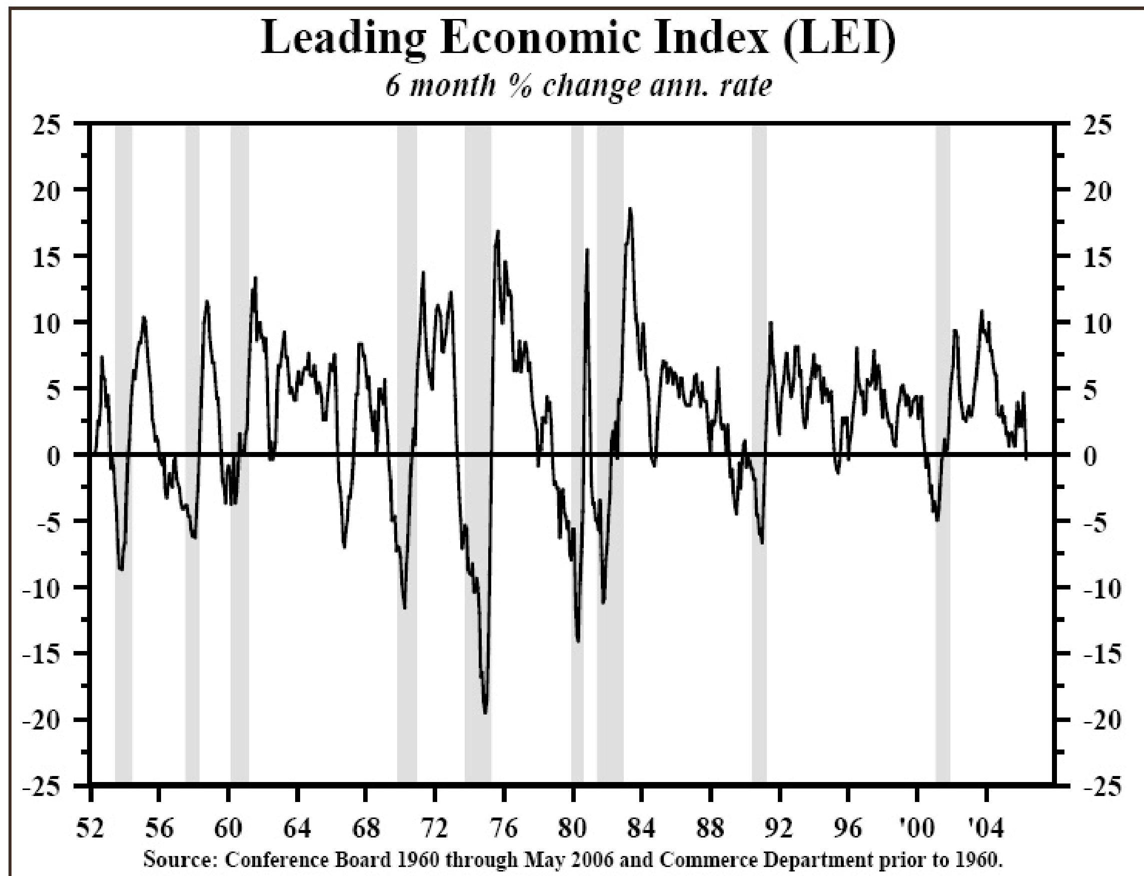
What David means by a 3 handle is inflation running above 3%. The Fed will be forced to tighten more aggressively in such a scenario.

The Possibility of a Recession

Martin Barnes emphasized that the economy is slowing down. Therefore the Fed will not need to raise rates all that much as the inflation rate will come down on its own. While the latter remains to be seen, the former is certainly true.

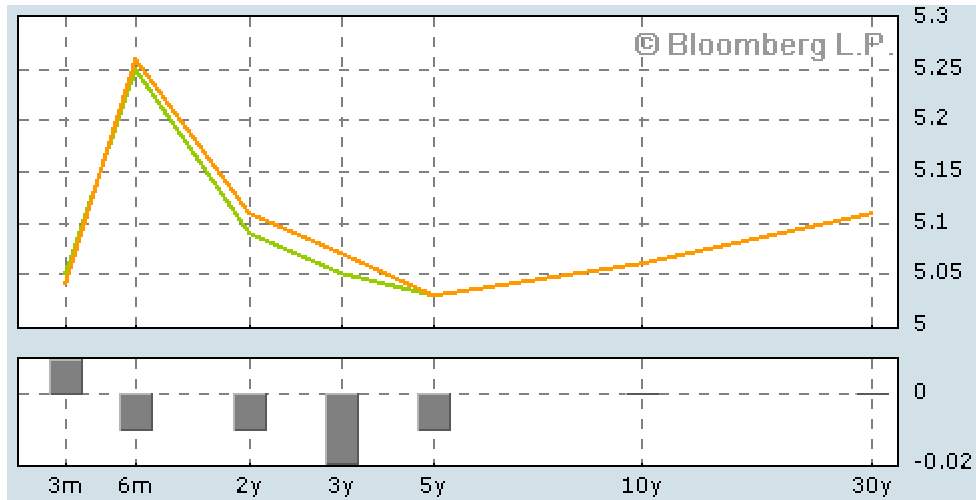
The Possibility of a Recession

In their *Quarterly Review and Outlook,* Van Hoisington and Lacy Hunt, gives us a few facts and graphs that are not all that optimistic. The Leading Economic Index, as compiled by the Conference Board, has now contracted over the past six months (see chart below). 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.



They also note that there have been 7 times when the yield curve has inverted and the LEI also contracted for six months. The last 6 of those times have seen a recession an average of 9.3 months later.

Look at the graph of the yield curve below. The yield curve is odd, in that the 6-month is a full 20 basis points above the 3-month. Normally, when looking at the data which correlates inverted yield curves and recession, you look at the difference between the 3-month T-bill and the 10-year bond. Today, the 10-year bond is 1 basis point above the 3-month bill. I expect that to change shortly after August.



At that time, or some time shortly before that, the yield curve should be fully inverted over the whole curve. Dave Wescott, who has been trading bonds for over 30 years, wrote this note to me about the unusual shape of the curve:

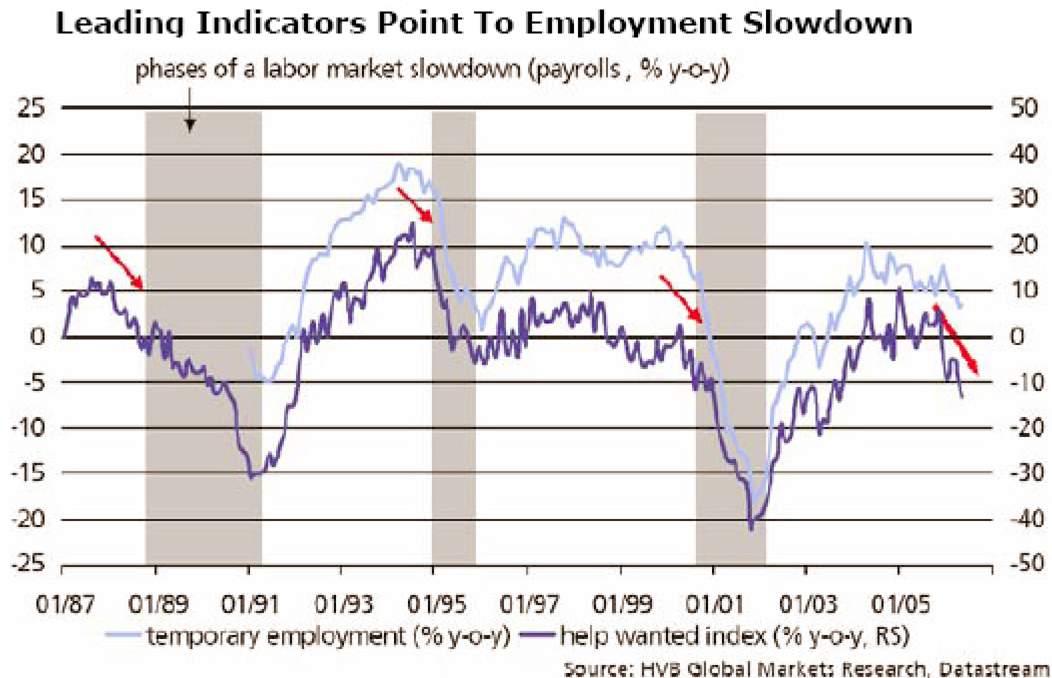
"With almost 30 years of experience of managing U.S. Treasury and Agency fixed income portfolios I thought I would try to provide some additional insight to your observation of the three month bill trading so rich to the six month bill and Fed Funds. This relationship is really not that odd during periods of rising rates. When looking at Fed Funds, the 3 month bill and the 6 month bill, investors only have two choices in making an investment. Fed Funds can not be purchased by investors so the choice to invest is limited to the 3 month or 6 month maturities. The decision is usually explained by looking at a break even analysis. Currently, investors could choose a 3 month investment at 5% or a 6 month investment at 5.25%. If an investor chooses the 3 month investment at 5% he/she must be able to re-invest the proceeds at 5.5% at the end of 3 months to equal the return over 6 months with the 5.25% 6 month investment now available in the market. The short end of the curve is dominated by investor's choices of where rates will be over the near term. Investors today believe that 3 month rates will be higher by 50 basis points 3 months from today. Liquidity and flight to quality do play a part but those investors have a choice of where to invest and will also choose the maturity based on the current curve and their expectations of where rates will be in the future."

Leading Indicators Point to Employment Slowdown

And one last chart before we wind up this week's letter. Two key leading indicators of employment, the temporary employment index and the help wanted index are heading down. As the chart shows, when that happens, a recession or slowdown in the economy (shaded area) shortly follows.

"Has the US labor market had its day? 'Analytically, this expectation is based on a deceleration in GDP growth primarily caused by the end of the housing boom. It has been the main driver behind the increase in jobs for years. But more important is the fact

that corporate profit growth should have peaked: input costs have soared, but pricing power did not. Therefore, companies are becoming less keen to hire,' according to HVB." (Source: Barry Ritzholtz)



So, who's right? Are we beginning a slowdown so the Fed does not need to raise rates? Or is inflation a real problem and the Fed will have to keep raising?

In the longer term, it does not matter. There is a slowdown in our economic future, probably showing up in the data no later than the first quarter of next year. That means the stock market is going to have issues, as my kids would say. It also means bonds are going to be a good investment.

I have had readers ask me about the 4-year election cycle. I do not have a lot of faith in it as a reliable predictor, but to the extent it coincides with a tightening Fed cycle, it has a relative degree of accuracy, and that is the situation that we find ourselves in now. On average, the Dow dropped 22% from its election-year high to the low in the mid-term years. The *Stock Traders Almanac* from the Hirsch Organization issued a client advisory last week targeting a Dow, S&P 500, and NASDAQ at 8500, 950, and 1750 by the end of the year. The good news, as Matt Blackman noted, is that the Dow gained an average 50% from those lows to the highs over the next two years.

Is that where we will end up? I have no idea. The Fed is still the key. Beyond the August 8 meeting, I think they do not know what they will do. It will truly depend on the data that comes between meetings. We can speculate, but anyone who does without a few caveats is venturing into the territory of "Often wrong, but never in doubt."

Boston, Maine and Fly Fishing

It is time to hit the send button. It has been a long week, but youngest son Trey had a great time in La Jolla surfing, although he found the dinner with sci-fi writers David Brin and Vernor Vinge a little hard. “Dad, you guys used a lot of words I didn’t understand.” But he liked the food at George’s.

He may have a problem this next week as well. David Kotok at Cumberland Advisors invited me and a colleague to his annual fishing trip, along with other economists, Fed types, and other ne’er-do-wells in the money business. I asked if my son could be my colleague and he graciously allowed me to bring him, so we are taking a float plane from Bangor into a lake near Grand Lake Stream. Three days of camping and fishing (plus a lot of good wine!). I understand my cell phone will not work. I think withdrawal should be easy. And my guess is that Trey will have so much fun that he will just overlook the conversations full of jargon. But then, economists are likely to use a lot of words I don’t understand either. It should be fodder for a future e-letter, as there is a lot of discussion (and minor wagering) about the future of the economy.

But it means a layover in Boston on Wednesday night, so Trey and I will be available for a clients and prospects and friends dinner.

I am actually wired about going. It should be a lot of fun. I need a few days off here and there. Have a great week and remember to take some time with family and friends!

Your going to learn to fly fish analyst,

John Mauldin