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Trudges, the nation's business

Growth in manufacturing and trade sales sits not far from a 17-month low, growth in GDP stands at an 18-month low and growth in industrial production registers near a 72-month low. Economic cycles, interest rates and the dollar are the topics at hand. Skipping down to the bottom line, we speculate that the dollar will turn weaker as the Fed raises the funds rate in the teeth of a downshifting business cycle.

"Speculate" is the operative word, as the future is a book slammed shut. Especially do the thought processes of the voting members of the Federal Open Market Committee defy prognostication. Still, one must try to imagine the future, even if one can't predict it.

Thus, we reckon: The Federal Open Market Committee, meeting on Dec. 16, will lift the funds rate from zero. Having to choose between a loss of institutional face (how many times has it hinted that *this time* it will act?) and the mounting evidence of weakness in the segments of America's economy that produce and transport goods, Yellen et al. will chose face. Markets will register no immediate objection; they've had years to get used to the idea of a funds rate just a little higher than zero.

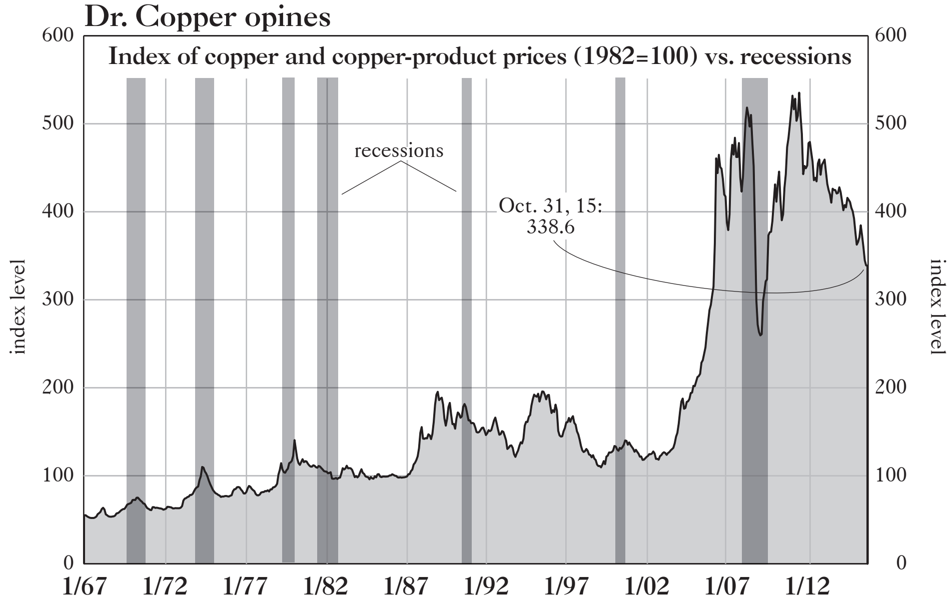
Trouble follows. The passing months will reveal that there is, again, no "liftoff," but rather a dwindling in the economic and financial vital signs. Mortified at what is looking more and more like an unforced policy error, the mandarins will return the funds rate to zero. In speeches, they will drop broad hints about some new round of experimental monetary measures. The dollar bulls, participants in what Bank of America Merrill Lynch last week identified as the world's "most crowded trade," will have already acted. They will have beaten the Fed to the punch by trading in their greenbacks for euros, Swissies and other alternatives (including the seemingly hopeless one that can be found in the Periodic Table). Worshippers of the paper calf will begin to reconsider their allegiance.

Few will envy the monetary deciders their Dec. 16 vote. The data are always ambiguous, and today's figures leave plenty of room for interpretation. Thus, the S&P 500 is up, but commodity prices are down. The headline jobless rate has fallen to 5%, while the U6 measure of unemployment and underemployment still stands at 9.8%. Year-over-year growth in average hourly earnings recently hit a 6¼-year high, but not for any good reason: Growth in hours has been falling faster than growth in pay.

Neither is the evidence in support of a call for an imminent recession exactly clear-cut. Focusing on the prospects for home construction, economists at the University of Michigan project that GDP growth next year will reach 2.6%, its highest in a decade. Steve Blitz, chief economist at ITG Investment Research, Inc., singles out strong weekday hotel rates as evidence of a thriving service sector.

And even if home-building and services fall short, a prophet of economic weakness must come to terms with the fact that oil-price spikes and a rising funds rate are the common antecedents to modern recessions. To contend

Dr. Copper opines



source: Federal Reserve Bank of St. Louis that a downturn has begun in the absence of those time-tested auguries is akin to speaking the forbidden words, "It's different this time."

We'll say them anyway. It's always a little different, after all (every cyclical episode is distinctive), and novelties abound today. China is one such new force in the economic world; zero-percent (or lower) interest rates are another. Many cycles ago, the Wall Street thinker John Mendelson identified the price of copper as a bellwether of business activity. "Dr. Copper," Mendelson respectfully wrote, "the metal with a Ph.D. in economics." Chalk it up as something notable, if not unprecedented, that copper prices (and nickel prices, too) are plunging in what is still, officially, an expansion. The so-called new normal—booming asset markets, lackluster GDP growth, chronic underemployment—is another kind of novelty. So are the creatively disturbing inroads that digital technology continues to make on the conventional ways of doing things. ISIS and presidential politics constitute disturbances of another kind.

You might ask what the stock market is doing at these penthouse levels if a business-cycle downturn is beginning. The answer is that, by one school of thought, a bear market is already in progress.

We take our cue from an article of wisdom dispensed a century ago by William Peter Hamilton, longtime editor of *The Wall Street Journal*. It holds that you know that a bull stock market is in good trim when industrial stocks and railroad issues move synchronously. Let one portion of the market diverge from the other—the goods-producing end, for example, makes new highs while the transportation end languishes—and there's trouble, possibly a change, in what the adepts call the primary trend. By the light of the Dow Theory—or, rather, by some construers of the Dow Theory, for there is schism in technical analysis as there is in other departments of human thought—the primary trend is down. You know it because the May 19 peak in the Dow Industrials has gone unconfirmed by a subsequent new closing high in the Transportation Average (which put in its last new high almost exactly one year ago). Actually, you may not know it, since stock-market technicians sit below the salt in modern finance. We refer scoffing readers to "Transported by Mr. Dow" in the June 12 issue of *Grant's*, as well as to the discussion that resumes below.

The macroeconomic sightings so far related come courtesy of Lakshman Achuthan, chief operations officer of the Economic Cycle Research Institute, a producer of rigorous and thoughtful analyses of the macroeconomy. What ECRI says it sees is a rate of economic growth that is perilously close to no growth.

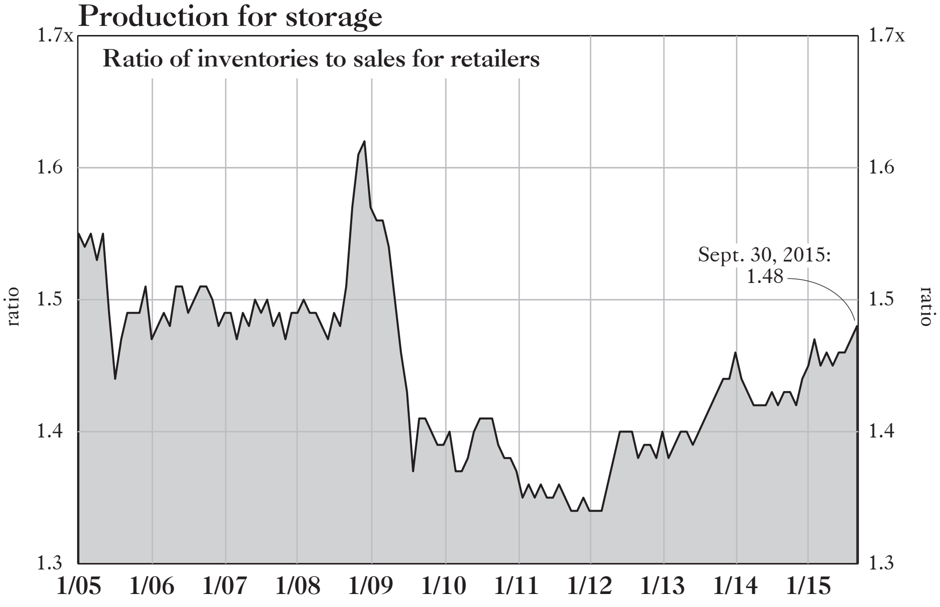
"What is very slow will get slower," Achuthan tells *Grant's*, "but in order to make a recession call, we need to see our leading indicators fall in a pronounced, pervasive and persistent way, and we don't have that yet. I'm not saying it won't come, but as of today [Nov. 16], I don't have that. . . . The forward-looking indicators, which correctly anticipated the slowdown we are experiencing, point to more slowing ahead of us. As to an outright recession, stay tuned. We need to see the levels of our indicators actually fall."

Achuthan can testify to just how fine is the line between recession and nonrecession. He had predicted that the final six months of 2012 would register contraction. The first estimate of GDP growth came in at 1½% (that is, at an annual rate of 1½%). The fifth revision to that initial estimate, unveiled in July, pushed down the measured rate of growth to a quarter of 1%, about as close to shrinkage as a positive growth figure can be.

The deceleration in GDP growth began 10 months ago, Achuthan continues. He says it's the 22nd such measured cyclical pause since 1948. It's a "moderately severe slowdown by 21st-century standards." The book on slowdowns, he goes on, is that half lead to recessions, half don't: "It's not over, so it's likely to get worse. How much worse is the $64,000 question." The readers of *Grant's*—the editor of *Grant's*—would like a little more certainty, of course. It is not to be had.

Profits may tell the tale. They're strong and rising, according to the comprehensive measure produced in the National Income and Product Accounts (NIPA). They're nothing of the kind, according to the narrower readings of the component companies in the S&P 500. Reuters observes that S&P 500 earnings are poised to record their first quarter of year-over-year shrinkage since the third quarter of 2009. "We can't think of any instances when the Fed was hiking during an [S&P 500 earnings] recession," the news service quotes Joseph Zidle, portfolio strategist at Richard Bernstein Advisors in New York, as saying. It's worth noting, we think, that while the NIPA and S&P 500 earnings data track closely over time, they can diverge in the short run, particularly during recessions. At the start of a slump, S&P net income falls much more sharply than NIPA profits do. And at the onset of recovery, S&P net income rises much faster than NIPA profits do.

Production for storage



source: The Bloomberg

Interest rates discount the value of future profits. The stock market anticipates whether those profits will materialize. When Charles Dow compiled the first-ever stock index, the Dow Jones Railroad Average, in 1884, he couldn't have anticipated the coming of the service economy, the computer, e-commerce, Amazon or Uber. Nor could have Hamilton, writing a generation later. What each man, Hamilton especially, intuited was that goods, once produced, must be moved, lest they pile up in a warehouse. So a new upside (or downside) record on the production side of the stock market is of no predictive value unless confirmed by a new upside (or downside) record on the transportation side.

"When they fail to [confirm]," as we quoted Louise Yamada, eponym of Louise Yamada Technical Research Advisors, as saying in *Grant's* in June, "often a market correction is being signaled. The confirmation, or non-confirmation, often takes place over months. The last major divergence took place in the 2007 top, as the Transports moved to a new high but the Dow failed to confirm. In 1999, the DJIA moved to a new high and the Transports diverged, as is happening now. Each occurrence progressed to a market setback."

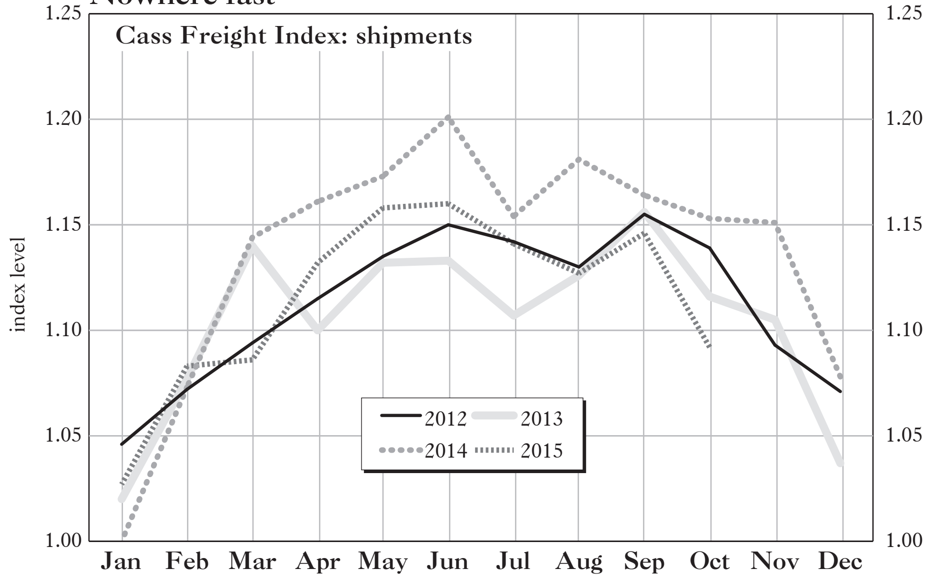
The story is much the same today, Yamada relates: "Strong rallies in weak markets have often proved bull traps. Strong rallies initiating bull markets carry dynamic positive statistics, which are not visible today." By the light of Dow Theory, this is a bear market, Yamada tells colleague David Peligal. Stocks have been rising "on poor indicator readings so there is no indication that the topping process is being reversed."

In June, Yamada had observed that "a top is not a place, it's a process." Where are we now in the speculative journey? Peligal asked.

"We don't know," the technician replied. "But we could argue that we have been in this process since mid-2014, when you actually had that mid-October dip that took you down to 1,820 in the S&P 500. And now, we've come down and tested that level again. So you're failing to put in place a series of higher highs and higher lows. You're going sideways, basically."

Oppenheimer & Co. points out that only 33% of NYSE stocks are above their 200-day moving average, meaning that many stocks (including not a few of *Grant's* favorite value plays) are in their own bear markets. This ties into market breadth, or the lack thereof. It's no front-page news that a few high-growth, consumer-facing technology companies (e.g., Amazon, Google, Facebook) have accounted for most of the S&P 500's gain this year. "Hedge funds continue to favor the small list of mega cap stocks that have driven a vast majority of the S&P 500 return YTD," Goldman Sachs relates in its Nov. 20 "Hedge Fund Trend Monitor." "Ten S&P 500 stocks have accounted for more than 100% of the index-level return in 2015. Seven of the top 10 contributors are also members of our Hedge Fund VIP list."

Nowhere fast



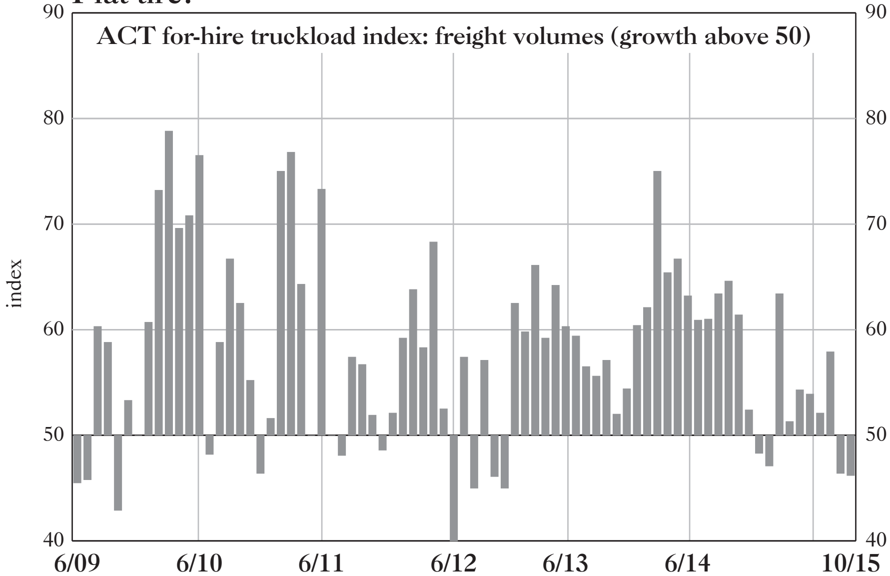
source: Cass Information Systems

The reason to dwell on a century-old interpretation of the movement of a pair of technically deficient (price-weighted, not market-cap-weighted) equity indices is because the stock market may reset expectations for the dollar and monetary policy. To emphasize, we are star-gazing. Even the best of us do. The late, great Richard Russell, author of the "Dow Theory Letters," who died on Saturday at the age of 91, wrote in what stands as a predictive valedictory that "market analysis has now become central bank analysis. All the old methods of analyzing markets have given way to deciphering what the Fed or ECB will do next. I've talked about the pattern of the Dow Jones Averages ever since 1958. Based on the action of the two averages now, I'd say that the market is headed higher." So, no, there is no clarity, only the dueling of ideas.

And, to be sure, of facts, including the ones concerning the business of moving goods to market. The number of freight shipments, rail and truck, dropped by 5.3% in October, measured year-over-year, according to the Cass Freight Index. "The freight shipment index," the data compilers relate, "now sits at its lowest October level since 2011. This month's decline was much sharper than in recent years and can be directly correlated to falling imports and exports as well as decreased domestic manufacturing levels. Burdened by bloated inventories, and under the shadow of a possible interest-rate increase by the Federal Reserve, businesses cut back on new orders placed in the last three or four months. This is resulting in lower import volumes, less freight to move and faltering industrial production. With the dollar still strengthening, export growth decelerated in the third quarter."

The Cass narrative is the standard one nowadays, Peligal reports. Thus, October freight volumes aboard Class 8 trucks (the behemoths) were the lowest since December 2012, according to an index compiled by ACT Research. And it was the first October to register a year-over-year decline since the survey was initiated in 2009. "Anecdotally," says Kenny Vieth, ACT's president and senior analyst, "we are hearing that shippers are coming into the market

Flat tire?



source: ACT Research Co. LLC

early for bids, which underscores the softening in the supply-demand dynamic as they look to take advantage of current weakness."

And so by sea: "America's busiest ports are sending a warning about the U.S. economy," *The Wall Street Journal* reported on Nov. 15. "For the first time in at least a decade, imports fell in both September and October at each of the three busiest U.S. seaports."

Union Pacific Corp. (UNP on the New York Stock Exchange) opens another window on the not-so-vibrant American economy. "Volumes at the railroad are down by 5% in the year to date," Peligal says. "At a Nov. 11 investor conference, UNP's chief financial officer, Rob Knight, elaborated thus: 'This softness has continued into the fourth quarter with car loadings down about 8% right now. With the exception of automotive, which continues to be strong [give credit where it's due, in this case to Fed-facilitated EZ finance—ed.], we are seeing declines in all other lines of our business.' In agricultural products, fourth-quarter volumes to date have fallen by 2% from the year-ago period; chemicals are down by 5%, intermodal by 8%, industrial products by 15% and coal by 17%. Cars and trucks are higher by 7%."

Vacationing in Myanmar, paid-up subscriber Preston Hutchings snapped the picture of a sign, below, that the management of his hotel had posted to steer tourists away from some hazard or other. The investment applications of the charming phrase "self-accidented/self-responsible" are obvious.

Our monetary affairs are self-accidented since we the people are self-responsible for them. We the Wall Street people have bet heavily not only on a higher funds rate but also on a lower euro exchange rate. *Grant's* is proposing that the higher funds rate will prove transitory and that the dollar exchange rate, in company with the U.S. stock market, will pull back.

On Monday, the Dollar Index topped 100 for the second time this year (not since early 2003 has it held that level for very long). Also on Monday, the Markit Flash U.S. Manufacturing Purchasing Managers' Index for November fell to 52.6, down a point and a half from October and the lowest reading in 25 months. Markit chief economist Chris Williamson connected the dots: "Domestic demand appears to be holding up well, but the sluggish global economy and strong dollar continue to act as dampeners on firms' order-book growth. Export orders showed a renewed decline, dropping for the first time in three months."

We are betting against, among others, Goldman Sachs, which predicts that the FOMC will "raise the funds rate by 100 basis points next year, or one hike per quarter—a fair amount above the 55–60 basis points pace priced into the bond market."

We are betting, too, against the stock market's typical early-year strength and against the many fixed-"income" investors who, self-accidentingly, have pushed the yields of $2 trillions' worth of European sovereign debt to less than zero. If we're right on currencies and economic growth (or the lack of

Investment words to live by.

it), the long-dollar/short-euro bets will fail to pay off.

Monday brought the Markit Flash Eurozone Manufacturing PMI for November, which reached a 19-month high. The text that accompanied the data referenced a three-month high in the growth in manufacturing output and the biggest gain in order books since April 2014. "Factory headcounts also rose at a faster rate as firms raised capacity in line with the improved demand environment," Markit reported. Maybe the high dollar and the low euro have already completed their missions.

Harping on gold for the past four fruitless years, it is we who have self-accidented. Still, we shall continue to harp, seeing in this (for now) widow- and widower-making metal a liquid and time-tested alternative to such instruments as the German two-year note, now priced to deliver minus 39 basis points.

Hear Bill Dudley, president of the Federal Reserve Bank of New York, declaim on the path of monetary policy (he said it last December): "With respect to 'how fast' the normalization process will proceed, that depends on two factors—how the economy evolves, and how financial-market conditions respond to movements in the federal funds-rate target. Financial-market conditions mainly include, but are not necessarily limited to, the level of short- and long-term interest rates, credit spreads and availability, equity prices and the foreign-exchange value of the dollar."

Considerations of institutional dignity will serve up a 25-basis-points funds rate next month. Economic and financial reality will force a redo next year. We are speculating, naturally.

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GRANT'S

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EDITOR

Vacation delectation

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