
Something Will Happen

Mid-Year 2007

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Two things that just don't seem to fit together.

There are periods in history when the stock market and the economy temporarily head in different directions. There is evidence that this is one of those times, it makes for an interesting story as you will see, and the divergence tends not to last over a long period of time. So, with a phrase made somewhat famous by Paul McCartney, our view is that "Something Will Happen" and this divergence will not last.

Exhibit A: Stock Markets are Rising

At this writing, the best performing sector in the S&P 500 Index are the Energy stocks and the worst sector has been the Financial stocks, but overall the stock market continues to rise. Will it hold?

Exhibit B: What is the Economy REALLY Doing?

Low Inflation? - or "They don't make 'em like they used to!"

One of my great friends is fond of saying in recent years "I don't know what they are measuring with the Consumer Price Index, but prices of the things I buy keep going up and up."

It had been some time since I last dug through the efforts of the few overly ambitious economists who have come to similar conclusions that the economic statistics reported by the government don't always reflect reality. You will not read about this in the newspaper:

You may remember that changes were made to the calculation of the CPI Inflation Index early in the Clinton Administration in the 1990s (and this is not necessarily a political comment.) Most people think the CPI measures the monthly and annual changes in the costs of a fixed basket of goods, such

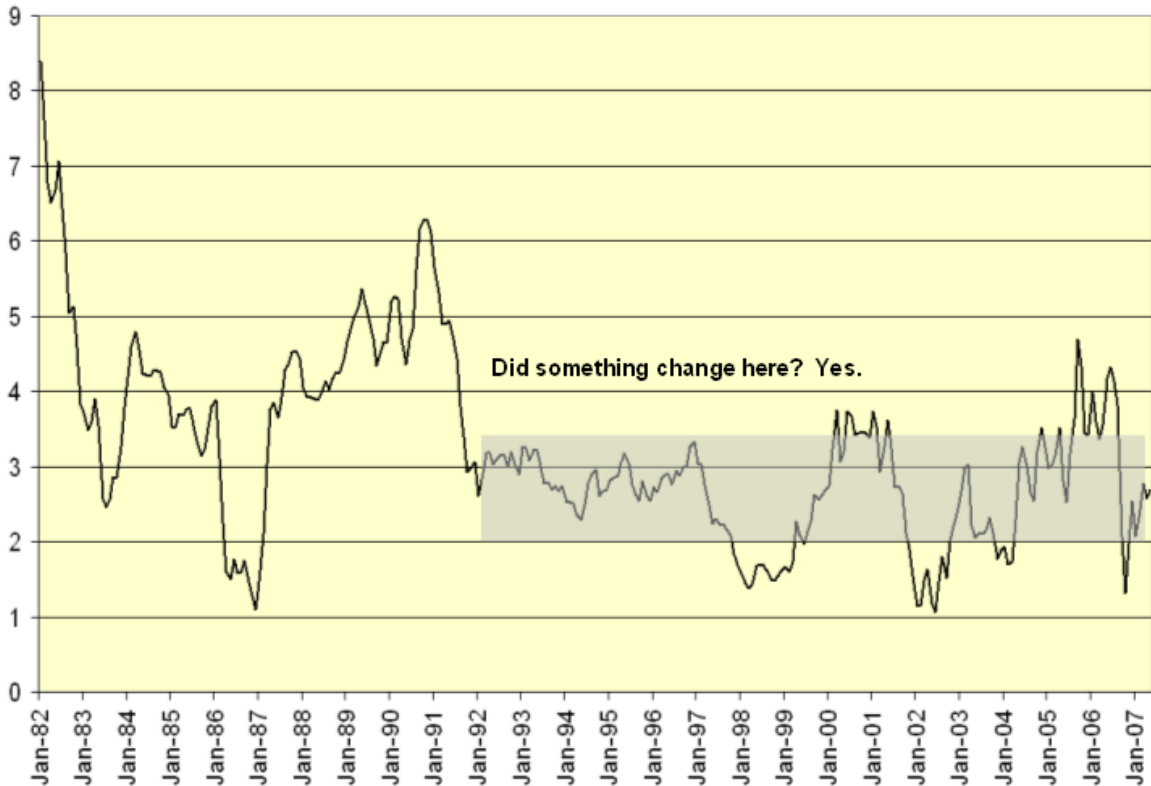
products being those to maintain a constant or average standard of living. The fact is that many changes have been made in the last 15 years, most all of which is documented on the Bureau of Labor Statistics website if you dig long enough. We can discuss this more in person rather than to here discuss the impact of changes to geometric weighting and the effects of swapping items in and out of the “fixed market basket” – but one of the new games worth discussing are the Hedonic Adjustments.

A hedonic or pleasure adjustment is made on the assumption that the new product has gone up in price because of an improvement in quality, not inflation. So if the government decides that half of the price increase of your new car or new kitchen toaster is attributable to quality improvements, then only half of the price increase is reflected in inflation... but you still have to buy the new toaster or can opener or whatever even if you don't really need one with special LED lights and new touch-sensitive controls. They didn't make qualitative adjustments before, and I'm not so sure my pleasure with products is always improving. Am I the only person who thinks the old and less-cute can-openers worked better and lasted longer?

Which brings me to the next topic: hedonic adjustment vs planned obsolescence, or “They don't make 'em like they used to!” Because of rising costs (we used to call this inflation), companies began making products out of cheaper materials using cheaper labor to gain a cost advantage. Your old washer and dryer lasted 20+ years and was made like an M60 military tank fit for General Patton. With the new ones, let's hope we make it 8 years before the plastic nub buttons crack or some of the electronics zap out, because our washer has more lights and buttons than Apollo 12 (which justifies a hedonic adjustment at the Bureau of Labor Statistics.) Now the rationalization to the consumer, of a shorter product life expectancy, is that because of changing technology, you won't want your old washer more than 8-10 years anyway. So it's built to be obsolete and last about half as long. Planned obsolescence is apparently not part of the equation in determining “quality” for hedonic adjustments.

Bottom line, once the raw data is re-weighted, adjusted for hedonic quality, adjusted for seasonality, and then statistically smoothed – surprise, surprise, you get a much steadier series of numbers.

Annual Percentage Change in CPI over the last 25 years:



Annual rates of inflation according to the Bureau of Labor Statistics look very well behaved. That's pretty amazing considering a barrel of crude oil sold for \$12 ten years ago, and it has been increasing about 20% annually since to nearly \$70 today. The prices of copper, natural gas, and industrial materials have been increasing over 15% annually over the last ten years. The costs of energy and materials are fairly central to the component costs and transportation of most products in the economy. To be fair, there are deflationary impacts from China, Wal-Mart, technology, and global competition, so this analysis is not perfect, but there is evidence that my friend is right when he says "I don't know what they are measuring with the Consumer Price Index, but prices of the things I buy keep going up and up." It is possible to estimate that the actual rate of inflation for the things you and I buy is 4-7% higher than the reported figures. Calculating inflation the way we did before the Clinton years, could make the 2.5% increase in the CPI instead be well over 6%. Interested in your feedback as to whether this in fact seems more accurate based on your own personal expenses, but this is also important for other reasons:

U. S. Economic Growth and Employment

The newspapers quote the growth rate for the U.S. economy as the Gross Domestic Product (GDP) as reported by the Department of Commerce. Excuse me, make that the Real GDP as opposed to the Nominal GDP. Economic growth that results from rising prices is not "real" so economists subtract price inflation from the calculated Nominal GDP to arrive at Real GDP. If Nominal GDP is growing at 7% and the inflation rate calculation is 3% then the resulting Real GDP growth rate is 4%... a pretty good economy. If the inflation rate calculations involve some of the weightings, adjustments, and revisions we've just discussed, a higher actual price inflation figure would correspondingly result in a much lower Real GDP growth rate. Play with that, and you can arrive at some interesting possible results for the economy in recent years and future quarters.

Some economists have pointed to other problems in the reporting of GDP, but the impact of the inflation calculation alone on Real GDP is most interesting to us, and a reminder that the veracity of common statistics and news releases often requires more study and contemplation.

The government recently reported the unemployment rate for May to be unchanged at 4.5%. Again, we can get into the details in our separate discussions, but calculated the way the U. S. Department of Labor previously reported the figures... the unemployment rate for May could have been reported as being over 8%. That's not an insignificant difference.

Virtually all economists agree that the current economic expansion lags the typical experience of past cycles, in terms of GDP, employment, certain capital investment figures, and so on. But the current expansion has surpassed previous cycles in one very interesting category:

Corporate Profits and Debt

Profit growth during this economic cycle has far exceeded the normal experience. This remarkable result stems partly from accounting and fiscal policy factors such as reduced taxation, interest, and depreciation charges, but also from macroeconomic factors such as a weak dollar, international growth, controlled labor costs, and global outsourcing. As mentioned earlier in the year however, the benefits of the accounting and fiscal policy factors are receding over time.

Corporate share earnings, and the valuation of equities, have also greatly benefited from leverage. Extreme factors in this trend are the record corporate stock buybacks and leveraged acquisitions taking place. We have discussed the risks in the current multi-year credit cycle, and don't need to repeat the unprecedented growth in debt on multiple levels of government, business, and consumer balance sheets – but there are signs that the consumer has reached a limit. Sales trends at major retailers are lagging, late payments and defaults are rising dramatically, and the record levels of debt have started to impact family spending as interest rates have adjusted upwards. The consumer is being viewed as particularly important to the current cycle of US economic activity. Following a fourth quarter real GDP

growth rate of 2.5%, the initial estimate of 1.3% growth in the first quarter of this year has now been reduced to just 0.6%. Expect to hear more rumblings of recession through the remainder of the year.

We are not conspiracy theorists, but the combination of reduced confidence in the economic statistics reported to us from the District of Columbia, along with corporate earnings figures that increasingly seem to be assisted through “financial engineering” causes us to be careful in analyzing corporate earnings. The market may increasingly become suspect of the quality and durability of current earnings. I am... and that might also explain why P/E ratios are not at overly high levels.

Prudent Action

So the stock market is rising, yet earnings and economic momentum are moderating, and our vulnerability to recession has increased. Strategists at the large U.S. financial firms remain optimistic and quite bullish. Some of the economists at such firms have raised longer term concerns however, and the presence of so much leverage in the system provides multiple ways for “fear” to manifest itself. These things don’t necessarily go together, and we think that Something Will Happen.

Experience tells us that the catalyst for a financial shock typically originates from an unexpected source, but if something does happen, the current position of the economy is vulnerable to recession, and the impact of any financial shock is likely to be global in its reach considering the saturation of hot money around the world.

So our perspective is this – for now the stock market is likely to make another push to new highs, continuing the current momentum. Historically, rallies at this point in the cycle tend to have a weaker breadth of participation... with fewer and fewer sectors and stocks participating. However, we are losing conviction that the market would be able to hold those new highs and values, so we’ve expected these rallies in the second quarter and this summer to be used to reduce our exposure to the stock market and “bank some profits.”

The longer term trends and directions remain close to what we’ve discussed in the past...

At this writing, the best performing sector in the S&P 500 Index are the Energy stocks. The worst performing sector has been the Financial stocks this year. As the year progresses, increasingly it is the largest market capitalization companies that are taking the lead, and there is some evidence that market breadth and participation is thinning. Volatility is certainly increasing this year, as expected.

We are still uncertain about the timing of the next upmove in gold. Ultimately it heads higher, but over the near-term the dollar may strengthen and gold may weaken with these higher interest rates in the United States, so the stars aren’t quite aligned perfectly for gold at the moment. As discussed, cyclical inflation has rotated into more of the agricultural commodities, wheat prices are at multi-year highs for example, and the cost of food is going up right along with the price of gasoline and utility bills.

Our investment performance has continued to be quite good in most all accounts. If we make a mistake over the next few quarters, it may be that we will be too conservative with the investments. We certainly don’t intend to increase our risks at this point.

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