

# Our Expectations Appear to Be Unfolding

November 22, 2004

A cyclical economic top is in the offing. The NBER's (National Bureau of Economic Research) economic leading indicators have been down for five months in a row. "Back in the old days," three consecutive monthly declines were almost certain to be followed, within six months, by a recession. However, as we have, over the years, moved from a manufacturing economy to one of service, this long-standing relationship has been less sure. Not long ago we became aware of a new set of indicators, which took the original work (three in a row above NBER reference) to a new level, which takes into account the changing nature of the economy. This indicator is called the ECRI Weekly Leading Index and it has been in decline since April of this year. Nothing is certain except death and taxes, but one can be quite confident that at best a slowdown is in the cards.

Another compelling indication of trouble ahead is the gradual increase in the underlying inflation rate. Just as we were near deflation some four years ago, today it is our opinion that we are witnessing a cycle top increase in inflation which will move toward deflation again as a new recession unfolds.

If the above is correct, and we believe it is, we expect the markets to behave somewhat as follows. The stock markets should soon begin to discount a recession by going lower. Again, in our opinion, this will constitute the second leg down in an ongoing bear market and will probably reach new lows. The bond market should also weaken again along with most commodities markets, it's o-for-3 in the financial markets, to use an old baseball metaphor. While we believe the stock market is in a secular bear market, we continue to believe government bonds remain in their 20-plus year bull market. It's entirely possible that the 30-year government, now 4.85%, could move to 5.50% or so over the next several months. If so, a great buying opportunity will emerge and our 100% move to money markets funds on September 24, 2004 will have been validated.

Please take that to the table with you on Thursday.

A truly Happy Thanksgiving to all.