

# Things May Not Be Coming Up Roses

November 15, 2004

In all probability, you have heard us say these things before, but we believe it is important that it be said again. (1) Many times it is not the absolute numerical level that counts, but rather the trend. (2) The difference between 1% and 2% is not 1%, but 50%. (3) It is not mathematical formulas, but rather human behavior that drives markets.

In regard to (1) and (2) above, note the following historical record of Federal Reserve and market indices interest rate increases in the past and their effect upon the economy:

1. 90 T Bill rates went from 0.11% to 0.55% - 1937 Recession
2. 90 T Bill rates went from 0.92% to 1.14% - 1945 Recession
3. 90 T Bill rates went from 1.74% to 2.20% - 1949 Recession
4. 90 T Bill rates went from 2.60% to 3.35% - 1953 Recession
5. 90 T Bill rates went from 2.85% to 4.50% - 1958 Recession

Please note the levels from which the monetary tightening commenced. You see, there is a reason why rates are where they are at any particular time, and many times it has nothing to do with what the Fed has done. However, when they increase rates it means they are tightening and when they reduced rates, it means easing. In our opinion, the level makes little difference. Today we are on a tightening phase and in our view of the world, it signals a recession ahead.

Now, as to item (3), we are seeing the stock market experience a nice move upward. As you may remember, it began a few days before the election. How does this square with our outlook of a recession next year sometime? We believe it has to do with the election of George W. Bush. This may or may not make sense, but the perception is that Republicans are more pro-business than Democrats. Human behavior at work again. As a matter of fact, we believe it's quite probable that the GOP will rue the day they won the 2004 election. The world economic outlook is not all that good. Guess who will be blamed.

Our reasoning for a less than enthusiastic outlook for the economy is as follows:

1. Federal Reserve tightening
2. Lack of fiscal stimulus
  - a. No additional tax cuts
  - b. No further increases in defense spending
3. Too much consumer debt
4. Lack of historical employment increases
5. European slowdown
6. Probable Chinese hard landing
7. Possibility of a financial accident
8. Housing bubble
9. Consumer durable bubble – automobiles
10. Practical end of housing refinancing