

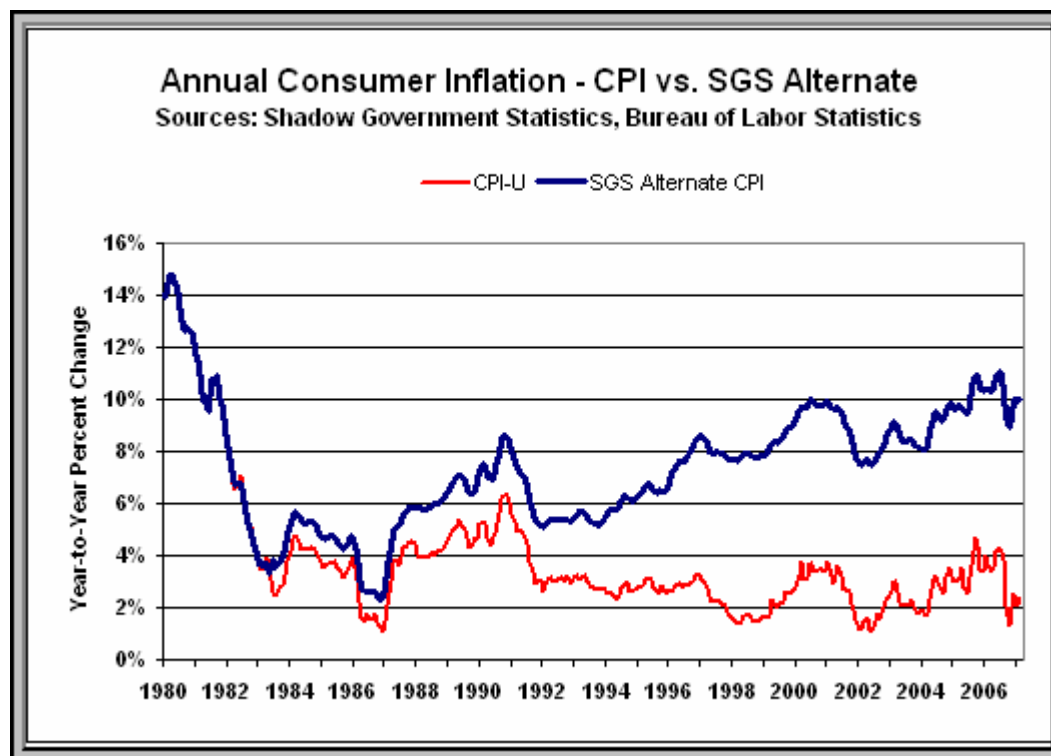
Is the US Economy already in Recession???

Marc Faber

According to David Rosenberg, the chief economist of Merrill Lynch, the Conference Board's Official Index of Leading Indicators did something in March it has not done since the final few months of 2000, which is to post a third consecutive monthly decline on a year-on-year basis.

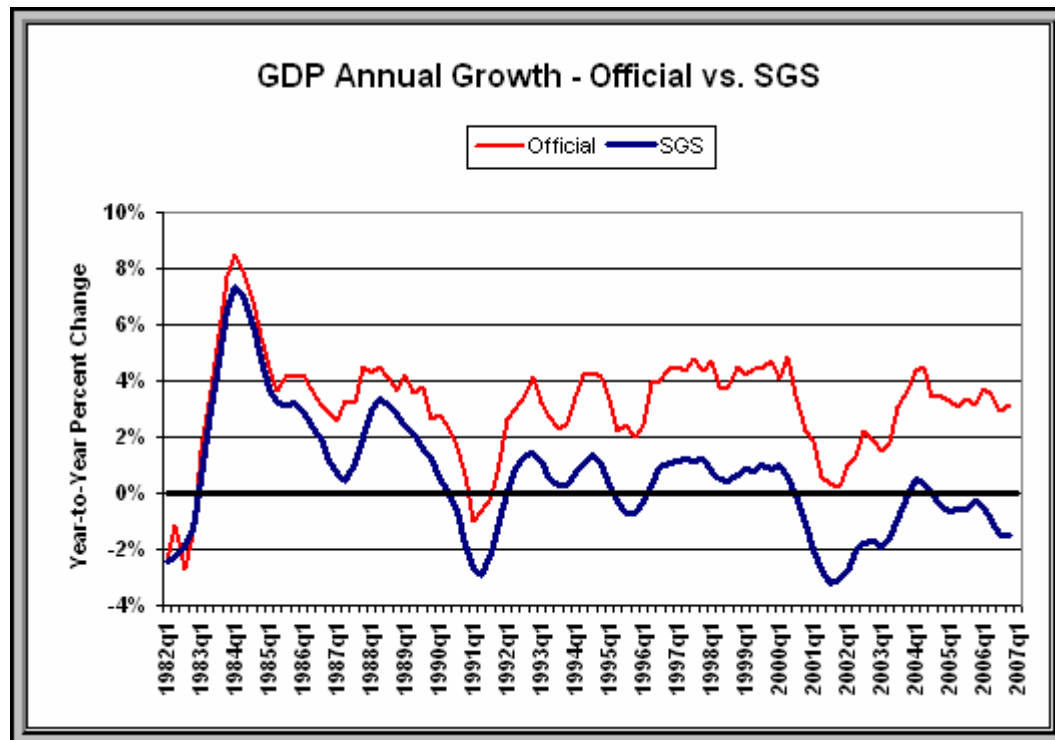
According to Rosenberg, "there have been eight other times in the past 50 years where we saw multiple year-on-year declines in the LEI, and this never failed to signal a sharp slowing in economic activity. In fact, in the year after the first move below the zero-line, GDP growth slowed all eight times and by an average of 375 basis points; on six occasions, or 75% of the time, growth in the subsequent year was 0% or less. On average, the S&P 500 was down 4% during these episodes".

There is no doubt that the US economy has been slowing down considerably and in fact, if inflation was properly measured there would likely be no growth at all in real terms. John Williams (www.shadowstats.com) does calculate the CPI based on the pre-Clinton methodology and according to the methodologies of the 1980s (no hedonic adjustments for quality improvements in manufactured goods and different weighting of the CPI basket of goods and services). According to him, adjusted to Pre-Clinton Era methodologies, annual inflation was about 6.2%, in March and reset to the methodologies of 1980, the SGS Alternate Consumer Inflation Measure rose to 10.2% in March (see Figure 1). Personally, based on my own calculation, inflation for well-to-do people is running in the US and elsewhere around the world at around 10% per annum whereas for the middle class inflation is running at minimum at 5% per annum.

Figure 1: US Inflation and Shadowstats Adjustments

Source: John Williams, www.shadowstats.com

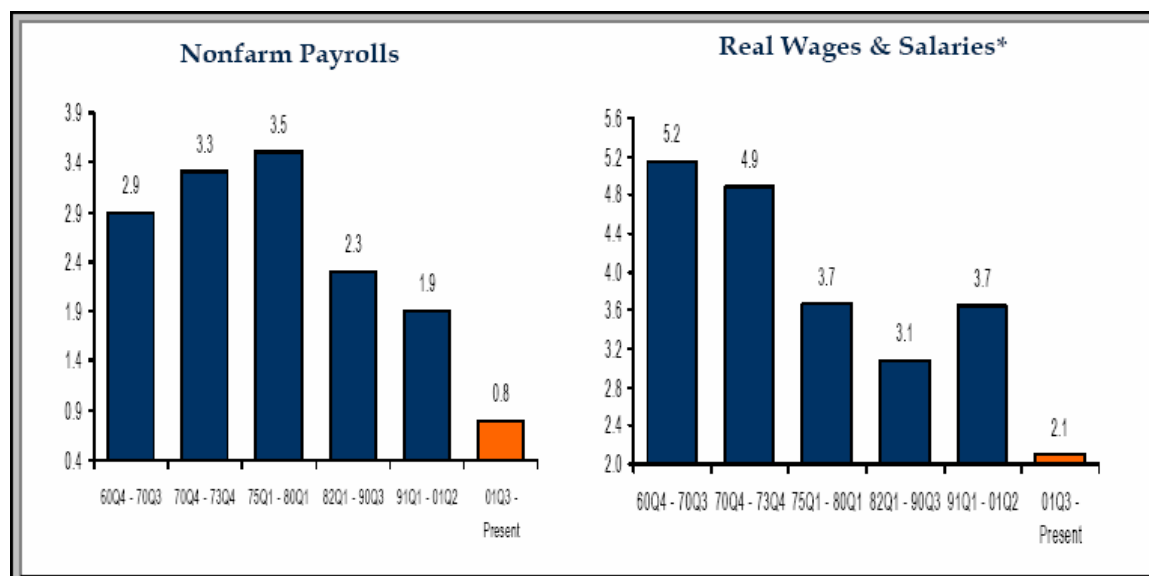
I must point out that the measurement of inflation is extremely complex, but it would seem to me that with the cost of health care and insurance increasing at around 10% per annum or more and with industrial commodity prices up substantially over the last twelve months (gasoline prices are up 50% year-to-date) the Bureau of Labor Statistics' inflation computation is significantly understating the true rate of price increases. The reason I calculate inflation for well-to-do people to be much higher than for the middle class is that most of the recent wealth accumulation accrued to just 5% of the population and, therefore, these 5% who live in prestigious areas, spend money in luxurious restaurants and hotels, do not travel on budget airlines and do send their children to private schools are subjected to far higher price increases than are common in the far less buoyant economy of the middle and working classes. But, if inflation in the US is not 2.2%, as the Bureau of Labor Statistics maintains, but ranges somewhere between 5% and 10% then obviously the economy has already entered a period of stagflation (see Figure 2).

Figure 2: GDP Growth Adjusted for “Correct Inflation Figures”

Source: John Williams, www.shadowstats.com

There is another point to consider. If we look at employment and wage growth during periods of economic growth, what is striking about the current US economic expansion is the sluggish behavior of both non-farm payroll and real wage growth (see Figure 3). In fact, if we calculated real wages adjusted by John Williams' inflation figures we would have had declining real wages and salaries over the last few years (this is my impression about behavior of real wages and salaries of the median American family).

Figure 3: Employment and Wage Growth During An Economic Expansion (average annual % change), 1960 – 2007



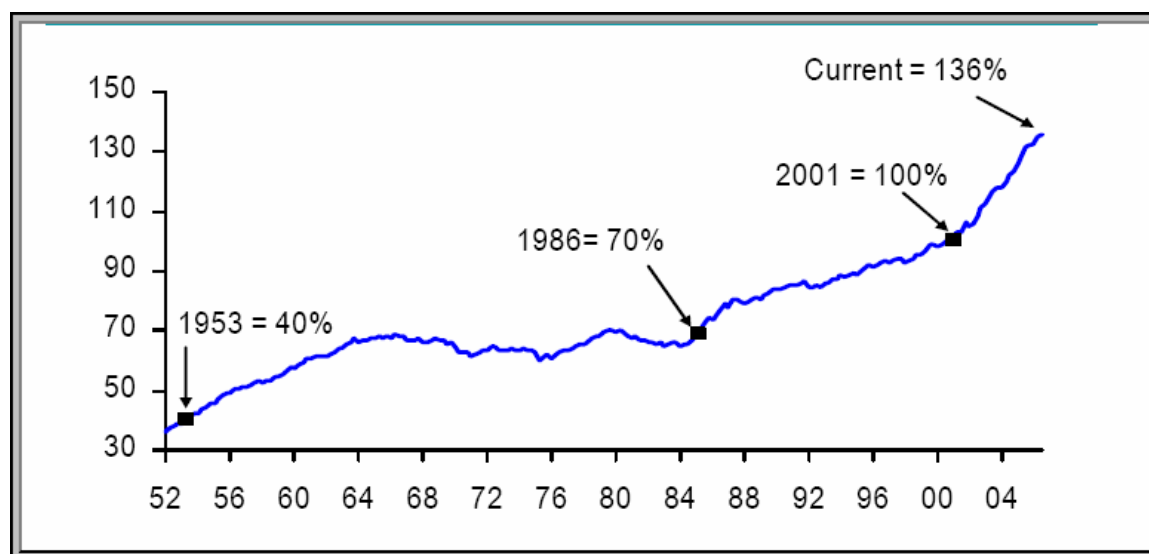
Source: David Rosenberg, Merrill Lynch

So, if the US economic expansion since November 2001 was not driven by employment and wage gains, and capital spending, which has remained extremely sluggish, the question is what drove consumption growth? According to David Rosenberg, “about twenty years ago, the questions that clients asked was how the economy was going to affect the stock market? How was the economy going to influence the housing market? Not anymore. Now it's about how the stock market and the housing market move the economy — both via the wealth effect, which has been the primary engine of growth for the US consumer in a cycle that goes down with the dubious distinction of being the weakest ever in terms of average annual employment and personal wage growth. Still, we can't help but wonder how economics has been turned on its head over the past two decades. It's now how assets drive the economy; not how the economy drives assets”. Even Mr. Greenspan expressed a similar view – belatedly – at his last Jackson Hole symposium in August 2005 when he said that, “The determination of global economic activity in recent years has been influenced importantly by capital gains on various types of assets, and the liabilities that finance them. Our forecasts and hence policy are becoming increasingly driven by asset price changes.”

But, both Mr. Rosenberg and Mr. Greenspan make, in my opinion, the mistake to observe the symptoms of the problem rather than the cause. The cause of the significant asset price gains is the easy monetary policy,

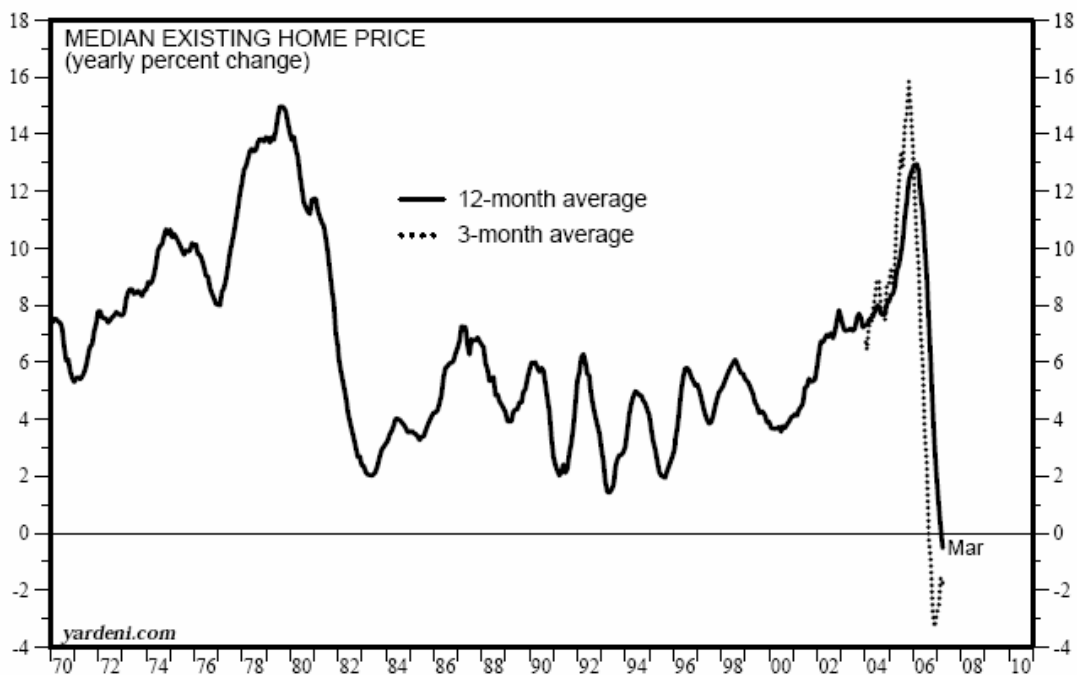
which Mr. Greenspan implemented over the last 20 years and which Mr. Bernanke has continued to pursue. I want to make this perfectly clear: it is the Fed's easy monetary policy which led to excessive credit growth and consequently boosted all asset prices from properties, commodities and equities to all kinds of totally useless collectibles. In particular, household debts rose exponentially with the Household Debt-to-Income Ratio increasing in the last five years as much as it did in the previous fifteen years (see Figure 4).

Figure 4: Household Debt-to-Income Ratio, 1952 - 2006



Source: Federal Reserve Board, David Rosenberg, Merrill Lynch

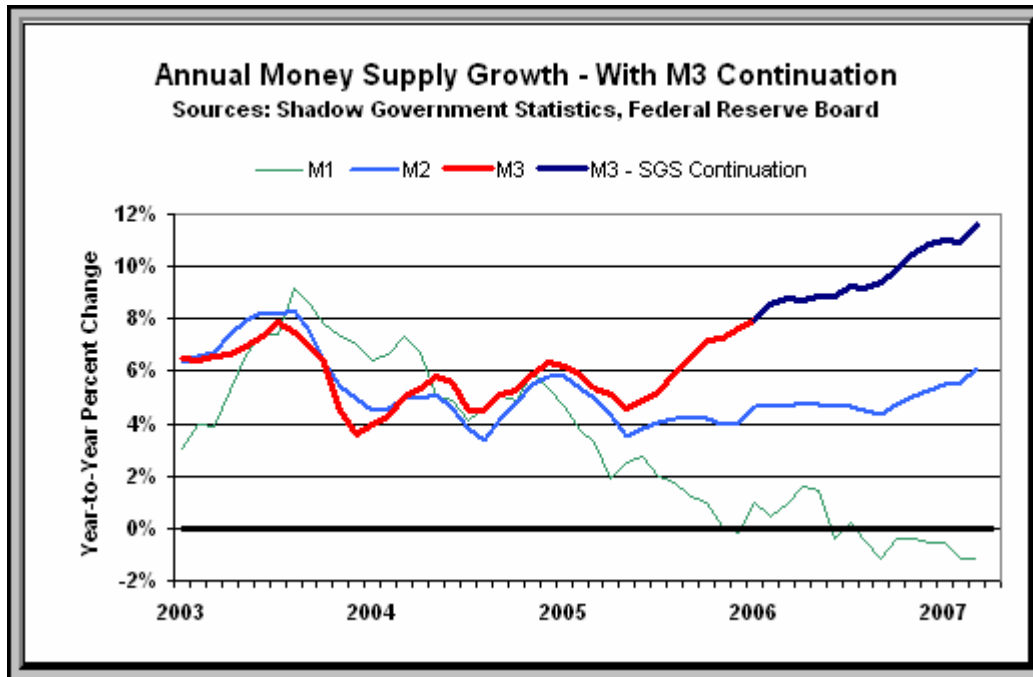
There are, however, problems with easy monetary policies driving up household debt levels and asset prices. For one we can see from Figure 4 that it took more than 30 years to increase household debt to income from 40% to 70% (1953 – 1986). Then, it took 15 years to increase household debt to income from 70% to 100% (1986 – 2001), but only five years to push it up from 100% to 136% (2001 – 2006). So, it would seem that in order to keep the economic plane flying household debt as a percent of income would need to continuously accelerate. But that may no longer be possible because lending standards for mortgages have been tightened and because home prices are no longer rising but declining (see Figure 5).

Figure 5: Median Existing Home Prices, 1970 - 2007

Source: Ed Yardeni, www.yardeni.com

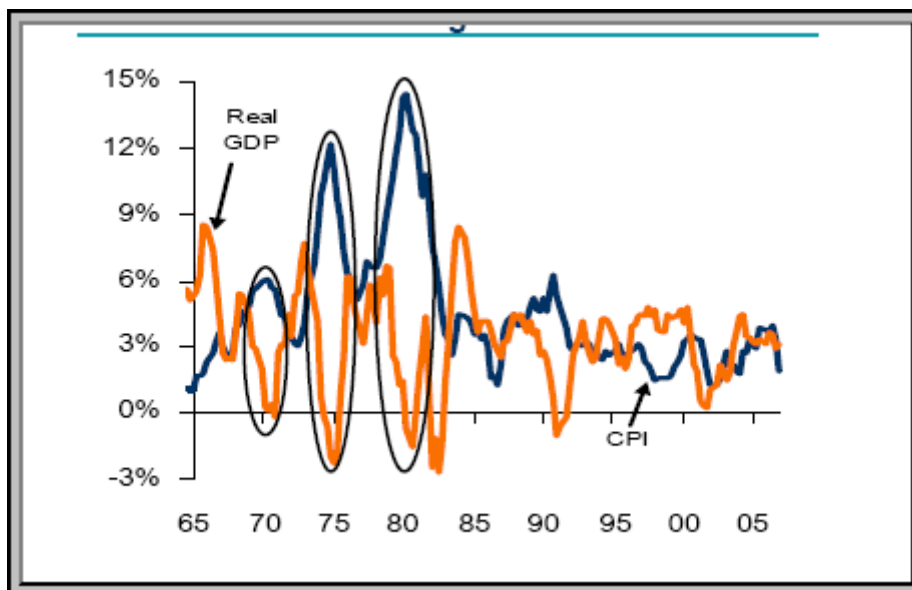
In fact, what is interesting is that home prices have been declining at a time of even faster monetary growth (see Figure 6). But whereas accelerating money supply growth has lately failed to boost home prices, faster money supply growth has continued to have some “favorable” consequences for other asset markets. The stock market took off as corporate debt growth for the purpose of acquiring assets accelerated. However, with M3, which is the broadest measure of money supply growth, now rising at close to 12% per year the question is how much further money supply and corporate debt growth (including financial leverage) can increase in order to sustain the stock market’s advance without having some painful side effects such as further dollar weakness, and rising commodity and import prices leading to stagflation or an inflationary recession (see Figure 7)

Figure 6: Annual Percentage Change Money Supply Growth



Source: John Williams, www.shadowstats.com

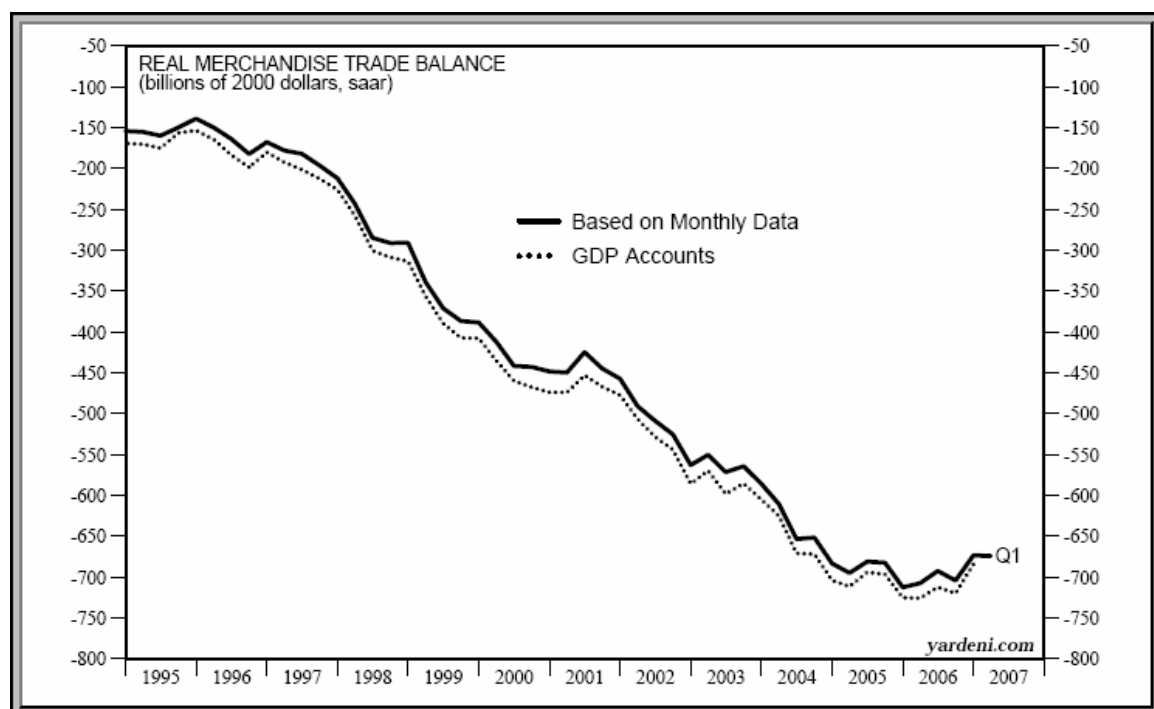
Figure 7: Stagflation in the 1970s



Source: David Rosenberg, Merrill Lynch

As can be seen from Figure 7, in the 1970s, the US experienced three inflationary recessions (1970, 1974 and 1982) as a result of “too much money printing”. It would, therefore, seem to me that Mr. Bernanke and the Fed have an almost impossible job. If money supply and credit growth do not accelerate further, asset markets will decline leading most likely to a deflationary recession. Conversely, if money supply and debt growth accelerate even more, the likelihood of an inflationary recession increases very materially. But what is more likely to occur – a deflationary or an inflationary recession??? Or should we consider the possibility of both occurring at short intervals? Given the extremely extended position of stock and other asset markets around the world at a time of some illiquidity in the US household sector, which has led households to sell equities to offset their declining Home Equity Extraction in order to sustain consumption, a whiff of, initially, a deflationary slowdown is quite possible. This even more so, as there is an almost universal conviction among investors that the various asset bubbles will continue to inflate. But, as I mentioned in the April report, one source of global liquidity – the US trade and current account deficits – is no longer expanding (see Figure 8).

Figure 8: US Trade Deficit, 1995 - 2007



Source: Ed Yardeni, www.yardeni.com

As a side, the stagnating or modestly improving US trade deficit is confirming the slowdown in the US economy. When the economy expands consumption increases and imports soar. This leads to an expanding trade deficit, as was the case between 1995 and 2006. Conversely, when the economy slows down or contracts, the trade deficit immediately stagnates, as was the case in early 2001 or as is the case now (see Figure 8).

But returning to global liquidity one has to wonder why diminished global liquidity from the US trade and current account deficits no longer growing have not yet hurt overseas stock markets and strengthened the US dollar. Because, as indicated earlier, money supply growth (see Figure 6) and “leverage” in the financial markets have increased. However, I would be very careful to play rising asset markets only on the basis of increased leverage at the very time we clearly experience a meaningful economic slowdown or when we are possibly already in a recession (see Figure 9).

Figure 9: Amex Airline Index (XAL), 2005 - 2007



Source: www.decisionpoint.com

Take as an example the Amex Airline Index. Since its January 2007 high it has plunged and is now no higher than in late 2005. Similarly stocks like FedEx, UPS and AMR seem to indicate a considerable slowdown in business activity. I am mentioning airline stocks because although the major stock market indices are making new highs, an increasing number of sectors are not performing. Weakness began in 2005 in homebuilding stocks, spread to sub-prime lenders in 2006, and is now becoming increasingly evident among economically sensitive stocks while at the same time bullish sentiment and optimism among investors is in record territory! We are truly in the midst of a buying frenzy or buying panic during which investors collectively believe that they can play the asset inflation game until it stops and then all get out profitably at the same time. But changes in a market's direction can be very subtle. Take the Chinese stock market (see Figure 10).

Figure 10: iShare FTSE/Xinhua China 25 Index Fund (FXI)

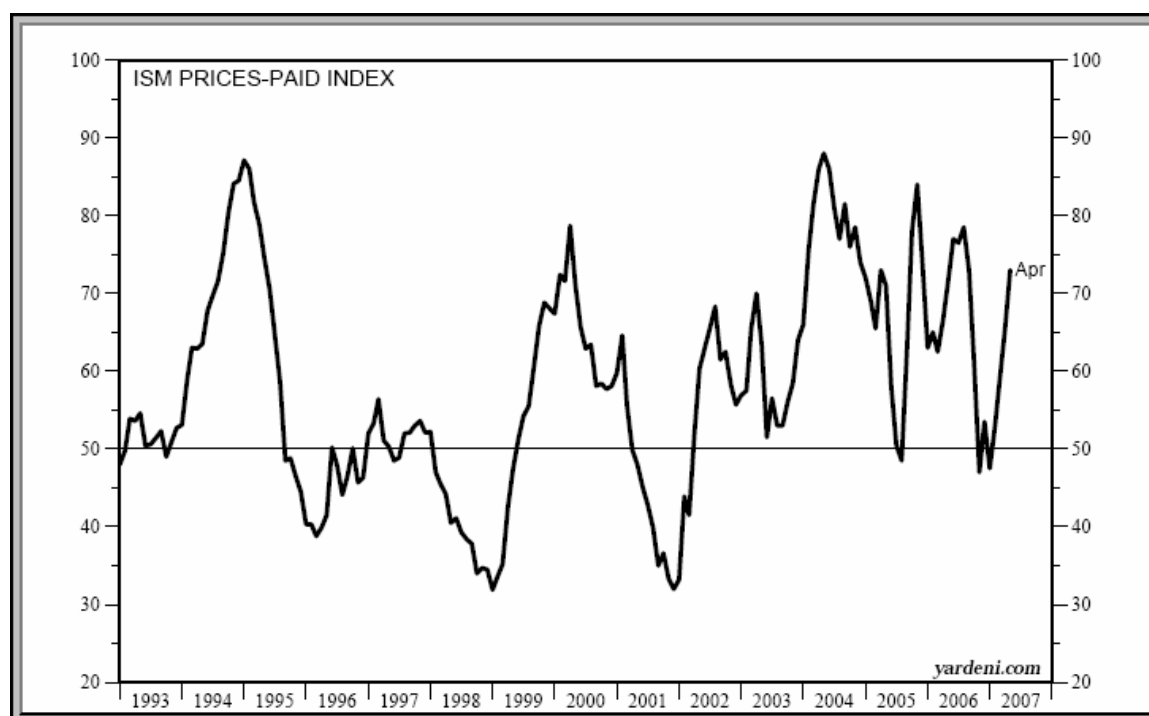


Source: www.decisionpoint.com

Whereas the domestic Chinese stock market has continued to make new highs, most Chinese equities are already significantly below their pre February 2007 highs. In other words, it would seem that the global asset inflation is slowly narrowing with fewer and fewer assets still surging. One asset class which has joined the downturn in US home prices is the Spanish property market, where the shares of some home builders and construction companies have crashed by 60% in the last two weeks.

Now, I concede that it would be wrong to conclude that a weakening US economy or a recessionary US economy may necessarily mean that asset prices will decline. After all, the Fed could aggressively cut rates in order to push even more liquidity (leverage) into the system. However, we should consider the consequences of even faster US debt growth. The dollar would likely tumble and consumer price inflation would most certainly accelerate (see Figure 11).

Figure 11: ISM Prices-Paid Index

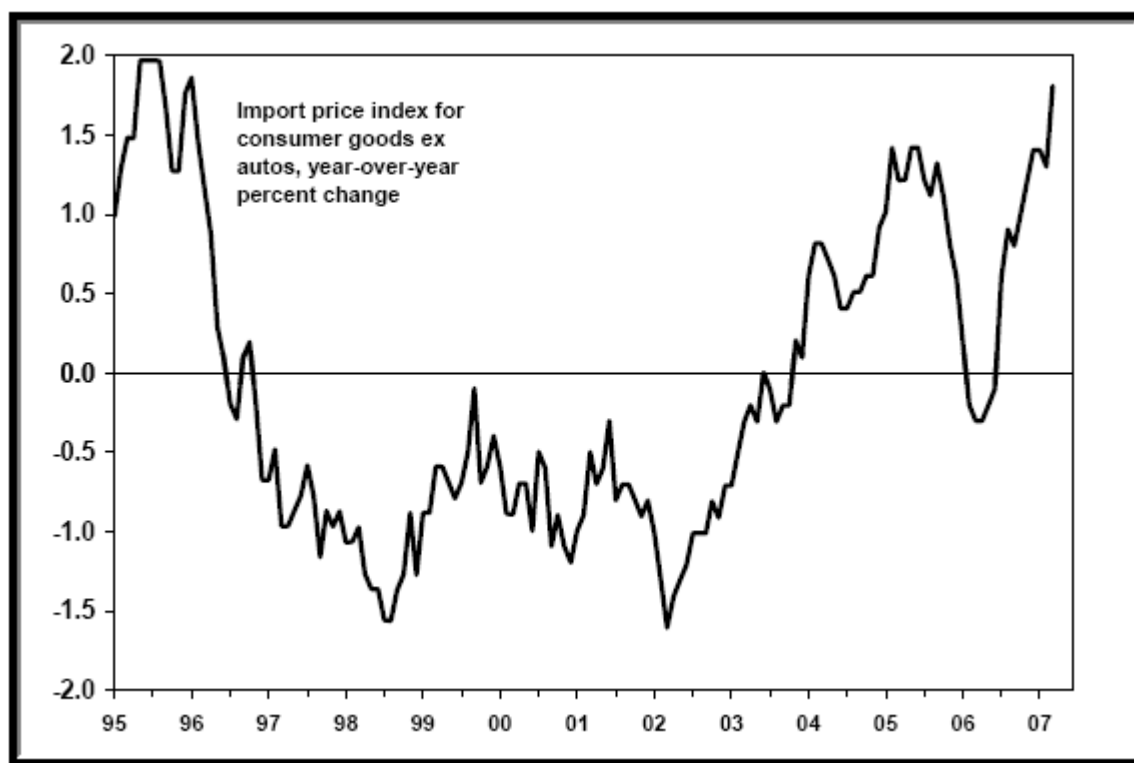


Source: Institute of Supply Management, Ed Yardeni,
www.yardeni.com

So, whereas the stock market celebrated the April rebound in the ISM manufacturing composite index little attention was paid to the sharp

increase in the prices-paid index. Moreover, a further sharp rise in money supply and debt growth would almost guarantee a further acceleration of import price increases (see Figure 12).

Figure 12: Import Price Index, Consumer Goods, 1995 - 2007



Source: Merrill Lynch

Therefore, even if I am wrong about a weakening economy, which could derail the bull market in asset prices, further economic strength could mean far higher inflation and interest rates, and also lead to the end of the colossal asset inflation, which we have experienced in recent years in property, commodities, collectible and equity prices on an unprecedented global scale.

If selling panics provide favorable entry points in asset markets I suppose that buying frenzies should offer excellent exit opportunities. I would, therefore, use the current strength in equity markets around the world, which has left them in an extremely overbought position, as an opportunity to sell and certainly not to increase positions. Particularly vulnerable are economically sensitive stocks such as consumer discretionary (specialty retailers), material companies (steel), and

investment banks and the overstretched and over-popular emerging stock markets. Energy stocks are likely to out-perform, and coal stocks such as Peabody Energy (BTU) and Arch Coal (ACI) have - following their significant correction over the last twelve months – some upside potential. Unlike other markets, the Thai stock market continues to offer good value with relatively low risk. My selection of stocks would include Thai Reinsurance (THRE TB), DSG International (DSGT TB), Charoen Pokphand Foods (CPF TB), Ayudhya Insurance (AYUD TB), TIPCO Food (TIPCO TB), Bangkok Expressway (BECL TB), L.P.N. Development (LPN TB), and Lee Feedmill (LEE TB).

Lastly, as a contrarian play I would buy the US dollar against the Euro. Sentiment about the dollar is very negative and the dollar is oversold near term. This is not to say that my long term negative about the dollar has changed but a near-term bounce is probable.

I continue to recommend the gradual accumulation of precious metals. Precious metals are the only asset class for which I have a high degree of confidence from a long term perspective. Also I would not hesitate to increase the exposure should precious metals correct by 10% or more.