

The Market School

Scit Uti Foro

Growth and Inflation Indicators and Outlook –Summer 2013

Long-term portfolios require confident patience rather than frequent, gut-felt modifications. Often, emotions of fear or over-confidence result in ineffective portfolio changes. As noted elsewhere, three of the greatest risks to asset performance are concentration risk, leverage risk, and timing risk. In each instance, investors are assuming enough foresight, complacency or conviction to make lop-sided commitments by doubling down, borrowing for more exposure or seeking to time a market move. Occasionally this leads to lop-sided gains--but more frequently, these methods go wrong, prompting far more lop-sided damage to the portfolio, damage which may require years from which to recover. The lesson is painful and reminds investors again and again that portfolios thrive in the long run not by timing upsides but by avoiding exaggerated downsides. In sum, and as *Moneyball's* Billy Bean noted, we should hate losing more than we like winning, because there *is* a big difference.

But does confident patience mean we avoid any active forecasting and portfolio modifications? And if so, what indicators can we rely on to make reasonable decisions regarding *tactically* over or underweighting certain asset classes under specific market conditions? Finally, is such “tweaking” of the portfolio a violation of the very timing and concentration risks mentioned above?

In fact, there is historically tested validation for executing and timing certain, tactical portfolio modifications. But such modifications need sober guidance. That is, they must be supported by empirical evidence as to the patterns by which asset classes behave in particular market environments. Toward this end, sophisticated investors have traditionally been able to track two broad indicators of asset performance to make such allocation decisions, namely: 1) GDP Growth and 2) Inflation. Both macro forces have historically and consistently impacted the price movements of the four primary asset classes (stocks, bonds, commodities and gold). **The strongest indicators for measuring these macro forces (growth and inflation) are,**

respectively: 1) bond spreads and 2) movements in the gold price. In this unprecedented era of both growth uncertainty and inflation/deflation risk—each caused by unusual global (central bank) manipulation of the world markets following the 08 crisis, these indicators may offer particular guidance—but with a big caveat, as we shall discuss below, regarding the new “history” created by the 08 crisis.

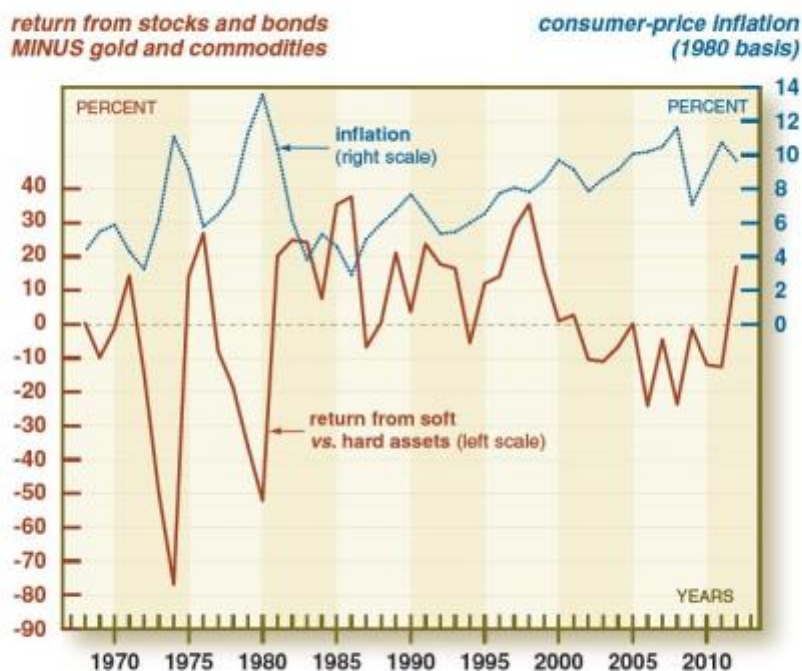
Today (August, 2013), valid concerns remain regarding the potential hazards on the global markets posed by the unprecedented “doping”/money-printing policies of the central banks of the US, Asia and the EU. (**See May 2013, White Paper, “Twilight Zone”**). The simultaneous and historically unrivaled experiment of dumping trillions of fiat-currencies into world exchanges will have consequences down the road that our children will read about in history books. For now, what can we do to manage these artificial markets? What follows is: 1) an examination of those consequences as to growth and inflation levels and 2) a guarded assessment of the predictive behavior of asset classes impacted by those levels. In some key ways, inflation and growth data can help us decide which asset classes should be over or under weighted in our portfolios.

I. Inflation and Asset Returns.

There is high inflation (inflation above average) and there is low inflation (inflation below average). In both cases, specific assets tend to perform differently. During high inflation, for example, gold and commodities *traditionally* tend to perform positively, whereas stocks and most bonds under-perform. Alternatively, in low inflation economies, there is inverse performance in those asset categories. In short, most recognize and accept that inflation affects asset classes. Asset classes, by reasonable deduction, will thus be either “risky” or “safe” depending upon such macro/inflation environments. For example, mortgage backed bonds or long treasuries would be considered “safe” bonds in one type of market, but risky in another, just as micro-cap stocks would be considered “safe” equities in one scenario but risky in another. In markets where inflation is low, portfolios should therefore be overweight those softer assets best suited for low inflation and underweight “hard assets” (i.e. precious metals) which tend to outperform more in high inflation trends. Put simply: Inflation favors hard assets and dis-favors soft assets. Looking at the graph immediately below (next page), which measures this relationship since 1967, the empirical/visual evidence is fairly obvious.

Inflation Promotes Hard Assets and Retards Soft Assets

calendar-year average data since 1967



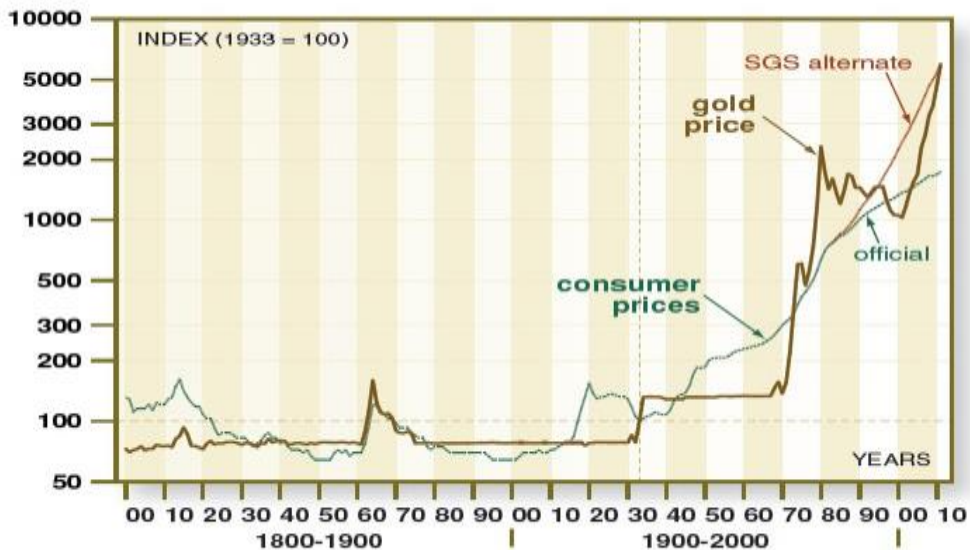
Data: Calendar-year averages of month-end total return indices for the S&P 500 and long Treasury bonds (University of Chicago/Dimensional Fund Advisors), of month-end spot prices for gold (Metals Week/Wall Street Journal) and industrial-metal prices (Reuters Bridge Commodity Research Bureau), and of monthly consumer-price index estimates recomputed on the pre-1980 methodology by Shadowstats Government Statistics.

Let's now consider the current state of US inflation. Brace yourselves. It seems no one wants to admit the obvious, or even how to measure it. A US Supreme Court justice once famously remarked, "I may not be able to legally define pornography, but I know it when I see it." The same, I feel, is true of inflation. According to the CPI published by the Bureau of Labor and Statistics, current inflation rests modestly at a rate of 1.8%. But any of us who frequent grocery stores, purchase gasoline or pay tuition, know this is a complete fiction. In other words, the CPI may say one thing, but "we all know inflation when we see it." (Here in Malibu, I pay \$4.60 for a gallon of gas due to a current oil bubble—to soon end, I hope.) I've written elsewhere about the broken inflation scale and the shifting methodologies used to measure inflation (*See May 9, 2010 White Paper, "Simple Macro Indicators"*). And the simple fact is that if we were to use consistent methodologies to measure inflation based on independent, empirical measurements (such as the SGS alternate to the government –fictional–CPI measurement), there is at least a 900 basis point gap between actual and reported inflation. In other words, real inflation--the kind we see and feel--is closer to 10.8% than it is to the reported 1.8%. Knowing this, we have to accept the reality (rather than published fiction) that we are already living in a high inflationary environment. With this knowledge, we can therefore prepare, build and weigh our portfolios accordingly.

We feel inflation at the Californian gas pump, the toll on the GW bridge in NYC, the grocery stores in Michigan or the tuition at University X,Y or Z, but how do we confirm and track it empirically? Rather than just poke holes in the checkered history and methodology of the CPI, we can best confirm inflationary environments by examining the historical relationship between the price of gold and the rate of inflation. The graph below provides plain evidence that US Inflation (as measured by either the official CPI standards or the SGS alternate) is profoundly signaled by the market price of gold. In short: gold pricing matters. It tells us how to forecast

and weigh inflation, which is essential to asset selection, especially when the scale otherwise used for such weighing (the CPI) is broken.

US Inflation is Signaled by the Market Price of Gold since 1800



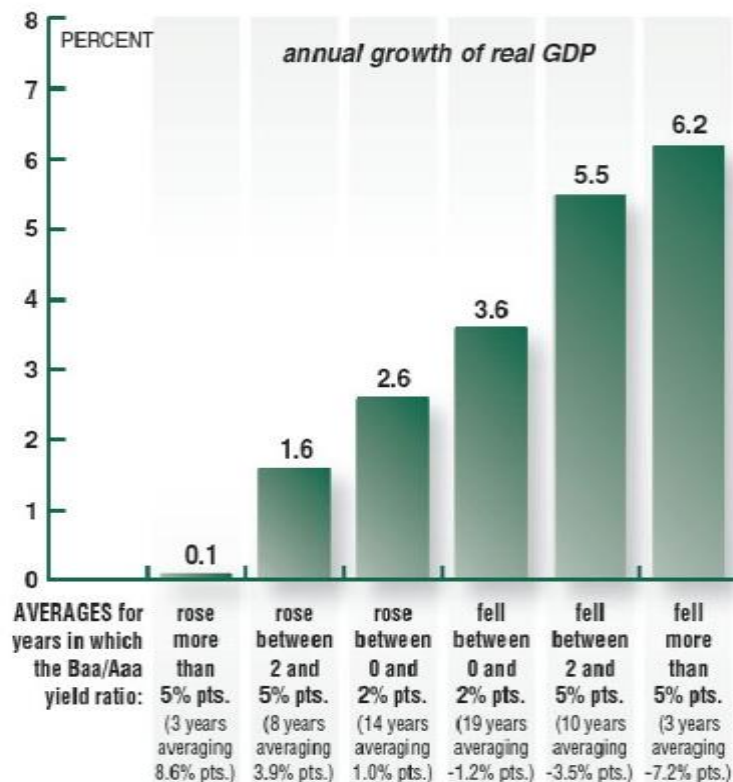
Data: Calendar-year averages of daily prices in US dollars for gold (Roy Jastram, *The Golden Constant*/Metals Week/Wall Street Journal) and of monthly US consumer prices (Federal Reserve Bank of New York/Bureau of Labor Statistics).

II. GDP Growth and Asset Returns

Just as asset classes behave differently in varying inflation scenarios (signaled by gold pricing), the same is historically true regarding the behavior of assets in varying growth scenarios (signaled, as we shall see, by bond spreads). GDP growth, for example, is an historical signal to enter riskier assets, such as smaller cap stocks while simultaneously pulling back on safer assets, such as certain types of bonds or gold. The inverse is true, of course, when growth declines. Again, what is risky and what is safe hinges dramatically upon the type of growth environment in which one is investing—low, stalled, or high. It is therefore important to have a clear understanding of where growth rates are, why they are behaving a certain way, and where they are heading. As hinted parenthetically above, the best indicator of growth conditions has historically rested with bond spreads—namely changes in the ratio of Baa to Aaa bond *yields*. The graph below (next page), which traces this relationship since 1948, offers visual clarity/confirmation of this powerful indicator.

A Linear Relationship between Economic Growth and Changes in the Ratio of Baa to Aaa Bond Yields

from 1948



Data: Changes in real GDP for calendar years (Bureau of Economic Analysis) and annual averages of the daily yields on Baa and Aaa corporate bonds for fiscal years ending in October (Moody's/Federal Reserve Board).

Credit spreads, by taking the pulse of growth projections, are thus strong indicators for anticipating growth rates, and, by extension, stock market moves. Where growth goes, stocks tend to follow. This is true not only in the US, but around the world. Looking specifically at calendar year average data since 1969, the two-year return from stocks in the US, France, Germany, Japan and the UK show remarkable correlation to the changing shifts in the Baa-Aaa bond spread. That is, in those years (4) where the yield spreads narrowed by more than 25 bps, all of those stock markets showed high, 22%-40% levels, whereas periods (6 years) where spreads widened by more than 25 bps, the global markets saw shared market declines in the 10% to -4% levels. In short: spreads matter too. They tell us where growth is, where it shifts, and how markets react.

III. Putting It Together.

Assets behave differently yet predictably during periods of high and low inflation; the same is true during periods of high and low growth. When looking at the major asset classes in most portfolios (i.e. equities, bonds, commodities and gold), one therefore needs to determine: A) the current growth and inflation status/outlook, and B) which assets are safe or risky within that status/outlook. From the evidence above, we have seen how gold pricing serves as a more reliable indicator of current and expected inflation; similarly, we have seen how bond spreads are equally reliable in demonstrating current and expected growth conditions and how markets

react. With these indicators, we can better examine how specific assets have and to behave in various growth and inflation scenarios. Looking at the relationships on the proceeding table, which shows the one-year return averages (percentages) from 1977 to 2011, we see how assets (from mortgage-backed bonds to the S&P Index) perform (+) and underperform (-) depending on growth and inflation conditions, suggesting that once we know the macros (inflation and growth), we can have more confidence in tactically predicting trends and thus weighing the asset classes.

US Asset Performance Classified by Prior Movements in Gold and Spreads
average one-year returns (percent), 1977-2011



Data: Calendar-year averages of month-end yields for Baa and Aaa corporate bonds (Moody's/Federal Reserve Board); month-end spot prices for gold and silver (*Metals Week/Wall Street Journal*) and crude oil and other non-precious commodities (Reuters Bridge Commodity Research Bureau); month-end total-return indices for the the S&P 500 companies and micro-cap stocks, long Treasury and high-grade corporate bonds (University of Chicago/Dimensional Fund Advisors), mortgage-backed bonds (Barclays Capital); and quarterly total-return indices for commercial real estate at transactions prices (MIT Institute for Real Estate Research/NACREIF).

As spreads widen (and hence growth slows), we predominantly experience performance favoring specific soft assets such as high-grade corporates, mortgage backed bonds, commercial real estate, crude oil and long treasuries as investors seek safety in slow economies. As spreads tighten (and growth improves) riskier, soft assets such as micro-cap stocks and the S&P Index show strength. Those same soft assets perform equally well in low inflation economies (where the prior-year change in gold pricing is down). In years, however, where inflation is rising (i.e. the prior-year change in the gold price is up), we typically observe—and hence overweigh—strength in silver (precious metals), the CRB index, crude oil (energy/commodities) and commercial real estate (hard assets).

Summing It Up.

So what does all this mean for the summer of 2013 and the year to come as far as tactical allocations and historical indicators? Based on the indicators highlighted above (i.e. gold-pricing and bond spreads) we are experiencing a sort of bi-polar market: bearish gold/inflation indicators and bullish spreads/growth signs. Looking first at inflation, it's fairly obvious that gold pricing— even changes in it—is so unusually high (and volatile) that inflation (regardless of what the CPI says) is a real concern and trend. The trillions in sovereign liquidity created by central banks and aggressive monetary policies (“AMP) only suggest greater risks to come regarding inflation, and I see this as the critical (and perhaps the most obvious yet misunderstood turning point) coming our way (and I’ve written of that elsewhere). History therefore tells us to allocate more to those assets which perform best within such a macro profile, namely various hard assets/commodities. As for growth indicators in the corporate bond

spreads, current levels are bullishly tight—though precariously so, giving mixed signals as to whether we are trending toward a higher or stagnant growth environment. That is, the bond market has bullish spreads (safely below the 20 year median) but bearish yields. So can these spreads be trusted to predict a more “risk on” tactical shift into soft assets (stocks and bonds) that favor high growth trends? Certainly the record-breaking highs in the early summer markets suggest that the growth environment is favorable to equities. History and the spreads confirm this; indeed, the entire point of this white paper suggests this. In short: risk on for 2013!

But here’s the rub, the elephant in the room, the game changer, the conundrum, the problem: *history has changed*. Of course, there’s no more hated expression in the markets than “this time it’s different.” Veterans of the markets scoff at such views and stick to their hard-won faith in the invisible hand of the markets and the natural flow of supply and demand cycles which make indicators like those discussed above more reliable than trendy macro views. Thus, if history says tight bond spreads suggest higher growth, trust history, not your savings account and enjoy this equities rally. But history has changed. Something *is* different. Current markets are not led by the invisible hands of commerce but by the highly visible hands of Bernanke, Draghi and any one of nine or more finance ministers hired and fired in Japan in the last five years. The smartest equity manager I know, by the way, is 40% in cash during this so-called “recovery”...

Thus, if bond spreads are tight, it may not be in the historical context we could otherwise trust. *The back testing discussed above regarding spreads was done in a pre-08 world* where sovereign-manipulated markets were not awash in the current era of M2 gone wild. When central banks—rather than investors-- are purchasing MBS, treasuries and other securities, can we really trust current spread data (or any data, really) for making the tactical allocations? In short: are markets truly measurable by traditional standards and thus safe to navigate? This is hard to know, and this, at least to me, is the primary question of the post-08 markets. It’s also why every serious money manager I know (and not just the buy-and-hold index-huggers and fee-gatherers) consider this post 08 era one of the hardest markets to trade—except, of course, in 20/20 hindsight. Views regarding growth or no-growth, recovery or no recovery are passionate and varied. Many point with tremendous conviction to tailwinds in corporate balance sheets, housing starts, energy production etc. as signs of a recovering, growing economy. The spreads suggest growth/recovery as well. But just as the CPI misleads to inflation,

I feel QE Infinity misleads as to spreads and growth, and therefore I remain cautious as to the reliability of the indicator in particular and the direction of our growth/ “recovery” in general. In sum: I see us in a high inflation low growth cycle—despite the traditional signals to the contrary. Portfolios seeking tactical guidance based on macro conditions can accept or reject this view, which is only partially supported by market history—a history which I feel changed in 2008, making the markets, the economy and history even less predictable. 2013 will likely do well for stocks and bonds—whether the indicators are natural or artificial. But in the long run, artificial markets are not sustainable, as central banks can’t beat natural market forces—instead they can just buy time with artificial tricks.

NOTE: All graphs/data shown herein were provided by express permission from H.C. Wainwright & Co. Economics Inc., who have given considerable attention to researching growth and inflation indicators and building investment decisions around that research.