

# Monthly Chartbook

## January 2007

**The US Economy & the Dow Jones  
Industrial Average has been *Photo  
shopped*...**

*...Living in the worlds largest “managed” economy*

**“The future *pre-decided*,  
Detached and subdivided  
In the mass production zone”**

-Rush, Subdivisions, 1982

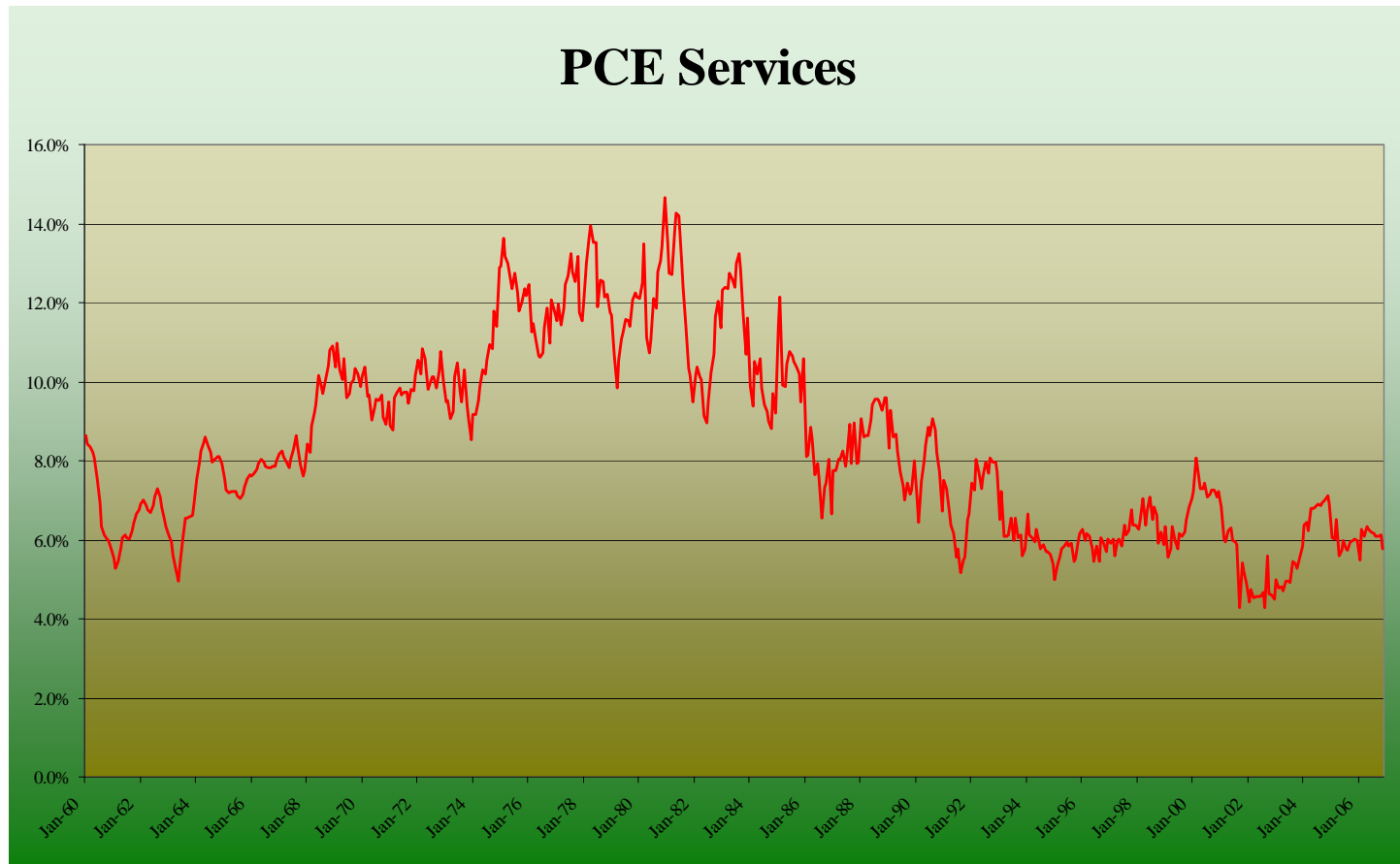
## Broad Points of “Managed Economy Thesis”

- **Major Sub-Theme: Risk is under-priced**
  - **US\$**
    - The dollar is weaker than it seems
    - Putin has more control over the future of the US\$ than Ben Bernanke (read: coming conversion of Russian Reserves to Euro)
  - **Fed’s Role**
    - The Fed no longer manages rates, inflation and employment but *asset prices as asset prices are more important to final demand*
    - We are sitting on the largest credit expansion in the history of mankind, with little to show for it other than Big Boxes and consumer spending
      - » In credit expansions bust always follows boom
  - **Housing/Potential effect on the market**
    - Condos are a bear market
    - Single Family housing is an inventory correction
  - **Inflation**
    - Wall Street is focused on commodity prices for the future of inflation, *wages determine the real course of future inflation*
    - Labor markets for skilled employees are tight and getting tighter.
    - Inflation remains a problem as employers compete for talent
    - Very real possibility of *profits recession* in next 18 months due to salary, wages and benefits
  - **Valuation**
    - Credit spreads in the first and third world have no risk premium built into them
    - Stocks are only cheap because the 10 year UST is below 5%
    - Growth in the US economy is flat at best at the low single digits

## Further Points of “Managed Economy Thesis”

- **PPT (Plunge Protection Team)**
  - **Active to manage outcomes in this economy because this is a War Time Whitehouse, actions seen as benefiting National Security and the War on Terror**
  - **Since Secretary Paulson was sworn in, the PPT has been very active in the Capital Markets.**
    - **Consider that Dow Jones Industrials Futures are rumored to be the favorite vehicle of the PPT**
      - » *To the average CEO the stock market is the leading indicator*
      - » **The DJIA was the leading index for 2006**
      - » **The S&P 500 went 162 trading days in 2006 without a 2% correction**
- **Debt and the US\$**
  - **We are relying on the kindness of strangers to finance unsustainable deficits (a la Mexico in the early 90’s)**
  - **As a nation in the USA, since the middle nineties, we seem to move from asset bubble to asset bubble**
- **Risk**
  - **It is clear to Cornerstone that the leading investment banks understand the PPTs actions**
    - **There profits are outsized at this point in the cycle**
      - » **Investment banks are taking on huge risks because they believe the Feds will bail them out if the bets go against them (SEE LTCM)**
- **Risk is under priced**
  - **Many financial intermediaries are only long financial assets at these prices because they have to be..**

## Macro-economic research



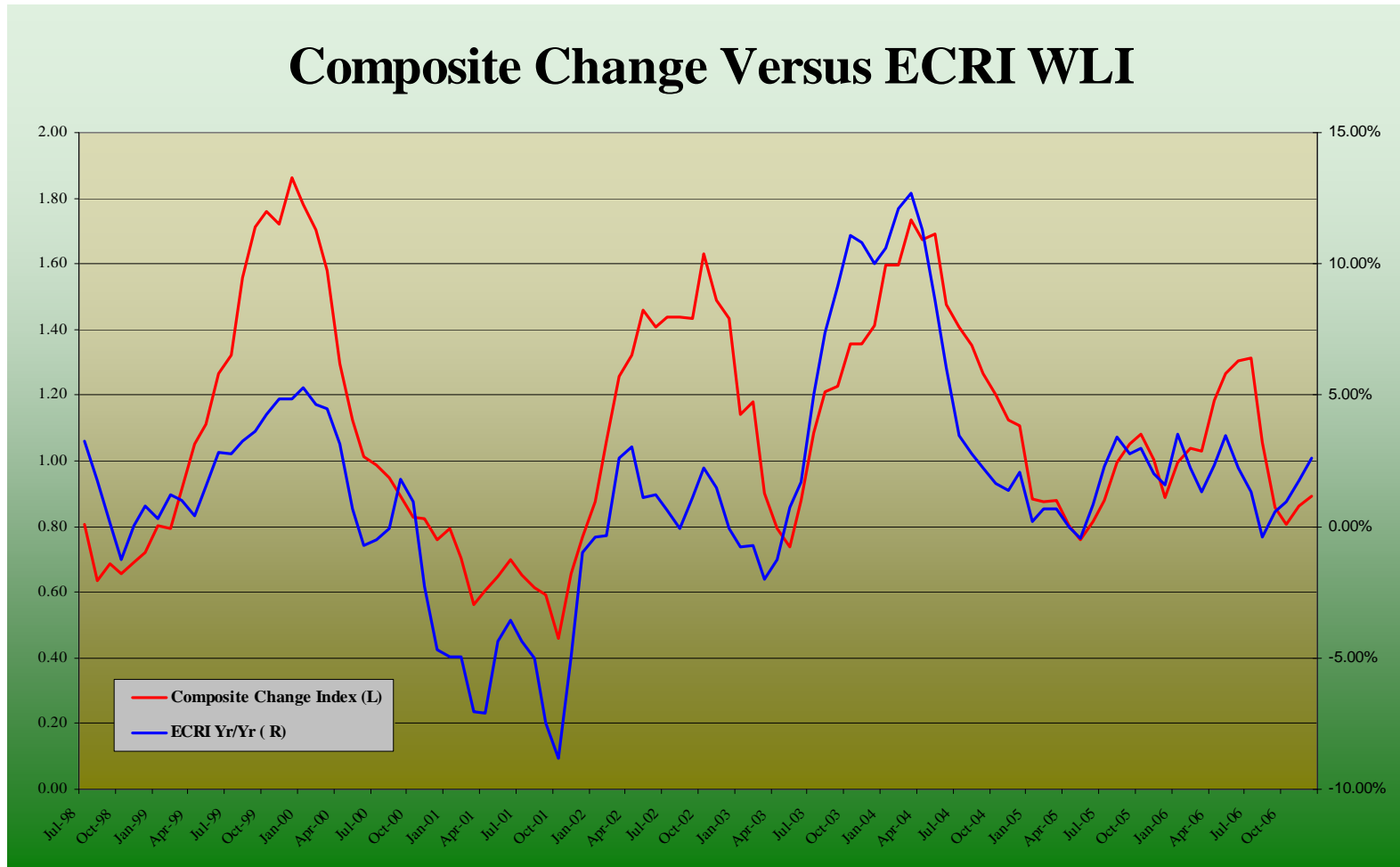
Inflation is low and falling? What? Not in this service based economy. The PCE (personal consumption expenditures) for *services* are running above 5.00% and has been for years. Goods prices fall over time (think VCR), service prices rise and keep rising (think about getting an electrician out to do something simple for less than \$80). All of the sudden owning the 10 year treasury below 5% doesn't look so good right?

## Macro-economic research

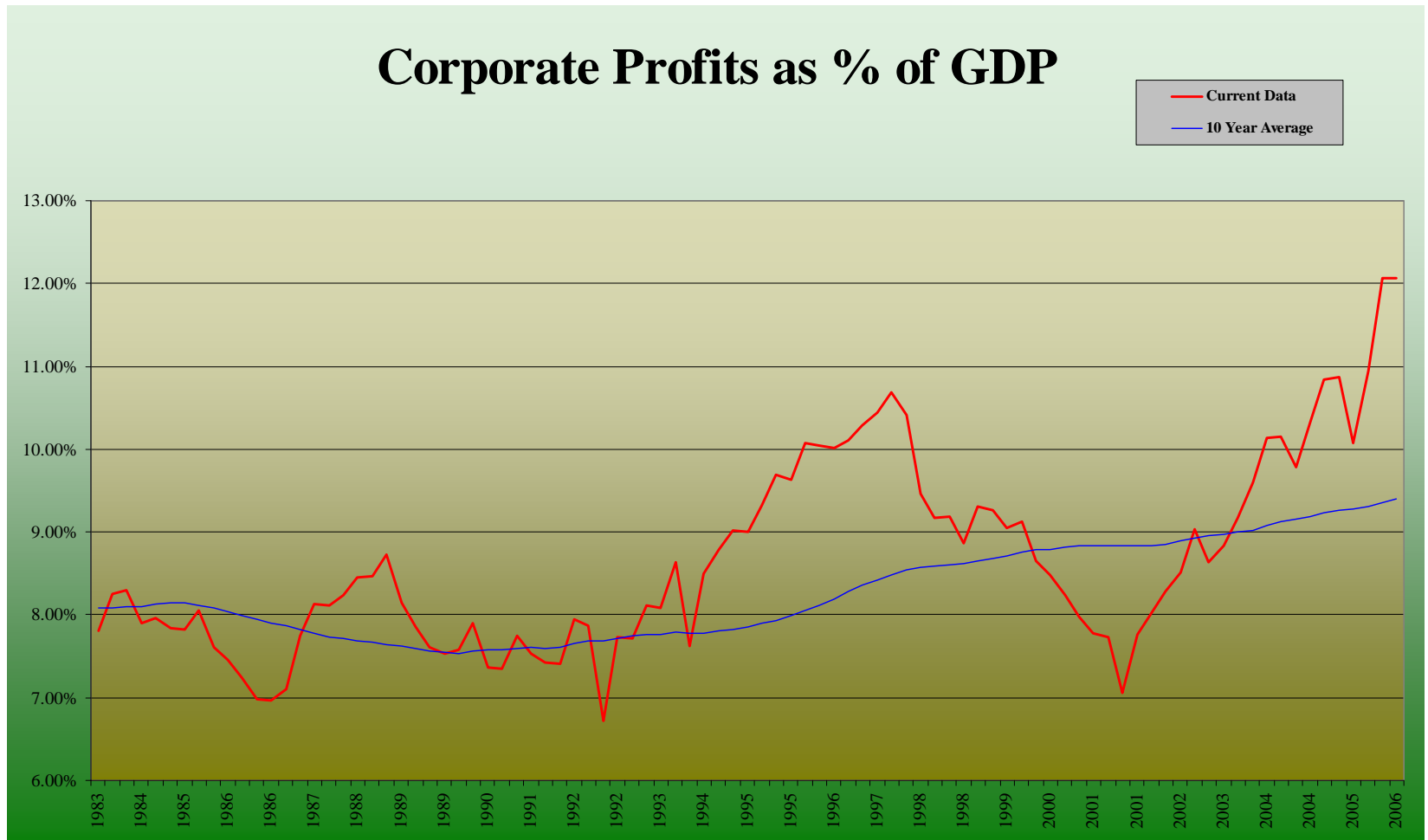


This series is at the top end of the historic range, like 1995. Either personal income is going to rise at a pace above growth or retail sales are going to fall, or some combo of the two. Betting on the consumer to keep us out of the next recession *is a bad idea.*

## Macro-economic research

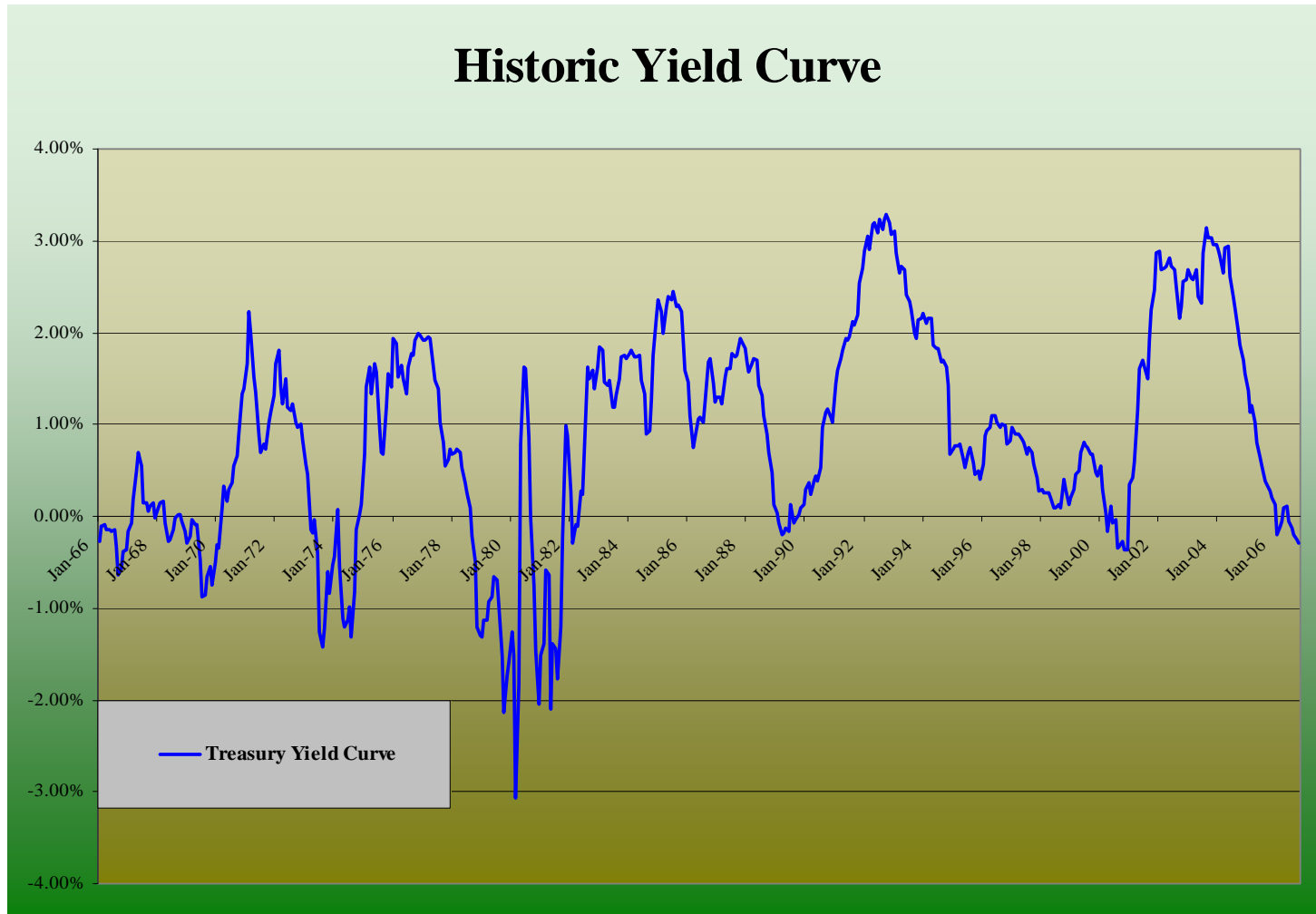


Who is right? The bond market predicting recession or the stock market with continued expansion? Well, in our view the markets are partying like it is 1995. The only problem is, it isn't 1995. Yahoo went public in 1995, the birth of a new industry and the internet as the "killer app" No such luck here in Jan 2007.



With corporate profits at all time highs, methinks that labor is going to be looking for its share.

## Macro-economic research



The last two business cycles were preceded by an inversion of the yield curve. Here we measure the 1 to 10 year US treasury.

## Macro-economic research



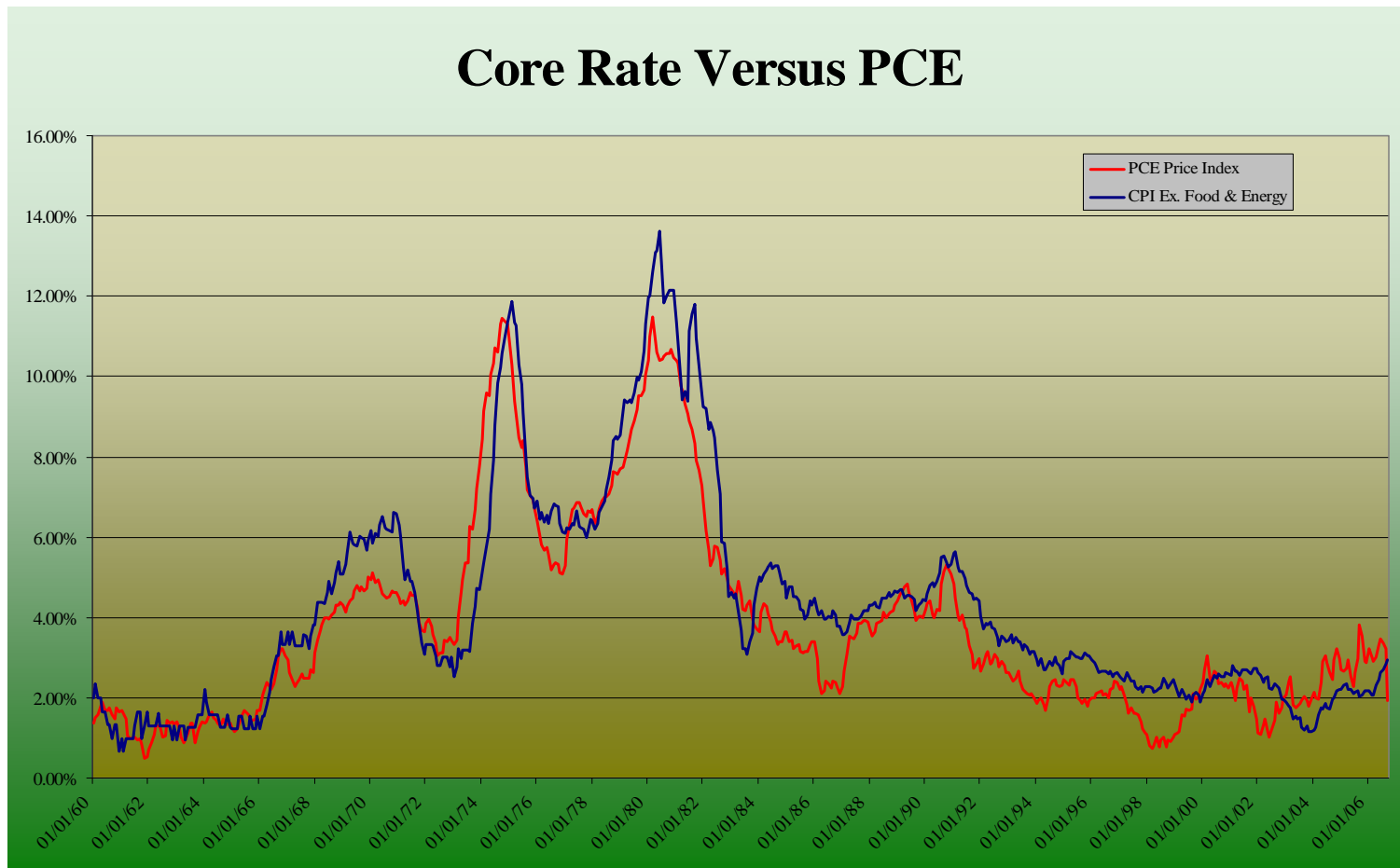
Robust labor conditions are incompatible with recessionary conditions.

# Inflation expectations

Falling energy prices mask the underlying trend. Comps were easy 12 months after the Katrina bump in energy. Raw materials and energy account for less than 20% of the content of the CPI

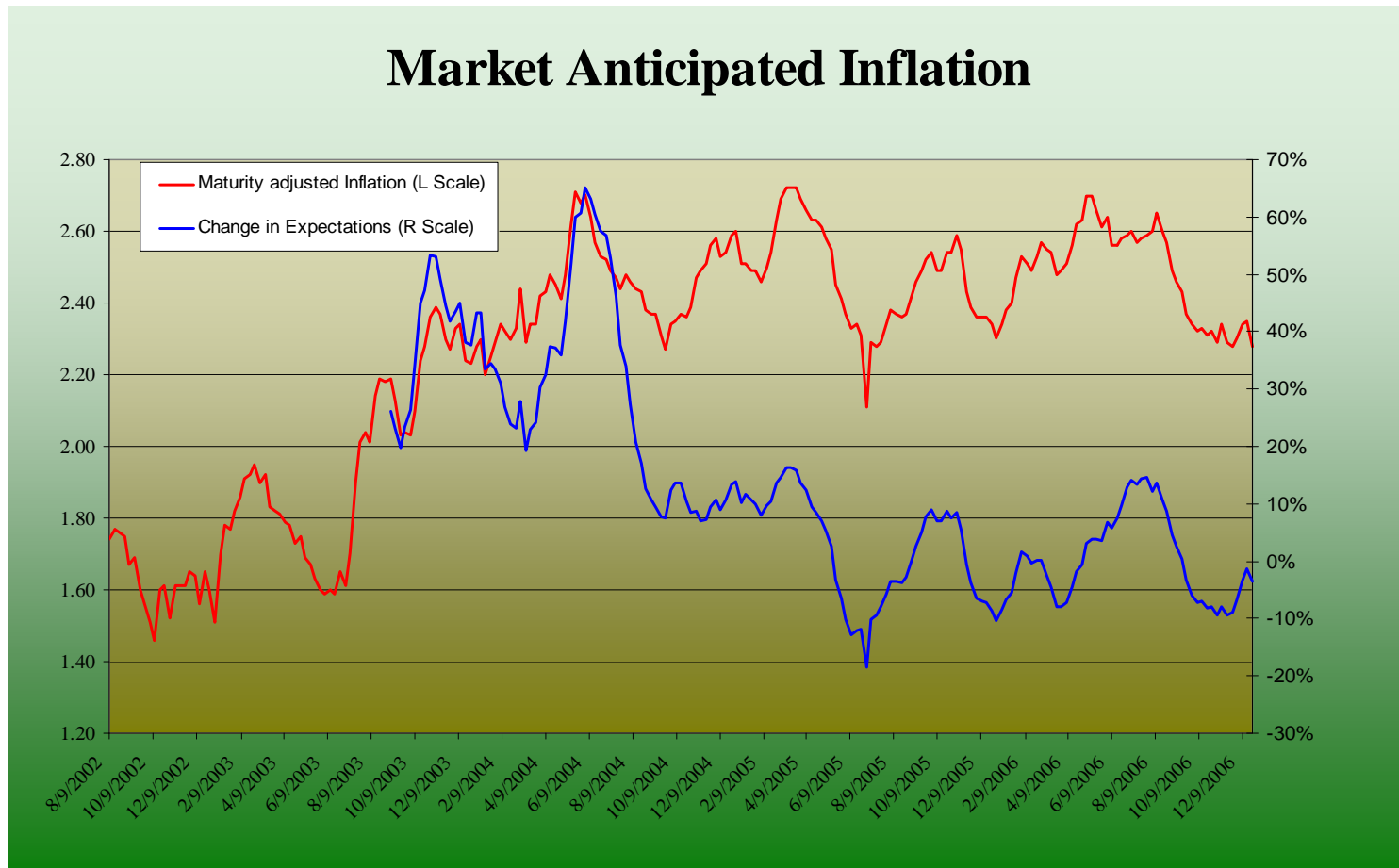
The anticodal evidence of a tight labor market for skilled is out there...

## *Inflation expectations*



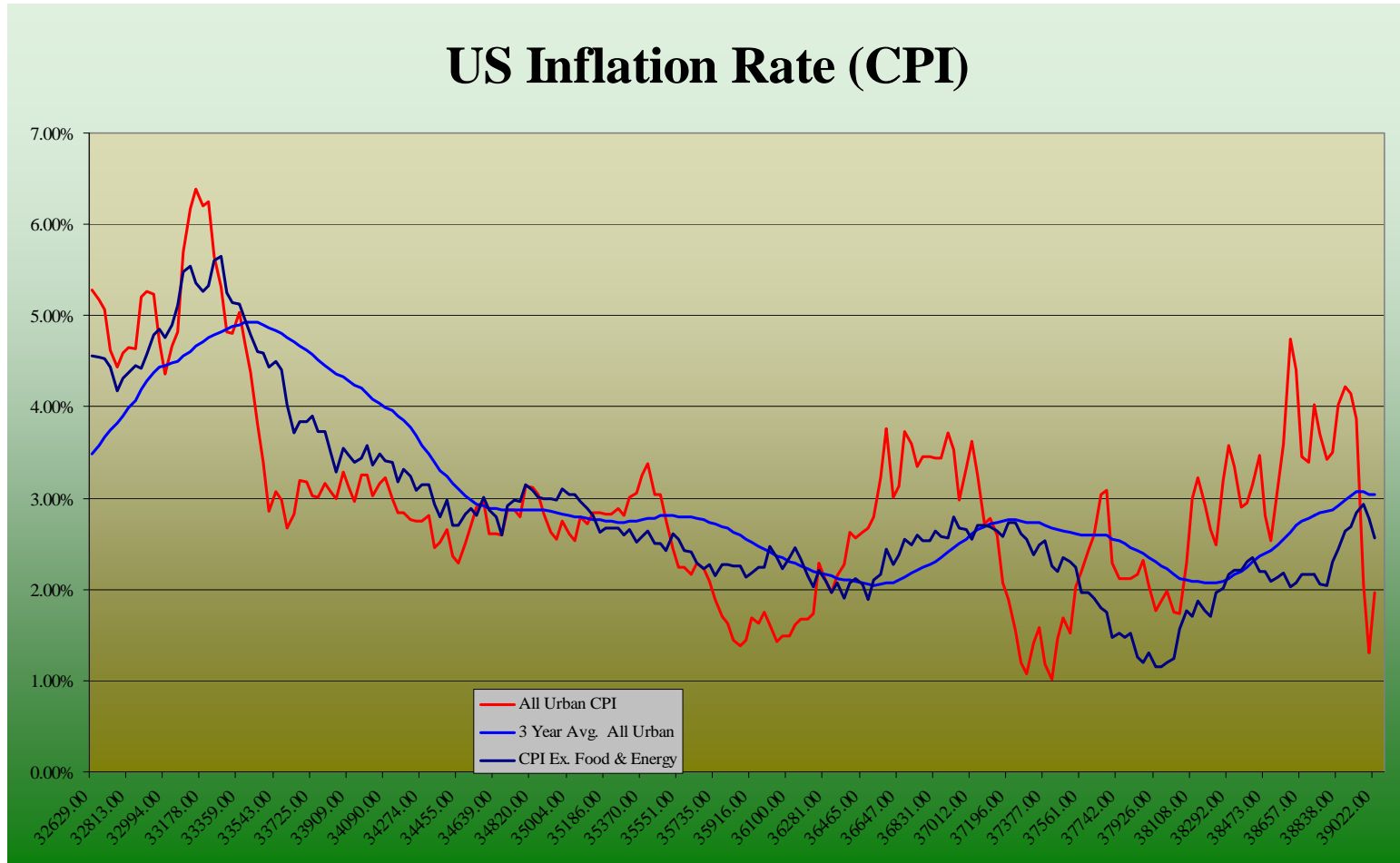
I often feel like Alice in wonderland when reviewing these numbers... “drink this one and inflation will be little”. (cameo appearance of this chart)

## *Inflation expectations*



The saving grace has been the modest inflation expectations of the bond market.

## *Inflation expectations*



All urban looks funny, doesn't it? Y/Y includes an easy comp because of the bump up in gasoline prices from Katrina one year ago.

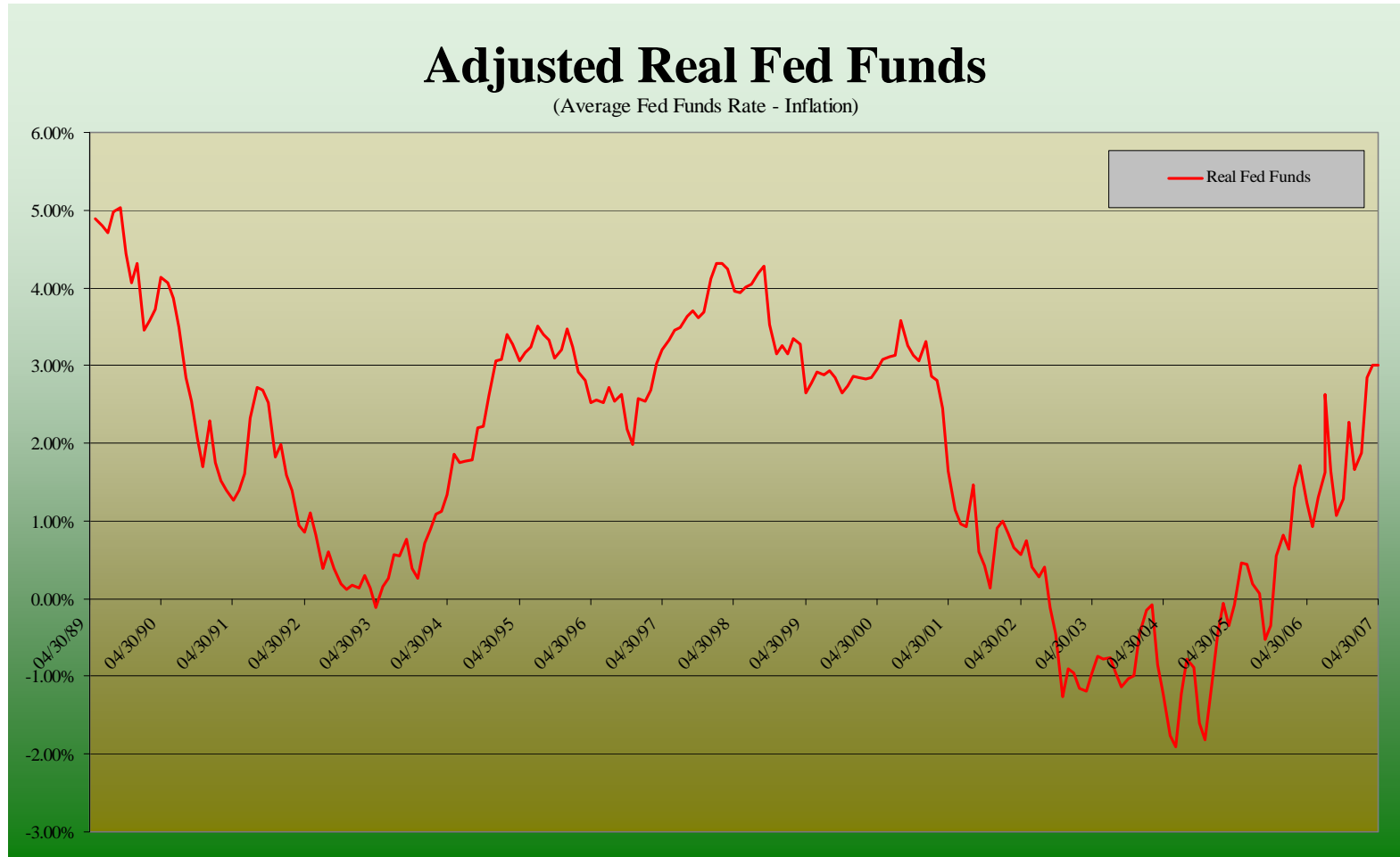
# Federal Reserve Watch

We view the Fed as on hold until signs of broad weakness are detected in the economy.

We are not willing to bet on a rate cut.

The weakness in the US\$ has them painted into a corner.

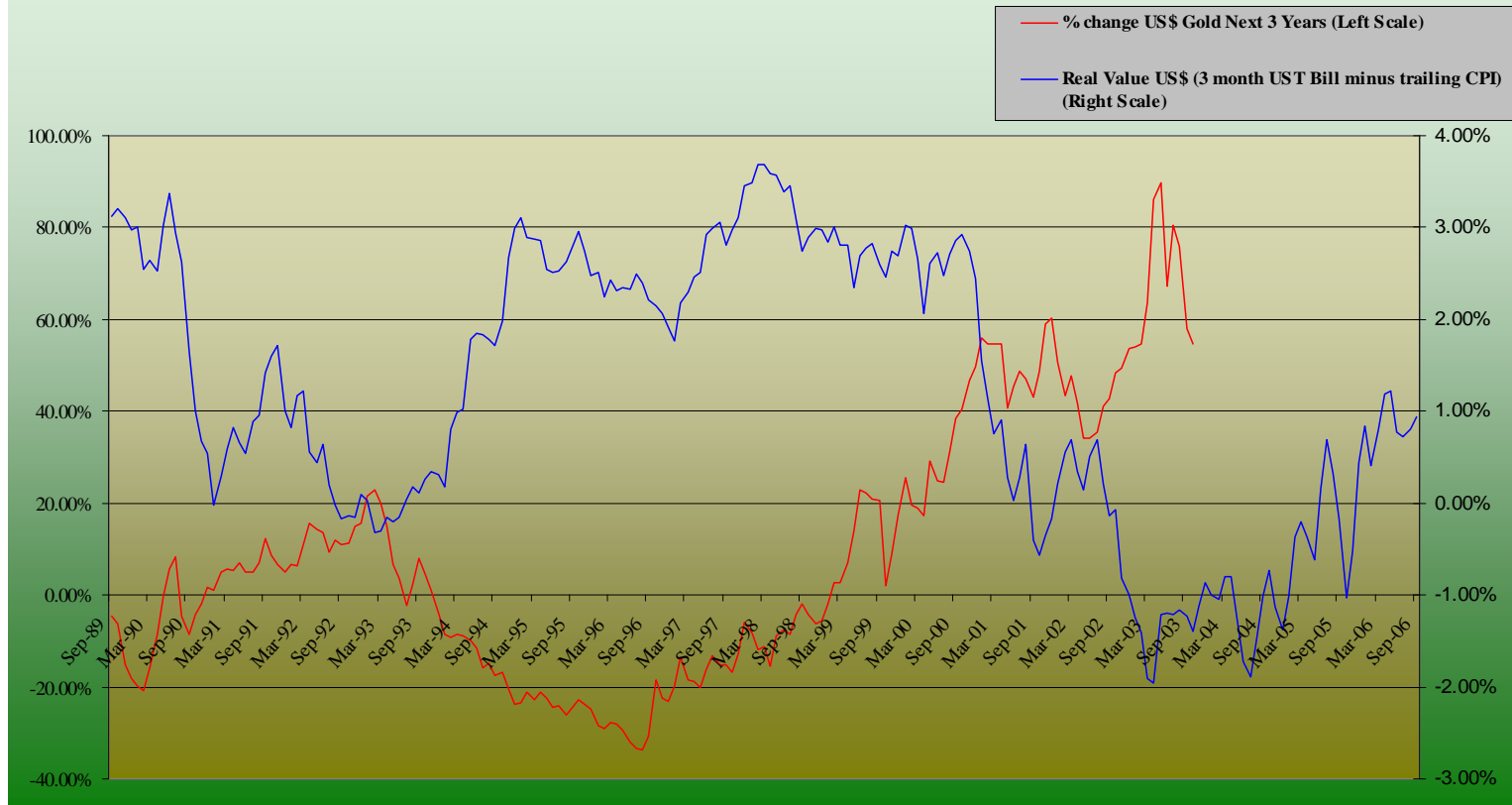
## Federal Reserve Watch



If the Fed leaves the Federal Funds Rate unchanged in the next six months, the Real Fed Funds rate will continue to climb as easing energy prices flow through the CPI. The data presented is based on oil prices static at \$70 a barrel for West Texas Intermediate.

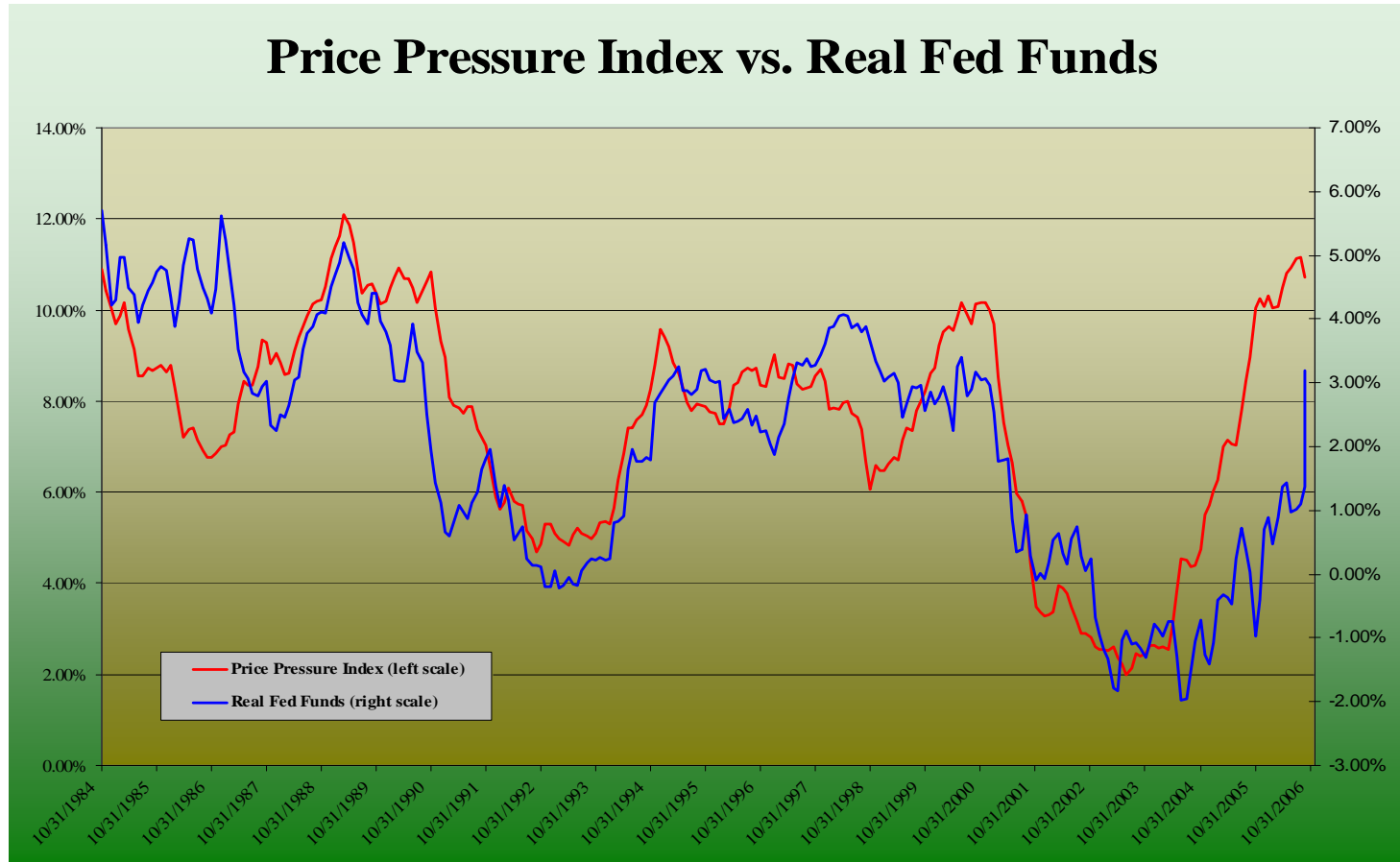
## Federal Reserve Watch

### Gold, Real Short Term Interest Rates



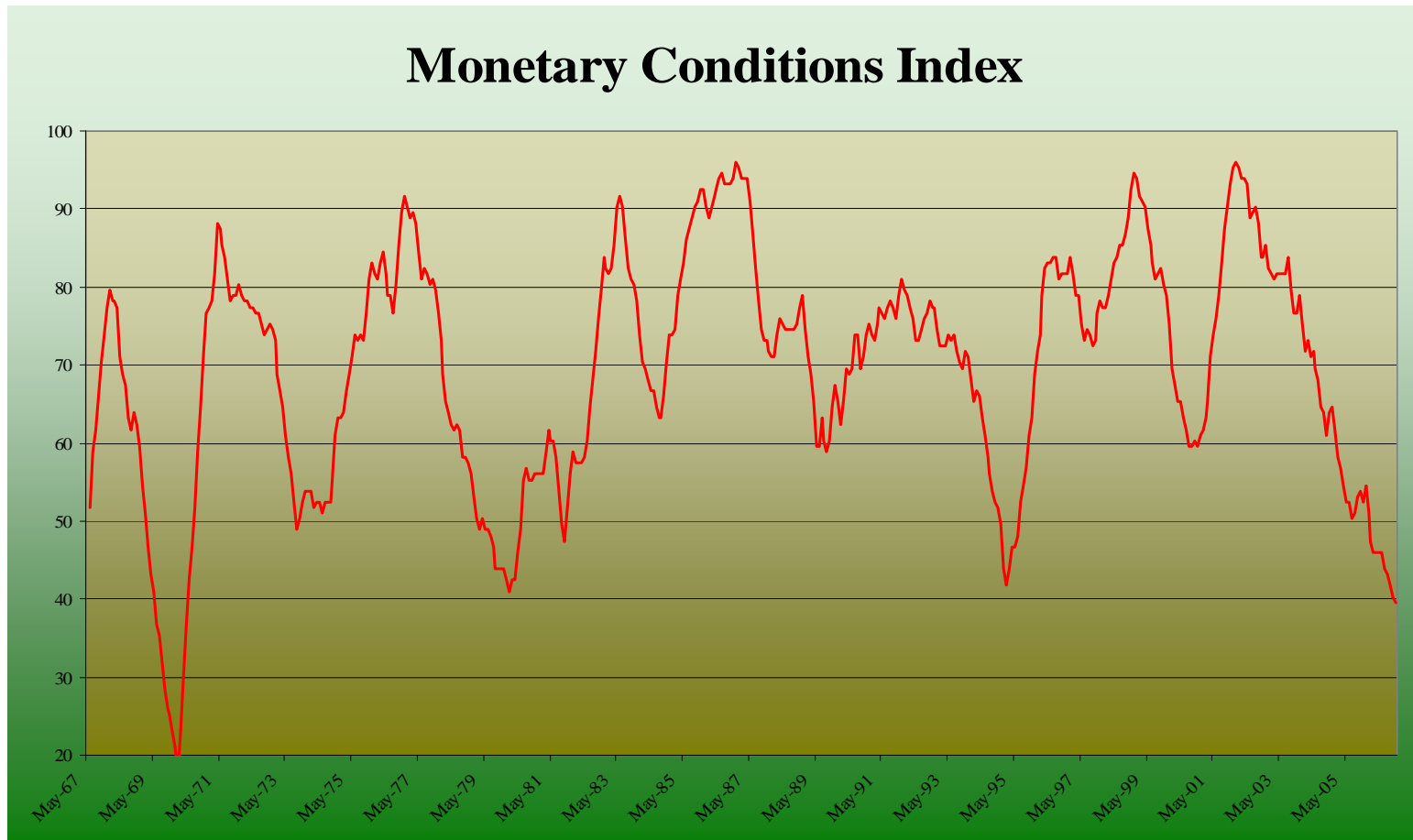
In a world awash in Fiat money, the only real value of the US dollar is the spread it earns on short term US treasury bills above inflation. The Fed's interest rate cuts to avoid a deflationary spiral held rates at negative real returns for an unprecedented amount of time. Negative real rates contributed to sharply higher gold. Only since December 2005 has the spread been positive.

## Federal Reserve Watch



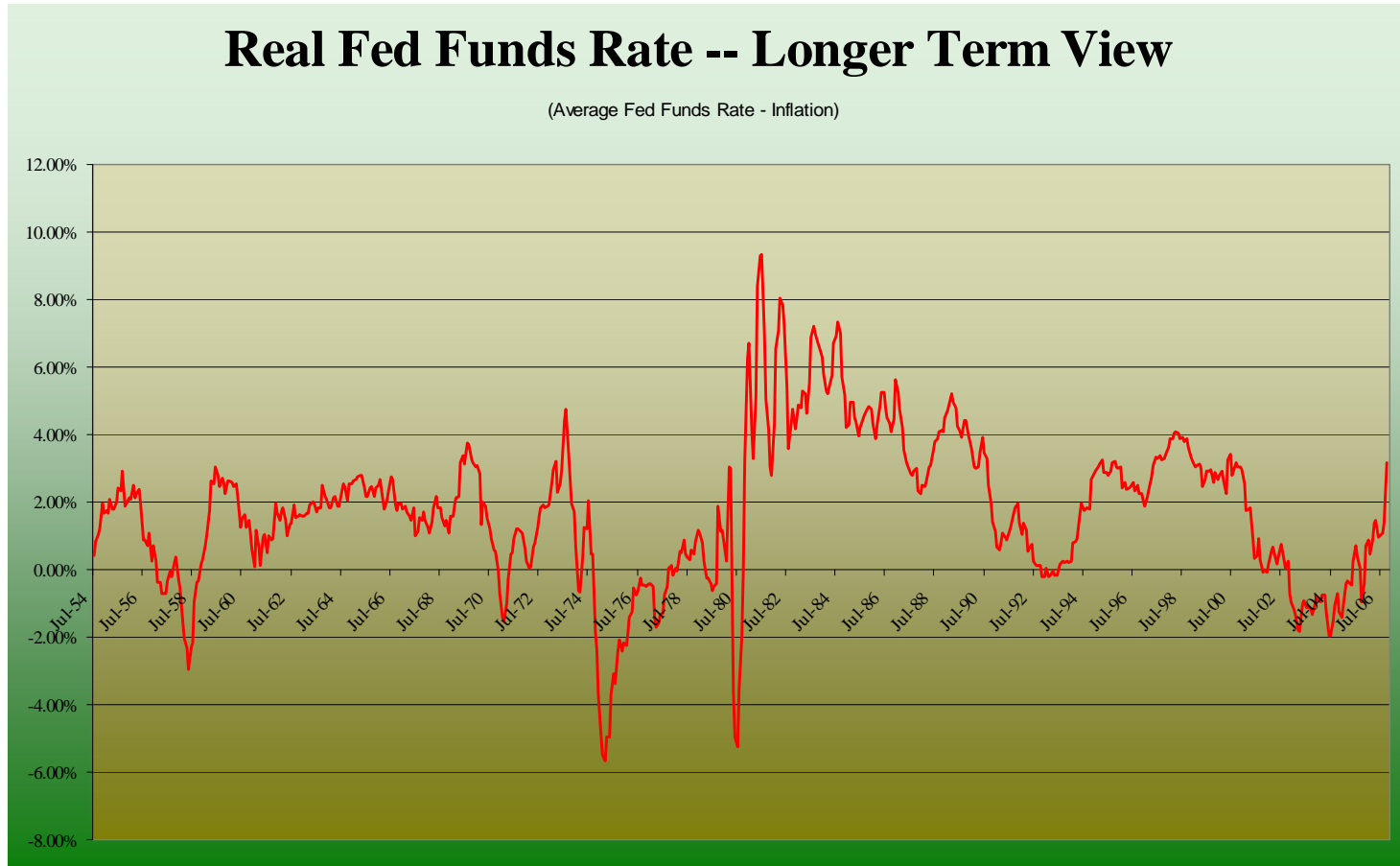
You might be thinking, what is the Fed waiting on? Weakness doesn't scare them as much as persistent inflation.

## Federal Reserve Watch



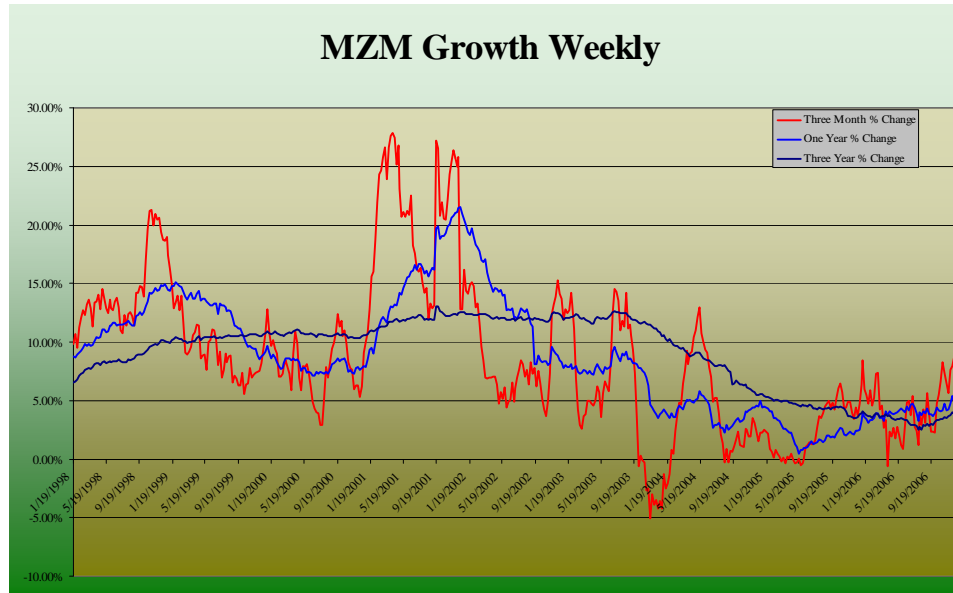
The smoothed Monetary Conditions index continues to slide. Perhaps it will put in a bottom, and it will be off to the races again. Then again, maybe not.

## Federal Reserve Watch



Again, if Energy prices continue to abate and the Fed does nothing, real Fed Funds will rise as inflation falls. Real Fed funds are only now at the levels of the 95 tightening cycle.

# Federal Reserve Watch



Signs of life...