

June 14, 2010

Hello CFG clients . . . Brian here. One of the many stock market commentators/analysts I like to follow (besides Val) is a fellow by the name of Jon Markman. He is a very level-headed guy who takes into account what is happening in the economy and markets and suggests appropriate trading strategies.

Last Thursday, Jon wrote an article about a reliable, yet not so well known leading economic indicator that was about to turn negative. The indicator, the *ECRI Weekly Leading Index* has a good track record in predicting economic recessions and recoveries the near term (6-12 months). On Friday of last week this index turned negative, indicating that over the next 6-12 months, the U.S. economy will at a minimum slow substantially or (worse case) experience a double dip recession.

While the majority of Americans only have time to take in the barrage of rosy headlines about economic recovery provided by the mainstream media sources, we hope this type of forward leaning information allows you and your family members the opportunity to prepare for what REALLY lies ahead.

Here is the article in its entirety:

## **Beyond the Ouija board**

### **Commentary: Economic predictor set to turn negative, spook market**

**By Jon Markman**

SEATTLE (MarketWatch) -- The most prescient statistical guide to the health of the U.S. economy is set to turn negative on Friday for the first time since early 2009, an event that is going to spook super-bulls and give comfort to super-bears.

But the keeper of the measure's flame says both sets of extreme views will be unwarranted, as it only means growth is about to slow noticeably -- not collapse.

The gauge is called the ECRI Weekly Leading Index, and for the past five decades it has been one of the few products of economic research that has risen above the level of tarot cards and necromancy.

While not considered mainstream due to its reliance on non-linear math to predict cycle turns rather than on regression formulas that extrapolate the past, the WLI has nevertheless forged an enviable reputation for accurately calling recessions and recoveries well in advance.

In mid-2007, the WLI forecast the 2008 recession when most economists and investors were still seeing blue skies ahead. In late 2008 it surprisingly forecast a u-turn higher into recovery amid the depths of the global financial crisis. The WLI accurately retained its positive posture for a year, garnering criticism from bears all the way, before peaking and rolling over last winter again.

Now the flip downward that began in November 2009 is about to swing all the way down into negative territory. So I called up Economic Cycle Research Institute chief Lakshman Achuthan in New York to find out what this means.

Achuthan, who's always quick with the metaphors, says that an economy recovering from a recession is like a jet aircraft, which logs its strongest acceleration when taking off -- defying the forces of gravity and pointing toward its maximum expected altitude.

Once it's at 30,000 feet, a plane levels off and stops accelerating. But it doesn't fall, it just cruises.

"You wouldn't want your plane to accelerate throughout its flight," Achuthan said. "It would blow up or burn through all its fuel before getting anywhere."

The business cycle expert says the WLI's steep decline of the past two months so far only suggests that U.S. GDP growth has peaked for this cycle, so there won't be any quarters in the recovery that rise at more than 5%. And while it does not forecast a peak in employment growth yet, the fact that the WLI is rolling over now suggests job growth will peak in late summer. Though forecasts like this are always messy, if they're accurate they should help government and business leaders determine the best policy remedies now, rather than waiting to witness it occur later.

### **Slowdown or recession?**

The big question now is not whether a slowdown lies ahead but whether it will turn into a recession. The WLI's current condition says the answer is not knowable yet, and won't be known for a few months because while the downturn so far is pronounced it is not yet persistent.

There is still time for policy makers to roll out new forms of legislated stimulus that could blunt the effects of a nascent downturn in commodity prices, consumer sentiment and mortgage applications -- just as there was in early 2008, at a similar juncture, before tax refunds were doled out too late to prevent recession.

So how would the downturn affect stock prices? Lakshman says that equity markets tend to halt their own fast-paced recoveries from downturns a few months after WLI growth tops out. WLI growth peaked in October, so the April peak in stocks was right on time. The next phase should be a desultory decline or march sideways as corporate profit growth peaks and softens from current super-strong levels.

The good news is that for now, at least, the recovery continues to roll at a pretty good clip. ISI Group reports that its company surveys continue to show a powerful, broad-based surge in the economy that has not been as hampered by lack of employment growth as you might imagine.

Here's a quick list of positives and negatives, provided by ISI, to ponder until next time:

- Positives: The yield curve is positive (cheap profits for banks); short-term interest rates are zero; profits have increased 31% year over year and corporate balance sheets are strong; household employment over the past five months is up 1.3 million, or a positive

2.4% annualized rate (not including the Census hiring); hours worked in the past seven months are up at a 3.7% annualized rate; employment is projected to keep rising over the next 12 months; vehicle sales and housing starts have room to move higher; inventories are very lean.

- Negatives: The euro zone economy is likely to enter another recession later this year, China's real GDP growth will slow to 7.5%, U.S. tax rates are headed up, U.S. and state budget cuts and tax rates are likely, the oil spill will persist in reduced profits in the Gulf region; Israel and Turkey are fighting; European auto and retail sales are collapsing; Japan's political establishment is as stable as tofu; credit spreads are blowing out in Spain; and uncertainty about the U.S. economy is so great that a survey of a small group of fund managers last week found a range of opinion about 2011 unemployment from 6.5% to 14%.

Add it all up, and ISI expects a 3% to 3.5% GDP growth rate in the U.S over the next year, which is consistent with the idea of what Achuthan called "cruising speed." It's not a great cruising speed, as 4% was seen in the mid-1990s, but it's enough to support corporate earnings growth of 12% from smart, steady companies like medical waste disposal specialist Stericycle Inc. /quotes/comstock/15\*!srcl/quotes/nls/srcl ([SRCL](#) 63.57, +0.38, +0.60%), an old favorite of last decade that ought to find renewed popularity now.

The bottom line is that as the economy slows, the sharp, robust, exciting advance in the broad range of stocks seen from March 2009 to April 2010 is probably over. And even if equities recover from the recent troubles, the next stage will be much more muted.

This does not mean that you can't make money in stocks this year. It only means you'll have to be more nimble, willing to go short as appropriate, and depend more on dividends and fixed income.

Looking out over the horizon using his longer-term leading indexes, Achuthan sees a "strong chance" of more frequent recessions in the coming decade than at any time since the 1970s.

If that occurs, then he points out there will be major constraints on politicians' counter-cyclical response that did not exist in 2008. That's because the next recession will begin with unemployment not at 4.5%, as the last one did, but in the high 8% range. Also policy makers won't be able to cut rates as they are likely to still be near zero, and fiscal spending will be a problem due to all of the borrowed stimulus already fired off.

A lot of people are going to wonder, Achuthan says, how this could happen again so soon after the last crisis. And he points out that the "great moderation" in economic growth from 1985 to 2007 -- when recessions seem to have been ironed out of the system -- is over. That was an anomaly. The new reality will be a return to sharp cyclicalities with a vengeance that will prove less and less susceptible to gentle prods from policy makers, like antibiotic-resistant viruses.

Since Europe, Australia and Japan have already flipped to the dark side, one way to play this at home with ETFs would be a portfolio that is 40% short the EAFE region, 30% long U.S.

defensive sectors, like consumer staples; and 30% bonds. The best short EAFE fund -- which covers developed markets in Asia and Europe -- if you are so inclined, is ProShares Short EAFE.

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