CLUELESS IN LOS ANGELES – NOT ANY MORE

Don Gimpel – September 2008

QUESTIONS AND ANSWERS

1 – STOCK, GOLD AND OIL MARKET CLUES

1.1 Short-Term Interest Rates … relates to business profitability

Where: Barron's Market Week/Commodities/Financial & Money/30-Day Federal Funds/Settlement Column
Timeliness: Daily form the Internet, Weekly + 1 Day from Barron's Market Week
Sensitivity:
What: The expected 30 day Fed Funds rate is obtained by subtracting the number in the settlement column from 100. If the number 97.3, then 100 – 97.3 = 2.7%
Interpretation: Short-term interest rates are important to business because they are a direct expense. If short-term rates head down, it is a positive sign for corporate profits and a rising market. The number itself is the consensus estimate of large futures Buyers/Sellers.

1.2 The Fed Fund Rate … when to buy stocks

Where: Barron's Market Week/Market Laboratory/Indicators/Money Rates/30-Day Fed Funds Rate
Timeliness: Weekly + 1 Day from Barron's on Saturday Morning
Sensitivity:
What: Fed Funds Rate 13-week Coupon
Interpretation: Expectation of Fed actions is the driving force behind magnitude and direction of short-term interest rates. Institutions try to predict the Fed Open Market Committee decisions but the driving force is the Fed Funds Rate. A decline in the rate signals lower company interest costs and higher profits. The first drop in the Fed Funds Rate is an alert. The second drop is a signal to "Buy the market."

Sector rotation based upon monetary policy can significantly outperform the broad US market when investors rotate into cyclical sectors when the Fed Discount Rate begins falling. Conversely, one can outperform the market by investing in non-cyclicals when the Fed Discount Rate begins rising. Examples of non-cyclicals are resources, consumer goods, non-cyclical services and utilities. Examples of cyclicals are cyclical consumer goods, cyclical services, general industrials, information technology, financials, basic industries.

REF: http://cxoadvisory.com/blog/internal/ Go to blog for March 15, 2007

1.3 The Housing Market … health and direction … precursor to a rising market

Where: http://www.nahb.org/generic.aspx?genericContentID=529
Timeliness: End of Month + 2-weeks on the internet.
What: The NAHB (National Association of Home Builders) publishes the NHAB/Wells Fargo Housing Market Index every month You can also obtain information on:

(1) Single Family Home Sales – present
(2) Single Family Home Sales – six months
(3) Traffic of Prospective Buyers – a leading indicator of the housing and therefore the stock market.

Interpretation: The Wells Fargo Housing Market Index is one of the earliest of all the indicators. Look for the **Index of Prospective Buyers**, the very first sign of activity in housing. This index is found at the bottom of the Internet page.

Housing Market Index (Seasonally Adjusted)																			
2007											2008								
Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
39	36	33	30	28	24	22	20	19	19	18	19	20	20	20	19	18	16	16	18

Housing Market Index Components (Seasonally Adjusted)																			
2007											2008								
Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep
Single-Family Sales: Present																			
40	36	33	31	29	24	22	20	18	18	19	19	20	20	18	17	17	15	16	17
Single-Family Sales: Next 6 Months																			
53	50	44	41	39	34	31	26	26	24	26	28	27	26	30	28	27	23	24	30
Traffic of Prospective Buyers																			
29	28	27	22	22	19	16	17	15	17	13	14	19	19	19	18	16	12	13	14

1.4 What's the Fed Going to Do?

Where: http://tfc-charts.w2d.com/marketquotes/ZQ.html or weekly from Barron's Market Week/Options & Futures/Financial
Timeliness: Daily on the Internet or the Wall Street Journal, Weekly from Barron's/Options & Futures.
Sensitivity:
What: 30-Day TBill Futures Settlement Data
Interpretation: The Federal Reserve Open Market Committee meets 8 times a year at 5 to 8 week intervals. The Fed is charged with the responsibility to maintain orderly economic growth. One of the two tools provided the Fed is the ability to set the Fed Funds Target Rate, the rate charged their member banks for overnight loans to each other.. By studying these rates, Fed Watchers can usually anticipate the magnitude, direction and timing of Fed Fund rate changes. Because these rates affect those member banks, they watch and usually anticipate any changes and adjust their short-term rates accordingly. Businesses who enter into short-term loans have their borrowing costs immediately affected. If rates go up, their profits go down and their stock prices usually follows.

An example of the data presented in the above reference is shown below. The first column is the month and day of the futures. The second column labeled Prior Day Settlement is 100 – the implied FFR. What is of interest is the change in the FFR month-to-month in the "Back-months." Back-Months are those following the first entry. In a market in equilibrium, the back-month interest rates should increase by 3 to 4 basis points because of interest rate compounding. The bid-ask spread in cash Fed Funds is about 3 basis points so that one would expect a rise of between 4 to 9 points. There are 100 basis points to a 1% change in the interest rate.

The spread is calculated by subtracting the rate for any month from the next future month. You would look at any month that had a spread larger than would normally be expected. If the large change is up, this implies that the FOMC is raising rates to curb a rising market. If the spread is too narrow or negative, then the Fed is lowering rates to encourage growth.

Example of Futures Listing
September 2008 through February 2009

Date	Prior Day Settlement	Implied Fed-Funds Rate %	Spread %
Sept. 2008	97.985	2.015	.010
Oct. 2008	97.975	2.025	.025
Nov. 2008	97.950	2.050	.005
Dec. 2008	27.945	2.055	.018
Jan. 2009	97.925	2.073	.077
Feb. 2009	97.850	2.150	

All of these spreads, except the last, are below the spreads normal in an equilibrium market so this pattern would be interpreted as the Fed mildly lowering rates to encourage investment. One would not expect a FFR rate hike or reduction from such a pattern.
REF: Reference 2 contains a complete discussion of this topic in Chapter 3 starting at Page 29.

Month	Session								Pr.Day		Options
Click for chart	Open	High	Low	Last	Time	Sett	Chg	Vol	Sett	OpInt	
Sep 08	98.0300	98.0475	97.9900	98.0000	Sep 19, 12:58	-	-0.0550	16263	98.0550	75793	Call Put
Oct 08	98.1200	98.1200	98.0300	98.0600	Sep 19, 13:00	-	-0.1600	35470	98.2200	121290	Call Put
Nov 08	98.1750	98.2000	98.0150	98.0850	Sep 19, 13:01	-	-0.2100	53027	98.2950	132284	Call Put
Dec 08	98.2000	98.2100	98.0500	98.1050	Sep 19, 13:01	-	-0.2100	30758	98.3150	98182	Call Put
Jan 09	98.2000	98.2000	98.0150	98.0900	Sep 19, 13:06	-	-0.2250	11710	98.3150	52888	Call Put
Feb 09	98.2000	98.2000	98.0450	98.0850	Sep 19, 13:06	-	-0.2250	13653	98.3100	61223	Call Put
Mar 09	98.1150	98.1450	98.0100	98.0500	Sep 19, 13:06	-	-0.2650	5820	98.3150	12496	Call Put
Apr 09	98.1150	98.1150	97.9500	97.9950	Sep 19, 12:57	-	-0.3300	4064	98.3250	11889	Call Put
May 09	98.0350	98.0350	97.8350	97.8950	Sep 19, 12:45	-	-0.4050	876	98.3000	9912	Call Put
Jun 09	97.9850	97.9850	97.8500	97.8700	Sep 19, 12:12	-	-0.4000	59	98.2700	2351	Call Put
Jul 09	97.8300	97.8300	97.7600	97.7600	Sep 19, 12:45	-	-0.4700	145	98.2300	1392	Call Put

1.5 Will high oil prices affect the market?

Where: http://tfc-charts.w2d.com/marketquotes/ZQ.html Select Oil/Energy then Brent Crude Oil
Timeliness: Daily
Sensitivity:
What: Brent Crude Oil Futures.
Interpretation: This table provides information on the expected price of oil. We have just had a demonstration where the price of a barrel of crude oil broke above $100 a barrel to about $150. This sharp rise in price signaled a broad drop in corporate profits and this caused the steep market decline during the first half of 2008 followed by a highly volatile non-trending market as the price of oil slowly dropped to its current still above normal range.
<u>If the futures maintained at or near their peaks, then one would expect a continuing market decline.</u>
Ref. 2

1.6 Is Gold a Good Buy?

Where: http://tfc-charts.w2d.com/marketquotes/ZQ.html Select Currency and then Euro
Timeliness: Intraday and End of Day.
Sensitivity:
What: Euro Futures
Interpretation: The Conversion ratio of the EURO is listed as 1.46 for September 2008 with a slight decline to 1.435 by December 2009. This does not represent a significant change. The Conversion Rate of the dollar against a basket of international currencies is inversely related to that of gold. At this time, the conversion rate is relatively flat and you would expect the price of gold over this period to remain largely unchanged. If the price of the EURO were seen to rise, or equivalently, the dollar to fall against the EURO, then one would expect the price of gold to rise inversely.

The way to look at this is to imagine that the price of gold is entirely in a foreign currency so that when the value of the dollar goes down (the value of the EURO goes up compared to the dollar) then it would be more and more expensive to buy gold.
Ref. 2

1.7 Is US industry becoming more productive?

Where: www.bls.gov/news.release/prod2.t02.htm
Timeliness: End of Quarter + 5-weeks
Sensitivity: Very high.
What: The Bureau of Labor Statistics site provides information on non-farm Unit labor costs, Real Hourly Compensation and Output per Hour. This information can be used to signal whether industry is becoming more or less competitive with that of other countries. It is desirable for industry to be competitive.
Interpretation: This site provides information on the year-to-year change in output per hour (column3), the compensation per hour (column 6) and unit labor costs (column 8). <u>If the output per hour is trending down, then industry is becoming less productive and less able to compete in worldwide markets</u>. This would signal a falling market and in time a falling dollar conversion rate, i.e., the economy is becoming increasingly unhealthy.. If the output per hour is larger than the compensation per hour, then unit labor costs are driven down and the country is becoming more efficient. For example, if the change in the $ output per hour is 2.2% and the change in compensation is 3.6%, then labor cost is rising faster than productivity and the difference, +1.4 means that productivity (unit labor costs) is decreasing which is very negative for the stock, bond and dollar markets.

The Output per Hour (Column 3) is a measure of productivity. <u>If this series is trending up then the country is becoming more productive and the value of the dollar against a basket of foreign currencies goes up.</u> Look for this series to significantly lead the currency conversion rate. **REF** 1, Pgs. 275-281

Year (1)	Qtr. (2)	Output/.Hr. (3)	Output (4)	Hours All persons (5)	Comp./Hr (6)	Real Comp. per hour (7)	Unit Labor Costs (8)	Unit Non-labor Payments (9)	Imp. Price Deflator (10)
		Percent change from corresponding quarter of previous year							
2006	I	1.3	3.7	2.4	4.2	0.5	2.9	4.3	3.4
	II	1.7	3.7	2.0	3.9	0.0	2.2	5.9	3.6
	III	0.3	2.6	2.3	2.9	-0.5	2.6	3.8	3.1
	IV	0.6	2.6	2.0	4.3	2.2	3.6	0.5	2.4
	ANNUAL	1.0	3.2	2.2	3.8	0.5	2.8	3.6	3.1
2007	I	0.0	0.9	r1.0	4.2	1.7	4.2	-0.2	2.5
	II	0.5	1.6	1.1	4.2	1.5	3.7	-0.2	2.1
	III	2.5	2.9	0.4	r4.5	r2.1	2.0	1.5	1.8
	IV	2.7	2.4	-0.3	3.6	-0.4	0.9	3.7	2.0
	ANNUAL	1.4	2.0	0.5	4.1	1.3	2.7	1.2	2.1
2008	I	3.3	2.8	-0.5	r3.3	r-0.8	r0.0	r4.3	1.6
	II	r3.4	r2.2	r-1.1	r4.0	r-0.2	r0.6	r2.9	r1.5

1.8 What about Unemployment and Initial Jobless Claims

Where: Barron's Market Week/Indicators/Employment/Initial Jobless Claims
Timeliness: Monthly + 1-Day (Saturday)
Sensitivity: Very high
What: You can find this data weekly in Barron's.
Interpretation: A downward trend in unemployment is very positive for the market since it indicates that employment is rising. Note that the US core unemployment rate is 4.5% and a move below this rate is very inflationary.

1.9 The PMI Index verifies a recovery.

Where: http://www.ism.ws/ISMReport/MfgROB.cfm?nav/ItemNumber=12942
When: End of Month + 1 business day
Sensitivity: Very High
What: The PMI Index
Interpretation: The Purchasing Manufacturer's Index, PMI, trends up early in a recovery as shown in the appended Production Sequence Cycle. A steady rise in this index shows that companies are buying to support increasing production. This is an early sign of recovery. A reading of 50 or higher means that industry is expanding and this is a good indicator of a rising GDP. A reading of 42 or higher is the benchmark for expansion with 42 to 50 an indicator of the strength of the expansion. A reading of less than 42 is a sign of an oncoming recession.

MANUFACTURING AT A GLANCE
AUGUST 2008

Index	Series Index August	Series Index July	Percentage Point Change	Direction	Rate of Change	Trend* (Months)
PMI	49.9	50.0	-0.1	Contracting	From Unchanged	1
New Orders	48.3	45.0	+3.3	Contracting	Slower	9
Production	52.1	52.9	-0.8	Growing	Slower	4
Employment	49.7	51.9	-2.2	Contracting	From Growing	1
Supplier Deliveries	50.3	55.1	-4.8	Slowing	Slower	14
Inventories	49.3	45.0	+4.3	Contracting	Slower	2
Customers' Inventories	54.5	47.0	+7.5	Too High	From Too Low	1
Prices	77.0	88.5	-11.5	Increasing	Slower	20
Backlog of Orders	43.5	43.0	+0.5	Contracting	Slower	4
Exports	57.0	54.0	+3.0	Growing	Faster	69
Imports	48.5	46.5	+2.0	Contracting	Slower	7
OVERALL ECONOMY				Growing	Slower	82
Manufacturing Sector				Contracting	From Unchanged	1

1.10 Where can I learn more about indicators, how they are constructed, used and interpreted?

Where: www.investopedia.com/university/releases/default.asp
Timeliness: Not applicable.
What: This site provides links to 25 Investopedia pages where the background and use of economic indicators is explained.

1.11 How do consumers feel about spending? … The Conference Board Consumer Confidence Index

Where: www.conference-board.org/economics/consumerconfidence.cfm
Timeliness: Monthly on the last Tuesday of every month.
Sensitivity: Very high.
What: The Consumer Confidence Index
Interpretation: This is a very early index of how consumers feel about spending and a strong report can move the market. Rather than look at individual values, look for trends in the index. This index has been a good predictor of consumer spending and the GDP since consumer spending makes up about 2/3 of the GDP.

1.12 What employment data tells about the future

Where: http://www.bls.gov/news.release/empsit.nr0.htm scroll down for Table A Major Indicators of Labor Market Activity
Timeliness: Monthly
Sensitivity: Very High
What: Employment Data
Interpretation: Look first for the change in the size of the civilian labor force and the number employed. Changes in the Household Civilian Labor force are a sensitive indicator of an economic recovery. The index includes both the self-employed and the people they hire. This number increases faster than the rest of the labor market in the early stages of a recovery.

Look for the changes in the household unemployment rate for all workers. This is a leading indicator of an impending downturn.

The most significant economic statistic is the monthly changes in non-farm employment because this provides the strongest evidence of job creation. To find out what is happening in the private business sector, subtract the government's contribution from the total non-farm payroll.

The difference in hours worked is a leading indicator of economic activity. Look for changes in the average hours worked per week because it is closely correlated with the GDP and changes in personal income. If there is an increase for 3 consecutive months, business will accelerate hiring. If it has a decline, expect layoffs and a decline in consumer spending.

Robust employment is good for the economy and little or no employment growth is a bad sign for the economy.

1.13 What triggers sector-rotation?

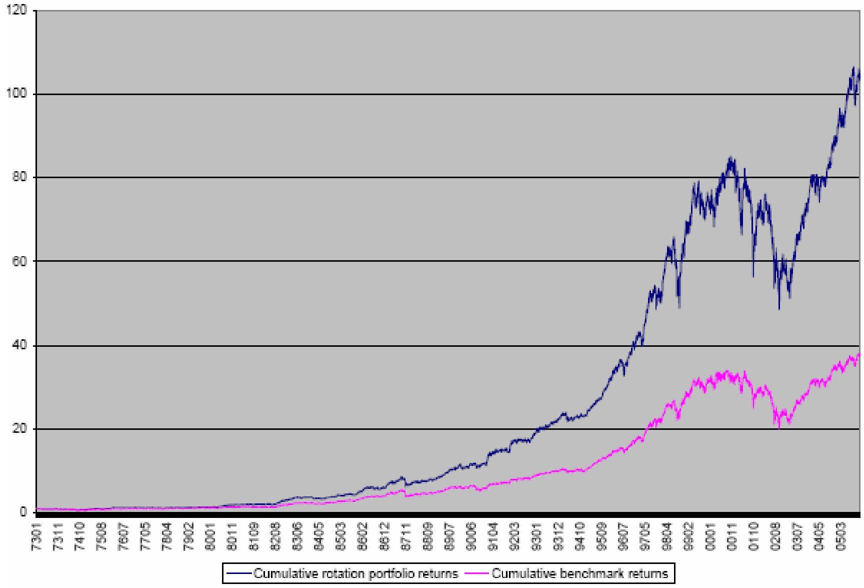
Where: http://www.cxoadvisory.com/blog/external/blog11-16-07
What: The Fed Funds Rate provides a guide to sector rotation.
Interpretation: An investor can significantly outperform the broad US market by using monetary policy as a guide. When Fed Funds rate falls, rotate investments into cyclicals. Similarly, when the Fed Funds rate rises, invest in non-cyclicals.
Interpretation:

Sector Rotation with the Discount Rate

		Cyclicals/Non-cyclicals	
		Cyclicals	**Non-cyclicals**
Fed Discount Rate	**Falls**	In	Out
	Rises	Out	In

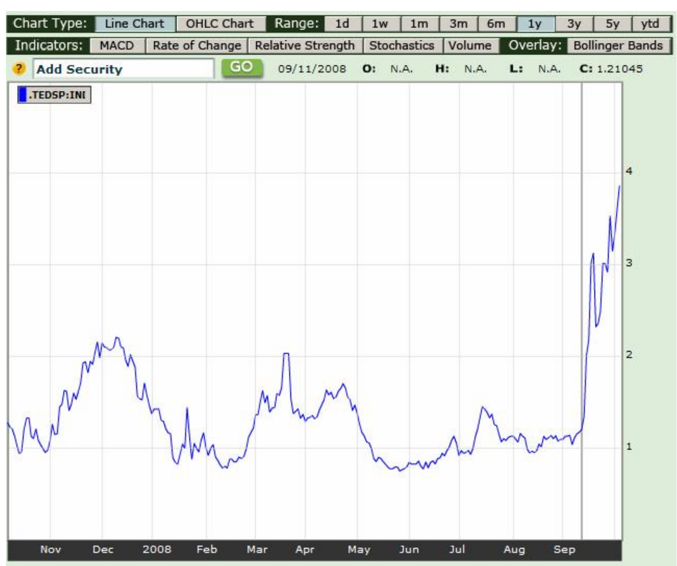
REF: Sector Rotation and Monetary Conditions, Conover, C; Jensen, G.; Johnson, R.; Mercer, J. see the CXOAdvisory reference for access.

EFFECT OF SECTOR ROTATION USING THE FED DISCOUNT RATE RULE



1.14 MEASURING RISKINESS WITH THE TED SPREAD

Where: http://www.bloomberg.com/apps/cbuilder?ticker1=.TEDSP%3AIND
What: The TED Spread is an indicator of perceived general economy risk in # Basis Points.
Timeliness: Daily on the Internet
Sensitivity: Very High
Interpretation: The TED Spread is the difference between Inter-bank loans and short-term US Government debt expressed sometimes expressed as the number of basis points. It measures the perceived risk in the US economy. If, for example, the T-Bill rate is 5.1% and the Eurodollars futures contract (ED) is at 5.50%, then the TED Spread is 100*(5.50 – 5.10) = 40 basis points.

- 

This chart illustrates the effect of the late September 2008 bank panic on the TED Spread. In this illustration, the spread rose to close to 4.00 well above its range near 1.0% with the warning clearly visible by Sept. 17, 2008.

1.15 Can you forecast the market?

Where: http://www.cxoadvisory.com/status/#status

What: This site predicts the S&P 500 index 9 months into the future.

Interpretation: The prediction is based upon the inflation rate and corporate operating earnings.

1.16 Where can you find the very earliest sign of business conditions?

Where: **http://www.phil.frb.org/econ/bos/bosschedule.htm**

What : The Philadelphia Fed Report or the Philadelphia Business Outlook Survey

Timeliness: The very first report on business conditions appears on the 3rd Thursday of the current period, i.e., before the period is over.

Interpretation: Even though the territory covered is limited to the area around Philadelphia, this report provides the first clue on the state of the economy.

1.17 Measuring Market Fear with the VIX Index

Where: **http://finance.yahoo.com/q/bc?s=%5eVIX&t=1d&c**=

What: VIX Index is a measure of the implied volatility of the S&P 500 Index Options. It represents one measure of the markets expectations of volatility over the next 30-day period. Volatility is a measure of the market's uncertainty or as commonly used, the markets riskiness. It is also called the "Fear Index."

Timeliness: This index is available intraday.

Interpretation: If VIX =15, this means an annual change of 15%. In one month, the change would be 15 / 12^0.5 = 4.33 . The Confidence Level relative to the market is S&P500 / VIX . VIX peaks are normally associated with market bottoms.

A common set of rules for timing the market is to Buy the S&P 500 when the VIX is higher than it's 10-day EMA (trending up).. Sell when the VIX (today) is less than yesterday's 10-day EMA (trending down).

Ref: Colby, R. W., The Encyclopedia of Technical Market Indicators, 2nd-Edition, pg 732., McGraw-Hill

2. - <u>ECONOMIC HEALTH CLUES</u>

2.1 The Limits to Growth without Inflation … when is inflation likely to occur

Where: http://www.bls.gov/news.release/prod2.t02.htm Table 2 columns (3) and (5)
Timeliness: End of Quarter + 5 weeks
What: Column (3) provides the output per hour of all persons. Column (5) provides the hours of all persons
Interpretation: The sum of the two columns is the safe limit on economic growth without inflation. <u>If economic growth exceeds the sum, inflation will follow.</u> This is negative for the market..

2.2 How healthy is manufacturing? … traces through the production growth cycle

Where: http://www.ism.ws/ISMReport/MfgROB.cfm?navItem=12942
Timeliness: Monthly + 1 business day.
What: This site provides an index for each stage of the manufacturing cycle enabling the user to trace through the cycles complete propagation. In addition to indexes, the site provides the change in index values, the direction and rate of the change and its duration. The following are the specific indexes:

New Orders - (NO)
Purchasing Manager Index – (PMI)
Employment – (Emp.)
Supplier Deliveries – (SD)
Production – (Prod.)
Inventories – (Inv.)
Customer Deliveries – (CD)

Interpretation: This set of indexes allows the user to trace through the wave of manufacturing activity. The sequence starts with new orders. Employment rises so that the orders can be fulfilled. The suppliers deliver their products which then go into production and are either placed in inventory or delivered to the final customer.. Faltering of new orders is the first sign of a weakening market. See the attached chart.

2.3 Is a recession likely?

Where: Los Angeles Times/Financial Section or Wall Street Journal
Timeliness: Daily
Sensitivity: Low because of the time delay
What: Compute the difference between the 5 Year T Note and the return of the 90-day TBill Coupon. If that difference is less than or equal to –0.25, then an interest rate inversion has taken place and there is a strong likelihood of a recession sometime with the next six to twelve months.
Interpretation: Long-term bond returns are normally higher than short term returns reflecting the incentive offered to bond holders to buy a long term bond. When there is a strong demand for short term money, then short term rates go up and they may exceed long-term rates. <u>This condition is called an interest rate inversion and signals an oncoming recession.</u>

2.4 Is inflation likely to occur?

Where: www.federalreserve.gov/releases/g17/current **or** Barron's Market Week/Market Laboratory/Indicators/Economic Growth and Investment/Capacity Utilization
Timeliness: Monthly + 2-weeks
Sensitivity: Medium
What: Capacity Utilization (CU) measures the degree to which manufacturing facilities are being used and the short-term capacity available to support growth.
Interpretation: As a practical matter, when Capacity Utilization approaches 84%, new factories or other manufacturing facilities must be built to support increased production. Money must be spent to increase production and it takes time to build new facilities. This added investment <u>reliably signals an oncoming inflation</u>.

2.5 Is money available to fuel an expanding economy? Is there inflationary pressure?

Where: http://Research.StLouisFed.org/fred2/data/MZM.txt
Timeliness: Weekly +1-Day
What: The list provides the values of Money to Zero Maturity, the money available for short term loans to finance economic growth. If the 1-year percent change in MZM is greater than the 1-year change in Gross Domestic Product (GDP), then there is money available for expansion and inflationary pressure.
Interpretation: If there are no funds available to finance growth, then growth will not take place. If funds are available, the economy will grow and heat up.

2.6 Is employment likely to fuel inflations … the unemployment rate.

Where: Barron's Market Week/Market Laboratory/Indicators/Employment/Unemployment
Timeliness: Monthly on first Friday
Sensitivity: Very high.
What: The Unemployment Rate is a measure of the percent of those employable who are currently unemployed. When the unemployment rate nears its "full-employment value, 4.5%, then in order to expand, employers are forced to offer more money to attract new employees and this is inflationary.
Interpretation: There is a low rate where all those who want employment can find employment and in the United States that number is 4.5%. There are always people who are between jobs or who for one reason or another may not be employed. That number can actually be negative as in Switzerland where there is more demand for workers than the population can provide. Switzerland has a guest worker program where they import workers typically from southern Italy and these workers are given documents to permit them to work. These workers are monitored and when their pass expires, they either apply for a new pass if work conditions allow or are sent back to their home country.

2.7 What index offers the first look at Inflation? … the Producer Price Index

Where: Barron's Market Week/Market Laboratory/Indicators//Inflation/Producer Price Index
Timeliness: Month end +2-weeks. This is the first leading indicator of consumer prices supplied by the government.
Sensitivity: Very high.
What: The Producer Price Index is an early indicator of oncoming inflation.
Interpretation: A jump in the PPI is an early inflationary sign though there is no consensus on how much of a jump is good for business profits and how much is too much. A high jump in the PPI signals price inflation and rising interest rates and this can depress bonds.

2.8 What index offers an early hint of an oncoming recession? … Housing starts and New Building Permits.

Where: Barron's Market Week/Market Laboratory/Indicators/Construction/Building Permits and New Housing Starts
When: Monthly + 2 to 3-weeks
Sensitivity: Medium
What: Because of their economic impact, Applications for Building Permits and then New Housing Starts are early signs of recession. Also see Traffic of prospective Buyers 1.3
Interpretation:

2.9 What Index reports on the health of the economy? … CFNAI-MA3

Where: www.ChicagoFed.org/economic_research_and_data/CFNAI_data_series.cfm
Timeliness: Month End + 4 to 5 weeks.
Sensitivity: Low
What: The CFNAI-MA3 is an index composed of 85 measures and it is designed to report on the health of the economy.
Interpretation:

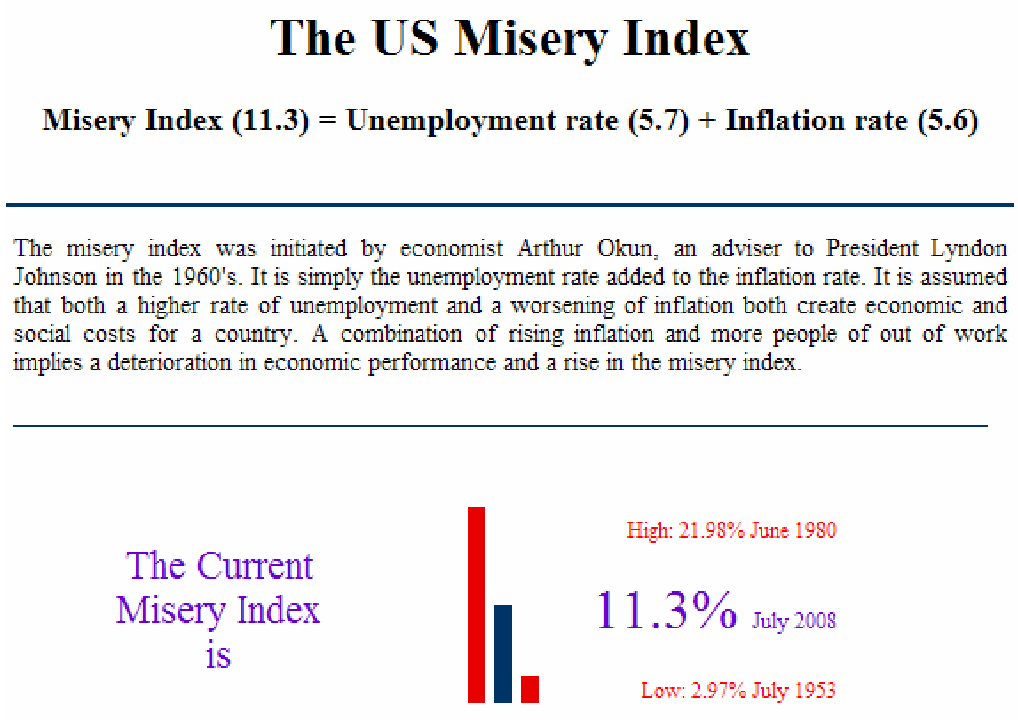
If less than –1.5, the economy is probably in a recession.
If less than –0.7, there is a good chance of a recession.
If less than 0, the economy is below potential and there might be increasing unemployment.

If 0, The economy is growing at full potential, the fastest pace possible without inflation (called “Trend Growth”).
If the 3-month SMA is greater than 0.2, then the recession is likely over.
If greater than 0, the economy is expanding above its safe speed; demand is outstripping supply and this is inflationary.
If greater than 0.7 two years into an expansion, this is a warning that inflation is in danger of accelerating.
If greater than 1.0, business may be overheating and rising inflation is likely to follow.

Ref: 1 (216-217)

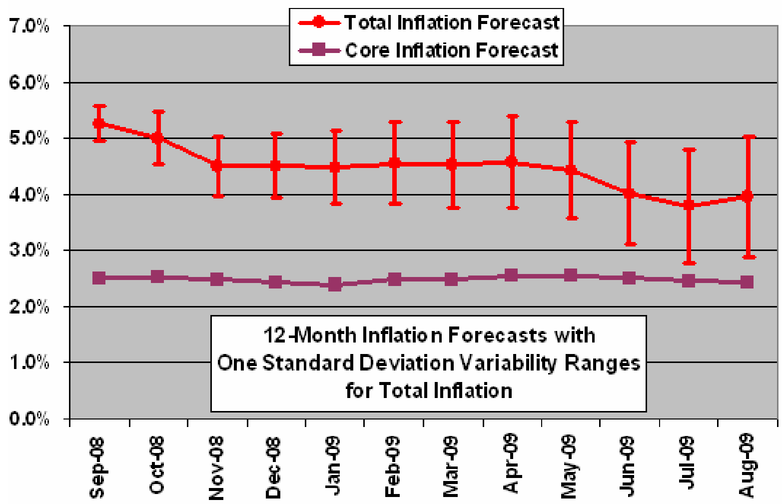
2.10 How do people really feel? … The Misery Index

Where: www.miseryindex.us/
When: Monthly
Sensitivity: Low
What: The Misery Index us the sum of the Unemployment and Inflation Rates.
Interpretation: This index measures the well being of the economy and how people feel. It is highly correlated to the crime rate and leads it by about a year. It originated with economist Arthur Okum. Look for trends in the Misery Index to lead trends in the equities market.



2.11 Is it possible to forecast inflation?

Where: **http://www.cxoadvisory.com/inflation**
What: Provides a 1-year forecast of both core and total inflation.
Interpretation: The chart provides a forecast of inflation. High inflation is very negative for both the bond and stock markets.
Reference The prediction is based on the CPII non-seasonally adjusted index. The reference for this work is “Core Inflation as a Predictor of Total Inflation,” by N. Khottry and L. Mester of the FRB of Philadelphia.



3. <u>BOND MARKET CLUES</u>

3.1 When is it time to buy bonds?

Where: Barron's Market Week/Market Laboratory/Indicators/Money Rates/Fed Funds Rate
Timeliness: Weekly on Saturday Morning
What: Fed Funds Rate 13-week Coupon
Interpretation: Expectation of what the Fed does is the driving force behind short-term interest rates. Institutions try to predict the Fed Open Market Committee decisions but the driving force is the Fed Funds Rate. A rise in the rate signals higher Bond Market returns. The first rise in the Fed Funds Rate is an alert. The second rise is a signal to buy Long Term Bonds.

3.2 When is the best time to hold Junk Bonds?

Where: LA Times Financial Section page containing NYSE listings, bottom of Bond Box at top of page.
Timeliness: **Weekly on Sunday morning**.
What: Look for Junk Bond Yield. Also locate the 5-year TNote yield.
Interpretation: Compute the spread between Junk Bond and 5-year TNote yield. If that spread is 5 or greater then be in Junk Bonds. Hold Junk Bonds until the spread falls below 3.0 and then sell. When the spread rises above 5.0, buy Junk Bonds. With a good Junk Bond Mutual Fund like Massachusetts Mutual, this method yields a <u>consistent annualized total return between 14 to 15% with few round trips.</u>

3.3 What you can learn from Weekly Claims for Unemployment Insurance.

Where: www.ows.doleta.gov/unemploy/claims_arch also look in Barron's Market Week/Indicators/Employment/Initial Jobless Claims
Timeliness: End of week on following Thursday.
Sensitivity: Very high.
What: Weekly Claims for Unemployment Insurance
Interpretation: <u>Increasing claims for Unemployment Insurance is favorable for bonds especially if there is a jump of 30,000 or more.</u> A drop in New Unemployment Claims is negative for bonds.

3.4 The Bond Market is affected by the ISM PSI Report!

Where: www.ism.ws/ismreport/mfgrob.cfm?nov/itemnumber=12942
Timeliness: Monthly + 1 business day.
Sensitivity: Very high.
What: The ISM publishes the PMI report
Interpretation: According to many economists, ISM's PSI Index is the most reliable near-term barometer. <u>It is the first to come out after the end of a month</u>. A reading above 50 is bearish for fixed incomes. A reading below 45 is a plus for the Bond Market because it flags a weakness in manufacturing.

3.5 What's going to happen to mortgage rates

Where: http://www.bankrate.com/brm/ratewatch/other-indices.asp
Timeliness: Daily
Sensitivity: High
What: The LIBOR (London Inter-bank Offering Rate.
Interpretation: The LIBOR is the most common benchmark used to make adjustments to adjustable rate mortgages. A rise in the rate means the home-owners with a mortgage will pay more and reduce their discretionary spending which is a negative for business.

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5. Mauboussin, M. J. "More than You Know," Columbia
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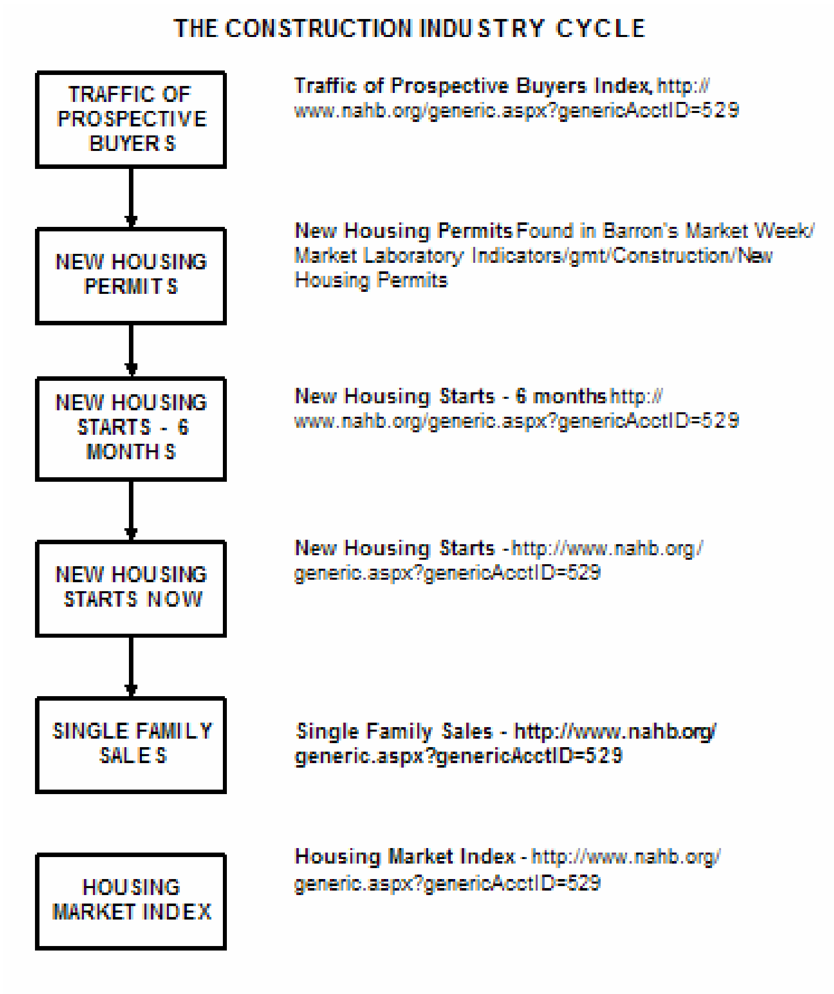
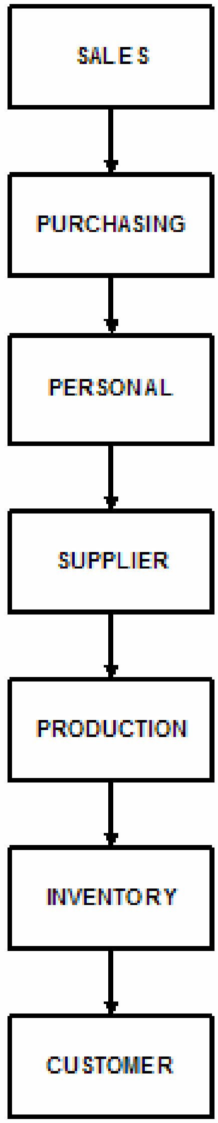


STEPS IN THE PRODUCTION CYCLE



NEW ORDERS - NO Found in Barron's Market Week/ Indicators/Orders/Durable Goods

PURCHASE ORDERS - PO Found in Barron's Market Week/Indicators/Purchasing Mgmt. Index PMI

EMPLOYMENT - EMP. Found in Barron's Market Week/Indicators/Employment/Employed

SUPPLIER DELIVERY - SD

PRODUCTION - P Found in Barron's Market Week/ Indicators/Consumption & Distribution/Factory Shipments

INVENTORY - INV. Found in Barron's Market Week/ Indicators/Inventories/Business Inventories

GROSS DOMESTIC PRODUCT - GDP Found in Barron's Market Week/Indicators/Economic Growth & Investment/Gross Domestic Product

Index and Direction of Change can be found on the Internet at http:// www.ism.ws/ISMReport/MFGROB.cfm?navitem=12942