

# The Seven Signs of a Changing Economy™

**“What to look for, where to find it and what to do when you see trends changing!”  
As of April 2010**

Pre-script:

As this month's Seven Signs of a Changing Economy™ was written on 5/3/2010 prior to the market "glitch" on 5/6/2010 I wanted to add comments that were made on the Seven Signs of a Changing Economy Conference Call, which happened to be taking place as the U.S. equity markets glitched.

Perhaps my comments on Greece caused it all: Here's what I said on the call.

## Greece Matters!

The European Union (EU) and the International Monetary Fund (IMF) have completed a near \$150 billion rescue plan to prevent the bankruptcy of Greece. Why is Greece such a big deal, they are only 4% of the EU economy?

The fear is that if Greece collapses into bankruptcy other countries like Portugal, Spain, Ireland and Italy would potentially follow. Thus Greece is the fuse to the powder keg and it must be extinguished as the flow of events appear as follows:

- Greece owes France \$75 Billion
- Greece owes Portugal \$9.7 Billion
  - Portugal owes France \$45 Billion
- Greece owes Ireland (who is also struggling big time) \$8.5 Billion
  - Ireland owes France \$60 Billion
- Greece owes Spain (20% unemployment and on the ropes) \$1.3 Billion
  - Spain owes France \$220 Billion
  - Spain owes Germany \$238 Billion

This is just one "debt line", but it is fairly straightforward to connect the dots to systemic failure. If Greece falls, the problems in France and Germany could cause a worldwide systemic failure of key global economies, which would be the tidal wave and possibly the end game for the Euro.

Thus, governments and central banks will, and are, doing everything they possibly can to prevent a default by Greece.

In this crisis there is, and will be, investment opportunity for those of us who choose to be proactive. And I am choosing to be proactive. Buy and hold, as I detailed in *Surviving the Storm*, will remain challenged for several years.

## Summary:

Sign #1, Personal Consumption Expenditures (PCE) is a key driver of the U.S. Economy, as it represents approximately 70% of the U.S. Gross Domestic Product (GDP). If you read nothing else this month, do yourself a favor and read the Sign #1 summary below. The economy has stabilized, which you would expect, after the government sponsored bailout programs totaling trillions of dollars. However, we now find ourselves at that point in time where we will see if the economy can grow on its' own.

The Seven Signs of a Changing Economy™ are suggesting that we are not economically out of the woods quite yet. The investment markets, of course, are a leading indicator and the never before seen increase in value of over 70%, without so much as a 10% correction, is suggesting we are out of the woods. As stated all along, we are pleased to be participating in the uptrend, even though we don't necessarily have high confidence in it. After all, our Target Violation Exit Strategy™ is regularly updated and ready for action, if and when our data points are violated.

So why the low confidence level in this extended rally? Well, you are not a great consumer if you don't have a job. Jobs matter! As this summary is being written on 5/4/2010 and the jobs report will be released on 5/7/2010, we need to take a guess at the results. The guess is the number will be good – very good. Likely 200,000+ new jobs! That said, Sign #4 (Employment rate and after tax income) below focuses on the subset of facts in the number, not just the number itself. The fact remains that most of the new jobs will be created by U.S. Census Bureau hiring and seasonal hiring. Both of these job categories will terminate before 2011. Quality long-term jobs are likely to be a small percentage of the total.

Where do jobs come from? Almost 99% of all companies consist of small and mid-sized businesses, which make up 50% of all jobs. Small businesses, those with less than 20 employees created 9.7 million jobs in the 1990's. Large corporations, those with over 500 employees, reduced their workforce by 3.8 million during the same period. At present, more than 60% of all new jobs in the U.S. originate from new business ventures; companies like Google, YouTube, Skype, etc. (Source: Loyola University Chicago)

When the Bush tax cuts expire on 1/1/2011, small businesses, those that create the jobs, will have less money to grow, expand and create new jobs. By 2013 the new tax law will increase Medicare tax on incomes over \$200,000 by 62% (from 1.45% to 2.33%). Top tax rates on interest and rental income jump to 44%. Medicare tax on dividends and capital gains jump from 0% to 3.8%. My personal property taxes have increased 80% in the last two years.

Do you still think these value creators (those that create jobs that put money in people's pockets to go out and consume and grow our GDP) will want to jump out of bed at 5:00 A.M. to risk their family's future and personal assets for less and less profits? I don't either! According to the National Federation of Independent Business, the Small

Business Optimum Index fell 1.2% to 86.8, raising concerns about prospects for future job growth! Maybe that is why one third of U.S. citizens live off food stamps, one quarter of the houses are worth less than what is owed and one sixth of the work force is not able to find a job!

Housing matters! On April 30, 2010 the \$8,000 tax credit for first time home buyers ended and won't be extended for a third time. It appears at this point 1.8 million buyers took taxpayers up on the offer, for a total cost of \$12,600,000,000.00. At least that is the U.S. Treasury website data as of the end of February 2010. No doubt it will be much higher. Did it work? It did work!

- Existing home sales rose 6.8% in March. 5.35 million homes sold annualized, of which 44% were first-time buyers. (Source: National Association of Realtors)
- New home sales rose 27% in March, the largest percentage gain since records started being kept in 1963. (Source: U.S. Commerce Department)

Facts:

- ✓ New home sales remain down 70% from their 2005 peak
- ✓ Mortgage applications fell 11%
- ✓ The Case-Shiller 20-City Price Index has risen .6% (demand up and price flat suggests the banks hold a lot of supply via foreclosures)
- ✓ RealtyTrac reports 1Q10 foreclosures rose 16% to over 930,000 homes versus 1Q09
- ✓ Vacant homes hit a record 19,000,000 in 1Q10 (Source: U.S. Commerce Department)

This data suggests the consumers' home equity line of credit is exhausted for the next few years, likely more.

The S&P 500 Fair Market Value (FMV) is posted under Sign #7. Current market value of the S&P 500 is above FMV. Thus, as stated, our confidence in this aging rally is low.

In addition to the Target Violation Exit Strategy, we seek to keep a close watch on "The Rule of 10". The Rule of 10 was created by Roy Neuberger. It simply issues a buy signal after the market has climbed 10% from its low, and a sell signal after stocks have fallen 10% from their high.

Our Target Violation Exit Strategy has specific action points based on pre-determined data points being violated, two out of three of which are less than a 10% sell-off. Our sell action based on these data points is subjective to our overall interpretations of the general market activity, news, etc. But, like The Rule of 10, we strive to be out of equity positions at a 10% + reduction from current highs.

Right or wrong, it is a reasonable and cautious approach that preserves assets in a volatile period of time.

Enjoy this month's Seven Signs of a Changing Economy and feel welcome to call with questions, comments or discussion. Please call me at 303-933-2107 or e-mail me at [JLunney@wealthstratgroup.com](mailto:JLunney@wealthstratgroup.com).

Respectfully,

James O. Lunney, CFP®, CEP  
CERTIFIED FINANCIAL PLANNER Professional  
Certified Estate Planner  
Registered Investment Advisor

The Wealth Strategies Group was founded by James O. Lunney under the guiding principle that comprehensive wealth counseling combined with independent investment advice will provide high net worth clients with complete trust in our competence, execution and integrity.

**P.S. We have a new format for our monthly conference call.** You now have the option of calling in or listening live for free from your computer. To call in, simply dial our new number, **347-826-7481**. There is no longer an access code. To listen live from your computer, go to our website, [www.wealthstratgroup.com](http://www.wealthstratgroup.com), and click on the “**LISTEN LIVE**” button on the home page. You will be sent directly to our page on the Blog Talk Radio website and you can click on the link there. Instead of having a live Q & A session at the end of the call, you can now e-mail your question to Jim prior to the call at [JLunney@wealthstratgroup.com](mailto:JLunney@wealthstratgroup.com) and he will address them after his commentary on The Seven Signs of Economic Change.

**The call is always on the first Thursday of each month at 1:00 p.m. MDT/3:00 p.m. EST. Please mark your calendar to join me for the next call on Thursday, June 3, 2010.**

You're welcome to invite people from your family, work and social circle to join in the call. Just forward my e-mail notification to your e-mail list. It is very timely information and in the volatile investment environment a second opinion may be greatly appreciated in these uncertain times.

1. **Indicator:** Personal Consumption Expenditure (PCE)

**Where to find it:** [www.bea.gov](http://www.bea.gov)

**What to look for:** Consumer spending drops for three consecutive months

(Neutral)

The Personal Consumption Expenditure (PCE) increased .6% for March 2010, the most current month, as PCE takes a month to tabulate and report. It is interesting to note that PCE has been positive for the last five months. January 2010 has

been revised lower for the last three months. Originally reported as +.5 and reduced down to +.4 in February it now stands at +.3%, but positive it remains.

These levels have recovered from the lows of 2009, but have yet to exceed the 2007 peak. When graphed, the data appears like the top of a plateau. So, the data reads well, but when plotted it continues to take on the same look as the peak spenders in appearance. By this I mean the peak of people born in 1961 – 1963 pushed forward to their peak in consumer spending approximately 48 years later, i.e. 2009 – 2011, with births dropping about 20% over the following 12 years, until approximately 1973. This comparison strongly suggests consumer spending has leveled off near these levels for a short period of time before resuming that same downward trend as baby births 48 years prior.

Last month I introduced a very interesting source of data created by Rick Davis of The Consumer Metrics Institute ([www.consumerindexes.com](http://www.consumerindexes.com)). Rick's group measures web based consumer "demand" in real time via a proprietary model of internet purchases, inquiries and downloads. This data is compiled and reported in their "Daily Growth Index" (DGI). The DGI has proven to lead the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce Leading Economic Indicators (LEI), see Sign #3, by roughly 18 weeks.

The LEI data is based on readings in production, or "supply" side. Simply stated, this means people buy X, the store orders X, the factory ramps up to build X for delivery, creating "supply". Consumer metrics takes out that lead time and reports what people bought yesterday, no need to wait for the order of X to be created at the factory level. Thus, we can now peek around the corner 18 weeks ahead of historical data.

So, what is this "live" consumer demand data suggesting right now? Well, first of all, it suggests a reduction in 1Q10 Gross Domestic Product (GDP). GDP was just reported 43% below the prior quarter. So far, so good. Per the consumer metrics 5/3/2010 commentary "we should see the 2<sup>nd</sup> quarter 2010 GDP contracting at 1.5% clip". Rick goes on to suggest the "should" is due to the fact that factories rarely contract production until forced to by inventory build-up.

We will continue to report and update on this exciting "live" consumer demand data going forward, but for now the data suggests the consumer is still contracting. I should also add here that with the huge number of units closed inside of chain stores, in addition to the large number of closures at the mom & pop retail level, you would expect "same store" sales to improve. Why? Because the Home Depot by me closed and I need to drive 2 miles to the next one— pushing up "same store" sales data. Misleading isn't it?!

You really need to measure the consumer activity via sales tax revenue. Yes, same store sales are up, but sales tax revenue is flat to down. The logical conclusion is that Personal Consumption Expenditures are down, hence Sign #1

remains neutral. And yes, this is going against the data. We will know soon enough!

In addition, the housing market has seen very positive signs of late, but first quarter 2010 also saw foreclosures increase to more than 930,000 homes, a 16% increase versus of the same quarter last year. Many of these are people who no longer make house payments because the house is worth less than they owe. Thus, they have decided to walk away and the lender takes the house back. This doesn't necessarily mean they are out of a job, i.e. income, but they no longer make their prior house payment. That is money they can go consume "stuff" with. HmMMM!

2. **Indicator:** Institutional Money Flow  
**Where to find it:** [www.wordenbrothers.com](http://www.wordenbrothers.com) or [www.barrons.com/convictionoftraders](http://www.barrons.com/convictionoftraders)

**What to look for:** Decreasing prices on high volume of large block trades

(Neutral)

With several hundred point swings in the Dow Jones Industrial Average (DJIA), it would be fair to conclude many still struggle with where the market's value is fairly priced. Lately, we have seen many days where the market values drop with increased volume of shares. Historically, this implies urgent selling.

On the days where the DJIA is up, the volume has been less. One could conclude a sense of anxiety as the market goes up, and fear on the days the market goes down. Nonetheless, the trend remains up and our Target Violation Exit Strategy™ is up-to-date, locked and loaded. No need to fight the trend and also no need to go to sleep. A 10% drop in value from recent highs would engage the highest alert signals for full liquidation. Until then, enjoy the trend.

3. **Indicator:** Leading Economic Indicators (LEI)  
**Where to find it:** [www.businesscycle.com](http://www.businesscycle.com) or [www.newyorkfed.org/research/global-economy/globalindicators.html](http://www.newyorkfed.org/research/global-economy/globalindicators.html)  
**What to look for:** Trends down for three to four months

(Positive)

The Conference Board Leading Economic Indicators (LEI) increased 1.4% last month. The six-month change rose 5.2% (a 10.6% annual rate) slightly lower than the prior six month's 6.2% (12.8% annual rate).

As reported here regularly, this has been the theme for several months. The various government economic stimulus programs are behind the positive contributors and clearly not behind the non and negative contributors.

For example, the largest positive LEI contributor is the interest rate spread. This is just the 10-year U.S. Treasury Bond yield (which mortgage rates are based

from) less the Federal Funds rate (the interest rate the bank can borrow from the Fed). When there is a wide difference between where banks can borrow money from the Fed, say .50%, and loan it to you for a house, at say 6.5%, there is a chance to make 6%. Generally, a very nice, low-risk, collateralized return! However, banks are so backed up with bad existing loans they have lost the desire to make new loans.

In the LEI, this appears to be a very good sign for inducing economic growth, but under the current economy, appears to be a less reliable indicator of future growth!

The weekly LEI remains flat, but at least is no longer dropping. Thus, Sign #3 remains positive, like the interest rate spread, but both appear to be less reliable indicators of future growth.

4. **Indicator:** Employment rate and after-tax personal income

**Where to find it:** [www.bls.gov](http://www.bls.gov)

**What to look for:** A flattening, then downward trend in non-farm employment with a flattening to decreasing after-tax income

(Negative)

There is good news here. The Labor Department announced the largest job gain in three years. Great! Why is the unemployment rate still 9.7% and the U.S. jobless rate, which measures underemployment and workers who have given up finding a job, up to 16.9%, as measured by the “U-6” unemployment rate? To a large extent, the answer is population growth. As stated here on many occasions, we need to create 100,000 jobs a month just to break even with new workers entering the workforce. We need at least another 100,000 jobs a month to start putting the 7,500,000 lost jobs back into place. That’s 200,000 jobs a month every month for 6 more years, just to get back to where we were.

The press failed to report that of the 162,000 “new” jobs, 48,000 were jobs created by the U.S. Census Bureau and approximately 80,000 were seasonal hirings. That leaves about 34,000 real jobs versus a need of 200,000. Expect more of this kind of reporting. Keep the focus on the unemployment rate and “U-6” unemployment rate. No job means no consumer. No consumer means weak economic recovery. See Sign #1.

5. **Indicator:** Durable goods spending

**Where to find it:** [www.census.gov/indicator/www/m3](http://www.census.gov/indicator/www/m3)

**What to look for:** A decreasing trend, especially a downward trend of four to five months out of six

These long shelf-life items like non-perishable, non-fashion items are usually the first to show signs of a slowing economy. Remember, these are items we can do

without, if need be. New orders decreased 1.3% in March. The trend here has been positive as inventory has been kept historically low due to the recession and reduced cashflow caused by it. Based on the “real time” data presented in Sign #1, one could easily conclude that this may be the first of several months of decreased new orders. It will be very interesting to watch and confirm this! Shipments increased 1.2%. This is expected after big new orders for the prior two months as business rebuilt inventories. Inventories increase .2%.

Once in production, factories are reluctant to slow down even when new orders have dropped off. It will be interesting to see if next month confirms the detail in Sign #1 with a decrease in new orders, increase in shipments and increase in inventories when this data is updated next month. Stay tuned.

6. **Indicator:** S&P 500 earnings per-share growth

**Where to find it:** [www.standardandpoors.com](http://www.standardandpoors.com)

**What to look for:** Two down quarters of S&P 500 earnings per-share growth

(Neutral)

The term “stepping over a string” comes to mind. 1Q09 S&P 500 earnings per share (EPS) were the second lowest in decades at \$10.11/share. 1Q10 is estimated at \$16.50/share. As strong as this actually is, up 63% YOY, the \$16.50/share 1Q10 estimate is below 4Q09’s actual of \$16.73. When complete, 1Q10 EPS is likely to be higher than both 4Q09’s \$16.73 and the estimated \$16.50.

The S&P 500 full-year estimate of \$74.98 now looks lofty based on the data presented in the previous five signs. For instance, the 63% increase over the prior year, posted above, drops to a 10% year over year (YOY) when the financial sector (banks) are removed.

In addition Caterpillar (CAT) hit a new annual high on 4/26/2010 when they announced earnings per share of \$.50 versus analysts expected \$.40. “Economic conditions are definitely improving in the world’s developing economies”, chairman and CEO Jim Owens said. “As a result, we are hard at work ramping up production to meet increasing demand from customers.” Source: Market Watch 4/26/2010

**Really? “Caterpillar Inc.’s first quarter revenue fell 11%, but the company reported a profit on lower costs and raised their 2010 outlook.” Source: Wall Street Journal 4/26/2010. Again, you can only cut human capital back so far until you reach the bone.**

7. **Indicator:** Inflation/deflation numbers

**Where to find it:** [www.bls.gov/ppi/](http://www.bls.gov/ppi/) or [www.bls.gov/cpi/](http://www.bls.gov/cpi/)

**What to look for:** An interruption to the consistent but modest increase in the cost we all pay for goods and services

(Negative)

The Producer Price Index (PPI), a general indicator of what future price increases could be at the consumer level (CPI) rose 6% year over year. The data in this space has been volatile suggesting a fairly large change is coming. (Comment below.) The Consumer Price Index (CPI) is generally the cost increase you and I experience in our day-to-day life. CPI rose 2.3% YOY, based on last month's data.

In my opinion more of the inflation seen at the PPI level is starting to drop into our day-to-day life via the CPI, but the CPI is adjusted "regularly" for "Owners Equivalent Rent (OER), which now represents 40% of the calculation. As housing prices are not expected to increase, and could actually decrease even more, CPI will remain benign even though our day-to-day expenses are clearly increasing.

I will continue to use a CPI rate of 5% for the Fair Market Value (FMV) calculation of the Rule of 20.

Thus:                    The Rule of 20 is:  $20 - \text{inflation rate of } 5\% \times \text{the S\&P } 500 \text{ estimated earnings per share} = \text{Fair Market Value (FMV)}$

Therefore:             $20 - 5 = 15 \times \$74.58 = 1124.70 \text{ Fair Market Value}$

As of 5/3/2010 the S&P 500 = 1202.26 Current Value

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All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.