MY MODEL AND PAST FORECASTS

My book ***Profiting in Bull or Bear Markets***, published by McGraw-Hill, discusses in detail my approach to forecasting business and financial cycles. What follows is an overview of my model and its strategic implications.

The financial markets and the real economy interact between themselves, and in doing so they display cause-and-effect relationships. The outcome is business and financial cycles which last 5 to 7 years.

The great majority of economic indicators fall into one of the following categories: leading, coincident, and lagging indicators.

The basic thread tying together all the indicators is their **lead-lag relationship** and the important feedbacks keeping the system under control. These features make investment risk move between extremes, creating investment opportunities.

In my model I give considerable weight to monetary aggregates (**leading indicators**). The reason is that they are quite reliable in anticipating changes in the economy and the financial markets.

Important turning points in the growth of the money supply lead turning points in the growth of the economy (**coincident indicator**) by about 1 to 2 years. Furthermore, a trough in the growth of the economy leads a rise in inflation and interest rates (**lagging indicators**) by about 1 to 2 years. A peak in interest rates and inflation occurs within 12 months from the beginning of an economic slowdown.

The **important feedback** in the system is that a decline in interest rates and inflation is followed within 6 months by an increase in liquidity, setting the stage for a new business and financial cycle. On the other hand, a rise in interest rates and inflation causes the growth in liquidity to decline within a few months, eventually leading to an economic slowdown and poor stock market performance.

Some of the most important **leading indicators** I rely on, besides some proprietary ones, are the growth of the money supply, stock prices, slope of the yield curve, bond yield quality spreads, and the dollar. The coincident **indicators** I follow reflect the intensity of economic activity. Some of them are employment, production, housing activity, retail sales, car sales, and purchasing managers indexes.

In my model the **lagging indicators** are the most crucial gauges because I use them to predict the leading indicators. The most significant ones are short-term interest rates, bond yields, commodities, inflation at the producer and consumer level, growth in consumer credit, growth in wages and unit labor costs, and growth in inventories and backlogs.

Real interest rates (the difference between interest rates and inflation) have proven to be excellent measures to assess the impact of monetary policy on commodities, inflation and interest rates as mentioned in detail in my book *Profiting in Bull or Bear Markets*.

As the business and financial cycles go through various phases, the leading, coincident, and lagging indicators follow well-established trends. The **configurations** of these indicators during a typical business and financial cycle are a very powerful tool for the business and financial strategist. **In each issue I give you a snapshot of what is happening—I tell you where we stand and what to expect.**

LEADING INDICATORS

- STOCK PRICES (% CHANGE)
- MONEY SUPPLY (% CHANGE)
- BOND YIELDS QUALITY SPREADS (RATIO BAA AND 10 YEAR BOND YIELDS)
- YIELD CURVE (10 YEAR LESS RATE ON T. BILLS)
- DOLLAR
- PROPRIETARY INDICATOR

COINCIDENT INDICATORS

- ALL THE INFORMATION RELEASED ABOUT THE ECONOMY
  (orders, production, income, sales, employment)

LAGGING INDICATORS

- COMMODITIES
- INFLATION (CONSUMER AND PRODUCER PRICES)
- INVENTORIES AND INVENTORY TO SALES RATIO
- UNIT LABOR COSTS
- SHORT-TERM AND LONG-TERM INTEREST RATES
- COMMERCIAL AND INDUSTRIAL LOANS
- CONSUMER INSTALLMENT CREDIT

I made the following forecasts using the model discussed in my book *Profiting in Bull or Bear Markets* published by McGraw-Hill. The main assumption behind this model is that business and financial cycles repeat themselves as they have done with impressive regularity since 1955.

The model I use can be described as follows.

- A peak in the growth of the money supply is followed, after 12-18 months, by a peak in the growth of the economy.
- A peak in the growth of the economy is followed, within 12 months, by a peak in short-term interest rates, bond yields, inflation, and commodities (lagging indicators).
- A peak in the lagging indicators is followed, within 6 months, by a trough in the money supply.
- A trough in the money supply is followed, after about 12-18 months, by a trough in the growth of the economy.
- A trough in the growth of the economy is followed, after about 12-18 months, by a trough in short-term interest rates, bond yields, inflation, and commodities (lagging indicators).
- A trough in the lagging indicators is followed, within 6 months, by a peak in the growth of the money supply.

FORECAST	**WHAT HAPPENED**
Issue of Nov 28, 1997. The money supply will continue to grow at a strong pace. The economy will remain robust. In spite of the uncertainties created by the Asian crisis, the fundamentals for the US stock market remain quite positive.	The **money supply** continued to accelerate from 7% to 15% in 1999. As a result the **stock market** soared. The **economy**, thanks to the injection of liquidity, boomed until mid 2000.
Issue of Dec. 19, 1997 The Asian crisis is positive for the market. This is a contrarian view, but we believe policy makers will try everything possible to avoid a global crisis. They will achieve this by flushing the globe with money. And stocks strive on liquidity.	The **stock market** soared until mid 1999.
The strong growth in the money supply M2 and M3 points to continued solid economic growth ahead, confusing those analysts looking for a sharp slowdown due to the Asian crisis.	The **economy** remained very strong until mid 2000.
Issue of Feb. 20, 1998 Strong growth in the money supply will continue to fuel a strong economy and, eventually, result in higher inflation.	**Inflation**, **commodities**, and **interest rates** bottomed toward the end of 1998 and rose until the end of 2000.
Issue of Jun. 5, 1998 MZM is sill in its accelerating phase, predicting at least 12 months of solid economic growth. The business cycle will eventually place upward pressure on inflation. Short-term interest rates will stay close to 5% in the coming months. However, the odds favor much higher rates beginning at the end of summer.	**The economy** remained very strong until mid 2000. **Inflation** bottomed toward the end of 1998 and rose through 2000. **Short-term interest rates** (T. bills) bottomed at 4.3% at the end of 1998 and rose in 1999 and 2000.
Issue of July 10, 1998 Commodities are forming a major bottom.	The major **commodity indexes** bottomed at the end of 1998 and rose in 1999 and 2000.

<u>Issue of July 24, 1998</u>

Bond yields are at a major bottom.

Bond yields bottomed in late 1998 at about 5.2%.

<u>Issue of October 9, 1998</u>

The money supply will continue to soar preparing the stage for the next cycle of rising commodities and interest rates.

The growth of the **money supply** continued to rise until early 1999. **Commodities**, **short-term and long-term interest rates** rose through 1999.

<u>Issue of Dec. 12, 1998</u>

Real bond yields are low. Bad for bonds.
The economy will continue to baffle the bears.

Bond yields were at a bottom and rose through 1999. **The economy** remained strong until mid 2000.

<u>Issue of Jan. 22, 1999</u>

The only way to slow down the money supply is to let short-term interest rates rise 300-600 basis points.

In October 1998 the rate on **13-week Treasury bills** was standing at 3.57%. By November 2000 it soared to 6.20%, 263 basis points above the level of October 1998.

<u>Issue of Feb. 22, 1999</u>

We may be at the beginning of important changes. The growth of the money supply will decline, slowly setting the stage for the economic slowdown not before the end of the year. Bond yields will move higher.

The growth of the **money supply** peaked in December 1998 and declined until fall of 2000. **Yields** on long-term Treasuries moved higher from 5.1% to above 6.5% in early 2000. 1999-2000 was a volatile period for the **stock market**.

<u>Issue of Jul. 9, 1999</u>

There is no doubt this is an unfavorable environment for the stock market. The economy is gaining momentum and the upward pressure on short-term interest rates is rising, certainly not declining. They are becoming unfavorable for stocks.

The **S&P 500** was standing at 1403,28 and the **NASDAQ** at 2793.07. On December 29, 2000 the S&P 500 was 1320.28 and the NASDAQ was 2470.52 after rising to 5048.62. Short-term interest rates kept rising until November 2000.

<u>Issue of July 19, 1999</u>

Commodities have bottomed.
Real bond yields are very high and at levels associated with a top in yields.

Crude oil rose from $20 to $36.
Bond yields (10-year Treasuries) declined from 5.67% to 5.11% on December 29, 2000.

__Issue of Oct. 11, 1999__

Interest rates should not peak before May 2000.

Short-term interest rates peaked in November 2000.

__Issue of Nov. 8. 1999__

Times of crisis are good news for stocks. The Y2K issue has the features of a crisis to be avoided at all costs.

The Fed pumped money into the system and the money supply accelerated. The outcome was a strong **stock market** until early April.

__Issue of Dec. 16. 1999__

The odds favor slow growth in the latter part of 2000. In the meantime short-term interest rates will keep rising.

The economy began to slow down in the second half of 2000. **Short-term interest rates** peaked in November 2000.

__Issue of Jan. 10, 2000__

It looks like 2000 will be a difficult year for investors due to lack of crises on the horizon, a strong economy and rising short-term interest rates.

The **S&P 500** declined 10.1% and the **NASDAQ** declined 39.3%.

The rate on 13-week Treasury bills will have to rise to 6-7% from the current 5.19%.

The rate on 13-week **Treasury bills** peaked in November 2000 at 6.20%.

__Issue of Feb. 7, 2000__

Rising interest rates and gradually slower growth in monetary aggregates are setting the stage for more subdued growth toward the end of the year or 2001.

The **economy** began to slow down in the second half of 2000 and into 2001 as monetary aggregates continued to slow down during the year.