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Overview and Outlook

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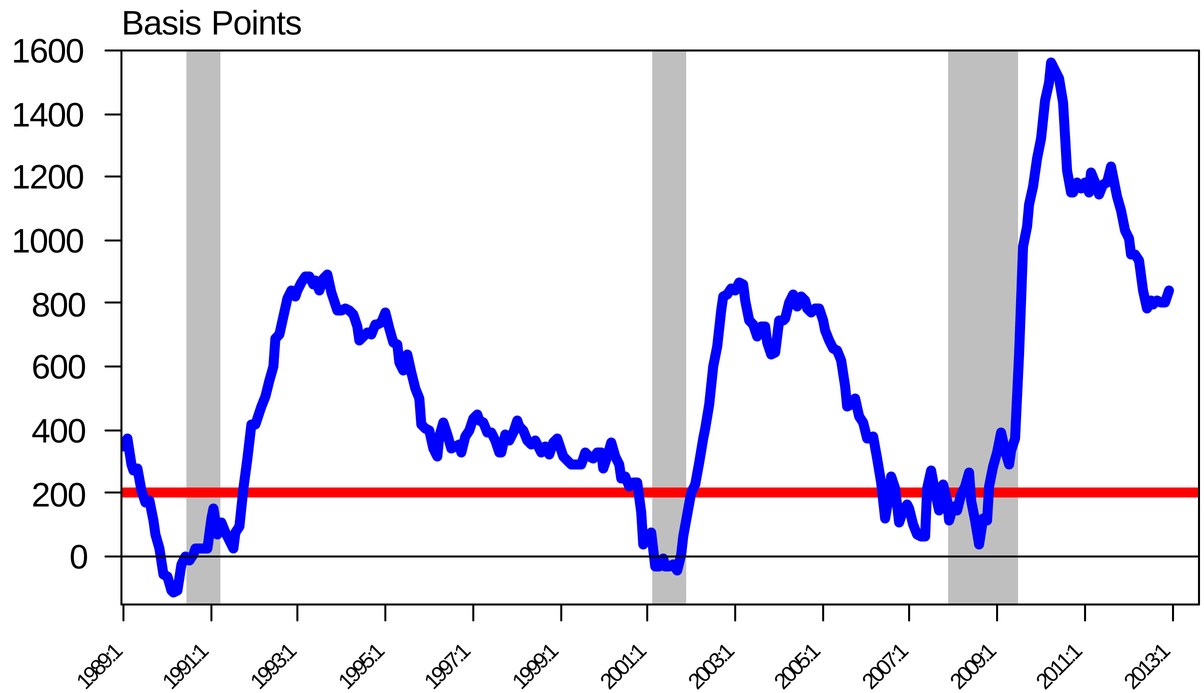
Chart 1 -- AGGREGATE SPREAD

Latest = December 2012 = 841

"There I go. Turn the page." --
Bob Seger, *Turn the Page*

With the publication of the March 2012 elements of the model, we now have all of the information for the Aggregate Spread for 2012. As you can see on the chart, there are no values in the series between now and the end of the year that would indicate the onset of a recession in calendar 2012.

As a result, I now find myself in statistical opposition to all those who are calling for a cycle peak in 2012. I use the "statistical" qualifier in that sentence because after doing this for more years than I care to admit, one has to be cognizant of the fact that strange things can happen. So it is possible, but highly improbable, that the conditions associated with a cycle peak could present themselves before we "turn the page" on 2012.



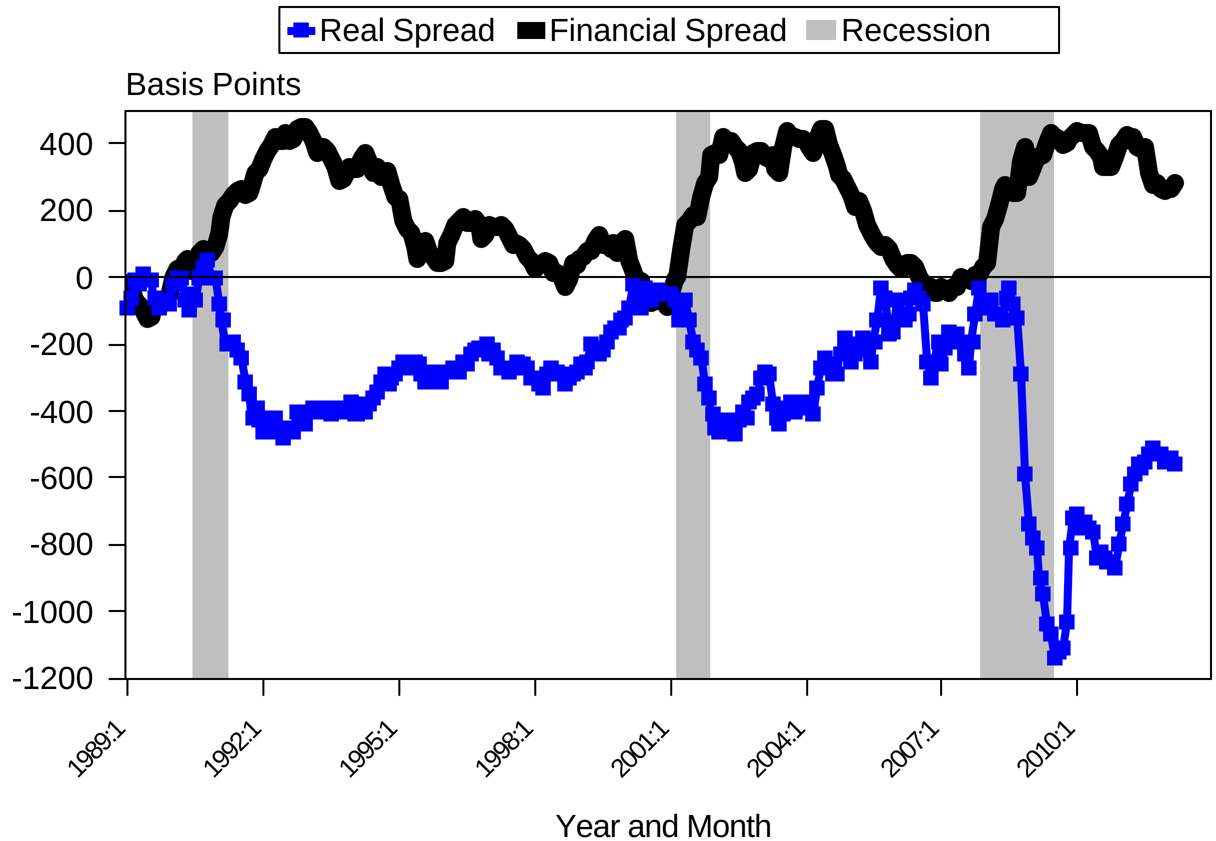
Year and Month

Aggregate Spread	
2012:4	938
2012:5	844
2012:6	785
2012:7	810
2012:8	794
2012:9	810
2012:10	802
2012:11	805
2012:12	**841**

Chart 2 -- Real and Financial Spreads

I had notes recently from two readers (and you know who you are) asking about the dynamic of the model in general and the Aggregate Spread in particular. I sent both of them this chart, which I was updating for this report. In the comments, I told them that the dynamic of the model is expressed by the convergence of the two series. The Aggregate Spread is just the distance between the two lines. 281 BP **minus** -560 BP = 841 BP which is the latest value of the Aggregate Spread.

I then went on to mention that the periods in which the two lines are separate are those in which we expect the economy to expand. How it will do so in any given period has mostly to do with the specifics of each period. Thus, we have had expansions led my manufacturing, and expansions led by dot-coms and expansions led by real estate. Each produced their own set of problems that culminated in cycle peaks. But all the expansions happened in periods when the Aggregate Spread was positive because the two lines on this chart were widely separated. Just like they are now.



Real Spread	
2011:12	-550
2012:1	-540
2012:2	-540
2012:3	**-560**

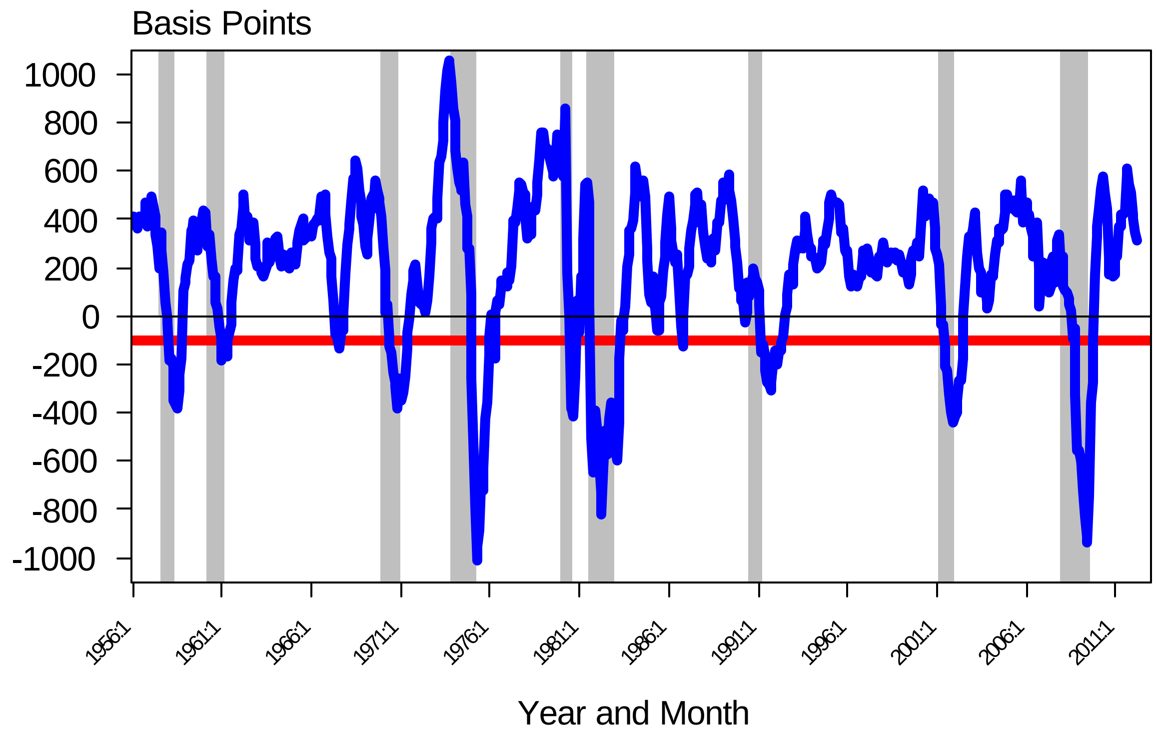
Financial Spread	
2011:12	260
2012:1	262
2012:2	265
2012:3	**281**

Chart 3 -- FRED
Latest = March 2012 = 311

FRED = Aggregate Spread nine months ago minus Aggregate Spread this month + 200 Basis Points

With all the information we are going to get from the Aggregate Spread now in hand, we will be looking to our coincident indicators to tell us whether the growth dynamic the Aggregate Spread is forecasting is actually playing out. We already had several such indicators in place, and I have added a few more to increase the scope of our coverage.

The first indicator comes directly from the model. FRED is based on the Aggregate Spread. The full record of FRED will continue to be displayed. But, as you see on the chart, I have made a small format change. Namely, I moved the red line that previously had been at +200 BP to -100 BP. Why? Because I am a big fan of the “what did they know and when did they know it” rule.



We know the level of FRED in real time. But we don't know, and won't know, the location of the next cycle peak for some time until after it has occurred. Persistent readings below -100 BP seem to be a better representation of the flow of information and how we would have interpreted it in front of the other cycle peaks and troughs. This is also the place to put in the observation about cycle event forecasting being a combination of art and science. Thus, if we start to get readings here that suggest we should be questioning the Aggregate Spread information, we will do that with coincident indicators from outside the model.

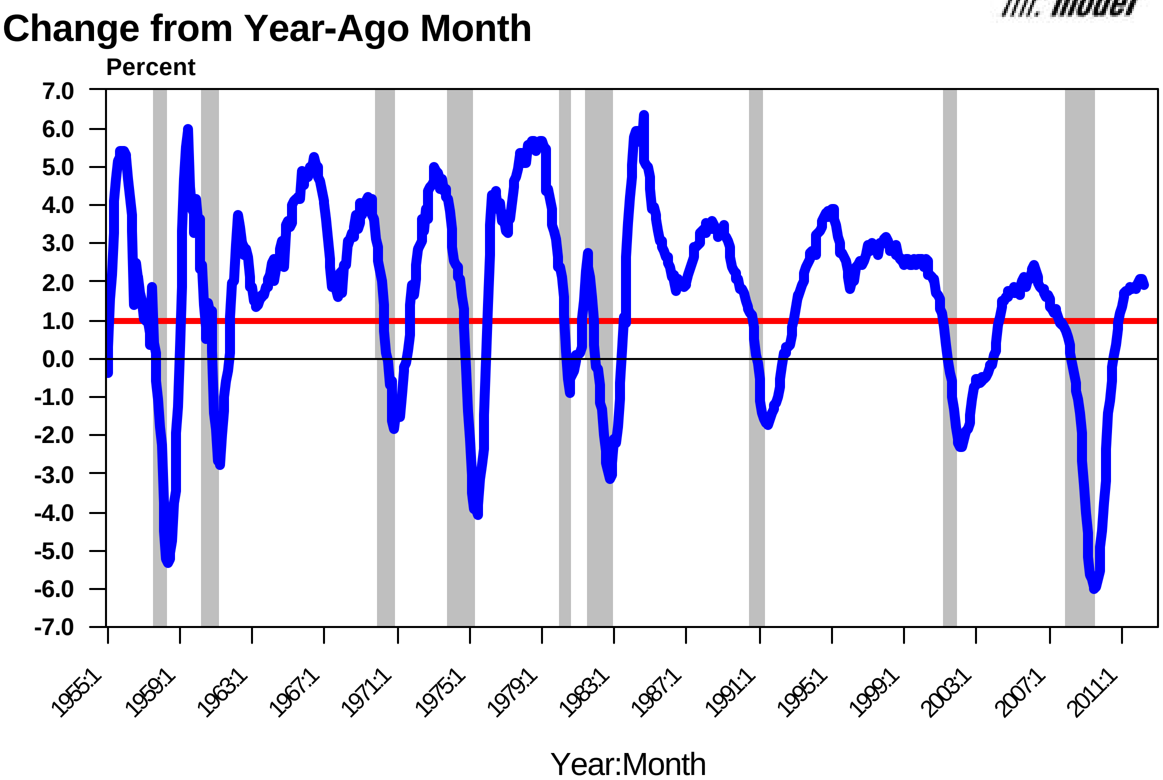
Date	FRED
2011:12	423
2012:1	406
2012:2	347
2012:3	**311**

Chart 4
Total Private Nonfarm Payroll Employment

First and foremost among those indicators will be the ones associated with the employment data. Because we devote an entire report to those figures, we will only look at one of them in these pages.

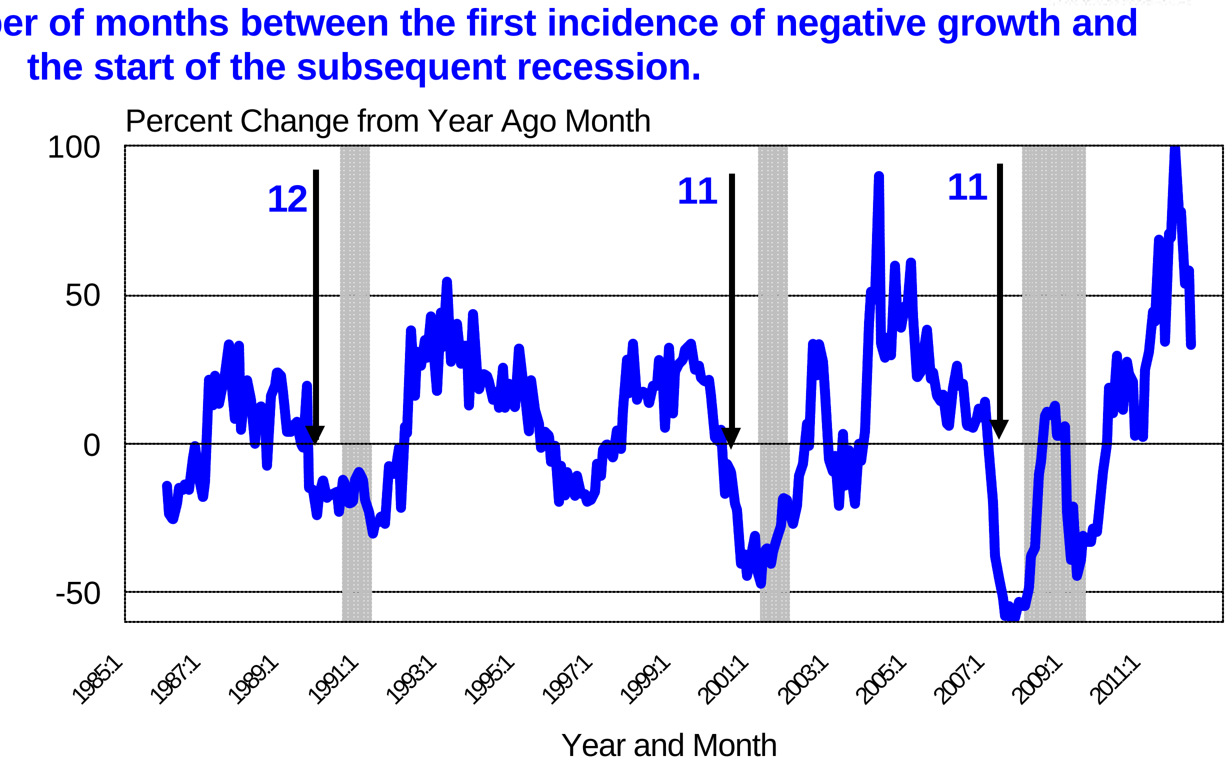
The track of private payroll growth has an impeccable record when it comes to locating cycle peaks and troughs. This is due partly to the fact that this series represents the bulk of aggregate economic activity and partly due to the fact that it is one of the series used by the National Bureau of Economic Research (NBER) in the process of determining cycle event dates.

As you know, the NBER does not forecast recessions. They perform autopsies on the corpses of expansions. This line going negative is one of the indicators that an expansion is ready for autopsy.



Date	%Chg
2011:12	1.95
2012:1	2.09
2012:2	2.06
2012:3	**1.93**

Chart 5 -- Class 8 Retail Sales



Now for something completely different, and new.

This chart is for all of you who complain that the government-originated numbers that make up the bulk of the data used on the charts here are a bunch of phony baloney cooked up by bureaucrats with bad intent.

The figures here come exclusively from the private sector. They are compiled by a private entity whose copyright appears below. They are not seasonally adjusted. They are almost never revised. And, if they are revised, the reason for revision is almost always a reporting issue from the companies that provide the source numbers.

Furthermore the figures are published regularly in various industry media venues which are not, to my knowledge, financed by the government or any other entity with an agenda. What are these? Class 8 vehicles are trucks with a Gross Vehicle Weight of more than 33,000 pounds. You know them as the front end of an 18-wheel tractor- trailer rig. A semi.

Class 8s are the flagship of the truck industry and the level and trend of their sales are considered to be the best measure of industry health. As you can see on the chart, the rate of change of those sales have turned negative about a year ahead of each of the last three cycle peaks.

Chart 6 -- Class 8 Retail Sales

This chart is the analog to the one I showed you earlier on housing starts. The difference is that the red bars on this chart are the twelve months of 2007, which, of course, are the precursors to the last cycle peak in December 2007.

As you see, sales dropped precipitously between March and September of that year. As you can also see, sales in each of the first three months of 2012 have each been progressive higher than the previous entry.

The gray bars are 2011. As you see there, we have had an improving market since the middle of last year.

But there have been some hiccups. In January 2012 sales were down from December 2011 because of a problem with the brake system used by one of the truck manufacturers. That issue has been resolved and sales have rebounded.

So, going forward, this will be another measure we will look to for confirmation that the expansion is continuing. Or not.

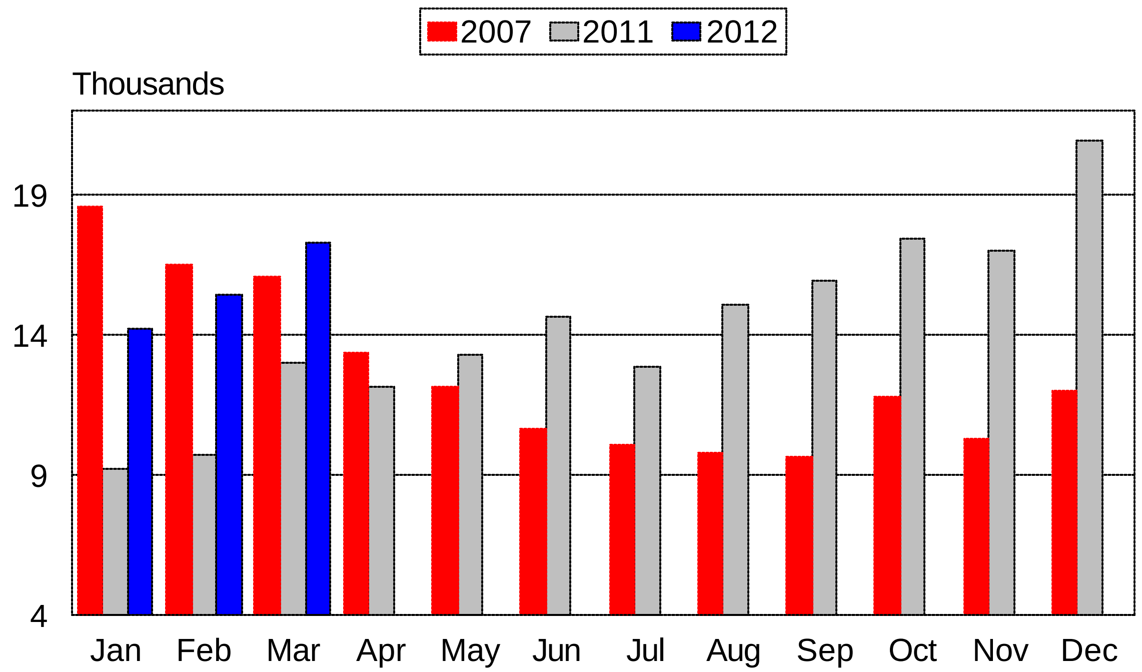
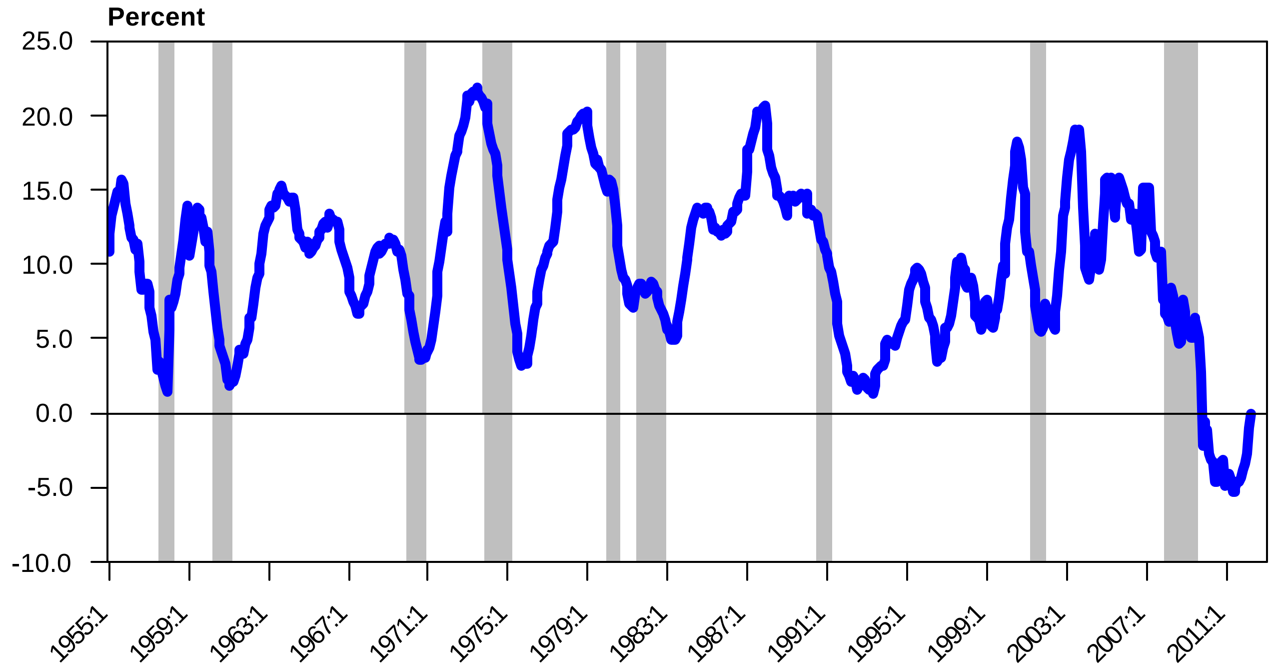


Chart 7
Total Real Estate Loans At Commercial Banks

Change from Year-Ago Month

While we have recently seen evicence of a thaw in commercial lending, of potentially greater moment is what has finally happened here. For the first time since September 2009, this series is not in negative territory.

Since we are not in the business of forecasting loan volumes, we will not hazard a guess as to whether the line will stay above zero. But the fact that it has finally gotten back to a neutral stance is good news.



Date	%Chg.
2011:12	-3.44
2012:1	-2.70
2012:2	-0.99
2012:3	**0.00**

Chart 8
Total Real Estate Loans At Commercial Banks

Because I vaguely recall having said that I would show you the level of lending at which the Real Estate Loan series reversed direction, I am including this chart.

It is probably a coincidence, but I found it interesting that the level at which the line recently turned upward was approximately the same level that had been attained before the start of the recession. I had not realized that until I made this chart. The pace of lending continued to grow even as the economy had turned down, and as noted on the chart, the financial system had gone into near collapse.

There is still much to be done here and we cannot be sure that the series will not resume its downward trend. Which is the second reason why I think we should stop looking for help from the real estate sector.

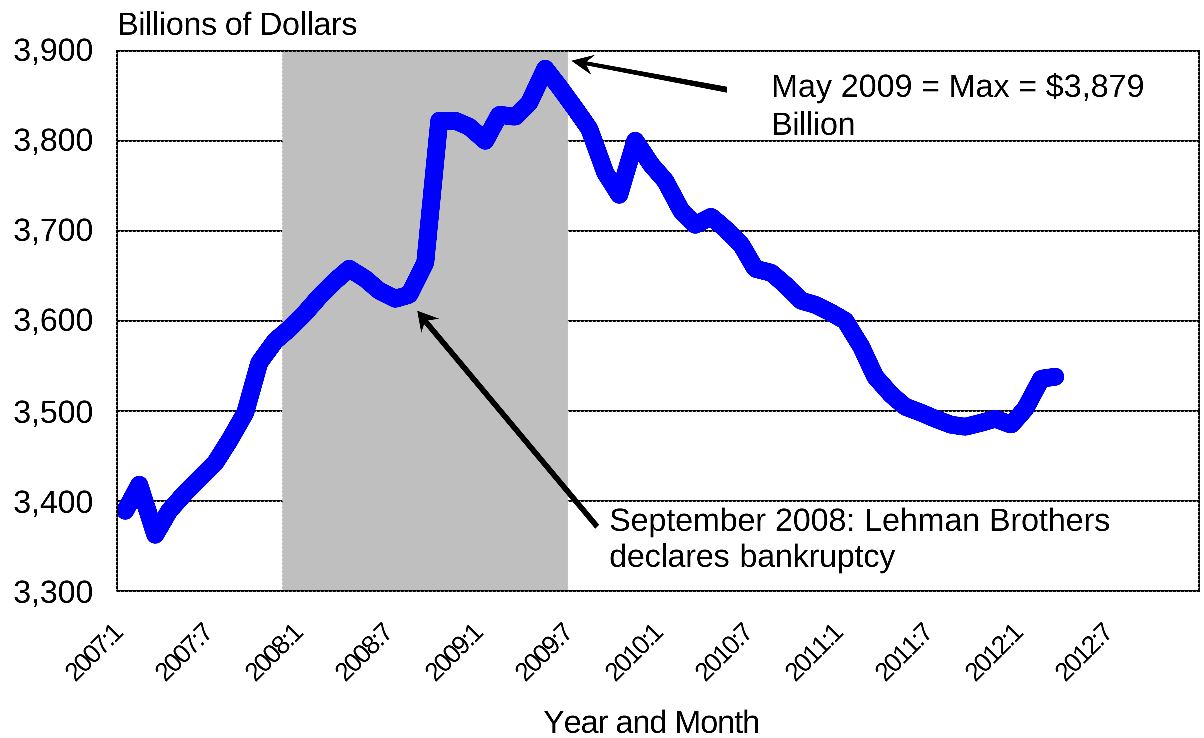


Chart 9 -- SP500 2012 Daily Close with Zone of Death Limits

Meanwhile, back at the equity market....

The generally sideways trend in prices still seems to be in place. Because I don't make market calls, I won't speculate on where the line might be headed next. My interest, as always, is in what this series can tell us about the onset of a recession.

Right now, I don't think it is telling much of anything. But, I will defer to those of you with greater expertise. If you see something please let me know and I will pass it along.

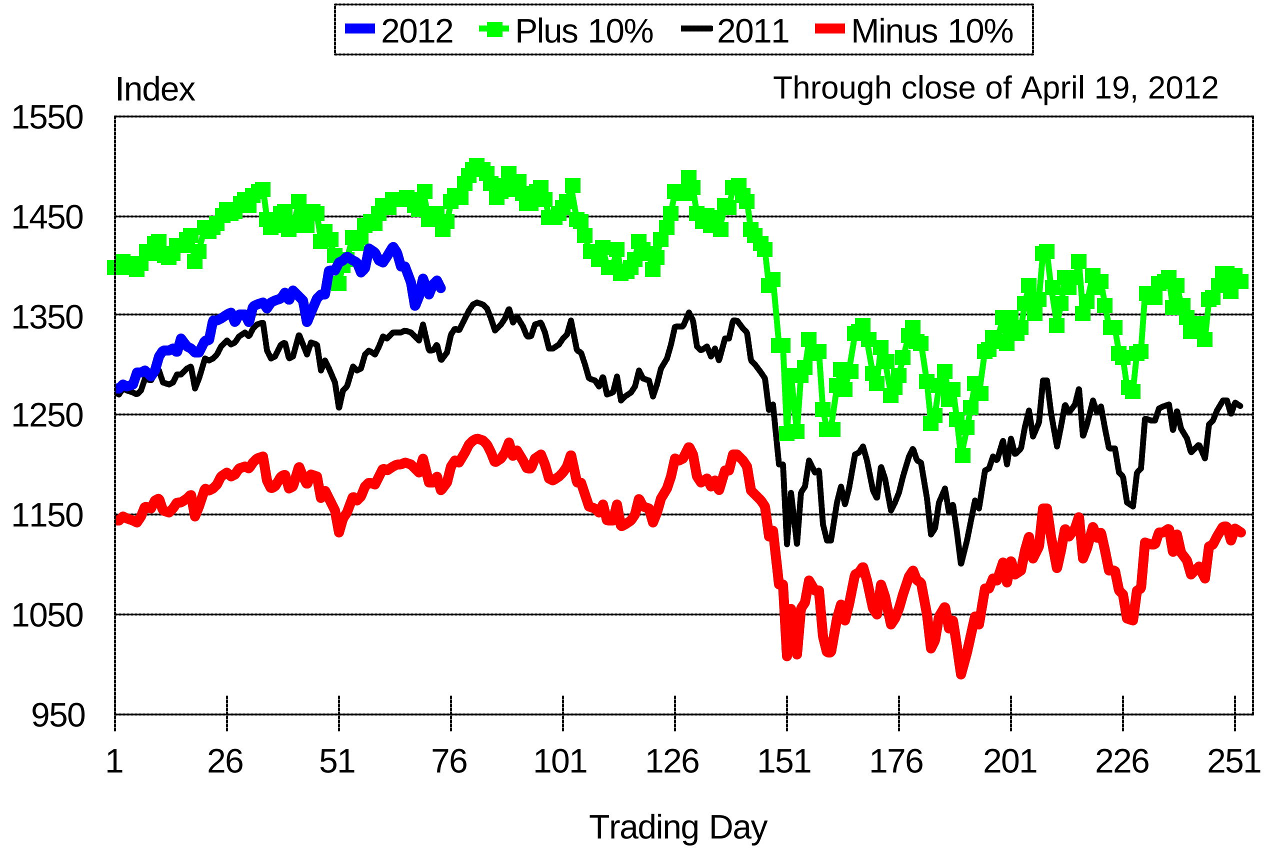


Chart 10 -- SP500 Daily Close

As I was putting the truck sales chart together, it occurred to me that it might be fun to do the same thing for the stock market.

So, here we have the level of the SP for all the trading days of 2007 plotted as the black line. The 1565.15 peak, from which the index still has not recovered, occurred on trading day 194. Which also happened to be October 9, 2007. Which would be just short of two months before the onset of the cycle peak on December 1, 2007.

Again, probably just one of those coincidences, but I find it fascinating that the market these days is at a level very close to that which it had reached early in 2007.

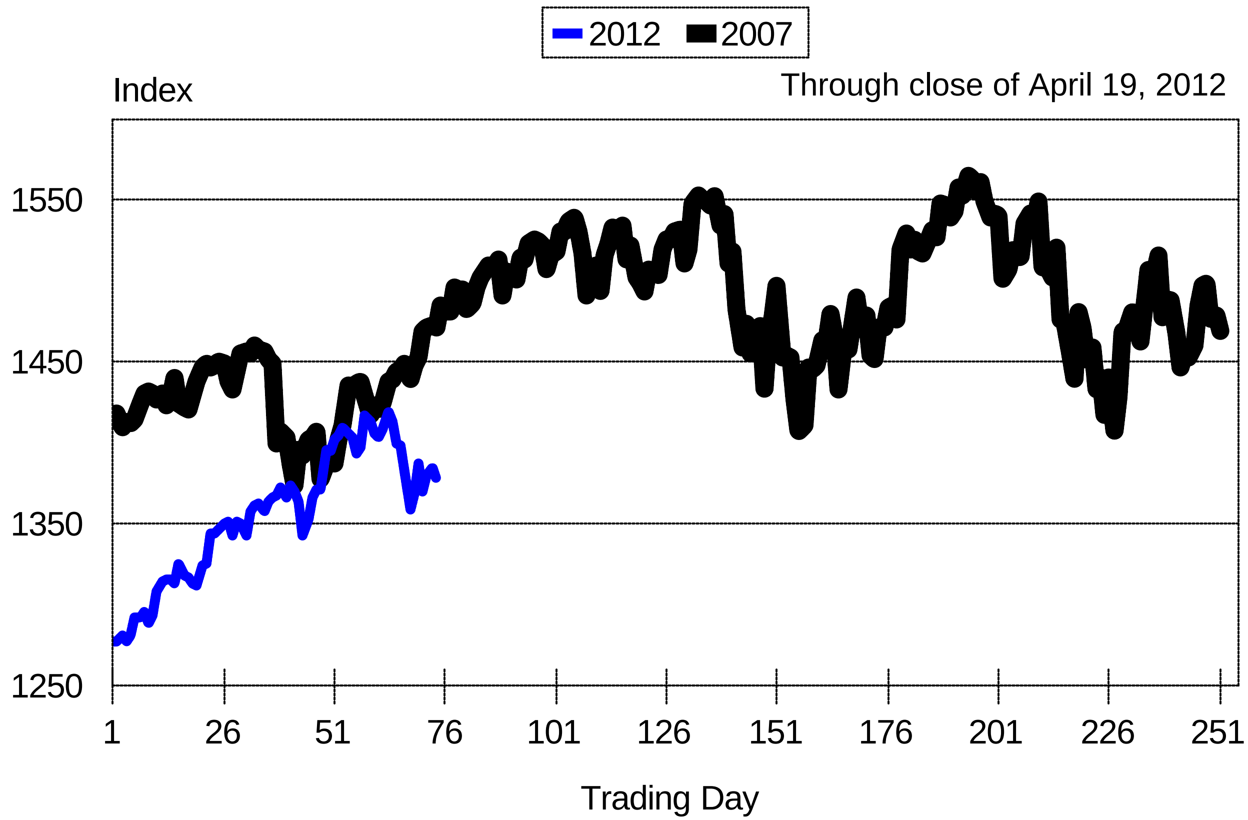
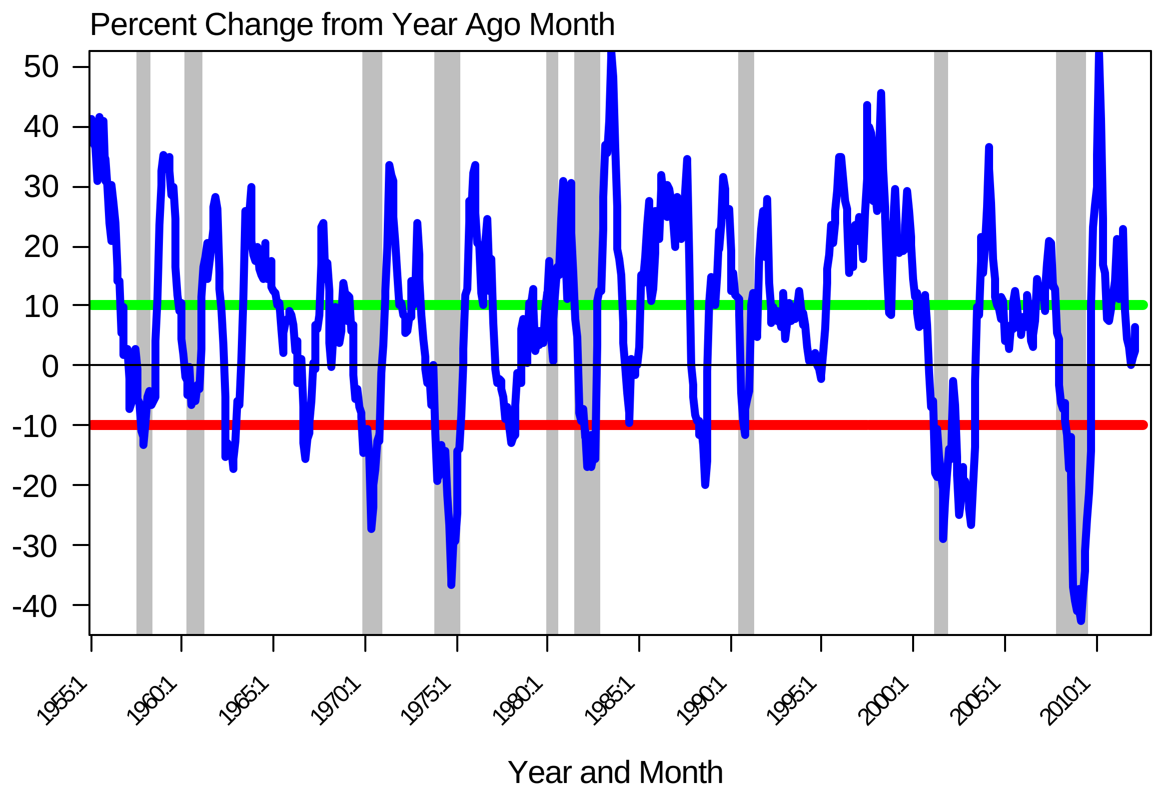


Chart 11 -- Standard and Poor's 500 Stock Index

From the way things have been going so far in April, it would appear likely that the blue line will hook down again towards zero. The last time we had a formation like that was between September 1994 and February 1995. And there, as you see, the blue line soon went forcefully back through the green line and stayed there until the onset of 2001 recession.

In order to get some "color" on the 1994 episode, I called my good buddy Ron Griess at The Chart Store. He has a great site that goes into this type of information in great detail (www.thechartstore.com) and he told me that the pattern of the fall of 1994 was the combination of the effects of the end of a four-year cycle in the stock market and the political events associated with the mid-term elections. That was the election in which Newt Gingrich spearheaded the Republican takeover of the House of Representatives based on the Contract with America campaign.

Through the entire episode, by the way, the Aggregate Spread averaged 733 basis points.



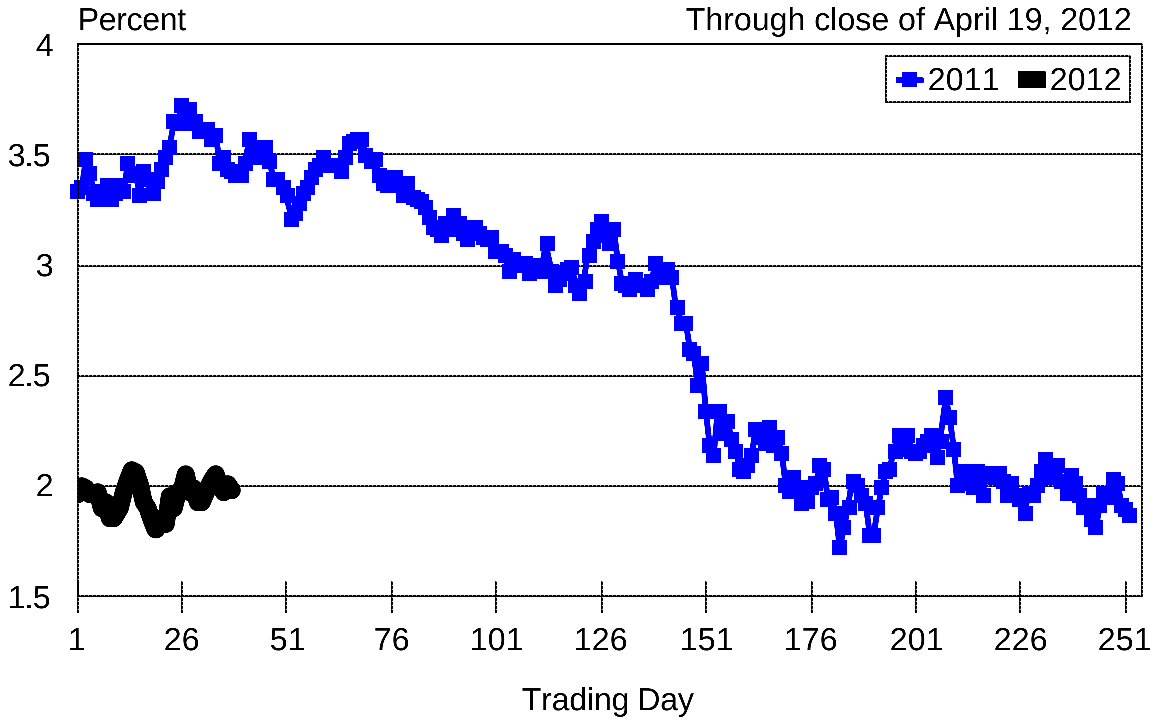
Date	%Chg.
2011:12	0.15
2012:1	1.39
2012:2	2.38
2012:3	**6.50**

Chart 12 -- 10-Year Treasury

Meanwhile back at the fixed-income market...

At lunch the other day with my former boss from the fixed-income desk I mentioned that I was glad that I no longer was a fixed-income portfolio manager. Making portfolio decisions in a market that is still hostage to the flight-to-quality crowd has got to be one of the hardest things to do these days. He concurred.

As evidence that lending practices are changing, I heard an ad on the radio for home equity loans at 1.5% for the first six months and 2.5% for the second six. After that the “small print” voice (you know the guy who mumbles about reset rates in these ads and the side-effects of medications in the pharma ads) mentioned that the rate could go to 75% of the state usury law limit. The ad leads me to believe that the funding desks at the banks have bought into the low rate promise by the Fed and so are offering product at 150 Basis Points over their cost of funds. Let's hope the loan committees are more diligent in their approval procedures this time. As we have learned many times, spreads don't offer much solace when it comes to writing down bad loans.



Summary and Conclusions

- The Aggregate Spread can now “see” through the end of 2012 and it does not point to the conditions associated with a cycle peak. But, keeping in mind that Saint Offset is an angry and vengeful god, we will only go so far as to say that the statistical evidence does not suggest an economic downturn during 2012. Shocks are always possible. And, we call them shocks because they are, by their very nature, unpredictable. That said, we stand with Mr. Model.

- As noted, we look to a set of coincident indicators for confirmation of the conditions the leading indicator said would be coming into being. In other words, the Aggregate Spread has told us that we should be expecting news of expansion from the coincident indicators. Through the first three months of the year that is exactly what we have seen. Long time readers will recall that when the Aggregate Spread began to flash warnings of a peak in 2007 the message here was consistent with those warnings.

- The range of coincident indicators we use includes measures that are part of the NBER’s cycle dating kit as well as several others we have found to be useful in assessing current conditions. We are always looking for such indicators and if you have some that you like, please share.

- I chose the epigraph for this month's piece on Wednesday night as I started to put the charts together. Perhaps it was just a nice touch by Saint Offset, but the last song I heard on the radio as I was driving in this morning was Turn the Page.

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