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Leading Indicators: Leading Where?

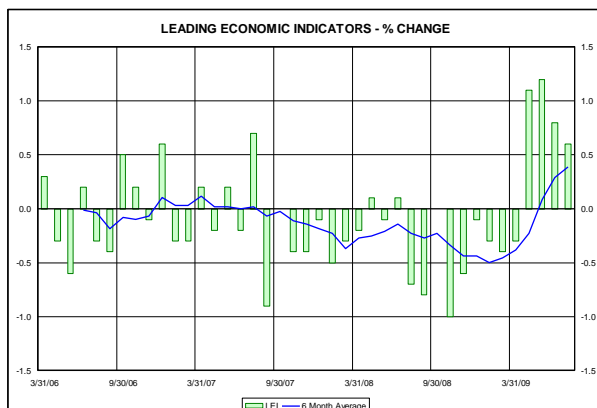
Forecasts of L-shaped, U-shaped, V-shaped, W-shaped, even square-root shaped recoveries abound. We see merit as well as holes in each argument. As always, we do not choose among them but try to construct portfolios which will endure whichever pattern plays out.

To us, more important than wagering on the specific pattern of recovery or relapse is identifying what forces are predominating, what risk and opportunity factors are pushing or pulling the hardest, and the implication for asset values.

Now, we believe, the single biggest risk factor is the federal government. This does not mean we're playing a new game. But government represents more than a wild card – consider it instead as a dealer who may add or retire cards from the deck at will, and in moments of acute drama, either reshuffle mid-hand or change the relationship among cards such that, say, a King beats three sevens or a Joker (Goldman Sachs, maybe?) automatically takes the pot.

As I discussed last month, government surrogacy for market factors may stave off collapse, but it is unlikely by itself to sustain a recovery; at some point, we need organic growth independent of government freebies or centralized concoction.

As for the outlook for growth, the Conference Board's Leading Economic Index (LEI) has ticked higher for four months straight.

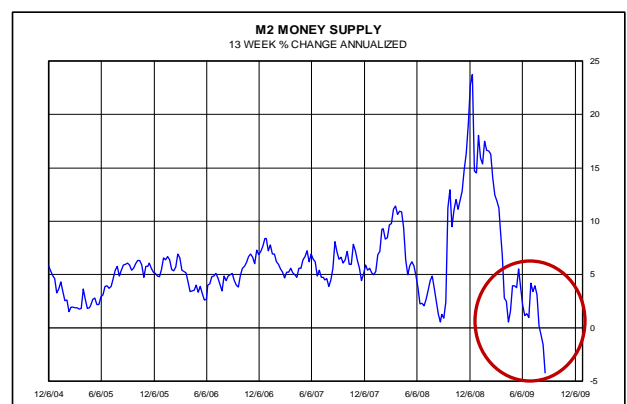


Source: Northern Trust

At the risk of looking a gift horse in the mouth, we've got to ask: Does the LEI's predictive power suffer when federal incursion is of such an extreme as it's been in the last year? We believe likely so.

Also, consider two components of the LEI which have been pulling the index higher: rising stocks and interest rate spreads. We are wary of the circular logic implicit in predicating higher stock prices on an LEI whose buoyancy derives in part from rising stock prices. Self-fulfilling prophecies are fine while they last, but they constitute nothing so much as a momentum game, and as such are prone to abrupt failure; technical (temporary!) rather than fundamental factors should be regarded with caution. During three of those four months of rising LEI, stock market gains were the first or third largest contributor to index gains (out of ten components). What's more, during all four months, interest rates were the first or second largest contributor to LEI gains. Why should this matter? With a target Fed Funds rate near zero, the steep yield curve is a consequence of policy engineering – again, non-market decision making.

Lastly, look at one of the recalcitrant indicators, money supply, which has been the first or second largest *detractor* from the LEI in three of those last four months: It is shrinking. If Milton Friedman was right in declaring that "inflation is always and everywhere a monetary phenomenon," this should throw ice water on any hysteria about imminent, hot-running inflation.



Source: Northern Trust

This chart shows 13-week annualized change in M2 money supply. Despite pedal-to-the-metal liquidity efforts, M2 growth isn't just slackening again, it's going negative for the first time in years.

We'll say more on the inflation vs. deflation debate in the months to come. Till then, our counsel to Friedman's disciples is simple: Dress warm.