



WTF?

John Mauldin | December 11, 2013

It is a regular ritual for major US businesses: the end-of-the-quarter conference call in which the CEO dissects what just happened and gives us some insight on what to expect for the future of the company. My good friend Rich Yamarone, the chief economist at Bloomberg, is the creator of the *Bloomberg Orange Book*, a compilation of macroeconomic anecdotes gleaned from the comments CEOs and CFOs make on their quarterly earnings conference calls. He not only sits and listens to them present their views, he also picks up the phone and talks to them. He is very clued in on what's happening in the real world of business.

In New York last week, at our dinner with a table full of economist types (including Art Cashin, Dan Greenhaus, and Ed Yardeni), Rich voiced his concerns about what he had been hearing. He let his inner Darth Vader out and ponderously informed us that we might soon be in a recession. The point was vigorously debated by Greenhaus and Yardeni, but Yamarone held his ground. So, for today's *Outside the Box*, I asked Rich to summarize what he is hearing on the conference calls and tie it into his read on the economy. I am pleased that the resulting piece is delivered in his usual entertaining style, with lots of red meat. I think Lord Vader outdid himself.

I write this note from 35,000 feet, flying to Seattle, and there has been a LOT of white on the ground since I left home. Dallas is just today getting back to normal from a storm that left us with two inches of ice; and we were better off than 50 miles further north, where they had a four-inch mantle of slippery ice to contend with. Snow is so much easier.

I am off to Geneva tomorrow after a quick stop in Dallas to swap suitcases. That is a lot of uninterrupted reading and writing time, which I really need. Even worse than the ice, there has been a blizzard of email lately, and my inbox is overflowing worse than ever. I have always tried to enter the new year with an (almost) empty inbox, but this year keeping that resolution will be a challenge. If I owe you an email, hang in there; I'm working on it.

While I'm away, they are going to redo the office in the new apartment. Seems my contractor and my niece/architect/designer are not happy with the results, so someone has to start all over. And the glass doors keep getting cut wrong; but maybe by the time I get back I'll see more of the finished product rather than continuing to live in a construction zone. Door handles would also be nice touch. Seems the hardware has been on back order for quite some time.

But in general I am spectacularly satisfied. Given the significant explosion from whatever was the initial budget, it is good that I am pleased. One thing I am actually quite amazed by is the quality of the new TVs. In spite of harassment from my kids, I had not gotten around to updating the TVs for about seven years, and the technology has made some great leaps since 2006. Watching movies on the latest Samsungs and the Sony 4K is a revelation. It is almost like being in the room with the actors, as if it were live theater seen on a stage. I caught a few moments of *Apollo 13* with Tom Hanks and was simply blown away by the clarity. *Apollo 13* featured some cutaways to 1970 tube TVs with their grainy pictures, and the contrast was almost jarring, though it brought back memories of what I thought was cool tech in 1970. I had not understood the hype until now. I guess TV was not one of my priorities, so the new stuff just came upon me all at once. But the kids are ecstatic about the new media room, so I guess that means I will get to see more of them.

There is just so much change happening everywhere, it is hard to keep up. But I try, as I know you do. Have a great week.

Your just trying to get through one email at a time analyst,



John Mauldin, Editor
Outside the Box

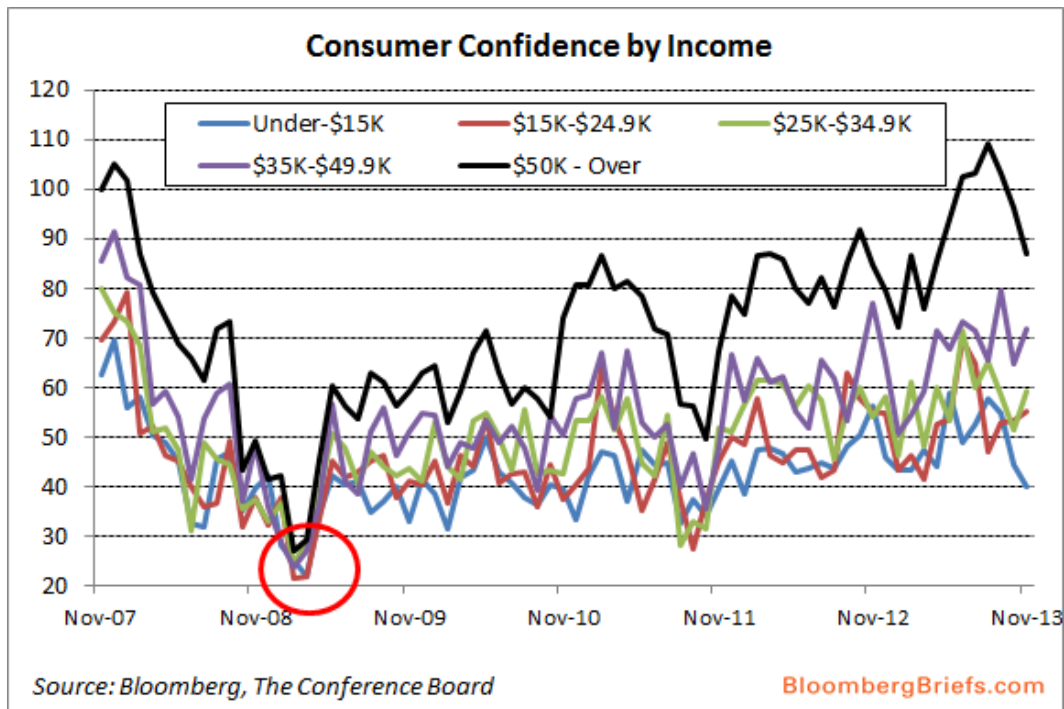
WTF?

By Rich Yamarone, Chief Economist, Bloomberg

What's the Forecast? Economically speaking, existing conditions are cloudy with a chance of a storm. According to the latest entries in the *Bloomberg Orange Book*, we should expect to see more of the same – that is, sub-par economic activity with a propensity toward a downturn.

The economic data are poor given that the economy is 54 months into the expansion – the post-WWII average length of expansion is 60.5 months. The looming fiscal and monetary issues certainly aren't likely to be stimulative. In fact, both are set to be more restrictive. Meanwhile, households remain plagued by inadequate real incomes and lacking employment prospects. Businesses are saddled with heavy government regulation and uncertain economic prospects – both domestically and globally.

I'm writing this note at the Lied Library on the UNLV campus in "Sin City," also known as the Biggest Little City in the World," "Glitter Gulch," "The Marriage Capital of the World," and "The Entertainment Capital of the World." That's a lot of nicknames for a city with about 600,000 people. The motto here is "What Happens in Vegas, Stays in Vegas." From an economic standpoint, it should read, "What Happens in Vegas is What's Happening in the U.S." That is, the "haves" have and continue to spend particularly on luxury items. The "have-nots," or the "have-not-a-lots," are struggling. This is evidenced in the latest sentiment measures.



Those at the lower end of the income spectrum are considerably less confident than their upper-crust counterparts. And the higher income group isn't exactly optimistic in recent months. This is crucial to the outlook since the middle-to-lower income group is the true driver of consumer spending, and subsequently overall economic growth. They determine the pace of expansion, recovery or downturn. The higher income group spends, and basically puts a floor of about 2 percent for total expenditures, while the lower income strata spends on necessities like food, fuel, shelter, and to an extent, clothing. The issue is that this middle income driver has been slipping into the lower income category, while the lower income group has fallen into the poverty level.

There's a bit of irony here in Las Vegas. I'm an economist and part Welshman, making me one of the more frugal people on the planet. Economists aren't exactly the first to run to "The Capital of Second Chances" – yet another nickname – and this place isn't among the first consumers head off to when the going gets tough. For that reason, I have expenditures on casino gambling in my "Fab Five" indicators of discretionary spending.

During September, spending on casino gambling fell 1.6 percent from the previous month, and was up only 2.4 percent from year-ago levels. The outlook isn't that encouraging according to the related comments in the Bloomberg Orange Book.

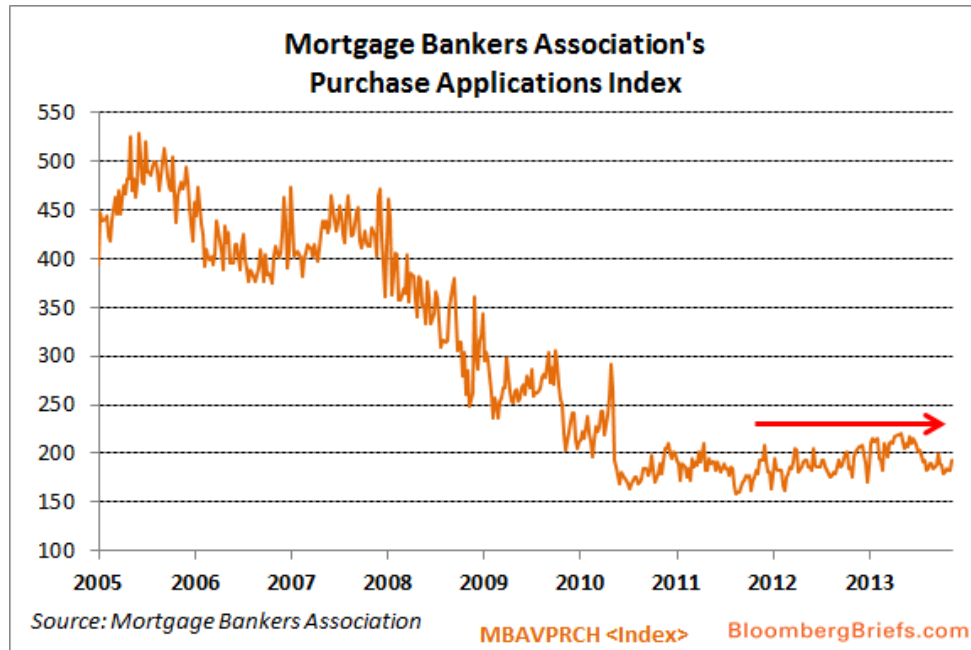
Caesar's Entertainment CFO Don Colvin said: "Third quarter results, performance was driven by similar factors as the first half of the year, including continued softness in the domestic gaming market and competition." Colvin added that "We see the Vegas gaming market kind of flattish I'd say and the hospitality in Vegas a strong positive...But we don't believe there's going to be a snapback in the challenged regional markets next year." That's not exactly encouraging commentary from an industry insider.



[Courtesy of my Bloomberg colleague, Julie Hyman, on assignment at Caesar's in Atlantic City, NJ]

Dan D'Arrigo, MGM Resorts' CFO, highlighted from where the strength is coming, and again it appears to be from those atop the income spectrum. D'Arrigo noted, "On the casino side, we continue to see strong activity from our high-end international customers as our marketing team remains focused on driving that business to our Strip resorts. Our efforts are evident as baccarat volumes grew over 20% in the quarter driving a 16% increase in table games revenue at our wholly owned Las Vegas resorts." I'm pretty confident that most middle- and lower-income people don't even know what baccarat is – and some might confuse this with singer/songwriter legend Burt Bacharach who wrote 'Walk on By.'" This is apparently what Americans are doing when it comes to hitting the gaming tables. [For the record, Burt Bacharach and the card game baccarat are not the same thing.]

Most market pundits point to the housing market as a possible source of strength. I'm not exactly convinced that there has been a definitive improvement. The Mortgage Bankers Association's Purchase Index has been locked in a sideways channel since mid-2010. And since June when the Fed first sent out the feelers that it might commence a tapering of policy in September, the level had slumped.



Interest rates – the price of money – matter. Yes, that's right, the prevailing level of mortgage rates do matter to would-be home buyers. To argue that a higher interest rate will not have an adverse effect on the housing market is fundamentally wrong.

Most market participants were caught off guard when the Federal Reserve didn't reduce its asset purchase plans in September after building in higher rates in June when the expectations of a taper were initially floated. I thought that a "no taper" announcement in September was a much easier call than many had expected. Admittedly, I thought it was more of a fiscal issue than the unknown impact of the higher interest rate environment.

Bernanke said during the presser following the Fed's meeting that "We are somewhat concerned. I won't overstate it, but we do want to see the effects of higher interest rates on the economy, particularly in mortgage rates, on housing." Well, most of the associated data show a deceleration from a mid-year peak. Housing starts were 883,000 in August, lower than the 919,000 in May and 1,005,000 in March. Existing home sales were 5.12 million, lower than the 5.39 million units in July and August, while new home sales totaled 421,000 in August, down from a 454,000 pace in June. Pending home sales have fallen for five consecutive months, and are 2.2 percent lower than a year ago.

The Fed minutes from the Sept. 17-18 meeting ultimately revealed "While downside risks to the outlook for the economy and the labor market were generally viewed as having diminished, on balance, since last fall, a number of significant risks remained, including those related to the potential economic effects of the sizable increases in interest rates since the spring, ongoing fiscal drag, and the possible fallout from near-term fiscal debates."

I still believe that the pause was a function of the government shenanigans rather than concern over the rising interest rate environment. In my world, I bet the conversation around that big marble and mahogany table at 20th & Constitution probably went something like this...

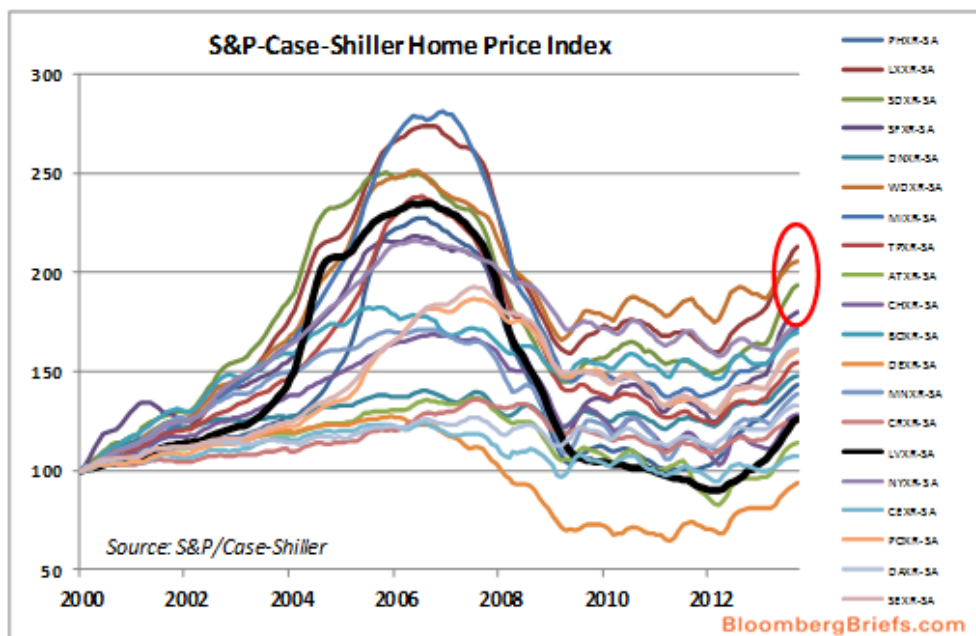
Chairman: "Okay, let's wrap this meeting up. Does anyone here have a conceivable and legitimate reason why we should keep our foot on the pedal, and refrain from pulling back the monetary stimulus?"

Unnamed Fed Governor: "Well, there's always Congress..."

Chairman: "Congress? They haven't done anything, why should we worry about them? What could they possibly do that could cripple the economy more than they already have? We know that both parties want restrictive policies, Republicans want to cut spending and Democrats want to raise taxes, but they don't ever propose legislation. It's a catatonic state of affairs over there."

Unnamed Fed Governor: "They could shut-down, and furlough about 800,000 workers, crush already dampened spirits, and send a message that they have no ability or interest in solving the nation's top ills."

Chairman: "Whoa, that's quite a stretch there Governor, don't you think? I mean, who would risk re-election and public humiliation just to send a message of incompetence? Er, um, ugh, ahh...you know, why don't we hold off from tapering here? Maybe the feeble economic recovery cannot withstand the simultaneous withdrawal of monetary stimulus, restrictive fiscal policy, and a government shut-down."



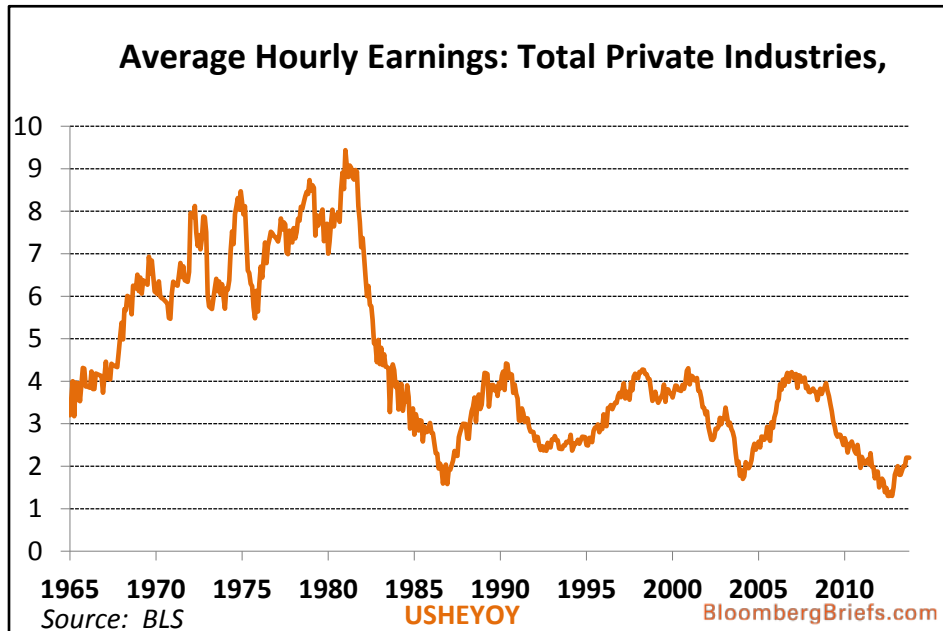
While the investment world is convinced that the U.S. housing market has recovered since home prices as measured by the S&P Case/Shiller 20-City Home Price Index is 13.3 percent higher than a year ago, a detailed perspective would suggest the contrary. Activity in the individual regions finds only four areas (Washington, DC, Los Angeles, San Diego, and San Francisco) that have home price indexes that are convincingly above those levels registered during the throes of the housing crisis. Our beloved Las Vegas, NV region has increased as the thick black line in the associated chart suggests, but only to a level seen in January 2009, which was a crisis level.

Two Orange Book accounts helped shed some light on the continued concerns in the housing industry:

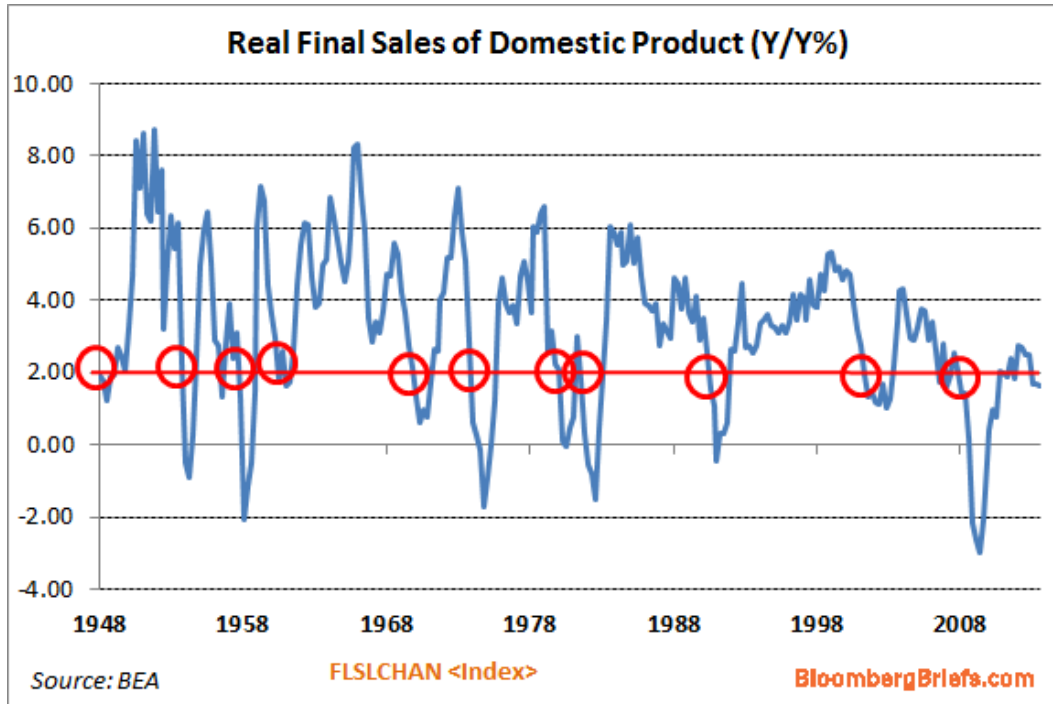
Armstrong World's CEO Matthew Espe noted: "Residential demand slowed down, still strong year-over-year, but I think sequentially slowed down as we entered the end of August and September. That's probably – we would assess that as being a function of a little rise in the mortgage rates, some overbuild in the builders and maybe some tightening of the credit restrictions."

Stuart Miller the CEO of Lennar was slightly upbeat, but predicated his optimism on a short-lived increase in rates. Miller said, "Clearly, interest rates have moved higher, and mortgage rates have moved from their unprecedented low point towards more normalized levels. Accordingly, over the past couple of months, we've experienced a slowdown in our sales pace and traffic in our communities, as the consumer has adjusted to the change in the interest rate environment. But it is our belief that this change is mild and temporary, given the extremely low levels of housing inventory in the market."

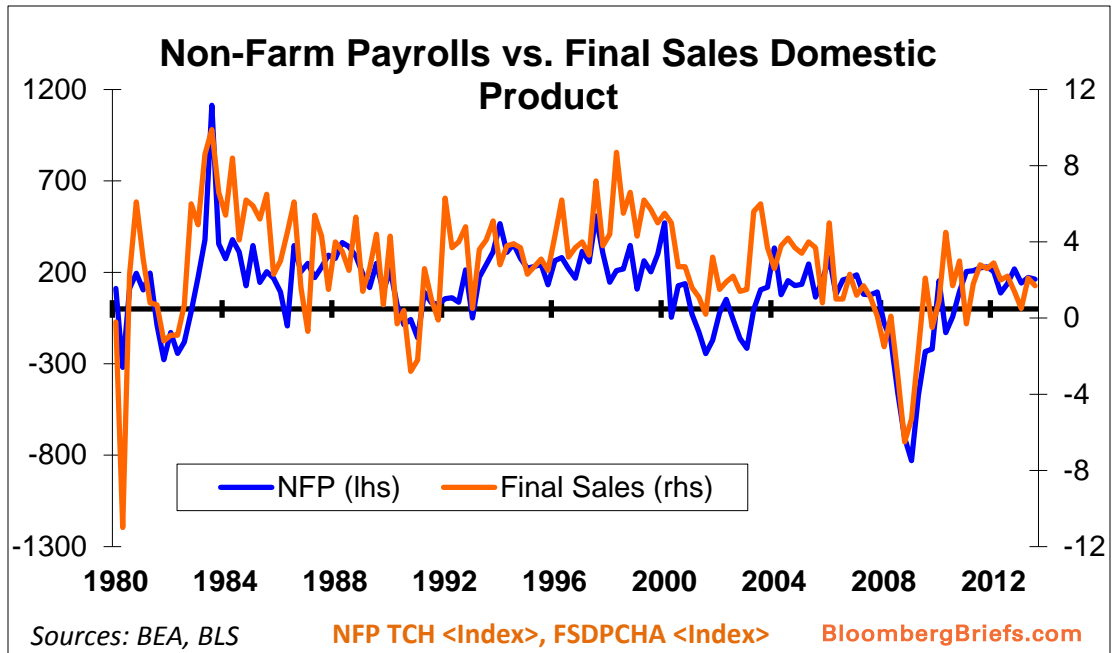
The local folks here refer to "The Gambling Capital of the World" – now this is just getting silly – as "Lost Wages," and that too is an issue currently plaguing the rest of the U.S. Average hourly earnings have increased by 2.2 percent over the last 12 months – and a less than desirable 1.3 percent once you adjust for inflation. Clearly running in place isn't going to get the economy going. The earl chatter regarding the upcoming holiday season is that it will be heavily promotional.



And since consumers can't spend what they don't have, they've reduced the pace of spending to below that critical sub-2 percent pace of spending on real final sales of domestic product. There's a little known rule of thumb in the economics world: when the annual growth rate of several economic indicators falls below 2 percent, the macro economy eventually slides into recession. Currently several of these statistics are flashing warning signals: real GDP (1.6 percent), real disposable personal incomes (2 percent), real consumer spending (1.7 percent), and real final sales of domestic product (1.6 percent). These are the broadest measures, possessing exceptional recession predicting abilities. The explanation for this is simple: like riding a bicycle, if you don't pedal, you tip over. And when the tier one indicators don't advance by a 2 percent pace, the economy grinds to a halt amid softer employment, incomes, and spending.



Linked ever-so-closely with changes in final sales of domestic product is the pace of employment, and both appear to be slumping in recent quarters. The frail economic recovery is simply not advancing at a swift enough pace to engender greater job creation. Staffing company, Kelly Services CEO Carl Camden said, "There are larger forces at play that continue to impact our business. 2013 has been beleaguered by the same slow and uneven growth trends we saw in 2012 and DC politics are shaking what little confidence US businesses had going into the fourth quarter... Given the uncertain climate and unimpressive job growth thus far in 2013, staffing revenues remain constrained in the staffing markets in which we're engaged and there is still significant pressure on margins. Looking ahead, we don't expect any meaningful improvement in the U.S. labor market and we believe that most companies will continue to hold off making key investments in people and capital until economic confidence and stability are restored."



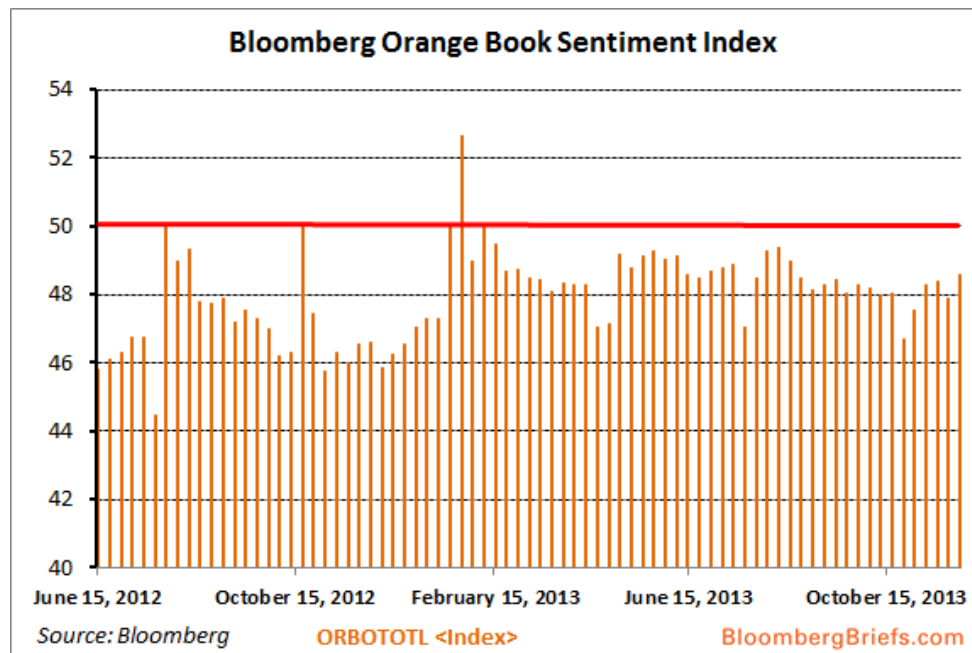
The most recent additions to the Bloomberg Orange Book show economic uncertainty is lingering. While it is doubtful that consumers withdrew spending altogether due to the temporary government closure in Washington, businesses that are dependent upon government reported feeling an impact. Housing activity advanced from low levels, but higher interest rates had a negative influence on activity. China's economic recovery reportedly strengthened, while emerging markets activity deteriorated.

Interestingly, one quirky indicator – hair color sales – increased in the last reporting period, suggesting that some part of the population opted to self-style rather than head to the pricier salon.

The Bloomberg Orange Book Sentiment Index for the week ended Nov. 29 was 48.57, an increase from the 47.90 registered during the week ending Nov. 22. It was the 42nd consecutive weekly reading below 50.

Sub-50 readings suggest contractionary conditions, while above-50 is indicative of expansion. When looking at the Bloomberg Orange Book Sentiment Index, there are some things to keep in mind: Unlike the ISM or any of the Fed's regional indices, the Bloomberg Orange Book includes comments from several industries, some of which are doing quite poorly -- restaurants, select retailers, household products, etc. The ISM measures sentiment in the manufacturing sector, which is indeed on fire. In fact, very strong signals are coming from the manufacturers in the Orange Book. Unfortunately, there's little-to-no associated hiring in this sector, but output is undeniably strong. The Orange Book comments that make up the Orange Book Sentiment Index are made with respect to the overall US economy, not just an individual sector.

To date, the lengthy string of sub-50 reading in the OB Sentiment Index has been spot on, predicting a sub-par economic performance. That's exactly what we have experienced domestically here since the second quarter of 2012. Over the last six quarters, the average quarterly increase in real GDP has been 1.75% -- that has traditionally signaled an economic recession -- at least every time since 1948.



Some excerpts from the latest edition imply weakness in several, different industries.

Simon Property [SPG] Earnings Call 10/25/13: "...it is clear that the economy has slowed. You've seen it with wages, you've seen it with employment. Needless to say we don't have to get into what's going on in terms of leadership in our country, none of which we use as an excuse, because we put blinders on to the best of our abilities when it comes to that kind of stuff. But we're operating at a high level in a very slow growth economy, and we're outpacing the growth in the economy and that's all that we can do, but we are affected by the economy."

Caterpillar [CAT] Earnings Call 10/23/13: "...while it looks like there's a good chance that the world economy could improve next year, there's still much risk and uncertainty. The direction of U.S. fiscal and monetary policy remains uncertain, and the climate in Washington is divisive. Eurozone economies are far from healthy, and China continues to transition to a more consumer demand led economy. In addition, despite higher mine production around the world, new orders for mining equipment have remained low. As a result, we're holding our preliminary outlook for 2014 sales and revenues flat with 2013, in the plus or minus 5% range."

DuPont [DD] Earnings Call 10/22/13: "The macroeconomic environment and in particular global industrial production is improving sequentially, but at a slower pace than we expected three months ago. As a result, we recently lowered our global industrial production outlook for 2013 from 2.5% growth to slightly under 2%."

Brinker International [EAT] Earnings Call 10/23/13: "The malaise we've seen in the category didn't let up this quarter. Consumer sentiment is guarded at best and consumer confidence remains somewhat volatile. And there's some evidence that guests have shifted some of their spending to larger ticket items like homes and automobiles. And while we believe this is a temporary phenomenon, but one that has certainly impacted casual dining here in the short term. And while employment rates are showing signs of improvement, casual dining in particular is being impacted by struggles many young adults are facing, particularly those in that 18 to 24 age range. Many are graduating college significantly un- or underemployed, weighted down with debt and often moving back home with their parents. And as a parent with two of those, it's a scary thought."

Air Products [APD] Earnings Call 10/29/13: "Economic activity in the second half of 2013 was slower than we had initially anticipated in most regions. Given the current economic conditions, we are planning for economic growth to be modest again in 2014. Globally, for the regions we operate in, we are forecasting manufacturing growth of 2% to 4%. In the U.S., uncertainty in the economy remains, despite the government restart. The combination of unresolved fiscal challenges, weak job growth, low consumer confidence and diminished global demand are likely to continue to act as a headwind on economic growth, despite the positive drivers of lower energy costs and strength in housing. We are forecasting a range of 2% to 4% growth."

Revlon [REV] Earnings Call 10/24/13: "Total company net sales in the third quarter were \$339.4 million, an increase of 1.1% excluding the impact of foreign currency fluctuations as compared to last year. This increase was primarily driven by higher net sales of Revlon color cosmetics despite low year-over-year new product net sales particularly in the U.S. as well as higher net sales of Revlon ColorSilk hair color and Revlon Beauty Tools."

Timken [TKR] Earnings Call 10/24/13: "It's now clear to us that the weakness in several of the key markets we serve, including the emerging market infrastructure, mining and energy exploration, is more a structural and will be longer lasting than we had expected. This leads us to believe that the slow steady improvement in demand that we've seen thus far in 2013 will extend well into next year. This situation has been exacerbated in the third and fourth quarter of this year by seasonal reductions in demand in some sectors."

AutoZone [AZO] Earnings Call 9/25/13: "A key macro issue facing our customers today is the reinstatement of payroll taxes back to historic norms. This reduction in our customers' take-home pay began at the beginning of the new calendar year and at this point it has been difficult to objectively quantify the ramifications of this change, however, we believe this is and will continue throughout the year to be a headwind to our consumer's spending habits."

Yamarone

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